Guest Article

The Benefits of Mezzanine Financing for Middle Market Companies

Patrick Rond – prond@kppinvest.com
Nicholas Stone – nicks@kppinvest.com
Key Principal Partners

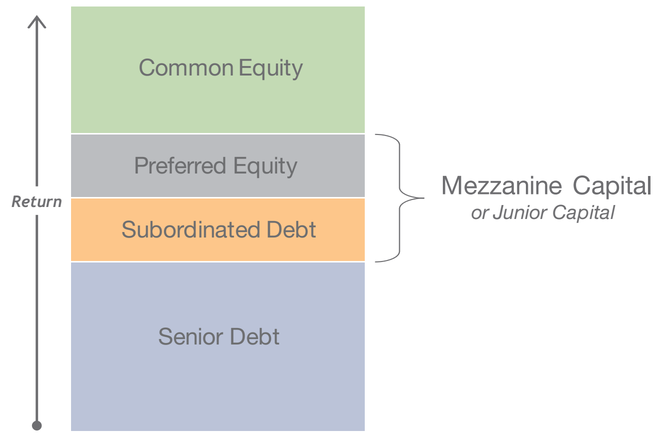
Recent market conditions have re-established mezzanine financing's appeal as a tax-efficient source of long-term capital. With the reduction of traditional senior bank credit and the reluctance of banks to lend under the lenient terms and low rates offered over much of the last decade, mezzanine is one of the more effective vehicles for owners of closely held private companies interested in facilitating liquidity for wealth diversification or succession purposes, pursuing acquisitions, or funding organic growth.

Mezzanine Financing and Capital Structure

Mezzanine, or junior capital, financing is the portion of a company's capital that sits between senior debt and common equity in the form of subordinated debt, preferred equity, or some combination of these two securities. While mezzanine financing can be structured in a number of ways, common characteristics include:

- Subordinate to senior debt in terms of payment priority, mezzanine is senior to common equity.
- Unlike bank loans, junior capital is typically unsecured and commands a higher yield than senior debt.
- There is no principal amortization.
- A portion of the return is fixed making this class of security less dilutive than common equity.
- Subordinated debt is comprised of a current interest coupon, payment in kind (PIK), and warrants.
- Preferred equity is junior to subordinated debt and viewed as equity from those more senior in the capital structure.

Mezzanine Capital: Example Capital Structure



Subordinated debt characteristically has a fixed interest rate or coupon as well as a small equity component, and typical returns range from the mid-to-high teens. Preferred equity returns are naturally higher than subordinated debt and often include a fixed return coupled with equity or equity-like instruments.

Common Uses for Mezzanine Finance

Shareholder Liquidity and Intergenerational Transfer

Reallocating assets to diversify an owner's holdings

Entrepreneurs and family held businesses often reinvest free cash flow back into their companies over time and, as a result, shareholders find that a majority of their personal net worth is encumbered by the business. Mezzanine financing can be an effective way to fund a one-time dividend, providing liquidity for this past reinvestment and diversifying an owner's holdings.

While many senior lenders, even today, are open to lending against collateral to provide for a shareholder dividend, rarely is it without restrictions or personal guarantees. Once mezzanine financing has been introduced as part of the capital structure, senior lenders often accept the junior capital as a long-term equity oriented security making it possible for the owner to avoid the personal guarantee requirement.

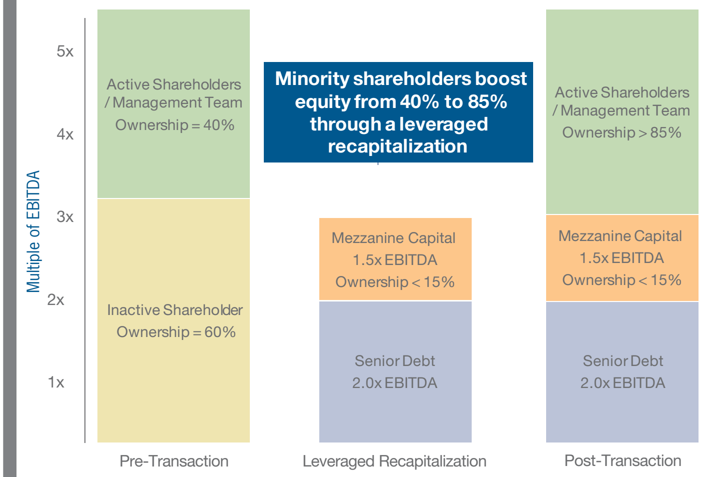
This small but significant change in the capital structure provides owners with an attractive way to leverage a company, take a meaningful dividend, and mitigate risk. The capital received by owners can be used to diversify their holdings and increase allocations in other investments, establish a family trust or other tax advantageous structure to prepare for future estate needs, and most importantly, safeguard the wealth they have created by establishing assets unrelated to the company, its creditors, or traditional market risks inherent in the business.

