



Mezzanine Finance White Paper

2nd Edition

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Amendments to
Mezzanine Capital Structures section with
Ian Giddy, NYU Stern School of Business, 2012

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MEZZANINE FINANCE

Mezzanine finance is a layer of funding between senior debt and equity. It is used to fill a funding gap due to insufficient capital from other sources in business transactions or as a means of improving a company's return on equity by reducing a company's weighted average cost of capital.

Mezzanine investments are tailored investments that bring the preferred features of both debt and equity into a single facility. Mezzanine investors are often non-bank institutions and specialty funds seeking absolute return on capital. Mezzanine facilities are customized to the specific cash flow need of the investee company, which not only helps the investee company get more senior debt capital, but may also reduce the need for equity and thus dilution to the shareholders. Common transactions that use mezzanine facilities include growth through expansion projects, acquisitions, recapitalizations, management buyouts, and leveraged buyouts.

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Companies that use mezzanine capital access more capital and can achieve higher returns on equity. The availability of mezzanine capital can be cyclical, while the amount used in any transaction is influenced by market leverage profiles and the availability of senior debt and equity sources. The pricing of a combination of senior debt and mezzanine debt can be comparable to that of a high yield note. Most mezzanine investments are repaid through cash generated by the business, a change-of-control sale or recapitalization of the company.

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)*

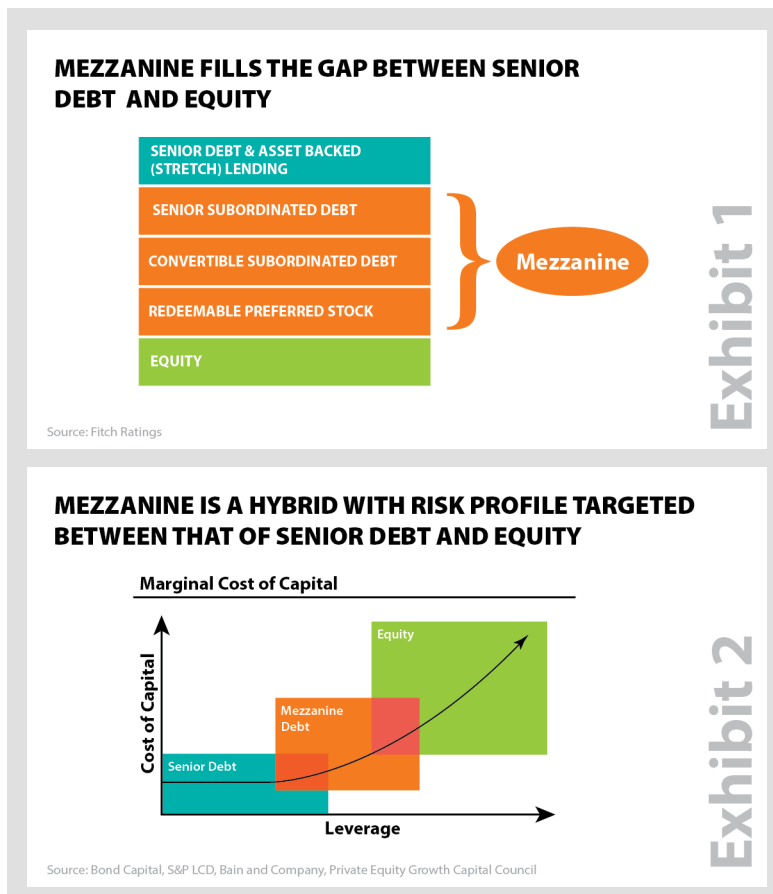
In a broader sense, mezzanine debt may take the form of convertible debt, junior debt, subordinated debt, private "mezzanine" securities (debt with warrants or preferred equity), or second lien debt, and is sometimes referred to as quasi-equity.

Mezzanine capital is typically used to fund corporate growth opportunities such as an acquisition, new product lines, new distribution channels, plant expansions, for company owners to take money out of the company for other uses, or to 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.

