Zachary Scott
INVESTMENT BANKERS

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# The Credit Window is Open

*Due to weak demand and banks efforts to shrink balance sheets, bank capitalization has improved substantially.*

*by Michael T. Newsome*

Just a year ago, we expressed real concern about capital adequacy within the banking system and the potential for a further credit squeeze if and when loan demand picked up. In particular, we were uneasy about the implications of a major wall of non-bank credit maturities that would compete for scarce bank capital over the next several years. Now, at the outset of 2011, our fears of a capital shortage have not been realized. In fact, given the weak demand for credit in general, there is ample bank capital available and little or no constraint on commercial and industrial (C&I) credit for those borrowers that qualify.

Business credit is delivered to middle market businesses in the Pacific Northwest primarily through the banking system, which we look at in three categories.

- **The "Mega Banks"** Bank of America, KeyBank, JPMorgan Chase, Union Bank, US Bank, and Wells Fargo. These banks have aggregate assets in excess of $6 trillion and collectively represent more than 51% of total bank assets in the US, as well as the preponderance of C&I lending in the Northwest.
- **The "Regional Banks"** Columbia, Banner, Sterling, Umpqua, Washington Federal (WFSL), and Washington Trust (WTB). With the exception of Banner and WTB, these institutions have been actively engaged, in cooperation with the FDIC, in the restructuring of the industry through acquisition of troubled community banks. Collectively, these institutions are important providers of credit to lower middle-market firms and small businesses.

A third category, the "**Community Banks**", comprised of some 65 banks in Washington and 19 in Oregon, account for approximately $14 billion in assets. Currently, 28 in Washington and 9 in Oregon of these institutions are troubled and operating under close regulatory supervision. With a predominate focus on real estate, very small business and consumer credit, they have little impact on middle-market borrowers. Consolidation of many of these banks into the regional banks is likely to continue over the next few years.

## THE MEGA BANKS

This group stepped into more than a few deep holes. Collectively, their net loan charge-offs exceeded $167 billion in the past two years. Because the largest of these institutions were deemed too big to fail, the group has enjoyed a series of advantages. The accommodations include access to a potent combination of exceptionally cheap funding from the Federal Reserve; an alphabet soup of market support programs, such as TARP and TALF, put forward by the US Treasury; an ability to extract non-interest fee income for ancillary services; and access to public and private equity markets. All of this, in combination with an effort to trim balance sheets, led to rapid replenishment of capital. The group's weighted average Tier-1 capital ratio surged from 8.5%, before the crisis, to 11.4% as of September 2010. By any measure, this has been a surprising rebound.

In 2010, this group re-established its appetite for new credit, especially C&I loans to well-performing large and middle-market businesses. Nevertheless, the curve of their aggregate loan portfolio values has continued downward. This is particularly evident when the major acquisitions completed in 2008 and 2009 are removed. Aggregate loan portfolios, which peaked in late 2008, are roughly the same now as in mid-2007, prior to the onset of

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## CAPITAL IS NO LONGER THE CONSTRAINT

The price and availability of capital are traditionally major drivers of economic activity. Three years have passed since the first cracks in the CLO market appeared in August 2007. Since then, lenders have contracted, some closed their doors for good, and some, aided by the federal government, were taken over and absorbed by others. Equity investors turned inward to attend to portfolio companies. The resulting statistics show the story of a market going to sleep.

As discussed in the accompanying articles, lenders and private equity investors are now flush. Yet, in the main, businesses are not acquiring external capital to build capacity or fund new initiatives. Despite the fear of increased taxes on sale proceeds and the inevitability of age, private owners desiring liquidity have not yet rushed to market.

We think the primary factor for delay is owners' disappointment in the financial performance of their businesses. The downward crash of the GDP demand curve has negatively affected many industries and owners have not yet figured out the new equilibrium for their specific businesses. This uncertainty, enhanced by the unknown effects of large-scale public policy initiatives, including taxes, healthcare, and the value of the dollar, are creating a drag on business investment and equity monetization efforts.

We see capital transaction activity on an upward trend with capital flowing first to logical consolidation in reforming industries and to the small number of growth opportunities. As owners perceive greater stability in external factors over time, we expect to see an uneven, but upward trajectory of liquidity transactions across a wide range of industries. ❖

the financial panic. There are a number of contributors to the decline. The two most notable factors have been light demand for consumer and business credit in the absence of real economic growth and overt efforts to shrink balance sheets to meet regulatory capital requirements. Borrowers have been paying down bank debt. At the same time, these six banks have collectively pared back their portfolios by selling or charging off troubled loans, much of that being real estate related.

