Amsterdam Institute of Finance

Leveraged and Mezzanine Finance

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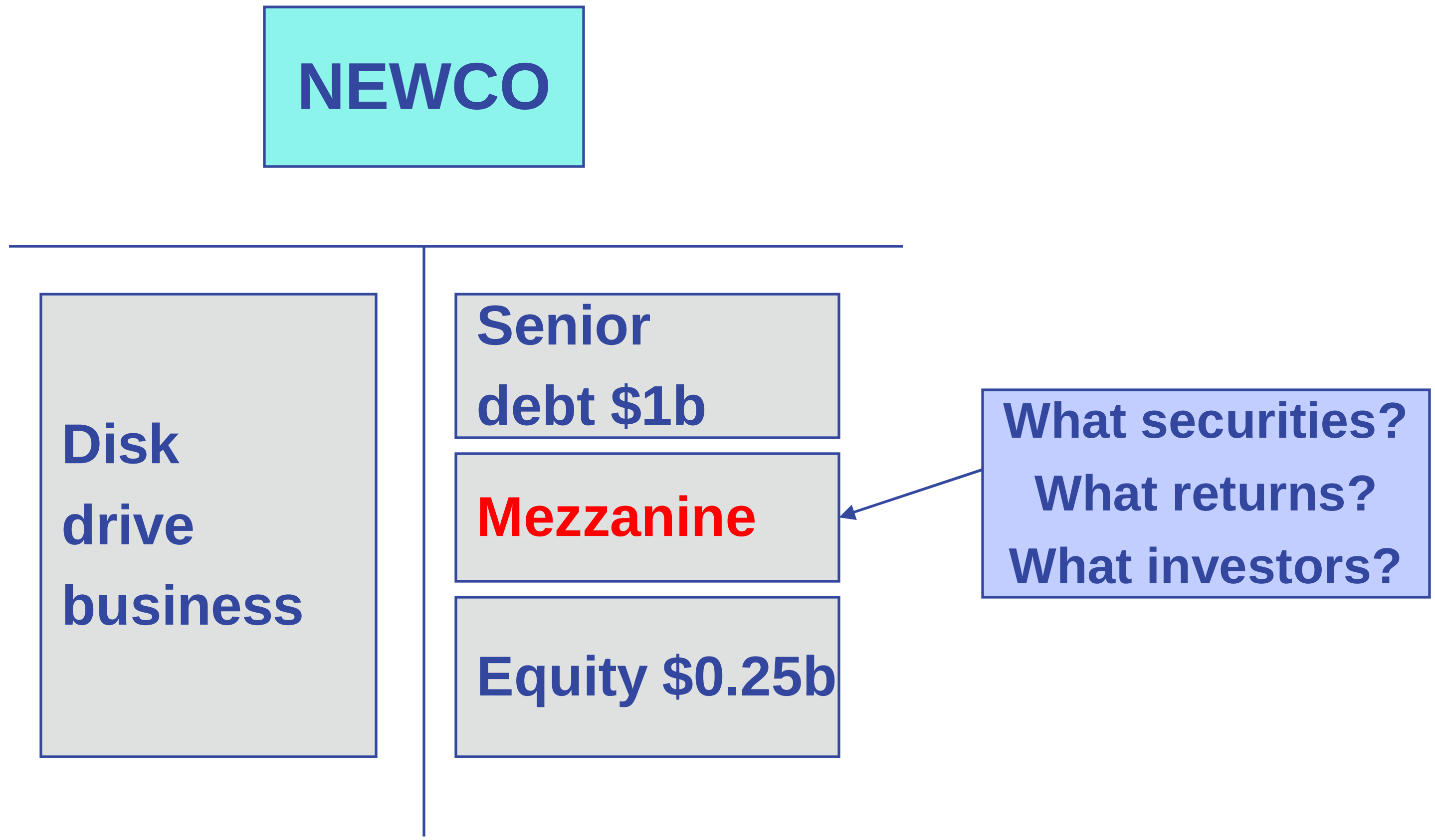
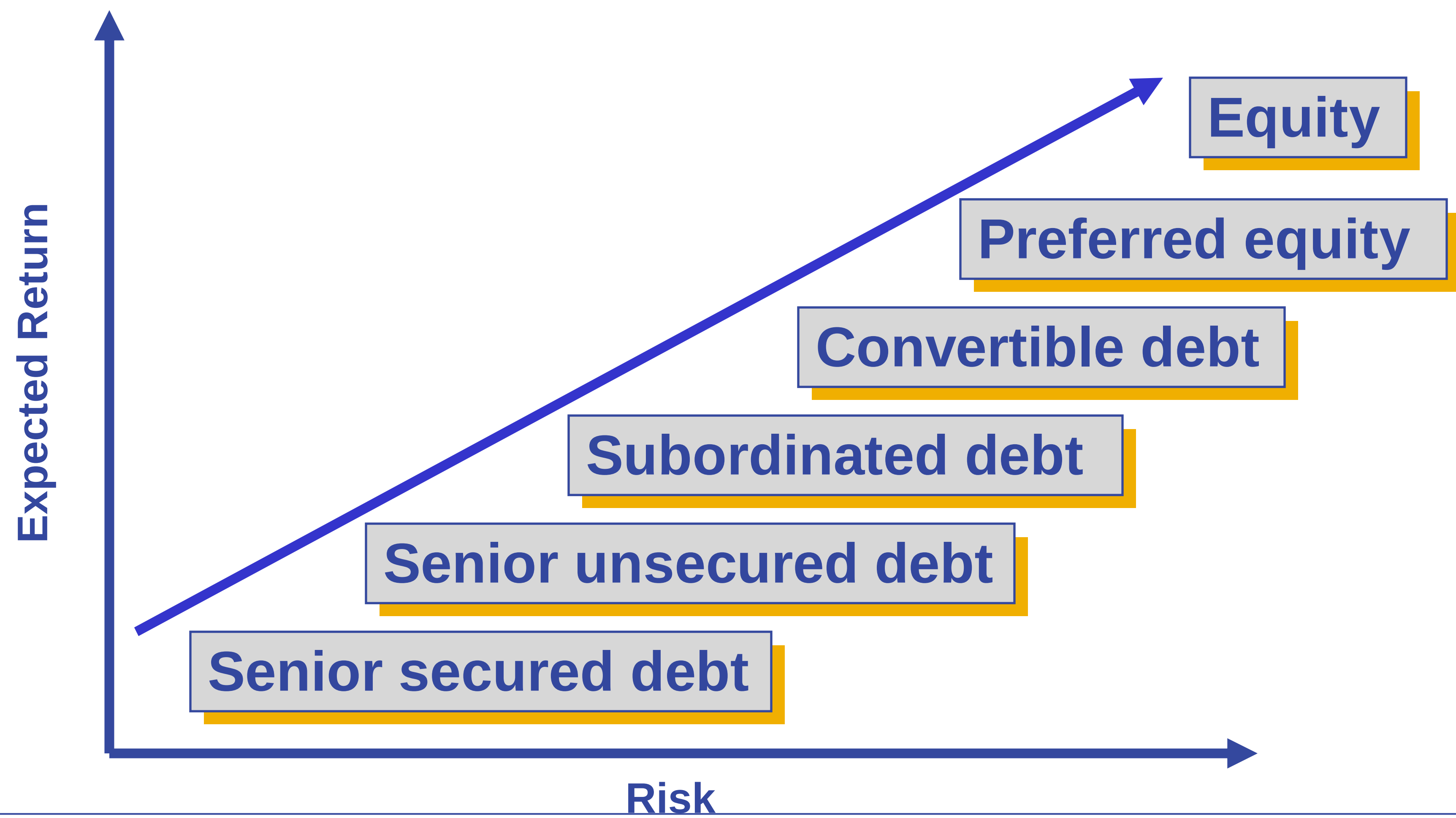
Mezzanine Debt



The Financing Spectrum



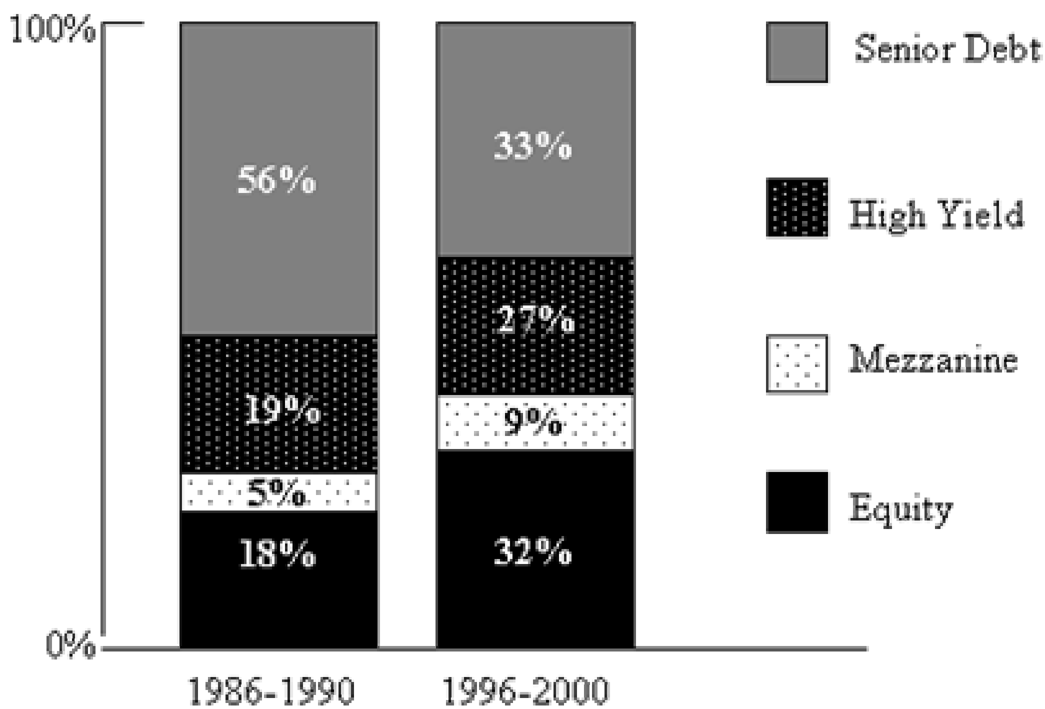
Some Leveraged Financing Techniques

- Senior Debt
  - Asset-backed debt: first lien, mortgage, leasing, ABS
  - Bridge loans, term debt, revolving credit facilities
  - Second lien notes
  - Senior unsecured debt
  - Seller note
- Mezzanine
  - High-yield bonds
  - Subordinated debt with deferred interest: PIKs, step-ups
  - Subordinated debt with equity options: warrants, converts, participating
- Equity
  - Convertible preferred stock – LBOs and VCs
  - Common stock: “Stub” (previous owners’ share); managers

