



Credit Markets Update

by Michael T. Newsome

It is now safe to admit, the country is experiencing a business slump, possibly even a recession (two consecutive quarters of economic contraction), a scene unvisited since 1991. The conventional prophecy has been that the Federal Reserve will engineer an economic soft-landing through the adroit management of monetary policy. But, our expectation is for a somewhat more jarring touch-down. There is no lack of causative grounds for the rapid cooling of the nation's economic

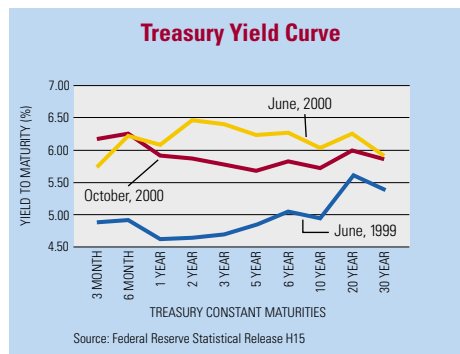
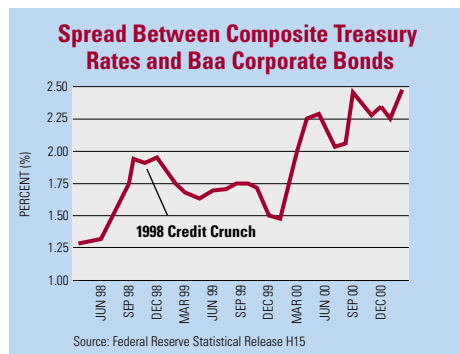
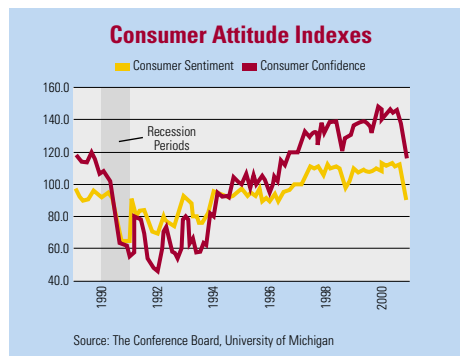
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climate: energy prices are high and supplies are uncertain, corporate profit-margins have weakened, the stock market is in a skid, access to the public debt and equity markets has severely contracted, and major banks are pulling in their horns in response to scolding from bank regulators.

An economic slump is part of the natural pattern of the business cycle. In fact, it is the necessary and healthy consequence of a sustained period of economic expansion. The simple fact is that overly enthusiastic investors and lenders have made a lot of errors—investments that once seemed compelling, now, in the clarity of hindsight, make little or no economic sense. Economic downturn is, at its



core, the adjustment process whereby marginal financial and economic assets are revalued and recycled.

Perhaps the most prominent recent episode of malinvestment has been in the high-flying internet and telecommunications sectors in 1999 and early 2000. During that period, any idea with even a feeble connection to the Internet or wireless communications could attract capital from equity and bond investors,

and even bankers. With no hint of an earnings model, valuations equal to three-digit multiples of revenues were commonplace. If it all seemed absurdly speculative—it was. A large segment of this industry is now suffering through the adjustment process. A lot of money changed hands, but little enduring economic value was created.

Likewise, highly leveraged debt financings seemed to many to be reasonable just a short time ago. In recent years, an abundance of buyout transactions has been put together, using leveraged financing structures (> 4 times trailing cash flow), in concert with private equity, to consolidate fragmented industries or fund expansion. To justify the leverage, investors and lenders anticipated steady growth and stable or improving margins, based on the realization of operating synergies. While many transactions have proven successful, a significant portion of these deals have flopped, or will, for a variety of reasons, including higher capital costs, overly optimistic management, unanticipated changes in the competitive or regulatory environment, or too high a price at the outset. Many of these firms will be reorganized, dismembered and sold off or liquidated, often under the auspices of a bankruptcy court.

WHERE DO WE GO FROM HERE?

If we are in the midst of a period of economic readjustment, what are the implications? First, negative economic news (layoffs, stock market declines, bankruptcies, weak sales reports, corporate earnings warnings and higher energy prices) is having an impact on consumer confidence in the economy. Ultimately, consumer confidence will be a critical indicator for gauging the severity and duration of the downturn. There has been some notable erosion in consumer confidence over the past five months, but it remains sufficiently healthy to avert a severe recession. This measure deserves close monitoring in the coming months.

Second, it is clear that the credit markets are preoccupied with the process of economic

readjustment in the form of troubled loans and bond defaults. As discussed elsewhere in this issue, the consequence is that credit is tougher to come by and more expensive. The heightened selectivity of lenders in the placement of their capital is evident in the widening risk premium between Treasury securities and higher risk (Baa) corporate bonds. While financing is more of a challenge for companies that are reliant on banks as their principal source of capital, funding is still available, as asset based lenders and commercial finance companies have become more active. Companies in certain highly cyclical industries (building products and consumer durables) will find the current environment more challenging than others will.

Finally, by cutting the discount rate twice

in January for a total of 100 basis points (1%), and then again by 50 basis points on March 20, the Fed has taken some aggressive action to soften the downturn and forestall a bonafide recession. It seems likely the Fed is poised to make additional cuts in response to further signs of economic weakness. The current yield curve is notable in two respects. First, average rates (as measured by 10-year Treasuries) are down 79 basis points since last October. This means the cost of capital has been lowered, which should help sustain investment and construction activity, lighten the consumer debt burden, and offset the higher risk premiums that corporate borrowers are being asked to shoulder. Second, the yield curve has reverted to a more normal slope, as yields on shorter maturities have fallen more rapidly than those

on medium- and long-term maturities. We strongly suspect that this is an additional sign of the "flight to quality" by investors seeking a lower-risk refuge for their capital in the form of short-term Treasury securities.

It is clear that the country is in the throes of an economic downturn. With interest rates trending down and the promise of some modest tax reductions on the horizon, this downturn may not evolve into a full-blown recession. Nevertheless, the effects of the slowdown can be expected to vary in severity from industry to industry and region to region. Given the energy situation and the dot com implosion, the impact will be felt in the Northwest. We suggest that business owners and managers will be well served to prepare for a bit of a choppy ride over the next six to twelve months. ♦



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