

The Basics of Mezzanine

By Samir Desai

When making a major investment, buying out a partner, or planning for the transfer of a family business to the next generation, business owners often have a number of financing options. One method worth a closer look is mezzanine capital, a combination of typical bank debt and equity, also known as subordinated debt.

What is Mezzanine?

Mezzanine capital – like debt – earns an interest rate, can be secured by the assets of the company (generally on a second lien basis), and has a loan agreement that looks similar to that of bank debt. Like equity, which is longer in term, mezzanine capital has minimal or no scheduled principal payments until the due date and, in some cases, has equity participation.

The Uses of Mezzanine:

As the name suggests, mezzanine capital fills the gap between what the senior bank is willing to lend, the available equity, and the total need for the transaction. Mezzanine capital is commonly used to finance acquisitions, but it can also be used to support organic growth opportunities or pay dividends to shareholders. The amount of mezzanine available for each deal is more an art than science. To determine the maximum debt capacity of a company, issuers and investors will consider a ratio of total funded debt to EBITDA of 4.0 as a reasonable starting point. But one must not look at this ratio in a vacuum. The industry, amount of recurring capital expenditures for the business, strength & depth of management team, and other factors all play into determining the amount of debt a particular company can handle.

Pricing Mezzanine

Similar to what all providers of capital face today, providers of mezzanine capital have to face a "commoditization" of their product. With the increase in the number of mezzanine providers, less stringent underwriting standards from the banks and development of the second lien market, current pricing trends may work to the advantage of the business owner. Providers who formerly expected a percent of return in the low to mid twenties, today may offer a range of 14% to 18 %, with less emphasis on equity participation.

The typical current interest rate – or pay rate - can range from 10% to 14%, plus a 1% to 5% Payment-In-Kind ("PIK") rate that accrues but does not have to be paid in cash.

Equity participation, also known as the warrant, allows the mezzanine provider to share in the equity creation of the business. The amount of the warrant is dependent on the projections and subjective assessment by the mezzanine provider as to the achievability of projections. To provide a formula: the return to the mezzanine provider = Current Pay + PIK + Warrant = 14-18%.

Terms of Mezzanine

Mezzanine or subordinated debt is inherently a debt product, with a governing loan agreement and norms that govern the underlying security. The term of subordinated debt is longer than conventional bank financing, with maturities ranging from 5 to 10 years with minimal amortization during the early periods and larger or bullet payments near or at the maturity date. Financial covenants will mirror, but be slightly more lenient than, those of the senior bank. The two most common covenants are total funded debt to EBITDA and the fixed charge coverage ratio. As with bank financing, all rights and remedies become available upon default of covenants.

Inter-creditor Issues:

Given that bank financing and mezzanine are both debt instruments, the two groups must have a legal agreement that specifies the working arrangement. The two most common legal documents are the inter-creditor agreement and the subordination agreement. The inter-creditor agreement describes the handling of major items such as: i) cross acceleration, ii) blockage of the subordinated debt interest, iii) subrogation and iv) bankruptcy rights. The subordination agreement simply states that it is "junior" to the senior debt. While mezzanine providers weight the importance of each item differently, the basic concept of repayment of senior debt first and then subordinated debt second holds true.

Types of Mezzanine Providers

Not all mezzanine providers are created equal. Most firms fall into the category "sponsored mezzanine," when a company is being acquired by a private equity group which utilizes mezzanine financing to round out the capital structure.

There are a few groups that focus on "sponsorless mezzanine," in which the mezzanine provider invests directly into a situation where the stakeholders are not professional investors, typically a privately held or family held business. When considering a sponsorless transaction, the stakeholders should interview the mezzanine provider on their investment philosophy and conduct reference checks with existing and previous portfolio companies, including those that have not performed well, to understand how a mezzanine provider reacts when times get tough. An effective sponsorless mezzanine provider will be your partner, and you should think of them that way.

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