Zachary Scott
INVESTMENT BANKERS

Zachary Scott—an investment banking and financial advisory firm—has published this newsletter since 1997 to bring you a thoughtful analysis of issues affecting middle-market businesses.

PERSPECTIVES ON THE CAPITAL MARKETS SUMMER 2010

INSIGHT

The Middle-Market Credit Worm Turns Again

Many lenders and investors are pursuing middle-market opportunities with gusto, but for how long?

by Michael T. Newsome

If you have followed our credit market ruminations in this space over the past several years, you know that our view has been that most banks have suffered sufficient trauma in 2008 and 2009 to impair their risk appetites for years to come. Could it be otherwise? The rubble left behind by the credit dislocation is only beginning to be digested. Nevertheless, we have been genuinely surprised by the brio that many lenders and investors have exhibited over the past three or four months in pursuit of credit opportunities. It seems that risk aversion is again being pushed aside as some financing is getting done on what can best be described as pre-crisis terms.

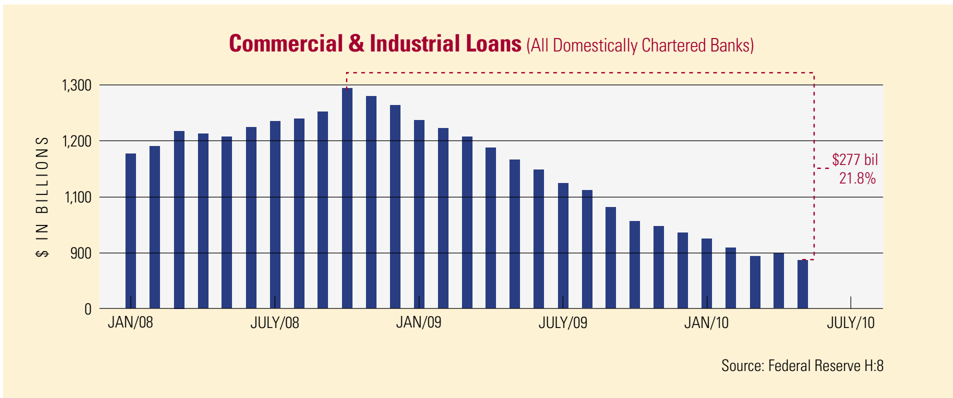
The real eye opener has been the speed at which skepticism and selectivity have faded among high-yield bond investors, a bellwether of risk appetite. There are some interesting examples in the past several months of companies in the Northwest and elsewhere issuing healthy increments of high-yield financing at leverage levels well north of seven times EBITDA. In the best of times, this is dicey territory for even bullet-proof middle-market businesses. One is left to wonder whether the bondholders that are stepping into these deals have a real grasp of the challenges faced in handling this level of debt. The astounding aspect of many high-yield financings is that much of the proceeds have been channeled towards shareholders, rather than into internal investments or accretive acquisitions.

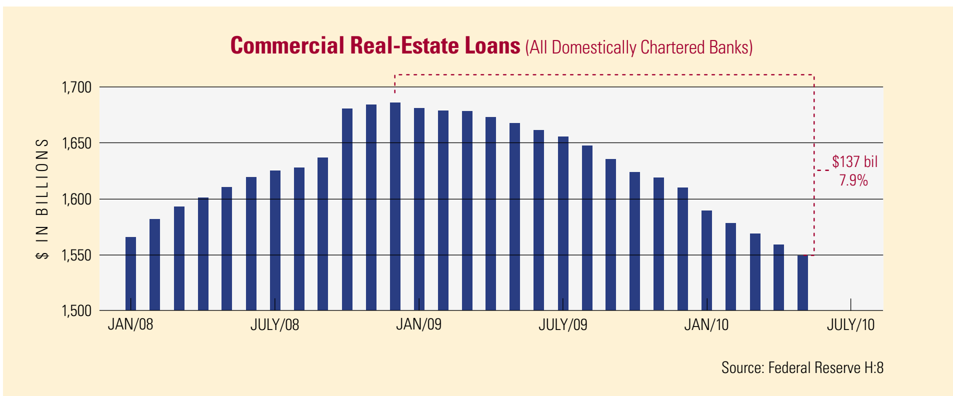
Admittedly, most of our clients are not tapping the high-yield market. But, as enthusiasm for return at the expense of risk gathers steam, similar sentiments are cropping up in leverage lending and are now finding their way into middle-market finance.

