



# Taking the Mystery Out of Mezzanine Debt

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# What Is Mezzanine Debt?

- Flexible layer of capital between senior debt and equity
  - Typically structured as unsecured, subordinated debt
  - Often includes combination of current coupon and equity participation to reduce cash burden on issuer
  - Bullet / longer maturity (after senior repayment)
  - Downside protection through maintenance and negative covenants (looser than senior)

# Who Uses Mezzanine And Why?

- There are many users of mezzanine
  - Equity sponsors / investors in LBOs
  - Companies seeking patient / flexible junior capital to complement bank financing without giving up control
    - Growth capital
    - Recapitalization / shareholder liquidity
    - Refinancing
    - M&A activity

# Who Uses Mezzanine And Why?

- Mezzanine is increasingly important when senior debt availability is limited
  - Bridges capital structure gaps
  - Cash flow loans (not ABL)
  - Less dilutive than straight equity issuance
  - Helps a deal get done

# Drivers of Cost of Mezzanine

- Size and stability of Revenues and EBITDA
- How much Debt is on the Company?
  - Ability to service principal and interest payments
- What is the Debt being used for?
  - Staying in the company to fund growth
  - Going outside the company to fund equity repurchases
- What are Other Fixed Obligations?
  - Contractual payments on Seller Notes, Earn Outs
  - Maintenance and growth Capital Expenditures

# Drivers of Cost of Mezzanine

- Sponsor Backed Transaction?
  - Can provide additional capital if needed
  - Board control and oversight of management
  - Industry expertise
- Other Elements of Risk in the Business?
  - Lack of pricing power for product or service
  - Customer/supplier concentration
  - Regulatory and industry risks

# Elements of Return

- Current coupon of 12%-15%
- Deferred coupon or PIK (Pay-In-Kind)
- Warrants to purchase equity

*Total all-in return target of deal depends on risk profile of company and transaction*

# Target Company Overview

## Value Added Distribution Business

- Privately owned / closely held
- Historical positive cash flow with \$4.0 million of EBITDA
- Steady organic growth of 6.0% per year
- Low capital expenditure requirements of \$100k / year
- No pre-transaction debt

# The Transaction

- \$20.0 mil purchase price (5x \$4.0 mil of EBITDA)
  - \$16.0 mil cash at closing
  - \$4.0 mil Seller Note (7.0% interest rate; 6-yr bullet maturity)
- To fund the acquisition Buyer requires \$16.5 mil cash (\$16.0 mil to the Seller and \$0.5 mil in fees/expenses)
  - “Asset light” business allows for \$4.0 mil in asset-based bank financing (80% AR & 50% Inventory), with a 6.5% interest rate
  - \$12.5 mil gap needs to be filled with debt or equity
- What should the buyer do, fund the \$12.5 mil in equity or take on mezzanine debt?

# Capital Structure

- Capital Structure A assumes \$12.5 mil in equity capital
- Capital Structure B assumes \$6.5 mil in equity capital and \$6.0 mil in mezzanine debt (19% cost)
- Should the Buyer be willing to pay 19% for debt capital?

## CAPITAL STRUCTURE A

(\$ IN '000s)

### Sources

Senior Asset-Based Loan	\$	4,000
Mezzanine Financing		-
Seller Note		4,000
Equity Contribution		12,500
Total	\$	20,500

### Uses

Cash Purchase Price	\$	16,000
Seller Note		4,000
Fees, Expenses & Working Capital		500
Total	\$	20,500

## CAPITAL STRUCTURE B

(\$ IN '000s)

### Sources

Senior Asset-Based Loan	\$	4,000
Mezzanine Financing		6,000
Seller Note		4,000
Equity Contribution		6,500
Total	\$	20,500

### Uses

Cash Purchase Price	\$	16,000
Seller Note		4,000
Fees, Expenses & Working Capital		500
Total	\$	20,500

# Operating Results

## Cummulative Operating Results Over 5 Year Period (\$ IN '000s)

	<u>Capital Structure A (No Mezz Debt)</u>	<u>Capital Structure B (With Mezz Debt)</u>
EBITDA	\$ 22,548	\$ 22,548
Capital Expenditures	\$ 500	\$ 500
Tax Distribution	\$ 8,493	\$ 6,194
Debt Service (Interest Only)	\$ 1,317	\$ 7,062
Cash Used to Pay Down Debt	\$ 8,000	\$ 8,792
Debt Balance at End of Year 5	\$ -	\$ 5,208
Distributions to Equity	\$ 4,239	\$ -

# Investment Exit

## Capital Structure A - Exit Calculation

Exit EBITDA	\$	5,050
Exit Multiple		5.50x
Enterprise Value	\$	27,774
Less: Debt Outstanding		-
Plus: Cash		150
Equity Value	\$	27,924
<b>Equity IRR:</b>		<b>21.0%</b>
<b>Equity Times-Money-Invested:</b>		<b>2.57x</b>

## Capital Structure B - Exit Calculation

Exit EBITDA	\$	5,050
Exit Multiple		5.50x
Enterprise Value	\$	27,774
Less: Debt Outstanding		(5,208)
Plus: Cash		150
Equity Value	\$	22,716
<b>Equity IRR:</b>		<b>28.4%</b>
<b>Equity Times-Money-Invested:</b>		<b>3.49x</b>

# Summary

- A better return profile is achieved with “expensive” mezzanine capital
  - Higher Internal Rate of Return (“IRR”) and Times Money Invested (“TMI”)

	Equity Investment	Distributions Received	Equity Value at Sale	Equity IRR	Times Money-Invested
Cap. Struc. A	\$ 12,500	\$ 4,239	\$ 27,924	21.0%	2.57x
Cap. Struc. B	\$ 6,500	\$ -	\$ 22,716	28.4%	3.49x

- Allows Buyer to retain “dry powder” for additional expansion initiatives
- Superior equity returns if growth rates are higher

# Typical Mezzanine Transactions

## Characteristics

- Cash flow positive
- Asset light
- Capital structure gap
  - Valuation gap
  - Ability to secure senior debt/equity
- Solid Management team

# Potential Road Bumps/Deal Killers

- 1) Quality and breadth of information provided
  - CIM/Company backgrounder
  - Sources and Uses
  - Historical and current Financial statements
    - Typically require audited financials to close
    - Reviewed may be acceptable with certain areas subject to testing
  - 3-5 year forecast/projections
- 2) Full disclosure throughout the process
  - Changes in the deal dynamics/structure
  - Business environment
  - Fee structure
- 3) 3rd Party Interactions
  - Senior lender – inter-creditor agreements
  - Legal
  - Background checks
  - Accounting

# Suggestions

- 1) Be prepared and organized
- 2) Understand the process
  - Nuances among mezzanine lenders
- 3) Set expectations with the buyer and seller
  - Due Diligence - 6-8 week process to fund
  - Depth of information needed
- 4) Manage the process vs. rush the process



# Q&A

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