Jefferies Insights

JULY 2017

Dear Clients,

Focusing On What You Can Affect Versus Being Overwhelmed Or Frozen By The Noise

One year ago, we wrote about what we felt were the best possible ways to navigate given the cross currents we were then collectively facing in the financial and political worlds. As a brief reminder, last July we were coping with the surprising Brexit vote, the U.S. was faced with the most confusing election of our lifetime with Bernie Sanders, Hillary Clinton and Donald Trump leading the packs, populism was seemingly on the upswing, isolationism was suddenly popular and many historic conventions were under fire. The financial markets were volatile with what seemed like half of the smartest investors believing we were heading toward a recession and the other half convinced we were well on our way to dangerous inflation. The Fed appeared adamant about the need to raise rates, but appeared paralyzed and almost clueless about how to do so without creating a massive market panic. Investors and CEOs were unsure of their very foundation and uncertainty seemed to rule every day. Regardless of your constituency, as an investor, corporate executive or employee-partner at Jefferies, it would have been understandable to have some type of delay in your decision-making or, worse yet, to be paralyzed by the overload of information and uncertainty.

Well, despite all of the incredible "noise," it is clear that one thing has certainly happened these past 12 months:

<u>MIRACULOUSLY THE SUN ROSE EACH AND EVERY DAY AND THE WORLD CONTINUED TO TURN</u>.

It turns out, of course, that if you were not paralyzed these past twelve months, the members of each respective aforementioned constituency now know that there were many productive ways to invest in the financial markets, improve your company's strategic and operating positions, and improve the capabilities, efficiency, importance and value of Jefferies. It is never easy – and hindsight sure makes it seem more obvious – but the reality is that those who were able to successfully parse through the incredible amount of "noise" to which we were each subjected every day came out ahead and those that got consumed or confused by it, fell behind.

So here we are today at the mid-point of 2017 and, surprise, every one of us can still continue to choose to be overloaded by the continual second-by-second flashes of news, data, rumors and opinions if we desire. Yes, we believe that every one of us needs to be educated, informed and pro-active in helping make the world a better place and it is our privilege and responsibility as citizens to be appropriately involved.

IN THIS ISSUE

It is what makes the world a better place, and active learning and participation in the political, economic and social realms by every capable person is critical and we greatly encourage it. However, that doesn't mean that we all need to be sucked into the vacuum of noise, despair and uncertainty thrown at us. To drive the point home, how many of the recipients of this email will be personally and actively involved with:

1. Determining what the Russians did or didn't do during the U.S. Presidential election and what to do about it.
2. Deciding whether central banks should raise or lower rates and by how much and at what pace.
3. Deciding what to do about Kim Jong-un.
4. Determining whether England will have a hard or soft exit from the EU or change its mind and lean back toward the status quo.
5. Deciding what is going to happen with U.S. healthcare reform, tax reform, infrastructure investment, global repatriation or regulatory policy. (As an aside, on this last point, we can only hope for some directional improvement in all of these areas as nothing massive appears possible--but even modest improvement would benefit us all).

We are not saying that all of these (and countless more) aren't truly important issues that require the time, expertise and focus of as many people as possible. In fact, we greatly appreciate and thank those who have committed their full-time efforts to best address all of these important challenges. We are just saying, *"C'mon, let's not allow all of us to get caught up in this incredible "noise" and have it distract us from the important areas that each of us can truly affect daily in our respective business lives."*

Here is a sample list of things we believe each of us may have a better chance of affecting this next twelve months than the five big-picture global challenges above:

1. Personally take steps to help improve the culture within your business. Mentor somebody or, better yet, set up a mentoring program. Work on a community outreach program with your co-workers. Make it a point to give clearer and more accurate performance reviews to people who work for you. Encourage people who work for you to give you open feedback and listen to it. Treat the people within your business with respect. Strive to help your organization increase its diversity. Lead by example in terms of integrity, honesty and long-term values.
2. Help find new clients for your business. They are the lifeblood of every company and, while there is nothing wrong with doing the best job possible to serve existing clients, nothing is more rewarding (or valued) than extending the reach of your business by bringing in new clients who value your firm's services and will help fuel growth.
3. If you are an investor, learn how to help market your funds and firm. If you are a marketer, learn as much as you can about investing. Always push outside your personal comfort zone. This is but one example of stretching and it can be extrapolated to every area of each business. Whether you wind up expanding your job scope or not, it will make you better at your existing responsibilities.
4. Continue your education. When you stop learning, you stop growing. This can be formal classes, on-line learning, reading or through novel experiences that you go out of your way to find.
5. Recruit new great partners for your business and help to retain the best ones who may have a moment of weakness. Help keep out all "bad apples."
6. Help cut costs smartly and efficiently throughout your business without being asked or forced to do so. Those companies that have a culture of efficiency and caring about the bottom line will be the winners. Better for you to be leading this charge than having someone inside or outside your business doing it for (to) you.

