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ROUNDTABLE

International Mezzanine Market

The mezzanine market has been squeezed over the past couple of years, mainly due to the meteoric rise of second lien lending, which has firmly established itself in the capital structure of leveraged transactions. Forced almost to re-invent itself, the mezzanine market has seen a change in pricing, structure and expected returns on its product. Warrants and covenant protection have declined as mezzanine providers push to enter deals. The result has been greater risk for many fund managers and their investors. Yet there are signs that the appetite for second lien loans may be waning, giving mezzanine providers an opportunity to regain some lost ground and firm up their terms.

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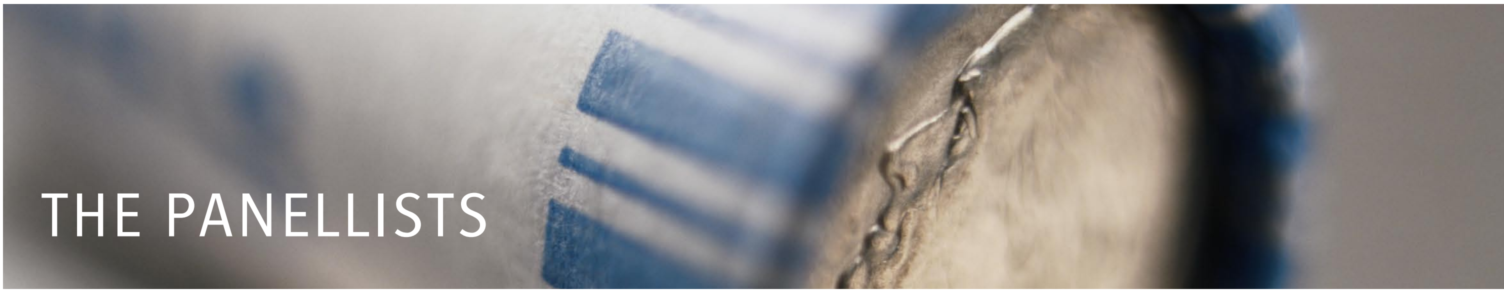

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In your experience, how has the mezzanine market evolved over the last 12-18 months?

Eisenbiegler: Over the last 12 to 18 months the level of activity in the mezzanine market has become thinner than it used to be, as a result of substantial pressure from the second lien loan and high yield products. Second lien financing has clearly taken market share away from mezzanine financing. Warrants continue to be the exception rather than the rule in mezzanine deals, other than in smaller or riskier deals. There is continued pressure to loosen covenants in mezzanine deals so they more closely resemble a high yield type offering. We also continue to see erosion in prepayment protection for mezzanine investors. Interest rates for mezzanine loans have become more competitive with second lien loans as the LIBOR rate has risen steadily. Just in the last few months, there are signs that sponsors are becoming more interested in mezzanine financing. One reason may be that the pricing differential between the mezzanine and second lien products has narrowed. Another reason may be that issuers and sponsors have gained an increased appreciation of the risks of second lien loans.

Gellis: In general, the variety of competitors has grown while few if any new mezzanine fund managers of note have been created. There has been a notable increase in competition from hedge funds over the past 12 months with a handful of competitors finally taking the asset class seriously enough to expand their credit departments rather than limiting their recruitment to traders or retired private equity professionals. Second lien competition has grown over the past few years but most recently has shown signs of abating, as the level of LIBOR has increased and fixed rate mezzanine becomes relatively more attractive to issuers.

Kaufmann: The last few years have been a difficult time for providers of mezzanine financing. Competition from alternative debt financing sources has been ferocious. The number of new mezzanine funds formed annually has declined. Some high-profile institutional limited partners experiencing disappointing returns have either discontinued their mezzanine programs altogether or greatly reduced their allocations to mezzanine. Several well-known general partners abandoned fund raising efforts or settled for funds drastically reduced in size from the original targets. Deal activity has also been down as banks, second lien lenders and others fill positions in deals traditionally occupied by mezzanine lenders. In the last 6 to 12 months, however, there have been signs of an improving environment. In 2006 versus 2005, year to date, fund raising is up, both in terms of the number of mezzanine funds formed and total dollars of capital raised. In our own experience, we have seen the level of mezzanine financing activity pick up, though it is still below 2002 and 2003 levels. Mezzanine deals are making a bit of a comeback as the funds adjust to market conditions and return expectations, find new deal sources, and adopt new structures. Private equity firms too have begun a shift back to using mezzanine as doubts arise over the staying power of second lien lenders, who in recent years have taken over a big part of the mezzanine market.

Tannenbaum: The mezzanine market is constantly in a state of flux. Both supply and demand have increased. Interestingly, the smaller mezzanine funds are not garnering sufficient interest from limited partners, while the larger ones, with significant competitive advantages, have attracted abundant capital. This 'imbalance' in the lower end of the middle market is allowing some firms to brand without encountering competition from the major mezzanine players. The market continues to move towards equity sponsors having a relationship with firms that are known for providing quality, quick decisions, and available capital.

