



MCKENNA GALE
CAPITAL INC.

Mezzanine Finance

*Financial Executives
International*

London Chapter

October 6, 2005

Agenda

- I. About McKenna Gale
- II. Debt Market Trends
- III. Canadian Mezzanine Market
- IV. CFO Considerations





ABOUT McKENNA GALE

Who We Are

- The most experienced subordinated debt/mezzanine investor in Canada – heritage back to 1988
- Focused on investing subordinated debt, convertible debt and common equity
- Eight experienced investment professionals; all investment decisions made in-house
- Backed by prominent Canadian and US institutions
- Independent of any one financial institution

Most Experienced, Entrepreneurial Group



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Track Record

- ❑ MG Stratum Fund III – **\$305** million in 2004
- ❑ MG Stratum Fund II – raised **\$200** million in late 1998
- ❑ MG Stratum Fund I – raised **\$100** million in 1996

Over \$600 Million of Committed Capital



What We Do

- Invest in all asset classes below senior debt
- Long term, private subordinated debt and/or common equity
- Bridge senior loans to facilitate speedy transactions
- Will underwrite up to \$75 million
 - Can arrange much larger transactions with Limited Partner base
 - Minimum investment of \$7 million
 - Terms up to 10 years
 - Private or public companies, in all types of industries

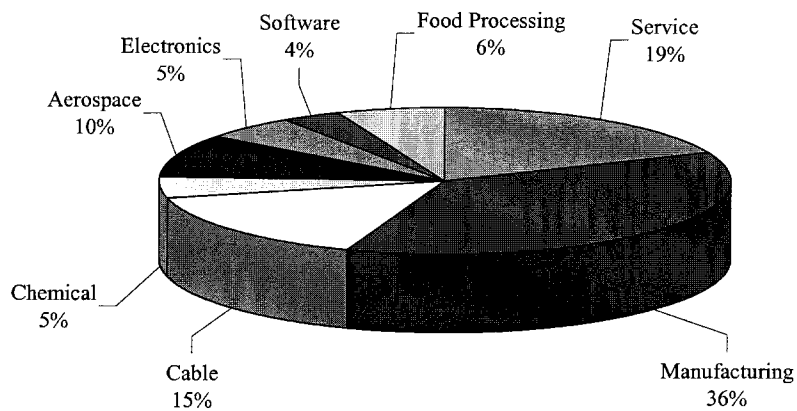
Very Flexible Capital



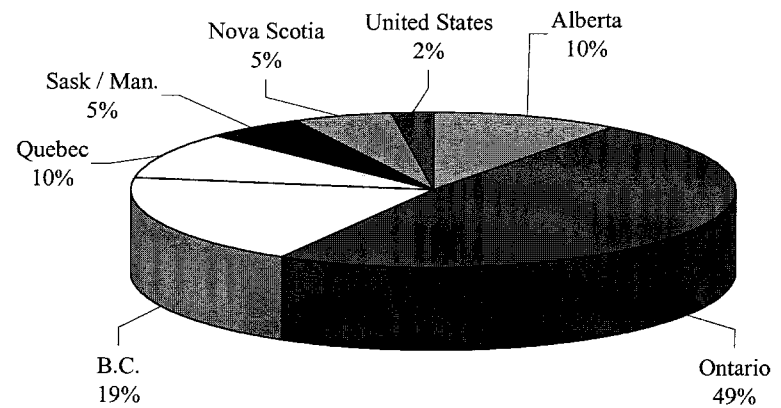
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Our Investments

