Investing in Credit Series
Mezzanine Debt

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UBS Financial Services Inc. (UBS FS) is pleased to provide you with information about alternative investments. There are a few points we would like to raise with you at the outset.

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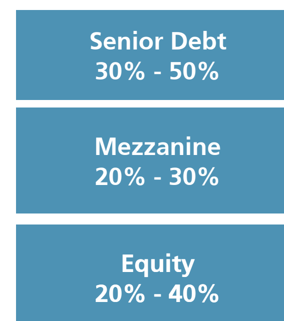
In this paper we analyze mezzanine capital's investment characteristics; make the distinction between mezzanine capital and high yield debt; explore supply and demand factors that drive pricing; point out similarities and differences in its usage in the U.S. and Europe as well as highlight important investing considerations.

The last decade has witnessed a dramatic increase in the number of private equity funds under management in both the developed and the developing world. The increased allocation to the private equity asset class has been accompanied by increased commitments of capital to mezzanine capital funds. Private Equity Analyst estimates that $75 billion of mezzanine capital has been raised in the last few years - largely structured as closed-end blind investment pools. We estimate that with around $400 to $500 billion in equity 'dry powder' – i.e. committed but uninvested capital waiting to be deployed in buyouts that need matching debt, and with less than $50 billion of uninvested mezzanine capital remaining, there is a sizable opportunity for new money to be raised in this sub-asset class.

Definition of Mezzanine

Mezzanine debt is privately negotiated subordinated debt with equity participation. The word "mezzanine" is derived from the Latin *medianus*, which means "in the middle, and is most commonly used to refer to the layer of capital which (from both a risk and return perspective) is located between a company's senior debt and its equity (see Figure 1).

Figure 1: Illustrative Capital Structure of a Leveraged Buy-out ("LBO") Transaction



Source: UBS FS Alternative Investments

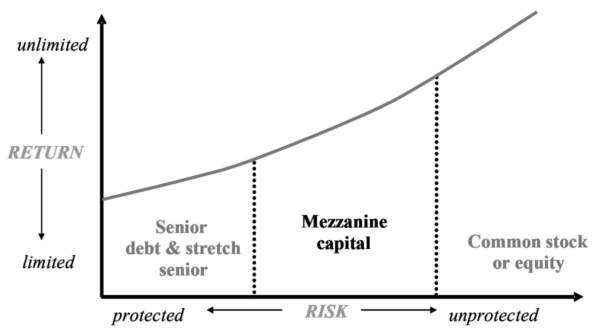
Mezzanine is either structurally or contractually subordinate in priority of payment to senior debt, but it ranks senior to the borrower's equity or common stock.

- Structural subordination is attributable to the legal structure which gives effect to the mezzanine lender's claims vis-à-vis a borrower being subordinated to the claims of senior lenders.

- Contractual subordination is through the registration of first priority liens, mortgages, or pledges in security over the borrower's real assets in favor of the senior lenders. There is usually also an inter-creditor deed which governs the rights of mezzanine and senior lenders.

These characteristics combined have led to mezzanine sometimes being referred to as "middle-risk - middle-return financing."

Figure 2: Capital Structure Risk and Return



Source: UBS FS Alternative Investments

The likely timing for the investment of mezzanine capital, such as, pre-IPO, middle/late-stage leveraged buy-outs ("LBOs") or management buy-outs ("MBOs") is also sometimes a reason for calling this type of capital "mezzanine".

Mezzanine capital can adopt many forms, most of which are hybrid instruments, including: senior subordinated debt with some sort of "kicker" or "sweetener" typically in the form of warrants; convertible loans; zero coupon bonds; original issue discount coupon bearing notes/loans; and preferred stock.

Figure 3: Comparing Mezzanine with other Securities

	Mezzanine	Leveraged Loans	High Yield	Public Equity
Security	Unsecured	First Lien	Unsecured	None
Ranking	Contractual/ Structural Subordination	Senior	Contractual Subordination	Junior
Covenants	Less Restrictive, Mostly Financial; Maintenance-Based	Generally Comprehensive	Incurrence-Based	None
Term	8 Years	5 Years	10 Years	Open Ended
Coupon	Cash Pay (Fixed)/PIK	Cash Pay – Floating	Cash Pay – Fixed	Dividends
Warrants	Almost Always	None	Generally Not	Not Applicable
Prepayment Penalties	Moderate Via Prepayment Premium, Usually After One Year	Minimal	Heavy Penalties/Call Premiums Attached	Not Applicable
Capital Providers	Private Capital	Banks, Non-Bank Institutions	Public Offering	Public/ Private
Recovery (%)	20	80	40	0
Liquidity	None	Medium	High/Medium	High
Rating Requirements	None	Required	Required	None
Buyers of Paper	Institutional companies, Mezzanine Funds/ Private Equity Funds	Collateralized loan obligations/ Institutional Investors	Institutional Investors/High Net Worth Individuals /collateralized bond obligations	General Public, Institutional Investors

Source: Fitch

Mezzanine investors, as secured lenders in most instances, have the benefit of a second ranking security interest over the assets of the company, junior to a company's senior lenders but ahead of all unsecured creditors, as well as the protection of certain maintenance-based financial and operating covenants. The protections for mezzanine investments are particularly strong as the laws of many jurisdictions favor secured creditors significantly.

Mezzanine funds tend to be structured as private equity funds - 10 year lives, with 3 to 5 year investment periods, 1% to 2% management fees and carried interest of 20% payable after a hurdle rate has been met.

Return Components

Interest payment and equity components of mezzanine debt capital are intended to compensate the mezzanine provider for its subordinated ranking in the assembly of lenders - the process where creditors gather to share in the borrower's assets or their proceeds upon disposal.

