Mezzanine Finance

Updated spring 2012
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With amendments to Mezzanine Capital Structures section with
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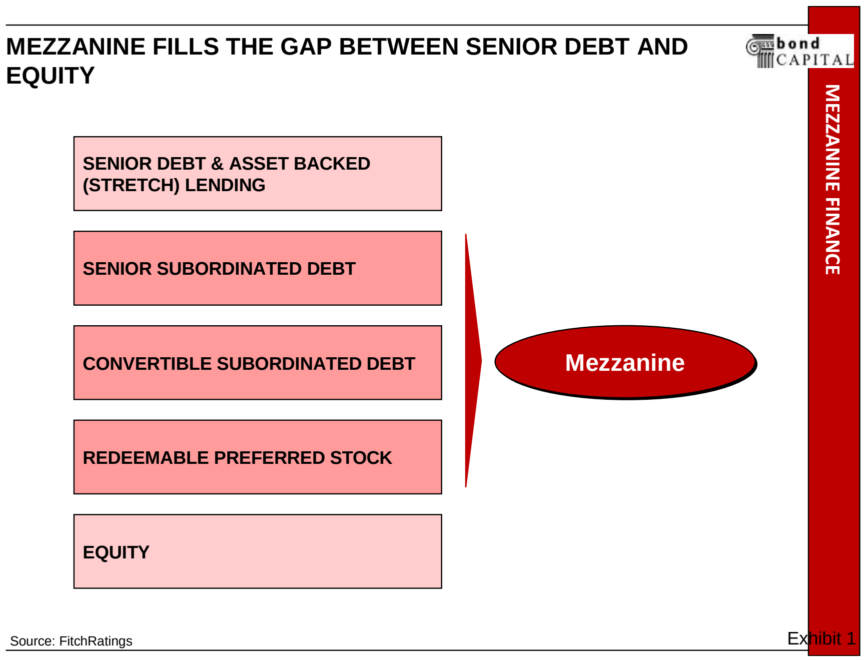
Mezzanine Finance

Mezzanine finance is used by companies that are cash flow positive to fund further growth through expansion projects; acquisitions; recapitalizations; and management and leveraged buyouts. Mezzanine finance (or the use of hybrid debt and equity securities, which is also known as mezzanine debt) comes in many forms. The common features of all mezzanine instruments and products are that they offer a risk/return profile that lies between debt and equity. Mezzanine finance is used as an equity substitute to increase the financial leverage of transactions (the ratio of debt to equity) where the senior debt capacity has been maximized and a company's cash flow has sufficient capacity for additional long-term borrowings.

When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity required in a business. As equity is the most expensive form of capital, the use of lower cost mezzanine debt along with traditional senior debt lowers a company's cost of capital and improves shareholder return on equity.

What Is Mezzanine Debt?

Mezzanine debt capital generally refers to that layer of financing between a company's senior debt and equity. Structurally, it is subordinate in priority of payment and security to senior debt, but greater in rank to common stock or equity (Exhibit #1). In a broader sense, mezzanine debt may take the form of convertible debt, junior debt, subordinated debt, private "mezzanine" securities (debt with warrants or preferred equity), second lien debt, and is sometimes referred to as quasi-equity.



Mezzanine capital is typically used to fund corporate growth opportunities, such as an acquisition, new product lines, new distribution channels or plant expansions; for company owners to take money out of the company for other uses, or help finance the sale of their business to management or another third party. Although it makes up a smaller portion of a company's total available capital, mezzanine financing is an important capital source, filling in the gap between debt and equity.

The gap in funding between senior debt and equity is common for the following reasons:

1. accounts receivable, inventories and fixed assets are being discounted at greater rates than in the past for fear that their values will not be realized in the future;
2. senior lenders are reluctant to lend, using goodwill or intangible assets as collateral;
3. senior lenders may wish to limit their exposure to any one company or industry; and,
4. equity may be limited or unavailable, prohibitively expensive, or highly dilutive.

