# Market Matters Q4 2011

*Quarterly Outlook*

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MARKET COMMENTARY

## Be Aware

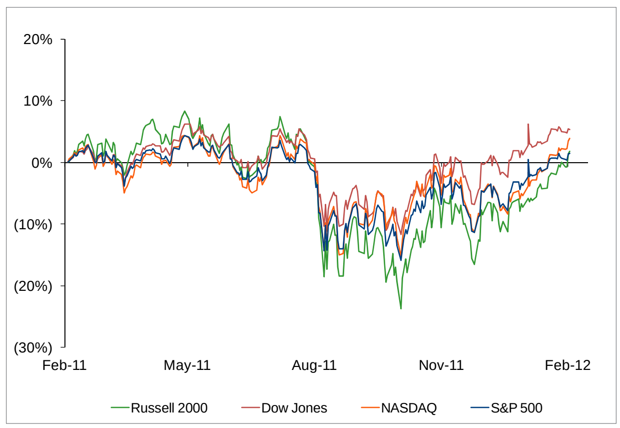
*February 7, 2012*

If we have learned one thing over the past 12 months, it is to exercise care in taking on risk when sentiment is positive as it was in the first quarter of 2011 and to be a more aggressive risk taker when sentiment is downbeat as it was in August and September. Currently, consumers and investors seem to be feeling better. Recent surveys of consumer confidence suggest a more positive tone yet real wage growth is slow and savings are down from the peak of recent years. For investors, purchases of stock mutual funds recently reached the highest level since the April, 2011 stock market peak. Current surveys of investors' sentiment show high levels of bullishness. The put-call ratio is relatively low suggesting more buyers represented by call option purchases than sellers reflected in the purchase of put options. The volatility index (VIX) is at 18 down from the mid 40s in August and September of last year. In 2010 and 2011, it paid to take on risk at 40 and to be more risk averse under 20. The S&P 500 has climbed over 7% since year end compared to 2% for 2011 and market breadth has been quite positive.

Fundamentally, it is important to note that economic growth in the U.S. and overseas will remain slow through 2012. In fact, the Federal Reserve recently indicated that short term interest rates are likely to remain low through 2014. Consequently, there will be ample opportunities for perceptions about growth to shift from time to time. At the moment the secular fundamentals which support slow growth are stronger than the cyclical fundamentals. The recent report of a 2.8% increase in fourth quarter of U.S. GDP reinforces the point. Most of the strength in the economy came from inventory building while final demand was reported as slowing. First quarter GDP is likely to do well to exceed 2% growth. We maintain a 2% growth estimate for the year.

Nonetheless, the Labor Department recently reported that 243,000 new jobs were filled in January, substantially above expectations for 150,000 - 200,000 new jobs. Moreover, the growth in new jobs was broad based encompassing construction, manufacturing, business services, and healthcare. Interestingly, the U.S. produced a similar number of jobs in February, March, and April last year. Job growth slipped dramatically through the summer as manufacturing activity slowed due to the interruption of component product pipelines by the Japanese earthquake. Some of the job growth in January may have reflected the continued recovery of manufacturing and sales, especially autos, since the late summer. Moreover, the relatively mild winter may also have favored construction activity. Nevertheless, the January job numbers are encouraging and may reflect improving business confidence. All pundits will be watching the results for February and March to see if the January jobs gains are sustainable.

**LTM U.S. Equity Market Performance as of 2/7/12**



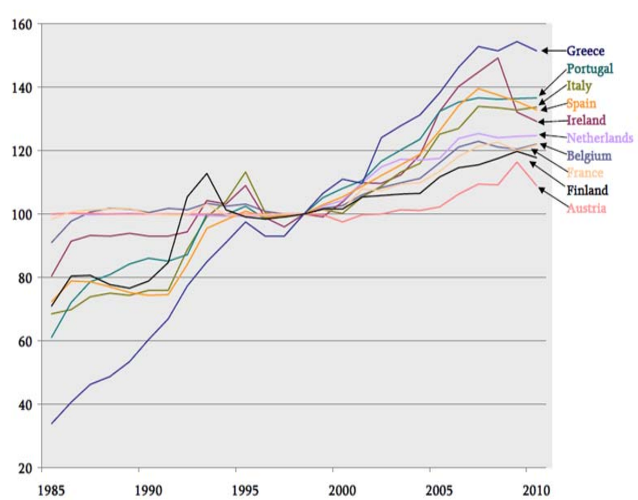
*Continued from page 1*

The rest of the world is slowing down. Europe, because of austerity measures, is projected to enter a recession this year. The remainder of the developed world is also realizing moderating or slow growth. Most of the emerging countries are experiencing or will experience varying degrees of moderating expansion.