Boyko: The past few years have been quite difficult for mezzanine investors. While mezzanine lenders have faced competition for years from new entrants such as business development companies (BDCs), leveraged funds, one-stop providers, and most recently hedge funds, many seemed caught off-guard by the exponential growth of the second lien product and its rapid penetration into the middle market. As equity sponsors embraced second lien providers, a number of new competitors with a menu of new product offerings – second lien loans, one-stop loans, private high-yields, holdco notes, rate-only loans, redeemed preferred stock and convertibles – competed fiercely for the mezzanine piece. Often times, these new competitors had lower return expectations than a traditional mezzanine fund, principally due to the use of leverage, access to the capital markets, and/or the securitisation of their assets. The combination of these new entrants, new products and lower return expectations, has profoundly changed the competitive environment faced by mezzanine lenders. While second lien and other alternative structures are still quite prevalent, we have begun to see renewed interest in the mezzanine product in the past six months or so. I suspect a number of factors have contributed to the increase – the rising interest rate environment, a growing concern by senior lenders about the rights of second lien lenders, a desire by equity sponsors for simpler and more traditional capital structures, and, of course, competitive forces. We have also seen a dramatic increase in the amount of capital raised for mezzanine investments. While much of this has been raised by known players, there are a number of new entrants as well. I suspect a number of factors have contributed to the increase – the rising interest rate environment, a growing concern by senior lenders about the rights of second lien lenders, a desire by equity sponsors for simpler and more traditional capital structures, and, of course, competitive forces. We have also seen a dramatic increase in the amount of capital raised for mezzanine investments. While much of this has been raised by known players, there are a number of new entrants as well.

Petrusic: The European mezzanine market grew by 75 percent in 2005 to reach a record €9bn of investment. This growth has been driven by the strong leveraged buyout market in which private equity sponsors have raised in excess of €70bn in new funds and the increase in refinancing of existing deals. During this period of continuing growth the mezzanine market has changed in several respects. First, it has become a more ▸▸

widely accepted financing solution by sponsors as increased capacity in the market has become available to help finance deals. Second, it has adapted to more highly leveraged financing structures, for example by accepting the inclusion of second lien. Third, it has provided flexibility on pricing (increase in downward flex/low incidence of warrants). Fifth, it has provided more flexibility on early repayment, which coupled with the private nature of the product has provided a significant advantage over publicly traded high yield paper. Last, a growing number of new entrants have come into the market, increasing the amount of capital available to meet the demand for mezzanine issuance.

Has tremendous liquidity in the debt markets reduced the pressure on mezzanine funds to perform, or is the search for standout returns more competitive than ever?

Kaufmann: It's more competitive than ever. Returns and returns expectations are down, it's true. New mezzanine funds are targeting IRRs in the mid to upper teens, while limited partners are expecting actual returns in the mid-teens and below based on recent experience. Established funds are working to manage the expectations of their investors with respect to IRRs, and to introduce new investment strategies consistent with the mezzanine asset class – or to make the case for slowing down until conditions improve. Nevertheless, there is still enormous pressure on mezzanine funds to earn the exceptional returns, on a risk-adjusted basis, necessary to attract institutional limited partners to their funds at a time when many are opting out of the mezzanine world. Chasing those returns is not so easy in the current marketplace, with an abundance of alternative financing sources available, and competing for too few good deals.

Boyko: The pressure to perform has increased dramatically. In this economic cycle, we are seeing far more interest in junior capital (second lien, mezzanine and preferred stock financings) than ever before. Junior capital has finally come of age. Leverage and purchase multiples are increasing, which are making quality investments harder to find. More funds are actively searching for deals than ever before. In fact, in the mid-90s there were about 50 funds making mezzanine investments. Today there are over 250. On the bright side, fund structures have evolved as well. More and more mezzanine investors are choosing to leverage their fund, adopt a CDO/CLO structure, structure themselves as a hedge-fund, or take advantage of the permanent capital offered by a public listing, such as a business development company (BDC).

Eisenbiegler: The pressure on mezzanine funds now is probably as great as it has ever been. Although there are signs that the environment for mezzanine investors is improving, for much of the last 12 to 18 months funds restricted to making mezzanine investments have been in a tough position. Leverage multiples have increased, pricing and yield protection have deteriorated and competition from other asset classes, most notably second lien loans, has been fierce. Mezzanine investors have been faced with a choice between maintaining traditional investment standards and passing on deals or making investments with a different balance of risk and return.

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FREDERICK F. EISENBIEGLER

Gellis: While return expectations continue to fall across all financial markets, in light of liquidity excesses, mezzanine managers continue to feel the need to produce competitive net returns, versus other alternative asset classes. Since it is impossible to change the market rate of return, there are two ways to respond: either go down the balance sheet and take more equity-like risk, or add a little more leverage to the portfolio to increase returns. The latter is the path we've chosen to take and believe others will also follow. For the larger mezzanine funds, leverage is a viable option. But the small funds all seem driven towards more equity-like risk, which we consider to be a flawed concept.