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 and 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. *(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 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.

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.

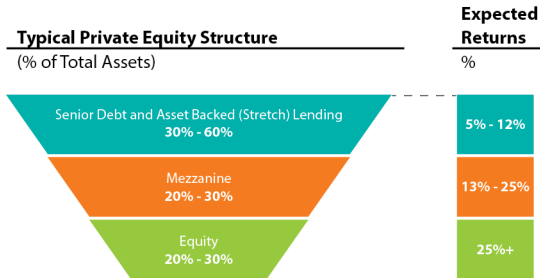
In structuring a mezzanine investment, the shareholders and mezzanine investor work together to match the business' future free cash flow with any repayment obligation. A well-structured mezzanine investment will leave excess free cash available to the company as a margin of safety for asset replacement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

Mezzanine debt is shown to add significant capital, enabling

COMPARISON OF PAYMENT STREAMS

Current Payments Paid monthly, quarterly or annually (Debt Attributes)	Deferred Payments Paid upon maturity of the mezzanine facility or late (Equity Attributes)
Cash Interest - a periodic payment of cash based upon a percentage of the outstanding balance of the mezzanine financing. The interest rate can be either fixed or floating.	PIK interest - payable in kind interest is a periodic form of payment in which the interest payment is not paid in cash but rather paid in kind by increasing the principal amount through capitalization of the interest payment then due.
Principal - scheduled repayments, a portion of which may be deferred until maturity and /or year-end cash sweeps based on a formula.	Bonus / Exit 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.
Royalties – variable payments based on a prescribed formula usually related to revenue, gross margin, EBITDA or net income.	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.

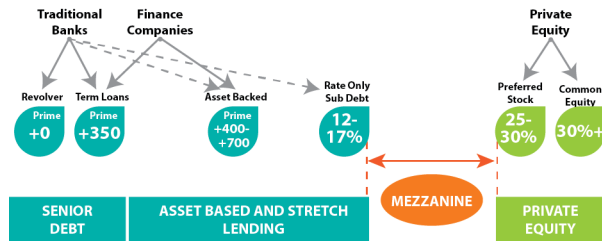
COMPANIES WITH EFFICIENT CAPITAL STRUCTURES EMPLOY A NUMBER OF CAPITAL SOURCES



Source: Management Magazine, Bond Capital

Exhibit 3

MEZZANINE FILLING THE GAP BETWEEN DEBT AND EQUITY



Source: Bond Capital

Exhibit 4

a company to grow while minimizing the issuance of equity. (*Exhibit 3 & 4*)

On the positive side; the owners face little dilution and maintain control of the business; the company's 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, or is paid off all at the end (also known as a full bullet payment).

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/Specific	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	Dividend
AMORTIZATION	5 years or less	Ties to Asset Life	Flexible / Engineered	Indefinite
RATE	Prime	Prime Adjusted	Risk Adjusted	Market Adjusted
EQUITY KICKER	None	Success Fee	Warrants	Shares
PREPAYMENT PENALTIES	Not Usually	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

Source: 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 a small equity holder, with buyout terms to payout the mezzanine fund and repurchase the equity at the appropriate time. More importantly, a business owner needs to analyze the difference in value between an ownership interest with the mezzanine investment and without. All else being equal, an improved valuation represents an improved return on equity for the shareholders. Another way to look at this calculation is: If the mezzanine investment costs less than the incremental return on the equity it makes sense, if it costs more than the incremental return on equity then it should be considered less favourably. What's more, having mezzanine debt in place can actually help a company secure more total capital and reduce risk if it helps to properly capitalize the business. **Exhibit 6** demonstrates how the addition of mezzanine capital provides more total capital to the business.

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.

