



INSIGHT

Why Banks Won't Lend

Credit is scarce and the outlook is gloomy, so what can be accomplished in this economic environment?

by Michael T. Newsome

Bank credit remains the essential lubricant of a free-market economy. Without it, many firms are in for a protracted bout of “liquidity gridlock,” making it difficult and, in some sectors, impossible to fund operations. It is no secret that the financial services industry and the broader economy hit a sharp inflection point in October, in what can best be described as a “deflationary debt bust.” In response, the U.S. Treasury and the Federal Reserve have intervened in credit markets in manners never before seen, applying virtually every tool at their disposal. Perhaps, this has slowed the pace of deleveraging in the financial markets, but it has not improved the availability of credit.

CAPITAL IS KING

While banks have experienced relentless pressure to rein in leverage, either by shedding assets or accumulating capital, collective leverage has actually increased slightly among the regional northwest (“NW”) banks¹ and significantly for the major NW banks², as illustrated in the chart on the following page. Several factors have been at play here. Aggregate assets have expanded as customers have drawn down outstanding commitments and securitized loans and mortgages have been moved on to bank balance sheets. At the same time, as non-performing assets mount, loan-loss reserves have ramped up. Collectively, over the past five quarters, the regional banks reserved nearly \$400 million, while the major banks pumped up loss provisions by ten times that amount. Bankers acknowledge that further credit deterioration will trigger significant additional loan-loss provisions in the coming quarters. That expectation, coupled with the pressure to de-lever, has made bank capital very dear.

The major banks offset the losses realized to date with \$59 billion of capital injections

PLAN FOR THE WORST, EXPECT THE BEST

The prospect of a prolonged downturn should cause managers to take an introspective look at their businesses to consider contingency plans for reducing costs, for selling excess assets to free up cash, and for reassessing the rate and direction of growth.

At the same time, managers should think through the opportunities provided by a downturn. Astute investments made during a downturn can position a company to strengthen its competitive advantages so as to realize benefits when times improve. A downturn can be a great opportunity to hire talent, to continue spending on strategic initiatives, and to target accretive acquisitions.

Getting to the other side will require, at minimum, continued access to external capital. Articles in this issue are intended to assist management in those endeavors, so that the business can be positioned to create the maximum amount of shareholder value when economic conditions invariably rebound. ♦

from Treasury's TARP program and raised another \$26 billion (mostly BofA) from private sources. The regional banks, except Frontier, also have been replenished with TARP infusions totaling \$718 million. No one has a clear understanding as to the amount of additional losses that reside on the loan books of NW banks. Given the severity of the recession and the yet to be fully unveiled spike in troubled assets, it is not unreasonable to believe that before this downturn has run its course, the losses may more than double, thereby bringing leverage ratios right back to where they started. Reflecting these concerns, institutions have stepped up efforts to trim commitment

levels and conserve capital.

TIGHT MONEY

Credit is scarce, but it begs the question, what can be accomplished in today's environment and over the next year? We set out to nail that down in a series of discussions with senior NW bankers to define the art of the possible. The answers were not reassuring; but, some common themes emerged.

Fear factor. There is palpable anxiety among bankers that their institutions, and therefore their jobs, may be in jeopardy. Nothing inhibits risk taking more effectively than uncertainty and fear for survival.

Suddenly, relationships matter. Bankers are reticent to admit that they're “out of the market.” For good reason, it sends a message that rarely resonates well with performing customers and major depositors. The line seems to be, “We are open to new opportunities.” In reality, the credit screen is set on “extra fine.” The prime consideration tends to be whether the prospective borrower is a customer or, at the very least, a well-known prospect. In other words, has the credit favorably crossed the desk of the bank's credit decision-maker in the recent past?

