THE NEXT BIG BUYOUT

A Screening of A-Rated Corporate Issuers as Potential Buyout Candidates

EXECUTIVE SUMMARY:

- In the past year or so, LBO minefields started to appear in the "safe and sound" investment-grade credit landscape filled with A and AA-rated names.
- About 27% of the A-rated corporate index may be buyout targets.
- The LBO of Sallie Mae brings takeover risk to the "safe haven" financial sector.
- All of the remaining independent finance names may be LBO targets.
- By sharing our screening process with our investors, we hope to communicate sensible credit management by separating fact from fiction and prudence from panic.

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NAVIGATING THE LBO MINEFIELD

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INTRODUCTION

Tales of leveraged buyout (LBO) deals, often fascinating and occasionally outrageous, never used to mean much to cash investors. LBO candidates used to be smaller, junk-rated bond issuers that did not make the approved lists of most risk-averse investors. In the past year or so, minefields started to appear in the "safe and sound" investment-grade credit landscape with not only BBB, but also A and AA-rated names being regarded as potential LBO targets. With a recent deal involving student loan lender Sallie Mae, the risk also spilled over to the traditional "safe haven" financial sectors.

In the past year or so, minefields started to appear in the "safe and sound" investment-grade credit landscape of A and AA-rated names.

LBOs are hazardous to bond investors since private equity firms often take over targets using one-third cash and two-thirds debt. The much higher debt leverage and higher interest paid on the new debt almost always pushes the target company's credit ratings into below investment-grade, or "junk" status. The value of the outstanding bonds often drops precipitously at the announcement of a leveraged transaction.

In this study, we will discuss some of the common screening criteria in finding which A and AA-rated corporate issuers may fall prey to private equity firms. Based on these criteria, we also produced two lists, one financial and one non-financial, of likely candidates from which investors can conduct research and apply their own judgment.

PROFILING THE LBO TARGET

Simply put, a firm becomes an acquisition target when the acquirer thinks it is worth more than its share price. Unlike acquisitions related to industry consolidations or vertical integrations, LBOs often involve private equity firms that hope to sell the target companies later for a profit. They typically do so in one of two ways: by selling the firm piecemeal or through better operational and financial management. These clues may lead bond investors to uncover at-risk investments if some "LBO-friendly" characteristics are present.

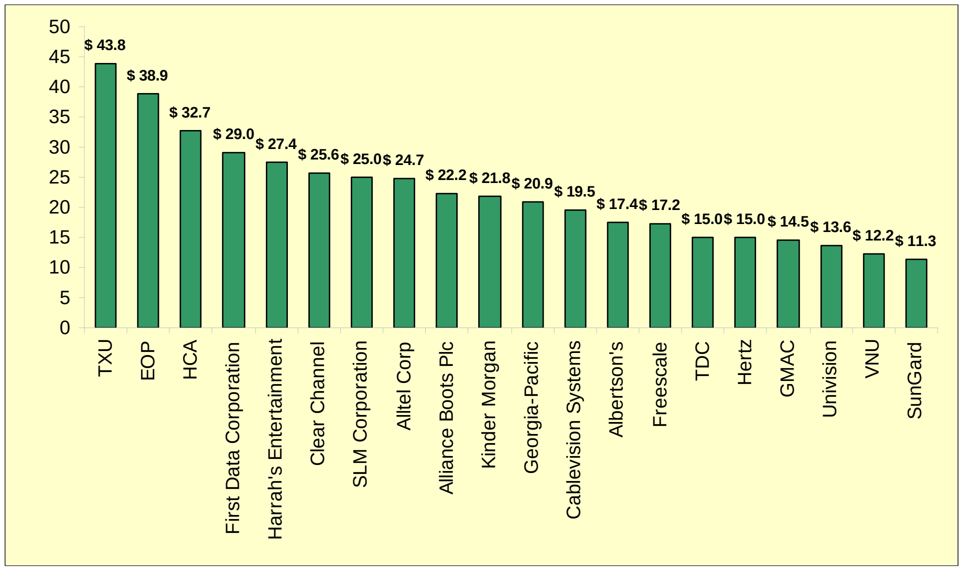
Meanwhile, it is customary for private equity firms to finance purchases with a combination of cash and debt. Factors that influence these two key financing components may be easily identifiable. The factors we discuss in this piece may serve as preliminary screening criteria in identifying likely candidates. Note that considerations for LBO deals are far more complex than these and that each transaction has its unique twist that may be impossible to anticipate ahead of time.