7. Help improve your business' brand every day. You are the critical asset. You are the voice and the face. You are what the customer, investor, supplier, vendor and recruit sees first and last. If you live the brand and strive to improve it every day, you and your business will become ever more valuable. If you think your brand is lacking in any one area, speak up and try to improve it.
8. Help innovate with technology. Be creative. Be aware of all opportunities that may be available to improve your business. You need to be open and available to think out of the box. Some things will work, some will not. Finding innovative solutions will require sometimes failing or taking a step back. Only winners have setbacks. Losers never do because they don't try.
9. Spend time thinking about strategy and where you and your business are going. Every leader appreciates reflective, constructive and smart feedback on how to improve the strategic direction of the team, department, division or company. Employees become leaders when they help set, adjust or improve their business's strategic direction.
10. Be constantly aware of the environment in which you operate, including all cross-currents from things you cannot control. There will be times to pause, reflect and wait for better clarity. There is nothing wrong with being smart and aware of the world around us. Just don't be paralyzed by it.

This list is far from exhaustive and, while the priorities will certainly differ from business to business, we suggest that these ten points may be universally appreciated within every endeavor, not just Jefferies or Leucadia. We cannot guarantee much, but we will promise each of you this: If you and the people in your (our) respective businesses focus on these ten versus wasting time fixating on what should be done with Putin or Kim Jong-un, each of you, our businesses and the world will be in better shape in one year's time. Next year, on July 1, 2018, there will still be myriad, brand new and seemingly urgent "life or death" issues that will provide an abundance of further "noise." We promise that on July 2, 2018, the sun will once again rise and the world will continue to spin. Always keep perspective.

With respect and appreciation,

Rich and Brian

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Economics and Strategy

The Terminal Funds Rate

On Wednesday June 14th, we got the fourth-rate hike of this cycle. And just as a reminder to all the folks who used to think the Fed could never raise rates again without sending us into a 1937-style second Great Depression – uh… that was a really dumb idea! But let's not dwell on the past mistakes of the doomsday crowd; it's time to move on to much more important subjects, such as finding a reasonable expectation of the terminal funds rate for this business cycle.

Now I could wax lyrical about what my state-of-the-art Dynamic Stochastic General Equilibrium model for the U.S. economy churns out for the equilibrium funds rate, but that would be a crock. Anyone who starts a sentence with "My model of the economy says…" loses me instantly (and they should lose you, too). So instead, I'm going to do what I usually do, which is to fall back on "informed economic heuristics" (aka storytelling) to provide my best guess at the answer to this question.

Let's begin by revisiting the basic supply and demand shock concepts I put forth in a recent commentary, "Stagulation rules, stagnation drools." In that piece I suggested that a large regulation-induced adverse supply shock had been responsible for much of the weak growth that has plagued our recovery. That supply shock caused output to be soft, inflation to remain robust, and capital investment to flee the U.S. In fact, as a side note, I would argue that the huge surge in Chinese investment that started in 2009 came from both demand AND supply forces. I have argued many times in past commentaries that when the Fed engaged in QE, it transmitted aggregate demand stimulus not just throughout the U.S. economy but also through the Chinese economy via the currency peg. And a rather healthy economy in China did not need such excessive stimulus. Of course, that set in motion what we all see today as an over-investment bubble. But what happened was not just about the QE/demand-side story. Our adverse regulatory supply side shock changed the relative global investment outlook in favor of China. This shift created a positive supply-side shock (or a positive relative cost-of-doing-business shock) for the Chinese. So in the end China got a double shot of stimulus from both the QE and regulatory increases in the U.S. No wonder the Chinese economy ripped from 2009 and is now in a highly fragile state. But I digress: This note is not about China; it's about the U.S.

Now, if our regulation-induced negative supply shock starts to reverse in the U.S., as I have conjectured it will, what should happen? Well, growth should surprise on the upside; inflation should surprise to the downside; and relative investment decisions should begin to favor the U.S. And to be sure, this shift out in the Aggregate Supply (AS) curve will create a confusing picture for the Fed – especially since most folks within the institution don't tend to believe in or focus on supply shocks. They will scratch their Phillips curve infused heads as employment, investment, and growth are robust while inflation fails to materialize. Further complicating matters, the Fed is on its fourth-rate hike, and they will likely intimate soon that the reinvestment of proceeds will start to taper by year-end. The Fed will be tugging the Aggregate Demand curve lower just as the AS curve is shifting out. The result will be a "double shot" of disinflationary pressure.

So where does this story leave us when we think about the Fed reaction function and the terminal funds rate for this cycle? Well, the Fed will likely keep trying to fit a demand-side square peg into a supply-side circular hole, if history is any guide. But in the end we need to make a simple determination: Will stronger growth and lower unemployment keep them hiking, or will the disinflationary pressures get them to slow the pace of future hikes? I am going to say the latter dominates, especially once the political motives of the current leadership structure at the Fed are removed in 2018.

