



# INSIGHT

## Syndicated Loan Market

*How financial needs are met and who supplies the capital has changed for large middle-market businesses.*

by Michael Newsome

A steady tide of change within the commercial credit markets has quietly altered the manner in which the financing needs of large middle-market businesses are served and even who the principal capital suppliers are. It also portends changes in how distressed loans will be handled in the future. The catalyst for these changes has been the development of a very robust market for syndicated loans over the past fifteen years. Today, there are in reality two distinct markets. In the primary market, credit facilities are structured and underwritten between a borrower (commonly known as an issuer) and a group of lenders. Each lender undertakes a separate, severable obligation for a specific

portion of the overall credit facility, which is governed by a common agreement and a single set of documentation. This isn't a new phenomenon; syndicated credit has been around for decades. The real innovation lies in the development of an active and liquid secondary market, where a growing spectrum of investors traded in excess of \$170 billion of syndicated loans in 2005.

### THE PRIMARY MARKET

Large commercial and investment banks lead the primary syndication market, with the top players being JP Morgan Chase, BofA, Citigroup, CS First Boston, Deutsche Bank, Wachovia and Goldman Sachs. These institutions and a host of smaller ones origi-

nate loans, arrange the lending syndicates, and provide administrative services over the life of the syndication. Innovations such as improved market information on credit quality, pricing and deal structure, standardization of documentation, segmentation of risk into various loan tranches and "market flex" provisions that serve as a "mark to market" mechanism for pricing and structure when financings are originated have streamlined syndicated corporate credit originations and stimulated market growth.

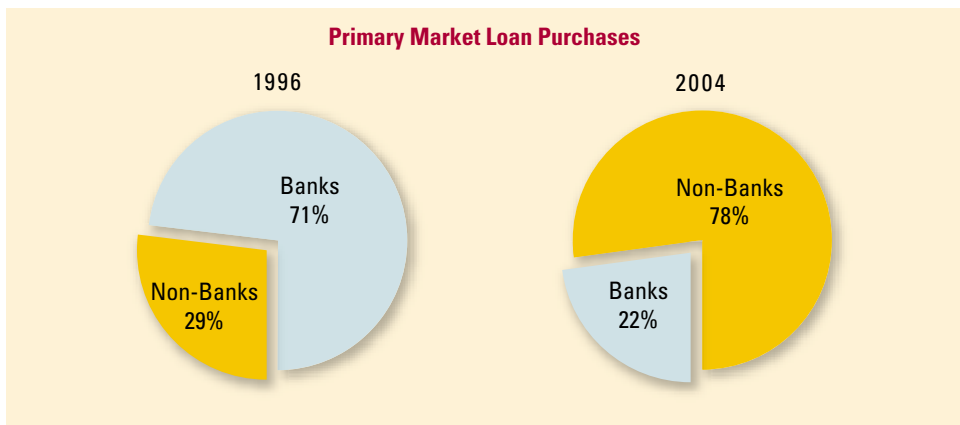
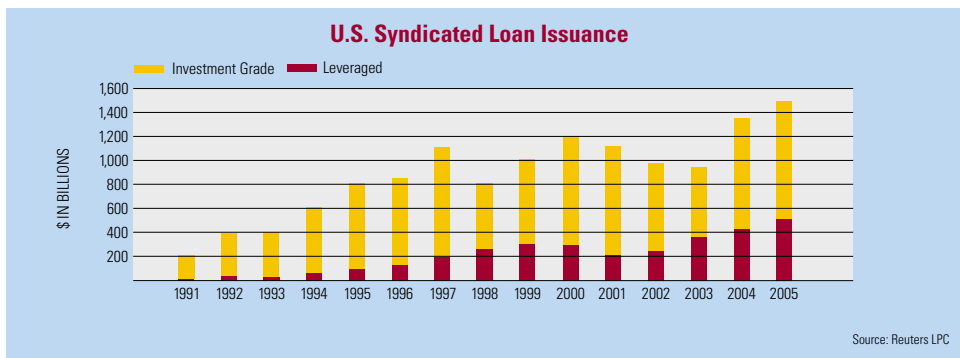
Improved information and standardization have allowed the syndicated loan market access to a much broader field of investors looking for attractive yield alternatives. The demand from non-bank investors for the paper fueled a massive increase in syndicated loan issuance. So much so that commercial banks are no longer the predominate holders of syndicated senior debt. According to Standard & Poor's, banks now account for less than a quarter of primary market loan purchases as compared to about 70% in 1996. The dominant buyers of syndicated loans are now non-bank institutions, including hedge funds, loan participation mutual funds known as prime funds, pension funds, traditional fixed income investors, and Collateralized Loan Obligations (CLOs). These structured finance vehicles assemble pools of syndicated loans that are then securitized as bonds with several credit rated tranches (AAA, AA, BBB, mezzanine, and equity) with corresponding returns. CLOs represent more than 25% of the market.

