BANKING & FINANCE

How a Hybrid Can Fuel Growth

By Andre Stokes

Joseph needed to raise $8 million to finance the growth of his composites manufacturing business. His company was running out of capacity as orders began to pour in from aircraft and automobile manufacturers. Based on the value of his assets, his bank would only extend him $2 million. The bank could not provide any additional financing based on cash-flow because EBITDA was only $3 million and his personal financial statements were not strong enough. Joseph needed the additional capital but wanted to ensure he maintained financial flexibility, retained control and minimized equity dilution.

Meanwhile Jessica, who was sole owner of a fast casual restaurant chain with 27 corporate owned stores and 76 franchised stores,needed $14 million to repurchase the franchised stores. Same store sales growth had declined during the recession but the company was still generating $4 million of cash flow. Jessica sought to remodel stores, update the menus and refresh the brand. However, her bank told her that because it was a turnaround and based on her business and personal assets, they could only loan her $6 million. Jessica saw significant upside in her plan and was willing to raise additional capital as long as she could preserve as much of her equity as possible.

Mezzanine Relative to Other Types of Financing

Both owners chose to pursue mezzanine debt (also known as subordinated debt) as the appropriate type of financing. Mezzanine debt derives its name from its positioning "between" senior debt and equity – it is a hybrid with characteristics of both. Mezzanine investors generally target returns in the mid to high teens – made up of a low double digit coupon plus warrants for companies under $10 million in EBITDA or low to mid-teens for larger companies. Equity investors target returns of 25% to 30% for smaller companies and 20% to 25% for larger companies.

Financial Instrument	Restrictions (Covenants)	Costs	Collateral/ Personal Guaranty	Equity Required	Amortization Requirement
Senior Secured Debt	Most	Least expensive	Yes—blanket lien & PG	No	Highest
Mezzanine Debt	Some	Moderate	2nd Lien but no PG	Sometimes	Moderate
Equity	None	Most expensive	No	Yes	None

Advantages of Mezzanine

Entrepreneurs find mezzanine debt attractive because it provides more flexibility than bank debt but is less expensive than equity. The amount of capital a mezzanine lender will provide is based on the cash flow of the business not the value of the company's assets or the financial strength of the individual owner(s) since mezzanine does not require a personal guaranty — a huge advantage. Importantly, a business with an existing line of credit that is happy with their bank relationship can often raise additional capital in the form of mezzanine debt and keep its bank relationship intact.

Mezzanine lenders are focused on achieving a target internal rate of return (IRR) and accordingly, have several levers they can adjust to meet yield requirements, including : upfront fees, coupon, amortization, cash interest expense vs. payment in kind interest (i.e., negative amortization), term (3 – 5 years), interest-only periods and warrants. For companies open to refinancing existing senior debt in conjunction with a mezzanine financing, lower overall cost of debt can be achieved through a unitranche facility (senior debt and mezzanine combined).

Sources of Mezzanine

Mezzanine financing is available from a variety of capital sources including Mezzanine Funds, Business Development Companies (BDCs), Credit Opportunity Funds (COFs), Family Investment Offices,and Small Business Investment Companies (SBICs). BDCs and COFs typically provide unitranche financing, which has captured market share from traditional leaders in the market – Mezzanine Funds and SBICs. Mezzanine Funds also face pressure from SBICs because of their lower cost of capital. SBICs are privately-owned investment companies licensed by the Small Business Administration (SBA) and can leverage their equity 2:1 with a low interest, long term loan from the SBA. Mezzanine Funds have also begun to partner with banks to provide competitive unitranche financing.

Caveat

In certain situations a private equity transaction would be more appropriate than mezzanine, which is ideal for companies with predictable and stable cash flows and for business owners who are comfortable carrying a heavy debt load. High-growth emerging companies which may have sufficient cash flow may be better off with equity so that further growth is not hindered by onerous debt service obligations. In addition, although mezzanine lenders do not require a personal guaranty they do hold the owner's equity as collateral.

Andre Stokes is a Managing Director with Calabasas Capital, a boutique investment banking firm that provides sell-side and buy-side merger and acquisition advisory services and private equity and debt capital raising services to lower middle market privately held companies.

Calabasas Capital works in a broad range of manufacturing, distribution and services industries and has specific expertise in working in the areas of food and restaurants, technology services, e-commerce, payment processing, consumer products and services, and business services.

Contact Andre at (818) 657-6130 or andre@calabasascapital.com.