

Mergers & Acquisitions  
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# Dealmakers' Forecast 2006

In the corporate finance arena, it is important to continuously analyse current forces driving the market and to predict their impact. How was the stage set in 2005? What culminating factors will shape corporate dealmaking through 2006? To answer such questions, Financier Worldwide canvassed the corporate advisory community to identify rising trends and key developments in mergers and acquisitions, private equity and venture capital, insolvency and corporate restructuring, banking and corporate financing, and specific sector activity. What follows is a collection of their thoughts on the year ahead.

## Mergers & Acquisitions

ROBERT FILEK AND GREG PETERSON, PRICEWATERHOUSECOOPERS

### Record cash reserves and a desire for growth will accelerate US M&A in 2006

The consolidation of key US industry sectors will intensify in 2006 as corporate and financial buyers take advantage of record cash reserves, low interest rates and a wide range of opportunities. Retail, energy, utilities and technology are well-positioned for sustained activity next year.

Although the retail sector is still an attractive real estate play, especially for private equity, 2006 will see big box consolidation move to grocery chains as mid-tier companies struggle to survive in an increasingly competitive environment.

In the energy sector, independents will become more acquisitive, as they need bigger balance sheets to offset political and geological risks of drilling in those parts of the world where large projects exist. However, they'll enter substantial hedging contracts before closing on mega-deals in this pricing environment.

National oil companies – which get government financing and are not afraid to do deals at current prices – may do the most mega-deals, at least until prices settle and integrated oil companies come back in a bigger way. Refining could also heat up as sustained high margins lure private equity and foreign buyers to the US market and trigger possible consolidation among the few pure refiners remaining.

Regulated utilities should continue consolidating into a small number of 'super regional' companies given the fragmentation of the US industry, the number of attractive acquisition candidates, and the ability of more companies to finance acquisitions. With the repeal of the Public Utility Holding Company Act (PUHCA) this year, barriers to non-regulated utilities investing in this sector were eliminated. But the impact is uncertain because state commissions have stepped up their scrutiny of pending deals.

Continued interest from private equity and hedge funds will drive significant deal activity in power generation. Coal and nuclear plants could fetch a premium leading to increased asset sales in this robust market.

**With valuations still moving upward, defaults at their lowest levels of the decade, and cash reserves at the S&P 500 and top 50 private equity firms up 8.5 percent to \$1.9 trillion in the first nine months of this year, the 'sweet spot' in this cycle may last longer than in previous ones.**

Corporate spending on technology is finally rebounding as companies replace aging equipment and software. Enterprise software consolidation should continue as customer preference for packaged solutions, anticipated platform shifts, and competition for dominance between the sector's two leaders intensifies. 'Going private' deals will pick up as private equity firms snap up mature, out-of-favour businesses with substantial free cash flow and/or restructuring needs. Portals will make acquisitions to add functionality and broaden their range of advertising-funded services as interactive media becomes more competitive. And networking equipment should consolidate further as data, voice and video communication continues to converge.

At this point in the cycle, the richest deals with the best returns should already have been done. But with valuations still moving upward, defaults at their lowest levels of the decade, and cash reserves at the S&P 500 and top 50 private equity firms up 8.5 percent to \$1.9 trillion in the first nine months of this year, the 'sweet spot' in this cycle may last longer than in previous ones. However a change in monetary policy under the new Fed chairman, Ben Bernanke, or ripples from the possible restructuring of a major automotive company could change all that. ■

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MARTA BELLOBI, ENVIRON

### Spanish environmental due diligence – a word of advice for equity investors

Environmental due diligence has its place in all but the most benign of mergers and acquisitions. It is also fair to say that it is still rarely a deal breaker, with equity investors choosing to use it to leverage price, and to protect their investments through the terms of the SPA. With the emphasis in recent years being focused in the UK, France and Germany, there is little evidence to disagree with this approach. However, private equity firms looking to invest in the burgeoning investment market of Spain, should perhaps sharpen their pencils in anticipation of greater uncertainty as to possible hidden liabilities and costs. Strong economic growth and low interest rates are making attractive viewing for the international and Spanish private equity players. The need for a clean exit and the avoidance of unexpected environmental financial liabilities is key to private equity investment in Spain, given the increasing trend towards secondary buyouts.

