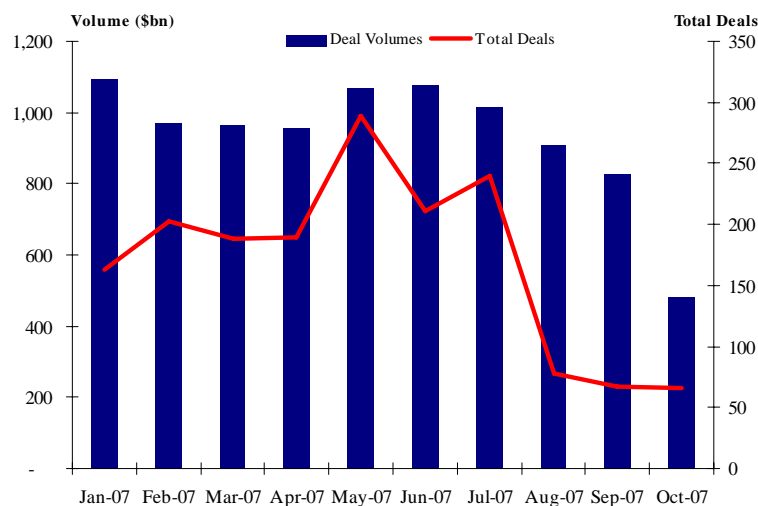


Steve Waters spoke to the ACG in Boston in mid October and his presentation was sobering. The title of his presentation was “The Bubble Bursts”. The following week I had the pleasure of monitoring a panel of bankers servicing the middle market in Southern Florida. The dichotomy of the two positions was interesting.

Mr. Waters outlined a number of issues he found concerning including subprime, credit market freeze, M & A ctivity almost at a standstill, slowing economic growth, with major lay off expected in the financial services sector. The subprime meltdown is not new news but the magnitude of the sector and its global reach are. Bankers sold some \$850 billion of subprime debt in 2005, and \$2.4 trillion of MBSs comprising subprime loans and collateralized debt obligations in 2006. The financial markets are just reporting the losses from these investments.

- Hedge Funds suffered large losses
 - Credit Arbitrage: borrowed heavily to buy the bonds of already highly leveraged companies
 - Sowood Capital Management LP lost about \$1.5 billion or about 50 percent of its value in July (Harvard lost \$250 million)
 - Two of Bear Stearns’ hedge funds became insolvent due to heavy bets on mortgage-backed securities
 - Goldman Sachs injected \$3bn into one of its largest hedge funds, Global Equity Opportunities, which lost more than 14% of its value
 - Analysts estimate as much as \$2 trillion in mortgage-backed securities were held by hedge funds globally prior to the crisis¹

M & A Activity in United States²



Yet the presenters on my panel described a totally different scene in middle market. Local banks continue to be aggressive in winning deals from the major banks. Asset based lenders are seeing some firmness in pricing, but competition remain strong.

¹ CNN Money August 2007

² Bloomberg as of October 17, 2007 – Compass Advisors Presentation

Earnings of portfolio companies of the presenters remained positive. That said the private equity firm on the panel reported that none of its portfolio companies had reached or exceeded plan. Conversations with bankers in the Northeast reflect some weakness within portfolios being reported in the last few months. Overall the middle market was seeing ample cash to fund deals. Banks continue to have high expectations on new business generation. Bankers are reporting that senior credit people are requesting some tightening of credit. It would appear the positive GDP news reported for the third quarter held up in the middle market as well but some slowness occurred in late September and October. One banker reported that casual dining restaurants are seeing marketed slow down indicated consumers and withdrawing a little.

Cash to invest in middle market deals remains plentiful as private equity firms raised significant sums of money and China has earmarked some \$200 Billion to invest in higher yielding opportunities. Per Mr. Waters:

- Private equity firms raised a record amount of money in 2006 (\$204 billion), to use towards buyouts, and relatively low interest rates continued to support high levels of debt financing
 - Private Equity firms were involved in \$758 billion worth of acquisitions in 2006, representing about 20% of total M&A volume³
 - M & A activity funded by bonds has come to a scrawl resulting in private equity firms turning to more traditional asset based financing to fund the buyouts.

The divergence of financial information appears unusually high. On the one hand we have the GDP coming in at a strong 3.7% for the third quarter and on the other we have Merrill Lynch increasing bad debt reserves by \$8 Billion, Citi Bank sitting on \$80 Billion of SIVs including \$40 Billion of subprime debt, oil prices geared to break \$100 a barrel, and the fed lowering interest rates to stave off a crisis. I am left asking myself these questions.

- At what price does gas really put a damper on consumer spending? Yesterday I paid \$3.29 for premium which was up \$.30 or almost 10%.
- Does home heating fuel at over \$3 per gallon hinder even the upper middle class spending? A cold winter could be very costly.
- The dollar is closing in on \$1.50 to the Euro creating inflationary pressures. When will merchandise in the retail stores reflect this new level?
- The bond market for larger LBO / private equity deals is moving along at a snails pace and almost frozen.
- Home building in many parts of the country is extremely slow hindering lumber yards, home improvement centers, large electrical / plumbing supply houses, etc.
- Is this the holiday season retailers live to hate?

³ Financial week September 2007 Compass Advisors presentation

- Will we see major layoffs in the financial services sector resulting from the downswing in M & A transactions affecting I bankers, public accounting, law firms and bankers. These are jobs creating lots of disposable income.
- Europe is reporting economic weakness. Will this slow US exports?
- Will a slow down in the US and Europe impact Asia, and if so by how much?

The US economy remains very resilient. The technology revolution continues to create millionaires as young companies with leading edge products are either purchased or brought public. Alibaba.com's IPO nearly tripled its opening price creating a market value of \$26 billion for this Chinese internet company. This begs the question regarding the value of the Chinese markets and the term "Bubble".

As we all look out over the next 18 months and wonder what is in store for our companies and investments it may be time for some conservatism. Two years ago we warned that the housing bubble would impact the global economy and it has taken a long time to come to fruition and continues to drag on the economy. The magnitude of the subprime market is staggering but most likely modest in a global context yet it will extract substantial pain for those who played in this high risk game. When subprime is included with the extensive refinancing of corporate America the impact may be more staging on the credit markets and ultimately the middle markets ability to finance its activities.

The US and the Fed is at a crossroads. The US economy appears to be slowing and the Fed may be in "checkmate". The WSJ on November 6th reported that a Brazilian model, earnings \$30 million annual, insisted on her contract be in Euros not dollars. If the US stops being the currency of choice because of our extensive debt load and faltering economy all bets are off.