

Mezzanine Finance and Buyout Economics

Summary/Conclusion

The history of mezzanine financing goes back a long way

Mezzanine finance provides entrepreneurs with capital ranking between debt and equity. As a principle this type of financing goes back a long way. Investors have, for a long time, sought out ways to reconcile the remuneration of the shareholder and the position of the lender.

5 billion €

The boom in the buyout market that started in the 1980s in the US, followed by Europe, strengthened new mezzanine products stimulating financial innovation¹. Thus the study of mezzanine finance led to a new examination of buyout economics.

European mezzanine finance has reached an annual volume of €5 billion. It has become a specific segment, within the buyout and structured finance market. Mezzanine covers a range of complex products that are put together by specialists.

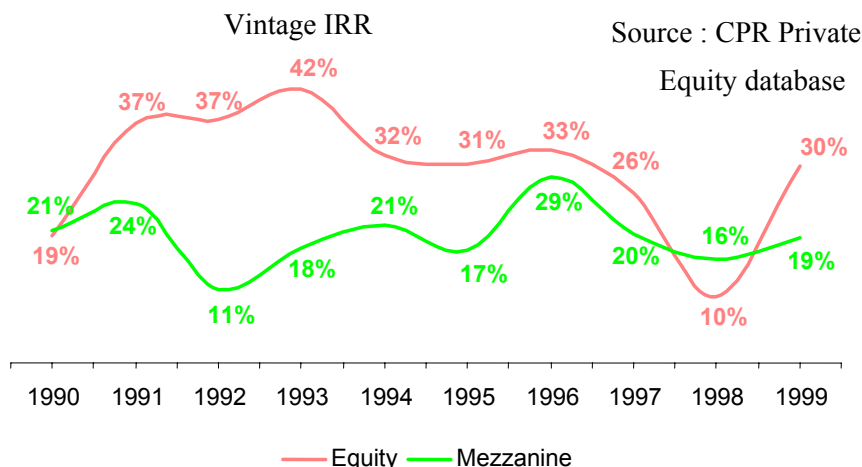
Contribution to the risk/return profile of the buyout market

In the early 90's the risk profile of the overall buyout market needed to be adapted. The development of mezzanine finance has been a response to that need. Mezzanine finance has contributed to the adjustment of the remuneration that each capital provider takes from the buyouts (from equity sponsors and lenders) in relation with the risks undertaken.

942 equity investments & 163 mezzanines

Two series of investments in leveraged buyouts, taken from the CPR Private Equity database, of 942 equity investments and 163 mezzanine investments measure the comparative performances over the period from 1990 to 1999. The overall IRR (gross) comes to 34% for equity and 21% for mezzanine:

→ 34% for the equity & 21% for the mezzanine



Out-Performance of equity with a high risk profile

The out-performance of the sample of equity investments varies over time. Sometimes it is reduced and it can happen that mezzanine out-performs equity. The overall out-performance of equity is the counterpart of a risk taken by the equity providers, which is measured by a 15% loss on the total capital invested of the series of equity investments. The returns on the best transactions are, however, high enough to compensate for that loss.

¹ In the United States the word *mezzanine* refers to both *real estate mezzanine* and hybrid products used in acquisition finance and buyouts, it is the latter category which interests us in this study.

Not surprisingly the risk profile of mezzanine is different. The total capital loss for the series of mezzanine investments is below 2.4%.

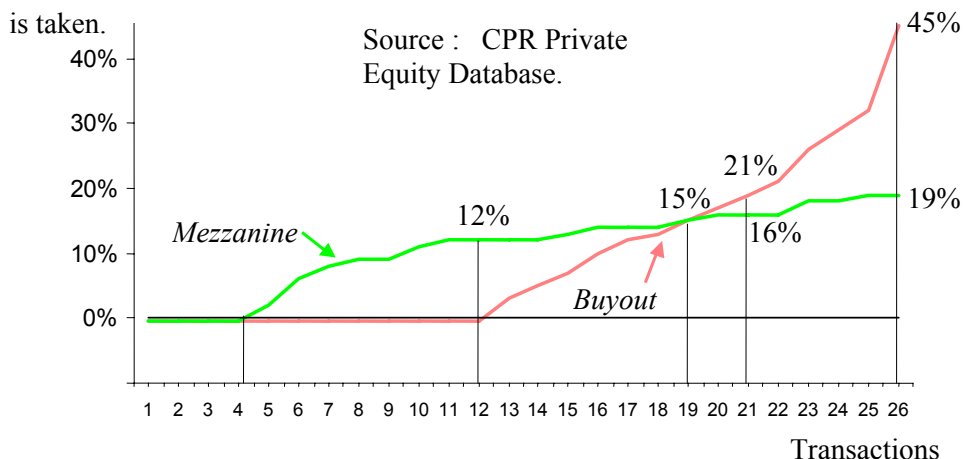
Mezzanine reflects the overall return of the buyout market

A detailed analysis of a typical transaction shows the composition of the returns of the two different categories of investment: the IRR of a mezzanine investment in a leveraged buyout is close to the overall return of the transaction including that of the senior debt. The IRR of the equity investment depends on the changes in the value of the target company. The equity outperforms the mezzanine when, in terms of target company value, a growth threshold is reached.

26 buyout transactions with both equity and mezzanine investments

Having said this, the number of cases where this threshold is crossed is not very high. A comparison of two series of investments made in the same buyout transactions illustrates the point. The comparison confirms that the out-performance of the equity results from a limited number of very profitable transactions:

IRR after each account is taken.



→ The out-performance of the equity is due to the best 4 transactions

Composition of IRR base zero for 26 transactions that used either a buyout or mezzanine investment (1990-1999)

This explains the differences in risks and returns between equity and mezzanine investments in European buyouts. During the 1990s the buyout market became organized and its practices standardized. As a result the risk of the overall market was reduced but the reward to the equity provider was preserved, and so was the market dynamic.

The risk of the buyout market has been reduced

Mezzanine financing, which has contributed to organizing the market, has benefited from the risk-adjusted returns of the overall buyout market. The performance of mezzanine remains lower than that of the best equity providers which enjoy the out-performance of a small number of very profitable transactions. The mezzanine risk/return profile is, however, very attractive.

Attractive risk/return profile for mezzanine

Mezzanine finance also differs from equity finance in terms of management style. There are very few independent mezzanine fund managers, and much fewer than for the equity providers. They face competition from the banks but have, nonetheless, easy access to a large number of opportunities. This is why they have no difficulty in satisfying the constraint of a higher risk diversification which is imposed by the return profile of mezzanine funds.

A specific management style ...

... with high risk diversification

Summary

For convenience, our study makes a distinction between the buyout funds that have equity investment policies and the mezzanine investors (which includes mezzanine funds) who utilize mezzanine finance.

The study begins with a look at the development process of mezzanine finance. Then it proceeds to compare the theoretical behaviour of a mezzanine investor and a buyout investor, detailing a typical transaction. Next, the analysis expands to examine two portfolios and the performance of two series of 26 investments of buyout and mezzanine funds, between 1990 and 1999. The conclusions drawn from these analyses allow us to better interpret the historical characteristics of both markets, starting with the transactions in our own database.

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The Development of the Mezzanine Market during the 1990s

MEZZANINE AND BUYOUT

The 1980s in the United States

The recent history of the Mezzanine finance market is parallel to that of the buyout market. In the eyes of capital investors, mezzanine finance has a well defined beginning: the appearance of acquisition transactions, as opposed to strategic acquisitions, in the United States in the 1980s. Mezzanine finance was one of the financial innovations developed by the pioneers of the American buyout market and of high yield obligations.² It contributed to the increase in leverage transactions and to the restructuring of the American industry in the 1980s.

Nevertheless, to the United States, mezzanine finance has become a key financing tool for the mid-sized firm. It is a nice alternative to bank debt, which is not easily obtained for a medium term, and to high yield bonds that are reserved for large, well-established businesses. Mezzanine finance was used equally effectively to finance the investment expenditures of the communications and technology sectors of the economy.³

In Europe, Mezzanine = 85% buyout financing

In Europe, private equity transactions make up the entire mezzanine investments market. Within private equity, buyout represents 80% of the transactions and 85% of the mezzanine market value between 1995 and 2002. The remaining balance was comprised of capital development transactions.

THE DEVELOPMENT OF MEZZANINE FINANCE IN EUROPE

Two statistics measure the development of mezzanine finance in Europe.

5,1 billion Euro in 2002

1. Mezzanine investments have increased steadily to reach 5.1 billion euros in 2002, 11 times the amount invested in 1995 (an increase from 0.5 billion to 5.2 billion euros).

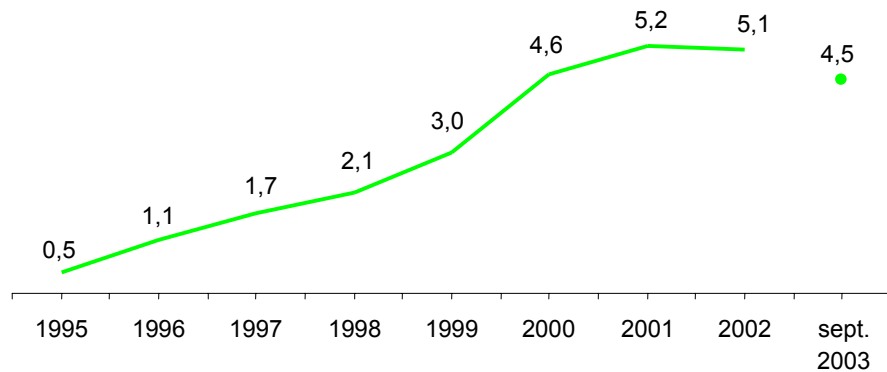
² Taken from the historical background in our study: *Le buyout Européen: historique, situation et performance*, de février 2002.

³ 42% of mezzanine investments in 2000 took place in the communications sector and 18% in the software sector. (Venture Economics, *Private Equity Market Update 2001*, NYSSA Conference, 15 May 2001 (www.ventureeconomics.com)).

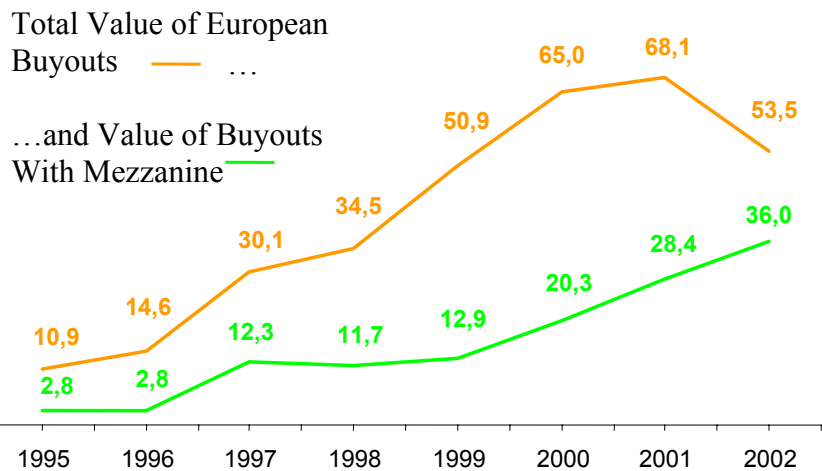
2003 Trends

The 2003 figure should continue the upward trend as the investments had already reached 4.5 billion euros at the end of the third quarter⁴.

