Zachary Scott
INVESTMENT BANKERS

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Nothing Lasts Forever

Cheap capital is still abundant but, with every passing day, credit retrenchment gathers momentum.

by Michael T. Newsome

It has been about four years since we have been able to say anything but "there has never been a better time to borrow money." That observation remains absolutely true, as an abundance of cheap and relatively constraint-free debt capital is queued up and looking for a place to be put to work. With the exception of the dicey sub-prime segment of the mortgage market, the appetites of lenders and investors for loans and debt securities remain intense, even though issuance is at an all-time high. But, the foundation for a credit retrenchment is being laid every day, at an accelerating pace. Lenders are not adequately paid for risk and, unless the economy continues upward unabated, a portion of these bets will be lost. When that happens, the entire market will be affected, as it has in every previous credit tightening.

THE MARKET CONTINUES UPWARD

Commercial and industrial loan portfolios of U.S. banks have grown from nearly $900 billion at the end of 2003, to over $1.2 trillion in April of 2007, a 9.5% annual rate. At the same time, portfolio delinquency rates are extraordinarily low by historical standards.

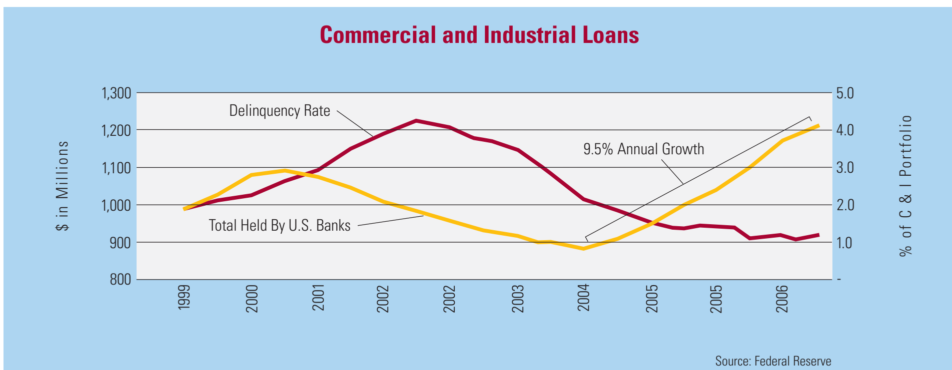
A notable development in the bank market continues to be the evolution away from the traditional "lend and hold" model towards the "lend (the actual term of art is "originate") and distribute" approach. Commercial credit demand has found ready pools of investment capital, much of it now organized in hedge funds or funneled through the new miracle financial product, Collateralized Loan Obligations (CLOs). It's not clear which came first, the assets or the capital—but they have come together to drive loan origination and distribution to the point where nearly 70% of syndicated debt is placed with non-bank lenders.

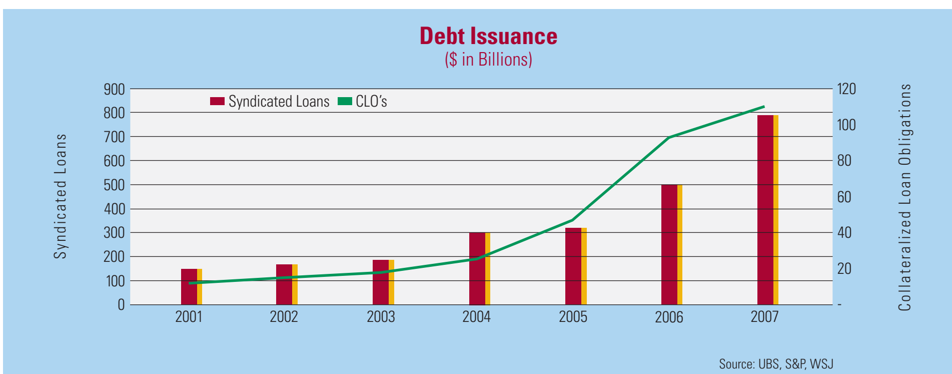
Hedge funds, which only a year or two ago were strictly investors, are now spawning a plethora of hybrid specialty lending units that are interested in direct loan origination outside the traditional realm of banks and asset-based finance companies. Firms such as Fortress Investments, Cerberus / Ableco, Contrarian Capital, and Crystal Capital fit this bill and are particularly targeting leveraged finance opportunities for buyouts, recaps and turnarounds where a lot of capital can be quickly put to work. Rarely a week goes by without learning of a new lender looking for opportunities to provide middle-market businesses with senior and junior debt, as well as equity capital.

The most striking aspect of today's leveraged lending is the steady compression of credit risk premiums (often expressed as the spread between low-rated bonds or syndicated loans and risk-free Treasury securities). Over the past 20 years, the average spread between high-yield "junk" corporate bonds and comparable duration Treasuries has been nearly 540 basis points. Currently, the spread has plummeted to 260 basis points. The same erosion is evident within the leveraged-loan market, where the average spread over LIBOR has dropped 28% from 330 basis points to 240 points since 2003.

The abundance of accommodative debt capital is a function of the demand for investment income, rather than evidence that lenders/investors have somehow cracked the code to neutralize credit risk and avoid defaults. Nevertheless, allusions to this are heard from lenders that are either using credit derivative contracts in an effort to transfer risk, or relying on a trading strategy in the belief that change can be detected before it happens, so that potential problems will be smoothly foisted off on a greater fool. It hardly matters; risk and the economic impact of default may be transferred, but cannot be abolished. Someone will take the pain.