In our most recent Leading View market commentary, we noted that profits and profitability are historically high. And unless top line growth picks up significantly, we doubt that these levels of profits and profitability can be sustained. Slower global growth is likely to have some degree of impact on the revenue and profit lines for U.S. multinational companies. Fourth quarter reports are indicating that top line performance for a number of companies is not as strong as it had been. To some degree, valuations of stocks are reflecting moderate revenue and earnings growth. Unfortunately, we do not know how much is being discounted and may not know until later in the first half of 2012. Any further shortfalls in revenue and earnings could be a source of volatility in equities prices.

Of course, the elephant in the room for the markets remains Europe. In the past month or so, the European Central Bank has provided a substantial amount of liquidity to European banks. However, this additional liquidity is only a short term measure. It does not deal with solvency. Consequently, the needs for recapitalization of sovereign debt remain great, especially in view of deteriorating growth and structural challenges, such as relatively high labor costs. Even if some of the sovereigns, such as Greece, Portugal, Italy and Spain, are able to recapitalize and /or add new debt their underlying economic competitiveness is not very good. This situation is concerning. To get to greater competiveness is likely to trigger worker unrest. To not improve their competitive positions will lead to recurrent financial problems which also may produce changes in political leadership. Most of the Eurozone is a secular problem. While additional measures may be put in place to alleviate short term pressures, we believe longer term structural issues will be difficult to manage.

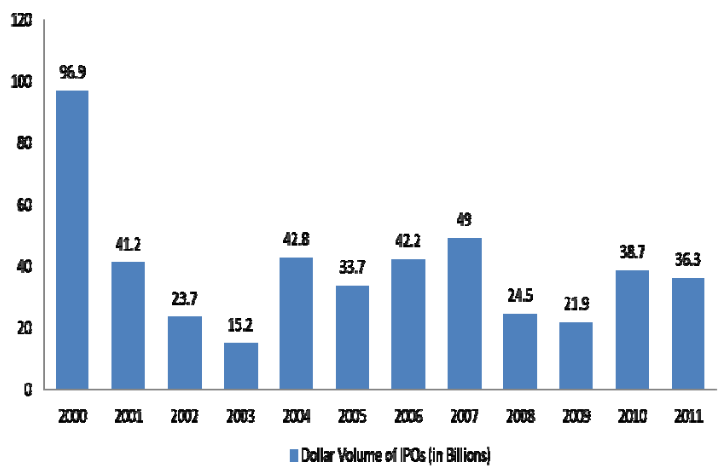
**Unit Labor Cost as a Ratio to Germany For Several Countries**




**Source: Bloomberg, IMF, Greenspan Associates (1998+100)**

Facebook has filed to go public which is expected to occur within the next few months. They are seeking to raise $5 billion in the initial public offering at a valuation that implies a market capitalization of $75 - $100 billion. With that size of an offering to kick off the year, then as the accompanying graph suggests, 2012 may be a big year for IPO dollar volume. A resurgent IPO market for a few large offerings could also be a drain on the availability for funds to purchase existing public equities. Something to think about.

**Annual Dollar Volume of U.S. IPOs From 2000 to 2011**




Source: Renaissance Capital, Greenwich, CT (www.renaissancecapital.com)

With slow growth, little inflation, and periodic worries about governments, etc., high grade corporate bonds remain appealing. High yield bonds also are attractive as long as U.S. growth is positive. Supply increases may put some pressure on municipal bond prices in the months ahead and present a buying opportunity. Emerging market bonds are worth a look. With real interest rates likely to remain low and the continuing potential for geopolitical shocks, gold and gold stocks are attractive on price setbacks. Selected emerging markets will capture increasing interest in the months ahead. Yield and growth will remain strong themes in the U.S. stock market.

