

A TURBULENT YEAR:

PREDICTIONS FOR 2008

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Preface

For anybody in the predictions business at the start of 2008, a larger dose of humility than usual is required. Breakingviews didn't do too badly with its crystal ball-gazing in 2007: we warned about the bubble in the US housing market, we said the buyout boom would end in tears, we worried that skewed incentives were encouraging reckless risk-taking, and we predicted global inflation would rise and the dollar fall.

But what no one – at breakingviews or anywhere else - foresaw 12 months ago was the seizure of the inter-bank lending markets for the first time in living memory, the first run on a UK bank for 150 years, the forced write downs of tens of billions of dollars by investment banks that were supposed to have learned how to diversify risk.

That has made for the most inauspicious start to a year for a long time. Conditions in the money markets remain tough. The credit crunch is spreading to other asset classes such as the UK residential and commercial property markets. Consumer confidence is cracking on both sides of the Atlantic. Meanwhile, the geopolitical outlook – subdued for much of 2007 – deteriorated at the end of the year, thanks to events in Pakistan and Kenya, sending oil prices soaring above \$100 a barrel for the first time.

So how will events unfold in 2008? Can central banks halt the credit crunch? Will the dollar continue its slide? Will the US slide into recession? Can emerging markets avoid being dragged down by developed countries? Will some of last year's private equity mega-buyouts blow up? Will hedge funds, which largely managed to dodge the credit crunch bullet in 2007, find their luck finally run out? And what should anxious investment bankers do in 2008 to keep themselves employed and employable?

At BV we anticipate another turbulent year for the global economy. This selection of articles contains our best bet on what lies in store for the world in 2008. No doubt when we look back in 12 months time we will find that some of what we predicted didn't happen, while much of what happened we didn't predict. But I hope you will find all the articles in this booklet stimulating and provocative.

Happy New Year.

Simon Nixon
Executive editor, breakingviews.com

Global Markets

Renminbi-dollar rate will hold in 2008

By Edward Hadas

The time will come for China to let its currency rise substantially against the dollar. But 2008 isn't likely to be the year. It is the euro that will feel most of the pain, again. That's not fair, but the only way to resolve the tension may be a new international currency accord.

Experts have been predicting a major revaluation of the renminbi for years. The 2% increase against the dollar in 2005 was heralded as a baby step to be followed by many bigger ones. But in fact, it has been followed by more baby steps – 4% annually in each of the last two years. Meanwhile, the US trade deficit with China has increased by 30%.

In China, a more valuable renminbi would reduce inflationary pressures, which are currently rising. Cheaper imports from the US would help directly, while a smaller trade surplus would ease the central bank's task of keeping the money supply under control. In the US and eurozone, a big Chinese revaluation would quiet the increasingly loud voices of protectionism.

But China's most pressing economic need is a steady supply of new jobs to employ the surplus labour force in the countryside. That is a more important challenge than improving consumer lifestyles, the main benefit from cheaper imports. And unemployment is a bigger threat to social order than inflation. So a big revaluation, which could make many export-oriented factories uncompetitive, is seen as the greater of two evils.

The desire for a relatively weak renminbi sits uneasily with another Chinese policy goal – to protect the value of the \$1.5 trillion of foreign currency that a steady trade surplus has put into its coffers. Most of that money is held in dollars, which the Chinese, like other US creditors, consider to be a weak currency. But any attempt by China to diversify its reserves will push the dollar down.

But not necessarily against the renminbi. For every sale of a dollar-denominated security, there must be a corresponding purchase in some other currency. The most plausible alternative is the euro. That process helped push the euro up against the renminbi in 2007, leading to increasingly loud complaints from the eurozone. Another increase and more complaints are likely in 2008.

The risk is that Europeans move from complaints to protectionism. But if they are sensible, they will instead push for a longer-term solution. The euro's problem springs from the current global currency system, in which some big trading nations fix the value of their currencies and others allow a free float. That is an inherently unstable arrangement. It becomes even more liable to topple into chaos when some countries run big trade surpluses and others big deficits.

The Chinese, Europeans and Americans could all agree that rapid changes in

currency values are a threat to everyone's prosperity. In the past, such thinking has inspired the world's big trading countries to establish more orderly systems for managing foreign exchange – the gold standard before the First World War, the Bretton Woods agreement after the Second World War and the Plaza Accord arrangements in the 1980s. Perhaps it is time for a new currency accord.

Published 02 January 2008

Treasury yields much too close for comfort

By Edward Hadas

Context news: *US two-year Treasury bonds were yielding 3.3% on Monday December 17. Up from 3.1% last Tuesday. For 10-year bonds, the yield rose from 4.1% to 4.2%.*

The US consumer price index, the leading measure of inflation, increased by 4.3% in the preceding twelve months.

Considered view: US government debt looks like a real non-bargain, even after last week's slight increase in yields. At 3.3%, two-year notes earn a full percentage point less than the current rate of US consumer price inflation. And with Alan Greenspan, still an uber-guru of finance, calling for a government bailout of troubled US borrowers – surely a sign that inflation-fighting is a low priority – why would anyone want to accept a meagre 4.2% yield over 10 years?

There's not much of a fundamental investment case. Normally, bond investors expect a return 2% or so higher than the rate of inflation. Right now they are getting less. To make current yields investor-friendly, the US economy will have to stall out for a good long time – against the will of the Federal Reserve Board and every US politician. At best, the small negative return on offer might not look too bad in comparison to the competition – stocks, commodities and real estate.

So why are yields so low? The best explanation for the recent fall – both 2-year and 10-year paper were yielding 5% in June – is technical. The losses and revaluations of the credit squeeze have created a shortage of capital at many US banks.

The main response is to use any cash from maturing loans to buy Treasuries. That makes sense under bank capital regulations, since government bonds don't require any capital backing. The rule is hard to justify, since government bonds are at risk from inflation, but the banks play by the rules. The same shift in bank portfolios has depressed European bond yields.

This technical pressure could persist for a while. But investors won't put up with low yields forever. With the dollar under pressure, foreign buyers of US

Treasuries could be the first to go on strike. Banks might then choose to reduce leverage further, rather than buy bonds at risk of losing value.

Where should US yields be? Inflation is above 4% and the yield on 10-year US inflation-protected bonds is just below 2%. That suggests that something like 6% is about right.

Published 17 December 2007

Wanted: a US president who can help the economy

By Edward Hadas

Context news: *The US primary season is in full swing. The Iowa precinct caucuses were January 3 and the Florida primary on January 8. Michigan, Nevada, South Carolina and Florida were due to vote later in January, before a "Super Tuesday" on February 5 in which 16 states on the Democrat side and 11 on the Republican side were to hold primaries, including California and New York in both cases.*

-With reporting by Elizabeth Eldridge.

Considered view: Investors argue about politics, but they should be able to agree on the upcoming US presidential election. None of the leading candidates show much economic common sense.

Start with the subprime mortgage crisis. Insofar as the Democrats have any policy suggestions, they all involve helping more underwater buyers float to the surface – ultimately at the government's expense. But no Republican candidate has shown any firmness either. It looks like the currently proposed "teaser-freezer", a plan to keep interest payments at what were supposed to be introductory rates, is just a first step.

