Mezzanine Finance

by
Corry Silbernagel
Davis Vaitkunas
Bond Capital

With a supplement by Ian Giddy

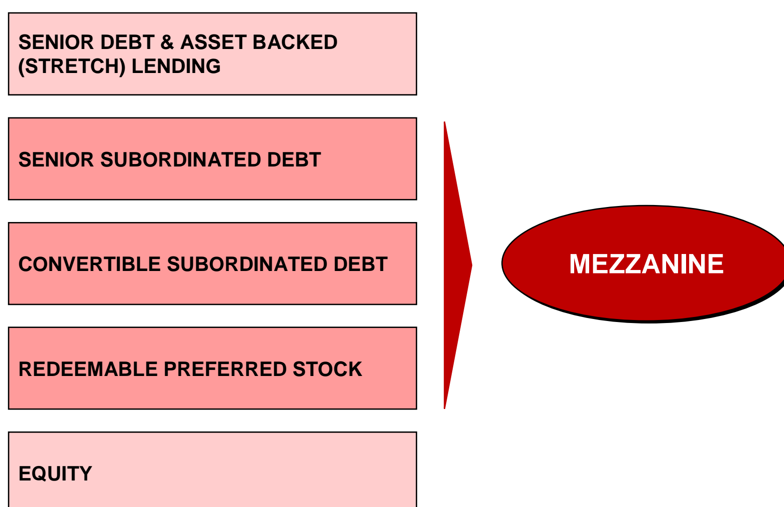
Mezzanine Debt--Another Level To Consider

Mezzanine debt is used by companies that are cash flow positive to fund: further growth through expansion projects; acquisitions; recapitalizations; and, management and leveraged buyouts. When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity required in the business. As equity is the most expensive form of capital, it is most cost effective to create a capital structure that secures the most funding, offers the lowest cost of capital, and maximizes return on equity.

Mezzanine debt has been around for over 30 years, however its use in Western Canada and the Pacific Northwest is relatively new and growing. Leading companies in this region are starting to use mezzanine debt to fund the growth today that the chartered banks will not fund until tomorrow.

What Is Mezzanine Debt?

Mezzanine debt capital generally refers to that layer of financing between a company's senior debt and equity, filling the gap between the two. Structurally, it is subordinate in priority of payment to senior debt, but senior in rank to common stock or equity (Exhibit #1). In a broader sense, mezzanine debt may take the form of convertible debt, senior subordinated debt or private "mezzanine" securities (debt with warrants or preferred equity).



Mezzanine capital is typically used to fund a growth opportunity, such as an acquisition, new product line, new distribution channel or plant expansion, or in private business' for the company owners to take money out of the company for other uses or to enable management to buyout company owners for

succession purposes. Although it makes up a portion of a company's total available capital, mezzanine financing is critical to growing companies and in succession planning in recent years.

The gap in funding between senior debt and equity is common for the following reasons:

1) accounts receivable, inventories and fixed assets are being discounted at greater rates than in the past for fear that their values will not be realized in the future;

2) many balance sheets now contain significant intangible assets, and,

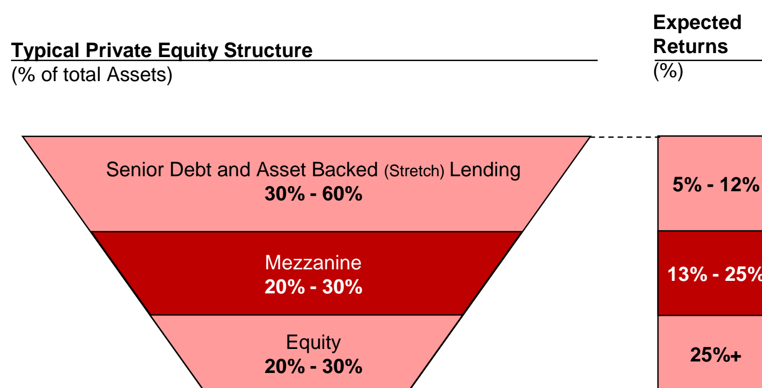
3) as a result of defaults and regulatory pressure, banks have placed ceilings on the amount of total debt a company can obtain.

While additional liquidity can be obtained from equity investors, equity is the most expensive source of capital. Further, equity capital, by its nature, dilutes existing shareholders. As a result, mezzanine debt can be an attractive alternative way to obtain much needed capital.

Capital Structures

While there are no hard and fast rules for optimizing a company's capital structure, companies that are ahead of the curve use an efficient combination of senior debt, mezzanine debt, and equity capital to minimize their true cost of capital.

