



INSIGHT

Instability on Wall Street Affects Main Street

As major financial institutions are caught in a vicious cycle of deleveraging, credit is contracting.

by Michael T. Newsome

Turmoil in the credit markets accelerates as investor confidence is shattered and we watch erstwhile Wall Street titans fall. As we submitted last spring in *Insight*, major financial institutions are caught in the thrall of a vicious cycle of forced deleveraging of their balance sheets. It is a relentless downward spiral of asset values that erodes capital and drives away lenders. Imprudent application of leverage is at the root of the crisis, but it has been the loss of liquidity (timely access to cash) that laid low Bear Stearns, IndyMac, Freddie, Fannie, Lehman, and AIG. To borrow a line from the Wall Street Journal, “in the Fed’s and Treasury’s game of whack a mole, the moles are winning.” The pace of events has picked up. Credit is contracting with the impact landing squarely on the largest and most sophisticated players in finance, with no clear end in sight. Why?

Though there has been much chatter fixing blame on insidious short sellers and speculators, it is not widely understood why the major securities firms (Bear Stearns, Morgan Stanley, Merrill Lynch, Lehman Bros and Goldman Sachs) proved so vulnerable to panic. The answer is found in the intricate and opaque funding strategies employed in the financial markets.

These non-depository firms and many other financial institutions fund their asset bases with a mixture of short- and long-term debt, coupled with a sliver of equity, in many cases, a wafer-thin sliver on the order of \$1 for every \$25 to \$30 of assets. For these firms, the key sources of short-term “hot money” funding have been commercial paper and repurchase agreements (“repos”), where a securities firm or bank agrees to sell owned and/or borrowed securities (treasuries, asset-backed paper, and other financial instruments) to counterparties

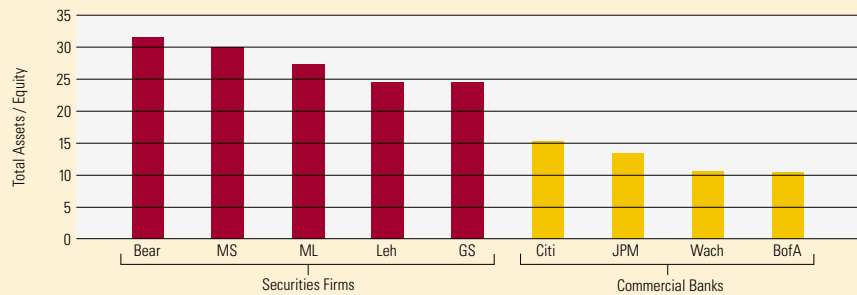
in exchange for cash. The sale is conditioned on the mandatory repurchase of the securities on a date certain for the original price plus a spread. In effect, repos are secured lending transactions, where borrowings are subject to advance rates and margin requirements on pledged (sold) securities in order to address swings in collateral value. Among the major, previously freestanding securities firms, repos provided between 30% and 45% of all debt capital. In less volatile times, repo markets have been large and liquid, with well-established processes. As such, they served as a cost-effective source of funds, never presenting the challenges cropping up now.

Traditionally, securities firms supplemented repo funding with the issuance of unsecured commercial paper, which is available only to

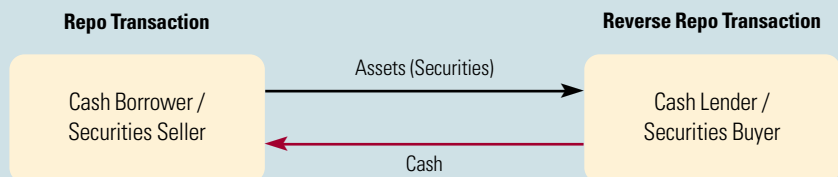
the most credit worthy. A faint whiff of lost confidence sends buyers hustling to the door, a classic example of “hot money.”

