Zachary Scott
INVESTMENT BANKERS

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Credit and Economic Update

Businesses with credit needs will find the lending environment with banks to be very good, and with bankers searching for new customers, senior debt financing will continue to be readily available.

by Michael T. Newsome

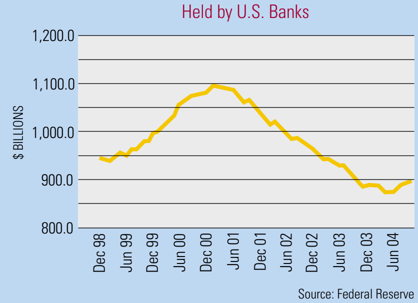
To put it bluntly, this is about as good as it gets—the lending environment is rarely as friendly to business borrowers as it has been over the past year. Nevertheless, the appetite of bankers for new commercial and industrial (C&I) loans is not even close to being sated and that portends a continued favorable borrowing environment.

The economy seems to be on pretty solid footing. In spite of some intermittent sputters, particularly with regard to energy costs and the weakening dollar, real business investment has been growing, employment numbers are up significantly, and industrial capacity utilization hit a three-year high in November. Even though the Fed has bumped up the discount rate on five separate occasions since last June by a total of 125 basis points, interest rates remain exceptionally low. Overall, the economy seems to be humming along. As a consequence, the prospects for brisk business credit demand would appear to be excellent. One might suspect that this would be one of those heady periods for bankers, when clients are knocking down the door to find the capital they need to fuel business growth.

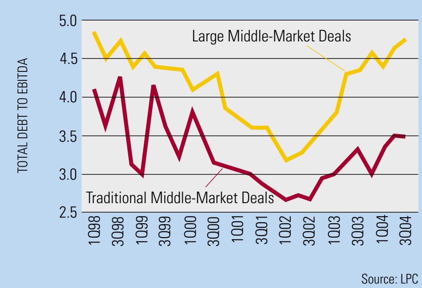
After a 20% slide in C&I loans held by U.S. banks since early 2001, the evidence indicates that credit demand has begun to strengthen a bit. But, it is not nearly as strong as bankers would hope at this stage in the cycle. In fact, the total volume of C&I loans held by U.S. banks is still $200 billion, which is 18.5% off the 2000 peak.

When the economy is growing, most firms are quite eager to make the capital and inventory investments necessary to meet customer demand. So why isn't loan demand stronger? In part, anemic C&I loan volume can be explained by the strength of corporate cash flow. Since early 2003, most industry sectors have generated sufficient cash to internally fund the investments necessary to meet customer demand. As illustrated by the accompanying charts, the general absence of a financing gap between capital spending and internal resources has resulted

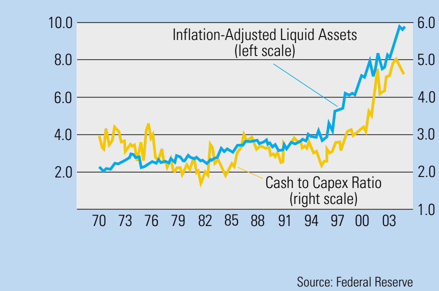
Commerical & Industrial Loans
Held by U.S. Banks



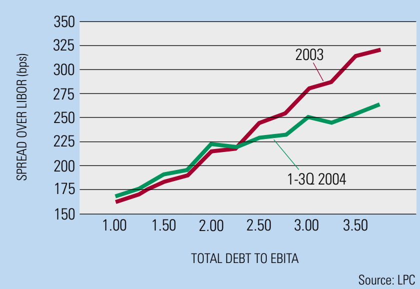
Financial Leverage Trends



U.S. Corporate Liquidity Indexes



Risk vs. Return



in an accumulation of liquid assets (cash and short-term securities) by non-financial U.S. corporations, and a surge in the ratio of liquid assets to capital expenditures. In 2003 and the first half of 2004, corporate liquid assets grew by $244 billion, more than 20%, to $1.3 trillion.

