Zachary Scott—an investment banking and financial advisory firm—has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

Zachary Scott
INVESTMENT BANKERS

PERSPECTIVES ON THE CAPITAL MARKETS WINTER 2012

IN$IGHT

Financing With Growth Equity

Equity capital could be an alternative for financing a rapidly growing business.

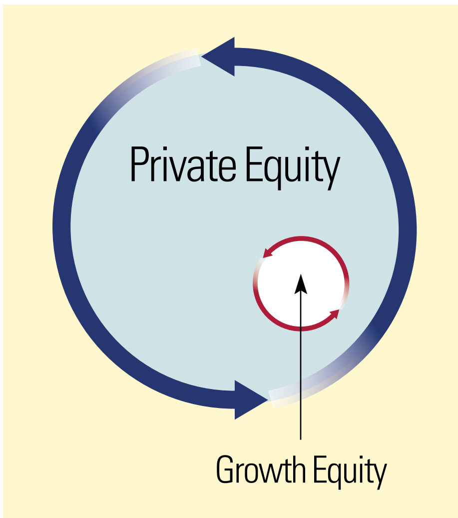
by Michael J. Black

The relationship between the passage of time and increase in business value does not follow a smooth curve. At certain times in the evolution of a business, the next step can result in an outsized change in the value of the business. Expansion of a product to a different channel of distribution, the creation of a new manufacturing plant, or any number of strategic initiatives might deliver the next breakthrough. Taking advantage of those value-creation opportunities typically comes with some additional risk, either operational or execution risk or, because such opportunities almost always require the investment of additional capital, financial risk. It is at this inflection point that growth equity can be used to raise the business to the next level.

Appropriately, business owners look first to their lowest cost of capital source, the company's banks or senior lenders. Most lenders seek to fund incremental growth, but may shy away from funding sizable new growth initiatives, particularly those that require outsized investment with uncertain timing for the realization of cash flow from that investment.

Mezzanine (subordinated) debt offers another source of capital if senior debt is approaching its reasonable limit. Although expensive, the potentially high returns on capital at this stage of the company's development generally justify the cost of mezzanine. Some owners may understandably resist coupling financial leverage together with the execution risk of the strategic initiative given the myriad of uncertainties in the business outlook. Therefore, if the level and timing of cash flow from the growth opportunity is uncertain, the prudent alternative might be equity capital, which does not have contractually scheduled calls on cash flow.

Growth equity is a specialized subset of the trillion-dollar private equity market. In addition to private equity, investors might include wealthy families or foundations. The



parameters of growth equity vary considerably depending upon the desired use of proceeds and the capital provider's industry, size, and structure preferences. Typically, but not always, growth equity takes the form of a minority investment, with the majority (again,

Growth equity is a specialized subset of the trillion-dollar private equity market.

not necessarily all) of the capital going into the business. The central tenet in a growth capital investment is that the funds unlock latent growth potential, creating a sustainable stream of incremental cash flows that increase the value of the enterprise.

If an opportunity exists to create incremental enterprise value (expected returns > the cost of capital), and taking on more debt is not available or is not appropriate, business owners should consider joining forces with a growth capital investor in order to execute the plan. Matching the growth investor with the appropriate company situation involves several considerations, the most important of which we address briefly here.

USE OF PROCEEDS

Growth equity investors generally target their investments to achieve the business growth initiative, not to generate liquidity for selling shareholders. In fact, growth capital investors typically require that some portion of current owners'/managers' capital remain at risk. That being said, some investors make the case that by freeing the entrepreneur (or inactive shareholder) from fear of wealth loss, business prospects improve through pursuit of prudent (if slightly more risky) growth opportunities. In all cases, a need must exist for capital to address new markets, targeted acquisitions, facility expansions, or similar strategic uses.

STRUCTURE

Growth equity investors act more like financing sources than owners, therefore their objective is not to "take over the reins." The most common investment by a growth equity investor takes some form of preferred minority equity. Typical terms include:

- The new money occupies a priority position in the capital structure relative to the common equity owners;
- The new investor is granted rights to a priority return, typically in the range of 6-8% that accrue if cash flow is inadequate to pay on a current basis.
- Although granted certain preferences, the new equity converts to common for all "economic" events.

