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Presentation by Ranjit Munro, Managing Director
Rothschild Debt Advisory

"The Credit Crunch – A Borrower's Perspective"

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1. Upheaval in the credit markets

1.1 What has happened to the credit markets?

End of an era of unprecedented liquidity in the global debt markets

- Fostered by loose monetary policy, strong growth, low unemployment, low default rates
- Combined with loose lending criteria, securitisation, globalisation and new sources of liquidity and risk absorption through hedge funds, conduits and SIVs
- Overall leverage in the system increased dramatically as both underlying borrowers (consumers, corporates, PEHs) and investors (hedge funds, conduits and SIVs) increased leverage
- Pricing of loans fell and the covenant protections afforded to lenders became heavily diluted, culminating in the covenant-lite structures of early 2007
- Banks were at the centre of this merry go round, originating loans, selling them onto investors as well as providing facilities to those investors
- Created a moral hazard by de-linking those responsible for scrutinising borrowers from those taking the risk of those borrowers defaulting

The “sub prime trigger”

- Sustained US housing boom fuelled by low interest rates and relaxation of lending criteria for impaired borrowers
- Defaults increased in early 2007
- Banks began to make margin calls on investors, who then had to sell assets from their portfolios to repay debt
- Fire sale of assets elicited prices well below par, which in turn triggered asset price deflation across the credit markets
- Syndication of loan assets, particularly in the leveraged market, stalled, and several high profile LBO financings are still sitting on the balance sheet of underwriting banks eg Alliance Boots, Saga/AA, Harrahs etc

Non-bank 'lending' accounted for 65% of the primary loan leveraged market in Europe and 85% in the USA in 2006/07

… double the levels of three years ago

The financing merry-go-round

Banks

- Lend money to funds (through their prime brokerage units)
- Provide liquidity lines to conduits
- Sell repackaged loans

- Originate loans i.e. make the initial bridge loans or mortgage loans

Investors

- Hedge funds
- Participant banks
- Structured investment vehicles
- CLO managers
- Asset backed commercial paper conduits

Debt instruments

- LBO debt and CLOs
- Residential mortgage backed securities
- Commercial mortgage backed securities
- Other asset backed securities

Borrowers and assets

Sub-prime mortgages

- LBO Borrowers
- Commercial property
- Prime residential mortgages
- Credit cards
- Auto loans

1. Upheaval in the credit markets

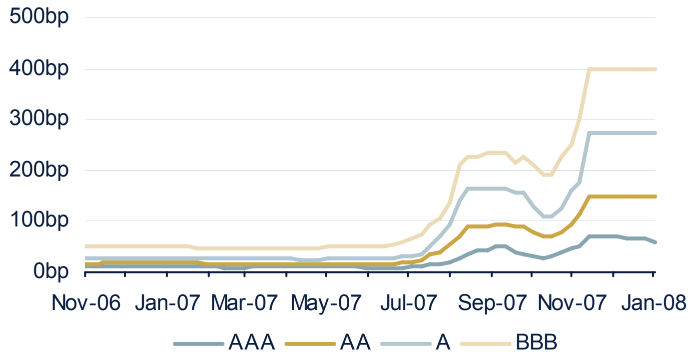
1.1 What has happened to the credit markets?

Volatility has been a feature of credit markets since July 2007

- The asset backed market was the first to be affected
  - Due to cross holdings by the leveraged investor base – CDO’s, auto loans, credit card receivables, commercial mortgages, prime residential mortgages, not just sub-prime mortgages
- The confidence crisis spread to the commercial paper markets as money market funds retreated from asset backed commercial paper
  - Conduits (particularly those with heavy sub-prime exposures) had difficulty rolling maturing commercial paper
  - The US commercial paper market has contracted by c30% since its peak in August
  - Commercial paper funded assets have come back onto the balance sheets of banks
  - Banks began to hoard cash to cover drawdown requests under commercial paper back up lines
- The collateral damage to the financial sector was severe, from Northern Rock to Citigroup
  - Northern Rock, seen as a bellweather in the securitisation market, failed in its attempt to raise financing resulting in a bank run and a state sponsored rescue
  - Massive asset right downs and senior level departure at banks whose business models were weighted towards the origination and securitisation of assets, the secondary market value of which had plummeted
  - Dislocation in the money markets caused unprecedented spreads between short term interest rates and base rates, although this has corrected since the year end