Interest Returns: Interest payments on mezzanine capital typically involve both a current cash interest component, and a payment-in-kind ("PIK") component. It is the cash interest component of mezzanine that makes it generally unavailable to early stage companies that are often cash-constrained.

Equity Returns: The remainder of the mezzanine provider's all-in return is normally provided by the equity-linked component of these bifurcated instruments, most commonly in the form of warrants that enable the grantee of the warrant to purchase common stock in the borrower at a predetermined price; in such cases, the issuer company is valued at the inception of the transaction, and the warrant strike price is determined with reference to this initial valuation. The equity-linked portion of the total return is realized when the investor disposes of the warrants or the underlying stock upon the occurrence of a so-called "exit event" or "put back" to the company at some pre-agreed date. This is based on a formula or strike price determined at the initial closing of the transaction. Examples of exit events include sale of the company's business, a change in control of the company, or a recapitalization of the company.

The warrants granted to the mezzanine provider usually rank *pari passu* ("ranking equally") with the sponsors' equity, and typically give the mezzanine provider an uncapped upside.

For downside protection, mezzanine providers are dependent on negotiating: contractual rights; seller undertakings; representations and warranties; loan covenants; event defaults; and so-called 'second bite at the cherry provisions' - provisions that increase the PIK interest component of a mezzanine loan or the lender's warrant allocation in the event of borrower default.

Expected Returns

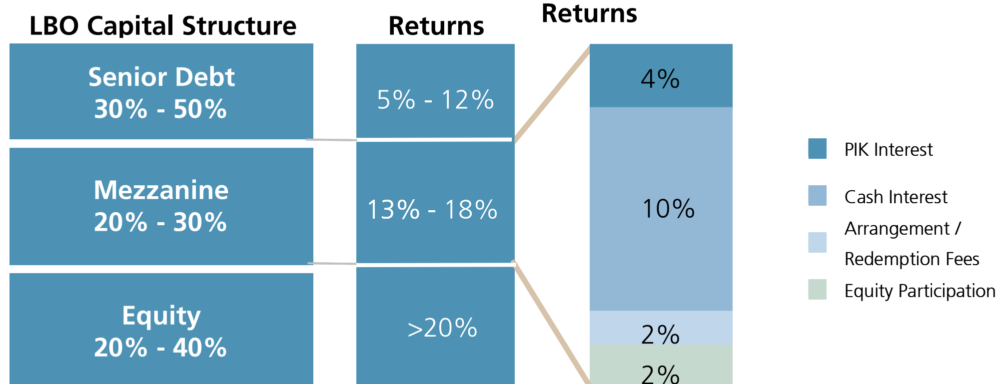
The high contractual yield, including current income, and the potential upside through equity participation have combined to produce historically high returns with lower volatility than many other private equity investments. Mezzanine funds tend to target gross internal rate of return ("IRR") of approximately 13% to 18%. This is typically composed of (i) a contractual return (7% to 12%) which includes current cash and PIK interest, and (ii) equity participation, usually in the form of warrants:

• Cash Interest: Mezzanine investments are usually structured to provide high current cash income, normally yielding around 4% to 7% over LIBOR[1].

• Payment-in-Kind Interest: In addition to current cash pay interest, in an amount which generally ranges from 3% to 5%[1]. The PIK interest typically compounds annually or semi-annually and is paid at realization. A part of returns is also derived in the form of a prepayment premium, or similar form of return enhancement.

• Equity Participation: In addition to cash and PIK interest, mezzanine returns are enhanced through the exercise of equity warrants or other forms of equity participation.

Figure 4: LBO Capital Structure and Expected Returns



[1]Source: Stylized illustration and estimation by UBS FS Alternative Investments

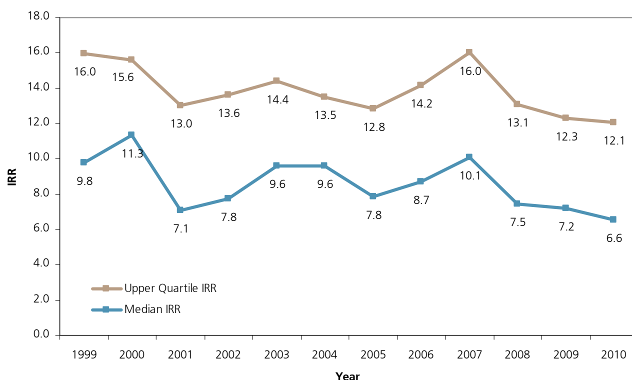
Expected returns is not indicative of future results

The addition of modest leverage applied to a diverse portfolio of mezzanine investments has the potential to increase the targeted gross IRR to approximately 20% or more.

In the past, lightly levered mezzanine deals had grossed returns in the high teens – typically around 10% cash interest, 4% PIK interest, 2% arrangement fees/ prepayment penalties and around 2% equity participation.

Figure 5 illustrates the upper quartile and median IRR of mezzanine funds.

Figure 5: Internal Rate of the Return



Source: Thomson One

Historically, there has been moderate performance dispersion between fund sizes. Larger funds in general have underperformed smaller funds.

