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Striving to educate and consult Small Business and Middle Markets to help create jobs for our fellow Americans

Mezzanine Financing Structures

By

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COMMERCIAL MORTGAGE BANKERS
A Member of Cordell Financial Group

What is Mezzanine Finance

- A hybrid of debt and equity financing that is typically used to finance the expansion of existing companies
- Mezzanine allows the lender to convert loans into equity interest in the company
- It is a Subordinated debt to Bank Loans, Senior Lender and Venture Capital
- Mezzanine is the highest risk grade loan, next to Preferred Equity
- The loan has minimal due diligence
- The estimated return on capital can range from 11 to 25%, depending on structure
- In some cases, the lender requires a fixed rate of return on the loan with equity participation
- The loans are highly complex with various different clauses that are for sophisticated borrower
- Many cases, the lender can create options to buy in the future for a strike price that is favorable to the lender
- Mezzanine finance has many types of loans, it is not just one loan.
- Many Mezzanine Finance Structures have term, time and dates that are critical and often needs Investment Bankers and Attorney’s to execute
- Devils in the details

Mezzanine Finance

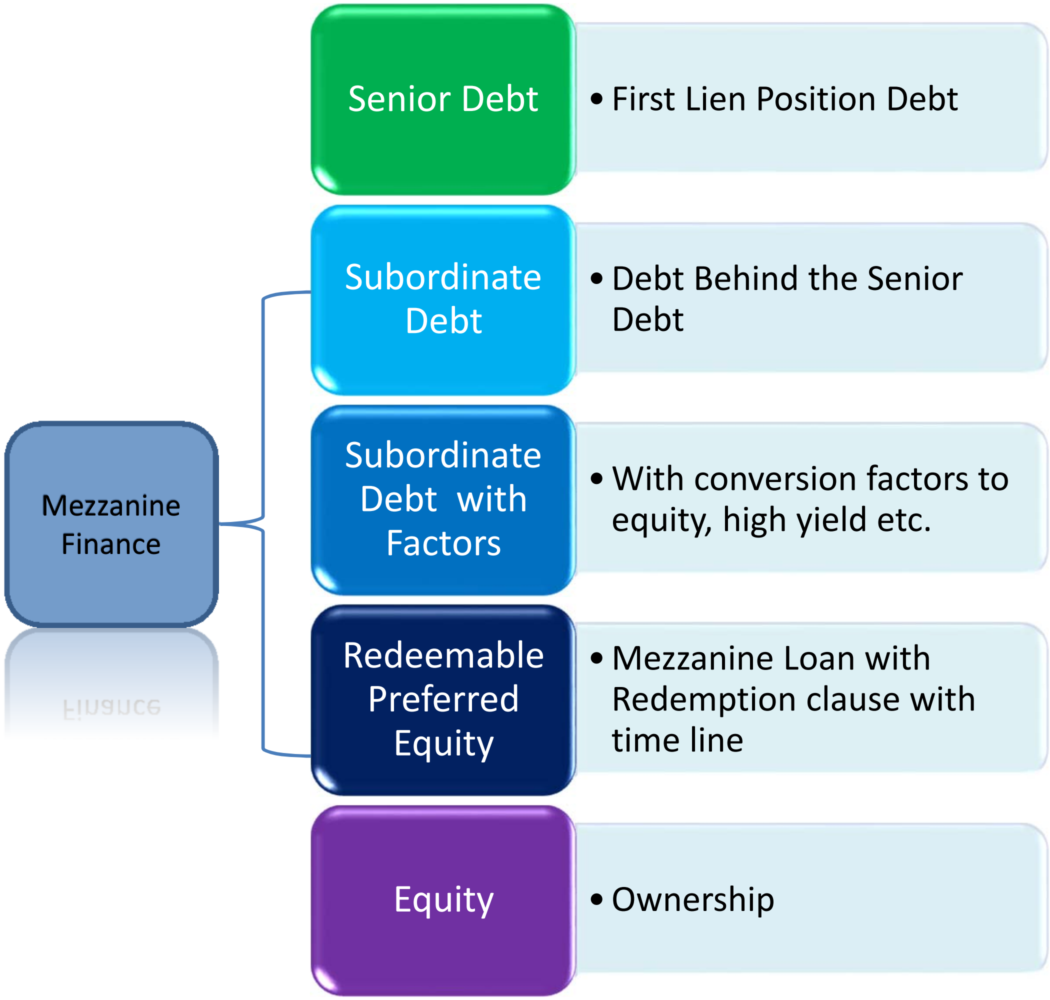
- Many Mortgage Brokers claim to offer Mezzanine Finance, which is simply not true
- Mezzanine Finance is a complex financial instruments for Commercial Mortgage, but without experience, Mortgage Brokers can unintentionally mislead the client into structures that are not the best option as a lending vehicle
- Mezzanine Finance needs to be reviewed by business Attorney’s and Investment Bankers to fully understand the options of the loan, and how it behaves
- Nothing in the Mezzanine Finance is simple, the terms and structures can be extremely complex depending on the lender
- Since Mezzanine is a subordinated debt, often the lender wants some skin in the game, high interest, some cases equity ownership, or combination of the two
- There are many types of Mezzanine Finance:
  - Debt Orientated Mezzanine
  - Balanced Mezzanine
    - Convertible
    - Warrants – etc.
  - Equity Mezzanine

