



The ESOP Association

Financing Alternatives for ESOP Companies November 9, 2010

2010 Technical Conference

Morgan Lewis

Scott Adamson
Morgan Lewis & Bockius LLP
300 South Grand Avenue, 22nd Fl.
Los Angeles, CA 90071
sadamson@morganlewis.com
(213) 612-7365

 **HOULIHAN LOKEY**

Kreg Jackson
Houlihan Lokey
123 North Wacker Drive, 4th Fl.
Chicago, Illinois 60606-1700
kjackson@hl.com
(312) 456-4748

MERIT | CAPITAL PARTNERS

David Jones
Merit Capital Partners
303 West Madison, Suite 2100
Chicago, Illinois 60606
djones@meritcapital.com
(312) 592-6120

Introduction

Introduction: Panelists

Scott Adamson

Scott is partner in the Business & Finance Practice of Morgan Lewis & Bockius, LLP. He represents public and private companies in complex transactions with a special emphasis on those involving ESOPs. As a member of the Firm's multidisciplinary ESOP Team, Scott structures and implements transactions using ESOPs to provide employee ownership while creating liquidity on a tax-advantaged basis, and regularly represents clients involved in debt and equity financing involving funds, mezzanine lenders and banks. Scott is a member of the Finance Committee of the ESOP Association and is a frequent lecturer on ESOP topics and matters.

Kreg Jackson

Kreg is a Director in Houlihan Lokey's Chicago office, where he heads the firm's national Employee Stock Ownership Plan practice. He has over a decade of experience providing financial advisory services to public and private clients in connection with strategic alternatives assessments, mergers and acquisitions, recapitalizations, leveraged buyouts, leveraged ESOP buyout transactions, and capital-raising activities (senior, mezzanine and equity). He also renders fairness, solvency and transaction-related opinions to companies, boards of directors, special committees, financial institutions and independent fiduciaries.

David Jones

David M. Jones, Managing Director, joined Merit Capital Partners in 1993 in conjunction with the closing and initial investing of Fund I. Based in Chicago with an office in Phoenix, Merit manages over \$1.6 billion through five institutionally sponsored limited partnerships. Merit invests mezzanine and equity capital in middle-market companies principally in manufacturing, distribution and services industries. A Managing Director of Merit Capital Partners since 2000, David currently serves on the Board of Directors of Sales Performance International, Inc., B.E.T. - er Mix, Inc. and Cobra Wire & Cable. David also is active with the Employee Stock Ownership Association having served as a member of the Finance Committee since 2001.