So you can mark me down as supply-side-driven, low-terminal-funds-rate guy! What's my number? I'm going to say 2.5% as a base case. The Fed will find supply-side-driven disinflation quite uncomfortable as we approach that level for the funds rate. And the risk at that point is the Fed may have overcooked the withdrawal of aggregate demand stimulus.

You might then ask, how does this terminal rate position square with my view that real rates are headed back towards a more normal level of 2%? Easy, I just add in a very large risk premium for deflation – which is perfectly sensible given the deflation scares of the early and late 2000s. Investors will remain much more concerned about future reinvestment risks at low or negative rates, as opposed to being worried about having their cash locked up at a low rate in a potentially higher-inflation world. Investors will thus pay a premium to lock out deflation risks.

Here are the baseline numbers I have in mind for a breakdown of the terminal nominal funds rate into all of its subcomponents:

- Terminal nominal funds rate: 2.5%
- Terminal real funds rate (r*): 2%
- Terminal inflation compensation: 0.5%
- Terminal inflation expectations: 2%
- Terminal "deflation" risk premium: -1.5%

The trading implications are clear. Higher real rates are still dollar-supportive, so I'm fine with our long USDJPY (dollar vs yen exchange rate) call. TIPS look extremely vulnerable in this scenario. And blues (bluepack of Eurodollar rate futures) look like a good value at current levels over 2%. More importantly though, this deregulation/low-terminal-funds-rate story has me thinking about going back to recommending my one true trading love: risk parity. Since Brexit I have not been able to get myself excited about spoos (S&P futures). Populism scared me. And today populism still scares me. On top of that, the Fed has been, and is still, hiking. Spoos and blues both felt vulnerable. However, thinking through the power of this deregulation trade on a "hedged" position with both spoos and blues is actually starting to get me a little giddy. I'm not 100% there yet, but I'm definitely ready to start flirting with this beauty again, especially as my confidence gains in these deregulation trends.

— David Zervos, Chief Market Strategist

Global Equities: A Disinflation Boom

The momentum in global equity markets from 1Q rolled into 2Q with most bourses up quarter-over-quarter. Moreover, fund flows into global equities were robust with Europe experiencing 27 consecutive weeks of solid buying. Interestingly, the breadth of the equity rally is improving with cyclicals enjoying a renaissance with container freight rates, paper and even silicon wafer prices rebounding. Analyst earnings revisions have also moved into positive territory, underwriting many unfashionable sectors.

Despite the lack of follow-through on Trump's initial proposals, the U.S. is still benefiting from relatively loose monetary policy, M&A activity and a turn-around in corporate profits. With the European election calendar almost over and the fear of a wave of populism now diminishing following Marcon's French Presidential election victory, investor sentiment is turning bullish coinciding with improving economic data. Although China's economic data has cooled after a strong 2016, the rest of the emerging markets are enjoying an upswing in data and corporate profits helped by base effect and subdued inflationary pressures.

There are uncannily similar macro conditions today compared to the late 1990s when NASDAQ melted up despite financial crises in EM. G7 Central banks back then ran loose monetary policies helped by disinflation while the corporate sector spent on the disruptive 'digital economy'. Today, after a series of 'geopolitical shocks,' the global economy is growing with subdued inflation and real rates zero. Companies are just starting to spend on 'AI' and the 'internet of things'.

We continue to favor Europe, Japan and selected markets in EM and Asia. After two solid quarters, we would expect equity markets to take a breather as well as undergo some 'rotation' between different sectors and countries. But with global economic growth broadening, we would not expect much of a setback.

— Sean Darby, Global Head of Equity Strategy

U.S. Outlook – Federal Reserve Accelerates Policy Normalization

The combination of the June 14 policy statement, the Summary of Economic Projections (SEP) and Janet Yellen press conference reinforced the Fed's commitment to an accelerated normalization process for both the fed funds rate and a reduced size of the balance sheet.

The precise time line has yet to be clarified, but Fed "smoke signals" point to a preferred FOMC 2017 time line for one more rate hike in September, as well as the first step in the System Open Market Account (SOMA) balance sheet normalization process in December when the FOMC also "pauses" the rate normalization process.

Regardless of the timing, the FOMC will utilize the September and December meetings to implement one more rate hike and initiate the balance sheet normalization process.

As expected on June 14, the FOMC raised its Interest Rate on Excess Reserves (IOER) by 25 basis points to 1.25% and raised the fed funds rate target range by 25 basis points to a 1 - 1.25% range. The Board also voted to raise the discount rate by 25 basis points from 1.5% to 1.75%.

