



INSIGHT

The Journey Through Special Assets

If you encounter the bank's Special Assets Group (SAG), what should you expect and how should you respond?

It's a depressing story—times are tough, demand remains soft. The business is making little progress against the strong head wind of an uncertain economy. A financial covenant or two in your credit agreement has been breached. The bankers are coming around with greater frequency and there is an unmistakable undertone of concern in their questions. Without an abrupt turn of fortune, one day soon you may field a call bringing news that the bank's workout group has assumed responsibility for the relationship. Banks apply a variety of labels

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to these folks—Special Asset Department (SAD), Managed Assets Division (MAD), Loan Adjustment Department (LAD), or as we refer to them, the Special Assets Group (SAG).

Over the past several years as the economic boom faded, the number of companies that have encountered SAG has grown. This trend may become more acute once economic recovery begins to take hold. As business begins to grow, companies often hit a brick wall of insufficient capital that can trigger problems with the bank. A transfer to SAG is typically not a huge surprise. Just the same, it tends to be traumatic as it confirms a loss of confidence on the bank's part and breeds a heightened sense of uncertainty and anxiety

IS RISK A FOUR-LETTER WORD IN OUR ECONOMY?

The American economic system is untidy – little happens in an orderly, predictable way. A lot of mistakes are made in vibrant, robust economic times. Not all ventures succeed and the failures are not necessarily mistakes. When economic times are less robust, it is easy to focus only on the failures and forget that failure is often the price that must be paid for success. In times like these, we can lose track that risk is the secret to innovation and economic growth. Wisdom means weighing carefully the risks and rewards, not eliminating risk.

Yet that's our observation about the mergers and acquisitions market today. Few are willing to take risks. Lenders and investors have tightened their purse strings. Their view of the future characterizes a glass that is half empty and draining quickly. The search for a "sure thing" continues.

In this issue, we comment on the attitude of lenders in their special asset groups and the psychology of the private equity investor today. And we offer some guidance to the business owner who seems poised to take advantage of opportunities when the economy is fully back on track and risk is not seen as a four-letter word. ❖

in a critical relationship. A host of questions come up. With whom will we be dealing? How will the bank's attitude, objectives, and requirements change? Will they try to manage the business? Does this automatically mean bankruptcy or liquidation? How

should management respond? What should the priorities be?

WHAT THEY SAY AND WHAT THEY MEAN

The standard speech that management is likely to hear from the workout people at the outset of the SAG ordeal (measured in months and, in some cases, years) may seem confusing because what is said and what is meant often are quite different, as shown in the following examples:

■ *"We will take responsibility for the relationship."* This means all other relationships with the bank are immediately severed and all future communications must be directed to SAG. You are unlikely to get much help (other than a few words of encouragement) from your old friends at the bank even if they are senior officers. It's fair to say that interference with the workings or dictates of SAG has never advanced a banker's career. While in SAG, consider Harry Truman's advice, "If you want a friend, get a dog."

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■ *"We will be available to help you address issues and needs quickly."* Not true, particularly with a big bank and a relatively small credit exposure (< \$10-15 million). Special assets groups tend to be painfully slow and inflexible bureaucracies. The situation has worsened as banks have consolidated and as decision-making has been centralized. In reality, the typical SAG officer has almost no authority—decisions come from nameless, faceless executives in Minneapolis, Charlotte, or elsewhere. One would think that workout situations would demand direct, clear com-

munication, but many banks erect barriers between the customer and the decision-makers that render direct communication difficult at best. And a double standard generally applies. If SAG wants something, it is unlikely to brook any delay. The flip side is that time is rarely a constraint when addressing a borrower's needs.

■ *“Our mission is to rehabilitate rather than liquidate.”* True, in part, liquidations are usually disasters for banks. But rehabilitation is not the goal either. Implicit in moving the credit to SAG is a determination that the bank is at the least ambivalent about retaining the relationship and would be happy to see the company take its business elsewhere. The priority is either to whittle down the credit exposure quickly or to exit the relationship. Large banks in particular have limited patience for protracted turnaround efforts and are willing to roll over small companies without remorse.

WORKING WITH SAG

At best, you can expect a cordial relationship with SAG. But a pleasant demeanor or expressions of empathy should not be confused with support for management or the company. SAG's agenda is to reduce problem loan commitments as rapidly as possible and minimize loan losses. Several Northwest banks even set the compensation in their workout units to specifically reinforce these objectives. SAG will pursue its own interests with little regard to the implications for business operations, other creditors, management, or shareholders.