MEZZANINE IS A HYBRID WITH RISK PROFILE TARGETED BETWEEN THAT OF SENIOR DEBT AND EQUITY

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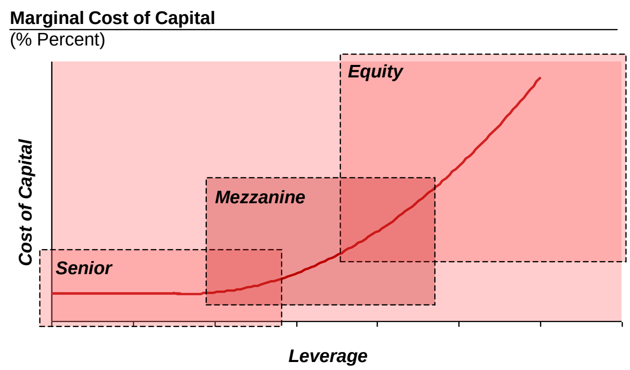


Source: Bond Capital

Exhibit 2

A mezzanine provider will generally seek a risk profile between that of senior debt and equity with corresponding pricing. Mezzanine debt can often be thought of as borrowing equity, as senior banks will treat it as such, while the cost of mezzanine debt will be less than equity because of the interest paid and security preference it takes ahead of equity as illustrated in Exhibit 2. While capital can be obtained from equity, equity is usually the most expensive and most dilutive source of capital. Shareholder dilution with mezzanine investments is up to 90% less than with equity investments because much of the mezzanine return is from the loan repayment (interest and principal) rather than from capital gains. Additionally, it is common for a company to repurchase any equity issued to a mezzanine investor and revert back to its pre-financing equity structure.

Mezzanine Capital Structures

While there are no hard and fast rules for optimizing a company's capital structure, companies that use an efficient combination of senior debt, mezzanine debt, and equity capital, seek to minimize their weighted average cost of capital (WACC) in order to boost shareholder return on equity (ROE).

Mezzanine financing can be completed through a variety of structures based on cash flow, the specific objectives of the transaction and the existing capital structure in place at the company. The basic forms used in most mezzanine financing are subordinated notes with warrants for private companies, and high yield debt (junk bonds) or convertible / preferred shares for public companies. Mezzanine lenders, typically specialist mezzanine investment funds, look for a target rate of return which can be earned through two basic components: current payment and deferred payments. These payment streams can be further divided as follows:

Current Payments (paid monthly, quarterly or annually)**:**

- ***Cash interest*** - a periodic payment of cash based on a percentage of the outstanding balance of the mezzanine financing. The interest rate can be either fixed or floating.
- ***Principal*** - scheduled repayments a portion of which may be deferred until maturity and /or yearend cash sweeps based on a formula.
- ***Royalties*** – variable payments based on a prescribed formula usually related to revenue, gross margin, EBITDA or net income.

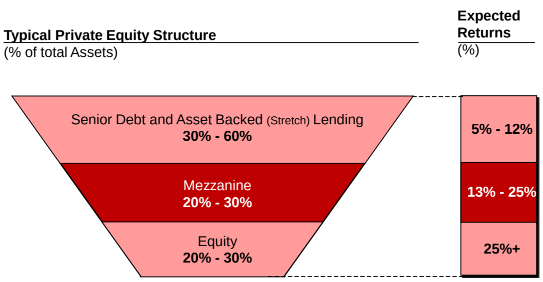
Deferred Payments (paid upon maturity of the mezzanine facility or later):

- ***PIK interest*** — payable in kind interest is a periodic form of payment in which the interest payment is not paid in cash but rather by increasing the principal amount through capitalization of the interest payment then due.
- ***Bonus Payment*** – fixed or variable payment that is negotiated. Variable payments are often calculated as a proxy for the business value or change in value of the company over the duration of the mezzanine facility.
- ***Equity Ownership*** — mezzanine capital will often include an equity stake in the form of attached warrants, a debt for shares conversion feature, or common shares of the company.

Mezzanine lenders will also often charge an arrangement fee, payable upfront at the closing of the transaction and ongoing administration fees to cover administrative costs and as an incentive to complete the transaction.

In structuring a mezzanine investment, the shareholders and mezzanine investor work together to match the business' future free cash flow with any repayment obligation. A well structured mezzanine investment will leave excess free cash available to the company as a margin of safety, for asset replacement, and growth of the business.