There was no change to SOMA reinvestment policy at this time, but the FOMC provided an "Addendum to the Policy Normalization Principles and Plans" that lays out a fairly aggressive trajectory for the normalization of the balance sheet. The plan begins slowly, with a $6 billion cap for Treasuries and a $4 billion cap for Mortgage Backed Securities (MBS), but these will increase at 3-month intervals by $6 billion for Treasuries and $4 billion for MBS. The cap for Treasuries will peak at $30 billion and the MBS cap will peak at $20 billion.

There are still lingering questions about the balance sheet normalization process. For example, there is no indication of the specific timing of the implementation of the change in reinvestment policy, although the FOMC indicated that it is set to begin before the end of 2017. Additionally, the FOMC has not provided guidance on a specific target size for a reduced balance sheet beyond Janet Yellen's comments that the reduced balance sheet will be "appreciably" below the current size. Without a specific target size for the "terminal" balance sheet, it is impossible to know the length of time that the FOMC envisions for the balance sheet normalization process.

Janet Yellen's comments at her press conference were dismissive of the deceleration in inflation since the February data was released. For example, she described recent lower readings on inflation as being "driven significantly by what appear to be on/off reductions in certain categories of prices such as wireless telephone services and prescription drugs" that will "restrain the twelve-month inflation figures until the extraordinarily low March reading drops out of the calculation."

These comments lower the bar for the inflation mandate and appear to suggest that the Fed is inclined to use the weak March data as a reason to below-target year-over-year inflation readings for as much as a year.

In short, after years of delaying the normalization process, Janet Yellen and the majority of FOMC members appear to have flipped to being less dovish and appear to be on a mission to get normalization on a steady path.

Finally, the relatively aggressive wind-down of the Fed SOMA Treasury holdings will increase Treasury financing needs dollar-for-dollar with the decline in these holdings on the Fed portfolio. The market implications of the upcoming changes in Fed reinvestment policy will depend primarily on the changes to Treasury financing that result from the Fed's balance sheet normalization, most notably the distribution of this increased issuance across the curve.

— Ward McCarthy, Chief Financial Economist

European Outlook – ECB Tapering and the UK Heading Back to the 1970s

After the conclusion of the elections in France, and with the likelihood of the early Italian vote receding, the European political calendar is quiet until the German Bundestag elections on September 24. This year had the potential to throw up some significant political challenges in Europe, but, Brexit negotiations notwithstanding, the focus can now turn back to monetary policy.

The challenge for the ECB is how to start normalizing policy in the face of stubbornly weak core inflation. From the ECB's perspective, the fact that deflation risk is lower than it was when QE started in 2015 is encouraging. But the slack in the labor market remains significant, wage growth continues to disappoint and the euro area is still some way off from 'normal' inflation dynamics.

In response, the ECB is bound to be patient in removing stimulus, with Mario Draghi signaling that QE will carry on well into 2018 and, importantly, reaffirming the commitment to policy sequencing whereby the deposit rate will not rise until after QE comes to an end. Yet, on a more hawkish note, there is also perhaps increasing acceptance at the Governing Council that it may take significantly longer than previously thought to get inflation sustainably back to target. This means that, perhaps like the U.S. Fed did back in 2014, the ECB will look through the weak inflation data and start to normalize policy regardless.

As such, the markets are generally prepared for the ECB to take the foot off the pedal, but it is still anyone's guess how quickly purchases wind down next year. Further confusion may arise if the ECB is forced to amend some of the Public Sector Purchase Programme rules as QE is extended. In terms of some of the longer-term challenges, as the global central banks prepare to reduce their dominant presence, there will be a much greater focus on the euro area's large current account surplus and how private sector capital flows are recycled.

With regard to the UK, the snap General Election was called to shore-up the government's position but produced the opposite outcome. One could envision very different scenarios in terms of what a hung Parliament means for Brexit negotiations, but ultimately it will be the rest of the EU that primarily determines the direction of travel. The rights of EU citizens, and perhaps the broad terms of the divorce bill, should be settled quickly, but nothing else will be. Trade negotiations, which may end up raising and not lowering barriers to trade, are unpredictable from the start.

The Bank of England also surprised this month, with the Monetary Policy Committee juggling the effects of a weaker currency on inflation and the all too familiar problem of soft wage growth. A rate rise this year remains unlikely, but the debate has stepped up a gear. Mark Carney's Mansion House speech was important, less so in its implications for rates, but more for what it said about services as the UK heads towards Brexit. FULL REPORT

— David Owen, Chief European Financial Economist
— Marchel Alexandrovich, European Financial Economist

Actionable Ideas for Companies and Sponsors

MERGERS AND ACQUISITIONS

SPACs Have Evolved to Become Viable Acquisition Vehicles

The market has seen a significant return of SPAC issuance, with 44 SPACs raising over $11 billion of capital since 2015. So far in 2017, 11 SPACs have raised approximately $4 billion, which represents the highest dollar level of SPAC issuance since 2007. Year-to-date, the average issuance has been greater than $350 million, approximately 50% larger than the average over this same period last year. In addition, SPAC technology has improved from earlier structures, by largely eliminating the risk of an adverse shareholder vote, reducing dilution from founder shares and warrants, and increasing SPAC sizes to facilitate larger transactions. Finally, SPAC issuance is occurring across numerous industry sectors, including healthcare, media, entertainment and energy.

