Washington Mutual BUSINESS BANKING
ZACHARY SCOTT & CO. INVESTMENT BANKERS
PERSPECTIVES ON THE CAPITAL MARKETS SPRING 2001

Washington Mutual Business Banking and Zachary Scott & Co. have collaborated to produce this newsletter designed to bring you a perspective on the private capital markets.

IN$IGHT

The Tightening Credit Market

Despite the recent decline in interest rates, the cost of credit is rising and availability is going down.

If you haven't yet heard this news from your banker, you soon will. The credit markets are tightening at a faster pace than at any time in the last 10 years. These realities are what we are observing in our contacts with lenders and borrowers and are confirmed by the most recent Federal Reserve Board survey on bank lending practices.

THE FEDERAL RESERVE SURVEY

The survey, which is conducted quarterly, indicates that among the 57 domestic banks polled 60 percent have tightened credit standards for large borrowers and 45 percent have tightened lending standards for smaller firms (revenues of less than $50 million). As illustrated in the accompanying chart, there is a decided shift toward more conservative lending practices since the previous quarterly survey.

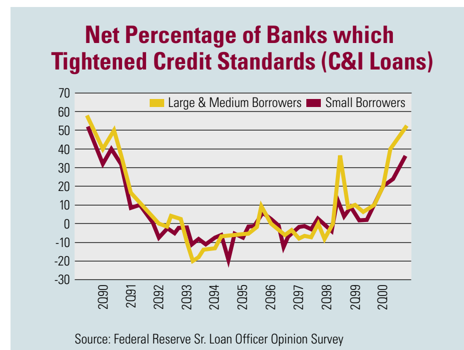
> Almost three-quarters of the institutions responding to the Fed survey reported charging higher premiums on riskier loans to large and middle-market firms. One-in-five report that they increased interest rate premiums "considerably."

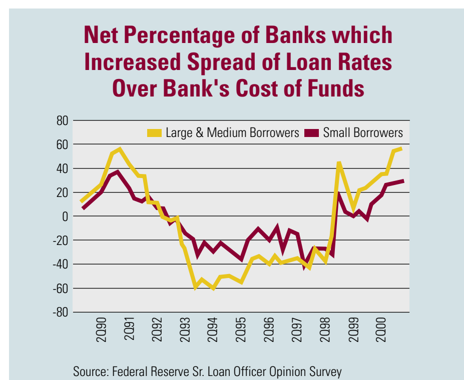
Not only is credit availability tightening, but it is also becoming more expensive as lenders increase the premiums they are charging to take risks. Almost three-quarters of the institutions responding to the Fed survey reported charging higher premiums on riskier loans to large and middle-market firms. One-in-five report that they increased interest rate premiums "considerably."

Nearly half of the lenders responding to the survey indicated that they are tending to tighten loan covenants and increase collateral requirements. The stated reasons for this abrupt change in lending policies is uncertainty over the economic outlook, worsening industry specific problems, and a reduced tolerance for risk. The realities are that credit problems are starting to show up in lender portfolios and there is genuine concern about increasing exposure in uncertain times.

IMPLICATIONS OF TIGHTER CREDIT

The implication of tighter credit standards is that it has become more difficult for companies to finance expansion opportunities and even to continue funding the current level of business. Twelve to eighteen months ago, many middle-market companies could expect to borrow up to four times trailing twelve-month cash flow with only modest collateral support. Today, the same segment of companies is fortunate to arrange financing at 2.0 times trailing cash flow in the absence of strong collateral support. Our observation is that, while certain lenders continue to tout their *(continued p.2)*





WASHINGTON MUTUAL'S PERSPECTIVE

Here at Washington Mutual, Business Bankers have been discussing the tightening credit environment for the past several months with our clients. There is no denying that lenders across the country are imposing more stringent standards and terms for lending, citing a worsening economic outlook and a reduced tolerance for risk.

Our approach to the current economic climate is two-fold. First, we want to assure that our clients have the funding that they need to operate their businesses effectively, and second, we need to manage risk prudently.

It is our advice that business owners and managers carefully review their 2001 business plans and update and stress-test those plans where appropriate. We believe that everyone is best served by a clear understanding of the implications of material changes in key business variables such as sales, production costs or overhead.

During a period of economic uncertainty, it is essential to work with a banker that understands your business and is committed to be there for you when you need them. We believe in maintaining open, honest and frequent dialogue with our clients. This helps build a better understanding of one another and minimizes surprises.

We trust that you will find the content of this issue of Insight, prepared by Zachary Scott & Co., to be beneficial as you chart your course through the current economic challenges.

