Zachary Scott
INVESTMENT BANKERS

INSIGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
FALL 2002

Economic Update

by Michael T. Newsome

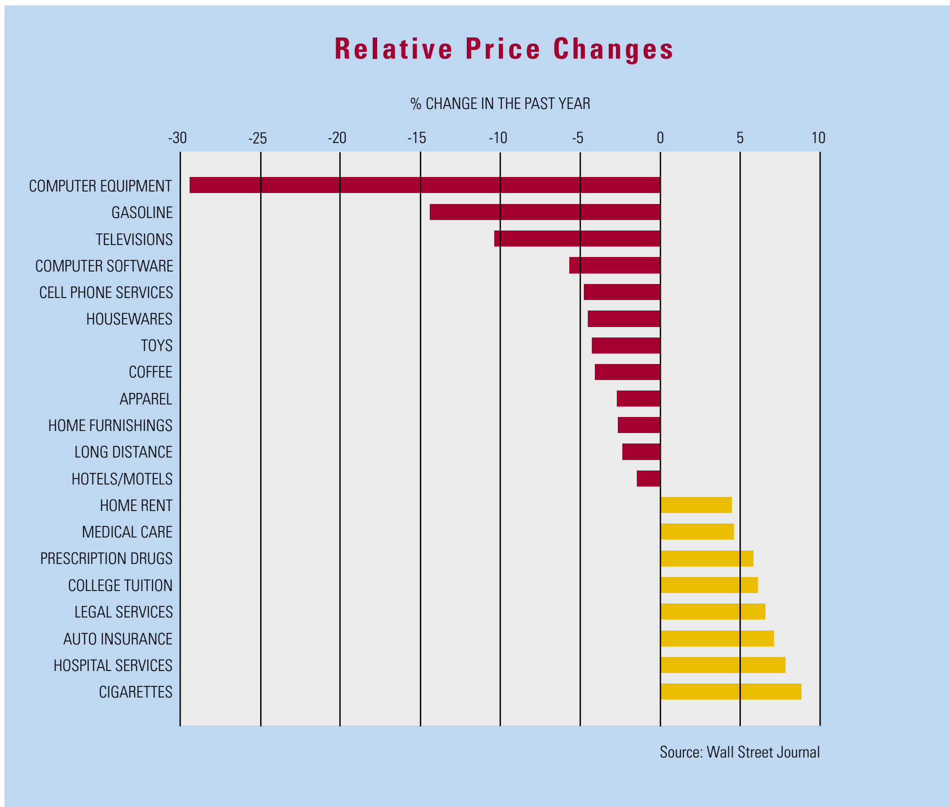
Based on all the clanging alarm bells set off by the media and politicians, the past six months have been grim: accounting fiascos, executive malfeasance, employee layoffs, and bankruptcies. All of this has been capped by a stock market swoon unlike any other in the past 30 years. It sounds pretty bad and a lot of remedies are being bandied about including intensified government regulation to "make sure this doesn't happen again." It has been a tough period for many but, as painful as they are, recessions clear away the rubble of failed deals that accumulate during economic expansions. It seems that the longer and stronger the expansion, the more traumatic the cleansing. This necessary purging process lays a solid foundation for the next period of economic growth.

The downward tumble of the financial markets since March of 2001 directly followed the pricking of the internet/telecom bubble, which ended a period of massive

As painful as they are, recessions clear away the rubble of failed deals that accumulate during economic expansions. It seems that the longer and stronger the expansion, the more traumatic the cleansing. This necessary purging process lays a solid foundation for the next period of economic growth.

over-investment in technology driven by the exuberance of investors. Too much money chased too few good deals. The availability of easy capital allowed many to lose their grip on economic reality. With business scandals erupting weekly, it is easy to surmise that the breakdown in financial disclosure and corporate governance and, more than anything, a fundamental lack of investor due diligence and skepticism swelled this investment bubble well beyond the norm.