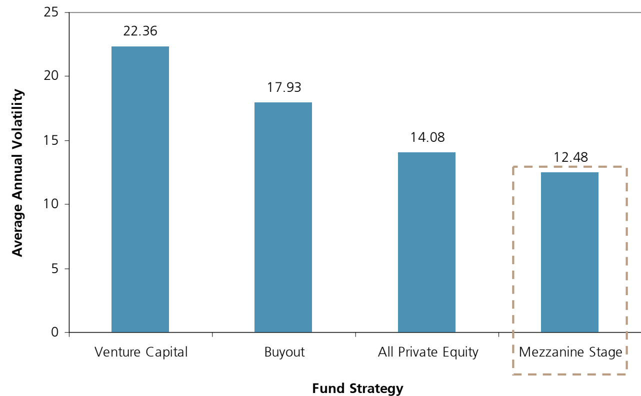
Figure 6: Mezzanine Fund Performance by Size (1991-2010)

USD in Millions	Upper Quartile	Median
0 - 30	14.89	12.04
30 - 50	6.12	3.43
50 - 100	15.80	11.66
100 - 300	12.52	7.07
300 - 500	10.25	3.90
500 - 1000	7.04	5.34
1000+	8.14	4.62

Source: Thomson One

Lastly, the interest rate and equity component act as a built-in hedge which protect mezzanine's value from interest rate fluctuations. As a result, mezzanine funds have had lower volatility than other strategies (please refer to Figure 7).

Figure 7: Average Annual Volatility based on Strategy (1991-2010)



Source: Thomson One

Analyzing and Mitigating Risks

Mezzanine capital is, in essence, a form of debt capital that is advanced to the borrower with an obligation, at a minimum, to repay/redeem the principal. Any analysis of a mezzanine investment opportunity therefore essentially entails a two-step credit evaluation process:

I. The first step is aimed at establishing the probability of borrower default (i.e. the likelihood of the borrower being unable to meet all of its financial obligations); and

II. The second step is to estimate the expected level of recovery (or loss severity) in the event of a borrower default.

In determining the likelihood of borrower default, mezzanine providers typically take into account the borrower's:

- Cash flow generating ability
- Degree of financial leverage
- Debt-service coverage
- Business risk
- Industry fundamentals
- Stability and consistency of historical financial results
- Quality and depth of management team and experience
- Accounting quality, and
- Sensitivity to macro-economic considerations.

Past performance is not indicative of future results

Some mezzanine borrowers are relatively small, and as a result, any credit review needs to focus on analyzing the impact that the borrower's lack of scale might have on the defensibility of its business position.

This credit analysis process requires a clear understanding of the company's principal growth opportunities, as well as the economic factors which underpin the markets it operates in, its profitability and its financial results.

Fitch Ratings says that a prevalent Issuer Credit Rating ("ICR") has assigned mezzanine borrowers a "B", indicating a highly speculative issuer or borrower. A "B" rating suggests that there is "significant credit risk present, but a limited margin of safety remains. In general, financial commitments are currently being met; however, capacity for continued payments is contingent upon a sustained, favorable business and economic environment."

The level of leverage acceptable to financiers is a function of the company's historic financial performance, the financial performance of the sector(s) in which the company operates, and the prevailing economy conditions as a whole. The stronger the overall position, the higher the permitted level of leverage, while weaker positions and economic uncertainty result in lower levels of leverage. Historically, higher levels of leverage have resulted in lower credit ratings due to increased debt obligations.

In attempting to determine the likely loss recovery in an event of default, mezzanine providers take into account that:

- Mezzanine capital is usually subordinated to all existing and future senior indebtedness of the borrower, and typically has no collateral rights over the borrower's assets
- Mezzanine securities are often held by either one creditor or a club consisting of a few creditors with closely aligned interests. This increases the likelihood of the business being restructured and reorganized in the event of the borrower experiencing financial distress.

The increased likelihood of a reorganization being promoted by mezzanine providers means that – when evaluating an investment opportunity – they need to pay greater attention to determining whether the borrower is a viable going concern, and place less emphasis on the value of the borrower's real assets. These going concern valuations entail stress-testing the borrower's cash flow projections to reflect a probable default scenario by applying a "haircut" to the business' earnings before interest, tax, depreciation, and amortization ("EBITDA") forecasts along the lines of the example set out in figure 8.

Figure 8: Dispersion of Recoveries Post Bankruptcy

Current EBITDA $m	50
Discount %	40
Distressed EBITDA $m	30
Transaction Multiples	4X
Valuation (30mX4) $m	120

	Amount $	Recovery $	Recovery %
Total debt	280	120	43
Senior Secured Debt	150	106	71
Mezzanine Debt (Operating Co.)	70	14	20
PIK Preferred Mezzanine (Holding Co.)	20	0	0

Source: Stylized Illustration by UBS FS Alternative Investments

The dispersion of recoveries forms the basis of any attempt to calculate the likely loss recovery, whilst other factors which also need to be taken into account

in predicting the loss recovery of mezzanine loans include:

- The probability of mezzanine creditors achieving recoveries in excess of their expectations due to their flexibility in the event of a reorganization;

- The fact that higher levels of senior debt in the overall structure will probably lower recoveries on the borrower's subordinated borrowings; and

- The fact that the cash-on-cash (cash received/initial cash outlay) return yielded by a mezzanine investment could be conceptually construed as a component of the mezzanine provider's recovery.

Warrantless Mezzanine

Warrantless mezzanine is mezzanine capital advanced without any requirement that the borrower issues warrants to the capital provider. Usually there is a reduced cash interest coupon, and a significantly higher PIK component. Although the market for warrantless mezzanine has grown significantly during the last few years, there is still a more finite appetite for mezzanine structured in this manner. Investors favoring warrantless mezzanine are attracted by the fact that:

- The higher contracted PIK return provides them with superior risk-adjusted returns; and

- Their entire return ranks prior to those of stockholders.

Sponsors and issuers are attracted to warrantless mezzanine due to the fact that it:

- Leaves their equity interests undiluted.

- Offers a lower all-in cost than traditional mezzanine (i.e. mezzanine with warrants or some other form of equity-linked kicker).

