



IN\$IGHT

Nothing Lasts Forever

Cheap capital is still abundant but, with every passing day, credit retrenchment gathers momentum.

by Michael T. Newsome

It has been about four years since we have been able to say anything but “there has never been a better time to borrow money.” That observation remains absolutely true as an abundance of cheap and relatively constraint free debt capital is queued up and looking for a place to be put to work. With the exception of the dicey sub-prime segment of the mortgage market, the appetites of lenders and investors for loans and debt securities remain intense even though issuance is at an all time high. But, the foundation for a credit retrenchment are being laid every day at an accelerating pace. Lenders are not adequately paid for risk and, unless the economy continues upward unabated, a portion of these bets will be lost. When that happens, the entire market will be affected as it has in every previous credit tightening.

THE MARKET CONTINUES UPWARD

Commercial and industrial loan portfolios of U.S. banks have grown from nearly \$900 billion at the end of 2003 to over \$1.2 trillion in April of 2007, a 9.5% annual rate. At the same time, portfolio delinquency rates are extraordinarily low by historical standards.

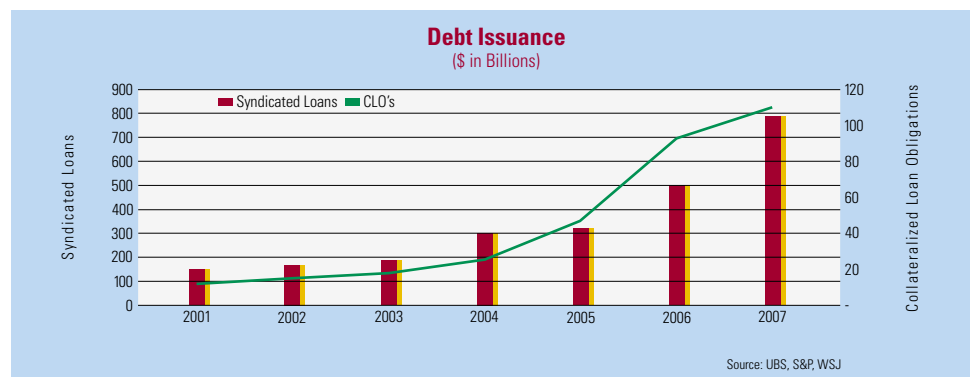
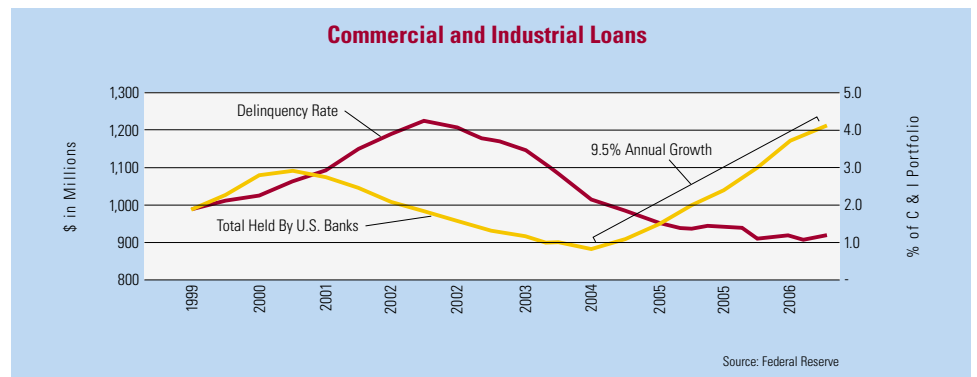
A notable development in the bank market continues to be the evolution away from the traditional “lend and hold” model towards the “lend (the actual term of art is “originate”) and distribute” approach. Commercial credit demand has found ready pools of investment capital, much of it now organized in hedge funds or funneled through the new miracle financial product, Collateralized Loan Obligations (CLOs). It’s not clear which came first, the assets or the capital—but they have come together to drive loan origination and distribution to the point where nearly 70% of syndicated debt is placed with non-bank lenders.

