IS MEZZANINE CAPITAL RIGHT FOR YOU?

by Steven J. Schwartz

How do you know if mezzanine capital is an option you should consider for your business? There are a variety of diverse situations for which mezzanine capital may be appropriate. Consider three examples, all of which are good candidates for mezzanine financing:

1. You have a profitable, growing business that could grow much faster if only you had the capital necessary to increase the amount of inventory you maintain; but, your bank is only willing to advance you 50% of the cost of such inventory.
2. You are the President of an established, profitable company and the owner is thinking of selling the business and you would love to buy it but the sum of the cash you are able to invest plus the amount that your bank is willing to lend you is not enough.
3. You and your 50% partner have run a profitable business for many years and now he wants to retire to Florida and you want to continue working for at least another 5 years, but you are not sure where you are going to get the money from to buy his interest.

Mezzanine capital is the middle (or “mezzanine”) layer of capital between the senior debt provided by banks and equity provided by stockholders. Accordingly, mezzanine capital is generally subordinate to bank financing, meaning that the bank loan has a first claim on any of the assets of the business and generally has a right to be repaid before the mezzanine capital. On the other hand, mezzanine capital is senior to the company’s equity. Most mezzanine capital comes in the form of a loan that is secured by all of the assets of the business (in second position behind the banks). However, in some instances, mezzanine capital can also be in the form of preferred equity without any collateral or requirement to receive current dividend payments. Such equity usually has a requirement that it be redeemed prior to any payments to the company’s common equity.

While banks generally require that their loans be adequately secured with assets of the company, mezzanine capital providers generally focus on the cash flow generated from the operations of the business. Accordingly, the most important aspect of a company looking to obtain mezzanine capital is that they have a proven track record of generating cash flow from their business. This generally disqualifies start-ups and turnarounds from being good candidates for mezzanine capital. In addition, how the company plans on using the capital is important. As the three examples above indicate, using mezzanine capital to fund inventory build-up, facilitate a management-led, leveraged buy-out, or to recapitalize the company are all good examples of when mezzanine capital is most helpful. As a general rule, a company seeking to establish a sales and marketing organization, to cover operating deficits or to provide partial liquidity to an owner that remains active in the business, should not use mezzanine capital. Those uses of capital are more appropriately funded with equity.

Since return expectations are correlated with risk, bank loans are the cheapest source of capital for a company, then mezzanine debt, then mezzanine equity, and then common equity. For this reason, it is best for a company to maximize each type of capital in the order of their cost. Accordingly, only after a company has obtained as much bank debt as the bank will provide (including a revolving line-of-credit and term loan) should it consider mezzanine debt. Then, only after a company has obtained as much mezzanine debt as the mezzanine capital provider will provide should it consider mezzanine equity, and so forth. Utilizing this financing strategy will minimize the company's cost of capital and allow the company's owners to retain ownership of as much of the company as possible.

The actual cost of each type of capital will depend on many factors as well as the amount of capital required. Economies of scale apply to capital, as they do to almost all supplies. So the more capital the company needs, the cheaper the cost of the capital. Those businesses requiring in excess of $10 million will most likely pay less for their capital than a company seeking less than $10 million. This is because there are so many capital providers competing for the over $10 million deal size. One reason for so many providers to that segment of the market is because they all have a lot of money to invest; and, since the amount of effort to find, underwrite and close a large deal is not much different than it is for a smaller deal, they prefer to spend their time on the larger deals. There are still many choices of mezzanine capital providers for loans under $10 million, but the cost is slightly higher.

For <u>mezzanine debt</u> of $10 million or less, expect to pay origination fees of 1% to 3%, a current interest rate of between 12% and 16% and options to purchase equity in the company (referred to as detachable penny warrants) so that the capital provider's total annual rate of return on their investment will be between 20% and 25%. There are many less providers of <u>mezzanine equity</u> of $10 million or less; but, if you can locate one, expect to pay between 30% and 35% annually for their equity investment. These yields are still less than institutional common equity investors that require more than 35% a year.

In addition to cost, there are many other advantages to mezzanine capital as compared to equity. Most institutional common equity investors require a controlling interest in the company. Most mezzanine providers only require the right to regularly receive financial information about the company and the right to attend the company's board meetings as an observer. In addition, most institutional equity investors require a high growth rate for the business to achieve their desired rate of return. Mezzanine providers will accept a business with limited or no growth potential so long as the business has consistent earnings sufficient to service their debt. Some mezzanine providers will even limit their rate of return on their investment, while equity investors almost never will.

Business owners should carefully weigh all of the factors discussed above the next time they are in the market for capital. And, if they qualify, consider mezzanine capital after they have met with their banker and before they consider equity.