A smaller group of growth equity investors invest in control positions, and some acquire entire companies. No set formula or standard terms exist for these securities and most investors customize the specific solution to accommodate the particular situation.

CORPORATE GOVERNANCE

Business owners must also seek agreement

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on company governance and what decisions must have the consent of investors. The minority growth investor trades receipt of a priority position and a preferred return for limited influence over the conduct of the business. Although they do not intend to control the board of directors, minority investors require certain controls on major corporate decisions such as:

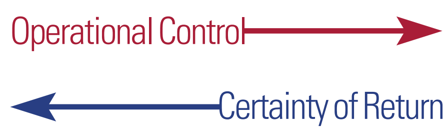
- Operating and capital budgets,
- C-level executive changes,
- C-level compensation,
- Mergers and acquisitions,
- Divestiture of assets,
- Borrowing money beyond specified limitations
- Material capital expenditures
- Divergence from strategic plans and/or expansion into new lines of business.

These decisions generally require the approval of the minority investor (if there is an otherwise affirmative vote among the majority investors). Investors do not want these provisions to dominate the nature of the relationship, but put them in place to protect the integrity of the business.

EXIT DYNAMICS

Growth capital investors, like all institutional investors have a contractual responsibility to return capital and profits to their limited partners in a specified time period. As a result, minority investors require a "certain" exit plan. Typically, this takes the form of a put feature triggered by the passage of time and/or by a serious deterioration in business performance. The value of the securities subject to the put is often at fair market value determined by a third-party appraiser or may be specified by a formula based on performance. As a practical matter, investors and owners almost always decide together on the timing and type of exit event regardless of contractual obligations.

In addition to the economic and structural issues identified above, matching a particular company or situation with the appropriate growth investor also involves a compatibility of styles, a similar investment horizon, a like-minded culture for making decisions, and an alignment of risk tolerance. Partnership dynamics permeate all aspects of the investment. The role of the financial partner impacts the specific structure of the investment. Required involvement ranges from an inactive or passive investor that simply observes at board meetings to partners with significant operating expertise that will weigh in on strategic and operating decisions. Generally, the more influence the growth investor has on operational matters, the lesser need for certainty of return. All parties must concur on the desired level of partnership to establish the bedrock for success of any growth investment.



Successfully employing growth capital rests on the ability to match the field of potential investors to appropriate company situations. The culture and desired use of funds by existing owners must synchronize with the level of partnership and appetite of the financial investor. While this requires a high degree of understanding and a close working relationship between existing owners and a new investor, a healthy partnership results in funds being deployed to the betterment of the company's prospects. Once these prospects are realized and monetized, the owners collectively benefit from the creation of increased economic output and the corresponding higher company valuation. Owners who finance expansion opportunities with growth equity must weigh the loss of total and absolute control against the potential benefit of a much larger and more valuable enterprise. ❖

Easy Money; Can It Continue?

Banks have the money and the willingness to lend, but not many companies want to borrow.

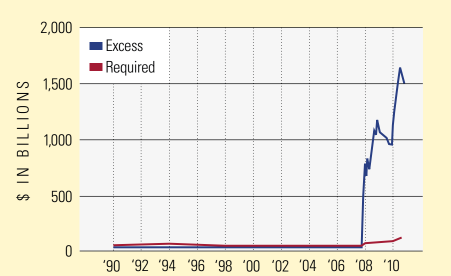
by Michael T. Newsome

Credit availability to middle-market companies appears to be cheap and easy. Borrowing money is never quite that simple, but we have observed steady downward pressure on loan pricing for some time. Now credit terms are loosening, as well. The question is whether these conditions will continue, and, if so, for how long.