By Sector



By Region



Experienced Across Diversified Industries



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DEBT MARKET TRENDS



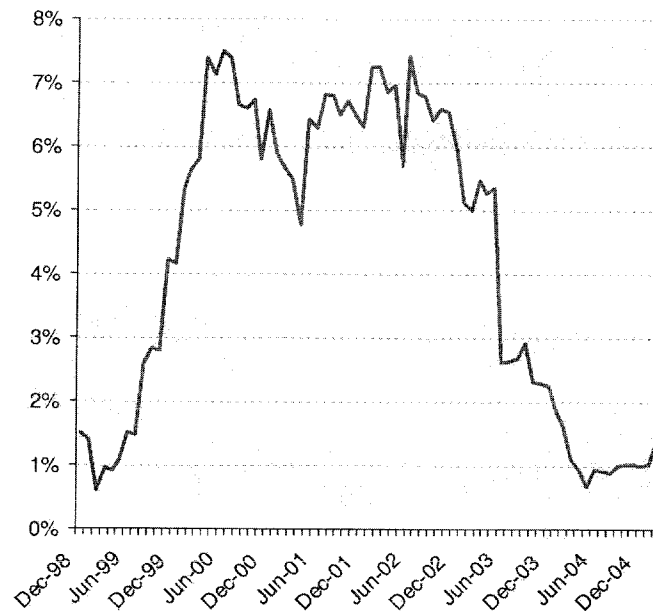
Debt Market Trends

- Interest rates trending up from historic lows
- Many “yield hungry” investors – retail & institutional
- Default rates have dropped to historic lows
- Abundance of capital



Debt Market Trends

Lagging 12-month Default Rate by Principal Amount



Source: Portfolio Management Data

Default Rates at Historic Lows



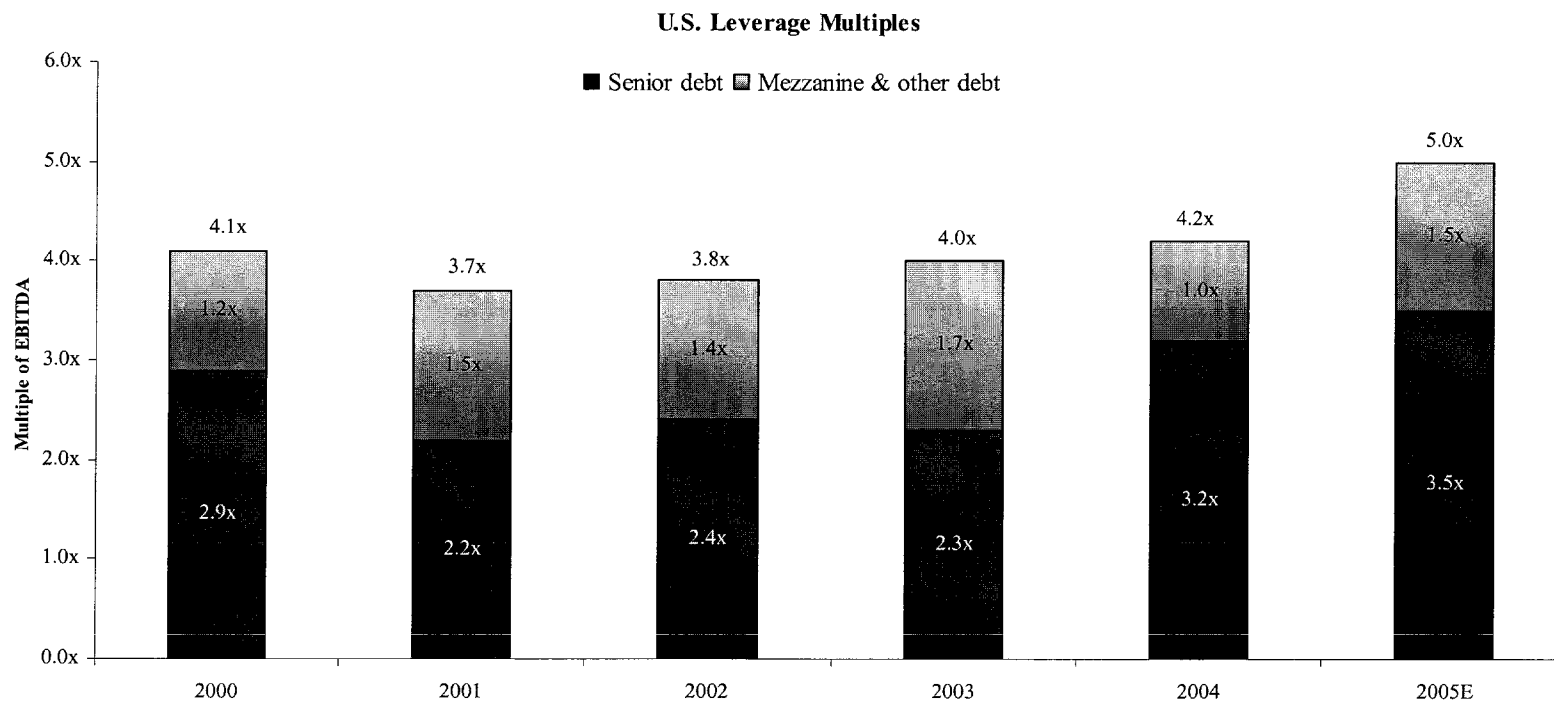
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Debt Market Trends