Spain is one of the most decentralised of European countries, where 17 autonomous regions have the power to develop and to implement environmental legislation. The extent to which environmental legislation is enacted and enforced is therefore highly variable. From an environmental liabilities perspective, Spain has its share of contaminated land, and its industries have the same challenges as the ►►

rest of EU member states to improve their operating environmental compliance.

What currently sets Spain apart from the traditional marketplaces is perhaps the extent to which its industry is lagging behind and hence the margin of effort and cost required to catch up. Some of the existing challenges are as follows.

Spain must develop an integrated environmental permitting system for its industrial base, and issue such permits to EU standards by October 2007. The meeting of such EU standards will inevitably have major capital expenditure impacts for a large proportion of the industrial sector due to the need for implementation of Best Available Techniques and other abatement measures.

A new Spanish Decree on land contamination requires the majority of the industrial sector to assess the risk of contamination and its impacts on property holdings and report this to regulatory authorities. Where potentially significant risks may exist, further investigation and possibly remedial action will be mandated. This approach must also be followed

in the event of change in land uses with involved potentially polluting activities.

Spanish firms have tight emissions allowances under the EU emissions Trading Scheme (EU ETS) for greenhouse gases. The first Sanction under the EU ETS has recently been made in Spain against a small Spanish manufacturer. The government ordered the company to cease its activity until further notice and is threatening a substantial fine.

In summary, it behoves private equity investors to ensure that they have environmental due diligence in Spain well in their sights, as they enter this emerging market. ■

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## Private Equity & Venture Capital

MICHAEL J. COCHRAN, MCKENNA LONG & ALDRIDGE LLP

### Private equity forecast for 2006

The dominating facet of the private equity middle market in the US remains an overwhelming supply of capital looking for significant investment opportunities. Certainly hedge funds and private equity funds have enjoyed a robust period of expansion. 2005 reflected a strong year for fund formation activities that should yield an active investing market.

Fund formation activity should continue through at least the first half of 2006. A number of substantial firms are currently raising new funds reflecting continued interest in the asset class by institutional and retail investors.

This excess of capital will cause traditional private equity firms to find heightened competition for attractive targets from strategic buyers and hedge funds. Deal multiples should remain high and continue to be buttressed by aggressive lending markets. Deal size will continue to increase through multiple expansion and deal leverage. Hot industries will include the energy sector, homeland security, health care and nanotechnology (for venture capitalists). While club deals remain fraught with peril for the unprepared, such deals allow for middle market firms to extend their reach into larger transactions.

When financial buyers find increased competition, sellers prosper. Corporate America will continue to emphasise growth through acquisition strategies as intrinsic growth remains stable but not robust. These market conditions will allow private equity firms to continue to monetise their investments through negotiated dispositions.

Will public exits be more in vogue during the coming year? While the number of successful IPOs continues to increase, the volume of early

revenue companies finding access to the public markets has not returned to its peak. The shadows of Sarbanes-Oxley and the lack of liquidity in the small cap market are not likely to dissipate in early 2006. Certain exit strategies such as SPACs and PIPEs will remain at the periphery of the middle market.

In 2005, hedge funds actively pursued attractive, out-sized yields by lending into the middle market. As a result the Tranche B and mezzanine markets became very crowded. Risky credits may lead to financial distress and underperforming investments.

Financial distress will be the pink elephant in the room during 2006. With leverage and multiples at such high levels, the spectre of defaults looms large. With so many new participants in the market, a period of heightened distress could bring a wave of insolvency and instability. When the cycle turns it could be a very vicious year. ■

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### The new megafunds: bigger and better?

In the first 10 months of 2005, several new private equity funds were launched with commitments ranging from \$8bn to over \$12bn. In April, the private equity arm of Goldman, Sachs & Co. closed on \$8.5bn in commitments. The Carlyle Group quickly followed suit, announcing two ►►

funds totalling \$10bn in commitments. Apollo Management is reported to be on the verge of closing a new \$10bn fund. And, the Blackstone Group is expected to raise approximately \$12.5bn in its current fundraising effort by year end. These developments have caused some to wonder if the label 'megafunds' – a term applied only a few years ago to \$3-4bn funds – is adequate to describe the new funds. Have we entered the age of 'super megafunds' or 'mega megafunds'? And what comes next?