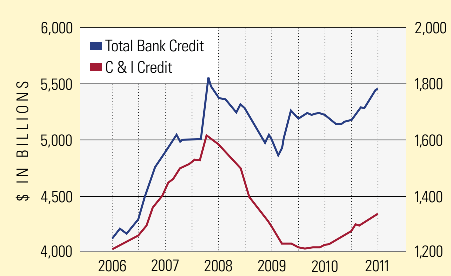
There is little doubt that banks have both the appetite and liquidity to lend. As evidenced by an unprecedented $1.5 trillion in excess reserves held nationally by banks (see the nearby chart), liquidity is no constraint to lending. After bottoming out in late 2010, commercial credit began to expand again. Roughly $133 billion in C&I loans have been added in the past 13 months. But, there continues to be a far greater appetite to lend than to borrow, and thus not nearly enough demand to make a dent in excess reserves.

Ample liquidity coupled with sluggish credit demand in the midst of a lumbering economic recovery translates into a highly competitive lending market. Most of the opportunities are refinancings, where bankers are scrimmaging for market share. Demand for new financing in support of growth, acquisitions and distributions to owners continues to be soft, but shows signs of picking up.

Bank Reserves



Total Bank Credit



Conversations with PNW bankers have a few common refrains:

- "We have a strong appetite for new C&I assets"
- "Quality is an overriding focus, and our credit people are prudent"
- "Leverage levels are stable but we may move a bit higher for the most desirable credits"
- "We can't believe what our competitors are willing to do!"

Companies that demonstrated resilience or an ability to adapt in the aftermath of the financial meltdown have a host of options. Contrary to the purported quality focus, virtually any middle-market business with a well-articulated business plan can access credit unless it is hemorrhaging red ink, is already laboring under insurmountable debt, or is on the verge of exhausting its liquidity.

Credit spreads continue to tighten due to the aforementioned competitive dynamic and long and short interest rates are at historic lows. Ten-year money can be obtained at 4% or less. The hunger for assets in this

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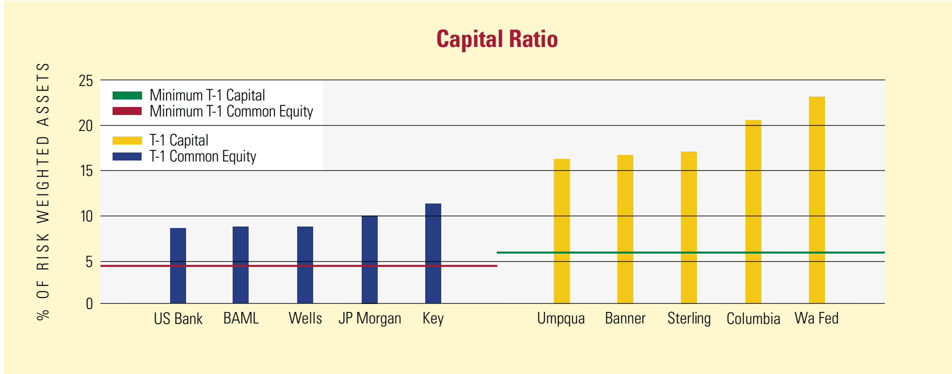
highly competitive market is leading to a relaxation of credit standards because pricing alone may not win the mandate. Collateral advance rates are easing, covenants are being streamlined to provide greater cushion, and personal guarantees are being scaled back. It is a subtle process driven by competition and it is well underway.

FROM TOO LITTLE TO TOO MUCH CAPITAL?

Three years ago, the federal government pumped some $105 billion in TARP capital into the major Pacific Northwest banks (Bank of America, Wells Fargo, US Bank, JPMorgan, and Keybank) and another $918 million into the regional banks (Columbia, Sterling, Washington Federal, Banner and Umpqua). This capital has been repaid with the exception of $417 million that was provided to Banner and Sterling. Each of these banks raised additional equity capital in the public (and in a few cases, private) equity markets and shed capital-intensive assets in order to repay the TARP funds and meet regulatory capital benchmarks. As illustrated in the adjacent chart, all of the PNW banks now comfortably exceed current risk-based capital requirements.



