OAKTREE INSIGHTS

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STRATEGY PRIMER: INVESTING IN MEZZANINE DEBT

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Managing Director and Co-Portfolio Manager

Mr. Casperson joined Oaktree in 2001. He has been with the Middle-Market Finance Group since its inception, and currently serves as co-portfolio manager. Prior to joining, Mr. Casperson worked in the Leveraged Finance and Global Syndicated Finance Groups at J.P. Morgan Chase where he was responsible for leading high yield deal teams in all phases of due diligence and "one-stop" financings including senior credit facilities, high yield bonds and bridge loans. Prior thereto, Mr. Casperson was a member of Chase Manhattan's Financial Sponsor Group, where he was responsible for managing relationships with a variety of buyout funds. From 1989 to 1998, Mr. Casperson worked at NationsBank N.A., most recently as a Principal in the High Yield Finance Group. Prior to NationsBank, he was an auditor at Touche Ross & Co. Mr. Casperson holds a B.A. degree in accounting from Rutgers University and an M.B.A. from the University of Michigan School of Business Administration with a concentration in finance.

"Mezzanine capital plays an important role in growth- and acquisition-related financings in the North American middle-market. Private lending in the middle-market is relatively inefficient; and with banks and other traditional lenders exiting the market, there remains a unique opportunity for seasoned mezzanine capital providers to find attractive investments." –Bill

"This paper intends to discuss the mezzanine debt asset class, the opportunity set and our perspectives at Oaktree. We hope you will enjoy it."

– Raj

RAJ MAKAM

Managing Director and Co-Portfolio Manager

Mr. Makam joined Oaktree in 2001. He has been with the Middle-Market Finance Group since its inception, and currently serves as co-portfolio manager. Prior to joining, Mr. Makam worked at Banc of America Securities LLC (previously NationsBanc Montgomery Securities LLC) for four years in their Leveraged Finance/High Yield Group. During that period he specialized in bridge and mezzanine finance, with responsibility for deal origination, market analysis, structuring, due diligence and legal documentation. Prior to joining Banc of America Securities in 1997, he worked for five years as a senior software engineer at Montage Group Ltd. and Dantec Electronics Inc. Mr. Makam received a B.S. degree with distinction in engineering from the Bangalore Institute of Technology, India. He then went on to receive an M.S. degree in engineering from the University of Akron, Ohio and an M.B.A. in finance from Yale University.

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INVESTING IN MEZZANINE DEBT

OBJECTIVE

In this paper we seek to provide information on investing in mezzanine debt. Any reference to mezzanine debt should only be considered with regard to investing in the North American middle-market, as some of the information discussed may not be applicable to other markets. We will also only briefly mention preferred equity, which can sometimes be considered mezzanine capital. We will explore the following six topics in order to provide a foundation for investing in mezzanine debt.

1. What is mezzanine debt?
2. What are the characteristics of the middle-market in North America?
3. What are the potential benefits and risks of investing in mezzanine debt?
4. What are the different ways to invest in mezzanine debt?
5. What is the current opportunity in mezzanine debt?
6. How does Oaktree approach investing in mezzanine debt?

WHAT IS MEZZANINE DEBT?

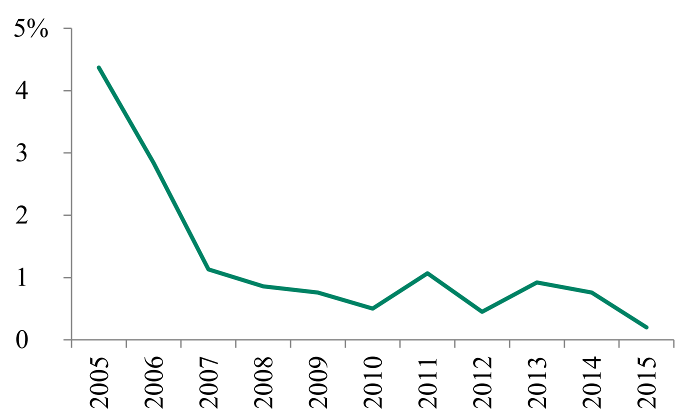
As its name implies, mezzanine debt is situated between the senior secured bank debt and the equity in an issuer or borrower's capital structure. Mezzanine debt is typically used to finance leveraged buyouts, recapitalizations and corporate acquisitions. It is also an alternative to public or private equity for companies seeking growth capital. Typically junior in credit standing, mezzanine debt provides additional capital beyond senior secured debt. As shown in figure 1, mezzanine debt typically takes the form of senior unsecured or subordinated notes, or second lien debt. From an issuer's perspective, mezzanine debt can reduce overall capital costs by providing additional debt financing that can enhance equity returns.

