

THE SHERIDAN ROAD MAP

The Best Route to Financial Success



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FROM BAD TO WORST

CFO optimism sinks to an all-time low as companies foresee a dismal year ahead

The CFO Magazine/Duke University Global Business Outlook Survey shows CFO optimism is plummeting with 81% of finance executives saying they are less optimistic than they were last quarter. Most expect their economic misery to last for at least a year.

The survey, conducted at the end of November and beginning of December, includes results from 1,275 senior finance executives in the United States, Europe, and Asia, and reflects the global scope of the recession. Nearly 60% of U.S. finance chiefs do not expect the domestic economy to begin to recover until the fourth quarter of 2009 or later, while 71% of their European counterparts say their own local economies will also remain stalled until at least the end of this year.

Announcements of layoffs were headlines in November and December, and CFOs forecast more job losses throughout 2009. U.S. and European finance executives say they expect to lay off 5% of their employees on average. That's a significant jump from last quarter, when U.S. CFOs anticipated cuts of less than 2% and Europeans were still forecasting hiring growth. U.S. companies will also reduce their outsourced workforces by 2%. Chinese CFOs will make smaller cuts, reporting that they expect to reduce head count by a percentage point over the next 12 months. Other Asian CFOs will also make small-scale layoffs.

With a dramatically changed employment picture, finance chiefs are much less concerned about attracting and retaining qualified employees than they have been in the past. Now, CFOs' top worry regarding their own companies is their ability, or lack thereof, to forecast results, followed closely by anxiety about maintaining employee morale and productivity

in the face of the recession.

Finance chiefs also continue to worry about consumer demand—an issue that won't be helped by the rash of mass layoffs—as well as the credit markets. Nearly 60% of finance executives say their firms have been affected by the increased cost or reduced availability of credit. Among firms rated B and lower that number soars to 79%.

About a third of CFOs say their companies have had difficulty establishing or renewing a bank line of credit. For some companies, such as those that banked with Lehman Brothers, credit lines have simply vanished. Three-quarters of survey respondents say their ability to access credit in the current environment has limited their ability to pursue attractive investments.

Faced with contracting consumer demand and shaky credit markets, CFOs plan to cut deeply in other areas besides payroll. Finance executives will slash their capital-spending budgets by more than 10% in the coming year. Spending on marketing and advertising will drop by 7%, while IT spending will fall by 4%. Overall, finance chiefs forecast an 8% decline in earnings, a stunning reversal from this time last year, when they forecast earnings growth of 6%, and a marked plunge from just last quarter, when they predicted earnings would grow by 4%. Companies will also cut their dividends by an average of 3%.

Jon Moreau, finance chief at Aarrowcast, is quick to point out that even in a recession, some pockets of the economy continue to hold up. A supplier of parts to military and agricultural equipment makers, Aarrowcast rang up sales during the third and fourth quarters of 2008, says Moreau.

RAILING AGAINST THE RICH: A GREAT AMERICAN TRADITION

Efforts to limit pay of the wealthiest gained traction in the 1930s; 'economic royalists'



Huey P. Long

The Great Depression of the 1930s created hardship and suffering among millions of Americans. It also created populist resentment of elites. Among the many signs of this anger was the astonishing popularity of Huey P. Long, governor of Louisiana and then U.S. senator. To the ordinary people across the U.S., Mr. Long was a heroic figure, fighting for the "common man"

and challenging the right of elites to monopolize power and wealth.

Starting in 1933, Mr. Long created a national organization called the "Share Our Wealth Society." He publicized it through his frequent national radio broadcasts, and his many speeches. His goal, he claimed, was a radical redistribution of wealth. Every needy American would receive a "household estate" of \$5,000 (almost \$80,000 in 2008 dollars), an annual wage of \$2,500 (\$40,000 in 2008 dollars). This great boon would be financed by high taxes on people making over \$1 million. There would be an \$8 million cap, with everything above that confiscated for redistribution. The plan was economically, and probably politically, impossible. But the inability of a wealthy nation to provide jobs and support to millions of citizens made Mr. Long's proposal appealing.

We are almost certainly entering a period in which resentment of financial and corporate titans will increase, and in which many politicians will feel they have no choice but to join the chorus of denunciation. In the 1930s, the popularity of "big business" dropped dramatically and did not revive until the corporate world recovered its wealth in World War II. The wealthy and powerful encountered challenges that make President Barack Obama's \$500,000 salary cap on companies seeking federal assistance seem pale by comparison.