The October 2004 Senior Loan Officer Survey published by the Federal Reserve reports that credit standards for large, middle-market, and small business loans have continued to ease and pricing has softened, as banks have sought to stimulate C&I loan volume and compete for market share.

Loan Pricing Corporation, which monitors syndicated loan markets for the large middle-market (deals > $100 million) and traditional middle-market (deals < $100 million), reported a bit of a split story in their third quarter review. Sponsor (private equity group)-related lending activity for the first three quarters of 2004 was at a five-year high and up 105% over 2003. The dollar volume of traditional senior debt financings by corporate clients, including acquisition deals, has grown, but by a less robust 40% over the same period in 2003, and has not yet rebounded to the level achieved in 2000.

The gap between credit demand and lending enthusiasm is evident in spirited competition among bankers. The standard measure of lender aggressiveness is how liberally the limits on financial leverage are set. The routine financial leverage benchmark is the ratio of total debt (senior, mezzanine and second lien) to trailing 12-month EBITDA. Lenders are pushing the leverage envelope back towards the levels that prevailed in the late 1990s. LPC's data suggests that borrower/deal size and institutional investor involvement have had a meaningful impact on how "sporty" financing structures have become over the first three quarters of 2004. More than 50% of large middle-market and

(continued p. 2)

sponsored deals have financial leverage covenants in excess of 4X. For the subset of large middle-market financings in which institutional investors provided a portion of the debt, leverage covenants were 5X or greater about 50% of the time. In contrast, total leverage in about 73% of traditional middle-market financings has been limited to 4X or less. Just 18 to 24 months ago, the average leverage covenant was 3.5X or less.

The appetite of lenders for risk is clearly illustrated by risk and return curves in the nearby chart. According to LPC, returns, as measured by average spreads over LIBOR, are down about 60 basis points this year, as compared to 2003 on the most-leveraged transactions in the market. Bankers are taking more risk at significantly lower pricing in order to land deals.

HERE IN THE GREAT NORTHWEST

Sadly, there is not an abundance of hard economic data available on a regional basis. But, anecdotal evidence tells a similar story. Conversations with numerous lenders are animated by their hunger for assets, yet most are having difficulty finding enough opportunities and only a few have achieved the loan growth goals that their institutions set for 2004. A good number of bankers have told us that they will not be beat on price, and a few have posited that they will not be beat on price or terms.

At the small end of the market there also seems to be an abundance of optimism. A host of community and regional banks have emerged in the Northwest in the past two years, and several more are in the works. Most of these banks have styled themselves as small business lenders (loans < $10 million) and have attracted a number of experienced lenders from larger institutions. Conventional wisdom has it that there is a void in the market left by the mega-banks that increasingly rely on a mass-market approach to small business lending based on highly standardized loan products, credit scoring systems and limited personal interaction. It is rumored that at least one of the mega-banks is contemplating a redefinition of small business to include companies with credit needs of $20 million and below. If so, the other behemoths are likely to follow suit, as the pressure to take cost (people are the largest controllable expense) out of their systems is unrelenting. The value proposition is that the emerging small banks can provide the customized credit arrangements and personalized service that the national banks are less inclined to provide.

Our expectation is that the current market situation–willing lenders outweighing willing borrowers–will be sustained through 2005. Assuming that the economy remains on track, a weaker dollar should stimulate domestic and export demand for U.S. products and services. There should be a corresponding increase in business capital and inventory investment to meet this demand. At some point, the capital spending and corporate internal cash flow trend lines will cross again and companies will need to borrow in order to fund growth. Credit pricing and underwriting standards probably will not be driven a whole lot lower. But, bankers will continue to be very accommodating. If it makes sense from a strategic and market perspective to expand or restructure existing obligations, this is a very good time to sit down with a couple of lenders and work out attractive financing arrangements. ❖

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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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