



INSIGHT

Sarbanes Oxley Matters to You

In response to the Enron and WorldCom scandals, Congress passed the “SOX” Act. How it affects private companies may surprise you.

by Mark D. Working

In July of 2002, Congress enacted sweeping corporate governance and financial reporting reform legislation known as the Sarbanes-Oxley Act of 2002 (“SOX”) in response to a litany of public company financial scandals (e.g. Enron, Worldcom, Tyco, Adelphia, Global Crossing). According to the Senate report on the legislation, the intent was to “improve quality and transparency in financial reporting and independent audits and accounting services for public companies,” and “increase corporate responsibility and the usefulness of corporate financial disclosure” in order to boost investor confidence.

SOX set in place a regulatory regime that holds corporate officers personally accountable for the accuracy and completeness of financial disclosures, and not in some minor way. The penalties for deceit or inattention

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are quite punitive, as much as \$5 million in fines and as many as 20 years in prison. Moreover, both the CEO and CFO risk forfeiture of bonuses and /or profits from company stock sales for any “material” non-compliance with financial reporting requirements.

It is arguable whether integrity can be legislated, but Congress’ intent was to ensure that managers would never again have an incentive to pull the wool over the eyes

TOP 10 CORPORATE FINANCE RESOLUTIONS

The outset of a new year is an excellent time to take stock of your business’ strengths and weaknesses and lay out an action plan to make needed changes. Here is the Zachary Scott hit list of corporate finance resolutions for 2005.

1. Adopt Economic Value Added (“EVA”) as a measure of business performance; look at 2004 from an EVA perspective and, then, prepare a 2005 budget that targets value creation;
2. Develop a rolling four-quarter forecasting model and update it quarterly;
3. Estimate the firm’s weighted average cost of capital and use it in evaluating capital spending /investment decisions.
4. Nail down key performance metrics and make sure that routine internal reporting highlights them.
5. Evaluate your management team and develop a succession plan for all key positions;
6. Take a fresh look at aligning management’s compensation with owners’ objectives;
7. Review the company’s capital structure for the ability to handle growth, as well as adverse business circumstances;
8. Broaden your capital provider contacts; focus on relationships with decision-makers;
9. Evaluate the application of Sarbanes Oxley to your business and your audit firm’s reputation with external audiences (bankers, investors and potential acquirers); and
10. Sell the “corporate jet.” ❖

of investors and regulators in the manner achieved at Enron and a host of others. While public company managers have been scrambling to comply, their private company counterparts have watched from the sidelines with lukewarm interest, comforted by the belief that SOX strictures don’t apply. It turns out that this is a shortsighted view. SOX has materially impacted the attitudes of public company decision makers, particularly with regard to the costs and risks that they are willing to undertake in the acquisition of a privately-held business. Business owners unaware of the implications of SOX may unknowingly narrow the potential market for their firm and sacrifice significant value.

SOX REQUIREMENTS

The SOX Act spans a broad spectrum of topics—auditor and audit committee independence, executive compensation, corporate responsibility, and enhanced financial disclosures and certifications. From a private company perspective, the provisions of Sections 302 and 404 relating to accounting practices and financial disclosures seem the most pertinent. SOX requires a fully documented system of practices, procedures, controls and certifications designed to insure the fairness, accuracy and completeness of disclosures to shareholders and others.

The documentation and effectiveness of a public company’s internal control processes are annually subject to a mandatory independent audit. Any material weakness in the internal controls and non-compliance requires a public disclosure detailing the deficiency.

SOX AND THE ACQUISITION PROCESS

For public company acquirers, uninterrupted SOX compliance has become a paramount consideration. The fundamental requirements of SOX apply to a new acquisition as of the closing date. The acquiring company is obligated to identify and disclose any material deficiencies in the acquired business’s internal financial controls in any of the following areas: selection / application of accounting policies, antifraud programs, control over non-routine / systematic transactions, and controls over period-end financial report processing. The timeframe in which the acquirer must correct or disclose

any significant deficiencies or material weaknesses varies depending on whether or not the acquired business is a “material” portion of the combined business. If the acquisition is “material” to the overall business, then immediate assessment and disclosure must be made, along with an estimate of compliance costs. Disclosure of concerns for immaterial acquisitions can be deferred for no more than a year.