Figure 1: Sample Capital Structure

Senior Debt: 30-40% Asset-based loans First lien cash flow-based loans	• Security: First Lien • Return Range: 5.25%+/- • Upside: None
Mezzanine Debt: 10-20% Second lien debt Senior unsecured notes Subordinated notes	• Security: Usually unsecured but can sometimes have a second lien • Return Range: 14%+/- • Upside: Through equity co-investment
Equity: 30-50% Preferred equity Common equity	• Security: None • Return Range: 25%+/- • Upside: Highest potential

For middle-market businesses, mezzanine debt typically takes the place of the high yield bonds used by larger companies. As highlighted in figure 2, the minimum issuance size for a company to access today's high yield bond market is generally $200 million or more. In other words, most middle-market businesses do not have the financing need or the ability to access the high yield bond market. By creating a capital structure with a "right-sized" combination of mezzanine debt and bank borrowings, middle-market companies can leverage their equity capital to generate attractive returns for their owners.

Figure 2: Debut High Yield Bond Issuance of $200 million or Less as a % of Total High Yield Bond Issuance



Source: S&P Capital IQ

WHAT ARE THE CHARACTERISTICS OF THE MIDDLE-MARKET IN NORTH AMERICA?

Middle-market companies account for the vast majority of businesses in the United States and represent approximately 33% of private sector GDP, 48 million jobs and, on a standalone basis, would be the world's fifth largest economy.[1] According to the U.S. Census Bureau's 2012 economic census, there were approximately 41,100 middle-market companies in the United States with annual revenues between $50 million and $1 billion. This compares to just 1,450 companies with annual revenues above $1 billion.[2] Most middle-market businesses that employ mezzanine debt have earnings before interest, tax, depreciation and amortization ("EBITDA") ranging from $10 million to $50 million.

Middle-market companies are usually closely held by their founders, families or by private equity firms. The majority of middle-market companies are privately held due to their limited resources and the costs associated with being a public company. Middle-market companies can be found in almost every industry sector.

WHAT ARE THE POTENTIAL BENEFITS AND RISKS OF INVESTING IN MEZZANINE DEBT?

Some of the potential benefits of investing in mezzanine debt include the opportunity for attractive total return, downside risk management through privately negotiated transactions, and less-volatile performance through a high current coupon component.

Potentially Attractive Total Return

Due to their subordinated or junior position in an issuer's capital structure, mezzanine debt investors generally demand higher prospective returns compared to senior secured debt investors. As shown in figure 3, total returns on mezzanine debt typically come from *(1)* high current coupons (typically fixed-rate and paid quarterly, mostly in cash), *(2)* commitment or arrangement fees (often paid in the form of original issue discounts) and *(3)* call protection (i.e., premium payments if the mezzanine debt is repaid early). Mezzanine debt, in contrast to senior secured debt, will most often come with an "equity kicker" in the form of the opportunity to purchase equity in the underlying borrower. This results in the potential for additional returns beyond those contracted for by the junior debt investment by itself. Mezzanine investors have historically targeted blended gross annualized returns in the mid-teens. Similar to other

Figure 3: Sample Mezzanine Debt Terms

Current Fixed Coupon	• 11-12.5% (11% cash, 0-1.5% PIK)
Ranking	• Subordinated unsecured
Maturity	• 6-7 year debt instrument
Equity Participation	• Purchased equity
Commitment Fees	• 2-3 points up-front (or via OID)
Call Protection	• 1-2 years non-call; premium prepayment schedule thereafter

debt investments, we feel the avoidance of defaults and subsequent losses, sometimes referred to as the "negative art of bond investing," can be the most important aspect for mezzanine investors striving to achieve attractive total returns.

