Zachary Scott
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Credit Confusion

It's challenging now, but not impossible, to get financing from banks.

by Michael T. Newsome

Although we have devoted a good deal of coverage in this and past editions of IN$IGHT to the constraints on the lending activities of banks, Northwest middle-market companies are not without access to debt capital. The credit situation remains challenging, but not impossible. A couple of things can be said with confidence about the bank credit market.

- Lenders seem to have lost some confidence in their own judgments. This is reflected in a much longer process to reach a decision and newfound skepticism regarding the future. From the outside, it now seems that there is little or no penalty for declining new lending opportunities.
- Companies are less creditworthy. The received wisdom among lenders regarding the stability of cash flow in numerous industries fell far short of the mark. Many bankers learned (relearned) a harsh lesson that, in the absence of customers and the attendant cash flow, the value of most tangible and intangible assets ends up severely impaired.

Credit underwriting is a blend of quantitative analysis and subjective judgments. The principal fault lines that segment credit availability are fundamentally tied to (a) business or cash-flow stability, and (b) business or credit size. While these fault lines are not altogether that different than in the past, today's credit standards are the tightest in many years. Some businesses that easily found credit in the past will be shut out in today's environment

Our experience with financing assignments in 2009 has been that lenders are highly discriminating, or more precisely, quite timid. This has been particularly true in any situation where there is limited familiarity with the industry, the business or its management. This trend is probably best evidenced by the number of proposals received for a given opportunity. Prior to the credit meltdown, we routinely received proposals from a large majority of the lenders contacted. Today, a similar lending opportunity may only draw genuine interest from a quarter to a third of the lenders contacted. In light of tighter standards, it is necessary to more thoroughly canvass the market in order to turn up interested lenders. Without doubt, there is greater hesitancy to lend, which is further confirmed by much greater diversity in the range of pricing, terms and conditions in the proposals received on individual deals.

No more Andrew Jacksons in your future? *While the credit situation with banks remains challenging, it's still not impossible to get financing for your company.*

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In spite of strong banker reticence, a large number of middle-market companies, if not most, have been able to maintain and renew their credit facilities. A smaller set of businesses has actually generated sufficient competitive fervor among bankers to expand or improve credit arrangements on terms reminiscent of the pre-crisis market.

HOLD STEADY

In an uncertain economic environment, no single factor carries more weight than cash flow stability. Businesses that have adjusted to the downturn and performed well over the past two years have a decided advantage in accessing bank funding, based on a presumption that they are more likely to continue to perform well. Most importantly, the perception of stability is tightly linked to familiarity with the industry, business and management.

In part, the evaluation of cash flow focuses on analyses of the characteristics of customer demand. Businesses that rely on discretionary consumer expenditures, particularly large ones, have limited access to credit. It is no surprise that manufacturers and retailers of autos, boats, furniture, and luxury products have been hard hit. The same goes for providers of travel and leisure services, such as resorts, gaming, cruise lines, hotels, and virtually anything related to construction. Borrowers in these and similar industry categories are likely to find little lender interest, small tolerance for leverage, and relatively punitive pricing. On the flip side, those industries and companies that have demonstrated resilience in spite of waning consumer demand, find a much more favorable reception among lenders.

Traditionally, bigger has been better. Larger companies are generally deemed to be more resilient and have a more diversified customer

(continued p. 2)

Cash Flow Stability: *Those businesses that have performed well over the past two years have a decided advantage over businesses that haven't.*

base, a deeper management bench, and more defensible market positions. Companies focused on consumer staples (food and beverage processing or distribution), utility-like services (waste disposal, energy, or communications), or healthcare remain quite attractive to lenders. For example, a beer distributor's favored status is a consequence of the rightful perception of stable demand and cash flow, and is manifested in higher permitted leverage and better-than-average pricing.

COMPETITIVE LANDSCAPE

Prior to the financial crisis, investor (bank and non-bank) demand for shares of large syndicated credits routinely exceeded supply, which made for very flexible terms and aggressive pricing of risk. The worm has turned; the market for syndicated credit is smaller today, as the credit appetites of banks and investors either have been trimmed or disappeared altogether. Many of these investors have learned the hard way that much of the pre-crisis risk they undertook constituted bad bets.

The contraction in the loan-investor pool has shifted negotiating leverage in broadly syndicated transactions from borrowers and their agent banks to loan investors. The last few investors in a syndicated deal now have an ability to drive market terms and pricing. As a result, large corporate borrowers no longer enjoy the most favorable credit arrangements.

All other considerations being equal, borrowers whose needs (< $50 million) can be met by a single lender have the opportunity to arrange credit on the most favorable terms, if a competitive process can be orchestrated. The single-bank financing "sweet spot" might be more tightly defined as $10 to $30 million, a range that presents the opportunity to get the broadest competitive interest. Lenders are very intent on retaining their highly valued customers.

The most highly contested situations generally involve Bank of America, Wells Fargo, and US Bank squaring off after the incumbent lender disappoints the borrower in some manner. Once the customer has begun to "explore alternatives," banks are more than willing to sharpen their pencils to gain market share and bragging rights for having landed a trophy customer from a competitor.

TACTICS

The stability and size fault lines of the post-financial-crisis credit market should inform borrowers on the tactics for dealing effectively with banks. First, it is wise to anticipate an extended time period to put in place a new banking relationship. Banks can be led, but they can't be pushed. Efforts to cultivate a relationship with a lender must focus on the following:

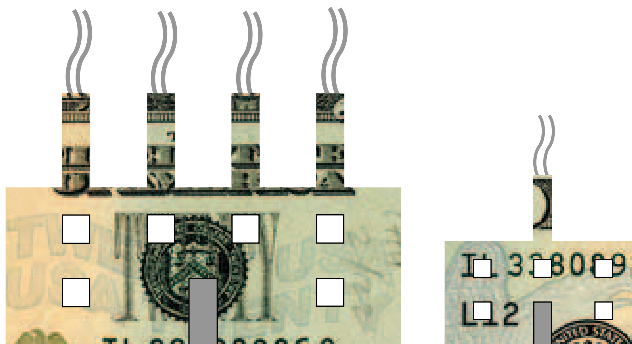
- A well-articulated business case, long on facts and evidence and short on "blue sky," that specifically addresses the competitive and other factors that may impact cash flow stability.

The worm has turned; the market for syndicated credit is smaller today, as the credit appetites of banks and investors have been trimmed or disappeared altogether.

- Sufficient time to develop familiarity and comfort with the business and its owners and managers.
- Fostering competition to get a "market" credit arrangement.

Of all of these considerations, the lender familiarity and comfort that can be derived from building positive relationships with a broad range of bankers is probably the most important. A relationship does not guarantee credit access, but it does diminish lender skepticism. Perhaps, this is just another way to say reputation matters. ❖

Advantage to Larger Businesses? *For lenders, larger companies are a safer bet. Larger companies are generally deemed to be more resilient and have a more diversified customer base, a deeper management bench, and more defensible market positions.*



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.

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101
www.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