Zachary Scott
INVESTMENT BANKERS

IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS

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Easy Money; Can It Continue?

Banks have the money and the willingness to lend, but not many companies want to borrow.

by Michael T. Newsome

Credit availability to middle-market companies appears to be cheap and easy. Borrowing money is never quite that simple, but we have observed steady downward pressure on loan pricing for some time. Now credit terms are loosening, as well. The question is whether these conditions will continue, and, if so, for how long.

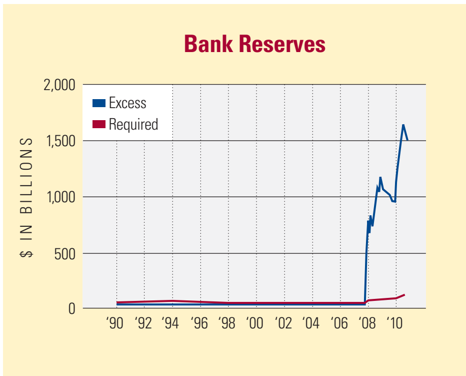
There is little doubt that banks have both the appetite and liquidity to lend. As evidenced by an unprecedented $1.5 trillion in excess reserves held nationally by banks (see the nearby chart), liquidity is no constraint to lending. After bottoming out in late 2010, commercial credit began to expand again. Roughly $133 billion in C&I loans have been added in the past 13 months. But, there continues to be a far greater appetite to lend than to borrow, and thus not nearly enough demand to make a dent in excess reserves.

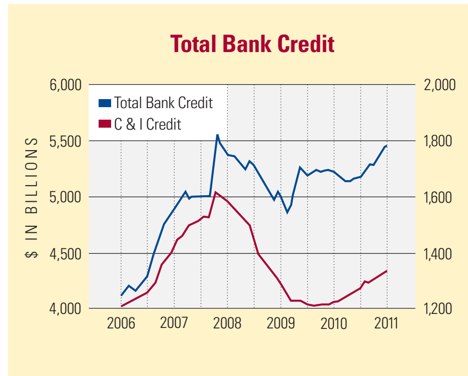
Ample liquidity coupled with sluggish credit demand in the midst of a lumbering economic recovery translates into a highly competitive lending market. Most of the opportunities are refinancings, where bankers are scrimmaging for market share. Demand for new financing in support of growth, acquisitions and distributions to owners continues to be soft, but shows signs of picking up.

Conversations with PNW bankers have a few common refrains:

- "We have a strong appetite for new C&I assets"
- "Quality is an overriding focus, and our credit people are prudent"
- "Leverage levels are stable but we may move a bit higher for the most desirable credits"
- "We can't believe what our competitors are willing to do!"

Companies that demonstrated resilience or an ability to adapt in the aftermath of the financial meltdown have a host of options. Contrary to the purported quality focus, virtually any middle-market business with a well-articulated business plan can access credit unless it is hemorrhaging red ink, is already laboring under insurmountable debt, or is on the verge of exhausting its liquidity.





Credit spreads continue to tighten due to the aforementioned competitive dynamic and long and short interest rates are at historic lows. Ten-year money can be obtained at 4% or less. The hunger for assets in this highly competitive market is leading to a relaxation of credit standards because pricing alone may not win the mandate. Collateral advance rates are easing, covenants are being streamlined to provide greater cushion, and personal guarantees are being scaled back. It is a subtle process driven by competition and it is well underway.