Mezzanine Investments in Europe in Billions €



2. The measured value of the completed buyout transactions, with and without mezzanine finance, provided by *Venture Economique*, illustrate the increasingly large role of mezzanine finance in the European buyout market⁵:



The two curves are not parallel. Between 1998 and 2000, the value of the total buyout market grew faster than that of buyouts incorporating mezzanine financing.

Mezzanine investors focus on large transactions

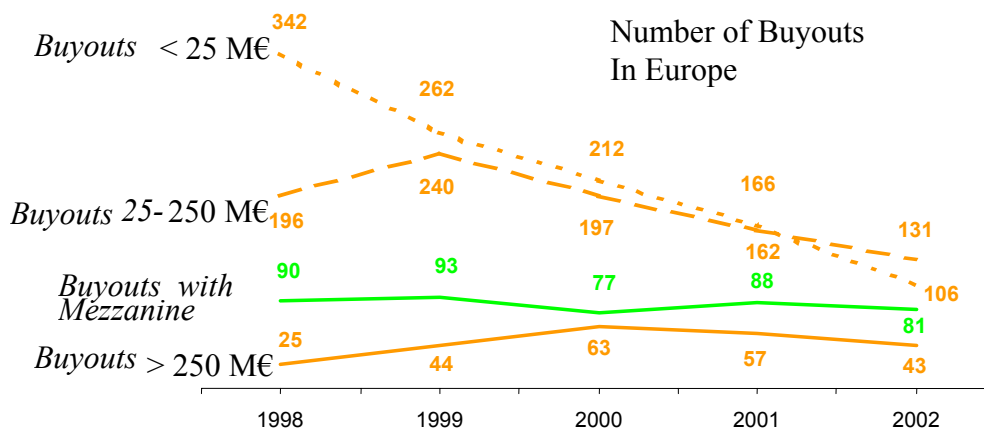
This phenomenon results from both the relaxation in banking finance constraints during this optimistic period (see below), and mezzanine finance's focus on large transactions.

⁴ Source : Initiative Europe, *The Europe Mezzanine Review*, 2003 (www.initiative-europe.com).

⁵ Ibid.

Variations in the Buyout Midmarket

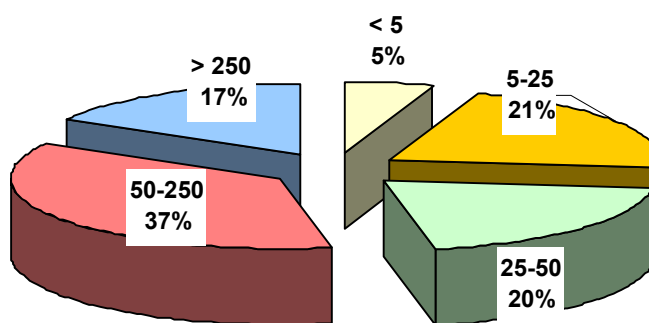
The observable trend regarding the number of transactions illustrates the consistent development of mezzanine finance in contrast to the more variable development of the buyout market, especially in the mid-market sector.⁶



MEDIUM AND LARGE BUYOUTS

Accordingly, mezzanine finance deals with primarily medium and large buyouts with large transactions comprising the majority of the investments. While its role in the realm of mid-sized transactions is well established, mezzanine finance is notably absent from any transactions involving less than 10 million euros.

Representation, by size, of the number of transactions with mezzanine 1995-2001



Average value of buyout transactions with mezzanine > 400 M€

In 2002, the average value of buyouts using mezzanine financing reached 406 million euros, larger than the average amount of all European buyout transactions involving more than 10 million €⁵ (184 million €).

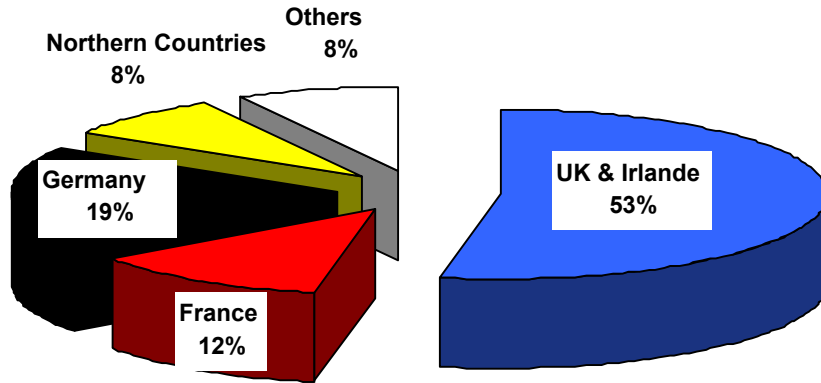
⁶ Source : Initiative Europe, *Europe Buyout Review*, et *The Europe Mezzanine Review*, 2003 (www.initiative-europe.com). It did not take account of buyouts whose size was not specified.

GEOGRAPHIC DISTRIBUTION

**British
Predominance**
...

There is a noticeable British prevalence in the geographic distribution that started in the early 1990s and that is now characteristic of the entire European private equity market. In 2002, the distribution was as follows:

Distribution of Mezzanine Investments in 2002



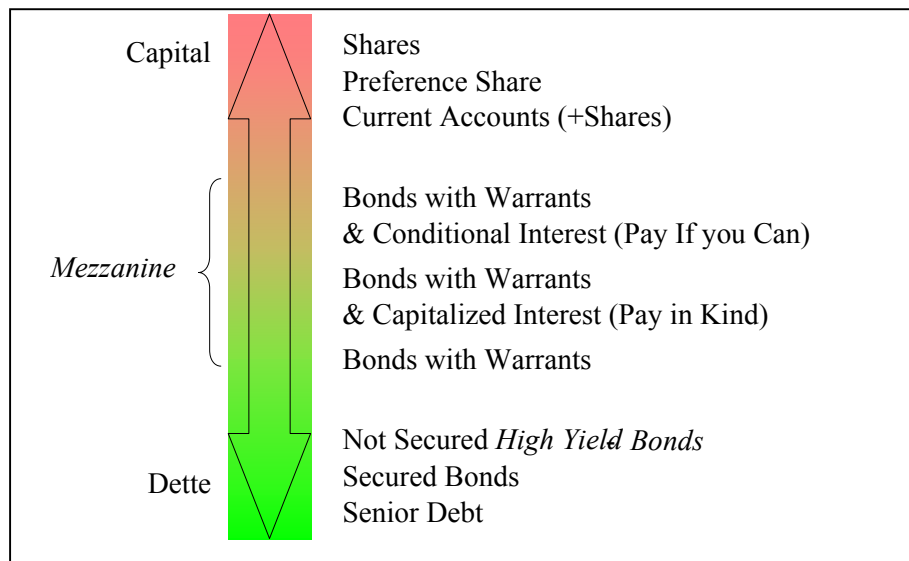
... but France
and Germany
and quickly
growing

British preponderance is, in fact, accentuated in the case of the mezzanine because its development reflects the maturity of the markets. Since 2001, however, the distribution has begun to change, most noticeably due to parts of Germany's, and in particular France's, increasingly mature buyout markets.

WHICH SECURITIES ?

The mezzanine market in Europe came about in response to need for hybrid securities. The following graph classifies the most popular mezzanine securities falling on a scale between debt and capital.

**Diversity of
Products**



**By definition,
there are four
criteria**

The classification criteria for the securities between debt, mezzanine and equity go beyond the passage of the creditor's status to that of the shareholder. There are four criteria as follows:

- The presence, or lack thereof, of company securities and the debt's ranking over company securities in the event that the firm fails
- The schedule of interest flows and settlement
- Access, or lack thereof, to the company's stake in the capital
- The listing, or lack thereof, of the security. This criterion distinguishes mezzanine finance from high yield bonds, which often have similar characteristics (as in the case of mezzanine without access to the capital). A high yield bond is a public bond, whereas a mezzanine security is not.

The refinement of financial engineering has subsequently led to the creation of a larger variety of mezzanine securities, thereby combining these criteria:

**Obligations
rank less than
senior debt**

- The simplest security is a bond, refundable by equal annual installments, and profiting from guarantees based on the securities of the company. This security, paired with warrants, is one tier below senior loans.

**Prime
Obligation**

- A second type of security, starting with the same concept, modifies the schedule of payment of interest or settlement of capital. Mezzanine finance, in general, takes the form of a premium settlement bond in which a part of remuneration, capitalized, is paid in the form of a premium account at the time of the settlement, this last step being deferred; In certain cases, all of the issued bonds are refundable in fine. The interests are occasionally completely capitalized, as in the case of mezzanines known as PIK (Pay in Kind). Such an assumption thereby closes the gap between the mezzanine and the capital by nature of the risk taken;

PIK

Pay If You Can

- Another variation can arise when establishing a flexible remuneration: the mezzanine's interest increases or decreases according to the financial standing of the firm, as evidenced by previously established criteria. The mezzanine becomes a kind of profit-sharing loan, for which the current returns depend on the success of the firm. This scenario gave rise to the mezzanine principle called "Pay if you can".

**Mezzanine and
High Yield**

- Finally, by default, the mezzanine incorporates both private bonds and non-guaranteed debt, neither of which have access to the capital. These unwarranted securities are comparable both to debt securities and high yield bonds. It is, in fact, accurate to say that it is generally concerned with the issuing of bonds alluded to within the framework of global finance, through which mezzanine investors profit from access to the capital along with other financial slots.

A product of Debt

Careful examination of this scale of securities shows us that in spite of its hybrid nature, the mezzanine is inherently a debt security. In all the hypothetical cases, the mezzanine investor accesses a small share of the capital of the financed company; it is not interested in assuming the position of shareholder, but rather wants additional returns. Mezzanine finance assumes a more important risk, on the other hand, than that of the senior debt lender, as it is on a lower tier and has a later pay date.

WHY MEZZANINE ?

The structured Finance Market ...

The mezzanine, as a debt security, owes its recent development throughout Europe to the evolving European structured credit market that has been becoming increasingly efficient ever since the mid 1990s.

... including lots of actors ...

In Europe, like in the United States, there are many players in the buyout market: managers of buyout or mezzanine funds, but also the structured finance groups from commercial banks, to consultants, lawyers, investment bankers, intermediaries...

The buyout market is a source of income (capital gains, interests, commissions, fees) for all those involved. They are all interested in its development, especially since past performance would indicate that the buyout market is less cyclic than that of merger-acquisitions involving large companies.

... had a crisis in the early 1990s ...

After an exhilarating expansion in the 1980s, however, the buyout market fell into a growth crisis during the early 1990s. Amidst many failures between 1990 and 1993, including the temporary collapse of the junk bond market in the United States, there was a significant reduction in returns. This crisis illustrated to all the equity market players, as well as to the risk managers of the banks, that leverage buyouts were not always profitable.

... then normalized

Also, when the market started up again in the mid-1990s, all the players contributed to the search for stability:

Less leverage ...

- The risk/profitability profile of the market, through the global reduction of leverage transactions,

... & hierarchy of remunerations

- and the hierarchy of risks and remunerations amongst the players: it quickly became obvious to senior debt lenders that the repercussions of the 1980s, that were characterised by large amounts of debt and few capital stocks, were forcing them to assume the entire risk of the transaction for only meagre compensation.

