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FINANCE TERMS

Bridge Loan:

A short-term loan that is used until a person or company secures permanent financing or removes an existing obligation. This type of financing allows the user to meet current obligations by providing immediate cash flow. The loans are short-term (up to one year) with relatively high interest rates and are backed by some form of collateral such as real estate or inventory.

Also known as "interim financing", "gap financing" or a "swing loan".

As the term implies, these loans "bridge the gap" between times when financing is needed. They are used by both corporations and individuals and can be customized for many different situations. For example, let's say that a company is doing a round of equity financing that is expecting to close in six months. A bridge loan could be used to secure working capital until the round of funding goes through. In the case of an individual, bridge loans are common in the real estate market. As there can often be a time lag between the sale of one property and the purchase of another, a bridge loan allows a homeowner more flexibility

Capital Markets:

Markets for buying and selling equity and debt instruments. Capital markets channel savings and investment between suppliers of capital such as retail investors and institutional investors, and users of capital like businesses, government and individuals. Capital markets are vital to the functioning of an economy, since capital is a critical component for generating economic output. Capital markets include primary markets, where new stock and bond issues are sold to investors, and secondary markets, which trade existing securities.

Capital markets typically involve issuing instruments such as stocks and bonds for the medium-term and long-term. In this respect, capital markets are distinct from money markets, which refer to markets for financial instruments with maturities not exceeding one year.

Capital markets have numerous participants including individual investors, institutional investors such as pension funds and mutual funds, municipalities and governments, companies and organizations and banks and financial institutions. Suppliers of capital generally want the maximum possible return at the lowest possible risk, while users of capital want to raise capital at the lowest possible cost.

The size of a nation's capital markets is directly proportional to the size of its economy. The United States, the world's largest economy, has the biggest and deepest capital markets. Capital markets are increasingly interconnected in a globalized economy, which means that ripples in one corner can cause major waves elsewhere. The drawback of this interconnection is best illustrated by the global credit crisis of 2007-09, which was triggered by the collapse in U.S. mortgage-backed securities. The effects of this meltdown were globally transmitted by capital markets since banks and institutions in Europe and Asia held trillions of dollars of these securities.

Collateralized Loan Obligation – CLO:

A security backed by a pool of debt, often low-rated corporate loans. Collateralized loan obligations (CLOs) are similar to collateralized mortgage obligations, except for the different type of underlying loan.

In a CLO, the investor receives scheduled debt payments from the underlying loans but assumes most of the risk in the event that borrowers default. The securities offer the investor greater diversity and the potential for higher-than-average returns. Typically, banks sell CLOs with various tranches, or slices, that reflect different levels of seniority to match different risk/reward profiles.

Commercial Mortgage-Backed Securities (CMBS):

A type of mortgage-backed security that is secured by the loan on a commercial property. A CMBS can provide liquidity to real estate investors and to commercial lenders. As with other types of MBS, the increased use of CMBS can be attributable to the rapid rise in real estate prices over the years.

Because they are not standardized, there are a lot of details associated CMBS that make them difficult to value. However, when compared to a residential mortgage-backed security (RMBS), a CMBS provides a lower degree of prepayment risk because commercial mortgages are most often set for a fixed term.

Debt Issue:

A fixed corporate or government obligation, such as a bond or debenture. A debt issue is a financial obligation that allows the issuer to raise funds by promising to repay the lender at a certain point in the future and in accordance with the terms of the contract. Debt issues include notes, bonds, certificates, mortgages, leases or other agreements between the issuer (the borrower) and lender. Debt issues, such as bonds, are issued by corporations to raise money for certain projects or to expand into new markets; municipalities, states and U.S. and foreign governments issue debt to finance a variety of projects such as social programs or infrastructure plans.

