RKJ PARTNERS
LOWER MIDDLE-MARKET INVESTMENT BANKING

RKJ Partners, LLC is an Atlanta, Georgia based investment banking firm designed to specifically assist lower middle-market growth companies in executing transactions less than $100MM.

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Overview – Mezzanine Capital

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Mezzanine capital typically refers to a tier in a company's capital structure between debt and equity, just as a mezzanine in architecture is an intermediate floor between two different floors of a building. For many years mezzanine investing was primarily a source of funding in a few select areas, such as real estate and growth capital transactions. The dislocation in the credit markets and the scarcity of capital in 2008 and early 2009, however, led to the increased prominence of mezzanine investing for a broader array of transactions, including a significant percentage of the few leveraged buyouts that closed during that time. The increased visibility of mezzanine financing during the financial crisis in turn generated additional interest on the fundraising side. Several financial institutions entered the mezzanine lending space or raised additional capital for existing mezzanine funds. As the dislocation of the credit markets has receded, non-investment grade issuers have again become able to raise capital by selling both secured and unsecured debt securities in the high-yield market. Nevertheless, even though mezzanine funds compete to a certain degree with the high-yield market as a source of capital for acquisitions and recapitalizations, the outlook for mezzanine finance remains strong:

- Mezzanine investors continue to invest capital in issuers with growth prospects.
- Mezzanine investment opportunities are likely to increase in both frequency and transaction size as private equity sponsors, many of which have raised large funds in recent years, begin to raise financing for acquisitions. Mezzanine funds can offer terms in a buyout context with an expediency and certainty of execution that is difficult for investment banks to replicate.
- As hundreds of billions of dollars of debt raised before the financial crisis to finance leveraged buyouts begins to mature, companies will have a significant need to refinance it, likely generating greater demand for capital and creating situations where mezzanine funds could play an important role.

Against this background, RKJ Partners examines the use of US mezzanine financings as a capital raising tool for corporate acquisitions and financings (including recapitalizations). It focuses on:

- Typical terms of mezzanine investments
- Primary documentation.
- Key issues that arise in mezzanine financing transactions.

TYPICAL MEZZANINE TERMS

Mezzanine financings tend to be highly negotiated transactions, customized for the particular situation. In the current financing environment, the market for mezzanine capital is fluid and evolving, and even less defined by a rigid set of standard terms. The more heavily negotiated terms are those relating to:

- Type of instrument
- Maturity
- Interest rates and fees
- Ranking in the capital structure
- Security
- Covenants. Redemption and call protection
- Equity participation

TYPE OF INSTRUMENT

Mezzanine financings typically consist of unsecured debt or, less frequently, preferred stock. An issuer may prefer one or the other depending on its capital structure or tax and accounting considerations. Investors may also have preferences based on their investment guidelines or their assessment of the potential investment's risk profile. In practice, most mezzanine financing takes the form of subordinated, unsecured debt. Initial structuring discussions often focus on whether the debt should be in the form of loans or debt securities, with the investors' view of the likely resale market (bank or bond) driving the result. Mezzanine financings in the form of debt are commonly characterized by the inclusion of an equity participation, usually in the form of warrants, options and/ or conversion features or co-investment rights associated with the primary mezzanine investment.

MATURITY

The maturity of mezzanine debt is typically five years or longer, but the maturity for a particular issue often depends on the scheduled maturities of other debt in an issuer's capital structure. For mezzanine debt that is incurred at the same time as bank debt (such as at the time of an acquisition or buyout), senior lenders often insist that the mezzanine debt mature later than the bank facility. However, because mezzanine capital tends to have a higher rate of return relative to other debt in the capital structure, some issuers prefer shorter maturities. Conversely, some issuers agree to longer maturities on their mezzanine debt in exchange for more flexible optional redemption terms.

INTEREST RATES AND FEES

As in other forms of leveraged debt financings, various permutations of interest rates and fees are used within mezzanine transactions to accommodate the needs of the specific issuer and investors. While many mezzanine debt instruments feature a cash coupon with a fixed rate, which can be payable semi-annually or quarterly, others carry a floating rate or give issuers an option to pay interest in-kind (by issuing additional mezzanine debt) in certain

circumstances. Mezzanine investors usually target a higher internal rate of return (IRR) on their investment than high-yield or bank loan investors, and seek to achieve their target IRR by a combination of the interest rate, fees and the equity component. Mezzanine preferred equity investments are typically structured with a high fixed-rate dividend, which may be paid in cash or in-kind, and may feature an optional or mandatory conversion into common equity. In addition, to achieve their target rate of return, mezzanine investors may negotiate for different types of one-time or periodic payments, including structuring, commitment or other fees and they may request that mezzanine debt is issued at a discount to par, which has the effect of increasing the instrument's yield. It is also not uncommon for mezzanine investors to be reimbursed for their legal and other out-of-pocket fees.