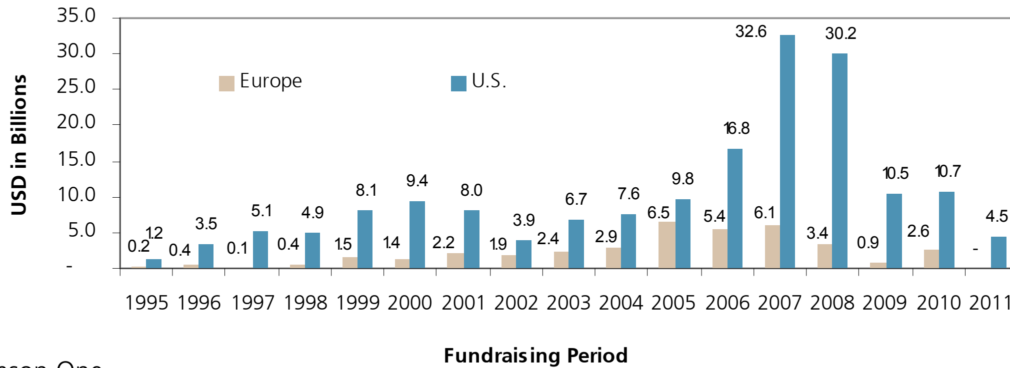
- Provides them with all the benefits of pre-payment flexibility normally associated with mezzanine capital; and

- Makes the entire debt service cost of the mezzanine deductible for income tax purposes since both the cash interest and PIK expense are deductible, whereas the costs associated with issuing warrants are generally not deductible for income tax purposes.

Some investors, however, believe that warrantless mezzanine has an inherent flaw if it fails to address prepayment risk by incorporating protection provisions which will preserve their target yield in the event of early repayment. They argue that without prepayment protection, their absolute returns can be adversely affected where a borrower outperforms, whereas if they were warrant-holders they would benefit from the growth in their warrant value.

Comparison: U.S. & European Mezzanine

Figure 9: Mezzanine Fundraising Europe vs. U.S.

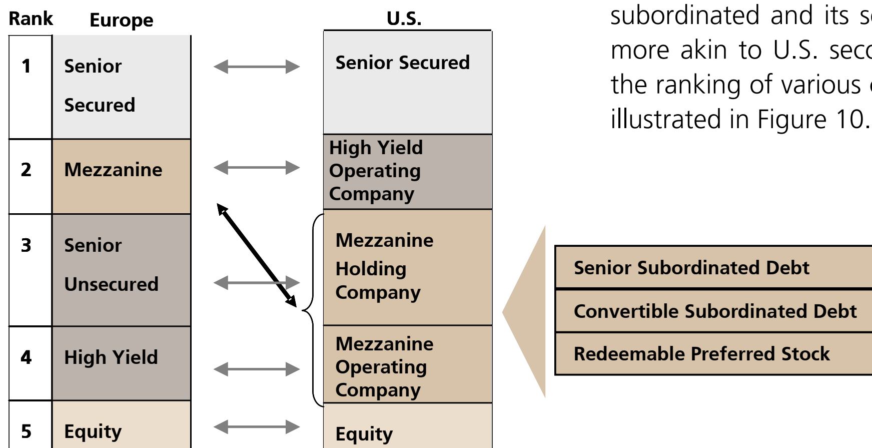


Source: Thomson One

It is helpful to analyze how mezzanine capital differs within the context of both the U.S. and European markets, since the comparison provides further insight into the characteristics of mezzanine capital as a distinct sub-asset class, and its particular attraction for prospective investors domiciled in these two jurisdictions.

As suggested earlier, mezzanine capital fills the funding gap between senior debt and equity in both the U.S. and European markets. However there are distinct differences in the likely attributes of a typical mezzanine asset on the two sides of the Atlantic. The primary difference relates to the priority of the mezzanine providers' claims and their associated collateral rights.

Figure 10: Mezzanine Characteristics Europe vs. U.S.



Source: UBS FS Alternative Investments

In the U.S., mezzanine is usually comprised of subordinated notes, which are junior in rank to all senior debt. This subordination is mostly contractual, though in some instances it may be structural too. In Europe, on the other hand, mezzanine typically enjoys a second priority lien over the collateral, immediately behind the first priority claims of senior lenders. Given its lower risk profile, the spreads paid in respect of European mezzanine are usually lower than the spreads paid in the U.S.

This suggests that mezzanine fills slightly different gaps in companies' capital structures in the U.S. and Europe. U.S. mezzanine is similar to European high yield bonds: as both carry fixed coupons, both may be structurally subordinated and both are totally unsecured and subordinated to all other indebtedness of the borrower. On the other hand, European mezzanine typically carries a floating rate coupon, is contractually subordinated and its second secured ranking makes it more akin to U.S. second lien loans. A comparison of the ranking of various categories of debt instruments is illustrated in Figure 10.

Mezzanine as an Alternative to High Yield Bonds

There are a number of reasons why many private equity sponsors tend to favor mezzanine financing over high yield:

- Relative certainty of funds and financing terms: Unlike high yield bonds, for which execution and terms are only determined after an extensive marketing effort, mezzanine financing is firmly underwritten by arranging banks and providing the sponsors with relative certainty of terms.
- Flexibility: Mezzanine finance typically features no, or relatively limited periods of, non callability, and only modest prepayment premiums, so that sponsors retain flexibility to exit investments opportunistically, as IPO markets open or trade buyers emerge.
- Private distribution: Mezzanine finance does not require extensive and expensive offering or registration materials and marketing in the primary market does not require a long and costly road show. It also eliminates the requirement for public disclosure of information, as well as the need for a formal rating process.
- Knowledge of investors: Mezzanine finance is syndicated amongst a relatively small number of identified investors, with limited secondary-market trading. Mezzanine investors often have a long history of collaboration with financial sponsors, which facilitates the process of consent or amendment requests.
- Private resolution of credit events and restructurings: Adverse credit developments are almost always resolved through private negotiation between the borrower, the lenders and the financial sponsors. This process does not attract unwanted attention from other constituents, such as customers or trade creditors, or participation from unknown bondholders.
- The larger volatility of the high yield debt market dissuades high yield as intermediate capital of choice.