- Acceptable corporate leverage has trended up
- New lenders have entered the market - hedge funds
- Companies revising existing terms and covenants to make existing debt issues less restrictive
- M&A activity increasing - funded by debt



Credit Statistics



Source: Standard & Poors Leveraged Commentary Data and and Robert W. Baird Co. 2005 estimate by McKenna Gale.

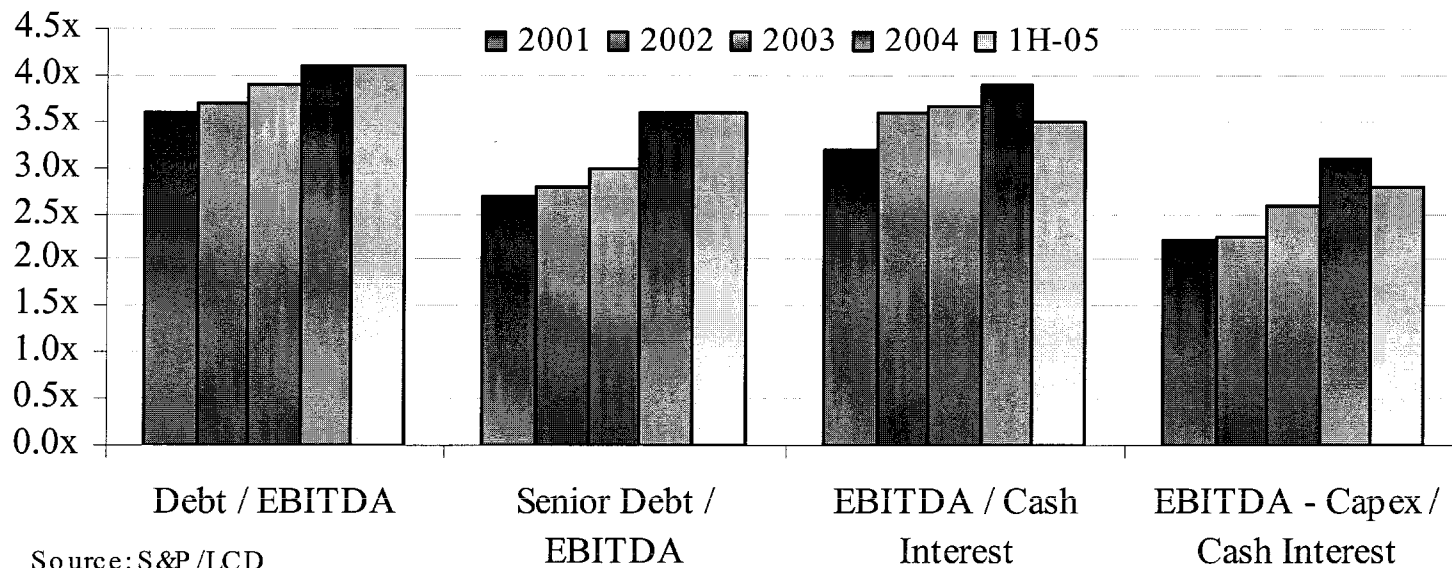
Leverage is Approaching Peak Levels



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Credit Statistics

Average Credit Statistics of Mid-Market Transactions

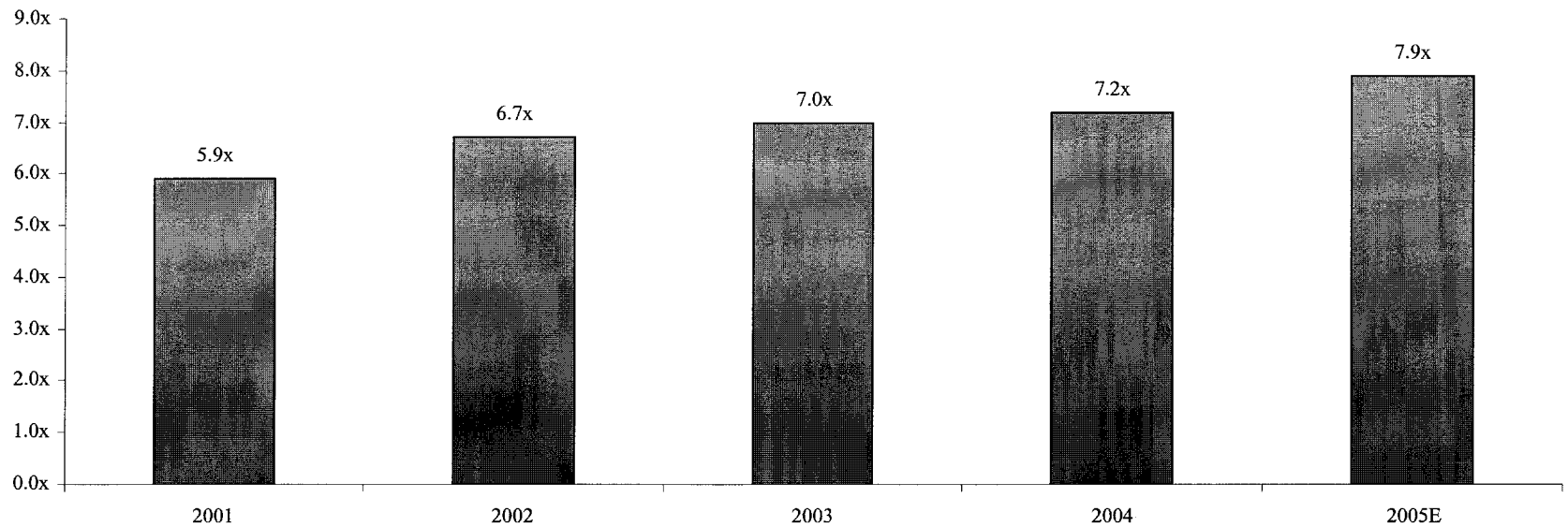


Covenants Have Been Trending Upwards



M&A Values

U.S. Middle Market* Median Enterprise Value / EBITDA Multiples



Source: B of A Capital Eyes

*Deals with EBITDA of US\$50MM or less and excludes Media, Telecom, Energy and Utilities deals.

Values are at Multi Year Highs



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Senior Debt Markets

- Secured Senior Loans
- Banks, institutions and other unregulated lenders
 - Increasingly accommodating and growth oriented
 - Less restrictive covenant patterns and longer amortizations – Term B Loans
 - Increasingly aggressive on EBITDA multiples/leverage
 - Senior leverage multiples of up to 3.5x (plus) EBITDA
 - Total leverage of up to 5x (plus)



Senior Debt Markets

❑ Senior Asset Based Lenders

- Becoming more prominent in Canada
- Asset intensive situations
- Focus on collateral / asset values / margin availability
- Less concerned with total leverage
- Covenant patterns often de-emphasized
- Generally will lend more than Banks when circumstances are right



