

## **Middle Market Mezzanine - Can it Remain Immune?**

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**IIR's Mezzanine Finance & the Subordinated Debt Market**  
**Conference**  
**London 15-17 October 2008**



# The Middle Market (MM) is not immune anymore

*Liquidity  
unwind has  
now  
reached the  
middle  
market*

Approx €90 billion of European leveraged debt is trading > 12% yield

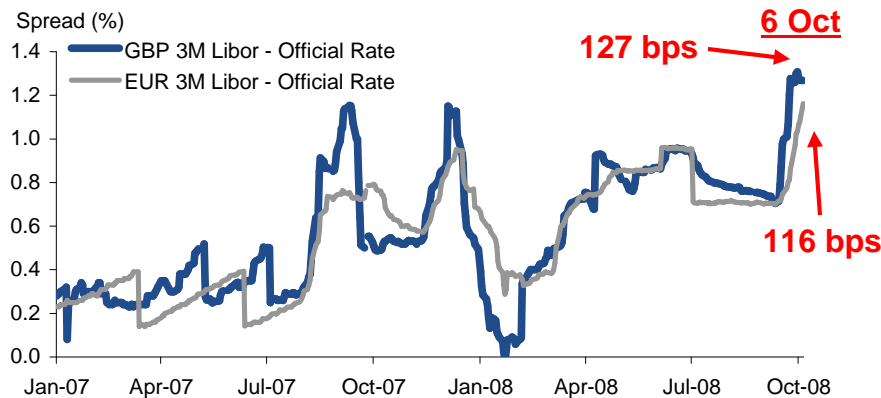
- ~2/3 is performing senior secured debt
- ~1/3 is performing subordinated debt

Unprecedented leverage unwind

- near-term inter-bank market seized-up – hopefully only temporarily
- several credit funds and banks now following CDO's in reducing exposure
- several banks have blown-up or are closed for further business

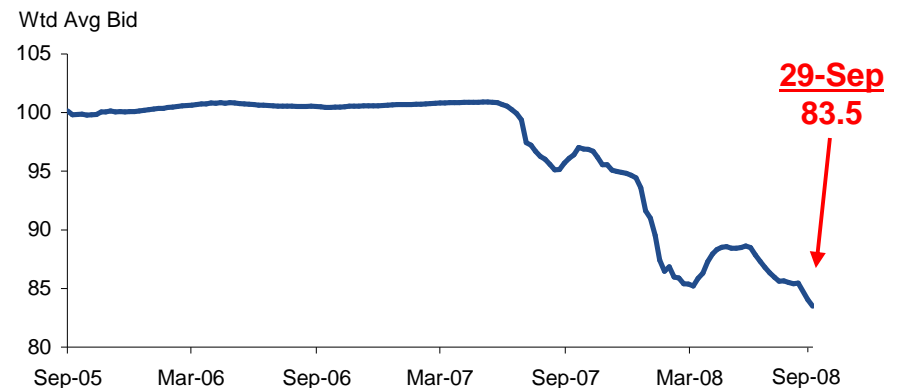
➔ middle market deals are now seriously affected