Petrusic: The liquidity in the debt markets has not altered the expectations of third party investors in mezzanine funds as they continue to look for managers who can display a good track record on asset selection and consistent risk adjusted returns. The pressure is more visible in the search for quality assets with appropriate risk/reward and this area of the market has become more competitive due to the increased appetite among investors for yield. However, this has been mitigated to a large extent by the strong growth in issuance in the market.

Tannenbaum: We operate in the lower middle market, which has not seen as much capital influx as the overall market. The pressure to perform still exists. There is definitely a balance between 'getting invested' and generating high returns. We struggle with that decision in every investment committee meeting. By investing a substantial amount of personal funds alongside our investors we ensure the appropriate alignment of interest and view each investment as our own. With that in mind, we have turned down some investment opportunities because of unfavourable risk/return profiles.

How would you characterise today's mezzanine investors? What are their intentions and objectives?

Petrusic: The mezzanine market today is broadly populated by three investor groups: traditional independent mezzanine funds, institutional investors and banks. The traditional mezzanine funds continue to look for a strong relationship with the sponsors, an alignment of interests in the success of the underlying business, a long-term hold and a controlling investment in the mezzanine tranche. The institutional investors appear to be more yield driven, looking at the mezzanine as part of a strip including second lien and B/C tranches to achieve a blended yield and they generally do not take controlling positions. The banks tend to make small investments in the mezzanine tranche as a way of enhancing their returns and underwriters use this as a sweetener during syndication.

Kaufmann: Mezzanine investors are adapting to a different and more competitive marketplace. They are concerned about preserving returns and finding or competing effectively for good transactions. We see our mezzanine clients looking for new types of deals and considering new investment structures, consistent of course with the investment limitations in their partnership documents. Some mezzanine funds are shifting their focus to 'unsponsored' (and theoretically less competitive) deals in which there are no private equity firms as sponsors. These transactions are typically growth capital or acquisition financings provided to family or entrepreneur-owned smaller businesses thought to be 'below the radar screen' of hedge funds and other competitors. Some mezzanine groups are avoiding traditional buyouts, and marketing financings for leveraged recapitalisations to private equity firms or other business owners that want some liquidity without having to sell out completely. Other investors are sitting it out until conditions improve – but it could be a long wait until the marketplace resembles what it was years ago. There are also mezzanine funds, including larger ones sponsored by Goldman Sachs and Blackstone, that are employing leverage of their own to enhance portfolio returns. Banks have aggressively entered the market for providing this leverage, and hedge funds have as well. In the middle market and lower middle market, the Small Business Investment Company program of the US Small business Administration remains a popular source of up to 2 to 1 leverage for mezzanine funds. A mezzanine fund's use of leverage, though, can be a problem for tax-exempt limited partners, like endowments and pension funds, who would incur unrelated business income tax as a result. For this reason a leverage strategy can scare off many potential limited partner investors in mezzanine funds.

Boyko: It's not as easy as it once was to describe the typical mezzanine investor. While most mezzanine investors remain credit-focused, a growing number of them are taking equity risk to generate their returns. We are also seeing mezzanine investors invest in industries that were largely off-limits, such as retail, energy and technology. As mezzanine investors struggle to find yield, a number of them have begun to invest down-market, often times in companies with less than $10m in EBITDA. At the higher end of the market, we are seeing the mezzanine product become more high yield like. 'Covenant-light' structures are becoming more prevalent, and even financial covenants are beginning to disappear. Even though there has been a lot of change, the objective has remained the same – to generate consistent high-teens returns.

Eisenbiegler: The typical mezzanine investor today generally falls into two categories. One is the traditional mezzanine fund restricted to mezzanine investments with little flexibility to invest in other asset classes. These investors generally have a longer term investment horizon, source deals principally from sponsors, are relationship-oriented and cannot recycle their investments. The other category includes hedge funds, business development corporations and CLOs/CDOs. These investors generally can recycle their investments and have the flexibility to invest in different asset classes. They look to generate mezzanine-type returns by investing across a blend of higher yielding senior or first lien loans, second lien loans, mezzanine investments and minority equity investments. This category of investor has the reputation of being less relationship-oriented, less sponsor-focused and less concerned about prepayment.

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>
> HOWARD GELLIS

How has the profile of limited partners in this asset class changed in recent years?

Gellis: The intentions and objectives of any investor, in any asset class, remain the same – that is, to maximise the return on investment. For those investors seeking a position in a low volatility, steady return business with a lower dispersion of returns, mezzanine can form an invaluable part of a portfolio. We have certainly noticed a shift in the profile of mezzanine investors, as demonstrated by comparing the participants in our first and second funds. Our first fund consisted primarily of Blackstone's traditional sources of capital, such as big public pension funds. In the second fund, we have attracted more insurance companies, fund of funds, and a number of foreign investors including European and Asian insurance company investors. Although this is, in part, attributable to our changed placement strategy, the interest from European investors in US domestic mezzanine funds is a significant change in the marketplace. We are seeing a number of European market participants very excited about the US market as a more attractive alternative. This change has been largely driven by the sophistication of European investors and their understanding of the differences between US and European mezzanine, combined with negative views on the European mezzanine market.