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CAPITAL MARKETS UPDATE

## Mergers and Acquisitions

After a strong opening to the year, deal momentum slowed in the second half of 2011 as persistent economic woes in Europe and concerns about the federal debt at home hindered companies' acquisition pursuits. Following the drop in the third quarter, M&A activity further declined in the fourth quarter. Aggregate M&A spending fell 22.2% to $172 billion while deal volume dropped 5.6%, closing with the lowest quarterly totals in 2011. On the year as a whole, however, both volume and value measures for 2011 exceeded 2010 totals.

Despite this quarterly decline in activity, dealmaking in Q4 was still up relative to the cyclical lows of late 2008 and early 2009, and we saw some exceptional "blockbuster" deals. Kinder Morgan agreed to purchase the El Paso Corporation for approximately $21.1 billion in cash and stock, representing one of the biggest energy deals in history. El Paso Corporation owns and operates the largest natural gas pipeline network in North America. Another notable deal was Cigna Corp's $3.7 billion acquisition of HealthSpring Inc., one of the largest managed care organizations in the U.S. The transaction was the largest for the quarter in the health services industry, which was among the most active industries for M&A in 2011.

Private equity activity also continued its slowdown in the fourth quarter. Capital invested and the number of closed deals fell 42.6% and 35.4%, respectively, from Q4 2010 to Q4 2011. Market uncertainty made lenders more cautious towards the end of the year, and some deals got sidelined until credit markets show more stability. Nevertheless, private equity firms have over $400 billion in committed but un-invested capital that they must deploy before investment periods expire. We have seen private equity firms eagerly and actively searching for quality investment opportunities with the potential to generate strong return. In fact, for good companies with solid track records in attractive markets, we have seen very strong buyer appetite.

Although 2011 did not finish as strongly as it started, we have renewed optimism for dealmakers in 2012. The health of the financial markets, affordable financing tied with attractive pricing multiples, strong corporate balance sheets for strategic buyers and a recovery in private equity activity will be important catalysts to a meaningful rebound in the U.S. M&A market.

## *Financing Markets:* Debt

The ongoing European debt crisis continued to produce volatility in the fixed income markets in Q4, as investor sentiment swung between hopeful expectations for, and subsequent disappointment with, E.U. leaders' efforts to adequately address the situation. Looking ahead in the new year, we expect more of the same as bond investors weigh Eurozone and other global macroeconomic threats against continued signs of improvement in the U.S.

The run-up in Treasury yields lost momentum in the fourth quarter as strong investor demand and the Fed's continued purchasing of long-dated Treasuries put upward pressure on prices. The Barclays Capital U.S. Treasury Bond Index returned only 0.89% in the quarter. For the year, however, Treasuries were one of the most rewarding fixed income classes, generating a 9.81% return.

By and large, corporate borrowers reported strong Q3 earnings, but Eurozone worries and fears of contagion to U.S. financial institutions resulted in a volatile fourth quarter market for U.S. investment grade bonds. In the end, spreads remained relatively stable from the beginning of Q4 and closed the year at 234 bps above similar maturity Treasuries. Returns were 1.93% for the quarter and a healthy 8.15% for the year.

Fifty-six new issuances of high yield debt raised $34.3 billion for non-investment grade companies in the quarter. The high yield market returned 6.18% in Q4, saving the asset class from negative territory and resulting in a 4.38% return on the year. While spreads tightened over the last three months, they expanded 141 bps for the year and closed at 724 bps above similar maturity Treasuries.

Despite the shocks and volatility in the institutional market, we saw lenders become increasingly competitive for attractive middle-market credits over the course of 2011. Overall, leverage multiples remained relatively conservative (1.50x-2.50x senior debt for companies with EBITDA less than $10 million and 2.50x-3.50x senior debt for companies between $10 and $25 million), while pricing as a whole remained stable for those size credits. For higher quality deals, we did see lenders become more aggressive as they fight against softer loan demand overall in the economy. Loan issuance is increasing. Another round of positive economic news domestically could further encourage lenders, but the cautious side of us expects macro concerns and election year uncertainty to keep some level of moderation in the lending markets for most of 2012.

