LOOKING AHEAD TO 2002

DESPITE A VOLATILE 2001 THE YEAR HELD SOME UNEXPECTED WELCOME SURPRISES. BUT WHAT WILL 2002 HOLD? **SAUL NATHAN** OF MORGAN STANLEY CONSIDERS THE POSSIBILITIES.

2001 was a year of both volatility and opportunity. Financing opportunities came and went with extraordinary speed as a function of unparalleled volatility. Once attractive financing solutions were rendered inoperable, often permanently. The forecaster standing on the threshold of 2001 would have been presented with a vista of endless cellular floatations (only one happened, Orange) – they would have been unlikely to predict the phoenix-like re-emergence of rights offerings as a mainstream financing tool, and certainly would have failed to estimate the volume of European equity financings would contract by 50-60% versus the prior year to fall to levels more reminiscent of 1996. And yet, there were successful transactions through the year pointing to the future outlook.

OPPORTUNITIES ABOUND. Whether it was the surprising resilience with which large initial public offerings (IPOs) were absorbed by the market – Agere, KPMG and Kraft in the US, or Orange, Statoil, Inditex or Friends Provident in Europe – or the success of sometimes daringly executed accelerated jumbo offerings – Vodafone, Swiss Re, Aegon or Ahold – the equity new issue market was remarkably robust and liquid. Institutional funds – both traditional and hedge – were capable of absorbing very large transactions that offered liquid investment opportunities in strong companies.

The greatest activity came in convertible and exchangeable debt transactions. This market saw volume that as I write exceeds that of the year 2000 by 20% and nearly four times the volume of 1996. The key drivers are not complex, since these instruments combine debt and option components, the unusual confluence of low interest rates and high volatility have offered issuers extraordinarily efficient financing opportunities. Instruments have been customised to achieve a broad range of specific objectives – from zero cost financing (Zurich Financial Services) to multiple portfolio monetisations (Telecom Italia exchangeable into TIM or SEAT) to the removal of a stock overhang (France Telecom). And consistent with past periods of emergence from an event-driven crisis, the convertible market was the first and most active market to reopen in the US and Europe following 11 September. The recognition by issuers that stock prices may not soon retrace their 2000 highs, has meant that the ability to capitalise on market 'mini rallies' by issuing an instrument with an embedded premium to the prevailing share price has offered an effective opportunistic financing source which can provide both balance sheet flexibility as well as realise significant proceeds. Indeed, the average European equity-linked issue in 2001 raised $654m compared with the five prior year average of $318m.

WHAT'S NEXT? For 2002, the equity markets will continue to focus on the global economic outlook. Equity markets have tended to discount economic recovery about two quarters in advance and most commentators would expect the trough in activity to be reached either side of the middle of the year. The geopolitical environment may nonetheless continue to contribute to a more volatile backdrop, which will in turn mean that financing 'windows' – periods of open access to financial markets, punctuated by more inaccessible phases – are likely to continue for some time. As in 2001, companies that are fully prepared to access the market opportunistically will find themselves at an advantage. The equity markets will be receptive to transactions (both IPO and follow-on offerings) for companies with compelling secular growth stories and a demonstrable track record. In general, the more liquid, the better, given the uncertain short-term outlook. Investors are unlikely to be willing to overpay for outsized earnings growth – particularly in sectors where the potential for disappointment is significant. As the year progresses expect to see further 'restructuring' based transactions, designed to allow firms either to rebuild their balance sheets with equity – some of which may be via rights offerings – or to refocus their business models, giving rise to subsidiary IPO and demerger transactions. And finally, the growth of the convertible market should continue. As a corollary, it is likely that the use of structured equity derivative transactions to achieve specific goals – tax, timing, balance sheet or rating agency driven – will also increase. In many ways, the least transparent of the equity markets, this area is likely to continue to offer innovative solutions for issuers who prefer an even more anonymous and customised approach to financing than that available in the public markets.

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