Jefferies Insights

APRIL 2013

To Our Clients

At the End of the Day, It Is All About Culture

What makes a business thrive and be sustainable across cycles? Why are some companies able to constantly reinvent themselves in an ever-changing world, while others remain complacent with products, strategies and services that worked yesterday? Who is responsible for making sure capital expenditures, acquisitions and investments are smart, targeted, and capital and cost efficient? Who is responsible for convincing clients and investors that the firm's foundation is strong, honest and trustworthy?

The answers to these and countless other questions that define and determine the success of every business rest in the hands of the most vital asset within every business: the people. People across our industry speak about "fortress" balance sheets. We all know that one weak individual guarding even the largest fort can allow the course of history to change instantly. People talk about businesses with incredible barriers to entry. Without the right people leading innovation and continuously taking smart, calculated chances, every barrier becomes porous, and even the best business models become vulnerable. How many businesses have we seen in recent years with world-class brands that were the envy of competitors? Well, how many of those companies fell because the people entrusted as stewards were arrogant or complacent? And then, when hope was lost, when the right team of people get together with a broken brand, often there is a rebirth and a new chapter begins.

Between the two of us, we have been at Jefferies (and now Leucadia) for 33 years. We have watched the competitive landscape evolve in a multitude of directions. We live in a very competitive industry that often feels like "the Land of the Giants." We succeed without a trillion-dollar balance sheet, a multi-trillion-dollar over-the-counter derivatives portfolio, our name on a sports arena, ATM machines on every street corner or a reliance on massive bank deposits from individual customers to fund ourselves. We are not too big to fail and we do not have the Federal Reserve or taxpayers standing by to protect us from ourselves if we take excessive risk.

We do have something that today appears to be a more valuable and scarcer resource than ever: we have a real culture of caring. Caring about our clients, caring about the value and differentiation we provide them, caring about the integrity of our profession, caring about the implicit promises we make in our work and caring about each other. We are 3,841 employee-partners around the world who have come together to form the foundation and core of Jefferies. We operate as a team and, as a firm, we greatly value the individual. None of our clients needs to do business with Jefferies (nor any other single investment banking firm or commercial bank, for that matter). The vast majority of our principal competitors believe the source of their strength and competitive position is their balance sheet or name.

IN THIS ISSUE

We believe our foundation rests primarily in our people, who are the ones who get the job done every day. Don't get us wrong, we have tons of capabilities. Our parent company, Leucadia, is a $10-billion-market-value enterprise with less than $1 billion of parent-level long-term debt. Leucadia's brand of 35 years of smart investing and remarkable shareholder results is wonderful to be associated with. Jefferies has a $38 billion balance sheet aimed at serving our clients. We are a full-service investment banking firm with every product and service one needs to meet your needs.

All that said, our only secret weapon is our people. We will remain a strong firm so long as our culture maintains its foundation of being honest, hardworking, transparent, client focused, devoid of politics, humble, aggressive and creative. The day we rest on our enhanced balance sheet, our brand or a belief that our clients cannot do without us, that will be the day we begin our decline—and it might not be a slow one.

We ask you, our clients, as our most important constituency, to remind us every day of our commitments to you and to hold us accountable to the high standards we aspire to consistently reach. Honest and timely feedback allows us to learn and, when necessary, make the right adjustments. What we ask for in return is that—if we are indeed treating you as a long-term client versus a short-term counterparty—you return the favor and treat us accordingly. It is a long race and we intend to win, in partnership with you and our 3,841 culture-bearing employee-partners.

Sincerely,
Rich and Brian

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Economics and Strategy

The Big Picture is Amazingly Clear

The markets continue to be driven in the short term by a lot of noise. People are focusing on the Italian elections, Cypriot bailouts, LTRO paydowns and the U.S. sequester. All of these "focal points" have about the same long-term relevance for financial asset prices—nil!

As we have argued for long while, there are only three primary drivers of asset prices globally—Ben, Mario and their new buddy Haruhiko—the rest is fluff! This does not mean that dollar-yen cross cannot air-pocket 3 figures on a lazy New York afternoon; or that Spoos can't drop 30 points on European political uncertainty and heated fiscal policy banter from DC. Grinding rallies and sharp sell-offs are the basic ingredients of a bull market. And if you are going to run with bulls, you will occasionally have to take a horn in the rear! That's why we always carry a little first aid kit with us full of blue eurodollars. They always ease pain from the inevitable piercings.

But as we move forward on this path to a reflationary recovery, it is critical to maintain a view of the forest for the trees. Central banks are diluting the value of fiat currency. And more physical cash will chase the same set of real assets. This in turn will drive asset prices higher and generate our much discussed reflation trade! Whether the Italians elect a comedian/criminal as their prime minister, the Cypriots haircut some Russian oligarchs or there is $8 billion less per month spent on a handful of bloated U.S. government programs does not matter. All of these "focal points" are but mere blips on the radar screen.

