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"Event Driven & Special Situations"

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Survey results and 2010 Event Driven strategy outlook

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Nomura Capital Introductions Briefing

Europe Volume VI – “Event Driven & Special Situations”

Nomura Capital Introductions sponsored a breakfast event titled "Event Driven & Special Situations" as part of an ongoing series covering topical subjects across the Alternative Investment Market.

The event took place on February 10, 2010 in London and consisted of an outlook on the M&A environment in 2010 and what the opportunities or pipeline might be, by Nomura's Adrian Mee, followed by a panel discussion featuring a group of distinguished managers.

Manager Panel

- **Amber Capital** – Joseph Oughourlian, PM & Managing Partner
- **Concordia Advisors** – Jason Hathorn, Co-Head Global Equity Relative Value Strategy & PM
- **Laffitte Capital Management** – Eric Robbe, Chairman & Founding Partner
- **Trafalgar Asset Managers** – Sean Laird, Senior Analyst

Nomura Presenter & Moderator

- Adrian Mee, Global Head of M&A, Nomura Investment Banking Division

Set out below, we are pleased to present a recap of some of the views expressed by the speakers.

Event Driven & Special Situations

The M&A outlook for 2010 – gradual improvement expected

The M&A cycle displays a consistent pattern, with a relatively strong correlation between deal activity and overall market capitalisation. M&A activity tends to follow an improving equity market environment, building to a peak over a four to five year period, before dropping away very rapidly once that peak is passed.

From the 2000 peak to the 2002 trough, for example, total global deal volume dropped by 65%, while from the 2007 peak, volumes dropped by 50% to the 2009 trough. Of note, in this latest cycle, sponsor volumes have been hardest hit, falling from 20%-25% of the total in the US and Europe in 2007, to around 6% in 2009.

Based on average monthly volumes, there were signs of a pick up in activity towards the end of 2009. This was more evident in the US and Asia than Europe (where volumes declined the most from the peak). Volumes in Asia were least impacted by the downturn.

This pick up has fuelled some market optimism that M&A is back and volumes can be expected to pick up substantially. However, doubts remain as to how quickly increased volumes will flow through. Assuming that economic conditions permit reasonable stability in equity markets and a modest appreciation in overall market capitalisation, deal volumes could improve by 20% plus.

A number of factors support this improvement in M&A activity, most important among which are the stabilisation in the global economy (including the relative strength of the emerging markets) and the momentum in equity markets. In such an environment, corporate confidence increases and underpins a pick up in activity.

The financing environment, too, has improved, particularly in the capital markets. Company balance sheets are becoming richer in cash, at a time when returns on cash are low. Against this backdrop, M&A presents an opportunity to gain incremental growth for companies operating in low growth environments. Additionally, stronger companies will seek to optimise their portfolios and to benefit from the restructuring and disposal of distressed assets by weaker competitors. Sponsor activity is also returning, albeit at the smaller end of deal sizes.

However, there are risks to some of these supportive factors – for example the uncertainty regarding the outlook for GDP growth, continuing tightness in the availability of bank finance and recent equity market volatility – and this will impact corporate confidence and can be expected to slow the rate at which M&A activity improves. M&A activity in 2010 will follow an upward track, but progress is likely only to be gradual.

Event driven and special situations fund manager panel discussion

Against the backdrop of an M&A market that is expected to show gradual improvement in deal activity from last year's trough, Nomura assembled an expert panel of fund managers to discuss the opportunities and risks in the event driven and special situations space.

- Strong companies, which are cash rich or have access to capital, will prey on weaker competitors with bad market position or poor access to capital;
- A 'perfect storm' in commodities, power and basic materials and the cash rich position of the technology and healthcare sectors suggests M&A will increase in these areas;
- Rationalisation of inefficient, antiquated capital structures will drive deal activity in continental Europe;
- Discounts at multi-year highs offer trading opportunities even in the absence of events;
- Market complexity in European and Asian markets offers the potential for returns;
- Analysis of stakeholder behaviour, timeline risks and suitable use of options are the keys to effective position risk management;
- Leverage utilised is a function of the available opportunity set, the type of trades held in the portfolio and the macro environment;
- Liquidity matching of assets and liabilities is now of greater importance in the post crisis market environment.

