Zachary Scott
INVESTMENT BANKERS

IN$IGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
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Twenty Years of Reflection

Much has changed, but not Zachary Scott's philosophy of working with clients.

"It was a dark and stormy night"… or so every Snoopy story began. Although admittedly there was some late night soul searching at the beginning, Zachary Scott opened its doors on a bright sunny day in the middle of a Pacific Northwest summer on August 1, 1991.

It would be a great story to tell that Zachary Scott was born out of entrepreneurial inspiration to field a "better mousetrap." The truth is that the firm was born out of change.

The late 1980's was a heady time to work at Bank of America's Pacific Northwest investment-banking outpost (still known as Seafirst Bank at the time). The combination of the bank's dominant position as a middle-market lender, a motivated team, and a dearth of direct competition led to a string of client successes. But, the business world is never static, and in spite of great success in this small corner of the BofA empire, we recognized that our group was just the tip of the tail on a rather large and growing dog.

In early 1991, BofA reorganized its investment banking functions to tighten its focus on large businesses as the wall separating commercial and investment banking—the Glass-Steagall Act—began to crumble. Money-center banks were pushing hard for deregulation, freeing them to compete with Wall Street. The implication for the private-company dominated Pacific Northwest was that BofA would target only the very largest businesses for investment banking services, leaving the middle market to others. Zachary Scott was created to be the "other". We designed our service model to fit our expertise and personalities—we are more financial engineers than salesmen. Our advice to clients is based on our opinion, after a thorough study of the economics of each business and the dynamics of its industry, of how to create the most shareholder value.

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We understood at the outset that the sales cycle in our business would be long, but that to be successful we must always put the client's interests above our own. Twenty years later, we are proud to say that we have been true to that principle.

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Our approach to business also provided some clear guidelines that have become the backbone to the firm's culture. We don't offer advice in areas we don't understand. Therefore, certain areas of technology and early stages of business development have escaped our grasp. Intellectual honesty is a prerequisite to all of our advice. Although not always right, there must be specific reasoning behind each recommendation. Our reputation depends on it.

We should get this out of the way up front. The name of the firm is rooted in family— "Zachary" is the name of Mark Working's oldest son, now 28, and "Scott" is the "S" in William S. Hanneman. In much the same way that a person's name can be inexorably linked to a personality, Zachary Scott has carved out its own unique identity, of which we are quite proud.

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RECOLLECTIONS OF THE LAST TWENTY YEARS

The Evolving Landscape

Looking back over the past twenty years, the one universal factor has been change. There are profound differences in the players, the markets, and even the way business is done. As with our own situation, business conditions evolve as do the players, or they go by the wayside.

PUBLIC ACCOUNTING

Virtually every segment of the financial services industry saw wrenching change. At the zenith of the "Big is Beautiful" era, the seemingly indissoluble "Big Eight" core of the accounting industry briskly consolidated into the Big Five to cater to the compliance needs of public companies. The ignominious implosion of Arthur Andersen, as the consequence of the malfeasance at Enron, left just the Big Four. Smaller national firms (Grant Thornton, RSM McGladrey, and BDO Seidman), as well as regional firms (Moss Adams, Clark Nuber, Berntson Porter and others) blossomed to fill the void left in the middle market as the "Big Four" moved to cater to the compliance needs of public companies.

CORPORATE LAW

The practice of corporate law was also reshuffled in this time. Preston Thorgrimson Ellis & Holman and Shidler McBroom Gates and Lucas merged and eventually merged again with Kirkpatrick & Lockhart to form K&L Gates. Riddell Williams became part of Graham & James and then returned to its previous state. Bogle and Gates disbanded, and Heller Ehrman followed suit some years later. Reed McClure split apart, with one part creating the Seattle office of Portland based Miller Nash in the model of how Jones Grey & Bayley became the northern outpost of Stoel Rives a few years earlier. In the late 1990's, a number of new firms set up shop in the Pacific Northwest to serve technology startups.

BANKING

We take great interest in the Pacific Northwest bank market, particularly the big national banks, the regional players, and the asset-based lenders. For many of our clients, these institutions are the primary external capital providers and, therefore, are of enormous importance. The banking landscape has been completely redefined by consolidation. Many familiar names have faded into history. At the inception of Zachary Scott, there were nearly 12,000 banks chartered in the U.S. Today, there are just 6,300 banks and the top 25 institutions hold 56% of total bank assets.

PRIVATE EQUITY

Important new capital providers arrived on the scene. In 1991, the private equity industry was in its infancy, with only one firm, the Northern Group, headquartered in the Pacific Northwest. But, as we were just getting our feet wet, a new private-equity firm emerged in Portland, Endeavour Capital, with the princely sum of $25 million to invest. Close on Endeavour's heels, a new $13 million fund known as Capstan, set up shop in Seattle. Neither the Northern Group nor Capstan endured, while Endeavour has flourished, today, managing over $1.75 billion. Other private equity firms have successfully followed in Endeavour's wake. Blue Point Capital, Evergreen Pacific Partners, and Northwest Capital Appreciation have collectively deployed more than a billion dollars in Northwest businesses. By our last count, in excess of 300 Pacific Northwest companies have private equity investors.