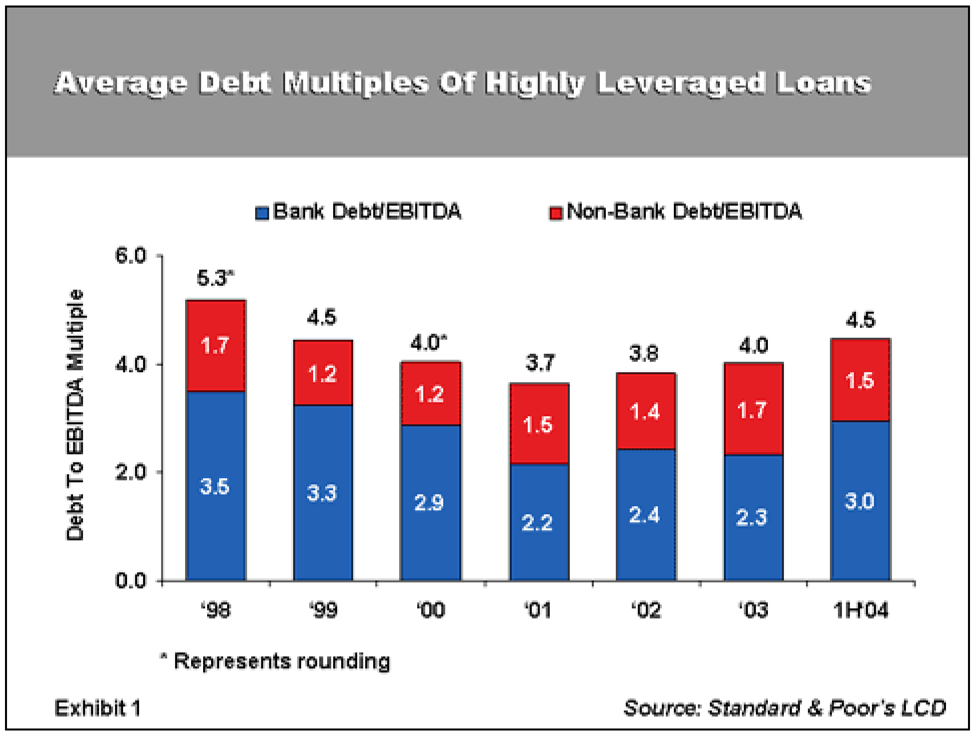
Typical LBO Transaction Structure

Financing	Percent of transaction	Cost of capital	Lending criteria	Likely sources
Senior debt	50-60%	7-10%	5-7 years payback 2x-3x EBITDA 2x interest coverage	Commercial banks Insurance companies
Mezzanine financing	20-30%	10-20%	7-10 years payback 1x-2x EBITDA	Public market Insurance companies Hedge funds LBO/Mezzanine funds
Equity	20-30%	25-40%	4-7 years exit strategy	Management LBO funds Sub debt holders

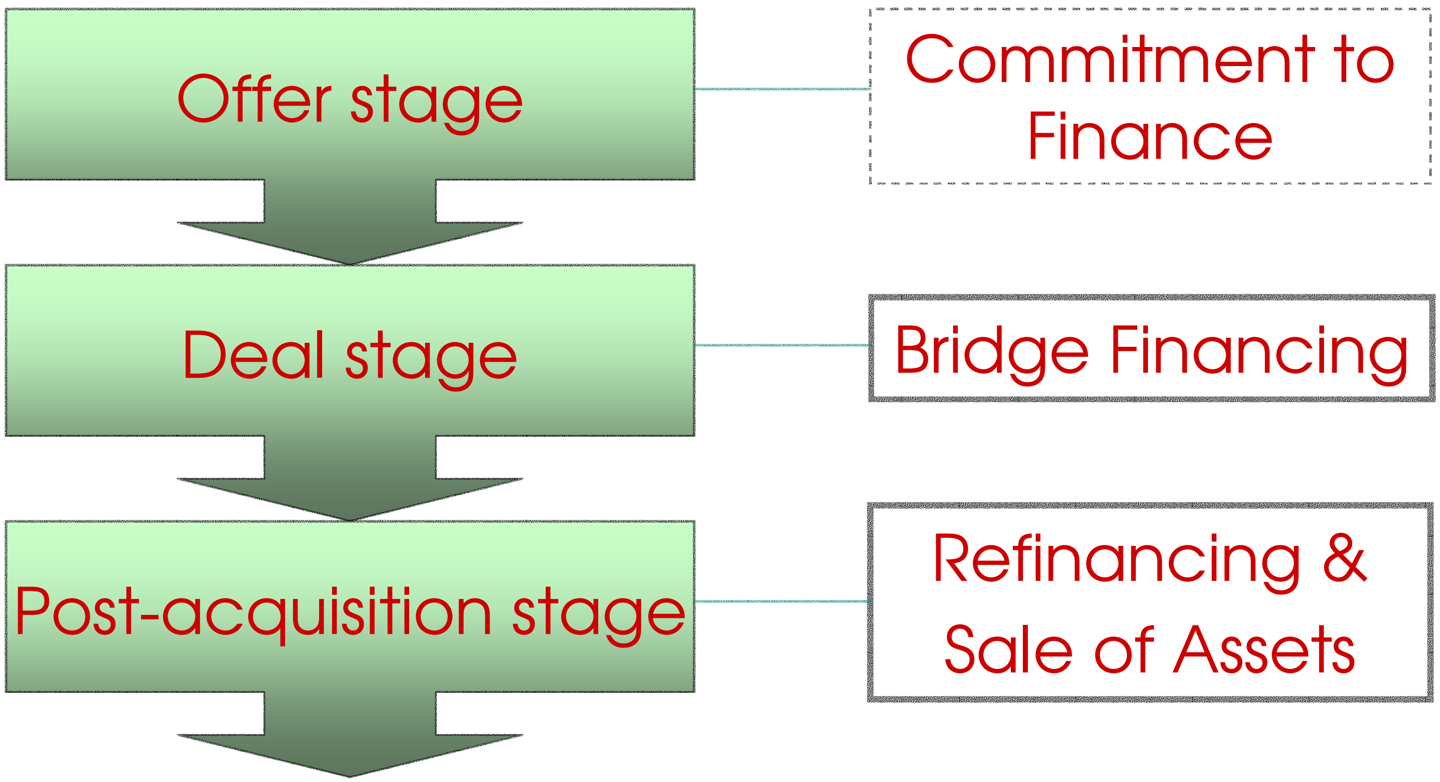
Changing Structures



Leveraged Finance Multiples



Leveraged Lending for Acquisitions



Trading and Transferring Loans

ASSIGNMENT

FULL ASSIGNMENT

The sale of *all* of the originating lender's or *assignor's* rights and interest in a credit facility to a purchaser or *assignee.*

ASSIGNMENT WITH NOVATION

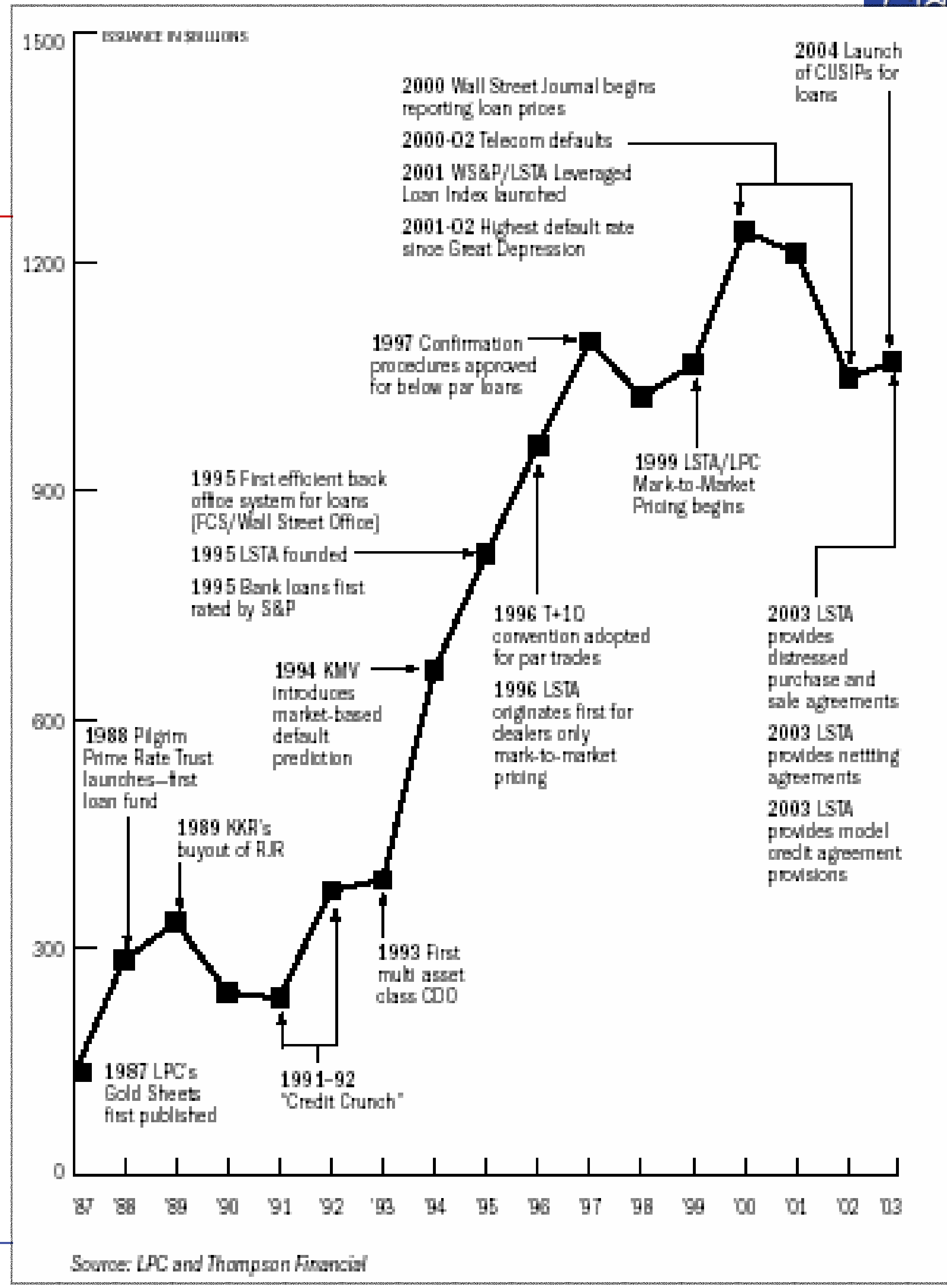
PARTICIPATION

PARTICIPATION

Participants have derivative rights, not direct rights against (or obligations to) the borrower.

