

The Mid Market – the Lender’s Perspective

Robin Menzel, Augusta & Co

IIR’s Mezzanine Finance & Subordinated Debt Market Leveraged Finance Summit

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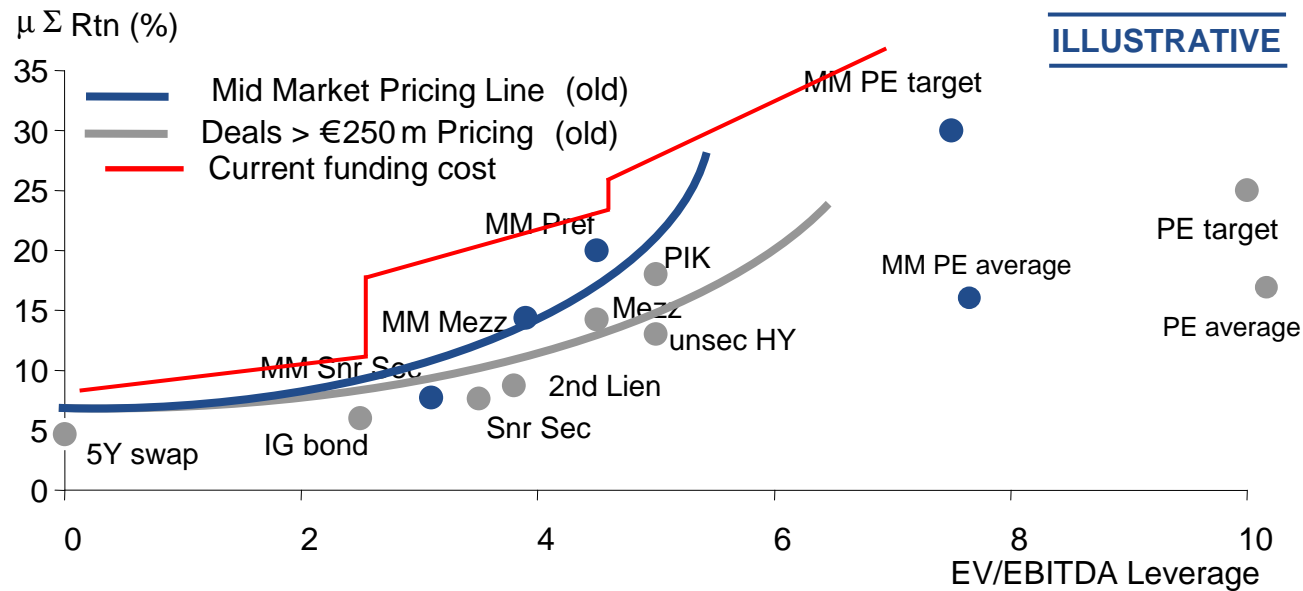


Repricing of risk across the capital structure...

Pricing has risen across the board but supply has not followed evenly

- Large deals currently very difficult
- Most demand for higher yielding assets in mid market sized deals
- Senior debt is under-supplied and hard to find
- Growing but cautious demand among junior debt and no-bank investors

Risk/Return Curves for Large & Middle Market (MM) Primary Deals



Sources: S&P LCD for 3Q08 and A&Co estimates based on investor discussions & our deal lists

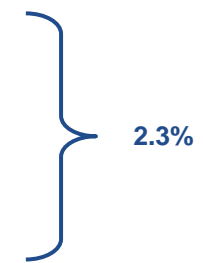
“Project X” £125m UK LBO – precedent mezz pricing and fees



*Mid market
mezz pricing
now 18-20%
all-in*

Transaction fees (excl arrangement fees)

- Legal = £725k (included LDD)
- FDD & Tax structuring = £650k
- Other DD = £390k
- Advisory Fees = c£1m across multiple advisors



Front-end fees*

2.5%

Project X - Offered Mezzanine Terms

	Investor A	Investor B	Investor C	Investor D	Investor E	
Cash Pay	550bps cash	400bps cash	550bps cash	600bps cash	600bps cash	550bps cash - 600bps cash
PIK	750bps PIK	950bps PIK	850bps PIK	PIK to be negotiated - min total return 18.25%	600bps PIK	550bps PIK - 600bps PIK
Libor Floor	Libor floor: 3.0%	Libor floor: 3.0%	Libor floor: 2.50%	To be negotiated - min total return 18.25%	Libor floor: 2.00%	Not Yet Determined
Warrants	225bps warrants	225bps warrants	150bps warrants	In line with market	300bps warrants	200bps - 400bps warrants
Arrangement fees	300bps	300bps	450bps	In line with market	500bps	250bps
All in Cost*	19.25%	19.75%	19.50%	18.25 - 20.00%	18.67%	17.83%

* Assuming 50% debt structure

All In Cost = Cash Pay + PIK + LIBOR floor (assumes 2.5% if no info) + warrants + 1/3 of fee (assuming a 3 year life)

Source: A&Co syndication

Leveraged lending volumes reduced to a trickle...