## *Financing Markets:* Equity

Despite a slow October, the final two months in 2011 featured some interesting and highly anticipated offerings in the IPO market. Volatility applied pricing pressure during the first part of the quarter, but eased through the end of the year creating a more attractive environment. The 29 offerings during the fourth quarter ranked lower than the first (32 offerings) and second (46) quarters of 2011, but far exceeded the eighteen during the third quarter.

The 29 companies completing IPOs during the quarter raised $7.1 billion, a 103% increase from the $3.5 billion raised by the eighteen companies that went public in Q3. Zynga, Groupon, Michael Kors, and Delphi Automotive headlined the quarter's offerings, raising a combined $3.2 billion. The largest offerings were Zynga (mobile gaming – $1.0 billion) and Michael Kors Holdings (luxury consumer products – $944 million).

Financial sponsor exits continued to drive IPO activity in the fourth quarter, representing over 60% of volume. Firms were able to successfully navigate exits in the U.S. public markets despite the challenging and changing pricing climate. We saw a continued aversion toward Chinese companies debuting on U.S. exchanges, as investor demand remains cautious due to a real or perceived lack of corporate governance over these entities.

The energy and technology sectors were the IPO leaders in terms of both size and volume during the fourth quarter. Investors remain interested in the prospects of Internet 2.0, as well as the explosion of domestic energy plays. Strong consumer brands with evident growth potential in emerging markets also garnered investor attention.

The strong push for offerings toward the end of 2011 may preview a strong first quarter of 2012, but the ever changing macroeconomic climate could quickly temper momentum. Facebook's upcoming offering is now the leading story and will likely continue to be so, despite a strong pipeline of other interesting companies that have already filed.

## *Financing Markets:* Venture Capital

The fourth quarter of 2011 marked the second straight quarter of declining venture capital ("VC") activity in terms of both dollars invested and deal volume. Venture capitalists invested $6.6 billion in 844 deals, representing a 10% decrease in dollars and an 11% decrease in deal volume from Q3 2011. Nevertheless, these second half declines were not enough to offset the strong investment levels seen in the first half of the year. For 2011, venture capitalists invested $28.4 billion in 3,673 deals, an increase of 22% in dollars and a 4% rise in deals over the prior year. Deal volume did not keep pace with dollar growth in part caused by higher round sizes due to increasing valuations for internet and software companies. The amount of venture dollars invested in 2011 represents the third highest annual investment total in the last decade, after 2007 and 2008.

Double digit increases in investment dollars for 2011 were spread across a number of industries, including the clean technology and Internet-specific sectors. Internet-specific companies raised $6.9 billion through 997 deals representing a 68% increase in dollars and a 24% increase in deals from 2010. Internet-specific companies accounted for 24% of all VC dollars in 2011. Accel Partners and New Enterprise Associates were particularly active investors in the space. The clean technology sector experienced a 12% increase in both dollars and deal volume in 2011, bringing the year's total to the highest level ever recorded at $4.3 billion going into 323 deals.

Three of the ten largest VC deals of the year were in the cleantech sector. Most notable were Palo Alto-based Better Place, Inc.'s $350 million Series C round and Oakland-based Bright Source Energy's $200 million Series E round. The biggest blockbuster deals were in the Internet-specific sector and 2011 marked the highest level of Internet investment since the dot-com bubble. VC investments in Dropbox, Livingsocial, and Twitter all garnered plenty of media attention as the three companies raised over $1 billion collectively.

In sum, thirteen of the seventeen industry categories tracked by PWC MoneyTree experienced increases in dollars invested for the year. While VCs continue to show interest in cleantech and Internet companies, most are acting prudently and not chasing excessive valuations (except perhaps in a few specific instances). Accordingly, despite the increase in investing, we are unlikely to see these sectors overheat like we saw in the 1999 to 2000 era. We expect investment activity in 2012 to maintain this past year's momentum perhaps tempered by persistently low levels of new VC fundraising.

INVESTMENT BANKING SECTOR COMMENTARY

# Industrial Group

Through our Industrial Group, Cary Street Partners serves middle market companies in a variety of sectors. Among others, these include:
– Automation equipment and controls
– building products,
– energy & commodities,
– industrial distribution and services,
– industrial equipment,
– metals,
– niche manufacturing,
– specialty chemicals and materials,
– test and measurement equipment, and
– textiles.

