Zachary Scott & Co.—an investment banking and financial advisory firm—has produced this newsletter designed to bring you a perspective on the private capital markets.

PERSPECTIVES ON THE CAPITAL MARKETS SUMMER 2001

IN$IGHT

Demystifying Bank Risk Ratings

Understanding how risk ratings work may give you an insight on how banks perceive your company.

Every bank employs a formal system for rating the credit risk associated with the commercial and institutional loans in its portfolio. Lenders use risk rating assessments in approving credit, portfolio monitoring, pricing and profitability analysis, setting loan loss reserves and allocating capital. Knowledge of a firm's risk rating can provide owners and managers a fairly accurate picture of how they are perceived within the bank, particularly by key decision-makers who may not have had any personal contact with the company.

Some lenders are reluctant to share specific conclusions of their risk rating assessments with their clients. These ratings are, however, important to borrowers for a couple of reasons. First, they are a key factor in determining:

- Extensions of additional credit;
- Loan pricing (higher risk = higher pricing);
- The level and frequency of review;
- The amount of credit held vs. sold;
- The approval level required for changes, renewals or new credit;
- Covenant flexibility; and
- Guarantee requirements.

Risk ratings are also central to regulatory oversight since periodic inspection of internal risk rating processes is the principal leverage that bank supervisory agencies have over the lending practices of an individual bank. The conclusions reached in the Office of the Comptroller of Currency's ("OCC") annual credit review greatly influence the risk appetite of most banks and the overall availability of commercial credit. In fact, many bankers will say privately that the OCC's heightened concern and criticism in the past 12 months of leveraged lending activities is a major reason for the recent tightening of the credit markets.

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Among larger banks (assets > $1 billion), there has been a trend toward standardizing risk rating systems in order to simplify regulatory oversight and facilitate the market for loan syndications. Most banks' internal systems closely parallel the credit risk rating scale used by the OCC and other bank supervisory agencies. The accompanying table on page 2 summarizes a typical risk rating system for a large bank. There are six risk tiers (1-6) for credits that qualify as a "Pass" or acceptable credit according to bank regulators. The remaining four tiers (7-10) correspond to the regulatory definitions of problem assets. The number of "Pass" rating categories and the specific criteria for each tier varies among banks depending on the bank's size, mix of business, and level of sophistication. For example, a bank with significant exposure to the large corporate loan market is likely to have more grades corresponding to investment grade[1] risks. Banks focused on middle market or small business lending may make finer rating distinctions among credits at the higher risk end of the "Pass" spectrum.

Fundamentally, bank risk rating systems provide a means of defining the probability of default ("PD") and the likely loss in the event of a default ("LLED") *(continued p.2)*

DOING BUSINESS THE RIGHT WAY

In an essay, Dr. John Rutledge outlines a few guiding principles for doing business. His simple points, if practiced consistently, will assure that your company's most valuable asset—its reputation— is protected.

1. Do the right thing. Right and wrong are powerful concepts.
2. Don't hide the ball. When you lose a big account or discover an error in your financials, don't hide it from your banker or your employees. Tell them.
3. You don't need to shout and swear. If others do so, end the meeting.
4. Leave something on the table for the other guy. The best business deal isn't the one that maximizes your advantage or your profits.
5. Make everyone your customer. Treat your customers in a way that will make them want to come back.
6. Stick to your principles.
7. Principles are not for sale. Be prepared to walk away from a deal, any deal, rather than violate your principles to win it.

Dr. Rutledge allows that businesses organized around principles are often more successful and make more money than those organized around the idea that greed is good. That's sound advice.