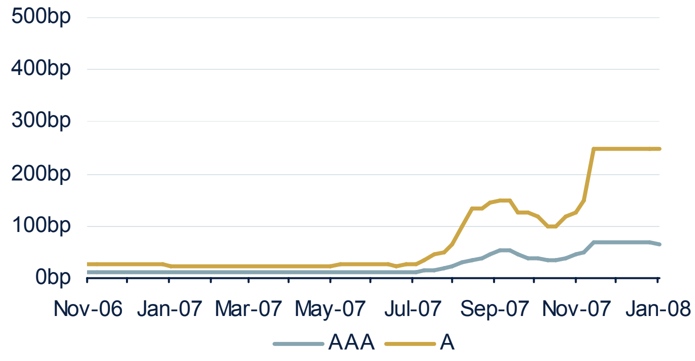
While securitisation indices show flat spreads in Jan 08, in reality spreads have risen further

RMBS spreads bps (5 years)



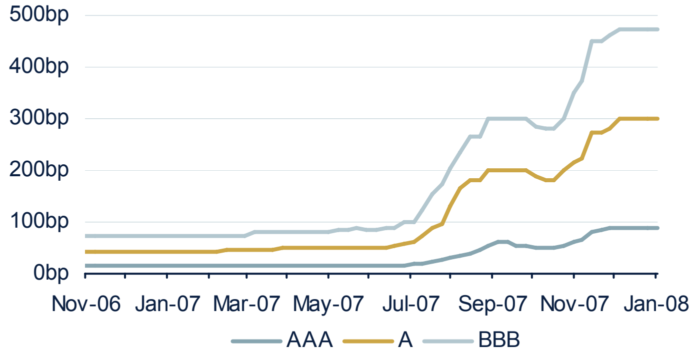
Source JP Morgan European ABS Weekly

Auto loans spreads bps (3-5 years)



Source JP Morgan European ABS Weekly

Credit card spreads bps (7 years)



Source JP Morgan European ABS Weekly

i-Traxx

Source iBoxx

1. Upheaval in the credit markets

1.2 What is the impact on banks?

Capital is king

- The focus for many banks has been and will be on conserving or bolstering capital, through equity issuance, dividend cuts and asset sales
- However, the risk of a big bank failing appears to have receded as in excess of $50 billion (and counting) of capital has flowed into the sector from sovereign wealth funds
- Recipients include Merrill Lynch, Citigroup, Morgan Stanley and UBS

Profits under pressure

- Banks are reducing leverage and taking unwanted assets such as those in structured investment vehicles (“SIVs”) back onto their books
- This is forcing a more cautious approach to lending, which together with the rise in cost of wholesale funding is likely to put the profits of some institutions under pressure
- Investment banks are also facing a slowdown in a number of businesses from M&A to equity underwriting

Equity injections by sovereign wealth fund injections

Date	Bank	Size of investment	Investor(s)
October 2007	Bear Sterns	$1.0 billion	CITIC (China International Trust and Investment Company)
November 2007	Citigroup	$7.5 billion	ADIA (Abu Dhabi Investment Authority)
December 2007	Morgan Stanley	$5.6 billion	CIC (China Investment Corporation)
December 2007	Merrill Lynch	$6.2 billion	Temasek (Investment arm of the Government of Singapore) Davis Selected Advisors
December 2007	UBS	$11.8 billion	GSIC (Government of Singapore Investment Corporation) Undisclosed Saudi Investor
January 2008	Citigroup	$12.5 billion	Government of Singapore ("GIC") Capital Research Global Investors Capital World Investors Kuwait Investment Authority New Jersey Division of Investment HRH Prince Alwaleed bin Talal bin Abdulaziz Alsaud Sanford J. Weil and the Weil Family Foundation
January 2008	Merrill Lynch	$6.6 billion	Korean Investment Corporation Kuwait Investment Authority Mizhuo Corporate

