Zachary Scott
INVESTMENT BANKERS

IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
WINTER 2002

Market Update

by Michael T. Newsome

Well, we have made it through the first year of the new millennium. This year was more tumultuous than we could have imagined at the outset – marked by the start of a national (if not global) recession as the tech/telecom boom of the 1990's ground to a halt, followed by stunning acts of terrorism and then a war to root out the terrorists. These events, and others as well, have had a fairly severe impact on everyone's economic endeavors in the form of heightened uncertainty. There is almost a conspicuous sense of collective relief that 2001 is over. As difficult as the year proved to be for many, it succeeded in discrediting much of the investment hype that flourished during the boom and reacquainted most of us with the concept of risk.

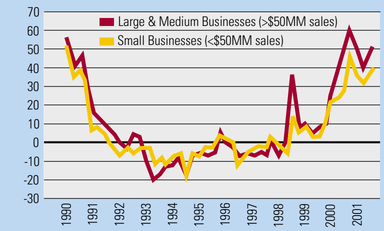
Risk (risk) n 1. The chance of something going wrong; 2. The possibility or danger of suffering harm or loss; 3. The quantifiable probability of less-than-expected returns or loss; 4. The volatility of returns from an investment.

In case we had forgotten during the great run of the 1990's, 2001 reminded us that the American economic system is quite untidy. Lots of mistakes are made. Financial markets go down almost as readily as they go up. Certainly, the past year has been punctuated by a startling set of crash-and-burn stories—the demise of Enron, the dot-com implosion (which pulled under a host of formerly high-flying Northwest companies), the telecom industry's unraveling, and the growing list of casualties within the retail, travel, aerospace, and insurance sectors due to the events of 9/11. In times such as these, the gut reaction of bankers and investors is to tighten up and eschew all opportunities with even a hint of uncertainty or controversy. Accordingly, business investment and lending has plunged.

To be fair, the conservatism that now defines the thinking of lenders and investors is, to a degree, appropriate. The signs of financial weakness are abundant. Corporate

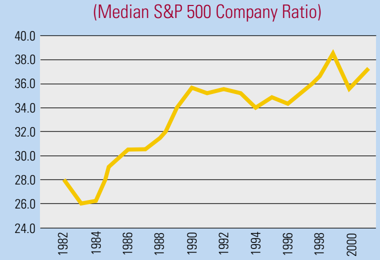
Federal Reserve Senior Lending Officer Survey

Net Percentage of Banks Tightening Credit Standards for Commercial Loans

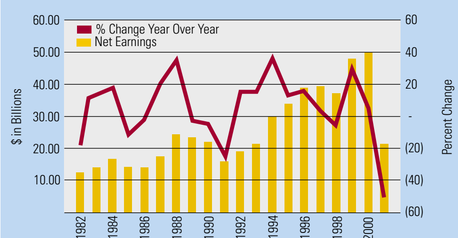


Long-Term Debt as a % of Total Capital

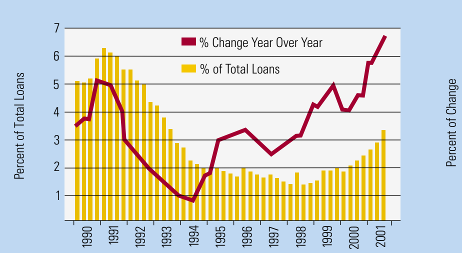
(Median S&P 500 Company Ratio)



S&P 500 Net Earnings



Commercial Loan Delinquencies



debt as a percentage of total capital has been steadily building for the past five years. At the same time, corporate earnings have been rocked. After taking into account the massive write-offs of non-productive investments made during the boom, net earnings were down more than 50 percent in 2001. Across the spectrum, default rates on corporate debt have surged. Obviously, the environment has been ripe for credit problems and they have been coming in waves. It is time to clean up the debris that always accumulates during a long period of economic expansion.

The solemnity of these financial trainwrecks tends to obscure the fact that economic failures are often the foundation upon which future success is built. The key characteristic of economic growth is that it is an evolutionary process of building up, tearing down, and building up again. Two steps up, one step back, two steps up.

Economic progress is risky. To paraphrase the early 20th century social commentator, Gilbert Chesterton—capitalism is a dangerous trade. Recently, in the financial press, and even closer to home in conversations with local bankers, the word "risk" has joined the ranks of those other four-letter words that we were taught in our youth to avoid. One might easily conclude that risk must be shunned at all costs. The ideal state of affairs would be a tidy, highly predictable world in which risk and uncertainty are regulated into submission. In fact, for the past two years, the Treasury Department's Office of the Comptroller of the Currency has been working hard to regulate the risk out of commercial lending. No doubt, in the aftermath of a boom, there were lending excesses that needed to be addressed. Nevertheless, we have some fear that this regulatory effort has gone overboard by prodding already conservative lenders into rationing credit for small and middle-market businesses. Most private companies cannot borrow on the same basis that they could two years ago. If your business falters in the downturn, your lender may make a concerted effort to show you the door.

We have heard more than a few bankers

(continued p.2)

suggest that they have an interest in making loans, but only in situations where there is no risk. Of course, there are few profitable opportunities that can pass through that fine screen. If, in the long-term, this view takes hold, the banking system will undergo radical change and the career prospects for bankers will be pretty dim. In reality, all business loans and investments are risky. They are based on guesses (most educated, some clearly not) about how the future will unfold —something that cannot be known with any certainty.

Despite last year's economic shocks, the economy seems to have stabilized and is probably already on the road to recovery. The recuperative power of our system of capitalism should not be underestimated. From our vantage point, it is hard to see how the economy will return in the near term to the robust growth that we enjoyed prior to 2001. We are inclined to believe that the economy will gather strength slowly over the next year, but will not shift into high gear until lenders and investors regain an appetite for new opportunities. Walter Wriston, the former CEO of Citicorp and a legendary figure in banking circles, once wrote, "If wages come from work, rent from real estate, and interest from savings—where do profits come from? The answer is that profits come from taking risk." If the economy is to regain its full measure of vigor, as it surely will, lenders and investors will have to meaningfully re-embrace risk as an essential element of capitalism. ❖

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

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, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com