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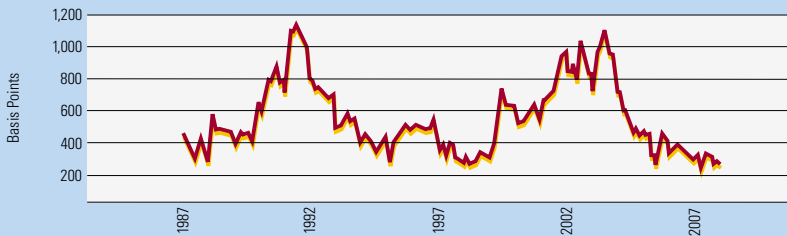
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that are interested in direct loan origination outside the traditional realm of banks and asset based finance companies. Firms such as Fortress Investments, Cerberus / Ableco, Contrarian Capital, and Crystal Capital fit this bill and are particularly targeting leveraged finance opportunities for buyouts, recaps and turnarounds where a lot of capital can be quickly put to work. Rarely a week goes by without learning of a new lender looking for opportunities to provide middle-market businesses with senior and junior debt, as well as equity capital.

The most striking aspect of today’s leveraged lending is the steady compression of credit risk premiums (often expressed as the spread between low rated bonds or syndicated loans and risk free Treasury securities). Over the past 20 years, the average spread between high yield “junk” corporate bonds and comparable duration Treasuries has been nearly 540 basis points. Currently, the spread has plummeted to 260 basis points. The same erosion is evident within the leveraged loan



Spread Between Low Rated Bonds and U.S. Treasuries (1987-2007)



Source: WSJ

market, where the average spread over LIBOR has dropped 28% from 330 basis points to 240 points since 2003.

The abundance of accommodative debt capital is a function of the demand for investment income, rather than evidence that lenders / investors have somehow cracked the code to neutralize credit risk and avoid defaults. Nevertheless, allusions to this are heard from lenders who are either using credit

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derivative contracts in an effort to transfer risk or relying on a trading strategy in the belief that change can be detected before it happens so that potential problems will be smoothly foisted off on a greater fool. It hardly matters; risk and the economic impact of default may be transferred, but cannot be abolished. Someone will take the pain.

The voracious demand for investment income has made available credit structures today that would have been considered hyper-aggressive just a couple of years ago. The amount of debt available to borrowers as a multiple of cash flow (EBITDA) is in record territory, and the controls or covenants that lenders normally insist upon are widely being relaxed, all while credit spreads are eroding. The clear implication of the current trend is that lenders are not pricing risk rationally. A psychology takes over in which many lenders feel compelled to take whatever the market will allow. Either accept the terms in the market or be relegated to the sidelines. For particularly aggressive credit structures, the margin for error is quite slim. Debt financings at five or more times EBITDA generally require steady earnings growth. Obviously, lenders

have convinced themselves of smooth economic sailing well into the future.

HISTORY RHYMES

Mark Twain is credited with cautioning that “history doesn’t repeat itself, but it does rhyme.” July of 2007 marks the 25th anniversary of the surprise collapse of Penn Square Bank, an obscure community bank headquartered in a very mundane shopping mall in suburban Oklahoma City, but a prodigious originator of loans to oil field service and exploration firms. Penn Square’s demise led to the near failure and forced sale of two major banks—Seafirst in Washington and the venerable Continental Illinois in Chicago—and the wounding of Chase Manhattan and a few other major Midwestern and Eastern banks.

Penn Square was the front-page story, but the underlying forces were a voracious appetite for loan assets by banks in an otherwise sluggish environment and a great demand for capital in a large growth sector of the economy. In the late 1970’s, well-informed and financially sophisticated people believed that there was a permanent shortage of fossil fuels and the price of oil would rise quickly to and remain at \$100 / barrel. Accordingly, billions of dollars of capital, much of it in the form of aggressive bank loans, was invested in highly speculative oil and gas development activities. For a time, the oil patch economy

absolutely rocked. Then, the unthinkable happened—oil prices dropped and stayed down. As lucrative as it seemed to bankers at the time, they failed to accurately assess and price the risk.