- **LIMITED VOTING PARTICIPATION**
- **FULL VOTING PARTICIPATION**
- **FULL PASS-THROUGH PARTICIPATION**

Syndicated Loans: Evolution of the Market



Bank Debt

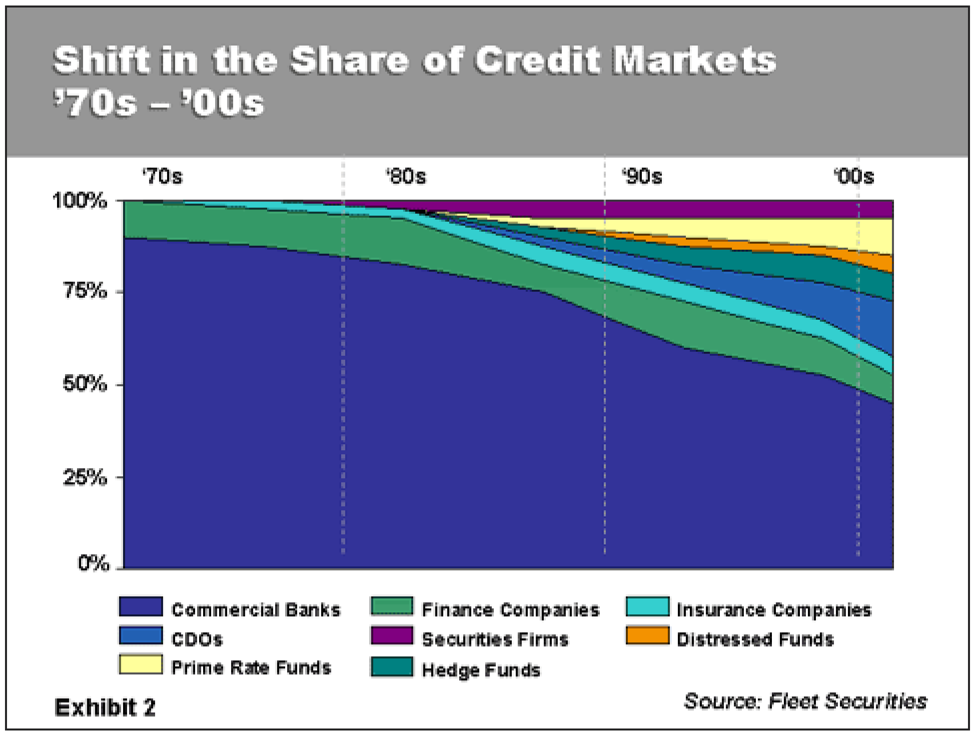
- Bridge loans
  - Bank loans providing funds quickly to get the deal done; refinanced in 1-6 months
  - May have step-up spreads and other incentives to pay down early
- Term debt
  - Private placements of syndicated loans underwritten and distributed like bonds -- sold to bank and insurance companies
  - Often secured
  - Priced at substantial spread over Libor
  - Repayments can be straight line amortization with or without a “grace period”
- Revolvers
  - Bank loans that company can draw down for working capital, certain capital investments, unforeseen costs
  - Usually have ongoing fees, borrowing limits, covenants, and conservative repayment terms

Giddy.org Resources in Finance

Syndicated Acquisition Loans

- Debt instruments that have features of public debt such as an active secondary market and credit ratings.
- Syndicated loans can be both secured and unsecured, but are always senior debt.
- Leveraged syndicated loans are typically senior to all other debt in the borrower's capital structure, while syndicated loans of investment grade firms are often at the same level of seniority as senior bonds.
- Generally callable at par without penalty – especially important in leveraged finance.

New Players


Shift in the Share of Credit Markets
'70s – '00s
'70s
'80s
'90s
'00s
100%
75%
50%
25%
0%
Commercial Banks
CDOs
Prime Rate Funds
Finance Companies
Securities Firms
Hedge Funds
Insurance Companies
Distressed Funds
Exhibit 2
Source: Fleet Securities

Case Study: Financing the Valvex Acquisition

- Would you advise Connexion to use a syndicated loan to finance its prospective acquisition?
- If so, how would it be structured and distributed?
- How should the bank evaluate and price the risk?

Bridge Financing an Acquisition: Valvex

The Context

- Connexion is the leading OEM supplier of one-way air connection valves for cabin pressurization for the airline industry.
- By the acquiring of the ventilation valve division of Valvex International, Connexion was able to increase its world-wide market share to 23%

Financing Needed

- Needed approximately EUR300 million
- Total financing of EUR 301.6 mn: GBP 172 mn purchase price as well as financing for general corporate purposes

The Choice

- Used term loan fully underwritten by SocGen
- Three tranches:
  - EUR 132 Mio. 7-year term loan
  - USD 112.5 Mio. 7-year term loan
  - EUR 47 Mio. 5-year revolver

Term Sheet

Terms and Conditions of Syndicated Loan

Borrowers:	Connexion SA, Toulouse, ("Connexion") and/or any majority owned subsidiary of Connexion.
Guarantors:	(a) Connexion.
	(b) Certain subsidiaries of Connexion representing at any time at least 60% of the consolidated assets and revenues of the Connexion group.
Facility:	Tranches A 1 and A 2: Syndicated Multi-Currency Term Loan Facility.
	Tranche B: Syndicated Multi-Currency Revolving Credit Fac.
Facility Amt.	Tranche A 1: EUR 131,830,000.
	Tranche A 2: USD 112,540,000.
	Tranche B: EUR 47,430,000.
Purpose:	Tranches A 1 and A 2: Financing of the purchase price for several companies comprising the ventilation valve division of Valvex International plc. ("VX Group").
	Tranche B: Refinancing of existing financial indebtedness of the members of the VX Group.
Final Maturity Date:	Tranche A 1: 7 years from the date of the facility agreement.
	Tranche A 2: 7 years from the date of the facility agreement.
	Tranche B: 5 years from the date of the facility agreement.
Repayment:	Tranches A1 and A2 will be repaid in semi-annual instalments.
	Tranche B: Each advance will be repaid at the end of its relevant interest period respectively on the Tranche B Final Maturity Date.
Applicable Margin:	The initial Applicable Margin will be 1.50% p.a.
Commitment Fee:	(i) 0.50% p.a. on the undrawn and uncancelled part o[illegible] and A 2.
	(ii) 50% of the Applicable Margin on the undrawn and uncancelled part of Tranche B.
Front-end Fee:	1.65 % flat on the Facility Amount underwritten by SocGen. The Front-end Fee includes the arrangement and underwriting fee for SocGen as well as

Full Screen
Close Full Screen

Source: http://pages.stern.nyu.edu/~igiddy/cases/connexion.doc

CLO Example

- Senior loans now being traded and repackaged into asset-backed securities

Presale: KKR Financial CLO 2005-1 Ltd./KKR Financial CLO 2005-1 Corp.

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$1.006 Billion Floating-Rate Notes Due 2017

This presale report is based on information as of March. 29, 2005. The ratings shown are preliminary. This report does not constitute a recommendation to buy, hold, or sell securities. Subsequent information may result in the assignment of final ratings that differ from the preliminary ratings.

Preliminary Ratings as of March 29, 2005

Class	Preliminary ratings*	Preliminary amount (mil. $)	Preliminary credit support (%)
A-1	AAA	615.00	28.96
A-2	AAA	100.00	28.96
B	AA	58.00	23.20
C	A	64.00	16.84
D	BBB-	64.00	10.48
E	BB-	15.00	8.99
F	B-	5.00	8.49
Subordinated notes	N.R.	85.50	0.00

*The ratings are preliminary and subject to change at any time. N.R.—Not rated.

CLO Example

Collateral Pool Characteristics

The collateral securing the rated notes is expected to consi
of U.S. dollar-denominated ABS. The expected breakdown
the collateral debt obligation portfolio by the most relevant
asset types is shown in table 2.

Table 2 – Collateral Guidelines	
	(%)
Senior secured loan percentage (min.)	90.00
Convert percentage (max.)	5.00
Convert right price percentage	2.00
Zero coupon percentage (max.)	5.00
PIK percentage (max.)	5.00
Short-term obligations percentage (max.)	5.00
Revolver percentage (max.)	10.00
Bond and second-lien loan percentage (max.)	10.00
'CCC' purchase percentage (max.)	5.00
'CCC' replacement percentage (max.)	5.00
Equity exposure percentage (max.)	5.00
Offers percentage (max.)	0.00
Single obligor percentage (max.)	2.00
S&P single industry percentage (max.)	9.00
Eligible countries other than the U.S. (max.)	20.00
Eligible countries other than the U.S. and Canada (max.)	10.00
S&P bi-variant risk percentage (max.)	20.00
S&P foreign obligor risk percentage (max.)	20.00
Small obligor percentage (max.)	5.00
Fixed-rate percentage (max.)	5.00
Nonquarterly pay percentage (max.)	5.00
Debtor-in-possession and current-pay percentage (max.)	5.00
PIK and partial PIK percentage (max.)	5.00
Structured finance and REIT preferred percentage (max.)	5.00
REIT preferred percentage (max.)	0.00
PIK—Payment-in-kind.	

Rationale

The preliminary ratings assigned to KKR Financial CLO 2005-1 Ltd./KKR Financial CLO 2005-1 Corp.'s floating-rate notes reflect:

- Credit enhancement provided through the subordination of cash flows to the respective class;
- The transaction's cash flow structure, which has been subjected to various stresses requested by Standard & Poor's Ratings Services;
- The experience of the collateral manager; and
- The legal structure of the transaction, including the bankruptcy remoteness of the issuer.

↑back to top

Standard & Poor's CDO Evaluator Benchmark Statistics

Benchmark results generated by application of Standard & Poor's CDO Evaluator to the proposed collateral pool are shown in table 1.