While for some the advent of the new megafunds has raised the spectre of a private equity 'bubble', there are compelling reasons to believe that megafunds represent the logical next step for private equity. As M&A transaction sizes have grown, potential buyout targets have climbed out of reach of all but the largest private equity funds. Access to the significantly larger pools of committed capital available to megafunds expands their equity target range.

Also, swelling fund sizes mean even greater investment banking fee-generating potential (and accordingly recognition from investment banks.) This can translate into preferred access to deal flow, as well as better financing and advisory terms for megafund sponsors, their funds and their portfolio companies.

Megafund status can further help to secure the best talent to add to the growing ranks of private equity investment professionals. Greater management fee income, which is generally linked to overall fund size, can be used to grow in-house 'operations' groups, which work on the ground to improve portfolio company performance, as well as to build overseas offices to source and execute buyouts outside the US. Both steps have become critical to the private equity business in recent years.

In an industry known for its high rates of return to investors, some wonder if the dramatically increased size of the new megafunds will mean more pedestrian returns. Too much capital chasing too few investments

could lead to upward price pressure, so the argument goes, as funds compete for buyout targets in an effort to put their billions to work. More optimistic observers note that private equity funds have yet to encounter any shortage of deal flow, especially those willing to pursue foreign targets, in particular in Europe and Asia. The growing number of large targets for leveraged buyouts, including large cap public companies, has also provided funds with ample opportunities. Finally, greater amounts of committed capital combined with larger and more diverse networks of deal professionals permit private equity funds to engage in 'theme experimentation', pursuing interesting investments that are potentially lucrative if off the beaten path, without necessarily risking significant resources to do so. Given the competitive pressures of the private equity business, it is unlikely that the trend toward megafunds will slow or be reversed in the foreseeable future. The challenge for private equity firms will, of course, be to continue to post impressive returns for investors, even as fund sizes grow. Investors in private equity funds will undoubtedly monitor performance closely, and will want to consider the long-term implications of concentrating their allocations with a dwindling number of large private equity franchises. Other participants in the private equity marketplace (including 'mid-size' funds and service providers) will be required to consider the ways in which the advent of 'super' megafunds will impact their roles in this business. And participants and observers will muse over whether private equity funds of \$8-12bn represent the 'final frontier' of fund size, or whether there will be future leaps in fund size. ■

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## Bankruptcy & Corporate Restructuring

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### Corporate distress on the horizon

2006 should see a dramatic increase in restructuring and bankruptcy activity. The US economy is overwhelmingly driven by consumer spending, and US consumers are nearly tapped out. Low interest rates, easy credit and rapid increases in real estate values and home equity borrowing have propped up spending for the past two years, but consumers will be forced to cut back in 2006 as interest rates rise and deferred payments become due. Real estate prices could drop sharply in certain markets, making it impossible for many consumers to refinance existing adjustable-rate or interest-only mortgages, and leading to defaults and foreclosures as required monthly payments rise. Declining consumer spending will ripple through the economy, reducing revenues and forcing businesses to cut back expenditures and reduce payrolls.

In addition to declining revenues, rising interest rates and maturing

debt will force a new round of business bankruptcies and debt workouts in 2006. Many heavily leveraged businesses were able to avoid bankruptcy during the 2001-02 recession because creditors were willing to enter into short-term debt restructurings at low interest rates. Unfortunately, financial restructurings often merely postpone the day of reckoning without addressing underlying business problems. Much of this restructured debt will begin to mature in 2006 and 2007. The combination of rising interest rates and declining revenues will squeeze these businesses as they try to refinance, and many will not survive under their current ownership.

The rise of second lien financing during the past several years will change the dynamics of debt restructuring negotiations. Second lien lenders depend upon going concern value for repayment. This creates incentives for them to support restructuring rather than sale or liquidation of a defaulting business. On the other hand, second lien lending increasingly is dominated by hedge funds, which are financial players rather than long-term investors and typically have no capacity to take control of a failing or restructured business. Because the second lien ►►

loan is often the pivotal debt in a restructuring situation, second-lien lenders could drive the process. It will be interesting to see how they react as defaults mount during 2006.