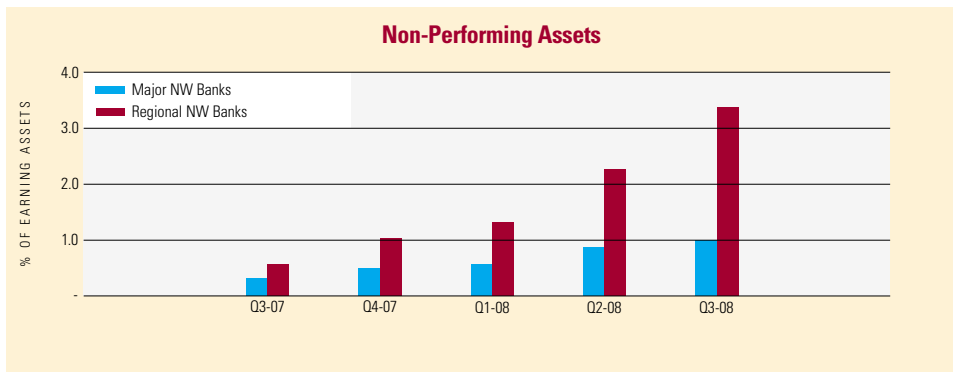
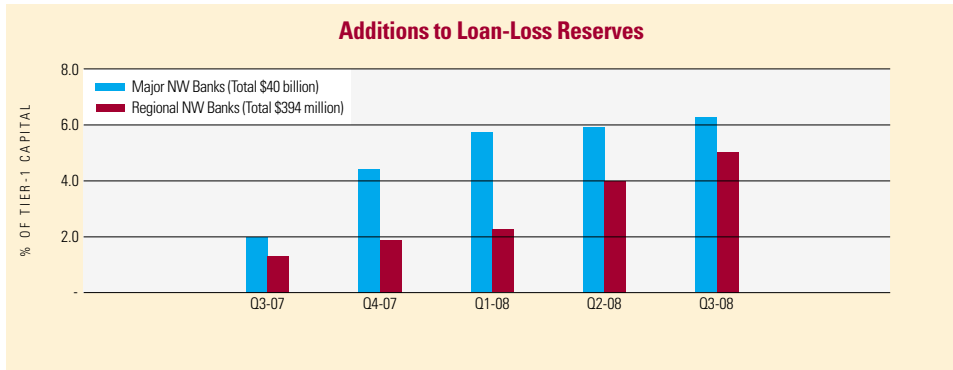
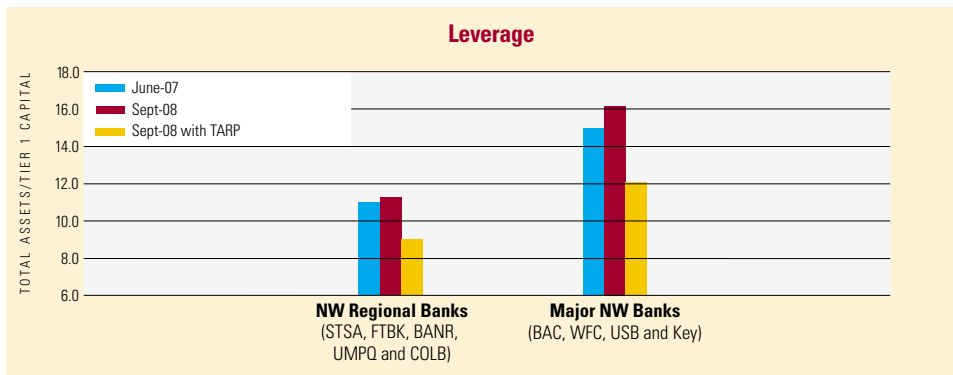
Every banker queried declared that they are focused on taking care of existing clients. However, the strength of that support varies widely, depending on the bank's situation and the specifics of the customer. Resilient, well-performing companies may have access to additional debt, particularly if the purpose is a value-enhancing opportunity (e.g., a conservatively priced acquisition).

Flight to quality. Bankers have become extraordinarily finicky. Assuming the relationship test is met, the terms under which new credit may be available are a major departure from what borrowers were accustomed to in the recent past. What little lending appetite there is will be focused on situations that meet the following criteria:

- Well supported (low advance rates) with

¹Regional NW banks include: Sterling Savings, Umpqua, Frontier, Banner and Columbia

²Major NW banks include: Bank of America, Wells Fargo, U.S. Bank and KeyBank



collateral valuations reflecting the weak market for most categories of real and personal property.

- Very modest financial leverage—1 to 2 times EBITDA. Bankers related stories of passing on one-times cash flow financing opportunities for performing businesses.
- Shorter maturities. Revolving credit line

expirations are being limited to 364 days, in order to minimize regulatory capital requirements. Maturities on term credit are being held to three years or less.

