

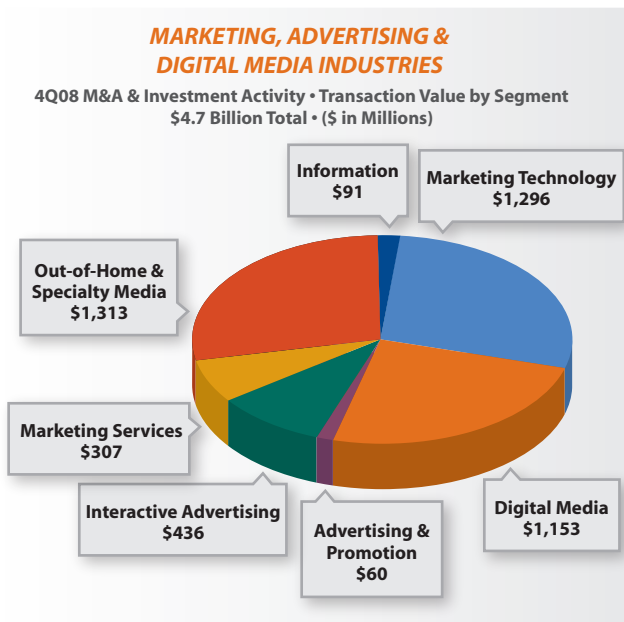
**DEAL NOTES** | M&A Review for the Marketing, Advertising & Digital Media Industries

**Marketing, Advertising and Digital Media Transaction Activity Drops Sharply in Fourth Quarter 2008**

**Fourth Quarter 2008 Review: 140 Transactions Totaling \$4.7 billion**

Transaction activity in the marketing, advertising and digital media industries showed a marked decline in the fourth quarter of 2008. Petsky Prunier tracked 140 transactions for a total of \$4.7 billion in 4Q08. Aggregate quarterly deal volume was down 42% from 4Q07 and 27% from 3Q08, as total transaction dollar volume dropped even more sharply, 79% and 61%, respectively. While the decrease in overall industry activity reflects the general market, transactions continued to be completed successfully in areas acquirers and investors believe will most appeal to marketers challenged by shrinking budgets and more stringent levels of accountability, including measurable and targeted media such as online and digital out-of-home businesses.

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**MEZZANINE FINANCING**

**Mezzanine Gets Deals Done in Tough Times**

*With liquidity at the senior level all but dried up and multiples down one to two turns, it's no surprise that deals in the advertising, marketing and digital media sector have slowed down in line with the general market. But, some companies and investors are still getting their deals done.*

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Mezzanine lenders, which are picking up the slack from senior lenders, couldn't be busier. They have plenty of money — albeit more expensive money — to lend or invest for the “right” company. If you're planning on seeking outside funding or growth capital in the next 12 to 18 months, mezz lenders may be your best bet. But with an increased number of opportunities on their table, you're going to have to really wow them with your first impression — you may not get a second chance.

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## Mezzanine Gets Deals Done in Tough Times *(continued)*

### WHEN MEZZ FUNDING MAKES SENSE

Mezz is often used by investors to supplement financing that is available for a transaction. In the current, illiquid environment where no senior financing may be available, even transactions with low valuations may use mezz, if that's the only funding to be had. Or, mezz may be used to give liquidity to owners without much equity dilution.

Andrew Strauss, partner at private equity firm The Riverside Company, believes mezzanine funding makes sense in very specific situations. "The first is when you're really stretching on purchase price," Strauss explains. "If you're paying what feels like a lot and trying to scrape together a way of financing, mezzanine's going to make sense. If you're buying something cheap, you tend not to use mezzanine. We only use mezzanine for transactions that have really good cash flow, because of the interest."

In addition, he adds that draining the cash flow to pay interest needs to be consistent with the investment strategy for the business. "If you're buying a media property and your strategy is to invest heavily in its online presence, you might not want to take all that good cash flow and have it leave the business to go pay a mezzanine lender. You might want to invest it in [a website], so that's an example of a situation where mezzanine might not be the best idea." He cautions, however, that every deal is unique.

Robert A. Smith, a partner with mezzanine investor Petra Capital Partners, which has invested successfully in a number of marketing services and media businesses, is seeing a very specific type of mezzanine transaction within the advertising, marketing and digital spaces that appears to be on the rise. "It's where companies and founders were hoping to sell their business, but have decided to put off selling, and instead are coming to mezzanine lenders to raise subdebt — half of which might go to the management team, with the balance being growth capital to position the business for sale two to three years down the road. For entrepreneurs who still feel they have a viable long-term strategy, it might make sense to wait, and a mezzanine loan is a nice way to do that and still raise the capital you need."