REASONS FOR THE FUNDING GAP BETWEEN SENIOR DEBT AND EQUITY

- 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, or are against goodwill or intangible assets as collateral.*
- 3. Senior lenders may wish to limit their exposure to any one company or industry.*
- 4. Equity may be limited or unavailable, prohibitively expensive, or highly dilutive.*

Having mezzanine debt in place can actually help a company secure more total capital and reduce risk.

LOWERING THE COST OF CAPITAL AND IMPROVING EQUITY RETURNS

MEZZANINE INSTRUMENTS

offer a risk/return profile that lies between debt and equity.

MEZZANINE DEBT

is sometimes referred to as quasi-equity.

ROE

Return on equity.

WACC

Weighted average cost of capital.

IRR

Internal rate of return.

EBITDA

Net income with interest, taxes, depreciation and amortization added back to it.

IPO

Initial public offering. The first time a company publicly sells shares on the open market.

CALL PROTECTION

refers to a period of time during which a bond issuer cannot buy back a bond.

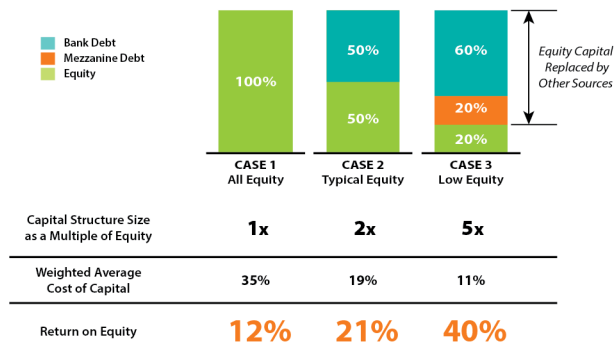
In addition to securing more capital, a mezzanine structure allows a business to reduce its cost of capital and boost both return on equity and absolute profits. The following three cases in *Exhibit 6* illustrate a traditional All Equity Company.

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.

LEVERAGE IMPROVES RETURN ON EQUITY AND AVAILABILITY OF CAPITAL

Company Capital Structures

(% of Company Value)



CASE 1 | All Equity

CASE 2 | Typical Equity

Transitioning to a more efficient capital structure through a small recapitalization into a typical company with debt.

CASE 3 | Low Equity

Re-capitalizing again to a final optimized structure using a higher degree of leverage.

Source: Bond Capital

Exhibit 6

MEZZANINE RETURNS

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 that fluctuate with economic conditions, traditional mezzanine finance is a consistent and stable market targeting an absolute return. The coupon rate on mezzanine notes and targeted returns of

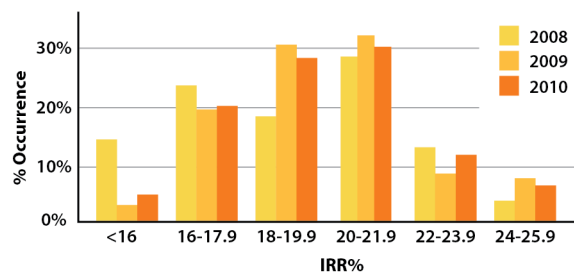
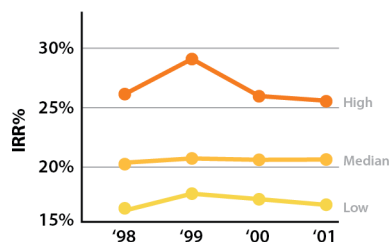
mezzanine investments have remained relatively constant over the last 20 years. (*Exhibit 7*)

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. Today's mezzanine investors are looking for an IRR (internal rate of return) between 11 and 25 percent compared to an IRR of 25+ percent 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.

In the 2000's the proliferation of Buyout Funds (Private equity funds that focus on buying companies through leveraged buyouts) created a market for specialized mezzanine providers that focus on funding Buyouts. At the same time low interest rates and a supply of debt capital from central banks have enabled increased leverage to mezzanine investors and the ability to sell mezzanine loans into securitized products like the CLO (Collateral Loan Obligation) Fund. The credit crisis of 2008 resulted in a high percentage of mezzanine funds exiting the market. The interest rate conditions continued to be favourable in the 2010's enabling a number of new funds to enter the market replenishing the supply of mezzanine capital.