Lions and Wildebeest

In the M&A market the strong prey on the weak. Cash rich companies have two options; return money to shareholders via dividends and buybacks or pursue external growth through acquisitions. In a low interest rate environment where costs have already been cut aggressively, expectations for organic growth will be limited and the acquisition route will be favoured. With capital markets now open again for strong businesses, the cash rich will be joined by those with access to financing in acquiring weaker competitors, which lack that access.

In the commodities sector, for example, small gold miners cannot currently access the capital required to build out pipeline projects and many trade at substantial discounts to NAV leaving them vulnerable to acquisition by the majors. The macro backdrop provides additional support for a significant pick-up in M&A in commodities, power and basic materials. These sectors face a near 'perfect storm' of strong commodity prices, robust stock prices (basic materials was the strongest performing sector in 2009), confident CEOs and the emergence of strategic buyers, such as China and India, which are worried about commodity supply risk.

Cash rich sectors that could prove fertile ground for events in 2010 include technology, in which IT hardware, semiconductor equipment, Internet, IT services and communications have the highest aggregate net cash positions in the market. In healthcare, which is also among the cash rich sectors, there is a need to position for change arising from healthcare reform. Regulatory change, alongside the need to raise fresh capital, could also be a factor in underpinning M&A activity in the financial services sector.

Antiques roadshow

After two very volatile years, businesses emerging from the crisis having cut costs are realising that there is also an opportunity to optimise their capital structures. In continental Europe and also in Asia, significant antiquated capital structures remain – such as family-owned businesses, cross-holdings and different classes of shares. The economic rationale for multiple share classes and listings is limited and companies often tidy up these inefficient structures. Over the last 12 years one panellist has profitably exploited more than 150 examples of such structures that have been optimised.

One panellist believes that, of the five categories of trades his firm considers, holding companies and stubs are most likely to produce events in 2010. In these categories, discounts – currently 20%-30% in many areas in both Europe and Asia – are at levels conducive to events occurring but the market is attaching a zero probability to an event. Discounts at the end of December 2009 were at their widest levels for many years, offering considerable opportunity, given correct trade selection, to position for a tightening. Should an event occur, discounts could jump from 20%-30% to less than 10%, providing the icing on the cake.

Further opportunities arise from understanding the vagaries of markets in different countries. Compared with the very mature and efficient US markets in which prices rapidly revert to fair value, markets in Europe and Asia offer the potential to exploit more persistent anomalies. While Europe is of a comparable economic size to the US, its many countries have political, regulatory and cultural differences. In China, meanwhile, returns can be generated in the stock market by exploiting the complexities surrounding the rights and dividend streams attached to different share classes, while in South America voting shares can trade at a discount to non-voting shares, contrary to the expected pattern found in more developed markets.

A good night's rest

While broader macro themes help define the opportunity set, the panel takes a market neutral view. The focus is more on bottom-up factors to try to capture the alpha in M&A activity, while using the equity market as a hedge to deliver returns regardless of market direction. Opportunity in the post credit crisis environment, however, must be balanced with a sharper focus on risk management. As one panellist describes it, this involves addressing two concerns: maintaining the ability to be able to sleep at night whilst retaining the ability to make money in chaotic markets.

The ability to sleep rests on knowing the financial downside to each investment, reached by a careful analysis of the potential reactions of all interested parties to each step in the M&A process and an assessment of the potential risks in the deal timeline, such as the potential for a counter-bid. Trade construction, too, plays an important role – for example with the use of put options to hedge the downside and using call options to lever the upside. The key to making money in chaotic markets, meanwhile, is to look across markets – for example, in equities, credit and mortgages – to find cheap hedges that can deliver returns each month.

The main risk in M&A activity is the risk of deal failure, which can occur for a number of reasons – antitrust issues, regulatory or shareholder approvals, or even exotic factors such as the weather (Hurricane Katrina de-railed the completion of one 2005 deal 2 days prior to completion). But the relative importance of different risks also varies across the economic cycle. For example, between 2003-07 when the expansion of the leveraged loan market was a key driver in the rapid growth of M&A activity, financing came almost to be taken for granted. But by the latter part of 2008, following the collapse of the syndication market, the need to have financing in place became a far more important factor in deal completion.

To lever or not to lever....

Using differing degrees of leverage is an important part of the risk management process and is a function of the available opportunity set, the type of trades held in the portfolio and the macro environment. If M&A activity increases, leverage would be expected to increase. If the portfolio, for example, contains predominantly pure relative value trades, leverage could be higher than in a book with more deep value distressed credit opportunities. The market and economic environment, meanwhile, through its impact on volatility, also helps determine the appropriate degree of leverage. If a fund is targeting returns of, say, 12%-13%, volatility will determine the extent of leverage required to achieve this performance. One panellist for example noted that in 2008 his fund used practically no leverage, given the high levels of volatility.