Private Structures Provide Downside Risk Management

In the middle-market, mezzanine debt is typically issued through privately negotiated transactions. A mezzanine lender's decision to extend credit to a borrower is usually based on the issuer's ability to generate free cash flow (as opposed to being based on asset backing) and on the growth prospects for the business and industry. Compared to what is often less than a week of limited, public-side due diligence for broadly syndicated loans, mezzanine debt investors typically are able to perform extensive private-side due diligence over a four- to six-week period. As part of this due diligence, mezzanine lenders receive greater access to company information, such as historical financial statements, earnings and audit reports, and environmental or other expert analyses. This gives mezzanine debt investors the ability to better understand the borrower, negotiate terms and structure loans in ways that are appropriate for the underlying business. In addition, mezzanine debt investors also have the opportunity to interact with the company's management several times before an investment is made.

After making an investment, mezzanine debt investors usually receive monthly or quarterly financial statements. In addition, many mezzanine lenders negotiate board observation rights as part of the terms of their investment. Receiving board of director materials and attending the meetings, alongside what is often frequent dialogue with company owners and management, gives mezzanine lenders the ability to closely monitor their investments and stay ahead of potential business issues. It also helps the investor keep up to speed with company performance and knowledgeable should amendments to the credit documents be necessary.

Lastly, although debt financing to large corporate issuers has increasingly become covenant-lite with no maintenance financial covenants (e.g., a maximum leverage ratio), loans to middle-market businesses continue to carry both incurrence and maintenance covenants. These covenants give mezzanine lenders additional tools should the business underperform. Mezzanine lenders often work with owners to take proactive steps to upgrade the borrower's operating performance and maximize liquidity. These proactive steps may include cost reductions, divestitures of less productive assets, and changes to operations or management. Additional steps to address underperformance may even include voluntarily deferring the cash portion of interest due on the mezzanine debt in order to help the company avoid defaulting on its senior secured debt. Senior secured debt for larger issuers is more likely to be syndicated and may include lenders who are less willing to work through cyclical downturns.

High Current Coupon Reduces Volatility

More often than not, mezzanine debt is structured with a fixed coupon that is paid quarterly (mostly in cash). This coupon compensates lenders for subordinating their position in the capital structure. In today's market, coupon rates are running from 11.0% to 12.5%, on the low end of the historical range. Still, for investors targeting mid-teen gross returns in a low-yield environment, mezzanine debt is an attractive alternative to other debt instruments. Furthermore, since mezzanine debt coupons are usually paid quarterly, the high current coupon component reduces the overall volatility of returns to investors.

Potential Risks of Investing in Mezzanine Debt

First and foremost, mezzanine debt is junior in the capital structure and typically in a first-loss position after the value of the company drops by more than the amount of its equity. Second, since mezzanine debt is provided through privately negotiated transactions, it is far less liquid than more public securities if it needs to be sold. Lastly, middle-market businesses often face greater idiosyncratic risks compared to larger companies. For example, due to their smaller size, loss of a customer or increases in the cost of raw materials may have a larger impact on the borrower's EBITDA than it would on a larger company. In certain instances, due to their size and ownership structure, middle-market companies may also have less professional or less seasoned management teams.

WHAT ARE THE DIFFERENT WAYS TO INVEST IN MEZZANINE DEBT?

The two main ways to invest in mezzanine debt are: *(1)* through directly negotiated transactions with a company or its owners, or *(2)* by investing in a pooled, private-fund structure that targets investments in mezzanine debt.

> *"Potential benefits of investing in mezzanine debt:*
> *1) attractive risk-adjusted return,*
> *2) downside protection of private structures,*
> *3) reduced volatility from high current coupon."*

Direct mezzanine debt investments are typically reserved only for investors with large amounts of capital. Direct investments can be sourced through relationships with family owners, investment banks or private equity firms. They are often purchased by large institutional investors or by smaller investors with relationships with the underlying borrower. Most mezzanine debt investments, whether directly made by an individual or made on behalf of a pooled fund, typically take several weeks to a few months to negotiate and close.