Even if the US government avoids additional mortgage subsidies, an economic slowdown would cause the fiscal deficit to balloon. The candidates' response is basically, "What, me worry?" The Democrats are busy making unrealistically low estimates of the cost of extending health insurance, while the Republicans are anxious to keep the Bush tax cuts in place.

Another non-worry for the candidates is inflation. No presidential candidate ever speaks on the topic. The mantra seems to be growth at any cost, including a bit more inflation. With the Federal Reserve Board on much the same wavelength, investors should be wary.

Then there is the trade deficit. In another era, politicians would be jumping up and down at the thought of the world's industrial superpower importing 45% more than it exports.

But there is no political talk of industrial regeneration or of ways to encourage

savings and investment. Instead, low interest rates are praised and candidates vie to frighten the trading partners – and creditors – of the world's super-debtor. As long as the US doesn't appear to be serious about reducing the trade deficit, the dollar remains vulnerable.

Bill Clinton won two elections by remembering that for voters, "It's the economy, stupid". The 2008 candidates are taking that advice to heart – by saying stupid things about the economy. If the next president stays true to his or her word, then investors should bet on higher government deficits, higher inflation and a weaker dollar.

Published 12 December 2007

UK binge yields to festive fear

By Ian Campbell

Context news: *The Council of Mortgage Lenders reports that gross mortgage lending was £30.7bn in November, down from £33.5bn in October and £33.2bn in November 2006. The CML's director general, Michael Coogan, said: "We welcome the recent initiative by the Bank of England with other central banks to inject liquidity. This support needs to continue, and be increased, in the coming months."*

In its monthly distributive trades survey, the Confederation of British Industry (CBI) said that 42% of firms reported higher sales volumes in the first half of December compared with a year earlier, while 33% said sales had fallen. The balance of +8% is down from November's +13% and the worst since November 2006. In January more retailers expect sales to be down than up: the balance of -5% is the first negative one since April 2006.

The Bank of England cut the benchmark bank rate by 25 basis points (a quarter of one percent) to 5.5% on December 6. The Bank's provisional estimates of M4 money growth in November show broad money to have grown by just 0.1% from October. The annual growth rate in M4 fell to 11.1%, down from 11.8% in October.

Considered view: As 2007 ends and a new year approaches few economies look less festive than the UK's. Years of excess and dependence are its problems. Its health has suffered, and all the charts show it. The price will be paid in 2008.

The excess has been in house prices, money growth and government spending that has been unregulated — unlike almost everything else in red-tape Britain. Economic growth has been dependent on consumers drunk on high house prices, over-ready to borrow and spend. The pound, too, has been on a high, the highest level in 26 years against the dollar. Over this island of excess presides a government that prates of prudence — and borrowed £11.2bn in

November, the most for seven years.

The trade numbers go one better: at their worst for eight years. They reflect consumers' wolfing of imports and the strong pound's restraint of exports. The current account deficit was £20bn in the third quarter, equivalent to 5.7% of GDP, the highest proportion since 1989.

But all binges must come to an end. The charts show this one has begun to. The consumer, no longer house-proud, seems to be stalling. One third of retailers sold less in the first half of December than a year ago, according to the Confederation Of British Industry.

Crunching winter credit is a part of it. Oodles of money have become mere flakes. Broad money growth is plummeting, rising by just £300m in October and November combined: less than a quarter of the August rise.

Mortgages no longer fly off the shelves. Mortgage lending was £30.7bn in November, down by 7.5% from a year earlier. Which means that house prices, the very source of the binge, will keep falling.

What can be done? The Bank of England is proffering more liquidity to alleviate the withdrawal symptoms. It's likely to provide another rate-cut draught on January 10 — and probably yet another in February. Those moves won't be enough to get the party going again, especially as that prudent government, having racked up a deficit during the good times, when revenues poured in, is going to have to tighten in bad ones.

These binges tend to end messily. It always takes a long while to clean up.

Published 21 December 2007

Lucky Mervyn King likely to hang on to job

By Simon Nixon

Context news: *The head of the British Bankers Association said that UK bankers would be happy to see Mervyn King reappointed as Governor of the Bank of England in 2008. The chancellor of the Exchequer, Alistair Darling, must decide whether to offer King a second term by May.*

The odds on King keeping his job were 1/5, according to bookmakers Cantor Index. Other candidates included Paul Tucker, Bank of England markets director, at 7/1, and the two deputy Governors, John Gieve and Rachel Lomax at 10/1 and 12/1 respectively.

Considered view: Mervyn King has had a dreadful year. The Governor of the Bank of England has been widely blamed for failing to spot the severity of the credit crunch, failing to respond adequately to the pressures in the banking

system that led to the collapse of Northern Rock, and failing to push hard enough for a market solution to Northern Rock when it failed. Yet despite all this, the bookies reckon King is a shoo-in to be reappointed to his job in 2008. They are probably right.

King's fortunes have turned around since the autumn, when much of the City and Westminster seemed to be clamouring for his head. This is partly because the man who must decide King's fate, chancellor of the Exchequer Alistair Darling, has seen his own credibility crumble faster – both as a result of his own role in the Rock debacle and several bungled tax initiatives.

People may suspect King is an ivory-tower academic with no feel for markets. But they trust him more than a politician with little understanding of finance and a tendency to make policy on the hoof. If Darling were to make King the scapegoat for the Rock without falling on his own sword, confidence in Britain's financial framework would take another knock.

King's position also looks more secure because, following last week's rate cut, he has won back some support in the City. The British Bankers Association says there is no problem with King getting a second term. The risk is that, with his reliance on City support, he has now become a prisoner of the markets – never a good position for a central banker to be in.

Published 12 December 2007

Oil prices should ease with 2008

By Cyrus Sanati

Context news: *Crude oil futures on the New York Mercantile Exchange nearly doubled in 2007. A barrel of West Texas Intermediate crude traded at \$50.48 on January 18th and steadily climbed to reach \$98.18 on November 23rd. After falling briefly, prices rallied in the last week of the year, pushing oil prices as high as \$96.70 on December 27.*

Considered view: If simple supply and demand determined the price of oil, it should never have hit \$99 a barrel this year. Higher prices have kept demand growth moderate, and there was enough supply this past quarter to keep inventories at 83 days of demand. That compares to 79 days in 2002, when prices averaged \$26, nearly a quarter of the current price.

Simple analysis of supply and demand suggests a lower oil price in 2008. Demand is expected to increase by 1.2m barrels of oil per day, according to Opec. That's less than it might be. A government-mandated 10% increase in fuel prices is tempering Chinese consumption growth, and higher prices and reduced subsidies should have a similar effect elsewhere.

Meanwhile, supply should easily keep up with demand. Recurrent fears of a

major disruption of Middle Eastern supply have as yet come to absolutely nothing. War with Iran looks highly unlikely given the latest US intelligence report that says the Islamic republic gave up its quest for nuclear weapons years ago. Meanwhile, Iraqi oil production has surpassed its pre-invasion level for the first time and is expected to grow further in 2008. Outside of the Middle East, non-Opec production is expected to rise by 1.1m barrels a day – 57% higher than last year.