### THE SECONDARY MARKET

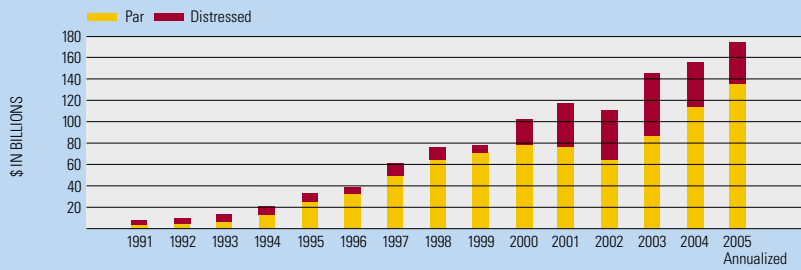
Secondary trading of syndicated loans began gathering steam in the 1990's. Initially, trading focused on distressed LBO<sup>1</sup> and LDC<sup>2</sup> debt originated during the 1980's. Regulatory guidelines for holding highly leveraged transactions and risk weighted capital requirements brought about by the 1988 Basel Capital Accord created incentives for banks to move loans off of their balance sheets. In the early 1990's, major investment and money center banks set up trading desks that matched buyers and sellers. Today, more than 50 institutions have trading desks. Since 1991,

<sup>1</sup> Leverage buyout

<sup>2</sup> Lesser developed country



### Secondary Loan Market Volume



Source: Reuters LPC

secondary loan trading volume has grown at an annual rate of more than 25% to in excess of \$170 billion (market value basis) in 2005.

#### WHERE ARE THE BANKS?

The upshot of the development of robust primary and secondary syndicated loan markets is the effective separation of loan origination and investment. The market now exhibits many characteristics of the public bond and commercial paper markets where underwriters are completely different than investors. Traditionally, the principal corporate banking model has been “buy and hold”, where lenders provided a high level of relationship and monitoring for corporate borrowers. This included the patience, personnel and infrastructure to workout and rehabilitate troubled situations. The advent of risk weighted capital requirements changed the analytical framework used by banks to evaluate portfolio performance and client profitability. It is pretty clear that commercial banks have concluded that the pricing available on most syndicated credits on a stand-alone basis does not provide an adequate return on the capital employed for these loans. Other investors provide cheaper capital. As a consequence, many banks have pared back their corporate lending infrastructure and pulled away from the syndicated

market. The old model has been succeeded by an “originate and sell” approach, where effective credit originators (the big banks) can earn acceptable returns based on ancillary relationship revenue, syndication fees, and a skim of the interest spread from other syndication investors.

Today, the predominant investors in the market are non-banks that have a significantly lower cost of capital and find the available yields attractive. These investors (hedge funds, prime rate funds and CLOs) act as portfolio managers that endeavor to earn a return by constructing portfolios within specific yield and risk parameters. They trade in and out of loans and use derivatives in an effort to achieve the target risk adjusted return.

#### TRADEOFFS

A deep and liquid market for syndicated debt is a good thing in most respects for corporate borrowers. It allows more efficient access to abundant capital on accommodating terms and pricing that accurately reflects the market. That has certainly been the case in today’s roaring corporate debt market —covenant constraints have been relaxed, financial leverage has crept back up to peak levels, and credit spreads on leveraged deals are thin by historical standards. With an

abundance of capital looking for yield, the situation could hardly be any friendlier for capital users.