In the repo market, the concern that has emerged is not default risk—the possibility of coincident failure of both borrower and underlying collateral is remote. The real vulnerability is liquidity risk to the party holding the securities as collateral. In today’s extraordinarily volatile financial markets, lenders to securities firms, for fear of losses, cannot bear the prospect of taking possession of and liquidating their security. As securities firm borrowers, such as Bear Stearns, Lehman and Morgan Stanley, began to look shaky, the securities lenders pulled back by decreasing advance rates, shunning illiquid collateral, shortening maturities, or worst case, suspending lending

Balance Sheet Leverage (as of Q2-08)

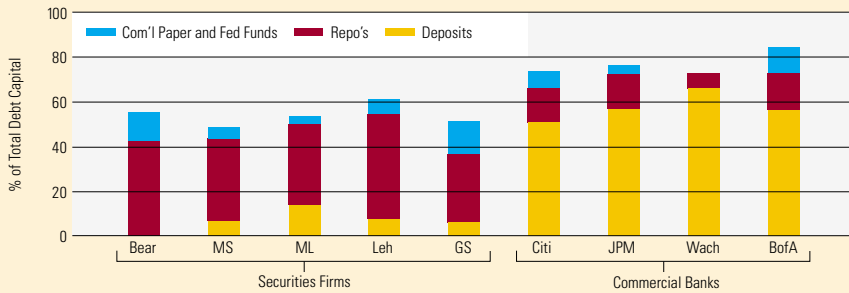


Repurchase Agreement Mechanics



¹ These transactions are referred to as repos from the borrower/securities seller perspective and “reverse repos” from the lender/securities buyer viewpoint. The names simply refer to the perspective of buyer or seller in the transaction.

"Hot Money" Capital Sources (as of Q2-08)



altogether. Measures taken to invoke greater conservatism, unfortunately, stoked borrower instability.

Of course, one might wonder what the issue is. If funding evaporates, simply sell the collateral assets on the open market and carry on. The flaw in this logic is that the use of the repo market has expanded far beyond highly liquid securities (e.g. Treasuries, or blue-chip bonds), which have deep and active markets. The repo addiction is so pervasive that repo-market lenders are over exposed to illiquid collateral that cannot be quickly converted to cash without suffering severe devaluation. At the heart of the problem is a classic asset-liability mismatch, where the average duration (maturity) of the repo liabilities is much shorter than the duration of the assets financed. This mismatch means that borrowers' funding must be frequently rolled over within a much shorter timeframe than the corresponding assets can be liquidated. In other words, securities firms and their lenders have engaged in transactions having tremendous refinancing risk in a jittery market.

BIGGER THAN IT APPEARS

It turns out that the use of repos to fund

balance sheets of securities firms is but the tip of the iceberg. Beyond funding to support owned assets, there is an enormous volume of highly complex, collateralized securities lending (repo and reverse repo) by the major securities firms, primarily to provide capital to hedge funds. Most of the activity is off-balance sheet and only reflected in the footnotes of SEC filings, the latest of which (2Q-08) amounts in aggregate to nearly \$3.5 trillion. Only a few months ago, prior to the forced sale of Bear Stearns and the rapid collapse of Lehman Brothers and AIG, this activity was unremarkable. As information becomes disclosed, it is apparent that the sheer size of repo financing activities has had implications to the interconnected market of lending in the financial system and brought into question securities industry solvency and the continuing ability of the financial markets to function.

COMMERCIAL BANK VULNERABILITY

In contrast to the repo funding on which securities firms depend, commercial banks rely on deposits as the dominant funding source, as reflected in the above chart. Like repos, deposits can be "hot money" vulnerable to customers' fears. Witness the overnight collapse

of IndyMac Bank, triggered by comments carelessly uttered by a U.S. Senator, and now, the forced sale of Washington Mutual, where nearly \$17 billion of deposits bled off over 10 days as the bank sought a buyer. Nevertheless, with the comfort of FDIC insurance, bank deposits have proven to be surprisingly resilient amidst the turmoil.

