
MEZZANINE ASSET CLASS

(Winner of "Survivor 2009")

TEXPERS

Presented By:

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Partner

SMITH WHILEY & COMPANY



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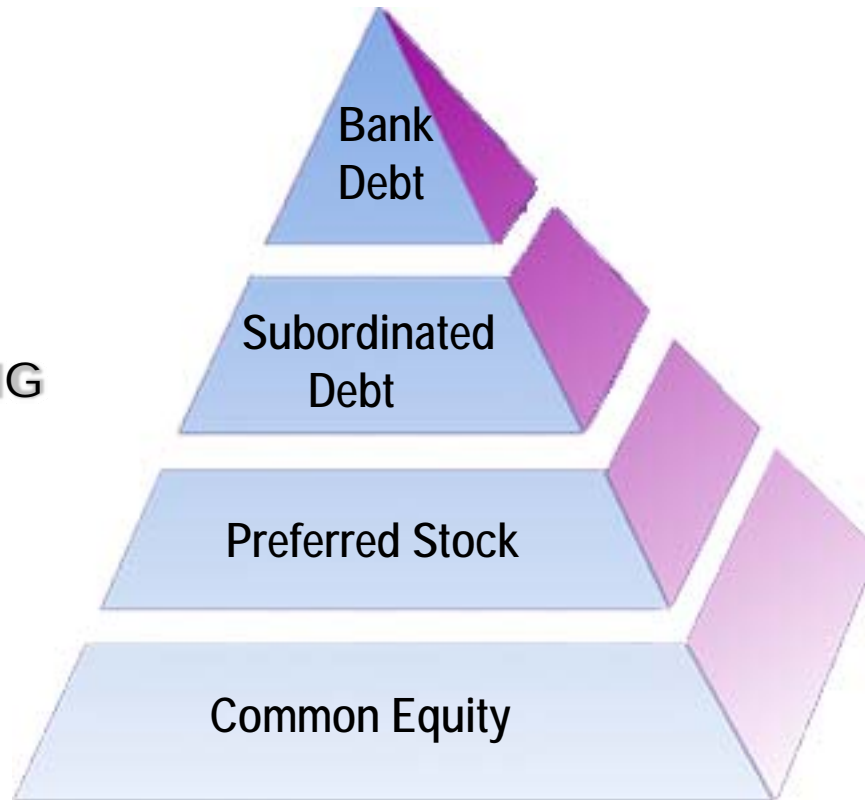
- Founded in 1994 through a joint venture with Aetna, Inc.
- Registered Investment Advisor headquartered in Hartford, Connecticut with an office in Evanston, Illinois
- Seasoned Principals in deal execution and in fund operations – team has almost 200 years of investment experience
- Established brand - has managed the SW Pelham Funds for 12 years
- SW Pelham Funds:
 - Pelham I – \$100 million, 1998 vintage year
 - Pelham II – \$100 million, 2003 vintage year
 - Pelham III – \$100 million, 2006 vintage year
 - Pelham IV – \$250 million, 2010 vintage year
- Industry recognition of performance in mezzanine asset class and deal execution
- Significant investment experience - historical track record in alternative investments totals \$9 billion; managed \$21 billion in assets ⁽¹⁾
- Smith Whiley has managed over \$600 million in assets since inception and invested in over 30 portfolio companies

Note: ⁽¹⁾ Investment and management experience primarily reflects that of the Principals in prior capacities with other financial institutions.



CAPITAL PYRAMID

MEZZANINE FINANCING
OR "JUNIOR CAPITAL"



WHAT IS MEZZANINE DEBT

- Mezzanine Financing: Junior capital in the form of subordinated debt with equity participation or preferred stock
- More flexible than traditional bank financing
- Mezzanine is typically less expensive than new equity financing with current return expectations of 18%+
- Equity participation (“kickers”) include:
 - Warrants
 - Options (such as call or put rights)
 - Rights to participate in cash flow or earnings
 - Bonus payments or success fees
- Mezzanine financing is attractive for companies who need capital for:
 - Growth and acquisitions
 - Management buyouts
 - Product development
 - Consolidation and recapitalization



