



INSIGHT

Northwest Banking Transformation

With the barriers to interstate banking falling in the 1980's, bank mergers dramatically changed the look of Northwest banking. Here's a look back.

by Michael T. Newsome

Looking back over the past 25 years that we have closely followed the banking industry, a quick retrospective provides a reminder of just how radically the Northwest banking landscape has been transformed. As the result of this makeover, discriminating users of commercial banking services probably have more options than ever before.

In 1980, Northwest businesses were served by less than ten institutions, most headquartered in Seattle or Portland. Seafirst was the leading bank in Washington followed by Rainier, Peoples, Old National (Spokane), Puget Sound (Tacoma), and Pacific National. U.S. National Bank was the dominant Oregon presence and First National Bank of Oregon and The Oregon Bank were significant players. At the time, interstate banking

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was a topic of great interest to bank executives, but it was not clear when and how the regulatory barriers to multi-state banking would fall. Since the 1940's, banks were confined to operating branches and taking deposits in a single state. There were a few notable exceptions such as Western Bancorporation, the predecessor to First Interstate Bank, a bank holding company that owned banks in eleven western states including Pacific National Bank in Washington and the First National Bank of Oregon.

CORPORATE FINANCE FUNDAMENTALS

Corporate finance combines creativity and complexity. It encompasses the ways in which businesses find the economic resources necessary to do their work, how these resources are structured in the most beneficial manner, and then how the outcomes of these efforts are monitored and valued. In spite of the importance it is accorded, no matter how creative, corporate finance is not the magic avenue to business success. There are a few fundamental corporate finance truths that have passed the test of time, and are worthwhile remembering when the capital markets are flush with optimism, as they currently are.

- Corporate finance does not win business ball games—customer service, marketing, manufacturing, and research excellence build businesses and create value. Finance can help, but it is rarely the decisive factor.
- Cash is king; everything else is a poor substitute. It is the one thing that no business can survive without.
- When financial markets are active and liquid, business value tends to be exaggerated. Buy low, sell high.
- Projections and economic models tend to be extrapolations of the past and are always created with a specific outcome in mind.
- High business risk and high leverage is a very dangerous combination.
- There is no benefit to owning a great business if earnings are not reinvested wisely or distributed to shareholders.
- Elaborate capital structures are invariably the hallmark of financially weak or troubled businesses.

Keep these things in mind as you build your business and commune with your financial advisors and bankers. It's just common sense. ♦

