Zachary Scott
INVESTMENT BANKERS

INSIGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
SUMMER 2010

The Middle-Market Credit Worm Turns Again

Many lenders and investors are pursuing middle-market opportunities with gusto, but for how long?

by Michael T. Newsome

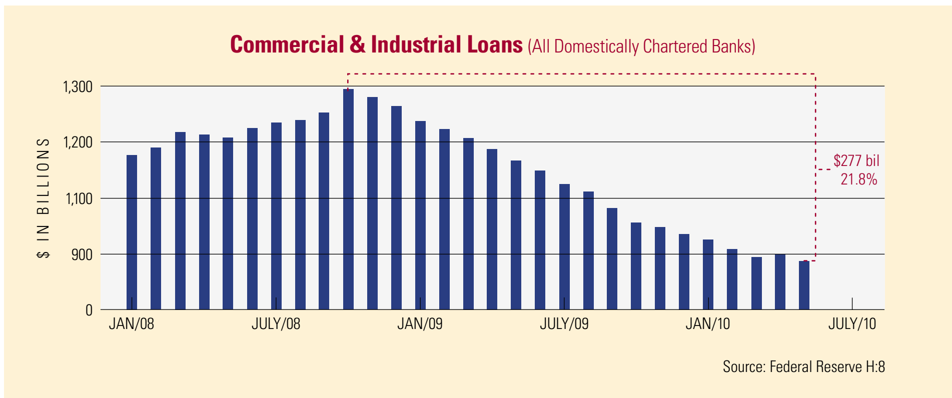
If you have followed our credit market ruminations in this space over the past several years, you know that our view has been that most banks have suffered sufficient trauma in 2008 and 2009 to impair their risk appetites for years to come. Could it be otherwise? The rubble left behind by the credit dislocation is only beginning to be digested. Nevertheless, we have been genuinely surprised by the brio that many lenders and investors have exhibited over the past three or four months in pursuit of credit opportunities. It seems that risk aversion is again being pushed aside as some financing is getting done on what can best be described as pre-crisis terms.

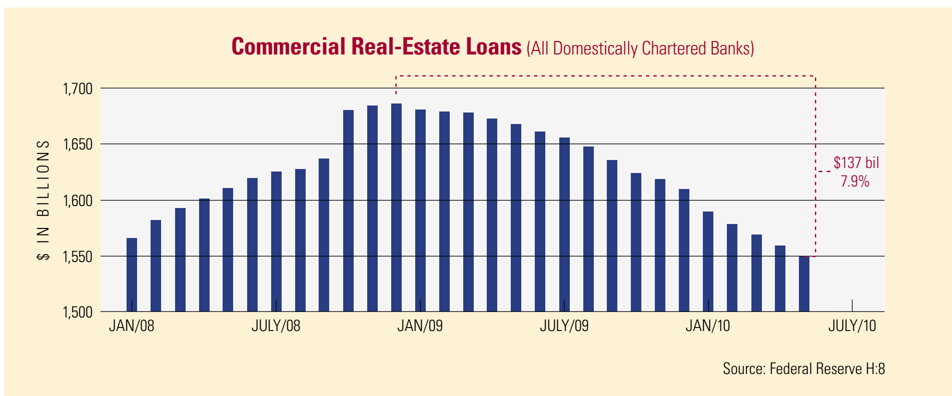
The real eye opener has been the speed at which skepticism and selectivity have faded among high-yield bond investors, a bellwether of risk appetite. There are some interesting examples in the past several months of companies in the Northwest and elsewhere issuing healthy increments of high-yield financing at leverage levels well north of seven times EBITDA. In the best of times, this is dicey territory for even bullet-proof middle-market businesses. One is left to wonder whether the bondholders that are stepping into these deals have a real grasp of the challenges faced in handling this level of debt. The astounding aspect of many high-yield financings is that much of the proceeds have been channeled towards shareholders, rather than into internal investments or accretive acquisitions.

Admittedly, most of our clients are not tapping the high-yield market. But, as enthusiasm for return at the expense of risk gathers steam, similar sentiments are cropping up in leverage lending and are now finding their way into middle-market finance.

BALANCE SHEET REALITY

The big banks have, in the main, rebuilt their capital positions through a combination of public equity raises, earnings aided in part by access to almost costless funding from the Federal Reserve, retention of TARP capital (e.g. KeyBank), and asset runoff. Asset contraction serves as the prime impetus for lenders' current desire to make loans. As





Admittedly, most of our clients are not tapping the high-yield market. But, as enthusiasm for return at the expense of risk gathers steam, similar sentiments are cropping up in leverage lending and are now finding their way into middle-market finance.

illustrated in the nearby charts, banks have seen significant loan reduction since the peak reached during the fourth quarter of 2008, representing evaporation of a bit more than $410 BN of C&I and CRE assets, a 13.9% decline. Bank capital and surplus liquidity are seeking better earning assets in a soft market. The choices are rather slim.