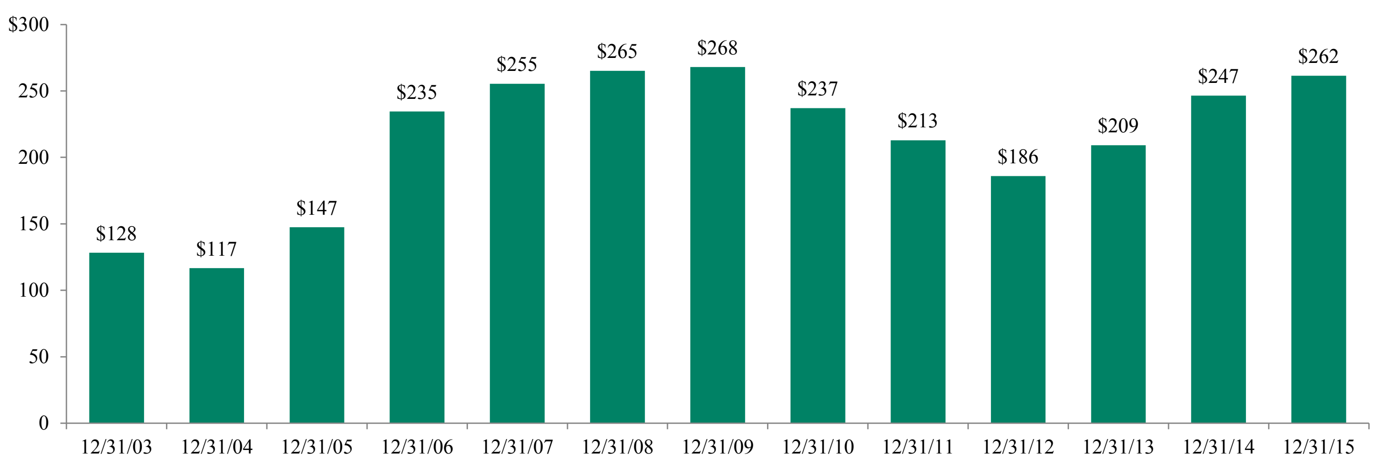
Private limited partnerships are the most common way for investors to access the mezzanine debt market. This is typically done through capital commitments that are aggregated with the express purpose of investing in mezzanine debt. Asset management firms typically organize these funds and act as the general partner. The general partner seeks attractive risk-adjusted returns for the partnership, while maintaining a diversified portfolio of investments.

Collateralized loan obligations ("CLOs") and business development companies ("BDCs") also invest in second lien loans, an asset class that is a competitive replacement for mezzanine debt. BDCs also invest directly in mezzanine debt. CLOs are securitized vehicles where payments from multiple loans (mostly first lien) are pooled together and passed on to different classes of owners in various tranches. BDCs are closed-end investment companies that raise capital by selling equity shares to investors, often in the public markets. Recently, however, fewer CLOs have been created due to regulatory rulings and a more expensive funding environment. BDCs are also undergoing structural issues that largely impede them from making new investments. At this time, it is difficult to forecast the full impact of these issues and the extent to which they will affect the market presence of CLOs and BDCs.

WHAT IS THE CURRENT OPPORTUNITY IN MEZZANINE DEBT?