2008 also marked a sea change in the need to address market liquidity as part of the risk management process. The panellists focus on liquid strategies, match the liquidity of their assets and liabilities and restrict position sizes to between one and three days daily average volume. Similarly, portfolio risk is mitigated by diversification. The panel's funds hold between 20-55 deals, which at the upper end of the range might raise concerns over portfolio management. The panel, however, highlights that the incremental work involved in adding a new trade in a sector that the manager has followed for 15 years is relatively low. Meanwhile, pre-filtering the potential universe for situations where the manager has an edge, or where there is scope for outsize returns, also improves the balance of risk versus return.

In summary, against an expected gradual improvement in the level of M&A activity, event driven managers look well-placed to exploit the antiquated capital structures and market complexities of the European and Asian markets, while also backing strong companies to acquire their weaker rivals in a post-crisis environment still constrained by selective access to capital.

Investor Intelligence

Investor audience

A total of 53 investors from 42 distinct investor firms attended the “Event Driven & Special Situations” event, held on Wednesday 10th February 2010. These firms combined allocate or advise over \$286 billion of assets to hedge funds. The event was attended by a diverse range of investors including Fund of Funds, Family Offices, Consultants and Wealth Management Platforms.

Survey background information

From the investor survey we wanted to understand investor’s likely allocations in the next quarter (i.e., up to June 30th 2010), how their portfolio is currently allocated in terms of regional exposure and structure, and also to identify investor’s top priorities when assessing a manager.

A total of 29 investors from 27 distinct investor firms responded to the questionnaire. To avoid double-counting, the key findings outlined below are based on responses at the firm level.

Key findings

Event Driven strategies will be receiving the greatest number of allocations in the next quarter according to the investors who responded. Interestingly, distressed strategies appear to only be receiving limited allocations in the next quarter, although investors believe that this will be one of the best performing strategies in 2010.

The respondents are planning on investing up to \$1.8 billion within the next quarter, with 38% expecting to allocate to 6 or more managers.

A majority of the respondents are currently invested in US-based managers (61%), with Europe (29%) and then Asia (10%) trailing.

94% of investments are in co-mingled funds, with UCITS vehicles and managed accounts making up the balance.

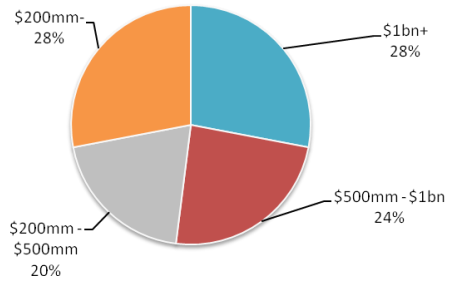
When assessing managers, the top priorities are transparency and liquidity, with size (AUM) and fees being the lowest priority.

Please find below a detailed overview of the responses by investors.

Question 1: Please state your current hedge fund AUM (\$mm)

27 investors responded to this question. Reflecting the diversity of investors in attendance, this was well distributed from those with below \$200 million to those with £1 billion plus.

Current Hedge Fund AUM \$mm



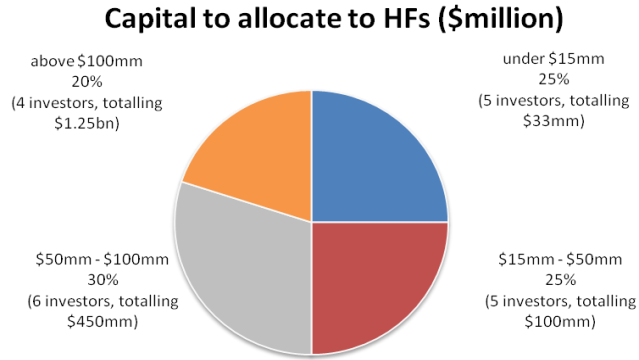
Question 2: Which strategies do you intend on allocating to in the next quarter?

- 26 investors responded to this question, providing 57 indications of strategy interest. Event Driven was by far the most popular strategy, followed by Macro and Equity Long/Short.

