

CapitalEyes

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Mezzanine Finance: Closing The Gap Between Debt And Equity

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Existing lines of credit have been reduced. New loans from traditional lenders are harder to obtain. Access to the public capital markets is virtually non-existent and the economic downturn has been financially challenging for many businesses. Where then, in these times, does the typical middle-market company turn for capital? Increasingly the answer may be mezzanine financing.

A hybrid form of capital, mezzanine financing is sandwiched between senior debt and equity on a company's balance sheet. Structurally it is subordinated or "junior" in priority of payment to senior debt, but senior to common stock or equity. Mezzanine capital typically is used to fund a growth opportunity, such as an acquisition, new product line, new distribution channel or plant expansion. Although it makes up a small percentage of a company's total available capital, mezzanine financing has become critical to middle-market companies in recent months.

"These days, mezzanine finance is often the factor that influences whether or not a deal closes," says Tim Shoyer, [Fleet Securities](#) managing director of high-yield and mezzanine debt. "As more cash-flow loans are being restructured, often there's a gap between the new asset-based deal and the amount financed previously on a cash-flow basis. Mezzanine fills that gap. It's been a big trend in the last 18 to 24 months."

Gaps of this nature are common for two primary 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; and, 2) 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. It also requires a greater "ownership give-up." As a result, mezzanine finance can be an attractive alternative.

Typical Terms

"The biggest benefit mezzanine debt provides is reducing the amount of equity required in the transaction," says Shoyer. "Mezzanine investors are looking for an 18 to 20 percent IRR (internal rate of return) compared to 25 to 35 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," Shoyer says.

Typically, mezzanine lending includes both subordinated debt and an equity component. The debt is issued with a cash pay interest rate of 12 to 12 1/2 percent and a maturity ranging from five to seven years. The remainder of the required 18 to 20 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. The fee for raising the money runs between two and three percent of the transaction. Deal sizes typically range from three million to \$25 million but can go as high as \$150 million.

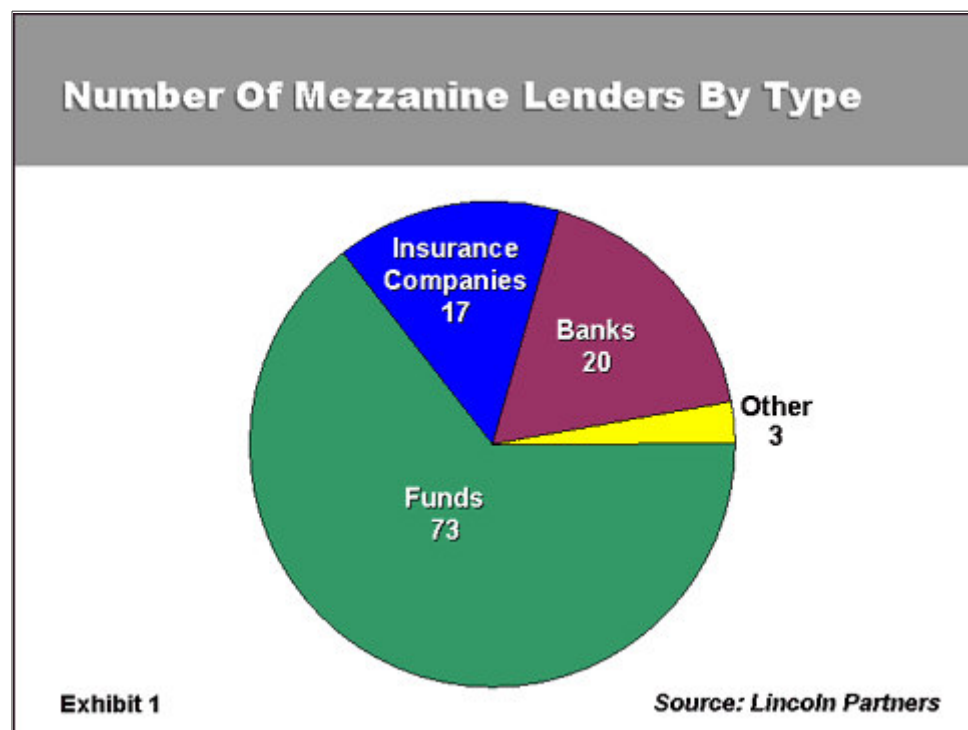
Growing Field of Players

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.

"During the mid-90's, it was common for banks to function as principal purchasers," says Shoyer, "but today, most of them are working as placement agents." In other words, the placement agent shows a deal to a wide variety of investors and creates a competitive auction environment, much like an underwriter in an investment banking transaction. "The auction environment is important to the client because it ensures the company gets the best deal available in the marketplace."

There are now more mezzanine lenders than active senior lenders as a result of industry consolidation and credit tightening. According to Chicago-based investment bank Lincoln Partners, there are approximately 113 mezzanine providers in the market

today (Exhibit #1—Mezzanine Lenders By Type).