As all are now aware, an unprecedented liquidity crisis pushed financial markets to the brink of disaster in mid-September, triggering the Lehman Brothers bankruptcy, the federal takeover of giant insurer AIG, the shotgun embrace of Merrill Lynch by Bank of America, Washington Mutual by JP Morgan and Wachovia by Wells Fargo, and an overnight conversion of both Morgan Stanley and Goldman Sachs to bank holding companies. As this is being written, the Federal Reserve and the U.S. Treasury pushed through emergency congressional action targeted toward soothing investor fears by moving impaired securities and loans from bank balance sheets to a newly formed federal agency to serve as buyer of last resort and liquidator. Even with the passage of a "bailout" plan, there is no assurance that the credit crunch will quickly be arrested. The market is almost certainly in an unstoppable process of wringing excess leverage out of the economy.

For businesses and industries that are dependent on external credit, even if they are far afield of housing and finance, some tough sledding is in store. As the major securities firms have found in spades, there is one thing that every company must have to survive – uninterrupted access to CASH. This is a time when the management and owners of businesses would be well served to carefully tend their credit relationships and conserve liquidity. ❖

Don't Count on Strategic Value

Strategic value is only realizable under specific circumstances.

by Mark Working

How often have you heard declarations along the following lines? "When I sell my business, I fully expect to be paid for strategic value, just like my competitor," or "My advice to the client is to hold out for strategic value, given the company's long-term industry position." Both statements are imprecise at best, if not completely incorrect, as they imply that strategic value is a constant reality, and that the seller has a choice in the matter. A fundamental misunderstanding of the nature of strategic value often tempts sellers into the erroneous belief that lackluster business performance will not hinder them from receiving a high value for their businesses. The four simple truths about strategic value are that it can be created only as a result

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of a business combination, the buyer must successfully execute the plan of consolidation to realize it, a seller can be compensated for it only if a buyer can be compelled to pay for what the buyer expects to create, and its existence is situational and transitory.

DEFINING STRATEGIC VALUE

The definition of business value, be it financial (intrinsic) or strategic, originates from the classic corporate finance theory of business valuation that equates current value to the sum of all expected after-tax cash flows from future operations and investment discounted to the present. Financial value reflects the expectations of the current plan and strategy of an existing business. Strategic value represents anticipated changes in the

economics of the business in combination with another that lead to expectations for accelerated sales, increased margins, and/or reductions in capital employed. These economic improvements are commonly referred to as “synergies.” In concept, it is as simple and straightforward as 1+1 = 2.5, but, in practice, it is decidedly more difficult to capture the fruits of a business combination. While the buyer might have the opportunity to reap the benefits of synergies, there is no assurance that the seller will be paid for them. Only in a competitive process might the buyer be coaxed to pay for some, but rarely all, of the value created by acquisition synergies.

The potential for strategic value requires the existence of meaningful industry inefficiencies. These are often a function of demand and capacity imbalances, particularly in mature industries. In these situations, the economics of consolidation provide impetus for rationalization of resources. New business models may emerge with improved cash flow generation capabilities based on economies of scale in production, customer service, delivery

the challenges and risks of consolidation, the remainder represents the limit of the premium available to pay sellers.

To illustrate the arithmetic of a business combination that results in strategic value, consider the admittedly simplistic example of two companies, Ace and AAA, both of which

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The logic underlying one deal may or may not extend to other situations or businesses. Moreover, even if strategic value now exists, it will not last forever.

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have substantial excess capacity relative to the demand for their products, and their competitor, Acme, which is bursting at the seams with customer demand. To cope, Acme is forced to inefficiently spread its production among multiple locations. Due to poor capacity utilization, all three companies perform well below

pay Ace’s owners the fantastic sum of \$200 million, a premium of \$170 million over the value justified by the company’s stand-alone performance. Most importantly, it’s a bargain for Acme, which pays \$200 million to acquire \$300 million in value. Break out the champagne; it’s a red-letter day in both camps.

