Alliance Mezzanine Investors
ALLIANCE MEZZANINE INVESTORS

NYU’s Stern School
October 31, 2001

The Creation of a Small Business Mezzanine Fund
AGENDA

- Need + Model = Solution
- The SBA Process
- Target Markets
- How Are We Doing?
- Q & A
Need + Model = Solution
THE NEED

• Over 50,000 Small Businesses in NY, NJ and PA
• Historically, Banks Provided All Outside Capital
  – However, minimum loan sizes have increased
  – Banks require substantial collateral + guarantees
  – Credit ratios must be within Secured Loan limits
• Bank Consolidations Have Reduced Availability of Mezzanine Capital to Small Businesses
  – Mezzanine minimums now in excess of $5MM
• The Alternative, Venture Capital, is Expensive
  – Cost typically > 35%; control always an issue
THE OPPORTUNITY

- Limited Availability of Growth Capital

Cost of Funds

- High
  - Mezzanine Debt Opportunity @ 20-27%

- Low
  - Banks @ 8-10%

Availability of Funds

- Low
  - Working Capital Financing @ 10-20%

- High
  - Venture Capital @ 30-45%
THE MODEL

• It Started in 1992 With Dr. Morris and $1 million
• In 7 yrs, Sirrom Had a Market Cap of $1 billion
• Investment Model was Simple & Straightforward
  – Under $3 million per deal
  – Company growth rates > 20%
  – Sustainable cash flow > 10% of revenues
  – Outside equity investor / sponsor
  – Management a substantial stockholder
• Sirrom’s Collapse Did Not Poison the Model
THE SOLUTION

Form an SBIC
Debentures Only
2 : 1 Leverage

~ 90% Portfolio in
Mezzanine Loans

Projected 28 - 30% Net Returns to LPs

• Private capital of $15 - $20 million
• An “alliance” of banks
• Regional network of similar SBICs
• “Regulatory Legitimacy”
• Strict market focus

• Subordinated Debt
• Current coupons
• Warrants for a minority interest
• All-in Mezzanine returns of 23%
• Equity returns of 30%

• Assumes 10% losses
• 50% current pay
• Balance in warrants
• Spread lending
• Equity level returns for a Cash Flow risk
THE VALUE PROPOSITION

- Few Mezzanine Players in < $3 Million Space
  - Virtually all are SBICs with mindset to share deals
  - AMI is only < $3 million Mezzanine SBIC located in NJ

- SBA Leverage costs ~ 9%; we lend at 23+%

- An Attractive, Yet Scarce Opportunity
  - 11% - 14% interest + loan amortizations
  - Warrants to generate an overall return of 22%-27%
  - Warrant returns realized via “liquidity” Put

- Net Returns to the LPs is 22%-31%
  - Including a 10% allowance for losses
The SBA Process
THE SBA PROCESS

- **Raise Minimum of $5 Million Private Capital**
  - Start with Friends and Family; slowly expand the circle
  - Have an “Institutional” draw (for SBICs – CRA credits)

- **The “MAQ”**
  - Is management “qualified” to be entrusted with SBA money?
  - Direct experience vs. indirect know-how

- **Have a Viable Business Plan**
  - Complement SBA objectives (AMI is the only Mezz SBIC in NJ)

- **Invitation for an Interview**
  - Meet the people and make your case
FUNDING THE IDEA

• **Individuals for the First $5 Million**
  – Portfolio balancing
  – Risk adjusted returns
  – Don’t have to hit the “long ball”

• **An “Alliance” of Banks**
  – One in each distinct market area
  – AMI operates as the bank’s Mezzanine affiliate

• **18 Months, 2 Sets of Tires, 8 Pairs of Shoes, and 23 Packages of Maalox**
## PARTNERSHIP TERMS

- **Fund Size:**
  - Private Capital: $15.5 M
  - SBA Capital: 31.0
  - Total: $46.5 M

- **Minimum Size:**
  - Institutions: $1.00 M
  - Individuals: $0.25 M

- **Term:** 10 years

- **Management Fees:** 2.5%

- **Investments of Principals:** $1 million, with 1% of Private Capital contributed as GP and balance as LP

- **Priority Return to LPs:** 8% compounded, plus a return of capital, before profit distributions to the GP
INVESTOR PROJECTIONS

- Base Case assumes a Fund size of $30 million, 2 : 1 SBA leverage, a mezzanine coupon of 12% and warrants to yield an overall mezzanine return of 22.5%, equity returns of 30%, a portfolio consisting of ~90% mezzanine loans, a return of capital and a priority return of 8% to the LPs before distributions to the GP, and an allowance for defaults/losses of 10% of the portfolio value.

