MEZZANINE DEBT – BASIC EXPLANATION

Background on Mezzanine Debt

Mezzanine financing generally refers to subordinated debt which is used to finances leveraged buy-outs ("LBOs") or acquisitions. The term mezzanine debt refers to where the instrument sits in the capital structure of the company. The mezzanine debt is in the middle between the senior debt, which is normally secured, and the equity at the bottom. Mezzanine securities are structured as subordinated debt which carry a fixed coupon - between 12-14% - and an equity kicker - in the form of warrants. The mezzanine debt is generally unsecured ranks junior to bank loans and usually high yield bonds and senior to the equity.

The mezzanine market really took off in the early 80s. During the LBOs of the 80s, the mezzanine portion of the capital structure accounted for 40% of the deal, 50% from senior debt and the balance of around 10% from equity. As a result of the mezzanine debt being in a subordinated position and the warrants, the mezzanine securities represent the most expensive form of debt. The mezzanine market is sometimes seen as an alternative to the high yield bond market which tends to focus on larger transactions. In the 1980s, Michael Milken, a successful corporate finance LBO investment banker with Drexel Burnham Lambert, a premier investment bank, was known as the "Junk Bond King", using mezzanine debt in the form of high yield bonds, so called "junk bonds" because they were well below investment grade, to finance many of his publicized LBOs.

Who Are the Mezzanine Investors?

There are generally 2 types of buyout funds - one is the captive mezzanine fund established The typical investors include hedge funds, pension funds, banks and insurance companies.
by large LBO firms in conjunction with their equity buyout vehicles. Generally, the limited partners of the LBO funds are also investors in the captive fund. The captive fund is used to supply capital to the LBO sponsor's deal with pre-arranged terms.

Third party mezzanine funds are the other source of capital. The typical investors include hedge funds, pension funds, banks and insurance companies. The portfolio of third party mezzanine funds is more diverse, working with numerous equity sponsors.

One point to note is that while this pricing structure of mezzanine securities has remained relatively constant, (a trend which may be changing, given the tightening credit standard in the market) the portion of the capital structure filed with sub debt has declined and the equity portion has increased.

How is Mezzanine Debt Structured

It is structured as a subordinated debt instrument with a fixed rate of interest (generally 12-14%) as opposed to a bank deal which is priced at a floating rate - namely a spread over LIBOR or Base Rate. In some deals, the mezzanine investor also received PIK interest. PIK interest provides an additional return to the mezzanine investor; essentially by capitalizing the interest - it gets added to the outstanding principal on each interest payment date - the return is based on the investor receiving a new note on each

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interest payment date rather than cash. The effect of PIK interest is to compound the return - meaning, you are earning interest on interest.

The debt generally has a 5-7 maturity with a bullet payment at maturity. In comparison senior debt typically amortizes and would get paid in full before the mezzanine debt.

The mezzanine financing usually includes an equity kicker in the form of a warrant. The warrant provides the investor with an opportunity to buy capital stock of the borrower for a nominal exercise price usually $.01. The warrant has real value when the company goes public. This is the means for the investor to increase the internal rate of return on the investment.

Although mezzanine debt is more expensive than bank debt, the terms are not as rigid. Generally has the same covenant package as the bank deal, with lesser financial covenants and baskets.

Documentation

1. Note Purchase Agreement/Securities Purchase Agreement
   - like a Senior Credit Agreement - representations/covenants/financial covenants/defaults
2. Note - may contain subordination provisions
3. Intercreditor Agreement - I will discuss the operative terms shortly
4. Warrant - right to buy equity for a nominal purchase price for 10 years
   - Put at FMV or multiple cash flow
   - Call: given to company 1-2 years after Put
5. Shareholders Agreement - tag along, drag along, preemptive rights, voting
6. [Registration Rights] - usually demand after IPO, unlimited piggybank, underwriters cut back

Subordinated Debt

Debt subordination is a contractually established relationship between lenders to a single borrower.