1.2 What is the impact on banks?

Leveraged loans (the elephant in the room)

- The overheated and overstretched European leveraged finance market crashed in late July 2007
- Liquidity disappeared overnight, particularly from the institutional investor, who was the primary source of liquidity for CLO's
- Price volatility spiked upwards, and as the market re-priced credit, unsold legacy transactions became impossible to syndicate in some cases
- European banks are still sitting on some $99billion of unsyndicated leveraged loans. Unlike in the US, very little of this backlog as been cleared since August.
- As secondary pricing of leveraged loan assets continues to deteriorate, banks which are open for business are disincentivised to buy assets in the primary market, even with significant discounts

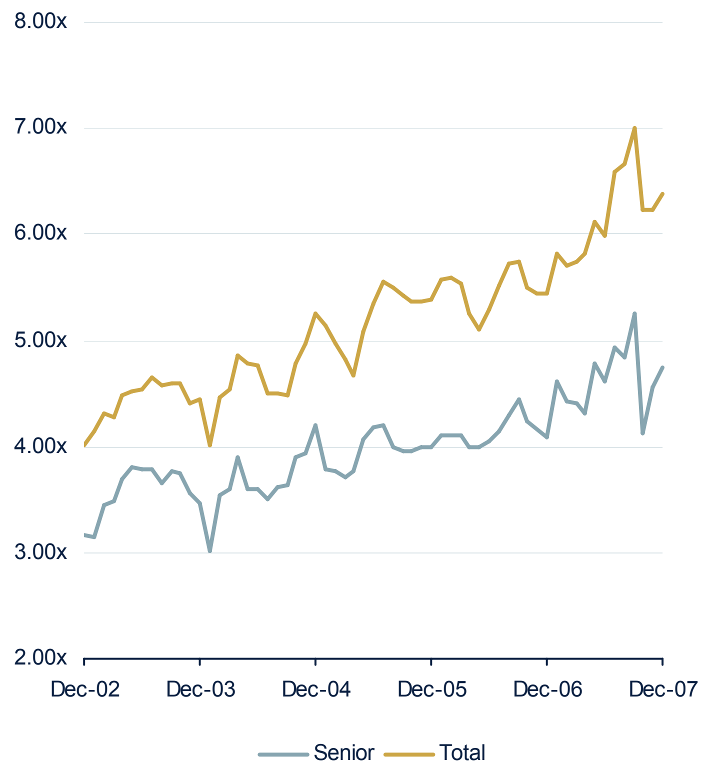
Transactions are selectively underwritten

- Syndication is now focused on traditional bank investors
  - Mid market transactions, which can be underwritten by a club of banks, minimising syndication risk
  - Amortising as opposed to bullet structures
  - Full suite of financial covenants
  - Credit analysis versus distribution analysis
  - Geographic differentiation – banks most likely to support "local" transactions

Which banks are open for business?