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*Andrew Strauss, partner, The Riverside Company*

**Mezzanine Financing** refers to a subordinated debt or preferred equity instrument that represents a claim on companies' assets, which is senior only to that of the common shares. Mezz financings are usually structured as either subordinated notes or preferred stock and may include any number of components that help boost the mezz investor's return, including:

- ▶ A periodic interest payment of cash based on a percentage of the outstanding balance of the mezzanine financing.
- ▶ Payable in kind (PIK) interest, a periodic form of payment in which the interest payment is not paid in cash but rather by increasing the principal amount of the security in the amount of the interest.
- ▶ Equity ownership in the form of attached warrants or a conversion feature similar to that of a convertible bond. The ownership component in mezzanine securities is almost always accompanied by either cash or PIK interest and, in many cases, by both.

### MEZZ LENDERS' EXPECTATIONS

In light of the current economy, mezzanine debt has become more expensive. "A year ago, companies could borrow up to 7x to 8x EBITDA all-in — senior debt plus mezzanine," says Hal Greenberg, partner with Veronis Suhler Stevenson's (VSS) structured capital fund. Today's market, he says, is 4x or 5x tops, "so pricing has increased, and leverage has gone down, which makes it a safer investment."

Petra Capital Partners has increased its return expectations for non-sponsored deals to 22-23 percent, up from 18 percent, while BNY Mezzanine Partners has increased its expectations on each transaction by one to two percent.

Maranon Capital is still seeing "between 12-14 percent cash pay and three to four percent PIK, plus warrants," says Rich Jander, principal. Maranon has also adjusted to a longer hold period, from up to two years to three years or more. The firm, which does both sponsored and unsponsored deals, has been leaning more toward sponsored. "To get those upper teens type of yields, you have to think harder about investing in nonsponsored situations that don't involve a private equity firm. You can use mezzanine funding more frequently now in sponsored situations to get returns that, historically, you would have only been able to get in nonsponsored," explains Jander.

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## Mezzanine Gets Deals Done in Tough Times *(continued)*

### WHAT THEY'RE LOOKING FOR

Mezzanine lenders are looking for companies with diverse customer bases, multiple revenue streams — particularly if one of those revenue streams is advertising — and strong growth opportunities.

Scott Chappell, principal at BIA Digital Partners, says advertising, marketing and digital media industry companies looking for mezzanine funding should be able to explain their 2008 financials versus their historicals. Having a 2008 financial audit in preparation of a 2009 capital raise is not mandatory, but “it shows an amount of rigor that we appreciate,” says Chappell. If a company is projecting growth beyond the industry’s projected growth rate, he wants to hear why that management team thinks their company will grow more than others.

It’s also important, he feels, to understand how the capital they’re raising fits with their business. “If someone says they need \$5 million to expand their sales force, we’re going to want to understand why they think adding more salespeople is going to result in getting them the traction they need in a difficult advertising climate,” says Chappell.

Other firms also bring a level of skepticism to evaluating a prospects’ growth opportunities in a difficult market. Justin Kaplan, principal at BNY Mezzanine Partners, says he wants to know the value proposition of the company that will allow it to continue to either grow or at least stay in place during a recessionary environment.

“You need to be in a position where you can demonstrate that you’ve got some level of reporting systems and financial sophistication in place to deliver information in a timely and accurate manner,” says Smith, adding that “numbers and expectations need to be accurate, and management needs to be able to deliver the details behind those numbers on a 12 months trailing basis.” In addition, Petra also wants to see an operating plan for a forward 12-month basis that is thoughtful and planned, as well as a specific use for the requested capital.

Maranon is looking for things that demonstrate clear value-add. “We like to see diversity of customers, a recurring revenue stream and scalable operating models that generate high free cash flow,” says Jander. “We want them to be recession resis-

tant or economically agnostic.” Having outsourced areas of operations that are clearly not a company’s core competency is also seen as a strength.

### LOOKING AHEAD

All agree that the first half of 2009 will be soft, while some feel the second half will start to show improvement, with the real growth coming in years 2010 and 2011.

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*Robert Smith, partner, Petra Capital Partners*

“Come the beginning of next year, you will start to slowly see some transactions getting done, but they will get done by a much smaller group of senior lenders that remain active in the market,” expects Jim Dunleavy, director of Orix Media Finance. “M&A is going to be slow. Pricing is going to be significantly up from where it was a year ago, and probably will stay that way until second half of ’09 at least. Lenders will be doing significantly more due diligence than they would a year ago, so expect the process to take longer — and expect you’re going to get less.”

Given a continuing lack of liquidity among senior lenders, Tim Dibble, managing partner at private equity firm Alta Communications, feels there may be opportunities in 2009 for mezz lenders to refinance companies with too much senior debt on the balance sheet. He notes, “There will be a role for mezz players that want to put new money to work 12 to 24 months out.”

Smith anticipates an active subdebt year with a slow buyout market. “We’re still looking at digital plans, because we feel that online advertising over the long term will be an attractive model. Companies that build their business thoughtfully and don’t have too much senior leverage will be strong in the 2009-2010 timeframe.” ■