- A well-articulated business strategy, along with a demonstrated ability to plan and budget, and evidence of highly reliable financial systems.

Struggling businesses, or those in industries deemed vulnerable or over-capitalized, are unlikely to find their bankers accommodating. The list is too long to enumerate, but credit is particularly scarce for vehicle and equipment dealers, building products manufacturers and distributors, travel and leisure operators, retailers, and, surprisingly, all aspects of health care. Several bankers confessed that no one is penalized for saying “no” in this environment, even to a compelling prospect. New business is met with a jaundiced eye; it is no time to be cold calling bankers.

Given the capital constraints and a dearth of acceptable lending opportunities, banks have little prospect of lending their way out of this hole. Nevertheless, they are energetically attacking their earnings problem by extracting fees and ratcheting-up credit spreads, wherever possible. Risk is being repriced across the entire financial spectrum. Even “Cadillac-quality” borrowers should anticipate paying more for credit—a 100 to 150 basis point bump for strong, modestly leveraged borrowers and a tripling, or more, of credit spreads for leveraged firms. Minor covenant modifications or violations are likely to garner hefty fees and, in many cases, unravel an existing deal, with a complete revision of credit pricing. Multi-bank financings are particularly vulnerable to repricing, as minority lenders have considerable leverage over terms. Finally, bankers will be more insistent than ever that credit relationships be augmented with deposits and other fee-generating, non-credit services.

In spite of the media and political chorus that government capital injections are intended to reinvigorate lending, the facts are that most banks are limited in their ability to extend new credit. With solvency still at issue, banks are conserving capital as they brace for default rates, over the next year, that may well test historical highs. Most bankers say that the opportunities they are seeing do not pass muster in this risk-averse world. The rules have fundamentally changed. Borrowers need to recognize this new reality and plan accordingly. ♦

Tending to Your Lenders

Mitigating your lender's fears may be the key to retaining a critical relationship.

by William S. Hanneman

Cash is the lifeblood of a business and relationships with capital suppliers must not be interrupted. Unlike previous downturns, businesses have fewer lenders to choose from, and those remaining are suffering from a crisis of confidence. The future success of your business may be predicated on your ability to mitigate your lender's fears.

Given the preoccupation of banks with their own problems and a reduction in alternative lender choices, it is essential for business

owners and managers to view the situation from their capital supplier's viewpoint, and work within this more-constrained framework. Due care is always advised in the handling of a credit relationship, but the situation is different now. The margin for error is less. Don't take this critical supply line for granted.

UNDERSTAND YOUR LENDER'S FRAME OF REFERENCE

While it is arguably true that lenders have contributed to, and perpetuated, the current

economic crisis, don't expect any consequent obligation to provide funding to your company. Everyone is in survival mode. The capital received from the U.S. Treasury and the Federal Reserve will not readily trickle down to borrowers. Lenders seem intent on using these funds to soften further loan-loss erosion in their capital bases. Capital is very dear to lenders, so asset additions must be bullet proof and very profitable.

The practical implications to borrowers

are that it will take longer for lenders to evaluate potential extensions of credit, the amount and term of credit will be more tightly limited, covenants will be more restrictive, reporting will be onerous, and money will come at a higher price. That's just the way it is.

The fallout of having extended credit aggressively in advance of the current economic decline has left lenders embattled. In this environment, internal auditors and external regulators require extensive reporting on substandard loans. Everyone is subject to second-guessing. As credit problems have mushroomed, lenders are suffering from a crisis of confidence. It's simply human nature.

Borrowers must recognize that extensions of credit are built upon confidence, which is derived from both a favorable economic outlook and comfort with the borrower's handling of the relationship. Planning, communications, and management of expectations are critical to the successful retention of lender confidence.

PLAN CONSERVATIVELY

Optimism is the hallmark of entrepreneurs. But when fear rules, lenders are more leery than ever of "blue sky" strategies and projections. In lieu of unbridled confidence, lenders find assurance in plans that address the following principles:

- All factors under management's control have been considered to rationalize the business;
- There is a well-articulated request to the lender that improves its situation (as well as your business) and does not require it to shoulder all of the risk; and
- The numbers justify the proposed action and confirm the story.