CURRENT MARKET DYNAMICS

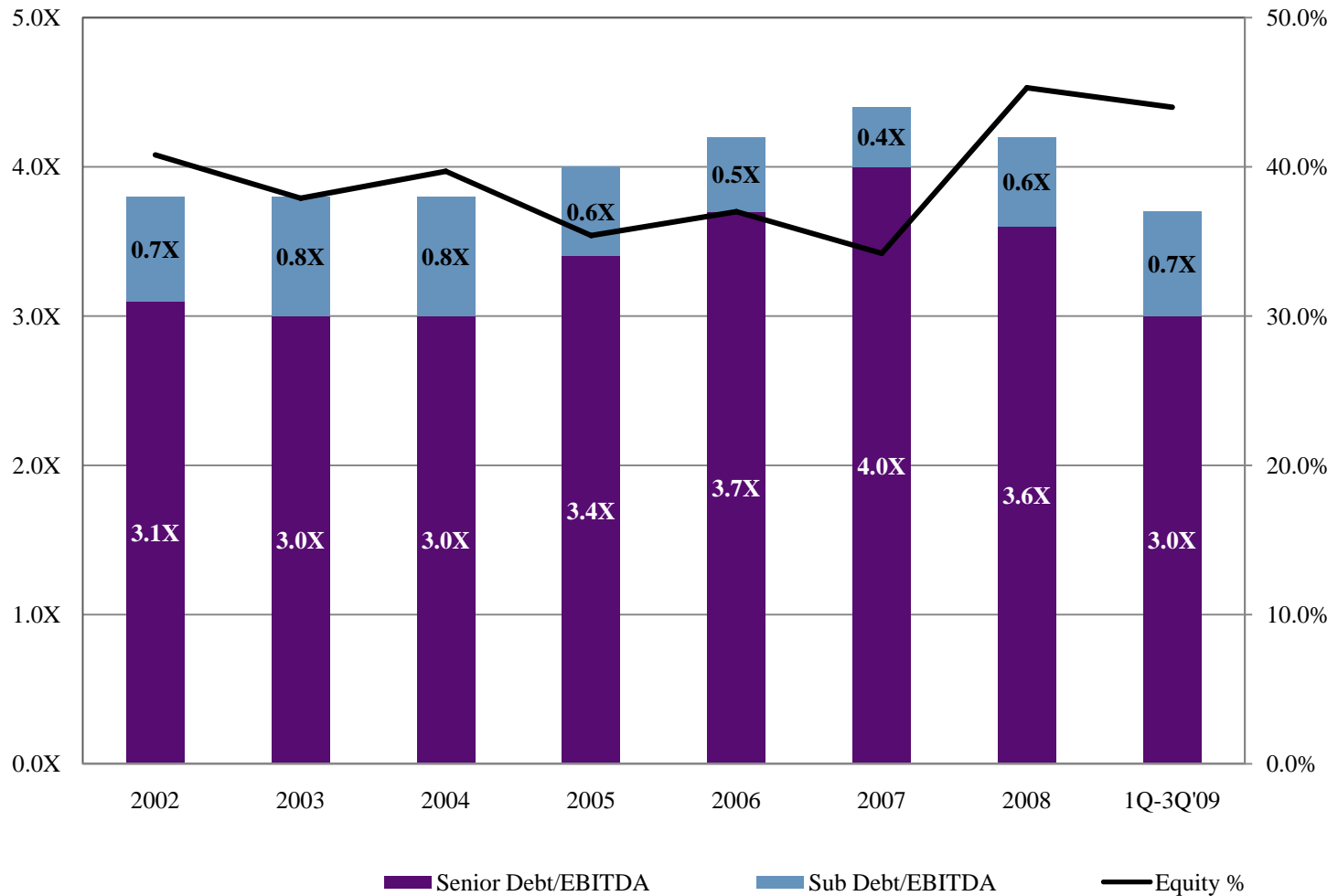
- Economic conditions continue to pose business challenges
- U.S. recovery anticipated to be muted as unemployment and other economic “noise” buffer real growth
- Investors hyper focused on existing portfolios
- Confluence of these factors has reduced transaction activity and lengthened the time to close, though purchase multiples have not fallen as dramatically as have lending multiples
- Credit availability starting to loosen though pricing is higher – ABL market more prevalent; banks focused on relationships with “good credits”
- M&A market sentiment is generally optimistic