However, there are tradeoffs that corporate borrowers need to appreciate. As economic growth slows, interest rates rise, and a share of the investments made in the past few years inevitably sour, the inclination for many investors will be to sell their positions in the large and liquid secondary market. These participants in the market are not relationship lenders equipped with workout expertise or patience.

In the place of today’s CLOs and hedge funds, troubled firms can expect to find distressed debt investors buying a large share of their credit facilities. This happened in the last downturn and it promises to be a bigger phenomenon the next time around when these investors will strive to earn a return by acquiring distressed loans at a discount and then enforcing their rights and remedies to improve the value of those loans. There is an abundance of firms (many are hedge funds) with explicit strategies of accumulating a sufficient share of a company’s senior and / or second lien debt to exert influence or control over how a business is restructured. In some cases, they will take direct control of the business by converting debt to equity. Troubled borrowers are likely to find that distressed debt investors will be less forgiving and flexible than relationship oriented banks that were willing in the past to reset covenants and rehabilitate the customer. So, the tradeoff for better pricing and more liberal terms is that borrowers will be held to those terms. Shareholders and management can expect a rough ride should they falter with a highly leveraged balance sheet. ♦

## The Ticking Time Bomb: Third Party Consents

*Uncertainties and transferability issues can blow up the sale.*

by Mark Working

Even a meticulously planned sale of a business can stumble if it comes down to a requirement for approval or consent that is beyond the control of both buyer and seller - the assignment of a crucial contract or lease, the agreement of a key employee, the issuance of a governmental consent or permit, or gaining information from a non-controlled source. Problems can arise when the consenting parties lack the buyer’s and seller’s sense of urgency, resist the risk dynamics of the new proposition, or simply view the situation as an opportunity to improve their position. Because the success of a sale transaction often depends upon following

the shortest path between an agreement in principle and closing, eliminating the uncertainties associated with third-party consents typically improves both the value and probability of closing.

Maximizing the value of a business in a sale depends on the seller’s ability to transfer to the buyer all critical elements of the business that contribute to its future performance. The worst time to identify those elements is when a transaction is imminent. Instead of addressing a buyer’s concerns in the heat of a deal, there is significant value to be gained by anticipating transferability issues and addressing them in the normal course of business.

Your corporate counsel is an important resource for systemically reducing dependence on third parties by identifying and addressing potential transaction bottlenecks long before a transaction is even contemplated. Our experience has yielded a few rules that should be incorporated into standard business practices.

#### MINIMIZE THE NUMBER OF PARTIES WHO CAN “VETO” THE DEAL.

If shareholder consent is required for the contemplated transaction, get them in the loop early with regard to the general direction and concept, and deal with any concerns in advance. Coming forward with a fully

negotiated deal with no forewarning is a recipe for problems, where some may be tempted to stall the transaction in an effort to gain special treatment.

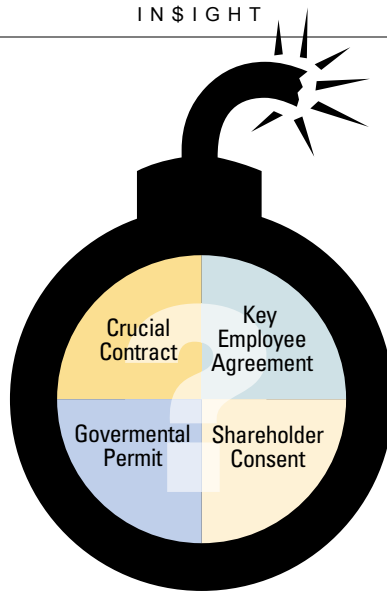
The same concept applies to key managers. Buyers often want assurance that key people will be retained and will require the comfort of employment agreements. Rather than wait for this situation to occur, it is wise to negotiate “stay and perform” bonus agreements that include a non-compete provision in order to align the interests of both the employee and the business in the event of an ownership change.

