



David Wilmot



David Wilmot joined Babson Capital Europe in November 2000. He is Joint Head of Mezzanine & Private Equity and a member of the firm's credit committee. David has extensive experience

in European leveraged debt origination, execution and portfolio management. Prior to Babson Capital Europe, he was Head of Société Générale's UK Leveraged Finance team which he developed into a leading arranger of senior and mezzanine LBO debt in the UK market.

FIRM OVERVIEW

Babson Capital Management LLC and its subsidiaries manage \$129.4 billion in assets for a broad range of global institutional investors and is the lead investment advisor to our parent, the Massachusetts Mutual Life Insurance Co. (MassMutual). Our goal is to build long-term relationships, based on transparency and trust, that provide value to our clients. Through proprietary research and analysis and a focus on investment fundamentals, we develop products and investment strategies that leverage our broad array of expertise in fixed income, equities, alternatives, structured product, and debt financing for corporations and commercial real estate.

* As of March 31, 2010. Assets include Babson Capital Management LLC and its subsidiaries Babson Capital Europe Limited and Cornerstone Real Estate Advisers.

A STRONG VINTAGE FOR EUROPEAN MEZZANINE DEBT

David Wilmot, Joint Head of Mezzanine & Private Equity

The macroeconomic and financial market turmoil experienced by most developed countries during the last 18 months has brought about some radical changes to the financing environment for European leveraged buyouts (LBOs). David Wilmot, Joint Head of Mezzanine & Private Equity at Babson Capital Europe, argues that these changes have combined to play to the adaptability of mezzanine finance and to generate a highly attractive risk-return environment for mezzanine providers.

What are the features of mezzanine debt used in European leveraged buyouts?

Mezzanine debt, used in the financing of European LBOs, is a high-yielding secured asset class, ranking second in priority to senior debt. Mezzanine tranches can be provided via a wholly contractually-priced formula, involving a combination of cash and accrued payment-in-kind (PIK) interest, or on a warranted basis, where part of the remuneration is driven by a share in the equity value of the business upon exit. The latter is often referred to as an "equity kicker." Some mezzanine providers also have the latitude to lend on a wholly-PIK basis which, in conjunction with the "bullet"¹ repayment characteristic of mezzanine, provides financial sponsors with additional options in generating optimal financing structures.

How does mezzanine debt help private-equity sponsors optimise capital structures for LBOs?

When executed well, mezzanine serves the shared objective of both borrowers and private-equity owners of businesses to establish a debt structure serviced by expected cash-flow patterns, with appropriate flexibility in the event of underperformance by the company. At the same time, mezzanine debt provides additional funding capacity for sponsors at a cost of capital which should enhance the sponsors' returns upon the successful sale of the business. During 2008-2009, banks retracted from the provision of senior debt on a take-and-hold basis as part of a financing club of lenders using a broad senior and mezzanine debt underwriting strategy, and have gravitated towards a highly risk-averse approach to deal structuring. Against this backdrop, mezzanine is a potentially powerful instrument in providing solutions which can help withstand economic downturns whilst driving increased value for private-equity users of the product.

¹ A way to structure the repayment of a loan in which the borrower does not pay the principal over the life of the loan, but rather makes a lump sum payment at maturity.



Do you see many LBO transactions in the current environment?

We are beginning to see more transactions again. In the fourth quarter of 2009 and into 2010, the European LBO market has been experiencing the start of a recovery in transaction activity, as both company vendors and private-equity investors have shown increasing preparedness to engage in M&A processes. Given the lack of investor appetite to fund acquisitions in such an uncertain environment, the restoration of some market confidence has helped vendors to market quality businesses which had little or no demand during 2009. However, the return to a more vibrant environment appears to be assured in light of the €115 billion² of uninvested European buyout capital available to private-equity sponsors. Increased convergence in price expectations between sellers and buyers of businesses is providing additional impetus to “deal traffic”.

Can you illustrate how mezzanine debt would be used in an LBO transaction? What are the benefits?