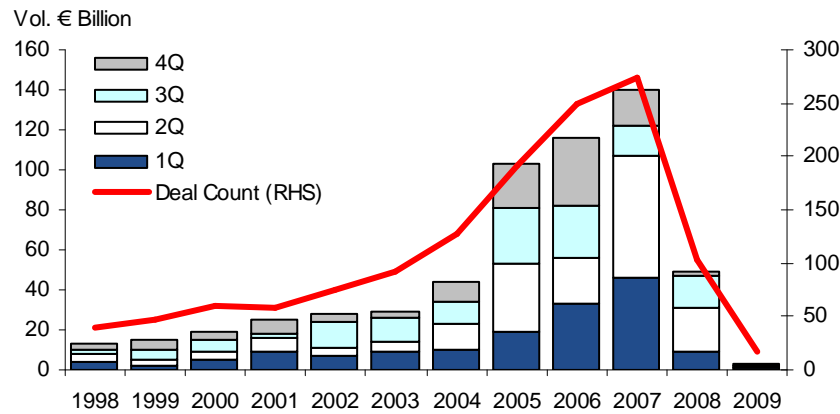
Some deals are getting done but volumes remain very depressed across Europe

Reported volumes remain depressed as

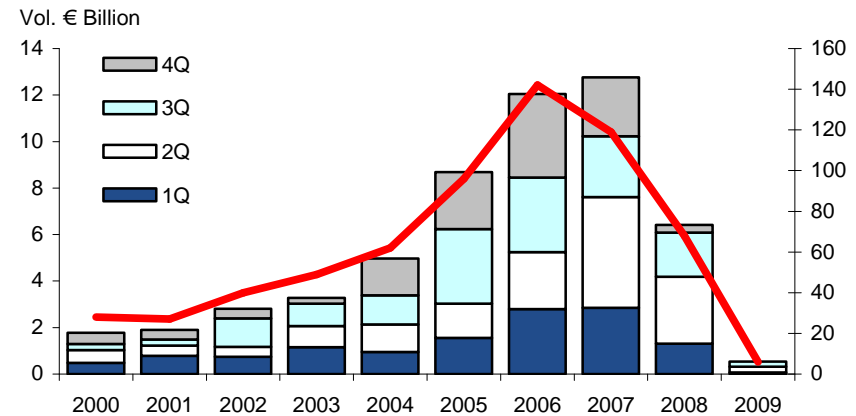
- Senior debt supply remains “locked-down” as banks restructure & retreat and the leveraged institutional investor base was largely destroyed
- High price of debt discouraging finance raises