SPACs have also shown a proven ability to successfully complete acquisition transactions of size. For example in May 2017, CF Corp announced the $2.2 billion acquisition of Fidelity & Guaranty Life; in March 2017, Capital Acquisition Corp III announced a merger with GTCR-backed Cision, in which GTCR rolled 100% of its stake for a 68% ownership in the combined public company valuing Cision at $2.4 billion; and in February 2017, Quinpario Acquisition announced a merger with HGM-backed SourceHOV and Apollo-backed Novitex where Apollo and HGM both rolled 100% of their equity stakes for a combined majority control valuing the combined entity at $2.8 billion.

Activists Increasingly Pushing for Strategic Sale or Merger

Corporate clients should place early focus on the targets of activists in their sector, as the bias is shifting to corporate sale as the likely outcome. While activists historically have focused on unlocking the value of subsidiaries via spin-off or sale as well as enhancing corporate efficiencies, activists are increasingly calling for outright sale transactions to capitalize on a market which continues to reward corporate consolidation. In addition, in some cases, activists are taking positions in both the target of their campaign as well as the possible counterparty to the sale or merger. Recent examples include: 1) Whole Foods, which in June was acquired by Amazon for $13.7 billion, had activist Jana Partners (9% stake) recommending sale to achieve the necessary operational improvements more rapidly; 2) Tribune Media, which in May was acquired by Sinclair Broadcast Group for $6.6 billion, had activist StarBoard Value (6.6% stake) recommending potential business combinations; and 3) LifeLock, which was acquired by Symantec Corporation for $2.5 billion in February 2017, had activist Elliot Management (7.6% stake) stating its intention to make an offer to acquire the whole company. Elliott also had 1.9% stake in Symantec at the time of its investment in LifeLock.

Family Offices Becoming Important Corporate Acquirors

Family offices are looking to leverage the sector expertise, relationships and entrepreneurial experience that have led to their wealth creation, as well as seeking to drive stable and steady returns over a longer investment horizon than private equity funds. A recent study published by research firm Family Wealth Alliance estimated there are 3,000 family offices in the U.S. representing over $1.2 trillion in assets. According to a year-end 2016 annual survey of family offices, the portion of family office assets allocated to direct investment eclipsed their investment in private-equity funds and is approaching their asset allocation to hedge funds.

Recent examples of significant direct acquisitions by family offices include: 1) Thyssen-Bornemisza Groups, the family office of one of Germany's wealthiest families, which announced the $900 million acquisition of DTN, a data and information provider from Schneider Electric SE; 2) Tom Pritzker's family office, Warren Stephens' family office and Redwood Capital (Jim Davis' family office), which announced the acquisition of South Carolina cable operator Hargray Communications from Quadrangle Group in a transaction rumored to be approximately $700 million in value; and 3) JAB Group, the global investment vehicle for Germany's Reimann family, which announced the $7.5 billion acquisition of Panera Bread.

EQUITY CAPITAL MARKETS

Issuers Turning to Convertible Issuance as a Preferred Source of Financing

Convertible issuance, up 70% year-to-date, is being driven by a perfect storm of rising interest rates, favorable equity valuations for issuers and robust investor demand. Convertible coupons are at or below 3-month LIBOR, offering the ability to earn interest income in excess of interest expense while waiting to deploy the capital. In fact, there have been 10 issuers year-to-date that have achieved coupons below 1%. In addition, as Fed rate increases leads to higher

3-month LIBOR (the benchmark for revolver and term loan interest rates), issuers have accelerated the use of convertibles to refinance floating rate debt and extend maturities. Finally, while issuance from growth oriented sectors, such as technology and healthcare, typically comprise approximately 50% of issuance volumes, we have seen a significant increase in activity from other sectors including financial, defense and energy. Issuance from these underweight sectors has scarcity value and has provided convertible investors with needed diversification.

Continental European Equity Issuance Volumes at Record Levels

The economic and political environment within Continental Europe continues to strengthen, presenting an extremely favorable window for Continental European issuers. The receding geopolitical risks and improving economic data is in sharp contrast to the uncertainty in the UK driven by Brexit and political change. Aggregating the 19 economies of the Euro zone, shows that GDP grew at an annualized rate of 2.3% in Q1 ’17, almost double the rate of the U.S. In addition, long term measures of business confidence are also firming, with the OECD business confidence indicators for France, Germany, Italy and Spain all rising over the past quarter. Finally, the need for institutional investors to deploy capital within Continental Europe is at recent highs, with equity fund flows extending to 27 consecutive weeks of inflows and $49 billion of net inflows year-to-date. This has set a favorable backdrop for Continental European equities with issuance (excluding the UK) totaling $102 billion, the highest year-to-date volume on record. Rights issues have driven 40% of the overall volume, the highest share of overall volume since 2009.

