

Mezzanine Financing: A Happy Medium in Corporate Finance

As credit tightened in the last year and equity markets retrenched, it is a little harder to get happy about sourcing capital for your business these days. As the happy medium of corporate finance, mezzanine financing may help put a bit of a smile back on your face.

As the name implies, mezzanine financing sits roughly in the middle of the corporate finance scale, between low cost senior bank debt and higher cost equity or venture capital, just as the mezzanine section of a theater is wedged in between the orchestra seats and the balcony.

Mezzanine financing or subordinated debt has long been a practical financing approach for growing companies but its profile has recently increased. More investors these days are turning back to mezzanine finance as they seek refuge from the volatility of equity investments. Similarly, entrepreneurs are realizing that mezzanine financing offers a range of advantages relative to more traditional bank financing or pure private equity or venture capital.

Mezzanine financing is typically composed of principal and coupon plus some form of equity-like component, in the form of pure equity participation (common shares, options, warrants), percentage of EBITDA or deferred interest payable at maturity. There is a lot of flexibility in the structure, which is generally determined by matching the needs of the company. Deferred interest and cashflow participation models are attractive for companies that want a defined

exit for the investor at the end of the loan life. In the case of deferred interest, the upside is capped, much like a pure debt coupon arrangement; however, the delayed payment terms are more closely matched to an equity timeline where the liquidity event and payment are further out. The equity component essentially rewards investors for taking added risk while limiting upfront debt service requirements for a business owner. Mezzanine financing investors are typically seeking a combined return of 15% to 25% from the coupon and equity component.

For entrepreneurs, the main attraction to mezzanine financing is that it can reduce the need for outside equity investment, allowing owners to retain more ownership and significantly reduce their overall cost of capital for a high growth business. For business owners or business purchasers targeting a return on equity of 25% or more, mezzanine financing provides for leverage beyond what traditional banks can offer and ultimately drives the return on equity higher.

At the same time, mezzanine financing offers far more flexibility in payment terms than senior bank debt. It is not uncommon to see principal payments deferred for a year or more. In some cases, principal may be repaid in a single “bullet” payment, which is more akin to equity. In these cases, many companies will refinance the senior loan to pay the bullet. This reduced debt service in the early years can allow business owners to reinvest free cash flow and ultimately



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accelerate growth of the business. Unlike the flexibility offered through equity however, the principal and interest payments are contractual and must be met regardless of the firm's financial position.

Another major advantage of this type of financing is that interest payments are tax deductible, which lowers the company's taxable income. For this reason, some mezzanine finance investors may not incorporate an equity component. Instead, they may accept a higher stepped-up interest rate towards the end of the loan or incorporate some type of formula tied to the performance of the company (e.g., a percentage of the sales or profit), thereby reducing taxable income and ultimately the business' cost of capital.

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Mezzanine financing may also improve a company's equity position because bankers may consider it part of the equity cushion that supports the senior bank debt.

Mezzanine financing has a wide range of applications. While mezzanine finance has traditionally been viewed as a bridging loan, today it is increasingly used as a stand-alone investment in buyouts or as a substantial investment to further expand a business.

So what do mezzanine finance investors look for? Like all lenders, mezzanine finance investors must evaluate

the borrower's ability to service the periodic interest payments and the loan repayment. However, mezzanine finance investors are more accepting of a subordinated security position and tend to be more stringent in their due diligence and focus on strong management and the cash flow generation of the business. In many cases, mezzanine financiers do not require a board seat but it is not out of the question, particularly in cases where principal repayment is deferred for a significant period of time.

The happy medium of mezzanine financing has put a smile on the face of at least a few entrepreneurs and investors in Canada, as the industry stands at over \$7.3 billion under management. With its many merits and an ever-changing economic climate, mezzanine financing is a solution for business owners to consider as part of a balanced corporate finance strategy.