In the 1930s, plans similar to Mr. Long's proliferated and attracted broad support. Francis Townsend, an aging physician in Long Beach, CA, launched the Townsend Plan, a promise to everyone over 60 of a guaranteed \$150 to \$200 a month from the government "on condition that they spend the money as they get it." A nationwide "transaction tax" (similar to a V.A.T.) would, he improbably argued, provide enough money to finance the system. The novelist Upton Sinclair almost won election as governor of California in 1934 by proposing the seizure of idle factories and farms from their capitalist owners. The properties would be managed as cooperatives to give work to the unemployed and to replace the profit system with what he called "production for use."

Franklin Roosevelt himself, trying to steal the thunder of the populists, proposed the so-called "soak-the-rich" tax, passed in 1935, which targeted high corporate salaries and investment income, even though it did little to increase government revenues or reduce the real wealth of those required to pay.

In the end, this anti-capitalist populism had relatively little impact on economic life. Mr. Long was assassinated in 1935.

Mr. Sinclair lost his election. Dr. Townsend joined forces in a third-party presidential challenge in 1936, an effort that received less than 2% of the vote in an election Roosevelt won by a landslide. Few New Deal measures bore any significant relationship to the proposals from these populist movements, although some historians believe that the Townsend Plan helped spur passage of the 1935 Social Security Act. A few years later, the New Deal abandoned its anti-business rhetoric in the face of a deepening recession. Instead, the government began to embrace Keynesian solutions, which promised economic growth through increased government spending.

The Great Depression may not have significantly weakened the power and wealth of the "economic royalists," but the animus toward them was not without consequences. The utilities magnate Samuel Insull fled the country to avoid prosecution for fraud, only to be extradited back to the U.S. to stand trial. (He was ultimately acquitted.) Sewell Avery, the president of Montgomery Ward, was carried out of his office by police during a 1944 labor dispute. There was a special gleefulness among much of the public in seeing once-powerful titans fall. Even those who flourished bridled at the rhetoric used against them.

As late as 1940 images of brutal and greedy capitalists remained staples of popular culture. John Steinbeck's 1939 novel "The Grapes of Wrath" was a great popular success because of their harsh denunciations of capitalists and their flunkies. Tom Joad, a young man politicized by the Depression, leaves his family after killing a strikebreaker, but not before making a classically radical-populist prophecy: "Wherever there's a fight so hungry people can eat, I'll be there. Wherever there's a cop beatin' up a guy, I'll be there.... An' when our folks eat the stuff they raise an' live in the houses they build—why I'll be there."

In the 1930s, the demonization of the upper class did not really begin until almost two years after the stock-market crash. We are now six months into our own economic crisis, and signs of populist resentment are already visible: with Bernard Madoff's remarkable fraud, the outrage at the tax problems of public officials, the growing contempt for the many overseers of the credit markets, the ruined investments of millions of ordinary people, the growing army of the unemployed, the likelihood of a recession that could last for years. These are the preconditions of populist revolts. Mr. Obama's chastisements of bankers and CEOs have been relatively mild compared to the routine denunciations of "economic royalists" in the 1930s. But the longer the crisis goes on and the deeper it grows, the more Huey Long-like challengers will arise, and the more pressure there will be for national leaders to launch populist battles of their own.

Whether that would help or hurt the Obama administration is hard to predict. Cultural populism has been a staple of the right since at least 1968, and it has alternately helped, and badly hurt, conservative candidates and causes. Economic populism has the same capacity either to bring down the president's ambitious agenda or to open up opportunities for greater change.

STATES' JOBLESS FUNDS RUN LOW

Seven Are Already Borrowing From Washington to Pay Unemployment Benefits

A growing number of states are running out of cash to pay unemployment benefits, a sign of how far social-welfare systems are being stretched by the swelling ranks of the jobless in the deteriorating U.S. economy.

Unemployment filings have soared so high in recent months that seven states have already emptied their unemployment-insurance trust funds, which were supposed to see them through recessionary periods. Another 11 states are in jeopardy of depleting reserves by year's end, according to the National Conference of State Legislatures, which published a January report entitled "The Crisis in State Unemployment Trust Funds." So far, states have borrowed more than \$2.3 billion in emergency funds from the federal government, money they are required to pay back.