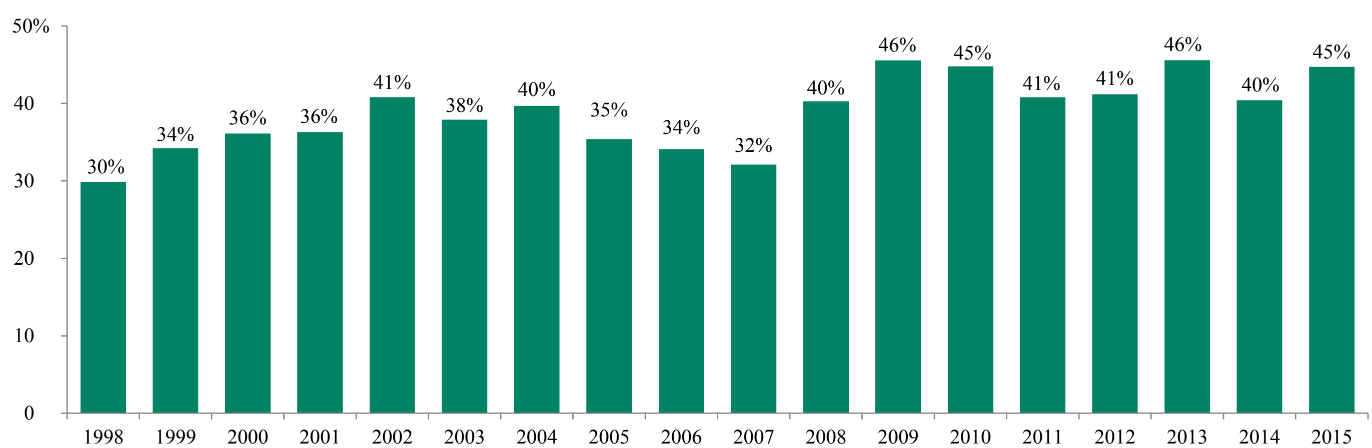
Following the end of the financial crisis, competitive conditions in the mezzanine debt market intensified as investors searched for yield in a low-interest-rate environment. CLOs, BDCs, commercial lenders and private funds all participated in driving down returns and loosening financing terms. That being said, as shown in figure 4, the pool of uninvested private equity capital available for leveraged buyouts remained large, helping maintain the demand for mezzanine debt. As shown in figure 5, private equity firms' equity contributions to buyout transactions also remained high (particularly compared to pre-crisis levels), mitigating risk to lenders. With such substantial equity capital invested, the enterprise

Figure 4: Total North American Dry Powder in Buyout Funds
($ in billions)



Source: Preqin

Figure 5: Average Equity Contribution for Middle-Market LBOs (EBITDA ≤ $50 million)



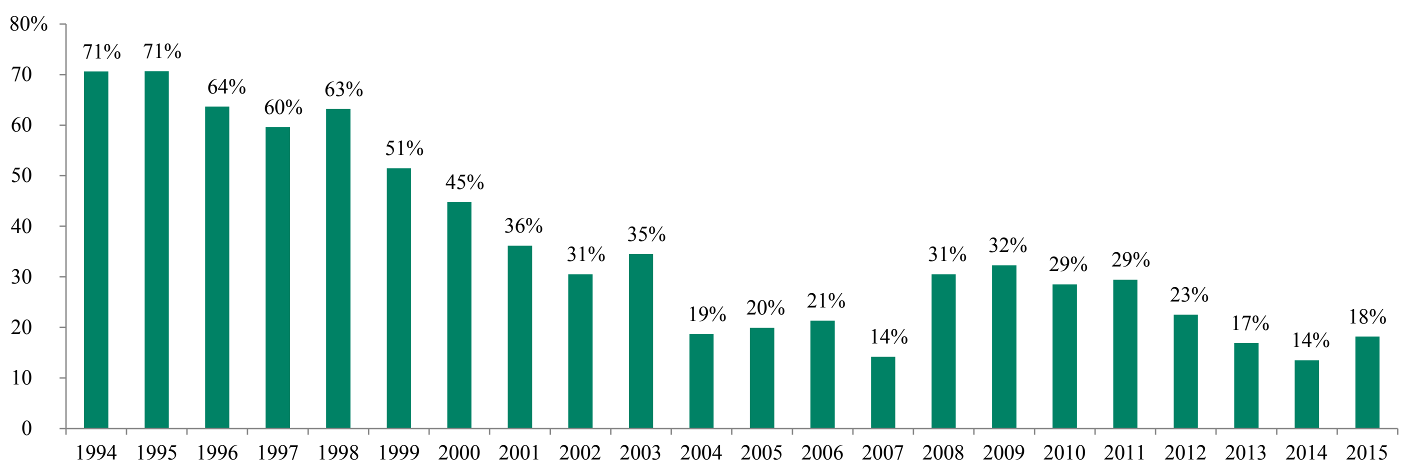
Source: S&P Capital IQ

value of a borrower can decrease up to 40% to 45% before the mezzanine debt becomes impaired.