...however, deals are getting done

European Primary Senior Lev Loan Issuance



European Primary Mezz Loan Issuance



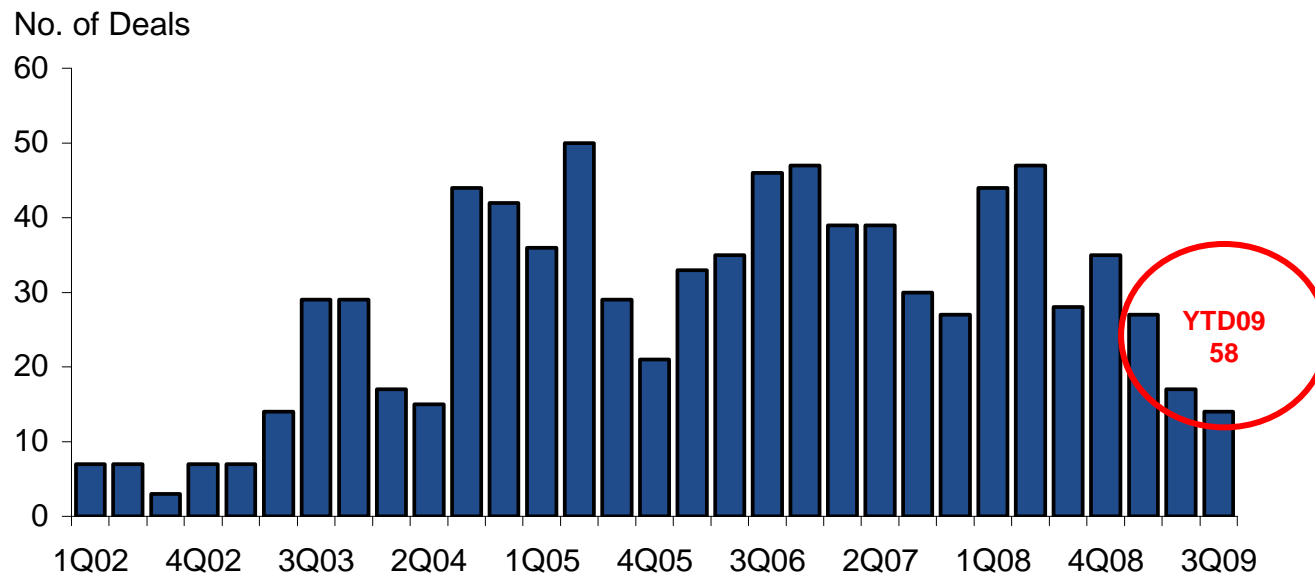
Sources: S&P LCD

...but mid market deals getting done under the radar

...however, deals are getting done

- New deals mostly limited to mid market
- EHY bond market & institutional lenders slowly replacing banks
- ...and new money is flowing into the market/investors

LBOs in German Speaking Markets tracked by L.E.K. Munich



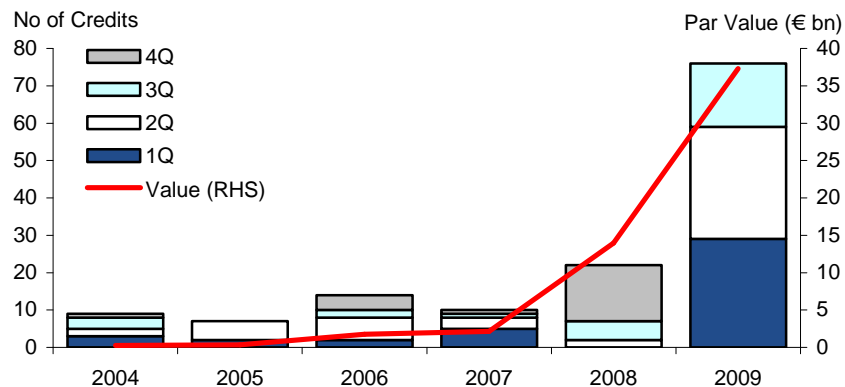
Investors dealing with a rapid deterioration in credit quality



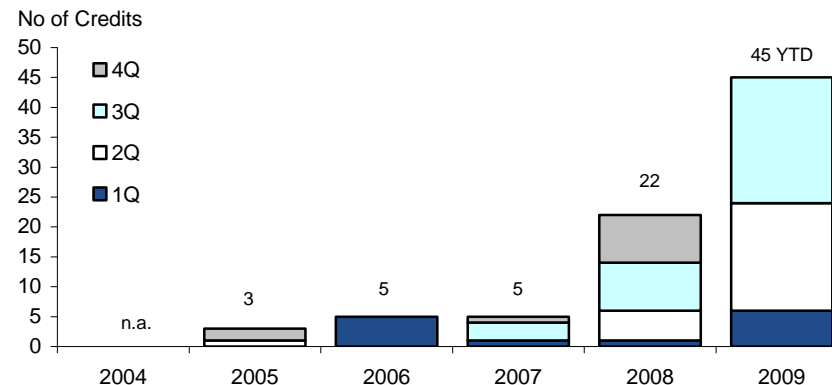
Rate of deterioration has moderated and now possibly peaked

- Especially among cyclical and consumer related credits
- Investors report covenant breaches across 25-40% of their portfolios
- We have tracked nearly 90 troubled mid market credits
- Default rate risen to 13.1% as of Sep-09¹
- Some expectation that this may have peaked
 - market forecasts range between 12-15% peak expectation