The acquiring company’s executives have two primary worries. First, the acquisition introduces a new and unknown set of employees and accounting / reporting procedures and, therefore, heightens concerns regarding both control and accuracy. Second, uncertainty surrounding controls and accuracy breeds doubt about the time and cost required to bring the acquired company into compliance. The upshot is that accounting due diligence has become much more rigorous and any lingering uncertainty is likely to be reflected in more onerous transaction terms (representations, warranties and indemnities), a more protracted process, and a value penalty. If the answers to SOX concerns are not reasonably clear-cut, the field of prospective buyers will shrink, possibly eliminating all except those who view the transaction as immaterial.

RECOMMENDATIONS

Maximizing the value of a privately owned company in a sale transaction depends on engaging those parties who can derive the greatest benefit from the business combination. Often, the best strategic fit—therefore the highest value—is provided by a public company. This means that one must pay at-

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MANAGEMENT MUST:	SOX REQUIREMENTS	
	SECTION 302	SECTION 404
Evaluate the responsibility for and design and effectiveness of	Disclosure controls and procedures	Internal controls over financial reporting
Assess the integrity of	All material financial and non-financial information included in public reports	Financial statements
Routinely review controls	Within 90 days from filing date	Each quarter
Document evaluations and disclose	Any material misstatements	Any significant deficiencies or material weaknesses in financial controls
Certify SOX compliance	Quarterly by the CEO and CFO	In an annual report by the CEO and CFO
Audit and attest	Not required	Annually by an independent third-party auditor

tention to SOX and address any deficiencies. We recommend the following:

- Audited financial statements bearing the unqualified opinion of a known and reputable regional or national audit firm.
- Substantive annual management letters from the auditors, together with documentation of management’s actions to address recommendations and issues.
- An assessment of SOX compatibility from the audit firm, including an estimate of the activities, time, and cost to become compliant.
- Improvements to company’s financial controls and reporting processes with special attention given to:
 - ▶ Documentation of internal financial controls;

- ▶ Elimination of manual and judgment procedures in month-end closings; and
- ▶ Elimination of year-end audit “clean up” to accrual processes.

Our advice is to always conduct the due diligence that a buyer will require prior to beginning sale discussions. Just as one would conduct an environmental assessment and correct any deficiencies before beginning the process of selling a business that owns real property, the same applies to SOX. A prudent owner will know the deficiencies in the company’s financial systems and will be working to correct them, rather than permitting an outside party to surprise them with a list of problems and an adjustment to the transaction timing or economics. ❖

Mergers and Acquisitions 2005

Favorable merger and acquisition conditions likely to prevail through 2005.

by William S. Hanneman

Much has been written lately about the strong rebound in M&A activity over the past several years. The market is more active relative to the dearth of activity that followed the late 1990’s deal frenzy. From our perspective, this has been a welcome improvement. However, we suspect that the recovery has not been quite as robust or broad based as one might expect from the headlines in the popular press and the supportive economic conditions.

In 2003, the M&A market began to emerge from a deep trough, when financial sponsors, attracted by improved equity valuations and the availability of high yield debt, picked up the pace of acquisition activity. Total deal value grew by 22% to \$570.3 billion in 2003. Predictions in early 2004 anticipated a return of corporate strategic acquirers and a resultant M&A market boom.

Indeed, M&A deal flow did surge in the first quarter of 2004, registering a 40% increase over the previous quarter’s performance. However, in the second and third quarters, M&A volume fell off as corporate acquirers exhibited caution in initiating new transactions. The apparent pause in activity has been linked to concerns about the ability of acquisition candidates to comply with the financial reporting standards of the Sarbanes-Oxley Act (see related article) and questions regarding the sustainability of U.S. economic growth. M&A activity heated up again in the fourth quarter, as transactions valued at more than \$260 billion (including a number of mega deals) were unveiled in December. In 2004, private equity firms accounted for roughly 15% of \$1.95 trillion of global M&A activity with in excess of \$300 billion in new investments.