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Interaction between Mezzanine & High Yield

It will be useful to make some observations regarding the interaction between the high yield bond markets and mezzanine capital markets. Ultimately, the interaction between these markets will affect investor demand for mezzanine capital, which in turn influences investors' perceptions of risk and expected returns.

At the outset, one needs to remember that whilst high yield bonds and mezzanine are not usually regarded as being substitutes for one another, there is definitely a trade-off between mezzanine debt and high yield debt. A sub-investment grade borrower would typically have senior, secured debt in the form of a leveraged loan and a subordinate tranche, which could be mezzanine debt or a high yield bond.

Historically, one of the key differences between the mezzanine and high yield markets has been the size/volume constraint of each. Given the cost of conducting road shows and capital raising, in the U.S., the prevailing view has been that it is not viable to raise debt via a high yield bond issue for amounts less than around $200 million; and in the European market, issues of less than €100 million are generally considered to be less viable. In fact, the minimum threshold for high yield bond issues has been increasing steadily, locking many borrowers out of this capital market and causing them instead to turn to the mezzanine capital market for some of their leverage needs.

A further issue which has caused a drop-off in the high yield debt supply (creating opportunities for mezzanine providers) has been the debate between bond holders and bank lenders over the levels of seniority of their respective claims. Having suffered heavy losses stemming from corporate high yield bond defaults, U.K. and European bondholders have lobbied for greater protection in the event of bankruptcy.

Mezzanine Supply & Demand Drivers

Senior debt remains limited as the collateralized loan obligations ("CLO") markets remain at a near stand still. Commercial banks that were active in the leveraged loan market have become a lot more conservative in their lending, thus, curbing supply.

As a distinct sub-asset class, mezzanine capital has rapidly increased in popularity in the U.S. and European capital markets over the last fifteen years. During this time there has been a dramatic increase not only in the aggregate amount committed to the asset class, but also in both the number of investors as well as the different categories of investors who have committed capital for investment in mezzanine instruments.

On the demand side, LBO sponsors have shown increased interest in incorporating layers of mezzanine funding into their investment capital structures. Traditional bank lending, after the credit crisis, has been significantly reduced and the amount of senior debt capital available as a component of total acquisition price is scarcer, and junior debt has become more expensive. An increase in equity needed to consummate transactions makes the debt piece more secure than transactions before the credit crisis.

Demand Considerations

The mezzanine market is expected to be driven primarily by the growth in LBO activities, particularly among medium size companies. Despite the difficult global economic environment and the general downturn in mergers and acquisitions activity, LBO activity is expected to remain a dominant portion to the private equity industry.

The LBO markets' resilience generally can be attributed to a combination of the large amount of capital raised by private equity sponsors over the past few years which remains uninvested, the re-focusing on core-activities by major industrial conglomerates, the acceleration of the asset disposal process by distressed or semi-distressed companies, and depressed public equity market valuations in certain sectors.

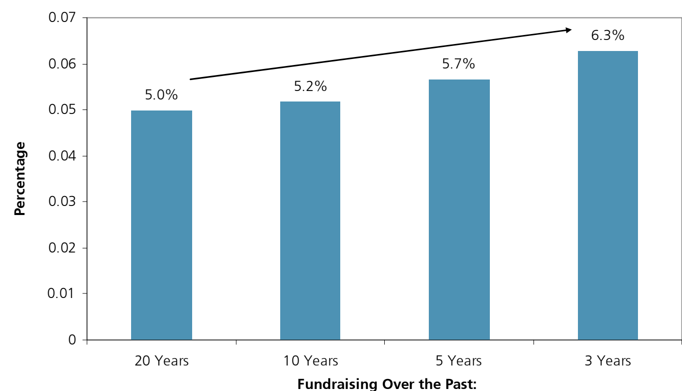
In comparison to the high levels of private equity buyout capital commitments that have been raised in recent years, there is currently a significant shortage of available intermediate capital typically used to help finance private equity acquisitions, expansions, reorganizations and LBO transactions.

We estimate that with around $400 to $500 billion in equity 'dry powder' waiting to be deployed in buyouts that need matching debt, a return of the M&A markets, as well as large scale refinancing needs. As a result, the demand for subordinated and mezzanine debt will continue to be robust. Our estimations suggests that less than $50 billion of uninvested mezzanine capital remains to complement debt financing needs of around $500 billion in the next five years.

Fund Raising

The last few years in particular have witnessed a notable increase in the aggregate amount of capital committed to the asset class, and market watchers predict that this trend will continue. With the new capital adequacy guidelines proposed by the Basel Committee on Banking Supervision, many banks will be less inclined to advance illiquid medium- to long-term leveraged and mezzanine loans, much of this growth is likely to come in the form of independent specialized mezzanine funds or securitization arrangements.