Despite the easing of some of the credit-policy strictures which some of the banks have had to operate under, the level of senior debt offered can present a significant obstacle to deal execution. In mid-market transactions, for example, senior debt is often limited to 3-3.5x EBITDA, which is generally insufficient when sponsors are contemplating entry multiples of 7x and above, and mezzanine debt can bridge the “financing gap.” I will give you an example which assumes that the sponsor acquires a business making €20 million in EBITDA, for a price of €160 million plus €10 million in fees, and exits after three years at an EV of €256 million (reflecting a flat transaction multiple of 8x, with EBITDA at €32 million). The example sets out two debt-funding scenarios - the first being an all-senior structure, and the second including mezzanine debt with a corresponding reduction in the equity contribution (see Figure 1).

Assuming senior debt costs of EURIBOR + 500 bps and mezzanine debt pricing at EURIBOR + 1300 bps, and allowing for corporate tax and capex outflows, the respective cash proceeds realised by the equity providers are €190.1 million in the senior-plus-mezzanine case and €218.3 million in the senior-only case. Clearly, the lower equity contribution in the senior-plus-mezzanine case drives a higher multiple of 2.4x and IRR of 33.4%, compared to corresponding levels of 2.2x and 29.7% in the senior-only case. In addition to underlining the utility of mezzanine to sponsors, this example serves to illustrate the attractive combination of risk and return available to mezzanine providers in the current environment.

FIGURE 1: LBO COMPANY - DEBT STRUCTURE³

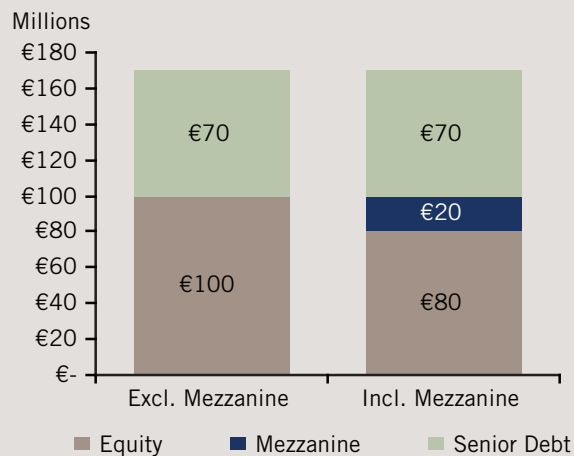
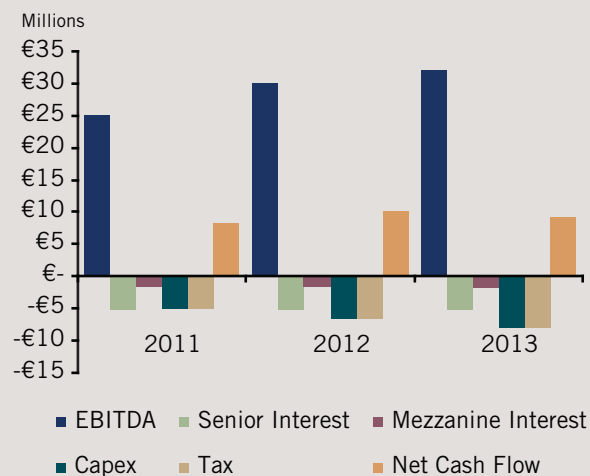


FIGURE 2: LBO COMPANY - CASH FLOW³



² Source: Preqin “Dry Powder - Buyout Funds by Region Focus”, as at January 2010

³ Source: Babson Capital Europe Limited (illustrative example)

How does the current investment opportunity compare to the height of the market?

The new vintage of mezzanine debt provides great opportunities for return generation. Current spreads of approximately 1300 bps compare with a market low of 780 bps in the third quarter of 2007. In addition, the advent of two- and three-year non-call protection has increased expected cash multiples, which in the past had been undermined by the use of minimal prepayment fees, effectively amounting to free call options for borrowers. Recently, the up-front and running cash element of returns has also been strengthened by increased arrangement fees and the establishment of LIBOR floors on a number of transactions. The use of equity warrants on some transactions provides the latitude to participate in added returns at exit with the sponsor.