Historically, M&A activity has been closely correlated with confidence in future business performance and the cost and availability of debt and equity capital. While most of these activity drivers are in place as we enter 2005, concern persists over high energy prices, rising interest rates, a weakening dollar, lofty levels of consumer debt, and progress in the war on terror. In spite of expectations of moderating economic growth in 2005, business leaders seem to be more confident about the outlook for their companies. As a consequence, we see signs of greater interest in middle-market M&A opportunities among strategic purchasers.

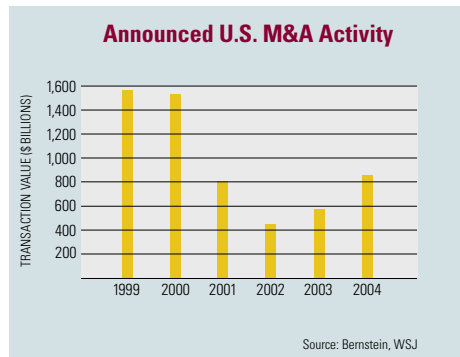
That interest is more selective than it was during the 1990’s deal frenzy, which, in our opinion, bodes well for a healthier and sustainable M&A market. Today, corporate acquirers tend to focus on building a port-

folio of businesses around a strategic theme rather than on diversification. It is fair to say that focused acquisition strategies offer the best opportunities for creating value through improved asset utilization and cost savings.

PUBLIC VS. PRIVATE COST OF CAPITAL

The recent sale of our client Mikron Industries, the leading North American producer of extruded vinyl and composite profiles used in the fabrication of windows and doors, to Quanex, a publicly traded firm with a significant presence in the building products industry, is an interesting benchmark of the current market. Quanex has built through acquisition a stable of subsidiaries that produce highly engineered window and door components. While the two companies' product lines do not overlap directly, they are complementary and the distribution channels are the same. Quanex's confidence in the strategic benefits of a business combination enabled them to pay approximately one times Mikron's annual revenues of \$215 million.

In spite of the obvious strategic benefits that Quanex expects to derive from Mikron, values put on the business by rival financial buyers were very close to Quanex's winning bid. Competition to acquire the company was keen. The final group of bidders included a mix of corporate and financial buyers. In part, this is due to the fact that the credit markets are currently quite accommodative for larger middle-market businesses with



track records of stable cash flow. In effect, the higher borrowing capacity afforded these companies reduces the weighted average cost of capital for financial buyers to a level that approaches that typically enjoyed by publicly-owned corporate acquirers. Just a year ago, this would not have been possible and even today remains unlikely for transactions of less than \$100 million.

In smaller M&A transactions, financial buyers do not typically enjoy comparable cost of capital competitiveness. This often puts them at a disadvantage when competing with corporate acquirers, particularly in situations where strategic buyers have opportunities for revenue enhancements or cost synergies.

THOUGHTS ON TIMING

Low interest rates, liberal credit availability, and expectations for stable economic

growth combine to make this an advantageous point in time, relative to recent years, for the owners of larger private businesses to consider a sale or recapitalization.

Owners of smaller middle-market firms may also find this to be a relatively good time to seek a buyer. Although strategic buyers have been a little wary, many private equity funds are anxious to put their capital to work. These equity funds have finite life spans—typically 10 years—but usually are restricted to investing that capital in new investments over the first six years of the fund's life. Equity funds established in the boom years of the late 1990's are nearing the end of their investment period, hence their desire to invest any remaining capital. The amount of capital available to private equity funds is estimated to be over \$100 billion, its highest level in at least 15 years.

It is rare for all of the factors necessary for a vibrant M&A market to align at once, as they arguably were in the late 1990's. It is even more unusual to line up an individual owner's investment horizon with a robust M&A market. Because these factors rarely move together, transaction timing always boils down to a subjective business judgment. From our vantage point, it appears that favorable M&A market conditions will prevail through 2005. ♦

Credit and Economic Update

Businesses with credit needs will find the lending environment with banks to be very good, and with bankers searching for new customers, senior debt financing will continue to be readily available.

by Michael T. Newsome

To put it bluntly, this is about as good as it gets—the lending environment is rarely as friendly to business borrowers as it has been over the past year. Nevertheless, the appetite of bankers for new commercial and industrial (C&I) loans is not even close to being sated and that portends a continued favorable borrowing environment.