Mezzanine Finance

Mezzanine Finance

- Capital layer between senior debt and equity in capital structure of a project or a company
- Long term source of largely subordinated risk capital with debt repayment characteristics
- Senior lenders and banks generally treat mezzanine as part of equity
- Flexible amortization and interest payments
- Cost between that of senior debt and equity
- If well structured, mezzanine can lower average cost of capital and improve the returns of existing shareholders of a project or company
- As provider of risk capital, the mezzanine lender/investor shares in a company’s financial success but without major dilution of existing equity

Graph of Mezzanine Finance



Senior Debt
- First Lien Position Debt

Subordinate Debt
- Debt Behind the Senior Debt

Subordinate Debt with Factors
- With conversion factors to equity, high yield etc.

Redeemable Preferred Equity
- Mezzanine Loan with Redemption clause with time line

Equity
- Ownership

Mezzanine Finance

Mezzanine Finance

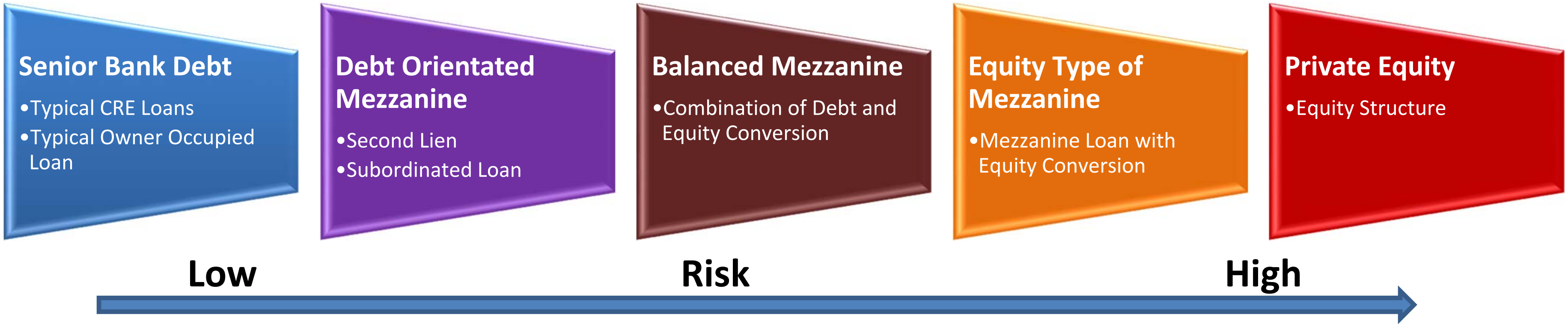
Debt

- Long-term loans with a 5–12 year final maturity that are generally subordinated
- Usually a fixed interest rate
- Base coupons generally at higher rates than senior debt
- Possibility of rolled up interest (partial)
- Other terms and conditions typically include (a) security (usually second liens on assets/pledge of shares) and (b) covenant protection, some of which resemble bank covenants

Equity

- Upside participation via equity kickers in the form of warrants, profit participation, conversion features or additional interest linked to key operational variables
- Exit through sale in IPO in local or international markets or to a strategic investor (via the exercise of drag and tag rights)
- Alternative exit structured via redemption features prepayment premiums and/or put options

Mezzanine Finance



Senior Bank Debt
- Typical CRE Loans
- Typical Owner Occupied Loan

Debt Orientated Mezzanine
- Second Lien
- Subordinated Loan

Balanced Mezzanine
- Combination of Debt and Equity Conversion

Equity Type of Mezzanine
- Mezzanine Loan with Equity Conversion

Private Equity
- Equity Structure

Low **Risk** **High**

	Debt-Oriented Mezzanine	Balanced Mezzanine	Equity-Oriented Mezzanine
Risk	▲	▲▲	▲▲▲
Cost	Lowest (but might not be available)	Generally mid-way between senior debt and equity	High
Dilution	None	Moderate	High
Typical Structure	Subordinated debt	Subordinated debt with equity kicker	Convertible preferred equity, or redeemable preferred equity
Expected Exit	Amortization	Combination of amortization (on debt) and trade sale or IPO (on equity)	Trade sale or IPO; or potentially contractual redemption if unconverted.
Availability (at holdco level)	Usually only for large rated issuers of high yield bonds	Yes (from mezzanine specialists)	Yes (from PE firms & some mezzanine specialists)