Subordination terms set the relationships between the parties: Primarily, the junior creditor "subordinates" to the senior creditor its right to receive payments from the debtor. In extreme cases subordinated debt will be placed so low in the capital structure that it is tantamount to equity. Basically, there are three types of subordination:

1.	Total or Complete Subordination	No payments on junior debt at all until senior debt is paid in full. Definitions of Junior and senior debt are worded broadly. Often accompanied by a complete block on remedies.
2.	Partial Subordinations	Certain specific payments are permitted to be made to the junior creditor, for example, interest. (In a closely held corporation salary, dividends and the like might also be permitted.) On occasion, one might also see principal payments allowed, although in a limited fashion. Payments can be stopped, however, upon the occurrence of certain events (essentially senior loan defaults).
3.	Contingent Subordination	Allows all scheduled payments to be received until the occurrence of certain events. Insolvency is the principal concern here.

In all cases, a well written subordination agreement prohibits prepayments of subordinated debt.

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The extent and scope of subordination terms will often depend on the identity of the subordinated noteholder (insider v. institution) and whether the deal is public or private. Inasmuch as most of us will only rarely deal with subordination of stockholder loans, and the situations where contingent subordination is appropriate are limited, I will concentrate on partial subordination today, the standard of the LBO area and what is generally meant when one refers to "the market in respect of subordination."

Why have subordinated debt? It depends on the situation, but from a senior lender's standpoint one would look, in part, for an enhanced loan to value ratio. Essentially, from the perspective of the senior lender, the junior debt is treated as equity, making it more likely that the senior lender will be repaid in accordance with the terms of its agreement with the borrower. Subordinated debt investors readily accept these debt obligations because, while they are subordinate in payment, they typically carry yields sufficiently high to justify the increased risk. As I mentioned, additional compensation for the increased risk is often present in the form of warrants or other equity kickers.

Elements of the Subordination

I.	Definition of Senior Debt	Defines class of creditors who will receive the benefits of subordination and which of the obligations due them are senior - principal, interest, late charges, prepayment premiums, expenses. Very Important to specify it includes interest accruing on the senior debt after filing of a bankruptcy petition.
		Senior lenders will try to make the definition as broad as possible; junior creditors will try to narrow. Issues that will arise:
		Specific debt or all debt not specifically designated subordinated.
		Trade debt.
		Increases in principal amount of senior debt.
		Extensions of maturity.
		Interest rate and other items.
		Extensions and renewals.
		Non-borrowed money obligations (e.g., letters of credit).
II.	Definition of Subordinated Debt	Typically includes principal, interest and premium on the subordinated debt. Fees, taxes and indemnity payments should also be considered, although absent an event of default on senior debt would be permitted.
		Consider in insider subordination salaries, etc.
III.	Bankruptcy/Reorganization Block Clause	"Double Dividends in Bankruptcy" all dividends which would otherwise be paid to the subordinated lenders are paid to the senior lenders until the seniors have received payment in full.
		Subordinated lenders will negotiate for an "X" clause --the right to receive and retain securities of the debtor provided they are subordinated to the Senior debt at least to the same extent as the

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		original subordinated securities. Senior Lender's counsel is always happy to exclude the "X" clause.
		Acceleration of Senior Debt often treated the same as a bankruptcy event.
IV.	Pre-Bankruptcy/ reorganization Block Clause	
	Triggered by	payment defaults
		generally continues for as long as the payment default not always so limited Sub Debt holders are seeking greater rights
		payment defaults
		sometimes specified defaults, sometimes all; generally heavily negotiated
		acceleration sometimes required although rarely
		limited periods ("fish or cut bait")
		179 days (semi-annual payment); flexibility in when block begins
		• not more than one in 360 day period
		• limitation on use of existing defaults for future blockage
		• clean-up of subordinated debt during "gaps"
		• exceptions to "clean up period"
		• sub debt right to cure
		• senior debt right to cure
V.	Remedies Limitations	Delays in instituting suit or other action to collect debt
		Forbearance on exercise of acceleration rights
		limited periods -- similar to non-payment default blockage periods
		Trust Indenture Act considerations
VI.	Turnover Provisions	Subordinated lenders must turn over to Senior Lenders payments received in violation of the agreement.
		Addresses borrower slip-ups and bankruptcy court's decision to ignore the agreement.
VII.	Filing and Voting Bankruptcy Claims	Power of attorney is granted by sub debt holders to senior debt holders - - Trust Indenture Act excludes it from public deals. In private deals the trend seems to be to allow claims to be filed but not voted by the senior lenders on behalf of the subordinated lenders.
	Forms of Agreements	Stand Alone
		Indentures, etc.
	Addressing payment terms up front	

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