CORE CAPITAL STANDARDS

	STANDARD	2012 MINIMUM BASEL II	2015 MINIMUM BASEL III
Systemically Important Institutions[1]	Tier-1 Common Equity Ratio	2.0% of Risk-Weighted Assets	4.5% of Risk-Weighted Assets
All Other Banks	Tier-1 Capital Ratio	4.0% of Risk-Weighted Assets	6.0% of Risk-Weighted Assets

[1] *Top 32 financial institutions (commercial banks, securities firms, insurance companies, Fannie Mae and Freddie Mac)*

While it seems that capital is abundant today, there are looming regulatory and market changes that will create greater challenges over the next several years:

▪ Basel Committee on Banking Supervision sets new and higher bank capital requirements, known as Basel III, that become effective in 2015;

▪ The regulations emanating from the Dodd–Frank Act establish numerous banking controls and operating constraints that most experts believe will step-up the complexity and costs associated with regulatory compliance and restrict profitable activities, such as proprietary trading; and

▪ Over the next five to ten years, it is expected that consumers will continue to deleverage. This trend will erode one of the banking industry's most profitable business segments.

McKinsey recently estimated that these factors together will reduce industry returns on equity from 11% today to 7% by 2015, a development that is incompatible with the addition of capital that Basel III will require.

In order to earn appropriate returns on capital, banks are going to change. Adaptation to these developments is likely to lead to a significant industry transformation, driven by intensified efforts to squeeze the most from every dollar of capital employed. This focus on returns is expected to trigger the following:

▪ Renewed fervor for consolidation among the regional and community banks, in part to rationalize excess capacity.

▪ Divestiture of non-core activities, particularly those with sub par returns.

▪ Efforts to pare back capital-intensive branch networks in favor of expanded consumer access via the Internet and mobile devices.

Ultimately, businesses require a well-capitalized, healthy banking system, which should result in greater discipline in pricing risk and the return of higher credit spreads. In the meantime, capital and liquidity appear to be adequate, if not in surplus. It also seems clear that the gap between middle-market credit supply and demand is sufficient to drive banks to continue to battle it out on price and terms. In the absence of an unforeseen economic shock, the current credit market situation is likely to prevail until business activity really begins to gather the steam necessary to sop up excess lending capacity, and/or the banking industry makes some headway toward addressing its new regulatory and market circumstances.

Now is an excellent time to reset credit arrangements on the longest terms possible, which is best done in a competitive process. History has demonstrated change often happens swiftly. There is a wealth of uncertainty in the world. The sovereign debt crisis, inflation resulting from the government's unrestrained appetite for debt, or the threat of military conflict is just a short list of the events that could unravel today's favorable market dynamic. ❖

How to Prepare for Different Types of Buyers

There is a difference between financial and strategic buyers.

by William S. Hanneman

Owners of businesses should understand that selling to a buyer with a financial orientation would be quite a different experience than selling to one that is pursuing a strategic objective. Understanding those differences in both perspective and process will greatly improve the probability of achieving expectations.

The difference between a financial and strategic buyer is rather simple. A financial buyer views the target business as a stand-alone entity that has its own life and future prospects based on the company's market position and the strategic direction established by existing management. A strategic buyer views the same business as having certain attributes that can fit into its already established strategy and infrastructure (usually an established business). In essence, the strategic buyer views the target business as a collection of ingredients while a financial buyer sees a finished product.

Today, a private equity fund invested in a current portfolio company may well be a strategic buyer. Similarly, companies pursuing conglomerate growth strategies will act much like financial buyers.

It is commonly thought that financial buyers are synonymous with private equity firms and only business corporations are strategic in

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nature. While that used to be a valid distinction, the lines have been blurred as private equity has expanded its ownership of corporate America. Today, a private equity fund invested in a current portfolio company may well be a strategic buyer. Similarly, companies pursuing conglomerate growth strategies will act much like financial buyers.

