



Credit Markets Update

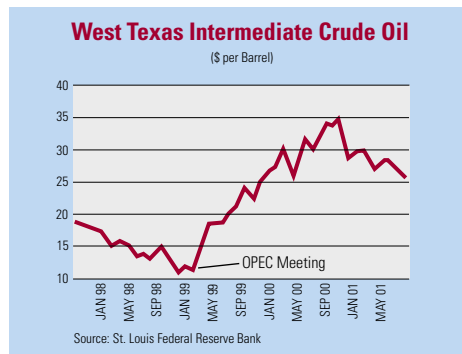
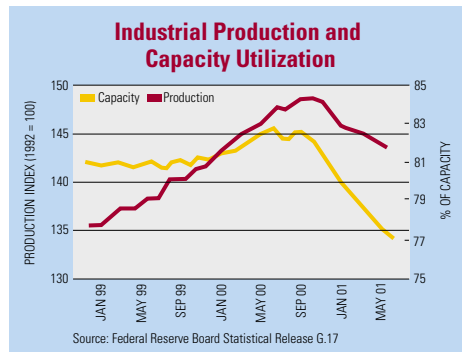
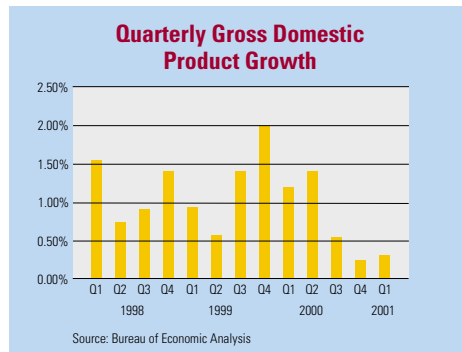
by Michael T. Newsome

Sifting through the unending deluge of economic news and opinion, it seems that nearly everyone agrees that business conditions are significantly weaker today than just one year ago and that the "line of sight" for future expectations has been lowered considerably. This has been clearly reflected in a very sobering stock market correction. Investors of all stripes are much more conservative in their views. Many economic pundits are now suggesting that the bottom has been reached and the dawn of a new economic expansion is on the horizon. A couple of nagging doubts make us wonder whether we may be looking at a longer period of weak business conditions.

While the financial markets soared in 1999 and early 2000, based on the economic growth apparent in gross domestic product (GDP), industrial production, and employment statistics, the Federal Reserve Board (Fed) harbored concerns that much of the investment being made was of questionable economic value, in effect fueling a speculative bubble. GDP growth, of course, measures spending and investment, and is indicative of future economic growth, assuming that the investments produce real economic returns. As a greater volume of individuals' wealth poured into higher risk investments, the Fed worried that a significant portion of the nation's savings might be squandered, when economic reality reared its ugly head. Clearly, in 1999, the Fed was uncomfortable with the "irrational exuberance" in the capital markets as a whole and the stock market, in particular. The Fed's desire to cool the economy was evident in moves to ratchet up the discount rate and tighten up supervision of bank lending practices.

GDP growth of more than 6% for the twelve-month period ended June 30, 2000 was incontrovertible evidence of robust expansion. In the twelve months since, the economic brakes have locked up to trim GDP growth by more than 75%, to a tepid 1.5% or less. Underlying faltering GDP growth, one finds a contraction in industrial output, which is almost 3% behind last year, after eight consecutive months of erosion.

In the latter part of the 1990s and into 2000



several distinct, but related, events stimulated a frenzy of activity in technology and telecommunications sectors that focused investment and spending that might normally occur over a period of years into a short span of time. The rapid integration of the Internet into our personal and business lives spurred massive investment in computer and tele-communications infrastructure in the form of network equipment, millions of miles of fiber-optic cable, servers and personal computers. It also

gave rise to scores of dot-coms that populated the Internet with content and services. At the same time, old economy companies were spending heavily on both carving out an Internet presence of their own and addressing Y2K concerns. Technology and telecommunication spending was not confined to the Internet alone. Huge investments have been made in wireless communication infrastructure, as well. Activity in all these areas powered a surge in economic growth. Tremendous excess capacity has been created and the pace of further investment activity has slowed to a crawl, which accounts, in part, for the decline in industrial production. Today, it is not clear how much of this excess capacity will end up being productively employed and earn a real economic return.

Adding to the impact of the Fed's purposeful move to tighter money, higher energy costs snuck up on many of us, even though the seeds of the problem were planted quite some time ago. In 1999, the Organization of Petroleum Exporting Countries (OPEC) renewed its effort to restrict output in order to increase oil prices at the wellhead. It has been successful, as the price of crude oil has risen from \$10 per barrel to peak at \$34.40 in November, 2000. At the same time, proven natural gas reserves have dwindled and the expansion of energy infrastructure (power plants, refineries, and power transmission capacity) has lagged well behind the growth in demand. As supplies of most forms of energy have tightened, prices have risen. It is not hard to comprehend that higher energy costs are manifested in reduced consumer purchasing power and weaker corporate earnings.

Since the beginning of the year, a variety of actions have been put in place to stabilize and stimulate the economy. The Fed has aggressively sliced the discount rate seven times, for a total of 275 basis points. The June 27th reduction of 25 basis points may be a signal that the end of the rate-cutting cycle is near. A modest tax reduction package has been enacted with about \$40 billion (\$300 per taxpayer) in rebates to be paid later this year. Lower interest rates have lightened the debt burden carried by

many individuals and businesses and helped keep the housing market chugging along. As rebate checks reach the hands of taxpayers, we should see a further boost to already relatively strong consumer spending. Investment in energy infrastructure has been rekindled and conservation has begun to take effect. In response, energy prices have slid from their peak in late 2000. Looking at the statistics, one might conclude that other than for a lag effect, the Fed has been successful in its objective and normal economic expansion may resume in the near term.

In spite of this optimism, the Fed's effort to stimulate the economy will only be successful

if it induces the creation of debt to provide investment capital. This brings us to that nagging concern, lack of capital availability. Even with low interest rates, if the credit appetite among banks is weak, business investment will be constrained and economic growth will be effectively throttled. Bank examiners continue to hold a very conservative view on the extension of commercial credit. Some bankers have confided that during the review of larger syndicated credits this year, examiners gave leveraged loans very close scrutiny and were unforgiving in their assessments. Rumor has it that the Office of the Comptroller of the Currency's (OCC) annual report on com-

mercial credit quality, to be issued later this summer, will be highly critical of leveraged-lending activities that prevailed until last year. If this proves to be true, we expect that many lenders will continue to maintain, and perhaps even further tighten, already conservative credit standards. Financing will be a challenge, particularly for companies that are struggling with sales and earnings deterioration, or are in industries that are out of favor. We suspect that the economy will not begin to fire on all cylinders until the banking system loosens up, and begins to more aggressively seek new lending opportunities. ♦



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