



INSIGHT

Credit Availability Affects Business Valuation

by Mark Working

The credit debacle in August brought the large, syndicated leveraged loan market to a standstill. While we are still assessing the full impact of these events on the middle market, it is clear that credit spreads have widened and the leverage allowed to borrowers has declined. Knowledgeable commentators in the field, including Zachary Scott, have predicted that a restriction on the availability of credit would dampen the prices paid for businesses. This is perplexing, as it flies in the face of accepted corporate finance theory.

The chart below shows the relationship between allowed leverage, as measured by debt-to-cash flow covenants required by leveraged lenders, and the prices paid for middle market businesses, as measured by the ratio of enterprise value-to-cash flow. The data appear to be highly correlated and our experiences in recent years support that conclusion. However, accepted corporate finance theory says that the availability of credit should not influence valuation conclusions, so what is going on?

THE "THEORY"

There are two corporate finance principles that tell us that the availability of high levels of leverage should not affect value.

1. The first principle is that the risk of an asset, as measured by the variability of the cash flow generated by it, corresponds to a specific expected rate of return appropriate for that level of risk. In other words, each business has its own distinct discount rate that reflects the operating risks of the underlying business, exclusive of its capitalization. The value of any business is the present value of its expected future after-tax cash flow stream, discounted by the rate that reflects the risk of that business.

2. The second principle is that, as a result of taxes (and the tax deductibility of interest expense), a modest amount of debt in the capital structure enhances the returns to the equity holder. As leverage increases, the risk of insolvency and the costs of bankruptcy correspondingly outweigh the advantage of

the tax deductibility of interest.

Without trivializing the nuances of these principles, our observation is that real world practices differ from accepted theory.

IS THERE AN EXPLANATION?

There may be factors at work that are not fully contemplated by the academic theories.

The first explanation is that in the course of an economic cycle, the prospects for businesses change. In a rising cycle, the prospects for growth in sales and profits are good, and both

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lenders and investors recognize that economic reality. A higher level of borrowing is allowed because the firm has better prospects to service debt and a higher valuation multiple can be justified due to expectations of future perfor-

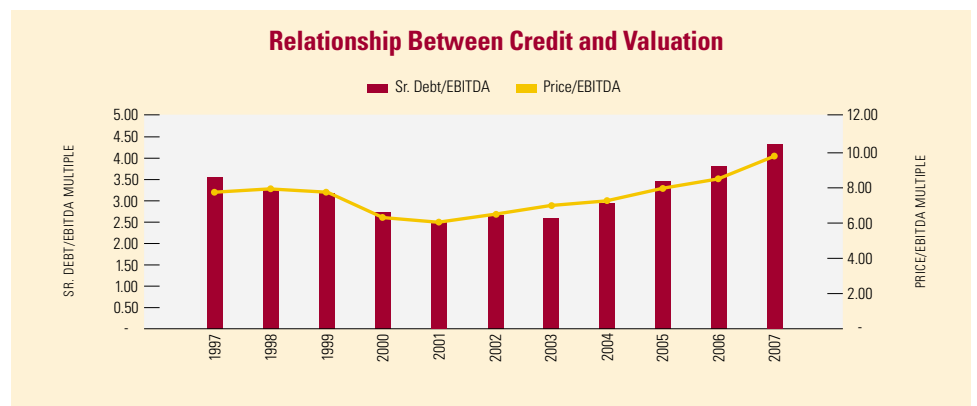
mance. As the economy crests and then slips into a down cycle, expectations are lowered and the allowed leverage and price that can be justified decline.

An alternative and more sinister view of the private equity arena suggests that the principals of private equity firms view their economic reward as consisting of a management fee plus a participating interest in, or "option" on, the increased value of the equity invested. Since there is no downside to the option, high-risk gambles are justified as beneficial to the firm.

A third explanation is that the structural relationship between private equity firms and their investors creates a bias toward high levels of financial risk that are supported by the availability of credit. This emanates from the thesis that investors in private equity funds view all such investments as being in a single category of risk, and thereby demand a corresponding single target level of return. The "promise" made by a private equity firm to its investors is to attempt to obtain that target level of return or more. There are two approaches to achieving the target return,

- take on high levels of financial risk through leverage, or
- use less leverage, but pay lower prices for acquisitions.