The voracious demand for investment income has made available credit structures today that would have been considered hyper-aggressive just a couple of years ago. The amount of debt available to borrowers as a multiple of cash flow (EBITDA) is in record territory, and the controls or covenants that





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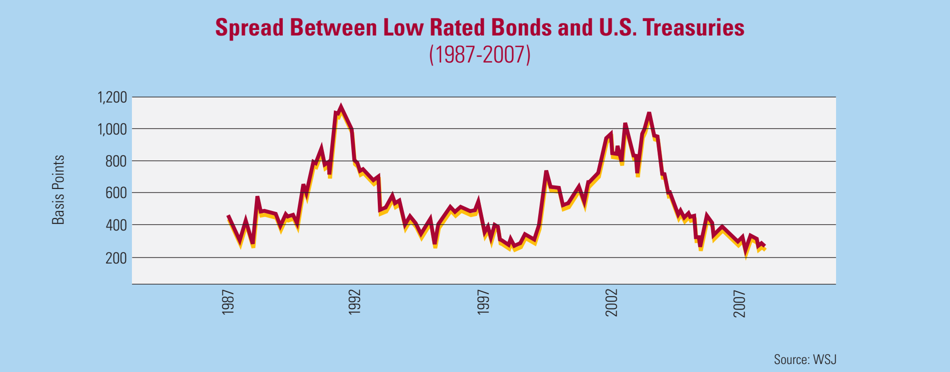
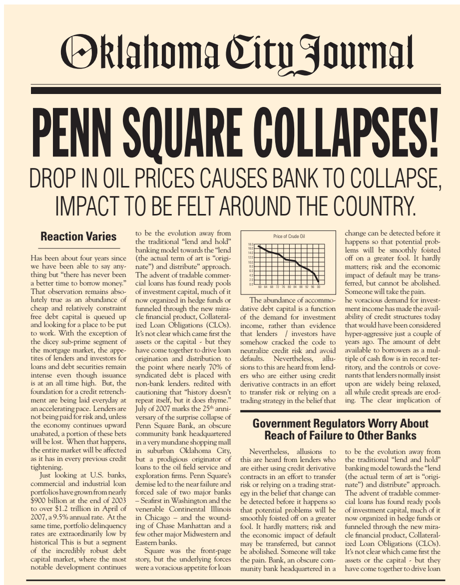


lenders normally insist upon are widely being relaxed, all while credit spreads are eroding. The clear implication of the current trend is that lenders are not pricing risk rationally. A psychology takes over in which many lenders feel compelled to take whatever the market will allow. Either accept the terms in the market or be relegated to the sidelines. For particularly aggressive credit structures, the margin for error is quite slim. Debt financings at five or more times EBITDA generally require steady earnings growth. Obviously, lenders have convinced themselves of smooth economic sailing well into the future.

HISTORY RHYMES

Mark Twain is credited with cautioning that "history doesn't repeat itself, but it does rhyme." July of 2007 marks the 25th anniversary of the surprise collapse of Penn Square Bank, an obscure community bank headquartered in a very mundane shopping mall in suburban Oklahoma City, but a prodigious originator of loans to oil field service and exploration firms. Penn Square's demise led to the near failure and forced sale of two major banks—Seafirst in Washington and the venerable Continental Illinois in Chicago—and the wounding of Chase Manhattan and a few other major Midwestern and Eastern banks.

Penn Square was the front-page story, but the underlying forces were a voracious appetite for loan assets by banks in an otherwise sluggish environment and a great demand


Oklahoma City Journal

PENN SQUARE COLLAPSES!

DROP IN OIL PRICES CAUSES BANK TO COLLAPSE, IMPACT TO BE FELT AROUND THE COUNTRY.

Reaction Varies

Government Regulators Worry About Reach of Failure to Other Banks

for capital in a large growth sector of the economy. In the late 1970s, well-informed and financially sophisticated people believed that there was a permanent shortage of fossil fuels and the price of oil would rise quickly to and remain at $100/barrel. Accordingly, billions of dollars of capital, much of it in the form of aggressive bank loans, were invested in highly speculative oil and gas development activities. For a time, the oil patch economy absolutely rocked. Then, the unthinkable happened—oil prices dropped and stayed down. As lucrative as it seemed to bankers at the time, they failed to accurately assess and price the risk.

The most marginal investments, companies and lenders (including Penn Square and virtually all of its customers) were the first casualties. But the impact was progressive, and expanded well beyond the oil and gas industry. Bigger industry players were eventually mired in problems as access to capital dried up, receivables proved uncollectible, and new opportunities disappeared. Although well-respected Texas banks (Texas Commerce, First City, Republic, and Allied) catered to top-tier oil and gas companies, and eschewed risky loans for drilling equipment and exploration, they all took a beating. It turned out that virtually every loan was in some manner dependent on the health of the oil and gas industry. As banks across the nation felt the pain from this part of their loan portfolio, credit tightened to all borrowers. The poorly conceived loans made much earlier ultimately impacted credit availability for a broader spectrum of borrowers. Although in the aftermath many claim otherwise, very few people actually saw it coming.

CREDIT CRUNCH COMING?

Perhaps the economy will continue to rock along and cover all of the recent lending and investment excesses. But, history favors the view that a meaningful portion of the aggressive leveraged-lending now on the books will turn out to have a negative net present value. Just in the past couple of weeks there has been a significant surge in chatter in the financial markets to that effect. The turning of the tide will become clear when today's very low default rates begin to revert to the mean. As we are fond of saying, there are but two emotions in finance—fear and greed. The needle has been stuck fast on greed for quite some time, but fear lurks around the corner. When that shift occurs, the prospects are good for a credit crunch that will impact access to capital for a far wider set of businesses than just highly leveraged firms. So, borrow prudently and keep your finances in order. ❖

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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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