Since the start of the oil and gas market downturn in mid-2014, credit markets have become less frothy, and certain providers of debt capital have, at times, retrenched. As shown in figure 6, over a number of years, banks have also gradually exited the middle-market leveraged loan business in order to focus on larger issuers with facilities that are more easily syndicated. According to Standard & Poor's, domestic and foreign banks have been steadily reducing the amount of leveraged loan new issuance they retain, from over 70% of primary issuance in the 1990s to less than 20% in recent years.

With traditional lenders having significantly reduced their middle-market debt holdings and, more recently, CLOs and BDCs facing the aforementioned issues, private funds with long-term capital and the ability to hold the full amount of a loan (or a large portion as part of a "club" deal) should continue to see attractive investment opportunities. While the middle-market typically lags larger market credit cycles, the recent negative shift in outlook for corporate credit did impact the volume of new middle-market transactions. This is highlighted by figure 7, which shows that LBO volume in the middle-market dropped from $83 billion in 2014 to $54 billion in 2015. Oaktree believes this was due to reduced confidence in the overall economic environment and the impact of the oil and gas industry dislocation on businesses with exposure to the sector. The owners of middle-market companies will often hold off commencing a sale process until weakness in the underlying business abates or buyer financing becomes more attractive.

Figure 6: % of Leveraged Loan New Issuance Retained by Domestic and Foreign Banks



Source: S&P Capital IQ

Figure 7: Total Volume of North American Middle-Market Buyouts (Enterprise Value < $1 billion)
($ in billions)

Source: Preqin

While it is hard to predict where middle-market M&A and financing markets will go from here, it is clear that the competitive landscape for mezzanine debt investing has changed since 2014. Oaktree is optimistic that these changes will provide additional opportunity for risk-focused junior debt investors with capital to lend.

HOW DOES OAKTREE APPROACH INVESTING IN MEZZANINE DEBT?

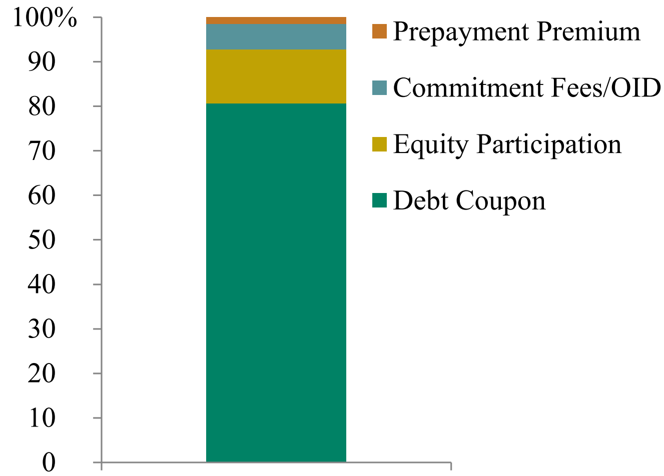
Oaktree targets mezzanine capital investments in North American middle-market businesses, providing loans to borrowers being purchased by private equity firms in leveraged buyouts. Due to the risks associated with both mezzanine debt and middle-market businesses, Oaktree believes it is prudent to not use leverage in this strategy, and to conservatively structure the investments it makes.

Many mezzanine funds buy preferred or common equity alongside their debt investments. Although Oaktree typically invests 10% to 15% in equity in connection with its mezzanine debt investments, this is limited in order to conservatively participate in the upside potential of each business, with a goal of adding 100 to 200 basis points to potential returns.

Mezzanine debt investments can be approached in two different ways: *(1)* with a credit emphasis, where a substantial portion of the return is in the form of a debt coupon supplemented by some equity upside, or *(2)* with an equity emphasis, where the return is primarily driven by equity investments. At Oaktree, we follow a credit-focused strategy with a heavy emphasis on safer, less-risky companies, and we structure our investments as extensions of credit with small equity kickers. As shown in figure 8, when structuring investments, we expect the majority of the return to come from the quarterly cash coupons.

When making mezzanine debt investments, Oaktree targets companies with sustainable cash flows, proven management teams, strong market positions, and diversified, well-developed businesses. As previously discussed, we have a conservative bias and employ a loss-avoidance approach. Oaktree works closely with private equity sponsors in conducting thorough and complete private-side due diligence, acting as the sole, lead or co-lead investor in most of its mezzanine debt transactions. We believe it is important to retain control over the terms of our investments, and we typically request board observation rights that allow us to continuously monitor each investment. We try to keep total debt multiples between 4.0x and 6.0x EBITDA or less and interest coverage ratios at 2.0x or greater.