Ben is on a mission, Mario will do whatever it takes and Haruhiko is the guy who called for a 3% inflation back in 2002. The G3 central banks are all engaged in the same policy. They are using their domestic portfolio balance channels (aka printing presses) to reflate risk assets. They are of course risking significant future inflationary pressures, but that's an issue for another day. These two facts are all you need to know. To get caught up in Italian politics, Cypriot haircuts or U.S. fiscal policy is missing the big picture.

In the end, we must keep our eye on the long-run prize and stay focused on the important drivers. The big picture is amazingly clear. Of course it will not be a one-way ticket to reflationary paradise without a few bumps on the road. But don't be confused by the occasional setback. These are normal. These are opportunities.

—David Zervos, Global Head of Fixed Income Strategy & Economics

Continued Outperformance for Equities in Developed Markets

Global equities performed well during the first part of 2013, helped by improving macro data from the U.S., ongoing monetary loosening by central banks and a switch in sentiment away from fixed income. In contrast to the start of previous years, developed markets led the way with the S&P 500 and European indices outperforming emerging market equities. Japan also saw a positive start to 2013 as investors sought to align their investments with "Abenomics" and the commitment by the authorities to pull Japan out of deflation. U.S. equities were helped by a better than expected 4Q earnings season and an upswing in M&A as well as strong equity fund inflows. European bourses began sprightly but gave back their early gains as the Italian election resulted in a stalemate and the Cyprus bailout was rejected by the country's parliament. Emerging markets experienced a mixed performance with the Asian markets leading the way while China saw its earlier gains eroded post Chinese New Year as economic data disappointed.

We continue to favor developed markets with the U.S., Japan, the UK and Switzerland our preferred stock markets. In particular, the U.S. and Japan are experiencing a resurgence in positive earnings revisions while weaker currencies have helped the UK and Swiss bourses. Global fund flows remain supportive for a rotation out of fixed income into equities while we also expect a significant rotation within equity markets as investors move away from defensive positioning into more cyclical sectors.

—Sean Darby, Global Head of Equity Strategy

Europe as the Next Japan, With or Without Cyprus?

Once again Europe stepped back from the brink and the EMU did not fall apart, although the compromise in this case (Cyprus) was for bank depositors to suffer losses. Even if contagion has been avoided, Cypriot GDP will collapse in coming quarters and the resulting knock-on effect on cross-country flows and confidence will further push back recovery hopes, suggesting the need for far more of a policy response from the European Central Bank. But, it should also be noted that it is often only in moments of crisis that there is the political will to complete more of the European project— perhaps after the German elections?

However, as things stand, the events of recent weeks further reinforce our thesis that the euro area could become the next Japan with a prolonged period of close to recessionary conditions, de-leveraging and low inflation, with more of the bloc falling into outright deflation. The other striking feature of the euro area economy—in contrast to the UK and U.S.—is the aging of the population. Going forward, what happens to the population of working age in the euro area may look uncannily like that of Japan 20 years ago. Please see the full report that runs through these arguments, looks again at prospects for Ireland and Portugal tapping the Outright Monetary Transactions, and compares across to the UK, with its Central Bank far more focused on growth. FULL REPORT

—David Owen, Chief European Financial Economist

Best Research Ideas

GLOBAL

Semiconductors: The Next Iteration of Moore Stress – EUV Critical Path Plays

We reiterate our Moore Stress thesis, which calls for a structural shift to Moore's Law (i.e., the number of transistors per chip doubles every two years). The team has identified a change as normal cost declines are not happening, and in fact our next iteration of our Moore Stress thesis argues that the delayed deployment of extreme ultraviolet (EUV) tools will translate to an upward inflection in transistor costs for the first time in 40 years. We argue that this is one of the most important developments in the semiconductor industry, with far-reaching implications for technology investors broadly. With Intel, Samsung and TSMC investing billions of dollars in ASML Holdings, the industry clearly has a sense of urgency around the risk of rising transistor costs; however, our sense is that the Street has yet to appreciate the industry's concern. Companies we have identified in the EUV critical path include: 1) Shin-Etsu (4063 JP), which produces mask blanks and photo resist; 2) HOYA (7741 JP), which produces mask blanks and EUV mirrors; and 3) Lasertec (6920 JP), the sole supplier of a mask blanks inspection system. FULL REPORTS

—Mark Lipacis, Senior Equity Research Analyst, Semiconductors
—Sundeep Bajikar, Senior Equity Research Analyst, Semiconductors
—Lee Simpson, Senior Equity Research Analyst, Technology Hardware
—Masahiro Wakasugi, Senior Equity Research Analyst, Japan Computer Hardware

AMERICAS

Transportation & Logistics – All Aboard: Jefferies' Second Annual Coal Primer for Transport Analysts

Our second annual Coal Primer for Transport Analysts, a 90-page deep-dive report, leverages both our Transportation & Logistics and Metals & Mining research teams to present an investment case on the rails relative to the coal market. As many investors know, coal is the biggest profit-driver of the Class I railroads—representing as much as 25–35% of earnings.