INVESTMENT BANKS

Seafirst/BofA, Security Pacific, Dain Bosworth, Ragen McKenzie, and firms outside the region, including Robertson Stephens (San Francisco), Houlihan Lokey (Los Angeles), and Piper Jaffray (Minneapolis), served the middle market in the early 1990's. Over the succeeding twenty years there has been significant churn in the participants, with a host of firms entering and subsequently departing. In contrast, Zachary Scott has been an island of stability, where no principal has felt the urge to move on. This is our turf.

INDUSTRY

Twenty years of change within bedrock Northwest industries-such as aerospace, forest products, agriculture, seafood, transportation, technology and building products—are simply too extensive to catalogue in this space. The privately held, middle-market firms, which form the core of this economy and our business, were not immune to shifting industry dynamics. These forces have served as a catalyst for a number of our assignments.

RECOLLECTIONS OF THE LAST TWENTY YEARS

Transformative Relationships

Our success is the consequence of having great clients. Many of our assignments have resulted in cherished, long-lasting relationships. With each client and engagement, we learned valuable lessons. A few relationships illustrate the ways in which clients have benefited from our range of capabilities.

CELLO BAG

Cello was an early client that reflected the breadth of needs a business and its owners might experience over time. The company produced flexible packaging in Tukwila, Washington. It extruded film, applied print, and created bags as packaging for diapers. They did it in a major way, supplying companies such as Proctor and Gamble and its ubiquitous Pampers brand. Cello was owned by a group of individuals that relished the benefits of the steady dividends it generated. Given its demanding global customers, this led to a conflict between the capital needs of a growing business and the requirements of owners for income. We had the good fortune to assist the management in structuring a buyout and recapitalization of the business to resolve that issue. This, in turn, set the stage for the construction of a new state-of-the-art production facility in the eastern U.S. With that expansion accomplished, we then led a series of recapitalizations; first, to buy out the private equity partner, and then to refinance the mezzanine debt with senior credit. As P&G sought global, rather than regional, suppliers, we ultimately engineered the sale of a minority interest to a large Australian packaging company. After several years, the next logical step was a complete merger, and we were there to help make it happen. The end result was a great deal of wealth for the group of talented managers who pointed the way.

MIKRON INDUSTRIES

A bit farther south of Cello in the Kent Valley was a little company, Mikron Industries, founded by two entrepreneurs, Mike and Ron. Over time, Ron Sandwith assumed control of Mikron and pioneered the extrusion of vinyl profiles (framing material) for the residential-window industry. This was a major leap forward in window energy efficiency and, as vinyl supplanted aluminum, the business grew. Powered by Ron's unstinting passion, Mikron cultivated an exceptional team of

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people, invested heavily in technology (much of it developed in-house), applied the principles of W. Edward Deming and Lean Manufacturing, and maintained a laser focus on serving its customers. Mikron was renowned for leading-edge window-frame design, just-in-time product deliveries, and tight inventory control. All of this led to Mikron becoming the sole-source supplier of vinyl profiles to most of the window companies in North America. The business grew tenfold from the time of our initial acquaintance with Ron.

Similar to Cello Bag, the company required capital to meet its customers' expanding needs. Again, it was our good fortune to help it through a string of refinancings to fund new plants and acquisitions. Unfortunately, Ron contracted a terminal illness and left us. His able management team, which included three of his sons, continued on. Eventually, as the industry matured, it became apparent that Mikron needed to broaden its product offerings. Rather than take on that stage of expansion, the company was sold, with our help, to Quanex Corporation.

RABANCO

Unlike corporations, individuals have investment horizons, which at times are driven by unforeseen events. And, so it was with Rabanco, the largest independent waste collection and landfill operator in the country. When the principal owner and CEO, Warren Razore, fell ill and was no longer able to lead the family business, the decision was made to sell. Warren was an industry icon and had hosted every waste industry CEO for dinner in his home at one time or another. All he needed to do was pick up the phone and buyers would be on the next plane.

Warren's advisors convinced the family to engage professional assistance and, although pursued by every bulge bracket investment bank in the country, the owners opted for the local presence and personal service model of Zachary Scott. At that time, the industry was in the midst of intensive consolidation and Rabanco represented a coveted opportunity in the state of Washington. Competition for Rabanco's market position and local reputation was intense. The transaction result still stands as the valuation high-water mark for a waste-industry transaction. The buyer, Allied Waste, followed by swallowing another industry giant, Browning Ferris, and then in turn was swallowed by Republic Services. Since that time, industry valuations have settled, pointing out that the strategic importance of a business is not permanent. While an unfortunate illness served as the catalyst, the transaction confirmed the importance of market dynamics, where strategic value can abruptly change as industries are reconfigured.