Coming at the end of a decade of expansion, the adjustment process was inevitable. The good news is that the excesses are now being wrung out of the economy. After a wretchedly difficult business recession, marked by weak earnings and sluggish investment, businesses have been forced to make some difficult decisions. Most companies have sharply slashed inventories, trimmed payrolls, improved productivity, and paid down debt. It is not all negative news. Many of the technological advances that were the sizzle of "new economy" firms during the boom are now finding real application among more traditional businesses. As a result, companies are ever closer to their vendors and customers, which has in turn, tightened supply chains and enhanced productivity.



DEFLATION WATCH

One factor that is getting little attention, but evidently is shaping this economic recovery is deflation. The impact of deflationary pressure is difficult to quantify but it arises from the fact that in the aftermath of the investment bubble, many industries are saddled with an unusually high degree of excess capacity on a global basis. This, in turn, has created keen price competition, particularly in consumer products and capital goods.

Auto sales, for example, have been an often-cited pillar of economic strength over the past year. New car demand, however, appears to be stimulated by declining sticker prices and an abundance of discounts, rebates and zero-percent financing offers that collectively lower the cost of acquiring a new set of wheels. Because of a huge overhang in auto

(continued p.2)

assembly capacity (as much as 40%) and high fixed-cost structures, car manufacturers have little choice but to discount heavily to maintain sales volume. This phenomenon is also clearly at work in retail consumer spending where demand has been spurred by promotional pricing schemes and lower financing costs. In the last year, retail sales are up about 6% in real terms and only 3% in nominal terms. The difference is price deflation—more goods for fewer dollars.

The downside of deflation is that demand, stimulated by price cutting, sacrifices profitability. In the absence of pricing power and profits, corporations are reluctant to hire new employees and are unwilling to undertake new capital spending. With prices falling faster than costs in many industries, there is little incentive to replenish dwindled inventories. It is better to postpone inventory investment, hiring and capital spending than to be caught with excess. Until consumption and capacity are back in sync, the pace of business investment will remain sluggish. If consumer confidence is undermined and spending is seriously curtailed, there is a danger that the advances made so far will be undone. In the extreme, left unchecked, deflation could put the economy on the slippery slope to the kind of economic stagnation that has plagued Japan since the early 1990s.

The impact of deflationary pressure is difficult to quantify, but it arises from the fact that in the aftermath of the investment bubble, many industries are saddled with an unusually high degree of excess capacity on a global basis.

The downside of deflation is that demand stimulated by price cutting sacrifices profitability. In the absence of pricing power and profits, corporations are reluctant to hire new employees and are unwilling to undertake new capital spending.

INVESTOR CONFIDENCE

The current stock market turbulence, at least in part, reflects investors' concerns about the strength of the economic rebound. Corporate corruption and business failures have a role in the bear market, but are not the sole culprits. Contrary to the political and media chatter, concerns regarding accounting veracity and corporate integrity are overblown. Only a small minority of companies is guilty of falsifying their financial reports and willfully deceiving investors. Rather, prices seem to be falling into line with less bullish economic expectations based upon concerns about business investment and the resilience of consumer spending.

In order for robust economic growth to be re-established, businesses must earn their way forward. Profits are required to trigger the investment in labor, inventory, and capital goods needed to drive the economy forward. And, capital must be available to fund these investments.

CREDIT MARKETS

The health of the commercial banking system is one factor that gives us reason to believe that progress can be made. Banks were relatively minor players in the excesses of the late 90's. The public equity and debt markets provided much of the fuel for the bubble. This is not to say that major banks have escaped completely unscathed. They have been burned by on and off-balance sheet financing for high-flyers such as Enron, Worldcom, and Global Crossing, and leveraged lending activities for private equity funds. Nevertheless, many banks have spent the past two years scouring their balance sheets of problem loans (to many companies' pain and torture).

It seems that the folks in bank special assets or workout groups here in the Northwest are beginning to see some respite in the troubled deal pipeline. We're also seeing signs that attitudes toward booking new business are shifting. For the first time in several years, if a company presents a good opportunity, bankers may do more than yawn and look at their watch.

Until demand appears sustainable and business margins improve, overall economic conditions will remain sluggish. The Pacific Northwest, with its high rate of unemployment and decimation of the high-tech sector, has a ways to go before emerging from these economic doldrums. ❖

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

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com