In credit friendly periods, private equity



	PURCHASE	YEAR 1	YEAR 2	YEAR 3	SALE
OPERATING ASSUMPTIONS					
Revenue		200,000	206,171	212,532	
Operating Profit		36,000	37,491	38,669	
Interest Rate	8.5%				
Tax Rate	35.0%				
HIGH LEVERAGE					
Interest Expense		13,770	12,542	11,163	
Net Income		14,450	16,217	17,879	
Debt	162,000	147,551	131,333	113,455	113,455
Equity	54,000				118,559
Enterprise Value	216,000				232,013
Leverage	4.50				
EBITDA Multiple	6.00				6.00
ROE					30.0%
LOW LEVERAGE					
Interest Expense		10,710	9,313	7,756	
Net Income		16,439	18,316	20,093	
Debt	126,000	109,562	91,245	71,152	71,152
Equity	73,203				160,862
Enterprise Value	199,203				232,013
Leverage	3.50				
EBITDA Multiple	5.53				6.00
ROE					30.0%

firms strive to achieve target returns through the maximization of debt and, in credit tight environments, by lowering purchase price multiples. The table above presents a simple mathematical example of the effect on price of different levels of leverage, with the intent of obtaining the same return on equity. In this case, the business is assumed to be sold after three years at a price equal to 6x operating profit, less the debt outstanding at that time. To illustrate the point, we assume two borrowing environments for the purchase. In one

case, the buyer can finance an amount equal to 4.5x operating profit, and in the other, only 3.5x operating profit. In both cases, equity is used to finance the remainder of the purchase price. The conclusion is that the constraint of earning a target rate of return (30% in this example) makes a difference (6.0x vs. 5.5x operating profit in this example) in the price that could be paid for the business.

Finance theory aside, in the real world, credit availability does affect the prices paid by buyers. The reasons are complex. Certainly,

the timing of when a sale occurs during an economic cycle can be a factor. For many years we have advised owners to sell when business prospects are good. Bankers and buyers are not immune to swings between economic optimism and pessimism. Our observation is that corporate buyers tend not to consider credit market conditions in making valuation decisions, while private equity firms do. The struc-

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ture of the relationship between private equity firms and their limited partners does appear to create a bias towards high leverage. Because their investors do not appear to distinguish the difference, most private equity firms would rather take on a higher level of risk to achieve a target level of return than take on lesser risk and miss achieving the target. With private equity accounting for upwards of 30% of all merger and acquisition transactions, this bias does affect valuations in the overall market.

There is an economic reason that the values of businesses vary as conditions and expectations change. Regardless of the economic or credit conditions, the best way to obtain the highest sale price is to organize competition for that business. When buyers compete for a prized opportunity, a fair price can be obtained under any set of conditions. ♦

Report From the Credit Front

Credit is tightening—be prepared.

by Michael T. Newsome

Certain segments of the global credit markets continue to experience great difficulty. Asset-backed structured-finance vehicles, known as CLO's, CDO's and CMO's, are still struggling with the sub-prime mess and have deeply shaken the confidence of money market (commercial paper) investors. Defaults on sub-prime mortgages were the catalyst for the turmoil, but credit problems are cropping up within other consumer loan categories (auto loans, credit card receivables, and home equity lines). Major banks (Citi, BofA, UBS, Merrill, JP Morgan, and even those with sterling credit reputations such as Wells Fargo and Suntrust) have been tarnished as they grapple with deteriorating asset values in structured investment vehicles that they sponsored or manage. Over the past few years, the practice by large commercial and investment banks of arranging and packaging increasingly risky loans in the quest for

fees and yield has proved that risk cuts both ways. In time, the rest of the credit markets will feel the pain.

GLOBAL CREDIT BUBBLE

The spread between 3-month LIBOR (the rate that reflects the cost of borrowing by banks among themselves) and 90-day Treasuries (the rate at which the U.S. Treasury borrows) provides a clear signal that investors and lenders see the problem. The spread averaged 35 basis points in the first half of 2007, and then spiked up to 243 basis points in August as the credit crisis took root. Investor fears subsided for a few months, but rebounded at the end of the year. Today's 200+ basis point gap denotes both a flight to quality by money market investors, anticipating that the global credit bubble is only beginning to unravel, and a troubling wariness among banks to lend to one another due to concerns about the relative quality of their balance sheets.