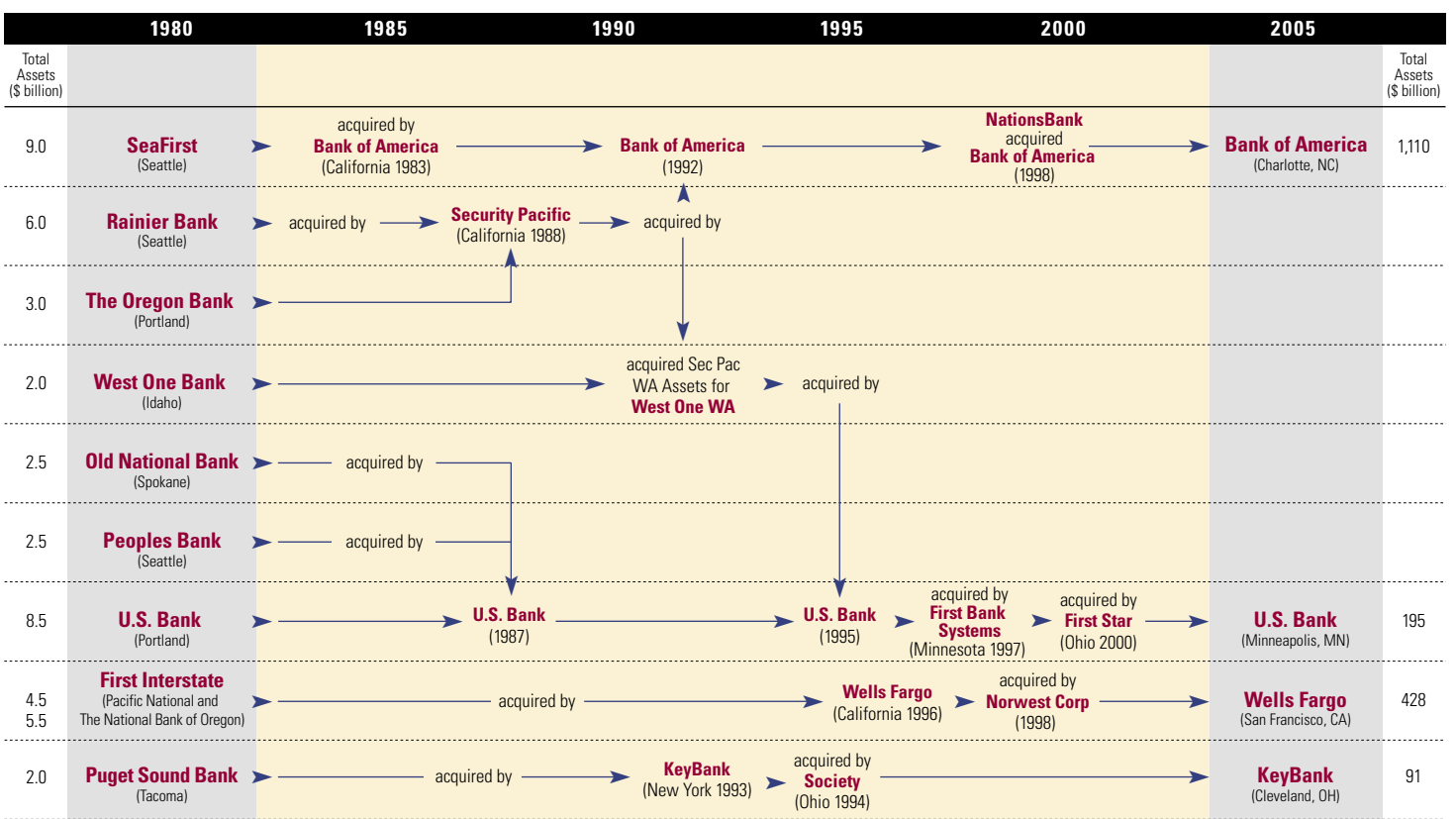
The hurdles to interstate banking began to erode in the early 1980's as many states liberalized in-state branching restrictions and began to authorize bank holding companies to make cross border purchases of banks. As a result, merger activity blossomed and a number of banking firms set out to build regional franchises. In 1994, the Riegle-Neal Interstate Banking Act was passed, wiping away all interstate-banking restrictions and igniting a wave of consolidation and integration that continues even now.

Mergers have generally occurred across markets, rather than within them, as bank regulators have been particularly sensitive to the creation of large local concentrations and impairment of competition. A case in point is the merger of Bank of America and Security Pacific in 1992, which combined the two largest commercial lenders in Washington—Seafirst and Security Pacific WA (Rainier). In order to win approval of the deal, Bank of America divested much of Rainier's Washington commercial loan portfolio and many of its branches. The acquisition of these assets propelled Idaho based West One Bank into a significant position in the Washington market.

TECHNOLOGY A DRIVING FORCE

In large measure, the fundamental force driving banking industry consolidation has been technology. Data processing and communications technology, through the use of very large databases, call centers and ATM networks, made it possible to centralize and dramatically reduce the cost of backroom operations and customer service units that are core to retail (consumer) banking.

For middle-market and small businesses, where credit needs are the major concern, service is predicated on local relationships with individual bankers. Here, the strategy of "bigger is better", and therefore "really big must be much better", has not proven to be as compelling. The drive for economies of scale in commercial banking has been manifested in the standardization of products, services and decision making. And, wherever possible, both customer service and decision making has been centralized so as to handle more volume with less staff. For example, every major Seattle bank used to have local



Northwest Banking Mergers and Acquisitions: A look back over the last 25 years of the changing bank scene in the Northwest.

trade finance capabilities to handle import and export transactions. While these services remain readily available, the vast majority of the work is no longer handled locally.

BANK HEADQUARTERS RELOCATE

The fact that no major bank makes its headquarters in Washington or Oregon (save Washington Mutual, which exited commercial banking last year) has had perhaps the most important impact. Policy is no longer made in the Northwest and the policy makers in Charlotte, Minneapolis, San Francisco, or Cleveland are not intimately connected to Northwest business people. Every major bank will tell you that the bulk of their credit decisions are made within the local market. This is true, but these decision makers are on a much shorter leash because the banks' credit policies are much more comprehensive than in the past. Bank-wide lending policies are prone to change without much local input or notice. This makes the rules of the game less predictable. Some will argue, but it is fair to say that local bankers at the major institutions do not have the same degree of discretion in serving the needs of their customers that they once enjoyed.