That analysis is much too simple. But the most obvious complication – economic growth that is slower than currently forecast – also points in the same, downward direction. The average of 35 forecasts of the average 2008 crude oil price is \$75 per barrel, according to Oppenheimer. That is \$5 above the expected 2007 average. But if the prediction comes true, 2008 will feel like a down, since the average will have been nearly 20% below the New Year price.

But of course there is more to the oil price than supply and demand. There are the financial players, who control a sizeable but unknown share of current inventory. And there is the cost and availability of credit, which determines how easy it is for customers and speculators to bid up the price.

Credit seems to be tightening everywhere. If financial conditions stay tough, the next oil price surprise just might be the speed of its decline. That would make current price forecasts look optimistic. But it would verify an earlier set. In June 2007, Consensus Economics found the average forecast for June 2008 of \$63 a barrel.

Published 26 December 2007

Political risk won't be so easy to ignore in 2008

By Simon Nixon

Investors were too focused on enjoying the boom to worry much about political risks in 2007. At a time when greed, rather than fear, is the overriding emotion, people tend to focus on opportunities rather than threats. But political risks may not be so easy to ignore in 2008. Not only does the assassination of Benazir Bhutto serve a grim reminder of the fragility of global security. But it comes at a time when the credit crunch is already triggering a much-needed repricing of other forms of risk.

If investors are in a mood to be fretful, there's plenty to fret about. Perhaps the most worrying aspect of the Bhutto killing is the signal it sends about the limits of US power. Bhutto's return to Pakistan was part of a US-brokered plan to shore up the position of President Musharraf while providing a check on his power. Now the US is left without an alternative. America's failure to secure its objectives in Pakistan – and its inability to protect its ally – is sure to have been noted in other global hotspots.

This spills over into the economic arena in all sorts of ways. Most obviously, fears that political instability will spread to other countries or even spill over into war point to higher oil prices, a flight to safer assets such as government bonds and a retreat from riskier assets such as equities. Meanwhile, heightened security fears could fuel protectionist sentiment around the world. Support for free trade appears to be waning in the West, reflected in the mounting backlash against sovereign wealth funds and the increasingly slim prospects for success in the Doha trade talks.

That inevitably focuses attention on what is sure to be – events in Pakistan aside – the key political event in 2008: the US presidential election. So far in the primary campaigns, security issues have not figured highly, but most of the candidates have sounded lukewarm on free trade. That's worrying. Current global prosperity is based on free trade backed up by US security. An American retreat on either score would have profound economic consequences.

Published 28 December 2007

Emerging market equities will suffer in 2008

By Martin Hutchinson

Context news: *The Morgan Stanley Capital International Emerging Market Share Index on December 12 was up 39.4% in 2007, following a 32.1% rise in 2006, a 34.0% rise in 2005, a 25.6% rise in 2004 and a 55.8% rise in 2003. This compared with 9.4% in 2007 for the MSCI Developed world index and a 6.4% return for the Morgan Stanley Emerging Market Bond Index.*

According to the World Bank's International Comparison Program published on December 17, developing countries were responsible for 40% of world GDP, measured at purchasing power parity. China was the world's third largest economy with 9% of the world's output and India its fifth largest economy with 4%.

The IMF estimates developing country growth at 6.7% for 2007, following a growth rate of 7.3% for 2006.

Considered view: Emerging stock markets have had five very good years. But don't bank on them enjoying a sixth. A combination of tighter credit conditions and rising domestic inflation will make life much tougher for companies in many developing countries in 2008. The two biggest emerging markets – China and India – have more downside potential than upside. One of the few candidates to outperform in the year ahead is South Korea.

Over the past five years, high world liquidity – whether caused by rapid US money supply growth or by a world “savings glut” – produced rapid worldwide growth and a commodity price boom. These enabled debt-ridden countries like Brazil and Argentina to escape from their trap, while helping rapidly growing

economies like China and India to finance their extraordinary economic expansion.

This has become too good to last. The US subprime mortgage crisis, while it has not affected emerging market credit directly, has forced international banks to reduce their off-balance-sheet assets and lowered the appetite of both capital markets and banks to absorb new debt. This will reduce the flow of funds to emerging markets, particularly those heavily dependent on foreign lending such as Turkey, Brazil and Indonesia.

The two largest emerging markets, China and India, have their own problems. In China, the government is increasingly determined to tighten liquidity, which is already resulting in dwindling investor enthusiasm for thinly traded Chinese stocks. In India, the public sector deficit is expanding, with spending up 28% in the first seven months of the 2007-8 fiscal year. In both countries, inflation is well above official targets. Thus both markets seem likely to be weak in 2008.

To outperform in 2008, a stock market must be reasonably valued, its domestic economy must have high liquidity and its growth trend must be positive. One such market is South Korea, which currently trades on a multiple of around 14 times earnings and also benefits from positive political risk. The outgoing anti-business government of Roh Moo-hyun has been replaced by the pro-business Grand National Party, and new President Lee Myung-bak has vowed to return the country to its traditional 7% growth. In Korea at least, the upside outweighs the downside.

Published 21 December 2007

Emerging market debt: a safe haven for 2008

By Simon Nixon

At times of political and financial risk, investors want safe havens. Traditionally, there was no safer haven than US government bonds. Investors are clearly betting they will prove so again: T-bond yields have tumbled as the credit crunch and events in Pakistan have spooked the markets. But T-bonds can't offer protection against the biggest financial risk in 2008: a major devaluation of the dollar. Global investors would do better buying local-currency denominated emerging market sovereign debt.

Emerging market government debt may seem an odd alternative to investors scarred by memories of the financial crises of the late 1990s. But consider the strides made by many emerging market countries since then: thanks to currencies pegged to the dollar at competitive levels, many, including Russia and China, have built up huge trade surpluses and accumulated vast reserves that dwarf those of Western governments. In terms of default risk, some of these countries are now better credits than many in the developed world.

Liquidity risks have been reduced too. Domestic economies are booming and saving rates are very high. That has allowed the creation of deep, increasingly liquid local-currency denominated bond markets in many countries. That means they are no longer so reliant on the international hot money whose sudden withdrawal was so devastating in the 1990s. This time it's the US that is most at risk from the withdrawal of international hot money – particularly as it cuts interest rates to halt a slowdown.

Of course, no emerging market will be entirely immune to a global slowdown. But the pace of domestic growth and the boom in intra-regional trade provides a fair degree of insulation. Indeed, the bigger problem could be keeping domestic economies in check as the impact of US rate cuts triggers further monetary easing in emerging markets. That in turn will lead to pressure on currency pegs, offering international investors the prospect of a potential juicy revaluation.

Some investors worry that emerging market government bond spreads are already very tight, having fallen to little more than 200 basis points over US T-bonds in some cases. But that is to look at the world the wrong way round. The real story is that emerging market bonds offer solvency, liquidity, currency upside – and a premium.

Published 31 December 2007

Venezuela's "strong" bolivar is likely to weaken

By Martin Hutchinson

Context news: *On January 1, Venezuela introduced the "strong bolivar" (currency symbol: VEF) by dividing previous bolivar figures by 1,000. The official exchange rate before the change, set in 2005, was Bs. 2,150 to the dollar; the unofficial "parallel" exchange rate was around Bs. 5,700 to the dollar.*

The country's balance of payments surplus in the third quarter of 2007 was \$3.9bn, compared with \$7.5bn in the third quarter of 2006.