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Mezzanine Structure and Financial Model

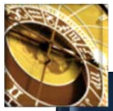
Financing	Scenerio 1	Scenerio 2 with Mezz
Senior Debt	$ 197	$ 170
Mezzanine Debt	$ -	$ 62
Equity	$ 110	$ 75
Total	$ 307	$ 307
Structure		
Senior Debt	64.17%	55.37%
Mezzanine Debt	0.00%	20.20%
Equity	35.83%	24.43%
Total		
Multiple of EBITDA		
Senior Debt / EBITDA	4.5	3.5
Mezz/EBITDA	0	1.8
Equity / EBITDA	1.9	1.1
Total / EBITDA	6.4	6.4
IRR		
Senior Debt	8.00%	8.56%
Mezzanine Debt	0.00%	1.98%
Equity	2.54%	1.18%

- The Mezzanine Structure enhances IRR return for the subject and increases cash-flow
- Give Higher Loan to Value
- Frees up excess cash
- It divides up the cost into various other categories of loans
- WACC (Weighted Average Cost of Capital) formula ought to used to determine the true cost of Mezzanine Finance

Types of Mezzanine Capital

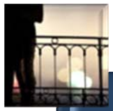
Debt with Warrants

- Typical subordinate debt with detached equity warrants
- Principal is repaid after Senior debt is largely or fully repaid
- Cash Coupon
- Equity Warrants can have zero or very low exercise price, and represent least dilutive minority stake in issuer
- May also have full strike price (but inherently more dilutive)



Convertible Loans

- Typically subordinated debt
- Principal repaid at maturity, unless conversion occurs (in which case, debt swap into equity at pre-agreed formula)
- Inherently more dilutive than debt w/warrants
- Most applicable on eve IPO, or a seed capital PE investor seeks to max out the downside risk



Participating Loans

- Alternative form of Mezzanine
- Base interest rate plus a performance-linked spread
- Interest rate linked to net profit, EBITDA, or sometimes sales-profit participation
- No Equity conversion
- Easy to structure in practice

Debt with Step Up or Deferred Interest

- Subordinate debt with large amount of interest deferred
- No equity participation, but potential for higher IRR
- Principal repayment is typically on the back-end
- Does not work well for long term finance

Convertible Preferred Equity

- Similar to Convertible debt except that default on payment does not accelerate other debt, and cannot force an issuer into bankruptcy
- Essentially a form of Senior Equity
- Widely used in startup financing – is equity
- Mostly for high risk business with the lender participating in ownership of the company

Mezzanine Capital

- Mezzanine Capital is a less dilutive form of risk capital
  - Allows original shareholders to retain ownership as a result of its higher priority in the capital structure
  - Facilitates partnership with strong sponsors and access to a broader and better quality deal flow
  - Incentives aligned through tailor-made structures and performance-based pricing
- Mezzanine Capital is a highly flexible financial instrument that allows for the design of tailor made structures to meet particular needs of companies
  - Debt and equity components can be adapted depending on the type of investment opportunity:
    - Lower interest payment and higher equity component in growth plays
    - Higher coupon and lower equity component in stable cash flow and/or value plays
  - Flexibility in terms of the type of instrument (sub-debt or preferred stock), security, amortization schedule and payment of interest
  - Equity kickers in the form of warrants, profit participation features, or additional interest linked to key performance variables
  - Exit via scheduled amortization, prepayment (normally at a premium) or sale to a strategic investor or IPO
- Mezzanine Capital is generally less costly than other forms of long-term risk capital
  - Reduced risk attributes of mezzanine allows it to offer a lower absolute cost of financing compared to private equity
  - Potential deductibility of interest can significantly reduce the after-tax cost of debt component
  - Equity kicker component linked to performance measures

Why Mezzanine Capital may be appropriate

- Mezzanine Capital finance of infrastructure growth companies in era of credit tightening
  - Tightening Credit for Borrowers
  - Tightening Equity Capital or Preferred Equity Capital
  - Financial Crisis of 2008 and 2009
- Infrastructure companies seeking "equity-equivalent" capital at the project (or onshore) level, and willing to accept lower dilution "debt-like" obligation at holding company (offshore) level.
  - Mezzanine will structure a holding company to serve the equity portion of the loan
- Infrastructure companies that have unexpectedly postponed an IPO, due to adverse market conditions
  - Mezzanine Capital as a replacement of other types of loans
- Mezzanine Capital finance of infrastructure company buyout opportunities
  - Opportunity to co-finance a loan with other Senior, Floating, Subordinate loans available for borrowers
  - Can create excellent options to divide up the loans into various categories like Preferred Equity, Senior Loan, Participating Loans and banks loans

Mezzanine Finance

- Mezzanine Finance is not appropriate for the general borrowers
- Since the lender is in a subordinated position, it is wise for the borrowers to review and analyze the details.
- Thank you, always striving to inform, educate and empower our clients