Naturally, when AAA learns the particulars of the Ace transaction through the omnipresent widget industry grapevine, its owners will take a keen interest in the transaction. They might apply the resulting transaction metrics to their business as an appropriate benchmark of value, no matter how outlandish in relation to their business performance. In this case, the owners of AAA might wrongly conclude that their business has substantial strategic value. These transaction metrics (e.g., multiples of sales, operating income or widgets) suggest a wide value range, perhaps in excess of \$600 million. Beware! The music always stops. At the point that industry efficiency has been reset, little or no strategic value remains, and the owners waiting on the sidelines for an ever-higher valuation are left standing.

PERFORMANCE:	ACE	ACME	ACME / ACE COMBINED	AAA		
Situation	Inefficient production; Substantial excess capacity	Inefficient production; Operating at capacity	Substantial operating leverage at higher plant utilization	Inefficient production with substantial excess capacity		
Widget Production (units)	75,000	125,000	200,000	100,000		
Sales (thousands)	\$ 95,000	\$ 155,000	\$ 250,000	\$ 150,000		
Operating Earnings (thousands)	\$ 5,000 5.3%	\$ 25,000 16.1%	\$ 75,000 30.0%	\$ 18,750 15.0%		
VALUATIONS:						
Intrinsic Value (6X multiple)	30,000	150,000	450,000	112,500	112,500	112,500
Implied Strategic Value	170,000	100,000	-	150,658	637,500	157,500
Total Value (thousands)	\$ 200,000	\$ 250,000	\$ 450,000	\$ 263,158	\$ 750,000	\$ 270,000
VALUATION METRICS:						
Sales Multiple	2.1	1.6	1.8	2.1		
Operating Earnings Multiple	40.0	10.0	6.0	40.0		
Production Multiple (\$/1000 widgets)	2.7	2.0	2.3	2.7		

efficiency, or geographic coverage. These forces drive the restructuring of the industry, hamstringing competitors that do not or cannot adapt to the changing competitive dynamic.

CAPTURING SYNERGIES

Once companies consolidate to capture synergies and realize higher levels of performance, all worth in the industry reverts to the collective intrinsic value of the individual firms. The difference between the aggregate pre- and post-rationalization cash flows of the industry, less transaction costs, is the maximum amount of strategic value available for industry participants. After the buyer keeps some portion of this strategic value for taking

par. For the sake of discussion, it is assumed that a discounted cash flow analysis for each of these businesses would result in an intrinsic value equal to a multiple of 6x current operating income.

The owners of Acme astutely see the potential of acquiring either Ace or AAA, in order to consolidate all production in under-used plant capacity. After being rebuffed by AAA, Acme is able to come to terms with Ace and, as illustrated in the accompanying table, the consequential economies of scale vastly improve profitability and, therefore, the value of the combined businesses. To put the two businesses together, Acme agrees to

DON'T BE MISLED

The implication of wringing out strategic value through business rationalization is that business owners cannot afford to be mesmerized or misled by the lofty transaction values they hear about in their industry. It is not reasonable to conclude that valuation metrics achieved in strategic transactions can be applied across an entire industry. There is specific economic reasoning that applies to an individual transaction, not a “new valuation paradigm.” The logic underlying one deal may or may not extend to other situations or businesses. Moreover, even if strategic value now exists, it will not last forever. ❖

The Indispensable Asset: Quality Management

In a good or bad economy, a quality management can make the difference.

by Mark Working

Quality leadership is always an essential element of a successful business but, in a tough economic environment, it is absolutely paramount. As the economy lags and performance pressure on businesses increases, the importance of the management that formulates and executes the right business plan rises to the top of the priority list. Finding and retaining quality executives may be the single most important responsibility of a board of directors and/or shareholder group that seeks to maximize the success of the business. And, of course, identifying and cultivating “quality management” is no simple feat. Experienced business professionals have a difficult time defining quality management, and probably find themselves in a position akin to Supreme Court Justice Potter Stewart when he said that he couldn’t define obscenity, but “I know it when I see it.”