BALANCE SHEET REALITY

The big banks have, in the main, rebuilt their capital positions through a combination of public equity raises, earnings aided in part by access to almost costless funding from the Federal Reserve, retention of TARP capital (e.g. KeyBank), and asset runoff. Asset contraction serves as the prime impetus for lenders' current desire to make loans. As illustrated in the nearby charts, banks have seen significant loan reduction since the peak reached during the fourth quarter of 2008, representing evaporation of a bit more than $410 BN of C&I and CRE assets, a 13.9% decline. Bank capital and surplus liquidity are seeking better earning assets in a soft market. The choices are rather slim.

Commercial real estate and consumer credit (including credit cards, mortgages and





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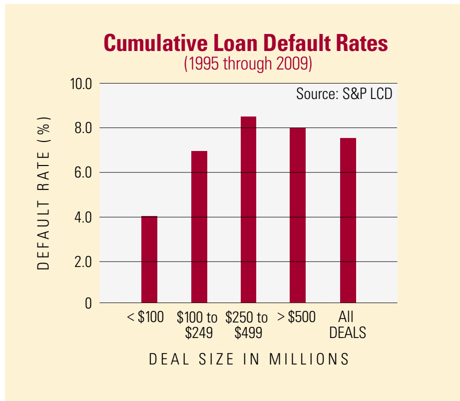
ASSET TYPE	CHANGE SINCE Q3-2008	STATUS
Securities	+ 17.1%	Growth attributed to flight to quality and nearly costless government funding. Banks are now trying to reverse this and shift toward higher yielding assets.
Commercial & Industrial	- 19.3%	Due to lower credit line usage, limited business investment, weak M&A activity, and charge-offs.
Commercial Real Estate	- 5.4%	Accelerating foreclosures and charge-offs translate into little lender appetite.
Total Consumer[1]	+ 15.8%	Growth reflects a now-completed refinancing surge and movement of assets out of securitizations on to bank balance sheets. Consumer demand is limited and mortgage applications are at all-time lows.
Other Loans & Leases	-22.2%	Fed funds and repos sold to non-banks and other miscellaneous loans.

[1]Includes credit cards, mortgages, home-equity loans, and other consumer debt

home equity lines) currently account for about 57% of total bank credit. Consumer loan demand is weak as the housing market continues to struggle. The recent growth in consumer credit can be largely attributed to the now-complete surge in mortgage refinancing and the movement of financial assets from securitization structures on to bank balance sheets. Banks have scant interest in putting new capital to work in the painfully over-capitalized commercial real estate sector, where further value erosion is foreseen.

Business lending remains as the one area where banks are hopeful of expanded activity. Asset growth goals for bankers have been cranked up in an effort to find higher returns for under-employed capital. Middle-market lending is back in vogue and the safety and security of a low-yielding securities portfolio is out. Right behind general middle-market lending on the bankers' dance cards is leveraged lending for middle-market buyouts. Resurgent appetites for this credit segment have been bolstered by the fact that middle-market loans have traditionally performed well relative to the broadly syndicated financings of larger companies. Over the past 15 years, the cumulative default rate on deals in excess of $100MM has been nearly double the default experience on smaller middle-market financings.



If the pricing for the risk is indeed better than for other alternatives, lenders will be drawn to the opportunity. Unfortunately, in today's market, the missing link is demand for credit. While rumor has it that the economy is on the mend, out here in the real world the rebound is tepid at best. A boost in activity was felt in late 2009 and early 2010 as businesses began to write or receive new orders to replenish dwindled stocks after one of the deepest inventory cycles in history. Currently, few companies are rebuilding inventories to pre-crisis levels, or expanding capacity with new equipment or facilities. There simply is no compelling economic driver for broad-based middle-market business or loan growth.

The upshot is that bargaining power has again shifted to the benefit of borrowers. The stronger banks in the Northwest are competing vigorously to protect existing relationships and to lure healthy clients away from other lenders. In this enviroment, it is again an opportune time to solidify and improve credit arrangements with the objective of building additional availability (liquidity), relaxing restrictive covenant arrangements put in place in just the past 18 months, extending maturities (well beyond three years), and rolling back pricing (Libor floors are disappearing and L+100 bps is no longer unusual). A fair and competitive process is likely to yield significant benefits to borrowers.