COMPANIES WITH EFFICIENT CAPITAL STRUCTURES EMPLOY A NUMBER OF CAPITAL SOURCES

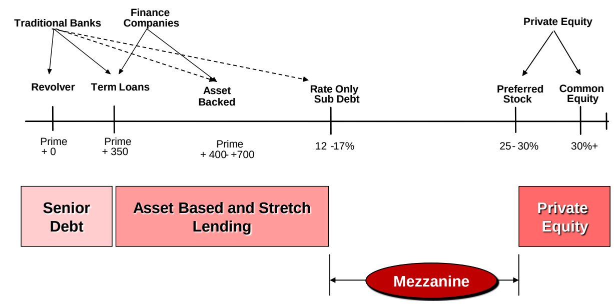


MEZZANINE FINANCE

Source: Management Magazine, Bond Capital

Exhibit 3

MEZZANINE FILLING THE GAP BETWEEN DEBT AND EQUITY



MEZZANINE FINANCE

Source: Bond Capital

Exhibit 4

In Exhibit 3 & 4, mezzanine debt is shown adding significant capital, enabling a company to grow while minimize the issuance of equity. On the positive side; the owners face little dilution and maintain control of the business; the companies total cost of capital is reduced; and the mezzanine debt has a flexible payment term that is structured as "self liquidating" and is paid off over time. On the negative side this is a debt structure that requires some interest payments over time; thus, there is less free cash available for growth and shareholder distributions. The table in Exhibit 5 outlines differences between capital sources:

CAPITAL SOURCES OFFER VARYING LEVELS OF FLEXIBILITY

	Senior	Stretch	Mezzanine	Equity
Security	Secured	Partial	Subordinated	none
Ranking	Senior	First on Specific Assets	Second	Third
Covenants	Tight	Tight	Flexible	none
Term	Demand	Term	Term / Patient	Patient
Coupon	Coupon - Floating	Coupon - Fixed	Coupon - Fixed	Dividend
Amortization	~ 5 years or less	Tied to asset life	Flexible / Engineered	Indefinite
Rate	Prime	Prime Adjusted	Risk Adjusted	Market Adjusted
Equity Kicker	none	Success Fee	Warrants	Shares
Prepayment Penalties	Yes	Yes	Fixed Period	No
Capital Providers	Bank	Bank / secondary lender	Private Capital	Private Capital / Capital Markets
Recovery %	High	medium	Low	Low
Liquidity	High	medium	Low	Right of Sale / Shotgun

MEZZANINE FINANCE

Source: FitchRatings, Bond Capital

Exhibit 5

Secure More Total Capital

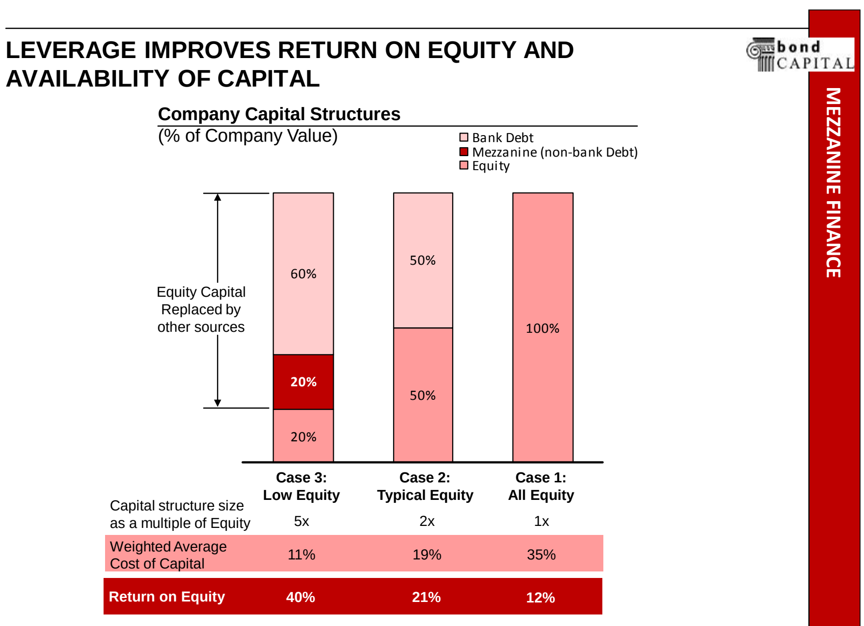
Some closely held companies, particularly those that are family controlled, are reluctant to consider mezzanine financing because it requires relinquishing a certain amount of ownership. However, a mezzanine investor's goal isn't to be a shareholder, but rather to achieve a target rate of return over a selected period of time. A typical mezzanine transaction has the mezzanine fund as small equity holder, with buyout terms to payout the mezzanine fund at the appropriate time. It's also important for a business owner to analyze the difference in value between an ownership interest in a stagnant or underperforming business and an ownership in a growing company. What's more, having mezzanine debt in place can actually help a company secure more total capital and avoid the small business pitfall of being under capitalized.

