

# Navigating Turbulent Markets

PRUDENTIAL  
CAPITAL  
GROUP

RELATIONSHIPS  
CAPITAL  
CONSISTENCY

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# Overview of Prudential Capital Group



- **Handles all private investment activity for Prudential Financial**
- **Investment Grade Senior Debt**
  - \$34.9 billion portfolio
  - \$6-8 billion typical annual transaction volume
- **Leveraged Loans/Non-Investment Grade Debt**
  - \$5.6 billion portfolio
  - \$500MM - \$1billion typical annual new transaction volume
- **Mezzanine/Equity**
  - \$1.5 billion portfolio
  - \$ 200-300MM typical annual transaction volume
  - Includes both private equity sponsored and sponsorless transactions

# Investment Grade – Public Bond Market



- **After dramatic spread widening in late 2008 and early 2009, substantial improvement in pricing and market access in recent months**
- **Increase in treasury yields has made change in all-in coupons less dramatic than change in spreads**
- **While “recession resistant” industries (food/ beverage, energy/utility) are clearly in favor, market is now “open” for cyclical issuers**
- **Volume of issuance up dramatically – large cap companies recognize need to lock in long term capital when available**

# Investment Grade – Public Bond Market



# Investment Grade – Private Bond Market



- **Strong investor demand for A – rated (NAIC 1) credits**
- **Demand limited for BBB (NAIC 2) and especially BBB-**
- **Pricing “stickier” than in public markets**
- **Many insurers reluctant to break through 6% coupon barrier**
- **Issuance lower on relative basis vs. public markets**
  - **Private market issuers appear more willing to “take their chances” with below market priced bank deals rather than pay up to term out now**
- **Most active sectors: energy and European multinationals**

# Investment Grade – Private Bond Market

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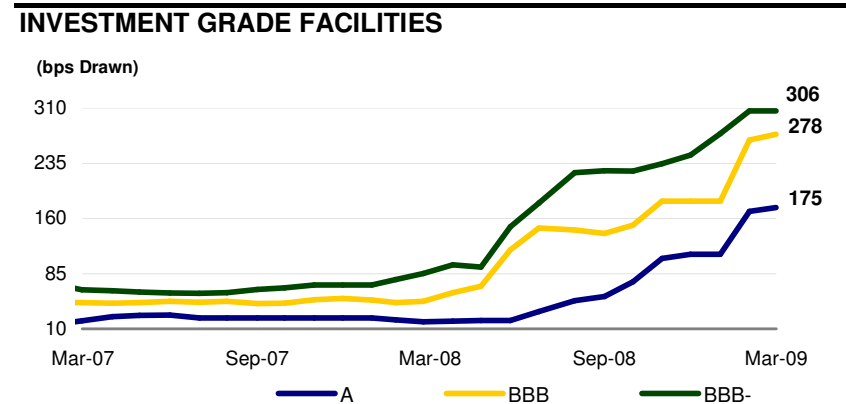


- **Volume is down 20% year over year through April (just under \$5 billion YTD vs. \$6.1 billion in 2008)\***
- **Foreign issuance accounted for >50% of dollar volume in last 2 months**
- **Activity appears to be increasing**