Commercial real estate and consumer credit (including credit cards, mortgages and home equity lines) currently account for about 57% of total bank credit. Consumer loan demand is weak as the housing market continues to struggle. The recent growth in consumer credit can be largely attributed to the now-complete surge in mortgage refinancing and the movement of financial assets from securitization structures on to bank balance sheets. Banks have scant interest in putting new capital to work in the painfully over-capitalized commercial real estate sector, where further value erosion is foreseen.

Business lending remains as the one area where banks are hopeful of expanded activity. Asset growth goals for bankers have been

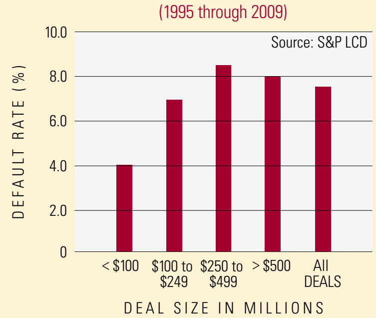
(continued p.2)

ASSET TYPE	CHANGE SINCE Q3-2008	STATUS
Securities	+ 17.1%	Growth attributed to flight to quality and nearly costless government funding. Banks are now trying to reverse this and shift toward higher yielding assets.
Commercial & Industrial	- 19.3%	Due to lower credit line usage, limited business investment, weak M&A activity, and charge-offs.
Commercial Real Estate	- 5.4%	Accelerating foreclosures and charge-offs translate into little lender appetite.
Total Consumer[1] [1]Includes credit cards, mortgages, home-equity loans, and other consumer debt	+ 15.8%	Growth reflects a now-completed refinancing surge and movement of assets out of securitizations on to bank balance sheets. Consumer demand is limited and mortgage applications are at all-time lows.
Other Loans & Leases	-22.2%	Fed funds and repos sold to non-banks and other miscellaneous loans.

cranked up in an effort to find higher returns for under-employed capital. Middle-market lending is back in vogue and the safety and security of a low-yielding securities portfolio is out. Right behind general middle-market lending on the bankers' dance cards is leveraged lending for middle-market buyouts. Resurgent appetites for this credit segment have been bolstered by the fact that middle-market loans have traditionally performed well relative to the broadly syndicated financings of larger companies. Over the past 15 years, the cumulative default rate on deals in excess of $100MM has been nearly double the default experience on smaller middle-market financings.

If the pricing for the risk is indeed better than for other alternatives, lenders will be drawn to the opportunity. Unfortunately, in today's market, the missing link is demand for credit. While rumor has it that the economy is on the mend, out here in the real world the rebound is tepid at best. A boost in activity

Cumulative Loan Default Rates
(1995 through 2009)



was felt in late 2009 and early 2010 as businesses began to write or receive new orders to replenish dwindled stocks after one of the deepest inventory cycles in history. Currently, few companies are rebuilding inventories to pre-crisis levels, or expanding capacity with new equipment or facilities. There simply is no compelling economic driver for broad-based middle-market business or loan growth.

The upshot is that bargaining power has again shifted to the benefit of borrowers. The stronger banks in the Northwest are competing vigorously to protect existing relationships and to lure healthy clients away from other lenders. In this enviroment, it is again an opportune time to solidify and improve credit arrangements with the objective of building additional availability (liquidity), relaxing restrictive covenant arrangements put in place in just the past 18 months, extending maturities (well beyond three years), and rolling back pricing (Libor floors are disappearing and L+100 bps is no longer unusual). A fair and competitive process is likely to yield significant benefits to borrowers.

Although the credit spigot is open, it is difficult to identify the rationale for a continued long-term favorable environment for middle-market credit. Conditions can change quickly. Just in the past month, what had been a red-hot high yield market, with record new issuance of more than $150 billion year-to-date, cooled rapidly in response to sovereign debt concerns and weak economic data. Worry is growing that the economy may again be turning lower. If this comes to pass, bank capital will be back under pressure and credit strains will reemerge. The evidence suggests that a wave of credit maturities lies ahead beginning in 2012. All of this portends the strong possibility of another period of tight credit. Today's respite should be seen as an opportunity to reset credit on improved terms. ❖

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