Do you also see more conservative capital structures along with better returns?

We do. As returns have improved, we have seen a reduction in leverage to 4-5x EBITDA, compared to 6.5-7.5x and above at the top of the market. It follows that equity contributions have increased, thereby adding to the protection for the mezzanine's "in the money" position. Given the cautious approach now demonstrated by banks and the reduced number of non-banks with "dry powder" available to invest in primary mezzanine assets, we expect this situation to be maintained for some time.

You mention the pick-up in new LBO transactions. Are there any other sources of deal flow which you expect to provide investment opportunities?

Yes. Mezzanine tranches should have an important role to play in the inevitable balance-sheet restructurings which lie ahead in the LBO arena. There are many instances of high-quality businesses which have inappropriately structured debt packages, with a high level of debt maturing over the next few years. We expect that the mobilisation of mezzanine debt will provide an important lifeline to companies which need time to focus on executing business plans with a more flexible structure. Again, mezzanine provided in this kind of situation should offer attractive returns to investors, whilst providing a creative solution to difficult problems for borrowers and private-equity sponsors.

Considering its subordinated ranking, does mezzanine debt have any downside protection should a business run into difficulties?

Although every situation is unique and there can be situations in which the mezzanine lenders face legal and practical obstacles, European mezzanine debt benefits from some important downside-protection features. The interplay of maintenance financial covenants and asset security provides the opportunity to engage with financial sponsors at a relatively early stage in the case of performance downturn. In most cases, this enables mezzanine providers to have an influential "seat at the table" in restructuring discussions. This position is strongest when the mezzanine debt is at least partly covered by reasonable estimates of corporate value and the likelihood of this being the case is enhanced in the current low-leverage environment. In some jurisdictions, mezzanine creditors can, if the situation demands it, address more radical solutions to restructuring situations - such as an equity control strategy, which brings with it the potential for an above-par return at exit.

What is your outlook for mezzanine debt?

In conclusion, we see the current vintage as one where mezzanine will be utilised to "do its job" of adapting itself to solving specific financing problems and generating additional returns for financial sponsors. Mezzanine has a clear role to play in an exciting market environment, and an asset vintage which should offer an attractive risk/return combination for investors.

U.S. DISCLOSURE

The information and opinions in this paper were prepared by Babson Capital Management LLC and/or one or more of its affiliates (collectively, "Babson Capital") and the author(s) named on page one of this paper.

Babson Capital is involved in many businesses and activities that may relate to companies or instruments mentioned in this paper. These businesses and activities include, without limitation, trading in various financial instruments, fund management, and investment advisory services. Babson Capital may trade as principal in the securities/instruments (or related derivatives) that are the subject of this paper. Babson Capital may have a position in the debt of the businesses or instruments discussed in this paper.

The securities/instruments discussed in this paper, if any, may not be suitable for all investors. This paper has been prepared and issued by Babson Capital primarily for distribution to market professionals and institutional investor clients. Recipients who are not market professionals or institutional investor clients of Babson Capital should seek independent financial advice prior to making any investment decision based on this paper or for any necessary explanation of its contents. This paper does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Babson Capital recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

Babson Capital makes every effort to use reliable, comprehensive information, but makes no representation that it is accurate or complete. Babson Capital has no obligation to tell you when opinions or information in this paper change. Past performance is not a guarantee of future results.

This paper is not intended as an offer or solicitation for the purchase or sale of any security or financial instrument. Private investments often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and may involve complex tax structures and delays in distributing important tax information. Typically such investment ideas can only be offered to suitable investors through a confidential offering memorandum which fully describes all terms, conditions, and risks.

IRS Circular 230 Disclosure: Babson Capital and its affiliates do not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with Babson Capital of any of the matters addressed herein or for the purpose of avoiding U.S. tax-related penalties.

AUSTRALIAN DISCLOSURE

Information contained in this publication: The opinions, advice, recommendations and other information contained in this publication, whether express or implied, are published or made by Babson Capital Australia Pty Ltd (ACN 140 045 656), Australian financial services license (AFSL 342787), and by its officers and employees (collectively "Babson Capital") in good faith in relation to the facts known to it at the time of preparation.

