



INSIGHT

Just Over the Horizon

With a possible slow down in the economy coming, the groundwork could be laid for rapidly mounting credit challenges.

by Michael T. Newsome

Unusual turmoil in the credit markets marked the dog days of this past summer, all leading to rising concern over the availability of corporate credit. The impact has painfully hobbled the high end of the buyout market. An unprecedented pipeline of multi-billion dollar LBOs (think Sallie Mae, TXU, First Data, Harman International, etc.) has been hung up at prominent commercial and investment banks when new issuance in the primary institutional syndicated loan and high yield bond markets ground to a halt. The fallout has been tighter leverage requirements, a spike in pricing, and speculation that a serious credit crunch is in the offing.

Interestingly, impact on middle-market lending has been more modest—slightly tighter leverage and perhaps a bump in pricing. Thus far, there is little evidence of the alarm that would precipitate a broad curtailment of credit in the middle-market. Our read on the situation is that the “crisis” is a result of an imbalance of supply and demand, fueled by investor jitters in specific markets. More than anything, it seems to be the classic case of a snake trying to swallow a large pig whole—an aching slow process with a good deal of indigestion. Already there is evidence that the market is functioning as deals are either pulled or restructured and completed. The real concern is that just over the horizon lies the potential for credit problems to emerge from the large number of highly leveraged loans booked in the go-go environment of the past couple of years.

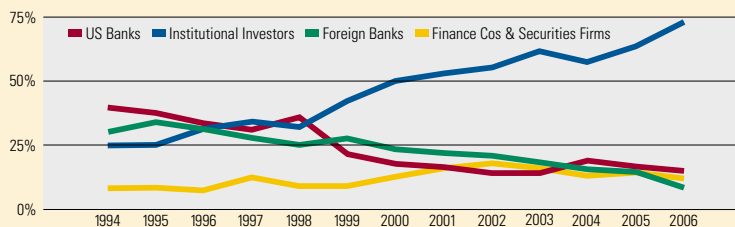
THE GLUT

The syndicated loan market has two major components. The more familiar is the bank or pro-rata syndication market, where bankers buy and hold loans between \$50 million and perhaps as much as \$2 billion. The institutional market is the newer and much broader segment where large multi-billion dollar financings occur. The loan buyers in this market are

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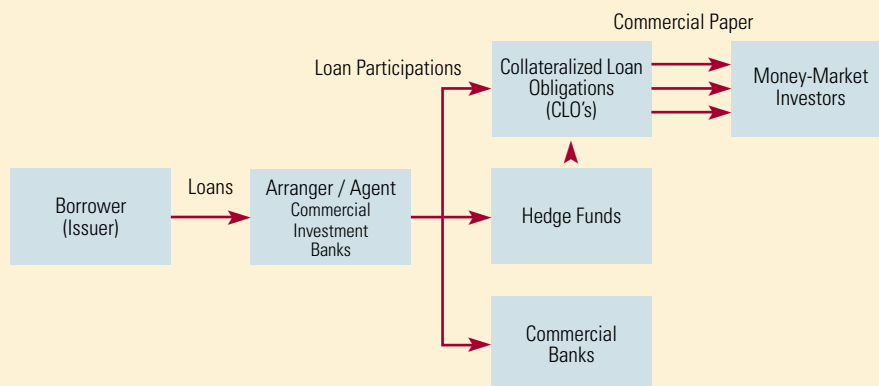
institutional investors that include collateralized loan obligations (CLO's), hedge funds, and other fixed income investors. CLO's hold the lion's share of the volume, although there is considerable overlap with hedge funds, which are major CLO organizers. Banks are minor players. A critical point to understand is that the major CLO funding sources are money market funds that buy the highly rated (A-1/P-1) commercial paper that CLO's issue. As illustrated in the adjacent chart, borrowers (issuers) rely on large commercial and investment banks, known as dealers / arrangers, to distribute shares of the syndicated debt to a broad array of investors (CLO's, hedge funds and banks). Like the bond market, investors use rating agencies (S&P or Moody's) for credit assessments. Because this distribution process is time consuming and embodies some risk, issuers frequently fund the loan on an interim basis with a short term bridge facility

Share of the Syndicated Loan Market



Source: GE

Institutional Syndicated Loan Market



or warehouse line from the banks that serve as dealers / arrangers. A hefty fee is paid for a “fully underwritten” commitment guarantying that the loan will be distributed on the agreed terms.