Dr. John Rutledge is the Founding Managing Director and Chairman of Rutledge Capital and a regular columnist in Forbes and other leading business publications. Rutledge Capital, a private equity firm based in New Caanan, CT, is dedicated to generating exceptional returns on capital by acquiring quality businesses for long-term investment. In the Northwest, the firm is probably best known as the owner of Stairmaster, one of the leading fitness equipment brands in the world, headquartered in Kirkland, WA. More information on Rutledge Capital and commentary by Dr. Rutledge is available at www.rutledgecapital.com across a portfolio of loans. In other words, if grade 5 credits have a PD of 3.0% and the LLED is 30%, then the bank can expect to sustain losses of 0.9% or 90 cents on every $100 of grade 5 loans in the portfolio. Banks independently calibrate PD and LLED based on their own historical loss experience. It is also not uncommon for the LLED to vary depending on the type of collateral supporting the loan.

> Although all risk rating systems use objective standards as a foundation, the process is, by definition, an exercise in human judgment. Biases, attitudes and perceptions influence rating conclusions.

DETERMINING RISK RATINGS

Assigning risk ratings is the subjective distillation of a variety of quantitative and qualitative risk factors that occur when the loan is first approved, and is subsequently reviewed and adjusted as new information emerges. Important considerations include: financial condition, company size, industry position and outlook, quality of financial information, management competence, loan structure (e.g., collateral, monitoring requirements, guaranties), and vulnerability to external events (e.g., changes in interest or foreign exchange rates, commodity markets, environmental regulations, energy availability).

Although all risk rating systems use objective standards as a foundation, the process is, by definition, an exercise in human judgment. Biases, attitudes and perceptions influence rating conclusions. For example, the Federal Reserve, OCC, and other regulators have expressed concerns about the expansion of cash flow (business value) lending, which up until last year was a cornerstone of leveraged buyout financing activity. As bank examiners have made their rounds, they have taken a very conservative view in risk rating these loans. These attitudes have infiltrated the credit risk management thinking within many banks and are, at least in part, responsible for the recent credit tightening.

In most systems, and particularly among bank regulators, the most influential rating consideration is the adequacy and sustainability of cash flow. Some banks use specific financial ratios as criteria for assigning risk ratings. The accompanying chart outlines the criteria that would typically correspond to grades 4-8, which are applicable to most middle market borrowers. *(continued p.4)*

RISK RATING SYSTEM FOR A LARGE BANK

This table summarizes a typical risk rating system for a large bank. The number of "Pass" rating categories and specific criteria for each tier varies among banks depending on the bank's size, mix of business, and level of sophistication.