PERSONNEL TURNOVER

The other notable effect of bank mergers is personnel turnover, which has always been a challenge for large banks. The issue has intensified in the sweep of mergers. For many companies, the process of "educating" their banker is a familiar, even routine, experience. The result is that the bonds that once

existed between the local predecessors of the national bank goliaths and their customers have weakened.

REGIONAL BANKS STEP UP

One might think that all the shuffling and consolidating over the past 25 years has changed the competitive environment to the detriment of the commercial borrower. In fact, the impact has not been quite as negative as this seems to suggest. The complexion of the market has been altered – BofA is not the Seafirst of old, just

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as U.S. Bank today bears little resemblance to its Northwest predecessors, U.S. Bank of Oregon and Peoples Bank. Nevertheless, the Northwest banking market may be as fiercely competitive as ever. The mega banks have developed capabilities that better serve certain customer segments, particularly large companies with operations in multiple states

or overseas, in certain industry specialties, or requiring syndicated credit facilities. Asset based lenders, once minor players in the market, now finance the challenging

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situations that are defined by fast growth, high leverage or deteriorating performance. Competent regional banks, such as Banner Bank, Washington Trust, First Mutual, Columbia Bank, Commerce Bank and Sterling Savings, have emerged to fill the gaps left by the mega banks and are aggressively courting middle-market companies. And, a number of community and newly chartered startup banks are targeting small businesses. Many of the more seasoned lenders that came up through the ranks of the mega banks have migrated to these institutions. These banks offer genuine expertise and flexibility.

There is an abundance of alternatives, though not every bank is a fit for every situation. It's our advice that choosing a bank should be the result of a thoughtful analysis of the needs and attributes of the business. The best results are usually achieved through a competitive selection process. ♦

Time To Leverage the Balance Sheet?

Lenders are ready and willing to make loans, but businesses remain wary; for some this could be a mistake.

by Mark D. Working

As we have repeatedly reported in Insight for more than a year, lenders are falling all over themselves to make loans. But, to their dismay, corporate America has not been taking them up on the proposition. Hesitancy may be a mistake for certain companies, as the window will not stay open indefinitely. There are points in every business cycle where it is possible to minimize a company's cost of capital, and we think that time is now.

WHY AREN'T BORROWERS BORROWING?

The slow recovery of the economy from its bubble bursting internet/telecommunications recession and the aftermath of 9/11 has kept corporate managers wary. The fact is that manufacturing capacity is still under utilized in many sectors. Therefore, the demand for investment in new production assets and the consequent requirement for capital has been less than might otherwise be expected. At the same time, productivity has continued its march forward. Businesses have pared costs and increased efficiencies. The result is that companies have enjoyed strong earnings and are more liquid than ever. Rather than borrow, corporate managers are reducing leverage and building liquidity. Until demand for working capital and fixed asset investment absorbs the current store of liquidity, external capital won't be required.

IS THERE REASON FOR CONCERN?

With a short supply of borrowers, won't bankers remain hungry until they achieve their goals for asset growth? We're beginning to think otherwise due to a nettling little issue known as the current account deficit and its potential impact on the economy.

The current account (net trade balance plus net investment balance) is currently \$600BN dollars in deficit, a level never before seen, whether measured on an absolute basis or relative to U.S. GDP. This shortfall is being funded by foreign entities. To put the situation in context, it is as if your company is at the top of its line of credit from multiple lenders, any or all of which could choose not to advance at any time. The current account deficit continues to grow at the rate of \$100BN per year and the U.S. economy is relying on foreign central banks to keep stepping up to higher amounts. An interruption to this pattern could cause problems.