For example, a business owner approaches a bank to provide a $10 million senior debt facility for the purchase of a company with a purchase price of $20 million. A conservative bank may discount the request and offer 75% of funding requested leaving the business owner to fund $12.5 million with equity. If a mezzanine lender were to fund $5 million (the mezzanine will be treated as equity) the senior bank has less risk due to a bigger equity buffer and can now lend up to $10 million. The total external debt sources are now $15 million including the mezzanine layer compared to $7.5 million without. The equity requirement from the owner is reduced from $12.5 million to $5 million.

Banks often look more favourably on companies that are backed by institutional investors such as mezzanine investors and may extend more credit under more attractive terms. This is a result of the mezzanine investors' risk reducing reputation, and the increased involvement of the mezzanine lender with the company as compared to with a (senior) bank alone. Simply put, the risk to the bank's investment is reduced because of their knowledge that the mezzanine lender through a more active role (often with a board seat), may enhance the success of the business. Additionally, mezzanine lenders are a source of reserve capital for a business, helping to diversify a company's reliance on any one capital source.

Lowering the Cost of Capital and Improving Equity Returns

In addition to securing more capital, a mezzanine structure allows a business to reduce its cost of capital and boost both return on equity and absolute profits. The following three cases in Exhibit 6 illustrate a traditional all equity company (Case 1: All Equity) transitioning to a more efficient capital structure through a small recapitalization (Case 2: Typical Equity) into a typical company with debt, and then recapitalizing again to a final optimized structure using a higher degree of leverage (Case 3: Low Equity). The result of the transition from an All Equity company into a Low Equity company creates a more efficient capital structure lowering the company's cost of capital, improving the return on equity, and releasing significant new growth and acquisition capital to a company's existing owners as demonstrated in Exhibit 6.



Source: Bond Capital

Exhibit 6

Mezzanine Terms

Mezzanine investors include pension funds, hedge funds, leveraged public funds, business development companies, private equity funds, insurance companies, as well as banks that have established stand-alone mezzanine efforts (also known as captives). Traditional mezzanine providers are book-and-hold investors, generally focused on cash-flow lending, looking for a minimum term (call protection) and equity participation to generate longer term results. Unlike traded equity, high-yield debt and interest rates which fluctuate with economic conditions, traditional mezzanine finance is a consistent and stable market. The coupon rate on mezzanine notes and targeted returns of mezzanine investments have remained relatively constant as shown in Exhibit 7.

TARGETED MEZZANINE RETURNS HAVE REMAINED RELATIVELY CONSTANT AT ABOUT 20%[1)]

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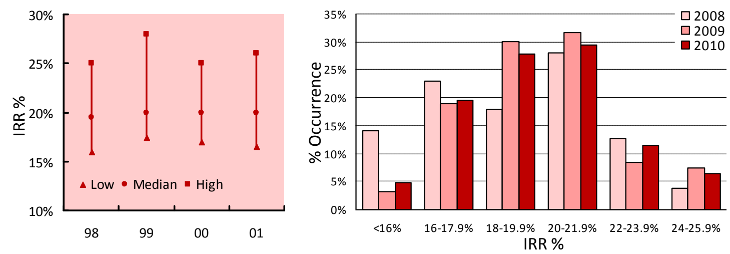
Mezzanine Targeted Returns
(Internal Rate of Return IRR %)



Source: Fleet Securities Inc., PNC Mezzanine Capital

Exhibit 7

Typically, mezzanine lending includes both subordinated debt and an equity component. The debt is usually issued with a cash pay interest rate of 10 to 14 percent and a maturity ranging from four to seven years with the ability of the borrower to buy out the debt earlier and repurchase any equity. The biggest benefit mezzanine debt provides is a reduction in the amount of equity required in the transaction. Today's mezzanine investors are looking for an IRR (internal rate of return) between 11 and 25 percent compared to an IRR of 25+ for equity investors. If the pricing is equal mezzanine is more cost effective than equity in absolute terms because of the tax shield generated from the tax deductibility of the interest and anti-dilutive features.

MEZZANINE RETURN CAN BE MADE UP OF SEVERAL COMPONENTS

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Simplified Mezzanine Facility Annualized Components and Return

($000's)	Initial	Year 1	Year 2	Year 3	Year 4	Year 5	Ending
Opening Principal	-	10,000	10,300	10,609	10,927	8,255	5,503
Closing Principal	10,000	10,300	10,609	10,927	8,255	5,503	-
Principal Repayment	-	-	-	-	3,000	3,000	5,503
Interest		1,523	1,568	1,615	1,439	1,032	-
Less PIK Component		(300)	(309)	(318)	(328)	(248)	-
Other Deferred Component							2,500
Mezz Cash Flow	**(10,000)**	**1,223**	**1,259**	**1,297**	**4,111**	**3,784**	**8,003**

Faility Assumptions	
Loan Size ($000's)	10,000
Maturity (Years)	5
Interest Rate	15.0%
PIK component	3.0%
Simple Annual IRR	**16.5%**

Source: Bond Capital

Exhibit 8

Exhibit 8 is an example of a mezzanine facility that is back end loaded, meaning that payments (PIK interest, principal and equity) are deferred until later in the facility term. It further demonstrates the majority of the mezzanine investor's return usually comes from interest and not from gains on equity.