Ranking in the Capital Structure

A key consideration in structuring a mezzanine financing is determining the position of the mezzanine debt in the issuer's capital structure. In some situations, mezzanine investors agree to invest in a preferred equity instrument that is junior to all debt in the capital structure. For mezzanine investments structured as debt, senior lenders generally expect that the mezzanine debt is subordinated to the credit facility and possibly other senior lenders, such as high-yield bondholders. Therefore, mezzanine debtholders typically agree to be contractually subordinated to existing and certain future holders of senior debt of the issuer. Less commonly, this subordination can take the form of structural subordination, where the mezzanine debt is issued by a holding company whose operating subsidiaries do not guarantee the mezzanine debt, while the other debt is issued by an entity that is closer to the assets in the corporate structure and is guaranteed by some or all of the operating subsidiaries of the issuer. Because of this structural subordination, in a bankruptcy or other liquidation of the operating company, cash or other assets will only be distributed to the holding company to satisfy its obligations after all other liabilities of the operating company are satisfied.

Security

One of the defining characteristics of mezzanine debt is that it is typically unsecured. In those instances where mezzanine debt is issued on a senior basis at the same level with other debt of the issuer, the remaining senior debt is secured, so the mezzanine debt will be effectively subordinated to any secured debt of the issuer to the extent of the value of the collateral securing that senior debt.

Covenants

Covenant packages used in mezzanine debt financings are usually based on high-yield style covenants or bank facility covenant packages. In the former case, the covenants are typically incurrence based only, whereas in the latter, the covenant package often includes some maintenance covenants. If the issuer has an existing senior bank facility, or is entering into a new bank facility in connection with the mezzanine debt investment, the mezzanine debt covenant package may be largely based on the covenants in the credit facility. In that case, the "baskets" and financial maintenance covenants are typically at least 25% to 30% more permissive than the corresponding provisions in the senior credit facility. Senior lenders often join the issuer in pushing for this additional flexibility to ensure that a breach or default under the senior credit facility does not immediately result in a similar breach or default on the mezzanine side requiring the senior lenders to invoke (and rely on) their contractual standstill rights.

Key negative covenants in mezzanine debt may include limitations on:

- Incurrence of debt
- Restricted payments
- Liens
- Change of control transactions
- Asset sales
- Affiliate transactions

Affirmative covenants may include those relating to:

- Financial reporting.
- Maintenance of insurance.
- ERISA compliance.

Covenant packages in many recent mezzanine transactions, especially those providing financing for acquisitions by financial sponsors, often look fairly similar to incurrence-based covenant packages in marketed high-yield debt instruments. The primary difference is that some mezzanine investors seek to tighten certain covenants and baskets as compared to marketed high-yield covenants, and to receive certain additional information rights. "Jumbo" mezzanine financings that are intended to be syndicated may also include provisions designed to enhance transferability of the debt.

Redemption and Call Protection

Redemption and call protection provisions vary widely in mezzanine financings based on changing market expectations and the specific purpose of each financing. Call protection, where an issuer is not permitted to repay the debt early or must pay a prepayment premium, is more commonly found in high-yield debt than bank debt. In bank debt, there is generally no prepayment penalty for mandatory prepayments. Most mezzanine debt contains mandatory prepayment/redemption provisions following certain events, such as change of control transactions or asset sales (at par), both of which are subject to customary exemptions. In addition, some mezzanine instruments include provisions allowing the issuer to redeem some or all of the mezzanine debt in connection with significant acquisitions and other major corporate transactions. In addition, mezzanine debt that is similar to bank debt may include mandatory prepayments tied to debt or cash sweeps, and optional prepayments at par or at low or declining premiums (for example, notes may be redeemed at 103% of their principal amount in the first year after issuance, 102% in the second year and 101% in the third year). Mezzanine debt that is more like high-yield debt often features call protection and optional redemption provisions that are similar to marketed high-yield notes, but these provisions tend to be more varied than marketed high-yield bond issues.

Equity Participation

Mezzanine investors regularly seek to enhance their returns by negotiating for equity participation alongside their debt investments (sometimes referred to as an "equity kicker"). Mezzanine equity investments can take various forms, including:

- Warrants or options to purchase a specified percentage of equity (often 1% to 5%) in the issuer. In these cases, the warrants or options are typically "penny" instruments that can be exercised or transferred, subject to compliance with Securities and Exchange Commission (SEC) rules, at any time.

