EQUITIES RALLIED DURING 2003 BUT WILL THE SURGE CONTINUE THROUGHOUT 2004? AND AFTER A TOUGH FIRST SIX MONTHS FOR IPOS, IS CONFIDENCE RETURNING? WE ASKED TWO EQUITIES EXPERTS, **GREG CHAMBERLAIN** OF CAZENOVE AND **KEVIN GARDNER** OF HSBC FOR THEIR VIEWS.

CAN EQUITIES KEEP UP THE MOMENTUM IN 2004?

- *There was a burst of equity-linked (convertible and exchangeable) issuance in the second half of 2003. Do you think supply of and demand for this will continue?*
- *The international public offering (IPO) market reopened late in 2003, but the number of issues was very low. Do you think the market will pick up?*
- *While we have seen a return of the rights issue in the past two years, many of them have been driven by necessity, in order to repair balance sheets. Will we see mergers and acquisitions (M&A)- and/or growth-driven rights issues in 2004?*
- *Many venture capital (VC) firms are sitting on investments made in the past three to five years that they would normally be looking to exit but have been unable to float/IPO because of poor market conditions. Are the conditions ripe for a rush of VC-led IPOs, or will VC houses have to look elsewhere for their exits?*
- *What is your prediction for the FTSE 100 index on 30 June and 31 December 2004?*

GREG CHAMBERLAIN
DIRECTOR, INTERNATIONAL CAPITAL MARKETS, CAZENOVE

DO YOU THINK SUPPLY OF AND DEMAND FOR EQUITY-LINKED ISSUANCE WILL CONTINUE?
The burst of activity was largely triggered by the fact that equity volatilities were at historic highs, enabling companies to issue convertibles on much more attractive terms than had previously been available. This was because the high volatilities meant investors placed a higher valuation on the equity option inherent in a convertible bond. A further contributory factor was that the convertible market was open and available to BB-rated issues, at a time when the pure equity and/or pure debt markets were either effectively closed or, at best, very expensive. Since then, many volatilities have slipped back, and the pure equity and debt markets have become more willing to fund BB-rated companies. It would not, therefore, be surprising if the pace of convertible issuance levelled off. Although the market remains very much open and is expected to show a good level of activity in 2004.

DO YOU THINK THE IPO MARKET WILL PICK UP?
Market conditions at the beginning of 2003 were such that the first significant European IPO, Benfield Group, did not take place until June. However, both this and the float of Yell Group were increased in size and traded at first day premiums, signalling a reawakening of the new issue market. The flotation of Wolfson Technology in October represented the first technology IPO in the UK for 18 months and received an overwhelmingly positive reaction from institutional investors. The revival of the new issues market continues to gather pace, albeit from extremely low levels, and a range of potential new issues should materialise in 2004 as companies and their owners detect an increasing appetite among investors. While the IPO market increases in confidence, the strength of each investment case and company management will

be tested to the full, as the terms and speed of recovery in the new issue market remain firmly in the hands of the demand side.

WILL WE SEE M&A - AND/OR GROWTH-DRIVEN RIGHTS ISSUES IN 2004?

More than £20bn has been raised in Continental Europe and the UK through rights issues since the beginning of 2002. So far in 2003, close to 50% of European equity capital market activity has been in this form and, for the most part, funds have been raised to refinance damaged balance sheets, most notably for European insurance groups. The extent to which future M&A activity occurs will be influenced by the economic recovery that has become increasingly evident in the second half of this year in the UK and the US and, to a lesser extent, Euroland. As companies see improving opportunities to grow their business through acquisition, we expect management to take advantage of improving equity market sentiment and use the equity capital markets, including rights issues, to fund that growth. Furthermore, an unwillingness to risk increasing gearing and debt levels, particularly as the interest rate cycle has reached its nadir, will focus companies' attention on turning to their shareholders, rather than banks, to fund value enhancing acquisitions as well as organic growth.

ARE THE CONDITIONS RIPE FOR A RUSH OF VC-LED IPOS, OR WILL VC HOUSES HAVE TO LOOK ELSEWHERE FOR THEIR EXITS?