Table 1 – Benchmark Statistics	
Weighted avg. rating (WAR)	B+
Weighted avg. maturity (WAM) (yrs.)	5.89
S&P default measure (DM) (%)	3.78
S&P variability measure (VM) (%)	2.28
S&P correlation measure (CM)	1.17

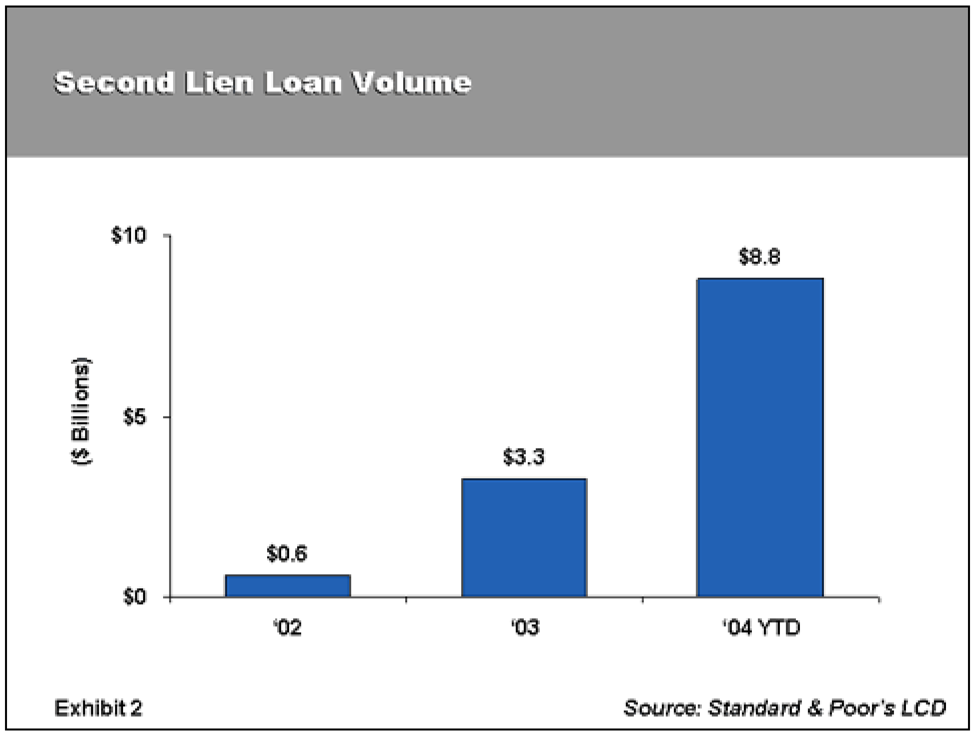
Subordinated Debt

- Optimization of financial leverage
- Regulatory-driven capital requirements
- Rated asset securitizations (senior-sub structure in asset-backed securities)
- Insider or supplier-credit subordination (eg in project finance)
- Work-outs and restructurings (existing borrowers agree to seniority of new loans, to buy time)

Second Lien Notes

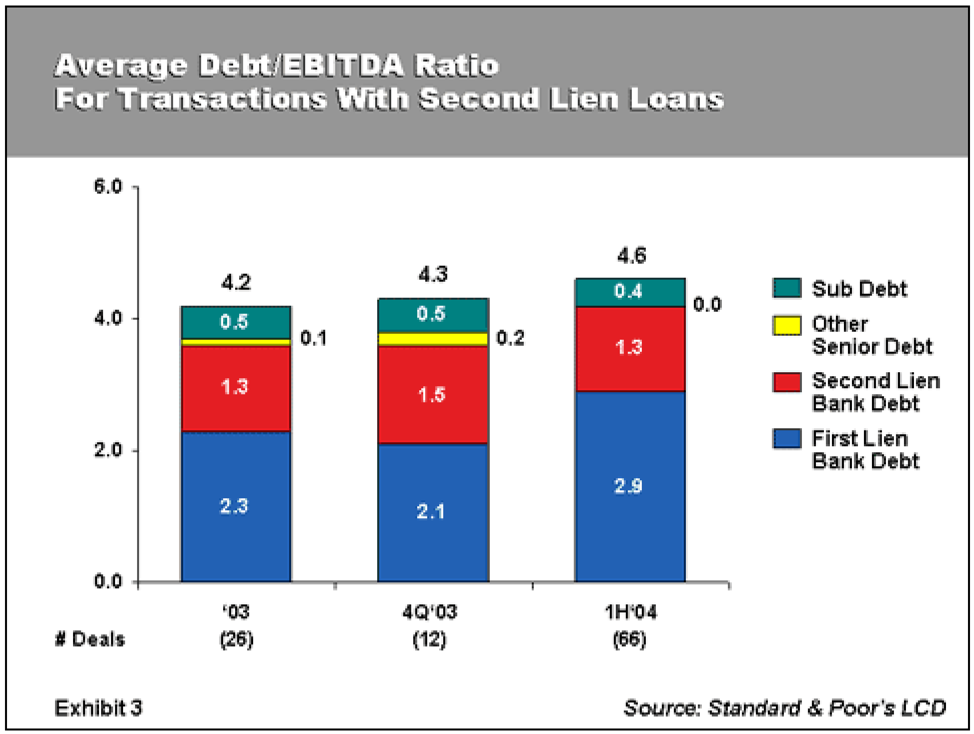
- Loaned against remaining value of collateral, sometimes more
- *Not* subordinated in right of payment to first lien lenders
- May have second lien claim on most liquid assets, like receivables, but first lien on equipment
- Higher rates than senior, but less costly than mezzanine
- No warrants or equity kickers
- Investor base includes hedge funds, specialized investment funds and mutual funds (unit trusts)
- But may have complex intercreditor agreements

Second Lien



Second Lien Loan Volume
($ Billions)
$10
$5
$0
$0.6
$3.3
$8.8
'02
'03
'04 YTD
Exhibit 2
Source: Standard & Poor's LCD

Second Lien



Average Debt/EBITDA Ratio
For Transactions With Second Lien Loans
6.0
4.0
2.0
0.0
4.2
0.5
0.1
1.3
2.3
4.3
0.5
0.2
1.5
2.1
4.6
0.4
0.0
1.3
2.9
'03
(26)
4Q'03
(12)
1H'04
(66)
Deals
Sub Debt
Other Senior Debt
Second Lien Bank Debt
First Lien Bank Debt
Exhibit 3
Source: Standard & Poor's LCD

Example of Wording

Senior Secured Second Lien Term Loan Summary of Proposed Terms & Conditions (Cont'd)	
	subsidiaries of the Borrower, assumed to be the same Guarantors as under the credit agreement governing the First Lien Credit Facility.
Security:	The Second Lien Credit Facility will be secured by a perfected second priority security interest and lien upon all tangible and intangible assets of the Borrower, assumed to be identical to the assets securing the First Lien Credit Facility.
Intercreditor Terms:	The Second Lien Credit Facility will be senior to all existing and future subordinated debt as will be reflected in documentation acceptable to the Purchaser. General intercreditor terms for the Second Lien Credit Facility shall include, but not be limited to: • Second Lien Credit Facility is lien subordinated and not payment subordinated to the First Lien Credit Facility; • Application of proceeds from collateral (including, but not limited to, those outlined in the Mandatory Prepayment provision) not applied to the First Lien Credit Facility shall be applied to the Second Lien Credit Facility in accordance with Mandatory Prepayment provision;
Management Access and Reporting Right:	XXX will have the right to receive all information, reports, and access provided to the senior lenders under the Reporting Requirements set forth in the Senior Credit Agreement. In addition, the Senior Secured Second Lien Lenders will meet quarterly with management to receive a formal update on the performance of the business and its prospects. Failure by the company to comply with such a meeting request will be an event of default

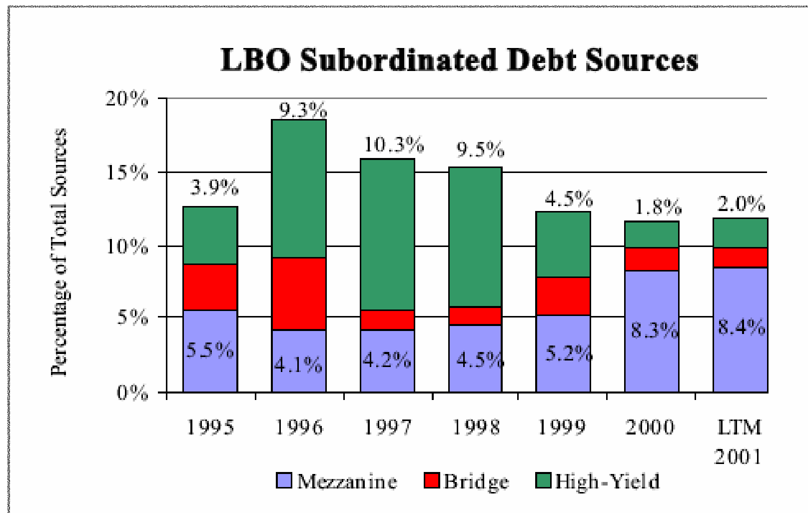
Seller Notes

- In March 2003, Blackstone Group acquired TRW Automotive from Northrop Grumman for $4.7 billion.
- Part of the debt financing was a 600 million, 8% pay-in-kind note payable to a subsidiary of Northrop Grumman Corporation
- Valued at $348 million on a 15-year life using a 12% discount rate

- As of September, 2004, the accreted book value totaled $417 million, and accreted face-value was $678 million
- That month TRW Automotive repurchased the Seller Note and settled various contractual issues stemming from the acquisition, for a net amount of $493.5 million.

High Yield and Mezzanine Financing

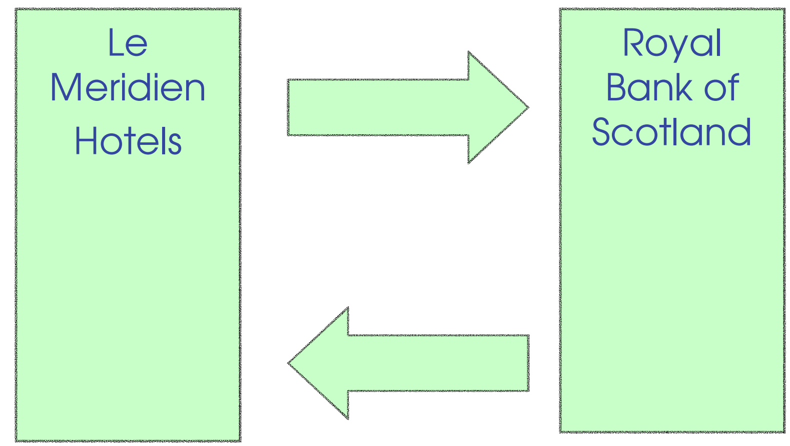
- High yield bonds sold to the public
  - High interest rates, “event risk” puts
- Subordinated private placements
  - High interest rates
  - Pay-in-kind interest (interest paid in form of additional notes
  - Step-up rates
  - Warrants to purchase shares (typically 2-5% of new company)
  - Convertible notes



Source:hewittinvest.com

Sale-and-Leaseback Financing

- This is an agreement in which the owner of property sells that property to a person or institution and then leases it back again for an agreed period and rental.
- Leaseback is often used by companies that want to free up capital tied up in buildings.
- The tenant/lessee often has some kind of option to buy back the property at the end of the lease period.



