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INVESTMENT BANKERS

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Credit Markets Update: The Pendulum Swings

Banks are becoming more interested in new financing opportunities.

by Michael T. Newsome

After a period of rapid credit expansion in the latter part of the 1990's, the needle on the commercial credit appetite pendulum swung sharply in early 2000 from the "greed" zone far into "fear" territory, where it has been firmly planted for the better part of three years. According to the National Bureau of Economic Research, the recession officially ended in November of 2001. Nevertheless, the rebound in economic growth has been extraordinarily slow as the economy has struggled to deal with massive over-investment, terrorism concerns, and intense competition from foreign competitors. At the same time, the productivity of workers has been unusually strong, meaning that business can meet sluggish demand for products without adding new jobs and activating idle capacity. The result has been a recovery, in the eyes of economists, that doesn't feel like one to many business owners, managers and workers. In fact, this downturn has produced a landslide of defaults and a record level of bankruptcies (more than 100,000 companies over the past 30 months). In this environment, commercial banks have taken a lot of hits, evidenced by the fact that loan-recovery rates plummeted as the supply of distressed assets mushroomed. Collateral always seems to be worth the least when it's needed the most.

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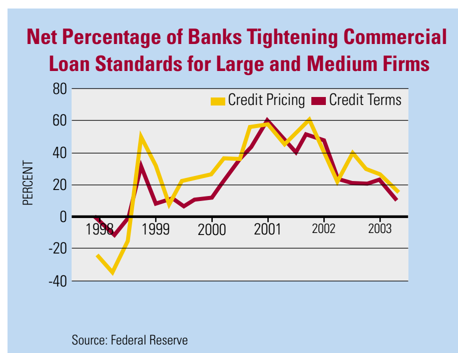
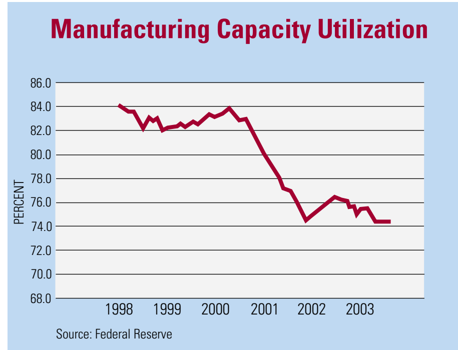
In such circumstances, bankers tend to turn inward, putting marketing efforts on hold. Invariably, this means tighter credit accommodations for middle-market firms. This time around was no different. Many borrowers suffered stricter terms, reduced availability, and higher pricing as bankers grappled with their problems. Aggressive efforts were undertaken to purge weak credit relationships from commercial loan portfolios. In 2001, BofA publicly announced a decision to reduce commercial credit commitments by some $30 billion. They were stunningly successful. Within a year they managed to run off more than $100 billion in commercial relationships.





Now, this process has largely run its course. Delinquency rates have stabilized and exposures are, for the most part, well-reserved. This economic downturn is notable for the lack of major bank failures or bailouts. Banks have emerged with their capital positions intact. Problem deals are being worked down through a combination of restructurings, refinancing, liquidations, loan sales and charge offs. The process of portfolio rationalization has been sped along by extraordinarily low interest rates that have allowed borrowers to lower debt service costs and work down or refinance debt. Even though a massive investment bubble has burst.

When you talk to local bankers, you hear concerns about the runoff of assets (loans) and the need to grow. Bankers at B of A, Wells Fargo, US Bank and all of the asset-based lenders are now saying that their organizations have a renewed appetite for credit and are beginning to shift from an internal credit focus into a marketing mode. Apparently, banks can't turn away new lending opportunities and meet Wall Street's revenue and earnings growth expectations. This shift in lending posture is borne out in the Federal Reserve's April, 2003 Senior Loan Officer Opinion Survey, which indicated that the proportion of banks tightening standards for commercial and industrial loans to large and middle-market companies fell to nine-percent, the lowest measure since November, 1999.

While no one is handing out cash quite like they were in the "easy money" 1990's, there has been a noticeable pick up in competitive interest in new financing opportunities. There is some evidence of more aggressive underwriting parameters. Selected leveraged financings have been getting done in the 3.5X debt to EBITDA range, as compared to the 2X - 2.5X range that prevailed over the past couple of years.

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While money is available, demand remains soft. According to the Federal Reserve, banks are generally reporting weak demand for new commercial loans by middle-market and large companies since the first of the year. Now that banks are in the mood to lend, it seems no one is clamoring for the money. Much of the current lending activity seems to be focused on refinancings that simply move existing credit from one lender to another in

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exchange for more liberal pricing and terms. Business investment has not yet begun to rebound. Capital-intensive manufacturers are generally not adding or revamping capacity and few seem to be building inventories. Annual growth in U.S. industrial capacity has declined to a near record low of almost one-percent. At the same time, middle-market M&A activity remains soft, although the overall level of activity has been bolstered by a handful of very large deals.

The world is awash in excess capacity in a host of industries (automobiles, telecom, consumer electronics and durables, airlines, hotels, apparel and banking services). Global supplies of goods and services exceed demand as the result of over investment in new capacity, particularly in China. The impacts of higher productivity and excess capacity are aggravated by a slump in demand brought about by weak consumer confidence. Manufacturers and retailers in many sectors have found it necessary to cut prices over and over in the effort to stimulate consumer demand.

As long as weak demand and excess capacity prevail, it is difficult to see a strong pick-up in commercial credit needs. The pressure on lenders to generate new loan assets won't evaporate anytime soon as the pendulum swings back toward the "greed" zone. It is fair to expect that lenders will compete vigorously to handle companies' financing needs as the economic rebound gains steam. ❖

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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.

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