Tannenbaum: The limited partners who are interested in mezzanine as an asset class can be classified in two separate groups. On one side, the high net-worth families are searching for a way to boost their equity portfolios, while at the same time providing for current income and preservation of capital. They expect steady distributions and a smooth curve of investing the funds. On the other side are the institutional investors, who are looking for investment multiple. They would like to have the capital outstanding as long as possible, generating strong cash on cash returns. In the past, a number of institutions have advised us that moving down the J-curve while generating high returns is important in their equity fund blends. With a diverse investor group, it is now important to stay focused on investing prudently in any strong risk/reward investment while remaining mindful of diversification and investment period.

How would you summarise mezzanine deal activity at the top end of the leveraged buyout market?

Boyko: Competitive. There are a number of well-known players in the top end of the market. There have also been a number of new entrants. Overall, market activity remains strong. We have seen tremendous pressure on pricing. In the mezzanine space, coupons have largely remained fixed, sometimes with cash pays as low as 9-10 percent. Terms have also become looser, with lighter covenants and less call protection. Warrants have virtually disappeared. Even equity co-invests remain difficult to find.

Eisenbiegler: The top end of the LBO market is very competitive. Sponsors run a very competitive process for financing. Syndicated second lien loans compete with mezzanine for a similar spot in the capital structure. High yield also competes with mezzanine at this end of the market. As a result, deals have higher leverage, lower pricing, weaker covenants, but more liquidity. These dynamics at the top end of the market have also produced 'covenant light' deals, which are a hybrid between a traditional mezzanine deal and a high yield deal. Covenant protection more closely resembles a high yield than a traditional mezzanine structure. Pricing is also a hybrid: higher interest rates than high yield but less prepayment protection and lower prepayment premiums.

Petrusic: Activity at this level of the market has become a capital market event characterised by broad distribution, which has led to significant demand for paper, heavily oversubscribed issues, downward pricing flex and scale backs on allocations. In addition, market stats also point to higher total leverage levels at the top end of the market where average multiples in large mezzanine facilities increased to 7.0x in Q1 06 (6.4x in 2005) compared with 6.2x for small mezzanine tranches (5.4x).

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>
> NICK PETRUSIC

Kaufmann: The second lien or 'tranche B' lenders – hedge funds, banks, other types of specialty lenders – have in the past few years made very, very substantial inroads into the upper and middle parts of the mezzanine market. Competition faced by traditional mezzanine providers in these sectors of the market from second lien lenders and high yield debt is fierce, and has reduced the role played by mezzanine.

Gellis: Activity has been uneven; very busy at one time then quiet for a while. As the high yield market goes through its usual inconsistent performance in light of weak equity markets, and the second lien market gets pricey, intermediaries are trying to figure out when it is appropriate to use mezzanine in larger deals. Some people who have not considered mezzanine as a viable alternative over the past few years are coming back and asking for a quote. There are definitely more large deals, in the $75-100m range, than we have seen for most of the last three or four years.

What main considerations do mezzanine investors take into account when assessing big deals, compared to mid-market deals? Which investment profile is proving most popular and why?

Tannenbaum: In bigger deals what becomes important, in addition to pricing, is the quality of the private equity group backing the transaction. Some factors to evaluate are the size of the fund, experience and track record, personal references, as well as demonstrated ability to step up to the plate in case of a problem. Additionally, we are utilising more than ever the resources provided by our vast network of LPs to help determine whether the investment/PE fund in consideration has a good reputation. Another important trend is the ability to provide a one-stop solution. Many of the PE groups we are involved with have expressed a desire to work with one source of capital through the capital structure. In addition to the savings which arise from only having to negotiate one set of documents, usually the one-stop structure provides for better pricing. Finally, a consideration which should not be overlooked is that in case of a problem, the PE fund will have to deal with only one creditor, as opposed to satisfying the demands of multiple lenders.

Petrusic: Credit considerations are basically the same irrespective of the size of the company: market position, financial performance, predictability of cash flows, management, etc. The mid-market still generates more volume than the large deal market, which offers greater opportunities to invest and greater diversity, however the tranches are smaller and the deals are more often placed with investors who have an established relationship with the sponsor. The sponsors exert greater influence over who is chosen to invest in the mezzanine in these deals favouring traditional mezzanine fund relationships over cheaper pricing. Larger deals tend to be more popular with the broader market due to larger tranches, broader distribution and easy access.

Gellis: Credit is credit – whether small, middle market or top end – so the fundamental analysis an investor makes doesn't vary by size. You can't just suspend disbelief because a company is large and well-sponsored. Lenders must be cynical by nature or they risk being abused by borrowers. Having said that, larger companies tend to have deeper management teams, greater market options and hence lower business risk. Unfortunately, sponsors are prone to abuse that advantage by adding greater financial leverage (hence more financial risk), eliminating much of the attraction of bigger companies. Still, it is very hard to generalise about size.