With this in mind, management must understand the following points to deal effectively with SAG:

- Credibility is a critical asset that is built by deeds not words. In SAG, broken promises are routine, which accounts for the skepticism that characterizes experienced workout bankers. Tell the truth, but manage expectations carefully—under promise, over deliver. Avoid surprises.
- Cash is king. You cannot operate without it. The majority of bankruptcies are the result of cash shortfalls, not earnings disruptions. Conserve or build liquidity by collecting slow accounts, cutting expenses, liquidating nonessential inventory and equipment, and eliminating unprofitable business units or product lines. Often this means booking losses as assets are written down to market value. These losses are less important than the cash generated. Carefully track cash receipts and disbursements. Do not depend on the bank to make additional credit available in a cash shortfall.
- Develop and articulate a conservative business plan. The company's performance will be measured in relation to the plan. Make sure the bankers understand the factors that

may positively or, more important, negatively impact results. Demonstrate to SAG that the business is doing all it can to improve its economic circumstances. Provide accurate and timely reporting.

- Proactively pursue alternative financing. It is important to understand the company's alternatives and the changes that are necessary to make a refinance feasible. SAG will expect to have refinancing options well defined before agreeing to a long-term workout.
- Beware of partial or one-sided deals with the bank. Workout bankers are trained to turn up the pressure with demands for personal guarantees or added collateral as a precondition to discussing the account's future handling—“trust us, we'll take care of you.” Collateral and guarantees should be granted only in concert with a restructuring of the loan terms that permits a reasonable chance of success. The suitable quid pro quo may be some combination of adequate credit line availability, default waivers, revised covenants, extended amortization, or lower interest rates. Resist SAG's inclination to keep the credit relationship on a short fuse (i.e., a series of rolling 30-day extensions). Hammer out a longer-term arrangement (six months to a year) that provides some certainty that the credit facilities will be available subject to reasonable performance hurdles.
- Expect to pay more for everything. The

SAG experience is expensive. Banks have become keen on ratcheting up interest rates and nicking the company with fees at every opportunity. This is done for two reasons: First, the risk has increased and the bank legitimately should be compensated, and second, higher costs provide the company an incentive to refinance elsewhere. SAG also tends to be liberal in the use of legal counsel and advisors at the company's expense. It is up to management to exert some control over the bank's spending.

■ Get help. Dealing with SAG is time consuming, just when the business demands maximum management focus. The guidance of an experienced attorney is essential to navigating through a workout. And a competent financial advisor will lighten management's load and instill greater confidence at the bank.

The path out of SAG is predicated on making a plan and achieving it. But all agreements, no matter how ingenious, at some point will require performance that provides sufficient cash flow to fund debt service and reinvestment to sustain the business over time. The bank is an unavoidable distraction; nevertheless, management must remain focused on customers and operations. If the company's performance can turn the corner, doors will open to financing alternatives that will allow you and SAG to part company. ♦

Making Critical Investment Decisions

Building greater value for your company hinges on allocating scarce capital resources prudently.

The economic storm of the past several years will soon end. Many think it already has. As the economy regains vigor, new opportunities will present themselves. The ability to select the right opportunities and build greater value will hinge on decisions about how to prudently employ the company's capital resources.

Possibly the most important resource decision a company makes is the allocation of its capital, a scarce resource for most companies. Capital must be allocated to the best opportunities—those that will yield superior returns. The criteria for capital investments must be more sophisticated than whether a profit can be earned and whether the bank will fund it. The appropriate analysis must take into account all of the investment's costs, the net cash flows generated by the investment, and the rate of return on the capital used to fund it.

ELEMENTS OF INVESTMENT ANALYSIS

The objective of investment analysis, or

capital budgeting, is to gauge the likelihood that the return earned from the investment will be sufficient to justify the project. There must be a reasonable expectation of returns at least equal to, if not greater than, the company's cost of capital. Anything less and shareholders lose value. Anything more creates shareholder value. The elements necessary to complete the analysis are:

- The capital to buy or build the equipment and facility, hire and train the people, carry the inventory and receivables, and otherwise launch the investment.
- The incremental free cash flow generated from the business opportunity after considering the operating profits (sales, less cost of sales, less marginal operating expenses), reduced by the marginal tax obligations and the ongoing requirements for working and fixed capital expenditures.

Mapping these two elements generates a profile that shows the initial outflow of the

Private Equity—Can You Raise It?

Liquidity in the private equity markets is making its way into new deals, but very selectively.

Recently you may have heard that now is a good time to sell a business or to raise equity capital. The story goes that a tremendous amount of private equity capital has been raised over the last few years that must be put to work. The thinking behind this advice, offered by various investment bankers, brokers, and intermediaries, is that investors have been burned by investments in dot-coms and technology start-ups, so they now are looking to invest all that money in safer “old economy” businesses. The implication is that a lot of capital is poised to pour into mature middle-market businesses.

We are not convinced. Even though there is substantial liquidity in the private equity markets, it is not gushing into new deals. It is trickling in very selectively.