Venezuelan consumer prices rose 3.3% in December 2007, to give a year-on-year inflation rate of 22.5%, up from 17% a year earlier.

Considered view: Venezuela's creation of the "strong bolivar" on January 1, its first currency re-denomination since 1879, will not provide its citizens with a stable currency. Underlying realities speak against it: prices rose 22.5% in the year to December 2007, state social spending is budgeted to be up 61% in 2008, and the black market bolivar/dollar rate is three times the official rate.

Currency re-denominations are common in Latin America, often alongside hyperinflation. Argentina, for example, underwent four in 22 years, in 1970, 1983, 1985 and 1992. But runaway inflation normally occurs in economies suffering from balance of payments problems, with the local currency declining

precipitously against the dollar. Venezuela, as a major oil exporter controlling the world's largest reserves in the Orinoco tar sands, ought to be immune.

Unfortunately, the Venezuelan government under Hugo Chavez is testing the limits of that immunity. It raised social spending 37% in 2007 and is planning a further 61% increase this year. While oil prices keep rising, Venezuela's balance of payments will remain positive. However, net foreign direct investment outflows of \$2bn in 2007 – a year in which massive international funds flows should have benefited a country with such huge oil wealth – suggest a complete lack of international confidence in Chavez's economic management.

Certainly the black market distrusts Chavez. While the official bolivar exchange rate (before allowing for the re-denomination) has remained at 2,150 to the dollar since 2005, the unofficial market is trading around 5,700. Venezuelans, allowed to spend \$5,000 abroad on their credit cards and pay at the official rate, are taking trips to Curacao, buying casino chips on credit, cashing the chips and selling the dollars on the black market for a profit of more than \$8,000 per trip, less travel costs and commissions.

The most serious hyperinflation ever recorded was in the Hungarian pengo between 1927 and 1946. There was no re-denomination until July 1946, when each newly introduced forint replaced 4 followed-by-29-zeros-worth of pengos. That's a record unlikely to be beaten. But while Chavez remains in charge, Venezuela will continue sliding towards traditional Latin American hyperinflation.

Published 02 January 2008

Finance

The ghost of credit future will deliver grim tidings

By Dwight Cass

If the ghost of credit past spirits you back to the Wall Street of one year ago, the boom you'll encounter will make today's market malaise look downright Dickensian. Bankers and investors may hope that the scale of the credit losses already disclosed – which run into the hundreds of billions of dollars – means most of the pain is over. They're being too optimistic. The ghost of credit future will bring tidings of worse to come.

The ghost of credit past, like his counterpart in the Dickens story, is the most merry of the three. His tour of the market of a year ago will show banks' and mortgage brokers' originate-and-distribute models humming along nicely, driven in large part by appetite from structured finance vehicles that were blessed by ratings agencies and gobbled up by investors who suspended disbelief in exchange for yield.

The ghost of credit present paints a far bleaker picture. Massive losses have brought investor disbelief – in the ability of ratings agencies to evaluate, and brokers to provide a liquid market for, complex credit investments – back with a vengeance. Banks are strapped for capital. Debt is hard to obtain.

But for the markets, as it was for Scrooge, the ghost of credit future will offer the scariest view. Credit woes could linger for years. Take the market for corporate loans. Banks hurt by their guarantees to supposedly low-risk structured investment vehicles are now loath to extend lines to other complex instruments, like collateralised loan obligations which package up loans and slice them and dice them to sell to other investors. These provided the bulk of loans to high-risk companies during the buyout boom.

To secure credit, CLOs will need to prove they can sell off their toxic equity tranches. But investors aren't biting. CLOs won't recover until appetite for risky, illiquid and opaque investments rebounds. Since investors are still taking a beating from US housing woes and subprime defaults, it's unlikely they'll be lining up for that sort of risk any time soon.

In the absence of CLOs, banks will once again become the main lenders to weak companies. But since the late 1990s, they have scaled back the amount they lend because loans suck up regulatory capital and, on a risk-adjusted basis, don't make much money.

Banks are even less eager to lend to iffy borrowers now, after getting stuck with billions of dollars worth of buyout loans no-one wants to buy. To convince banks to put some skin in the game, borrowers will have to pay higher rates. That will continue to curtail big-ticket, highly leveraged buyouts. And shutting the cheap refinancing option that has kept armies of zombie companies alive in recent years may tip many into default.

Those hoping that clever prop traders will find gold among this dross will also be

disappointed. Yes, Goldman Sachs made money on some audacious housing shorts. But everyone now wants to do the same, so no-one can. Sure, fleet-footed traders may exploit small dislocations between the stocks, credit default swaps and debt of stumbling companies. And specialised distressed credit funds may find rich pickings among the walking wounded. But for banks, these gains will pale in comparison with losses on mortgages, CDOs and buyout loans.

Finally, banks will be ladling much less alphabet soup than they did a year ago. Products largely depending on gaming the ratings agencies, like CDOs packed with other CDOs (so called CDO-squareds), constant proportion debt obligations (essentially highly leveraged credit index bets) and new vehicles stuffed with commodity or foreign exchange risk, will find few takers until the ratings agencies prove they know how to evaluate them.

Dickens' miser was sufficiently horrified by his view of the future that he mended his ways and changed his fate. But credit's redemption requires more than the gift of a turkey. Unless the current malaise teaches Wall Street to restrain its greed, investors and counterparties are unlikely to believe its fables. Until then, the credit market's future looks downright scary.

Published 17 December 2007

Default rates likely to rise sharply in 2008

By Simon Nixon

Context news: *US high-yield bond defaults could hit 5.5% by the start of 2009 – up from 1.3% in 2007, according to Citigroup. The main driver of Citi's forecast was a sharp widening of spreads on new loans to large and medium firms, as shown in the Federal Reserve quarterly survey of lending conditions.*

Recent predictions of higher default rates have proved wide of the mark. In 2006, Standard & Poor's forecast default rates would rise to 2.5% by the end of that year and 4% by the end of 2007. Moody's predicted defaults of 2.7% in 2005, 3.3% in 2006 and 2.6% in 2007. The actual outcome was only 1.9% in 2005, 1.3% in 2006 and 1.3% in the year to September 2007.

Considered view: Could 2008 be the year that default rates finally pick up? Ratings agencies such as Standard & Poor's and Moody's have predicted problems in the corporate credit markets for each of the last three years – and been proved wrong each time. In 2007, US high-yield defaults were close to record lows at just 1.3%. But undaunted, Citigroup now predicts default rates will rise to 5.5% by 2009. Europe probably won't be that different.

Clearly there was a problem in the statistical models used to predict default rates in the past. The main variables in these models typically include GDP growth, the Federal Reserve quarterly survey of lending conditions, which

shows the net percentage of banks increasing spreads on new loans to large and medium firms, and the slope on the interest rate curve. Using historical data, these variables show good predictive powers. So why did the models break down during the credit boom?