RISK CATEGORY: OCC [illegible]	RISK CATEGORY: DEFAULT PROBABILITY	DEFINITIONS / KEY CHARACTERISTICS
PASS	TIER 1	VIRTUALLY NO CREDIT RISK
	0%	■ Multinational firms with an exceptional degree of stability, substance and diversity. ■ Unquestioned access to public markets with public debt rating of AAA/Aaa. ■ Credits backed by cash or the U.S. Government.
	TIER 2	LOW CREDIT RISK
	0.1%	■ Multinational or national firms with a high degree of stability, substance and diversity. ■ Strong market and financial position with long history of income and cash flow. ■ Ready access to public markets with public debt rating of AA / Aa or A.
	TIER 3	GOOD RISK
	0.3%	■ National firms that is an upper tier performer in a stable industry with favorable trends. ■ Strong income and cash flow with low leverage and ample liquidity for many years. ■ Access to public markets under normal conditions with debt rating of BBB.
	TIER 4	ABOVE-AVERAGE CREDIT RISK
	1.0%	■ National or large regional firm with above-average performance based on stable or improving earnings, cash flow, liquidity, and moderate leverage over several years. ■ Strong management team with some depth. ■ Alternative financing readily available, but no access to the public financial markets.
	TIER 5	ADEQUATE/ACCEPTABLE CREDIT RISK
	3.0%	■ Average performer within industry or strong performer of limited size. ■ Reasonable leverage, liquidity, profitability and cash flow. ■ Performance is subject to economic or market uncertainties. ■ Competent management, but may be centered on a key individual.
	TIER 6	BORDERLINE (WATCH) CREDIT RISK
	6.0%	All of the characteristics of an acceptable credit risk, but warrants more than normal supervision due to: ■ Some doubt about future prospects (e.g., untested management, start-up operations, interim non-seasonal operating loss, or high leverage). ■ Occurrence of a non-recurring event that could strain financial condition. ■ Performance marginally above covenant level and trending down. ■ Improving credit profile, but additional seasoning required.
SPECIAL MENTION	TIER 7	POTENTIAL WEAKNESSES RESULTING IN DECLINING OF REPAYMENT PROSPECTS
	20%	Evidence of one or more of the following: ■ Declining revenue with eroding margins and cash flow. ■ Cannot meet scheduled obligations without eroding liquidity reserves. ■ High leverage and / or tight liquidity. ■ Covenant violations. ■ Management problems.
SUB-STANDARD	TIER 8	WELL-DEFINED WEAKNESSES THAT JEOPARDIZE COLLECTION IF NOT CORRECTED
	50%	Characterized by one or more of the following: ■ Operating losses and / or inadequate cash flow to meet scheduled obligations. ■ Insufficient liquidity and / or marginal capitalization. ■ Weak internal controls and reporting. ■ Repayment may be dependent on collateral or guarantors. ■ Repeated covenant violations, strong candidate for, or in bankruptcy. ■ Relationship usually managed by the bank's Special Asset group.
DOUBTFUL	TIER 9	COLLECTION IN FULL, BASED ON EXISTING FACTS AND CONDITIONS, IS QUESTIONABLE
	100%	■ Extremely high loss probability, but amount may not be known due to pending factors (merger, liquidation, refinancing plans, capital injection, or collateral perfection). ■ No interest accrues on the bank's internal books. ■ Relationship almost always managed by the bank's Special Asset group.
LOSS	TIER 10	LOSS
	100%	■ Considered uncollectable and of minimal value. ■ Some recovery or salvage value may be possible in the future.

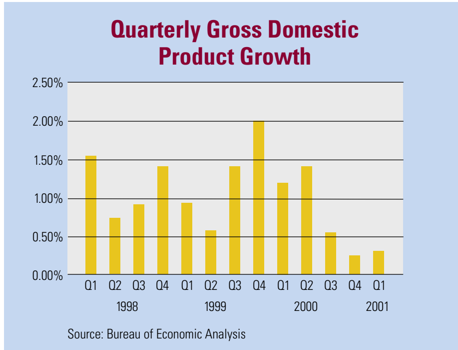
Credit Markets Update

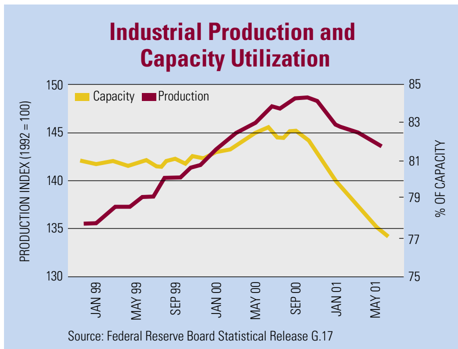
Sifting through the unending deluge of economic news and opinion, it seems that nearly everyone agrees that business conditions are significantly weaker today than just one year ago and that the "line of sight" for future expectations has been lowered considerably. This has been clearly reflected in a very sobering stock market correction. Investors of all stripes are much more conservative in their views. Many economic pundits are now suggesting that the bottom has been reached and the dawn of a new economic expansion is on the horizon. A couple of nagging doubts make us wonder whether we may be looking at a longer period of weak business conditions.

