CREDIT OUTLOOK SPRING 2009

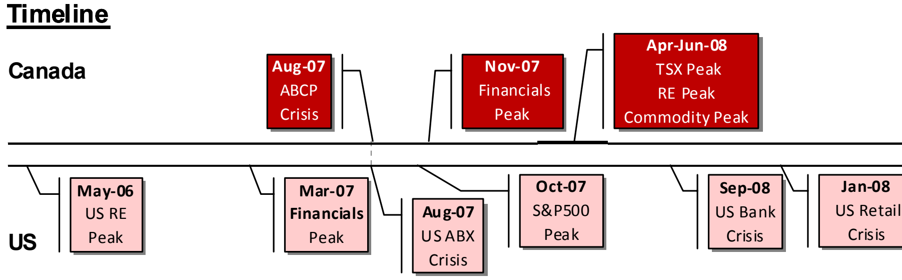
Capitalizing on Uncertainty

Asset devaluation has spread from the housing sector into other asset classes creating a negative economic feedback loop. Problems on Wall Street (the financial sector) are migrating onto Main Street (the broader consumer and business sector) which are now making the Wall Street situation worse and so forth. Asset values may continue to fall as the financial system deleverages and economy worsens despite the recent stock market rally. Canadian business should plan for US trends to find their way to Canada. With this in mind, business should play defense and patiently look for opportunities.

"This is not the first time that mortgage derivatives, hedge fund debacles, or the bursting of a credit bubble have taken down major financial institutions"
-Goldman Sachs ISG Forecast 2009

WHERE THE US LEADS CANADA FOLLOWS

Timeline



Asset Prices Will Continue to Fall

Asset prices fluctuate directly with the economic cycle. However, in the last 5 years, the US fed funds rate was reduced to thwart a slow economic cycle caused by the bursting of the technology bubble and consequently inflated the value of many assets. This in turn was coupled with the acceleration of securitization of debt and related financial derivatives which further lowered the cost of capital. In addition to the lower cost of capital, the securitization process separated contact between the borrower and lender which led to the mispricing of risk.

Money was lent against overinflated asset values (think houses) to people who could not afford them (think sub-prime borrowers). This created a situation in which people were likely to default on their loans because they couldn't afford them. Also, because the security (houses) was overvalued to begin with, the recovery from the bad debt resulted in losses to the lenders. While the increased availability of capital helped to stem the last economic downturn, the current monetary easing is not having the same effect because losses and asset devaluation continue.

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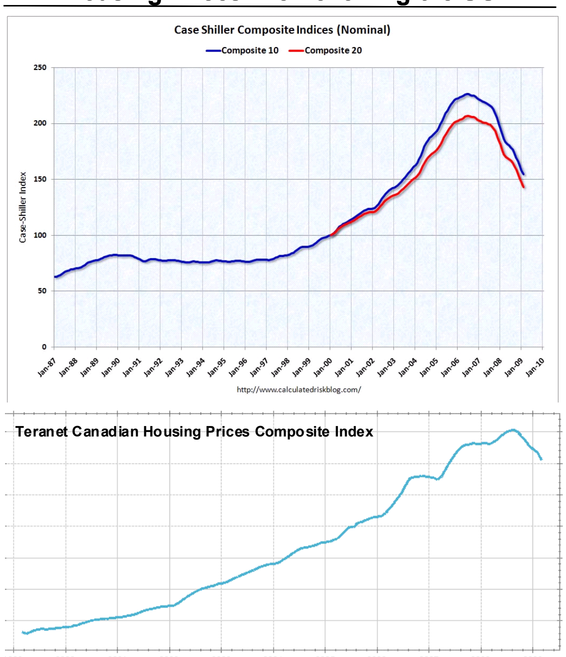
The negative feedback loop has asset prices continuing to fall, and people continuing to default. The first asset class affected was the US real estate market followed by a group of asset classes that were securitized on real estate and other related derivatives called asset backed securities (ABX), which, because of the global nature of the securitization process, included Canada's Asset backed Commercial Paper (ABCP). Set off by deterioration in the value of these ABX/ABCP issues, the US Financial Services Sector Index started falling in March 2007, followed by an all out liquidity crisis that summer. As US markets assessed the potential impact on the broader US economy, a basket of asset classes measured by the S&P500 began to fall. As Canadian banks disclosed that they had exposure to ABX issues they too started falling in the fall of 2007. The Canadian banking downturn, coupled with a US economic downturn started hitting Canadian assets in rapid succession with the TSX, real estate, and commodities indices all falling by early summer of 2008.