Introduction: Financing Alternatives

Senior

Junior Debt

Club Deal

Common Stock

Term B

Asset-Based

Cash Flow

Subordinated Debt

Libor

Seller Note

Floating Rate Note

High Yield

Dip Financing

Second-Lien

Private Equity

SAR

Synthetic Equity

Junk Bond

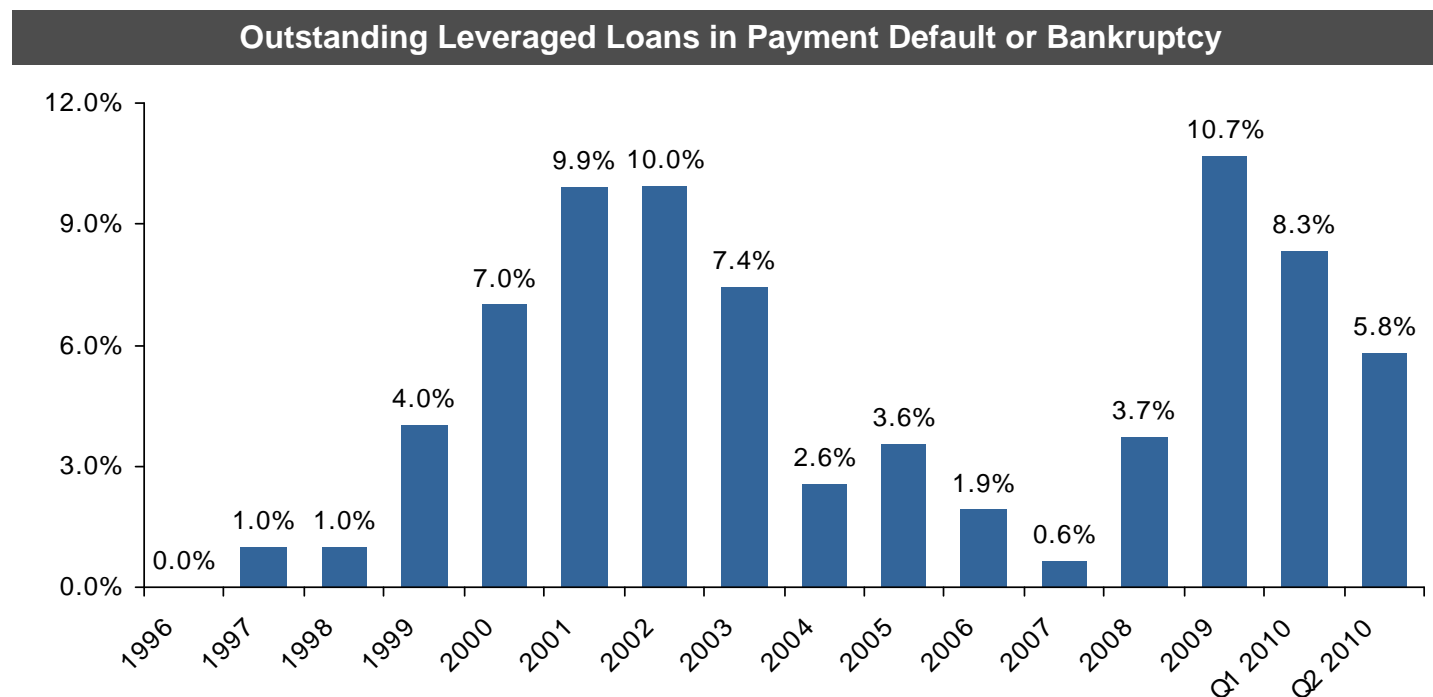
Mezzanine

Preferred Stock

Current Conditions

Current Conditions: Payment Defaults May Have Peaked...

- Defaults hit a high in April 2009, stabilizing at 10.7% by 2009 year-end and declining to 8.3% as of March 2010
 - While the default rate remains higher than S&P's historical average of 4.6%, S&P predicts a default rate decline to 2.5% by June 2011
 - As the pace of defaults continued to slow, Moody's lowered its year-end 2010 speculative grade default rate forecast to 2.6%