After last year's Primer accurately predicted the lower-than-expected risk to rails of a rotation into natural gas, this year we are predicting yet another differentiated upbeat view. We see significant upside potential from normalized coal volumes and the risk of weak export coal volume being significantly less impactful than consensus expectations. On the back of this analysis, we have upgraded Norfolk Southern (NSC) to Buy and raised estimates for CSX (CSX) on increased visibility into earnings potential. FULL REPORTS

—Peter Nesvold, Senior Equity Research Analyst, Autos & Auto Parts, Airfreight & Surface Transport

Telecommunications: Ma Bell, Cable Guy Attractive Internet Plays? Customer Information as Asset

This thought piece gives an in-depth look at customer data in the possession of telecom and cable operators. We believe customer usage information from the subscriber bases of the likes of AT&T and Verizon would be highly attractive to advertisers, especially in the U.S. We would posit that, by definition, usage intensity is far higher on the actual access platform than any specific edge player website or social networking platform for the vast majority of "active users." As the conduit for all fixed and mobile traffic, we believe the network operators could be uniquely positioned to gain from the shift in advertising dollars to mobile and the Internet. This is an underappreciated opportunity for network operators including VZ, T, CMCSA and TWC. FULL REPORT

—Thomas Seitz, Senior Equity Research Analyst, Telecommunications Services

—Peter Misek, Senior Equity Research Analyst, Telecom Equipment/Wireless

—George Notter, Senior Equity Research Analyst, Data Networking & Wireline Equipment

EMEA

Daily Mail and General Trust – Untapped Potential

Our coverage initiation report focused on unharvested revenue and profit opportunities within MailOnline as the next leg of value to follow a successful strategic mix shift over the last decade. MailOnline's attractive and timely consumer content has resulted in an impressive 100 million unique browsers a month, but the report notes only £27 million of revenue generated through this channel. Our report compared the more sophisticated offering of certain competitors and outlined options to help drive future growth, capturing investor attention in advance of the company's seminar on the consumer division. DMGT has enjoyed nearly a 15% gain since our initiation in early February, significantly outperforming the FTSE All-Share index. Crucially, the price target and Buy rating were struck off conservative assumptions around the execution of the MailOnline growth story, leaving this as a largely free option to the upside. FULL REPORT

—David Reynolds, Equity Research Analyst, European Internet & Media

Building, Construction and Residential Services – New Year, New Build

This 600-page comprehensive sector review demonstrates Jefferies' thought leader status within the industry, providing an extensive array of macro forecasts, momentum maps, overviews of the UK housing market, house prices, mortgage market, builders merchants, construction market, an outlook for global major construction, as well as updates for the covered universe of companies (including initiations on Howden Joinery and Rightmove). The report asserts 2013 should favor those with exposure to new build markets, in particular the new build UK housing market. The report argues that it is time for UK house builders to play their home advantage, having had three years to get their houses in order. The UK residential services sector is further expected to be a beneficiary of a recovering housing market. Away from residential, the construction markets likely remain challenging. FULL REPORT

—Anthony Codling, Senior Equity Research Analyst, European Building Materials

ASIA

China 2025 – A Clear Path to Prosperity

In this report, we shine a light on China's economic path to 2025 on a macro level and within 14 industry sectors. Over the next decade our analysts forecast China's GDP to reach approximately US$18 trillion (or 6.9% CAGR) by 2025. We believe that inequality, not excess savings, has suppressed consumption and that urbanization will be China's growth engine, while transfer payments will be the ignition key. The timing is ripe for reforms to occur organically and these are the megatrends to watch: urbanization, consumerization, slowing trade, slowing FAI, financial reform, information mobility and sector service development. 2025 Top Picks: Agricultural Bank of China (1288 HK), Baidu (BIDU US), CapitaMalls Asia (CMA SP), China Resources Enterprise (291 HK), China Resources Land (1109 HK), Hang Lung Properties (101 HK), Kunlun Energy (135 HK), Minsheng Bank (1988 HK), Ping An (2318 HK), PetroChina (857 HK), Sands China (1928 HK), Tencent (700 HK). FULL REPORT

—Global Equity Strategist Sean Darby and the Hong Kong-based analyst team (Ju, Yu, Bu, Chiang, Guo, Leung, Li, Meng, Tan)

Japan 2013 – Everything to Play For

Jefferies equity strategy has been bullish on Japan since late 2012 and continues to see upside in the Nikkei even after year-to-date gains have exceeded 25% as investors gradually accept that economic and monetary policy is moving toward financial repression. Most recently, all eyes were on the new Bank of Japan leadership at their April 3-4 meeting and they did not disappoint. Global Equity Strategist Sean Darby believes the FX, fixed income and equity markets should be pleased with the policy changes and that policy makers still have plenty of ammunition to turn the economy and drive inflation higher. There are six themes that we are watching: 1) improvement in dividend payouts by Japanese companies, particularly financials and pharmaceuticals; 2) switch from Korea's Kospi into the Nikkei; 3) rotation within the Japanese equity market from high quality names into more domestic asset reflation plays; 4) expansion of Japanese service companies overseas; 5) impact of monetary policy on cross-shareholdings and book values; 6) positive turn in inventory-to-shipment ratio. Our year-end Nikkei target is now 14,500, while our FX strategy team sees USD/JPY of 100 (3-month), 105 (6-month), 108 (1-year). Jefferies Japan Top Picks are: Astellas (4503 JP), Mitsubishi Heavy Industries (7011 JP), Mitsui & Co (8031 JP), Murata (6981 JP), Shin-Etsu Chemical (4063 JP), Tokio Marine (8766 JP). FULL REPORTS