The economy seems to be on pretty solid footings. In spite of some intermittent sputters, particularly with regard to energy costs and the weakening dollar, real business investment has been growing, employment numbers are up significantly, and industrial capacity utilization hit a three-year high in November. Even though the Fed has bumped up the discount rate on five separate occasions since last June for a total of 125 basis points, interest rates remain exceptionally low. Overall, the economy seems to be humming along. As a consequence, the prospects for brisk business credit demand would appear to be excellent. One might suspect that this would be

one of those heady periods for bankers when clients are knocking down the door to find the capital needed to fuel business growth.

After a 20% slide in C&I loans held by U.S. banks since early 2001, the evidence indicates that credit demand has begun to strengthen a bit. But, it is not nearly as strong as bankers would hope at this stage in the cycle. In fact, the total volume of C&I loans held by U.S. banks is still \$200 billion or 18.5% off the 2000 peak.

When the economy is growing, most firms are quite eager to make the capital and inventory investments necessary to meet customer demand. So why isn't loan demand stronger? In part, anemic C&I loan volume can be explained by the strength of corporate cash flow. Since early 2003, most industry sectors have generated sufficient cash to internally fund the investments necessary to meet customer demand. As illustrated by the accompanying charts, the general absence of a financing gap between capital spending and

internal resources has resulted in an accumulation of liquid assets (cash and short-term securities) by non-financial U.S. corporations and a surge in the ratio of liquid assets to capital expenditures. In 2003 and the first half of 2004, corporate liquid assets grew by \$244 billion, more than 20%, to \$1.3 trillion.

The October 2004 Senior Loan Officer Survey published by the Federal Reserve reports that credit standards for large, middle-market, and small business loans have continued to ease and pricing has softened as banks have sought to stimulate C&I loan volume and compete for market share.

Loan Pricing Corporation, which monitors syndicated loan markets for the large middle-market (deals > \$100 million) and traditional middle-market (deals < \$100 million), reported a bit of a split story in their third quarter review. Sponsor (private equity group) related lending activity for the first three quarters of 2004 was at a five-year high and up 105% over 2003. The dollar volume of

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traditional senior debt financings by corporate clients, including acquisition deals, has grown, but by a less robust 40% over the same period in 2003, and has not yet rebounded to the level achieved in 2000.