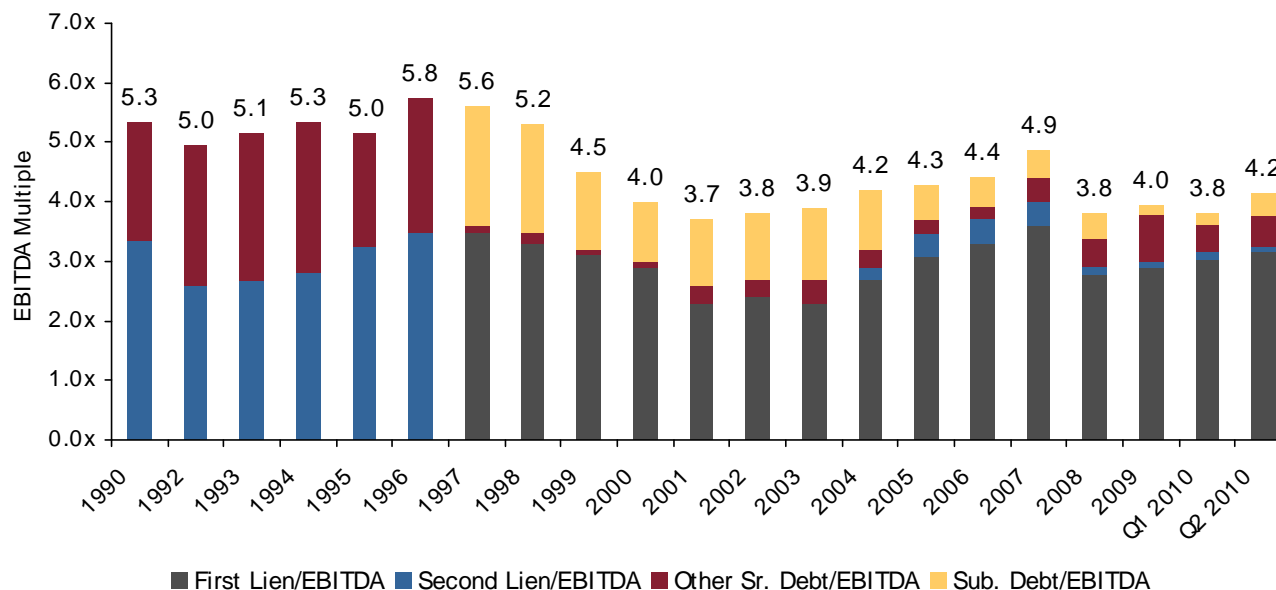


Sources: S&P LCD and Moody's.

...Leading To Less Conservative Leverage Levels for New Transactions....

- Leverage on 2Q '10 deals increased relative to 1Q '10 averages despite mid-quarter choppiness in the equity and bond markets
- That said, LBO multiples leveled out from the 5.5x – 6.5x highs reached in April, and dividend recaps and opportunistic refinancings were less commonplace than in the prior quarter

Average Debt Multiples of Highly Leveraged Loans



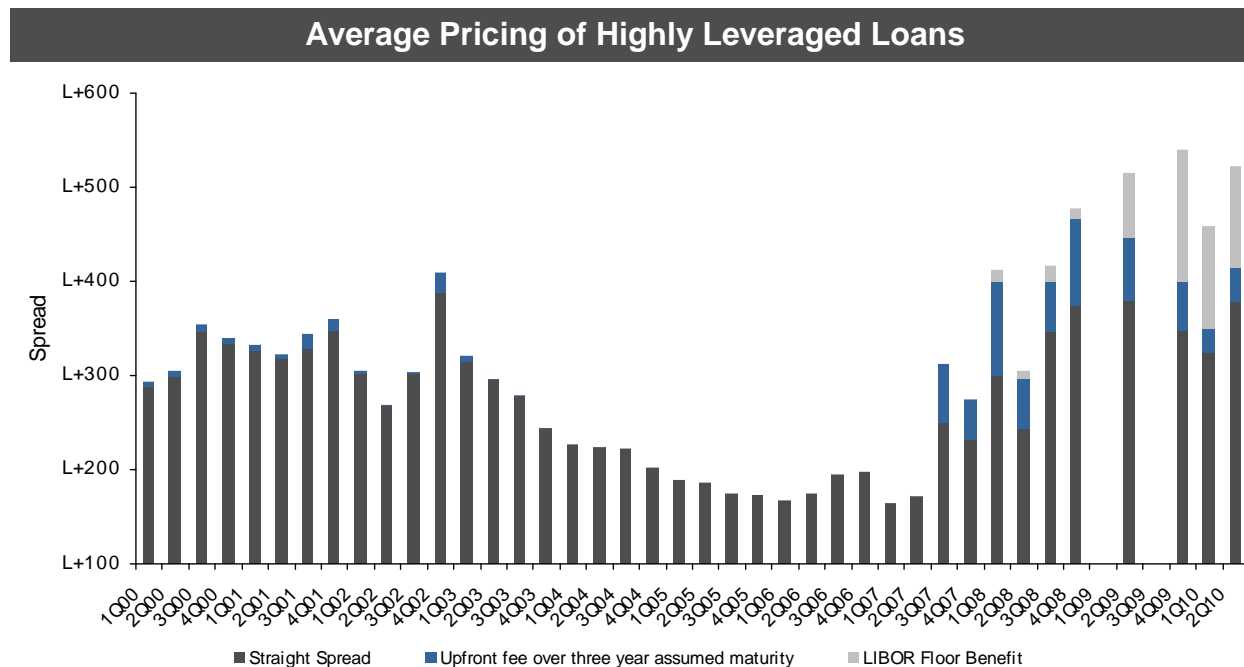
Source: S&P LCD.

Note: For 1990-1996, breakouts of First Lien debt & Second Lien debt were not available; therefore the lower portion of the column reflects Bank Debt/EBITDA and the top portion reflects all Non Bank Debt/EBITDA.