"cash flow" lending capabilities, the probability of completing a middle-market financing with a large unsecured "airball"

Our observation is that, while certain lenders continue to tout their "cash flow" lending capabilities, the probability of completing a middle-market financing with a large unsecured "airball" component is quite low.

component is quite low. There is currently a distinct bias among lenders toward asset based lending structures and stronger cash flow coverage. Cash flow credit structures are reserved almost exclusively for larger firms (revenues > $100 million) with well-heeled institutional equity sponsors and low execution risk. Story situations need not apply.

Although interest rates have declined, the contraction of availability and the increase in risk premiums have actually increased businesses' weighted average cost of capital as a larger proportion of a firm's capital must now be funded with more expensive, non-tax deductible equity. Assuming that the return requirements of equity investors have not declined, this increase in the cost of capital erodes the overall value of businesses. Buyouts News, an equity investor newsletter, reports in their recent survey of equity investors that corporate values have declined on average

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by more than 10 percent over the past several months. Our own discussions with equity investors and our recent experiences suggest that the value decline is even more pronounced. At a recent corporate finance conference, the founding partner at a large midwestern private equity fund summed up the impact of changing lending criteria on corporate valuations as follows. "In the past, if you invested at 7 times cash flow, grew at 7% per year, and then exited at 7 times cash flow, you earned a 30% return on equity. Under today's lending criteria an investment with these same parameters returns 17%; not enough to attract most private equity investors."

IN COVENANT DEFAULT?

Deteriorating economic conditions combined with tighter underwriting standards have increased the incidence of credit agreement defaults (either through breach of financial covenants or missed payments). Default may only be a technical or timing issue, or may signal a serious problem. You should expect more flexibility from your lender in dealing with a technical default than with a missed payment. In either case, there are certain actions you should take with your lender and certain responses that you should expect in return. At first discovery, make a quick assessment of the circumstances, and then approach the decision-makers that represent your lender. When problems are encountered, we have found that the most effective approach is to:

1. Tell the unvarnished truth about the situation. Your lender will carefully weigh your candor and knowledge of the situation.
2. Clearly articulate the reasons for the default and the operational changes that will be made in response (time alone won't make it better).
3. Provide a realistic projection of the performance required to restore financial stability, including:
   - the commitment of outside financial resources
   - the possibility of a guaranty
   - pursuit of alternative sources of financing
   - the sale of assets or the company

You should expect to negotiate a comprehensive agreement that provides sufficient flexibility and time to cure any defaults. Keep your emotions in check, as these discussions tend to be very difficult. Do not enter into one-sided or partial solutions. And, get the agreement in writing.

Successful restructuring of a company's finances to accomodate troubled times requires anticipation of the changing circumstances and a willingness to consider different alternatives. Time and creativity offer the best chance of success.

BORROWERS CAUGHT UNPREPARED

In the booming economy of the last five years, borrowing has been relatively easy. The robust economic outlook and a competitive banking environment combined to offer borrowers ample credit availability and low costs. Borrowers had a fairly wide array of choices. The abrupt change in lending policies has caught many borrowers unprepared. We have experienced an increasing number of calls from borrowers who are confused about the new borrowing environment and the implication for their business plans.

Smaller companies, in particular, have few alternatives to their banker for funds. Tighter credit conditions mandate that business owners adapt. They must learn to be more judicious in their capital investments and more aggressive in the management of their working capital. It is also time to:

- Reassess your company's business plan, testing the sensitivities of operating cash flow to changes in the business environment. Build in room for error. Evaluate ways to live on less credit than your lender is currently supplying.
- Develop back-up alternative sources of capital, even if they appear expensive. Subordinated debt and /or equity may appear to be expensive except when evaluated in the context of a liquidity crisis.
- Keep your lenders fully informed. Begin to think like a lender; recognize that they abhor negative surprises. Consequently, work to lower your lender's expectations for your company's performance so as to subsequently deliver only good news.

After an extended period of favorable borrowing conditions, it is perhaps easy to forget that the credit markets are highly cyclical. These cycles are inevitable and, in reality, the downside is indispensable to the process of adjusting for marginal investments that accumulated in the heat of a long economic expansion. The current disposition of lenders reflects anxiety over negative economic and stock market news and the proliferation of problems within many credit portfolios. It is likely that the market will remain tight while lenders grapple with an even higher level of credit problems. It is for this reason that borrowers should always maintain relationships with alternative sources of capital and seek capital structures that provide ample flexibility, even if the cost is somewhat greater. It has long been said that the capital markets are driven by two alternating emotions—fear and greed. At the moment, fear prevails. ❖

Credit Markets Update

It is now safe to admit, the country is experiencing a business slump, possibly even a recession (two consecutive quarters of economic contraction), a scene unvisited since 1991. The conventional prophecy has been that the Federal Reserve will engineer an economic soft-landing through the adroit management of monetary policy. But, our expectation is for a somewhat more jarring touch down. There is no lack of causative grounds for the rapid cooling of the nation's economic climate: energy prices are high and supplies are uncertain, corporate profit margins have weakened, the stock market is in a skid, access to the public debt and equity markets has severely contracted, and major banks are pulling in their horns in response to scolding from bank regulators.