Major Strategy Interests	# of Responses	Percentage
Event Driven	21	37%
Macro	10	18%
Equity L/S	7	12%
Fixed Income	4	7%
UCITS	3	5%
Emerging markets	2	4%
Distressed	2	4%
CTA	2	4%
Other	6	11%
Total	57	100%

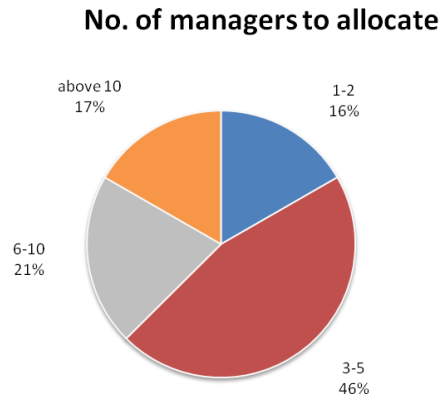
Question 3: How much capital (\$mm) do you intend on allocating in the next quarter?

- 20 investors, allocating approximately \$36 billion to hedge funds, responded to this question. In total the respondents expect to allocate up to \$1.83 billion within the next quarter, which equates to 5% of their total AUM. 50% of respondents intend to allocate \$50 million or less to hedge-funds within the next quarter (\$133 million in total), 25% expect to allocate less than \$15 million (\$33 million in total). 50% of respondents intend to allocate above \$50 million (\$1.7 billion in total) with 20% allocating above \$100 million within the next quarter (totalling \$1.25 billion).



Question 4: How many managers do you intend to allocate to in the next quarter?

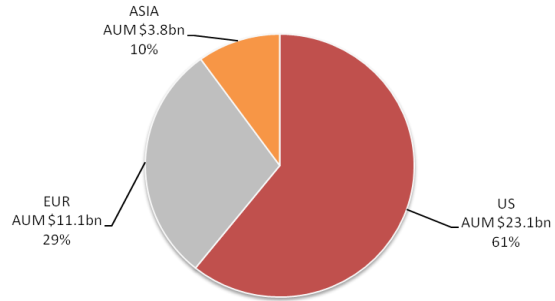
- 24 investors responded to this question. The majority expect to allocate to 3-5 managers with the remainder fairly evenly distributed. 38% intend to allocate to 6 or more managers, with 17 % looking to allocate to more than 10 in the next quarter.



Question 5: What is your portfolio's regional exposure (i.e. location of manager)?

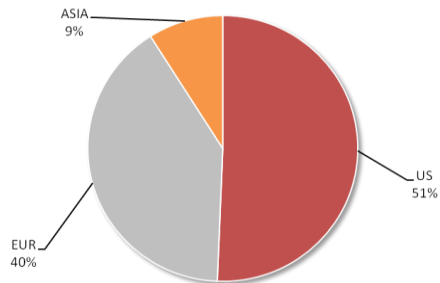
- 23 investors, allocating approximately \$38 billion to hedge funds, responded to this question. Based on the AUM of the respondents, the majority, 61%, is allocated to US managers, with Europe accounting for 29% and Asia for 10%.

HF regional exposure - based on AUM



- Based purely on the respondent's stated ratios of exposure across the regions, US managers account for 51%, Europe 41% and Asia 9%.

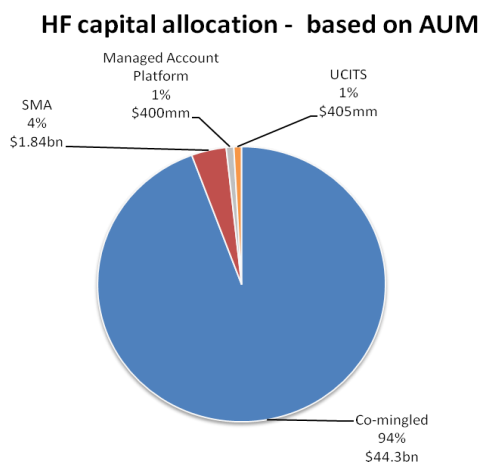
HF regional exposure - responses



Question 6: How is your capital allocated (%) across:

Offshore co-mingled, UCITS, Separately managed account, Managed account platform:

- 24 investors, allocating approximately \$47 billion to hedge funds, responded to this question. Based on the AUM of the respondents, the majority, 94%, are allocated to co-mingled funds, with SMAs, Managed Account Platforms and UCITS making up the balance.