Criteria: Pre-1996 data is based on all debt priced at L+250 and higher; 1996 to date data is based on all debt priced at L+225 and higher; Media loans are excluded; 1991 data is excluded given too few deals to form a meaningful sample.

...And More Stable Pricing For Leveraged Loans

- With the equity and bond markets showing signs of cooling off, companies in search of financing primarily tapped the loan market. As a result, leveraged loan volumes for 2Q '10 were up 56% from 1Q '10 volumes
- With credits flooding the loan market, spreads widened over last quarter. Out of 18 deals syndicated in June, 11 were flexed upwards on pricing, with the average spread in these transactions widening by 150 bps

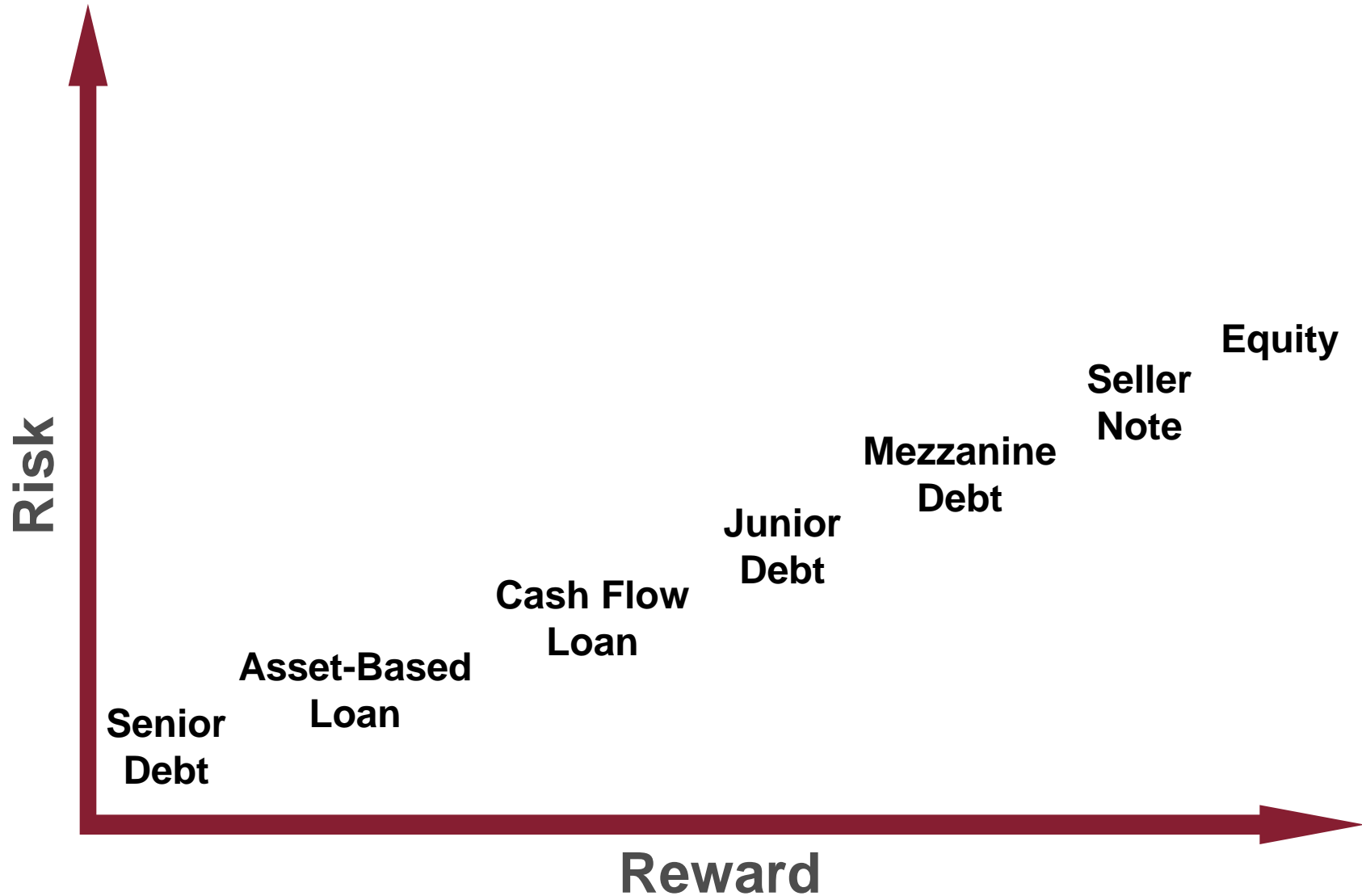


Source: S&P LCD.