The most marginal investments, companies and lenders (including Penn Square and virtually all of its customers) were the first casualties. But the impact was progressive, and expanded well beyond the oil and gas industry. Bigger industry players were eventually mired in problems as access to capital dried up, receivables proved uncollectible, and new opportunities disappeared. Although well-respected Texas banks (Texas Commerce, First City, Republic, and Allied) catered to top tier oil and gas companies and eschewed risky loans for drilling equipment and exploration, they all took a beating. It turned out that virtually every loan was in some manner dependent on the health of the oil and gas industry. As banks across the nation felt the pain from this part of their loan portfolio, credit tightened to all borrowers. The poorly conceived loans made much earlier ultimately impacted credit availability for a broader spectrum of borrowers. Although in the aftermath many claim otherwise, very few people actually saw it coming.

CREDIT CRUNCH COMING?

Perhaps the economy will continue to rock along and cover all of the recent lending and investment excesses. But, history favors the view that a meaningful portion of the aggressive leveraged lending now on the books will turn out to have a negative net present value. Just in the past couple of weeks there has been a significant surge in chatter in the financial markets to that effect. The turning of the tide will become clear when today’s very low default rates begin to revert to the

The turning of the tide will become clear when today’s very low default rates begin to revert to the mean. As we are fond of saying, there are but two emotions in finance —fear and greed. The needle has been stuck fast on greed for quite some time, but fear lurks around the corner.

mean. As we are fond of saying, there are but two emotions in finance—fear and greed. The needle has been stuck fast on greed for quite some time, but fear lurks around the corner. When that shift occurs, the prospects are good for a credit crunch that will impact access to capital for a far wider set of businesses than just highly leveraged firms. So, borrow prudently but keep your finances in order. ♦

Purchase and Sale Agreements: the Seller's Perspective

Once the sale price has been agreed, many sellers believe the rest is just paperwork. Think again, many important issues still need to be decided and the owner needs to stay involved.

by Mark Working

Many an owner involved in a sale of a business thinks that once the price is agreed the heavy lifting has been accomplished, and they have little interest in the remaining aspects of the transaction. We think that it is a mistake for a seller not to be acquainted with all aspects of the transaction documentation. Although it may look like many pages of legalese, most of the issues are business issues and have some bearing on the economics to the parties. We also advise prospective sellers to demand from their transaction team (investment bankers, lawyers, etc.) a clear understanding of the full scope of a deal in advance of documentation negotiations.

By acquainting oneself with the architecture of the deal and making sure that a business perspective drives the process throughout, the path to completion can be smoothed and the probability of closing enhanced. Failure to do so opens the process to a potentially protracted series of skirmishes on fine points that most owners don't understand or appreciate. These "victories" may not be worth the cost of the argument and can lead to a process in which the professional advisors lose sight of the forest in the midst of a battle over each tree. The result can be an expensive stalemate that creates growing frustrations and leads to irrational decisions that may jeopardize an otherwise highly desirable transaction.

Parties to a transaction care about the details, and it would be Pollyannaish to think that simply knowing all the issues in advance will make the process a breeze. However,

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there is no question that difficult issues and the tone and/or principles that guide how a transaction is negotiated are easier to deal with at the beginning when the parties hear each other and have not buried themselves behind righteous positions.

