Zachary Scott
INVESTMENT BANKERS

IN$IGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
WINTER 2004

Mezzanine Financing

An intermediate stage of capital, mezzanine is typically employed by middle-market companies to fill a shortfall in financing.

by Michael T. Newsome

Mezzanine is a tier of higher-risk capital almost exclusively geared toward 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 capital, squeezed between senior secured loans and equity financing.

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, public high-yield debt is a more attractive alternative for financings in excess of $100 million.

APPLICABLE SITUATIONS

Mezzanine capital is typically employed by middle-market companies (revenue of $20MM to $500MM) to fill a shortfall in financing imposed by limitations on secured borrowings, because of either insufficient collateral or excessive financial leverage (the ratio of debt to cash flow).These two variables, which are key determinants of senior debt capacity, tend to move up and down, depending on the appetite of bankers for new business.

Mezzanine is commonly an event-driven transitional financing source, providing funding for high-rate-of-return investment opportunities for mature, developed companies. It makes sense in circumstances where the investment will earn a return that creates incremental value for the equity holders. In other words, if an investment is realistically anticipated to provide a 12% return on capital, it makes little sense to fund it with subordinated debt that requires an 18% return. 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 and senior debt capacity expands, the relatively high cost of mezzanine capital provides a strong economic incentive to replace it.

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The two primary situations where mezzanine is typically employed are:

- Funding a capital investment as part of a major plant expansion or an acquisition that is intended to provide significant growth; or
- Re-engineering the capital structure in order to buyout one or more shareholders, or pay out a special dividend.

In the former case, the new investment is expected to be the catalyst for a significant increase in corporate value. The latter situation is designed to maximize equity returns through the application of financial leverage.

The most suitable mezzanine candidates are mature businesses with stable or growing margins, defensible market positions, well-defined strategies, and competent management teams. It is not a high-risk capital source that will step up when the bank balks because of performance problems. Likewise,

	SENIOR SECURED	JUNIOR SECURED	HIGH YIELD	MEZZANINE	PRIVATE EQUITY
Rank	Senior	Structural Subordinate	Contractual Subordinate	Structural/ Contractual Subordinate	Junior to all debt
Security	1st liens	2nd liens	Unsecured	Unsecured/ secured	N/A
Term	5-7 years	5-7 years	10 years	5-8 years	N/A
Coupon	Cash Pay (floating)	Cash Pay (fixed)	Cash Pay (fixed)	Cash Pay & PIK (fixed)	Dividends
Pricing					
Upfront Fees	1-2%	1-2%	None	2-3%	Varies
Interest Rate	L+200-300bp	11-13%	11-14%	12-14%	N/A
PIK	N/A	N/A	N/A	4-6%	N/A
Warrants	N/A	N/A	N/A	Almost Always	N/A
All-in Pricing	L+350-500bp	12-14%	9-10%	15-22%	25%+
Covenants	Comprehensive	Comparable to Sr. Debt	Incurrence tests	Financial Maintenance Tests; cross default with senior lender	None
Prepayment	Generally permitted w/o premium	Generally permitted w/o premium	Expensive call premiums	Expensive call premiums in the first 2-3 years	N/A
Capital Providers	Banks and Asset Based Lenders	Specialized Asset Based Lending Firms	Institutional Investors via Public Offering	Banks, Insurance Companies, Mezz Funds and Private Equity Firms	Private Equity Firms

(continued p.2)

it is not suitable for early-stage, emerging-technology, or turnaround situations.

TYPICAL TERMS

Mezzanine investments are typically structured as a term note, coupled with an "equity kicker" in the form of either warrants for the purchase of a minority share of common stock at a nominal cost, or a deferred fee. Investors/lenders earn their return from the combination of:

- An upfront commitment fee,
- Interest paid on a current basis,
- Accrued interest added to the loan and paid on a deferred basis (known as payment-in-kind or PIK interest), and
- Value realized from warrants as the company's equity value increases.

Mezzanine providers customarily target annual, all-in rates of return in the 15% to 22% range over the life of an investment. Required returns vary based on the degree of financial leverage, the size of the company, the strength and stability of the cash flow and the competition among lenders to provide the capital. The table above provides a comparison of the conventional terms and cost of mezzanine relative to other tiers of capital.

The one area where mezzanine tends to be decidedly less flexible than senior debt is call protection. Mezzanine often carries steep prepayment fees designed to keep the capital in place for as long as possible. A typical call-protection provision would require a prepayment fee of 5% of principal in the first year and ratchet down by 1% in each succeeding year. The note can be repaid without any penalty by the end of the fifth year. When the interest meter is running at 15% or more per annum, it often makes sense to repay the mezzanine in spite of the high prepayment costs.

WHY MEZZANINE?

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

Flexibility and patience – relative to senior debt, mezzanine is typically structured with a longer term and requires little or no amortization in the first three or four years of its tenor. It is common to see subordinated debt structured as a five-year bullet loan. The covenants usually contain less-restrictive financial tests that focus on maintaining cash flow and limiting financial leverage.

Control – although more expensive than senior debt, mezzanine does not impose the shareholder dilution and loss of control that is part and parcel of private equity.

The most significant benefit of mezzanine is that it reduces the amount of equity that is required to fund a transaction.

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

The most significant benefit of mezzanine is that it reduces the amount of equity that is required to fund a transaction. Although mezzanine is expensive relative to senior debt, it is substantially cheaper than equity. For owners of closely held businesses, the idea of parting with some amount of ownership can be a major deterrent to the use of mezzanine. Nevertheless, mezzanine investors are not long-term shareholders bent on control. The warrants are simply used as a method to tie the lender's return to the incremental value of the business that their capital helped create. The lender's fundamental objective is to earn a return that is commensurate with the business and financial risk taken.

MEZZANINE PROVIDERS

Historically, the most active providers of mezzanine capital have been insurance companies and dedicated mezzanine limited partnerships funded by institutional investors, such as pension funds and endowments. In recent years, the field of mezzanine providers has expanded to include leveraged public funds and the captive mezzanine lending arms of private equity firms, commercial banks and investment banks. The private mezzanine market was quite robust during the late 1990's - growing in concert with the overall M&A activity. As leveraged lending cooled and M&A activity sputtered during the past three years, the weak volume affected the demand for mezzanine. With senior lenders still showing conservatism, the market upturn is returning mezzanine to being an important component of leveraged finance.

CONCLUSION

When a significant opportunity presents itself to increase the value of the business, and the bank is unwilling to provide all of the necessary funding, mezzanine can provide the bridge capital to make that step without suffering significant shareholder dilution. We have been involved as advisors and placement agents in a number of situations where clients have used mezzanine to supplement senior debt, in order to fund major strategic opportunities. The ability to fund the business strategy with mezzanine propelled these companies to a new level and generated attractive returns to the shareholders. ❖

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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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