Corporations and municipal, state and federal governments offer debt issues as a means of raising needed funds. In exchange for the "loan," the issuer must make payments to the investors (the lender) in the form of interest payments. The interest rate is often called the "coupon," and interest payments are paid using a predetermined schedule and rate. When the debt issue matures, the issuer repays the face value to the investors. Short-term bills typically have maturities between one and five years; medium term notes mature between six and twelve years; and long term bonds generally have maturities longer than 12 years. Certain large corporations, such as Coca-Cola and Walt Disney, have issued bonds with maturities as long as 100 years.

Corporate debt issues are commonly issued through the underwriting process in which one or more securities firms or banks purchase the issue in its entirety from the issuer and subsequently resell the issue to interested investors. The underwriters impose a fee on the issuer.

The process for government debt issues is different since these are typically issued in an auction format. In the United States, for example, investors can purchase bonds directly from the government through its dedicated website. A broker is not

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needed, and all transactions, including interest payments, are handled electronically.

Debt Security:

Any debt instrument that can be bought or sold between two parties and has basic terms defined, such as notional amount (amount borrowed), interest rate and maturity/renewal date. Debt securities include government bonds, corporate bonds, CDs, municipal bonds, preferred stock, collateralized securities (such as CDOs, CMOs, GNMAs) and zero-coupon securities.

The interest rate on a debt security is largely determined by the perceived repayment ability of the borrower; higher risks of payment default almost always lead to higher interest rates to borrow capital.

Also known as "fixed-income securities."

Most debt securities are traded over-the-counter, with much of the trading now conducted electronically. The total dollar value of trades conducted daily in the debt markets is much larger than that of stocks, as debt securities are held by many large institutional investors as well as governments and non-profit organizations.

Debt securities on the whole are safer investments than equity securities, but riskier than cash. Debt securities get their measure of safety by having a principal amount that is returned to the lender at the maturity date or upon the sale of the security. They are typically classified and grouped by their level of default risk, the type of issuer and income payment cycles.

Derivatives:

A security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes. Most derivatives are characterized by high leverage.

Futures contracts, forward contracts, options and swaps are the most common types of derivatives. Derivatives are contracts and can be used as an underlying asset. There are even derivatives based on weather data, such as the amount of rain or the number of sunny days in a particular region.

Derivatives are generally used as an instrument to hedge risk, but can also be used for speculative purposes. For example, a European investor purchasing shares of an American company off of an American exchange (using U.S. dollars to do so) would be exposed to exchange-rate risk while holding that stock. To hedge this risk, the investor could purchase currency futures to lock in a specified exchange rate for the future stock sale and currency conversion back into Euros.

Financial Asset:

An asset that derives value because of a contractual claim. Stocks, bonds, bank deposits, and the like are all examples of financial assets.

Unlike land and property--which are tangible, physical assets--financial assets do not necessarily have physical worth.

Leveraged Buyout – LBO:

The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

In an LBO, there is usually a ratio of 90% debt to 10% equity. Because of this high debt/equity ratio, the bonds usually are not investment grade and are referred to as junk bonds. Leveraged buyouts have had a notorious history, especially in the 1980s when several prominent buyouts led to the eventual bankruptcy of the acquired companies. This was mainly due to the fact that the leverage ratio was nearly 100% and the interest payments were so large that the company's operating cash flows were unable to meet the obligation.

One of the largest LBOs on record was the acquisition of HCA Inc. in 2006 by Kohlberg Kravis Roberts & Co. (KKR), Bain & Co., and Merrill Lynch. The three companies paid around $33 billion for the acquisition.

It can be considered ironic that a company's success (in the form of assets on the

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balance sheet) can be used against it as collateral by a hostile company that acquires it. For this reason, some regard LBOs as an especially ruthless, predatory tactic.

Mezzanine Financing

A hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. Mezzanine financing is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

Since mezzanine financing is usually provided to the borrower very quickly with little due diligence on the part of the lender and little or no collateral on the part of the borrower, this type of financing is aggressively priced with the lender seeking a return in the 20-30% range.