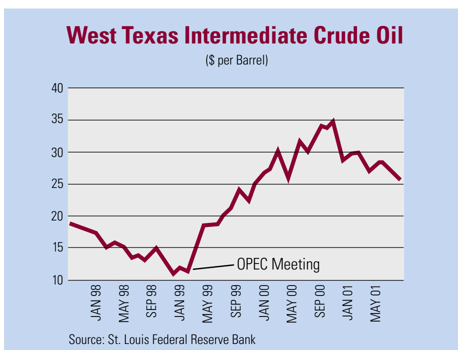
While the financial markets soared in 1999 and early 2000 based on the economic growth apparent in gross domestic product (GDP), industrial production, and employment statistics, the Federal Reserve Board (Fed) harbored concerns that much of the investment being made was of questionable economic value, in effect fueling a speculative bubble. GDP growth, of course, measures spending and investment, and is indicative of future economic growth assuming that the investments produce real economic returns. As a greater volume of individuals' wealth poured into higher risk investments, the Fed worried that a significant portion of the Nation's savings might be squandered when economic reality reared its ugly head. Clearly, in 1999, the Fed was uncomfortable with the "irrational exuberance" in the capital markets as a whole and the stock market, in particular. The Fed's desire to cool the economy was evident in moves to ratchet up the discount rate and tighten up supervision of bank lending practices.

GDP growth of more than 6% for the twelve-month period ended June 30, 2000 was incontrovertible evidence of robust expansion. In the twelve months since, the economic brakes have locked up to trim GDP growth by more than 75% to a tepid 1.5% or less. Underlying faltering GDP growth, one finds a contraction in industrial output, which is almost 3% behind last year after eight consecutive months of erosion.

In the latter part of the 1990s and into 2000 several distinct, but related, events stimulated a frenzy of activity in technology and telecommunications sectors that focused investment and spending that might normally occur over a period of years into a short span of time. The rapid integration of the Internet







into our personal and business lives spurred massive investment in computer and telecommunications infrastructure in the form of network equipment, millions of miles of fiber-optic cable, servers and personal computers. It also gave rise to scores of dot-coms that populated the Internet with content and services. At the same time, old economy companies were spending heavily on both carving out an Internet presence of their own and addressing Y2K concerns. Technology and telecommunication spending was not confined to the Internet alone. Huge investments have been made in wireless communication infrastructure, as well. Activity in all these areas powered a surge in economic growth. Tremendous excess capacity has been created and the pace of further investment activity has slowed to a crawl, which accounts in part for decline in industrial production. Today, it is not clear how much of this excess capacity will end up being productively employed and earn a real economic return.

Adding to the impact of the Fed's purposeful move to tighter money, higher energy costs snuck up on many of us, even though the seeds of the problem were planted quite some time ago. In 1999, the Organization of Petroleum Exporting Countries (OPEC) renewed their effort to restrict output in order to increase oil prices at the wellhead. They have been successful, as the price of crude oil has risen from $10 per barrel to peak at $34.40 in November, 2000. At the same time, proven natural gas reserves have dwindled and the expansion of energy infrastructure (power plants, refineries, and power transmission capacity) has lagged well behind the growth in demand. As supplies of most forms of energy have tightened, prices have risen. It is not hard to comprehend that higher energy costs are manifested in reduced consumer purchasing power and weaker corporate earnings.

Since the beginning of the year, a variety of actions have been put in place to stabilize and stimulate the economy. The Fed has aggressively sliced the discount rate seven times for a total of 275 basis points. The June 27th reduction of 25 basis points may be a signal that the end of the rate cutting cycle is near. A modest tax reduction package has been enacted with about $40 billion ($300 per taxpayer) in rebates to be paid later this year. Lower interest rates have lightened the debt burden carried by many individuals and businesses and helped keep the housing market chugging along. As rebate checks reach the hands of taxpayers, we should see a further boost to already relatively strong consumer spending. Investment in energy infrastructure has been rekindled and conservation has begun to take effect. In response, energy prices have slid from their peak in late 2000. Looking at the statistics, one might conclude that other than for a lag effect, the Fed has been successful in its objective and normal economic expansion may resume in the near term.