While Canada was feeling these effects, asset prices in the US continued to fall leading to banking runs in the US financial sector. The financial crisis has spread to the US consumer with holiday sales down year over year, unemployment jumping, and the first wave of consumer related manufacturers such as the auto companies and retailers hitting dire financial straights.

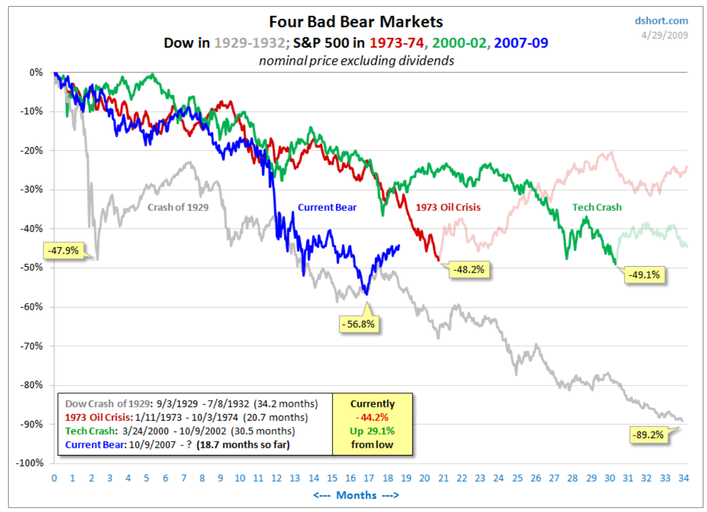
CDN Housing Prices Are Following the US



Media in the past year has argued that Canada is different and that the financial contagion and economic cycle in the US will not infect Canada; however, events suggest that we are feeling the same effects but on a delayed basis. The time lag from the US to the Canadian financial sector and main indexes selloffs were both delayed by roughly 3 quarters, indicating that stresses may hit the Canadian banking sector in Q3 this year. Mitigating factors include the fact that the Canadian real estate peak is more recent in Canada and the corresponding policy response in Canada relative to the peak in real estate values has been quicker than in the US, and that losses on subprime lending (think 0 down 40 year amortization) have already been nationalized through Canadian Mortgage and Housing Corporation (CMHC) insurance.

Is this Cycle Different?

Yes and No. By virtue of the fact that both an economic cycle is coinciding with a credit cycle this is not the usual economic downturn. We have seen cycles like this before and we have recovered.



The current bull commentator would argue that price to earnings ratio's are nearing historical lows and from a value perspective, this is the best time to buy. The bear commentator would note that the cost of capital has indeed gone up, and that a price-to-earnings ratio is based on past earnings. The bear would have lower profit expectations for next year and be uncertain about those earnings on the downside which might imply the market is overvalued today.

The recent rally has led to some head scratching. We are often faced with news screens that on one half report extremely negative news with respect to GDP, unemployment, housing figures etc., while the other half of the screen shows improving stock prices. Information flow is so rapid in the modern information world that the policy response globally has been swift and broad through the loosening of monetary policy with low interest rates and quantative easing (printing money). Easy money is what got us here in the first place. Despite the best of intentions, mark-to-market rules are being eased. The assets are worth what they are worth and pretending otherwise does not change this. While painful, asset values need to find their bottom without government intervention, leaving us to believe that this rally may well be a bear rally and that we may retest previous lows.

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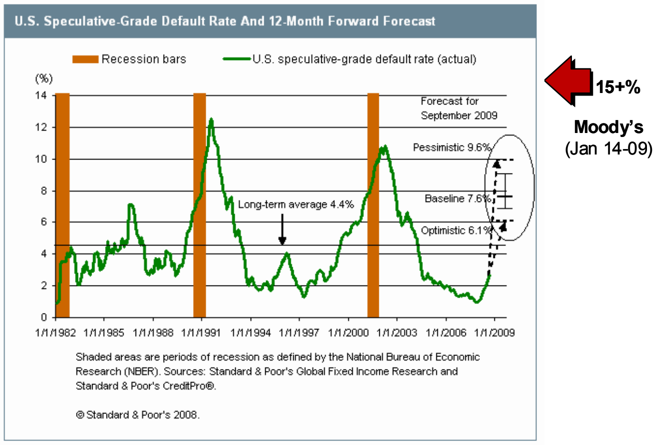
Record Defaults?