Recent changes in the Bankruptcy Code will prompt more out-of-court workouts and pre-bankruptcy planning than in the past. The debtor's exclusive period to file a plan cannot be extended beyond 18 months after the petition date, and the maximum period in which the debtor as lessee can assume a non-residential lease is now limited to 210 days after the petition date. Businesses with complex problems or large numbers of leases must plan their bankruptcy strategies thoroughly before filing or else risk losing control of the case. Secured lenders and other creditors that hope for a consensual resolution now have increased incentives to participate in pre-bankruptcy negotiations. On the other hand, the threat of an involuntary filing may give out-of-the-money creditors more leverage, particularly in dealing with second lien lenders. ■

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### What US bankruptcy professionals can expect in 2006

Changes in the make-up of the Supreme Court will create uncertainty through 2006. There will also be continued animosity towards the Southern District of New York as new filings continue to drift to that district due to the presence of a sophisticated and business savvy US Trustee, the convenience for the financial community, and the overall experience of the bench.

The new Bankruptcy Act will also bring changes. We expect to see more involvement by the Attorney General in the management and control of bankruptcy cases through the Executive Office of UST, with an increased involvement in the selection of trustees and examiners – as in the Bennett Funding case in the Northern District of New York. We also expect to see an increase in motions for the appointment of a Trustee when fraud, malfeasance, misconduct are 'reasonably suspected'. An increase by the SEC in the oversight of claims and bankruptcy related security trading is also likely. More pressure on the PBGC because of legacy cost issues is expected – will 2006 be the watershed year that drives the pension industry to a melt down?

Looking more broadly, signs of the next bankruptcy wave are emerging. This wave will be driven in part by the effects of continuing economic growth in China and India and continuing globalisation on the fundamental health of the US economy. Other key factors will be the explosion of second lien paper and the rise of interest rates, as well as the continued levels of energy pricing. 2006 will also see a continuation of the ever increasing size of the largest bankruptcy cases.

But until the bankruptcy wave strikes, there will be continuing pressure on the pricing of advisory services. Large firms will continue quietly discounting pricing to keep people occupied. The persistent lack of new cases, (particularly in the middle market), in the pipeline is forcing bankruptcy related departments to downsize and lose talent, and this will continue for the foreseeable future.

Finally, US bankruptcy non-legal professionals may well see an inflow of foreign competitors seeking to provide routine bankruptcy related services, such as claims noticing and vote solicitation and tabulation. In addition, we expect electronic filing and service to increase and put additional financial pressure on traditional providers of those services. ■

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NICK HOOD, BEGBIES TRAYNOR

### Corporate restructuring – a good year beckons for boutiques and sector specialists and those travelling to far-flung places

As we reach the end of 2005, a growing band of fast-footed restructuring boutiques will be quietly satisfied with the progress they have made in elbowing their way past the traditional players. They will be looking forward to 2006 with only one concern, about how to source the extra human skills and resources they will need. High profile recruits from accounting firms are signing up in increasing numbers, but will enough be tempted to leave the security of the big firms?

Specialists can also be optimistic about the forthcoming year, especially with more fall out expected in certain deeply-stressed sectors. The auto industry will offer further opportunities, as Ford continues to retrench and especially if GM is forced into Chapter 11. Retail is in tatters in the UK and still struggling across Europe. There will be further consolidation starting early in the New Year as funders move to exploit the window of opportunity when their exposure has been temporarily reduced by the Christmas trading peak.

Business is not only increasingly global, but spreading its tentacles into some previously unfashionable jurisdictions. Restructuring and insolvency regimes need to catch up – and quickly. INSOL International is working hard to lobby for improvements, as are a host of major financial institutions keen to get closely involved in regions like South Asia ▶▶

**Signs of the next bankruptcy wave are emerging. Key factors will be the explosion of second lien paper and the rise of interest rates, as well as the continued levels of energy pricing.**

and sub-Saharan Africa. Rigid controls over foreign direct investment must be relaxed, but governments can be maddeningly slow to accept this truth. Let's hope that we get good news in 2006 on this key aspect.

Along with reform of insolvency laws and regimes, there is an urgent need to create adequate professional capacity. Restructuring experts in the developed world would be well advised to shoulder their share of this burden, working with local champions. Spreading good practice is a clear moral obligation in return for the high returns we make in our own back yards. Expect a positive development in at least one major developing economy in 2006.