Figure 8: Oaktree's Target All-in Return Attribution



Oaktree tries to be opportunistic with respect to deal flow and to select those transactions that provide the best risk-adjusted returns. Oaktree has a proprietary private equity deal-sourcing network, which has been built across market cycles since the inception of the strategy in 2001. We are exceptionally proud of the fact that over 15 years, more than 70% of our investments have been with repeat sponsors, a statistic that highlights our relationship-oriented approach.

CONCLUSION

As with most credit strategies, the mezzanine debt market has been very competitive since the end of the financial crisis. However, Oaktree believes there have been, and will continue to be, opportunities for attractive risk-adjusted returns in mezzanine debt. Furthermore, the recent cooling in the credit markets reminds us that investors with durable capital and market experience should be able to take advantage of dislocations to find attractive opportunities and enhanced returns. Oaktree has a 15-year track record of investing in the debt of middle-market companies. Regardless of credit and economic cycles, we expect there will always be middle-market companies and owners in need of a relationship-oriented junior lender.

A BRIEF HISTORY OF OAKTREE'S MIDDLE-MARKET FINANCE GROUP

Oaktree's Middle-Market Finance Group was established in 2001, after observing a gap in the availability of directly-originated junior capital for middle-market companies too small to access the high yield bond market. Since inception, the Middle-Market Finance Group has invested $4.6 billion of capital in junior and senior debt across 192 transactions.[3] The group's strong, established relationships with middle-market private equity sponsors are the bedrock for finding high-quality investments.

We invested our first Mezzanine fund between 2001 and 2006, focusing on providing junior debt capital for sponsored middle-market leveraged buyouts. When we commenced raising our second fund in 2005, we recognized that the leveraged loan market was becoming overheated and thus that investing in the junior debt of certain businesses had become riskier. Given this shift, we decided to incorporate the purchase of senior secured debt investments into our strategy. Ultimately, this second fund consisted of approximately 40% senior debt, which we believe provided extra protection and helped us weather the Global Financial Crisis. While the decision to invest a greater percentage of the fund in safer, but lower-yielding investments lowered its prospective return and limited Oaktree's ability to earn carried interest, we believe it was the right thing to do for our investors.

As the global economy recovered in 2009 and 2010, we raised our third fund and refocused our strategy on junior debt investing. We made our last investment in our third fund in early 2015, and are well on our way investing our fourth fund, which has made 13 investments.

The Middle-Market Finance Group continues to employ the consistent, risk-controlled approach to investing that it was founded on in 2001. The senior members of the group have an average tenure of 13 years at Oaktree—this long-term presence in the middle-market furthers the group's ability to source attractive investments. We remain excited about the future of the group and Oaktree's continued participation as a reliable middle-market lender.

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ENDNOTES

[1] The National Center for the Middle Market (in collaboration with The Ohio State University Fisher College of Business) as of March 31, 2016.

[2] United States Census Bureau, Statistics of U.S. Businesses (2012).

[3] Includes transactions for Oaktree Mezzanine Funds, as well as Oaktree's middle-market CLO warehouse and BDC seed vehicles.

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Investments in debt instruments entail normal credit risks (i.e., the risk of non-payment of interest and principal) and market risks (i.e., the risk that certain market factors will cause the value of the instrument to decline). A default on a loan or a sudden and extreme increase in prevailing interest rates may cause a decline in a portfolio holding such investments.

Fixed income securities may be subject to redemption at the option of the issuer. If a fixed income security is called for redemption, the holder may be required to permit the issuer to redeem the security, which could have an adverse effect on the holder's ability to achieve its investment objectives.

Mezzanine debt and equity investments will typically be subordinated. Subordinated investments may be characterized by greater credit risks than those associated with the senior obligations of the same issuer.

Investments in mezzanine debt are expected to include companies whose capital structures may have significant leverage. Such investments are inherently more sensitive than others to declines in revenues and to increases in expenses and interest rates.

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