While tangible evidence of an uptick in loan volume has yet to be documented, there are reasons to expect that credit markets are poised for expansion. First and foremost, the recovery clearly started last year. The exuberance of the high-yield bond market last year was a clear signal that attitudes had changed —greater risk was acceptable in pursuit of incremental return. In excess of $350 billion in new high yield debt was issued (50% more than 2009 volume), and few companies that exhibited both the requisite scale and a pulse were denied access.

This confidence, in turn, spread to middle-market lending where the bigger banks began to aggressively court new customers, so long as the businesses and the industries where they operate were deemed to be relatively immune to the economic downturn. In the main, privately held companies did not build new productive capacity, buy other businesses, or take on leverage to return capital to owners. There was a bustle of lending activity, but no net credit growth resulted.

In an economy best described as tepid, the renewed commercial credit appetite of the big banks led to a number of "credit auctions" where long-standing relationships were shopped among a number of banks and often moved to a new lender. In part, this is a consequence of the relationship bruising levied by the credit tightening in 2008 and 2009. While the data is not available to quantify the shift in market share between the major players in the Northwest, it seems clear that US Bank and Wells Fargo made gains, while Bank of America and Keybank gave some ground. JPMorgan Chase made clear headway, but on a non-existent base and Union Bank appears to have held its own.

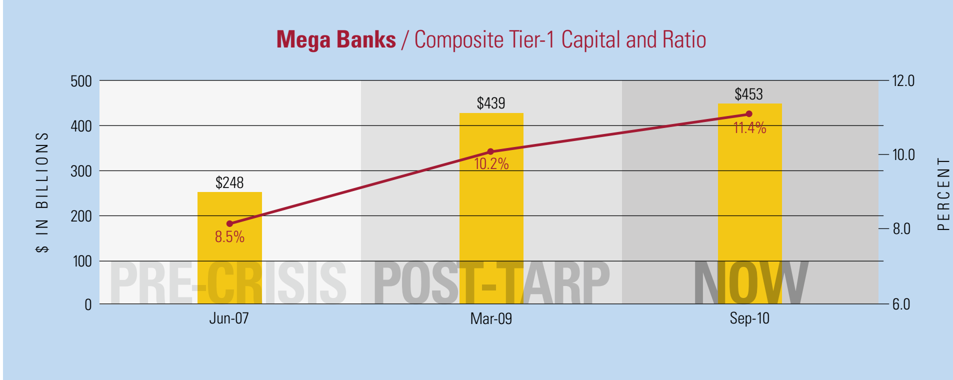
Excess credit supply has been reflected in lower credit spreads and the liberalization of terms, often unwinding tighter availability and covenant structures put in place just a year earlier. For the most desirable middle-market borrowers, 2010 looked remarkably like 2006 or 2007. Frailer borrowers, particularly those in riskier cyclical industries (e.g., building products or large-ticket consumer durables), either limped along with existing credit arrangements or found new homes with asset-based lenders. Banks, as a rule, were not underwriting new credit in turnaround situations.

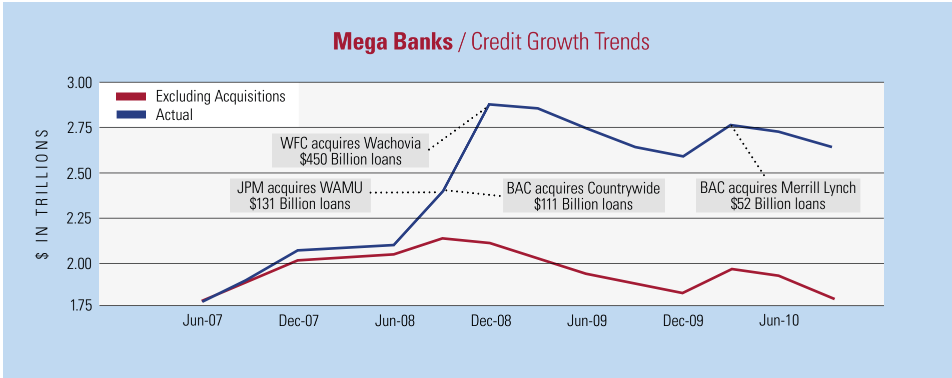
Two factors will provide both the motive and opportunity for further liberalization of the credit markets in 2011.

- A desire, on the part of bankers, to transition low-yielding assets (cash and short-term investments) to higher yielding assets, such as C&I loans; and
- Increasing optimism that the economy may be on the cusp of sustainable growth, which translates into improving perceptions of credit quality and borrowing capacity.