Mezzanine financing is advantageous because it is treated like equity on a company's balance sheet and may make it easier to obtain standard bank financing. To attract mezzanine financing, a company usually must demonstrate a track record in the industry with an established reputation and product, a history of profitability and a viable expansion plan for the business (e.g. expansions, acquisitions, IPO).

Portfolio Lender:

A company that not only originates mortgage loans, but also holds a portfolio of their loans instead of selling them off in the secondary market. A portfolio lender makes money off the fees for originating the mortgages and also seeks to make profits off the spread (difference) between interest-earning assets and the interest paid on deposits in their mortgage portfolio.

Many mortgage lenders avoid the risks of holding mortgages, only profiting from origination fees and then quickly selling off the mortgages to other financial institutions. There are pros and cons to both methods. Companies who profit off mortgage origination experience less risk and likely a more stable profit stream, while portfolio lenders have a chance to experience more upside on their portfolio, but also more risk.

Private Equity:

Private equity is a source of investment capital from high net worth individuals and institutions for the purpose of investing and acquiring equity ownership in companies. Partners at private-equity firms raise funds and manage these monies to yield favorable returns for their shareholder clients, typically with an investment horizon between four and seven years.

These funds can be used in purchasing shares of private companies, or in public companies that eventually become delisted from public stock exchanges under go-private deals. The minimum amount of capital required for investors can vary depending on the firm and fund raised. Some funds have a $250,000 minimum investment requirement; others can require millions of dollars.

Private equity has successfully attracted the best and brightest in corporate America, including top performers from Fortune 500 companies and elite strategy and management consulting firms. Top performers at accounting and law firms can also be recruiting grounds, as accounting and legal skills relate to transaction support work required to complete a deal and translate to advisory work for a portfolio company's management.

The fee structure for private-equity firms varies, but it typically consists of a management fee and a performance fee (in some cases, a yearly management fee of 2% of assets managed and 20% of gross profits upon sale of the company). How firms are incentivized can vary considerably.

Given that a private-equity firm with $1 billion of assets under management might have no more than two dozen investment professionals, and that 20% of gross profits can generate tens of millions of dollars in fees for the firm, it is easy to see why the private-equity industry has attracted top talent. At the middle market level ($50 million to $500 million in deal value), associates can earn low six figures in salary and bonuses, vice presidents can earn approximately half a million dollars and principals can earn more than $1 million in (realized and unrealized) compensation per year.

Private Finance Initiative – PFI:

A method of providing funds for major capital investments where private firms are contracted to complete and manage public projects. Under a private finance initiative, the private company, instead of the government, handles the up-front costs. The project is then leased to the public, and the government authority makes annual payments to the private company. These contracts are typically given to construction firms and can last 30 years or longer. In the United States, PFIs are called public-private partnerships.

Private finance initiatives were originally started as part of Great Britain's strategy for providing high quality services. PFIs were first implemented there in 1992 and become popular after 1997. They were used to fund major public works projects such as schools, prisons, hospitals and infrastructure. Instead of funding these projects up front from tax receipts, private firms construct them and then make their money back through long-term (25+ years) repayments, plus interest, from the government. Thus, the government does not have to outlay a large sum of money at once to fund a large project. PFIs are also supposed to improve on-time project completion and transfer some of the risks associated with constructing and maintaining these projects from the public sector to the private sector. Financial advisers such as investment banks help manage the bidding, negotiating and financing process.

A key drawback is the interest and payments associated with PFIs burden future taxpayers. In addition, the arrangements sometimes include not only construction, but also ongoing maintenance once the projects are complete, which further increases these projects' future cost and tax burden.

In the United Kingdom in the 2000s, a scandal surrounding PFIs revealed the government was spending significantly more on these projects than they were worth, to the benefit of the private firms running them and to the taxpayer's detriment. PFIs have also been criticized

Private Placement:

The sale of securities to a relatively small number of select investors as a way of raising capital. Investors involved in private placements are usually large banks, mutual funds, insurance companies and pension funds. Private placement is the opposite of a public issue, in which securities are made available for sale on the open market.