Credit Norms

...

The banks accordingly established several standards not only leading to a better balance between the contributions of various actors (ratios of debt to EBIT⁷), but also leading to a close watch over the course of transactions (ratios of financial expenses⁸). The ratios that followed made it possible for banks to quickly establish guarantees in the event of foreseeable difficulties.

... in the US and Europe

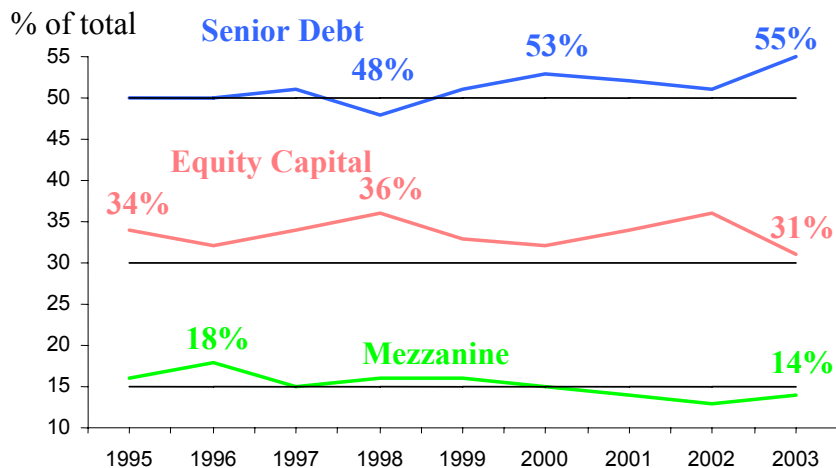
The buyout market is also controlled by a set of professional criteria, which determine both the methods of the studies conducted (standards of due diligence), financial arrangements, and the rules applying to follow-up. Established in the United States, these standards spread to Europe in the 1990s by means of large buyout transactions and have since been adopted by small and medium firms for use in their own buyout finance policies.

The Mezzanine permits the application of those norms

The mezzanine is a useful tool as it makes it possible to reconcile the interests of all the actors involved while at the same time respecting the established professional standards, mainly because of its hybrid character, the diversity of the products which it covers, and its flexibility. Banks are, consequently, able to respect the financing ratios established in the form of multiples of the EBIT, without sacrificing the potential returns of the buyout fund, the impetus behind the whole market.

Europe establishes financial ratio statistics regarding buyout transactions⁹:

Ratios of Buyout Finances



Distribution of European Buyout Financing Including Mezzanine

On average, the ratios are: 34% in equity, 15% in mezzanine, and 51% in senior debt.

⁷ Earnings Before Interest and Taxes

⁸ *ibid.*

⁹ Source: Initiative Europe, *Mezzanine : A European Overview*, 2002, et *Mezzanine Monitor Third Quarter 2003* (www.initiative-europe.com)

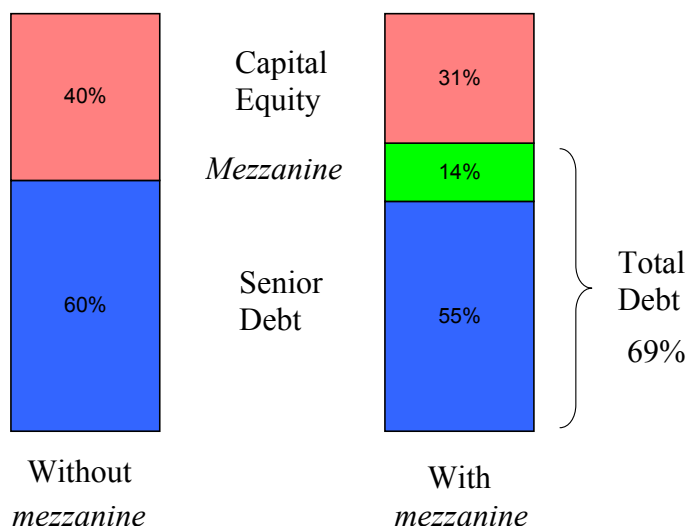
High quality transactions during the crisis

Time variations in the ratios, such as are evidenced by the progression of the levels of debt since 1998, can be explained by both the nature of the transactions and the general economic situation. Both these factors have similar ways of influencing the market: during strong economic periods, the acquired firms are smaller, and thus the transaction is riskier. In more difficult periods, however, the transactions involve target firms with more stable cash flows. Even when more expensive, however, these targets have higher levels of debt and thus, paradoxically, the rates of debt increase rather than decrease during the more difficult economic periods.

In this scenario, mezzanine finance is responsible for balancing the market. An analysis of the financial structures of buyouts in 2003 illustrates this point¹⁰:

The mezzanine's share is from both debt and capital equity

Distribution of European Buyout Finance in 2003 with and without mezzanine financing



A sign of maturity

A retreat to mezzanine finance has the effect of at the same time reducing the distribution of the debt and that of the capital stocks. In the end, the recourse to mezzanine financing results in a slight increase in the total debt. Taking into account the range of possible remunerations, the changes in the risks assumed by the senior banker change very little. On the other hand, the lower ratio can significantly improve the profitability of the capital stocks.

Consequently, the need for mezzanine financing increases in proportion to the maturity of the market and finance firms.

¹⁰ Source : Initiative Europe, *Mezzanine Monitor Third Quarter 2003* (www.initiative-europe.com).

Refinancing and Secondary Buyouts

This conclusion is substantiated by the role of mezzanine investments in the secondary buyout transactions, and in buyout refinancing transactions¹¹. The financial community involved in such transactions (fund managers, bankers, consultants) can easily work out complex financial arrangements for the companies they know well, as in most cases, they have tracked their growth for many years. The flexibility introduced by the arrival mezzanine makes it possible to finalize a suitable transaction, whereas the potential growth of the target firm can be somewhat reduced.

Unfortunately, we do not have to date statistics that would allow us to fully apprehend secondary buyouts, nor do we have the unit weight of the mezzanine in these transactions¹².

MEZZANINE FINANCIERS IN EUROPE

First banking teams ...

The inherent features of the mezzanine explain why the main actors in the mezzanine market are initially banking groups, whose profession is essentially founded on credit risk analysis. In Europe, a large number of banks are simultaneously involved with both the senior debt and the mezzanine markets.

... looking for commissions ...

With all the various actors vying for the largest commissions and smallest risks while still respecting the established standards, the position of lead investor is considered to be extremely rewarding.

... and supporting the demand for buyout funds

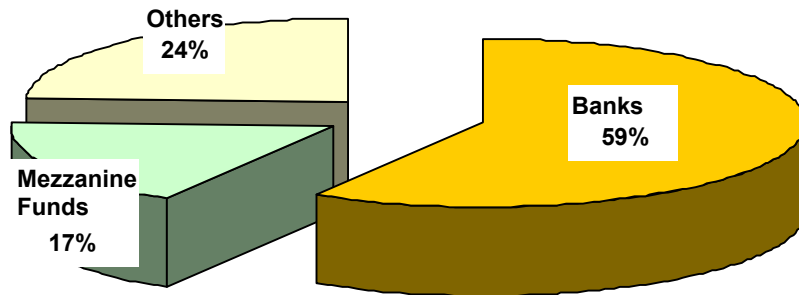
The financial propositions and recruitment of clients on the part of the banks and the mezzanine groups is thus quasi-exclusive toward the managers of buyout funds who play a large role in expanding business for the whole financial community. This explains why, in essence, preserving the profitability of the buyout funds may be beneficial to all the actors involved in the market.

¹¹ Secondary Buyout: a buyout involving a firm bought by a buyout fund who subsequently leaves the transaction. Refinancing: restructuring of the buyout debt through the repayment of the initial debt before the due date and the creation of a new senior debt. This method often consists of the creation of a new holding that buys bonds from the initial recovery holding and allows the buyout fund to amass capital profits on its initial investment (the balance having been reinvested in the new holding) or to reduce the capital of the holding.

¹² Our database indicates that for many transactions, the mezzanine investments were made after the initial buyout

Predominance of Banks

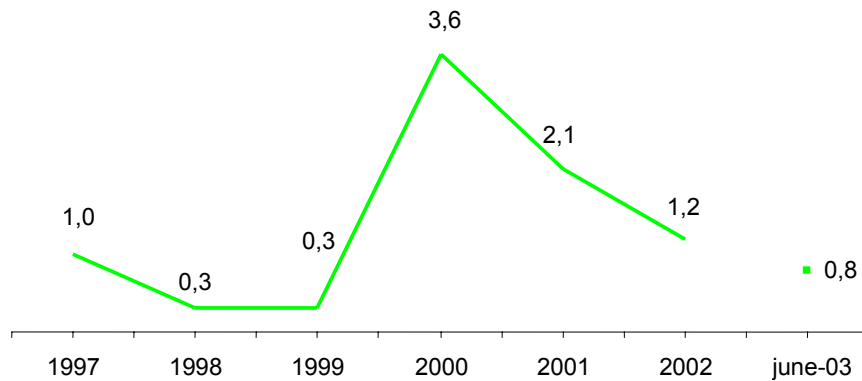
The following diagram illustrates the distribution of financial actors in mezzanine finance in Europe between 1995 and 2001, in number of investments:



Few Independent Funds

The job of independent manager of mezzanine funds is considerably less developed in Europe as compared to in the United States. The recent fundraising figures are as follows:

Mezzanine Fund Raising in Europe in billions €



These raised funds are centred around a small number of actors (less than 10 raised funds per year). The reduction in fund raising in 2002 is in keeping with the general European capital-investment trends. In the first half of 2003, fund raising was higher than in the first half of 2002.

Private management funds

Certain mezzanine funds are managed by banking groups with the support of their credit management teams. They are marketed within the vicinity of their private management customers. The mezzanine is thus presented to the client as if it were a bond security rather than a capital investment security.

Complexity of mezzanine funds

Additionally, one should note that the creation of a mezzanine fund is always complex, especially if it is considered Pan-European. Mezzanine funds take into account not only capital gains, but also interest returns. The risk of increased tax burdens, with holding tax, is higher than in the creation of buyout funds.

Easy access to a large number of clients

The narrow nature of the market of independent mezzanine funds in Europe favours fund managers, but that is not to say that the competition in the mezzanine market is any weaker than in the buyout market. Clearly, banks are the main active competitors and capital offers abound, but the managers of buyout funds, who have far more independence than the banks, have a distinct advantage¹³.

CONCLUSIONS OF THE MARKET ANALYSIS

Three conclusions can be drawn based on market research.

1. **Five billion euros are invested in the mezzanine market every year.** Thus the mezzanine market has grown substantially.
2. **Its development is a result of the standardization of structured financing,** including that of the buyout market. Mezzanine finance satisfied the need for a balance between risk and profitability in the market and it established a hierarchy based on the risks taken and the remunerations of the parties involved.
3. **There are very few independent mezzanine fund managers,** far fewer, in fact, than buyout fund managers. Consequently, they have easy access to a large number of potential clients in a market dominated by bankers.

¹³ They have the usual advantages of independent teams: the absence of any conflicts of interests, stability, and exclusive specialization

CHARACTERISTICS OF MEZZANINE FINANCE: THE MODELING OF A TRANSACTION

4 investors

The analysis of a buyout transaction enables one to characterise the behaviour of a mezzanine investment.