The result is a liquidity problem within the bank market that is reflected in higher funding costs for banks and their consumer and commercial customers.

THE SUB-PRIME FALLOUT

To address the sub-prime fallout, a number of institutions have been forced to replenish their reserves by cutting dividends and raising additional capital. At the same time, central banks (the Fed, the European Central Bank, and the Bank of Canada) have cut rates and pumped a stunning amount of liquidity into the inter-bank market in an effort to stave off the risk of the financial system seizing up. By itself, the ECB injected the extraordinary sum of \$502 billion on December 18th. More will be done in an effort to keep the money markets functioning. While bankers and regulators are not publicly professing doom and gloom, there is little doubt that the problem is quite serious and has not been fully defined.

THE CHANGING MARKET

In spite of the turmoil, it is not yet clear that there has been a major change in the availability of credit to middle-market companies. Firms are still finding accommodating lenders offering reasonable terms and rates. Nevertheless, you can feel a change in the market:

- Leveraged lending has tightened up.

Credit spreads are up more than 150 basis points for large institutional financings. Middle-market leveraged deals are now priced in the range of Libor + 450 to 600 basis points, as compared to a 250 to 300 basis point spread when the market was roaring along in the first half of 2007.

■ Permitted leverage (senior and total debt to EBITDA) is declining. Nine months ago, it would have been reasonable to arrange senior debt approaching 4x EBITDA for a middle-market buyout. Today, the limit is closer to 3x in most situations.

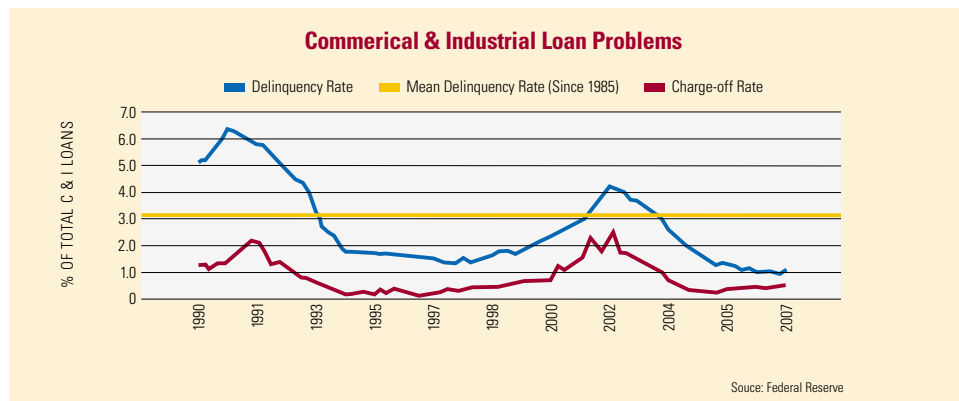
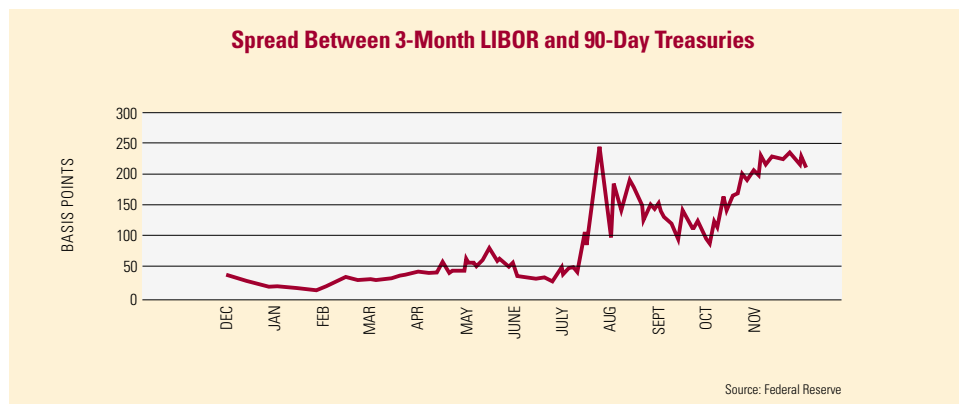
■ Second lien financing activity has dwindled to nothing as lenders eschew the risk/reward ratio of this structure.