Ownership transition

When shareholders in a privately held company are interested in personal liquidity, most view their only option as a sale of the company. While a shareholder seeking liquidity may consider the option of selling his or her equity to other existing shareholders or the management team, rarely do either of these latter groups have the personal assets available to finance the purchase of the company. Mezzanine financing can facilitate the transition of ownership in these scenarios without the need for seller financing or other expensive equity alternatives. In order to affect this type of transaction:

- The owner agrees to sell his or her portion of the business to family members, other existing shareholders, or the management team.
- The company borrows a combination of senior debt and mezzanine capital.
- The capital proceeds created by the combination of senior debt and mezzanine are then used to buy out the inactive shareholder at a fair market value, leaving active shareholders or the management team as the company's controlling shareholders.

Ownership Transition Example



Please note that the example above is hypothetical and is intended for illustration purposes only

The *Ownership Transition Example* illustrates how this type of transaction is affected. Assuming an initial debt-free balance sheet and total leverage of 3.5x earnings before interest, taxes, depreciation, and amortization ("EBITDA") at close, the inactive shareholder receives a 5.8x EBITDA valuation for his or her 60% ownership position, leaving the active shareholders or management team with an ownership position equal to or exceeding 85%.

Since mezzanine debt is less dilutive and less expensive than equity, it allows the remaining shareholders to increase their original equity stake and naturally leverage their return.

Distributions prior to the scheduled increases in long-term capital gains

There is a current timing wrinkle that encourages owners to move quickly if they are considering taking capital out of a business. As part of the 2005 Tax Increase Prevention and Reconciliation Act, which extended the terms of the original 2003 Tax Act until the end of 2010, long-term capital gains tax rates were reduced from 20% to 15% for the highest tax brackets. Under the federal budget proposed for 2011, these tax cuts will be allowed to expire and the original, higher rates will prevail.

Additionally, the recently passed health care reform legislation calls for another tax on investment income of 3.8% for couples earning more than $250,000 in annual income beginning in 2013, bringing the effective rate to 23.8%.

Therefore, owners planning to take capital out of a business may want to move quickly to avoid these tax consequences. Since a sale of the company to a strategic buyer or institutional investor can take three to nine months, a dividend recapitalization utilizing mezzanine financing may be one of the few options available to shareholders interested in liquidity prior to the end of 2010.

Acquisition Financing

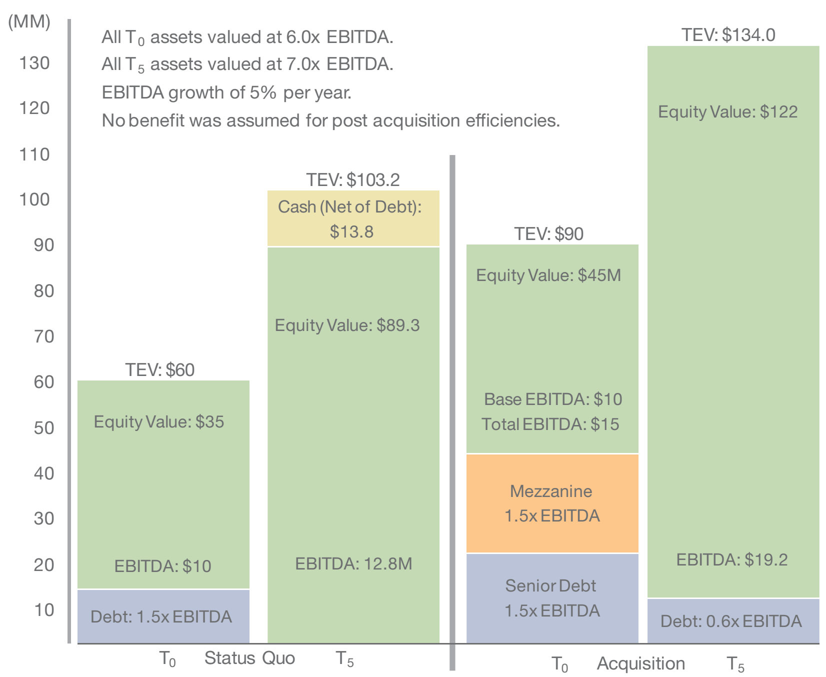
For companies looking to grow through acquisition, the last few years have presented an unusual confluence of circumstances:

- Many companies were adversely affected by the economic slump, which resulted in dampened profitability and naturally depressed valuations. This chain of events has many equity owners, once with unrealistic valuation expectations, now willing to consider a liquidity event with reasonable terms.
- Due to a lack of transaction activity since mid-2008 coupled with the number of aging shareholders searching for ways to exit their businesses, the number of companies that will be sold over the next few years is expected to swell.
- Financing for acquisitions made by privately held companies has been especially tight. As evidenced over the past 24 months, banks have pulled back from M&A lending, and the covenants for loans that are made have become far more rigid. This credit tightening is most pronounced for lower middle market companies.