Finally, our commercial world grows ever more litigious. As regimes develop across the world, there are constant complaints among professionals about the low numbers of insolvency judges and their inexperience. Here too, we must act positively to improve this situation. The best laws in the world will be wasted if there are not enough good judges to interpret them and keep the system moving. ■

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### Green light for solvent schemes post British American Insurance Company (BAIC)

In July this year, a ruling of the High Court in England in the BAIC case sent shock waves through the insurance sector as a result of the Court's refusal to sanction BAIC's proposed solvent scheme of arrangement. The reaction of some in the industry was that the decision would amount to the kiss of death for solvent schemes.

The opposition to the BAIC scheme itself was organised mainly from

the US, where some policyholders' lawyers took the view that the very short period between the effective date and the bar date (120 days) was draconian. Not only that, they argued that once a scheme of arrangement is passed, creditors are locked into the scheme procedure for settling claims and resolving disputes, leaving very limited scope for an appeal to the Courts.

It turns out that the BAIC scenario was an extreme case. One feature (albeit not unusual) was the existence of numerous contingent, long tail claims (IBNRs). Many of BAIC's scheme creditors were from outside the insurance sector, typically manufacturers who had purchased, for example, asbestos insurance. As the Judge noted, it is now impossible to purchase that kind of insurance anywhere on the market. BAIC's policyholders were being asked to give up their rights under their policies in exchange for early payment based on estimates of their claim. A significant minority of the policyholders with IBNRs voted against the scheme, preferring to hold on to their policy and await future claims, a process which could take 20 to 30 years or more. The Judge decided that they were entitled to do just that.

However, contrary to general expectation, a series of other solvent schemes came before the English and Scottish Courts this autumn (including DAP Holdings, M&G and Scottish Eagle) and were sanctioned, including one sanctioned by the Judge who had refused to sanction the BAIC scheme.

The upshot is that most of the doubts about the viability of solvent schemes have now been removed. It is clear that the solvent scheme of arrangement will continue to be a most useful tool for insurance companies going forward in preference to a lengthy run off. There are a number of solvent schemes in the pipeline and it is likely that insurance companies which had ruled out the possibility of doing a scheme will now be re-examining their potential. ■

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## Banking & Corporate Financing

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### The financing market in 2006

The financing market is very active up and down the capital structure and this should continue in 2006. We should see the continued convergence of non-bank lenders and investors, with intense competition among private equity funds, hedge funds and other alternative lenders.

The second lien market has exploded with a record year in 2005 and the signs are for more of the same in 2006. Traditional asset-based lenders are still very active in this area, but the tremendous growth is being fuelled by the growth of the product in the syndicated loan market and to finance mergers and acquisitions. Larger companies are increasingly users of these funds. Also, hedge funds continue to be a major source of funds in this area.

Aggressive terms and deal structures will likely continue in the mezzanine area generally and middle market asset-based lending, in large ►►

part fuelled by an active mergers and acquisitions market. For example, the absence of a financing condition in many M&A deals is common. This practice may not last for long, however, if interest rates continue to rise in 2006 and, depending on the health of the economy, credit terms inevitably tighten. Running in a parallel but somewhat different direction, most leveraged acquisitions combine senior bank debt with a high-yield bond offering, provided that if the offering is not fully subscribed by the time of the closing of the acquisition, funds are provided through bridge financing. Most borrowers have not had to face the expensive rates and harsh terms of bridge financings, but this could change if market conditions dampen the high-yield market.

Some market changes may appear in 2006 as many second lien and mezzanine loans made in the last two years mature and need to be rolled over or refinanced. With rising interest rates, an increase in defaults and workouts could be on the horizon. A downturn could change the lineup a bit and many anticipate some sort of shakeout in the next year to 18 months, particularly for small hedge funds with significant commitments in these areas. Some market participants, including the rating agencies, fear that a systemic event could trigger a series of defaults, as funds appear more likely to pull the trigger than to seek workouts and restructurings. ■

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### Asset-based lending in Europe

2006 is likely to see two significant trends. The first trend is the emergence of big ticket asset-based lending (ABL) as a significant European capital markets product. In the US, data capturing ABL transactions (i.e., greater than \$100m) has become more freely available over the past four years, through Loan Pricing Corporation. In Europe, no such information is recorded. We suspect that a growing number of bilateral and 'club' transactions have already closed in Europe, structured as cross-border financings. However, hard data is not in evidence. It was clear from a recent gathering of all the large players in European ABL that the appetite to lead and participate in pan-European deals is enormous.