\$100 BILLION OVERHANG

It is true that by historical standards, the amount of capital raised in the past five years is phenomenal—more than \$300 billion, specifically earmarked for investment into later-stage private companies. Another \$320 billion has been queued up for early-stage “venture” investments.

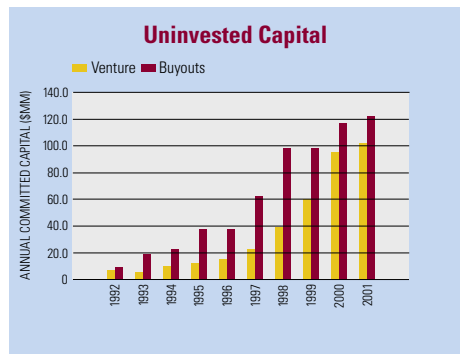
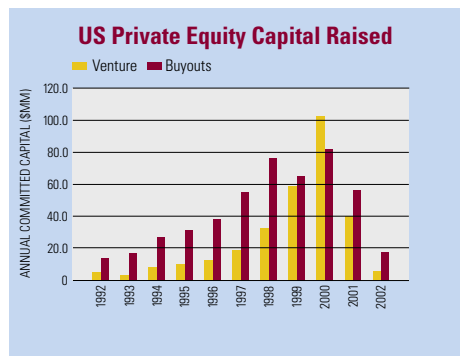
It is also true that the slowdown in the rate of investing has left a huge overhang of uninvested capital, estimated to be more than \$100 billion. Since equity capital employed in private company buyouts is typically leveraged with debt, this implies that the total sum available to fund private equity investments is several multiples higher.

From frequent discussions with private equity firms, it is apparent that the pace of new investment is sluggish. Many investors report that their deal pipelines are as empty as they can remember. One would surmise that there is pressure building to put unused capital to work. If so, why isn't the private equity spigot wide open? Behind the scenes there seems to be another dynamic at work.

THE PRIVATE EQUITY BUSINESS

The private equity business depends on investment performance. Over the past 15 years, institutional money managers determined that overall portfolio returns could be enhanced by allocating a greater share of capital to the “alternative investment” category—primarily private equity. This has been accomplished with investments in limited partnerships (“funds”) that are stewarded by private equity fund managers. Early leveraged buyout successes of the likes of Thomas Lee, KKR, Forstmann Little, and others accelerated the interest in these investment funds and led to the creation of the private equity industry.

Private equity fund managers are com-



pensated with fees tied to the amount of money under management and a share of the profits generated by investment of the fund's capital. Although management fees are not dependent on a particular level of investment returns, profit sharing is. More important, the potential for attracting investors to the next fund is closely correlated with investment success.

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In today's environment, private equity fund managers are swimming against the current in the effort to earn acceptable investment returns and raise new capital. Recent investments by private equity investors have met with limited success. A combination of factors, including a sluggish economy, the negative impact of leverage in tougher times, overly enthusiastic investment expectations and assumptions, and a tight public equity market, have diminished the overall value of many private equity portfolios.

This has happened on such a grand scale that institutional investors are rethinking their allocation decisions and have pulled back from the private equity asset class. Limited partners had lofty expectations when

they committed to private equity funds, and disappointment is setting in. Some investors have even demanded that funds return monies previously committed but not yet invested. In this environment, the energies of fund managers are being directed toward their problem investments (e.g., changing management, rethinking strategy, and re-financing the businesses) and attending to disgruntled limited partners.

The personal fortunes of fund managers depend on raising more capital. More capital can be raised only if the track record has been good. It hasn't been. For this reason, fund managers are hesitant to invest in anything but the very highest potential opportunities. Unlike in past years, private equity investors are warily avoiding the types of risk that burned them in the past. Volatile market demand (less than a dominant market position), execution risk (no more rollups), optimistic projections (having to rely on lots of add backs), and inexperienced management teams are major red flags.

RISK IN PERSPECTIVE

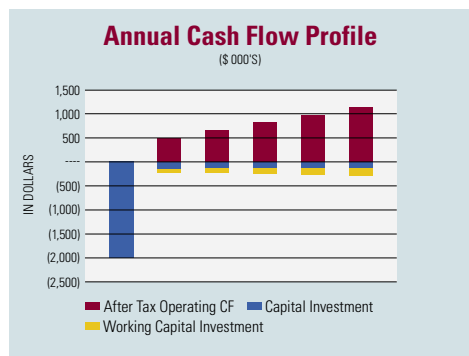
Risk has again been put into perspective. In our own dealings, it is clear that investors remain cautious. They are undertaking extensive due diligence and accepting no fact without independent verification. Lenders are following the same drill.

