



## BULLETIN

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## MEZZANINE FINANCING

A franchisor or franchisee looking to expand faces the issue of how to finance growth. Although the company's sales may be booming, and the company is profitable and has positive cash flows, money for growth is usually tight.

Relying on an established relationship with its bank, the company may initially look to a traditional lender for funding. However, if the company expands its senior credit facilities significantly, or negotiates new ones, the payment of interest and principal on those new loans may put a great strain on its cash flow. Taking on a sizeable payment could put the company in a defenseless situation if the economy weakens or new sales are slow to materialize. Furthermore, the company may not have the collateral that its bank requires.

The next alternative that the company may consider is raising capital by issuing stock. It may look to venture capital or institutional funds, or individual investors. An Internal Rate of Return (IRR) exceeding 30-35% will generally be expected by institutional investors for a private company. The company will also dilute its present investors, maybe significantly, by issuing new stock. In addition, the new investors may impose additional stipulations and covenants (including seats on the board), which may not sit well with the company's current financial backers.

The growth of mezzanine or subordinated debt has bridged this recess or gap in financing alternatives. Today, many investment funds either focus strictly on mezzanine financing or offer it as part of its other investments. Used interchangeably, the terms mezzanine and subordinated debt describe the layer of a company's capital structure that bridges the recess between senior debt (including long-term and working capital lines) and equity. Technically, mezzanine financing is one type of subordinated debt. The loan is *subordinate* to senior debt, i.e., in the event of foreclosure, senior lenders will be paid before mezzanine lenders. Due to the elevated risk to a mezzanine investor compared to the senior lender, the investor expects to reap a greater interest coupon and overall return than a traditional bank loan. But, because the mezzanine investor is higher up in the company's capitalization table than an equity investor and may have a security interest in certain collateral, the mezzanine lender will accept a reduction on his return compared to his equity counterpart. Generally, a mezzanine investor seeks returns of close to 18-27% based on the element of risk against such returns that an equity investor targets.

Those who furnish mezzanine capital are both lenders and investors. As with equity funds, risk profiles vary between funds. Although net assets and collateral may not cover their investment, a mezzanine investor may lend on a company's projections and expected overall yield. On the flip side, as lenders, they are chiefly interested in the return of their money before considering the profit made on their money. Hence, strong sales, income growth, and positive historical cash flows are typically expected. Mezzanine deals vary because such financing can be a pliable form of financing, depending on the individual transaction. Negotiations are the governing factor in the deal, co-mingled with a hint of rivalry.

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Common mezzanine traits include:

- ❖ An interest rate is customarily higher than that witnessed in senior debt – approximately in the 10-14% range (some funds may agree to capitalize part of their interest, to be paid when the loan expires, more so, if the interest rate is on the high end);
- ❖ No principal paid for the duration of the loan, thereby lowering cash expenditures for the company significantly;
- ❖ Principal commonly paid in a lump sum at the end of the loan (after the senior debt is repaid); and
- ❖ Nominally priced warrants for an equity interest in the company – this equity interest, nevertheless, will be much smaller than your conventional equity investor and will be determined based on the company's projections to arrive at a target IRR (18-27%), for the investor/lender, including the interest rate.

Mezzanine lenders will customarily provide financing that, in conjunction with senior debt, is up to three to four times historical EBITDA. Additional characteristics of a mezzanine deal may involve conditions where the number of warrants issued by the company to the investor/lender is linked to the company's performance on a year-by-year basis or at the conclusion of the loan. Prudent consideration must be given to the quality of the projections submitted to the mezzanine investors/lenders and to the negotiations involving these provisions. More so than in many equity investments, realizing quarterly and annual numbers is paramount, when percentages of equity are of concern. Funds will frequently offer companies a choice between a limited percentage of warrants, or a flexible provision that reduces the quantity of warrants if a company surpasses its objectives, but raises them if a company under performs.

Although a company should explore less expensive senior financing first, mezzanine financing is supportive to certain situations, i.e., management buyouts, acquisitions, and financing high growth. There may be circumstances where more expensive equity is desirable. But, growth opportunities should not be constrained by a financing option.

If you have any questions regarding mezzanine financing, please contact one of the following capital markets professionals at Renaissance Partners:

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