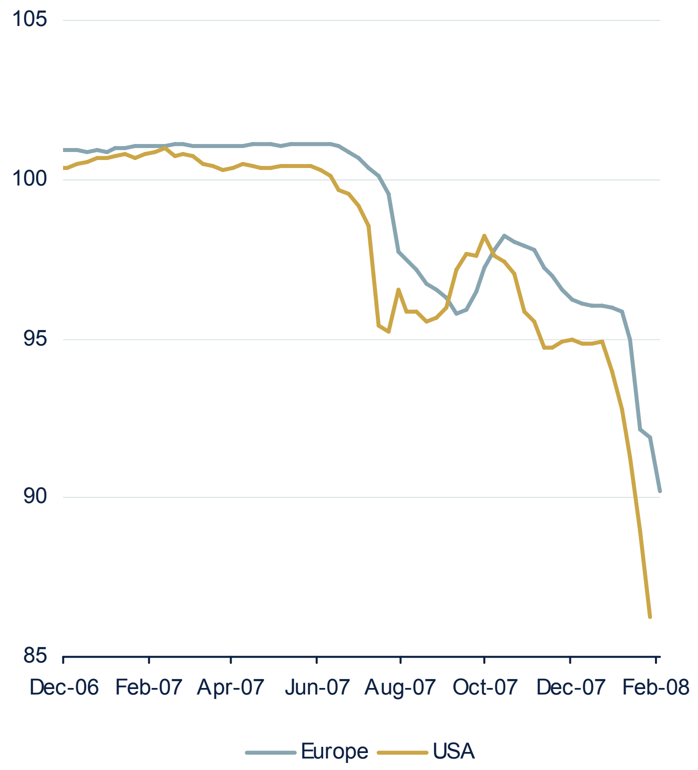
- All banks are to some degree open for business
- However, there are some banks which are under pressure to conserve capital and are only deploying their balance sheet in support of key sponsor or corporate relationships
- On the other hand, there is a meaningful constituency of European banks that are looking to take advantage of current market conditions to extend their corporate franchises

Average leverage multiples



Source S&P LCD

Price of most actively traded leveraged loans (100=par)



Source S&P LCD

2. The impact on corporate borrowers

2.1 The corporate markets are still open; but the parameters have changed

Capital markets

- The investment grade market is still open, but volatility persists
- The high yield market has been closed since July last year
- Activity levels are still extremely low in the investment grade market and bookrunners are sitting on their largest corporate pipeline ever
- The issue in many cases appears to be market rather than fundamentally credit driven
- Investors are still concerned about the ability to appropriately price credit
- This has led to a widening of spreads in the primary market to levels nearly double that of 12 months ago
- Issuers that have chosen to broach the market have done so at generous spreads and relatively short maturities e.g. OTE and Heidelberg Cement

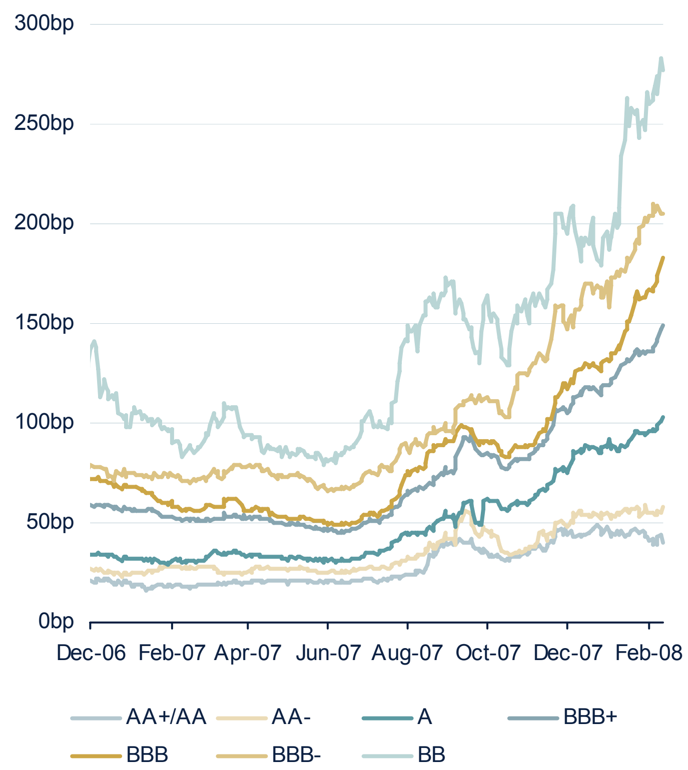
The Eurobond market is gradually opening up, but at wider spreads