Even if a prospective investment stands up to heightened scrutiny, debt is less readily available. The cost of debt is lower, but the constraint on its availability means that equity must fund a larger share of the capital structure. Because equity investors' return expectations have not declined, a shift in the mix of debt and equity in a deal increases the weighted average cost of capital. Higher capital costs connote a lower value for the cash flows from business operations.

Pressure on operating cash flow, murky economic prospects, higher weighted average capital costs, lower business values, and the extreme scrutiny of business risk by investors combine to make this a difficult time to be in the market selling a business or raising private equity capital.

It is true that when large, profitable firms with leadership positions in growing industries do come to market, their values are bid up. Demand for low-risk, high-performing businesses far exceeds the supply. Unfortunately, this phenomenon applies to only a small segment of companies. Of course, these situations make good news stories that lend credence to the advice that private equity is freely available. Forgive the bankers; they are only trying to make a living. ♦

Investment Decisions *continued from p.2*



capital investment and the return of that capital over time.

The analysis must be forward looking, not retrospective. So, although the main planning assumptions may be easily identified, the calibration of those assumptions can be extraordinarily challenging. How much capital will be needed? How much cash flow will be generated? What is the timing of the cash flows? How predictable will it be? The analysis tends to be an iterative process of sorting through a complex web of dependent and independent variables to reach reasonable conclusions about the investment's key elements. Rarely is there a single right answer; instead, there is a range of potential outcomes based on the interaction of all of the variables.

Having modeled the expected cash flows, the third factor central to the investment analysis is applying the appropriate after-tax weighted average cost of capital (WACC). Much argument can occur over what the proper rate should be. It is commonly estimated as the weighted average of the cost of equity (25% to 30% in most privately held, middle-market businesses) and the after-tax cost of debt (3.5% to 4.0% in the current interest rate environment). The weighting is often a judgment based on the optimal capital structure for the industry. An equally weighted capital structure of debt and equity would imply a WACC of approximately 16% per annum.

The value of the investment is determined by discounting the free cash flows in each future period by the WACC and then subtracting the initial capital outlay. To the extent that the result is a positive number, value is created and the investment is beneficial. If the result is negative, the investment detracts from the company's value.

AN INVESTMENT EXAMPLE

A major customer approached Sea Tac Corp. with an opportunity to expand its business by supplying widgets at an attractive price. In fact, the customer would commit to buy a certain volume of widgets from Sea Tac over the next five years. With this added volume, Sea Tac would be able to increase sales at a higher profit margin than has been

earned from its existing customers. The company would need to expand capacity to manufacture the additional volume.

The company's bank reviewed the revised financial projections and agreed to underwrite the plant expansion with a five-year-term loan commitment. Given the low leverage on the business and the fact that the expansion represented only a small incremental change to the overall business, the approval by the company's bank did not require a detailed analysis of the business opportunity.

Recognizing that the bank's credit analysis is different from an investment analysis, Sea Tac's CEO asked two financial advisors to evaluate the investment. The first advisor mapped out the expected consolidated cash flow and, using the company's WACC of 16%, determined that the project was slightly positive, confirming that the project was justified.

The second advisor considered the opportunity differently. This advisor also concluded that the new business was desirable, but questioned whether the investment in the new capacity created value. The thinking was that because the existing capacity was suitable for the production of all widgets, the added capacity could be considered as being built to service the company's lowest margin customers. The second advisor conducted the analysis

Advisors' Analyses		
	Advisor 1	Advisor 2
Initial Investment	(2,000)	(2,000)
Annual Capex	(100)	(100)
After-Tax Cash Flows		
Year 1	428	330
Year 2	570	440
Year 3	713	550
Year 4	855	660
Year 5	998	770
Net Present Value	12	(527)
Investment Justified?	Yes	No

in the same manner as the first advisor, except used the company's margins on its current customers rather than the higher margin expected from the new business.

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With an improving economy and new opportunities arising, wise capital decisions made now could make a meaningful difference in future value.

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This analysis led to the conclusion that building new capacity was not justified by the cash flow earned from the lowest margin customers. The implication was that the current business should be repriced at higher margins to justify the new facility, or else the existing plant capacity should be used to service the new business in lieu of the lowest margin existing customers. In other words, although the new business would add value, the investment in a new facility would not.

EVERYDAY INVESTMENT DECISIONS

Every time you open the door, flip on the lights, crank up the plant, take an order, or leave a dollar of retained earnings in the business, you are making an investment decision. Investment analysis is a discipline that is useful for analyzing all elements of the business (customers, product lines, plants, equipment, marketing campaigns, training, etc.), whether existing or potential additions. The purpose is to guide the allocation of capital so it is employed wisely in a manner that will generate an appropriate return for the risks taken. Corporate value will be enhanced if an investment mind-set is ingrained into the organization's culture. With an improving economy and new opportunities arising, wise capital decisions made now could make a meaningful difference in future value. ❖

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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