Since a private placement is offered to a few, select individuals, the placement does not have to be registered with the Securities and Exchange Commission. In many cases, detailed financial information is not disclosed and a the need for a prospectus is waived. Finally, since the placements are private rather than public, the average investor is only made aware of the placement after it has occurred.

Project Finance:

Defined by the International Project Finance Association (IPFA) as the following:

The financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cashflow generated by the project.

In other words, project financing is a loan structure that relies primarily on the project's cash flow for repayment, with the project's assets, rights, and interests held as secondary security or collateral.

Project finance is especially attractive to the private sector because they can fund major projects off balance sheet.

Real Estate Mortgage Investment Conduit – REMIC:

A special purpose vehicle (SPV) that is used to pool mortgage loans and issue mortgage-backed securities (MBS). Real estate mortgage investment conduits (REMIC) hold commercial and residential mortgages in trust, and issue interests in these mortgages to investors.

Similar to collateralized mortgage obligations (CMOs), REMICs piece together mortgages into pools based on risk, and issue bonds or other securities to investors. These securities then trade on the secondary mortgage market

Recapitalization:

Restructuring a company's debt and equity mixture, most often with the aim of making a company's capital structure more stable. Essentially, the process involves the exchange of one form of financing for another, such as removing preferred shares from the company's capital structure and replacing them with bonds.

Recapitalization can be undertaken for a number of reasons, such as defending against a hostile takeover, minimizing taxes or to implement an exit strategy for venture capitalists. Companies often want to diversify their debt-to-equity ratio to improve liquidity. A good example is when a company issues stock in order to buy back debt securities, thus increasing its proportion of equity capital as compared to its debt capital.

Generally speaking, when a company's debt decreases in proportion to its equity, it has lower leverage and thus, ceteris paribus, its earnings per share should decrease following the change, however its shares would be incrementally less risky, since the company's shareholders have fewer debt obligations which must be paid by the company before shareholders can see profits.

Reit (Real Estate Investment Trust)

A security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.

Equity REITs: Equity REITs invest in and own properties (thus responsible for the equity or value of their real estate assets). Their revenues come principally from their properties' rents.

Mortgage REITs: Mortgage REITs deal in investment and ownership of property mortgages. These REITs loan money for mortgages to owners of real estate, or purchase existing mortgages or mortgage-backed securities. Their revenues are generated primarily by the interest that they earn on the mortgage loans.

Hybrid REITs: Hybrid REITs combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages.

Individuals can invest in REITs either by purchasing their shares directly on an open exchange or by investing in a mutual fund that specializes in public real estate. An additional benefit to investing in REITs is the fact that many are accompanied by dividend reinvestment plans (DRIPs). Among other things, REITs invest in shopping malls, office buildings, apartments, warehouses and hotels. Some REITs will invest specifically in one area of real estate - shopping malls, for example - or in one specific region, state or country. Investing in REITs is a liquid, dividend-paying means of participating in the real estate market.

Residential Mortgage-Backed Security (RMBS):

A type of mortgage-backed debt obligation whose cash flows come from residential debt, such as mortgages, home-equity loans and subprime mortgages. A residential mortgage-backed security is comprised of a pool of mortgage loans created by banks and other financial institutions. The cash flows from each of the pooled mortgages is packaged by a special purpose entity into classes and tranches, which then issues securities and can be purchased by investors.

Residential mortgage-backed securities and commercial mortgage-backed securities serve as the foundation for other financial instruments, such as collateralized mortgage obligations (CMO). Their complexity depends on the income provided to investors and the amount of risk that investors assume. A pass-through style of RMBS allows an investor to receive a share of interest and principal payments, while a CMO may have a structure that allows investors to assume more risk but also potentially more return.

