



Subordinated Debt– It Just Might Be Your Answer

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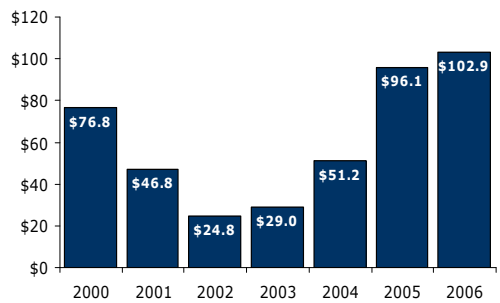
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"...mezzanine lenders have become far more responsive to borrowers' needs, providing not only traditional corporate acquisition and expansion capital, but also funding dividends and the liquidity needs of principal owners."

Given the generally favorable capital markets today and abundant liquidity among mezzanine investors, now is an excellent time for owners of privately-held, middle market companies to raise subordinated debt to finance their strategic objectives. These financing proceeds are often used for corporate expansion or acquisitions, leveraged recapitalizations, management buyouts or buy-ins or other growth initiatives. Typically structured on a subordinated basis, mezzanine debt represents the tier of institutional capital between senior debt and equity. Fundraising by buyout and mezzanine funds has jumped significantly in the past three years, surpassing previous record levels not seen since 2000. During 2006, 138 funds raised approximately \$103 billion, clearing 2005's record level of \$96 billion and *twice* the amount raised in 2004.

Mezzanine & Buyout Fundraising (\$ in Billions)



Source: Thomson Venture Economics + National Venture Capital Association.

In view of the excessive supply of capital relative to deal opportunities, mezzanine lenders have become far more responsive to borrowers' needs, providing not only traditional corporate acquisition and expansion capital, but also funding dividends and the liquidity needs of principal owners. Institutional investors' aggressive search for new investment opportunities is contributing to particularly attractive financing terms. Stonebridge Associates recently capitalized on this market dynamic by completing two innovative subordinated debt financings which enabled our clients to lever their com-

panies' balance sheets while at the same time achieving the objectives of certain shareholders.

Financing Structure

In recent years, an increasing amount of mezzanine capital has been employed by privately-held, small and mid-sized companies to facilitate recapitalizations, management buyouts, acquisitions, leveraged roll-ups and internal growth. Many of these companies had reached their bank borrowing limits yet were reluctant to finance the remaining capital need with pure equity. Subordinated notes often represent the optimal source of financing, having a term of five to ten years, deferred principal amortization, a fixed interest rate and relatively modest financial covenants. Properly structured, subordinated debt is considered to be quasi-equity by senior lenders. This form of junior capital often enhances the issuer's overall borrowing capacity while minimizing dilution of the existing shareholders' ownership stake.

Mezzanine investors are generally willing to finance companies in a wide variety of industries; however, they tend to focus on issuers that generate annual sales of at least \$10 million and a sufficient annual free cash flow to cover debt service. In view of their junior position in the issuer's capital structure, these investors often seek a current return via a coupon rate in the 10% - 13% range and equity participation in the form of detachable equity warrants, the combined effect of which produces a target rate of return ("IRR") of between 15% and 20%. However, the widespread availability of funds today has prompted institutional investors to improve pricing and accommodate the financing needs of earlier stage companies. In order to boost deal flow, many mezzanine investors have lowered their target IRR's below the median 17.5% return noted above. Furthermore, reflective of their efforts

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to land high quality investment opportunities, investors frequently offer a non-dilutive payment-in-kind ("PIK") feature instead of warrants to obtain their incremental return above the coupon rate.

Recent Developments

The new issue environment for mezzanine debt is exceptionally attractive at the present time. Several factors contribute to this dynamic market environment: relatively high equity market valuations, benign interest rates, generally less restrictive bank lending limits and comparatively few corporate bond defaults.

Stonebridge Associates capitalized on these positive market conditions in two recent transactions. In the first transaction, Stonebridge arranged mezzanine financing for a privately-held manufacturer of advanced materials. As the client's financial advisor, Stonebridge structured and arranged a \$10 million private placement of seven year subordinated notes. As a result of the keen interest generated in the transaction, the subordinated notes were structured to yield 14% through an 11% coupon rate and a 3% PIK feature in lieu of equity warrants. The company used the proceeds from the transaction to fund a stock buyback program designed to provide partial liquidity to several large shareholders.

In another transaction, Stonebridge helped the owners of a privately-held, mid-sized service operator recapitalize their business, allowing the owners to achieve partial liquidity yet retain operational control and a significant minority interest in the Company. Stonebridge assisted in negotiating a transaction with the selected equity partner which, in addition to an equity investment, included subordinated debt with an interest rate of 10% (8% current pay and 2% PIK); plus warrants to purchase a nominal equity interest in the Company. The transaction was very competitive, and as a result, Stonebridge negotiated an "earnout" feature which will allow the owners to receive addi-

tional cash as well as the ability to earn back up to 10% of the ownership of the company at a future date.

About Stonebridge Associates, LLC

Stonebridge Associates is an NASD-registered investment banking firm that provides mergers and acquisitions, private placements of debt and equity securities, fairness opinions, and other strategic and financial advisory services to middle market and emerging growth companies. The firm's division, Stonebridge Technology Associates, specializes in raising equity capital and providing merger and acquisition advisory services to software, hardware, Internet, healthcare, and other technology product and service companies. To learn more about Stonebridge, please visit our website at www.stonebr.com.