Note: Assumes upfront fee is amortized evenly over an assumed three-year life; Upfront fee represents Original Issue Discount. Insufficient sample size in 1Q 2009 and 3Q2009 to draw meaningful conclusion.

Financing Tools

Financing Tools: Overview



Senior Debt

Senior Debt: The Basics

- Pure debt: no equity component
- Typically acquisition/expansion financing and working capital loan

Senior Debt: Advantages and Disadvantages

- Advantages
 - Lower cost
 - Lenders does not share in the “upside” of company exceeds forecast
- Disadvantages
 - Unlike equity, it has a stated maturity (i.e., it must be repaid) and is senior in the capital structure
 - Loan covenants, particularly in a tight credit market

Senior Debt: Underwriting – Four C's

- Collateral base
- Cash flow
- Character of management
- Capital base

Senior Debt: Underwriting – Four C's Plus An E

- ESOP specific underwriting issues
 - Tax benefits often enhances cash flow
 - Repurchase obligations
 - Balance sheet impact
 - Solvency

Senior Debt: Underwriting – Enhancements

- Credit enhancements
 - Guaranties
 - Pledge of qualified replacement properties

Senior Debt: Traditional Bank Financing – Characteristics

“COMMERCIAL” LOANS

- Typically are less leveraged
- Due to bank comfort level, company has limited reporting requirements
- Lowest “spread”/pricing
- Personal guarantee may be required
- Secured by assets – limited monitoring

ASSET BASED LOANS “BUSINESS CREDIT”

- Due to higher leverage and or lack of earnings - banks very focused on asset values usually based on a borrowing base
- Specific asset advance rates applied
- Set reporting of loan to asset values
- Lock-box mechanism
- Field exams and Inventory valuations done yearly (possibly more frequently)

Senior Debt: Asset Based Loan – Characteristics

UNDERWRITING CRITERIA

Asset Values

- Current Assets
 - A/R x 70%-80%
 - Finished Inventory x 40%-50%
- Fixed Assets
 - Equipment (OLV) x 80%
 - Real Estate x 60% - 75%

SECURITY INTEREST

First lien on all assets

PRICING

“Floats” based on LIBOR with spread of 200 to 400 basis points

MATURITY

Three to five years

CURRENT MARKET CONDITIONS

Open with many banks investing

Senior Debt: Air-ball Loan – Characteristics

UNDERWRITING CRITERIA

Asset values and short-term earnings outlook

SECURITY INTEREST

First lien on all assets

PRICING

“Floats” based on LIBOR with spread of 300 to 500 basis points

MATURITY

Under 12 months for air-ball portion of the loan

CURRENT MARKET CONDITIONS

Limited to companies based on industry and earning strength

Senior Debt: Cash Flow Loan – Characteristics

UNDERWRITING CRITERIA

Enterprise multiple and cash flow projections

- Collateral value less important

SECURITY INTEREST

First lien on all assets

PRICING

“Floats” based on LIBOR with spread of 200 to 500 basis points

MATURITY

Three to five years

CURRENT MARKET CONDITIONS

Limited availability on cash flow coverage and business strengths; LIBOR Floor

Senior Debt: Second Lien – Characteristics

UNDERWRITING CRITERIA

Enterprise multiple and cash flow projections

SECURITY INTEREST

Second lien on all assets and junior to the first lien lenders

PRICING

“Floats” based on LIBOR with spread of 700 to 1000 basis points

MATURITY

Six to seven years with maturity longer than senior lenders

CURRENT MARKET CONDITIONS

No availability due to capital market constraints

Senior Debt: Covenants

- Collateral Reports and Audits to Monitor Assets
- Financial Covenants to Monitor Performance
 - Fixed Charge Coverage
 - Cap Ex
 - Leverage – Senior and Total
 - Net Worth – Not used in new ESOPs
 - Minimum Earnings
- Restrictive Covenants to Keep Control of Cash Flow
 - Dividends
 - Management Compensation
 - Financial Statements
 - Acquisitions