—Global Equity Strategist Sean Darby and the Japan-based analyst team (Salman, Azuma, N. Kumagai, Y. Kumagai, Pham, Wakasugi)

Actionable Ideas for Companies and Sponsors

EQUITY CAPITAL MARKETS

Strong Convertible Markets Continue

Robust equity markets, low-interest-rate environments and convertible bond supply/demand imbalances continue to drive a strong convertible issuance environment in the U.S. and Europe. Deals with aggressive price talk at launch are achieving both tighter coupons and higher premiums as well as increased deal sizes during the marketing periods.

United States: (1) Attractive Terms: 26 of 32 offerings (82%) year-to-date priced at the midpoint or better of marketed price talk; (2) Offerings Upsized: 28 of 32 offerings (88%) year-to-date were upsized; and (3) Market Open to Convertible Preferreds: The lowest convertible perpetual preferred dividend in 13 years was priced in February (3.75% dividend and 25% conversion premium).

Europe: (1) Attractive Terms: 8 of 13 offerings (62%) year-to-date priced at the midpoint or better of marketed price talk; (2) Country and Industry Diversification: Recent issuance has been heavily diversified by both country and sector; and (3) Market Open to Mandatory Convertibles: Two multi-billion-euro/dollar mandatory offerings have been executed in Europe recently, and future European mandatory issuance should be driven by recent revisions in accounting standards that result in mandatory convertibles receiving at least 80% equity treatment and no mark-to-market requirement.

Insider Stock Sales Accelerating

Corporate insiders are taking advantage of near-record U.S. stock prices by selling shares in their companies at the fastest pace in two years. In the first three months of the year, there were approximately 12 insider stock-sale announcements for every insider stock purchase by Standard & Poor's 500 Index companies, the highest ratio since January 2011.

During the first quarter of 2013, nearly one-quarter of all secondary share follow-ons have included stock from insiders. Since 2012, 46 follow-ons have included secondary shares from directors or named management. Key characteristics of these offerings are as follows:

- Insider sales typically occur concurrent with primary issuance and/or other sponsor monetization transactions, with the average insider sales representing 18% of the follow-on offering size and 29% of the secondary component of the offering.
- On average, insiders held 14% of the company prior to the follow-on, sold 20% of their holdings in the offering and retained 11% of shares outstanding post deal.
- CEOs sold stock in 70% of the offerings, CFOs sold stock in 46% of the offerings, and CEOs and CFOs both sold stock in 35% of the offerings.

Global IPO Momentum and Themes

Ninety global IPOs priced in Q1 2013, raising $24 billion in proceeds, up 40% from Q1 2012 driven substantially by the U.S. market, which accounted for 50% of global supply. The outsized aftermarket returns from recent IPOs should lead to tightening IPO discounts. Key 2013 year-to-date IPO pricing statistics by region are as follows:

- United States: $8.7 billion in proceeds raised through 33 offerings; 79% of all IPOs have priced within or above the filing range, up from 60% in 2012; 39% of priced IPOs were upsized; average 2013 IPO is up 17% in the aftermarket.
- Europe: $5.3 billion in proceeds raised through 13 offerings; all deals have priced at the midpoint of the filing range or better, up from 58% in 2012; average 2013 IPO is up 5% in the aftermarket.
- Asia: $5.3 billion in proceeds raised through 30 offerings; 97% of deals have priced at the midpoint of the filing range or better, up from 80% in 2012; average 2013 IPO is up 28% in the aftermarket.

Key themes that we expect to continue to drive the 2013 IPO market include: (1) issuers will look to de-risk IPO execution by engaging investors earlier with pre-marketing to test investor interest prior to filings; (2) broader syndicates will be assembled, using multiple bookrunners with complementary distribution platforms to maximize demand; (3) financial sponsors will continue to use the public markets to monetize positions, specifically for circa 2007 LBOs; and (4) investors will remain very disciplined when evaluating low-growth or highly levered equity stories.

