Bank of America Higher Standards

CapitalEyes

A Bank of America Business Capital monthly e-newsletter on middle-market leveraged finance.

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Mezzanine Debt--Another Level To Consider

U.S. investors are increasingly looking for alternative asset classes to generate above-average returns. One particular asset class, while not new, is gaining increasing interest: private mezzanine debt securities (mezzanine debt). While mezzanine debt often provides growth capital for a company, it is by no means business plan financing. Despite the fact that most mezzanine issuers have limited access to the broader capital markets, mezzanine borrowers are "real" companies.

The private mezzanine debt market is geared almost exclusively toward "middle-market" companies with specific financing requirements, such as an acquisition, capital expenditures or recapitalizations. As bank lenders reduce their commitment levels and the high-yield market increasingly raises its minimum threshold level, the growth of this asset class will continue.

What Is Mezzanine Debt?

Mezzanine debt capital generally refers to that layer of financing between a company's senior debt and equity. Structurally, it is subordinate in priority of payment to senior debt, but senior in rank to common stock or equity (Exhibit #1—Mezzanine Capital Structure). In a broader sense, mezzanine debt may take the form of convertible debt, senior subordinated debt or private "mezzanine" securities (debt or preferred equity).

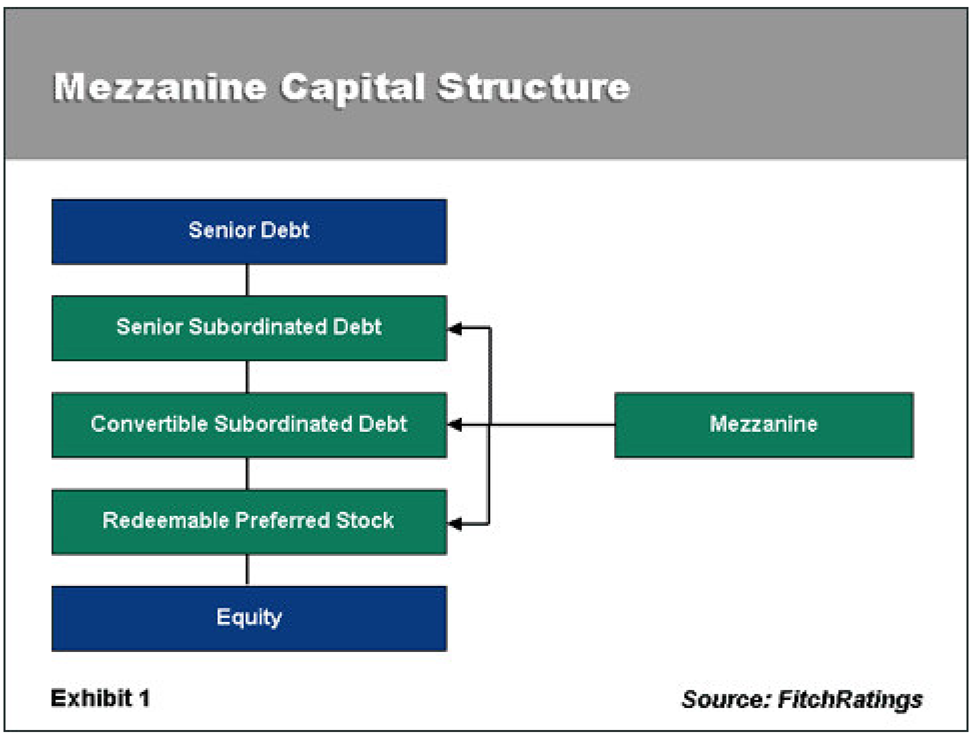


Exhibit 1 *Source: FitchRatings*

This article will concentrate on the private mezzanine debt securities used to fund middle-market companies with total revenue of generally less than $500 million. These securities include debt with an equity "kicker". The equity "kicker" is usually a contingent common equity interest, either by way of warrants or a conversion option to which registration rights are typically attached. Interest payments on private mezzanine debt securities usually involve both a cash pay portion and pay-in-kind (PIK) portion. The total stated interest rate usually ranges between 14%-16%, with the cash portion of interest generally ranging between 12%-14% and the remainder interest portion in PIK. Private mezzanine debt securities usually have a maturity of between six and eight years, with little or no amortization. The average transaction size for mezzanine securities reviewed in this report ranged between $10 million-$30 million. (Exhibit #2&3—Comparison Of Single B Security Classes)