The answer may be the remarkable loosening in credit standards during the boom – typified by the widespread use of covenant-lite loans – which the models failed to pick up. These leveraged loans abandoned traditional maintenance covenants for more flexible terms that only required borrowers to meet stress tests when they wanted to take particular actions, such as pay a dividend. The result was to give issuers much greater flexibility, enabling them to avoid default.

Quantifying such flexibility is a bit tricky. But Citi has found a way by looking at the LBO loan market, which saw a similar decline in lending standards to the bond market. The bank measures the "headroom" a borrower has to increase its leverage at the time a loan is taken out as a ratio of ebitda. This headroom expanded rapidly in recent years, delaying the day of reckoning. Citi's new model fits not just the long-run data well but more recent history too.

Unfortunately, the model does not offer investors much comfort for the year ahead. It shows US high-yield defaults picking up sharply to 5.5% by 2009. The key driver is the tightening of spreads shown up by the Fed Lending Survey. Optimists may point out that company balance sheets do not look particularly stretched. But many borrowers kept their interest costs down during the boom by refinancing to take advantage of lower rates. That option is no longer available, so interest costs may start to rise, leading to higher defaults.

Worryingly, Citi's gloomy forecast is only based on Fed Lending Survey data to the end of September 2007. The next survey is likely to be a lot gloomier if a similar report from the Bank of England, out today, is anything to go by. And although Citi assumes further US interest rate cuts, it does not assume the US slips into recession. That suggests that if spreads continue to widen or the US economy deteriorates further, the actual outcome may even be worse.

Published 03 January 2008

Private equity, like the Chinese zodiac, goes from pig to rat

By Lauren Silva

The Chinese calendar will soon cycle into the year of the rat. Buyout barons are also set to scoff less from the trough than in 2007, the year of the pig. The dealmaking architects of more than \$700bn in takeovers are now on the sidelines. Restructuring teams will be left to nibble on the leftovers.

Excess was the watchword for much of 2007. In February, Sam Zell's auction of Equity Office Properties eventually handed Blackstone the biggest buyout ever.

Other huge deals followed, including Kohlberg Kravis Roberts' \$43bn buyout of TXU. Along the way, Blackstone chief Steve Schwarzman took his firm public, capturing – fleetingly – a valuation of \$33bn and attracting unflattering public attention for the industry.

The party fizzled abruptly in August when previously over-lubricated credit markets seized up. Next year private equity firms will be starved of deals. New lending will remain scarce. Mega-deals will be replaced by small to mid-sized buyouts. Some private equity firms will probably go directly to hedge funds rather than banks for loans.

Lacking outright purchases, buyout firms will take minority stakes in public companies, as Providence tried with Sprint Nextel. Expanding portfolio companies with add-on strategic acquisitions could become more popular.

A few prominent private equity firms could fall off the map. Two well-known buyout groups during the dotcom boom, Forstmann Little and Hicks Muse, lost out in the bust and haven't really bounced back. The credit crunch could also knock holes in the industry.

Returns are also likely to fall. Buyouts last year were at top-of-the-market prices. Some analysts now expect a recession. That's not good for highly-leveraged companies. Cashing out will be harder, and valuations will fall. Eventually, this could even lead to pressure from investors to cut fees.

The backlash triggered by Schwarzman's conspicuous 60th birthday party could continue. Stress in portfolio companies could bring job losses or bankruptcies. That in turn could intensify the scrutiny of private equity, and precipitate higher taxes for its ultra-wealthy practitioners.

But it won't all be doom and gloom. Nimble firms could thrive on plentiful bargains. Some – publicly traded Blackstone, say – might even be able to expand by scooping up struggling smaller managers. Above all, though, the coming year could mark the beginning of a rat race for restructuring and turnaround teams.

Published 27 December 2007

Which buyout is most at risk?

By Dwight Cass and Lauren Silva

Context news: *Sam Zell's \$8.2bn buyout of Tribune closed on December 20. After the close, the company will have over \$10bn in debt.*

It cost \$1.8m to insure \$10m of Tribune debt against default for five years in the credit derivatives market on December 21.

Considered view: The bankruptcies of Revco and Federated heralded the end of the 1980s buyout boom. Traders and lenders are starting to wonder which of this year's crop of monster LBOs will become the busted bellwether of the current downturn. One hint – the guy who bailed out Revco two decades ago, Sam Zell, is backing what appears to be today's biggest potential time-bomb.

Of course, when confronted with parallels between the bloody end of the 1980s buyout boom and the today's larger binge, dealmakers tick off how things have changed. Deals, they say, have less leverage, and are subject to fewer restrictive debt provisions.

That's true – up to a point. But buyout shops' attempts to wriggle out of deals from Sallie Mae to United Rentals shows they realised they were overpaying, much like their 1980s predecessors. And the shutdown of the junk market in 1989 looks like a smaller version of today's global credit crunch.

It's difficult to pick the next Revco or Federated, though not for lack of choice. Cerberus's Chrysler faces declining demand for its iffy product line and is selling assets to raise cash. Lenders have twice snubbed a \$10bn loan supporting its buyout. Blackstone's Freescale Semiconductor is highly leveraged, and struggling Motorola remains one of the cyclical chip business's biggest customers.

Then there's Apollo's Realogy, which runs residential real estate brokerages. It was one of the first deals to suffer push-back from lenders, who demanded more interest on a loan backing its buyout way back in March, when lenders were throwing money at other deals.

Wall Street is placing bets against those and a number of other big deals – Clear Channel Communications, Univision, ServiceMaster and US Foodservice among them – by aggressively hedging their risk of default in the credit derivatives market. But the big buyout that credit traders see as most risky is Sam Zell's acquisition of Tribune. Indeed, after the deal closed, credit traders asked a staggering \$1.8m to insure \$10m of Tribune debt against default for five years. To do the same for New York Times debt cost only about \$81,000.

They've got good reason to worry. First, Tribune's core media business is facing an industry-wide decline in advertising revenues, which could be exacerbated if there is a recession. Zell believes he can increase Tribune's revenues, despite this.

Then there's the leverage. The company will have over \$10bn of debt after the acquisition. Its forecast ebitda for this year is \$1.2bn and is expected to fall slightly over the next two years, according to Factset. That has to support debt service that could be as high as \$900m, assuming a blended interest rate of 9% on its various loans.

Lenders have become increasingly antsy about Tribune's loans, although Zell says the company has a significant cash-flow cushion and it will be able to service the debt. Despite these assurances, the \$5.5bn term loan issued in May at 99.25 cents on the dollar had fallen to about 85 cents after the acquisition

closed on December 20, according to S&P Leveraged Commentary & Data.

Finally, Zell has limited exposure to Tribune's fortunes. He's only injecting \$315m for a note and a warrant for 40% of the company's equity. Until then, it's owned by the employee stock ownership plan. So Zell has a lot less skin in the game than buyout shops have in other mega-deals, where equity can account for as much as 30% of the price tag. If Tribune's business hits the skids, Zell has less economic reason to bail it out.

Of course, betting against Sam Zell has usually proven to be a bad idea. His turnaround expertise and eye for diamonds in the rough are legendary. After all, he helped turn around embattled drug store Revco – one of the first LBO flame-outs. But the Grave Dancer – who jokingly called Tribune “the deal from hell” at a press conference held to announce its close – now faces an uphill battle.