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LEONARD M. TANNENBAUM

Eisenbiegler: Benefits of investing in bigger deals include an investment with greater liquidity and a company with greater stability, access to capital markets and depth of management. Some downsides include higher leverage, weaker covenants and lower pricing. Also, the increased competition at the higher end of the market can decrease the 'hit rate' for mezzanine investors.

Kaufmann: There is no question that the competition at the high end of the market is causing larger mezzanine investors to look down market to mid-market deals and even the lower end of the middle market. In this way, we are seeing the mezzanine market evolve the same way that private equity has in response to competition at the high end.

Boyko: The quality of the equity sponsor and the management team are critical to the investment decision. While bigger can often be better, it can also mean higher debt levels (5x, 6x or 7x EBITDA) and a need to grow by acquisition, rather than by internal growth. As a result, the quality of the equity sponsor and their success in creating value in large, highly leveraged situations is often scrutinised. All in all, neither deal size is proving more popular, each has its pros and cons and stable of interested investors.

How can mezzanine funds continue to gain access to the booming buyout market given the widespread competition from alternative debt sources to enter the capital structure?

Kaufmann: Adapting quickly to new structures and opportunities is one way. One example is the pursuit of 'unsponsored' deals by mezzanine funds which previously relied on private equity sponsors for their deals. Broadening the product offerings is another; there are many firms now that provide both mezzanine and second lien financing, and even senior financing, all as part of a broader menu of options available to fit each situation. Partnering with the deal sponsors is another way – by adjusting financing terms, covenants, exit strategies and other objectives to align more closely with the sponsor's deal objectives. Standardised terms and documentation are beginning to emerge as the marketplace matures, and this is viewed very positively by deal sponsors. No private equity firm relishes the extended negotiation of subordination terms that historically was the norm between senior and mezzanine lenders. Similarly, holding down transaction costs has become more important than ever, to enhance the investor's attractiveness to deal sponsors and company owners. Another strategy is differentiation by industry specialisation, a technique that has served the private equity industry itself very well. With demonstrated expertise the mezzanine investor brings more to the table in a deal than just its money. One strategy in which I think mezzanine providers are lagging is in pursuing deals globally. Private equity firms are out ahead in this – private equity has been much more aggressive in the last few years about accessing deals and identifying capital needs overseas, especially in emerging markets where there is a great deal of opportunity.

Eisenbiegler: In terms of competing with second lien lenders, mezzanine funds have a number of ways to distinguish themselves. Their interests may be more aligned with equity sponsors and issuers than those of second lien lenders. Their investment horizon tends to be longer than second lien investors. They often will be more flexible than second lien investors when it comes to waivers and amendments. They may be more relationship-oriented with sponsors and issuers than second lien lenders. The covenant structure of their deals is generally more relaxed than that of second lien lenders. And the payment and remedy subordination features of mezzanine deals offer a greater opportunity to work out defaults than a second lien structure. In terms of competing with high yield investors, selling points for mezzanine funds include lower up front fees, more prepayment flexibility, lower prepayment premiums and more flexibility if waivers or amendments are required.

Petrusic: Competition in the market is not new; the increase in the supply of product helps to lessen the impact this has on market participants. In addition, traditional mezzanine funds have a track record of buy-and-hold investing and working with shareholders and management teams should an investment hit a difficult patch. Sponsor relationships are a key ingredient in winning new business and obtaining meaningful allocations and prior experience of working together goes a long way to increasing the chance of accessing deals.

Gellis: There is no substitute for marketing and frequency of contact, with sponsors, intermediaries and other sources of deal flow. Frequency of contact breeds familiarity and greater likelihood of getting a chance to quote terms when a deal arises. Our deal flow is a derivative of that of others, so we need to be in the face of those who are instigating the deals to get a chance. It is also necessary to have a good product that is user friendly, priced at the market and gives the issuer confidence in your ability to deliver on offered terms.

Boyko: One of the most attractive features of mezzanine funds to equity sponsors is their tendency to act more like equity investors than debt investors over the long-term. While many equity sponsors have chased 'rate' over the last few years, recent experiences with new entrants trading out of positions at the first sign of trouble or charging large amendment fees for minor covenant defaults, have led some equity sponsors to consider whether a mezzanine lender might be a better fit for their capital structure. Recently, we have seen, a number of equity sponsors who are willing to pay an extra 100 or 200 basis points to find the right fit. Mezzanine investors who can demonstrate a track record of working through difficult situations will be well positioned against some of the new entrants who are unknown and untested.

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STEPHEN A. BOYKO

Tannenbaum: In general, alternative sources of capital lack the understanding of the mezzanine market. They do not have the infrastructure to support mezzanine deals and lack the manpower and knowledge to provide oversight in case of a problem. We built our team around the portfolio management function, which many hedge funds do not have. As a consequence, the smart institutions realise that they want a specialist originating debt, as opposed to a generalist.