US High Yield Debt

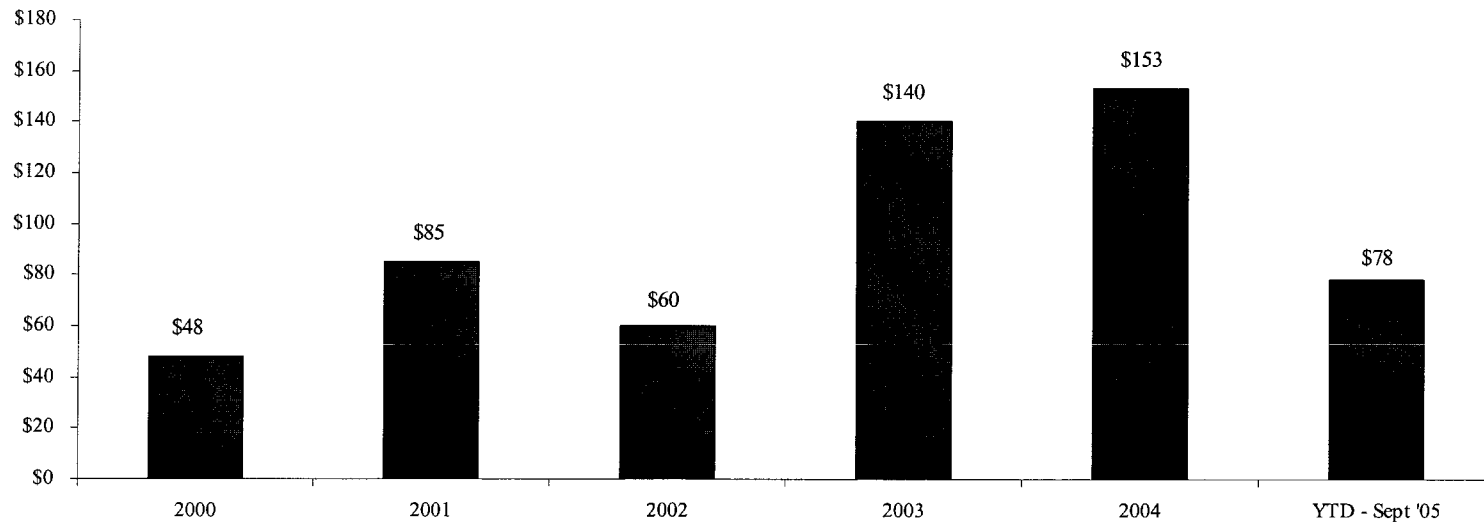
- ❑ Public non investment grade debt market in US
- ❑ Market not developed in Canada
- ❑ Accessible in certain circumstances
 - Minimum issuance size of US \$100-150 million
 - Cross border considerations
 - Fixed rate pricing – Treasuries plus 200 to 500 basis points
 - No prepayment for 4-5 years
 - Costly to issue (5%-8% of fees & expenses)
 - Public disclosure requirements and Sarbanes-Oxley exposure
 - Requires ratings



US High Yield Debt

- ❑ Market was very strong in 2003 and 2004
- ❑ Spreads at tightest levels since 1998