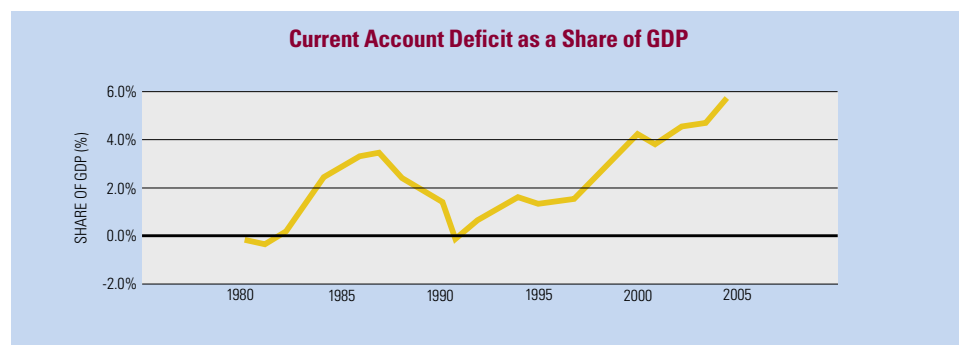
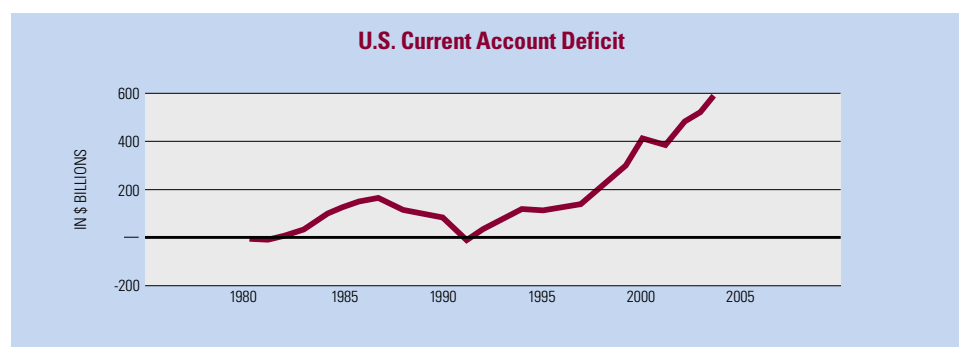
Alan Greenspan has argued that we should not lose sleep over the size of the deficit. First, the deficit is largely being funded by Japan and China, which have been willing to stomach relative currency depreciation in exchange for the economic growth provided by trade with the U.S. This policy is irrational

from an economic standpoint but appears to serve a political purpose. The conventional wisdom is that everyone has an interest in keeping the game going. Political instability would be risked if the music stops. The second argument is that the United States remains by far and away the best place in the world to invest money. The country is stable, financially healthy, and home to some of the most productive and profitable companies in the world.

As we learned from the internet bubble, economically irrational behavior can con-

businesses rush to lever up their balance sheets to take on additional financial risk in the face of increasing business risk. What we are suggesting is the following:

1. All businesses should lock up long term borrowing arrangements that will provide liquidity to the business tomorrow on today's terms. That could mean expanded borrowing bases, multi-year commitments, and term loans that free up the line of credit as a liquidity reserve.
2. Middle market business owners with



continue longer than one would expect, but eventually reality prevails. So, what happens if/when foreigners decline to fill the growing void? The dollar will be driven down against almost all currencies, interest rates will climb, and inflation pressures will grow. The adjustment process may not be smooth and painless. Some businesses will be adversely affected.

One thing is certain, lenders and investors abhor instability. Regardless of the shortage of loan assets, once business performance becomes less predictable, the needle will begin its swing from "greed" back towards "fear" and credit parameters will tighten. This will affect all borrowers. The consequences are likely to be less lenient term lending, lower advance rates, tighter covenants, and upward pricing pressure.

HOW TO BENEFIT FROM CURRENT CONDITIONS

Of course, we are not recommending that

stable franchises should consider taking advantage of the borrower's market to take some chips off the table. When the cycle turns, it will be a few years before today's lending conditions return.

3. Companies with sufficient scale to access the public debt markets, or the equivalent institutional debt market, should consider this alternative as they will find the risk/reward meter is pointing even more dramatically in the borrower's direction.

We don't know when conditions might change, but it appears that there's nowhere to go for the dollar but down. As it does, interest rates will have to rise. It is prudent to begin planning for changing conditions and, if appropriate, take advantage of today's unique conditions before they pass. ♦

Minority Equity: Structural Considerations

To succeed at fund raising when banks won't help, you need to understand private equity investors.

by Mark D. Working

A burgeoning economic climate has created an attractive opportunity to expand your business, but your banker can't fill the funding gap. Ideally, a "silent partner" who will provide the needed capital would be just the ticket. This would allow you to continue to drive the business forward unfettered.