In what ways have the structures and documentation of mezzanine deals changed over recent years? Do these changes reflect a shift in the risk-return profile for mezzanine investors?

Boyko: Structures have become more complex in recent years. The use of pass-through entities (such as limited liability companies, partnerships and S-corporations) has become much more prevalent. While there is no single reason that explains the increase, I suspect that equity sponsors and business owners are becoming more sophisticated in structuring their investments in order to maximise their return on exit. There are a number of risks for mezzanine investors in these structures, most of which are tax related. If there is an equity component in the transaction, the mezzanine investors must take care to structure their investment appropriately, or they (and possibly their limited partners) could suffer adverse tax consequences. We have also seen an increase in holdco notes (a loan to a single-purpose holding company that owns an underlying operating company) and other equity-like instruments. While these equity-like structures often generate higher returns for the mezzanine investors, they also expose the investor to more risk in a troubled situation (e.g., no creditor rights and unambiguous structural subordination).

In contrast to the complexity of the structural changes, documentation has become simpler in recent years. Most times, the mezzanine investor uses the senior lender's documentation package as a basis for its agreements with the borrower. This has made the process faster, simpler and less expensive. It is also easier to document equity-like products as there are fewer covenants, no creditor rights, and no security arrangements.

Eisenbiegler: Warrants are issued much less frequently, but this has been a feature of the market for some time. As warrants were phased out, mezzanine investors first compensated by negotiating greater prepayment protection and premiums. After a period of some success, prepayment protection and premiums have declined to perhaps the lowest levels ever. Pricing has generally declined, as the actual and target returns of equity sponsors has declined. Mezzanine investors have looked to equity co-investment rights as a substitute for warrants, but equity rights of co-investors are not always as strong as those of warrant holders. Covenant protection, at least at the higher end of the market, has declined as 'covenant light' deals have emerged.

Tannenbaum: There are many toggle points with the structuring of mezzanine deals; it is difficult to appreciate their complexity. Some major trends we have seen are smaller granted equity, a move towards standard intercreditor agreements, and a substantial reduction in equity rights. On risk-return changes, I do not see a material increase or decrease, more a standardisation of practice for many of the terms.

Gellis: On many larger transactions in the US we are seeing an increase in the use of covenant light deals, which combine pure mezzanine with a public high yield document. Although these structures have proved useful in transactions in the $500m range, it is my view that to apply such terms to a smaller transaction in the $40m range would be a mistake. These transaction terms basically provide no protective covenants, which otherwise give the subordinated lender a voice before it's too late. Covenants are like circuit breakers which warn of overheating and keep a house from burning down. You'd never build a home without them and I can't imagine why some lenders think it's perfectly alright to build a leveraged capital structure with such disregard.

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Petrusic: Debt structures in the LBO market have developed as an increasing number of hedge funds and CDOs with broader investment strategies have entered the European market. This has seen a move away from the traditional amortising A loans, which historically would represent around 60 percent of the debt financing to structures where the A loans now represent around 40 percent and the balance is in longer dated, bullet repayment loans (B, C and second lien and mezzanine/sub-debt). This has had the effect of reducing the demands on company cash flows and allowing increased amounts of leverage to be provided. This change to the typical debt structure has increased the risk and reduced the margin for safety in a number of transactions. At the same time, documentation has come under pressure with more flexibility sought by sponsors and a generally more borrower friendly package of covenants being agreed. Price reverse flex, yank the bank clauses and equity cure are some of the more recent changes to documents that have become more common. This general trend reduces the ability of the lenders to take action in a default situation and as a result the risk to those lenders has increased.

Kaufmann: In this highly competitive market, mezzanine providers are aggressively seeking high quality deals and new types of deals that will provide them superior returns within their asset class. Unsponsored deals, smaller deals, different industries, a movement away from buyouts – these are all changes in response to competition. As mezzanine lenders have sought to support their IRRs in the face of competitive pressure on interest rates, we have seen more use of PIK interest – where a portion is payable currently and the balance at the final maturity of the debt. This keeps rates up but doesn't impact the company's cash flow as much. Clearly there has been a major shift away from using warrants in deals. Warrants are almost never used anymore in larger mezzanine deals, and they are much less frequently seen in middle market transactions. Mezzanine lenders are much more commonly doing coupon-only financings, which clearly limit their returns. And when equity enhancement is needed mezzanine funds will now typically just purchase a piece of the company's equity on the same basis as the equity participants. This reflects lower return expectations, and also pretty clearly a greater willingness to take equity-like risks to improve returns. Documentation seems to be evolving into more standardised forms, and terms are negotiated within narrow parameters viewed as 'market'. Financial and other restrictive covenants, events of default, puts and calls, board representation, equity co-sale and registration rights, and other terms look more similar from fund to fund and deal to deal. The parameters of acceptable 'market' subordination terms are generally well understood and negotiations over them are much more limited than in the past.

What has been the overall effect on the mezzanine market of increasing competition from high yield products?

Tannenbaum: High yield products do not have any effect on the lower middle market loans.