With uncertainties continuing to weigh heavily on the global economy (e.g., EU debt crisis, slowdown in China and political gridlock in Washington), industrial companies have generally been taking a careful approach to strategic acquisitions. While organic growth prospects have reaccelerated recently (e.g., backlogs back up to pre-crisis levels for many capital equipment manufacturers), strategic players have mostly been targeting smaller, lower-risk "tuck-ins" that provide IP and higher-margin product and end market portfolios. At the same time, many industrial companies have divested solid performing but non-core assets to continue to de-lever and raise cash for higher return projects as part of a focused strategy. For example, SPX recently sold its automotive tools business, Service Solutions, to Robert Bosche for $1.3bn (12.7x EBITDA). In general, most industrial players we talk to feel cautiously optimistic in the near term as customers appear to be investing again in plant and equipment and/or maintaining or increasing product order levels (e.g., ISM Purchasers' Managers Index is hovering near 54).

Several dynamics are unfolding that are having a significant impact on some of the market segments above and may become catalysts for increased M&A activity. A few of these include a) the impact of hydraulic fracturing ("fracking") on multiple industries (to obviously include oil and gas), and b) the increasing demand for water management solutions.

The North American oil and gas production industry has just scratched the surface of the ultimate resources now accessible across the various shale basins given the use of horizontal drilling in conjunction with fracking. In fact, shale gas resources alone represent roughly 36 years of supply at current consumption. The spike in both demand and supply has caused oil and natural gas prices to decouple as gas continues to trend near historically low price levels. What we find interesting is the disrupting impact this is all having. A few examples include:

– The increasing use of natural gas liquids ("NGL") in steam crackers (and new capacity set to come on line near term) is resulting in increased production of ethane, propane and butanes, which is creating attractive secular trends in ethane based derivatives (i.e., ethylene based chemicals, plastics and fibers). At the same time, this is causing supply constraints and upward price pressure on propylene (i.e., use of NGLs produces much less propylene).

– A spike in the use of certain base chemicals in the fracking process has forced prices of certain chemicals (e.g., hydrochloric acid ) to levels not seen in recent memory. In addition, specialty chemicals producers with oilfield solutions are experiencing record order levels.

– Demand for specialty wellhead equipment and solutions is skyrocketing and well capitalized providers are experiencing record setting backlogs. Supply of some mission critical equipment, such as high-pressure pumps, is becoming constrained.

"Water, water everywhere, not a drop to drink". With the onset of fracking, increasing regulations for food and water safety and an ever growing middle class in emerging markets, the demand for water management (e.g., waste water solutions, desalinization technology, water transport resources, etc.) has escalated making the *The Rime of the Ancient Mariner* all too real. The increasing demand for these types of solutions is impacting several sectors. As tighter restrictions are placed on treatment specifications, industrial equipment and specialty water chemical manufacturers are seeing significant jumps in demand for more efficient and higher capacity wastewater treatment products. In addition, these regulatory demands are providing tailwinds to test and measurement equipment and services providers with relevant solutions. On the oil and gas front, equipment providers are scrambling to provide water treatment and transport solutions at the wellhead to handle the huge volumes of flowback and produced wastewater resulting from fracking. The growth in mining is also driving use of water and the need for wastewater solutions. Finally, we are seeing huge demand for water management solutions (across related chemical, equipment test and measurement applications) from developing areas to include China, India and South America.

A few relevant deals include 1) ITT's $4.7bn spin-off of its water technology platform, n/k/a Xylem, Inc. (now trading at close to 9.8x EBITDA), and 2) Ecolab, Inc.'s acquisition of Nalco Holding Co., a leading provider of water and energy related chemicals and services, for $8.2bn (11.2x EBITDA).

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## MARKET DATA

### Domestic Equity Markets

| Returns | Q4 2011 | LTM |
|---|---|---|
| Dow Jones | 12.0% | 5.6% |
| NASDAQ | 7.9% | (2.2%) |
| S&P 500 | 11.2% | (0.0%) |
| Russell 2000 | 15.0% | (6.2%) |

Source: Capital IQ.