- Approximate IRRs to the LPs net of Partnership expenses:

<table>
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<th>SBA Leverage</th>
<th>Allowance for Defaults/Losses</th>
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<tr>
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<td>2 : 1</td>
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<td>3 : 1</td>
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MEZZANINE vs. VENTURE CAPITAL

• **Mezzanine Does Not Require “Grand Slams”**
  – Modest Company Performance = Expected Returns
  – Loss Rate Substantially Less than Private Equity

• **Greater Universe of Attractive Investments**
  – Not Limited to High Growth Opportunities
  – Premium Pricing at the Downside End

• **A “Debt” Risk for “Equity” Level Returns**
  – Strictly a Cash Flow analysis
  – No requirement for an “Exit” event
AMI MANAGEMENT

• Bob Eberhardt - Principal
  – Commercial Banker Experienced in Corporate Credit, Buyout Finance, Loan Workouts and Financial Control
  – Started and Managed Summit Bank’s Mezzanine Finance Group

• Doug Smith - Principal
  – Investment Banker Experienced in Corporate Finance, Capital Markets, Project Finance, Management Consulting and M&A
  – Seasoned Financial and Strategic Advisor to Small Businesses

• Steven Fleisig - Director
AMI ADVISORY BOARD

• **Two Key Individuals w/ Name Recognition**
  – Senior Commercial and Investment Bankers
  – Both broad financial and mezzanine specific experience

• **Our “Alliance” Banks**
  – Experienced credit institutions
  – Familiar with asset-based lending

• **Our New Best Friends**
  – 3 Partners in 3 different SBICs in our market area
  – Wealth of experience and recognition within SBA
  – Informal board with no prescribed duties or responsibilities
Target Markets
TARGET MARKETS

- **Northeast**
  - NJ – NY – PA - CT
  - New England and Middle Atlantic with co-investors

- **Borrowers with Sales of $5 - $50 Million**
  - History of stable cash flow and profitable growth
  - Proven management team with a significant equity stake
  - Under $3 million for growth or recap purposes
  - Strong market niche or product position

- **Low Tech and Low Capital Intensity**
MEZZANINE STRUCTURE

- 12%-14% Current Pay Coupon
- Maximum Maturity of 8 Years
- Up to 3 Years Interest Only
- Maximum 30% Amortization in Any Year
- Warrants for 5% - 20% of Common Stock
- Overall IRR of 22%-27%
- Warrants Contain Liquidity Put After 5th Year
- Not Expensive Debt … but Cheap Equity!
How Are We Doing?
THE “ALLIANCE” MODEL WORKS

- Slightly Behind Plan, but Fund is Still Young
  - As of IIIQ01, 6 deals vs. 10; $11M vs. $15M
  - Portfolio companies results and prospects look very good

- Deal Flow Strong From a Variety of Sources
  - Since startup, reviewed 90 deals and committed on 7
  - Five principal sources, with LP Banks being the largest
  - Most effective source is other SBICs (Equity and Mezz)

- Under $3M Market Reasonably Well Insulated
  - Niche markets operate within their own rhythms
  - Small Businesses are impacted by overall economic trends
  - On balance, tight credit conditions are good for Mezz
“SLIDERS” = PRICING ADVANTAGE

- We Seek “Downside Protection”
  - Company Projections Significantly Discounted
  - High Warrant Coverage at Low Performance Levels
  - Downside Returns Protected ~ 24% IRR

- And Forego Maximum “Upside Potential”
  - Warrants Reduced as Performance Increases
  - Limited Returns Beyond ~ 33% IRR

- AMI’s Standard is Competition’s Reluctance
  - Warrant Coverage Typically is Single %
  - Requires “Agreement” on Future Performance
THOUGHTS TO DATE

• **After Slow Start, Now Catching Up to Plan**
  – Plan for 12 deals by yearend; expect to close 8+
  – One good quarter and we’re back on Plan

• **Business Model Validated**
  – Returns are as expected
  – Premium pricing available
  – Borrowers prefer a sliding warrant structure

• **Deal Flow Situational; Sources Expanding**
  – Somewhat affected by economic downturn
  – LP Banks continue as best source
  – Co-investing with other SBICs increasing