Eisenbiegler: In the middle market high yield poses little direct competition to traditional mezzanine investors. At the higher end of the market there has always been competition and that has not changed. The extent of competition from the high yield product has been largely dependent on how hot the high yield market is at any given time. Probably the most interesting effect of the high yield market on the mezzanine market is the covenant light or private high yield deals, which have really created a new product in between the traditional mezzanine product and the high yield product, offering more choices to certain issuers and sponsors.

Kaufmann: We don't see high yield debt as a competitive factor very much in our middle market mezzanine deals. Second lien lenders have a growing presence in the middle market, though, as competitors and have been very influential in causing changes in the business terms and documentation of mezzanine financings.

Gellis: The high yield market has been less of a factor in our world since the late 1990s than it had been in prior market cycles. That's because junk bond buyers swore off buying small illiquid issues after the last market melt down and, for the most part, stuck to their beliefs on this.

Petrusic: The main affect has been in relation to prepayment penalties and warrants, which have reduced particularly in transactions at the larger end of the market where a public high yield issue was a strong possibility as an alternative financing tool.

Boyko: Competitive pressures from high yield investors, second lien lenders, hedge funds and others have had a profound and lasting effect on the mezzanine market. Competition has forced mezzanine investors to stake their claim to the middle of the capital structure. Mezzanine investors are now more flexible than ever. Many are now willing to invest up and down the capital structure, depending on the risk of the investment and the company's capital need by offering a menu of investment options, including private high yields, second liens, mezzanine loans, one-stop loans and preferred financings. Competition has profoundly changed the market.

Has the rise of second lien loans had significant repercussions for the mezzanine market?

Gellis: The rise of second lien has had a significant impact on the US M&A market absorbing billions of dollars of paper that contributed to the explosion of deal activity over the last three or four years. The second lien market has impinged on the deal flow of the mezzanine market over the past three years, siphoning off some of the easiest deals. However, with interest rates on the rise second lien is becoming less financially attractive. As a result we are, once again, seeing issuers rediscover mezzanine as a viable alternative.

Boyko: The dramatic rise of second lien loans took the mezzanine market by surprise. Almost overnight, mezzanine investors faced tremendous competition for investments by a number of new entrants – senior lenders, hedge funds, CLOs/CDOs. In search of yield, a number of strangers to the mezzanine market became interested in providing junior capital. The repercussions are numerous – mezzanine investors have been forced to reduce their pricing expectations, accept greater leverage in their investments, become more flexible in their product offerings, and at times, migrate down-market to avoid the reach of second lien providers. In the face of competition, a number of mezzanine investors have even begun offering second liens themselves.

Eisenbiegler: The rise of second lien loans has had dramatic effects on the mezzanine market. Until relatively recently, mezzanine had virtually no competition from other financial products when borrowers required junior debt financing in leveraged middle market deals. The competitive environment changed dramatically with the explosive growth of second lien loans over the last four years or so. In that period, second lien financing became the private junior capital product of choice, as issuers and sponsors fell in love with the key benefits of the product: lower interest rates and lower prepayment premiums. As a result, the mezzanine product lost market share and mezzanine investors had to work harder to find mezzanine deals satisfying historical investment standards, allocate investments to other asset classes (such as second lien loans), and/or move down the capital structure and re-cast mezzanine as a more equity-like product. The most recent experience, however, indicates that issuers and sponsors are changing the way they balance the benefits and risks of the competing mezzanine and second lien products. In addition to the narrowing difference in interest rates between mezzanine and second lien, it may be that issuers, sponsors and senior lenders are now more aware of and more concerned about risks of second lien loans in a default and restructuring context. These risks arise because of the very features that have made second lien loans less expensive than mezzanine loans and as a result so popular: second lien loans are not subordinated in right of payment and they have the benefit of a second lien. These two features cause workouts to be more difficult, cause bankruptcies to occur more quickly and have generally caused restructurings of second lien financings to be more contested and less successful.

Kaufmann: Hedge funds as second lien lenders have a great advantage in that their investors' return expectations are much lower than mezzanine investors. Hedge funds have been returning around 8.5 percent, while mezzanine still targets the mid-teens. The second lien lenders have taken over a huge part of what traditionally has been the mezzanine market. Some mezzanine funds have been crowded out altogether. Another consequence is the shift by mezzanine providers to deal structures that look like those of second lien lenders. So we are seeing a greater incidence of mezzanine coupon-only deals, and traditional mezzanine providers routinely taking second liens. While much of the second lien activity has been at the high end of the market, hedge fund activity is up and (for the present) continuing to grow in the middle market. We haven't seen much of that activity though in the lower middle market. Hedge funds and other second lien lenders tend to think and act like conventional lenders in a deal. They have short time horizons, typically looking for an exit in three years or less. The advantage mezzanine has, in contrast, is that they will typically look for 5 to 7 year maturities, and view deals more from the perspective of owners or partners.