While a mezzanine investment may be more expensive than traditional bank debt, it is not as strict. Generally, it shares the same covenant package as a traditional bank deal, but the measurement characteristics are more tolerant. For instance, if the maximum leverage of Debt / EBITDA on a bank deal is 3.0, a mezzanine deal would be closer to 4 or 5. Mezzanine facilities are often customized or "engineered" to match the cash flow profile of each company by changing the timing and amounts of current and deferred payments to work with the senior bank debt requirements. Exhibit 9 depicts average debt multiples of US leveraged companies and differentiates between bank debt as a multiple of EBITDA, and non-bank debt (often mezzanine debt) as a multiple of EBITDA for companies with less than $50MM in EBITDA. For smaller size companies, say $10MM in EBITDA, total debt availability might be 70-80% as much as for a larger $50MM EBITDA company. For example, an average highly leveraged company with EBITDA of $5 million per year in 2004 would have had 3.2 times EBITDA times ~80% or $13 million in bank debt, with 1.0 times EBITDA times ~80% or $4 million in non-bank debt for total leverage of 17/5 = 3.4x EBIDA. In addition to size, industry stability or volatility and the availability of collateral can have an impact on capital availability.

MEZZANINE DEBT IS OFTEN A SIGNIFICANT COMPONENT OF A COMPANY'S CAPITAL STRUCTURE

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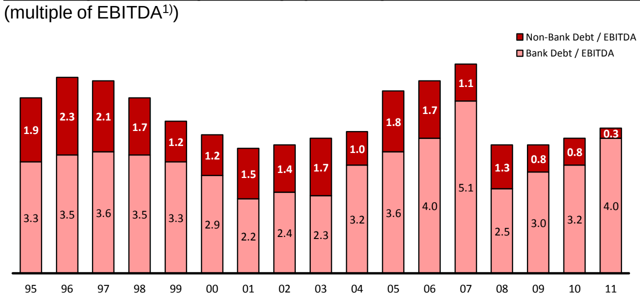
US Average Debt Multiples of Highly Leveraged Loans
(multiple of EBITDA[1)])



1) EBITDA = Earnings before interest, taxes, depreciation and amortization less than $50MM

Source: S&P LCD, Bond Capital

Exhibit 9

Mezzanine Exit

Most mezzanine investments are repaid through cash generated by the business, a change-of-control sale or recapitalization of the company. Many mezzanine capital providers believe the IPO "home run" is a rarity. While some mezzanine providers may look to invest in companies that represent strong IPO candidates, more frequently the mezzanine capital provider is looking for longer term capital deployment which receives a return commensurate with the risk being taken. It is very common that mezzanine investors are bought out by the initial owner. Other exits occur through recapitalizations, through the accumulated profits generated by the business, initial public offerings, or through an acquisition of the company by a competitor or other control equity investor.

About Bond *–Bond Capital provides capital for growth, succession and equity withdrawal strategies to small and medium sized enterprises. Bond focuses on mezzanine lending for expansion, mergers and acquisitions - M&A, recapitalizations, management, partner and leverage buyouts - MBO's and LBO's.*

About the Authors: *Corry J. Silbernagel, P.Eng. MBA is a Director of Merchant Banking for Bond Capital. Formerly a management consultant, Mr. Silbernagel has acted as both CFO and Board Member for a number of public companies. Prior to earning his MBA at INSEAD Mr. Silbernagel worked in management for several of Canada's largest energy companies. Prior to that Mr. Silbernagel was a project engineer and manager for a leading global engineering firm. Mr. Silbernagel earned his Bachelor of Applied Science – Civil Engineering from the University of British Columbia. Mr. Silbernagel is fluent in French and English.*

Prior to founding Bond Capital Davis Vaitkunas worked as a systems Integrator, a senior banker and as a merchant banker. Davis has completed over 120 banking transactions which helps to ensure a surety of close during the structuring, arrangement and funding phases that a financial transaction must progress through. Mr. Vaitkunas holds an undergraduate degree from the University of Alberta.

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