The national unemployment rate is expected to hit 7.5% when January job data are released Friday, and rates are approaching double digits in some hard-hit industrial states. Nearly 4.8 million people collected unemployment insurance last week, the most since federal officials began tracking such data 40 years ago.

New York has already borrowed more than \$330 million to pay unemployment claims, according to the U.S. Department of Labor. In the past, New Jersey borrowed from its trust fund to pay for other expenses, and now it has only a few months of payments in reserve.

Even states with relatively flush trust funds such as Tennessee are warning that they could go broke in the next year if unemployment levels stay high. Although West Virginia has relatively high reserves, business leaders already warn they will push for cuts in unemployment benefits to forestall tax increases. Some states like Kentucky have automatic triggers raising employer contributions when the insurance fund falls, but many states do not.

The crisis is most stark in South Carolina, where unemployment has approached 20% in some poor counties, and where the state of the unemployment trust fund, little noticed in boom times, has sparked a standoff involving the governor.

At the same time, proposals to raise payroll taxes to alleviate the crisis are going over like a lead balloon in state legislative sessions that started last month. While the economic-stimulus package being debated in Congress would pump billions of dollars into the unemployment system, it would also increase the amount of benefits paid. It wouldn't solve the core problem of the state trust funds' depleted reserves and balances outstanding.

Employers argue that raising payroll taxes isn't an option, as they cannot afford to pay more taxes in the midst of an economic crisis. Worker advocates worry that officials will impose some type of shared-sacrifice solution, in which benefits for the unemployed could be cut to lessen a payroll-tax increase.

Like many other states, South Carolina's unemployment trust fund was flush a decade ago. In what was deemed a tax break for businesses, the state lowered the rate that employers paid in payroll taxes for unemployment insurance.

In 2001, the fund had a balance of more than \$600 million, according to the governor's office. But the fund balance began to drop precipitously three years ago, as the state began paying out more for jobless benefits. The trust fund went broke last fall.

At the request of the state's Employment Security Commission, Gov. Mark Sanford sought an emergency loan in September from the federal government. But Mr. Sanford balked at signing a second request in December, demanding that the state agency agree to an outside audit and prove the authenticity of its data, which he routinely questions. He relented hours before the New Year's Eve deadline in what became a well-publicized standoff.

"You got 77,000 individuals out of work, and the unemployment check is the only lifeline they have," said Roosevelt T. Halley, executive director of the state agency. "There was this mental anguish that there wouldn't be a check for them."

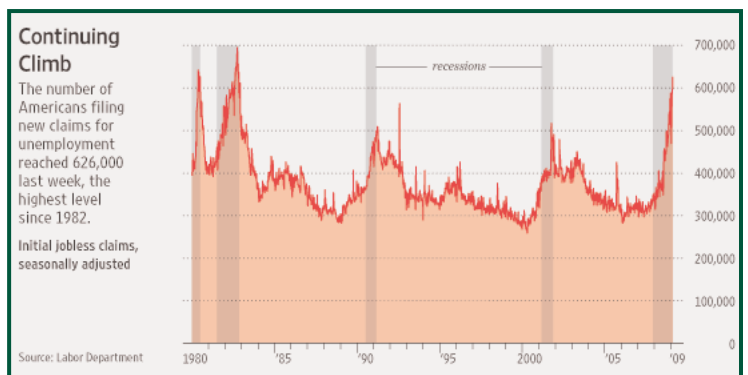
Gov. Sanford said he is using the only leverage he has to make the agency and its legislatively appointed leaders better stewards of public money. "Who held the unemployed of South Carolina hostage? The agency," he said. "If you watch \$600 million disappear over six years, and you have zero elbow room except to ask for an emergency loan, you put them as hostages."

So far, the state has borrowed more than \$110 million in emergency funds from the federal government, according to the Department of Labor. But unemployment filings are rising so rapidly that the amount requested just weeks ago for this quarter won't meet the growing need, Mr. Halley said. The amount the state paid in benefits per week reached \$20 million in January, compared with \$14 million in December, Mr. Halley said.

The impasse continues as Gov. Sanford threatens to fire agency officials unless they provide data by Feb. 9 proving the legitimacy of each unemployment filing, and more details about employers.