Figure 11: Mezzanine Capital as a Percentage of Total Private Equity Capital Raised



Source: Thomson One

Figure 12: Cumulative Global Mezzanine Fundraising

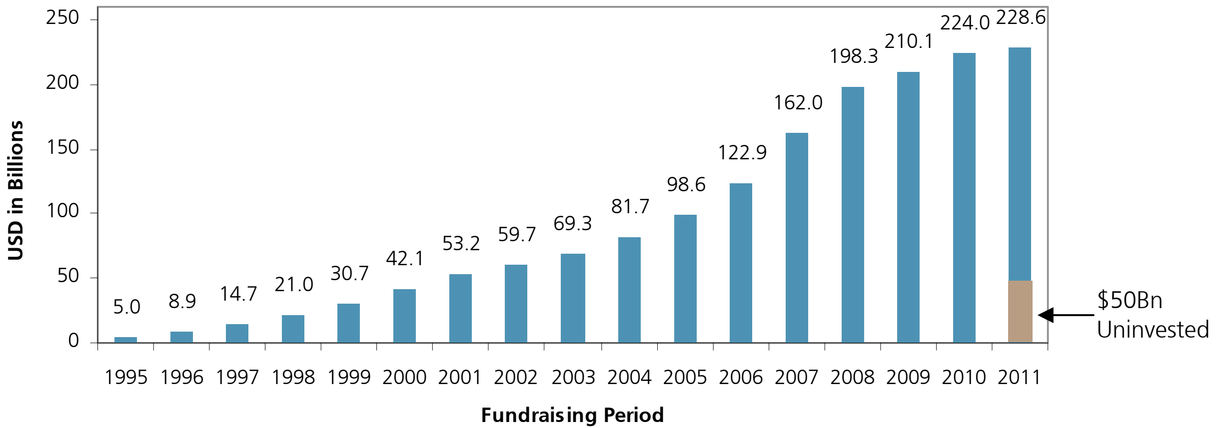


Figure 13: Buyout and Mezzanine Global Fundraising

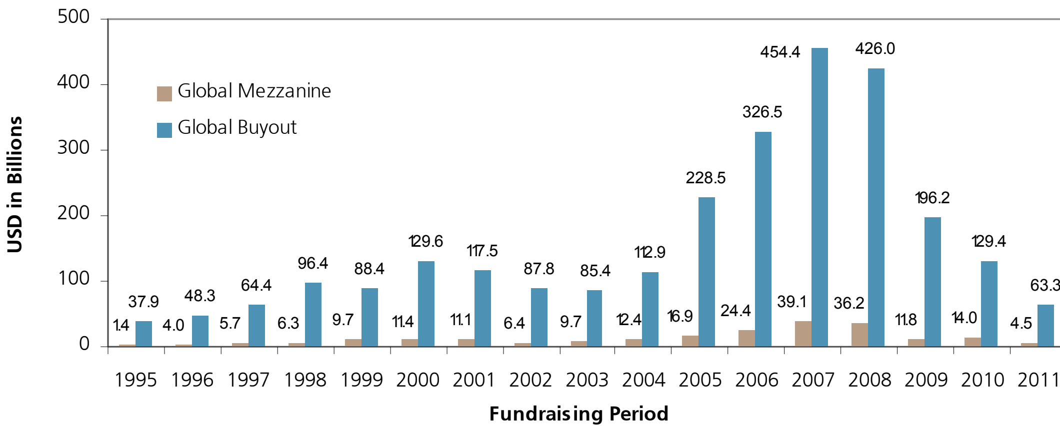


Figure: 14: Total Capital Raised by Fund Type 1991-2010

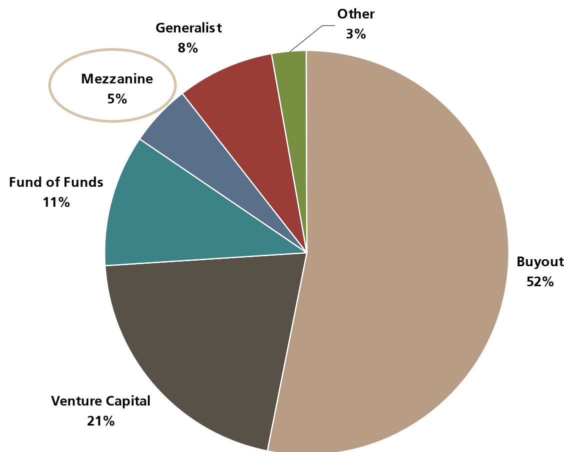
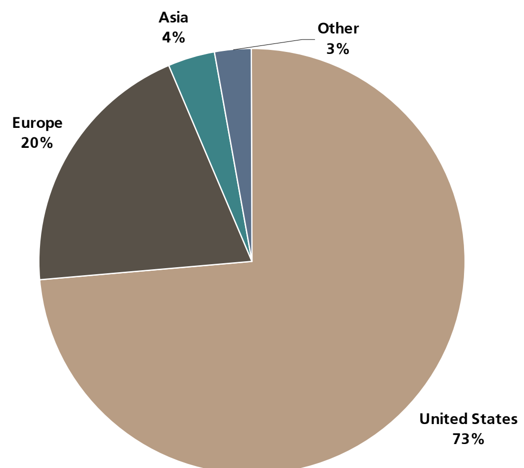


Figure 15: Total Mezzanine Capital by Geography 1991-2010



Source (Figures 12-15): Thomson One

Recent LBO transactions have had greater equity participation than those that were structured prior to the credit crisis. A 'typical' $100 million LBO deal going forward may be structured to have around $30 million of senior debt, $20 million of subordinated/ mezzanine debt and an equity cushion of around $ 50 million. The increased equity component from the $30 million needed prior to the crisis will provide an additional buffer to subordinated credits and the mezzanine tranche and the reduced leverage will improve mezzanine's risk characteristics.