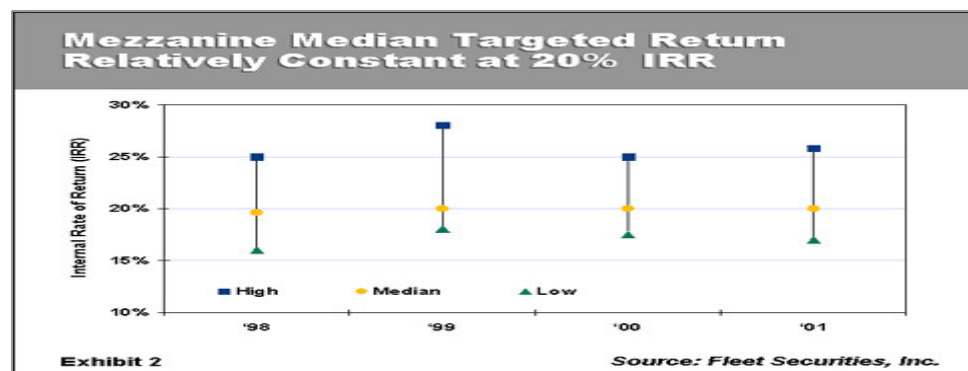
Ronald Kahn, managing director of Lincoln Partners said, "When the senior debt market contracted, people thought this would be a great opportunity for mezzanine. However, in reality, M&A volume was so low that there were few opportunities for mezzanine lenders. We see more money than demand now in the marketplace." Kahn's comments were made at a recent New York Business Forums, Inc. conference on mezzanine finance.

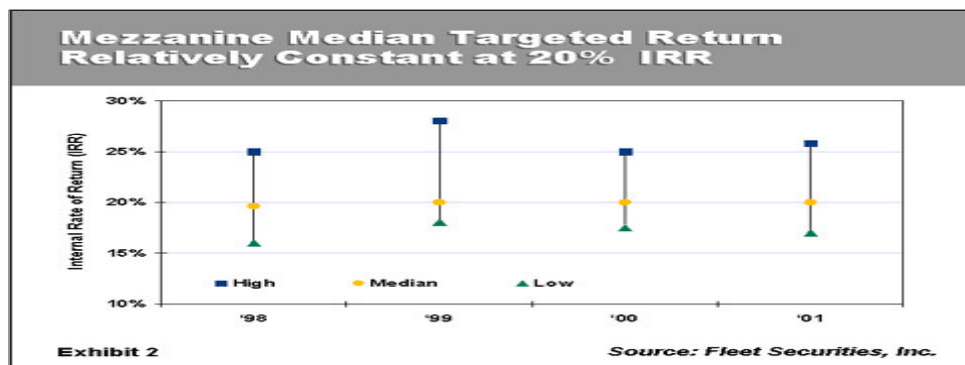
Shifting Structures

The supply/demand imbalance has precipitated a shift in the market as mezzanine players compete with high-yield for larger deals. "Traditional mezzanine lenders are book-and-hold investors," says Shoyer. "They're generally focused on cash-flow lending and they look for call protection and equity participation to generate longer term results. Because there's a dearth of traditional deals, mezzanine investors are bidding aggressively on deals and starting to show structural flexibility including shortening their call protection."

Another trend that is emerging is an increased focus on second liens. In the credit hierarchy, second lien investors are junior to bank debt. But, a second lien is not pure subordinated debt because it uses residual asset value. "Let's say a bank will lend at 85 percent of the value of the assets—plant, inventory, receivables, etc. The second lien holder will lend up to the remaining 15 percent depending on cash-flow strength and other factors," says Shoyer. "This is a small niche market dominated by hedge funds, but it's important to middle-market companies and is expected to continue to grow."

Unlike equity or high-yield, which fluctuate with economic conditions, traditional mezzanine finance is a very consistent and stable market. Over the past three years, the coupon rate on mezzanine notes has remained fairly steady—even drifting upward slightly in recent months—in spite of the downward drift in the prime rate. The total targeted return has remained stable as well (Exhibit #2—Mezzanine Median Targeted Returns). However, the use of PIKs is becoming more prevalent as company valuations have grown more complex and less predictable.





"PIK income is less risky than warrants and effectively increase the defined return portion of the deal," says Shoyer. "With PIK, the interest is added back into the loan so that the amount of the loan increases over time."

Speaking at a recent workshop on mezzanine lending for The New York Business Forums, Inc., Robert Ammerman, managing partner of Capital Resource Partners, said the rise in prepayment penalties appears to be more prevalent among funds than insurance companies, "because we don't want to get refinanced in a year. Our LPs are just as focused on multiples of cash-flow as they are on internal rates of return. Getting the targeted IRR for a short period of time such as six months, nine months or twelve months just doesn't do that much good for them. So, we may charge as much as a full year's interest in the first year as a prepayment penalty."

He went on to say he's also seeing more guaranteed target returns or "straight rates without equity," while noting that when there is an equity component, it tends to be more complex. "As we've become less certain over the past two years about business and management forecasts, two things have happened: more sliding scales are being used to determine exit value or financial performance, and, if the equity sponsor has an unusually structured security, we're seeing options and warrants tied into that security and not into common stock."