While the proposed U.S. stimulus package will likely bulk up unemployment benefits, the focus is on extending benefits to the long-term unemployed and expanding jobless insurance to part-time employees. The package is likely to extend the grace period for interest on federal money loaned to states like South Carolina, but they would probably need to pay it back.

Options include raising the payroll tax, pulling money from other state funds or potentially restricting eligibility, said Ms. Noel of the National Conference of State Legislatures, adding, "Unfortunately, they're all difficult choices to make."



WHERE'S THE MEZZ?

The mezzanine market, armed with billions of dollars, still needs the senior lenders to show signs of life before it can resume its renaissance

Last year, more than \$25 billion was raised by roughly 30 mezzanine providers, according to data from Thomson Reuters. While other lending sources have effectively dried up amid the credit crisis, one would think the mezzanine market would be one of the few financing options still available. Such a scenario, however, has yet to materialize.

"Very few private equity firms will do a mezz and equity deal; they want senior lending," says Andy Steuerman, a senior managing director with Golub Capital.

Another factor is that the deal market has effectively stalled. Economic uncertainty, on top of the credit woes, has both buyers and sellers retreating to the sidelines until more clarity emerges. For the most part, the only deals being pursued are the transactions that are absolutely necessary for a company's survival. That in turn keeps the private equity market stagnant, which effectively idles the mezzanine providers, even if they're armed with billions dollars worth of dry powder.

For the few deals that are out there, another factor is limiting the appeal of mezz financing; namely its price. The mezz market has become costly, almost to the point that it rivals the equity portion of the deal.

Last year, for instance, mezzanine shops were pricing deals with IRRs of between 15% and 18%, including a pay-in-kind component; rates that were already considered high. Today, mezzanine tranches are being priced between 16% and 20%, according to Ronald Kahn, a managing director at Lincoln International. He adds that mezzanine co-investments are now almost always being replaced with warrants and most deals also requiring higher pre-payment penalties, often starting out with two-year no-call provisions.

Accordingly, sponsors are over-equitizing their deals. "Private equity firms are willing to put more equity in transactions," Steuerman says, noting that the "return profiles [between equity and mezzanine] are converging." He adds, "There is also the benefit of [reducing risk] with less debt."

The current environment bears resemblance to other periods in the market. "This is the same thing we experienced in 1999 through 2001, when firms wanted to patch a deal together to avoid the cost of mezz," says Michael Hermsen, a managing director with Babson Capital Management. "Everyone came

back to mezz then and the same thing will occur again."

Like Steuerman, Hermsen alludes to the role the rest of the market will play. "The senior lenders aren't being very aggressive at all; we will be here to fill the gap," he says, adding "the purchase price multiples are becoming more attractive and pricing is getting better."

Babson is among those prepared for the market rebound, having closed its Tower Square Capital Partners III fund in

December with \$1.58 billion of capital under commitment.

Mezz is undoubtedly a necessary part of the deal structure. It is so important that many equity sponsors have raised their own mezzanine funds. Endeavour Capital, a lower middle market firm, is trying to raise between \$200 million and \$300 million for Endeavour Structured Equity and Mezzanine Fund I LP, which would finance deals sponsored by Endeavour Capital and other firms. KRG Capital Partners is in the market with a \$200 million mezz fund, which would be used to finance its own deals.

While the mezz market remains stagnant going into 2009, it has shown signs of life at times during the credit crisis. In the early part of last year when the second lien market crumbled and BDCs began showing weakness, the mezz market held strong. During the first two quarters of 2008 the percentage of mezzanine financing going into deals grew substantially over 2007, roughly doubling its average allocation within the capital structure.

"Prior to the chaos that started in September 2008, the mezz market was getting stronger, and it was starting to shine. We were busy," says Michael Klofas, a managing director with Babson Capital Management. "But since October, we are not seeing a lot of deal activity in general and mezz deals, in particular, have been few and far between."

The bottom line is that senior lenders need to start lending again before mezz players can make any kind of headway.

While few will even guess as to when the credit markets will loosen up, commercial banks weren't created for long term CDs. Eventually, when the remaining banks regain their appetite for risk, the mezzanine market will be positioned to benefit.

For now, however, it's just a renaissance delayed.

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By Danielle Fugazy • Mergers & Acquisitions, January 21, 2009



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