A. Size Bias - Equity Market Cap

Despite recent press coverage of private equity firms raising increasingly larger funds for buyouts, size of market capitalization still presents a meaningful hurdle. Using the common one-third cash, two-thirds debt formula for example, a firm with $3 billion market cap may easily be taken over with $1 billion in cash and $2 billion in high yield debt in today's funding environment. However, it's clearly much more difficult to raise $33 billion in cash and $67 billion in junk-rated debt than to take over a company with $100 billion market cap.

As of this writing, the 20 largest recent LBO transactions ranged between $11 billion and $44 billion in size (See Figure 1). Although deal sizes are trending higher, larger market caps could present more transactional and operational risks even for a consortium of deep-pocketed buyers.

Figure 1: Recent Large LBO Transactions ($billion)



Source: Bloomberg and Capital Advisors Group.

B. Lagging Share Price

Understanding the economic incentives of an LBO is an important first step towards uncovering potential targets. Lackluster share performance displeases equity investors. It is equally a concern for bond investors, as management often tries to improve share price through share buybacks or higher dividend payouts - measures that erode capital cushions protecting creditors. Activist shareholders, championed by hedge funds and buyout specialists, increasingly demand management to consider selling itself to the highest bidder.

Many of the conventional share metrics can provide some insight to the likely LBO candidates. Such metrics may include 52-week price change, price-to-earnings ratio and price-to-book ratio. Stagnant or declining share prices and low multiples are often associated with companies perceived to be undervalued by stock investors.

C. High Cash Capacity

Ironically, a company with excellent operational and financial management can fall victim to its liquid balance sheet and strong cash flows. Buyout funds often look for firms with high cash balances to fund part of the purchases. They also expect the target companies to generate substantial and sustainable cash flows to pay for higher interest expenses on future high-yield bonds.

A common measure of high cash balance in relation to indebtedness is the cash from operations (CFO) to Total Debt ratio. Operating Income to Total Debt and EBITDA (earnings before interest, taxes, depreciation & amortization) to Interest Expenses ratios provide additional insight in a firm's ability to service debt, especially in an industry with cyclical cash flows. The key is to compare these ratios amongst firms in similar industries and in relation to other LBO characteristics to determine the likely candidates.

D. Moderate Debt Leverage

Similar to high cash balances, a company with a conservative financial profile may fall prey to a buyout deal simply because it has the capacity to take on more debt to finance the transaction. Among the useful financial ratios to watch are Debt to EBITDA and Debt to Tangible Book Value ratios that measure a firm's financial leverage.

What is perhaps the most significant development in recent LBO history involves deals of solid investment-grade (A-rated and higher) names. Traditionally, buyout firms were constrained by their cash capital to focus on junk-rated and BBB-rated firms, which were by definition already highly levered in their balance sheets. With ample liquidity and low risk premium for corporate bonds, private equity firms are finding new targets with much more conservative financial leverage. An irony not lost in transactions is that supposedly safer high-grade names may be more likely LBO candidates than junk-rated names.

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PERFORMING THE LBO SCREENING

With the previously discussed screening criteria, we set out to identify the likely acquisition candidates. To make the exercise relevant to cash and short-duration investors, we start with the constituents of the Merrill Lynch 1-3 year A-rated and Higher Corporate Index as proxies for most widely-held corporate securities in cash accounts.

