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PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
SPRING 2015

Mezzanine Market Update

Companies commonly use mezzanine as bridge financing for a specific need.

by Michael Newsome

Mezzanine is a tier of capital below senior debt focused almost exclusively on privately-held companies with specific event-driven financing requirements. This capital combines the characteristics of debt and equity, and is often referred to as subordinated debt. Like the architectural term from which it is derived, mezzanine financing represents an intermediate stage of funding, spanning the gap between senior-secured loans and equity investment. Mezzanine is the private equivalent of public high-yield debt. Issuances usually range in size from $3 million to $25 million, but can be as large as $150 million. In most cases, the public high-yield debt market becomes an attractive alternative for financings in excess of $100 million.

AN EXPENSIVE DEBT ALTERNATIVE

Mezzanine is typically available for stable, cash-flow-positive, middle-market companies (annual revenue of $500 million and below). The funds are used where there is adequate cash flow but insufficient collateral, inadequate cash flow coverage, or excessive financial leverage (the ratio of debt to cash flow) to be funded with senior debt.

While a borrower may receive senior debt priced in the range of 1 to 3 percent over LIBOR, the next increment of borrowing (the mezzanine) is likely to cost an additional 7 to 10 percent. While more expensive than senior debt, the equity alternative is even more expensive.

Owners of privately held businesses are attracted to mezzanine for several reasons.

- *Flexibility and patience* – Relative to senior debt, mezzanine is structured with a longer term and requires little or no amortization. Covenants usually contain less restrictive financial tests than required by their senior debt brethren.
- *Cost* – Although more expensive than senior debt, mezzanine does not impose the shareholder dilution and loss of control that is part and parcel of arranging third party equity.
- *Leverage* – Mezzanine is an effective way to expand the total debt capacity of a business beyond the collateral and cash flow constraints imposed by senior lenders. It is fair to note that senior lenders tend to view companies supported by institutional lenders or investors

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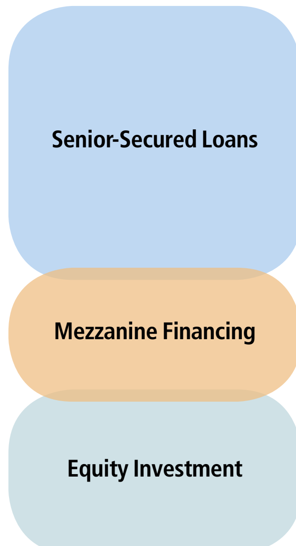

more positively. These firms are often rewarded with more favorable credit terms.

APPLICABLE SITUATIONS

Mezzanine financing is commonly an event-driven source of funding to address transitional capital demands, such as during periods of rapid expansion, rationalization of an acquisition, or entrance to a new market.

Mezzanine investments are usually structured as a term note. They customarily target annual, all-in rates of return in the 8% to 15% range over the life of an investment.

Companies tend to use mezzanine as bridge financing for events of this type.

Once the anticipated cash flow benefits begin to be realized from an acquisition or a major capital investment, senior debt capacity expands such that in a short few years the company refinances to repay the mezzanine debt.

The two primary catalysts for employment of mezzanine are:

- A major capital investment or acquisition that will take time to prove out the sustainable economics; or
- A buyout of all or part of an existing ownership group.

In the former case, the new investment is expected to result in a significant increase in value of the business. The latter situation is designed to solve control issues and/or maximize equity returns through the application of financial leverage. Mezzanine lenders earn a higher return for taking on the risk of higher leverage and longer terms for successful stable businesses. Businesses at an early stage of development, in distress, or in highly transitional industries need not apply.

TYPICAL TERMS

Mezzanine investments are usually structured as a term note. They customarily target annual, all-in rates of return in the 8% to 15% range over the life of an investment. Required returns vary based on the degree of financial leverage, the size of the deal, the strength and stability of the cash flow, and the competition among lenders to provide capital. Investors / lenders earn their return from the combination of:

- An upfront commitment fee,
- Fixed coupon interest paid on a combination of current and payment-in-kind, or PIK, interest (accrued and added to the principal of the loan), and
- Zero-cost equity commonly in the form of warrants or other customized security issued in the equity of the business. In the current market, these "equity-kickers" are rare other than in the small end of the market.

Although much more covenant-friendly than senior lenders, mezzanine providers are decidedly less flexible in the area of price protection. Mezzanine often carries steep prepayment fees to create disincentives for repayment over a three-to-five year period, usually having a declining prepayment fee over that period beginning as high as 5%.

MEZZANINE PROVIDERS

Historically, the most active providers of mezzanine capital have been insurance compa-

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nies and dedicated mezzanine limited partnerships funded by institutional investors such as pension funds and endowments. In recent years, the field of mezzanine providers has grown and become more varied and complex. New lenders have emerged to include hedge funds, family offices, business development companies, small business investment corporations, and captive mezzanine lending arms of private equity firms, commercial banks, and investment banks. In an environment where excess liquidity abounds, competition has led to a broad array and customization of structures. For that reason, most mezzanine financings are arranged with the guidance of an intermediary to sort out the alternatives.

CONCLUSION

When a significant opportunity presents itself to increase the value of a business and senior lenders are unwilling to offer the necessary funding, owners should investigate the alternative sources to achieve the business objective. Mezzanine may provide the bridge capital to take that step without suffering costly shareholder dilution. **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, go to **ZacharyScott.com.**

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