Through September, private equity led buyout transactions totaled nearly \$750 billion, almost equal to the entirety funded in 2006. When the music stopped, about \$237 billion of leveraged loans supporting these buyouts were in a massive queue, either having already been funded on a bridge basis or fully underwritten and awaiting distribution to investors.

WHAT WENT WRONG

The “credit crunch of 2007” is comparable to past financial market bubbles. In this case, syndication arrangers observed the willingness of the CLO and hedge fund market to absorb leveraged transactions on increasingly accomodative terms. The mistake was to assume that this young dynamic market was

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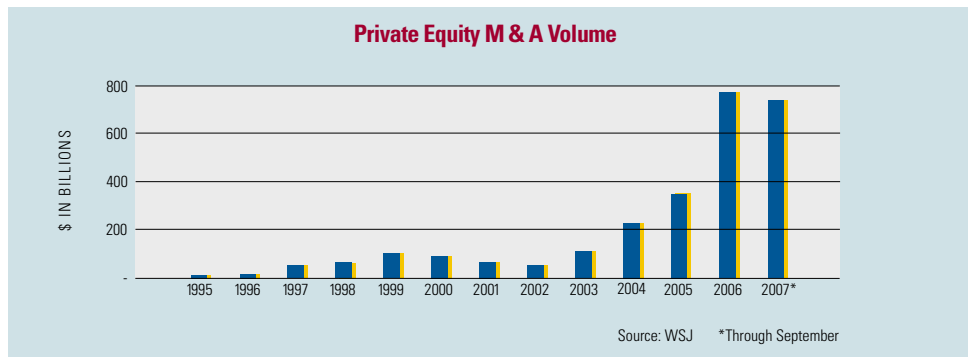
It was the collapse of the sub-prime market that initially spooked money-market investors, making them cautious about the limited transparency with regard to the type and mix of assets that back the commercial paper issued by CLO’s.

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stable and without limits. But, the size of any financial market is affected by the availability of substitutes. As terms got more aggressive, buyers had second thoughts. All the while, the large commercial and investment banks, driven by the perceived opportunity to profit from accessing this new market, underwrote a large volume of loans under terms the market would no longer accept.

The beginning of the rapid change in market conditions began at the source of all funding, the buyers of CLO commercial paper. It was the collapse of the sub-prime market that initially spooked money-market investors, making them cautious about the limited transparency with regard to the type and mix of assets that back the commercial paper issued by CLO’s. This triggered a flight from commercial paper to Treasuries. In turn, a number of large banks were forced to step in and fund back up lines that provide liquidity to CLO’s that could not sell their commercial paper. The impact was clearly evident in interest rates—Treasury rates fell sharply, as investors moved away from commerial paper, and LIBOR rates spiked as banks raised the funds at a premium to meet CLO liquidity calls.

The upshot of all of this is that financing activity for mega-LBOs in the institutional



loan and high yield bond markets is now essentially a trickle relative to the activity in the prior seven months. The biggest funding sources, CLO’s, are essentially shut down and out of the market until the portfolio transparency issue is sorted out. Many deals underwritten on the most aggressive terms remain in limbo, are being quietly withdrawn, or sold at discounts. The investment and commercial banks that arrange and distribute institutional syndications have put new deals on hold until they work through the backlog sitting on their balance sheets. A rash of earnings warnings are being issued by large investment and commercial banks (Citigroup, Morgan Stanley, and UBS were among the first) as deals are marked to market and sold. By the time this is read, many other big banks will have bitten the bullet and reported similar pain.

MIDDLE-MARKET IMPACT

As with most credit market trends, the events in the major markets drift downward to the middle market and this time is no exception. Credit spreads have drifted upwards, maximum leverage has declined, and covenants have reappeared. With the caution that the full story on the credit crunch is still unfolding, the truth is that the credit appetites of the middle market lenders active in the Northwest remain quite strong. Discussions with middle-market lenders, including Bank

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of America, U.S. Bank, Wells Fargo, Key-Bank, and the middle-market oriented regional banks, confirm they are open for business.

The ground lost was in an area that few prudent borrowers would care to occupy. The highly favorable terms and conditions obtained by some borrowers were short lived, as the market has returned to saner levels. In June and July, we observed several middle-

market sized (\$100-250 million) leveraged loans being made in excess of 6x EBITDA, with very attractive pricing and limited covenants. Today, the limit has been re-established closer to 4.5x EBITDA, with pricing more than 150 basis points higher (LIBOR +400 bps, compared to 250 bps earlier). In any period other than the past six months, these terms would be considered quite accommodating.