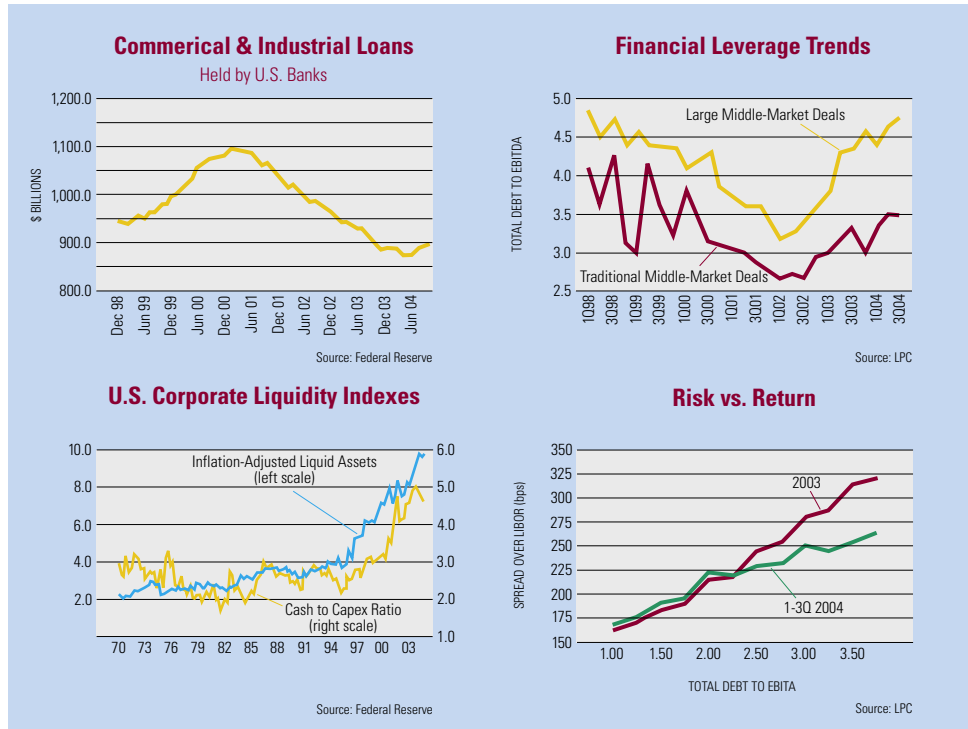
The gap between credit demand and lending enthusiasm is evident in spirited competition among bankers. The standard measure of lender aggressiveness is how liberally the limits on financial leverage are set. The routine financial leverage benchmark is the ratio of total debt (senior, mezzanine and second lien) to trailing 12-month EBITDA. Lenders are pushing the leverage envelope back towards the levels that prevailed in the late 1990's. LPC's data suggests that borrower / deal size and institutional investor involvement has had a meaningful impact on how sporty financing structures have become over the first three quarters of 2004. More than 50% of large middle-market and sponsored deals have financial leverage covenants in excess of 4X. For the subset of large middle-market financings in which institutional investors provided a portion of the debt, leverage covenants were 5X or greater about 50% of the time. In contrast, total leverage in about 73% of traditional middle-market financings has been limited to 4X or less. Just 18 to 24 months ago, the average leverage covenant was 3.5X or less.

The appetite of lenders for risk is clearly illustrated by risk and return curves in the nearby chart. According to LPC, returns, as measured by average spreads over LIBOR, are down about 60 basis points this year as compared to 2003 on the most leveraged transactions in the market. Bankers are taking more risk at significantly lower pricing in order to land deals.

HERE IN THE GREAT NORTHWEST

Sadly, there is not an abundance of hard economic data available on a regional basis. But, anecdotal evidence tells a similar story. Conversations with numerous lenders are animated by their hunger for assets, yet most are having difficulty finding enough opportunities and only a few have achieved the loan growth goals that their institutions set for 2004. A good number of bankers have told us that they will not be beat on price and a few have posited that they will not be beat on price or terms.

At the small end of the market there also seems to be an abundance of optimism. A host of community and regional banks have emerged in the Northwest in the past two years and several more are in the works. Most of these banks have styled themselves as small business lenders (loans < \$10 million) and have attracted a number of experienced lenders from larger institutions. Conventional wisdom has it that there is a void in the market left by the mega-banks



that increasingly rely on a mass-market approach to small business lending based on highly standardized loan products, credit scoring systems and limited personal interaction. It is rumored that at least one of the mega-banks is contemplating a redefinition of small business to include companies with credit needs of \$20 million and below. If so, the other behemoths are likely to follow suit, as the pressure to take cost (people are the largest controllable expense) out of their systems is unrelenting. The value proposition is that the emerging small banks can provide the customized credit arrangements and personalized service that the national banks are less inclined to provide.

Our expectation is that the current market situation—willing lenders outweighing willing borrowers—will be sustained through

2005. Assuming that the economy remains on track, a weaker dollar should stimulate domestic and export demand for U.S. products and services. There should be a corresponding increase in business capital and inventory investment to meet this demand. At some point, the capital spending and corporate internal cash flow trend lines will cross again and companies will need to borrow in order to fund growth. Credit pricing and underwriting standards probably will not be driven a whole lot lower. But, bankers will continue to be very accommodating. If it makes sense from a strategic and market perspective to expand or restructure existing obligations, this is a very good time to sit down with a couple of lenders and work out attractive financing arrangements. ♦

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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