Business or turnaround plans must be

conservative, meaning there is a clear bias toward exceeding rather than underperforming. In times such as this, the key assumption for success cannot be a "return to normal conditions." A well-conceived plan is but step one. Lenders must also understand what steps can be taken if the plan goes awry. Contingency plans are necessary.

CONSIDER WAYS TO IMPROVE THE BUSINESS

Regardless of what is expected by lenders, it is time to put all sacred cows out to pasture. Change is imperative and should begin with a careful examination of how and where your

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Regardless of the reason, surprises play to fears that the borrower is unknowledgeable or may be hiding the ball. In either case, management loses credibility. Once lost, credibility is difficult to restore and access to funding is jeopardized.

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business makes money. Nearly every business is in some manner unknowingly impacted by the 80/20 rule. So, the challenge is to take a detailed look at the individual earnings contributions of customers, products, markets, and facilities, relative to the investment of capital for each. Moreover, this effort should look beyond the confines of the existing business to consider the economic and competitive benefits of external alternatives, such as consolidation or joint ventures. All alternatives that strengthen the company's competitive position should be evaluated.

AVOID SURPRISES

Regardless of the reason, surprises play to fears that the borrower is unknowledgeable or may be hiding the ball. In either case, management loses credibility. Once lost, credibility is difficult to restore and access to funding is jeopardized. It is more critical than ever that your lender is up-to-date on all aspects of your business and financial situation. Revise projections and plans as conditions change. As problems crop up, surface them promptly with your lender, together with a rational solution that is cognizant of the bank's parameters.

GET HELP, CONSIDER AN ADVISOR

The reality of today's highly selective credit markets is that a well-reasoned and articulated plan that will pass muster in your lender's organization is a prerequisite to success. Capital cannot be arranged on an ad hoc basis. Convincing a bank to work with you, and the response you get, will be meaningfully influenced by how and what is asked for, as well as the strength and clarity of the business case supporting the request. With all that is at stake, consider using an advisor that has both experience in these matters and current market knowledge to assist in preparing and communicating your plan and negotiating the terms.

Treat your credit relationships with the importance they deserve. Promise only what can be delivered and gain your lender's confidence by demonstrating that you are on top of your business environment and acting prudently and promptly. Your lenders are critical partners and should be treated as such. But, they cannot be relied upon to plug all holes. Business owners and managers need to be resourceful and develop back up capital solutions to ensure that the business will emerge stronger and ready to create the next increment of shareholder value. ♦

Alternative Sources of Capital

With banks tightening credit, higher risk sources of capital may deserve consideration.

by Mark D. Working

As discussed elsewhere in this issue, bankers are both subconsciously and purposefully tightening corporate credit availability in response to their own crises. Greater lender conservatism, coupled with a dwindling field of sources, means that business owners and managers with a need for incremental funding to pursue strategies with more than minimal risk will be obliged to consider alternative sources of capital.

To be sure, these sources of capital tend to be more expensive than traditional senior debt and, for that reason, management would be advised to first look inside their businesses for sources of liquidity. All opportunities should be considered to more efficiently produce, distribute, and/or sell products and

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services, as well as freeing up working capital by accelerating the collection of receivables and streamlining the supply chain.

When loan proceeds from your banker and

internal optimization measures fall short of the capital needs of the business, alternative sources of capital, such as mezzanine lenders, private equity investors, and joint venture partners, deserve consideration.

MEZZANINE CAPITAL

Mezzanine, as described in the Winter 2004 issue of *INSIGHT*, is a flexible, cash-flow predicated, term loan that can extend borrowing capacity beyond the parameters of senior lenders. These loans are contractually subordinate to, and more expensive than, senior debt, even in today's pricey environment. Mezzanine lenders expect to earn between 15%-25% per annum from a combination of upfront fees, current pay interest, deferred interest (known as payment-in-kind

Alternative Sources *continued from p.3*

or PIK interest), and no-cost warrants that represent a share of the company's equity. Inclusion of mezzanine in a company's capital structure adds complexity, as it requires close coordination among the lenders and a tri-party negotiation of a variety of issues, including covenants, lender rights and remedies, prepayment terms, and corporate governance.

