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IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
SUMMER 2013

Middle Market Mezzanine: The Evolving Product

Changing markets have pressured providers for more flexible structures and pricing.

by Mark D. Working

Mezzanine financing for the middle market developed to support the burgeoning leveraged buyout activity in the early 1980s. Companies could be bought at prices that permitted investors to realize healthy returns by leveraging up the balance sheet at purchase and then working the debt down and reselling the business. Equity returns for LBO investors relied on financial leverage. The greater the leverage, the higher the return, if all went well. Mezzanine funds emerged to provide that extra increment of debt in the capital structure of private equity-backed acquisitions. Subordinating both collateral and payment rights to senior creditors, primarily banks, allowed greater leverage in the acquisition structure, thereby pumping up equity returns on successful businesses. Over time, the markets changed, putting pressure on the LBO model. In response, the mezzanine product has evolved into customized junior capital with expanded flexibility and broader application of the product.

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A BIT OF HISTORY

Mezzanine loans have historically been structured as subordinated notes. A typical mezzanine loan often had little or no amortization, and a maturity date beyond that of the senior lender. For example, if a senior lender made a loan that matured in five years, the mezzanine loan would mature in six or seven years. While the senior lender received both interest and principal payments, the mezzanine lender only received interest. As total leverage declined with the amortization of the senior debt, companies often refinanced the balance sheet to replace the more expensive mezzanine debt with new senior loans.

In the interim, if the company experienced difficulty meeting its payment obligations, the senior lender exercised its right to direct the company to suspend payments to the mezzanine lender, channeling more cash flow to retirement of its loans. Subordination of rights to payment and collateral created risk for the mezzanine lender, but was the key to achieving leverage.

Elements of typical mezzanine loan pricing included a coupon interest rate of 12-14% plus no-cost warrants for part of the equity, usually in the 10-15% range. Mezzanine lenders expected an overall return in the low 20% range in a successful company in exchange for the added risk.

The deductibility of the mezzanine coupon cut the cost to roughly half of the cost of equity. In that environment, senior lenders earned a spread over its cost of funds in the range of 3-4 percent, equity investors earned 30%, and mezzanine investors were in the middle. The buyout formula worked very well when a company was bought at 5.5x EBITDA or less. Senior lenders provided 60% of the financing (3x EBITDA), mezzanine lenders added another turn of leverage, and equity investors provided approximately 20% of the capital. Cash flows on a stable company brought down the leverage and companies could be dependably resold at equal or higher multiples. In the interim, if company profitability increased, so much the better.

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A foolproof formula, until things change.

WHAT CHANGED?

Imitation is the sincerest form of flattery. As equity and mezzanine firms reported high returns for their investors, new entrants emerged. A wave of new equity and mezzanine firms formed and funds for existing firms got much bigger.

Greater competition led to higher transaction prices. For a time, this was partially offset as capital providers absorbed the economic dilution. Senior lenders got greedy and took a larger slice of the capital structure as low-cost senior debt. Mezzanine lenders were pushed to a riskier place in the capital structure with less compensation. Warrants were replaced with PIK (deferred interest) securities and coupon yields declined. This altered risk-return equation led mezzanine providers to re-examine where and how capital could be put to work.

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Mezzanine lenders started patrolling the avenues for non-sponsor opportunities for the first time, and began to segragate their commitments into tranches of senior, mezzanine, and equity components, which in total achieved the average risk objective of the investment. Creativity was unleashed.

FAST FORWARD TO TODAY'S MEZZANINE

Aggressive leverage has lost favor as a component of creating return. Strategies with emphasis on business expansion better reward investors, or so it is argued.

As the mezzanine market continues to evolve, we now see a variety of structures for middle market companies:

- Interest-only term loans at 10-11% interest

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plus 2-4% PIK securities for traditional mezzanine loans, which represent a very significant decline in the cost of mezzanine.

- In private equity sponsored acquisitions, 10-12% coupon interest plus an opportunity to invest a small amount of equity alongside the equity investor is considered attractive.
- Innovative structures, such as revenue sharing on new investment projects, are being offered as payment for the capital needed to develop specific projects.
- Mezzanine providers are also offering entire "right hand side of the balance sheet" financing to unfunded sponsors and owner-operators, splitting their capital into equity, mezzanine, and senior debt components when appropriate.

The one thing that remains unchanged is that mezzanine providers do not want to manage a business. They are truly investors in risk assets and largely win or lose based on their judgment of the capabilities of those with their hands on the reins. ZS

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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