TARGETED MEZZANINE RETURNS HAVE REMAINED RELATIVELY COSTANT AT ABOUT 20%

Mezzanine Targeted Returns
(Internal Rate of Return IRR%)



Source: Fleet Securities Inc., PNC Mezzanine Capital

Exhibit 7

MEZZANINE TERMS

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 were 3.0, a mezzanine deal would be closer to 4 or 5. Mezzanine facilities are often customized or "engineered" to

MEZZANINE RETURN CAN BE MADE UP OF SEVERAL COMPONENTS

(\$000's)		INITIAL 0	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	CLOSE
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	-
DEBT ATTRIBUTES	PRINCIPAL REPAYMENT	-	-	-	-	3,000	3,000	5,503
	INTEREST		1,523	1,568	1,615	1,439	1,032	-
EQUITY ATTRIBUTES	LESS PIK COMPONENT		(300)	(309)	(318)	(328)	(248)	-
	OTHER DEFERRED COMPONENT							2,500
MEZZANINE CASH FLOW		(10,000)	1,223	1,259	1,297	4,111	3,784	8,003

FALLITY ASSUMPTIONS LOAN SIZE (\$000's): 10,000 INTEREST RATE: 15.0% SIMPLE ANNUAL IRR: 16.5%
MATURITY (YEARS): 5 PIK COMPONENT: 3.0%

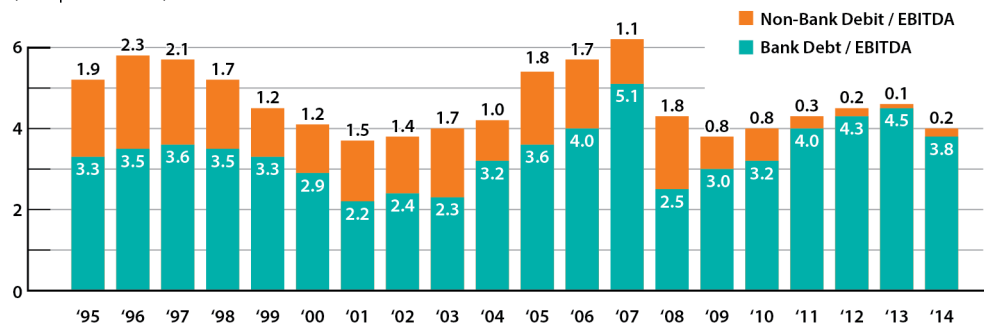
Source: Bond Capital

Exhibit 8

MEZZANINE FILLS THE GAP BETWEEN SENIOR DEBT AND EQUITY

US Average Debt Multiples of Highly Leveraged Loans

(Multiple of EBITDA)



