



# INSIGHT

## Credit Turmoil: It's a Vicious Cycle

*"When the tide goes out, we find out who's been swimming without a bathing suit." —Warren Buffett*

by Michael T. Newsome

Suffice it to say, we live in interesting and turbulent times, as witnessed by the unpredictable, broad-based upheaval in global credit markets. Turmoil first cropped up in the housing, mortgage and leveraged loan markets; but, contrary to most media coverage, the problems have not been confined to these economic sectors. Rather, the real concern is pervasive leverage that cuts across global finance and has been brought about by the aggressive and creative application of asset securitization, risk tranching, and derivatives. These elements combined with

the market to drive values even lower, leading to more losses and further margin calls.

■ Suddenly, the need for cash to satisfy repayment demands creates a self-reinforcing panic, where fire sales accelerate the plunge in asset values.

Leverage is a dual-edged sword that swiftly amplifies returns in robust markets and losses in bear markets. Of course, there are no greater margins of leverage than large commercial and investment banks, where a dollar of equity capital may serve as the foundation for up to \$30 of as-

to conserve liquidity that may be needed later. Lender and asset manager confidence is sapped and liquidity is wrung out of the credit markets. So far, more than a few highly-leveraged financial entities (Citigroup, UBS, Merrill Lynch, Bear Stearns, Carlyle Capital, CIT) have been forced to scramble for capital in a market with few providers. Undoubtedly, many others have come perilously close to the edge.

### THE RESPONSE

The Federal Reserve is obviously concerned about the health of the financial markets and broader economy, as witnessed by highly-publicized short-term interest rate cuts and the liquidity (newly-printed dollars) being pumped into the banking system. The discount rate, at which banks borrow from the Fed, has been whittled down by 375 basis

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a glut of cheap money to ignite an unbridled boom in complex financing activity spanning nearly five years. The net result of this frenzy has been unsustainable leverage and bone-rattling volatility in the credit markets. Like the air rapidly escaping a balloon, the boom ended last summer and, in its place, an urgent deleveraging process is playing out in what is often described as a "vicious cycle."

- First, asset values begin to erode; in this case, the original catalysts were faltering housing values and suspect mortgage loans.
- As asset values decline, the negative power of leverage kicks in to shrink the equity value of the bank or asset manager (hedge fund or special investment vehicle) holding the financial assets at an even faster rate and pushes down collateral coverage ratios.
- Lenders, fretting about deteriorating collateral coverages, resort to calling in loans, which forces a sell off of assets to raise cash, flooding

sets. By nature, they rely on short-term liabilities to fund long-term assets. Under the right circumstances, these enterprises are acutely vulnerable to a downward spiral in asset values, particularly given the regulatory mandate requiring that asset portfolios be routinely marked-to-market. In a chaotic environment, where anxiety overcomes reason, the resulting market-clearing price may bear little relation to the ultimate value to be realized if the assets are held to maturity.

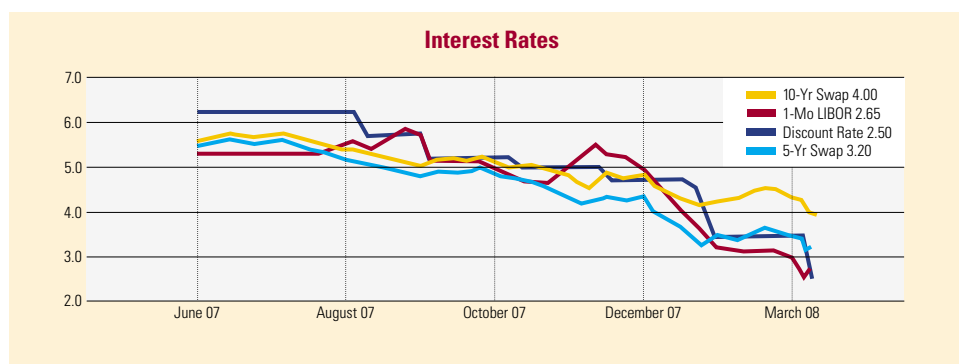
In the midst of a vicious cycle, the credit crisis is being aggravated by understated asset values and excessive write-offs. Nevertheless, the impact is all too real. As asset values and bank equity capital erode, fear of further loan losses and asset write-downs builds among lenders. The natural reaction is to curtail lending

points in a series of cuts, from 6.25% last August to 2.50% as of this printing. Market rates have moved down with the discount rate. Further cuts appear to be in store.

