



INSIGHT

Credit Critical to Deal Market

With access to cheap capital throttled and credit availability tight, the deal market is far from active.

There is little doubt that the roaring mergers and acquisitions market of yesterday has gone soft. Barely a trickle of deals is flowing through the pipeline as most sellers and financial and strategic buyers have stepped back from the market. According to Venture Economics, thus far in 2001, M&A activity is off 50% from the previous year and at the lowest level since 1997. The late 90's provided an environment in which historically high prices were offered for private companies. Two engines fueled demand for private company buyouts. The unprecedented ascendance of the public equity markets provided corporate acquisition teams cheap currency in the form of common stock to buy companies. At the same time, financial investors competed by funding their deals with an historically higher proportion of low-cost, liberally structured debt.

INVESTORS FINALLY BALK

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This decline effectively throttled access to cheap capital for acquisitive public companies. In response, these firms have turned their emphasis from the buyout market to internal initiatives that may improve performance and positively impact corporate value. Prices that such "strategic" buyers,

A SPECIAL MESSAGE FROM ZACHARY SCOTT

Zachary Scott entered its second decade this fall. During the past ten years, we have had the good fortune to work with many great clients, highly professional advisors, and wonderful businesses on many interesting and challenging transactions. During this time, we have sharpened our skills, broadened our capabilities, and grown our firm. Those of you who know us understand that our advice is straight forward and unvarnished. While our conclusions may not always be popular, we call it as we see it.

We want to take this opportunity to thank each of you who has contributed to our success during our first ten years. As you may have noticed, we begin the next decade with a slightly new look and a new address. What hasn't changed is our goal of providing the highest caliber objective advice on ownership transition and capital structure to companies in the Pacific Northwest.

We look forward to continuing to share our *Insights* on developments in the private capital markets and being of service in the decades to come.

are prepared to pay for acquisitions have dropped in concert with their reduced appetite for risk and the diminished value of their stock as currency.

One would think that this would leave the private company market wide open to financial buyers. Unfortunately, they have found themselves hamstrung by tightened credit availability. Ready access to liberal amounts of credit is a key element of an active deal market. Ultimately, the amount and structure of debt is an important deter-

minant of the price that can be offered by financial investors in a buyout transaction.

ECONOMICS OF A BUYOUT

To illustrate this point, we present a simple comparison of the economics of a buyout in the "go-go" environment of 1999 relative to the current market. The focus of our comparison is a hypothetical manufacturer of widgets earning \$10MM of EBITDA on

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\$100MM of revenue. Management believes that there are some immediate improvements that can be made in the company's performance and that its long-term growth prospects are attractive.

Example Transaction...an investor's view of the economics

(\$ IN MILLIONS)	1999 DEAL	2001 DEAL
Revenue	\$100.0	\$100.0
LTM EBITDA	10.0	10.0
Pro-forma Improvements	1.0	-
Expected Cash Flow	11.0	10.0
Acquisition Multiple	6.0X	6.0X
Enterprise Value	\$66.0	\$60.0

In 1999, investors and lenders would have been positively influenced by management's expectations of performance and would have factored the \$1 million of pro-forma improvements into their EBITDA expectations. The deal would be priced at a multiple of six times expected EBITDA, yielding a value of \$66 million. In the current market, (continued p.2)

the primary difference would be a reluctance to believe and pay for the improvements that might be realized in the acquisition. That is, today, the deal would be valued only on proven performance. Assuming the same purchase multiple, the price would be \$60 million.

Same Company...different financing structure

(\$ IN MILLIONS)	1999 DEAL	2001 DEAL
Acquisition Price	\$66.0	\$60.0
Transaction Costs	2.3	3.0
Total Acq. Cost	\$68.3	\$63.0
FINANCING STRUCTURE:		
Senior Debt (EBITDA MULTIPLE)	\$38.5 3.50X	\$25.0 2.50X
Mezzanine (EBITDA MULTIPLE)	\$16.5 1.50X	\$10.0 1.00X
Total Debt (EBITDA MULTIPLE)	\$55.0 5.00X	\$35.0 3.50X
Equity (EBITDA MULTIPLE)	\$13.3 1.18X	\$28.0 2.80X
Total Capital (EBITDA MULTIPLE)	\$68.3 6.18X	\$63.0 6.30X
Equity as % of Total Capital	19%	44%

Even more differences can be seen in the capital structure employed to fund the acquisition. The first disparity is transaction costs; financing fees and credit spreads are significantly higher today than two years ago even though the debt level is lower. In 1999, an investor could expect to arrange senior debt of up to 3.5X expected EBITDA (including pro-forma improvements). Today, those same lenders are likely to fund only 2.5X proven EBITDA. Mezzanine lenders are anxious to fill any funding gaps. In 1999, they could be expected to add another 1.5X EBITDA of subordinated debt to bring total leverage in our hypothetical example to \$55.0MM. In the current environment, it is likely that mezzanine debt will be limited to 1.0X EBITDA. Total borrowing capacity in today's environment, therefore, would only be \$35.0MM. The gap between value and credit

Five Years Later to justify the deal investors will need...