### International and Emerging Equity Markets

| Returns | Q4 2011 | LTM |
|---|---|---|
| EAFE (Europe, Australasia, Far East) | 2.9% | (14.8%) |
| Europe | 4.9% | (13.8%) |
| Pacific ex Japan | 5.2% | (16.3%) |
| BRIC (Brazil, Russia, India, China) | 4.0% | (24.9%) |
| World ex USA | 3.0% | (14.8%) |

Source: MSCI Inc.

### Hedge Funds

| Returns | Q4 2011 | LTM |
|---|---|---|
| CSFB Tremont Hedge Fund Index | 0.7% | (2.5%) |
| HFRI Fund Weighted Composite Index | 1.1% | (5.0%) |

Source: FactSet.

### Interest Rates

| | 12/30/2011 | 9/30/2011 | 12/31/2010 |
|---|---|---|---|
| Federal Funds | 0% - 0.25% | 0% - 0.25% | 0% - 0.25% |
| LIBOR - 3 Month | 0.58% | 0.37% | 0.30% |
| 10 Year Treasury | 1.89% | 1.92% | 3.30% |
| 30 Year Treasury | 2.89% | 2.90% | 4.34% |

Sources: Wall Street Journal and U.S. Department of the Treasury.

### Key Economic Indicators

| | |
|---|---|
| Unemployment Rate | 8.5% |
| Capacity Utilization | 78.1% |

| | S&P Earnings Growth* | GDP Outlook* |
|---|---|---|
| 2010 | **47.3%** | **3.00%** |
| 2011 | *15.9%* | **1.70%** |
| 2012 | *9.0%* | *2.30%* |
| Q3 '11 | **17.3%** | **1.80%** |
| Q4 '11 | *11.0%* | **2.80%** |
| Q1 '12 | *7.5%* | *2.00%* |

Sources: Standard & Poor's Index Services and Bloomberg.

### Initial Public Offerings

| | Q4 2011 | Q3 2011 | Q4 2010 |
|---|---|---|---|
| Number of Deals | 29 | 20 | 59 |
| Aggregate Value ($MM) | $7,100 | $3,138 | $24,698 |

| Q4 Notable Deals†: | Date | Amt ($MM) (1) | Return (2) |
|---|---|---|---|
| Zynga | 12/15/11 | $1,000 | (6%) |
| Michael Kors Holdings | 12/14/11 | $944 | 36% |
| Groupon, Inc. | 11/3/11 | $700 | (3%) |
| Imperva | 11/8/11 | $90 | 93% |

(1) Excludes underwriter over allotment.
(2) Represents performance from IPO date through December 30, 2011.
Sources: Capital IQ, PriceWaterhouseCoopers and Renaissance Capital LLC.

### Venture Capital

| | Q4 2011 | Q3 2011 | Q4 2010 |
|---|---|---|---|
| Number of Deals | 844 | 953 | 861 |
| Aggregate Value ($MM) | $6,566 | $7,286 | $5,519 |

| Q4 Notable Deals†: | Date | Amt ($MM) | Industry |
|---|---|---|---|
| Better Place, Inc. | 11/11/11 | $350 | Clean Tech |
| Dropbox, Inc. | 10/18/11 | $250 | Software |
| WhaleShark Media, Inc. | 11/10/11 | $150 | e-Commerce |
| Agios Pharmaceuticals | 11/17/11 | $78 | Pharmaceuticals |

Sources: CB Information Services, Capital IQ and PWC MoneyTree.

### High Yield New Issuances

| | Q4 2011 | Q3 2011 | Q4 2010 |
|---|---|---|---|
| Number of Deals | 56 | 46 | 172 |
| Aggregate Value ($MM) | $34,301 | $26,503 | $85,254 |

Source: Thomson Reuters.