To gain some insight into the elusive characteristics of “quality management”, we surveyed partners of private equity (“PE”) funds to gather their thoughts about the most important characteristics of high-performance management talent, on the theory that PE firms represent the category of business owners most reliant on the talent and competence of business leaders. We surveyed senior partners who have been in the business of investing in privately held businesses for a long time, through multiple business cycles and funds, and who have experienced both successes and failures. The distillation of their collective thoughts on the management characteristics they value emphasizes four general themes.

Track Record and Strategic Vision

PE investors value managers that have gained industry-specific experience successfully directing businesses through multiple market cycles. They are looking for evidence that key executives have a sophisticated understanding of the business model, know the rationale for its elements, and have a real-time sense of the condition of the business. A quantitative perspective with detailed insight into the dynamics of the enterprise and the interaction of key business drivers is seen as a hallmark of superior talent. This is in contrast to executives that rely principally on well-worn industry rules of thumb and customs that fail to recognize and account for the impact of innovation and competitive change. PE investors believe that the best leaders use their superior understanding of the business to articulate a clear vision of how the enterprise must evolve to compete successfully in the future. Nothing is more vexing to PE investors than surprise. Thus, great credibility is accorded

to managers that demonstrate a keen, almost instinctive, sensitivity to the pulse of the business and can anticipate deviations from expectations that may cause future problems. That difficult-to-acquire sense of the business increases reaction time and the opportunity to implement early corrective action.

Leadership Culture “No successful business is run by one person,” is how one experienced PE executive put it. Not only is a one-person team risky, it is not scalable, therefore growth becomes more challenging. It is not surprising that the risk-loving, autocratic gunslinger is rarely a fit. A quality CEO earns his/her pay by hiring highly capable people, articulating organizational goals, delegating responsibility, and building a cohesive team environment in which the members actively support and inspire each other to achieve common goals. An executive team that sets goals and expectations, and routinely measures against them, is highly valued. Investors look for leaders who instill a customer focus throughout the organization, acknowledge contributions and spread credit for success, emphasize a clean and safe work environment, and exhibit a degree of charisma that promotes progress by the organization. Unlike the “presidential” style of leadership that often prevails at major corporations, the ideal leader of a middle-market company is more of a field general that is frequently on the front lines in the middle of the fray. Patton would be preferred over Eisenhower.

Personal Characteristics Investors believe that effective leaders exhibit the ability to delicately balance a passion for the business

and a healthy perspective on life (can’t wait to get to work, but have other interests, as well), aggressive but realistic expectations for the business and its employees, and a sense of urgency and attention to detail. The action sequence of “Ready, Fire, Aim” doesn’t work.

Character Honesty and frankness are core qualities. PE executives look for straightforward and direct leaders that candidly share the bad, as well as the good. A CEO should be upbeat and optimistic, but if his/her view of the business’ prospects and challenges are consistently cast in a rosy light, red flags are raised. Experienced investors know that business is a continuous battle, with victories and defeats. Adjustments are always necessary to meet and overcome new challenges. Again, the unexpected is the bane of investment success. Problems cannot be dealt with by concealing them. Investors expect the “straight scoop,” so they can work together with the management team to solve the inevitable problems that surface.

The goal of a PE firm is to establish a system of employees, assets, and a strategy that is measurable, repeatable, and sustainable. PE investors believe that management teams composed of honest, capable executives who are easy to work with and for, have an open communication style, and possess a personal passion for the business, offer the best chance of success in building that system. Quality management, when coupled with the proper incentives and a thoughtfully conceived strategy, are a proven recipe for creating value. ♦

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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