

# ROC PREF III CORP.

## P-2 (LOW) RATED PREFERRED SHARES

UPDATE — March 2007

 CONNOR, CLARK & LUNN

CAPITAL MARKETS

### WHAT HAPPENED

Standard & Poor's recently announced that ROC Pref III Corp.'s preferred shares, which had been on CreditWatch since November 16th, 2006, have been downgraded from P-2 (mid) to P-2 (low) and removed from CreditWatch.

The move to CreditWatch and subsequent downgrade was precipitated by recent ratings downgrades within the ROC III portfolio. These downgrades came principally as a result of leveraged buyout (LBO) activity. The performance of the reference portfolio has been positive both in absolute terms and relative to the broad credit markets so far in 2007. The recent extremely high pace of leverage buyouts, however, has led to a number of credit rating downgrades of reference entities to below investment grade. This has, in turn, affected the rating of the Credit Linked Note (CLN) and the preferred shares. The current wave of LBO activity is largely driven by an extremely strong overall credit environment by historical standards and the consequently low price of borrowing for sub-investment grade companies.

### MANAGER COMMENTARY

- The ROC III preferred shares are trading cheaply compared to their rating, even after the downgrade
- NAV is performing reasonably well. Currently at \$23.14, it is at its highest in 18 months (since August 2005). NAV is a better indication of what the market thinks about the portfolio than the rating.
- ROC III is maturing. It goes inside 5 years to maturity this month, after which rating stability should improve. Default probabilities decrease with time and improve much more quickly once you pass the 5 year mark. For investment grade companies, default probabilities decrease at approximately 20% a year between 7th and 5th years. Between the 5th and 4th year that number increases to 27% and between 4th and 3rd years, to 34%.
- The investment manager has expressed continued confidence in the portfolio with respect to default risk. There has been significant trading carried out to improve the credit quality of the portfolio in the past nine months. The trading reserve account is sufficient to allow the investment manager to trade defensively should the need arise.

### COMPARABLES BASED ON MARCH 7 CLOSING PRICE

Preferred Shares	Rating	Yield to Maturity	Tax Treatment	Dividend Equivalent	Bond Equivalent	Years Left
ROC Pref III Corp	P-2(low)	6.87%	ROC	7.00%	10.41%	5.0
Sixty Split Corp.	Pfd-2(low)	4.68%	DIV	4.68%	7.19%	4.0
High Income Pref Corp.	Pfd-2(low)	4.90%	DIV	4.90%	6.14%	5.3
Charterhouse PSI	Pfd-2(low)	5.86%	ROC	6.21%	9.23%	7.4

- Trading can improve the portfolio's average rating and help stabilize the preferred shares' rating without necessarily improving the default probability of the portfolio. In the investment manager's opinion, it would be wasting the trading reserve account to trade up in average rating without actually reducing the probability of default. The trading reserve account is a significant asset that is not considered in assigning the credit rating. Thus the investment manager may allow the preferred shares to absorb a downgrade if the trades needed to avoid it would not improve overall credit quality.
- The high level of LBO driven downgrades poses a risk to the rating of the preferred shares, but the investment manager is not worried about increased risk of default.
- While downgrades have been increasing due to leveraged financing of the purchase of investment grade assets, default rates remain very low.
- **Note:** A leveraged buyout is a debt-financed transaction, usually via bank loans and bonds, aimed at taking a public corporation private. Because of the large amount of debt relative to equity in the post-LBO corporation, bonds of such companies are typically rated below investment grade.

### INVESTMENT MANAGER NOTES REGARDING SPECIFIC COMPANIES

- We do not believe four of the LBO names, Sabre, Qantas, ClearChannel and Tribune, are significantly higher default risks in the near term. Each entity will take on more leverage on closing of their respective transactions. ClearChannel is expected to close at the end of 2007. Qantas has cleared a significant hurdle in receiving government approval and is expected to close in the first half of the year. The Sabre transaction is scheduled for June 2007. A Tribune transaction has yet to be announced. While we will take any favourable opportunity to exit from an LBO company, LBOs are carefully structured by highly motivated equity investors and management, and we would not expect them to weaken quickly. As well, they are typically flush with liquidity after completing large debt financings.

*Notes continues....*

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- Radioshack has had difficulty in transforming itself from a tired retailer to a more focused convenience oriented consumer electronics/services provider. While significant issues remain, including a challenging wireless market and shrinking margins in important products such as flat screen televisions, the balance sheet remains solid and free cash flow generation should remain positive as the company pares down its capital expenditure spending. The company has closed 505 stores and eliminated 7,000 jobs since turnaround specialist Julian Day became CEO in July.

SG&A was down 16% in the fourth quarter and the company has generated positive free cash flow for three consecutive quarters. Spreads have responded strongly to recent positive operating results, significantly outperforming the market. In addition, Radioshack's stock has returned over 50% year-to-date. The risk of an LBO still cannot be ruled out, however, if the turnaround continues to gain traction, this risk becomes significantly diminished.

- TDS was traded out of the portfolio on March 3, 2007. Our concerns stem from ongoing internal accounting investigations which have resulted in material restatements. While restatements have not been alarming in size, the risk of future restatements and our lack of confidence in management has caused us to trade out of this name.
- TXU was traded out of the portfolio on March 3, 2007. Given our expectation of a single-B rating, spreads were not compensating for the risk. This trade was also driven by a better opportunity with a similar spread.
- With corporate credit ratings of B, Ford Motor Credit Corp and Lear Corp. are the lowest rated companies in the portfolio. We continue to remain confident that the underlying lending business at Ford Motor Credit Corp. is stable. In the event the parent, Ford Motor Company, should move towards default our view is Ford Credit would be sold in a similar manner to GM's sale of a majority stake in GMAC. We are monitoring the situation closely given the latter scenario would probably entail some volatility in ratings.
- Lear is the company with the highest spread in the portfolio (and therefore the one that the market perceives as the riskiest). On balance, we are less worried about default in this name than a year ago. The market agrees – Lear's spread has gone from over 900 basis points last March to around 400 today. The positive news is that the company appears to have adequate liquidity and has positive free cash flow. As well, Carl Ichan recently bid for the company, which could prompt a merger/partnership which could benefit Lear. New product lines have been moving well and costs appear to be under control. There is an overhanging concern however, given production cutbacks by the Big 2; 46% of Lear's sales are to GM and Ford.

 RECENT DOWNGRADES

<i>Company</i>	<i>Rating Change</i>	<i>Cause</i>	<i>S&amp;P Outlook</i>
RadioShack	BBB- to BB	General business deterioration	Negative
Tribune	BBB- to BB+	LBO candidate	CW negative
Clear Channel	BBB- to BB+	LBO announced	CW negative
Telephone & Data Systems	A- to BBB	Delay in issuing results	Traded out of portfolio
Sabre Holdings	BBB+ to BB	LBO announced	CW negative
TXU Corp.	BBB- to BB	LBO announced	Traded out of portfolio
Qantas	No change	LBO announced	CW negative
Lear Corp.	B+ to B	General business deterioration	CW negative