Current Trends in Execution Strategies for Follow-On Offerings

Reversing a trend that has existed for most of the past two years, marketed follow-ons (Wall-Cross or Publicly Marketed) are achieving better pricing and aftermarket performance than Accelerated Bookbuilds and Block Trades. Additionally, Block Trade transactions have underperformed in the aftermarket during the first three months of the year, with 67% of the block offerings trading down on the first day post transaction, which will likely lead to wider pricing discounts to attract institutional demand. For the first quarter of 2013, the average file-to-offer discounts for corporate follow-ons were as follows: (1) Block Trade (28 offerings): (2.8)%; (2) Fully Marketed (24 offerings): (3.5)%; (3) Wall-Cross (17 offerings): (5.5)%; and (4) Accelerated Bookbuild (37 offerings): (5.7)%. For 2013 YTD, the average offer-to-one-week performance for corporate follow-ons is as follows: (1) Fully Marketed: +8.8%; (2) Accelerated Bookbuild: +2.9%; (3) Wall-Cross: +2.6%; and (4) Block Trade: +0.8%.

Currency Risk Management for Follow-Ons and Block Trades Involving Cross-Border Holdings

ECM transactions can often give rise to FX exposure where (1) the selling shareholder is based in a currency different than the currency of the shares being sold, or (2) the use of proceeds is in a different currency from the proceeds currency.

In follow-ons and block trades where selling shareholders are based in a different currency, the FX movement can have a very material impact on their final returns. Therefore, any USD-based sponsor or corporate with a listed holding in EUR may have very significant prevailing value when the currency impact is also considered. Because it is extremely rare for companies and financial sponsors to have long-term FX hedges on listed cross-border holdings (as single stock volatility is typically far higher than FX volatility), these FX exposures are typically converted very close to the placing of the stock.

DEBT CAPITAL MARKETS

Sterling-Denominated High Yield Market Has Opened

Volume for GBP-denominated high yield and loan transactions surged in 2013, signaling a window for UK-focused companies, as well as non-UK companies seeking GBP-denominated funding. So far in 2013, GBP-denominated high yield and leveraged loan transactions as a percentage of European deals are up to 30% and 20% of the market, respectively, versus each at only 13% in 2012. The growing GBP investor base is supporting the depth of this market.

Issuers Utilizing Holdco Offerings to Capture Investor Demand

In the last six months the issuance of holdco notes has surged, as high yield bond investors seek higher yields. During this period there have been 18 holdco notes issued in the United States and five in Europe, raising $8.02 billion. Demand for holdco notes remains strong and issuers can benefit from this demand by issuing holdco notes that are not restricted by limitations such as debt incurrence covenants that restrict financing at the operating company level.

Market Demand for Shorter-Duration Leverage Loans

Clients, by structuring new transactions as either entirely short duration or including a shorter tranche as part of a multi-tranche offering, can access large pools of liquidity that are now focused on maturity profiles of five years or less. Investor interest in shorter maturities is being driven by the greater protection that shorter-maturity bonds provide investors (versus longer-dated bonds) in the event that record low interest rates begin to significantly increase. This can be advantageous to companies that may have short-term liquidity needs or capital projects that will generate significant cash flow in the near or medium term.

Investment Grade: Underfunded Pension Solutions

Underfunded pensions continue to garner market focus. Given the persistent low yield environment, the underfunded status of these plans has greatly increased. With little relief in sight, we continue to see corporations “de-risking.” Furthermore, corporate treasury teams are not in the pension business and don’t want to be, and for many corporations it is a large drag on earnings and takes away from a management team’s ability to focus on their respective core business. This means they are either making larger cash contributions, or in some cases turning to insurance companies to offload part or all of their pension risk.

European High Yield Trends: PIK Toggle Bond Issuance and Financing Portability in a Change of Control

As a result of strengthened market conditions, European investors have become more receptive to payment in kind (PIK) transactions and, following the lead of the U.S., European issuers and financial sponsors are taking advantage of these conditions to issue euro-denominated PIK toggle notes to fund dividends.

Financial sponsors who wish to monetize their investments through a dividend recap while preserving the optionality for M&A exit in the near future can now do so in the European high yield market. Specifically, the strength of the European high yield market has enabled some recent transactions to achieve the same portability features common to U.S. high yield transactions. Typically, the portability feature allows the debt financing to remain in place by not triggering the 101 prepayment penalty change-of-control put contained in standard high yield documentation if the business is sold and specified conditions on leverage, ownership and/or ratings are met.

MERGERS AND ACQUISITIONS

Collaboration Between Corporations and Financial Sponsors to Facilitate Transactions

Collaborations between corporations and financial sponsors to acquire businesses can provide a unique means of creating transactions. These partnerships can be structured in many ways, with the parties sharing the roles of owner, operator and/or financing source to help facilitate the transaction.

Examples of recent partnerships between corporations and financial sponsors to acquire businesses include: (1) Berkshire Hathaway and 3G Capital are teaming to acquire (February 2013) Heinz in a $23.2 billion transaction in which they will be equal equity partners; (2) Microsoft's $2.0 billion loan (February 2013) to help facilitate the $24.4 billion go-private of Dell led by Michael Dell and Silver Lake; (3) VF Corp. and Altamont Capital Partners bid $587 million (January 2013) for Billabong International, the Australian surfwear company—VF Corp. is interested in owning only the Billabong brand where they can drive the most synergies globally while Altamont would assume ownership of smaller niche brands; and (4) Wolverine Worldwide teamed up with Blum Capital and Golden Gate Capital to buy (October 2012) footwear retailer Collective Brands for $2.0 billion; Wolverine acquired ownership of the Sperry, Saucony, Stride Rite and Keds brands while Blum and Golden Gate acquired Payless ShoeSource and Collective's international business.