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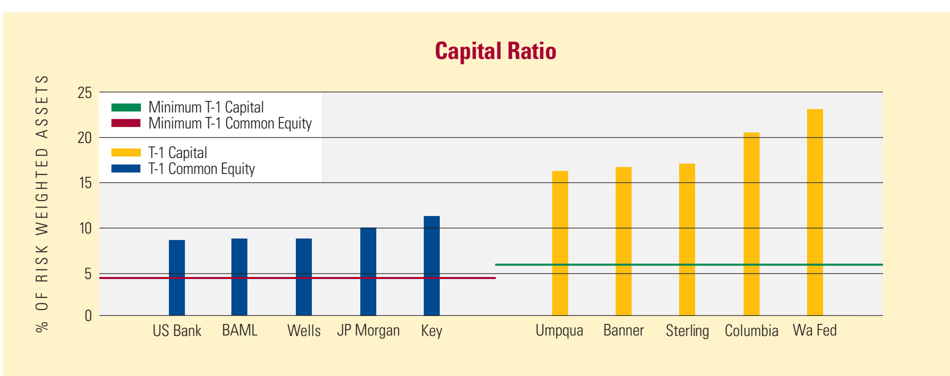
FROM TOO LITTLE TO TOO MUCH CAPITAL?

Three years ago, the federal government pumped some $105 billion in TARP capital into the major Pacific Northwest banks (Bank of America, Wells Fargo, US Bank, JPMorgan, and Keybank) and another $918 million into the regional banks (Columbia, Sterling, Washington Federal, Banner and Umpqua). This capital has been repaid with the exception of $417 million that was provided to Banner and Sterling. Each of these banks raised additional equity capital in the public (and in a few cases, private) equity markets and shed capital-intensive assets in order to repay the TARP funds and meet regulatory capital benchmarks. As illustrated in the chart below, all of the PNW banks now comfortably exceed current risk-based capital requirements.



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CORE CAPITAL STANDARDS

	STANDARD	2012 MINIMUM BASEL II	2015 MINIMUM BASEL III
Systemically Important Institutions[1]	Tier-1 Common Equity Ratio	2.0% of Risk-Weighted Assets	4.5% of Risk-Weighted Assets
All Other Banks	Tier-1 Capital Ratio	4.0% of Risk-Weighted Assets	6.0% of Risk-Weighted Assets

[1] *Top 32 financial institutions (commercial banks, securities firms, insurance companies, Fannie Mae and Freddie Mac)*

While it seems that capital is abundant today, there are looming regulatory and market changes that will create greater challenges over the next several years:

▪ Basel Committee on Banking Supervision sets new and higher bank capital requirements, known as Basel III, that become effective in 2015;

▪ The regulations emanating from the Dodd–Frank Act establish numerous banking controls and operating constraints that most experts believe will step-up the complexity and costs associated with regulatory compliance and restrict profitable activities, such as proprietary trading; and

▪ Over the next five to ten years, it is expected that consumers will continue to deleverage. This trend will erode one of the banking industry's most profitable business segments.

McKinsey recently estimated that these factors together will reduce industry returns on equity from 11% today to 7% by 2015, a development that is incompatible with the addition of capital that Basel III will require.

In order to earn appropriate returns on capital, banks are going to change. Adaptation to these developments is likely to lead to a significant industry transformation, driven by intensified efforts to squeeze the most from every dollar of capital employed. This focus on returns is expected to trigger the following:

▪ Renewed fervor for consolidation among the regional and community banks, in part to rationalize excess capacity.

▪ Divestiture of non-core activities, particularly those with sub par returns.

▪ Efforts to pare back capital-intensive branch networks in favor of expanded consumer access via the Internet and mobile devices.

Ultimately, businesses require a well-capitalized, healthy banking system, which should result in greater discipline in pricing risk and the return of higher credit spreads. In the meantime, capital and liquidity appear to be adequate, if not in surplus. It also seems clear that the gap between middle-market credit supply and demand is sufficient to drive banks to continue to battle it out on price and terms. In the absence of an unforeseen economic shock, the current credit market situation is likely to prevail until business activity really begins to gather the steam necessary to sop up excess lending capacity, and/or the banking industry makes some headway toward addressing its new regulatory and market circumstances.

Now is an excellent time to reset credit arrangements on the longest terms possible, which is best done in a competitive process. History has demonstrated change often happens swiftly. There is a wealth of uncertainty in the world. The sovereign debt crisis, inflation resulting from the government's unrestrained appetite for debt, or the threat of military conflict is just a short list of the events that could unravel today's favorable market dynamic. ❖

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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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