Published 02 January 2008

Hedge funds face funding squeeze in 2008

By Simon Nixon

Context news: *Three month Libor rates stood at 1% above official bank rates in the UK on December 18.*

The HFRI weighted average index of hedge fund returns was up 10.2% in the year to the end of November.

Considered view: Most hedge funds will look back on 2007 with satisfaction at having so far navigated the credit crunch. But next year could be much tougher. The key challenge will be to secure financing on competitive – or any – terms. With banks facing much higher funding costs themselves, as well as multiple demands for their scarce capital, that is not going to be as easy as it has been in the past.

Most hedge funds use borrowed money to juice up their returns. The average leverage across the industry is just under two times assets under management. But leverage varies considerably between strategies. Equity long/short strategies – the most common – use very little. But many arbitrage funds employ much higher leverage. This financing is typically provided by prime brokers, either as a debt facility or via the repo financing of specific assets or portfolios. Much of it is short-term, with terms rarely extending beyond 90 days. And often, banks can change margin requirements, or interest rates or the amount of finance available at whim.

Until August, competition between prime brokers was so fierce that hedge funds had little trouble securing generous funding on very attractive terms – typically just a few basis points over Libor. Few banks made money lending money on these terms. Some hoped that prime brokers would bring business to other

areas of the bank. But most relied on bullish predictions of market share gains to justify the expense.

Those arguments look much harder to sustain at the end of 2007. Three month dollar Libor stands at nearly 75 basis points above the Fed funds rate. Broker dealers, in particular, which fund themselves in the wholesale markets, face their own financing difficulties. Higher funding costs must eventually be passed on to clients. That will inevitably hit hedge fund returns. At the same time, some banks may conclude there are more profitable ways to deploy scarce capital and shut up shop – or scale back.

Hedge funds got a foretaste of this in August when several prime brokers changed their margin terms. But since then, banks have largely continued to indulge the industry. That's partly because it takes time for higher wholesale funding costs to work through the system. Some banks may also fear reputational damage if they pull back from prime broking. More importantly, banks have also been lending hedge funds money to buy distressed assets off their own balance sheets, thereby shoring up market prices and avoiding large-scale mark-to-market losses. If this game of pass the parcel were to stop, hedge funds might have to dump assets, creating more turmoil.

But the banks can't continue to indulge hedge funds for ever. Strategies that require large amounts of leverage, and those that invest in illiquid assets, will feel a real pinch next year. For hedge funds that fall into these categories, the solution is to try to secure longer-term funding. Earlier this year, for example, Citadel, a US hedge fund, raised \$500m via the bond markets. CQS, a \$9bn London-based fund, put in place longer term funding arrangements before the credit crunch, according to someone familiar with the fund. But not many funds had the foresight or the market clout to lock in their funding early. For those that haven't, it may already be too late.

Published 18 December 2007

Hedge funds: hoping to stay fit while getting fatter?

By Richard Beales

Not long ago, hedge funds were reserved for a few wealthy investors and even fewer pioneering managers. Now 7,500 funds have approaching \$2 trillion under management globally, according to Hedge Fund Research – increasingly from endowments and pension funds as well as wealthy individuals. Here are eight predictions for the rapidly evolving industry.

1) Big funds will get bigger. Having investor assets in the tens of billions helps support the back office and technology demanded by institutional investors. And funds of funds – conduits for more than 40% of hedge fund investment, according to HFR – often want to make big allocations, which leads them towards bigger funds. But smaller funds that lack a unique investment case are

already struggling for new money. The biggest hedge fund outfits currently manage \$30bn-plus. Watch for more consolidation and the first \$100bn fund group.

2) Returns will fall, on average. With so much money chasing similar opportunities, the average fund will find it increasingly tough to beat, say, stock market returns. Institutional investors' preference to avoid big risks won't help. Smaller players might appear more likely to reap the benefits of nimbleness, but the more "institutional" fund groups, such as Citadel Investment Group and Och-Ziff Capital Management have scale that can help them attract the best people and stay on top of multiple markets.

3) Fees will hold up, for now. You'd expect a crowded field and declining returns to put pressure on the archetypal hedge fund fees: 2% of investors' assets plus 20% of any gains. But returns are hugely dispersed around the average, especially after 2007's market volatility. The best do so well that investors will gladly pay up, while the least successful can always just close their doors. As long as investors hope for stellar performance, they'll pay for it. And with institutional demand for "alternative" investments like hedge funds rising, funds face only limited competition for investors' money.

4) Transparency will improve. As long as funds in the big US and UK markets avoid retail investors, regulators probably won't force much greater disclosure. But two other trends are doing the watchdogs' work for them. Institutional investors and funds of funds want plenty of information on what funds are up to. And with several managers – Och-Ziff, for example – now publicly traded, and others likely to follow, the standards for transparency are going up – as underscored by recent "best practices" proposals from industry groups.

5) Managers will pay more tax. Regulators may resist dictating how hedge funds are run, but lawmakers are unlikely to spare the managers from higher tax rates. In the US, hedge fund managers – and to a greater extent, private equity bosses – can call some of their pay capital gains, which attract a lower tax rate than ordinary income. It's legal, but it's such an obvious target that plenty of managers are privately resigned to the rules changing, if not in 2008 then soon after.

6) Retail investors will want in. Industry groups like the Managed Funds Association say they want to make it harder, not easier, for less wealthy people to get into hedge funds. After all, the funds can involve leverage and other risks some investors can't tolerate. But as the funds become truly mainstream in coming years, pressure will mount.

7) Cheap imitations will flourish. Academics and traditional asset managers are developing (somewhat) lower cost approaches that replicate some hedge fund investing techniques. For example, wildly popular "130/30" funds are an outgrowth of traditional stock fund management giving managers limited hedge fund-like flexibility to bet on share price declines and invest more in the stocks they really like.

8) Blow-ups will still happen. Maybe not in those big funds that are focused as

much on gathering assets as on returns. But others still make concentrated bets. Some will hit home runs, bolstering the industry's mystique. Others – even large ones – will, occasionally, lose out spectacularly. The first \$10bn-plus hedge fund collapse, anybody?

Published 31 December 2007

Alternative asset managers are still over-priced

By John Christy and Lauren Silva

Context news: *Fortress went public in February 2007 and ended the year down 16%. Blackstone went public in June 2007 and ended the year down 29%.*

Considered view: Shares of newly public alternative asset managers like Blackstone and Fortress have cratered since going public last year. But they still look pricey compared to those of traditional money managers like BlackRock and Franklin Resources. Alternatives may have further to fall before hitting the bottom.

Despite the credit crunch, private equity shops and hedge fund managers still command punchy valuation multiples. Alternative asset managers fetch an average of more than 20% of assets under management, versus less than 5% for traditional managers. Of course, not all assets under management are created equal. Alternative managers charge higher fees, so a dollar invested in a hedge fund throws off more revenue for the manager than a dollar in a municipal bond portfolio. That explains part of the difference.

One way to take this difference out of the picture is to look at multiples of net revenue, a reasonable valuation method provided steady-state profit margins aren't too different. Alternative managers trade at about six times revenue on average against roughly four times for traditional fund groups, a multiple premium of 50%. This suggests investors are expecting alternative managers to grow faster than their plain-vanilla peers – almost 10 percentage points faster every year for five years.