UNDERSTANDING A PURCHASE AND SALE AGREEMENT FROM THE SELLERS' PERSPECTIVE

The purchase and sale agreement is the document that memorializes the agreement between buyer and seller regarding the sale of the business. Although the effort to achieve both precision and clarity often results in reams of legalese, this agreement focuses on only a few major topics:

1. The Structure

Definition of what is being sold (e.g., stock, assets, and precisely which ones);

2. Price

The amount, timing and currency in which

the purchase price is to be paid (cash, stock, note, contingent payment);

3. Representations & Warranties

The promises made regarding the condition of the business being sold, including the absence of unknown or undisclosed liabilities;

4. Indemnification

The seller's obligation to protect the buyer against broken promises or other identified risks;

5. Conditions Precedent

The specific conditions that must be satisfied by both parties prior to closing; and

6. Covenants

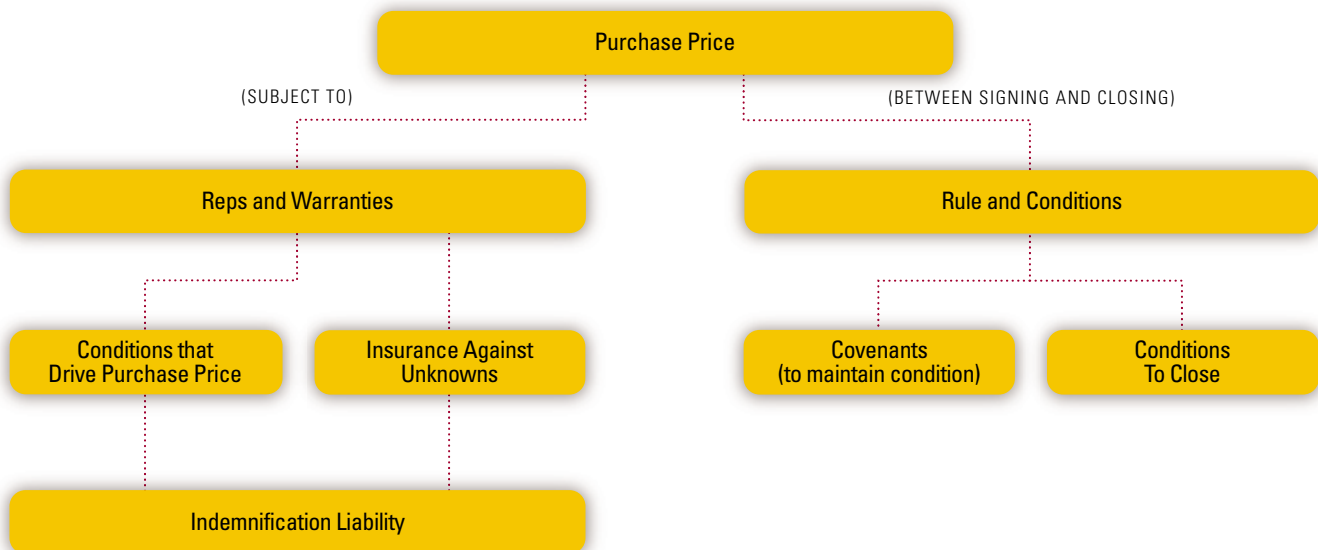
The rights and responsibilities of each party (whether between the date of signing and closing or even after closing).

The diagram below illustrates the basic components of a purchase agreement.

Within this framework issues other than purchase price can be very meaningful for the seller and require attention to the details.

Seller's Representations and Warranties serve three purposes. First, is the seller's formal disclosure of the pertinent facts regarding the business, upon which the buyer has based the purchase price. Secondly, these disclosures provide the basis for the allocation of risk between the parties. If one or more of the disclosures prove untrue in some material way, the buyer wants an avenue to recover a portion of the purchase price. Finally, the breach of a representation may give the buyer the opportunity not to close the transaction.

Eyes invariably glaze over when owners look at these provisions. In reality, only owners or



managers have sufficient knowledge to answer the questions and the insight necessary to weigh their importance and consequences. If a representation or warranty proves to be inaccurate, it is the seller, not the professional advisors, who knows whether it could damage the buyer. Most disagreements revolve around the extent to which the statements made are absolutely correct or are subject to the knowledge of the seller, and what standards the seller should have pursued to gain knowledge on the particular issue.