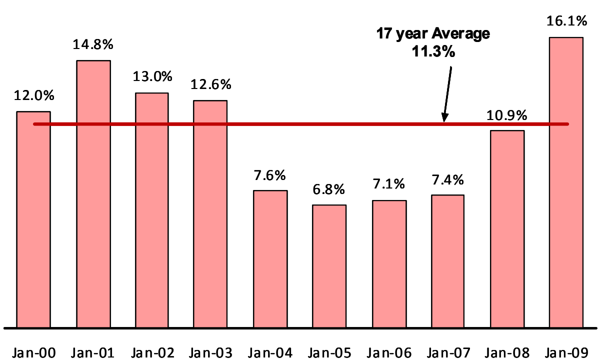
Corporate Default Rates and Predictions
(% Percent Default)



Consensus is emerging among commentators that the equity markets will not improve until the debt / credit markets recover. The news on the credit front is not encouraging. Much of the publicly traded credit is rated by one of the big rating agencies (S&P, Moody's and Fitch). Investor confidence in the agencies' ratings is slim to nil after it was learned that the AAA ratings on the ABX/ABCP that started the crisis were not fully transparent. Moreover, these ratings were issued without consistent third party independence.

Record Yields

JP Morgan US High Yield Index
(% Yield)



Ratings agencies forecast spikes in bond defaults of greater than 4 standard deviations. Most recently Moody's increased their 2009 default forecast to over 15%, which represents a higher default rate than experienced in the Great Depression. This increased risk of default is being seen in the high yield bond markets with interest rate spreads over US treasury rates in excess of 1,300 bps.

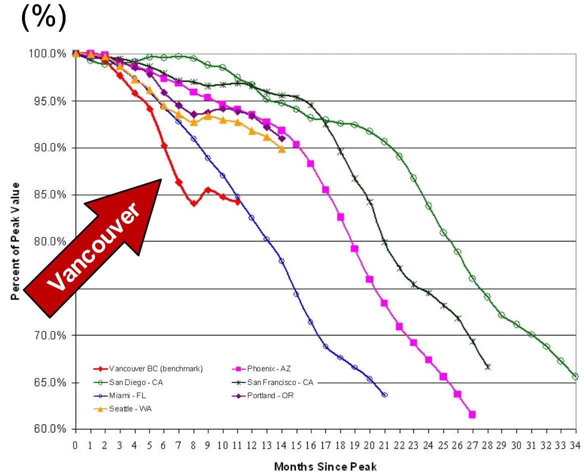
This credit and economic cycle may be worse than anticipated. This is because with the devaluation of assets loan loss recovery will be lower than usual exacerbating total losses as default rates rise to record levels.

Coming to Canada

There are many mitigating factors which may reduce the severity of the damage to the Canadian economy and local credit environments; then again perhaps we're just 3 quarters behind. ABC/ABCP products in both the US and Canada behaved similarly at similar points in time, just as real estate in Canada can fall as quickly as in the US.

Vancouver Benchmark and Case-Schiller Index from Peak

(%)

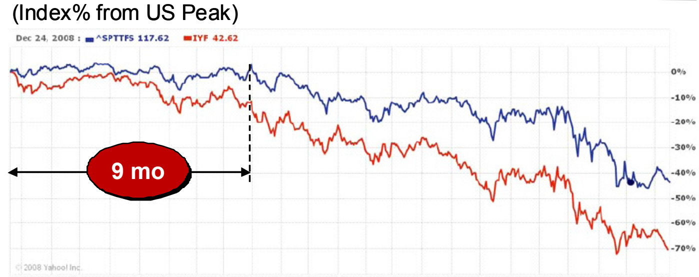


Source: Vancouver Housing Analysis

January through early March 2009 saw the Canadian banks continue to hit new 52 week lows. We compared the tangible net worth to total asset (TNW/Assets a measure of leverage) of several Canadian banks with several US peers. The Canadian banks fell into similar TNW/Assets ratios as their American counterparts with ratios in the 2.5% to 4%, or 25 to 40 times leverage.

Canadian Banks: More Room to Fall?

Canadian (SPTTFS) and US (IYF) Financial Indices
(Index% from US Peak)



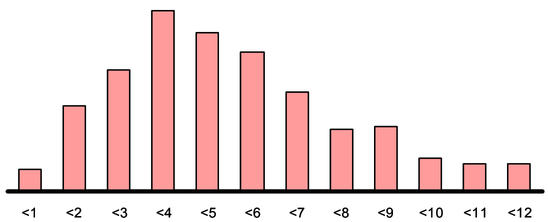
The valuation of publicly traded companies this winter in Canada was low from a historical perspective on an EBITDA multiple basis. The question is what happens to earnings or EBITDA? Either valuations are changing or the market anticipates poor earnings going forward.