We've seen this scenario arise regularly. Unfortunately, this is not a set of conditions that attracts professional investors, a group that represents the greatest source of equity capital available to business owners. For those owners facing a funding need, it is important to understand the motives and practices of private equity investors so that fundraising can be successful.

WHAT IS "INSTITUTIONAL PRIVATE EQUITY"?

An enormous amount of institutional private equity capital is raised every year by professional managers and is targeted toward investments in private companies. Local examples include Vulcan Capital (Paul Allen's investment vehicle), Endeavour Capital (a \$250MM fund headquartered in Portland), Evergreen Pacific Partners (a brand new \$275MM Seattle based equity fund), and Northwest Capital Appreciation (also based in Seattle). Depending on the nature of the business, industry, and degree of financial leverage, these investors are seeking investment returns ranging from 20% to above 30% per annum.

Institutional private equity managers have promised their investors that they will invest only in circumstances where they can control or influence the primary factors affecting the success of the investment.

The greatest concern facing a private equity investor is that individuals and/or family owners might sacrifice economic return for other benefits, such as status, employment, continuity, or lifestyle considerations. A private equity investor making the same choices would violate their fiduciary responsibility to maximize the return on their investors' money. Aligning the potentially conflicting interests of institutional and family owners and providing protection for both is the most challenging aspect to structuring an investment in a privately held company.

STRUCTURAL STRATEGIES

Institutional private equity investors have a few tools to help control the factors influencing risk and investment return. The table above summarizes the potential range of actions institutional investors typically demand to protect their investment.

The tradeoff between the current owners' desire to retain independence and the inves-

| RISK FACTORS | CONTROL OBJECTIVE | TOOL |
|--|--|--|
| Management | <ul style="list-style-type: none"> Assure that management will be evaluated objectively Power to make changes in the best interest of the business | <ul style="list-style-type: none"> Outright Board control Board control in the hands of economically minded parties "Springing Control" based on performance triggers |
| Business Strategy | <ul style="list-style-type: none"> Ability to control/approve the direction of the business and the parameters for allocating the firm's resources | <ul style="list-style-type: none"> Outright Board control Board control in the hands of economically minded parties Approval of annual operating budget |
| Capital Structure and Investments | <ul style="list-style-type: none"> Control financial risk (leverage) Control/approve investments of the company's capital | <ul style="list-style-type: none"> Outright Board control Board control in the hands of economically minded parties Super majority approval of changes in structure (new capital) or terms of existing capital Approval of annual capital expenditure budget |
| Exit Timing and Tactics | <ul style="list-style-type: none"> Make the determination of when and to whom the business is sold and the return to be realized | <ul style="list-style-type: none"> Control over sale events (timing and terms) Approval/veto of any suggested transactions "Put" or right to force liquidity event after specified time |

tors' need to protect their investment leaves two possible options for the company desiring external private equity. Either the existing owners can cede control over certain issues, or the investor can be offered economic priority. Often, in exchange for receiving a less risky position than the existing owners, the investor can be more lenient with regard to "control" issues. Generally, as the two parties' relative ownership approaches equality and there is a common purpose and investment horizon, negotiation of control provisions is emphasized.

When the ownership position of the outside investor becomes disproportionately small and investment horizons diverge, economic priority is a more customary avenue to align the parties' interests. Economic priority is typically achieved by tiering the equity

structure. The new capital can be structured as convertible preferred stock, with a "put" option. This assures that the investors' capital and a portion of their return will have priority over the other owner(s) and will have a measure of control over the timing of their exit.

The point of all of this is that when there is economic opportunity that requires external capital, a financial partner can provide the fuel to grow the business. The challenge is to customize an investment structure to meet the objectives and fit the constraints of all parties. With a full understanding of the variables and alternatives, a structure can be developed that allows all parties to achieve their goals and frees the business to realize the opportunities presented. ♦

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.

Mark Working
206.224.7382
mworking@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Ray D. Rezab
206.224.7386
rezab@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com



Zachary Scott

INVESTMENT BANKERS

500 Union Street, Suite 1000
Seattle, Washington 98101