Some reasons why there has been increased demand for mezzanine include:

- Mezzanine finance is more reliable than other forms of leverage, particularly high yield debt.
- Mezzanine is simpler to raise than high yield debt and is often raised from a single provider, with the funding available at the closing of the transaction (and therefore no need for bridge funding).
- Since mezzanine is mostly sourced from one provider, or at most a club of investors, this makes it much easier to deal with in the event of a default, an acquisition, or a re-leveraging. High yield on the other hand is far more complex, since there are a multitude of investors to deal with in all these instances.
- Mezzanine can now be raised in large volumes.
- Mezzanine is private, and therefore the reporting requirements may be less onerous for the borrower.

It is mezzanine's unique flexibility that has sometimes led to it being referred to as a "necessary evil;" since notwithstanding its potentially diluting effect, it often enables equity investors (i.e. the sponsors) in competitive bidding auctions to pay more for the business being acquired whilst preserving their internal rates of return by using mezzanine funding to reduce their effective price per share.

Other factors expected to contribute to Mezzanine's growth include the following:

- Any downturn in the high yield markets which have traditionally competed with mezzanine will create gaps for mezzanine providers to take up the high risk tranche of the debt capital component in many sponsored transactions.
- An increase in individual transaction sizes as well as the volume of sponsored private equity transactions will increase mezzanine capital's role. Traditionally, mezzanine finance has been a specialized financing instrument used almost exclusively for funding small LBOs (transactions with total enterprise value below $200 million equivalent). Mezzanine is still widely used for small buyout financings, and certain mezzanine providers continue focusing on this segment of the market. At the same time, the size of the average contribution of mezzanine capital as a proportion of total LBO financing has grown steadily.
- Relative shortages of other forms of capital at various times also created opportunities for mezzanine finance as a readily available alternative source of capital.
- Investors in mezzanine capital have been rewarded with much less volatile returns than investors in LBO funds (please refer to Figure 7), creating additional demand for mezzanine funds.

Another reason fueling the demand for mezzanine has been the increasing rate of refinancings in the low interest rate environment. However, many banks who were aggressively leveraging refinancing deals with senior debt - with EBITDA ratios of up to six times having experienced large defaults - are now adopting a more conservative approach, leaving space for mezzanine capital providers to bridge the funding gap.

Supply Considerations

There seems to have been a broadening of institutional investor interest in the asset class as investors strive to identify alternative investments which offer superior risk adjusted returns as well as a low correlation with traditional asset classes. Certain institutions, such as insurers, are particularly attracted to mezzanine as an asset class by the running/current yield which it offers them. Institutional investment supply has resulted in capital allocations/commitments to the asset class

being channeled to the market via various conduits in ever increasing volumes, including:

- Mezzanine providers who are much more flexible about the terms on which they will make the layer of mezzanine available:

    - They will normally be prepared to make price adjustments in exchange for a trade-off between the various components which combine to provide them with their return: current pay-interest, rolled-up interest (i.e. PIK), equity warrants, and in some instances equity itself. An example of this is the development of a Payment If You Can ("PIYC") coupon structure which gives the borrower an election regarding how much interest it wishes to pay in cash (within certain prescribed parameters), in exchange for paying the provider a higher margin.

    - Mezzanine providers often do not require call protection, whereas high yield bond investors typically want a return guaranteed for a few initial years.

    - The loan covenants for mezzanine are not as rigidly prescribed as they are for high yield bonds, and are negotiated on a case-by-case basis to provide the borrower with a bespoke funding arrangement to plug its funding gap.

- The growth of specialist mezzanine funds

Mezzanine now accounts for approximately 6.3% of private equity funds raised in both the U.S. and Europe. This has slightly increased over the past 20 years from less than 5% (please refer to Figure 11).

One of the principal reasons why an increasing number of investors want access to leveraged and mezzanine loans is for the purposes of portfolio diversification. A further reason for investors being attracted to investment in mezzanine is the lower correlation between the performance of mezzanine assets and other asset classes. The fact that stocks' values have an inverse correlation to interest rates limits the variability in the all-in-yield of mezzanine assets over the long term. This makes them useful investments to reduce the interest rate risk in a debt portfolio or to reduce the volatility in a private equity investment portfolio.

Banks have increasingly been allocating intellectual and financial capital resources to investing in mezzanine capital. They have been doing so for two primary reasons, one strategic and the other financial:

- Firstly, it presents them with a unique growth opportunity which can be tapped by exploiting their existing relationships with both corporate clients as well as private equity fund managers.

- Secondly, banks can capitalize on their existing expertise in credit risk management to enhance the returns on their lending activities by investing in higher risk mezzanine instruments.

Whilst most of the initial increase in the banking sector's interest in the mezzanine sub-asset class came from large bulge bracket commercial banks as market demand has grown for "one-stop shops" to cater to all the debt financing needs of private equity sponsors, investment banks and smaller regional banks have also started competing in this space. The effect of this increased competition is causing the players to specialize in sectoral, regional or structural niches.

Related Considerations

From a prospective fund investor's perspective, investing in a mezzanine fund is somewhat similar to investing in a private equity buyout fund. However, the principle difference between mezzanine and private equity buyout funds is that a mezzanine fund typically generates a material proportion of its earnings in the form of current income throughout the life of the fund (i.e. as coupon payments on the debt). It is this running yield which creates many of the issues peculiar to mezzanine funds that need to be dealt with in establishing and administering these funds on an ongoing basis.

- **Income tax**

The first cause for consideration is the tax treatment of interest income. This income is usually taxed in the hands of non-exempt investors (exempts investors include retirement accounts, endowments, etc.) on an accrual basis (potentially creating cash flow concerns in instances where one is dealing with PIK). Interest income is ineligible for capital gains tax, and may,

depending on the domiciles of the payer and the payee, be subject to a withholding tax.