COMPANIES WITH EFFICIENT CAPITAL STRUCTURES EMPLOY A NUMBER OF CAPITAL SOURCES



Source: Management Magazine, Bond Capital

Exhibit 2

In Exhibit 2, mezzanine debt is shown adding significant capital enabling a company to grow with no dilution to Company owners. On the positive side: the owners face little dilution and maintain their control of the business; the companies total cost of capital is reduced; and the mezzanine debt has a flexible payment term that is structured as "self liquidating" and is paid off over time. On the negative side this is a debt structure that requires interest payments over time.

The table in Exhibit 3 outlines differences between capital sources:

COMPANIES WITH EFFICIENT CAPITAL STRUCTURES USE A NUMBER OF CAPITAL SOURCES

	Senior	Stretch	Mezzanine	Equity
Security	Secured	Partial	Subordinated	none
Ranking	Senior	First on Assets	Second	Third
Covenants	Tight	Tight	Flexible	none
Term	Demand	Term	Term / Patient	Patient
Coupon	Coupon - Floating	Coupon - Fixed	Coupon - Fixed	Dividend
Rate	Prime	Prime Adjusted	Risk Adjusted	Market Adjusted
Equity Kicker	none	Success Fee	Warrants	Shares
Prepayment Penalties	Yes	Yes	Fixed Period	No
Capital Providers	Chartered Bank	Chartered Bank / secondary lender	Private Capital	Private Capital
Recovery %	High	medium	Low	Low
Liquidity	High	medium	Low	Right of Sale / Shotgun

Source: FitchRatings, Bond Capital

Exhibit 3

Secure More Total Capital

Some closely held companies, particularly those that are family controlled, are reluctant to consider mezzanine financing because it requires relinquishing a certain amount of ownership. However, a mezzanine investor's goal isn't to be a long-term shareholder, but rather to achieve a target return rate by some specified time. In fact, a typical mezzanine transaction has the mezzanine fund as a minority equity holder, with buyout terms to remove the mezzanine fund at the appropriate time. It's also important for a business owner to analyze the difference in value between a ownership interest in a stagnant or underperforming business and an ownership in a growing company. What's more, having mezzanine debt in place actually can help a company secure more total capital and avoid the small business pitfall of being under capitalized.

For example, a business owner approaches a bank and says, 'I'm buying a company for $20 million and I want all the debt to be bank debt and I'll put the balance in as equity,' and requests a $10 million banking facility. Often, when a bank is approached with a $10 million request for financing they typically discount the business owners request as excessive and will lend only 75% of funding requested leaving the business owner to fund $12.5 million with equity. In this situation a mezzanine lender might offer to fund $5 million in mezzanine and work with the business owner to secure senior debt through a chartered bank. With a mezzanine component, the bank see's the mezzanine as equity and as a reputable partner and is willing to lend the original request of $10 million, and often at a better rate with the addition of the mezzanine component. The total amount raised through external sources is

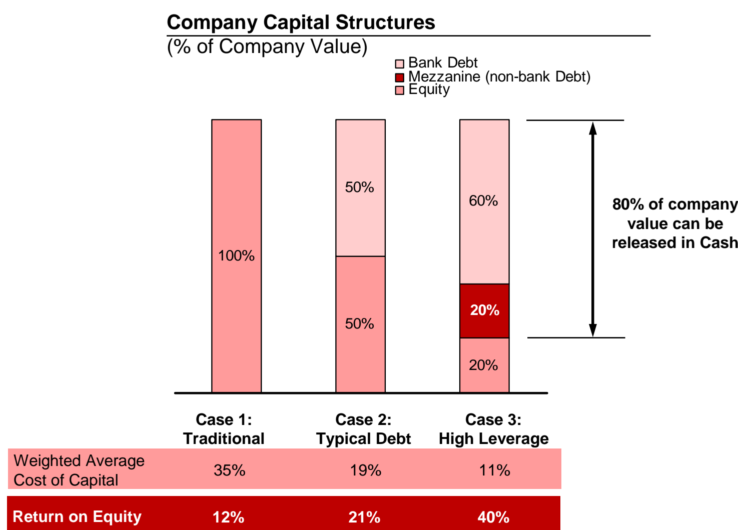
now $15 million with the mezzanine layer compared with $7.5 million without. Ultimately this reduces the equity requirement from $12.5 million to $5 million.