■ The market for broadly syndicated loans remains bogged down. In December, Standard and Poors reported a queue of \$157 billion in new financings, down from a peak of more than \$237 billion last July. A good share of the difference reflects deals that simply evaporated. In any case, the pace at which new deals clear through the pipeline has slowed. CLO activity, which accounted for about 60% of the demand for leveraged loan securities before the market shifted, is a shadow of its former self. Other investors (hedge funds, regional banks, and alternative investment vehicles) have filled a portion of the void left by CLO's, but their appetite for new commitments is weak relative to that for seasoned loans at very attractive discounts to par value available in the secondary market.

BANKERS CHANGING ATTITUDES

Thus far, bankers have had few worries regarding their commercial and industrial loan portfolios. Default and charge-off rates have been well below the historical mean. But, as a harbinger of challenges down the road, problems—tight borrowing bases and blown covenants—are springing up in the portfolios of asset-based lenders that cater to middle-market companies. Odds are that default rates will begin to revert to (and possibly move well above) the mean in 2008 as the credit bubble deflates and the economy slows. There is nothing like a loan loss to change the attitude and appetite of a banker.

For the owners and managers of middle-market businesses, all of this may seem a bit esoteric. If you are not selling a business or raising a large amount of debt capital to buy or build something, why worry about the turmoil in the structured-finance and leveraged loan markets? But, remember, just like the broader economy, all of the credit markets are intricately knitted together. The problems



in mortgages, commercial real estate loans, CLO's/CDO's, and leveraged buyout financings that are plaguing big banks will impact access to middle-market business credit.

SOME SIMPLE ADVICE

Our advice is simple; "Don't be caught unprepared." This is the time to begin to adapt to a more restrictive credit environment:

- Stockpile liquidity by increasing credit commitment amounts and extending maturities.
- Develop alternative sources of capital.

- Be more aggressive in the management of working capital.

- Reassess your company's business plan, testing the sensitivities of operating cash flow to changes in the business environment. Adjust your cost structure to build in room for error.

- Be judicious with capital investments.
- Keep your lenders well informed about your business.

It is not too late and there is no reason to panic, but start now! ♦

Fairness Opinions: How Fair?

New SEC regulations don't solve any problems.

by William S. Hanneman

On October 17, 2007, the Securities and Exchange Commission published Rule 2290 involving fairness opinions, the document that boards of directors routinely rely on to determine whether shareholders are receiving appropriate compensation in merger and acquisition ("M&A") transactions. The new ruling does not require a board to obtain a fairness opinion. It simply provides minimum standards of disclosure if a fairness opinion is to be relied upon in M&A transactions. The rule was first proposed in 2004 and, after much controversy and numerous re-drafts, it has finally worked its way into securities regulation. After these years of effort, an opinion letter now states only that a transaction is "fair from a financial point of

view". The original concerns still exist.

SCOPE & PURPOSE

Faced with an offer to buy the business they advise, board members have a fiduciary duty of care that requires them to be reasonably informed when making decisions that affect public shareholders or minority investors who are not active participants in the decision. Since most boards are not made up of M&A and valuation experts, they often seek financial advice to assist with that decision-making. A formal opinion, most often referred to as a "fairness opinion," serves as "evidence" that the board conducted a process that was sufficient to satisfy its fiduciary obligations.

Although not required, fairness opinions have become standard practice in corporate

transactions after a Delaware court ruled in 1985 that a corporate board breached its fiduciary obligation to carry out its “duty of care” by approving a merger without adequate information. In that case, *Smith v. Van Gorkum*, even though the purchase offer represented a 50% premium over the pre-deal trading price, the court held that the board acted with gross negligence and imposed personal liability on its directors. In response to that ruling, boards have routinely sought fairness opinions to demonstrate that they have thoroughly considered the transaction terms and have thus satisfied their fiduciary duties. Courts have found that relying in good faith on fairness opinions is one way that a board can demonstrate that it met its duty of care.