Junior Debt

Junior Debt

Institutional Mezzanine

Junior Debt: Institutional Mezzanine – The Basics

- Subordinate payment right
- Subordinate security interest
- Higher interest rate
- Warrant or other equity “kicker”
- Unsecured

Junior Debt: Institutional Mezzanine – Advantages and Disadvantages

- Advantages
 - Increased cash for sellers
 - Provides financing where senior not available
- Disadvantages
 - High cost
 - Complex

Junior Debt: Institutional Mezzanine – Characteristics

UNDERWRITING CRITERIA

Enterprise multiple and cash flow projections

SECURITY INTEREST

None; board seat may be required

PRICING

Fixed rate of 12% -18% split between cash interest or PIK interest; warrants for additional upside maybe required

MATURITY

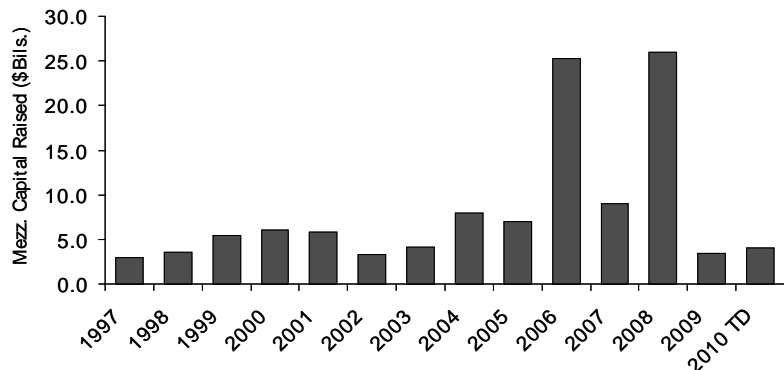
Six to seven years with maturity longer than senior lenders

CURRENT MARKET CONDITIONS

Active based on industry and company dynamics

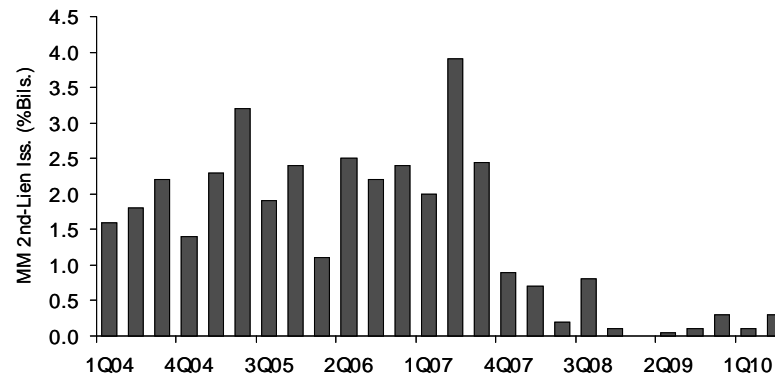
Junior Debt: Institutional Mezzanine – Recent Mezzanine Transaction Activity

Mezzanine fundraising in 2010 has already surpassed last year's depressed levels



Source: Reuters Buyouts

Middle market second-lien issuance is still low, only reaching \$0.3B so far in 2Q10



Source: Thomson Reuters LPC

Mezzanine Terms & Conditions

	2007	2010
Origination Fee	● 1.5-1.75%	● 2-3%
Cash Coupon	● 10-12%	● 12-14%
PIK Coupon	● 0-2%	● 2-5%
Total Coupon	● 10-14%	● 14-18%
Total Leverage Multiple	● 5.0x - 6.0x	● 3.5x - 4.5x
Warrants	● Not available	● Available
Equity Co-Investment	● Heavily negotiated	● Generally at Lender's Option
Covenants	● Yes, but based on limited and loose senior debt tests	● 85-90% of more restrictive senior debt tests
Prepayment Restrictions	● No	● Non-callable period (1-2 years) with step down premiums (3-2-1) or (2-1) thereafter

Source: Maranon Capital Estimates.