Corporate High Yield Debt Offerings



Source: Goldman Sachs



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Second Lien Loans

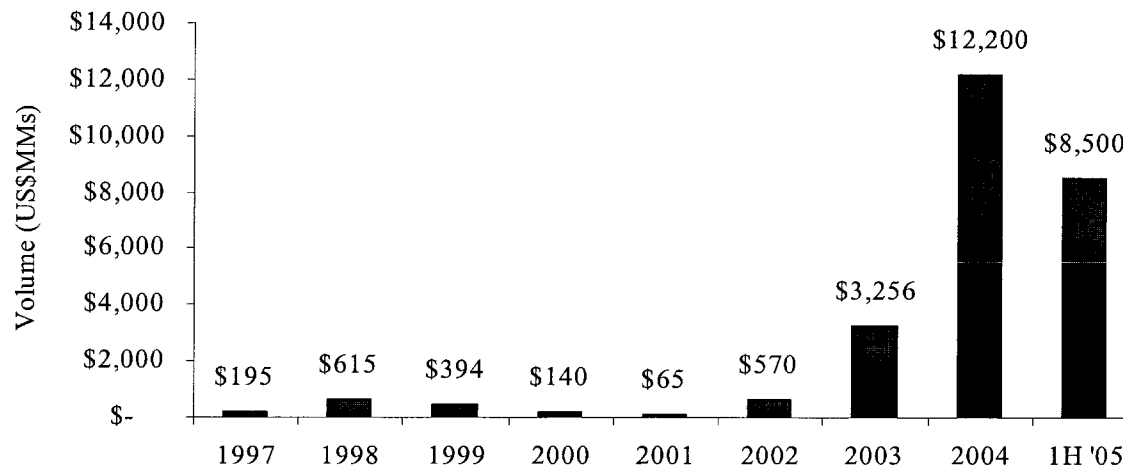
- Developing market
- Predominately in the US
- Second secured private debt
- Leverage .25x to 1.00x less than mezzanine EBITDA multiple
- Hedge funds large players
- Pricing LIBOR + 600 to 800 basis points (floating rate)
- Open mainly to larger companies (EBITDA >\$25mm)



Second Lien Loans

- ❑ In 2004 the second lien market nearly quadrupled that of the prior year which was 6 times larger than the year before
- ❑ 2005 on pace to exceed 2004
- ❑ Fueled by an abundance of hedge fund capital

Second Lien Loan Volume



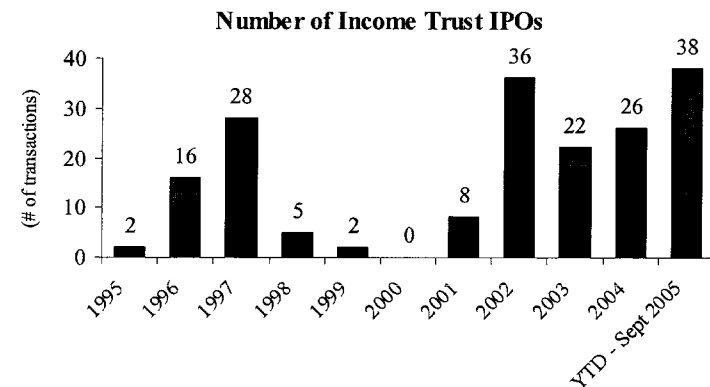
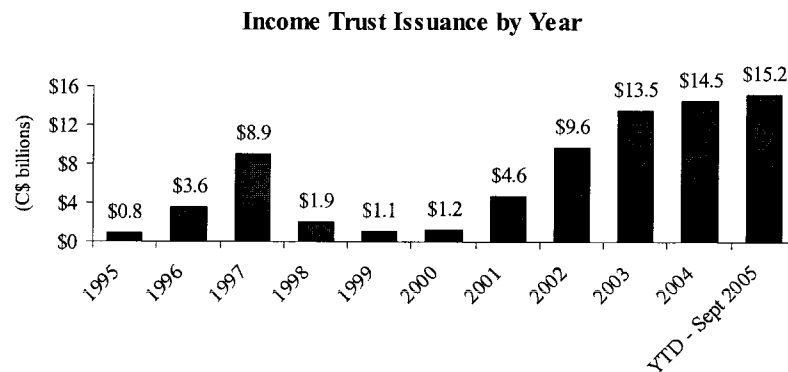
Source: S&P



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Income Trust Market

- ❑ 228 trusts with market capitalization of \$167 billion
- ❑ 164 business trusts (trusts excluding Oil & Gas and REITs) with a market capitalization of \$82 billion
- ❑ Canadian proxy for high yield market at retail level



Satisfies Demand for Yield



Income Trust Market

- ❑ Goodale's announcement on September 19, 2005 resulted in a number of Income Trust IPO's and conversions being postponed or pulled
- ❑ Approximately \$700 million of Income Trust IPOs have been put on hold
- ❑ S&P will not add trusts to the S&P/TSX Composite Index until Goodale decides on the fate of Income Trusts