High Yield and Mezzanine Financing

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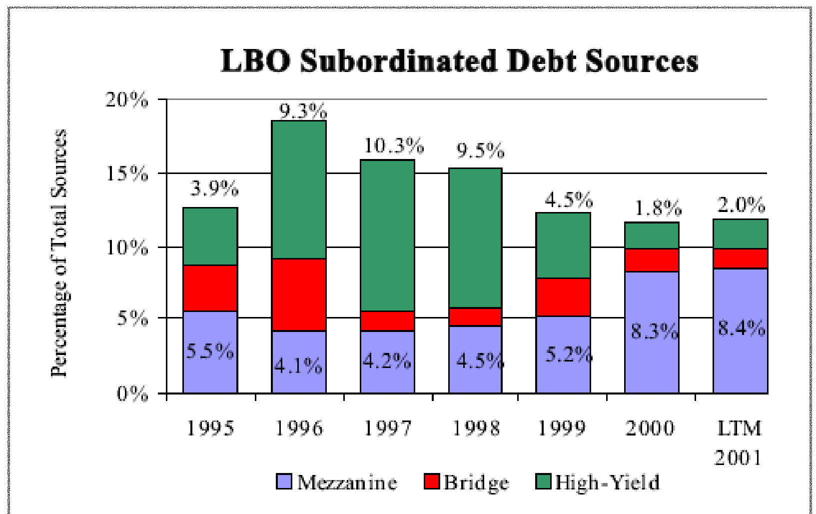
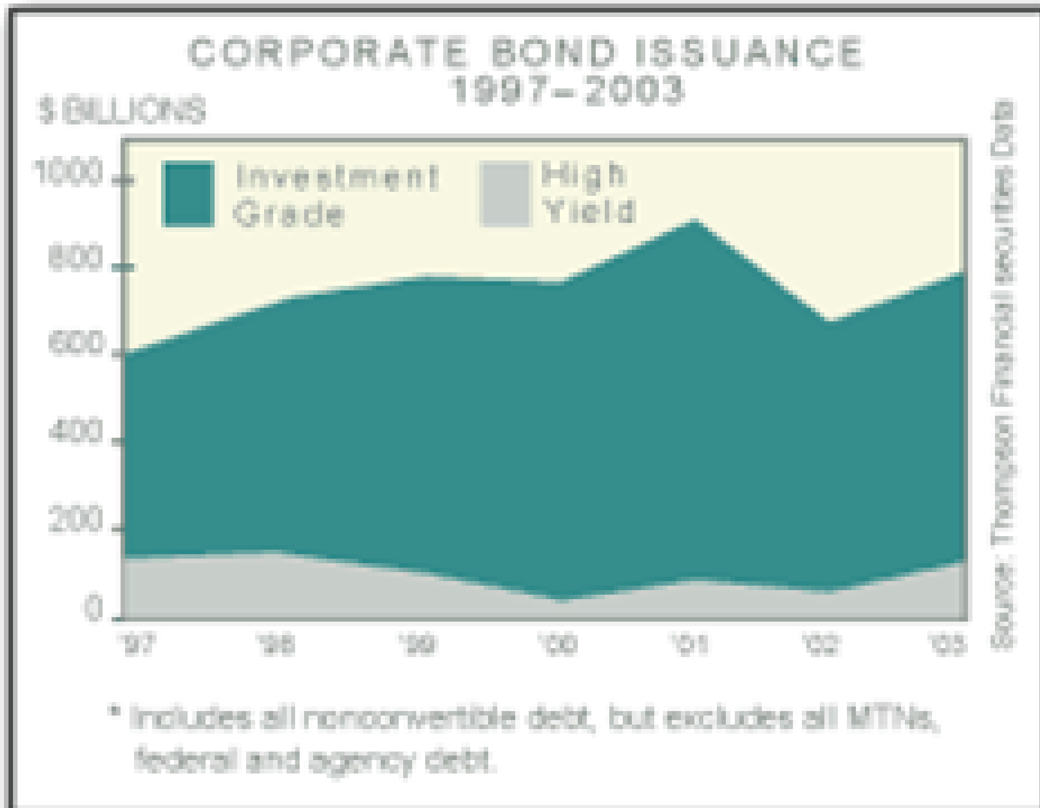


Source:hewittinvest.com

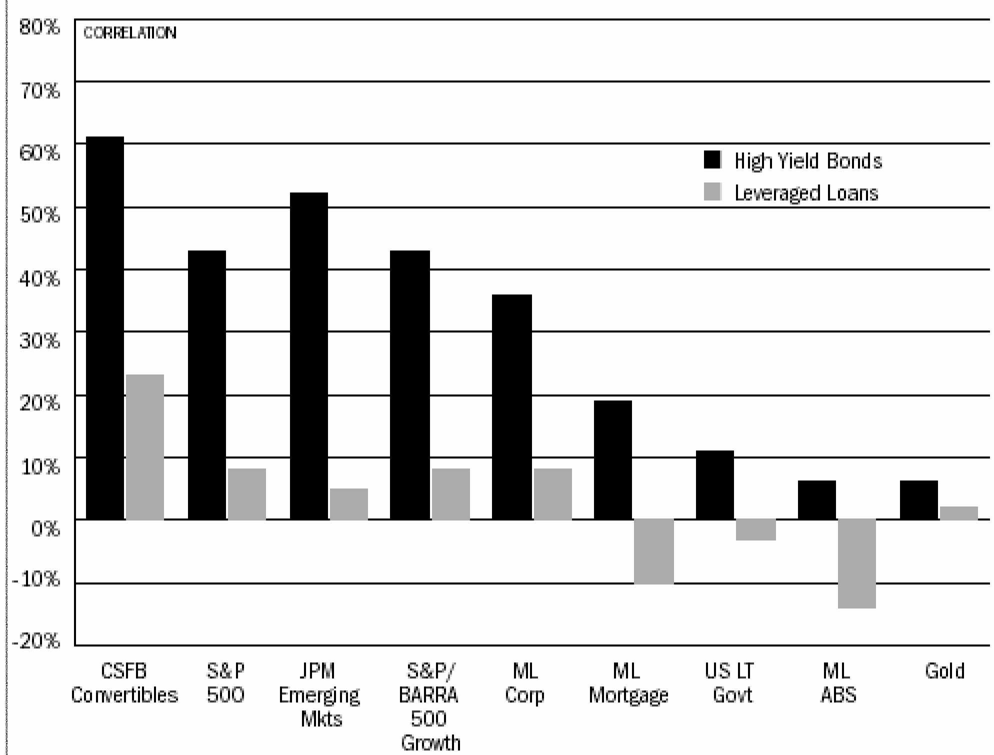
High Yield Bonds



Source: investinginbonds.com

High Yield is Like Equity

FIGURE 27: LEVERAGED LOANS AND HIGH YIELD BONDS, 1992-1H04



Source: CSFB, Ibbotson

Case Study: Piaggio

- Who buys "speculative grade" bonds?
- What protections do high yield investors want?
- What yields do these investors expect, and in what form?
- What did Piaggio offer?

Rating: B2/B
Amount: Eu150m
Maturity: 30 April 2012
Issue price: 100.00
Coupon: 10%
Call options: at 105% from 30 April 2009; at 102.5% from 30 April 2010; at par thereafter
Spread at launch: 688bp over the 5% January 2012 Bund
Launch date: Thursday 21 April
Payment date: 27 April
Joint books: Lehman Brothers, Deutsche Bank, Caboto

Bookrunner's comment:

Lehman — The credit markets have backed up in recent weeks and this has had an effect upon the new issue environment.

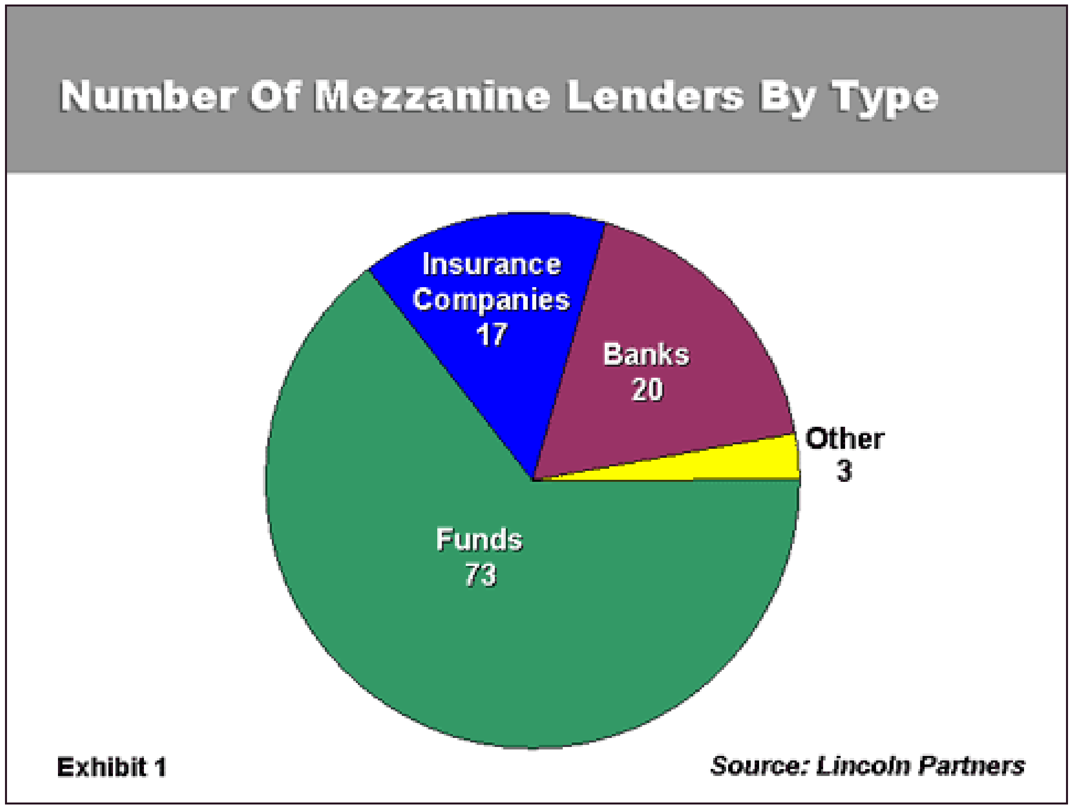
However, it remains attractive when compared to the last couple of years. It has certainly been choppy with all of the auto-related news but Piaggio was a success as we were able to get investors to focus on the brand, the management team and what the company does. This was why we were able to tighten pricing up from 10.25% to 10%.

Investors recognised that this was a nice asset to own. The bonds were priced at par and traded up to 101.125 on the break.

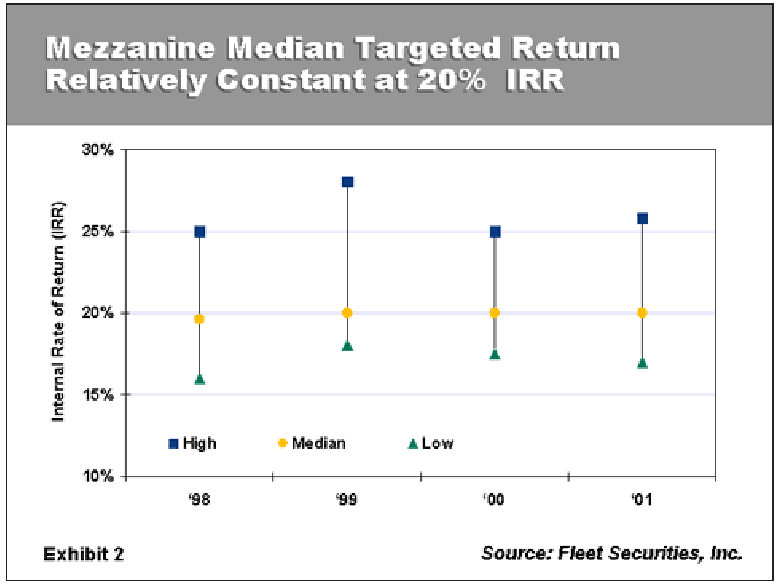
There was a healthy representation from investors in the UK and the continent with a strong participation from Italy.

