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INVESTMENT BANKERS

IN$IGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
WINTER 2006

Second Lien Financing Redux

Once reserved for restructure or rescue financing, second lien notes have quickly grown to replace subordinated-debt mezzanine financing.

by Michael T. Newsome

A little over two years ago, we wrote about the emergence of a new tier of capital for middle-market companies—second lien term notes or "tranche B" debt. In the robust financing market that has prevailed since then, second lien financing has evolved rapidly. Deal volume ballooned from $3.1 billion in 2003 to $12 billion in 2004. Through the third quarter of 2005, the market is on an annual pace to grow by an impressive 25%.

Second lien notes were originally employed in restructure or rescue financings for struggling firms in need of an extra shot of liquidity when cash flow was tight. These loans were based upon incremental advances on asset values beyond the normal first lien comfort zone, or on other less conventional assets that senior lenders shied away from. Today, second lien financings are no longer reserved for turnaround situations. They have become

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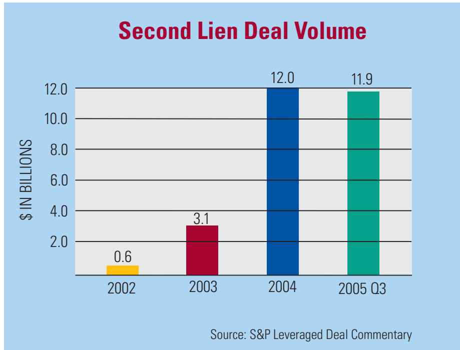
a common component in the capital structure tool kit for leveraged buyouts, recapitalizations, stock buybacks and even growth financings. In each of our last three large sell-side M&A engagements, second lien commitments were prominent features of the financing arrangements supporting some of the most competitive acquisition bids. Interestingly, second lien structures have evolved from asset-based financings into cash flow or enterprise value loans that are, more often than not, predicated on expected operating cash flow, business breakup value or the strength of intangible assets. The underlying credit thesis is that the business has significant realizable value in excess of its senior



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debt, even in a distressed situation.

SECOND LIEN VS. MEZZANINE

The advent of second lien financing has further segmented the middle ground between senior bank debt and equity. It has become an increasingly favored alternative to unsecured, subordinated debt mezzanine financing, crowding out the mezzanine providers and pushing them toward smaller companies and higher risk structures. There are a number of differences between the two; but the key distinction boils down to lien subordination (second lien) versus payment or debt subordination (mezzanine). Lien subordination means a duty to turn over to the senior lenders only the proceeds of shared collateral. Payment subordination is an obligation to allow the senior lender to receive all cash flow from the borrower from any source unless specific performance thresholds are being achieved.

In default situations, payments to second lien lenders are typically not blocked and there is only a short standstill period before a second lien lender can exercise its remedies to collect its principal. In contrast, post-default payments to mezzanine lenders are typically blocked by the senior lender and their right to pursue remedies can be deferred via a standstill period for as long as nine months. From a practical point of view, the combination of payment subordination and absence of collateral solidifies the senior lender's absolute priority over the mezzanine lender. Senior lenders do not have that same right over second lien lenders.

A second lien lender is a secured creditor. Black letter bankruptcy law establishes that secured lenders are entitled to the fair market value of their collateral (provided there is value). The simple fact is that secured (even marginally secured) lenders fare better and have more rights in bankruptcy than unsecured creditors, including:

- Pre-petition rights to foreclose;
- Adequate protection rights;
- Priority over trade and other unsecured creditors;
- Post-petition interest;
- Right to credit bid; and
- More leverage in the negotiations regarding a plan of reorganization.

These rights improve the recovery prospects for a second lien note relative to a mezzanine loan. Typically, most of these rights are the subject of detailed negotiations between the first and second lien lenders and are embodied in an inter-creditor agreement.

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As the market has grown, the rights and remedies of second lien lenders have been liberalized to improve the strength of their claims relative to first lien lenders.

For borrowers, this modest move up the chain of capital priority translates into more favorable pricing, without the dilutive warrants or equity kickers and the onerous call provision that acompany mezzanine loans. Although a complete set of data to support our hypothesis is not readily available, it appears that second lien financing is increasingly favored over mezzanine because it yields a

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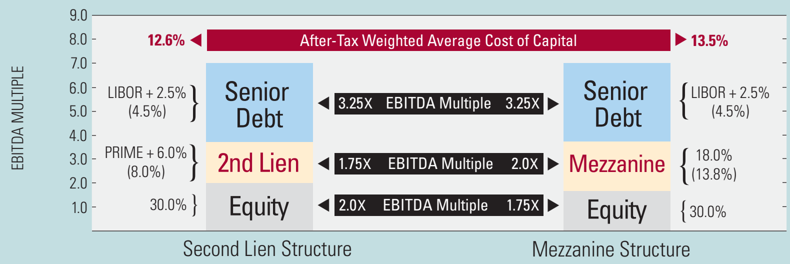
Second Lien and Mezzanine Structure



lower overall cost of capital. As illustrated in the nearby chart, a capital structure employing second lien debt may require a bit more equity, but that expense is more than offset by the cost differential between second lien and mezzanine funding.

Second lien loans are specifically directed towards middle-market companies that do not have access to the high-yield market or borrowers that would rather avoid SEC disclosure requirements. Second lien activity is expanding and moving down-market. Target company parameters have widened to include firms with as little as $10 million of EBITDA.

The ready availability of second lien financing is being carried on a wave of liquidity that has defined the capital markets for the past few years. The primary providers are hedge funds, which control large capital pools and have insatiable appetites for higher yielding debt instruments, and a new breed of specialty finance companies, known as business development corporations or BDC's. Publicly traded BDC's, such as American Capital Strategies, Gladstone Capital, and Capital Source, are one-stop lenders that offer first and second lien credit, as well as mezzanine loans. Major commercial and investment banks are also originating and managing second lien financings, which are either being syndicated to investors (primarily hedge funds) or securitized as collateralized loan obligations known as CLOs. Commercial banks are not typically holding large portfolios of second lien debt. There will be strong demand for second lien transactions among lenders/investors, as long as they view the pricing premiums over thinly priced first lien credit as attractive, relative to the perceived risk of loss.

At some point, the economy will cycle down and highly leveraged companies will face tougher sledding. In some cases, there will not be sufficient asset value or cash flow to meet the needs of both first and second lien lenders.

WHERE DOES IT GO FROM HERE?

One of the more interesting questions for second lien borrowers and lenders is what happens next. The market has grown rapidly in a very robust economic environment. At some point, the economy will cycle down and highly leveraged companies will face tougher sledding. In some cases, there will not be sufficient asset value or cash flow to meet the needs of both first and second lien lenders. The claims and rights of this new capital segment have yet to be hashed out in bankruptcy courts. How assets are managed and when they are sold will have a major bearing on the recoveries realized.

The way the market has grown, spurred by hedge funds, has some implications for borrowers in a downturn. Unlike banks or asset-based lenders, these lenders are not set up to closely manage distressed situations. They tend to be traders rather than patient money or relationship lenders. It is reasonable to expect that when challenges arise, hedge fund managers will mark these loans to market and sell them. As a result, it may be difficult for managers of a distressed firm to figure out with whom they can deal to effect a restructure.

Ultimately we will not know whether second lien finance will be a meaningful source of capital over the long haul for middle market firms, until the economy has run a full cycle. Nevertheless, in today's leveraged finance market, second lien loans are an attractive alternative to traditional mezzanine capital. Stay tuned; there will be more developments in this market segment, as it matures. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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