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# Mezzanine Debt—An Alternative in Tight Credit Markets

*Where can creditworthy businesses turn for capital?*

*by Michael T. Newsome*

Many of us have seen clear evidence that banks have curtailed business lending. Bankers argue otherwise, that credit remains available, albeit more expensive, for those that are "qualified." Most CFOs or corporate treasurers are feeling the impact of tight money and would testify that credit is much more difficult to obtain today than in recent years. The banks, themselves, substantiate this view. The Fed's latest quarterly survey of lending practices shows that bank chief credit officers uniformly reported either tightening or unchanged underwriting standards.

So, in the absence of accommodative senior lenders, where can a creditworthy business turn for capital?

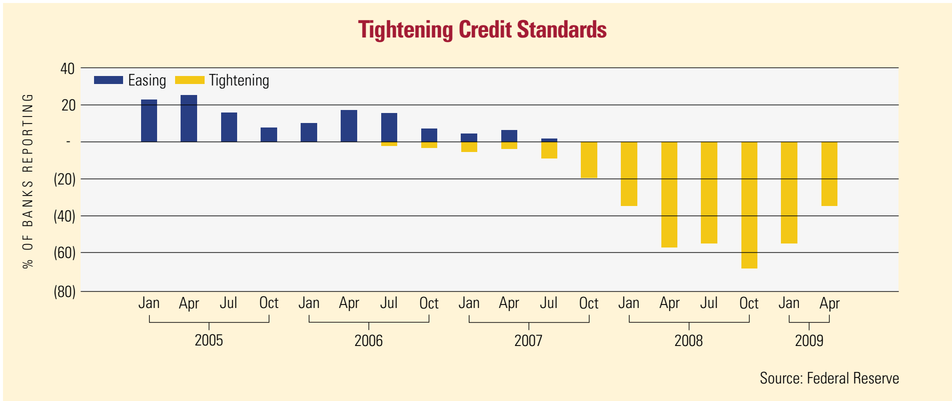
**THE MEZZANINE ALTERNATIVE**

Traditionally, mezzanine has been a junior-priority, cash-flow-predicated, bullet loan, geared toward privately held companies with specific event-driven financing requirements. The combination of a term commitment, minimal amortization, and compensation structure provides an incentive for investor patience and flexibility in support of the company's business objectives.

Mezzanine is a source of intermediate "bridge" financing for a company in transition. It is used to fortify the balance sheet against the prospect of prolonged economic softness, fund business acquisitions that strengthen competitive position and create value, or fund the purchase of interests of minority shareholders. The transactions described in the companion article, "An Industry Consolidated," are prime examples of situations where mezzanine can be effectively employed.

Mezzanine capital is typically employed by middle-market companies (revenue of $20MM to $500MM) to fill financing shortfalls due to bank-imposed constraints concerning collateral advance rates or cash flow coverage ratios (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, and are certainly at a low-ebb these days.

The most suitable mezzanine candidates are mature businesses with stable or growing margins, defensible market positions, well-defined strategies, and experienced management. Mezzanine is particularly suited to service industry or asset-light situations, where credit capacity is constrained by the lack of collateral support. However, it is not a high-risk capital source that will step up to fund a turnaround when senior lenders balk.




**TYPICAL STRUCTURE**

Mezzanine investments are typically structured as 5- to 7-year term notes. Providers tend to fall into one of two camps. The first views the capital as an extension of debt, relying on covenants, yield, and second-lien positions. The second sees the capital as more akin to minority equity, where greater emphasis is placed on the value to be created by the business plan. The structural flexibility of mezzanine provides the opportunity to tailor the capital to fit specific circumstances. Of course, as the structure moves from debt toward equity, risk/return requirements increase for the lender/investor, which are earned through some combination of the components in the table below.

Required returns vary based on the degree of financial leverage, the size of the company and its market position, the stability of its cash flow, and competition among lenders to provide capital.

**WHY MEZZANINE?**

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

▪ Flexibility and patience—bullet loan with little or no amortization, coupled with less-

| COMPENSATION | DESCRIPTION | MARKET RANGE |
|---|---|---|
| Cash Interest | Fixed or floating rate interest, payable quarterly or semiannually | 12% to 14% p.a. |
| Deferred Interest | Accrued, but deferred, interest known as payment-in-kind (PIK) notes | 3% to 6% p.a. |
| Equity | No-cost warrants or conversion rights with sufficient prospective value under an "expected case" business plan to achieve a target all-in return over the life of the investment | Varies to achieve target return |
| All-In Rate of Return | Total target return on a per annum basis | 15% to 22% p.a. |
| Call Protection | Sliding prepayment fee designed to keep the capital in place for at least several years | 5% falling to 0% by the end of the 3rd or 4th year |

*(continued p. 2)*

restrictive covenants focused on maintaining cash flow and limiting financial leverage.

- Control—less invasive than private equity, lenders require far less shareholder dilution and often observe board meetings, but have no voting rights.
- Cost—tax deducibility of interest expense makes mezzanine much less costly than equity.

For owners of closely held businesses, the idea of parting with some amount of ownership can be a major deterrent to raising junior capital. Nevertheless, mezzanine investors are not long-term shareholders bent on control. Warrants are simply a method to tie the lender's return to the incremental value that their capital helped to create. In the final analysis, with target annual yields of 16% to 22%, this is expensive money. To make sense, it must be matched with investment opportunities that offer even higher returns.

**CURRENT MARKET**

Up until mid-2007, mezzanine lenders (primarily banks, insurance companies, and dedicated limited partnerships funded by institutional investors) have been the odd-men-out of buyout finance. Aggressive senior- and second-lien credit structures, where total leverage (senior and junior debt) frequently topped five (if not six) times EBITDA, squeezed mezzanine out of many opportunities.

**It is interesting to note that in the past 90 days, activity has jumped in the investment-grade and high-yield bonds markets, as a growing wave of issuers have arranged more than $60 billion in new long-term funding.**

The market has since come full circle, as senior lenders are hiding in the weeds and leverage (in all of its forms) is way out of vogue. Mezzanine capital remains available and competitive. In 2008, 16 funds reportedly raised $20.2 billion of mezzanine capital. This is a 126% increase over the $8.9 billion raised in the prior year. As senior credit has dried up, mezzanine is an increasingly attractive way to fill the gap for firms with the appropriate credit profile and return prospects.

In spite of the availability of capital and the urge to put it to work, today's lenders are highly selective. Issuance activity has been weaker than expected. In part, this is due to lender reticence to take on any new situation where performance has not clearly stabilized. For prospective mezzanine borrowers, the chief implication is the necessity for presenting a well-articulated business strategy and plan that demonstrate relative stability in the face of continuing economic softness.

**THE OPPORTUNITY**

It is interesting to note that in the past 90 days, activity has jumped in the investment-grade and high-yield bonds markets, as a growing wave of issuers has arranged more than $60 billion in new long-term funding. A number of issuers, including Microsoft and Berkshire Hathaway, have raised capital, even though they already have substantial cash or credit lines on hand. So, what do public company CFOs see that private-company managers do not? The message is one we have been preaching for some time, that in a tight credit market, access to capital can be a powerful competitive advantage. Mezzanine capital is one of few sources currently available to private companies to build the liquidity necessary to take advantage of opportunities that are likely to emerge during this down cycle. ❖

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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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