Comparison Of Single B Security Classes

	Leveraged Loans	High Yield	Mezzanine	Public Equity
Security	First Lien	Unsecured	Unsecured	None
Ranking	Senior	Contractual Subordination	Contractual/Structural Subordination	Junior
Covenants	Generally Comprehensive	Incurrence-Based	Less Restrictive, Mostly Financial; Maintenance-Based	None
Term	5 Years	10 Years	8 Years	Open Ended
Coupon	Cash Pay – Floating	Cash Pay – Fixed	Cash Pay (Fixed)/PIK	Dividends
All-in Rate	L + 437.5	T + 583	13.00%	Variable
Warrants	None	Generally Not	Almost Always	Not Applicable

PIK – Pay-in-Kind. L – LIBOR. T – U.S. 10-Year Treasury.

Exhibit 2 *Source: FitchRatings*

Comparison Of Single B Security Classes (Continued)

	Leveraged Loans	High Yield	Mezzanine	Public Equity
Prepayment Penalties	Minimal	Heavy Penalties/Call Premiums Attached	Moderate Via Prepayment Premium, Usually After One Year	Not Applicable
Capital Providers	Banks, Non-Bank Institutions	Public Offering	Private Capital	Public/Private
Recovery (%)	80	40	20	0
Liquidity	Medium	High/Medium	None	High
Rating Requirements	Required	Required	None	None
Buyers of Paper	CLOs/Institutional Investors	Institutional Investors/High Net Worth Individuals/CBOs	Institutional Companies, Mezzanine Funds/ Private Equity Funds	General Public, Institutional Investors

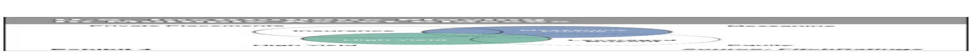
CLO – Collateralized Loan Obligation. CBO – Collateralized Bond Obligation.