- A right to co-invest in the issuer alongside the controlling stockholder or a private equity sponsor. In these cases, the co-investment is typically at the same price as the controlling stockholder's or sponsor's investment and the purchased equity is bound by the terms of any stockholders' agreement or other arrangements among other stockholders

PRIMARY DOCUMENTATION

The documents used in mezzanine investments tend to be similar to those used in other corporate and financing transactions. The principal instrument governing the terms of the investment is usually an indenture or credit agreement (in the case of mezzanine debt) or the certificate of designations (in the case of preferred stock). In addition, mezzanine holders often enter into: ☐ For mezzanine debt that takes the form of notes, a securities purchase agreement under which the mezzanine investors agree to purchase the notes in reliance on certain issuer representations and warranties and the satisfaction of covenants and closing conditions. The securities purchase agreement may also contain the covenant package (in which case, a separate indenture with a third-party indenture trustee is not required).

- In some cases, in addition to the contractual subordination provisions in the indenture, credit agreement or securities purchase agreement governing the mezzanine debt, a separate intercreditor agreement with the issuer's senior creditors.
- A co-investment, option or warrant agreement, in which the equity participation by mezzanine investors is documented
- Stockholders, registration rights and other similar agreements with the issuer's other equity holders

KEY ISSUES IN MEZZANINE FINANCINGS INTER-CREDITOR RELATIONSHIPS

A key element in any mezzanine transaction is the critical relationship of the mezzanine holders to senior and junior creditors. The type and amount of debt to which mezzanine investors will agree to be subordinated is frequently a highly negotiated point. Some deals make the mezzanine debt subordinated to all debt of the issuer that is not explicitly subordinated by its terms. Others provide that the mezzanine debt is subordinated only to the credit facility and debt above a specific threshold that is identified on the closing date for the mezzanine financing. The subordination provisions in the debt instruments, together with the intercreditor agreement, commonly provide that payments on the mezzanine notes will be suspended if a payment default occurs on the designated senior debt. Moreover, if a covenant default under the designated senior debt occurs, holders of such senior debt usually have the right to send a blockage notice to the mezzanine debtholders, which suspends payment on the mezzanine debt for up to 179 days. The mezzanine investors generally limit the senior lenders to one blockage notice per 365-day period and sometimes limit the total number of blockage notices that can be delivered during the term of the mezzanine debt. For more information on subordination provisions. Senior lenders expect the mezzanine holders to be subject to standstill provisions that limit their ability to exercise any remedies, such as bringing suit for payment after a default or acceleration, until action is taken by the senior lenders. Some mezzanine investors negotiate to shorten the standstill period. At the end of the payment blockage period, the issuer must make catch up payments to the mezzanine holders or the mezzanine investors have a right to accelerate their debt. Some senior lenders negotiate for complete subordination where the mezzanine holders are prohibited from exercising any contractual remedies before maturity absent consent of the senior creditors. In most cases, mezzanine investors resist these requests. The intercreditor agreement also typically includes a turnover provision where the mezzanine investors (or the trustee or

other agent representing them) agrees that if any payment is made to the mezzanine holders during a time when they are otherwise blocked from receiving payment, the payment will be turned over to the senior lenders. Mezzanine investors often negotiate to include an exception to the turnover provision. Referred to as an "X clause," this permits payments in the form of permitted junior securities, typically consisting of subordinated debt or capital stock, to the mezzanine holders in limited circumstances before senior creditors are paid in full. Some senior lenders resist including X clauses out of concern that they permit mezzanine investors to assert a right to receive a form of payment at a time when the mezzanine holders would otherwise be subject to the standstill provisions. X clauses and subordination provisions have been litigated in many bankruptcies and have generally been held to be enforceable. To reduce potential conflicts between the secured creditors and the mezzanine investors, some intercreditor agreements require the mezzanine investors to vote for any plan of reorganization supported by lenders holding a majority of the issuer's bank facility.