Loan markets

- Whilst the credit crunch has had the most severe impact on leveraged finance market, the corporate market has also been affected
- The willingness of banks to provide large (>€500m) sole underwrites is limited for all but the very highest quality borrowers
- Club syndication and "club underwrites" are therefore typical of the market
- Margin and fees have re-trenched at levels approaching 50% higher than those seen in June for medium-sized corporates
- Unlike in the leveraged market, liquidity is not as significant an issue for investment grade borrowers
- Structural protections are becoming more important as banks are looking at assets on a take and hold basis
- Backend (year 4 & 5) amortisation
- Pressure for backend covenant ratchets
- Banks are increasingly looking for assured and higher front-end fees to justify putting time into processing credit applications for what is still seen as a scarce resource

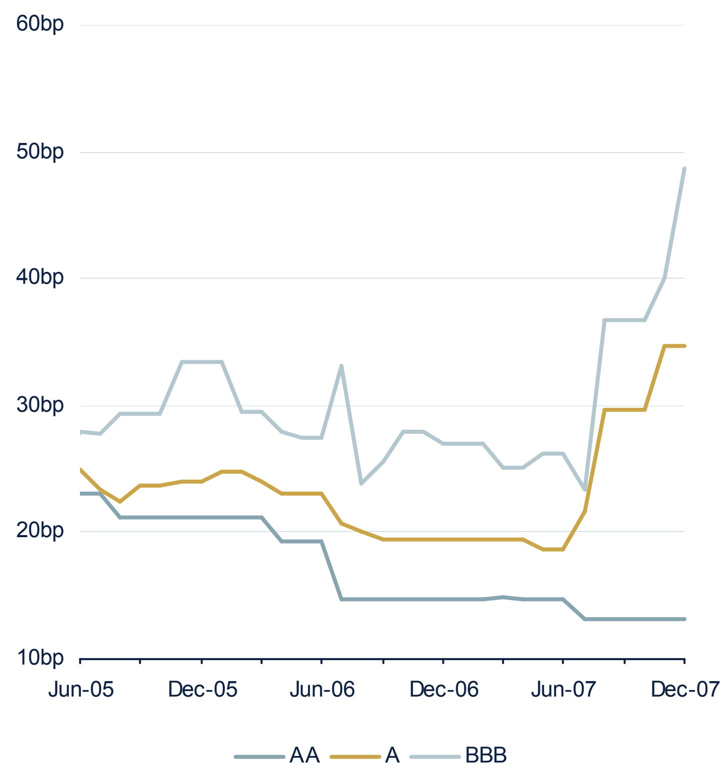
The loan market continues to be active, but the preferred club approach introduces more complexity for borrowers

European bond spreads



Source Bloomberg

European loan spreads



Source LoanConnector

2. The impact on corporate borrowers

2.2 How should corporate treasurers approach financing in 2008?

Start the process early

- This will enable borrowers to test both the bank and institutional markets for best value
- In addition, borrowers should widen their discussions to banks outside of their traditional relationship bank group, targeting those banks which have demonstrable interest in developing new corporate relationships. This takes time, but will offer value

Organise a "borrower led" process

A carefully organised and sequenced debt process is key for borrowers

- Relationship banks are putting pressure on borrowers to organise a club solution on day 1
  - Less competitive tension
  - The risk is that terms are based on the "lowest common denominator"
- Our experience still points to running a competitive process with banks even if a club solution is the ultimate outcome
  - Before awarding any mandate, banks need to be encouraged to maximise credit approved hold or underwrite levels
  - Borrowers should build appetite for more than 100% of the financing requirement
    - Competitive tension is maintained through contract negotiation because you can "afford to lose a bank"
    - But banks themselves are pressing for all-bank meetings to create mutual self-assurance over pricing and structure and underwriting / syndication
- Early credit positioning is key
  - Banks are now looking at long term take and hold positions and fundamental value
  - Borrowers' opportunity to create momentum and appetite among banks

2. The impact on corporate borrowers

2.2 How should corporate treasurers approach financing in 2008?

Be wary of pre-hedging

- The Mitchells & Butler case illustrates the danger of hedging an expected debt transaction in volatile credit markets
- In this case the company took out interest rate hedging in anticipation of creating a sizeable and geared property joint venture. When the debt commitments were withdrawn by banks, the company unwound the position 6 months later at a post tax cost in excess of £270m
- This could cost Mitchells & Butler its independence