Investing in a residential-mortgage backed security can expose the investor to prepayment risk and credit risk. Prepayment risk is the risk that the mortgage holder will pay back the mortgage before its maturity date, which reduces the amount of interest the investor would have otherwise received. Prepayment, in this sense, is a payment in excess of the scheduled principal payment. This situation may arise if the current market interest rate falls below the interest rate of the mortgage, since the homeowner is more likely to refinance the mortgage.

Secured Debt:

Debt backed or secured by collateral to reduce the risk associated with lending. An example would be a mortgage, your house is considered collateral towards the debt. If you default on repayment, the bank seizes your house, sells it and uses the proceeds to pay back the debt.

Assets backing debt or a debt instrument are considered security, which means they can be claimed by the lender if default occurs. Obviously unsecured debt is higher risk, and as such lenders of unsecured money typically require a much higher return.

Securitization:

The process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors. The process can encompass any type of financial asset and promotes liquidity in the marketplace.

Mortgage-backed securities are a perfect example of securitization. By combining mortgages into one large pool, the issuer can divide the large pool into smaller pieces based on each individual mortgage's inherent risk of default and then sell those smaller pieces to investors.

The process creates liquidity by enabling smaller investors to purchase shares in a larger asset pool. Using the mortgage-backed security example, individual retail investors are able to purchase portions of a mortgage as a type of bond. Without the securitization of mortgages, retail investors may not be able to afford to buy into a large pool of mortgages.

Structured Finance:

A service that generally involves highly complex financial transactions offered by many large financial institutions for companies with very unique financing needs. These financing needs usually don't match conventional financial products such as a loan.

Structured finance has become a major segment in the financial industry since the mid-1980s. Collateralized bond obligations (CBOs), collateralized debt obligations (CDOs), syndicated loans and synthetic financial instruments are examples of structured financial instruments.

Subordinated Debt:

A loan (or security) that ranks below other loans (or securities) with regard to claims on assets or earnings.

Also known as a "junior security" or "subordinated loan."

In the case of default, creditors with subordinated debt wouldn't get paid out until after the senior debtholders were paid in full. Therefore, subordinated debt is more risky than unsubordinated debt.

Syndicated Credit/loan:

A loan offered by a group of lenders (called a syndicate) who work together to provide funds for a single borrower. The borrower could be a corporation, a large project, or a sovereignty (such as a government). The loan may involve fixed amounts, a credit line, or a combination of the two. Interest rates can be fixed for the term of the loan or floating based on a benchmark rate such as the London Interbank Offered Rate (LIBOR).

Typically there is a lead bank or underwriter of the loan, known as the "arranger", "agent", or "lead lender". This lender may be putting up a proportionally bigger share of the loan, or perform duties like dispersing cash flows amongst the other syndicate members and administrative tasks.

Also known as a "syndicated bank facility".

The main goal of syndicated lending is to spread the risk of a borrower default across multiple lenders (such as banks) or institutional investors like pensions funds and hedge funds. Because syndicated loans tend to be much larger than standard bank loans, the risk of even one borrower defaulting could cripple a single lender. Syndicated loans are also used in the leveraged buyout community to fund large corporate takeovers with primarily debt funding.

Syndicated loans can be made on a "best efforts" basis, which means that if enough investors can't be found, the amount the borrower receives will be lower than originally anticipated. These loans can also be split into dual tranches for banks (who fund standard revolvers or lines of credit) and institutional investors (who fund fixed-rate term loans).

Synthetic CDO:

A form of collateralized debt obligation (CDO) that invests in credit default swaps (CDSs) or other non-cash assets to gain exposure to a portfolio of fixed income assets. Synthetic CDOs are typically divided into credit tranches based on the level of credit risk assumed. Initial investments into the CDO are made by the lower tranches, while the senior tranches may not have to make an initial investment.

All tranches will receive periodic payments based on the cash flows from the credit default swaps. If a credit event occurs in the fixed income portfolio, the synthetic CDO and its investors become responsible for the losses, starting from the lowest rated tranches and working its way up.