### Mergers & Acquisitions

| | Q4 2011 | Q3 2011 | Q4 2010 |
|---|---|---|---|
| Number of Deals | 2,212 | 2,342 | 2,451 |
| Aggregate Value ($B) | $172 | $222 | $191 |

*Q4 Notable Announced Deals†:*

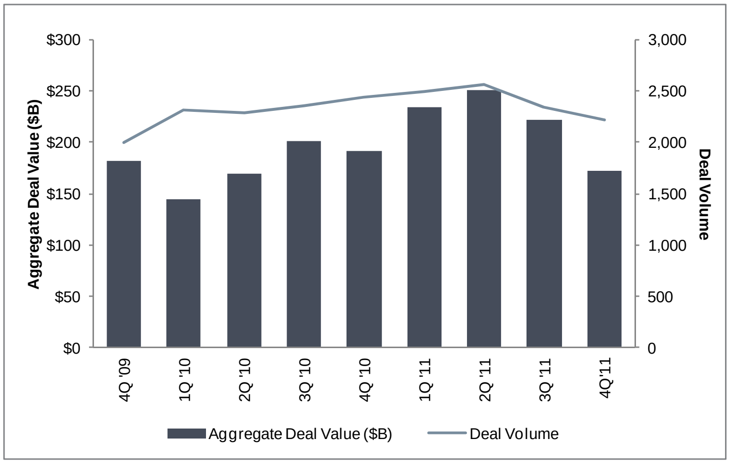
| Target | Acquiror | Date | Equity Value ($MM) |
|---|---|---|---|
| El Paso Corp. | Kinder Morgan | 10/16/11 | $19,998 |
| Pharmasset, Inc. | Gilead Sciences | 11/21/11 | $10,378 |
| Vulcan Materials | Martin Marietta | 12/12/11 | $4,741 |
| Brigham Exploration | Statoil ASA | 10/17/11 | $4,282 |

Sources: Mergerstat and Capital IQ.

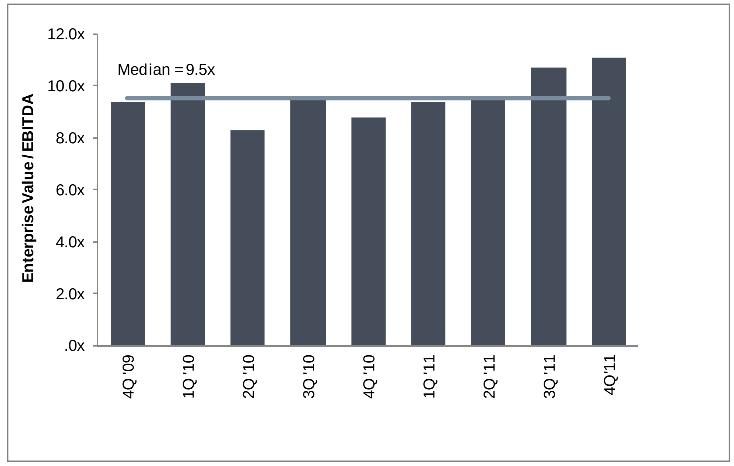
* S&P Earnings Growth and GDP Outlook statistics are derived from third-party, non-affiliated analyst estimates.
Cary Street Partners does not make estimates. Actual figures are in bold and estimates are italicized. Figures subject to change. Data as of 12/31/11. **Please refer to Page 8 for additional important disclosures.**
† Notable deals presented herein were selectively chosen by Cary Street Partners as deals which, in our opinion, are representative of recent activity in that sector of the capital markets. This is not an exhaustive list. **Please refer to Page 8 for additional important disclosures.**