"Take-Unders": Change-of-Control Transactions Targeting Companies Trading Below Their IPO Price

Historically, boards, financial sponsor investors and shareholders have been reluctant to embrace transactions below the IPO price. More recently, this trend has changed and public companies trading below their IPO price have been acquired in "take-unders," with boards relying on the view that the public markets no longer ascribe appropriate value to their growth prospects.

Change in CEO as a Catalyst for M&A

CEO changes are often a catalyst for immediate or rapid acceleration of M&A deals. Catalysts brought on by CEO changes include: (1) reversal of strategies that were being pursued with the personal backing of the former CEO; (2) new openness from the new CEO regarding strategic direction; or (3) a new CEO who wants to be seen by shareholders, the board and employees as making a significant break with the past regime.

Recent M&A transactions catalyzed by CEO changes include: (1) AkzoNobel's $1.0 billion sale of decorative paints to PPG, following the arrival of new CEO Ton Büchner (December 2012); (2) the announcement (December 2012) by Tesco's new CEO that they would divest their U.S. business Fresh & Easy; (3) the $2.0 billion sale of Cable&Wireless Worldwide (April 2012) to Vodafone following the departure of CWW's CEO John Pluthero and a business review being undertaken by the incoming CEO Gavin Darby (ex-Vodafone); and (4) Yahoo's acquisition (October 2012) of Stamped (value undisclosed), a mobile recommendation platform built by three ex-Google product engineers, following the recent arrival of Marissa Mayer from Google; Yahoo's predecessor CEO was criticized in the press for not being sufficiently focused on mobile.

The "Sign-and-Consent" Structure

The "sign-and-consent" structure allows a selling company to terminate a signed merger agreement if the majority shareholder(s) do not deliver written consents approving the transaction within a prescribed period of time, often within 24 hours of signing.

While common in private company M&A, corporate boards are increasingly employing the "sign-and-consent" structure in transactions involving a public company target that has a significant shareholder.

This structure essentially facilitates a strong deal protection mechanism without violating the seller's fiduciary responsibilities or the Delaware Supreme Court's prohibition against fully locked-up transactions (Omnicare, Inc. v. NCS Healthcare, 2003). The ability to terminate the transaction, albeit in a short window, validates the structure since the merger agreement does not force the transaction on a shareholder (as confirmed by the courts in OPENLANE, September 2011).

"M&A Options" Used to Facilitate Transactions

While earn-outs, CVRs and similar mechanisms are often used to bridge value or financing gaps in M&A negotiations, an "M&A option" can be a creative way to structure around other contingencies that otherwise may be difficult to overcome in a potential transaction. Specifically, for an up-front option payment typically 10% or less of the ultimate purchase price, an acquirer can secure the right to acquire a potential target in the future. The price payable on option exercise can be pre-agreed upon or can be determined by a formula based on future financial performance.

For the acquirer, this structure can allow it to lock up the target, while waiting for the outcome of a material contingency or liability, seeing if an important business milestone is reached, arranging its own financing, or simply observing the target's financial performance. For the target, the option payment provides non-dilutive capital and avoids the need for a future sale process, while potentially preserving upside based on the back-end valuation formula.

RESTRUCTURING AND RECAPITALIZATION

Asset Impairments May Indicate Restructuring, Refinancing or M&A Transactions

Asset impairments are usually required pursuant to audit rules that require assets to be carried at market values. In many circumstances, goodwill from previous acquisitions may become impaired as the acquisitions have failed to reach expected performance levels. Asset impairments typically flow through the income statement and result in a reduction of net worth, so companies having net worth covenants may be impacted. Similarly, losses can impact a company's ability to pay dividends under credit agreements and bond indentures.

Asset impairments may trigger several financing or strategic needs by clients: (1) M&A may become relevant as certain businesses may no longer be viewed as core or strategic and divestiture becomes the preferred route; (2) refinancing bank debt with bond debt may be required to alleviate pressure by banks on covenants or dividend restriction; and (3) restructuring may become relevant depending on the magnitude of the impairment and the amount of leverage in the capital structure.

11 Reasons for Using Chapter 11

Global companies requiring insolvency laws to accomplish their objectives may have several venue choices available. However, the U.S. Chapter 11 process offers multiple benefits versus many other jurisdictions.