OVER THE HORIZON

Much like the sub-prime market, a very large stock of highly leveraged loans is already in place in the institutional market. The firms shouldering the burden of this debt must either consistently perform at a high level for an extended period or have an attractive

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arbitrage to the public equity market. These borrowers are vulnerable to event risk, such as the loss of a key customer, an unanticipated competitive development, or general economic decline. With news of weaker consumer spending, a prolonged stall in housing, and increasing commodity prices, one has to wonder whether a slowdown in the economy is in the works. Loan delinquency rates remain at extraordinarily low levels. But, there should be very little doubt that there is plenty of grist in place for deterioration when conditions change. Even a modest downturn will make it more difficult for highly leveraged companies to maintain the cash flow needed to support razor thin debt coverage ratios. Not all companies will make it.

Far from projecting impending economic malaise, what we are saying is that the groundwork has been laid from which credit challenges could rapidly mount. When lenders encounter tougher sledding, all borrowers can suffer the effects of a credit crunch, even those with conservative capitalizations. ♦

The Case for Face to Face

New technology has changed corporate finance, but has the human element been lost?

by Mark Working

Over the last decade, the industrial world has undergone a sea change as technological innovation has been applied to business processes in a relentless search for greater productivity. Day-to-day business practices have changed, employees have learned new skills, and overall production efficiency has increased. Companies that have failed to meet this challenge have shrunk, gone out of business, or been absorbed by others who have invested in modern techniques. Those of us who execute corporate finance transactions of one kind or another have also experienced the inescapable influence of technology on our business practices. Most of the changes have been beneficial, others we are not so sure about.

THE OLD PROCESS

Not that long ago, the sale of a private business would include the distribution by mail of a written information memorandum, followed by a meeting with management, a tour of the facilities, and a visit to a due diligence “data room” to allow potential buyers to become knowledgeable enough to submit a meaningful offer to buy the business. The “data room” was actually a specific place, usually located at the company’s law firm, where prospective buyers could sit and review, under supervision, binders and binders of organized documents that covered different aspects of the business. Once the final buyer was selected, lawyers would send a first draft of purchase documentation by mail or courier. Shortly thereafter, the buyer’s and the seller’s deal teams would congregate to conduct face-to-face negotiations. Closing was an event, where both parties and their teams of advisors met in person to sign and exchange documents.

THE NEW PROCESS

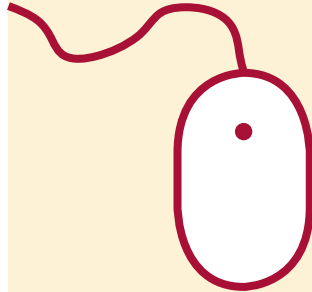
The process is very different today. Starting at the initial phase of investigation, information on the subject company is transmitted electronically, often supplemented by review of the company’s website and other digital media (e.g., animated presentations, films, and video conferences). The job of understanding the business, “seeing” the facilities and employees at work, and even meeting management, can now be accomplished without leaving one’s office.

The data room of yesteryear has been replaced with a sophisticated virtual “data room” accessible via website in which authorization can be restricted and regulated to “view only” or copy. The activities of each prospective buyer can be monitored on a real time basis.

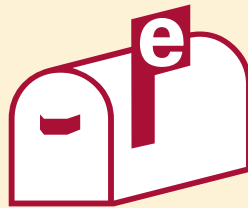
When it comes to documentation,

THE NEW AGE/TECHNOLOGY DEAL PROCESS

Instead of an on-site visit, click your mouse and you’re there through the web.



Instead of talking, send emails.



Instead of traveling or person to person meetings, do a video conference.



phones, video conferencing, email, and electronically transmitted documents mean that hard copies never have to be exchanged and in-person meetings are no longer required. Closings are almost always “virtual,” where each party’s attorneys come to a stage where they declare the deal complete and money changes hands via wire transfer. Earlier this year, in an actual face-to-face meeting between the two sides and their transaction teams,

one of the attorneys working for the buyer acknowledged that this was the first time he had been in a face-to-face negotiating session in over two years! Sometimes, the attorneys never even meet their clients in the process.