Over the past few months, reflecting improved market conditions, institutional investors have become much more enthusiastic about new issues and they are keen to see good quality investment opportunities. To date, however, there have been a limited number of IPOs, largely because, prior to committing to an IPO, companies want some certainty of success. However, assuming a continued and sustained improvement in economic conditions and greater confidence, there should be a larger number of IPOs in 2004 and good companies will be well received. This should provide an opportunity for private equity investors. Institutional investors will be deterred, however, if lower quality businesses start coming to the market. IPOs apart, private equity investors have other exit options, namely secondary buyouts, trade sales and refinancings. At present, in most cases, all these options are open to financial investors and, in devising an exit strategy to create greatest value, they will give consideration to each.

WHAT IS YOUR PREDICTION FOR THE FTSE 100 INDEX ON 30 JUNE AND 31 DECEMBER 2004?

We expect the FTSE 100 to be around 4,400 in June of next year and at a similar level in December. Although the UK equity market appears relatively cheap compared with US equities, trading on 13 times next year's earnings, it remains at the higher end of its historical P/E ratio range. Moreover, the lower rating of UK equities, in large part, reflects the sector composition, in particular the high weighting of the banking sector, which accounts for more than 20% of the index. We believe that a strengthening global economy next year is now discounted by global equity markets and the cyclical sweet-spot is nearing its end. Next year, good economic news is likely to coincide with rising interest rates and, consequently, markets are unlikely to make much headway. However, the high dividend yield of the UK market suggests that equities are likely to deliver a more normal total return in 2004 after a very strong 2003. greg.chamberlain@cazenove.com

KEVIN GARDINER
HEAD OF EUROPEAN EQUITY STRATEGY, HSBC

DO YOU THINK SUPPLY OF AND DEMAND FOR EQUITY-LINKED ISSUANCE WILL CONTINUE?

The UK corporate sector in aggregate is running a financial surplus that has rarely been larger. Some of the sectors that were particularly hard-pressed, such as telecoms, have largely rebuilt their balance sheets and are raising payout ratios – the need for external finance has fallen. Moreover, the decline in equity volatility, and the turn in the interest rate cycle and corresponding backing-up in gilt yields, suggests the relative attractiveness of convertibles in particular may have faded somewhat. However, we believe that activity in the convertibles market will be underpinned at relatively healthy levels. Institutional demand for assets other than conventional equities will likely remain structurally higher than in the last cycle, and mergers and acquisitions (M&A) activity – a source of more opportunistic issuance – has yet to pick up materially.

DO YOU THINK THE IPO MARKET WILL PICK UP?

With profits growing again and investor appetite for risk slowly recovering, the conditions for equity issuance are improving. Meanwhile, after the paucity of public offerings in the past two years, and the recent buoyancy in the private equity market, there must be some pent-up supply to come. However, there are still plenty of macroeconomic risks around – rising short-term interest rates in the UK and the unresolved issue of the US current account globally – and general market conditions will likely remain volatile. The likely revival in IPOs will be a gradual one.

WILL WE SEE M&A - AND/OR GROWTH-DRIVEN RIGHTS ISSUES IN 2004?

We believe we will see both. Corporate activity has recently been running at its lowest levels in a quarter century and capital spending has been cyclically depressed. Meanwhile, most distress-driven issues are probably behind us.

ARE THE CONDITIONS RIPE FOR A RUSH OF VC-LED IPOS, OR WILL VC HOUSES HAVE TO LOOK ELSEWHERE FOR THEIR EXITS?

A rush of IPOs of any kind is unlikely. VC owners in particular will likely be patient: having had the nerve to buy assets at a time when investor confidence generally has been at its lowest levels in a generation, they are unlikely to be panicked into selling into the early stages of the equity rally. Meanwhile, financial and trade sales will likely remain an important exit route for VCs: many balance sheets are being streamlined and refocused, and acquisitions as well as disposals will feature on many boards' agendas for 2004.

WHAT IS YOUR PREDICTION FOR THE FTSE 100 INDEX ON 30 JUNE AND 31 DECEMBER 2004?

At current dividend and bond yields (3.3% and 5% respectively), the UK market looks still to be discounting a significant and lasting decline in profitability. This looks overly pessimistic and as it becomes clearer that profitability is indeed being rebuilt, we expect the equity market to rally further. We see the FTSE index at 4,700, roughly 8% above its current level, in a year's time. kevin.gardiner@hsbcib.com