Babson Capital has prepared this publication without consideration of the investment objectives, financial situation or particular needs of any individual investor, and you should not rely on the opinions, advice, recommendations and other information contained in this publication alone. This publication contains general financial product advice only.

To whom this information is provided: This publication is only made available to persons who are wholesale clients within the meaning of section 761G of the Corporations Act 2001. This publication is supplied on the condition that it is not passed on to any person who is a retail client within the meaning of section 761G of the Corporations Act 2001.

Disclaimer and limitation of liability: To the maximum extent permitted by law, Babson Capital will not be liable in any way for any loss or damage suffered by you through use or reliance on this information. Babson Capital's liability for negligence, breach of contract or contravention of any law, which cannot be lawfully excluded, is limited, at Babson Capital's option and to the maximum extent permitted by law, to resupplying this information or any part of it to you, or to paying for the resupply of this information or any part of it to you.

No warranties made as to content: Babson Capital makes no warranty, express or implied, concerning this publication. The publication provided by us on an "AS IS" basis at your sole risk. Babson Capital expressly disclaims, to the maximum extent permitted by law, any implied warranty of merchantability or fitness for a particular purpose, including any warranty for the use or the results of the use of the publication with respect to its correctness, quality, accuracy, completeness, or reliability.

Copyright: Copyright in this publication is owned by Babson Capital. You may use the information in this publication for your own personal use, but you must not (without Babson Capital's consent) alter, reproduce or distribute any part of this publication, transmit it to any other person or incorporate the information into any other document.

General matters: These Terms and Conditions are governed by the law in force in the State of New South Wales, and the parties irrevocably submit to the non-exclusive jurisdiction of the courts of New South Wales and courts of appeal from them for determining any disputes concerning the Terms and Conditions.

If the whole or any part of a provision of these Terms and Conditions are void, unenforceable or illegal in a jurisdiction it is severed for that jurisdiction. The remainder of the Terms and Conditions have full force and effect and the validity or enforceability of that provision in any other jurisdiction is not affected. This clause has no effect if the severance alters the basic nature of the Terms and Conditions or is contrary to public policy.

If Babson Capital does not act in relation to a breach by you of these Terms and Conditions, this does not waive Babson Capital's right to act with respect to subsequent or similar breaches.

© 2010 Babson Capital Management LLC. All rights reserved

CONTACT

SALES

Anthony Sciacca
Managing Director
Global Business Development
+1.704.805.7226
asciacca@babsoncapital.com

CONSULTANTS

David Acampora
Managing Director
+1.917.542.8375
dacampora@babsoncapital.com

Glenn Weiner
Managing Director
+1.704.805.7350
gweiner@babsoncapital.com

PRESS

Marty McDonough
Managing Director
Corporate Communications
+1.413.226.1187
mmcdonough@babsoncapital.com

OFFICE LOCATIONS

BABSON CAPITAL AUSTRALIA PTY LTD

Suite 22.06, Level 22
Grosvenor Place
225 George Street
Sydney, NSW 2000
Tel: +61.2.9241.5144

BABSON CAPITAL EUROPE LIMITED

61 Aldwych
London WC2B 4AE
UK
Tel: +44.203.206.4500

BABSON CAPITAL JAPAN KK

Atago Green Hills
Mori Tower
2 - 5 - 1 Atago, Minato-ku
Tokyo 105-6204
Japan
Tel: +81.3.5733.4727

BABSON CAPITAL MANAGEMENT LLC SPRINGFIELD, MA USA

1500 Main Street
P.O. Box 15189
Springfield, MA 01115-5189
Tel: +1.413.226.1000

BOSTON, MA USA

Independence Wharf
470 Atlantic Avenue
Boston, MA 02210
Tel: +1.617.225.3800

CHARLOTTE, NC USA

201 South College Street
Suite 2400
Charlotte, NC 28244
Tel: +1.704.805.7200

NEW YORK, NY USA

340 Madison Avenue
18th Floor
New York, NY 10017
Tel: +1.917.542.8300