The big banks are carrying in excess of $2.1 trillion in reserves. There is considerable pressure to redeploy a meaningful portion of those assets into C&I loans where credit spreads are far more attractive. The reason is relatively simple—loans to middle-market businesses have provided superior risk adjusted returns relative to the carnage banks have endured in their real estate and consumer portfolios over the past several years.

Nearly all of the bankers we speak to report that the push is on for growth—double digit if it can be found. Asset growth goals are being ratcheted up and there will be consequences for failure to find and capitalize on new opportunities.




**Whenever credit supply exceeds organic credit demand, there is a temptation among capital providers to compete for share by lowering returns, easing credit standards, applying more capital (a bigger share and/or more leverage) for a given borrower, and relaxing covenants.**

## THE REGIONAL BANKS

Like their larger brethren, PNW-based regional banks have experienced portfolio erosion ($9.6 billion since 2008) for the same reasons: light demand, a need to shrink in order to bring capital ratios in line, and loan losses. Nevertheless, four of the six (Columbia, WFSL, Umpqua, and WTB) are in good shape as evidenced by rebounding earnings and re-solidified capital footings. For the first three banks on the list, this has been accomplished while repaying some $290 million in TARP capital. As a consequence, these banks have been able to take advantage of opportunities to acquire weaker institutions.WTB has not yet repaid its TARP funding or expanded by acquiring failed bank assets.

The remaining banks (Banner and Sterling) have been on a rougher road, where the repayment of TARP is not a near-term possibility. Like the others, Banner has worked its way through a bevy of challenges and appears to have sufficient capital, but is still working to restore profitability. Remarkably, Sterling Bank, which many had consigned to the morgue, has been reincarnated by virtue of a $730 million recapitalization. All of these banks have set their sights on building greater presence as C&I lenders.

## 2011 OUTLOOK

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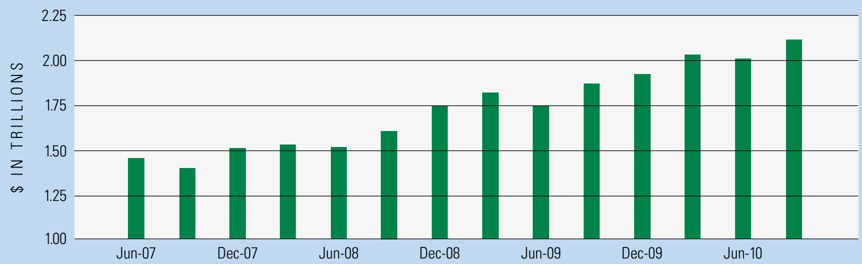
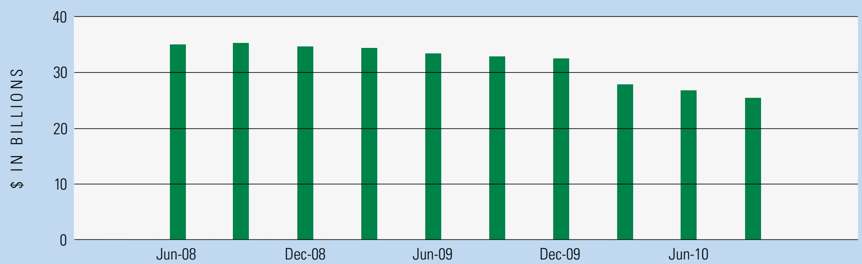
**Mega Banks** / Aggregate Reserves Held




**NW Regional Bank Credit**




leverage) for a given borrower, and relaxing covenants. In this environment, risk aversion inevitably fades.

Assuming steady economic recovery, 2011 will be a good year to negotiate credit. Terms will relax and spreads will tighten as competition heats up among bankers. Because credit availability encourages merger and acquisition activity, we expect greater lender willingness to underwrite leveraged loans for acquisition transactions in an effort to spur loan volume. This was already underway in the 4th quarter.

Credit markets change quickly, sometimes violently. No one can be sure when the market will reverse course, but it will. In fact, there are a number of clouds more or less visible on the horizon—fiscal crises at all levels of government, potential further asset deflation from residential and commercial real estate problems, concerns regarding the murkiness of big bank asset quality (e.g. mortgage repurchase exposure), and a lingering wall of credit maturities a couple of years out, any of which could stress bank capital. If it didn't get done last year, now is the time to extend maturities, enhance flexibility, and improve pricing. ❖

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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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