In a challenging environment, mezzanine offers some distinct advantages. Stabilizing a portion of the capital structure for an extended period, without a rigid amortization requirement, can provide breathing room during periods of slack demand. Although heightened leverage adds financial risk, mezzanine leaves the current owners in control and is far less dilutive than raising equity. Typically, the catalyst for an attractive financing is either a value-creating corporate development opportunity or ownership transition. In most cases, mezzanine is only available to businesses with strong and sustainable cash flows. It is not a source of capital for distressed situations.

The traditional providers of mezzanine capital have been insurance companies and dedicated mezzanine limited partnerships funded by institutional investors, such as pension funds and endowments. Over the past ten years, the field of providers has expanded to include publicly traded business development companies and captive mezzanine lending arms of private equity firms, commercial banks and investment banks.

Very few mezzanine providers market directly to prospective borrowers. Most transactions are structured and arranged with an investment banker acting as the intermediary.

In spite of the credit crisis, borrowers approaching the mezzanine market are likely to find renewed enthusiasm among lenders. The risk and return tradeoff has greatly improved for this capital segment. Mezzanine providers can now lend at far more attractive returns into situations that, pre-crisis, would have attracted senior debt. As a result, there is an abundance of capital queued up for mezzanine opportunities.

PRIVATE EQUITY CAPITAL

Historically, private equity firms have been "control" investors with a preference to own a majority, if not all, of the voting shares of the businesses in which they invest. That general motivation has not changed, but investments from private equity funds and other pools of private equity will become more inventive as opportunities emerge to help good companies strengthen their franchises in pursuit of further success. Many traditional buyout firms have recently indicated a willingness to make "Warren Buffett" type investments, via minority preferred positions in the capital structure.

Valuation will be a concern as current conditions have put pressure on prices. In-

**Alternative Capital Suppliers
with a Northwest Presence**

Firm	Fund Size (\$ in Millions)
MEZZANINE	
Key Principal Partners	400
Roynat (Royal Bank of Nova Scotia)	N/A
US Bank Mezzanine	N/A
Wells Fargo Mezzanine	N/A
PRIVATE EQUITY	
Blue Point Capital	415
Buerk Dale Victor	100
CopperLion	100
Endeavour Capital	450
Evergreen Pacific Partners	445
Graham Capital	N/A
IntraCorp	N/A
Joshua Green Corp	N/A
Laird Norton	N/A
Northwest Capital Appreciation	N/A
Pender West Capital	N/A
River Lake Capital	150
Sienna Partners	N/A
Stern Partners	N/A
Tricor Pacific	555
Winona Capital Management	150

trinsic value has returned to the marketplace. Rather than relying on "market multiples" or on pie-in-the-sky assumptions about how a business might be valued in the future, investors are returning to the fundamentals, where valuations are based on well-justified expectations for future business performance. Expect a critical evaluation of the business plan that challenges all of management's assumptions. Owners must put out of their minds "what might have been" a year ago. Instead, equity investments should be evaluated based on the incremental shareholder value that may be created with the benefit of new capital.

Private equity firms are not all interested in

the same opportunities. Different perspectives on the stage of evolution, industry, control and governance parameters, dollar amounts, condition of the company, geographic location, and quality of management, make for a highly fragmented private equity market. Steering your way through the jumble of alternatives requires a guide.

The accompanying table lists capital providers with a Pacific Northwest presence. Each targets its own particular segment of the market, with surprisingly little overlap. There are many firms located outside the region that have both experience and interest in providing capital to local companies.

CAPITAL RELEASED FROM BUSINESS COMBINATIONS

As businesses adjust to lower demand, managers will find that excess capacity and duplicate functions can be eliminated in cooperation or combination with other businesses. An outright sale to a competitor can accomplish the cost reduction objectives, but a joint-venture arrangement, in which parties share facilities and consequent cost savings, may also be worth considering.

When rationalization of a business or industry occurs, cost reductions free up capital. Improved performance also makes the resulting business more attractive to senior, mezzanine, and equity capital providers.

Survivors of this economic downturn can expect to find unprecedented opportunities, once the decks are cleared. One thing that has not changed, capital remains the lifeblood of business. Firms that anticipate their needs and adjust their capital structures accordingly, including considering non-traditional alternative funding sources, can strengthen the prospects of building future shareholder 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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