We analyze various assumptions about the progression of the transaction from the point of view of four hypothetical actors:

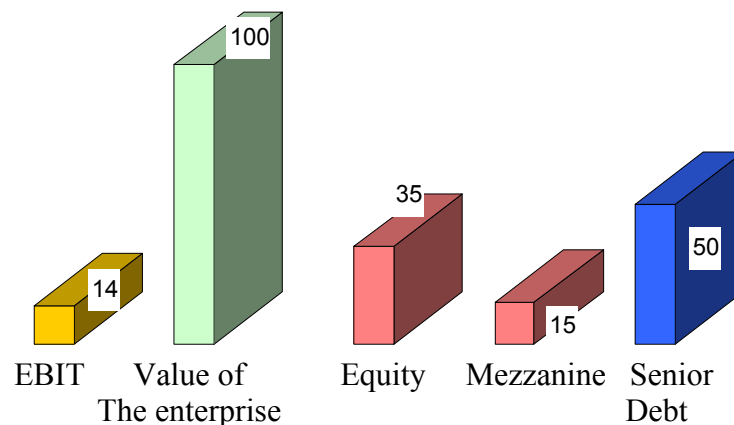
- The equity investor (called the buyout fund)
- The mezzanine investor
- The senior banker
- And a fourth investor, called the global investor, who chooses to finance the transaction through each of the above-mentioned methods¹⁴

The basic rate in the medium term¹⁵, referring to the risk free rate, is supposed to be 4%.

ANALYSIS OF A BUYOUT TRANSACTION

The key figures of the transaction are expressed as a percentage of the acquisition value of the target firm:

**Hypothetical
Transaction =
35% capital
equity & 15%
mezzanine**



¹⁴ Such investors exist to handle the small transactions. An industrial purchaser, who would assign the transaction various types of financing (in debt, obligations and shares) would be in the position of this theoretical investor.

¹⁵ A rate similar to a resource rate, or at an opportunity cost for the investors.

7,1 fois l'EBIT

The firm is acquired at a value (100) worth 7.1 times its EBIT (14). Half of the financing is secured by senior debt, at 7 years, refundable by equal annual instalments. It is assumed that the contractual remuneration of the senior banker is equal to the annual interest that is calculated based on the basic rate for a medium term plus an additional 2%.

The mezzanine accounts for 15% of the acquisition price. Subordinate to the senior debt, the mezzanine allows the senior banker a 1 to 1 ratio of debt to equity or assimilated equity. It also allows the buyout funds, responsible for the transaction, to limit the amount of equity to 35% of the value of the firm.

Thus the mezzanine has, in theory, the following characteristics:

Duration of 3 years ...

- a duration of 3 years, to be paid in a lump sum at the end of that period
- interest, paid annually at 3% more than the average long term rate,

... base rate of 3% ...

- capitalized interests, payable at the time of settlement in the form of a premium account, calculated on the basis of a 5% interest rate per year,

... 5% interest rate

- the issue of warrants attached to the financing and allowing for the purchase of shares in the holding, on the basic subscription value of 35 up to a total stake of 3.75% of the capital.

... 3.75% of the capital

It is subsequently possible to observe the outcome of the four actors based on several assumptions about the progression of the transaction.

HYPOTHESIS 1: TOTAL FAILURE (Difficulty with the holding)

If payments cease ...

In the event that the holding stops payments, only the senior banker and the mezzanine investor (and consequently the global investor) are likely to recover part of their capital. The buyout fund loses its entire investment.

... the recovery rate depends on the guarantees

The fate of the senior banker depends on its previously established guaranties. We do not have statistical data examining the levels of investment recovery in failed buyout transactions. The amount that can be recovered depends on the amount of debt and the quality of the assets on which the guarantees are based. The guarantees refer to the shares and, in keeping with the Anglo-Saxon right, to the assets of the targeted firm.

**Recovery >
60% on
guaranteed
debts**

A study of buyout transactions in Europe, published by the Deutsche Bank, emphasized a good rate of recovery of the senior debt when the latter was guaranteed. On average, the rates of recovery on senior debt of the companies in receivership, the United Kingdom, France and Germany in the analyzed sample, were as follows:

- approximately 60% on guaranteed debts (“protected”)
- approximately 30% on non-guaranteed debts

**→ 45% for
mezzanine?**

Thus, the position of the mezzanine investor depends, like that of the senior banker, on what guarantees it has. When it is protected by guarantees, the average level of recovery for the mezzanine investor is better than that of the senior banker who is not guaranteed and receives, on average, approximately 45%¹⁶. In the current market, however, one sees the development of non-guaranteed mezzanines. In this case, the risk of losing everything (following the example of a buyout fund) in the event of the failure of the holding grows larger.

**United
Kingdom
>Germany and
France**

There are important differences between levels of recovery in England, on the one hand (on average, 82% of guaranteed senior debt is recovered), and France and Germany (52%) where the bankruptcy procedures favour public and social creditors, over the creditors who would profit from the guarantees. British bankruptcy law is, however, in the process of becoming less and less favourable towards guaranteed creditors.

HYPOTHESIS TWO: AN EXTREMELY PROFITABLE CASE WITH EXIT AFTER THREE YEARS

**Very Profitable
Case =**

This second hypothesis is the complete reverse of its predecessor. In this case, the assumption is that the transaction benefits from three extremely favourable conditions:

**All the good
characteristics
of a buyout ...**

- the progression of benefits from the target company. All the positive aspects of a buyout are present: a reduction in the agency effect in the behaviour of the management, a reduction in costs, and an increase in market dynamics due to an increased focus on basic activity¹⁷. We have retained a increase of the EBITDA of 20% in 3 years,
- a quick sale, 3 years after the initial buyout, with a purchaser, industrialist or financier, hoping to acquire developing corporations

**... in three
years ...**

¹⁶ Figures presented by Michael Jinn, Head of Securitised Products de Deutsche Bank, at a conference on mezzanine finance in Europe, in London, October 22, 2003

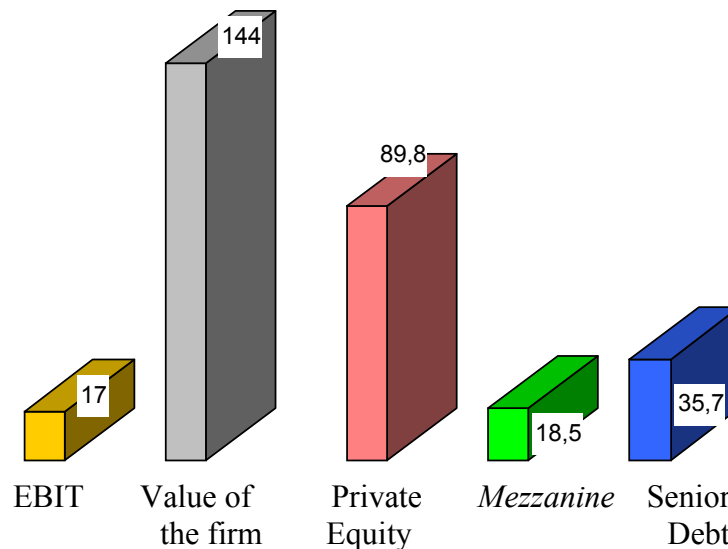
¹⁷ For information on these potential, favourable effects of a buyout, please see our study of February 2002, “The European buyout: history, situation and performance”

... with
multiple
arbitrage

- Establishment of multiple arbitrage, that is to say: transfer on the basis of a superior multiple to that established at the start of the transaction, due to a strong desire on the part of the buyer. In our hypothesis, we kept an increase of 20% of the multiple, that correspondingly changed from 7.1 (the initial multiple of the buyout) to 8.6.

In this case, a reasonable scenario when compared to the most-profitable transactions of the buyout, the value of the firm would increase by 44% in three years, to reach 144 (compared to the 100 of the buyout).

Taking into account the debt settlement of the holding, the payment of the premium account, the settlement of the mezzanine, and the exercise of warrants by the mezzanine investor, the principle data figures for the transactions would be as follows:



Thus, the returns of each theoretical investor would be as follows:

Global TRI = 21%

Buyout = 37%

Mezzanine = 18%

- Returns for the global investor (this is the total returns for the transaction): IRR of 21%, multiplied by 1.7
- Returns for the buyout fund: IRR of 37%, multiplied by 2.6
- Returns for the mezzanine fund: IRR of 18%, multiplied by 1.6
- Returns for the senior banker: equal to the remuneration specified in the contract

The success of the transaction favours the buyout fund, whose returns are appreciably higher than those of the mezzanine fund.

HYPOTHESIS 3 : SOMEWHAT PROFITABLE CASE WITH EXIT AFTER 3 YEARS

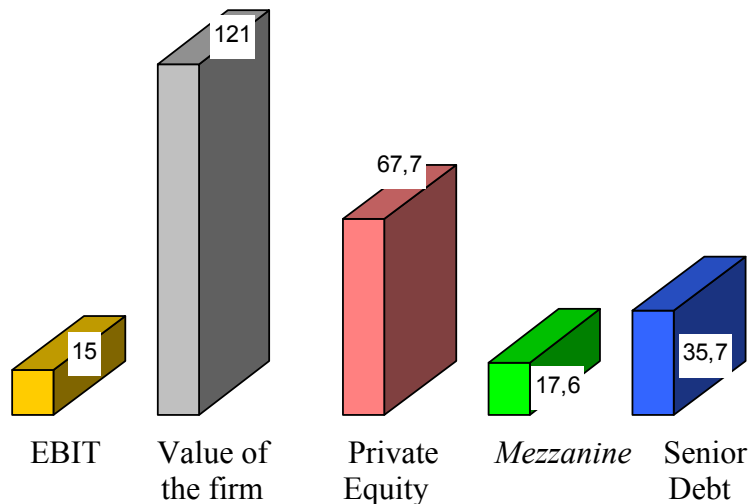
This third hypothetical situation involves a more typically successful transaction:

Normal buyout scenario...

- The target firm grows, but only 10% over 3 years
- The sale is still established 3 years after the initial transaction
- The sale conditions are less favourable. The arbitration multiple is weaker: the sale is carried out on the basis of a rate 10% higher than that established at the start of the transaction, which would be: 7.9 (compared to the original 7.1)

In this scenario, which would be fairly average in the European buyout market, the value of the firm would increase by 20% in three years, to reach 121 (compared to 100 at the time of the buyout).