Driving this appetite is UK and US players experiencing lower growth rates in their own markets seeking to maintain momentum. Also driving the market towards larger transactions in Europe is the increasing acceptance of ABL in the US among large companies. Many multinationals are seeking to replicate their US financing structures overseas. This is sure to grow in 2006.

The other trend sure to develop next year is the loosening of structure and the inclusion of more esoteric collateral. Already in Europe, ABL shops are providing cashflow loans in addition to the traditional asset-based structures. The inclusion of 'airballs' (the piece of the debt structure not covered by typical advance rates under borrowing base) in the US has become much more widespread in the past 12 months. In terms of collateral, in Europe we have seen invoice financiers embrace types of trade receivables (e.g., construction, contractual) that have

historically been excluded. In the US in the past year, ABL inventory collateral has included such unusual items such as uranium pellets and human plasma. The rationale for such loans clearly envisions sale of the business rather than liquidation of the collateral and as such ABL lenders are taking the market to a place sometimes closer to enterprise value lending than historic asset-based lending.

While the wall of liquidity in the marketplace remains, these are the developments envisioned in Europe in 2006. ■

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### AIM in 2006: the new NASDAQ?

Interesting opportunities for 2006 are happening on the London Stock Exchange. Despite the recent volatility in the global public equity markets, AIM (formerly the 'Alternative Investment Market'), the junior stock market of the London Stock Exchange (LSE), has continued to attract new issuers, investors and investment bankers. This past year has seen another record year in the AIM market's growth story with over 450 new admissions, raising around £4.5bn in equity capital. Of those new admissions, approximately 22 percent were international companies, of which just under 20 were US and Canadian issuers.

The number of new issuers attracted to AIM is only half the story. AIM has now convincingly demonstrated that there is a vibrant market where high-risk emerging-growth companies can harness much needed growth capital. However, of equal importance to the market's overall development has been the extent of liquidity during 2005. Indeed, the value of on-market trades has more than doubled the previous record level, with an average daily volume of over 434 million shares traded and an average daily value of just under £170m between 1 January 2005 and 30 November 2005. With the LSE's continued efforts to promote AIM as the 'market of choice' for small- to mid-cap companies, these trends augur well for 2006.

In addition to the global marketing efforts undertaken by the LSE last year, a number of other factors will also drive AIM's international reach in 2006. The nature of the AIM market itself, with its more flexible admission criteria, the relative simplicity of the admission process, its more lenient disclosure requirements (both initial and ongoing), and the reduced costs of obtaining (and maintaining) a listing, all combine to deliver a distinct advantage over other junior markets, most notably NASDAQ. The decision by the LSE to take AIM outside the scope of the EU Prospectus Directive has meant that preparation of the admission documents remains less burdensome and more streamlined than for the main market of each of the 25 Member States. The reduced regulatory burden has obvious commercial benefits: because AIM's admission process is less complex, management has more time to develop the underlying business, thus delivering improved shareholder value. By contrast, it is estimated that US companies chasing a public flotation will spend an additional \$2m annually on Sarbanes-Oxley compliance costs. Overall admission costs are also significantly less than other competing markets. ►►

The LSE calculates that the cost of listing on AIM is between 4.5 and 5 percent of funds raised, compared to the 8 to 10 percent in the US.

Second, success breeds success. As more US, Canadian and other global companies join the AIM market, the more familiar UK corporate finance, accounting and legal advisers become with them, thus further reducing the overall costs of admission. Of even greater significance is the increased familiarity of institutional investors with holding international paper. Whereas, once an overseas company joining AIM may have been viewed with various degrees of scepticism with executive management often feeling that they have to 'tick all the boxes' more than once, the UK's 'blue chip' investor base is now far more acclimatised.