Junior Debt

Seller Notes

Junior Debt: Seller Notes – The Basics

- Typically fills a “gap” in the capital structure
- But also can comprise 100% of the transaction financing
- Enables transaction to get done that might not otherwise be possible in a difficult environment

Junior Debt: Seller Notes – Advantages and Disadvantages

- Advantages
 - Increased consideration to sellers
 - Sellers get the benefit of return on the note
- Disadvantages
 - Less cash to sellers
 - Must be repaid by company

Junior Debt: Seller Notes – Characteristics

UNDERWRITING CRITERIA

Limited underwriting criteria

SECURITY INTEREST

None

PRICING

At seller and company discretion but must exceed IRS limitations; must not exceed market returns per the trustee

MATURITY

Repaid after all other debt

CURRENT MARKET CONDITIONS

Increase in use as it is “friendly capital”

Junior Debt

Payment-In-Kind Interest

Junior Debt: Payment-In-Kind Interest (“PIK”) – Characteristics

- PIK interest is often used when a company lacks cash flow to pay the required return on a current basis
- PIK interest accrues to the seller note balance
- Accrued interest often compounds with interest calculation made using a higher loan balance
- PIK is repaid when the seller note is retired

Junior Debt: Payment-In-Kind Interest (“PIK”) – Advantages and Disadvantages

- Advantages
 - No cash required to make payments
- Disadvantages
 - Possible phantom income
 - Taxed as ordinary income rates

Junior Debt

Warrants

Junior Debt: Warrants – Characteristics

- Right to acquire shares in the company in the future at a pre-determined price
- Typically used in conjunction with a note
- “Puts” and “Calls” may be used

Junior Debt: Warrants – Advantages and Disadvantages

- Advantages
 - Possible higher return to the holder of the warrant if the company exceeds forecast
 - Possible capital gains treatment
 - Company does not have to “repay” if the company does not exceed forecast
- Disadvantages
 - No guaranteed return to holder
 - Increased complexity and cost

Equity

Equity: The Basics

- Equity holder shares in the risks and rewards of company performance
- No interest

Equity: Advantages and Disadvantages

- Advantages
 - Does not have to be repaid
 - Holder has “skin in the game”
 - Inexpensive if the company does not perform
- Disadvantages
 - Expensive if company performs

Equity: Types

- Common stock
- Preferred stock
- Synthetic equity

Equity: Institutional – Characteristics

UNDERWRITING CRITERIA

- Board rights or seats
- Target return of 22% +

SECURITY INTEREST

None

PRICING

No interest, realization of investment through sale or dividend recap

MATURITY

No formal exit strategy, usual hold period is 5 to 10 years

CURRENT MARKET CONDITIONS

Multiple firms with funds that understand ESOPs

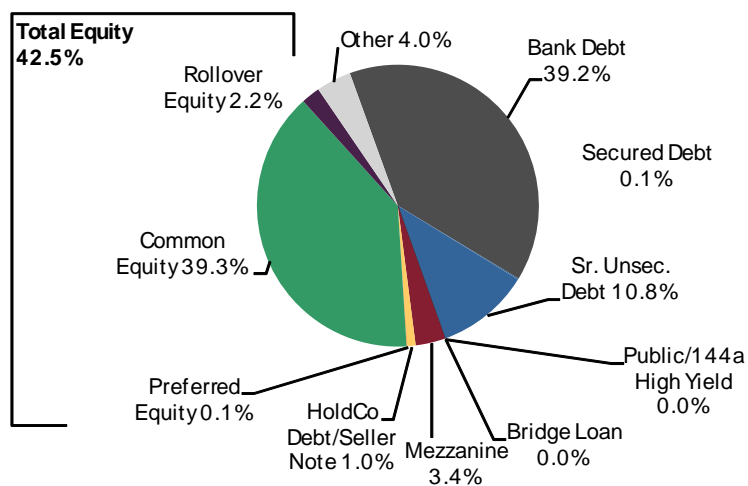
Equity: Other

- Private equity
- Management “rollover”
- 401K / Qualified Plan Assets
- Selling shareholders
- Public markets and Rule 144A offerings