Economic slump is part of the natural pattern of the business cycle. In fact, it is the necessary and healthy consequence of a sustained period of economic expansion. The simple fact is that overly enthusiastic investors and lenders have made a lot of errors—investments that once seemed compelling, now, in the clarity of hindsight, make little or no economic sense. Economic downturn is at its core the adjustment process whereby marginal financial and economic assets are revalued and recycled.

Perhaps the most prominent recent episode of malinvestment has been in the high-flying internet and telecommunications sectors in 1999 and early 2000. During that period any idea with even a feeble connection to the Internet or wireless communications could attract capital from equity and bond investors, and even bankers. With no hint of an earnings model, valuations equal to three digit multiples of revenues were commonplace. If it all seemed absurdly speculative—it was. A large segment of this industry is now suffering through the adjustment process. A lot of money changed hands, little enduring economic value was created.

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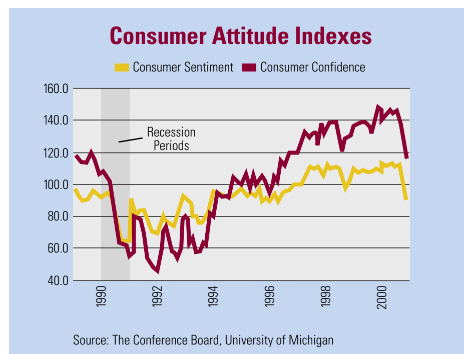
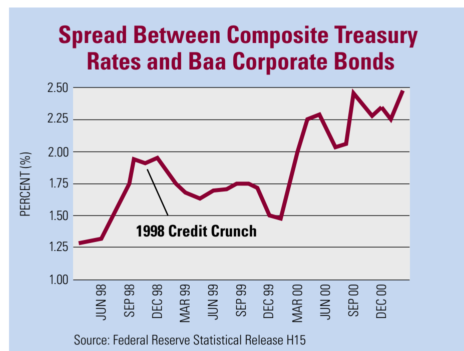
Consumer Attitude Indexes



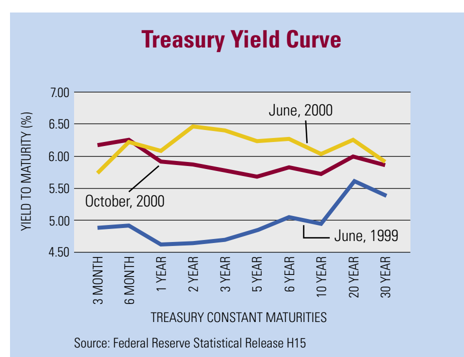
Source: The Conference Board, University of Michigan

Spread Between Composite Treasury Rates and Baa Corporate Bonds



Source: Federal Reserve Statistical Release H15

Treasury Yield Curve



Source: Federal Reserve Statistical Release H15

Likewise, highly leveraged debt financings seemed to many to be reasonable just a short time ago. In recent years, an abundance of buyout transactions have been put together using leveraged financing structures (> 4 times trailing cash flow) in concert with private equity to consolidate fragmented industries or fund expansion. To justify the leverage, investors and lenders anticipated steady growth and stable or improving margins based on the realization of operating synergies. While many transactions have proven successful, a significant portion of these deals have or will flop for a variety of reasons, including higher capital costs, overly optimistic management, unanticipated changes in the competitive or regulatory environment, or too high of a price at the outset. Many of these firms will be reorganized, dismembered and sold off or liquidated, often under the auspices of a bankruptcy court.

WHERE DO WE GO FROM HERE?

If we are in the midst of a period of economic readjustment, what are the implications? First, negative economic news (layoffs, stock market declines, bankruptcies, weak sales reports, corporate earnings warnings and higher energy prices) is having an impact on consumer confidence in the economy. Ultimately, consumer confidence will be a critical indicator for gauging the severity and duration of the downturn. There has been some notable erosion in consumer confidence over the past five months, but it remains sufficiently healthy to avert a severe recession. This measure deserves close monitoring in the coming months.

Second, it is clear that the credit markets are preoccupied with the process of economic readjustment in the form of troubled loans and bond defaults. As discussed elsewhere in this issue, the consequence is that credit is tougher to come by and more expensive. The heightened selectivity of lenders in the placement of their capital is evident in the widening risk premium between Treasury securities and higher risk (Baa) corporate bonds. While financing is more of a challenge for companies that are reliant on banks as their principal source of capital, funding is still available as asset based lenders and commercial finance companies have become more active. Companies in certain highly cyclical industries (building products and consumer durables) will find the current environment more challenging than others.