The Fed hopes that cheap and abundant money will:

- Inject confidence into credit markets to encourage the rational assessment of asset values and stem the deleveraging freefall;
- Allow financial entities room to recognize and write-down impaired assets in an orderly fashion; and
- Lower the cost of capital through the ample availability of credit in order to rekindle consumer and business spending to head off an economic contraction.

At the same time, the Fed, in an unprecedented move, opened the discount window to



lend to capital-short investment banks (primary broker-dealers), as well as retail banks, which has found very strong demand. Moreover, they are offering to swap Treasury securities for poorly-trading AAA-rated mortgage securities to shift the balance between supply and demand and relieve the downward pressure on prices. Here again, the goals are to provide liquidity as a lender of last resort, short-circuit the deleveraging process, and help markets function smoothly again.

As aggressive as the Fed has been recently, there is no certainty that its actions will resolve the problems and break the vicious cycle. The course of the economy and financial markets is at the mercy of human psychology and unexpected events. It cannot be fine-tuned with precision. Much may depend on whether consumer and business confidence has already been sufficiently undercut to slide the economy into a broad-based recession. The effectiveness of the Fed's expansionary monetary policy and other actions will only be known in retrospect over the next six to twelve months.

**AN EXPECTED CONSEQUENCE**

Unfortunately, the Fed's approach has a troubling flip side. When the money supply expands at a faster rate than the economy's expected average long-term growth, as it is

doing now, the likely result is inflation. This, in turn, drives up interest rates, particularly long-term rates. Many economists believe that the recent surge in commodity prices, as evidenced in food, energy, and metals, is an indication of mounting inflationary pressure. The most recent consumer and producer price indices reflected an unfamiliar level of inflation at 4.3% and 6.4%, respectively. The Fed is on the horns of a dilemma—it can affect short-term rates in the market simply as a result of altering the supply of dollars, but eventually the market will clear and concerns about a faltering economy, a weak dollar, and inflation will drive rates higher. The Fed has a fine line to tread.

**NORTHWEST IMPACT**

While this drama is playing out on a global stage, the implications will be felt here in the Northwest. First, interest rates are likely to rise. With that in mind, some hedging suggestions are provided in the following article.

The pressing concern is the availability of credit for middle-market businesses. Major banks, including Bank of America and Wells Fargo, have reported losses and found it necessary to raise additional capital. Without naming names, certain lenders are sufficiently capital-constrained to be reluctant or even unable to take on new business.

Due to the liquidity crunch, the costs of funds for most banks are well above historical norms. Higher costs, coupled with increasingly wary credit decision-makers, translate into higher credit spreads for borrowers. As this filters down to the local market, bankers can be expected to deliver messages of either higher pricing or lukewarm support for marginally profitable relationships. Capital will be allocated to the most attractive risk-adjusted opportunities. Unless the business is deemed bulletproof in a downturn, banks will demand higher pricing at renewals or for incremental credit commitments.

Terms are tightening too. Less leverage, stricter covenants, more collateral, lower hold positions, and personal guaranties all are on the agenda. More importantly, companies that hit a rock in the road can expect less lender cooperation and patience simply because troubled loans require higher allocations of scarce capital. So, the pressure will mount to “get it up or out”—either fix credit problems quickly or the sell the loans at a discount.

The sky is not falling. The economy is as healthy in the Pacific Northwest as anywhere in the country. Nevertheless, companies that rely on senior debt would be wise to stockpile liquidity to ride out the vicious cycle. ♦

# Taking Risk Out of Risky Times

*Now is a good time to consider locking in longer-term fixed rates.*

by Michael T. Newsome

**M**itigating the sensitivity of business cash flows to the movement of interest rates is the prime motivation of hedging and is usually achieved with interest rate derivatives (swap, cap or collar contracts). An alternative, and perhaps more common, rationale for employing interest rate derivatives is an effort to time the market to reduce the cost of capital. No matter whether the objective is hedging or market-timing, now is a prudent time to consider locking in longer-term fixed rates.