Canadian IPO Issuance has Reemerged

The Canadian IPO market is off to its most active start since 2010, with ten offerings completed raising over $2 billion in proceeds. While there has been a historical concentration in the natural resources sector, 12 technology, healthcare and consumer companies have completed IPOs on the TSX since 2015, representing 40% of Canadian IPO activity. IPOs have achieved attractive pricing performance with over 80% of the IPOs pricing within or above the initial filing range. Furthermore, the Canadian market is accommodating selling shareholders, with 50% of the IPOs including secondary shares. Recent examples of notable Canadian IPOs include: 1) Kinder Morgan Canada (oil & gas), which priced a $1.3 billion IPO on May 25th, representing the 4th largest IPO in North America this year; 2) Canada Goose Holdings (consumer), which priced a $290 million IPO on March 15th {dual-listed: TSX and NYSE) and ranking as one of the best performing IPOs in North America, up 75% since IPO; and 3) Freshii (consumer), which priced a $109 million IPO on January 25th, currently ranking it as the second best performing Canadian IPO in 2017.

DEBT CAPITAL MARKETS

Using Preferred Equity to Achieve Incremental Leverage in LBOs

The strength of the financing market for leveraged buyouts has pushed leverage to extremely high levels. As the traditional leverage loan and high yield bond markets limit leverage, sponsors have looked for additional financing in the form of preferred equity. This preferred equity generally does not pay cash interest, but rather is payment-in-kind, or, in other words with more preferred equity. If structured correctly, this is a ratings neutral financing source that can provide additional leverage when acquiring companies for large acquisition multiples. We have recently seen large preferred equity tranches in Avantor’s acquisition of VWR Corp and Temasek’s LBO of Global Healthcare Exchange (GHX).

Credit Agreement Work-Arounds

The impressive strength of the high yield market is allowing issuers to put in place creative structures to work around Most Favored Nation (MFN) restrictions in their credit agreements. MFN covenants reprice the interest rate of an existing term loan higher in the event the company borrows at a rate higher than the defined threshold amount. One such work around was executed by PetSmart which recently issued secured bonds structured to not trigger the term loan’s MFN restrictions and therefore allowing PetSmart to not have to reprice their existing term loan. In addition, borrowers have also been addressing pending MFN restrictions by increasing the prevalence of sunsets defining when the protection expires, and in several recent deals borrowers have increased the yield thresholds before MFN limitations kick in.

Middle Market Covenant-Lite Term Loans

The leveraged loan market is broadly bifurcated into middle market loans for companies with $50 million of EBITDA or less, and institutional market loans for companies with greater than $50 million of EBITDA. Historically, terms were far more stringent for middle market loans, particularly with respect to requiring financial maintenance covenants. Recently we have seen a large uptick of instances of middle market loans being arranged without a maintenance covenant, with covenant-lite term loans executed in June representing 60% of the middle market issuance. We expect this trend to continue, as it is being driven by both investors who are now accustomed to covenant-lite structures moving down into the mid-market and by financial sponsors and corporates taking advantage of the loan supply/demand imbalance favoring issuers.

RESTRUCTURING AND RECAPITALIZATION

Amazon's Purchase of Whole Foods Will Increase Distressed Activity in the Retail Sector

Even prior to the announcement of Amazon's acquisition of Whole Foods, all signs were already pointing to a massive restructuring of the retail sector. These trends include: 1) AlixPartners' 2017 Restructuring Survey, which overwhelmingly (67%) identified the U.S. retail sector as the most likely industry to face financial distress over the course of this year, surpassing the oil & gas sector and health care industry; 2) 27% of all high yield retailer bonds trading at distressed levels, suggesting that the market is pricing in some form of reorganization or bankruptcy; 3) Fitch predicting that the default rate for the retail sector will exceed 9% over the next twelve months; 4) the ongoing migration of spending to the internet, and shoppers seeking value as they turn away from pricey brands; and 5) retail's cost base being structurally difficult to lower because of the industry's large real estate footprint, with the U.S. having the largest retail footprint.

The acquisition by Amazon significantly exacerbates these distress trends in the retailing sector, because if Amazon can enmesh itself in the frequent purchases of groceries, Amazon's experience shows that customers will turn to Amazon to purchase other types of goods as well.