Contractual agreements with customers, suppliers, and landlords are important elements of value that are regularly subject to change of control or anti-assignment clauses. These provisions are easy to ignore, but can turn into costly and time-consuming headaches that have derailed some transactions. Wherever possible, avoid such provisions altogether or, as a fallback, make sure contracts require that consent cannot be unreasonably withheld or delayed.

#### **CONSISTENT HOUSEKEEPING PRACTICES CAN MINIMIZE CLOSING CONTINGENCIES.**

There is real value in a disciplined approach to handling business details, such as documenting and protecting intellectual property, employment policies, environmental exposures, or product warranties. Complete records of such rights and investigations minimize uncertainty with regard to the assets owned by the business and potential liabilities not reflected in the firm’s books. Invariably, there is a significant price to be paid if issues that are cloaked in uncertainty have to be resolved under the pressure of a pending transaction.

Environmental matters deserve special attention. They can take considerable time to



#### **A Ticking Time Bomb**

*Before selling your company, make sure you have the ability to transfer all critical elements of your business to the buyer.*

investigate and the conclusions drawn from the analysis may be very subjective. Drifting off into a battle of experts can bog down a process for months. We recommend engaging a nationally recognized environmental firm to conduct all phase-one investigations and provide these results during the due diligence phase of the transaction. In that way, material concerns will be on the table before transaction negotiations are underway.

Employee compensation, option, or phantom stock plans may need to be terminated at closing. By taking care of amendments to these agreements prior to initiation of a transaction, it may be possible to avoid employee consent under the pressure of a closing.

It is not uncommon for small business owners to provide personal guaranties for a

host of purposes. These guaranties are a perennial stumbling block in business transfers. Avoid them whenever possible; otherwise negotiate specific criteria for their release. At the end of the day, other than for financing arrangements that will be replaced by the buyer, removing guaranties at the time of a sale can offer an unwanted challenge. Sophisticated buyers are likely to treat guarantee requirements as an increase in purchase price. That implies less value to the seller. Even if otherwise willing, some buyers, such as private equity funds, often have prohibitions against replacement guaranties in their charters.

#### **BE ORGANIZED WHEN SEEKING THIRD PARTY APPROVALS.**

The key to minimizing the impact of third party consents is discipline as to when and how constraints are placed on the flexibility of the business and shareholders in a change of control transaction. Realistically, privately held businesses do not have the negotiating leverage to avoid consents in all circumstances. It is important to have a handle early in the sale process on all the consents that will be required, who will make the decisions to grant the consents, the process and timing specified in the contracts, and what the consenters’ reasonable concerns might be. Each consent request should be managed like any other important aspect of the project, with a plan, someone with specific responsibility for carrying it out, and an ability to monitor progress.

While it may not be possible to eliminate the requirement for third party consents, contemplating the need for releases or assignments at the time the agreements are put in place is one of those time tested business practices that enhances both value and probability of closing the sale of a business. ♦

## **Hanging on to the Purchase Price**

*Representations and warranties can have a significant effect on the purchase price of your business.*

by William S. Hanneman

Previous issues of Insight have offered guidance on how to evaluate an acquisition candidate in accordance with a strategic vision, design a due diligence investigation to objectively ferret out the important details about the target company (and incorporate those realities into the conclusions of value), and most recently, calibrate the purchase price to the target’s working capital cycle. Even with all of that hard work to arrive at a purchase price, a variety of issues remain that can meaningfully impact the economics of the deal for both buyer and seller. These are the promises regarding the condition of the business and the absence

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of negative factors that may affect its future performance, commonly referred to as representations and warranties and the indemnity obligations that support these promises.

Some buyers and sellers view representations and warranties as the sole purview of attorneys, in effect segregating the transaction between price and terms. In our experience, this is a mistake that can have significant negative consequences.

#### **BALANCING RISK PERSPECTIVES**

Understandably, the seller wants to walk away clean with all of the sale price, while the buyer demands protection from risks that were not of its making. The normal state of

affairs is that sellers, who have often lived intimately with these risks for years, judge them to be minimal. At the same time, buyers, who are often new to the industry or at least new to the particular business, view them as monumental. Balancing these perspectives without objective connections to the transaction economics results in higher costs, longer closing periods, and a higher risk of failure.