The adjacent hedging matrix offers guidance for hedging strategy based upon the shape of the yield curve, Fed policy, and economic activity. For example, a steep yield curve, loosening Fed policy, and an economy gathering steam signals that interest rates are expected to rise. Therefore, locking in up to 75% of debt with longer-term fixed rates likely would be beneficial. Conversely, a flat or inverted yield curve, coupled with tight Fed policy and a slowing economy, implies falling rates and a strategy of staying predominately short with floating rates.

With the economy sagging, the normal inclination would be to stay short in the hope of further rate softening. But, for the reasons outlined in the preceding article, low or falling

rates may not be a safe bet. We are not strong proponents of market-timing, as the effort seldom hit the mark. Nevertheless, long-term rates approaching the 40-year lows achieved in 2003 and the prospects for escalating inflation are two compelling reasons to consider hedging alternatives now.

Current credit market volatility has created an unusually inverted yield curve through the first 24 months, in anticipation of further short-term rate reductions. Beyond two years, a steeper, more normal curve reflects an expectation that rates will rebound. If concerns

about future inflation are valid, long-term rates will continue to rise, dragging the entire yield curve upwards.

To strike the fine balance between flexibility and the lowest all-in cost of capital, the guidance of a hedging advisor can be valuable in the development and implementation of a hedging strategy. Of course, banks are an excellent source of expertise, as interest rate risk is central to their business. But, in a complex market that lacks pricing transparency, an independent advisor offers some meaningful advantages:

- **A broader range of alternatives.** Swap

Interest Rate Direction	LIKELY HIGHER			Neutral	LIKELY LOWER	
	Yield Curve	Steepest	Steepest	Flattening	Flat	Flat
Federal Reserve Activity	Loosening	Steady	Steady	Modest Tightening	Tightening	Tightest
Economic Activity	Slow Recovery	Growth	Growth	Slowing	Slowing	Recession
% Hedged	Max Fixed 75%	60%	50%	40%	35%	Minimum Fixed 30%
Maturities	Maximum 10-30 Yrs	5-10 Yrs	Medium 5-7 Yrs	1-5 Yrs	1-3 Yrs	Minimum 0-2 Yrs
Hedging Instruments	Swaps Forward Swaps Collars			Reverse Swaps Reverse Forward Swaps Caps		

providers have a natural predisposition toward hedging approaches that offer the greatest profit. To that end, bankers often push long-dated swap contracts, with lucrative embedded fees, rather than rate caps or collars that also provide the desired protection and flexibility for a flat premium.

■ **Real-time information.** Breaking economic news can materially move derivative-market pricing in a matter of minutes. Most middle-market companies do not have access to the real-time market information necessary to monitor the market closely for opportunities or compare quotes from multiple sources.