Rule 2290 was originally stimulated by the controversy that has raged over the process of rendering, and the content of, fairness opinions. The criticism is that fairness opinions can be deeply flawed because they are prepared utilizing methodologies that allow considerable subjectivity. Surprisingly, there is no standard for “fairness” and, given the huge fees that investment banks stand to gain if their transactions are successful, they are rife with conflicts of interest. In addition, fairness opinions are of virtually no value as “insurance policies” to provide restitution for shareholders who may be damaged as a result of the board relying on a faulty opinion. Although the new rule set out to alleviate these criticisms, the rule that has been promulgated has been watered down to be virtually meaningless.

THE RISK TRANSFER PROBLEM

Fairness opinions are generally two- or three-page letters that set forth the transaction terms as well as the qualifications and assumptions underlying the issuer’s determination of fairness. If you read the text of a typical fairness opinion, it seems that the letter’s primary purpose is to manage and restrict the investment bank’s liability for rendering the opinion. The bulk of the text is taken up with a laundry list of qualifications and assumptions. It is only at the letter’s end, in one sentence, that an opinion is actually given that the transaction is “fair from a financial point of view.”

Engagement letters for fairness opinions routinely incorporate indemnification provisions that absolve the investment bank of all risk or liability (outside of gross negligence). There is no history of an investment bank paying for damages resulting from a flawed opinion.

THE CONFLICT OF INTEREST PROBLEM

Fairness opinions are routinely written by the same investment banking firm that represents the seller in an M&A transaction. While the fees paid for the fairness opinion are not contingent upon completion of a transaction, the considerably greater M&A advisory fees are. This creates an inherent conflict of interest. Many wonder, is the deal best for the share-

holders, or is it best for the investment banker?

A more subtle conflict is the relationship between an investment bank and management. Bankers often have relationships that span more than one transaction and thereby may be influenced to find a particular deal fair to avoid alienating management, which stands to benefit from it. And, perhaps the most egregious conflict is where an investment bank participates on both sides of a transaction, by advising the seller on value and also arranging financing on behalf of the acquirer.

THE VALUATION PROBLEM

A fairness opinion is not an appraisal. The opinion does not specify a set value or presume to be a determination of price. Rather, the opinion offers only that a specified transaction is within a range of values encompassing finan-

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cial fairness. A specific definition of fairness is almost never provided.

The worth of a fairness opinion ultimately lies in the reliability and accuracy of the underlying valuation analysis. This is a realm of finance where there remains considerable controversy. There are many elements of subjectivity, both in the choice and application of the valuation methods. There are no uniform, specific, objective guidelines to arrive at fairness, and this variability makes it difficult to rely on or compare the conclusions unless disclosure is made of the various inputs to the valuation analysis. Substantial discretion and

lack of guidelines or standards make the process vulnerable to manipulation to arrive at the “right” answer.

The concept of fairness has inherent limitations. As readers of this publication understand, value is in the eye of the beholder and, because the investment bank does not have access to the mindset and information upon which an acquirer is acting, value to the buyer can never be known. Only the intrinsic value of a corporation to the current stockholders can be analyzed with any objectivity.

A REMEDY

So, with all these problems, why use fairness opinions at all? We find that a compelling question. It seems reasonable that a fairness opinion should not be necessary or considered relevant in the exercise of the duty of care by the board of a seller if the process followed is correctly structured to produce a market price—that is, an auction.

There is, however, a role for fairness opinions in situations where auctions are not possible or when the disclosures that accompany an auction may damage the company. We do not argue that an investment bank that stands to earn a contingent success fee should be disqualified from proferring fairness opinions, as long as there is full disclosure of the type and nature of the conflicts. However, directors and shareholders should have access to the entire valuation analysis (its methodologies and assumptions), as well as its conclusions. It would be reasonable that the opinion’s conclusions incorporate a range of values that represent what the business could be worth to prospective buyers, minus the potential costs (monetary and otherwise) of selling the business in an auction. Absent these disclosures and consideration of the rationale that leads to the valuation conclusions, an oblique statement of fairness should not absolve the board of its obligations. ❖

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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