The process of purchasing and selling a business forces a more systematic sifting of information and identification of risks than is the case during normal business operations. In addition, simply undertaking a transaction may interject new specific risks. For example, if the business has more financial leverage post-transaction, there is likely to be less tolerance for swings in performance or unexpected costs.

The process for selling a business is likely to identify and focus considerable attention on risks in three general categories:

TYPE OF RISK	EXAMPLES
<b>1. Ownership and authority</b>	<ul style="list-style-type: none"> <li>ownership of stock or assets</li> <li>lien or other priority to assets</li> <li>authority to complete the transaction</li> </ul>
<b>2. Quality of assets and operations</b>	<ul style="list-style-type: none"> <li>defects in tangible or intangible assets</li> <li>ability of operations to “produce” as expected</li> <li>existence of all requirements to operate</li> <li>strength of contracts and relationships</li> <li>commitment of essential people</li> <li>accuracy of financial reporting</li> </ul>
<b>3. Unknown liabilities</b>	<ul style="list-style-type: none"> <li>tax obligations</li> <li>environment liabilities</li> <li>employee claims</li> <li>product liability</li> </ul>

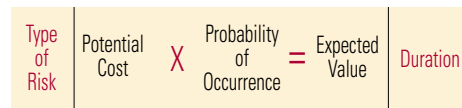
Undoubtedly, the first objective is to mitigate any of these risks so that the list of issues to discuss is shortened. Lawsuits can be settled, back taxes paid, and accounting treatments adjusted. If they can't be mitigated, both real and perceived risks must be quantified and, through a process of negotiation, allocated among the parties. The results of that effort are the basis for a series of representations, warranties, and the allocation of risk through indemnification obligations.

While there are certainly “average” ranges for indemnification limits, the fact is that no two businesses are alike. Forcing a standard template on a unique set of circumstances is analogous to jamming a square peg in a round hole. It can be done, but it is seldom a proper fit. Although an interesting reflection of market terms, the average indemnification terms in the last 20 transactions in unrelated industries serves as a poor benchmark for any particular situation.

**EXPECTED VALUE**

Categorizing risks in a specific situation according to the potential cost, the probability of occurrence and the duration of the

exposure provides a framework for assigning an economic value to each of the risks. The expected economic value is a product of the potential cost of a particular risk and the probability of its occurrence. The duration requires an estimate of how long the exposure continues (i.e. does it expire according to a statute of limitations, resolve itself by flowing through the business, or is it indefinitely ongoing?).



This framework has been used successfully to weigh risks for the purpose of negotiating the amount and survivability of indemnity obligations.

Unquestionably, many of these risks require subjective judgment because they are difficult to quantify. However, this process provides a sense of relative value to evaluate

trade-offs and suggest creative solutions to what might appear to be intractable problems, and, perhaps most importantly, provides common decision criteria for the negotiating team. Debates about facts can replace emo-

tional arguments.

Due to often gaping differences between the buyer's and seller's perceptions of risk, allocating those risks in a business sale transaction can be more difficult than negotiating the purchase price. Crafting the best combination of price and post-closing risk requires that members of the negotiating

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team have a common understanding of the tradeoffs and where lines should be drawn. Those conclusions must be considered in relation to the alternatives that are in hand. Situations have arisen more than once where tens of millions of dollars separated the top two purchase offers, yet deal-threatening arguments erupted over risks that were worth substantially less. Such discussions can unravel a desirable transaction.

**SELLERS MUST THINK LIKE THE BUYER**

The best way to limit risk indemnification is to define and resolve risks in advance of entering the market to sell a business. Good records and attention to detail makes it possible to quantify and weigh real risk issues and reduce the potential for negative events. Surprises in due diligence feed uncertainty and simply aggravate divergent perceptions of risk. As difficult as it might be when contemplating these risks, the seller and its team must think like a buyer and honestly consider both the appropriate amount of indemnification reasonably required to provide comfort and the total economic difference between alternatives. ❖

**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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