**\*Source: Private Placement Letter**

# Investment Grade – Bank Loan Market

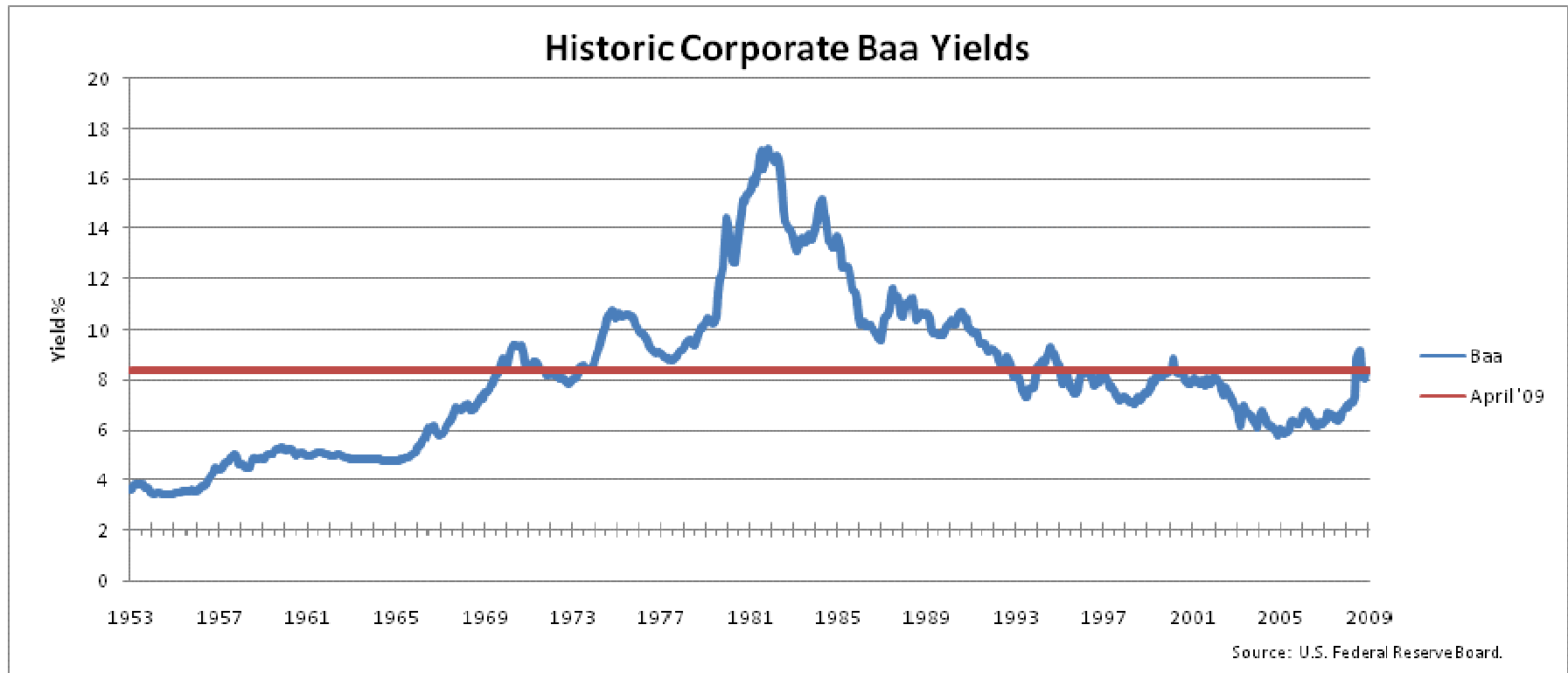
- Trend toward shorter (364-day) revolving facilities ~ 80% of loan volume YTD
- Virtually no term loan market beyond 3 years
- More (and tighter) financial covenants
- Substantial increase in pricing



Source: Bank of America

- Higher fees: BBBs in 1% upfront range
- Some banks using minor amendment requests to re-price deals
- New pricing dynamic – tie spread to CDS levels

# Is Now a Good Time to Issue Long Term Debt?



- In the last 55 years, Baa rates have been higher than current rates 42% of the time
- In the last 39 years, Baa rates have been higher than current rates 59% of the time
- The longest consecutive period historically where Baa rates have exceeded current rate environment is 20 years (1972 – 1992)
- In a medium to long term inflationary environment, locking in fixed rate debt could be attractive

# Below Investment Grade – Public Bond Market



- **Similar dynamics to IG but more dramatic**
- **Market largely closed in late 08/early 09**
- **Issuance has accelerated dramatically and spreads have tightened**
  - largely driven by high-yield mutual fund cash inflows
- **Some out of favor sectors able to issue at relatively attractive yields. Even homebuilders:**
  - Toll Brothers (BBB-/Ba1): 8.5 year deal at 9.25% yield (4/13)
  - Lennar (BB-/B3): 8 year deal at 12.25% yield(4/23)
  - Ryland (BB-/Ba3): 8 year deal at 8.75% yield (4/30)

# Below Investment Grade – Public Bond Market



# Below Investment Grade – Public Bond Market



# Below Investment Grade – Private Bond Market

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- **Virtually non-existent**
  
- **For those institutions with appetite, bite size much smaller**
  
- **Insurance company appetite for BB (NAIC 3) paper limited due to:**
  - **High reserve requirements**
  - **Overexposure to BBs resulting from downgrades of corporates and subprime RMBS & CMBS**

# Below Investment Grade/Leveraged Loan Market



- **Similar constriction in capital availability as other markets but worse – middle-market issuance in Q1 down 63% YOY (Reuters)**
- **Low secondary trading levels and high yields on large leveraged loans, increased risk aversion, and disappearance of traditional term loan B buyers (CLOs/hedge funds) lead to much higher new issue pricing – L+600-700 typical for LBOs – and scarcity of new issues**
- **Recent improvement in secondary trading levels a positive sign (single B bid 82 in April vs. 61 at YE)**
- **LIBOR floors (3-3.5%) in virtually every syndicated deal**
- **LBO senior leverage down from 3.5x+ at peak to 2-2.5x today**
- **Only 18% of middle-market deals have 4+ year revolver YTD (Reuters)**