**3 Month Libor Spread to Central Bank Repo Rates**



Sources: BBA, FT, ECB & Bank of England

**Weighted Bid of European Snr Sec Lev Loans**



Sources: S&P LCD Euro ELLI

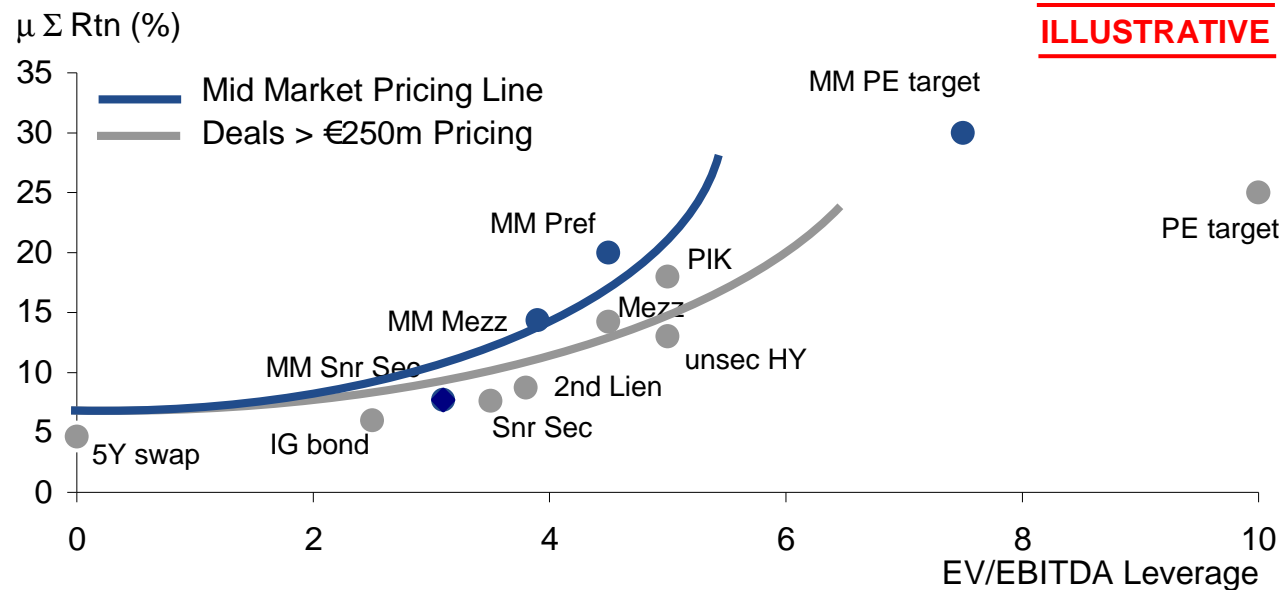
# MM risk–return premium has significantly narrowed

*Market technicals have reduced traditional premium pricing per unit of risk of MM deals*

Traditional middle market pricing premium has essentially evaporated

- large primary deal pricing  $\geq$  primary MM deals
- weak secondary market is pushing out pricing across the board
- senior debt is hard to find

## € MM vs. Large Deal Indicative Risk/Return Curves



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

# MM credit risk differential only favourable at smaller end

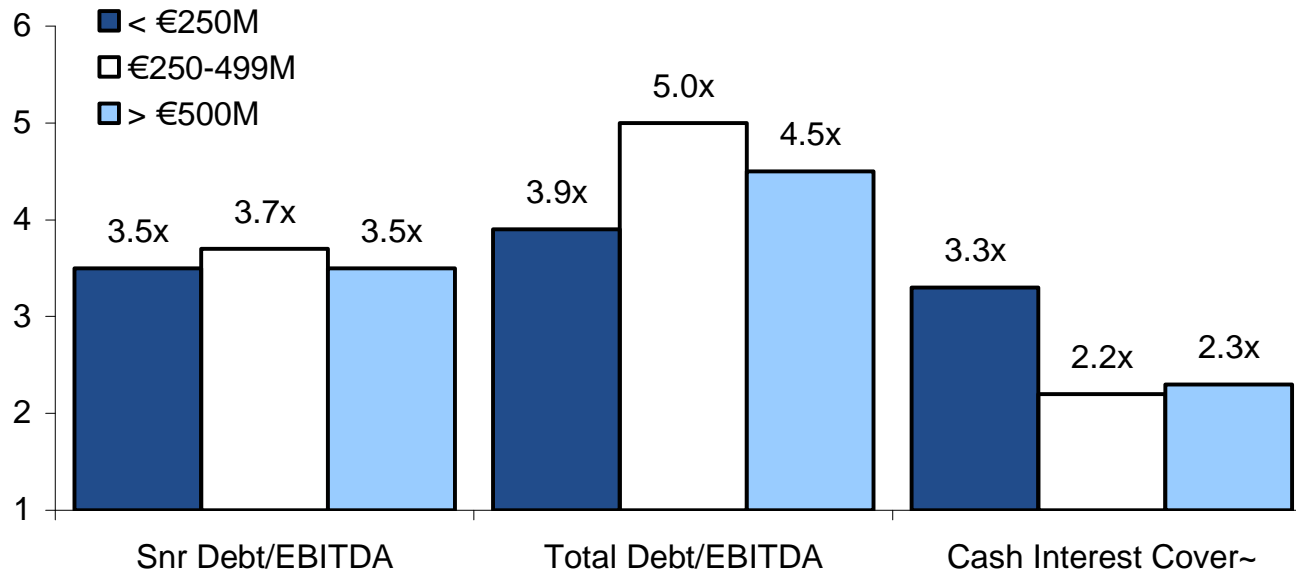
*Smaller MM credit metrics comparatively attractive but structures are converging...*