(\$ IN MILLIONS)	TARGET RETURN	REQUIRED VALUE 1999 DEAL	REQUIRED VALUE 2001 DEAL
Equity	30%	\$49.4	\$104.0
Mezzanine	20%	\$ 9.8	6.1
Remaining Mezzanine Debt		16.5	10.0
Remaining Senior Debt		10.0	-
Enterprise Value		\$85.7	\$120.1
EBITDA Exit Multiple		6.0X	6.0X
Implied EBITDA		\$14.3	\$20.0
EBITDA CAGR		5.4%	14.9%

availability has to be filled with equity capital. In 1999, that meant \$13.3MM (19% of the capital structure). In today's market, it means \$28.0MM, nearly 44% of the capital required to complete the deal.

Of course, this doesn't tell the full story. In 1999, investors had to believe that within five years from closing the company would have a total value of at least \$86 MM, enough to repay the remaining debt, allow mezzanine lenders an all-in return of at least 20% per annum, and provide the equity investors a 30% annual return. Assuming a sale multiple of six times EBITDA, investors would have to be convinced that EBITDA would grow to \$14.3 million, a 5.4% compound annual growth rate (CAGR). This was an expectation that would have been readily accepted.

INVESTMENT MATH CHANGES

Today, the investment math is a bit more challenging. To provide the capital suppliers their required returns, the business will have to be worth \$120 million at the end of five years. Assuming, again, a sale multiple of six times, EBITDA would have to grow to

\$20MM, a 14.9% CAGR. Given the competitive environment in which most businesses operate, this kind of growth, especially without significant additional investment, is extremely rare. Few investors are likely to buy into a challenge like that.

So, what gives? As long as credit remains tight, either values have to come down, or equity investors must accept lower returns. Otherwise, deals won't get done. In reality, all of these forces are at work. Many deals are being negotiated at lower prices. Some owners are helping to finance the sale by providing junior subordinated debt (probably without current pay provisions). And, equity investors are beginning to accept lower returns on the logic that their risk is lessened by the more conservative capital structure. Until senior lenders feel their portfolios are under control and begin aggressively looking for more business, the M&A market will likely be less robust. ❖

Three Elements of Success

Strong management teams distinguish themselves in an economic downturn with vision, precision, and urgency.

In times of plenty, most privately-held companies do well, or at least well enough. It seems that the rising tide of economic growth raises all boats, often with little discrimination between mediocre, good, and great firms. This has been the environment in which businesses have operated for the last decade. But now the tide has turned—revenues and margins are under pressure, and capital availability has

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tightened. Some of the cushion is gone. Fundamentally, an economic downturn cleanses investment mistakes and over-indulgences that are the product of a long expansion. It is at these times that the best management teams distinguish themselves.

In our experience, there are three traits that characterize strong management: vision, precision, and urgency.

VISION

Vision as displayed by great economic revolutionaries such as Bill Gates, Jack Welch, or Warren Buffet is not required. Prescience about the evolving order of the economic universe is not necessarily a critical ingredient of success in a medium size, privately-held business. However, it is necessary that managers have a clear sense of the factors that drive growth within their particular market and the forces that potentially could alter the current pattern. Managers should understand who their competitors are and how and why their company fits into the market. It is this perspective of the economic environment that is typically the basis for a well-formed vision of how the market works and the business model that is likely to lead to a competitive edge.

A good example of such vision was demonstrated by one of our clients in the flexible packaging industry. This \$50 million company's management had a strong grasp of the dynamics of the market in which they competed and recognized that the competitive environment was changing as major consumer products companies consolidated. They believed that their company either needed to be smaller with a (continued p.4)

Credit Markets Update

Readers of Insight are aware that we have held the view for some time that the economic slowdown would be longer and deeper than what most prognosticators have been suggesting. Underlying our fears is a concern that until recently, consumers had not adjusted their expectations and spending patterns to the cooling economy. Spurred by the events of September 11th, an adjustment in consumer attitudes is now underway.