Third, increased US investor interest in holding AIM stocks may continue this virtuous circle. If US demand for the market increases, it is reasonable to expect an increase in the number of US companies attracted to the market. The question is whether the price of increased US institutional investor participation will be the adoption of US disclosure standards – as was the experience of many global markets when Rule 144A portions of global offerings became the norm.

The AIM market developments of 2005 augur well for both issuers and

existing shareholders. However, for US companies a key issue remains, namely the need for physical stock to be issued in order to comply with the strict requirements of the safe harbour from registration offered in respect of offshore offerings pursuant to Regulation S under US securities laws. Although institutional investors in the UK are becoming more accustomed to holding shares of US companies in physical form (as opposed to electronic or 'dematerialised' form for settlement in CREST), it remains a distraction to be explained to investors during a road show. AIM is in the process of attempting to follow the lead of other exchanges such as Sweden, Australia and EASDAQ by seeking a 'no action' letter from the SEC through offering a number of alternative safeguards while permitting US shares to trade electronically. A satisfactory resolution of this issue should be a critical path item for the LSE. ■

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## Sector Analysis

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### Restructuring the European automotive sector

Consistent margin pressure from global competition has left a tangible scar on European automotive suppliers. A surprising amount are living hand-to-mouth financially, operating on tight margins and fixed cost foundations while needing to keep production and quality levels up to satisfy the dependency of OEMs on just-in-time deliveries.

Since the volume of vehicles sold in Europe has been stagnant over the last few years, suppliers who have invested in capacity on a thin margin base are having trouble maintaining current levels in order to survive. Many are family-owned, mid-market businesses that have been working with OEMs and first tiers successfully for decades. Now under pressure, they are failing to understand and control their own cost structure. Frequently, they are making commitments on prices, terms and conditions which they can no longer meet. Energy prices and rising material costs, especially for resin metals, are additional factors making it difficult for some European suppliers to operate effectively.

It is not surprising that the number of restructuring cases in this industry space is high and growing. But, as the industry becomes global, restructuring challenges are increasingly cross-border. Many suppliers have already taken steps to move some parts of their activities to lower cost countries, creating multi-region complications.

In 2006, we will continue to see how the European insolvency legislation, developed to support pan-European restructuring measures,

actually operates in practice, with all the confirmations and disappointments it brings. OEMs and first tiers are being pushed to understand how these mechanisms work and how to use them to full advantage.

The movement of selected areas of the automotive supply industry towards low cost countries in Eastern Europe and Asia will continue. However, even a 10-year outlook would not suggest a complete exit of the supply base in high labour cost countries. In fact, as the sector consolidates, winners and losers are emerging. Successful European suppliers are consolidating their knowledge base and honing their ability to differentiate in the market through technology, size and scale.

While some of the larger suppliers are expanding their reach globally and moving selected elements of their production processes to low wage countries, they are keeping high tech elements in Europe. That trend will continue. In the fiercely competitive automotive sector, OEMs and first tiers are heavily reliant upon the technology and technological impulses of their supply base in order to keep their products current and distinguishable from their competitors' products.

So the sector has a volatile dynamic at present. On the one hand, there is a strong movement toward relocating products that lend themselves to production in low cost countries. On the other hand, there is an increasing willingness to spend more to make sure that competitiveness and product quality levels are where they should be. ■

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MICHAEL KOROTKIN, PHELPS CONSULTING GROUP

### Restructuring in the global automotive supply industry

There is little doubt that 2005 saw one of the most dramatic shifts in direction taken by automotive OEMs and Tier 1 suppliers in decades. Many of the largest players are now squarely focused on attempting to restore financial as well as operational viability to their organisations. Having been through a decade or more of expansion – through both M&A and organic growth, it seems that the industry is poised for a downsizing and a roll-up of weaker players the likes not seen for over 25 years. The reasons for this inevitable restructuring are varied. Highly competitive market factors as well as poor business decision making have contributed to the difficult conditions that will grip these businesses throughout 2006 and beyond.