Finally, by cutting the discount rate twice in January for a total of 100 basis points (1%) and then again by 50 basis points on March 20, the Fed has taken some aggressive action to soften the downturn and forestall a bona fide recession. It seems likely the Fed is poised to make additional cuts in response to further signs of economic weakness. The current yield curve is notable in two respects. First, average rates (as measured by 10-year Treasuries) are down 79 basis points since last October. This means the cost of capital has been lowered, which should help sustain investment and construction activity, lighten the consumer debt burden, and offset the higher risk premiums that corporate borrowers *(continued p.4)*

Turnaround Equity

In today's economic environment, distressed companies seek help from "non-traditional" sources of capital.

Frequently, we are approached to assist in raising equity for companies that have encountered financial difficulties and are feeling pressure from concerned lenders. In today's environment, many firms find themselves over-leveraged, without adequate liquidity, and in default of their credit agreements. A seemingly obvious answer is an infusion of fresh equity capital from a new investor to pay down excessive debt and ease liquidity constraints. In truth, "turnaround" or "special situation" investors are rarely willing to assume the problems of others and dole out capital to preserve the investments of existing capital providers (owners and bankers). They are, however, willing to participate in the restructuring of the balance sheet of a distressed company by supplying liquidity at a time when the current capital providers will not or cannot.

For serving as the capital provider of last resort, turnaround investors expect to earn returns on par with venture capital, which means that the business or assets will be conservatively valued going in. As a condition to becoming involved in a distressed situation, turnaround investors require recognition of economic reality on the part of all capital providers and management. They will insist that all the current capital suppliers "mark-to-market" their positions; this may entail, subordination, cancellation, or conversion to equity of debt, and dilution of current shareholders' equity positions. Moreover, they are rarely hesitant to insist on control in order to protect their investment. This gives them the authority to make the operating management changes that they deem necessary to restore the business to financial health.

Special situation investors can be likened to financial engineers, rather than business operators. They seek to invest in turnaround plans that are predicated on cost reduction, capital availability, capital investment and, in some cases, the introduction of new management. Turnaround situations, where success relies solely upon revenue growth, technology development, or the ability to complete subsequent acquisitions, generally are less attractive.

A well-known turnaround investor tells us that they are most often part of a financial engineering play designed to adjust the capital structure to fit the current circumstances, provide time to address the factors that caused the current distressed situation, and align the interests of management, employees and capital. Lionel Boissiere of the turnaround investment fund of Doyle & Boissiere, LLC (www.DBLLC.com) says that they seek fundamentally sound businesses that are burdened with over-leveraged capital structures and cannot otherwise attract capital. The business must have a history of financial performance other than for an explainable set of conditions that can be rectified according to a concrete turnaround plan. The new capital that DBLLC invests is usually structured as common equity or preferred convertible equity depending on the situation. Their expectation is to work with the company to "right the balance sheet" and demonstrate positive operating performance, after which they will often exit via a recapitalization or sale to a buyout fund.

Turnaround investors are short-term partners who provide, in essence, bridge financing until the circumstances that caused the distress are corrected and stability is proven. The expectation is that once the problem is corrected, the company will be able to support a more normal capital structure and will pursue its natural evolution. ❖

Credit Markets Update *continued*

are being asked to shoulder. Second, the yield curve has reverted to a more normal slope as yields on shorter maturities have fallen more rapidly than medium and long-term maturities. We strongly suspect that this is an additional sign of the "flight to quality" by investors seeking a lower risk refuge for their capital in the form of short-term treasury securities.

It is clear that the country is in the throes of an economic downturn. With interest rates trending down and the promise of some modest tax reductions on the horizon, this downturn may not evolve into a full-blown recession. Nevertheless, the effects of the slowdown can be expected to vary in severity from industry to industry and region to region. Given the energy situation and the dot com implosion, the impact will be felt in the Northwest. We suggest that business owners and managers will be well served to prepare for a bit of a choppy ride over the next six to twelve months. ❖

ABOUT WASHINGTON MUTUAL BUSINESS BANKING

Washington Mutual's Business Banking serves commercial clients through Western Bank and WM Business Bank locations in five western states: Washington, Oregon, Utah, Idaho and California.

What we offer is unique: as a division of one of the largest financial institutions in America, we are backed by a robust financial infrastructure, but we're also agile, quick to respond, and free to make our own decisions. In other words, we unite strength with innovation.

We furnish the latest in banking technology and a full spectrum of commercial services, including:

- International Banking Products
- Deposit and Cash Management Services
- Revolving Lines of Credit
- Term Loans
- Acquisition Financing

ABOUT ZACHARY SCOTT & CO.

Zachary Scott & Co. 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 planning and analytical capabilities and proven expertise in structuring and negotiating complex transactions.

For more information on Zachary Scott & Co., go to www.zacharyscott.com.