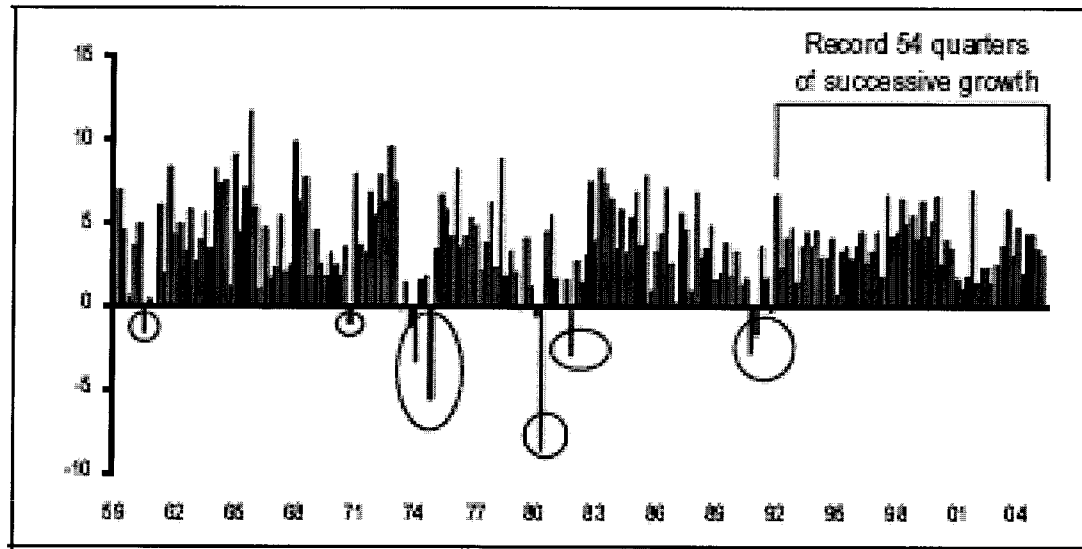
Future?



Economic Outlook

U.S. Real Consumer Spending

(Quarter/Quarter % Change, Annualized)



Source: Bureau of Economic Analysis, Merrill Lynch

Recession May be Near

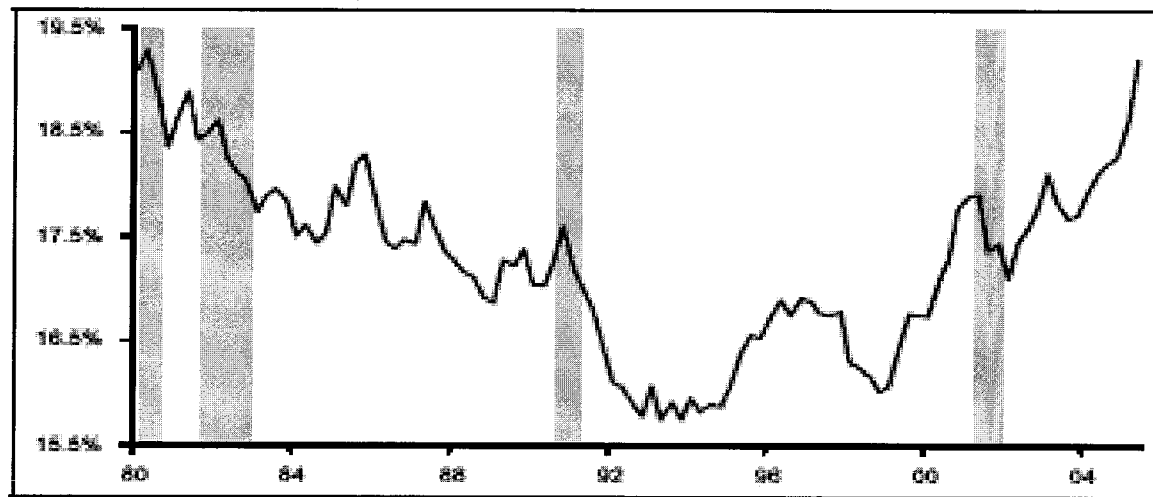


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Economic Outlook

Energy in Interest: Interest in Energy

(U.S. Consumer Spending on Interest and Energy Payments as % of Personal Disposable Income)