European Distressed* Credits



European Covenant Amendment Requests~



1. S&P: 96 companies with total outstanding funded debt of €69 billion defaulted in 12 months up to Sep-09

* Defined as credit downgraded to D or in restructuring

~ tracked by S&P LCD service

Source: S&P LCD, Moody's Investor Services, S&P, Debtwire

... that has reduced risk & valuation metrics

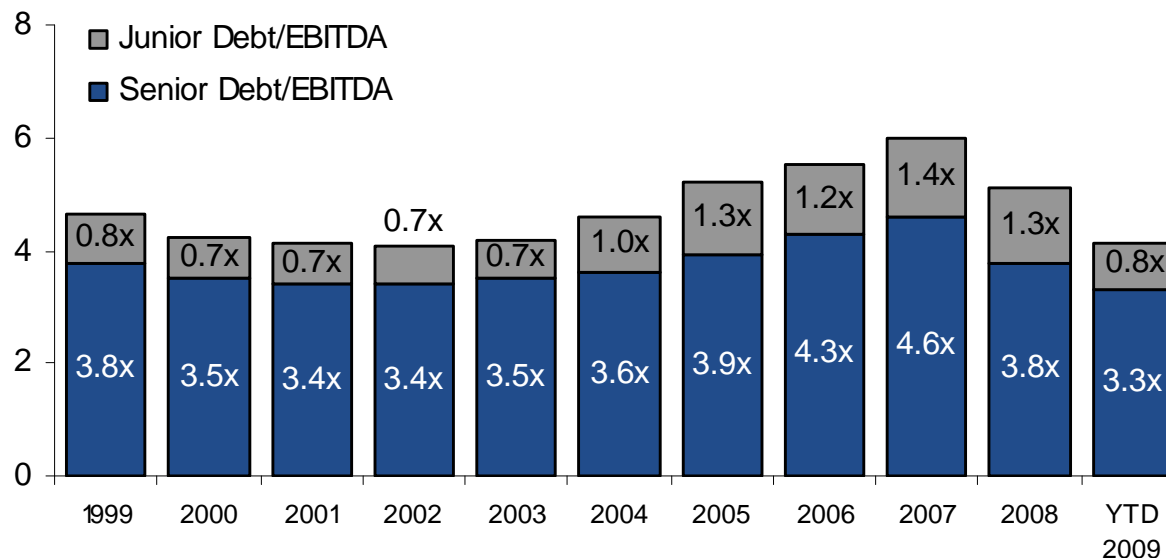


Reduced risk metrics have pulled down Enterprise Values

Leverage multiples have declined to

- Max leverage now up to 3.0-3.5x senior, 4.0-4.5x total
- Smaller deals usually at 0.5x multiple less, distressed 1.0x less
- Equity cushion requirements of 50% at current market value