HUMAN ELEMENT CRITICAL

In conversations with transaction specialists (e.g., attorneys, bankers, and investment bankers), all agree that the physical logistics of transactions have become much easier to manage. Many also comment that the infusion of modern communications technology into dealmaking has not curbed the time and cost associated with transactions. Reality is often quite the opposite. At the same time, the improvements fashioned by the electronic age have the unintended consequence of eliminating the human element that is so important to the psychology of a deal.

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People do business with people. Nothing is perfect and no one is singularly virtuous. In person, we are able to see these facts, accept them, and work around them. When working from behind the curtain, it is too easy to avoid hearing or understanding the other’s position. Saying “no” in person is harder than by email. It is also difficult to grasp the entire context of someone’s comments when there is no opportunity for interactive real time probing questions and answers. Body language, facial expressions, and tone are essential elements of communication that often reveal more about meaning than words alone. In essence, the efficiency of transmitting data has led to the removal of the rest of our senses, and thereby, made negotiations much more difficult and precarious.

TECHNOLOGY AS A TOOL

Technology clearly has its place, making many aspects of transactions more efficient. However, these tools should be used judiciously, not at the expense of the personal interaction that can be critical to meetings of the mind and relationship building. The relationships that evolve from the insertion of the human element into negotiations help to get deals done. The personal touch also serves to reduce post closing recriminations that often haunt deals even after both parties have signed off on all the words. ♦

Best Practices

Although few and far between, trusted advisors are worthy of emulation.

by William S. Hanneman

In the years in which we have advised owners and managers of privately held businesses, we've worked with a multitude of professional service advisors of different types and persuasions. Cutting across the fields of law, accounting, banking, investment management, insurance, and investment banking, certain individuals stand out. They set the bar for everyone who gives advice for a living, including those of us at Zachary Scott, to try to emulate. The essential characteristics of these stars are worth acknowledging as they may act as a reminder to all of us in professional service endeavors, that the service we offer is personal and is taken personally.

SHARED CHARACTERISTICS

The most trusted advisors that we've known all seem to share a few common characteristics. Of course, they are competent in their specific fields, responsive to client needs and concerns, and great communicators. More importantly, they:

1. Have earned their clients' trust;
2. Give unvarnished advice without targeting a specific outcome or worrying about whether the message is politically expedient; and
3. Do the right thing, without regard to conflicts with their own short-term best interests.

Many advisors sell on the basis of technical competence, however, most buyers buy on the basis of emotion. Technical competence

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is the easy part. Resumes, credentials, and tombstones demonstrate activity and experience; but, honesty and compassion, the essential prerequisites to trust, can only be earned over time.

TRUST IS ESSENTIAL

Trust cannot be developed simply from demonstrating knowledge in an area of expertise. Rather, trustworthiness involves complex emotional elements of reliability, intimacy with the client, and demonstration that the focus is consistently on the client – that is, it is not self-oriented. Enduring advisory relationships develop over time as a result of a demonstrated “client-first” orientation and an intimacy that begets trust. Only after the relationship

TRUSTED ADVISOR COMMON CHARACTERISTICS

- **Competent**
- **Responsive to client needs and concerns**
- **Great communicator**
- **Have earned client's trust**
- **Give unvarnished advice**
- **Always do the right thing**

develops to that point can the client and advisor speak openly about difficult agendas.

Doing the right thing should be self-evident, even common sense. However, it is amazing how often advisors can forget this most basic of tenets. Maybe the ability to do the right thing comes from having confidence in themselves, as well as the strength of the relationship; thereby not feeling anything is at risk.

The hallmark of a relationship built on trust is the ability of the advisor to tell the client what they don't want to hear. People wouldn't be in the personal services business if they didn't want to please their clients, but “going with the flow” can lead to over promising and delaying hard decisions and realities. The advisor who has developed the level of trusting relationship that allows open, honest, and clearly stated advice without fear of recrimination is a valuable asset and a pleasure to witness.

CLEAR, ARTICULATED ADVICE

The most common breakdown in com-

munication is a misunderstanding about what has been said. It happens in personal relationships, in businesses, and with daunting frequency between advisors and clients. It is a fact of life that people don't always say what they mean. They tend to hint a lot. Accordingly, truly successful advisors excel at clearly articulating their advice and its relevance to the client, but only after “hearing” the client's needs and objectives. As Jack Welch once said, “he is really a great advisor, he listens better than anyone else.”

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combination of technical skills, thorough understanding of the issues at hand, an ability to relate to the personalities involved, and a solid base of trust to give credibility to the advice. The talented few who excel in this area are very valuable assets to their clients and worthy of emulation. ♦

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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