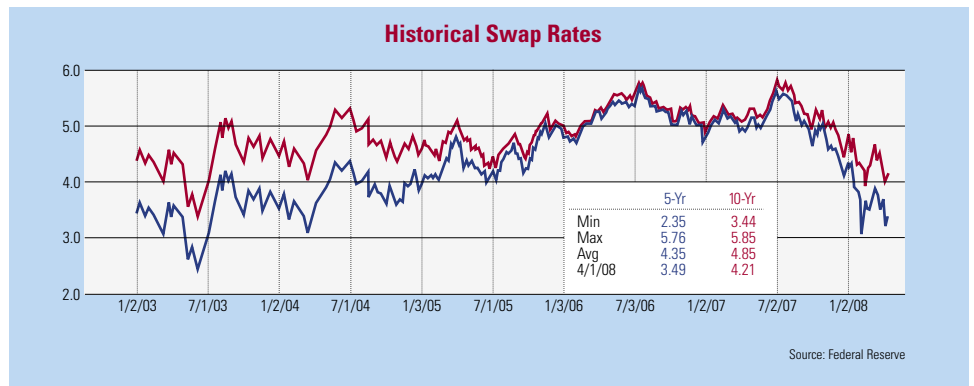
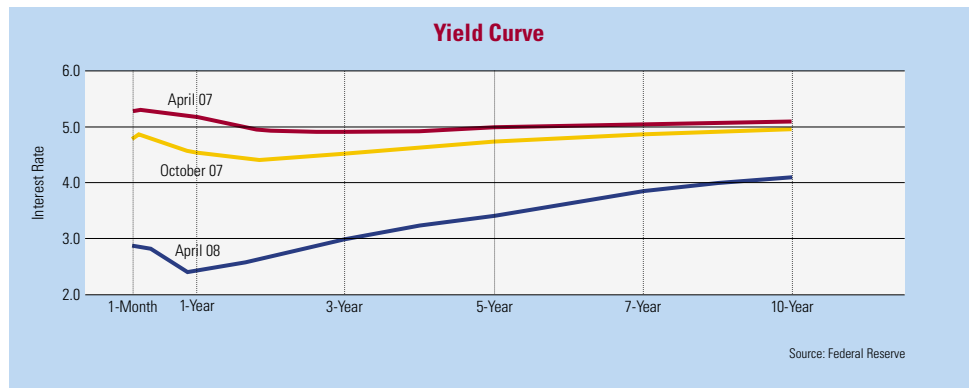
■ **Pricing transparency.** The compensation for the provider built into a swap quote can vary widely in the absence of pricing insight. An independent advisor can quantify the spread and inject competition into the process.

We can offer a few suggestions regarding hedging strategies:

**Separate hedging from credit structure.** Structuring hedges (swaps, caps, collars) that are independent from debt is generally superior to a fixed rate loan that is often subject to a prepayment penalty. Keeping borrowing arrangements on a floating rate basis provides greater flexibility to make adjustments to credit terms as conditions warrant, without unwinding interest rate commitments and tripping make-whole provisions.

Banks view the credit risk of a fixed-rate loan the same as a floating rate loan, while swap or collar contracts are perceived as added credit exposure. When arranging derivative contracts, it is worthwhile to have an ability to preserve the hedge in the event it is necessary to change lenders for the underlying borrowing. This may require a pledge of specific collateral, either at the time the hedge is implemented or at the time of change.

Finally, the value of a derivative contract increases or decreases as interest rates move up or down. The gain or loss accrues to the



borrower. In the case of a terminated fixed rate loan, it is not unusual for the borrower to pay a prepayment penalty, without regard to the movement of interest rates.

**Hedge interest rates for a period that makes sense based on capital structure and business.** The funding for long-life assets, such as plant and equipment, should be hedged for a corresponding duration<sup>1</sup>.

Any business in which customer demand is adversely impacted by rising interest rates should pay particular attention to interest rate risk. The concern is most acute in firms where debt is a major component of their long-term

<sup>1</sup>Weighted average maturity of an asset's or a liability's cash flow.

(> 3-4 years) capital structure. Rising rates are reflected in both increased borrowing costs and reduced operating earnings. This combination can painfully erode the capacity to service debt.

Lower interest rates have saved the bacon of many leveraged businesses by lightening the interest burden. It would be tragic to permit rising rates to undercut the economics envisioned at the time of the borrowing. There is an open window to take advantage of the current interest rate environment. We can't know how long it will last, but it is certain that without a defined interest rate strategy, today's opportunity will be lost. ❖

## Creativity + Timing = Opportunity

### Taking Another Look at ESOPs.

by William S. Hanneman

Regardless of the claims by ESOP proponents concerning the relative performance advantages of ESOP-owned companies over their non-ESOP-owned brethren, readers of *Insight* know that we have not been enthusiastic advocates of ESOPs, except in special circumstances. Perhaps, that is because we are typically engaged by private business owners to achieve the highest value in the sale of a business and it is rare that an ESOP can justify paying the highest value, much less afford to do so. While there can be some meaningful economic incentives to the seller with a sale to

an ESOP, those incentives are not typically sufficient to trump a strategic buyer's ability to justify paying the highest after-tax present value.