At smaller end, MM credit differential still attractive but necessary to compensate for

- higher (perceived) business risk
- lower transparency
- illiquidity

*...larger MM deals have less favourable metrics*

**Average Leveraged Loan Credit Metrics\* (3Q08)**



\* for 'out-of-the-box' pro forma credit metrics, excluded deals > €1bn  
 ~ average for the nine-months YTD Sep-08  
 Source: S&P LCD

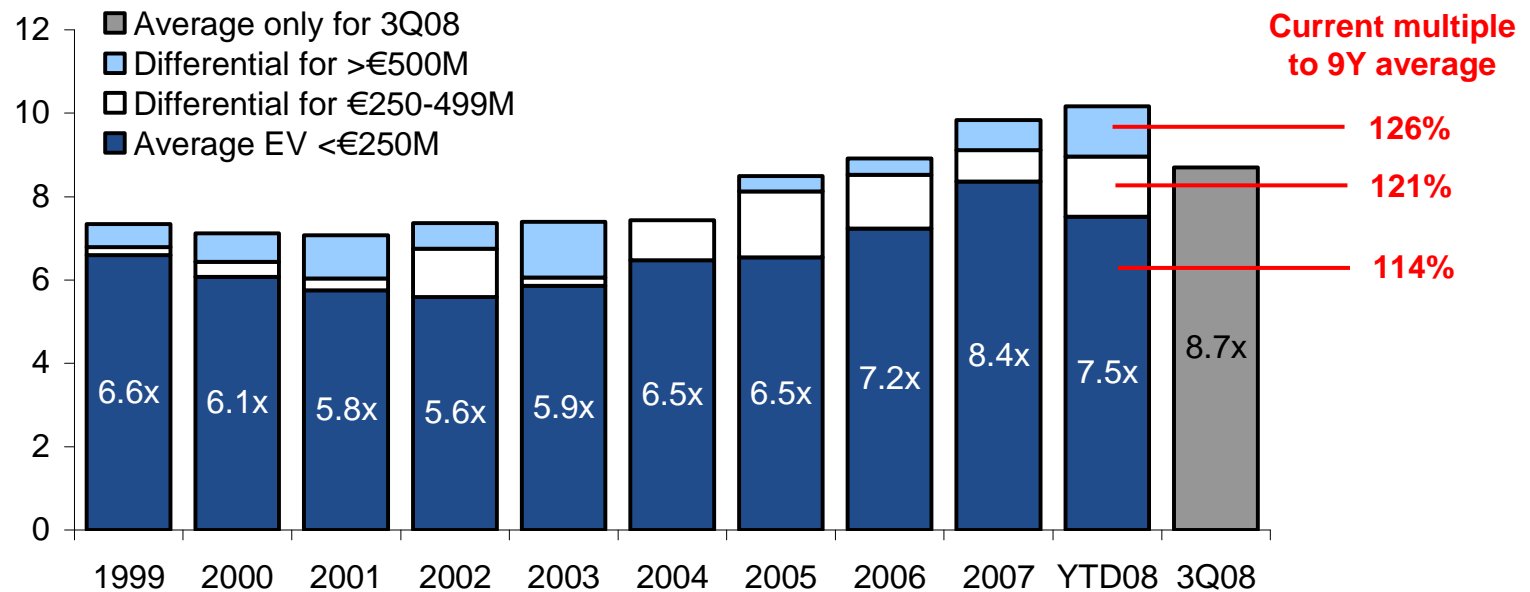
# MM deals less subjected to “multiple inflation” but...