Although the credit spigot is open, it is difficult to identify the rationale for a continued long-term favorable environment for middle-market credit. Conditions can change quickly. Just in the past month, what had been a red-hot high yield market, with record new issuance of more than $150 billion year-to-date, cooled rapidly in response to sovereign debt concerns and weak economic data. Worry is growing that the economy may again be turning lower. If this comes to pass, bank capital will be back under pressure and credit strains will reemerge. The evidence suggests that a wave of credit maturities lies ahead beginning in 2012. All of this portends the strong possibility of another period of tight credit. Today's respite should be seen as an opportunity to reset credit on improved terms. ❖

Auction or Negotiate?

When selling your company, process matters.

by William S. Hanneman

Is the highest value in a sale of your business achieved by negotiating with a single buyer, or by auctioning the company to a broad group of buyers? It depends.

In a pure auction, competition among buyers does the job of ratcheting up the price. In negotiations, price improvements are achieved by exploiting value-creating opportunities unique to a particular buyer.

Preparing for and conducting these two sale processes is entirely different. In auctions, competitive pressure comes from the same-side-of-the-table, whereas in negotiations the pressure comes from across the table, as is illustrated on the next page.

The objective in a sale is to identify value-creating opportunities and to convince the buyer to pay a portion of that value to the seller. Value creating opportunities, often times called "synergies", may include expanding a product line, offering access to a new distribution channel, or eliminating the redundant costs of a combined operation. This can be a delicate trade-off. While auctions do a great job of boiling everything down to price, the competitive process might not be particularly conducive to exploring the possibility of win-win moves.

Negotiations, on the other hand, provide an opportunity for each party to learn the other's preferences, to make trade-offs across different issues, and to craft deals that can create a larger overall pie. At the same time, competition among buyers, or at least the perception thereof, is almost always required for a buyer to be influenced to carve off a portion of the synergies and pay that value to the seller.

PROCESS DETERMINANTS

Accordingly, the process that will most likely achieve the highest value is a key decision when embarking on a sale of a business. When deciding whether to conduct an auction or to negotiate privately with an individual buyer, we consider four primary factors:

1) Characteristics of the business and its industry,

2) Number of probable bidders,

3) Profile of those bidders, and

(continued p.3)

4) Context of the negotiation.

Company Characteristics

The structure of the industry and the position of the company to be sold in that industry are among the key considerations in determining how to achieve the highest value and go-to-market strategy. A company that represents a small market share in a fragmented industry would generally argue for a broad-based sale process. However, that conclusion may be tempered if the subject company relies on a few critical third parties (vendors or customers), or if the misplaced leak of a sale could damage the business. Businesses that operate in narrow market niches or that generate returns far in excess of the capital invested may best be sold in a negotiated sale process. Businesses that could form a platform for an industry consolidation (and therefore would likely draw the attention of financial investors), would benefit from a broader-based competitive process.

Number of Bidders

An auction is likely to wring out the maximum value when serious competition is engendered among multiple qualified buyers. When there are many capable suitors, there is more same-side-of-the-table competition, which will result in driving up the price.