Capitalizing on Uncertainty

Cheap Valuations?

EV / EBITDA Multiples for TSX Listed Companies

(Frequency distribution at Jan-09 Co's<12xEBITDA)



Source: Data: Aswath Damodaran, Analysis: Bond Capital

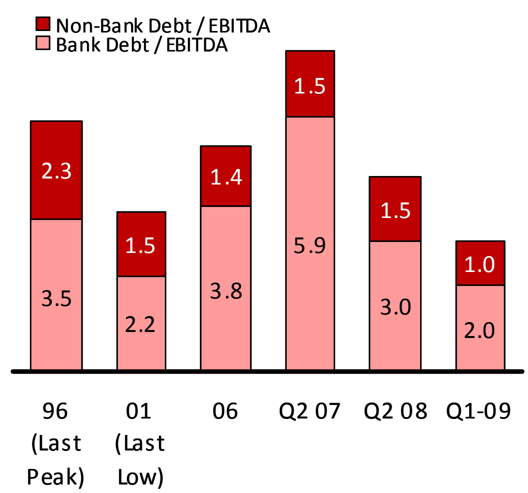
Implications for Canadian Business

Given that the crisis started in the US and that the US is more advanced in the crisis we can look to their economic and credit climate to help understand what may be coming to Canada.

In our Credit Commentary from the spring of 2008, we noted that leveraged loan issuance and leverage multiples had reached excessive levels when compared to the previous peak. This led us to believe that leverage would come down. Leverage levels have been substantially reduced from their peak in Q2-07 resulting in a reduction in the number of leveraged buyouts starting in the fall of 2008 over prior periods.

US Average Debt Multiples of Highly Leveraged Loans

(multiple of EBITDA[1), source: S&P, Bond Capital)

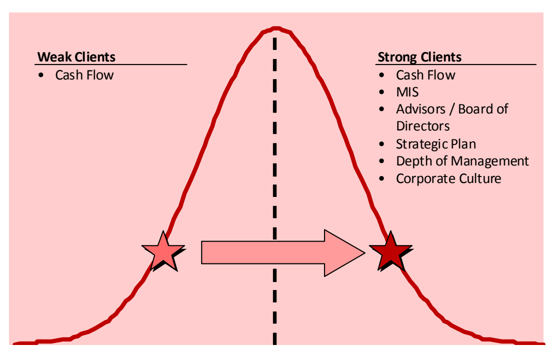


We are seeing that senior bank debt is dearly priced. Many capital providers have exited markets or pulled back. In prior periods, capital was readily available and leverage and pricing would vary by deal risk. In the current environment, only the highest quality deals are done at premium pricing, skewing the data. We have seen US deals done with no senior bank debt, in one case 50% mezzanine debt and 50% equity, and in another with all debt being provided as a vendor note.

The summer of 2008 saw many US capital providers exit the Canadian market. Late fall of 2008 saw many Canadian banks retrench. The Canadian focus is on lending with existing clients. Retrenchment can be expected to continue until asset prices stabilize, and greater economic certainty is attained. Canadian banks will continue with relationship lending; however, the leverage multiples have come down into sub 2 times EBITDA, and this level is often limited to a lower loan to asset value ratio. Mezzanine debt is an increasingly important tool in today's CFO toolbox.

Play Defense and Look for Opportunities

Business needs to be proactive. Detail your capital needs over the next 12 months and determine the likelihood of missing obligations to your creditors. Calculate your breakeven case for your worst month. Ensure you have enough safety capital available if the pessimistic case occurs. If you do not have sufficient capital, go find it. Diversify your lenders. Ask yourself where you sit on your current lenders depth chart, and how their definition of weak or strong customers will change. Over the next twelve months plan to be their best client, the one they can't do without. Becoming the banks best customer will serve you in both good credit cycles and bad. Seek help from outside advisors if you need help conveying your story.



Focus on your core business and reduce your leverage. Optimize your operating structure to maximize your profits and pay down debt. Be diligent with your capital expenditures, limiting them to the need to haves and foregoing the nice to haves. If there are assets that have value that are not core to your business consider divesting them.

Look for opportunities to gain competitive advantages in your market space by being a capital source to your value chain, offering payment terms to customers or suppliers that offer better margins to your core business.

It's back to basics… "Cash is King".

***About the Author** – Corry Silbernagel, P.Eng., MBA is a director of merchant banking at Bond Capital. Bond provides capital for growth, succession and equity withdrawal strategies to small and medium sized enterprises in Western Canada. Bond focuses on mezzanine lending for expansion, M&A, MBO and LBO's.*