*Enterprise valuations only coming off slowly as sponsors have been making up the gap with more equity*

- While MM deals had less multiple inflation they may now be less protected
- higher share of EV ‘wasted’ on transaction costs
- new deals may be less immune to multiple inflation as sponsors chase deal flow into the “middle market”

**Differential in EV/EBITDA multiples\* for LBOs by Size**



\* Based on trailing pro-forma EBITDA before transaction costs  
Source: S&P LCD

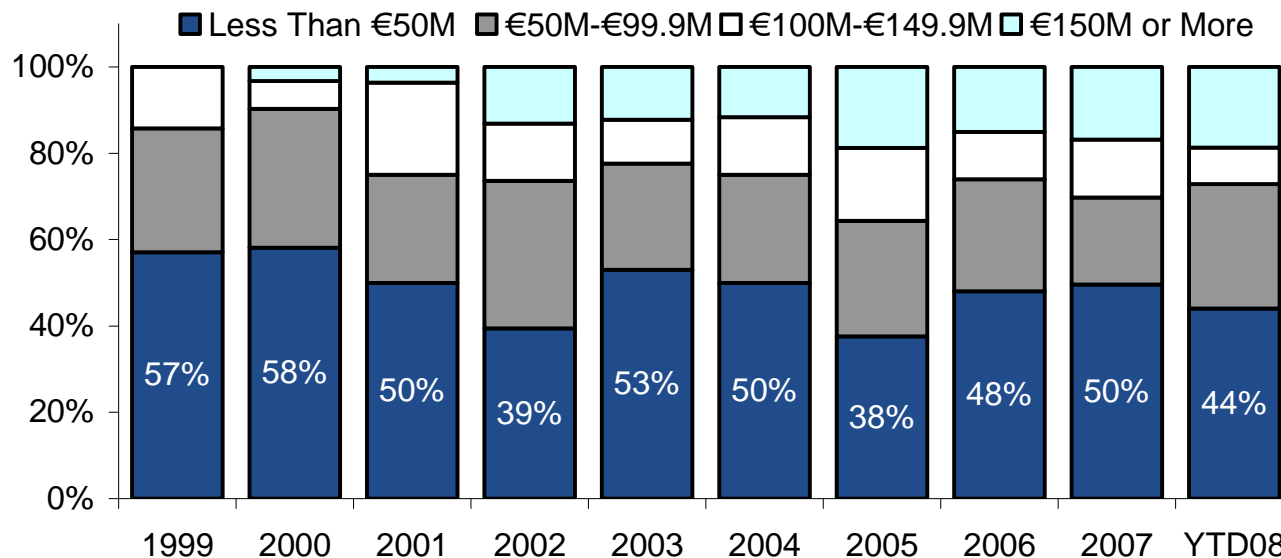
# MM demand–supply balance favourable...

*The traditional middle market mezz funds & some select credit funds currently have the market to themselves*

Overall MM supply is now reduced

- traditional mezz lenders replacing lost institutional bid & filling senior gap
- local MM banks exhibit less appetite to lend “across the strip”
- many MM mezz funds busy fund raising

