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DOING THE DEAL®

Subdebt Survey

June 2006

Benesch has undertaken a follow-on survey regarding the state of the subdebt market over the last 12-18 months. The survey updates the results that we published this past July. We have noted in our practice that subdebt funds are co-investing with sponsor groups in strips of equity in addition to subordinated debt. Doing so allows for returns to be increased over what the market is now for a pure subdebt deal. What we did not know was how prevalent this is and how it has been received in the market. This mini-survey reports on these matters. We expect to have our full annual survey available late in the third quarter of this year.

Mix of Structures

Of the funds responding, 50% reported using a mix of subdebt structures over the last 18 months that included interest-only deals, subdebt with warrants and subdebt with an equity co-investment component. A minority of the funds (about 15%) reported that their subdebt deals continue to have warrant coverage. More than two-thirds, however, reported that each of their deals have included an equity co-investment component.

What Percentage of Total Subdebt Investment Per Deal is Equity?

Approximately 50% of the funds reported that there is no rule of thumb to determine what percentage of their fund's investment per deal is in equity. Most funds, however, reported that the equity component of their investments ranges generally has constituted from 10-20% of their total invested capital per deal.

Total Blended IRR

On average, the funds reported expected blended returns in the high teens, with several funds looking for returns in the low 20s. We find that these return expectations tended to be higher than for funds whose investments do not include an equity strip.

Resistance from Sponsor Groups

More than one-half of the funds reporting have encountered resistance from sponsor groups in their willingness to share equity. Those responding in the affirmative deal with the resistance in a number of ways. Those include foregoing the equity, walking away from the deal, negotiating for warrant coverage or working to build the relationship with the sponsor to facilitate receptivity to an equity component in future deals.

Term B and Second Lien Market

More than 70% of the funds reported continuing strength in the Term B and second lien markets. In that regard, the subdebt market remains strongly competitive. We expect to see some softening in these markets.

We hope that this brief picture of a piece of the competitive landscape in the subdebt market has been helpful. As always, we appreciate your feedback to our survey, and would welcome suggested survey questions. To comment or suggest questions just click on an e-mail address in the box below.

For more information or to share some thoughts, please contact:

James M. Hill
216-363-4444
jhill@bfca.com

Douglas E. Haas
216-363-4602
dhaas@bfca.com

Ira C. Kaplan
216-363-4567
ikaplan@bfca.com

Julie M. Price
216-363-4689
jprice@bfca.com

Please join us at our **Doing the Deal® Conference** on **June 21** at the Ritz-Carlton in Cleveland, Ohio. For details and to register, visit http://www.bfca.com/events/deal2006.asp.

Cleveland
2300 BP Tower
200 Public Square
Cleveland, Ohio 44114-2378
Phone: (216) 363-4500
Fax: (216) 363-4588

Columbus
88 East Broad Street, Suite 900
Columbus, Ohio 43215-3506
Phone: (614) 223-9300
Fax: (614) 223-9330

Benesch Pacific LLC
Foreign Representative Office
15F One Corporate Avenue
22 HuBin Road
LuWan District Shanghai 200021
P.R. China
Phone: 86 21 6122 1098
Fax: 86 21 6122 2418

www.bfca.com