- **Phantom income**

Secondly, the whole question of tax on interest is complicated somewhat by the hybrid nature of typical mezzanine securities. Since these instruments are comprised of debt and linked to detachable warrants, mezzanine funds frequently accrue material amounts of original issue discount ("OID") on their investments. For example, assume a mezzanine fund invests $10 million in a mezzanine loan with a face value of the same amount and a linked warrant with the right to acquire $2 million worth of stock at a nominal strike price. U.S. tax rules allocate the $10 million investment between the two securities based on their relative values, in this example, $8 million to the loan and $2 million to the warrant. The $2 million OID on the loan is taxed in the hands of the mezzanine providers on a yield to maturity basis, irrespective of the timing of the actual cash receipts. Investors in mezzanine funds need to take into account the consequences of such "phantom income" (Taxable income not matched by equivalent cash receipts) especially when they invest in funds permitted to take-on leverage. In leveraged funds, the manager would be permitted to apply the cash interest in meeting the fund's debt service obligations, and the investors would need to fund their tax payments on the phantom income themselves. PIK payments will give rise to OID on a similar basis.

- **Fund distributions**

Thirdly, consideration needs to be given with regards to how best to deal with the interest income for the purposes of making fund distributions. In mezzanine funds, the proceeds of a sale or disposition are dealt with in the same way as in buyout funds: first the capital is returned to investors; then they are paid a preferred return (in the region of 8%); thereafter there is a catch-up period for the general partner; followed finally by an 80%-20% split of all remaining profits. As far as distributions of current income are concerned, it is common for it to be applied first towards the fund's preferred return obligations rather than towards the return of capital. In some funds, the interest return on a particular investment is matched to the preferred return on that investment, whilst others prefer to apply it in contributing to a fund-wide preferred return. In the end though, the economic impact of these current returns will often be overshadowed by the larger distributions emanating from the disposition of investment by the fund. Moreover, some mezzanine funds attempt to enhance their returns by raising leverage; they then apply the fund's current income to servicing its borrowings. Whilst this use of leverage does have the benefit of reducing investors' tax exposure to current income, it obviously creates more financial risk for the fund, and in addition can create an unrelated business taxable income ("UBTI") problem for the fund's tax-exempt investors.

- **Unrelated business taxable income**

The fourth area which needs to be attended to, relates to the whole question of UBTI. Any mezzanine fund with U.S. tax exempt investors needs to plan for the fact that these investors have concerns regarding the receipt of UBTI because they are taxed on it, and hence it affects their net returns on investments. With offshore mezzanine funds, UBTI is most likely to arise if the fund is permitted to use leverage, in which case a portion (i.e. its distributive share) of its income allocable to such borrowings will be regarded as UBTI. It is possible to plan for this eventuality by structuring a parallel or offshore feeder fund to serve as a conduit for the mezzanine fund's tax exempt investors, and in doing so to block any UBTI. Such "blocker" entities can however give rise to the imposition of withholding taxes on interest, as well net basis income tax. In fact, in certain instances, the net aggregate tax incurred by investors as a consequence of investing via a "blocker" entity may exceed the tax that they would have incurred had they invested in the mezzanine fund directly.

- **ERISA**

A fifth issue requiring attention from private pension plans and Employee Retirement Income Security Act ("ERISA") investors, is the necessity of ensuring that the mezzanine funds commit to qualifying as venture capital operating companies ("VCOC"). In order to do so, a fund must have qualifying management rights in at least 50% of its investments (valued at cost) and it should actually exercise these rights. Unlike conventional buyout funds, it is somewhat more difficult for mezzanine funds to ensure that they secure sufficient mechanisms for influencing a borrower's

management - buyout funds, unlike mezzanine funds, mostly take control of the companies they invest in, and will invariably have a right to appoint representatives to sit on the company's board of directors.

In order to secure these rights, mezzanine funds typically have regard to the Department of Labor's advisory opinions, which have provided some guidance as to what type of direct contractual rights will suffice. In the past, these have included: the right to consult with and advise management of the portfolio company; the right to examine the books and records of the company; and the right to have a representative attend board meetings as an observer. Mezzanine funds therefore need to be careful to ensure that they secure the necessary level of management rights in order to protect their investor base.

Conclusion

To summarize, the mezzanine debt specialties of private equity share characteristics of both private debt and private equity financing. Mezzanine debt firms provide a middle level of financing in leveraged buyouts - below the senior debt layer and above the equity layer. A typical mezzanine investment includes a loan to the borrower, in addition to the borrower's issuance of equity in the form of warrants, common stock, preferred stock, or some other equity investment. Often, the loan is contractually subordinated to a loan made by one or more senior secured lending institutions. Typically, the note evidencing the loan has a maturity of between six and ten years, with interest paid only during the first five years. Because the loan is subordinated, the interest rate is generally higher than the rate on the senior debt, and a limited amount of equity is issued to the mezzanine investor for nominal consideration.

Mezzanine investments have been used extensively to help fund the purchase and recapitalization of private, middle-market companies. Mezzanine investors also invest in smaller public companies and in foreign entities.

Because mezzanine investments include both debt and equity portions, mezzanine investors have defied the traditional classifications of lenders and equity investors. The flexible nature permits a mezzanine investor to emphasize the capital preservation and cash-pay features of a loan, and at the same time, to seek significant upside on its investment through the equity participation.

Investor interest in the asset class appears to remain strong, and given mezzanine's unique investment characteristics, is likely to continue for some time.

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