Banks often look more favorably on companies that are backed by institutional investors such as mezzanine lenders and may extend more credit under more attractive terms. This is a result of the mezzanine lenders' reputation, and the increased involvement of the mezzanine lender with the company as compared with a bank alone. Simply put, the risk to the banks investment is reduced because of their knowledge that the mezzanine lender through a more active role – may enhance the success of the business. Additionally, mezzanine lenders are a source of reserve capital for a business owner helping to diversify a company's banking relationships thus reducing dependence on any one lender.

Lowering the Cost of Capital and Improving Equity Returns

In addition to securing more capital a mezzanine structure also allows a business to reduce its cost of capital, and boost both return on equity and absolute profits. The following three cases illustrate a traditional all equity company (Case 1: Traditional) transitioning to a more efficient capital structure through a small recapitalization (Case 2: Typical Debt) into a typical company with debt, and then recapitalizing again to a final optimized structure using a high degree of leverage (Case 3: high Leverage). The result of the transition from traditional company into a more efficient capital structure lowers the company's cost of capital, improves the return on equity, and releases significant capital to a company's existing owners as demonstrated in Exhibit 4.

OPTIMIZING CAPITAL STRUCTURE TO LOWER A COMPANY'S COST OF CAPITAL CAN RELEASE SIGNIFICANT VALUE AND IMPROVE RETURN ON EQUITY



	Case 1: Traditional	Case 2: Typical Debt	Case 3: High Leverage
Weighted Average Cost of Capital	35%	19%	11%
Return on Equity	12%	21%	40%

Source: Bond Capital

Exhibit 4

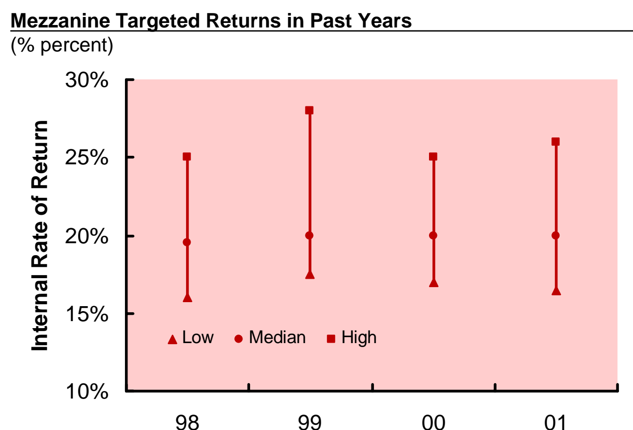
The capital received by the company's owners can be used to diversify risk exposure to other investments or retirement, to reinvest in the company, or to acquire other businesses.

Mezzanine History

Mezzanine lending has been around for more than two decades. In the 1980's, the business was dominated by insurance companies and savings and loan associations. By the 1990's, limited partnerships (LPs) had entered the arena. Today, investors include pension funds, hedge funds, leveraged public funds, LPs and insurance companies, as well as banks that have established stand-alone mezzanine efforts.

Traditional mezzanine lenders are book-and-hold investors, generally focused on cash-flow lending, looking for a minimum term (call protection) and equity participation to generate longer term results. Unlike traded equity, high-yield debt, and interest rates which fluctuate with economic conditions, traditional mezzanine finance is a consistent and stable market. The coupon rate on mezzanine notes and targeted returns of mezzanine investments have remained relatively constant as shown in Exhibit 6.

THE MEDIAN TARGETED RETURN FOR MEZZANINE INVESTMENTS HAS REMAINED RELATIVELY CONSTANT AT 20%[1)]



1) This does reflect mezzanine returns which can vary based on company performance and loss ratio.

Source: Fleet Securities, Inc.

Exhibit 5

Typical Mezzanine Terms

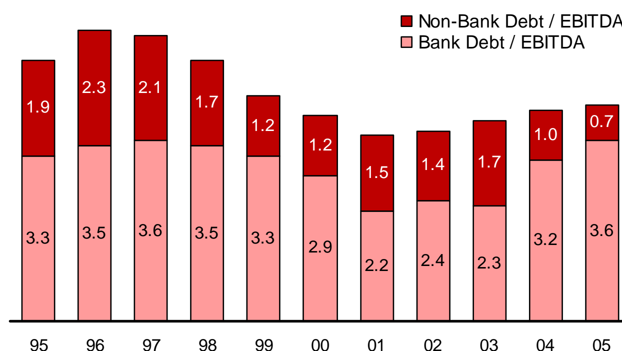
The biggest benefit mezzanine debt provides is reducing the amount of equity required in the transaction. Mezzanine investors are looking for between 15 and 25 percent IRR (internal rate of return) compared to 25 to 50 percent for equity investors, so it's more cost effective.