Source: S&P LCD, Bond Capital, Capital IQ

Exhibit 9

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-

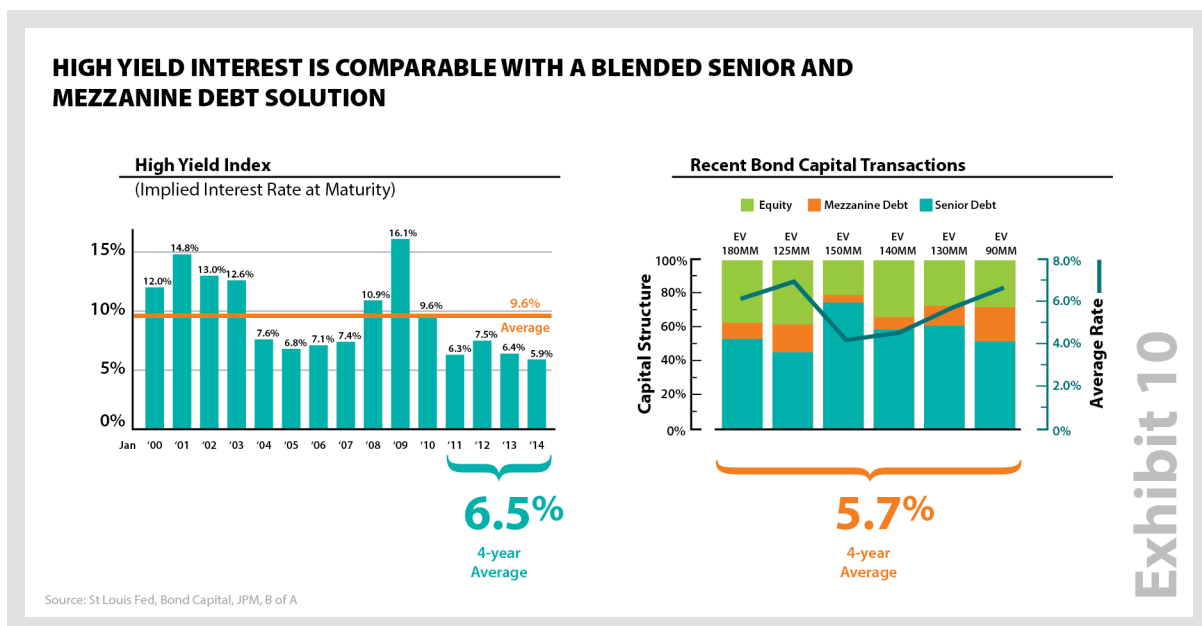
bank debt (often mezzanine debt) as a multiple of EBITDA for companies with less than \$50MM in EBITDA.

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 $17/5 = 3.4x$ EBITDA. In addition to size, industry stability or volatility and the availability of collateral can have an impact on capital availability.

MEZZANINE AND HIGH YIELD DEBT

The average cost of senior debt and mezzanine debt in a private company to publicly traded high yield notes is comparable. While there are pros and cons to both

structures, generally, a high yield debt offering requires a much larger minimum amount than a private debt solution, while the private debt solution would require a liquidity risk premium and therefore in theory cost more. Comparing high yield interest rates with the average cost of private debt shows that rates between the two can be quite similar. (*Exhibit 10*)



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.



About Bond Capital

Bond Capital is an award winning institutional provider of structured business debt and equity to successful business owners and management teams wishing to capitalize for growth, acquisitions, or buyouts. As a true entrepreneurial partner, Bond Capital identifies common goals and objectives, tailors a creative financial solution, and provides the necessary investment in real dollars. Since 2002, Bond Capital has provided funding and advice to later stage companies with strong management teams and EBITDA between \$2 million and \$50 million, making direct investments between \$2 million and \$30 million. Bond Capital has also arranged syndicated transactions ranging up to \$250 million.

Bond Capital was named by Preqin for best global performance by a mezzanine debt fund for 2015. Bond Capital is located in Vancouver, Canada.

About the Authors

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understands how to determine the right mix of debt and equity to amplify investee companies' success using cash flow analysis and other tools. As managing director and head of originations at Bond Capital, Corry is responsible for new investment opportunities.

Corry's strong operational finance skills come from twenty years working as a management consultant, CFO, project engineer, and engineering project manager at some of Canada's largest energy companies and for a leading global engineering firm. Corry enjoys participating as a board member and treasurer for various public companies, private companies, and not for profit organizations.

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has spent over twenty years advising business owners about finance, capital structure strategy, raising capital, and the cost of capital. Davis has funded over 150 transactions using a wide variety of creative capital solutions. As the founder and managing partner of Bond Capital, Davis has successfully raised and deployed multiple Bond Capital private equity funds.

In addition to being a banker, Davis is a successful entrepreneur who understands sales. He formerly worked in the information technology industry implementing enterprise resource planning (ERP) software, hardware, and network solutions for large manufacturing and retail clients at a Global 100 Corporation.