**European Mezz Size Distribution**



Source: S&P LCD, YTD08 is for the nine months through to Sep-08

## ...leading to hardening pricing

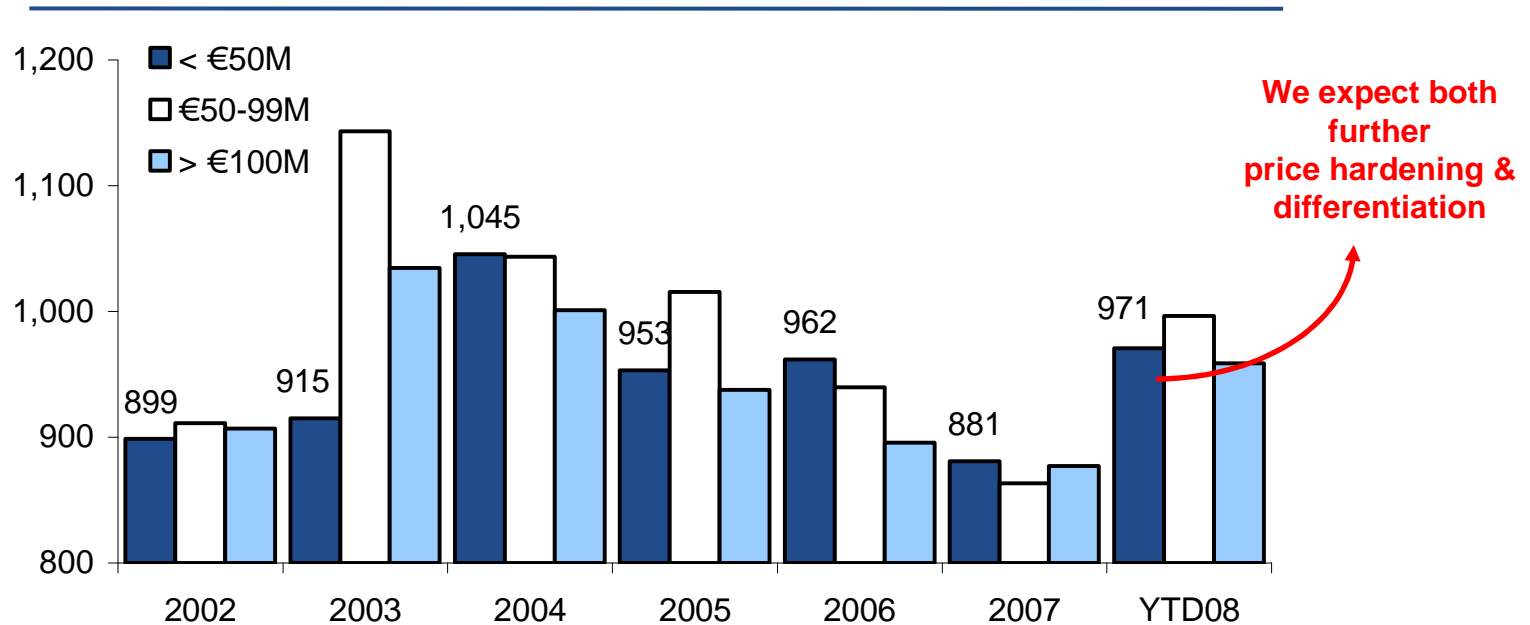
*Senior is most difficult to find, greater supply of mezz*

*Deal stats getting thinner – and pricing benchmarks show greater dispersion*

MM pricing has recently started hardening across the strip

- senior pricing widely spread, starting at anywhere from L+2.75 to 3.50
- mezz pricing now L+9-12 increasingly with warrants
- mezz no-call periods between 1-3Y with extension possible under flex

**European Mezz Spreads by Facility Size**



Source: S&P LCD, YTD08 is for the nine months through to Sep-08

## Comparison of current transaction dynamics

	The Big Deals > €500 Million	The MM Deals €50-500 Million
Deal Flow	<ul style="list-style-type: none"> <li>Everything is auctioned</li> <li>Underwriting now mostly via clubs of take &amp; hold lenders</li> </ul>	<ul style="list-style-type: none"> <li>Almost everything is auctioned</li> <li>Club deals among take &amp; hold players</li> <li>Localised market</li> </ul>
Placement	<ul style="list-style-type: none"> <li>Take &amp; hold banks &amp; credit funds</li> <li>Large wrap &amp; pack MLA's side-lined</li> </ul>	<ul style="list-style-type: none"> <li>Placement via agents or local club syndication</li> <li>Relationships/chemistry more important than price</li> </ul>
Issues	<ul style="list-style-type: none"> <li>High transparency</li> <li>Good level of documentary diligence</li> <li>Strictly homogenous terms</li> </ul>	<ul style="list-style-type: none"> <li>Weak transparency &amp; diligence challenges</li> <li>Have to play the "local game"</li> <li>Tailor-made structures</li> </ul>
Possible Solutions	<ul style="list-style-type: none"> <li>Credit events allow for opportunity</li> <li>Liquidity should allow active credit trading (market dependent)</li> </ul>	<ul style="list-style-type: none"> <li>Small clubs allow for closer borrower relationships and information benefits but loans more difficult to trade out of</li> <li>Structures better tailored to each credit</li> </ul>