Pension funds are boosting allocations to hedge funds and private equity, so alternatives will probably add assets more quickly. But even if such rapid growth sounds plausible, there are other reasons to be sceptical. Alternative managers' incentive fees fluctuate based on investment performance. This volatility means these fees should trade on a lower revenue multiple than steadier, asset-based fees. Back out the value of incentive fees at two times revenue (the revenue multiple investors ascribe to Goldman Sachs), and the implied multiple for alternative managers' asset-based fees is about 12 times, or three times that for traditional managers – indicating an improbably strong growth outlook.

Moreover, alternative asset managers face greater headwinds from the credit

crunch because of their heavier reliance on leverage – perhaps depressing their fees. And traditional managers are staking out territory with hedge fund-like products of their own, which could lift theirs. All of this suggests the valuation gap should narrow. While shares of several alternative managers have lost their IPO lustre, they still look overpriced.

Published 03 January 2008

Dealmakers start 2008 bloodied but unbowed

By John Foley

The M&A business started 2007 with a bang – and ended it with a crunch. The gumming up of the credit markets has left investment bankers facing a gloomy economic outlook, and the withdrawal from the dealmaking scene of private equity buyers, a major source of fees. But they needn't be crying into their cups.

Despite the credit crunch, 2007 held up pretty well. Deal volumes beat last year's record and hit \$4.7 trillion, according to data provider Dealogic. The end of the year saw corporate buyers, perhaps emboldened by the retreat of buyout shops, returning to the fray. If that continues, mining, energy and financials all offer plenty of room for consolidation. Expect strategic industrial deals, rather than financial abandon, to be the order of the year.

Mining should be a rich seam. BHP Billiton's quasi-hostile approach to rival Rio Tinto – a deal that would create a \$350bn metals supermajor – should get rivals such as Vale and Anglo-American thinking about consolidation of their own. Xstrata and Antofagasta, though both protected by big shareholders, are the most likely targets. Steelmakers too – particularly those in China and western Europe – will look for ways to absorb potential cost increases, through consolidation or buying mines of their own.

The energy sector is also ripe for a further round of dealmaking. Both upstream and downstream firms are enjoying rising prices, steep demand from emerging markets and barrels of cash. Downstream, Centrica will continue to look attractive, as one of the few players with an open share register. Energy distribution and infrastructure will also be one of the few areas where the debt spigots should remain open. Upstream, a mega-cap merger such as the much mooted BP/Shell deal might well come back onto the agenda.

Meanwhile, upheaval in the financial sector will keep bankers busy for months to come. Initially, that will mean more capital-raising and stake sales. Banks reliant on wholesale funding may even become takeover candidates. Think Alliance & Leicester and Bradford & Bingley in the UK. At the bigger end, RBS's audacious bid for ABN Amro broke the received wisdom that consortium deals and bank break-ups don't work. UBS, which trades 20% below the sum of its parts, may be next.

Published 02 January 2008

Don't bet on sovereign wealth funds staying passive

By Una Galani

It's rare to get something for nothing. Over the last year sovereign wealth funds have spent billions buying stakes in major Western financial institutions. To get there, these funds have had to abstain from board seats and offer repeated reassurances of political neutrality. Yet such funds aren't just being benevolent global citizens. Like any investor, they're chasing returns – not all of these financial.

So far, the \$60bn invested in big Western banks looks passive. Yet there are no guarantees that investments like China Investment Corporation's \$5bn stake in Morgan Stanley, or the Government of Singapore Investment Corporation's (GIC) \$10bn punt on Swiss bank UBS will remain so. China Development Bank is the only group to have secured representation at a major Western bank with its bet on Barclays. Yet not having a board seat won't prevent sovereign funds turning into activists later.

The reality is, now that sovereign funds have built up leading positions, they will be less afraid to make their presence felt. This may not happen on the scale some people fear. Bankers mockingly refer to UBS as the "Union Bank of Singapore" amidst speculation that its new largest shareholder will demand the Swiss shift their headquarters overseas, yet such brazen requests are unlikely to materialise. In practice, sovereign funds will seek strategic returns in more subtle ways.

For example, Singapore may hope that its stake in wealth management specialist UBS will help consolidate its strong domestic wealth management position. Similarly, Qatar clearly expects that, in return for supposedly "protecting" the London Stock Exchange from an unwanted takeover, Doha will receive assistance in promoting its stock market as a rival to its neighbours in Dubai.

But sovereign funds' main concern will be achieving decent financial returns on their investments. If these don't stack up, sovereign funds are unlikely to keep quiet. The size of their stakes alone gives the opinions of such funds validity. Saudi Prince Alwaleed didn't have a seat on the Citigroup board, but that didn't stop then chief executive Chuck Prince paying him several personal visits a year to keep him onside. Sovereign funds realise that they are buying similar power – it would be foolish to believe they won't use it.

Published 20 December 2007

Learn Arabic and the bankruptcy code in 2008

By Jeffrey Goldfarb and Rob Cox

The demise of the buyout boom and the credit bubble that fuelled it has many investment bankers fretting about job security. As losses continue to mount at Citigroup, Merrill Lynch and elsewhere, Wall Street's 35,000 announced job cuts may look like an appetizer.

How can enterprising bankers remain masters of this fast-shifting financial universe? Like unemployed auto-workers, they need to learn new skills. This is especially true of those who specialised in areas that went from hot to not, such as financial sponsors, leveraged lending and structured finance.

Some will, of course, get lucky and be shifted to other, more active, departments of their firms. Many will use their past glory to land plum jobs with rivals. And countless others will look at their fattened chequebooks and call it quits. Either way, as the turmoil casts one generation off to sail away in its Ferretti yachts, the next class lies in wait.

So where will the action be? Banks are tripping over themselves to establish castles in the sands of Dubai and Abu Dhabi. Go-to gangs pulling in Middle East petro-bonuses fit for an emir will emerge as surely they as once did on Silicon Valley's Sand Hill Road. Learning Arabic and the Burj Al Arab hotel's conference centre floorplan look like good bets.

Similarly, someone will need to restructure all of those overly leveraged buyouts, particularly if the economy slows in 2008. Reading up on the US and European bankruptcy codes would be a wise idea. Finally, with environmentally inclined Democrats poised to take the White House in the fall, don't count out some type of inspired climatology futures or energy hedges entering the pantheon of Wall Street lore next year either.

Published 28 December 2007

Buffett's late-year deals could be just the beginning

By Richard Beales

Context news: *The Wall Street Journal reported on December 28 that Berkshire Hathaway was starting a bond insurance unit, Berkshire Hathaway Assurance Corp. The insurer was reported to be close to gaining approval in New York State, and to have applied for approval in several other states including California, Texas and Florida.*

The same day, ING said it would sell its NRG NV reinsurance unit to Berkshire for about E300m.

Berkshire announced its \$4.5bn deal to buy 60% of Marmon Holdings on December 25.

Berkshire shares were up about 30% since the beginning of August by December 31.