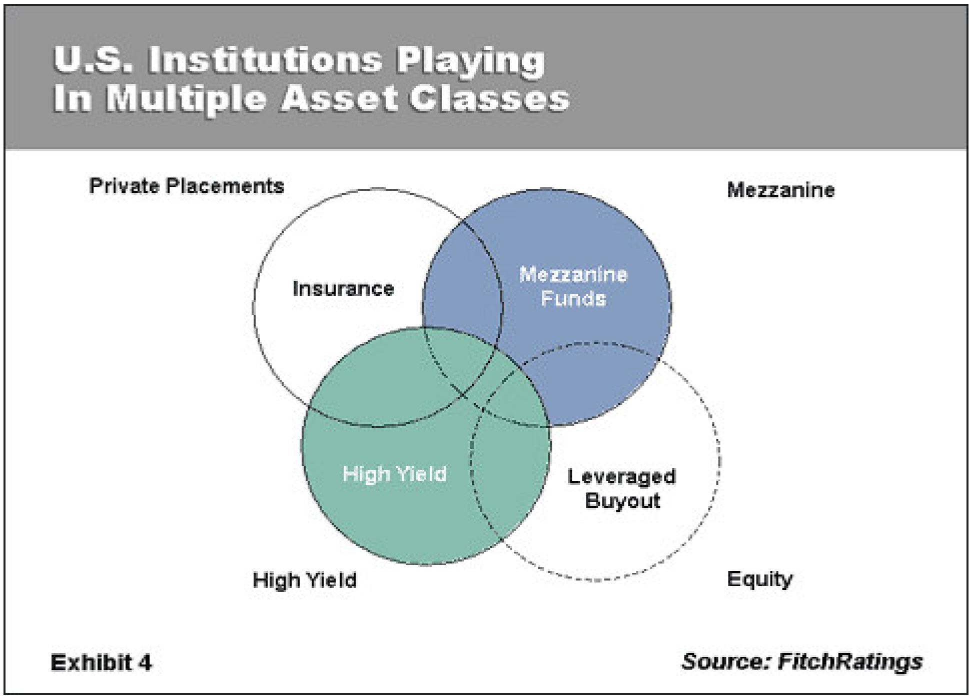
Exhibit 3 *Source: FitchRatings*

Private mezzanine debt securities are highly negotiated instruments, and are thus illiquid investments. No active market exists to trade these securities. As a result, any trading usually involves a negotiated process directly involving buyer and seller. From a borrower's perspective, mezzanine capital is more flexible than bank debt and less expensive and dilutive than common equity. Private mezzanine debt securities are generally the lowest ranking debt obligation in a borrower's capital structure and contain a very loose covenant package.

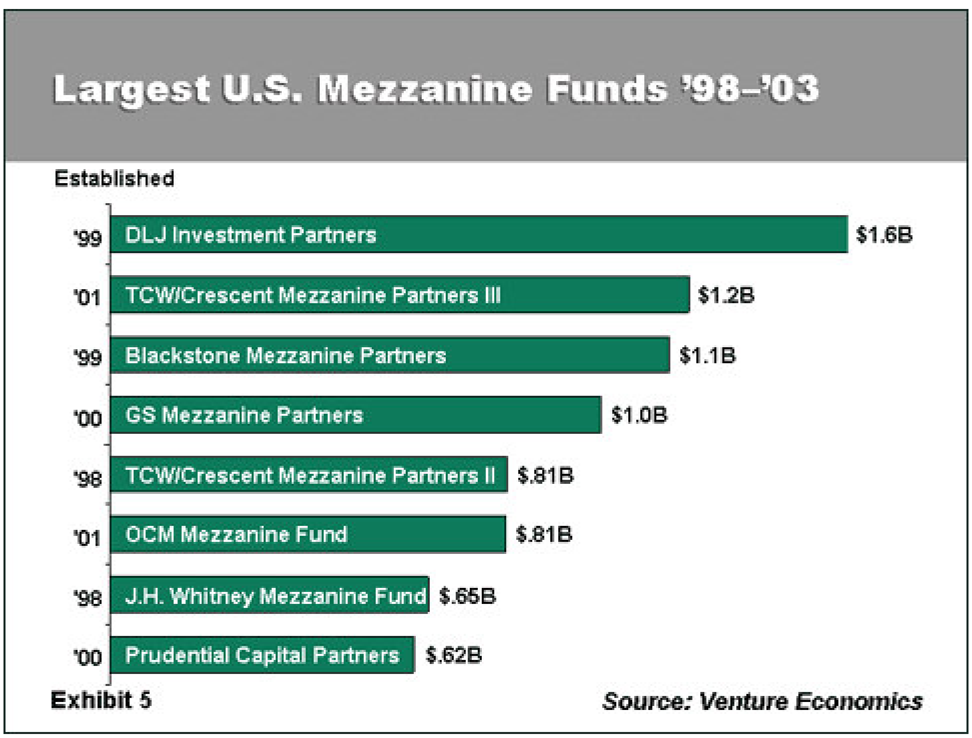
Mezzanine Market Overview

Historically, the largest providers of mezzanine capital have been insurance companies, pension funds and endowments. Given the historically attractive percentage returns (high teens to low 20s) the number of mezzanine providers has expanded to include private equity groups, leveraged public funds, commercial banks and investment banks with dedicated mezzanine funds (Exhibit #4—U.S. Institutions Playing In Multiple Asset Classes).