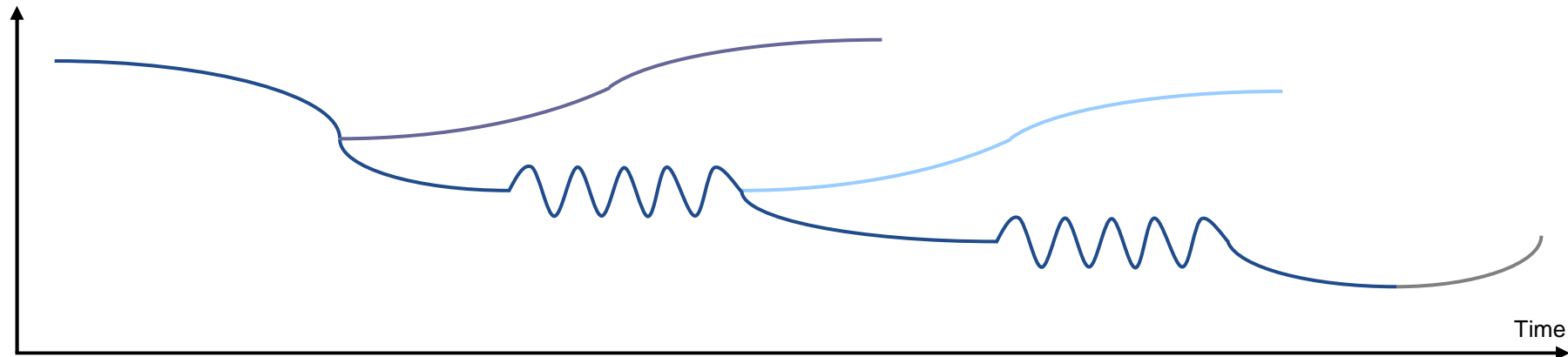
Development of Average Credit Metrics



Source: S&P LCD

Restructuring steps

Illustrative EBITDA Development



	<u>Temporary Decline</u>	<u>First Turnaround Failed/Delayed</u>	<u>EBITDA slips again</u>
Restructuring Options	<ul style="list-style-type: none"> • Buy covenant headroom • Debt reduction • Equity cure/injection 	<ul style="list-style-type: none"> • Amend cov's & Extend maturities • Discounted debt buyback • Credit bid the entire debt structure 	<ul style="list-style-type: none"> • Super senior funding • Debt for Equity exchange (D2E)
Restructuring Tools	<ul style="list-style-type: none"> • Amendment • Debt buyback by auction • M&A to explore value &/or disposals 	<ul style="list-style-type: none"> • Distressed credit bid or debt exchange • Distressed M&A • Consensual cram down or D2E 	<ul style="list-style-type: none"> • Bankruptcy driven cram-down or flushing out of junior/old equity • Bankruptcy driven D2E • New super senior funding
Funding Sources	<ul style="list-style-type: none"> • Mostly: sponsor or shareholder • Rarely: new external sources 	<ul style="list-style-type: none"> • Mostly: new external sources • Rarely: sponsor or shareholder 	<ul style="list-style-type: none"> • Almost exclusively: lenders (old & new/distressed) – lender led process

Restructurings now more costly & difficult



Restructurings now much more adversarial, costly & time consuming

Restructuring now much more complex & brutal

- Refinancing only available at lower leverage – requires new money
- EV multiples still deteriorating
- New money – drives the deal & defines value break
- Multi-level cap structures raise complexity
- Increasing senior resistance to shareholder led proposals (want the keys)

1990s Restructuring

Environment

- Simple 3 layer cap structures
- Little junior in structure
- Banks valued relationships & protective of equity

Typical Consensual Restructuring

- Senior stayed in, motivated by deleverging & relationship maintenance
- Junior converted
- 1-5% retained by old equity

2000-2007 Restructuring

Environment

- Debt traded, with new funds in senior pushing for refi at 80-90c
- Greater junior
- Value breaks in junior

Typical Consensual Restructuring

- Senior refinanced or senior sticking plaster
- Junior converted or flushed out
- 1-2% retained by old equity at best

2008-2009 Restructuring

Environment

- Debt more actively traded
- Multiple parties
- Senior syndicates often dysfunctional, can't follow the money
- Value breaks deep in the junior if not in the senior

Typical Consensual Restructuring

- New money driving distressed debt/equity exchanges – “pay to play”
- Junior & old equity flushed out
- If no new money required, senior often effect short-term “sticking plaster”, creating “zombie” companies

Current restructuring issues

*Access to
new money
drives
successful
restructuring*

Each situation is different but key issues to address

- When will there be a new money requirement?
- Jurisdiction of assets and value: what cram-down compulsion exists & value maximisation compulsion exists?
- Cross-over among creditor classes
- Management – where is/who buys their loyalty?
- Documentation – junior inter-creditor protections often very weak
- Litigation/frustration value of a valuation fight

New Money Requirement

- Those senior lenders that can not provide new money effectively become a forced seller
- Sponsor/New Money bids very low as can buy without DD, close quickly but will bid with a very short leash
- Lender led restructuring proving difficult, especially without management
- If lenders want to equitise, have to go through insolvency which is much riskier & costlier

No New Money Requirement

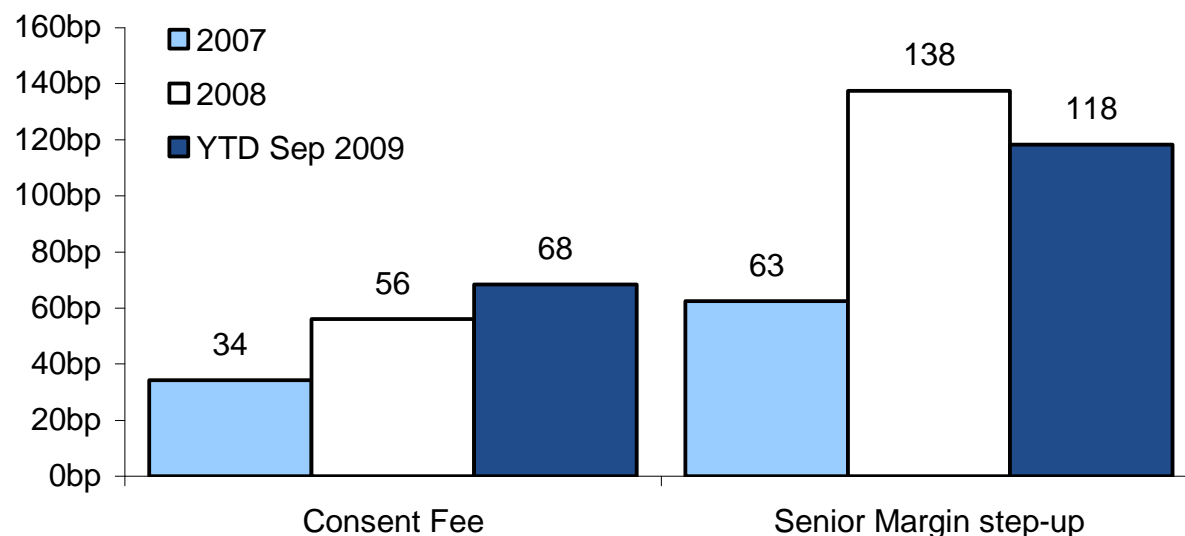
- Lenders effect short-term fixes to price-up but keep the loan “current” to avoid write-offs
- “Amend & Pretend” does not fix the capital structure
- Companies become zombies
- Management disincentivised