Favorable investor dynamics in the primary and secondary markets, particularly for junior capital



U.S. LOWER MIDDLE MARKET AVERAGE DEBT LEVELS AND EQUITY CONTRIBUTIONS

DEALS WITH EBITDA OF \$50MM OR LESS

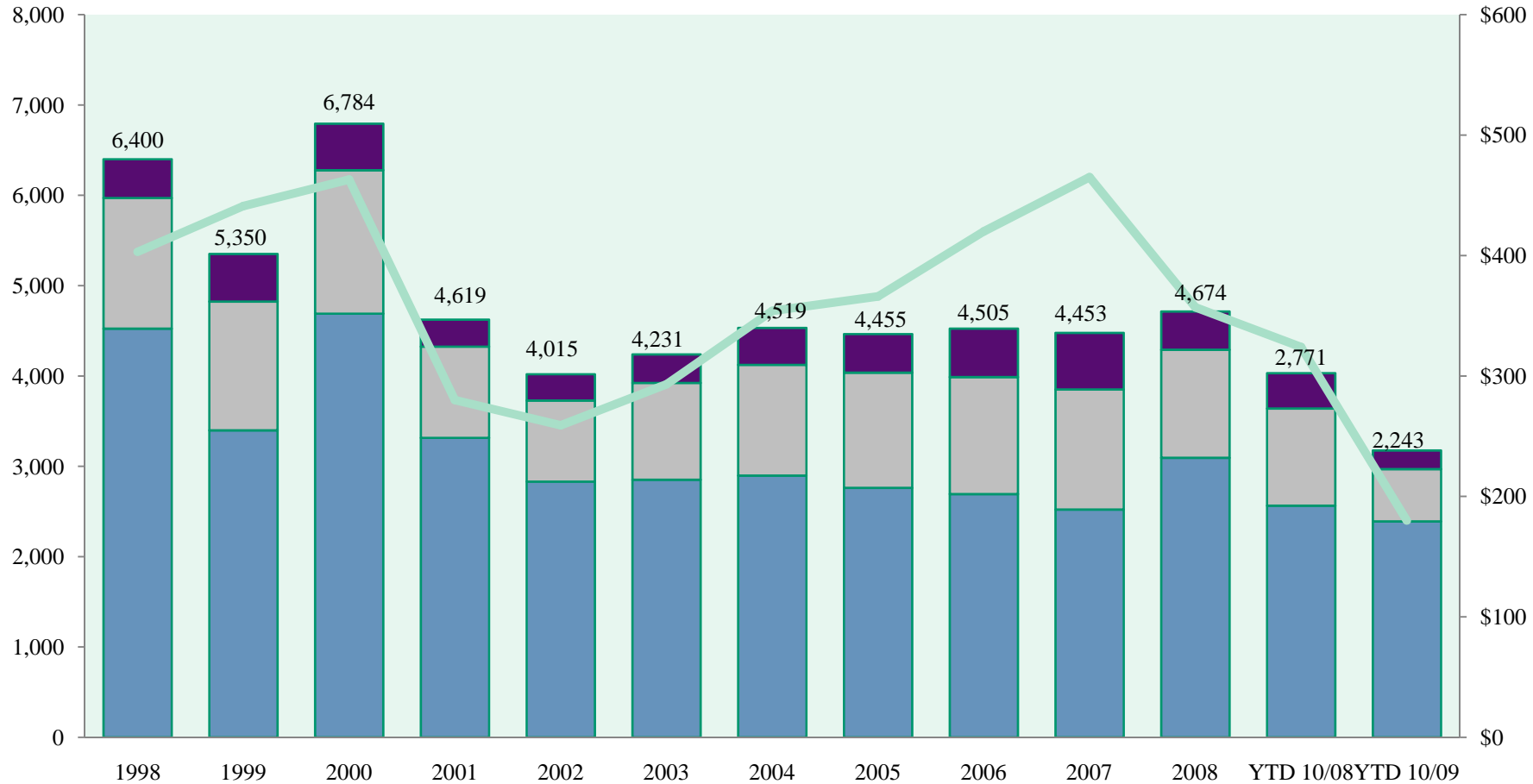


U.S. MIDDLE MARKET DEAL VOLUME

■ <\$50
 ■ \$50-250M
 ■ \$250-750M
 — Deal Value

Number of Deals

Deal Value
(\$ in billions)