The principle data for this transaction would be as follows:



Global TRI = 15%

Buyout = 25%

Mezzanine = 16%

Thus, the returns of each of the theoretical investors would be as follows:

- Returns for the global investor: IRR of 15%, multiplied by 1.5
- Returns for the buyout fund: IRR of 25%, multiplied by 1.6
- Returns for the mezzanine fund: IRR of 16%, multiplied by 1.5
- Returns for the senior banker: equal to the remuneration specified in the contract

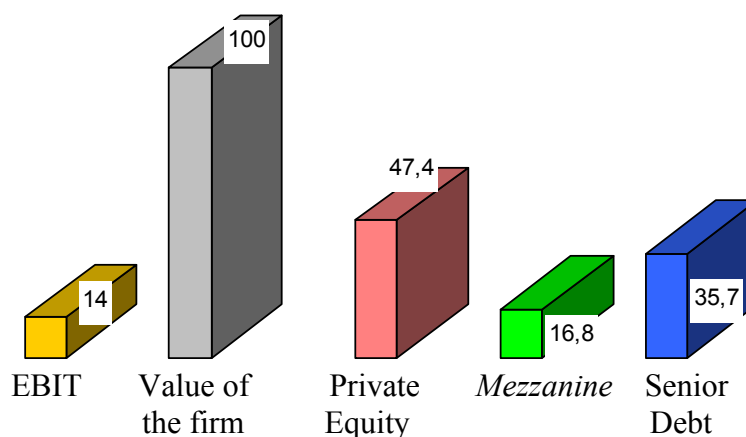
HYPOTHESIS 4: NEUTRAL CASE WITH NO DIFFERENCE IN THE VALUE OF THE TARGET FIRM

This fourth hypothetical case represents a partial failure of the transaction:

- The profits of the target firm are stable. It ensures repayment of the acquisition debt, but does not profit from any additional favourable effects (no new acquisitions, no increases in productivity and no market expansion)
- The sale is still conducted 3 years after the initial transaction
- The conditions of the sale are exactly the same as the original. The multiple is stable at 7.1.

Neutral case = stable target value

The principal figures for this transaction are as follows:



Thus, the returns for each theoretical investor are as follows:

Global TRI = 9%

Buyout = 11%

Mezzanine = 15%

- Returns for the global investor: IRR of 9%, multiplied by 1.3
- Returns for the buyout fund: IRR of 11%, multiplied by 1.4
- Returns for the mezzanine fund: IRR of 15%, multiplied by 1.5
- Returns for the senior banker: equal to the remuneration specified in the contract

The mezzanine investor's returns are thus better than those of the buyout fund. The mezzanine fund benefits from the debt revenues and from the redemption premium. The buyout fund benefits only from the leverage (settlement of the acquisition debt).

HYPOTHESIS 5 : UNPROFITABLE CASE INVOLVING EXIT AFTER 3 YEARS

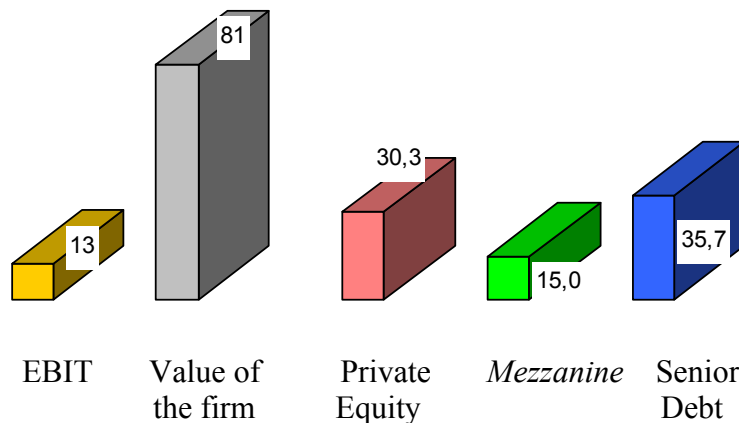
This hypothesis presents the case of a failure in the transaction that does not result in the holding stopping payments, but rather the value of the target enterprise falls due to unfavourable market conditions or the effects of management changes.

Loss of 20% in the value of the target firm

- The profits of the target company fall by 10% over three years
- The sale of the business still takes place three years after the initial agreement
- The conditions of the sale are effected by the lack of company dynamics: the final multiple is 10% lower than that at the start of the deal, which would be: 6.4 (compared to the original 7.1)

In this hypothetical case, which is actually seen rather frequently in reality, the value of the firm would decrease by 20% over three years to end at 81 (compared to the original 100).

The principle data would resemble the following:



Thus, the returns for each theoretical investor would be as follows:

Global TRI = 3%

Buyout = <0

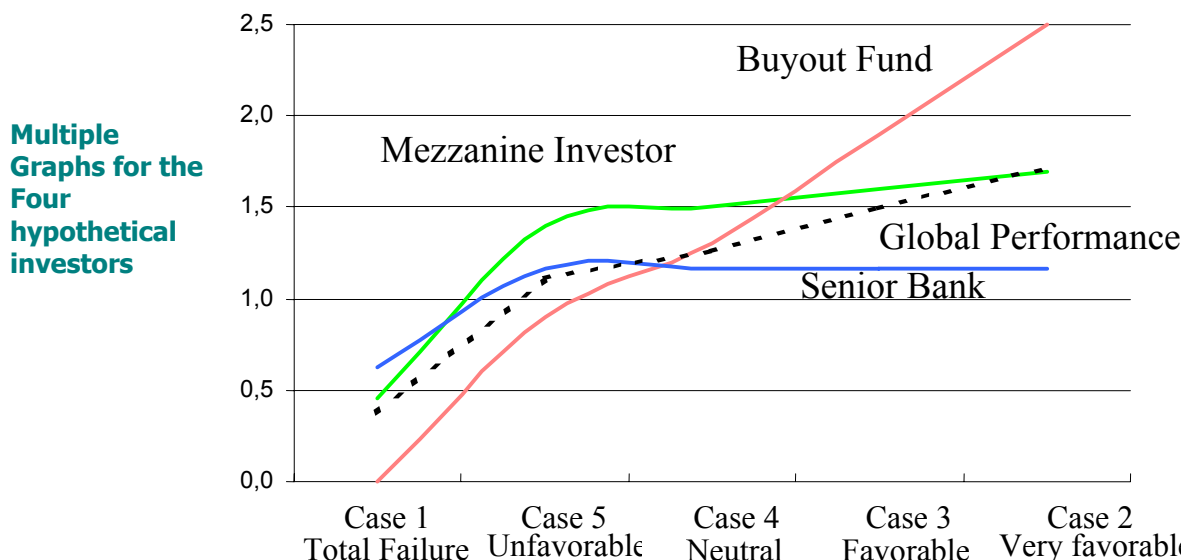
Mezzanine = 12%

- Returns for the global investor: IRR of 3%, less than the basic long term rate, multiplied by 1.1
- Returns for the buyout fund: a negative IRR, multiplied by 0.9
- Returns for the mezzanine fund: IRR of 12%, multiplied by 1.4
- Returns for the senior banker: equal to the remuneration specified in the contract

The mezzanine fund, that does not exercise its warrants for the holding company, profits from interest. It continues to profit, even though the buyout fund is losing money. The leverage alone is not enough to compensate for the fall in the firm's value. On the contrary, the mezzanine debt revenues play the role of a shock absorber.

SUMMARY OF INVESTOR PERFORMANCES

The following graph summarizes the different levels of returns for our theoretical investors, expressed in multiples of capital investments, for all five hypothetical situations (the case of total failure assumes that the mezzanine is guaranteed):



The buyout fund curve illustrates the importance of the performance gaps of the latter in respect to the total returns of the operation. It also shows that the buyout fund curve does not level out but increases steadily.

→ **absorption of risk by the mezzanine ...**

On the other hand, the senior banker curve illustrates that the senior banker has lower risks than the other investors. In the unfavourable case, the senior banker has better returns than that of the deal as a whole.

... through continuous revenues

The mezzanine investor curve shows that the continuous revenue acts as a type of shock absorber. This curve is very close to that of the global performance.

BREAKDOWN OF AN IRR

Total TRI =

An analysis of the Risks vs. returns of investors can be refined by taking into consideration the composition in returns between:

Levies on the target

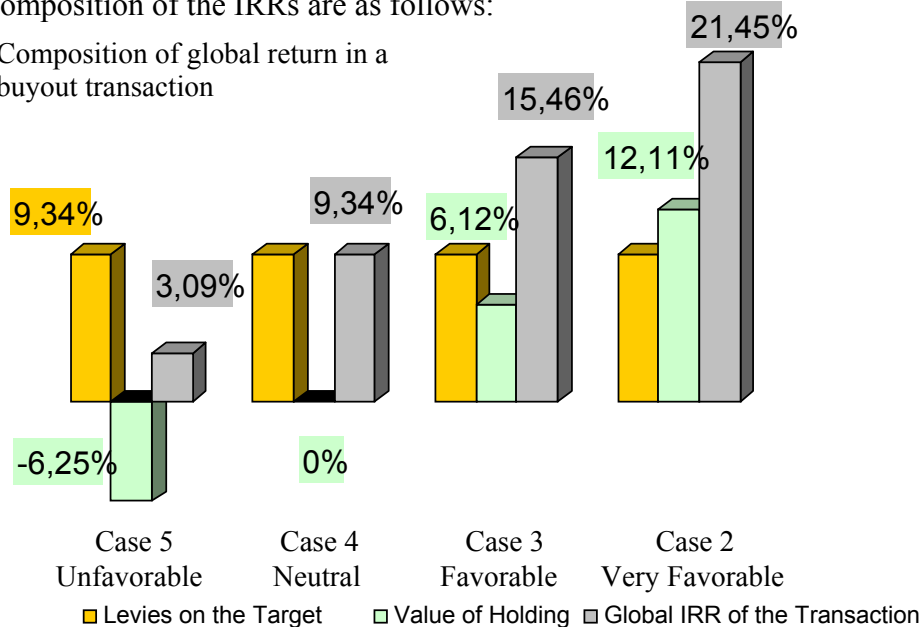
- The issued IRR resulting from levies on the cash flows of the targeted firm, which encompasses the current interests of both the senior debt and the mezzanine, including the repayment premium,
- The IRR resulting from changes in the value of the holding. These changes are random, contrary to the levies on the cash flows of the targeted firm.

+ value of the holding

Breakdown of the IRR in each of the 4 hypothetical cases

These IRRs are calculated, in accordance with the formal financial assumptions¹⁸ in every case except for the first (total failure). The level and composition of the IRRs are as follows:

Composition of global return in a buyout transaction



These calculations lead to three conclusions.

→ role of levies placed on target firm

1. The importance of levies, those made on the target firm, in the profitability of a buyout.

→ mezzanine access

In all cases (and with the assumption of a basic long run rate of 4% per year), the IRR, resulting from the levies on the cash flow of the targeted company, amounts to 9.34% per year.

This observation, in and of itself, could be enough to justify such an investment, if it was possible to easily access the source of the profits. Based on the presented hypothesis, only the senior banker and the mezzanine investor profit from the current returns.

However, this does not always represent the profits of the transaction. The buyout funds often profit from preferred shares, with respect to a priority dividend. The majority of deals in the United Kingdom utilise this method. These arrangements in no way change the nature of the risk taken by the buyout fund. In the case where the firm fails, the holder of the share does not have right to a claim in the company. Its risk is, thus, of an entrepreneurial nature.

These deals, however, serve to further increase the role of levies placed on the target firm in the total profitability of the deal.

¹⁸ Basic rate of 4% interest on senior debt equal to the base rate increased by 2%, mezzanine interest equal to the base rate increased by 3%, and the mezzanine's premium redemption equal to 5% capitalised.

Value of holding =

Transactions profits + value of the target

2. Importance of the profit resulting from the arrangement that benefits from the use of mezzanine financing.

The IRR resulting from the increase in the holding value moves from -6.25% to 12.11%, according to the documented cases. It does not have, however, any innate impact on the returns for the senior lender. Only the buyout fund and the mezzanine investor profit from it or are affected by the change.