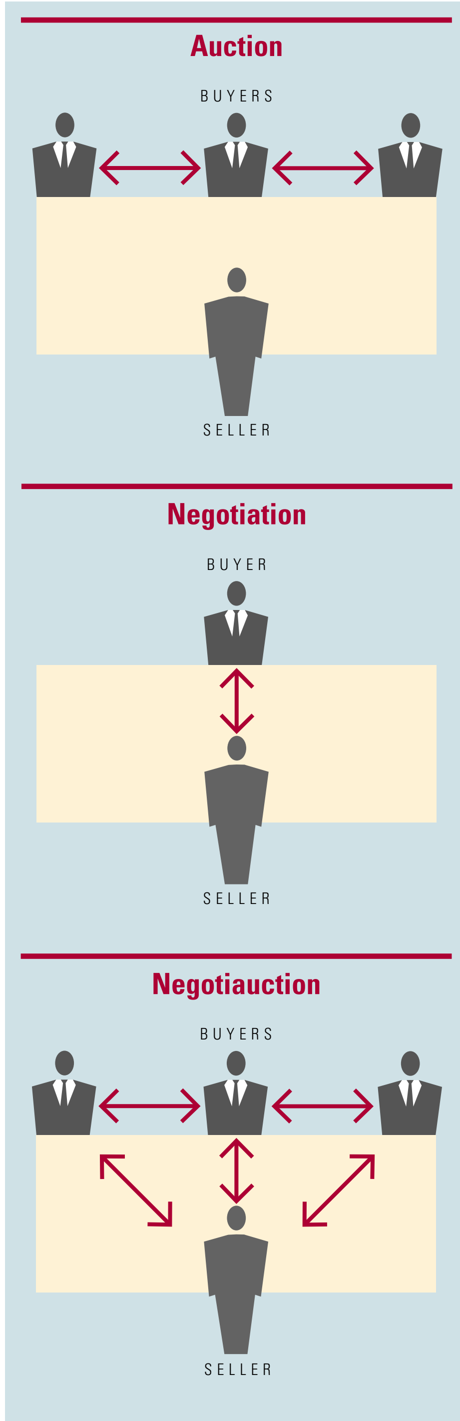
Robust auctions typically ratchet up value in a succession of small increments. The natural implication is that more bidders are better; but there is no magic number other than that it is necessary to have more than one. We have conducted successful auctions with a small number of intent participants. Sometimes the perception of multiple buyers is sufficient to achieve the benefits of an auction process. However, there can be too many. When members of the buying group perceive a large number of participants, they might calculate that the odds of "winning" are too low to justify the effort necessary to treat the opportunity seriously.

Bidder Profile

Another criterion for deciding whether to hold an auction is the degree of certainty regarding the set of potential buyers. Bidders are often wary about participating in auctions, so a key consideration in determining the marketing strategy is the difficulty of attracting the most economically-logical parties to participate. In some situations, where prospective buyers enjoy multiple alternatives to fulfill a perceived strategic need and, when the downside of losing the auction is insignificant, a more focused process may be required to bring the desired bidders to the table.

Contextual Factors

There are also contextual factors to consider when determining whether to pursue an auction or to negotiate with a single party. Among these are the need for secrecy and speed, and the importance of the future relationship. Broad-based auction processes are difficult to keep under wraps, even when all bidders have executed confidentiality agreements. And, the more broad the auction group, the higher the probability that word will get out. Accordingly, if disclosure could be damaging to customer confidence, employee morale, and supplier relationships, consider negotiating privately with one, or a few, buyers.



The process by which a company is sold has a meaningful impact on the ability to achieve sellers' objectives.

Closely related to confidentiality is the need to execute a sale quickly. The passage of time rarely benefits a seller, if for no other reason than the longer the process is underway, the more likely it is that the negotiation leverage will shift in favor of the buyer. Auctions tend to happen more quickly, following a defined timetable. The duration of a negotiated sale, on the other hand, is always difficult to predict, depending entirely on the intent of the buyer (and the seller's preparation).

A negative aspect of auctions is that they can signal that the seller is indifferent among buyers other than the price received. Whether or not true, buyers can often be influenced to pay somewhat higher values if they perceive to be favored in some way.

THE NEGOTIAUCTION

In representing a seller, our role as investment banker is to design a sale process that will maximize the after-tax present value of sale proceeds. As the process setter in these situations, we constantly evaluate all the relevant factors in designing the marketing strategy. In practice, we almost never conduct a pure auction, and we generally shy away from single party negotiations. It depends entirely on the circumstances. Often, we have had the most success combining elements of both of these processes—a negotiauction[1].

A negotiauction is a hybrid process that brings to bear the appropriate source of pressure at the optimal time. It is a customized approach designed to take advantage of both the across-the-table pressure and same-side-of-the-table competition, constantly evolving the process as the deal progresses.

In practice, the trajectory of most deals is to commence with an auction process and, as the deal progresses to incorporate more negotiation-like mechanisms. This deal process captures the benefit of same-side-of-the-table competition early in the process as the most economically-logical buyers are identified, and shifts toward fleshing out value-creating opportunities and relationship building with those particular buyers that can justify the highest value.