The private mezzanine securities market has grown from $15.2 billion raised by 1998 to more than $37.3 billion by 2002, according to Venture Economics. Fund-raising during the late 1990s was particularly robust due to the favorable credit environment and high volume of M&A/leveraged buyout activity (Exhibit #5—Largest U.S. Mezzanine Funds '98-'03). The level of mezzanine financing is closely tied to the overall level of M&A activity. However, recent trends suggest growing opportunities for mezzanine financing. Given the extraordinarily high amount of corporate defaults and the weak economic environment, many commercial banks have tightened their lending standards. Additionally, the high-yield market has an implicit minimum threshold between $125 million-$150 million. As a result, private mezzanine securities are increasingly being used to fill this gap.



Another trend contributing to the growth of this asset class is the increasing rate of refinancings. The low interest rate environment, along with a sluggish M&A environment, has aided this trend. In fact, repayments on institutional loans totaled $8.6 billion in the first quarter of 2003, or 6.5% of total outstanding loans, according to Loan Pricing Corporation. This equals 2002's fourth quarter repayment rate, although it is lower than in the third quarter when repayments totaled 9.6% of outstanding loans. Bank lenders in the late 1990s, who were aggressively leveraging deals with up to four times senior leverage, are now more likely to refinance at more conservative senior debt multiples. For companies that need to round out their capital structure, private mezzanine securities may be used to fill this void. As a result, the size of mezzanine funds and transactions is likely to increase.

The J-Curve Effect

So why are mezzanine funds gaining so much attention recently? The sudden attention may be best explained by the "J-Curve" phenomenon. The J-Curve is a private equity investment measurement tool used to determine the rate of return for investments over a certain period of time. Typically, private equity funds experience negative returns during the first few years due to fees, overhead expenses and other costs charged to the fund. As an investment matures, expenses are recouped and valuations rise.

Correspondingly, the internal rate of return (IRR) generally rises to positive levels. In effect, you have an IRR that looks like a slanted "J," reflecting negative returns during the early life of an investment with an increasingly upward sloping return as the investment matures.

Given the spectacular crash in equity values in the technology sector, many venture capital funds are faced with the possibility of inverted J-curves. By contrast, mezzanine fund managers are attracted to the cash-on-cash returns (cash received/initial cash outlay) generated by the debt element of private mezzanine securities. Typically, an average performing mezzanine fund is able to avoid the steep negative returns compared to a pure equity fund as a result of the contractual cash coupon.

Mezzanine CDOs And Non-Traditional Funds

The growth of middle-market, private equity and other alternative asset class mezzanine collateralized debt obligations (CDOs) is on the rise. It seems that given the attractive risk-adjusted returns of mezzanine debt securities, they would be a natural fit to join this ongoing trend. Of course, the illiquid nature of assets (mezzanine debt securities) and the uncertainty of the ramp-up period are just a couple of challenges that would need to be overcome to construct a mezzanine-backed CDO. On the other hand, other nontraditional funds have started to emerge. Traditional limited partnership funds (LPs) are under increasing pressure to sustain their high level of returns in the face of lower returns experienced by equity providers. Leveraged LP structures in which LP interests are tranched may be a means of satisfying various investor return thresholds.

Trends And Outlook

By all accounts the leveraged loan product is a viable capital markets solution. The benign credit environment, coupled with the tremendous
evolutionary growth in leveraged loans during the late 1990s has created a permanent place for leveraged loans. However, the extremely aggressive lending practices during this time period, as evidenced by the particularly poor vintage of transactions completed between 1997-1999, resulted in approximately 64% of the default volume between 2000-2002. This staggering default rate has caused bank lenders to vow to maintain more conservative lending standards. Companies that might have previously tapped the bank loan and high-yield markets in the late 1990s, may now turn to mezzanine securities or senior "stretch" loans as a likely alternative.

Most mezzanine investments are taken out either through a change-of-control sale or recapitalization of the company. Many mezzanine capital providers believe the IPO "home run" is a rarity. While larger mezzanine providers may look to invest in companies that represent strong IPO candidates, more frequently, the high-yield market is the likely take-out option. So, while historically the private mezzanine debt market and high-yield market have been competitors, high-yield is increasingly being viewed as a friend rather than foe to mezzanine investors.

This article was excerpted from a recent FitchRatings report on Mezzanine Debt.

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