Our theory has been that over the past several years the economy has been fueled by a massive investment of speculative capital in the creation of “new economy” businesses and the adaptation of “old economy” firms to the internet and the Y2K problem. Over a three-year period, hundreds of billions of dollars were raised through the IPO market, from venture capitalists, and in the high yield market to fund these new, primarily technology and telecom based, businesses. These investments were paralleled by billions of dollars of investment by “old economy” businesses. That capital has been spent (often unwisely) in a manner that stimulated greater activity in most economic sectors.

COMPANIES, BUT NOT BUSINESSES

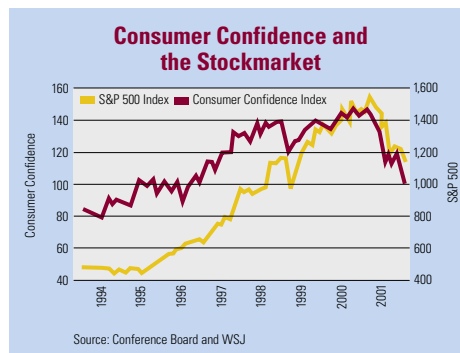
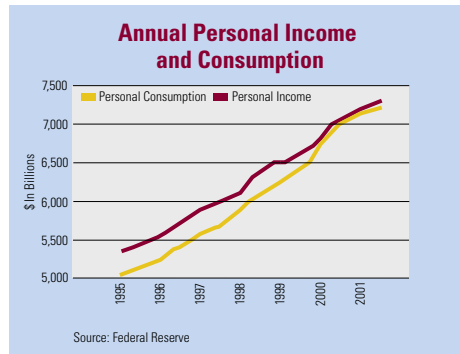
Unfortunately, many of these “new economy” ventures were not businesses at all. A rational analysis of the venture investment activity during this period would characterize much of it as the shameless merchandizing of companies with minimal economic prospects in order to transfer the wealth of indiscriminate investors to the pockets of promoters (investment bankers and venture capitalists). By March of 2000, economic reality began to reassert itself. As investors came to the realization that many of these “new economy” dogs simply weren’t going to hunt, the IPO market basically shut

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down. In the absence of a public market exit, venture capitalists tightened up. Suddenly, the wellspring of capital ran dry for many nascent “new economy” companies. All across the economy, we’ve now experienced several quarters of corporate earnings disappointments resulting from slowing product demand and excess capacity, which



has resulted in the revaluation of assets and investments. This trend is likely to continue as businesses resize to accommodate the sustainable demand for their products.

SURPRISING STRENGTH

Through this process, the economy flattened, but maintained surprising strength. Much of the economy’s resilience can be attributed to the behavior of consumers. For ten years, incomes have risen in an environment of ever-lower unemployment. At the same time, the value of homes and stock portfolios increased at historically unprecedented rates giving consumers a perception of enhanced personal wealth. Accordingly, personal consumption swelled on the tide of this newfound wealth. Although a robust economy delivered strong growth in personal income, it was not enough to fund the rate of expansion in personal consumption. To maintain spending habits, individuals pared back the rate of personal saving and stepped up the use of debt. There was little necessity to “save” as it was taken care of through the

rapid appreciation of financial and real estate assets. Although consumers have had a good run and served as the key driver behind our modest economic growth over the past year, they are not exempt from economic reality. It has been our view that consumers would eventually have to bring spending in line with income, and that this adjustment would

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Although, consumer confidence has eroded over the past nine months, it remains strong relative to the average over the past ten years. Maintaining consumer confidence is a prime concern of the Fed. Its principal tool in this effort has been to reduce short-term interest rates a total of 300 basis points through the end of August. The goal has been to bolster the consumer’s balance sheet and buying power by reducing interest costs. This strategy seemed to be working in-so-far-as housing markets and consumer spending remained strong in 2001. Economists and media predicted that the economy had dodged a recession and resumption of the long-term growth curve could be expected. The conventional wisdom was that the consumer would pull the economy through, aided by the actions of the Fed.

CONSUMER CONFIDENCE SUFFERS

The course of the economy changed with the horrific events of September 11. Beyond the human toll taken, the economy, in general, and consumer confidence, specifically, appears to have suffered a harsh blow. After a four-day halt in trading, the equity markets endured the largest one-week plunge in value since the Great Depression. Although these markets have rebounded in the interim, the promise of war, fears of further attacks, earnings adjustments, and layoff announcements, have stoked economic uncertainty among consumers and investors. Within a week after the attacks, the consumer confidence index dropped 16 points to 97.6, which is 33% below the high point in May of 2000 and the lowest point since 1996.

HOW DEEP THE DOWNTURN?

We suspect that consumers will pare back their spending in the coming (continued p.4)