Question 7: Please rank the following in order of priority:

Fees, Transparency, Size (fund AUM), Liquidity, Track record, Operational infrastructure (1 = most important / 6 = least important):

- 25 investors responded to this question, combined they have approximately \$38 billion allocated to hedge funds. Transparency and liquidity were the two most important factors to the respondents, whereas size (fund AUM) and fees were seen as the lowest priority for most investors.

Overall Priority Ranking

Rank 1	Transparency
Rank 2	Liquidity
Rank 3	Operational Infrastructure
Rank 4	Track Record
Rank 5	Size (fund AUM)
Rank 6	Fees

	Priority: Transparency	Priority: Liquidity	Priority: Op. Infra.	Priority: Track	Priority: Size (AUM)	Priority: Fees
Total Responses	25	25	25	25	25	25
Top Rank 1 & 2	60%	52%	44%	40%	12%	4%
Middle Rank 3 & 4	32%	32%	40%	32%	40%	16%
Bottom Rank 5 & 6	8%	16%	16%	28%	48%	80%

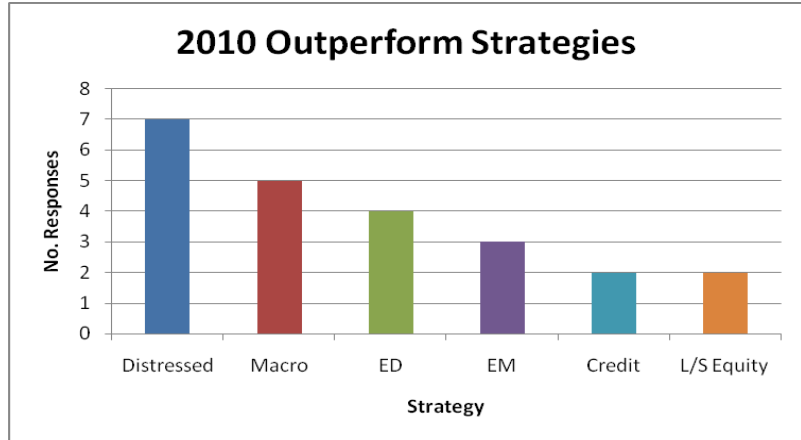
Individual Rankings With Combined AUM of Respondents

	Priority:	\$ Capital		Priority:	\$ Capital
	Transparency			Liquidity	
Top Rank 1 & 2	60%	19,810	Top Rank 1 & 2	52%	8,470
Middle Rank 3 & 4	32%	15,310	Middle Rank 3 & 4	32%	20,600
Bottom Rank 5 & 6	8%	3,100	Bottom Rank 5 & 6	16%	9,150
	Op. Infra.			Track	
Top Rank 1 & 2	44%	23,910	Top Rank 1 & 2	40%	23,010
Middle Rank 3 & 4	40%	11,970	Middle Rank 3 & 4	32%	11,300
Bottom Rank 5 & 6	16%	2,340	Bottom Rank 5 & 6	28%	3,910
	Size (AUM)			Fees	
Top Rank 1 & 2	12%	1,440	Top Rank 1 & 2	4%	100
Middle Rank 3 & 4	40%	15,360	Middle Rank 3 & 4	16%	1,700
Bottom Rank 5 & 6	48%	21,420	Bottom Rank 5 & 6	80%	36,420

- 60% of the respondents ranked transparency in the top two, which equates to \$19.8 billion of the \$38 billion represented by the questionnaire.
- While liquidity ranked highly as measured by the number of respondents, it was less significant on a capital weighted basis. 52% of respondents ranked it in the top two, representing \$8.4 billion of the \$38 billion total. Whereas the 32% of respondents ranking liquidity 3rd or 4th represent \$20.6 billion.
- Operational infrastructure was strongly ranked in the top and middle ranks, with 44%, representing \$23.9 billion, ranking it in the top two.
- 40% of the respondents, representing \$23 billion, ranked track record 1st or 2nd. Whilst 28% ranked this in the bottom two, which only represents \$3.9 billion of the total.
- Only one respondent ranked fees in the top two and they represent only \$100 million of the total \$38 billion. In dollar terms, \$36 billion of the \$38 billion placed fees in the lowest two rankings.

Question 8: Which strategy/ies will in your view outperform this year?:

- 18 investors gave a total of 29 responses to this question. Distressed was indicated the greatest number of times, with Macro and Event Driven close behind. EM, Credit and L/S Equity were also expected to outperform.



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