Despite the choppy market, the deal got done because the management team did a fantastic job on the road and people focused on the team behind Piaggio, the brand and its business.

US Mezzanine Providers (2002)



Mezzanine's Big Problem: High Expected Rate of Return



Solutions

- ❑ Deep discount subordinated debt
- ❑ Step-up rates
- ❑ Subordinated debt with equity warrants
- ❑ Convertible subordinated debt
- ❑ Participating subordinated debt
- ❑ Puttable subordinated debt

From Bank of America:

- Mezzanine debt is issued with a cash pay interest rate of 12 to 12 1/2 percent and a maturity ranging from five to seven years. The remainder of the required 18 to 20 percent all-in-return consists of warrants to buy common stock, which the investor values based on the outlook of the company, or incremental interest paid on a "pay-in-kind" or PIK basis.
- The fee for raising the money runs between two and three percent of the transaction.
- Deal sizes typically range from three million to $25 million but can go as high as $150 million.

Source: Bank of America

Example of Term Sheet

FM Mezzanine Partners LLC
Summary of Proposed Terms & Conditions
Senior Subordinated Notes

Issuer:	Old Time Pottery ("OTP" or the "Issuer")
Securities:	Senior Subordinated Notes (the "Notes")
Principal Amount:	$15.0 million
Issue Price:	100%
Purchaser:	FM Mezzanine Partners LLC (the "Purchaser") or one or more of its affiliates and other investors mutually acceptable to the Purchaser and the Issuer.
Use of Proceeds:	The proceeds of the Notes will be used to (i) finance the acquisition of the Issuer by the Private Capital Group of BNP Paribas ("PCG") and (ii) pay fees and expenses in connection with the acquisition.
Closing Fee:	1.00%
Interest Rate:	12.00% per annum payable quarterly in cash in arrears.
Warrants:	3.50% of the fully-diluted equity of the Issuer including the assumed issuance of all equity under any current or future management equity plans; provided that Warrants for 0.50% of the fully-diluted equity of the Issuer shall be canceled (the "Clawback") if each of the following conditions are achieved: (i) The sum of EBITDA for fiscal years 2005, 2006, and 2007 shall exceed $50.0 million, (ii) EBITDA shall be higher in each of fiscal years 2005, 2006, and 2007 when compared to the prior fiscal year, and (iii) Total leverage shall be less than 2.25x at the end of fiscal 2007. All Warrants will have a ten year term and be exercisable at a nominal exercise price, in whole or in part, at any time after Closing. The Warrants will have cashless exercise, tag-along, drag-along, anti-dilution, piggyback registration and pre-emptive rights to be agreed upon. The Warrants will have put and call features to be mutually agreed upon.
Maturity:	The earlier of (i) the 6-year anniversary of the Closing Date and (ii) 6 months following the maturity of the senior credit facilities.
Ranking:	The Notes will be senior unsecured subordinated

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6/5/2005, 6:32 PM

European Mezzanine: Some Developments

- Security. Some benefit from the same security-collateral package as the senior banks (but on a second-ranking and subordinated basis).
- “Warrantless" mezzanine. Based on the emergence of a new class of "institutional" mezzanine investor in Europe, who views mezzanine as a "current pay" asset and evaluates investments based on coupon. (Eg CDOs)
- “Mezzanine notes.” Securities issued by the holding company of the senior debt borrower (as for a high-yield issue), have high-yield-style covenants and benefit from subordinated upstream guarantees from the senior debt borrower and its operating subsidiaries.

U.S. vs. European Mezzanine

Source: fitchratings.com, “Mezzanine Debt”

Case Study: Jefferson Smurfit

- What is a Holdco PIK?
- List the factors that determine the rating of the Jefferson Smurfit PIK

■ Example – Jefferson Smurfit Group

Investors may have had a sense of déjà-vu when JSG announced plans for EUR300m HoldCo PIK notes in January 2005. Almost a year earlier in February 2004, it had attempted to sell EUR250m equivalent of 10-year-non-call five Senior PIK notes.

The US and European high yield markets were awash with liquidity at the time. A USD450m PIK note transaction from Nalco and a USD250m issue by Dex Media funded dividends to the respective equity sponsors in January 2004.

However, JSG's proposed transaction was cancelled in February 2004 as investors grew more cautious and demanded more yield. The higher yield made the transaction unattractive from JSG's point of view and the plans were shelved.

In contrast, even though the recent HoldCo PIK note transaction from JSG was larger than the previously proposed deal, the issue was increased from EUR300m to EUR325m. This indicates a shift in the risk appetite of investors in the European high yield market.

Although the issue increased JSG's financial leverage, the interest on the notes will remain non-cash unless the issuer elects to pay cash interest and, therefore, should not affect the group's cash interest coverage ratios until maturity.

The HoldCo PIK notes do not benefit from any guarantees, nor would a default under the HoldCo PIK notes trigger a default on JSG's existing liabilities.

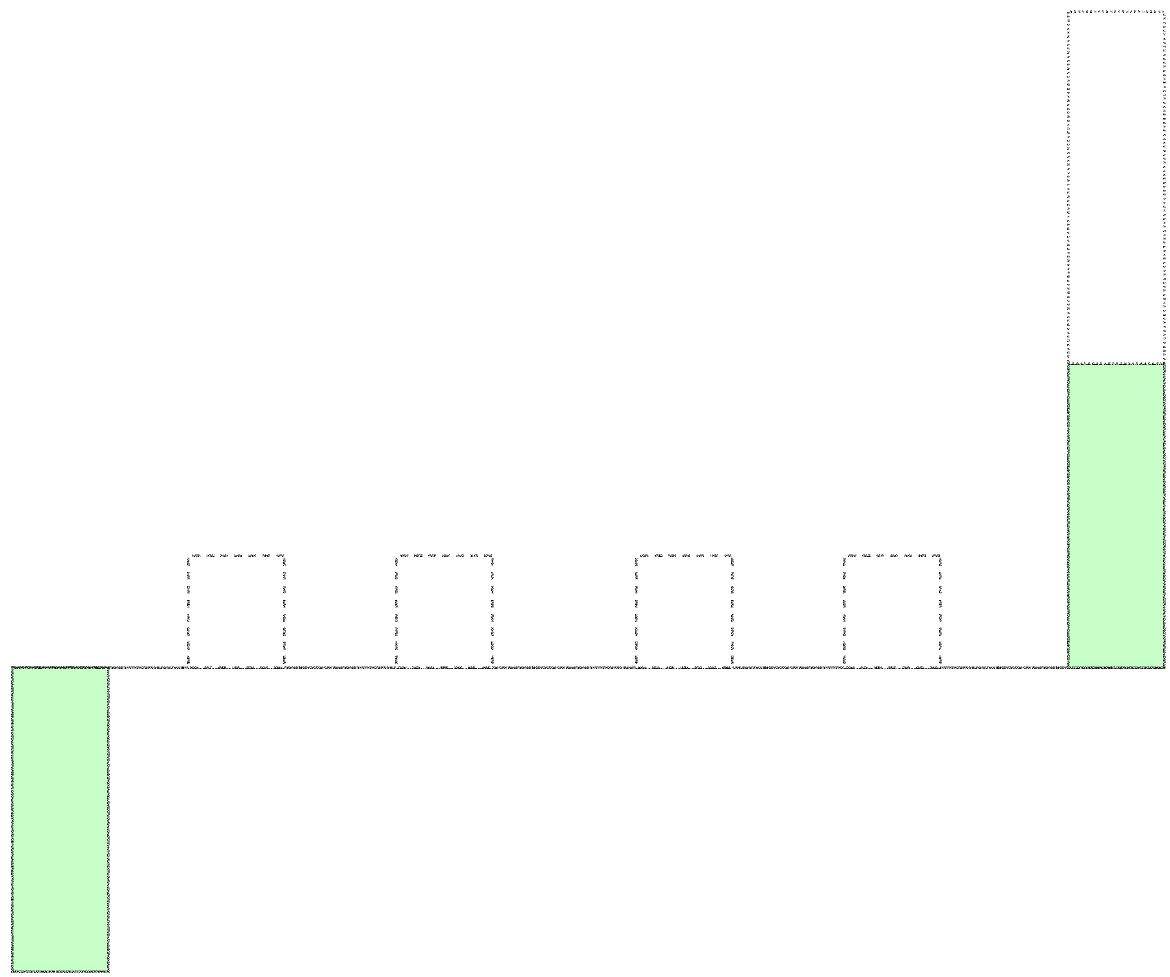
Furthermore, JSG Funding Plc and its subsidiaries are restricted by the indentures governing the existing senior secured facilities, senior notes and senior subordinated notes from paying dividends to JSG Holding.

The issuance of the HoldCo PIK notes does not impact the recovery prospects of existing debt issued by JSG. The HoldCo PIK notes are contractually and structurally subordinated to all existing liabilities within the group and their maturity falls beyond those of all existing debt instruments, except for the USD292m bonds due 2025.

