

SEAF Blue Waters Growth Fund Overview of Mezzanine Investment

What is Mezzanine Investment?

Mezzanine Investment is an investment structure that is a hybrid of debt and equity generally used to finance the expansion of existing companies. It can provide an attractive financing solution for innovative and high-growth companies. The primary characteristics of Mezzanine Investment are:

- ❖ Largely unsecured risk capital with debt repayment characteristics;
- ❖ Combining attractive features of equity and debt, but without certain drawbacks. Mezzanine Investment does not usually require a significant ownership stake or have onerous collateral requirements;
- ❖ Long-term investments with flexible terms typically tied to the cash flows and performance of a company;
- ❖ Structured to complement other forms of capital, and positioned between senior debt and equity in a company's capital structure; and
- ❖ Capital whose costs are between those of bank loans and equity investment.

What are the Benefits of Mezzanine Investment for SMEs?

The benefits of Mezzanine Investment for SMEs include:

- ❖ Provides sufficient growth capital without significant ownership dilution or onerous collateral requirements;
- ❖ Less rigid than traditional bank debt, and less expensive and dilutive than equity;
- ❖ Investment decisions based on the strength of a company's cash flows and expected growth, rather than the value of collateral;
- ❖ Flexible, with the repayment terms often tied to projected cash flows of the business; and
- ❖ If properly structured, Mezzanine Investment will lower the cost of capital for a company, and improve returns to existing shareholders.

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How Does Mezzanine Investment Compare to Equity and Bank Debt?

Mezzanine Investment is a hybrid investment structure that includes components of equity and debt, and whose characteristics typically fall between those of equity and debt:

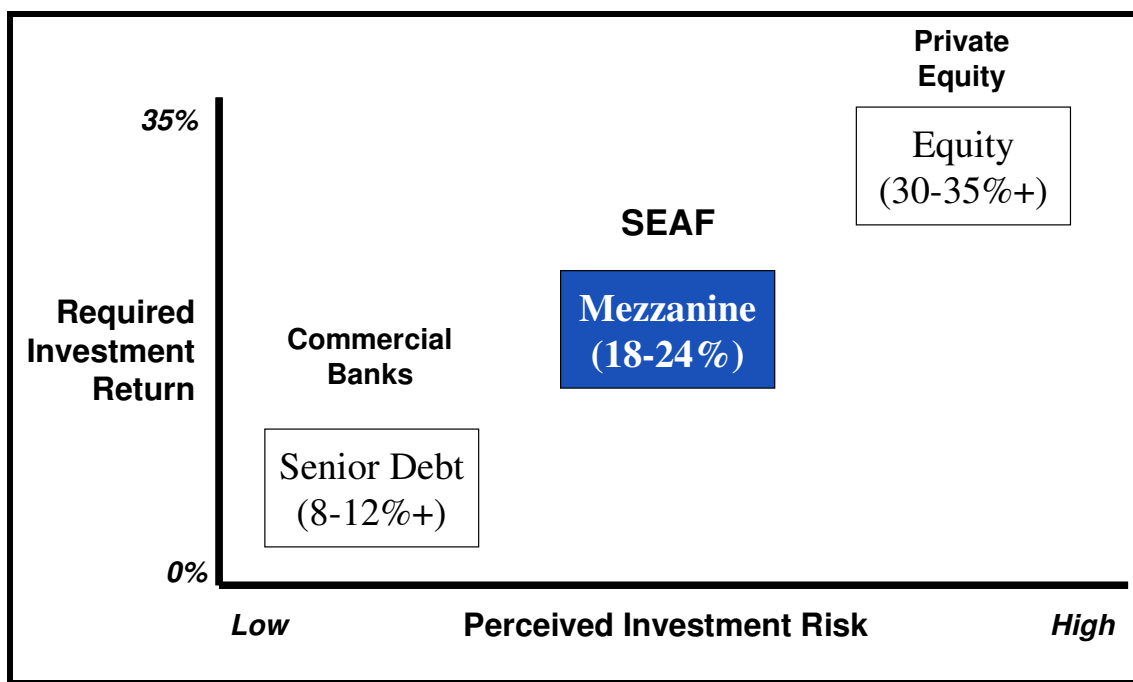
	Equity	Mezzanine	Bank Debt
Cost of Capital	30-35%+	18-24%	8-12%+
Investment Horizon	Varies	Long term	Short term
Risk Tolerance	High	Medium	Low
Collateral	None	Low	High
Equity Dilution	High	Low	None
Seniority	Residual	Second	First
Capital Structure	Owner's Equity	Owner's Equity/ Unsecured Debt⁽¹⁾	Senior/Secured Debt

(1) Often treated as equity by senior debt holders and for financial reporting purposes.

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What is the Cost of Mezzanine Investment for a Company?

The ‘cost’ of external capital invested into a company is equal to the investment return required by the investor. This cost is sometimes hidden, as in the case of equity investments, and is typically related to the perceived risk of the investment. In other words, higher perceived investment risk by the investor will require a higher cost of capital to the company, while lower perceived investment risk will require a lower cost.



What are the Typical Terms of Mezzanine Investment?

Mezzanine Investments are usually structured with the following terms and conditions:

- Investment instrument:** Subordinate or convertible debt with a junior security interest.
- Term:** Long-term, with investment terms of 1 to 5+ years.
- Cash interest rate:** Annual cash interest payment of 12-15%.
- Repayment terms:** Flexible, and can be structured to match the expected cash flows of the business.

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- Covenants:*** Similar to covenants for bank debt (coverage ratios, etc.), but less rigid.
- Equity component:*** Small equity position through conversion features or warrants.

What do Mezzanine Investors Look for in a Company?

Providers of Mezzanine Investment generally look for many or all of the following characteristics in their investments:

- ❖ Expansion stage companies with a history of positive cash flows.
- ❖ Strong management team that is experienced and has a significant ownership interest in the company.
- ❖ Attractive growth opportunities for the business, with both the industry and company well positioned for growth.
- ❖ A well thought out business plan for addressing the opportunities and challenges in the market.
- ❖ Use of proceeds to fund the growth and expansion of the business, including capacity expansion, acquisitions, and development of new markets.

Is Mezzanine Investment Right for Your Business?

Mezzanine Investment is right for companies that are in expansion mode, with a history of positive cash flows and a high potential for growth, but that:

- ❖ are currently unable to obtain from a bank all of the funds necessary to achieve their goals; and
- ❖ do not have access to sufficient equity investment, or are unwilling to dilute their ownership position significantly.