While mezzanine debt is more expensive than bank debt, it is not as rigid. Generally, it shares the same covenant package as a bank deal, but the measurement characteristics are looser. For instance, if the maximum leverage of EBITDA on a bank deal is three and a half times, a mezzanine deal would be

closer to four or five. Exhibit 7 depicts average debt multiples of leveraged companies and differentiates between bank debt as a multiple of EBITDA, and non-bank debt (often mezzanine debt) as a multiple of EBITDA. For example, an average US highly leveraged company with EBITDA of $10 million per year in 2004 would have had 3.2 time EBITDA or $32 million in bank debt, with 1.0 times EBITDA or $10 million in non-bank debt. The ability of smaller companies (<$100 million in revenue) in western Canada and the pacific northwest of the United States to attract senior debt levels at this average is difficult, especially for non-traditional transactions and special situations. As a result of reduced senior debt levels initially, the use of mezzanine capital is more relevant in this region.

MEZZANINE DEBT CAN PLAY AN INTEGRAL PART OF A COMPANY'S CAPITAL STRUCTURE

US Average Debt Multiples of Highly Leveraged Loans
(multiple of EBITDA[1)])



1) EBITDA = Earnings before interest, taxes, depreciation and amortization.

Source: Standard and Poor's LCD

Exhibit 6

Typically, mezzanine lending includes both subordinated debt and an equity component. The debt is issued with a cash pay interest rate of 12 to 18 percent and a maturity ranging from five to seven years with the ability of the borrower to buy out the debt earlier. The remainder of the required 15 to 25 percent all-in-return consists of warrants to buy common stock, which the investor values based on the outlook of the company, or incremental interest paid on a "pay-in-kind" or PIK basis.

Mezzanine Exit

Most mezzanine investments are taken out either through a change-of-control sale or recapitalization of the company. Many mezzanine capital providers believe the IPO "home run" is a rarity. While some mezzanine providers may look to invest in companies that represent strong IPO candidates, more frequently the mezzanine capital provider is bought out by the initial owner through a recapitalization with inexpensive senior debt, through the accumulated profits generated by the business or through an acquisition of the company by a competitor. The typical mezzanine transaction is for 5 to 8 years, with the possibility of early exit.

Structure

Mezzanine financings can be completed through a variety of different structures based on the specific objectives of the transaction and the existing capital structure in place at the company. The basic forms used in most mezzanine financings are: **subordinated notes** and **preferred stock**. Mezzanine lenders, typically specialist mezzanine investment funds, look for a certain rate of return which can come from four sources: (each individual security can be made up of any of the following or a combination thereof):

- **Cash interest** — A periodic payment of cash based on a percentage of the outstanding balance of the mezzanine financing. The interest rate can be either fixed throughout the term of the loan or can fluctuate (i.e., float) along with LIBOR or other base rates.
- **PIK interest** — Payable in kind interest is 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 (e.g., a $100 million bond with an 8% PIK interest rate will have a balance of $108 million at the end of the period but will not pay any cash interest).
- **Ownership** — Along with the typical interest payment associated with debt, mezzanine capital will often include an equity stake 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 interest or PIK interest and in many cases by both.
- **Participation payout** — Instead of equity, the lender may take an equity-like return in the form of a percentage of the company's performance, as measured by total sales, or EBITDA as a measure of cash flow, or profits.

Mezzanine lenders will also often charge an arrangement fee, payable upfront at the closing of the transaction. Arrangement fees contribute the least return and are aimed primarily to cover administrative costs and as an incentive to complete the transaction.

Illustration. The following are illustrative examples of mezzanine financings:

- $100,000,000 of senior subordinated notes with warrants (10% cash interest, 3% PIK interest and warrants representing 4% of the fully diluted ownership of the company)
- $50,000,000 of redeemable preferred stock with warrants (0% cash interest, 14% PIK interest and warrants representing 6% of the fully diluted ownership of the company)

In structuring a mezzanine security, the company and lender work together to avoid burdening the borrower with the full interest cost of such a loan. Because mezzanine lenders will seek a return of 14% to 20%, this return must be achieved through means other than simply cash interest payments. As a result, by using equity ownership and PIK

interest, the mezzanine lender effectively defers its compensation until the due date of the security or a change of control of the company.

Mezzanine financings can be made at either the operating company level or at the level of a holding company (also known as structural subordination). In a holding company structure, as there are no operations and hence no cash flows, the structural subordination of the security and the reliance on cash dividends from the operating company introduces additional risk and typically higher cost. The advantage to the company is that the debt at the holding company level is not normally included in assessing the leverage or coverage ratios that constrain how much a company can borrow.

- Ian Giddy