Seller's Indemnification Liability is simply the exposure that the seller retains after the sale closes for claims of breaches of representations and warranties or other specified risks. This is always heavily negotiated and carefully documented. The headline transaction price should be less material than what the seller ends up keeping when everything is said and done. The battle over indemnification usually is in terms of establishing certain

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limits and constraints on the dollar amount of claims required before they matter (to reduce the incentive to “nickel and dime”), the absolute limit of liability, and the window of time in which claims can be submitted.

There is no inherently right answer to setting these limits, or that there even should be limits, other than that less and shorter is better from the seller's perspective. There is, however, market information regarding the limits and timeframes set in other transactions, which can be useful guides. There also are arguments that can be made that certain risks are part of the business, as well as due diligence that can provide comfort as to the likelihood of unfavorable outcomes. This is all about allocating the risk of the unknown and the unexpected. The bottom line is that limits on indemnification are sought in order to provide certainty for sellers within reasonable ranges of safety for the buyer.

Covenants are contractual promises that establish rules of behavior. The primary focus of covenants are actions between signing of the purchase agreement and closing, which can be a lengthy period depending on the number and nature of the conditions precedent to closing. Covenants can be a reliable source of controversy. The buyer wants to assure that the conditions that were in effect when the deal was signed will still be in effect when it closes. This means some control on

the decisions the owner can take without the buyer's consent. The natural point of conflict is the seller's sometimes-countervailing desire to assure that the business is not unreasonably constrained from making business decisions in a dynamic market, particularly where there may be no certainty of a closing. The buyer's second objective is allocation of risk in the event that a representation or warranty is breached prior to closing. Issues include whether the parties, or either party, have responsibilities to disclose knowledge of this changing condition. Does the seller have to fix the condition, and at what cost and on what terms? Or, does the seller have to close and bear the indemnification responsibility of a breach of representation? Does the buyer have to close, or does this reopen negotiations?

Conditions Precedent defines what must occur prior to closing to meet the expectations of each party. This boils down to whether the purchase agreement is a commitment or an option to purchase. For example, if closing of the transaction is subject to approvals by a board or the arrangement of financing, in practical terms the buyer may have no real commitment to complete the transaction. In that context, a major issue is the level of effort and expense required of each party to remove closing conditions, as well as the consequences for not doing so.

Owners need to understand the “gaming” aspect of negotiations. As an example, it may be a “win” for the buyer if closing is conditioned upon arranging financing satisfactory to the buyer, in its sole discretion, while simultaneously gaining agreement that the seller will be obligated to close if the financing is arranged. In this situation, the buyer has a practical “out” if conditions change, but the seller may not have the reciprocal right.

THE IMPORTANCE OF DETERMINING THE APPROACH IN ADVANCE

The point of this article is not to understate or over simplify the challenges of docu-

menting a buyout transaction. It is a complex process where a multitude of variations for balancing different promises and conditions that make up a deal can lead to active, expensive, and time intensive negotiations. Owners are well advised to assemble a knowledgeable and experienced team of advisors. This team should be expected to advise the owner how to balance the risks and responsibilities

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of buyer and seller and how these positions should be negotiated. Otherwise, owners may hear from their advisors that the buyer team is “totally unreasonable” and find themselves at an impasse. In the trenches of transaction negotiations, battles over nuances can take on unreasonable levels of importance and, once a point of ultimate frustration is reached, it can be very difficult to resolve conflicts.

It is far more productive to deal with contentious issues early in the transaction when the parties are more inclined to hear each other. Obviously, the best environment for the seller to negotiate these parameters is when there is competition from different suitors. Competition forces a cost to be assigned to gamesmanship and disagreement over relatively unimportant provisions, and allows clarity to be achieved in a more timely manner. ♦

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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