For this screening exercise, we limit our search to only U.S.-based publicly traded names. As of April 30 2007, the index included 183 corporate bonds from 90 issuers. Further, we limit our search to the 62 non-financial issuers in the index. We will discuss the financial sector later in this report.

Incorporating the characteristics of the Standard & Poor's 500 Index firms and our subjective judgment, we screened the 62 issuers based on the scoring system below. Companies receive a single point for meeting each criterion below for a possible total of 9 points. A higher score correlates to a more attractive takeover target.

		Share Price			Cash			Leverage	
	Mkt Cap ($ bln)	1-Yr Price Chg. (%)	P/E Ratio	P/B Ratio	CFO/ Debt	EBITDA/ Int. Exp.	Op. Inc./ Debt	Debt/ EBITDA	Debt/ Tang. Bk.
Less than	50	20%	19x	3.6x				3x	5x
More than					0.5x	3x	0.25x		

About 27% of the A-rated corporate index may be buyout targets.

Seventeen firms scored 6 or higher in the 9-factor screening test, representing 27% of the A-rated corporate index (see Figure 2). We would like to remind readers that this is simply a preliminary list of at risk candidates based on our scoring system and data analysis. It is not intended to predict any future aquistions. On one hand, investors ought to demand an event-risk premium for bonds with LBO risk. On the other hand, an all-out retreat from corporate exposure for the fear of LBO risk may also be premature.

Figure 2: Non-financial LBO Candidates

		Ratinges		Screening
Ticker	Description	Moody's	S&P	Score
AMGN	Amgen	A2	A+	8
BHI	Baker Hughes	A2	A	8
BMS	Bemis Company	Baa1	A	8
DOW	Dow Chemical	A3	A-	8
HD	Home Depot	Aa3	A+	8
OXY	Occidental Petroleum	A3	A-	8
DD	Du Pont (E.I.)	A2	A	7
EMR	Emerson Electric	A2	A	7
GCI	Gannett Co.	A3	A-	7
GD	General Dynamics	A2	A	7
MMM	3M Company	Aa1	AA	7
TGT	Target Corp	A1	A+	7
HON	Honeywell Internationl	A2	A	6
KFT	Kraft Foods Inc	Baa1	A	6
KSE	Keyspan Energy	A3	A	6
PBI	Pitney-Bowes	Aa3	A+	6
UTX	United Techynologies	A2	A	6

Source: Bloomberg, Thomson Financial and Capital Advisors Group.

FINANCIALS - IS SALLIE MAE A TREND IN THE MAKING?

Financial firms had not been likely LBO candidates for at least two reasons 1. their balance sheets are already highly levered and 2. most of the firms are regulated with minimum capital requirements. Then on April 16, 2007, student loan lender SLM Corp (Sallie Mae) made news as it agreed to be acquired by a consortium led by JC Flowers, a private equity firm. Credit spreads of financial names quickly widened on the fear that the LBO wave would soon come crashing onto the finance landscape.

The LBO of Sallie Mae brings takeover risk to the "safe haven" financial sector.

In discussing whether the buyout game plan has changed to include the financial players, one needs to recognize that the focus is very much on the specialty finance field. The field includes independent finance companies including CIT and Countrywide Financial, and finance subsidiaries of larger and diversified firms such as American General Finance, HSBC Finance, and GE Money. Other than market cap and share price concerns, here are some of the factors that may result in finance companies being taken over by investor-led buyers.

A. The firm does not need market funding.

A typical finance company operates on a "borrow low and lend high" spread lending model. A leveraged deal will almost always result in much higher funding costs due to severe and expected rating downgrades. If a firm can survive without resorting to market-based fund, then a buyout may make sense.

As an example, SLM will receive $16.2 billion debt from Bank of America and JPMorgan Chase to finance the initial purchase and more purchase commitments for its assets from the banks for at least the intermediate term. Part of the reason the banks were willing to commit internal funding is the government guaranteed nature on up to 94% of SLM's student loan portfolio with little to no credit risk. Non-student loan lenders may find it difficult to secure as favorable funding terms as SLM did.