MUNICIPAL FINANCE

Issuers Increasingly Crossing Over Between Municipal and Taxable Markets to Lower Their Cost of Capital

We continue to see increasing crossover by both municipal clients into taxable executions, as well as by private/corporate clients finding ways to benefit from low cost tax-exempt borrowing.

Our municipal housing finance clients have successfully married their tax-exempt financing needs with CMBS market structures to achieve further reductions in cost of capital. By placing their tax-exempt debt with CMBS buyers, these municipal issuers have lowered their cost of capital by 30-100 basis points, while at the same time providing investors with above market returns, when adjusted for the benefit of federal tax-exemption.

Separately, corporate and private entities are lowering their cost of capital by crossing over to tax-exempt ownership structures for certain public benefit assets, including student housing, public facilities, utilities, healthcare centers, among others. By working closely with non-profits and/or governmental partners as owners, corporates can finance and monetize assets on a tax-exempt basis, with cost of capital savings up to 100 basis points. Additionally, such ownership structures can reduce or eliminate real estate taxes, further increasing enterprise values. Finally, with more accommodative Qualified Management Contract rules in place, these partnerships allow private entities to generate ongoing income and returns from these non-profit/governmental partnerships.

Best Research Ideas

AMERICAS

Jefferies 2017 Healthcare Conference Recap – Highlighting the Incremental

A recap of the Jefferies 2017 Healthcare Conference identifies highlights from the 400+ company presentations, panel discussions and meetings in early June. Analysts were asked about what was most incremental from the conference, whether they came away with more or less conviction in any stocks or themes, and where investor sentiment currently stands. Of note: most device company commentary concluded that space is not seeing the procedure weakness that some of the hospitals have flagged, Healthcare IT companies that presented have not seen evidence of a spending pause, and additional generics price cuts could be on the way in 2018. FULL REPORT

— *Jefferies Healthcare Equity Research Team*

U.S. Insights – Ocean Waves for Heat Waves: 54% of MSAs Have Strong Affordability and Fundys

Jefferies released a collaborative report focused on the U.S. housing market. The firm analyzed 180 of the largest MSAs to identify markets with affordability, as defined by the NAR Housing Affordability Index, and also strong economic fundamentals. Jefferies identified 97 MSAs that met these criteria, more than half the MSAs studied. Notably, Texas, Florida and North Carolina account for ~21% of the "Hot 97." Jefferies analysts screened their coverage for stocks that were most economically exposed to these markets and identified a number of names they believe should benefit from continued home price appreciation and strength in these affordable markets. The analysis also lends credence to the view that the overall housing recovery should continue. The stocks highlighted in this report include: HOME, HD, CUBE, SAH, ABG, AN, LAD, MYCC, CASY, OC, FBHS, MAS, TCBI, and FHN. FULL REPORT

— *Jefferies U.S. Equity Research*

EMEA

SKY Materially Undervalued, with or without Merger Approval – Upgrade to Buy

Sky (SKY LN) is trading ~10% below the FOX offer recommended last December. While this suggests risk of deal failure, Jefferies believes UK approval prospects are favorable given the principles established in previous reviews. Standalone Sky prospects have been enhanced by Wholesale Local Access (WLA) proposals (creating a potential £130-140 million saving for Sky by FY20/21) and BT/Virgin travails. This supports a new 1200p fair value and leads us to argue that shareholders could hold out for a better offer. FULL REPORT

— *Jerry Dellis, Equity Research Analyst, UK & European Telecoms*

UK Retail Survey: Consumers Still Hoping for the Best

In this quarterly report, Jefferies shares the macro-economic results of the latest survey of 3,000 UK consumers. Findings suggest consumer confidence has marginally improved as young and wealthier consumers who voted to remain in the EU have become less bearish and job security remains very high. However, Jefferies still sees risks to consumer confidence from rising inflation, increasing automation diminishing high levels of job security, and an abnormally low savings rate. FULL REPORT

— *Caroline Gulliver, Equity Research Analyst, UK & European Retail*

ASIA

Japan Industrials – Dawn of the Heavies: Initiating Coverage on Three Heavy Industry Majors

Jefferies believes project cost overruns and headwinds in aircraft manufacturing may continue to dampen market confidence on the three firms' medium-term profit generation. Initiate coverage on IHI with a Buy, preferring a lower exposure to unsettled projects and projection of a solid profit recovery track since FY3/18. Initiate on Mitsubishi Heavy Industries with a Hold rating as market re-rating may not take place until a roadmap for the mitigation on downside risks from MHI's minority investment becomes clear. Initiate coverage on Kawasaki Heavy Industries with an Underperform rating and expectation of share-price performance to be hit by the likelihood of prolonged earnings pressure from KHI's shipbuilding operation and projection of sluggish profit-bookings in aerospace business. FULL REPORT