Note:

Source: Dealogic and William Blair & Company, L.L.C. Mergers and Acquisitions Market Analysis

CAPITAL STRUCTURE

CAPITAL PYRAMID	PRE CREDIT CRUNCH	CURRENT ENVIRONMENT
SENIOR DEBT	60% to 70%	30%
SUBORDINATED DEBT	10% to 15%	20% to 25%
PRIVATE EQUITY	20% to 30%	35% to 50%
TOTAL %	100%	100%



MARKET RETURNS AND SPREADS

	1995	2000	2007	2009
Five-Year Treasuries	7.8%	5.0%	4.5%	2.5%
Average Mezzanine Targeted IRR	22.7%	19.1%	18.0%	18.9%
Spread Over Treasuries	14.9%	14.1%	13.5%	16.4%
Average Buyout Equity Targeted IRR ⁽¹⁾	30.0%	27.5%	22.5%	21.0%
Spread Over Treasuries	22.2%	22.5%	18.0%	18.5%
Buyout Equity Targeted IRR Less Mezzanine Targeted IRR	7.3%	8.4%	4.5%	2.1%

Source: 

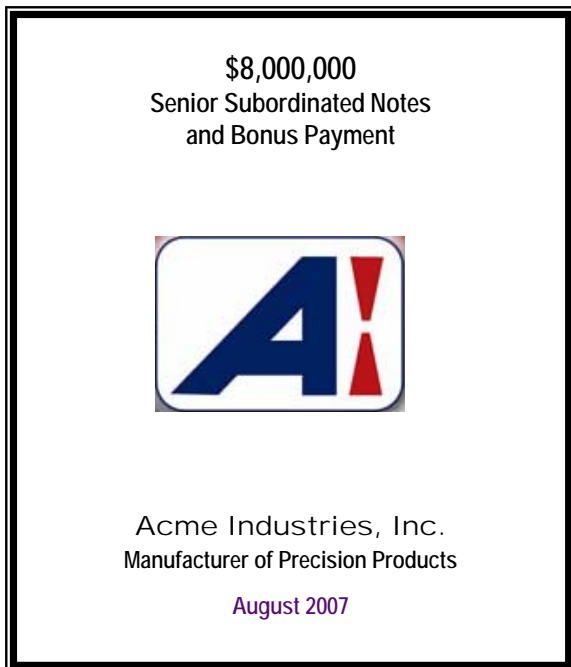
Note

(1) Approximations based on market data (for illustration purposes).



CASE STUDY # 1

ACME INDUSTRIES, INC. ("ACME")



Sponsor:

- Direct

Purpose:

- Recapitalization

Business:

- Precision manufacturing

Form of Participation:

- \$8 million Subordinated Notes Bonus Payment

Debt Features:

- Current Coupon: 12%
- PIK feature: 2%
- Bonus payment: Minimum return of 1.75x cash on cash in years 1-3 and 2.0x thereafter

Entry Multiple:

- 4.5x (August 2007)



VALUE PROPOSITION – ACME INDUSTRIES, INC.

- Attractive and defensible niche in fragmented industry – provides precision machining of short run but repeatable and highly complex parts that are critical to customers' end products
- CEO is a long-term machining industry veteran who has assembled a strong management team
- Management team demonstrated ability to weather a storm
 - Grew and diversified customer and industry base – includes blue chip OEM's who permanently outsource production
 - Drove up margins by redefining focus to complex, higher margin, critical parts
 - Established partnering relationships to add capacity and maximize internal utilization of higher margin value-add capacity
 - Improved production processes - implemented continuous improvement, lean manufacturing, and Kaizen processes
- Strong and sustainable financial performance through attractive margins and significant customer ties
- Meaningful barriers to entry from foreign competition



EXECUTION TO DATE – ACME INDUSTRIES, INC.