1. Qualification for U.S. bankruptcy is a relatively low threshold: Generally, a company must have property in the U.S. to qualify for Chapter 11. The company need not be headquartered in the U.S. or have the majority of its assets in the U.S.
2. Debtor in possession: U.S. Chapter 11 generally lets management remain in place to operate the business.
3. Ability to reject executory contracts.
4. Ability to raise additional financing via Debtor in Possession (DIP) loans.
5. Ability to sell assets free and clear of all liens.
6. Ability to obtain releases for directors and officers under a plan of reorganization.
7. Ability to bind minorities: U.S. Chapter 11 enables companies to drag along minorities of impaired consenting classes so that the out-of-court threshold of 100% approval is not required.
8. Ability to cram down junior interests: Provided the code's confirmation requirements are met, U.S. Chapter 11 provides the ability to give no recovery to junior creditors of equity interests.
9. Exclusive right to file a plan: The debtor initially has the exclusive right to file a plan of reorganization for the first 120 days in a bankruptcy case, and this period is frequently extended.
10. High degree of predictability based on extensive case laws.
11. Global automatic stay: U.S. Chapter 11 provides a global stay from creditors taking actions.

European Lenders Continue Their Retreat

Euro-region banks may shrink their loan books by €132 billion (US$172 billion) this year in response to tougher regulation and capital rules, according to a recent report by Ernst & Young LLP. In addition, the report highlights an increased outlook for bad loans, as credit quality in the 17-nation currency area has deteriorated more sharply than expected. Non-performing loans will rise to 7.6% of lending in the region in 2013 from 6.8% in 2012, Ernst & Young estimated.

Further, PricewaterhouseCoopers LLP reported recently that it expects European banks may sell about €60 billion of non-core loans this year, as they shrink their balance sheets more quickly. Aside from changing the overall lending landscape, these loan purchases may be completed by shrewd investors taking a less accommodating approach to historical amend and extend practices championed by European banks and provide a catalyst for increased restructuring activity.

This forecast implies multiple considerations for European companies, including: (1) leveraged finance, high yield and convertible products to meet new financing needs, as well as fill in any financing gaps left by weak European lenders; and (2) increased M&A as the drive toward further consolidation increases in the wake of capital scarcity.

Completing Debt-for-Equity Conversion Using Exchange Offers

Debt-for-equity conversion may be accomplished through a Chapter 11 process, but in today's environment highly leveraged companies also will want to understand the issues and determinants of success for completing the conversion through an exchange offer, without using an insolvency process. There are several important considerations in using exchange offers to complete out-of-court debt-for-equity conversions.

1. The company must have enough authorized but unissued shares in order to complete the exchange (or complete a shareholder vote to authorize issuance of adequate shares) and, to the extent listed, comply with exchange requirements for shareholder approval.
2. The relationship between a company and its creditors is also key, as the success of an exchange offer will be impacted by whether the company has been a victim of difficult market circumstances or whether management overplayed its hand with an unrealistic strategy.
3. Out-of-court deals take time to negotiate and may be difficult to complete if also accompanied by a liquidity crisis, since exchange offers generally do not also bring in additional liquidity.
4. A very high acceptance rate (e.g., 95%) among bondholders is usually required, as most debentures in the U.S. have no collective action clause to drag along dissenters.
5. Concentrated ownership of the relevant debt tranche that would be the subject of the exchange offer is important, as more concentration means fewer parties to negotiate with.
6. Change of control provisions in other debt instruments of the company can be triggered in debt-for-equity exchanges, thereby creating additional liquidity issues.
7. Tax liability is also a consideration, as cancellation of debt income may result in a tax payment.
8. The company must have a clear runway going forward with respect to both liquidity and other debt maturities in order to be attractive for creditors to relinquish claims in exchange for equity.

IRS Regulations to Affect Amend and Extend Transactions

Recent regulations by the U.S. Treasury Department and the IRS provide guidelines for the potential taxation of amend and extend transactions. The new rules provide that virtually any amendment of a loan would be treated, from a tax perspective, as the retirement of the pre-modified loan in exchange for the "modified loan," requiring a mark-to-market for "publicly traded" syndicated bank loans to recognize cancellation of debt income when amending illiquid credit facilities.

These rules have the following impact: (1) potential taxation of amend and extend transactions for publicly traded debt, even though there has not been a reduction in the face amount of debt and there is no new source of cash to pay the tax liability; (2) possible taxable gain associated with an amendment for an investor, even though they did not sell their position; (3) possible application of net operating losses by companies forced to recognize cancellation of debt income; (4) companies now are tasked with undertaking their own reasonable diligence to determine whether debt with a principal amount exceeding $100 million qualifies as "public debt"—the new rules expand the definition of "publicly traded" to include debt in which there are sales transactions or price quotes available; and (5) incentive to reduce bank debt to less than $100 million to gain safe harbor under middle market exemptions that do not require recognition of gains for amend and extends.

PUBLIC FINANCE

Consideration Should Be Given to Long Tax-Exempt Municipals Versus Treasuries

The period from March through mid-April is a seasonally difficult time for tax-exempt municipal bonds as issuance ramps up moving into the new year while fund flows often turn negative as investors sell securities to fund tax payments. Compounding this seasonal difficulty this year is the low absolute level of interest rates and an increasingly growing expectation of rising rates. This has led to substantial underperformance of long tax-exempt municipal bonds to long U.S. Treasuries. It is Jefferies' position that the underperformance is approaching an oversold position.