— *Sho Fukuhara, Equity Research Analyst, Japan Industrials*

China Pharmaceuticals – All about Earnings: Set to Diverge

Jefferies foresees a major industry transition amid: 1) large provincial tendering near term; 2) mixed influence from changes to National Reimbursement Drug List in mid-term; and 3) impact from R&D policy reforms in the long run. The market has partly priced in the benefit of industry upgrade and consolidation in the mid-to-long term and thus favored leaders but overlooked the risks of price cuts. With a valuation mismatch, an EPS-based divergence is just starting, with a company's current drug portfolio seen as the most important criterion in the face of a transition with uncertainties. Thus, Jefferies' top Buy is CSPC, with Underperform on SBP and Hold on 3SBio. Other Buys: HEC, TRTCM, and CMS. FULL REPORT

— *Eugene Huang, Equity Research Analyst, China Healthcare*

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NOTABLE RECENT TRANSACTIONS

Healthcare, May 2017 Pending avantor **$6,400,000,000** Acquisition of **VWR Corporation** Joint Financial Advisor	Media, April 2017 CCC Information Services Inc. **$1,475,000,000** Credit Facility to Finance Acquisition by **Advent International** Joint Lead Arranger	Technology, Pending AVAYA **$7,500,000,000** Restructuring Financial Advisor to the Official Committee of Unsecured Creditors	Industrials, May 2017 Munters Your Perfect Climate **SEK 4,039,000,000** Initial Public Offering Joint Bookrunner
Energy, April 2017 June 2017 EagleClaw Midstream **$2,000,000,000** Sale to **Blackstone Energy Partners** Sole Financial Advisor **$1,350,000,000** Credit Facilities to Finance Acquisition by **Blackstone Energy Partners** Joint Lead Arranger	Consumer, May 2017 PetSmart **$2,000,000,000** Senior Notes Offering Joint Bookrunner	Healthcare, June 2017 exact sciences **$245,000,000** Common Stock Offering Joint Bookrunner	Gaming, May 2017 EVERI **$855,000,000** Credit Facility Sole Lead Arranger
Industrials, April 2017 ACS Actividades de Construcción y Servicios **€554,000,000** Common Stock Offering Sole Global Coordinator and Sole Bookrunner	Healthcare, May 2017 Pending Surgery Partners **$2,323,000,000** Sale of Controlling Stake from **H.I.G. Capital** to **Bain Capital** Sole Financial Advisor **$760,000,000** Acquisition of **National Surgical Healthcare** Sole Financial Advisor	AeroDefense, May 2017 StandardAero **$1,151,000,000** Credit Facility to Refinance Existing Debt and Finance Acquisition of **PAS Technologies** Joint Lead Arranger	Municipals, April 2017 New York State of Opportunity. Environmental Facilities Corporation **$925,000,000** Revenue Bonds Joint Bookrunner
Automotive Aftermarket, May 2017 April 2017 Truck Hero **$1,025,000,000** Credit Facility to Finance Acquisition by **CCMP Capital Advisors, LP** Joint Lead Arranger **Undisclosed** Sale to **CCMP Capital Advisors, LP** Lead Financial Advisor	Real Estate, May 2017 Tritax **Tritax Big Box REIT plc** **£350,000,000** Common Stock Offering Sole Bookrunner	Healthcare, May 2017 True North Therapeutics **$825,000,000** Sale to **Bioverativ Inc.** Lead Financial Advisor	Industrials, May 2017 Charter NEX Films **$685,000,000** Credit Facility to Finance Acquisition by **Leonard Green & Partners** and **Oak Hill** Joint Lead Arranger
Finance, May 2017 Pending Fidelity & Guaranty Life **$1,835,000,000** Sale to **CF Corporation** Joint Financial Advisor	Healthcare, April 2017 Air Methods **$1,375,000,000** Credit Facility to Finance Acquisition by **American Securities** Joint Lead Arranger **$500,000,000** Senior Unsecured Notes Offering Joint Bookrunner	Consumer, April 2017 Floor & Decor **$213,000,000** Initial Public Offering Joint Bookrunner	Energy, May 2017 LINN Energy **$582,000,000** Sale of Western Wyoming Assets to **Jonah Energy LLC** Sole Financial Advisor
Healthcare, April 2017 Neurocrine Biosciences **$518,000,000** Convertible Notes Offering Joint Bookrunner	Municipals, May 2017 **The Regents of the University of California** **$1,136,000,000** General Revenue Bonds Joint Bookrunner	Finance, April 2017 BFF Banking Group **€250,000,000** Initial Public Offering Joint Bookrunner	Power, May 2017 ACWA Power أكوا باور **$814,000,000** Senior Secured Notes Offering Sole Structuring Advisor and Joint Global Coordinator

JEFFERIES KEY FACTS & STATISTICS

(as of May 31, 2017)

Founded: 1962

Total Long-Term Capital: $10.8 billion

Number of Employees: 3,324

Companies under Global Equity Research Coverage: 2,000+

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