# Covenant waivers more difficult to obtain

- headroom extensions for >1Y now generally require prepayment
- smaller credits being penalised disproportionately

	Gala Coral Group Gaming & Gambling Oct-05 Lev. Acq.	Sanitec Bathroom fittings Apr-05 2nd LBO	Mach Mobile Telco Serv. 05 LBO, Refi May-07	INGG Plc Gaming Software Jun-06 AIPO	Global Closure Systems Oct-05 LBO	Yell plc Directory Services Jul-03 IPO
Equity Injection	£125m	€70m + €15m g'tee <sup>1</sup>	0	£40m	€30m up from €20m	0
% of Total Financing	4.8%	8.3%	0.0%	26.4%	6.0%	0.0%
Senior Prepayment	£83m	€54m	€0m	£10m	€15m	€0m
% of Net Drawn Senior Debt	3.6%	5.2%	0.0%	12.8%	c10%	0.0%
<u>Resultant Leverage</u>						
Net Senior Leverage	5.4x	na	na	3.1x	na	4.9x
Net Senior & 2nd Lien Lev.	5.8x	5.1x	na		na	
Net Total Lev. through Mezz	7.2x	na	na		na	
<u>Resultant Snr Covenant Headroom</u>						
Year 1	15.5%	15.0% <sup>2</sup>	2Q08 +12.0% <sup>3</sup>	waived until Apr-09	na	20.0%
Year 2	17.5%	15.0% <sup>2</sup>	2Q09 +12.0% <sup>3</sup>	na	na	20.0%
<u>Waiver Cost</u>						
Consent Fee	0.50%	0.25%	0.50%	0.375% + 1.0% exit	0.50%	0.50%
Snr Margin Step-up	0.50%	0.25%	0.25%	1.50%	na	1.00%
2nd L/Mezz Margin Step-up	0.75%	4.00% PIK	0.50%			
<u>Waiver Approval Status</u>						
Required Approval Threshold	66.6%	Interim (1Q08) 66.6%	assumed 66.6%	100% due to disposal		66.6%
Reported Approval Rate/Date	75.0%	passed	turned down Jun-08	07-Jul-08	25-Jul-08	07-Oct-08
		Full (2Q08-FY10) 66.6%				
		passed 17-May-08				

1. Further equity on call until 2014 callable on payment default, covenant breach or significant reduction in headroom or liquidity

2. Reduced from original ask of 17-18%

3. Current headroom unknown, waiver seeks additional 12% headroom for 12 months only

Source: Company announcements, news reports and A&Co estimates

A&Co is an independent mid-market focused merchant bank



*Founded in 2002 we have now advised on / or placed over €3.5 billion of mid-market transactions*



<p>2008</p> <p>£153m financial restructuring (co-advisory)</p>	<p>2007</p> <p>€50m senior &amp; €30m junior debt placement</p>	<p>2007</p> <p>€420m M&amp;A and debt advisory</p>	<p>2006</p> <p>£116m senior debt placement supporting £115m IPO on AIM</p>	<p>2005</p> <p>\$75m senior high yield bond placement (co-arranger)</p>	<p>2005</p> <p>debt advisory on a £50m private placement bond</p>	<p>2004</p> <p>€70m senior refinancing advisory &amp; €30m mezz placement</p>
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# Augusta & Co contacts

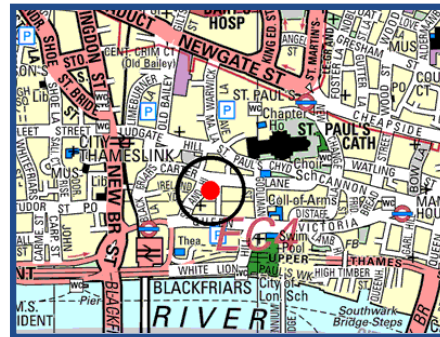


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