# Below Investment Grade/Leveraged Loan Market

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- **ABL borrowing base structures leading way out of doldrums:**
  - Through March 2009, ABL represented close to 50% of leveraged loans, and about 40% excluding "DIP" financing, up from more normalized levels of 10-15% of the leveraged loan market in past years (S&P LCD)
  
- **Some regional banks beginning to become more active in small LBO lending**
  - Pricing much more aggressive than national banks/institutions
  - May take asset-based approach
  - Look for personal guarantees to cover "airball"

# Mezzanine Market Trends



- **Substantial capital raised in 2008**
- **Mezzanine needed to fill larger voids in capital structures, but deal flow slower than expected due to lack of sponsor activity and senior debt constraints**
- **Warrants are definitely “market”**
- **Recaps an attractive alternative to sale at current purchase price valuations**
- **While cost of capital is high (18+%), if can do mezz without repricing bank facility, it may be a solution**

# Private Equity Market Trends



- **Lots of money to put to work, but...**
  - **Valuation gap between buyers and sellers**
    - Buyer: large required equity contribution often makes high multiple deals unattractive (Reuters survey: 93% of lenders require 40% + equity contribution)
    - Seller: Can't get 2007 valuation out of head – lower multiple off of depressed earnings
  - **Many deals fall out of bed due to financing**
  - **Other deals die due to company performance – “catching a falling knife”**
- **PE Firms more willing to look at minority stakes/distressed situations due to lack of deal flow**
- **Certainty of close at least as important as price**

# Optimizing Capital Structure



- **Focus on availability vs. cost of capital (look at who is issuing in public market – Microsoft, Berkshire Hathaway)**
- **Head in the sand strategy (bank deal comes up next year but I will wait until market conditions improve...) is high risk**
- **Diversify capital sources – reliance on single bank or sector of the capital market risky – target more long-term capital in cap structure**
- **Cost cuts, working capital management, business recovery may make your business look attractive in the long run BUT...**
- **Refinancing risk prevents some companies from getting to the long run**
- **Establish a capital structure that allows your business to weather “the perfect storm” – remarkable how many companies hit the perfect storm at the same time**

# Managing Lending Relationships



- **What your banks don't know CAN hurt you**
  - Relationship officer is advocate for the company – if he/she is surprised by bad news, BOTH lose credibility
  - Other reason for loss of credibility: overly optimistic projections leading to constant need to re-forecast
  
- **Amendments: act ahead of the curve**
  - Time pressure to close an amendment to meet a public filing or other deadline will invariably result in a worse outcome for the borrower
  - Have a plan to present to lender as to how you will manage liquidity and financial results to return to original credit quality
  
- **Recognize the “two-way” nature of the relationship**
  - Many borrowers have become accustomed to lenders giving overly aggressive pricing and terms
  - If lender is willing to support company through difficulties, it should be fairly compensated (per S&P average rate increase ~200bps and fee of 50-75 bps for covenant relief amendments YTD through March)

# Raising Capital



- **Before looking externally, are you doing all you can to manage costs and squeeze cash out of working capital?**
- **First/best source of new money in a challenging environment will be existing shareholders**
- **If you need to look outside existing shareholder group:**
  - **Be prepared to demonstrate ability to survive the downturn**
  - **If business is not starting to turn around, don't expect investors to bet on the V-shaped recovery – show how your business can prosper based on actions taken now**
  - **Consider alternative financing vehicles (subordinated debt, preferred) to minimize dilution**

# Prepare for Recovery



- **If capex has been deferred, determine which lines of business are core and focus spending**
- **Consider divesting non-core assets to fund growth of core business**
- **Downturn forces greater discipline on capital spending, working capital management, and cost control – don't allow companies to lose this focus when business recovers – best companies make cuts BEFORE the downturn arises**
- **Maximize access to capital by considering a broad range of financing sources and developing relationships now**

# The Good News



- **Worst appears to be over for corporate lending**
  - **Banks seeking to repay TARP and raising public equity**
  - **Bond spreads tightening dramatically**
  
- **Some signs of life in consumer confidence**
  
- **Large amounts of capital will need to be deployed**
  - **Institutional and individual cash hoards**
  - **Substantial private equity appetite**
  - **Substantial mezzanine capital raised**
  
- **Changes companies making to survive today will (to the extent maintained) result in leaner and more profitable businesses when recovery arrives**

**THANK YOU!**