Zachary Scott
INVESTMENT BANKERS

IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS

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Report From the Credit Front

Credit is tightening—be prepared.

by Michael T. Newsome

Certain segments of the global credit markets continue to experience great difficulty. Asset-backed structured-finance vehicles, known as CLOs, CDOs and CMOs, are still struggling with the sub-prime mess and have deeply shaken the confidence of money market (commercial paper) investors. Defaults on sub-prime mortgages were the catalyst for the turmoil, but credit problems are cropping up within other consumer loan categories (auto loans, credit card receivables, and home equity lines). Major banks (Citi, BofA, UBS, Merrill, JP Morgan, and even those with sterling credit reputations, such as Wells Fargo and Suntrust) have been tarnished as they grapple with deteriorating asset values in structured-investment vehicles that they sponsored or manage. Over the past few years, the practice by large commercial and investment banks of arranging and packaging increasingly risky loans in the quest for fees and yield has proved that risk cuts both ways. In time, the rest of the credit markets will feel the pain.

GLOBAL CREDIT BUBBLE

The spread between 3-month LIBOR (the rate that reflects the cost of borrowing by banks among themselves) and 90-day Treasuries (the rate at which the U.S. Treasury borrows) provides a clear signal that investors and lenders see the problem. The spread averaged 35 basis points in the first half of 2007, and then spiked up to 243 basis points in August, as the credit crisis took root. Investor fears subsided for a few months, but rebounded at the end of the year. Today's 200+ basis point gap denotes both a flight to quality by money market investors, anticipating that the global credit bubble is only beginning to unravel, and a troubling wariness among banks to lend to one another due to concerns about the relative quality of their balance sheets. The result is a liquidity problem within the bank market that is reflected in higher funding costs for banks and their consumer and commercial customers.

THE SUB-PRIME FALLOUT

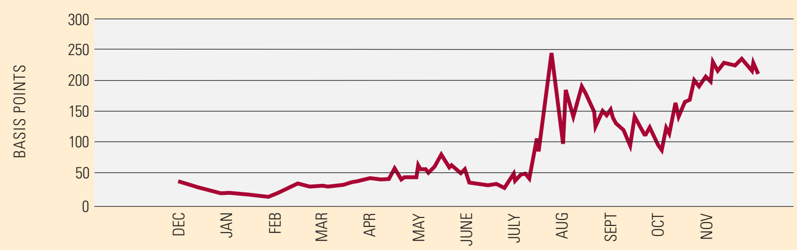
To address the sub-prime fallout, a number of institutions have been forced to replenish their reserves by cutting dividends and raising additional capital. At the same time, central banks (the Fed, the European Central Bank, and the Bank of Canada) have cut rates and pumped a stunning amount of liquidity into the inter-bank market in an effort to stave off the risk of the financial system seizing up. By itself, the ECB injected the extraordinary sum of $502 billion on December 18th. More will be done in an effort to keep the money markets functioning. While bankers and regulators are not publicly professing doom and gloom, there is little doubt that the problem is quite serious and has not been fully defined.

THE CHANGING MARKET

In spite of the turmoil, it is not yet clear that there has been a major change in the availability of credit to middle-market companies. Firms are still finding accommodating lenders offering reasonable terms and rates. Nevertheless, you can feel a change in the market:

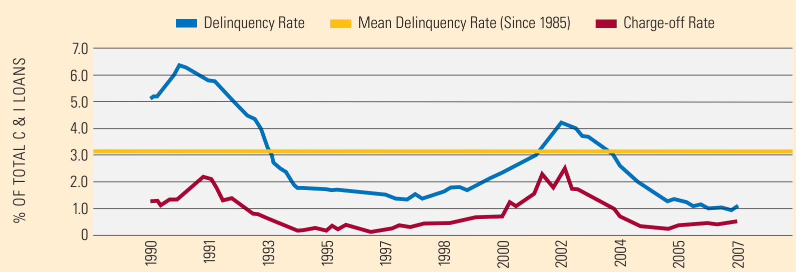
- Leveraged lending has tightened up. Credit spreads are up more than 150 basis points for large institutional financings. Middle-market leveraged deals are now priced in the range of Libor + 450 to 600 basis points, as compared to a 250 to 300 basis point spread when the market was roaring along in the first half of 2007.
- Permitted leverage (senior and total debt to EBITDA) is declining. Nine months ago, it would have been reasonable to arrange senior debt approaching 4x EBITDA for a middle-market buyout. Today, the limit is closer to 3x in most situations.
- Second lien financing activity has dwindled to nothing as lenders eschew the risk/reward ratio of this structure.
- The market for broadly syndicated loans remains bogged down. In December, Standard

Spread Between 3-Month LIBOR and 90-Day Treasuries



Source: Federal Reserve

Commerical & Industrial Loan Problems



Souce: Federal Reserve

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and Poors reported a queue of $157 billion in new financings, down from a peak of more than $237 billion last July. A good share of the difference reflects deals that simply evaporated. In any case, the pace at which new deals clear through the pipeline has slowed. CLO activity, which accounted for about 60% of the demand for leveraged loan securities before the market shifted, is a shadow of its former self. Other investors (hedge funds, regional banks, and alternative investment vehicles) have filled a portion of the void left by CLOs, but their appetite for new commitments is weak relative to that for seasoned loans at very attractive discounts to par value available in the secondary market.

BANKERS CHANGING ATTITUDES

Thus far, bankers have had few worries regarding their commercial and industrial loan portfolios. Default and charge-off rates have been well below the historical mean. But, as a harbinger of challenges down the road, problems—tight borrowing bases and blown covenants—are springing up in the portfolios of asset-based lenders that cater to middle-market companies. Odds are that default rates will begin to revert to (and possibly move well above) the mean in 2008, as the credit bubble deflates and the economy slows. There is nothing like a loan loss to change the attitude and appetite of a banker.

For the owners and managers of middle-market businesses, all of this may seem a bit esoteric. If you are not selling a business or raising a large amount of debt capital to buy or build something, why worry about the turmoil in the structured-finance and leveraged-loan markets? But, remember, just like the broader economy, all of the credit markets are intricately knitted together. The problems in mortgages, commercial real estate loans, CLOs / CDOs, and leveraged-buyout financings that are plaguing big banks will impact access to middle-market business credit.

SOME SIMPLE ADVICE

Our advice is simple; "Don't be caught unprepared." This is the time to begin to adapt to a more restrictive credit environment:

- Stockpile liquidity by increasing credit commitment amounts and extending maturities.
- Develop alternative sources of capital.
- Be more aggressive in the management of working capital.
- Reassess your company's business plan, testing the sensitivities of operating cash flow to changes in the business environment. Adjust your cost structure to build in room for error.
- Be judicious with capital investments.
- Keep your lenders well informed about your business.

It is not too late and there is no reason to panic, but start now! ❖

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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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