THE ART OF DEAL MAKING

The process by which a company is sold has a meaningful impact on the ability to achieve sellers' objectives. M&A deals are maddeningly fluid; the dynamics between the parties continuously change in response to the competitive environment, the buyer's investigation, external events, and the passage of time. Understanding and managing those subtleties in order to know when and how to shift from a multiparty auction to negotiating value-creating opportunities with a single buyer is the art of deal making. ❖

[1] *Negotiauction, trademarked by professor Jeffrey Teich of New Mexico University, is a term, in conjunction with a computer algorithm and Internet software, that combines auction and negotiation processes.*

The Open Window

With investors eager to make transactions, sellers are in a unique position.

by Mark D. Working

After more than two years in the doldrums, conditions are again ripe for a resurgence of mergers and acquisitions. Modest improvements in the general economy have helped, but the primary impact is the current imbalance between supply of investible funds and availability of investment opportunities. For the moment, the advantage goes to the sellers.

The recession has caused corporations to batten down the hatches and build cash positions. Corporate entities are well into the process of completing internal restructurings to reduce costs and trim leverage. As a result, cash as a percentage of total assets is at the highest level in forty years. Some of these businesses are now turning their heads to growth through acquisition.

Financial investors are anxious to put money to work. As discussed in the 2010 Spring edition of IN$IGHT, undrawn cash levels at private equity firms remain at record levels. Many of these firms are running out of time to put their committed funds to work. Faced with the expiration of investor commitments, a more aggressive approach is understandable. Estimates are that over half of current fund commitments will expire by the end of 2012. Given that it usually takes four years to invest a fund and many of these funds have had little or no activity, crunch time has arrived.

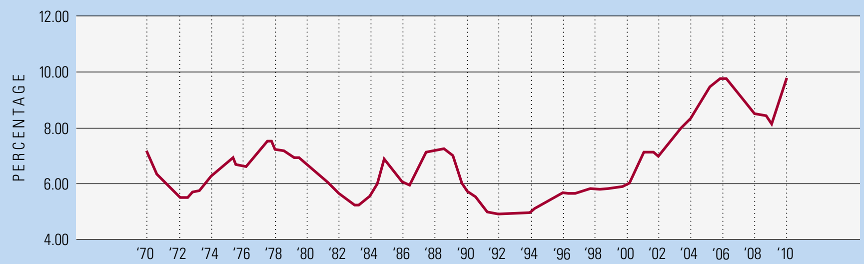
The other ingredient that whets the appetite for equity firm investments is the availability of debt to fund a portion of the transaction. As chronicled in IN$IGHT over the past two years, that spigot has been shut tight. Now, the pipeline has re-opened, with a growing number of transactions occurring at pre-crisis leverage levels and pricing. In a companion article on the front page, we examine the dynamics that have led to the break in the credit dike.

Sellers, on the other hand, have largely sat on the bench for the past couple of years awaiting improved economic conditions. Those families and entrepreneurial founders that had thought the time was right to gain liquidity for their long hard work have put that to the back of their minds. However, the goals of liquidity and wealth diversification haven't gone away. While this pent up need waits for the opportune time, our government has presented another consideration as capital gains tax rates are scheduled to rise from the current 15% rate to 20% on January 1, 2011. In 2013, the new healthcare law applies Medicare taxes to capital gains. The combination represents over a 60% increase in gains taxes. Many owners are asking themselves what they can do to increase the value of the business to make up for the increased tax burden.

Those few who have recently entered the market have been favorably received. Every private equity firm we have met within the past six weeks has commented on the emergence of strategic buyers, the competition for deals, and the higher prices being paid. This current imbalance of supply and demand is creating a pricing advantage for sellers. The primary beneficiaries of these market conditions have been private equity firms selling portfolio companies. Private company owners have yet to enter the fray to any meaningful degree.

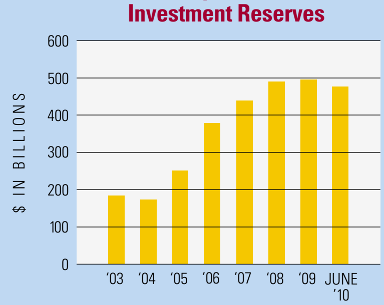
How long the window will stay open remains uncertain but, at present, strong companies are again commanding values reminiscent of pre-crisis levels. Accordingly, owners who are interested in gaining liquidity and diversifying wealth would be well served to accelerate their thinking to take advantage of a compelling market and a more favorable tax environment. ❖

Cash as Percentage of Assets on Corporate Balance Sheets[1]



[1]Largest 1,500 stocks, excluding autos, financials and utilities.
Source: Empirical Research Partners Analysis

Private Equity Undrawn Investment Reserves



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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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