## MARKET DATA

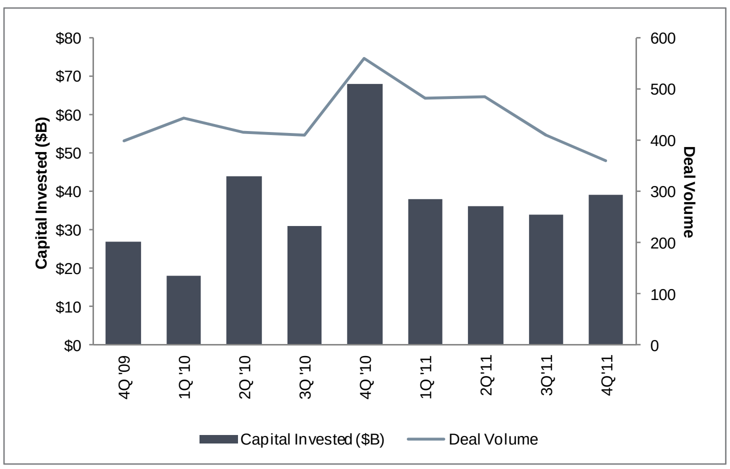
### U.S. M&A Activity



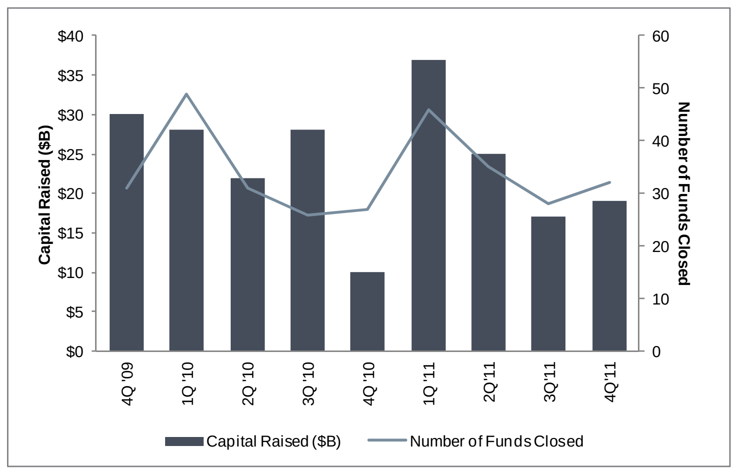

### U.S. Middle Market M&A Multiples



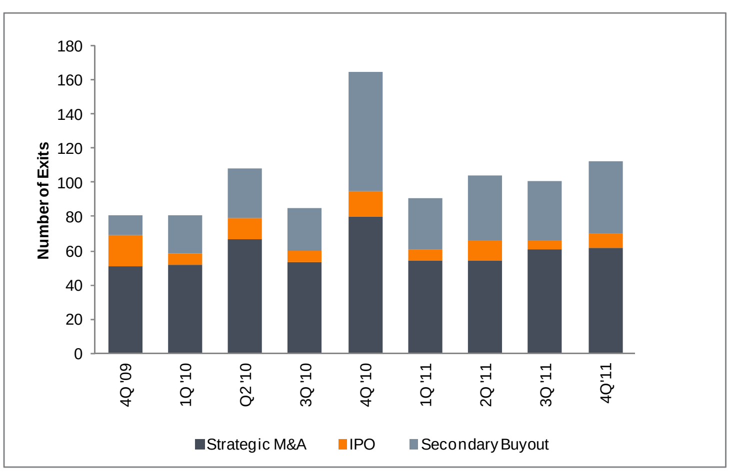

### U.S. Private Equity Investment Activity



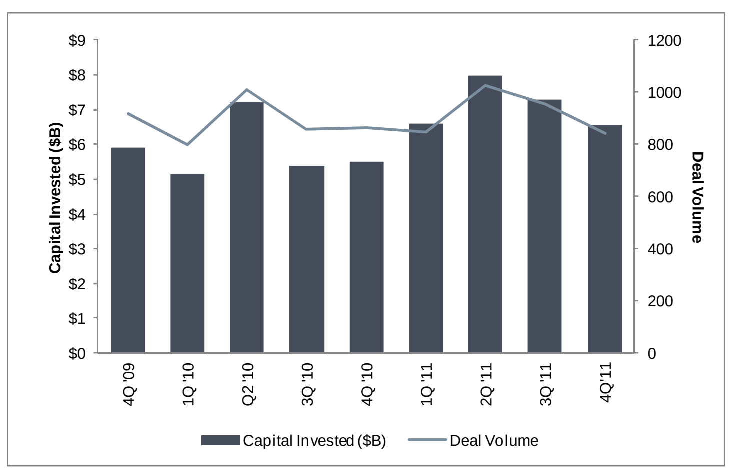

### U.S. Private Equity Fundraising




### U.S. Private Equity Exits




### U.S. Venture Capital Activity




Sources: FactSet Mergerstat; PitchBook Data, Inc.; Thomson Reuters.
Note: "Middle Market" defined as transactions with an enterprise value between $1 million and $500 million.

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