For fixed income investors whose returns are measured against a long benchmark, strong consideration should be given to formulating a strategy for an overweight in long tax-exempt municipals versus Treasuries. The combination of an increase in federal tax rates and the additional 3.8% Affordable Care Act tax on taxable interest and dividends will create additional demand for tax-free debt—particularly in an increasing yield/curve-steepening environment that should manifest itself as the economy expands. In this scenario, it is rational to expect long tax-exempt high-grade municipal bonds to outperform long Treasuries. For those with shorter-term time horizons and/or those who need enhanced liquidity, security selection should focus on high-quality/high-beta names that enjoy the most attractive liquidity. For those with flexibility to set up longer-term strategies, Jefferies recommends higher-quality/low-beta names, which should see more investor demand and prove more resilient to rising yields than their higher-beta counterparts. The strategy should provide longer-term performance in a tenor that many investors ignore due to their expectation for rising rates.

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NOTABLE TRANSACTIONS

Healthcare January 2013 zoetis **$2,239,000,000** Initial Public Offering Joint Bookrunner	Energy January 2013 Pending COPANO **$5,000,000,000** Sale to **Kinder Morgan Energy Partners, L.P.** Joint Financial Advisor	Telecom February 2013 FairPoint communications **$715,000,000** Credit Facility Joint Lead Arranger **$300,000,000** Senior Notes Offering Joint Bookrunner	Industrials January 2013 DuPont Performance Coatings Financing for Acquisition by **The Carlyle Group** **$3,232,000,000** Credit Facility Joint Lead Arranger **$1,083,000,000** Senior Notes Offering Joint Bookrunner
Media March 2013 McGraw Hill Education Financing for Acquisition by **Apollo Global Management** **$1,200,000,000** Credit Facility Joint Lead Arranger **$800,000,000** Senior Notes Offering Joint Bookrunner	Consumer February 2013 Cole Haan **$390,000,000** Credit Facility to Finance Acquisition by **Apax Partners** Sole Lead Arranger	Real Estate March 2013 Countrywide integrated solutions local expertise **$338,000,000** Initial Public Offering Joint Bookrunner	Healthcare February 2013 Pending Bristol-Myers Squibb Latin American OTC Products **$482,000,000** **Upfront and Option Payment** Collaboration Agreement with **Reckitt Benckiser Group plc** Sole Financial Advisor
Energy January 2013 CVR refining **$690,000,000** Initial Public Offering Joint Bookrunner	Healthcare March 2013 Ventas **$500,000,000** Senior Notes Offering Joint Bookrunner	Consumer February 2013 Vector Group Ltd. **$450,000,000** Senior Notes Offering Sole Bookrunner	Finance January 2013 New York Life **$350,000,000** Senior Notes Offering Joint Bookrunner
Healthcare February 2013 Pending Strides Arcolab Limited Up to **$1,850,000,000** Sale of Agila Specialties to **Mylan Inc.** Sole Financial Advisor	Consumer March 2013 francesca's collections **$212,000,000** Common Stock Offering Sole Bookrunner	Finance February 2013 JGWPT Holdings, LLC **$445,000,000** Credit Facility Sole Lead Arranger	Lodging February 2013 **MSR Resort Golf Course LLC** **$1,900,000,000** Restructuring Financial Advisor to Official Committee of Unsecured Creditors
Energy March 2013 Williams Partners L.P. **$636,000,000** Common Units Offering Joint Bookrunner	Energy March 2013 **Offshore Group Investment Ltd.** a subsidiary of Vantage Drilling Company **$775,000,000** Senior Notes Offering Joint Bookrunner	Consumer January 2013 five BELOW **$464,000,000** Common Stock Offering Joint Bookrunner	Media January 2013 February 2013 Rizvi Traverse SESAC **$574,000,000** Acquisition of **SESAC Holdings, Inc.** by **Rizvi Traverse Management LLC** Sole Financial Advisor to Rizvi **$360,000,000** Credit Facility to Finance Acquisition by **Rizvi Traverse Management LLC** Sole Lead Arranger
Consumer February 2013 Landry's **$1,025,000,000** Credit Facility Joint Lead Arranger	Healthcare February 2013 Pending Independent Committee of the Board of Directors 3SBio **$366,000,000** Sale to **Decade Sunshine Limited** Sole Financial Advisor	Real Estate March 2013 Lexington Realty Trust **$269,000,000** Common Stock Offering Joint Bookrunner	Energy February 2013 Pending Chesapeake Energy **$1,020,000,000** Mississippi Lime Joint Venture with **Sinopec** Joint Financial Advisor

JEFFERIES KEY FACTS & STATISTICS

(Latest 12 months ended 2/28/2013)

Founded: 1962

Total Capital: $9.6 billion

Total Assets: $38 billion

Adjusted Net Revenue: $3.0 billion

Adjusted Net Income: $310 million

Number of Employees: 3,841

Investment Banking Professionals: 700

Equities Professionals: 700

Fixed Income Professionals: 550

Commodities Professionals: 350

Companies Under Research Coverage: 2,300

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