To be sure, the automotive sector remains as one of the largest industries in the world. For example, just the automotive supply segment (Tier 1 and 2) alone is made up of over 9,000 companies employing over 1 million people and generating \$250bn in annual sales. However, years of record sales within the sector throughout the 90s led to a significant amount of M&A activity and growth that was not particularly well managed. Size was gained but financial flexibility was lost. To make matters worse, many of the acquisitions by Tier 1 suppliers were designed to broaden their product lines as they grew away from the core of their expertise. The thinking at the time was that Tier 1 suppliers could use their size and breadth of product offers to compete more successfully with each other and alter the structure of their relationships with their customers, the OEMs. In retrospect, this was a poor decision as the OEMs found the international markets such as China and Korea to be a good source of competition for the North American and European suppliers. This has kept pricing at near deflation levels and making it difficult for suppliers to navigate toward profitability. While the Asian markets remain a small percentage of the total automotive suppliers (they currently represent less than 1 percent of the components used in US manufactured cars and light trucks) they are growing fast and there is little doubt they will play a major role in supplying the world's parts in the next decade.

All of these market factors mean that 2006 will see continued pressure on the suppliers to downsize, shed unprofitable business units and initiate significant restructuring plans. Some will succeed but many will fail and it is likely that there will be over half a dozen major bankruptcy filings in this sector in the first half of 2006 alone. ■

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TERRY NEWENDORP, TAYLOR-DEJONGH

### Energy, oil & gas, petrochemicals

The high prices of hydrocarbons, which have been sustained throughout 2005, have started in motion several significant trends that will achieve prominence in 2006.

There are massive cash balances accumulating at the international oil companies (IOCs), which need to be invested in the development and

expansion of reserves, either through greatly expanded exploration and production or through M&A. The high cash flows to the national oil companies (NOCs) continues to be primarily directed to the respective national treasuries, rather than in increased capital expenditure capacity and the ability to become more self-sufficient in development and production of known reserves.

We are seeing a flight of petrochemical producers to lower-cost feedstock locations, such as Saudi Arabia, UAE, North Africa, Venezuela, Trinidad & Tobago, among others. The new capacity investments are not focused entirely on the ability to build incremental capacity for the highly vaunted China and India markets, but are also being used as replacement capacity for existing plants located in high cost feedstock jurisdictions, such as the US and Europe.

There is a continued trend, at least in North America, away from combined-cycle gas turbines and gas-fired power generation and towards coal and, where possible, hydro and other non-hydrocarbon fuels (including renewables).

A few select NOCs have shown an interest in moving further downstream in the hydrocarbon value chain in order to capture more revenues. Where this has previously been demonstrated in LNG production and shipping, this trend is now expanding in the gas sector, to regasification terminals and even gas marketing. Further we see significantly increased interest among certain NOCs in more significant participation in refineries and in the distribution of new refined products, even into OECD and middle-market countries.

The flood of new projects, particularly in certain geographic locations, at all stages of upstream and downstream investment, is putting significant upward pressure on capex investments in all sectors. In the Middle East, there is 'congestion in the EPC marketplace' leading to dramatically higher cost estimates for refineries, petrochemical projects, and the whole range of midstream and downstream gas processing projects.

There are a number of ramifications arising from the trends outlined above.

First, commercial banks – even those who were sitting on the sidelines six months ago – are rushing headlong back into the energy sector in order to try to book assets, in some cases at virtually any price.

Second, the Middle East, awash with petro-dollars from the record new oil prices, is mostly keeping it 'at home' and building industrial capacity, refining polyolefins and aromatics, more LNG and metals smelting (and the power generation to drive all that). This concentration of capital expenditures in a relatively confined geographic area is driving up EPC prices and specialty steel product prices to record highs as purchase order congestion and execution shortfalls hit the region in particular.

Third, the sheer size of the capital requirements on each specific deal (e.g., the Rabbigh refinery in Saudi Arabia, whose capital target moved from \$4.5bn to \$8.5bn) will test commercial bank capacity available on a transaction-specific basis and on a regional basis. In certain countries with investment grade ratings and sponsors, international capital markets will return as viable funding options. In other countries, large tranches of ECA and special bilateral funding will be required to fill gaps in the debt plan (e.g., JBIC participation in Rabbigh to the extent of \$2bn as a primary underwriter on the debt side).

Finally, project financing and highly structured financings will become even more necessary, despite the massive availability of capital in the Middle East, as the enormous size of the transactions will require experience and expertise in structuring in order to attract capital on a per transaction basis and on a macro industrial economic basis. ■

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