The following case studies are good examples of how an organised "borrower-led" process can create value for the borrower

3. Case studies

3.1 UK plc €1,000m refinancing

Transaction highlights

ROTHSCHILD

Advice on raising of a €1bn debt facility to finance an acquisition and refinance existing indebtedness

Oct 2007

- €1,000m multicurrency term and revolving facilities, raised for:
  - Acquisition of Dutch target
  - Refinancing existing debt
  - Enlarged group working capital
  - Firepower for future acquisitions
- Underwritten by 8 banks

Deal characteristics

- Capital structure was a complex legacy from past leveraged acquisitions
- Refinancing was launched on 12 September 2007 during the worst uncertainty of the credit crunch
- Initial market reaction from some relationship banks was that the deal could not be done
- Rothschild advised UK plc to approach a very broad group of European banks due to large debt quantum and limited underwriting appetite
- Rothschild ran a highly competitive process among 15 banks, negotiating terms directly
- Addressing syndication concerns was central to getting underwrites, Rothschild anticipated this and designed the process accordingly

Added value

- Successful completion of one of the largest corporate deals to be underwritten during the credit crunch
- Reduction of more than 100bp in the plc's blended margin, interest savings of more than €10m per year
- Significant additional operational and strategic flexibility, particularly with regard to acquisitions
- Negotiated all key commercial terms with banks on an individual basis to maximise competitive tension
- Put together a pan-European 8 core banking group
  - Maximised certainty
  - Reduced syndication risk
  - Minimised underwriting fees
  - Geographic 'match' for future deals

Independent advice from Rothschild helped UK plc refinance on flexible and competitive terms during highly challenging market conditions

3. Case studies

3.2 Negotiating UK plc £110m multicurrency term and revolving facilities

"Throughout the process we appreciated the invaluable advice of the debt advisory team at Rothschild, who guided us through our largest borrowing to date, in difficult credit markets, to reach a great end result."

Source **Group FD**

The initial approach of the UK plc's sole relationship bank to the transaction was on fully 'leveraged' terms and high pricing

- The initial offer made by the relationship bank included
  - Aggressive pricing, significantly above the negotiated deal (as shown in the chart to the right)
  - Heavy and early amortisation of the term loan
  - Permanent quarterly testing of covenants and quarterly management reporting
  - A guarantee and security structure which would have covered most of the global group, incurring significant cost and administrative burden
  - Generally restrictive and 'bank-friendly' terms imported from the existing facility

Rothschild negotiated a new 'club' facility between the existing bank and two UK clearing banks who were new to the company on more 'corporate' terms

- Rothschild ran a highly competitive process between the banks to maximise value and optimise terms despite current challenging market conditions
  - The best terms offered by each bank were taken to put together the most attractive 'target' terms
  - The threat of being 'cut out' of the deal was used to bring the existing bank into line with the favourable deal negotiated with the other banks
  - Significant additional flexibility (especially around acquisitions) was achieved along with other 'corporate' terms

Significant cost savings were achieved

- Margin and fees savings with an NPV of **£1.5m** were achieved on a facility of £110m

4. Rothschild added value

4.1 Unrivalled debt advisory capability

1 **Leading debt advisory team**

- We do materially more transactions then anyone else and thus have access to more information on terms and appetite across the market – crucial at this difficult time in the market
- Completely independent and unconflicted
  - Can resolve multi-MLA situations where each underwriter is pushing for a different solution
  - Can be used as a buffer for more difficult negotiations with relationship banks (more likely in current market)
  - We are known and trusted by all the leading banks for delivery of fair solutions

2 **Loans**

- Club deals are now the "norm" - this is at best time consuming, at worst a complicated negotiation that needs skill to avoid "lowest common denominator" terms