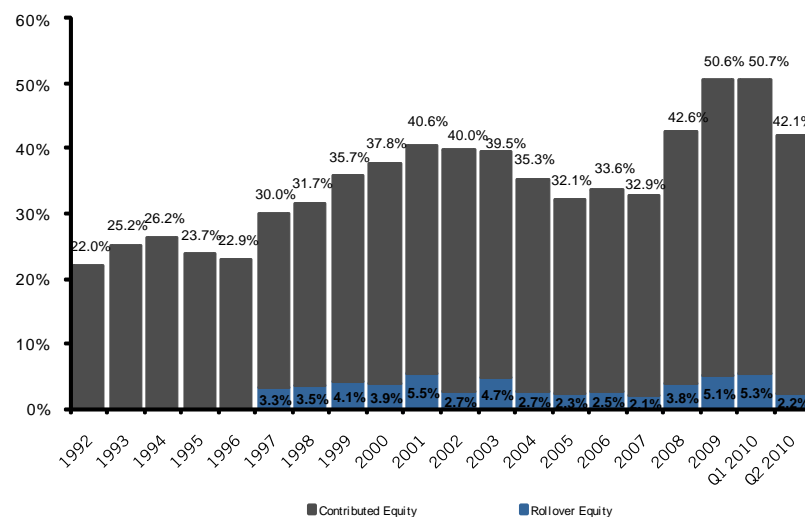
Equity: Recent Transaction Activity

- Equity as a percentage of transaction value saw an increase to all time high's in 2008 and 2009 as sponsors needed to bridge value gaps created by lower financing. While these percentages held steady in 1Q '10, equity contributions declined materially in 2Q '10 with the return of bank financing. It now remains unclear whether equity contributions will continue to decline as the momentum in the credit markets may not be sustainable into 2011 with the economy remaining fairly flat

Average Sources of Proceeds for U.S. LBOs
Q2 2010



Average Equity Contribution to U.S. LBOs
1992 – Q2 2010



Source: Standard & Poor's Q2'10 Leveraged Buyout Review.

Note: The total equity fields are calculated using different methodologies. The preferred equity and holdco debt/seller note contribute to the discrepancy.

Disclaimer

- © 2010 Houlihan Lokey. All rights reserved. This material may not be reproduced in any format by any means or redistributed without the prior written consent of Houlihan Lokey.
- Houlihan Lokey is a trade name for Houlihan Lokey, Inc. and its subsidiaries and affiliates which include: Houlihan Lokey Financial Advisors, Inc., a California corporation, a registered investment advisor, which provides investment advisory, fairness opinion, solvency opinion, valuation opinion, restructuring advisory and portfolio management services; Houlihan Lokey Capital, Inc., a California corporation, a registered broker-dealer and SIPC member firm, which provides investment banking, private placement, merger, acquisition and divestiture services; and Houlihan Lokey (Europe) Limited, a company incorporated in England which is authorized and regulated by the U.K. Financial Services Authority and Houlihan Lokey (China) Limited, a company incorporated in Hong Kong SAR which is licensed in Hong Kong by the Securities and Futures Commission, which provide investment banking, restructuring advisory, merger, acquisition and divestiture services, valuation opinion and private placement services and which may direct this communication within the European Economic Area and Hong Kong, respectively, to intended recipients including professional investors, high net worth companies or other institutional investors.
- Houlihan Lokey gathers its data from sources it considers reliable; however, it does not guarantee the accuracy or completeness of the information provided within this presentation. The material presented reflects information known to the authors at the time this presentation was written, and this information is subject to change. Houlihan Lokey makes no representations or warranties, expressed or implied, regarding the accuracy of this material. The views expressed in this material accurately reflect the personal views of the authors regarding the subject securities and issuers and do not necessarily coincide with those of Houlihan Lokey. Officers, directors and partners in the Houlihan Lokey group of companies may have positions in the securities of the companies discussed. This presentation does not constitute advice or a recommendation, offer or solicitation with respect to the securities of any company discussed herein, is not intended to provide information upon which to base an investment decision, and should not be construed as such. Houlihan Lokey or its affiliates may from time to time provide investment banking or related services to these companies. Like all Houlihan Lokey employees, the authors of this presentation receive compensation that is affected by overall firm profitability.