The remuneration has two origins: a profit resulting from the establishment of the deal, and a profit related to the increase in value of the targeted firm.

The analysis of the returns in the neutral case, where the value of the target firm does not increase, illustrates the profit resulting from the establishment of the deal.

Returns for each Investor in the Neutral Case

IRR tied to the value of the holding's shares resulting from the transaction

The mezzanine → makes a profit from the transaction ...

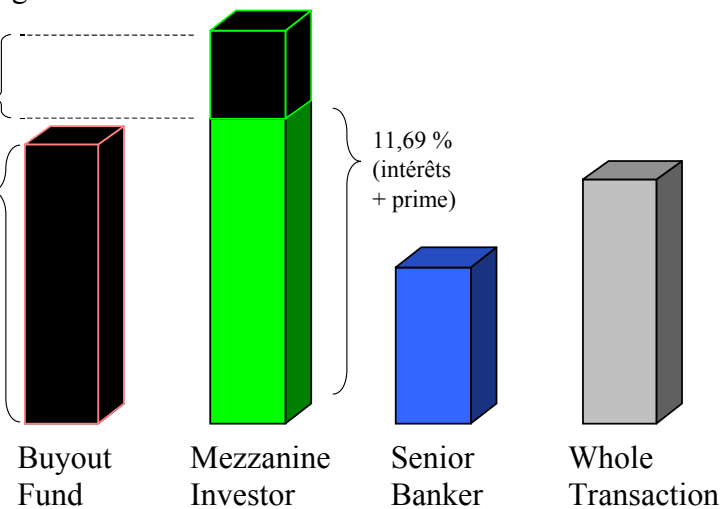
Mezzanine Investor

3,40%

Buyout Fund

10,67%

11,69 %
(intérêts + prime)



IRR for Investors : 10,67% 15,09% 6,00% 9,34%

The profits from the arrangement of the transaction, when confined to solely those due to leverage action, are measured:

... tied to leverage

- For the buyout funds: by the total returns that are 100% attributable to the leverage,
- For the mezzanine investor: by the additional output acquired beyond the IRR on the leverage on the target firm, that value being equal to 3.40%.

Thus, the mezzanine investor makes a substantial profit from the arrangement of the operation, equal to the third party of the buyout fund's profit.

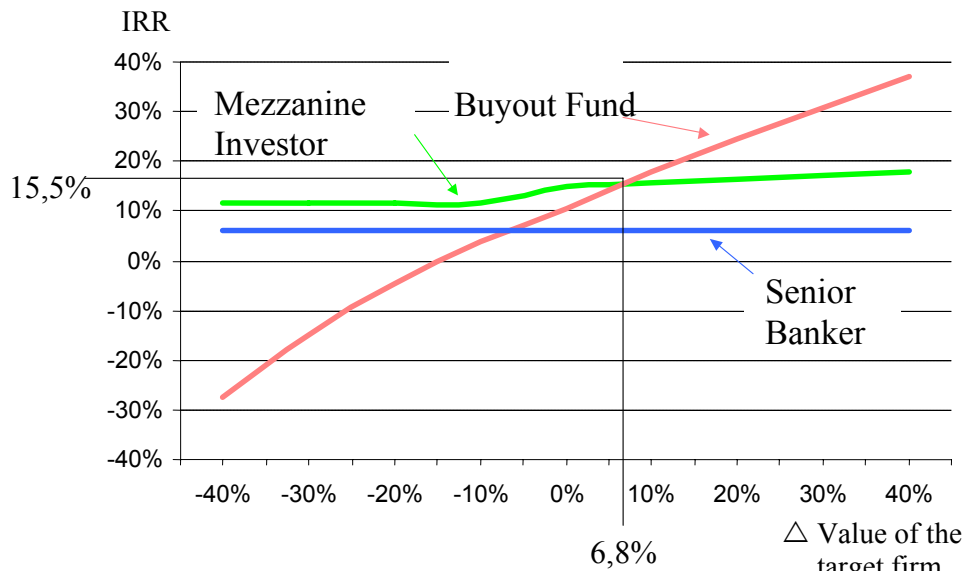
Buyout Fund → profit tied to Δ in target firm's value

3. Beyond a certain threshold, the change in value of the target company is reflected almost exclusively in the buyout fund.

The graph below presents the IRR of the investors according to the changes in the value of the firm after three years.

The IRR of the buyout fund is proportional to the changes in value of the target firm over three years:

IRR curves for the 3 hypothetical investors



IRR of investors as a function of the change in value of the target firm after 3 years (base rate = 4%)

The IRR curve for the mezzanine shows that the coupled risk/profitability of the mezzanine investor is close to that of the lender, confirming that the mezzanine is initially a credit security. The mezzanine investor functions by lending the money, assuming a higher risk of losing money than the senior banker in the event that the transaction fails, and accepting that part of its remuneration depends on the risks of the firm.

Asymptotic Remuneration of the Mezzanine

Consequently, its remuneration floor is higher than that of the senior banker, but it has a limited benefit, due to an asymptotic curve, from an increase in the value of the target firm.

Threshold at which buyout > mezzanine

The graph makes it possible to determine which area of increase in the value of the target firm, starting with the buyout fund's investment, will become advantageous: The IRR curve, net of the buyout fund, cuts into that of the mezzanine investment when the increase in value of the target over three years is limited to 6.8 (2.2 per year). At this level, the IRR of the buyout funds (equal to that of the mezzanine funds) reached 15.5%.

CONCLUSIONS OF THE THEORETICAL ANALYSIS

The examination of a hypothetical transaction leads to four conclusions:

1. The mezzanine makes a profit **in a different manner to that of the buyout funds**. The mezzanine's returns are generated by levies on the target companies and a profit related to the arrangement of transactions.
2. The profits of the mezzanine investor are subject to laws different to those of the buyout fund: **the profitability of the mezzanine investor is close to the total returns of the buyout transaction ...**
3. ... with a difference in the **profitability of the buyout funds, which are indexed on the changes in value of the target firm**.

The out-performance of the buyout compared to the mezzanine starts with the crossing of a relatively weak threshold from whence the value of the target firm increases.

4. Consequently, **the managers of mezzanine and buyout funds have different management styles**.

The mezzanine managers approach the buyout transactions with credit logic. The returns on each of their investments have an upper limit. They are forced to work under the constraints of a split risk in order to limit the impact of the loss of a deal.

The current mezzanine market, however, allows them access to a large number of clients and thus remedies this constraint

ANALYSIS OF A PORTFOLIO'S PERFORMANCE

EXAMINATION OF THE BEHAVIOUR OF 26 TRANSACTIONS IN RESPECT TO BOTH BUYOUT AND MEZZANINE INVESTMENTS

Based on the conclusions drawn from the theoretical analysis of a transaction, we analyzed the differences between the make up of a buyout portfolio and a mezzanine portfolio.

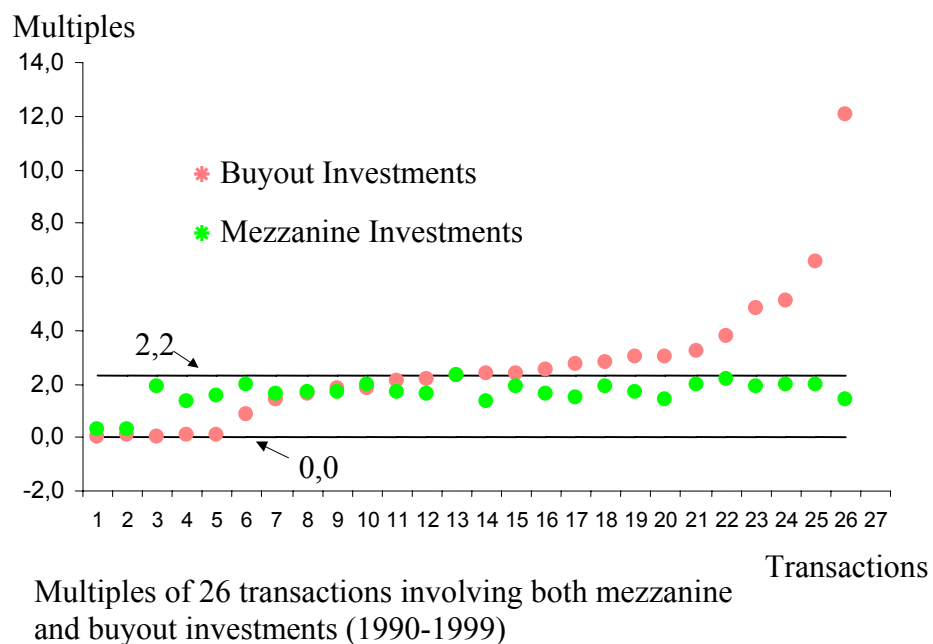
26 buyout transactions → 1 buyout investment and 1 mezzanine investment

We have, for this purpose, taken from our database a list of 26 transactions from the same time period that involve both types of financing: mezzanine investments (invested by mezzanine funds) and buyout investments (invested by buyout funds). We are familiar with the final performances of both investments in the 26 chosen cases.

The following table illustrates the distribution of the multiples:

The buyout multiples → 5 multiples at zero & one at 12 ...

... the mezzanine → fewer zeros but a maximum of 2,2



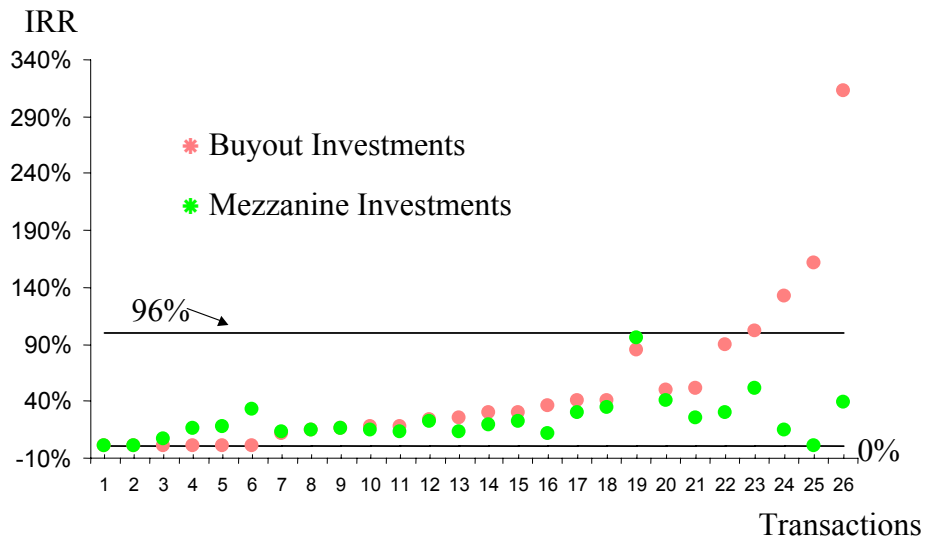
The conclusions taken from the theoretical analysis are confirmed: the buyout investments have a higher occurrence of a zero multiple, but also of a very high multiple. The mezzanine investments reach a maximum multiple of 2.2 with the median being 1.7.

Six of the twenty-six (23%) transactions were not profitable (meaning a multiple of less than one) for the buyout fund. Amongst those six, however, only three did not perform for the mezzanine.