Secure More Total Capital

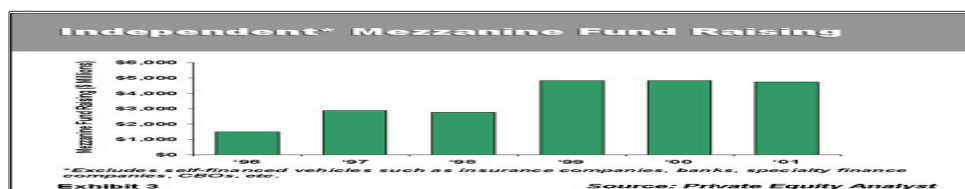
Some closely held companies, particularly those that are family controlled, are reluctant to consider mezzanine financing because historically it requires relinquishing a certain amount of ownership. However, a mezzanine investor's goal isn't to be a long-term shareholder, but rather to achieve a target return rate by some specified time. "It's also important for a business owner to realize that a large ownership interest in a stagnant or underperforming business may not be as valuable as a smaller ownership interest in a growing company," says Shoyer. What's more, having mezzanine debt in place actually can help a company secure more total capital.

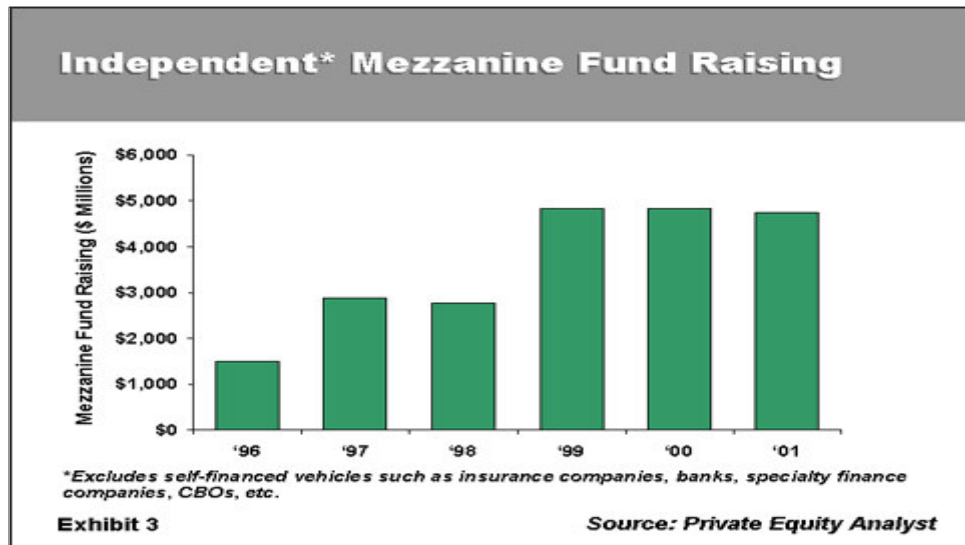
"For example, if a client approached a bank and said, 'I'm buying a company for \$100 million and I want all the debt to be bank debt and I'll put the rest in equity,' the bank may lend \$50 of that \$100 million. However, with a mezzanine component, the bank may lend less, let's say \$40 million and the sub-debt lender might put in \$25 million, bringing the total debt raised to \$65 million." As the overall level of debt increases, the actual amount of bank debt shrinks due to increased risk, but the total amount raised is higher when the mezzanine layer is added. Ultimately, this would reduce the equity requirement from \$50 million to \$35 million.

In addition, banks often look more favorably on companies that are backed by institutional investors and may extend credit under more attractive terms. Mezzanine lenders also may reserve a portion of their available capital in order to make additional investments in those companies that perform well.

Tapping the Mezzanine Market

The amount of money raised for mezzanine financing has grown dramatically in recent years (Exhibit #3—Increase in Mezzanine Fund Raising). Currently mezzanine providers are struggling to find good investments for billions of dollars of committed, untapped capital. Their approach to evaluating opportunities is similar to that of equity investors. "First and foremost, they're looking for a strong, credible management team," says Shoyer, meaning stable leadership and a team of professionals with an industry track record. "Does the company have a defensible position in its industry? Is it a leader or does it fill some niche? What's the overall outlook for the industry? Are the long-term prospects favorable? These are the kinds of issues that are probed in the due diligence process," he says.





Finally, a clearly defined exit strategy is pivotal to the decision since the overall return on investment hinges on the investor's ability to obtain the value of its equity position. The sale of the company, a recapitalization, a refinancing, and—less frequently these days—an initial public offering, all are potentially viable liquidity events.

Regardless of the exit event, experts agree that now is a great time to invest in this asset class. Lincoln Partners' Kahn believes that companies that are constrained by traditional bank debt increasingly will turn to mezzanine lenders for junior capital. "Over the next 12 to 18 months, there's tremendous opportunity for mezzanine to fund a company's growth and working capital needs," says Kahn. Fleet Securities' Shoyer concurs. "By tapping into this liquid source of capital, middle-market companies can make the strategic investments required to take their business to the next level."

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