B. The firm does not need investment grade ratings.

Instead of borrowing on an unsecured basis, financial issuers are increasingly using asset-backed securities to fund purchases. Securitization allows firms to issue highly rated, often AAA-rated securities through over-collateralization, subordination of lower classes, and other structural enhancements. Even without LBO considerations, securitization often represents cheaper funding options and results in more aggressive revenue recognition than unsecured on-balance sheet funding.

A company with a high percentage of *securitizable* assets on its balance sheet may become an LBO candidate. Stable, short-term and liquid financial receivables with measurable borrower credit risk and payment behavior are typically good securitization candidates. These include auto and student loans and credit card receivables. Subprime home equity loans and equipment leases may be less desirable assets for securitization. In this regard, American Express and Capital One may be better LBO candidates than CIT, all else being equal.

C. The independent finance company model is a viable one.

One of the recent debates on the business model of an independent finance company has been on its profitability and its earnings growth prospect. Equity investors ought to expect a firm to produce higher profitability metrics and to have a faster growth prospect than the overall industry in order to justify staying independent versus going with a stronger financial parent.

Over the last decade, higher funding costs and fierce competition eventually forced most of the independent firms to go with higher-rated financial companies. These firms included Associates, Household, Heller, and MBNA. Although an LBO remains an option, strategic acquisition by better rated financial firms may be a better, easier and safer option.

A SLIM FIELD OF LBO CANDIDATES

In screening for potential acquisition candidates among the financial names in the Merrill Lynch index, we remove names in the three major regulated industries: banking, brokerage and insurance. What we are left with are four independent finance companies – American Express, Countrywide, CIT, and Capital One (See Figure 3).

All of the remaining independent finance names may be LBO targets.

Figure 3: Financial LBO Candidates

	Ratings		Screening
Description	Moody's	S&P	Score
AMER EXPRESS	A1	A+	3
COUNTRYWIDE	A3	A	7
CIT GROUP INC	A2	A	6
CAPITAL ONE	A3	BBB+	6

Source: Bloomberg and Capital Advisors Group.

In our applying our 9-factor screening test, 3 of the four names scored 6 or higher as likely LBO candidates. The premium brand value of American Express and the highly liquid receivables asset pool may also make it an attractive target for a large buyout fund. Thus, we consider all four to be potential targets. In fact, each of the four has appeared on the screens of industry LBO watchers and each had to defend it self in public that management did not intend to enter into a deal.

On the other hand, each of the finance names may be less attractive to a potential suitor than SLM Corp. For American Express, the market cap of $76 billion will be a big hurdle. Both Countrywide and Capital One have bank charters that need to be spun out first to avoid federal regulations. At issue is also the low cash earnings at Countrywide. CIT's current loan asset mix of equipment and aircraft portfolios seems to rule out securitization as a funding option.

On a larger scale, significant debt outstanding for these finance names represents meaningful risk to bond investors in general, as overall financial credit spreads tend to move with them in sympathy. Investors should proactively seek the "LBO premium" if and when deciding on purchasing any of these names.

CONCLUSION

Leveraged buyouts of investment-grade firms, especially A or AA-rated, used to be quite rare, as high ratings usually came from sound business practices that typically improve market valuation and discourage potential predators. In recent years, high cash balances and the desire to improve equity returns have encouraged private equity firms to pursue ever larger deals. Some of the previously unthinkable multi-billion dollar industry titans, such as Anheuser-Busch Cos. ($38 billion in market cap), Dow Chemical ($43 billion market cap), and Home Depot Inc. ($76 billion), are now in play.

At the onset of the LBO wave, we as risk-averse liquidity-driven cash investors went through an internal process of identifying companies that may be potential acquisition targets. By sharing our screening process with our investors, we hope to communicate sensible credit management by separating fact from fiction and prudence from panic.

