

MEZZANINE FINANCING

By Marijean Stallings*

What exactly is mezzanine financing? You may have heard of this term before but are unsure of its meaning. This is not uncommon as it is difficult to precisely define mezzanine financing.

Mezzanine is a hybrid of debt and equity financing with risk and performance characteristics that are similar to that of equity. It is a source of capital that has characteristics of both debt and equity, and is considered to be unsecured as it is the last debt in line for any claim on assets. There are usually both debt (debenture) and equity (shares or warrants) instruments involved. The existing shareholders avoid the dilution levels of a straight equity deal while the mezzanine debt investors have security, unlike a straight equity deal.

Mezzanine financing usually has terms (postponements and standstills) causing it to behave as equity in the eyes of senior debt holders. In fact, while mezzanine financing may have a debt component (with the right terms), banks view it as equity. Therefore, mezzanine financing can be used to engineer bank debt/equity ratio covenants while avoiding the dilution shareholders' equity.

Debt interest rates vary with risk. As mezzanine debt has an equity-like risk level, the returns expected by a mezzanine lender are close to expected equity rates of return.

While expected returns might approach or exceed 20% for mezzanine financing, unlike sub-debt, the investor's returns are not entirely coupon driven. For example, the investor's expected yield of 20% might be comprised of a 12% interest rate on a debenture and equity warrants that an investor expects will deliver an additional 8%. How much is paid via coupon and how much is paid

via warrants or equity can be tailored, making this a very flexible product.

Mezzanine financing (or "Mezz" as it is often called) is a product best suited for short-term situations where the total capital required exceeds traditional borrowing capacity. Another excellent use is in conjunction with bank financing. As mezzanine debt can be made to mimic equity, mezzanine financing can be used to extend bank financing. Businesses at the critical stage of "just turning the corner" might also find mezz debt attractive; they want to avoid dilution at the current low valuation yet are not able to qualify for enough debt with a senior lender.

For example a bank may reject a \$5 million revolver based on poor a debt/equity structure. As an example, inserting \$1 million in mezz financing, would remove this issue. The company then has the capital they require at a blended rate that is still at historically low numbers. ■

About the Author

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