In the twenty cases where the transactions were successful, the buyout multiple was always higher than that of the mezzanine with the exclusion of a few exceptional cases (with low multiples). That is not to say, however, that it is significantly higher in all those cases: there is only a significantly large difference in a small number of cases.

The following table illustrates the IRR distribution:

Same distribution of IRRs but a larger performance corridor for the mezzanine



IRR of 26 transactions involving both mezzanine and buyout investments (1990-1999)

The range of the mezzanine's performance is broader than in the examination of the multiples, since there are quick returns in which the IRR of the mezzanine reaches 96% (for a multiple of 2). In this case, the buyout multiple is higher (6.6) but the IRR is limited to 84%.

Additionally, a small number of cases present a significant gap between the mezzanine's and the buyout's performances.

Calculate IRR base zero with a transaction involving both mezzanine and buyout

This conclusion is confirmed by the analysis of the composition of the total IRR of the analyzed series. We have, for simplicity, calculated an IRR base zero¹⁹, of the 26 investments, one part mezzanine and the other part buyout, supposing that all the investments were of the same amount.²⁰

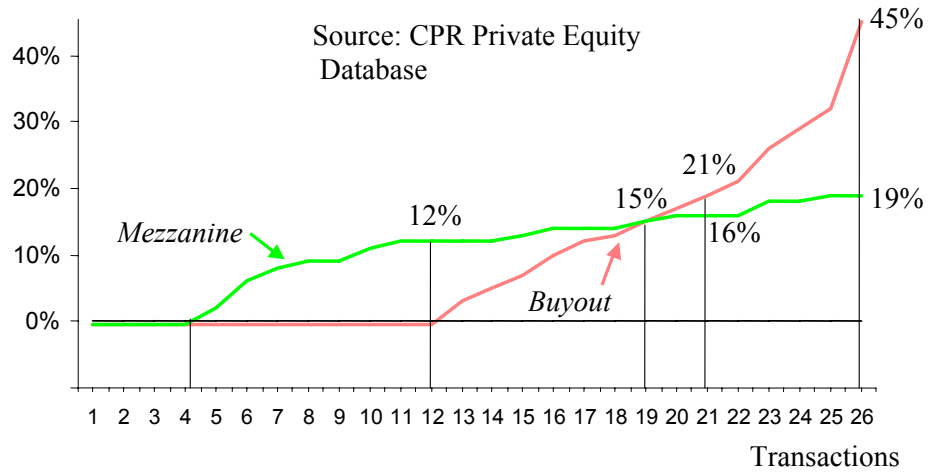
The following graph details the composition of the global IRR of the buyout series of investments and the mezzanine series of investments. The transactions are classified based on their contributions to the global IRR of the buyout series.

¹⁹ IRR is calculated based on the assumption that all the investments were realized at the same initial date (date zero)

²⁰ This hypothesis, and the calculation of the zero base, admittedly introduce another potential bias. The calculated global IRR of the investment agglomerations, however, would have been artificial in any event.

IRR taken after
each transaction

Composition
of IRR base
zero of the
two series



Composition of IRR base zero of 26 transactions involving both mezzanine and buyout investments (1990-1999)

The total result is an IRR of 45% for the buyout and 19% for the mezzanine. Thus, the discrepancy is important. What is interesting here, however, in addition to the difference between the IRRs, is their composition:

Four
transactions
that have no
IRR

The *buyout* >
the *mezzanine*
after the 19^{eme}
transaction

- The first four transaction (15% of the transactions) do not generate any IRR in either of the two series,
- then the buyout series underperforms compared to the mezzanine series. Ending with the 12th transaction (46% of the transactions), the buyout still has no returns, whereas the IRR of the mezzanine always reaches 12%.
- The buyout rejoins the mezzanine after the 19th transaction. The IRR then reaches 15%. It is thus necessary to integrate the top 8 transactions (31% of the transactions) in order for the buyout to have an on-performance,
- the difference between the two remains small until the twenty-second transaction (85% of the transactions) where the true out-performance of the buyout comes from the top four transactions, each characterised by extremely high multiples.

Focus on the
out-
performance
of the buyout

Thus, the performance of the buyout fund is somewhat concentrated. Its out-performance of the mezzanine is obtained through a small number of extremely profitable transactions. These transactions, often involving the best managers in the market (that the selector of funds must attempt to find), are those in which the buyout funds profited from the increase in the value of the target firm.

RISK/PROFITABILITY ANALYSIS OF BUYOUT AND MEZZANINE FINANCE BASED ON PAST PERFORMANCE

The aforementioned analyses allow us to better interpret our performance statistics of both the buyout and the mezzanine.

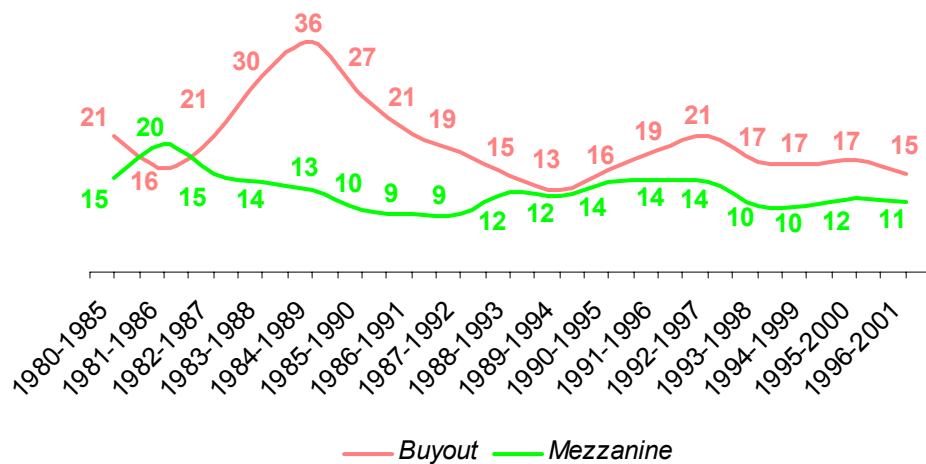
COMPARISON OF BUYOUT AND MEZZANINE PERFORMANCES ACCORDING TO AMERICAN PROFESSIONAL STATISTICS

Venture Economics, on behalf of the NVCA²¹, calculates performance indices for private equity. Average IRRs after five years are thus available for both the mezzanine and the buyout²² markets in the United States. In the American market more than in the European, the mezzanine is used not only in buyout transactions but also for the financing of investments with SMEs.

These indices facilitate comparisons between the performances of the two medium-term categories. The following graph includes the data for each five year period since 1980.

IRR after 5 years according to Venture Economics

IRR after 5 years in buyout and mezzanine in the US



Buyout IRR is greater than Mezzanine...

...but the difference is diminishing

The buyout is more profitable than the mezzanine: the median deviation per year of investment is 6.5%. The buyout's returns, however, are appreciably more variable, although the drop in profitability of the American buyout market since the early 1990s is helping to reduce the difference

²¹ National Venture Capital Association

²² Sources: Venture Economics presentation at the EVCA conference (European Venture Capital Association – www.ventureeconomics.com)

ANALYSIS OF THE HISTORICAL BEHAVIOUR OF BUYOUT AND MEZZANINE BASED ON DATA SERIES TAKEN FROM THE CPR DATABASE

CPR Private Equity Database

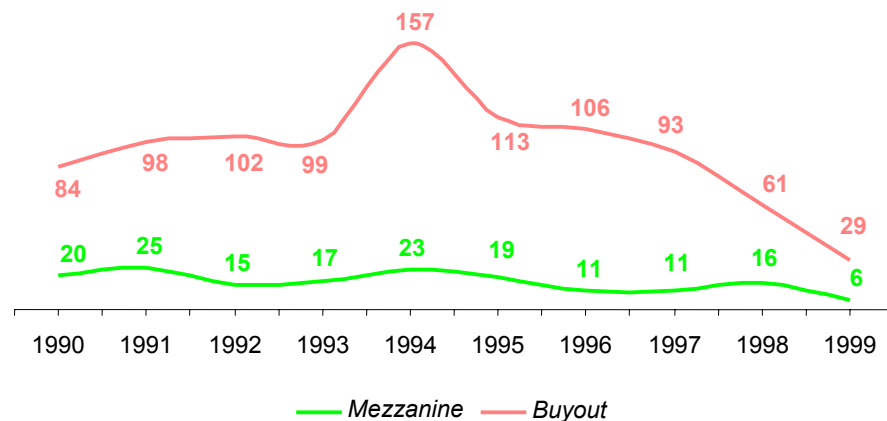
The CPR Private Equity database allows for a comparison between observations regarding the behaviour of some sample data series. It includes information pertaining to settled capital investment transactions, including whether the transaction yielded returns or losses. The data comes from placement memoranda.

COMPOSITION OF THE SAMPLES

1990-1999

We focus on a series of buyout and mezzanine transactions in Europe, while distinguishing the years, for each category, during which the number of transactions is significant. We observe the nature of 942 buyout transactions and of 163 mezzanine transactions over the period from 1990 to 1999:

Number of transactions in the sample



The vintage corresponds to the time which the transactions were conducted, that is to say, paid out. These transactions were then settled, after variable durations, between 1991 and 2003.

It is difficult to ascertain how representative our token sample would be compared to the market. It is likely that the original data (memoranda of funds raised only by teams that posted a good enough record that they could continue to fund raise) creates a rather optimistic distortion in the sample.

Pertinence of our data when comparing market behaviours

Our data base, however, approaches the situation in a slightly different manner to that of the professional indices. Thus, it pertains, not only to the market's tendencies, but also to differences in behaviour between the markets.

The updated sample, following the growth of our database since our preceding study, illustrates a relative constancy in the results, even if some differences do appear²³.

In addition, it is obvious that the buyout sample used here, due to its size, is more representative than that of the mezzanine. The size difference between the samples, however, is representative of the actual markets.

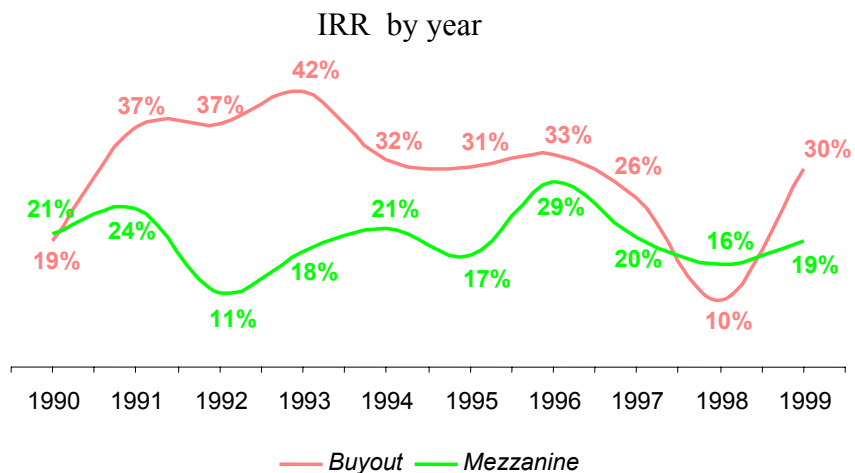
Returns of Mezzanine vs. Buyout

From the examination of the samples, we can learn a lot about the compared behaviours of the mezzanine and buyout market, with respect to the risk/return profile.