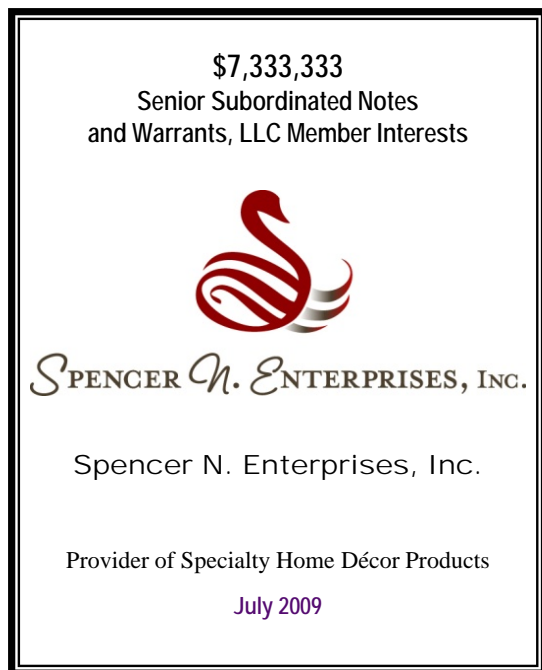
- Investment exceeding expectations: Revenue and EBITDA expansion despite down economy
- Reduced senior debt by \$5.7 million – unused credit line provides \$4.5 million of liquidity
- Completed plant consolidation / expansion to increase operating productivity, efficiencies and capacity
- Ongoing focus on continuous improvement and Kaizen events
- Fund investment on track to generate targeted return
- Using downturn as opportunity to position Acme to be a leader for the long term
 - Opportunistic hires to add or improve bench strength
 - Opportunistic equipment purchases at below market prices
 - Commissioned third party reviews of competitive position and sales practices
 - Aligning with additional reps to gain entry into new industries – mining, wind energy

*Proactive management team that drives continuous improvement
and rewards performance at all levels of the organization*



CASE STUDY # 2

SPENCER N. ENTERPRISES, INC. ("SPENCER")



- Sponsor:**
- Ancor Capital Partners and 21st Century Group
- Purpose:**
- Acquisition
- Business:**
- Designer, marketer, manufacturer and importer of decorative pillows and soft window coverings
- Form of Participation:**
- \$7.3 million Senior Subordinated Notes and Warrants, LLC Member Interests
- Debt Features:**
- Current Coupon: 17%
 - Optional PIK feature: 3%
 - Warrants: 1.89%
- Entry Multiple:**
- 4.9x (July 2009)

VALUE PROPOSITION – SPENCER N. ENTERPRISES, INC.

- EBITDA margins greater than 20%
- Elegant, cash generating business model; limited manufacturing infrastructure and low inventory risk
- Attractive structural considerations:
 - Acquisition multiple < 5x EBITDA
 - Little senior credit
 - Very favorable transaction economics
- Immediate accretive growth prospects, including an imminent new business relationship with Wal-Mart as well as expansion opportunities with existing customers



EXECUTION TO DATE - SPENCER N. ENTERPRISES, INC.

- Began shipment of decorative pillows to Wal-Mart in August – a new relationship that was not priced into the transaction
- 2009 sales higher than budget, a high water mark for the Company
- Company has been asked by Bed Bath & Beyond to develop a new decorative pillow strategy resulting in increased SKUs

Negotiated through several credit iterations to achieve an exceptionally structured opportunity



CONCLUSION: KEYS TO SURVIVOR 2010
(for the Mezzanine Asset Class)



SUCCESSFUL MANAGERS WILL:

- Focus on “Existing Portfolio”
 - Make critical investments needed for top line growth
 - Monitor and reward cost containment
 - Provide strategic direction towards an exit

- Make “New Investments”
 - Look for portfolio companies with strong value propositions
 - Provide needed goods and services
 - Command high margins
 - Back exceptional management teams
 - Pay reasonable purchase price multiples
 - Structure acquisitions conservatively to avoid excess leverage