In summary, while more accretive acquisitions will likely be available to strategic buyers at reasonable prices, bank lending capacity to complete these acquisitions has been significantly constrained and appears to change day to day.

Owners are then faced with foregoing the acquisition or raising outside capital to support the theoretical "gap" in the capital structure.

Acquisition Finance Illustration



Please note that the example above is hypothetical and is intended for illustration purposes only

The *Acquisition Finance Illustration* compares two strategies, a commitment to the status quo versus expansion through acquisition. Each case assumes a sale of the company at the end of the fifth year. While no credit is given for post acquisition efficiencies or economies of scale in the Acquisition scenario, the valuations at T_0, inclusive of the add-on acquisition, are assumed at 6.0x EBITDA, and the exit valuations at T_5 are assumed at 7.0x EBITDA.

By using mezzanine capital to expand through acquisition, the equity value in year five is 18% higher than in the status quo case, underscoring the net benefit to the common equity holders. This further illustrates that mezzanine capital is a cost-effective solution for expansion-minded companies seeking alternatives to raising outside equity.

Growth Capital

Mezzanine capital can also be particularly suitable for companies that have established themselves but lack access to commercial paper or the global funding sources of large corporations. The advantages of mezzanine to finance capital expenditures to support increased capacity, research and development, or new market expansion are the same as for other applications: it's cheaper than equity and offers more flexible terms and covenants than senior debt.

The Benefits of Mezzanine Capital

Non-amortizing, resulting in improved cash flows

Senior debt usually has a highly structured amortization schedule with relatively short maturities, often no more than three years for privately held companies. Most junior capital securities have longer maturities, usually five to seven years, with the principal paid at maturity. Because mezzanine financing does not require amortization during the term of the debt, companies are able to use the increased cash flow to: (i) pay down senior debt, (ii) invest in working capital, product development, or other expansion, or (iii) accumulate the cash on the balance sheet to take advantage of future unforeseen opportunities.

Source of flexible long-term capital

As a rule, mezzanine financing offers significantly more flexibility in coupon structure, terms, and amortization than banks and senior debt providers. A mezzanine investment can easily be tailored to a company's particular financial situation and concerns. Unlike a traditional bank loan, mezzanine capital is unsecured and thus, requires no readily marketable collateral. Because mezzanine investors are more equity oriented than senior lenders, they tend to be more amenable to customizing their investment to meet the borrower's financial, operating, and cash flow needs.

A less expensive, tax-advantageous alternative to equity

Mezzanine capital, when utilized in conjunction with senior debt, reduces the amount of equity required in a business. Since common equity is the most expensive form of capital and is not tax deductible, mezzanine debt can create a more efficient structure that lowers the after-tax cost of capital, is less dilutive than equity financing, and enhances the return on equity.

Mezzanine financing offers other benefits to companies focused on optimizing their capital structures and expanding access to funding. Since mezzanine capital providers take a long-term view of a company, banks may look at firms with institutional investors in a more positive way, extending credit with more attractive terms and relinquishing the need for personal guarantees. Additionally, mezzanine investors help diversify a company's funding relationships, reducing dependence on any one investor or lender.

Considerations in Mezzanine Financing

Of course, no single type of funding is perfect for every situation, and borrowers need to make sure that the lenders and terms are right for them. In addition, there may be certain business or transaction characteristics which make it difficult to utilize mezzanine financing. These attributes may include but are not limited to the following:

- High customer concentration
- Capital expenditure intensive business
- Lack of management
- Commodity-like products or services
- Cyclicality resulting in volatile cash flow
- A current debt to EBITDA ratio close to or exceeding the market value of the company

Mezzanine Financing – Filling a Niche for Middle-Market Companies

According to Thomson Reuters, over $25 billion has been raised by limited partnership mezzanine funds since 2008, evidence that the mezzanine financing market is mature, well developed, and accessible for issuers. Again, no single type of financing is appropriate for every instance. There are cases where mezzanine financing may not be available to a company, but for well-managed companies with strong cash flow and good business prospects, mezzanine financing can be a smart solution for a variety of liquidity or expansion needs.

Patrick Rond and Nicholas Stone are investment professionals at Key Principal Partners Corp., a $1.2 billion private equity and mezzanine fund with offices in Cleveland, Greenwich, and San Francisco. KPP makes investments of $10 - $40 million per transaction and has the flexibility to structure its investments as subordinated debt, preferred stock, and common equity. Mr. Rond can be contacted at 216.828.8138 or prond@kppinvest.com, and Mr. Stone can be contacted at 415.439.5371 or nicks@kppinvest.com (www.keyprincipalpartners.com).