Mezzanine Financing – Filling the Gap Between Your Bank and Your Wallet

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Despite the difficult economic business climate that has prevailed for the past several years, many service industries have achieved slow, sustained growth. As we emerge from a highly publicized "credit crunch", senior lenders, those that lend primarily against the cash flow or the inventory and accounts receivable of a business, appear ready to finance appropriate opportunities.

The growth in the services sector, as well as the blossoming availability of "senior" debt, makes sense given that the financial risk model in most service industries mitigates the risk to businesses and their lenders. This is particularly true where the business is associated with an established franchise or brand, where the risk relates to developing and operating at specific locations, in effect creating an asset (a future cash stream), rather than a liability (start-up and development costs).

Notwithstanding the fact that senior debt is, in the current economic environment, becoming more readily available, a void often still exists between an enterprise's "equity" capital contributed by the business owners and its senior debt. This void tend to be significantly larger where the enterprise is expanding rapidly or has a limited asset (and therefore collateral) base. The spread between the capital requirements of a rapidly growing business and the availability of senior debt results from the methods used by senior lenders to calculate a borrower's ability to repay the loan, which is based upon the value of specific assets.

In many instances "mezzanine" financing can be effectively used to fill the void between equity capital and available senior debt. Simply defined, mezzanine financing is debt or preferred stock that is subordinate or junior to senior debt, but senior to or "ahead" of equity. Accordingly, in the event of a liquidation or sale of the enterprise, the

senior debt is paid first, and the mezzanine investment is paid before the equity investors receive a return on their investment.

Mezzanine financing is, from the lender's perspective, akin to an investment in the enterprise. As a result, the terms and conditions of a mezzanine investment will be highly negotiated. Moreover, different mezzanine lenders utilize different investment models, which are based upon the particular objectives of each individual mezzanine lender.

Mezzanine financing may either be structured as debt or preferred stock. Irrespective of the how the investment is structured, it is generally structured to have the financial attributes of subordinated or junior "term" debt, with a defined exit strategy for the mezzanine lender. In the case of term debt, the principal will usually be payable as a "bullet" on the due date. Where preferred stock is used, the lender will generally insist upon a put, which allows the investor to require the enterprise to repurchase the stock on or after a pre-established date.

Interest terms are based upon the mezzanine lenders desired IRR, or internal rate of return. Most equity lenders desire an IRR in excess of 15%, less than most institutional investors that purchase common stock. This desired return, with mezzanine debt, is generally in the form of interest combined with a "fee" payable at the end of the term. If the investment is made in preferred stock, the IRR usually includes a combination of mandatory dividends and a calculation performed when the put is exercised.

Additionally, mezzanine lenders often desire to participate in the upside generated if the enterprise is successful. This participation is achieved by the mezzanine investor by means of a "success fee" based upon the enterprise's performance, the right to purchase a defined percentage of the enterprise's common stock at a nominal price, or the right to convert all or a portion of the investment into common stock.

A mezzanine lender will generally require certain other rights that allow it some degree of control over its investment. These rights may include a seat on the board of directors or board of managers of the enterprise, the right to attend meetings of the board of directors or board of managers, information rights, and the right to approve certain fundamental transactions.

Mezzanine financing, however, is not appropriate for every business. In order to generate the desired return to the mezzanine lender, a business must be able to show strong sales, income growth and positive cash flows. Unlike senior debt, however, these sales, growth, and cash flow requirements only need to be demonstrated by well reasoned financial projections and modeling. Rather than examining the current status of the business, as a potential senior lender does, mezzanine lenders determine the viability of a potential investment based upon the expected future performance of the enterprise. As a result, mezzanine financing is often a valuable tool to fill the void between the owner's equity investment and available senior financing.