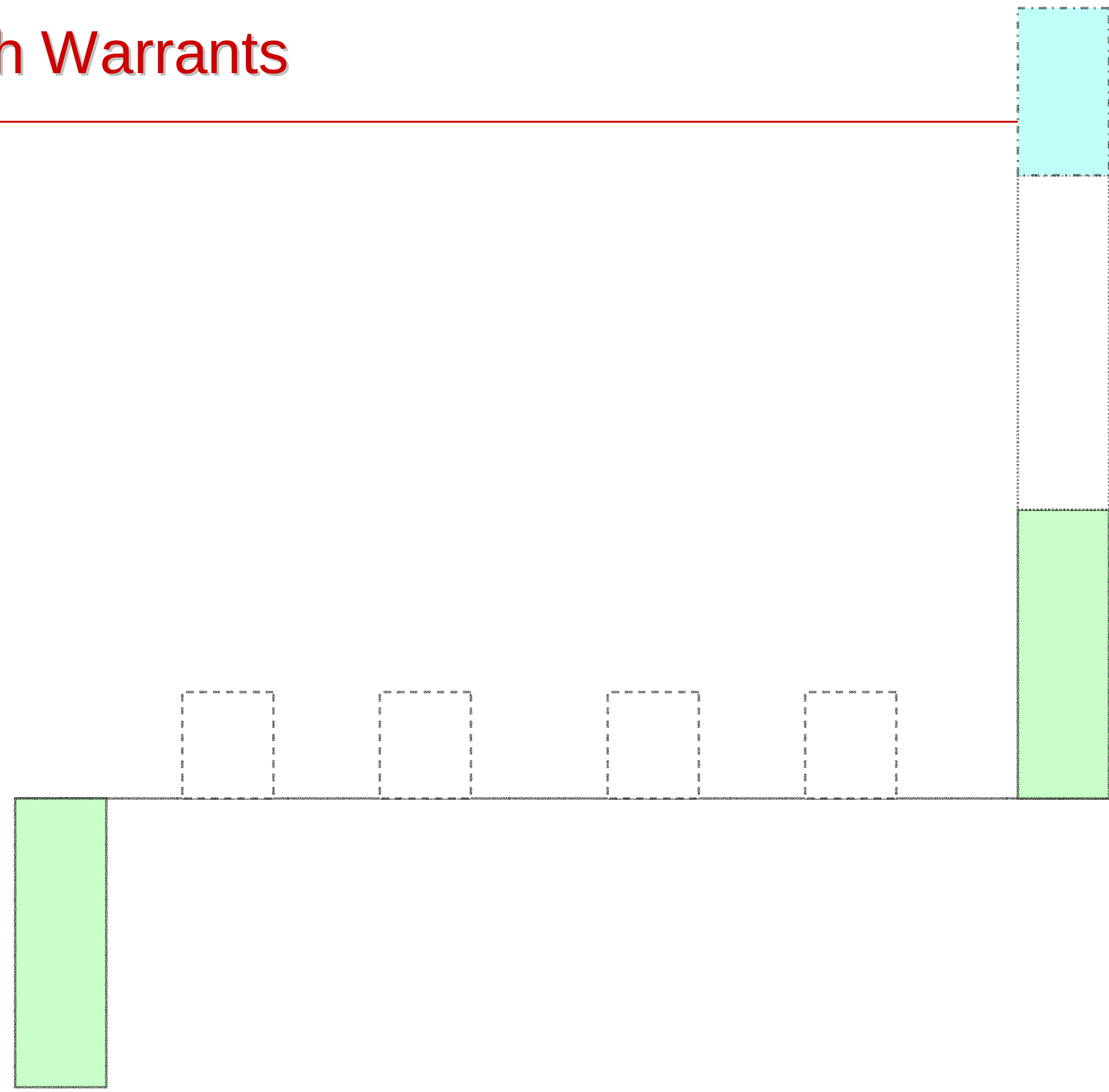
Mezzanine Debt with Warrants

- Typically subordinated debt with attached equity warrants
- Principal is typically repaid in a lump sum at the maturity of the loan -- after senior debt is repaid
- Cash coupon
- Warrants are typically nominally-priced and represent a minority stake in the issuer

Payment in Kind

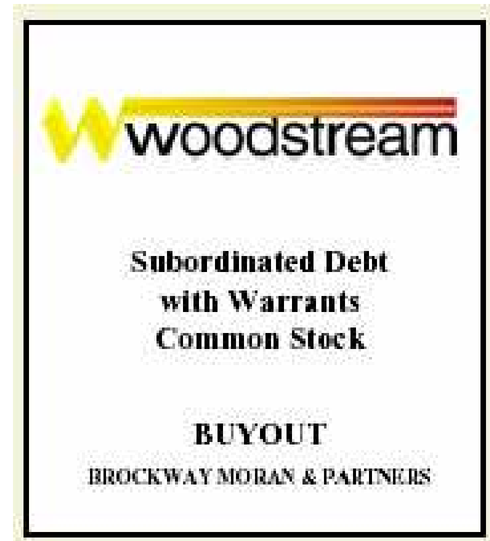


PIK with Warrants



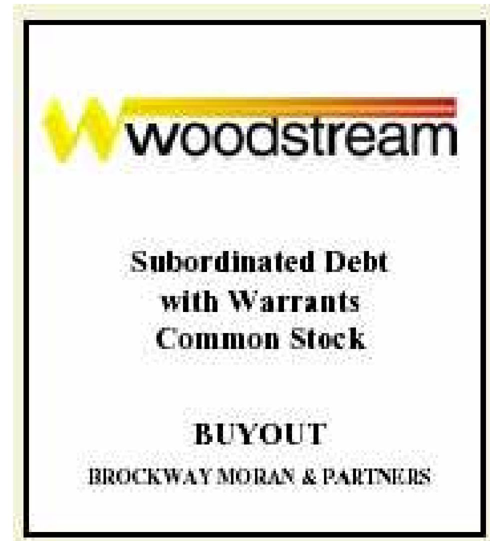
Case Study: Who Got the Warrants?

- In a deal that closed June 12, Brockway Moran & Partners purchased Woodstream Corp., a maker of wild animal cage traps, rodent control devices and pesticides, from Friend Skoler & Co. LLC. The $100 million purchase price is equivalent to between 6.5 and 7x EBITDA.
- Of the equity, Brockway contributed 85% of the total, with management chipping in 10%. Lenders Antares Capital Corp. and Allied Capital Corp. fill in the remaining 5% gap. Total equity represents approximately 40% of the purchase price.
- On the debt side, Antares led a $58 million senior facility, along with Merrill Lynch and GE Capital Corp. The senior debt component also contains a revolver to be used in the future as working capital (and not included in the $100 million purchase price). CIT Private Equity and Denali Advisors LLC provided a subordinated note in the amount of $17 million.



Cost of the Mezz?

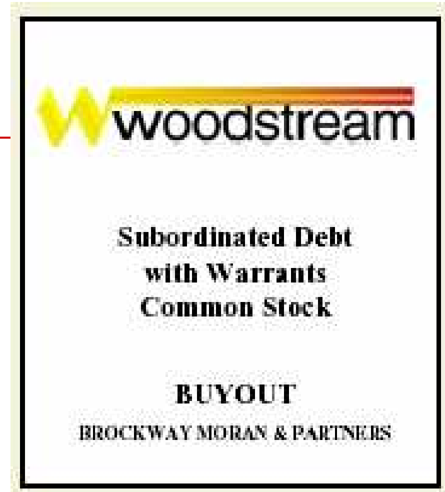
- Senior debt: Libor + 3.50%, 4 year amortization
- Subordinated notes:
  - 7% cash interest
  - 7% pay-in-kind interest
  - Warrants to purchase 5% of the company's equity at $0.05 per share
  - Repayment after 5 years or at exit event
- Equity 27% required return

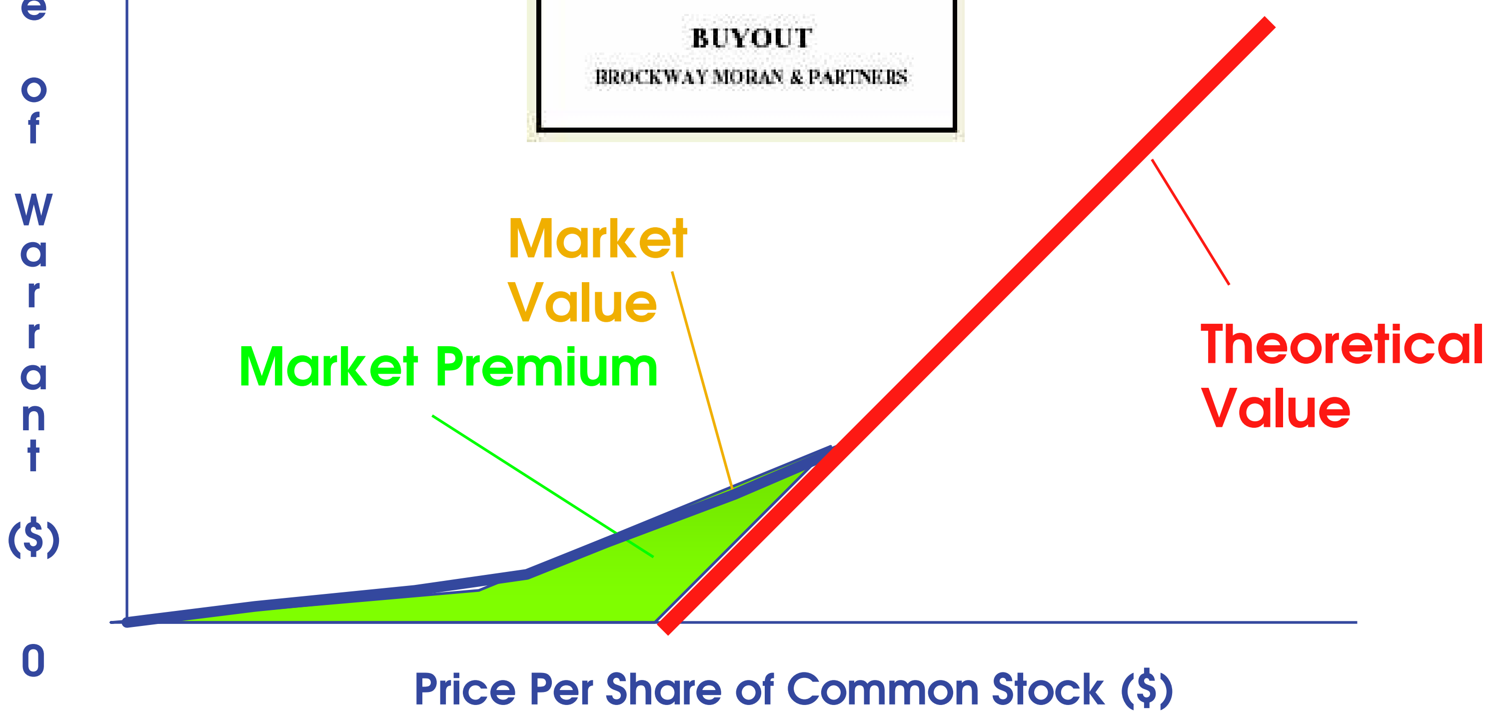


Brockway – One Way

Face value of debt		17					
Value of Equity		40					
Warrants		5%					
Year		**0**	**1**	**2**	**3**	**4**	**5**
Out - Principal		-17					
In - Coupon	7%		1.19	1.19	1.19	1.19	1.19
In - PIK	7%						6.84
In - Principal							17
In - Warrant value		2					
Sum of cash flows		-15	1.19	1.19	1.19	1.19	25.03
IRR		16.4%					

Warrants


woodstream
Subordinated Debt
with Warrants
Common Stock
BUYOUT
BROCKWAY MORAN & PARTNERS


Value of Warrant ($)
0
Market Value
Market Premium
Theoretical Value
Price Per Share of Common Stock ($)

Warrant Agreement

COMMON STOCK WARRANT

Date of Issuance: April 23, 2003

For the purchase price of US$1.00 and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, Exult, Inc. (the "**Company**"), hereby grants to Bank of Montreal ("**Holder**"), the right to acquire one million (1,000,000) shares (the "**Warrant Shares**") of the Company's Common Stock, par value $.0001 per share (the "**Common Stock**"), less the number of shares used in exercise as described in <u>Section 1.2(b)</u>, at an effective price per share (the "**Exercise Price**") equal to the greater of (i) US$7.55 (the "**Base Exercise Price**"); and (ii) the difference obtained by subtracting the Maximum Spread from the Market Price (as defined below) on the Exercise Date (as defined below). The "**Maximum Spread**" initially means US$10.36. The amount and kind of securities obtainable pursuant to the rights granted hereunder, the Exercise Price, and the Maximum Spread are subject to adjustment pursuant to the provisions contained in this Warrant.

