

A higher yield

How mezzanine financing can be a cheaper alternative than additional equity capital

In today's tight credit market, even well managed, profitable businesses find themselves with limited options for financing growth. In order to combat that, these businesses should explore alternatives to traditional capital/financing sources.

Mezzanine financing, according to Sheila A. Enriquez, a senior audit manager with Briggs & Veselka Co., could be the answer.

Mezzanine debt is a hybrid instrument that falls between pure debt and pure equity. It is designed to fill the gap between the amount a senior lender will provide and the amount of equity capital the owners or buyers are willing to commit. Mezzanine financing is typically issued in the form of subordinated debt, and almost always includes "equity participation" or "equity kickers" in the form of warrants to purchase equity or conversion rights to common stock.

The debt has an amortization period, typically 5 to 7 years, earns an interest rate a few points higher than senior debt, and contains terms and conditions — which resemble bank covenants — and some equity conditions.

Smart Business spoke with Enriquez about mezzanine financing and what sets it apart from other capital options.

What are the advantages and disadvantages of mezzanine financing?

It offers more flexibility to structure coupon, amortization and covenants to accommodate the specific cash flow requirements of a business. It's also a cheaper alternative than additional equity capital, and requires only interest payments for relatively long periods. Mezzanine financing does not require any type of management control or voting position; even though the owner loses some independence, he or she rarely loses complete control of the company or its direction. Mezzanine financing also increases the value of stock held by existing shareholders, even though they will not have as great an ownership stake. Most importantly, mezzanine financing provides business owners with the capital they need to acquire another business or expand into other areas.

As for disadvantages, the owner will have to relinquish some measure of control over the company, and lenders of mezzanine funds will typically have significant abilities to take action if the company does not meet its financial projections. Also, mezzanine financing is more expensive than traditional or senior debt arrangements.

Since mezzanine lenders usually do not



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have any direct security interest in the assets of the borrower, they typically incorporate restrictive covenants into loans by which the borrower must abide. They also include agreements by the lender not to borrow more money, refinance senior debt from traditional loans, or create additional security interests in the assets. The borrower must also meet various financial ratios.

Business owners who agree to mezzanine financing may be forced to accept restrictions in spending in certain areas, such as compensation of important personnel. Business owners may also be asked to take pay cuts themselves and/or limit dividend payouts.

What sets mezzanine financing apart from other capital options?

Mezzanine financing increases the range of financing options available to companies. For example, companies with a good credit rating, but whose funding requirements are not large enough for financing on the capital markets, can use this option to meet capital needs. Further, lenders of mezzanine financiers are not really interested in the company unless there is a default. Traditional equity investors usually want to take control. With mezzanine financing, it can be guaranteed that financiers will make a way for you to pay off the debt without opting for default. This

funding comes in a form of stand-alone subordinate and equity transactions.

How does the financing process compare to traditional bank loans?

Traditional senior debt financing offered by banks and financial institutions are oriented towards collateral because of the regulatory environment and a bank's financing structure. Consequently, a bank providing a loan will always be looking to secure it with mortgages or pledges of receivables and inventory.

Mezzanine funds are yield-oriented providers of risk capital who want to participate in the growth of the enterprise value. The risk of mezzanine finance is not covered by collateral but generally by financial covenants. Thus, mezzanine funds tend to be more liberal when it comes to tailoring the investment to meet the needs of the borrower.

However, because of the absence of collateral, the criteria companies must meet to qualify for mezzanine funding are also considerably more stringent than those for loan financing. The company's ability to generate cash flow is often the most important consideration. Lenders also examine ownership flexibility, company history, growth strategy and acquisition targets (when applicable).

What are some key terms and negotiating points?

Among the key questions that businesses must be aware of when negotiating with mezzanine lenders include: Does the mezzanine lender require the same covenant package as a bank deal? Will the lender want to put people on your board? After the loan is issued, how closely will the lender scrutinize your financial statements? If the debt cannot be repaid, how will the lender handle it? Will it agree to restructure or refinance? What percentage of warrants will be required, and when can they be claimed? What are the relevant put (investor's right to be paid in full) and call (company's right to buy back the investment) provisions and how will the investment be valued at that time?

Business owners in need of capital should do some comparison-shopping when selecting a source of mezzanine financing. The ideal investor is one that understands the business and will respond consistently and appropriately in the event best laid plans go awry. <<

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