The reality that significant shareholder value can be created during periods of industry transition has been proven time and again in engagements for the owners of Seabird

Electronics, Nile Spice, Davinci Gourmet, SeaCoast Foods, Sun Media, Working Solutions, MacGregor Publishing, and many others. The owners of each of these companies were able to recognize an inflection point in their industries and had the presence of mind to exit at or very near the peak of value. When it comes to strategic value, it turns out that timing really does matter.

Along the way, some owners waited too long or the changing dynamics were not apparent until too late. Our distress situations practice has, over the years, been fueled by many of those unfortunate situations.

UNIVERSAL TRUTHS

Through observation and experience, several "truths" have repeatedly been proven and form the core of our thinking about the way the world works.

1: Investment bankers don't create value. Value is created by the owners and managers who direct strategy and capital deployment, and by the seasoned employees that carry out the blocking and tackling. That being said, investment bankers play a critical role in assisting managers to consider business and financial strategy, arranging capital to grow the

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business, and, ultimately, helping to unlock the value that has been created.

2: Trust is earned. Certain advisors, whether they are investment bankers, lawyers, board members, or caring friends, often provide valuable input on company strategy and direction. However, advice is only "heard" from an advisor who has earned the right to speak.

3: People do business with people. The strongest business relationships develop as a result of people helping other people. In every industry there are firms that can compete on price and volume, but those who prove to be worthy of trust and are consistently reliable are the most valuable.

4: What's good for the owners isn't always what's good for the business. The strategic value of a business is time sensitive and perishable with the changing dynamics of an industry. Rarely does the timing of industry restructuring or the peak of value coincide with the retirement age of the owners.

5: There is no free lunch. Enduring economic value is only created from new or better ways to fulfill an economic need, combined with hard work and persistent effort. The reward for meeting that economic need is profit, which ultimately is the sole determinant of value.

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RECOLLECTIONS OF THE LAST TWENTY YEARS

Next Twenty Years? *It has been a heck of a ride so far. We have experienced long periods of robust economic growth punctuated by bursting asset bubbles and painful retrenchment.*

While we don't pretend to be economists, just interested observers, we can't help but note a couple of financial market trends that we think will be important in the future:

1. The use of leverage in the economy as a whole has spiraled up relentlessly. Businesses and consumers have only recently begun to deleverage in the aftermath of the financial crisis. Much of today's economic policy discourse has addressed redirecting this trend,

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yet governments here and around the world continue to borrow heavily. As the eminent economist Herb Stein once observed, "Trends that can't continue, won't." When the painful process of deleveraging does gather momentum, it is likely to heighten uncertainty and the perception of business risk. The prudent business decision is to reduce financial risk by employing more conservative capital structures.

2. Private equity has steadily evolved from its slim beginnings in the 1980's to a maturing market, deep with capital and a diverse set of investors. Today, it is estimated that private equity accounts for roughly one-third of the ownership of privately held U.S. businesses. Some half a trillion dollars of capital is currently queued up to pursue new opportunities. As the use of leverage is tempered, private equity is destined to become an even more important capital source. To compete, family-owned businesses will need to polish and refine management, systems and strategic decision-making.

As businesses adjust to changing conditions, so have we changed our approaches, learned new skills, and adopted new processes in an effort to meet the new rhythms of a global market. The same will be true over the next twenty years. Yet, some things won't change for us. Zachary Scott began with and adheres to the simple objective of providing our very best advice to owners, whether or not they want to hear it. This shouldn't be construed as arrogance, but rather as a commitment to remain objective as honest brokers of the merits of competing alternatives. Sometimes, that has created conflict with a potential client's desire to hear only good news, and can mean pulling away from a transaction because the economics aren't favorable, or undertaking initiatives to improve the business before pursuing a transaction. Many clients and their advisors have appreciated hearing an unvarnished perspective. As experience, knowledge, and talent have been added to our team, we have more to offer our clients. We will continue to grow and improve, and look forward to continuing to build on this legacy with future clients.

IN$IGHT

This publication has become our trademark connection with the market. After experimenting for several years with different forms of newsletters, we settled on this quarterly format where, in each issue, we attempt to address a few topics relevant to business owners and their advisors and capital providers. Readers have suggested some of our subject matter and we appreciate those who take the time to provide constructive thoughts

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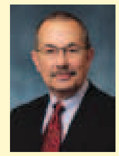
and ideas on each issue. Articles from more than ten years are available on our website. The work of crafting each article tends to be a process of untold internal debate and strife. But, we prevail as, like it or not, it's only us.

THANK YOU!

To our great pleasure, the vast majority of our clients over these past twenty years continue to be close friends and our most ardent supporters and references. Likewise, many professional advisors have graciously brought us into their confidence and shared their clients. To each of you we offer our sincere gratitude. We are humbled by your trust and support and look forward to continued professional collaboration and friendship. ❖

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.



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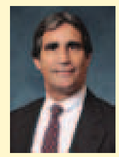

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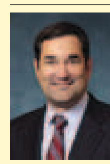

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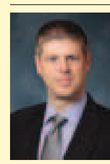

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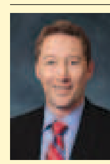

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