Petrusic: The main impact of second lien loans on the mezzanine market has been to increase the leverage levels in transactions and push the mezzanine tranche deeper into the structure. Where second lien is present and mezzanine has a third lien it is unclear what the dynamic will be in a restructuring.

Tannenbaum: All nine of our investments in the second fund have second liens or first liens, yet we are a traditional mezzanine firm. It is not the lien per se, but what supports it that determines the class of the loan. As we emphasise the enterprise value of the company when reviewing a potential investment, we follow a different methodology than many traditional second lien lenders. As a result, our segment of the market has not seen much competition from those new developments. We believe the second lien is important in a distressed scenario, and our bank partners have been flexible enough to allow us to have that security in all of our transactions.

What benefits can mezzanine financing bring to companies at various stages of their growth cycle?

Eisenbiegler: Mezzanine is generally a good fit for middle market growth companies. Mezzanine is generally not a great fit for an asset-heavy company because that type of company will typically be able to obtain cheaper financing on an asset-based basis. Mezzanine is also a good choice for middle market companies that have some risks in their business plan. Mezzanine investors tend to be more flexible and more relationship-oriented than either second lien or high yield investors, so if there are bumps along the road they often will have the flexibility to accommodate them if it is consistent with their longer term investment objectives.

Petrusic: Mezzanine has certain features that are of benefit to any company looking to raise debt finance: long maturity date (typically 10 years), bullet repayment, mixture of cash coupon and rolled-up interest, flexible prepayment terms and private placement. While it is not a product that lends itself to start-ups, businesses that have gone beyond the initial growth stage and are profitable/cash positive after capex can benefit from the product as it allows them the flexibility to continue to invest free cash flow in growing the business rather than amortising debt. For companies at a later stage in their development, the longer term nature of the product can allow further debt capacity to finance acquisitions or dividend payments to shareholders.

Gellis: Over the years mezzanine has firmly established itself as a form of mid-life growth capital. This form of financing is a natural way for an established, growing company to reach beyond its secured loan resources and its equity base to fuel expansion and take the business to the next level of performance.

Tannenbaum: Mezzanine debt as a source of capital is utilised in different ways, for example: to leverage the equity return, provide additional funding to capital constrained equity groups, and to allow for non-control financing of growth objectives. We have encountered many cases where a company is negatively predisposed to potential equity dilution or control issues, and has approached us to provide capital for acquisitions and internal growth. Fortunately for mezzanine players, senior lenders are very formula-based and hence reluctant to stretch too far into the cash flow loan (tranche B). Consequently, this allows mezzanine lenders to exploit the additional turn or two of EBITDA necessary to complete the acquisition or build a new factory. Unlike the senior debt lender, the mezzanine provider has more of a vested interest in the company's success, and therefore the equity firm or portfolio company has a partner that would be more willing to act in the best interest of the business in case of trouble. We always have board observation rights or a board seat, which in turn provides for more than the traditional lender/borrower relationship. When we complete a loan with an equity partner, they effectively obtain a ticket into our vast network. It is a diverse group of high net-worth individuals, former CEOs and senior executives, and major institutions; this provides for numerous sales leads for our partners. In that regard, we are working alongside the PE firms and always remain focused on enhancing value.

Boyko: Mezzanine financing can be used at various stages of a company's growth cycle to fill a gap in their capital structure. There are mezzanine investors willing to lend to companies in all stages of their growth cycle – from venture backed companies to companies with hundreds of millions of dollars in revenue. Mezzanine financing is often used to provide funds for growth, acquisitions, capital expenditures, stock redemptions and changes of control. Some business owners prefer mezzanine financing to a leveraged buyout because they are able to retain control of their business (and a majority of the equity). It is often a less permanent solution than a buyout.

Kaufmann: Mezzanine financing with its regular coupon is still not very attractive for early stage companies. For later-stage companies with regular and predictable cash flow, mezzanine is a competitive alternative, especially for companies that are not asset-rich. Mezzanine providers have traditionally had a strong presence in buyouts of service industries. Mezzanine is also good for sponsors and owners that want some liquidity without selling the entire company or giving up control and for owners that want a financial partner with a somewhat more equity-oriented mindset than other lenders would bring to the table. Also, some would say that mezzanine investors, compared to hedge funds and other lenders, generally have a better understanding of what's required to fund a successful buyout, are better at providing patient, longer-term growth capital, have superior buyout know-how and post-closing operating expertise, and bring to the table superior networks of consultants, advisers and other financing sources. ■

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JUNIOR CAPITAL GROUP

Proskauer's Junior Capital Group is comprised of seasoned attorneys experienced and active in all aspects of the junior capital market. We represent a large number of mezzanine lenders and second lien lenders (including limited partnerships, hedge funds, CLOs/CDOs, business development companies, SBICs, insurance companies, and speciality finance companies) borrowers and equity sponsors in various financing transactions. Our junior capital attorneys provide practical advice that leverages our industry knowledge and formidable tax, private equity and restructuring expertise. Each attorney is experienced in insolvency and intercreditor issues that are critical to all financing transactions.

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