Mezzanine Financing - Versatile Debt and Equity

by S.G. Brooke Tucker

Mezzanine financing or subordinated debt fills an increasing role in capital markets transactions where corporate owners and buyers can find very flexible financing to achieve future goals. Simply put, mezzanine financing is a layer of debt in between senior debt and equity. It is a hybrid loan with equity features. It is a financing vehicle that often bridges the gap between what the bank will lend and what the borrower needs in equity to achieve a future goal. That goal could be rapid internal growth, a management buyout or an acquisition. As such, it is a capital markets transaction with a private financing company.

The chart below demonstrates some of the significant differences in bank debt, mezzanine debt and equity.

Issues	Senior Debt	Mezzanine Debt	Private Equity
Loan Type	Line of Credit	Debt/Warrants	Preferred Stock
Risk Level	Low	Medium	High
Interest Rates	5-8%	12-14%	N/A
All in Cost	5-8%	20-35%	35%+
Collateral	Yes	No	No
Flexibility	Rigid	Flexible	Very Flexible
Seniority	Senior	Junior	Unsecured
Equity Dilution	None	Low	High
Other Costs	Personal Guarantee	None	Loss of Control
Board Representation	None	Visitation	Yes

Example

The best example of the versatility of mezzanine debt is in acquisition financing. Often the acquirer's assets and those of the target company are insufficient to obtain bank financing for the whole transaction. Moreover, if the bank would go along with the transaction (stretch financing), there would be insufficient working capital to run both companies. There is a gap in the financing, often amounting to one or two EBIT multiples. The opportunity to acquire another company is just too good to pass up and the combined companies would significantly increase shareholders' value. The financing gap can be filled with mezzanine financing. While giving up some of the fruits of the deal, owner's have a well capitalized combined company and adequate bank lines of credit (liquidity).

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SENIOR DEBT VS. MEZZANINE FINANCING

Mezzanine financing is unsecured and subordinated to the senior debt position (bank debt). As such, the bank looks at mezzanine financing as if it is either expensive debt or cheap equity. Either way, it is below the bank in priority and therefore fills the role of equity. An inter-creditor agreement between bank and mezzanine lender is required. Mezzanine financing does not require personal guarantees and is less dilutive to ownership than equity.

EQUITY VS. MEZZANINE FINANCING

First, mezzanine financing is far more available to middle market companies seeking to give up just a little equity. There are very few minority equity investors for small companies, unless that upside is extremely attractive (bordering on venture capital). Mezzanine financing companies seek total returns of 20-35%, while private equity groups seek more than 35%. Therefore, the amount of equity to contribute to the financing is far smaller and less dilutive to ownership. Many companies may prefer equity funding, in that equity does not require interest, payments or guarantees. In equity financing, owners may give up significant control.

PRICING

Mezzanine financing for middle market companies is priced appropriately between bank debt (Prime/LIBOR plus a %) and equity financing (usually 35%+). A typical transaction might be a five year term loan with interest only in the first year, followed by 48 monthly payments. Interest charges (coupon rate) would range between 12% and 14% fixed. An origination fee of 2% is fairly standard. In addition, the mezzanine financing company would require warrants to purchase stock, a royalty, or a revenue participation fee based on the growth of the business. Mezzanine financing companies will look for an overall internal rate of return (IRR) of 20% to 35%. While interest rates are straight forward, the warrant position or "equity kicker" is not. The warrant position is typically less than 10% of the outstanding common equity (but not always) depending upon the future value of the company and the certainty with which that value growth is viewed by the investor.

Managers may well ask - How can we pay a 14% coupon rate? The answer is fairly simple. If you cannot – you do not qualify for mezzanine financing. If you can, then return on invested capital far exceeds the 14% coupon and the value created with the financing is far greater than the company would achieve without the financing.[1]

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[1] Mezzanine pricing is as complicated as any equity financing involving present and future business valuation issues and is beyond the scope of this article.

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Companies Best Suited for Mezzanine Financing

As discussed, sufficient cash flow (and projected cash flow) to fund growth is essential to obtain mezzanine financing. Therefore, startups and declining businesses need not apply. Since this type of financing is intermediate in its time horizon, companies and industries which require long periods (>5 years) to show significant profitability and marketability are not suitable candidates. Best candidates are companies looking to grow through acquisition, management buy-outs and ownership successions, recapitalizations and growth financings. To be successful in obtaining mezzanine financing companies must demonstrate an ability to grow revenues and profits rapidly. There are many companies that can afford to pay high interest rates, but it is the equity portion of the financing arrangement that is most attractive to mezzanine lenders. The value of the warrant position (equity kicker) at the end of the financing determines the lender/investors' ultimate return. Here are some attributes of companies best suited for mezzanine financing.

- An experienced management team with a significant stake in the company's future.
- A business strategy or vision that addresses rapid growth within the company's management ability and resources.
- The company produces value-added products or services that are competitive in the marketplace and result in a measurable and defensible market share.
- There have been sufficient historical cash flows to service debt and projected debt levels.
- The company is not in a high tech, faddish, rapidly changing or fashion related industry.
- The company is projecting a substantial increase in value as a result of the business strategy and financing.

Where's the Exit?

For mezzanine investors the "Exit" is crucial to receiving the equity return portion of their financing. The exit is at the end of the term of the loan (or through an early redemption) when the mezzanine lender has the opportunity to cash in its warrant position. The value of the warrants is the percentage ownership represented by the warrant position times the then current value of the company. Assume that the company is worth $10 million after five years and the warrant position was for 10% of the company. The company owes the lender/investor $1 million to redeem the warrants. The redemption can be paid with current cash flow, additional bank or equity financing, an IPO or a sale of the company.

Conclusion

In spite of what looks like expensive financing, the versatility of mezzanine financing to make acquisitions, fund growth initiatives and transfer ownership positions is far more valuable. Unlike private equity groups and venture capital firms, mezzanine financing companies seek only to achieve the same IRRs that owner's expect of their own risk capital. By borrowing on or leveraging their own equity, owners can greatly expand their operations and ultimate returns (exit).

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