Reporting and Information Rights

Another point that can vary widely is the amount and frequency of information that the issuer must provide to mezzanine investors. Because of the limited liquidity for most mezzanine instruments, mezzanine investors often focus on receiving extensive reporting and information rights. Most deals require the issuer to provide annual audited and quarterly unaudited financial statements. For mezzanine deals where the parties want the debt securities to be eligible for resale under Rule 144A, issuers commonly covenant to provide holders and potential investors with all financial and corporate information required by Rule 144A. However, even deals with SEC-style reporting usually exempt the issuer from certain requirements applicable to SEC filers, such as providing information that is not material for the mezzanine investors, or having the chief executive officer and chief financial officer certify each quarterly or annual report or certify the issuer's internal controls. Some deals have required issuers to deliver reports to investors upon the occurrence of each event that would trigger a Form 8-K filing for an SEC reporting company. With the ever-increasing number of Form 8-K triggers, however, many issuers have succeeded in eliminating this requirement or limiting it to events that, in the issuer's view, would be material to investors. In some mezzanine deals, the reporting covenant originates from the issuer's credit agreement, and requires the issuer to provide an annual budget to the mezzanine investors or even to provide certain key operating information more frequently than on a quarterly basis. Several issuers have argued that given the extensive due diligence and active ongoing involvement of mezzanine investors (including board rights), extensive reporting obligations impose significant compliance costs on the issuer without an appreciable benefit for mezzanine investors and create potential defaults by the issuer. Some sponsor-backed issuers have been able to lessen the reporting burden by obtaining waivers from mezzanine investors that permit the issuer to suspend certain requirements under the reporting covenant unless the waiver is revoked. In addition to receiving the issuer's information in accordance with the reporting covenant in the applicable debt instrument, mezzanine investors commonly negotiate for the rights to receive all board materials and to appoint a board observer (or in some cases, a director) if they hold a specified percentage of their initial investment, which can be as low as 10% or as high as 50%. Mezzanine investors structured as investment partnerships may have ERISA compliance responsibilities with respect to their own investments. Guidance from the Department of Labor has suggested that even where an investment partnership has not obtained the right to representation on the board or its equivalent, it is possible to fashion sufficient management rights if the investment partnership obtains the right to inspect issuer books and records and receive certain financial information coupled with consultation rights. The term "management rights" is defined for these purposes as contractual rights, running directly between the investment

partnership and the issuer, to substantially participate in, or substantially influence the conduct of, the management of the issuer.

Equity Component of Mezzanine Investment

Because the overall return to the mezzanine investor includes the investor's ability to realize the value of its equity participation, a viable exit strategy is critical to the decision to participate in a mezzanine funding. Potentially viable exit events include:

- The sale of the issuer.
- A recapitalization.
- A refinancing.
- An initial public offering.

Similarly, provisions regarding the liquidity of the equity participation may be critical to achieving a successful exit. The terms of the equity investment can be heavily negotiated, especially for privately held issuers whose mezzanine investors and existing equity holders take different views on the valuation of the issuer. While precedents vary, in cases where mezzanine investors will receive only limited equity interests in the issuer, ordinarily they have limited leverage to negotiate for more than standard tag-along rights and registration rights, as well as customary anti-dilution protections. In cases where mezzanine investors are also taking larger equity stakes, however, they may also negotiate for veto rights for specified corporate actions including equity offerings, mergers, affiliate transactions or changes in senior management.

ABOUT RKJ PARTNERS, LLC

RKJ is an established advisor to leading lower middle-market growth companies. We provide our clients with experienced-based solutions and unbiased advice. Our comprehensive array of strategic advisory and execution capabilities allows us to meet the needs of our clients and provide an outstanding level of service in connection with a variety of transaction processes, including:

- **CAPITAL ADVISORY**: RKJ possesses substantial expertise in assisting lower middle-market clients raise capital to fund growth strategies. Whether the capital source is senior debt, mezzanine/subordinated debt, private equity, or venture capital, RKJ has both extensive and relevant relationships within the capital community to enable the deployment of optimal solutions for our clients.

- **MERGERS & ACQUISITIONS**: RKJ serves as a trusted advisor in executing merger and acquisition transactions for lower middle-market clients. In addition to our significant investment banking transactional experience, RKJ's bankers have owned businesses and have served in interim CFO roles for clients. Because of our experiences as business owners and senior level managers, RKJ's bankers are able to bring a unique perspective to the mergers and acquisitions process. RKJ's mergers and acquisitions services include:

  - Buy-side and Sell-side Advisory
  - Divestitures
  - Leveraged & Management Buyouts

- **STRATEGIC ADVISORY**: RKJ provides financial advisory services to owners, management, shareholders and their boards to assist in the evaluation strategic alternatives and options for extending and/or maximizing shareholder value. RKJ's advisory services include:

  - Business Valuations
  - Capital Structuring & Planning
  - Negotiating Joint Ventures
  - Strategic Business Development