Shaded regions represent periods of U.S. recession.
Source: Bureau of Economic Analysis, Merrill Lynch

Spending on Interest and Energy at 20 Year Highs



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Current Capital Structure

	2001		2005	
	EBITDA Multiple	%	EBITDA Multiple	%
Total Senior Debt	2.5x	50%	3.5x	50%
Mezzanine	1.0x	20%	1.5x	21%
Equity	1.5x	30%	2.0x	29%
Enterprise Value	5.0x	100%	7.0x	100%



CANADIAN MEZZANINE MARKET



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What is Mezzanine Capital?

- Layer of capital between senior debt and equity
- Characteristics of both types of asset classes
- Mainstream credit product that can fill key role in capital structure



Characteristics of Mezzanine

- 1 to 1.5 times EBITDA advance rate
- Securities:
 - Subordinated or convertible debentures
- Flexible maturity
- Non-amortizing
- Second secured debt behind senior lender
- Covenants less restrictive than senior debt



Mezzanine vs. High Yield Debt

	Canadian Mezzanine	U.S. High Yield Debt
Minimum Size	C\$5 million	US\$100-\$150 million
Covenants	Custom - depend on sr. debt	Standard/incurrence
Maturity	5-10 years	7-10 years
Floating / Fixed	Fixed	Fixed
Security	Second charge	None
Amortization	Bullet	Bullet
Rated	No	Yes
Registration	No	SEC
Reporting	Private	Public
Call Protection	Negotiable	3 to 5 year no-call



When is Mezzanine Used?

- Leverage franchise value of the business to achieve strategic business goals
 - Expansion or Growth
 - Acquisition
 - Re-financing / Special dividend
 - Going-Private
 - Corporate Spin-off
 - Buy-out transaction



Benefits of Mezzanine Capital

- Flexible
- Minimal dilution
- Patient
- Private
- Cost is tax efficient
- No amortization
- Negotiable prepayment terms



What Businesses Qualify?

- Established operating businesses
- Focus on:
 - Franchise value
 - Industry fundamentals
 - Cash flow generating ability and historic stability
 - Sound management with depth
 - Accounting quality
- Balance sheet fix
- Diversified industries



Terms and Conditions

- Risk-based pricing
- Historically target IRR was 20% plus
- Current market is low to mid-teens target IRR
- Components of pricing are flexible
 - Upfront fee, interest and equity kicker



Canadian Providers of Mezzanine Capital

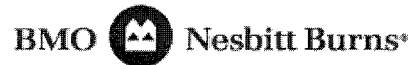
Above \$5 million



Up to \$5 million



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CFO CONSIDERATIONS



CFO Considerations

- Expertise with your target capital structure
- Adequate depth and capacity
- Build a relationship and not just do a transaction
- Understanding the fundamentals of your business

Partner Qualifications are Important



CFO Considerations

- Potential conflicts of interest in the capital structure
- Certainty of execution
- Repayment, partner's exit strategy and timing
- Balance cost of capital and debt service / cash flow obligations
- Potential to invest across all of the "junior capital" asset classes, including equity

Alignment of Interests are Important

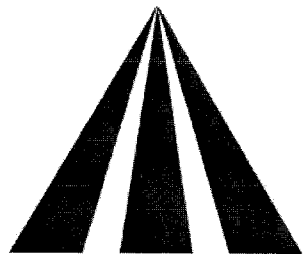


CFO Considerations

- Track record and ability of mezzanine partner to work with senior lender on subordination arrangements/covenants
- PIK interest options to preserve cash flow and covenant compliance
- Flexibility on call features and prepayment options
- Track record in dealing with significant equity co-invest positions

Flexibility is Key





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