In spite of this optimism, the Fed's effort to stimulate the economy will only be successful if it induces the creation of debt to provide investment capital. This brings us to that nagging concern, lack of capital availability. Even with low interest rates, if the credit appetite among banks is weak, business investment will be constrained and economic growth will be *(continued p.4)*

Bank Risk Ratings *continued*

Risk Rating	Fixed Charge Coverage[2]	Cash Flow Leverage[3]
4	≥ 1.50	≤ 3.75
5	≥ 1.25	≤ 4.50
6	≥ 1.00	≤ 5.00
7	< 1.00	> 5.00
8	< 1.00	> 6.00

Bankers and regulators know from experience the difficulties associated with determining and realizing upon the value of collateral. Consequently, a loan that is well secured by readily marketable collateral, but with weak cash flow support, is likely to have a higher risk rating than a similar loan with stronger cash flow coverage and marginal collateral support.

Grade 4 credits are typically strong performing, privately held regional or local firms that display many characteristics of an investment grade credit risk, except for size and access to public financial markets. These firms are often able to borrow on an unsecured basis. Most profitable middle market, privately-held companies that borrow on a secured basis will be grouped in grades 5 and 6. Firms with asset based credit facilities and fairly low debt service coverage ratios (1.0 to 1.25 times) will generally carry a risk rating of 6 or 7. Companies within the 8 category are likely to be either supervised by the bank's workout or special asset group, or working with an asset based lender, such as Foothill Capital, CIT, or Heller Business Credit. Because asset based lenders are more comfortable evaluating collateral, many specifically target companies that would rate as a 7 or 8, even though the current bank is looking for a way to end the relationship.

CURRENT IMPLICATIONS

In the current tight credit environment, some banks are making far-reaching policy decisions based primarily on risk ratings. New or increased borderline (grade 6) deals are generally discouraged and are now primarily the province of asset based lenders. At least one major Northwest bank has a blanket policy of moving all grade 7 and 8 credits to the workout or special asset group. Some institutions now hold the view that loans in these categories either must be upgraded or moved out of the bank within a relatively short time. To enforce that desire, special asset groups at some institutions are aggressively increasing pricing and ratcheting down credit availability and flexibility. In some quarters, there seems to be little patience for a protracted turnaround.

As a general rule, bankers abhor surprise. Likewise, business owners/managers should never be surprised about where they stand with their bankers.

RECOMMENDATIONS

As a general rule, bankers abhor surprise. Likewise, business owners/managers should never be surprised about where they stand with their bankers. Now is a good time to have a candid discussion about how your credit is currently risk rated and the specific basis for that rating. Knowing the risk rating should help you work with your lender, anticipate requirements and determine the optimum source of debt capital.

If you find that the rating is borderline or worse (grade 6 or higher), then you should explore the triggers that would cause the credit to be downgraded, the likely implications of that action, and what can be done to improve the rating. Armed with specific knowledge, owners and managers will be better positioned to weigh alternatives that may help preserve financial flexibility, such as:

- Seeking alternative lenders;
- Restructuring operations;
- Selling non-essential assets;
- Raising capital (equity or mezzanine); or
- Consulting with a financial advisor to determine the best course of action. ❖

[1] *i.e., public debt ratings of AAA/Aaa through BBB-/Baa- by independent rating agencies S&P and Moody's.*

[2] *(EBITDA—unfunded capex—cash taxes) / (interest + CMLTD)*

[3] *Total funded debt / EBITDA*

Credit Markets Update *continued*

effectively throttled. Bank examiners continue to hold a very conservative view on the extension of commercial credit. Some bankers have confided that during the review of larger syndicated credits this year, examiners gave leveraged loans very close scrutiny and were unforgiving in their assessments. Rumor has it that the Office of the Comptroller of the Currency's (OCC) annual report on commercial credit quality, to be issued later this summer, will be highly critical of leveraged lending activities that prevailed until last year. If this proves to be true, we expect that many lenders will continue to maintain, and perhaps even tighten further, already conservative credit standards. Financing will be a challenge, particularly for companies that are struggling with sales and earnings deterioration, or are in industries that are out of favor. We suspect that the economy will not begin to fire on all cylinders until the banking system loosens up and begins to more aggressively seek new lending opportunities. ❖

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.

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