Appendix A:
Non-Financial LBO Worksheet

		Ratinges		Market Cap	Share Price 1 Year Price	P/E	P/B	Cash CFO to	EBITDA to	Op. Inc.	Leverage Debt to	Debt to	Screening
Ticker	Description	Moody's	S&P	($ billion)	Change (%)	Ratio	Ratio	Total Debt	Int. Expense	Total Debt	EBITDA	Tang. Book	Score
AMGN	Amgen	A2	A+	62.7	-19.46	13.86	3.18	0.6	46.78	0.56	1.49	1.52	8
BHI	Baker Hughes	A2	A	26.4	5.90	18.99	4.76	0.55	34.37	1.8	0.45	0.27	8
BMS	Bemis Company	Baa1	A	3.5	12.55	18.08	2.38	0.44	9.9	0.42	1.62	1.11	8
DOW	Dow Chemical	A3	A-	43.8	13.39	11.47	2.53	0.44	9.86	0.49	1.4	0.71	8
HD	Home Depot	Aa3	A+	76.1	1.22	14.45	2.97	0.66	26.33	0.83	1.01	0.6	8
OXY	Occidental Petroleum	A3	A-	48.2	18.36	11.5	2.25	2.36	28.39	2.75	0.29	N/A	8
DD	Du Pont (E.I.)	A2	A	43.8	21.76	17.34	4.87	0.5	7.27	0.3	2.08	1.41	7
EMR	Emerson Electric	A2	A	36.7	13.96	19.38	4.38	0.62	17.76	0.76	1.1	2.24	7
GCI	Gannett Co.	A3	A-	14	9.41	12.42	1.65	0.28	7.9	0.38	2.29	-2.28	7
GD	General Dynamics	A2	A	32.8	29.03	18.85	3.27	0.77	19.29	0.94	0.92	13.48	7
MMM	3M Company	Aa1	AA	62.6	3.27	18.89	6.22	1.08	41.31	1.3	0.62	0.88	7
TGT	Target Corp	A1	A+	49.9	20.10	18.23	3.2	0.48	10.57	0.51	1.53	0.65	7
HON	Honeywell Internationl	A2	A	45.7	41.75	18.81	5	0.63	9.73	0.6	1.31	-13.03	6
KFT	Kraft Foods Inc	Baa1	A	53	5.11	16.86	1.88	0.36	11.86	0.51	1.69	-1.57	6
KSE	Keyspan Energy	A3	A	7.2	4.38	16.73	1.56	0.23	4.73	0.18	3.72	1.47	6
PBI	Pitney-Bowes	Aa3	A+	10.3	13.81	17.36	15.66	-0.07	6.67	0.27	2.85	-2.86	6
UTX	United Techynologies	A2	A	68.9	10.42	17.97	3.8	0.61	11.41	0.77	1.11	14.3	6

Appendix B:
Financial LBO Worksheet

		Ratinges		Market Cap	Need for	Ease of	1-Yr Price	1-Yr Loan	P/E	P/B	Return on	ROE	Profit	Screening
Ticker	Description	Moody's	S&P	($ billion)	Mkt Funding	Securitization	Chg. (%)	Growth (%)	Ratio	Ratio	Assets (%)	(%)	Margin (%)	Score
AXP	AMER EXPRESS	A1	A+	76.5	High	High	12.75	22.96	20.81	7.28	3.07	35.20	19.63	3
CFC	COUNTRYWIDE	A3	A	24.0	High	High	-8.80	11.51	10.37	1.62	1.43	19.72	20.85	7
CIT	CIT GROUP INC	A2	A	11.4	High	Low	10.44	24.32	12.09	1.66	1.45	14.81	20.38	6
COF	CAPITAL ONE	A3	BBB+	32.3	High	High	-14.29	61.26	12.11	1.23	2.03	12.27	24.05	6