3 **Bonds**

- We know the bond investors and can have direct, unconflicted conversations with them – lead managers will push for their own solutions in this market

4 **Structured products**

- Rothschild has specialists in securitisation, infrastructure financings, and property financing – structured capital market issues are particularly challenging in the current market

5 **Hedging**

- In the present volatile markets interest rate and foreign exchange risks are amplified – our hedging specialists provide advice across the whole spectrum of hedging and derivatives products

6 **"Leveraged" / "crossover" corporates**

- "Crossover" deals for corporates are particularly challenging given current market conditions – our detailed knowledge of the leveraged market can help corporates achieve the best terms when they are gearing up

Rothschild leverages its market knowledge, creative thinking and transaction experience to deliver the best debt financing packages available for its clients

Selected credentials

BNFL	British Energy	Dublin Airport Authority	Eurotunnel	Canary Wharf Group	Royal Mail	John Lewis
Advice on the restructuring of the BNFL Group arising from the establishment of the Nuclear Decommissioning Agency	Advice to British Energy on debt capital structure options	Advised on capital structure and financing strategy	Advised ad-hoc committee of Eurotunnel's creditors	£726m debt financing and CMBS restructuring	Advised on £1.2bn Senior and PIK facilities	Advising on a capital structure review
Current	**Current**	**2007**	**2004-07**	**2007**	**2007**	**2007**

Tata Steel	Investcorp	Wm Morrison Supermarkets plc	3i / NCP	Group 4 Securicor	Focus DIY Group	British Airways
Advised £6.2bn recommended offer for Corus Group by Tata Steel	Advised on the £325m all-senior refinancing of Welcome Break	Advised on raising of a £1.1bn debt facility	£790m sale of Off-street to Macquarie Infrastructure fund	Advice on US$400m 10, 12 year US$ private placement	Advice on the restructuring and sale of Focus DIY Group	Advised on New Airways Pension Scheme to tackle £2.1 billion actuarial deficit
2007	**2007**	**2007**	**2007**	**2007**	**2007**	**2007**

Marston's	BAA	Liverpool Football Club	Severn Trent plc	Arsenal Football Club	Dairy Crest plc	Red Football Limited
Advised on £330m securitisation tap issue	Independent debt advisor to BAA regarding the £16.4bn acquisition by Ferrovial Consortium	Advising on funding options for its new stadium	Debt financing review for the company	Advised on structure and execution of interest rate hedging in refinancing following 2004 advisory role in £260m debt financing	Advised on the financing of the bid for St Hubert from Uniq for €370m	Independent debt and hedging advice for the acquisition of Manchester United plc
2007	2006	**2006**	**2006**	**2006**	**2006**	**2005**

5. Conclusions and outlook for 2008

1. **We have not seen confidence returning to the credit market in 2008**

2. **The corporate bond markets have re-opened tentatively with issuers having to compensate and woo investors with pricing and covenant concessions to compensate for volatility**

3. **Whilst the bank market is supportive of new transactions, large underwriting positions are reserved for trophy investment grade transactions, for example the BHP/Rio Tinto bid situation**

4. **There are legitimate concerns about a further wave of stress in the financial sector:**
   - The impact of monoline downgrades on the structured finance and credit default swap market
   - The impact of the real economy on the quality of leveraged loans still housed on bank balance sheets

5. **There is little evidence that conditions in the credit markets will improve significantly in 2008, other than through a flight to quality for certain borrowers**

6. **With credit providers in the driving seat for the moment, debt raising should be carefully planned and orchestrated to engender price tension**

7. **Leveraged borrowers will suffer liquidity constraints and we are already seeing increased restructuring activity**

5. Conclusions and outlook for 2008

8 **Corporate borrowers will experience price and covenant pressure**

9 **M&A is the most likely trigger for corporate borrowers to access the credit markets, most having refinanced embedded debt on attractive terms during the credit boom**

10 **Trade buyers will be able to access bid finance more readily than private equity bidders as the leveraged market continues to suffer from an overhang of transactions underwritten during the boom**