Economics aside, there are some circumstances in which a sale to an ESOP may make sense, either because there are no readily identifiable strategic buyers, or in situations where the preponderance of the value is inherent in the employees that are under no compulsion to remain after a sale, such as in personal services firms.

We were intrigued when one of the savviest investors of our time, Sam Zell, recently

took the Tribune Company private using an ESOP. As a public company, the opportunity to purchase the company should have been open to all interested buyers, both strategic and financial. With no other media properties to combine with the Tribune Company, Zell was the quintessential financial buyer. We were curious why a financial buyer was apparently able to justify paying the highest value, and what Zell got out of the deal. In particular, we wondered whether there was something to learn from this transaction that would improve the position of ESOPs as an

**ESOPS** continued from p.3

acquisition or corporate finance vehicle.

### THE TRIBUNE COMPANY

With revenues of \$5.5 billion and generating more than \$1 billion dollars of operating income, the Tribune Company has its roots in print journalism. Over the years, it had

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branched out into virtually every aspect of modern media. It currently owns 11 daily newspapers, including the Chicago Tribune and the Los Angeles Times, approximately two-dozen television and radio stations, as well as a number of investments in online media. In addition, the Tribune Company owns the Chicago Cubs and Wrigley Field.

Although a public company, the Tribune Company was effectively controlled by the Chandler family, which owned approximately 20% of the equity. An ESOP that had been established some years earlier also owned a portion of the stock. Prior to the Zell transaction, the company's revenues had been stagnating and operating profitability had been under pressure, primarily due to the challenging newspaper business.

### THE TRANSACTION

The multi-step transaction was quite complicated. After cutting a deal with the Chandler family to support his offer, Zell purchased stock, loaned the company money, and arranged for additional debt that the company used to fund a redemption of its own shares. Because the stock was redeemed and not tendered to the ESOP, the traditional justification for using an ESOP did not apply. The sellers could not defer the capital gain by rolling the proceeds into qualifying replacement securities.

The redemption left the ESOP as the primary shareholder (along with management and Zell's investment company). Once the business was private, the company elected to be taxed as an S-corporation, therefore the company pays no federal income taxes on the approximately 92% of the business owned by the ESOP.

Unlike C-corporations, S-corporations do not pay income tax directly. Instead, income is passed through to the S-corporation owners, based on relative ownership, where

it is taxed at each owner's personal tax rate. ESOPs have the unique status of not owing any federal income tax on S-corporation income; therefore if an ESOP owns 100% of an S-corporation, there is no federal income tax to be paid by either the S-corporation or its shareholder. The end result is that the funds that would have been used to pay taxes can be used for profitable corporate purposes.

In the case of the Tribune Company, the virtual elimination of federal income taxes greatly improved its debt service capacity. This incremental leverage allowed the ESOP to pay more for the business than other prospective buyers were able to justify. Perhaps this was a fine result for the selling shareholders and may even be a fair result for the ESOP shareholders (although that remains to be seen), but what benefit did Zell derive from the deal?

When the dust settled, Zell, among other things, paid \$90 million for a warrant that allows him to buy, over a 15-year period, up to

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40% of the fully-diluted equity of the company at a total price of between \$500 and \$600 million. The warrant was structured to have an extended life so that it could be exercised after the 10-year period, after which the built-in gains created in converting to an S-corporation would expire, and was cleverly structured so that it was not deemed to be a second class

of stock that is prohibited in an S-corporation. In the end, it is likely that Zell will never exercise his purchase rights. Rather, he ultimately will sell the warrant to the ESOP, or to other investors at the time of a public offering or sale of the company.

### LESSONS FOR THE MIDDLE MARKET?

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The Tribune Company transaction took advantage of a significant shareholder that was not happy with the performance of the business and was looking for a way out. The fundamentals of this business and its industry were not particularly attractive to most investors. Finally, the transaction clearly took advantage of the unusually aggressive financing conditions that existed prior to the crash of the credit markets.

While this transaction does not appear to provide any new corporate finance tools for middle-market transactions, ESOPs will remain interesting acquisition vehicles in situations where an owner does not require the highest value, is willing to sell interests over a period of time, or where no strategic buyer exists. ♦

## 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](http://ZacharyScott.com).

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