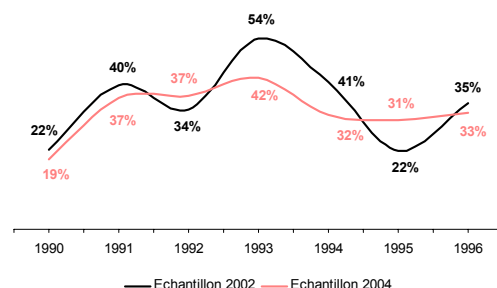
Obviously, the buyout generates (in Europe as in the United States) higher gross returns than the mezzanine:

- The sample of 942 buyout transactions, between 1990 and 1999, emphasizes an IRR of 34%, for a multiple of 2.7.
- The sample of 163 mezzanine transactions, between 1990 and 1999, emphasizes an IRR of 20.6%, for a multiple of 1.6.

The IRR per year is as follows:



²³ Our study from February 2002 on European buyout from 1986 to 1996 (Le Buyout Européen: historique, situation et performance) involves a sample of 583 transactions giving results closer to our sample for the years 1990 to 1996. The 2004 sample, which has an even larger number of transactions, presents a smoother profile (see opposite graphic).



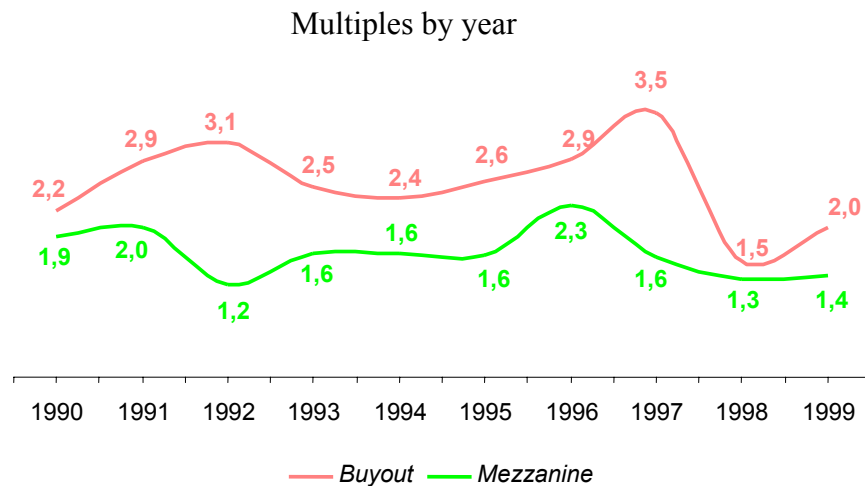
**Exceptional
Times : 1991-
1996**

The difference between the returns generated by the mezzanine versus the buyout is significant. The median deviation between the two samples is 11%. Thus, we see the exceptional nature of the buyout market between 1991 and 1995²⁴.

Performance Calculations: Multiple and Durations

The analysis of the performance calculations reinforces the out-performance of the buyout. In every year, the buyout's multiples are indeed higher than those of the mezzanine:

**Buyout
Multiples are
always >**



The difference between them, however, is variable. It reaches 2 points in the years where the buyout profits the most.

The effect of the reduction in the average duration of an investment and that of the perception of current revenues, are also systematically verified by the time scale analysis²⁵.

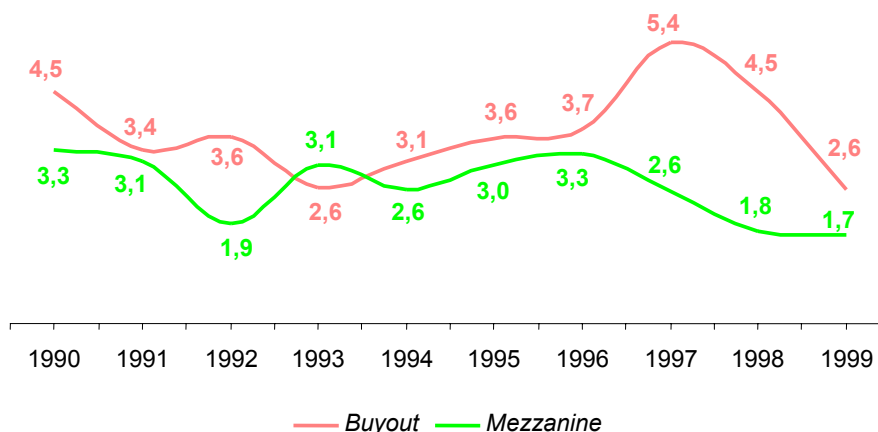
²⁴ The favourable character of this time period has already been touched on in our previous study : *Le Buyout européen: historique, situation et performance*, of February 2002. The period is distinguished by reasonable entrance fees (investments at the beginning of each economic cycle) and by exit prices driven up by the euphoria surrounding the stock market involving merger-acquisitions.

²⁵ The mathematical duration of an investment (one transaction of a series of transactions) externalizes the IRR and the multiple of the investment, in the case where the number of investment flows would be reduced to two (a negative entry flow and a positive exit flow).

In all the cases, with the exception of one, the duration of the buyout exceeds that of the mezzanine and the difference between them can be very important:

Duration of the mezzanine is almost always <

Durations by year



The low risk of mezzanine finance, which reflects that of the global market

Loss of capital for the Mezzanine sample = 2,4%

= reflects the global market

The risk, measured by the amount of capital lost compared to the amount invested, is historically very low with mezzanine finance. The total loss of the capital for the entire sample does not exceed 2.4% of the funded capital.

We do not have statistics regarding the total risk of the buyout market, including senior debt, but it is certain that the low risk of the mezzanine reflects the low risk of the total market. Our theoretical analysis showed us that the profitability of the mezzanine transactions was close to the total returns on the transaction, including senior debt. The low risk, coupled with strong margins, explains why there is such a high demand for buyouts (especially by banks) and also explains the market dynamic.

Role of recovery rates in receivership in the UK

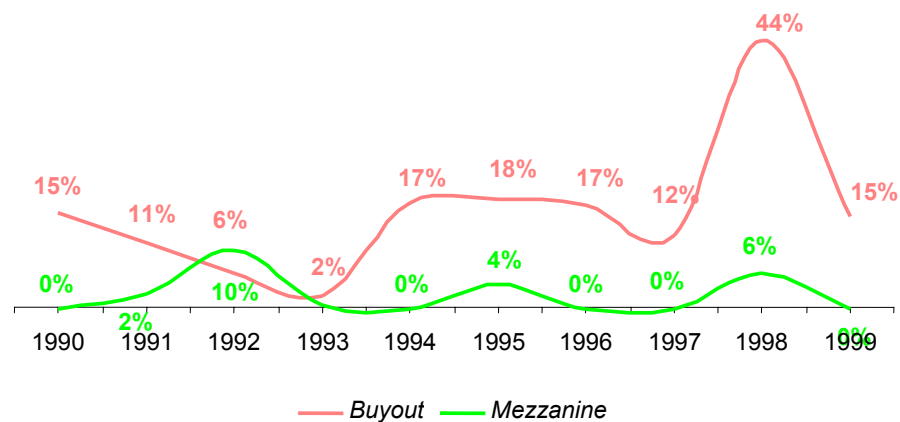
It is significant, however, that the high recovery rates on claims on English holding companies put into receivership strongly contribute to the limitation of the total risk. They were addressed in the analysis of the theoretical case where the holding suspends payments. If British legislation suddenly changed substantially and joined that of Continental Europe, the total levels of losses could increase. In this case, the mezzanine's losses would also increase. Such changes, however, would not have an effect on the fundamentals of the buyout economy.

The capacity of buyout to generate transactions based on the increase in target values

Capital losses for the buyout series = 15% ...

Capital losses (on the whole, 15% of funded capital) are considerably higher for buyout transactions as compared to mezzanine transactions. There are, however, exceptions to this rule as was the case in one of our 15 sample transactions in 1992 where one mezzanine transaction lost almost all its invested capital. Such a total loss of capital, however, rarely occurs with mezzanine financing:

Capital Losses by Year



... compensated for by transactions with high multiples

This data confirms the conclusions drawn based on our previous buyout studies: relatively high rates of losses are compensated for by transactions with large multiples based on overall performance²⁶.

The level of buyout losses, like the number of transactions with high multiples, sanctions the risks taken by the buyout fund, whose performance depends on the changes in value of the target firm.

The mezzanine = an attractive risk/profitability profile

Thus the conclusions of the theoretical analysis of a transaction are confirmed: the mezzanine has lower returns than the buyout but a more favourable risk-return ratio. This conclusion reaffirms the notion that it is in the best interest of the mezzanine to diversify its portfolio with private equity funds.

²⁶ See our study: *Le Buyout européen: historique, situation et performance*, of February 2002 and *Le Mid-Market Américain : un marché d'opportunités pour le Lbo*, of June 2003.

Buyout's capacity to generate stars since 1990

The constant out-performance of the buyout when compared to the mezzanine, however, is evidence that the best buyout fund managers were able to generate, since 1990, enough extremely profitable transactions to compensate for the higher losses and thus to end with an overall superior performance.

Impact of debt on mezzanine funds ?

Mezzanine fund's debt can reduce the difference of IRR when compared to buyout ...

Our analysis focuses on gross returns before management fees, carried interest and the impact of the structure of the fund.

The managers of mezzanine funds, however, can benefit from the low volatility in mezzanine risks by resorting to placing levies on their own funds. Such a levy, if reasonable, does not change the nature of the risk of the investor whose interests still depend on the fundamental risk of the transaction. Moreover, the use of the levy increases the diversification constraints that weigh on the mezzanine fund managers.

... but it varies between funds

The analysis of the impact of debt of the funds on the net yield of the mezzanine is a delicate affair. A simple theoretical calculation would suggest that a systematic debt of 1/1 (1 of debt for every 1 of capital) would be enough to cancel out the difference in profitability between buyout and mezzanine. That assumption, however, does not hold true in the real world. The real leverage rates are lower than that and, in fact, vary according to the time period, national legislation, and the market conditions.

CONCLUSIONS BASED ON THE ANALYSIS OF PERFORMANCE HISTORIES

The analysis of the historic behaviour of mezzanine and buyout funds leads to two conclusions:

1. It confirms the underlying characteristics of the two markets: **the low risk of the mezzanine and the large returns of the buyout, with a highly concentrated performance.**
2. **Mezzanine investments are justified by the harmonious operation of an increasingly mature market.** Indeed, the risk/profitability profile of the buyout and the mezzanine faithfully reflect the nature of the risks taken:
 - The managers of buyout funds are dependent on the changes in value of their targets. The best buyout managers have known, for 10 years, that they need to orchestrate a sufficient number of successful transactions, characterized by large increases in the value of their targets, to compensate for their losses and continue to make profits. The out-performance of the unit is extremely dependent on those few transactions;
 - The risks undertaken by the mezzanine investors, and their subsequent returns, are close to those of the general buyout market. The risk is smaller, however, because of the standardization of practices in the world of structured finance. The returns are high because of the levies placed on the target firms. **The operation of the buyout market as a whole ensures the mezzanine its enticing risk/profitability profile.**

Thus the use of mezzanine finance diversifies management styles and increases the ways in which investors can access the European buyout market.