Considered view: Warren Buffett's move to start a bond insurer validates the battered business model. But that should be small comfort for incumbents such as Ambac and MBIA. The legendary Omaha investor must think those firms are so discredited that Berkshire Hathaway can break into the market while charging more than they do. More broadly, Buffett's move underlines his enviable position now that almost everyone else is short of capital.

Berkshire had \$47bn of cash at the end of September. Apparently eager to put that to work, Berkshire has kept reporters busy during the Christmas season with news of a \$4.5bn controlling investment in Marmon Holdings, the Pritzker family's industrial group, and a \$400m-plus deal to buy a reinsurance business from ING. The latest venture to insure bonds, Berkshire Hathaway Assurance, is starting small with initial capital for its New York State business – the first of several applications to be approved – of just over \$100m. But you can bet Buffett and Ajit Jain, his insurance supremo, want it to get much bigger.

BHA isn't going to stray beyond straight municipal finance, according to Buffett. Still, there's plenty of room. US state, city and local borrowers raised nearly \$400bn in the first 11 months of 2007, according to the Securities Industry and Financial Markets Association. If BHA's backing reduces their funding costs by more than the fees it charges, then it should attract business – especially as investors are discounting the value of existing insurers' guarantees. It should also be easy for BHA to make rival insurers, with their challenged capital levels, look financially weak.

Buffett must have decided against investing in the existing bond insurers. So far, he has also shunned buying into banks, leaving that to Asian and Middle Eastern investors. But a couple of Berkshire's recent moves suggest the credit crunch is at last producing investments he finds attractive. That must be a relief. "I got worried the directors might fire me if I didn't do something this year," he jokingly told Fox Business Network.

The Sage of Omaha still needs to find new investments, and big ones. Buffett already has his towering reputation and Berkshire's huge cash pile and rock solid credit to draw upon. If the opportunities are finally emerging, the holiday news could be just a taste of things to come in 2008.

Published 31 December 2007

Web 2.0's big challenge: privacy

By Robert Cyran and Jeff Segal

Context news: *On December 11, search engine Ask.com unveiled AskEraser. It allows users to delete their search history from the company's servers. The company hopes the service will attract users who do not want the data used for commercial purposes.*

Considered view: If advertisers didn't want to know, and influence, consumers' desires, Google wouldn't exist. Internet search is a fantastic way to collect data, and create highly effective, targeted advertising. Not only do advertisers waste less money on sending their message to the wrong people, they can also target small groups that couldn't be reached economically through mainstream media. The next step in the evolution of internet advertising, knowing and influencing how groups of people relate, is potentially far more valuable. A number of so-called Web 2.0 businesses and services have sprung up to find this El Dorado. Yet the trade-off between privacy and economic desires is far more evident in the internet's second wave. In fact, the forfeiture of privacy is fundamental to the success of Web 2.0.

Of course, privacy problems aren't new. Search engines have their own set of them. Years ago, AOL released the search histories of more than 650,000 anonymous users. User 4967938 for example, searched for "happy birthday mary-kate & ashley", "ugly puppies" and "how to make a bomb". A sample of searches can make a normal person look like a polygamous hypochondriac with criminal tendencies – or vice versa. One can imagine the damage such information could cause in the wrong hands.

So what's changed? New broadband services make it easier and faster for people to upload lots more data about themselves. This has fostered giant new businesses such as social networks MySpace and Facebook. Users like the fact that they can keep their friends up to date. They, and advertisers, also like to peer into other users' lives. Both activities present conflicts – which can alienate customers and lower the amount of advertising revenues that can be harvested from each user.

For example, in September 2006, when Facebook first unveiled its "News Feed", which made users' changes in their profiles public, the backlash was huge. Within a day, protests among Facebook's then-collegiate audience of 8m users surged. One group that promised a petition got 285,000 members in 24 hours. Users were part of the News Feed unless they specified otherwise.

Over time, Facebook's users actually grew to love the feed. That clearly emboldened the website to push things further. A little over a year later, Facebook launched a service that collects data about users' purchases from partner sites and makes that (potentially embarrassing information) visible across its social network. The ensuing controversy caused advertisers to hesitate. Management eventually apologised and made it easier for customers to opt out of the program.

Similar controversies have popped up in other social networks and in other countries. StudiVZ, a popular German social network, had to back down from plans to share client data with advertisers after a user backlash.

In sunny Silicon Valley, of course, the privacy backlash isn't just creating gloom – it's also seen by many as a business opportunity. Ask.com may not be at the avant-garde of search – it only has a 5% share of the market – but it recently introduced a feature that allows its users to delete their search history from its servers.

This is a worthy idea, but such schemes may be hard to put into practise. After all, Ask.com, a division of Barry Diller's IAC Interactive, contracts its search function out to Google, which can use the data for its own purposes. Deleting this data also creates tradeoffs that some consumers may find cumbersome. For example, it's harder to save web links or search results after deleting the information.

And to make it really confusing, what is socially acceptable will change over time. Just look at Google's free email service, Gmail. Google mines messages so that it can insert context-related advertising. Just a few years ago, this seemed like an outrageous incursion into privacy. Now, Gmail is common, and the number of accounts doubled in the past year. It may just take a bit of time for people to realise privacy is dead.

Published 31 December 2007

Green muck could fuel your car

By Robert Cyran

Context news: *Shell and HR Biopetroleum are building a pilot plant in Hawaii for the creation of biodiesel fuel from algae. The companies are exploring the use of algae to capture carbon dioxide and other greenhouse gases produced by industrial processes. Algae can increase their mass several fold in a day if adequately supplied with sunlight and carbon dioxide.*

Considered view: Turning food into fuel is an odd idea – both on first and second glance. It takes a lot of fertilizer, effort, subsidies and land to make not much energy. The entire landmass of the US would barely produce enough corn to power its automobiles. Most studies show ethanol produces less harmful emissions than gas, but the benefit probably doesn't outweigh the higher price of everything from bacon to burritos. This explains why energy giant BP and a host of start-ups are examining turning green muck into fuel.

Algae may be ickier than corn, but it has a number of advantages. It grows far faster, multiplying its weight several-fold in the course of a day. Theoretically, one acre of algae can produce 40 times the energy produced by an acre of

corn. And it doesn't need prime farmland – a brackish pool of water in a sunny area suits it just fine.

For all these benefits, green goo isn't ready to take over the world. It can be fickle to grow. Crops can get infected with useless strains of algae. Separating the fuel from the water is difficult. And nobody in the field can agree whether it is better to grow diluted amounts of algae in cheap open ponds or concentrated amounts in expensive, closed areas. Indeed, neither may work. Venture capitalist and green guru Vinod Khosla, for example, thinks the near-term economics of algae only work if one grows genetically modified strains in the middle of the ocean – a politically unfeasible idea.

But algae have an advantage that may eventually tip the scales; they need lots of carbon dioxide to grow fast. Start-up Greenfuel Technologies, for example, uses power plant emissions to boost the production of algae. The company says this can cut CO2 emissions from a gas or coal plant by 80%. Indeed, US government researchers have said that algae may be the cheapest way to reduce pollution from coal. This would be a big advantage if the government imposes a carbon tax. Turning food into fuel doesn't make much sense, but turning waste into fuel does.

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