Cost of covenant amendments



- Blended cost for covenant amendments still close to 4Q08 peak
- High divergence around mean – very much situation dependent
- Disproportionately higher cost for smaller deals & greater perceived risk

Average European Covenant Amendment Economics



Source: S&P LCD (YTD Sep-09 data includes amendments proposed but not yet approved)

Who has money and really wants to lend/invest



We expect further bank retreat from leveraged lending which is the opportunity for non-bank funds

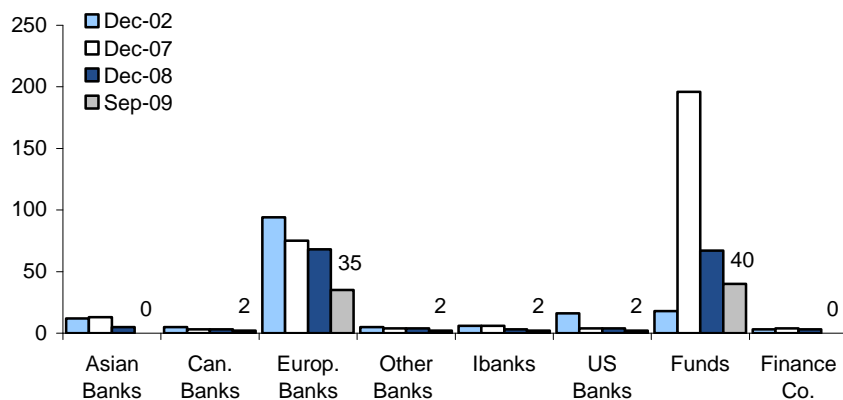
New money sources

- PE funds with quality investor backing
- Traditional mezz funds or credit funds with long-term unleveraged funding
- Distressed debt and HY funds

New money is slowly coming into the market attracted by attractive opportunities

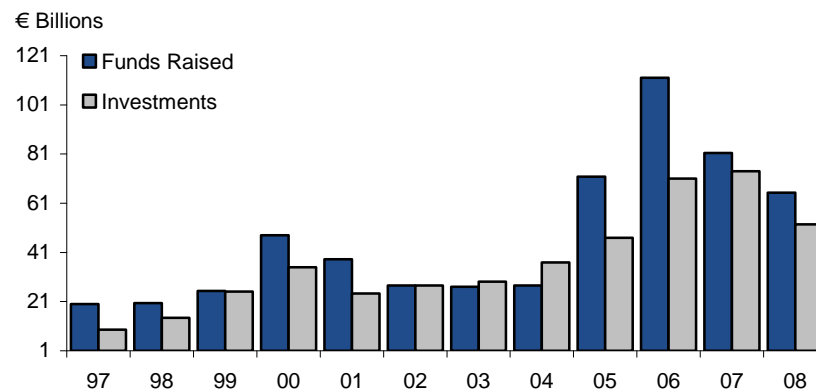
- We have tracked nearly €20bn of new money dedicated to Europe in 2009
- We see currently see approximately 43 banks very selectively lending
- We see approximately 40 non-bank funds actively looking and lending

Active European Lev Loan Lenders



Source: S&P LCD & A&Co estimates for Sep-09

European Private Equity/Buyout Funds Raised



Sources: EVCA

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Augusta & Co contacts



www.augustaco.com

Contact Details

London Office

2 Wardrobe Place
London EC4V 5AH
Tel: +44 (0)207 236 0100
Fax: +44 (0)207 236 0111



Frankfurt Office

Opernplatz 6
60313 Frankfurt
Tel: +49 (0)69 770 759 0
Fax: +49 (0)69 770 759 20



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