This Warrant is subject to the following provisions:

1. **Exercise of Warrant.**

1.1 <u>Exercise Period</u>. The Holder may exercise this Warrant in its entirety (but not in part) in a single exercise transaction at any time from (but not before) the second anniversary of the Date of Issuance listed above (the "**Date of Issuance**") until (but not after) 5:00 p.m. California time on the fifth anniversary of the Date of Issuance.

1.2 <u>Exercise Procedure</u>.

(a) This Warrant shall be deemed to have been exercised on the date not later than the fifth anniversary of the Date of Issuance when the Company has received this Warrant and a completed Exercise Notice in the form of Exhibit A executed by the Holder (the "**Exercise Date**").

(b) In lieu of payment of the Exercise Price in cash, this Warrant shall be exercised only on a cashless, net issuance basis pursuant to which the Holder shall receive upon exercise a number of Warrant Shares equal to the value (as determined below) of this Warrant on the Exercise Date, computed using the following formula:

$$X = \frac{1{,}000{,}000\ (A-B)}{A}$$

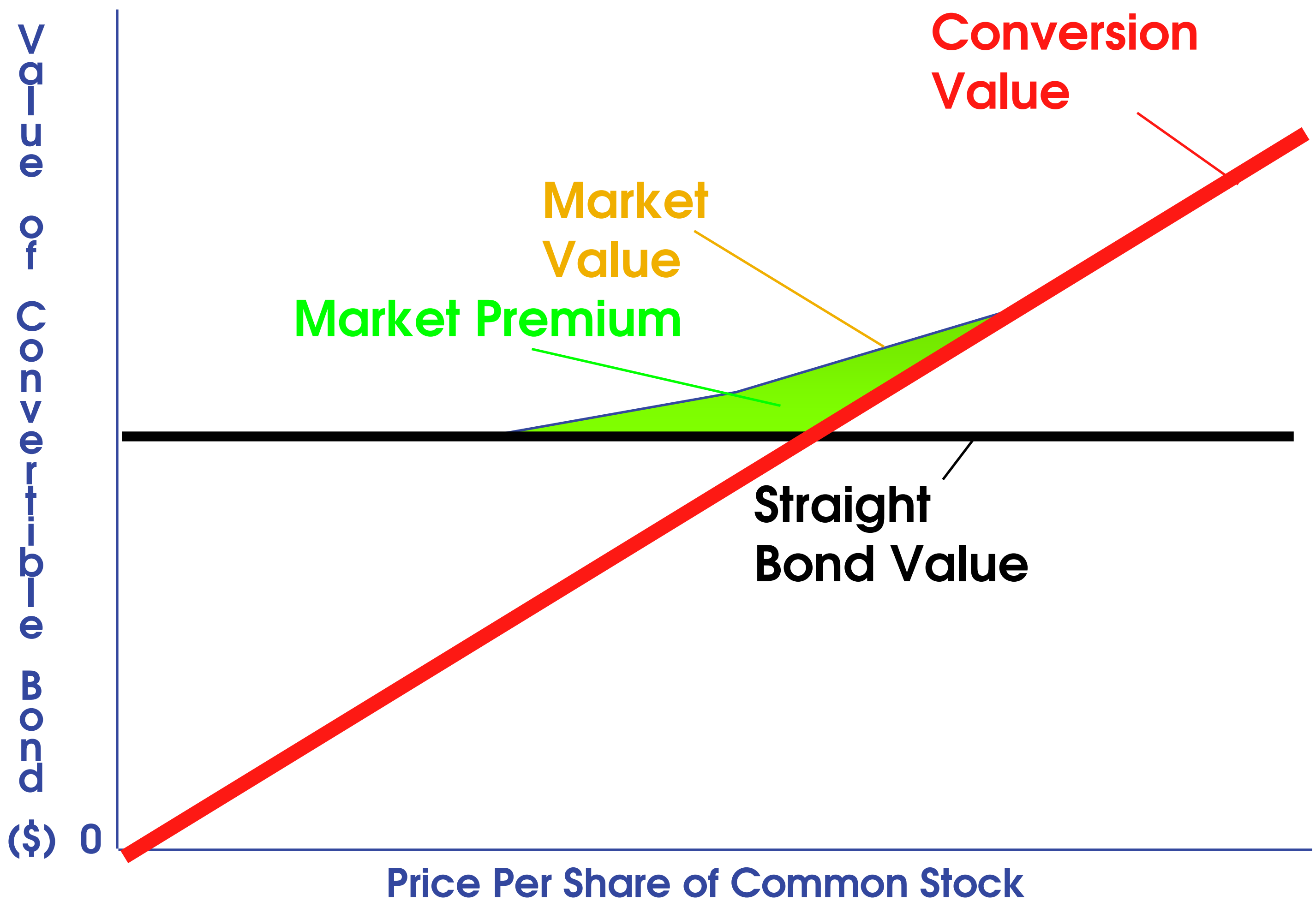
Case Study: The Woodstream Termsheet

- Examine this termsheet.
- As investor, which features would you insist on?
- Where would you be willing to give way?

IHG Mezzanine Partners LLC
Summary of Proposed Terms & Conditions
Senior Subordinated Notes

Issuer:	Woodstream Inc ("Issuer")
Securities:	Senior Subordinated Notes (the "Notes")
Principal Amount:	$17.0 million
Issue Price:	100%
Purchaser:	IHG Mezzanine Partners LLC (the "Purchaser") or one or more of its affiliates and other investors mutually acceptable to the Purchaser and the Issuer.
Use of Proceeds:	The proceeds of the Notes will be used to (i) partially finance the acquisition of the Issuer by the Private Capital Group of Brockway Moran and (ii) pay fees and expenses in connection with the acquisition.
Closing Fee:	1.50%
Interest Rate:	7.00% per annum payable quarterly in cash in arrears.
PIK Interest Rate:	7.00% per annum payable quarterly in kind in arrears.
Warrants:	5.50% of the fully-diluted equity of the Issuer including the assumed issuance of all equity under any current or future management equity plans; provided that Warrants for 0.50% of the fully-diluted equity of the Issuer shall be canceled (the "Clawback") if each of the following conditions are achieved: (i) The sum of EBITDA for fiscal years 2005, 2006, and 2007 shall exceed $55.0 million, (ii) EBITDA shall be higher in each of fiscal years 2005, 2006, and 2007 when compared to the prior fiscal year, and (iii) Total leverage shall be less than 2.25x at the end of fiscal 2007. All Warrants will have a seven year term and be exercisable at a nominal exercise price, in whole or in part, at any time after Closing. The Warrants will have cashless exercise, tag-along, drag-along, anti-dilution, piggyback registration and pre-emptive rights to be agreed upon. The Warrants will have put and call features to be

Do Convertibles Make Sense as Mezzanine Finance?



Preferred Equity

- Legally a form of equity
- Claim senior to ordinary equity
- May have fixed dividend, or may be “participating”
- But cannot trigger liquidation if payment missed
- Par value determines liquidation claim

Convertible Preferred

- Used by venture capital firms
- Permit investors to participate in growth
- But give preference in liquidation if the venture fails
- And disguise share value (tax!)
- A variant – PERCS* give issuer right to convert into common stock

- *Preferred equity redemption cumulative stock

Performance-Linked Participation Debt

- An alternative form of mezzanine
- Often base interest rate (fixed or floating) plus a performance-linked spread
- Examples:
  - Interest rate linked to profit
  - Interest rate linked to EBITDA
  - Interest rate linked to sales
- Which makes sense, in which situations?

Summary: Mezzanine and High Yield Debt

Comparison of Security Classes
(Single B Category)

Security Class	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
Prepayment Penalities	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 Requirments	Required	Required	None	None
Buyers of Paper	CLOs/Institutional Investors	Institutional Investors/ High Net Worth Individuals/CBOs	Insurance Companies, Mezzanine Funds/Private Equity Funds.	General Public, Institutional Investors.

PIK – Pay-in-kind. L – LIBOR. T – U.S. 10-year treasury. CLO – Collateralized loan obligation. CBO – Collateralized bond obligation.

Source: fitchratings.com, “Mezzanine Debt”

Application: Structuring the Mezzanine

- Goal: achieve higher return without burdening the company or infringing on owner's/sponsor's control
- Methods: lower interest rate plus participation in the company's equity or performance
  - Warrants
  - Payment linked to turnover
  - Payment linked to EBITDA
  - Payment linked to after-tax profit
  - May have a floor or a cap

Case Study: Albania Bridge

- The following preliminary financing plan has been proposed. It must be refined in order to meet all the parties' objectives and provide a fair return to investors. **Can you help?** You may use the financial information provided in the spreadsheet financing_abc.xls.

Source	*EUR millions*	*%*
Equity/Subordinated Loan		
Albanian Sponsor Equity	3.0	
Dutch Sponsor Equity	2.0	
FMO Subordinated Convertible Loan	2.0	
Sub total	**7.0**	**48.9%**
Mezzanine Loan		
a. FMO	1.5	
Sub total	**1.5**	**8.6%**
Senior Loan		
a. Bank group A	7.0	
b. Bank group B	2.5	
Sub total	**9.5**	**52.5%**
Total Financing	***18.0***	***100%***

Sharing the Returns

- How can we make these cash flows work to achieve the desired return for all the parties?
  - Sponsors
  - FMO as mezzanine investor
  - Senior lenders

Cash Flow Analysis	2005	2006	2007	2008	2009	2010
Revenue	21	25.2	30.2	33.3	36.6	40.2
EBITA	3.15	3.8	4.5	6.7	7.3	8.0
+ Depreciation	2	2.1	2.2	2.3	2.4	2.6
- Capex	-3	-3.2	-3.3	-3.5	-3.6	-3.8
- Incr in Net Working Cap	-0.8	-0.4	-0.5	-0.3	-0.3	-0.4
FCF Before Financing	1.4	2.3	2.9	5.2	5.8	6.4

Post-Deal Mezzanine Management

- The ABC deal was financed as proposed. It is two years later, and some of the projects have been delayed. As a result, payment has been slower. Covenants may not be met. What do we do?

Cash Flow Analysis	2005	2006	2007	2008	2009	2010
Revenue	21	22.1	24.3	27.9	30.7	33.8
EBITA	3.15	2.2	3.6	5.6	6.1	6.8
+ Depreciation	2	2.1	2.2	2.3	2.4	2.6
- Capex	-3	-3.2	-3.3	-3.5	-3.6	-3.8
- Incr in Net Working Cap	-0.8	-0.1	-0.2	-0.4	-0.3	-0.3
FCF Before Financing	1.4	1.1	2.3	4.1	4.6	5.2

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