IT'S A MATTER OF PERSPECTIVE

Strategic buyers have specific views on the best strategy to succeed within their industry. They already possess a particular collection of assets, customers, supply relationships, and management from which they have developed a unique view of the future. That knowledge allows them to view the attributes of a target business and determine quickly how those attributes can be integrated with what they already possess to create a stronger, more profitable business. Change is a common theme. Strategic buyers believe that they can either create revenue enhancements or reduce costs (or both) as a result of integrating the target's assets and capabilities. The intention to integrate the two businesses means that the strategic buyer needs to own 100% of the target business.

Because financial buyers bring only their money to the equation, there is no integration to consider. They view the business as a standalone enterprise. Financial buyers often have no industry strategy framework from which to evaluate the target business. Gaining that perspective is essential prior to making a determination of interest. That can take time. Rather than change, financial buyers desire stability, which can lead to a transaction where less than 100% of the business is purchased in order to create an incentive for continuity of management and employees.

TRANSACTIONS ARE APPROACHED DIFFERENTLY

Understanding the perspective of each type of buyer is not simply an etymological exercise. The differences have real implications for how each will approach a transaction.

Value A strategic buyer evaluates a target business based on what the acquired assets can contribute to its existing business strategy. Oftentimes, the value of the seller's assets in the hands of the strategic buyer will be worth more than the same assets in the hands of the seller or a financial investor. What the strategic buyer will ultimately pay depends upon a number of factors, including its assessment of the cost to independently build the asset or capability ("build vs. buy"), and the implication to its competitive position if the opportunity is lost to a competitor.

If the strategic buyer is a public company, an additional constraint can raise its head. Public entities are always sensitive to earnings-per-share. Most strategic buyers will not make an offer that will cause earnings-per-share dilution in the long run.

Due Diligence and Timing Because they already operate in the industry, strategic buyers are already knowledgeable about the current trends and the competitive environment. As such, they will spend the bulk of their due diligence effort on verifying the specific attributes of the target and how the pieces would be integrated.

Financial buyers use the due diligence process to first confirm the desirability of the industry, and then the business. Because the entirety of the enterprise is the target, they are highly concerned about understanding everything about the entire "machine." It is quite typical for financial buyers to engage outside professionals to assist with conducting a comprehensive business review, market studies, a quality of earnings assessment, and background checks on key managers. Transferability of all assets, employees, and relationships are paramount. Making sure "everyone" is on the same page after closing is essential. This can be laborious and time consuming.

Understanding the perspective of each type of buyer is not simply an etymological exercise. The differences have real implications for how each will approach a transaction.

Making acquisitions is a core competency of financial buyers. So, once a decision to acquire has been made, financial buyers can often move faster. As a result, they follow a well-worn playbook to evaluate, finance, and close acquisitions. Strategic buyers tend to have slow internal processes. They may not have a dedicated merger and acquisition team and may be encumbered by slow-moving boards of directors and investment committees. Many set annual budgets for investments and may need to secure extra resources or delay their bids to the next budget cycle.

Given this difference in timing, if including both financial and strategic buyers in the process, it makes sense to give financial buyers a head start. And, because the probability of closing with a financial buyer tends to be lower than with a strategic buyer, choose an advisor that understands the profiles and styles of the different parties.

THINK ABOUT THE DIFFERENCES BEFORE STARTING

The best advice that can be given is to know the audience and design a sales process accordingly. When positioning a business for sale, different types of buyers require different positioning strategies. Therefore, the thrust of materials, conversations, presentations, and timing should be very different depending on the audience.

Financial buyers need to be schooled on the comprehensive macro view of the industry and the micro view of how the target company competes within that framework. Particularly key is a clear articulation of how the company is going to grow its revenue and free cash flow. Management should be showcased; back office and operational capabilities must be emphasized.

Each strategic buyer should be viewed separately. Discussions and presentations should be focused on the uniqueness of the target company's attributes and how the financial performance will change if the company is combined with the suitor's business, assets and capabilities.

Given that different types of buyers make decisions on different schedules and processes, it makes sense to accommodate those differences in the process so that all will be ready to commit simultaneously.

In most cases, it makes sense to consider both types of buyers. By evaluating both alternatives simultaneously business owners can make the best decision for themselves and the company. ❖

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

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