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Mezzanine Financing:
Bridging the Funding Gap

As mezzanine financing gains understanding and acceptance throughout the capital markets, it is proving to be a powerful resource for funding growth and provides lenders and borrowers alike a tool in bridging the funding gap.

By Theodore H. Sprink

A well-known and respected manufacturer of automobile parts is focused on an opportunity to acquire a leading competitor, which will firmly position the new entity as a market leader for its combined product line. Each company has operated for more than 15 years under its current ownership and management, each believes it has a solid balance sheet and both enjoy positive cash flows. Both have impressive production facilities, and each firm's product line complements the other's customer list. There are savings that can be associated with eliminating certain expenses once the companies are combined; and it appears the purchase price is right.

To fund the acquisition, plant expansion and to provide working capital, a loan of $35 million is required. Because the borrower does not believe it is a candidate to issue new stock through a private placement for the purpose of raising capital, a loan facility is needed. The problem, as it turns out, is that the borrower's balance sheet is not quite as "solid" as the borrower represented, or as strong as the lender had anticipated.

Particularly challenging for the asset-based lender are the rather conservative credit underwriting standards, recently implemented to protect the bank during today's uncertain economic times. Notwithstanding sufficient cash flow to service the proposed new debt, the bank is able to loan only $25 million, referring to insufficient collateral as the basis for the $10 million short-fall in required funding.

So, where does a qualified borrower with a proven track record, strong management, a solid business plan and healthy cash flow go during a time in which a "credit crunch" has become a factor?

Bridging the Funding Gap

Mezzanine financing can provide additional capital to middle-market businesses in a manner gaining understanding and acceptance throughout the capital markets. It is a powerful resource for funding growth, oftentimes an important component of a larger financial structure, frequently involving expansion, leveraged buy-outs, and re-capitalizations. Such funding opportunities generally represent a high yield loan facility for lenders and (private & institutional) investors in so-called "mezzanine funds". Many such funds target transactions in the $5-100 million range.

Defining the Bridge

Essentially, mezzanine funding provides subordinated debt financing with greater returns than traditional bank debt. The term "mezzanine" can be related in the context of a capital structure to the phrase "in the middle". Sometimes referred to as "mezzanine capital", it is a form of junior debt that bridges the gap between private equity investment and the traditional bank loan. The mezzanine debt is senior to the original equity but junior to the bank, hence, viewed to reside in the middle. Mezzanine financing is generally used to fill the gap between first mortgage financing and the equity participation of the principals of the borrowing entity. The mezzanine loan is often viewed as "interim" financing, and is sometimes referred to as a "bridge".

The mezzanine component generally represents well below 50% of a "transaction's" capital structure. With the Loan-To-Value (LTV) ratio of first mortgage financing commonly limited by loan agreement to 75% (this agreement frequently restricts further encumbrances in the form of second mortgages), the additional mezzanine component can contribute to an aggregate LTV of up to 95%. The 20% "differential" in this example, serves as the equity that can be used by the borrower or its principals to gain access to additional capital vis-à-vis the mezzanine loan facility.

The bridge then, is "new" capital available to finance acquisitions, growth, recapitalizations and working capital needs in a manner that complements the underlying relationship with the senior lender.

Mezzanine financing is most often extended to the partners or equity holders of a borrowing entity, frequently a Limited Liability Corporation (LLC). The partners or equity holders are also commonly structured as LLC's with the lender taking a pledge of the party's equity interest as its security. The pledge of the equity interest in the LLC can be defined as either "investment property" or "general intangible" (personal property) pursuant to Revised Article 9 of the Uniform Commercial Code (UCC), and can be insured for attachment, perfection and priority in a manner similar to traditional real estate title insurance for the real estate portion of the loan transaction.

Why the Bridge?

In the middle market there is a need for the funding of growth and expansion, there are many borrowers without sufficient traditional collateral to access necessary capital and there are many highly qualified investors attracted to filling the gap between debt and equity.

The domestic commercial and industrial loan market has been estimated to exceed $1 trillion annually, and there may be as many as 185 mezzanine funds with accrued total commitments since inception exceeding $35 billion at this time.

To some degree, mezzanine financing for mid-markets gained in popularity as the result of significant reductions in the junk bond market that led to the high yield markets targeting "major" market transactions closer to the $150 million level. In the early 90's many insurance companies withdrew from commercial lending. Mezzanine funds filled the gap. Today, many mezzanine funds target the $5-100 million level for a single company.

Although mezzanine debt may represent less than 5% of all private equity fundraising, it is viewed by many to be of a lower risk profile than venture capital or Leveraged Buy Out (LBO) funds. The credit crunch that began in the late 1990s resulted in tightened credit standards, but has not led to increased losses in this portion of credit structures; and accordingly the pricing structure has not increased substantially, making mezzanine financing both attractive and affordable.

Building the Bridge

Targeted gross returns for lenders and investors are in the high teens to low twenties, and equity "kickers" or conversion rights are commonly factored into this expectation. Generally, mezzanine loans are interest-only at prime plus 2-4 points, often payable every six months with an average maturity of 5-7 years. The loan costs to the borrower, including legal and accounting fees may equal 5% of the loan amount, exclusive of any additional fees.

Unlike many banks seeking an early return of principal, mezzanine lenders generally focus on the relationship's overall yield, hence the attraction of future equity participation. Typically the exit strategy for the mezzanine lender is the borrower going public, an equity issuance, or the borrower being sold or otherwise re-financed. When one of these events take place, the lender gets back principal, interest and any capital gains on the sale of the stock generated as the result of exercising conversion rights.

Because many senior lenders view mezzanine financing as having strengthened the balance sheet of the borrower by adding capital that is junior to their loan, an opportunity exists for the asset-based lenders to benefit from the popularity of mezzanine financing, and the strength and impressive expertise of many of the major players underwriting and funding mezzanine loans.

The names of many of the prominent mezzanine lenders reads like the "who's who" of American capitalism and success. Among the leading and very recognizable names are Merrill Lynch, Morgan Stanley, Bear Stearns, Greenwich Capital, Lehman Brothers, Goldman Sachs, Capital Trust, Deutsche Bank, Credit Suisse First Boston, JP Morgan, MONY and GMAC to name just a few.

Strengthening the Bridge

The mezzanine market segment is commonly linked to the commercial real estate market, with a pledged equity interest being closely tied to income producing real property. The transaction is often a hotel, office building, apartment complex or development project with similar characteristics. As a result, underlying concerns to mezzanine lenders involve declining real estate values, aggressive low interest rate lending by traditional lenders, buyers who may have over-paid for a property and general economic factors. These fundamental market conditions contribute to impact property rent growth and future revenue streams. Naturally, any new debt can represent potential strain on a property, and exposure to increased vacancies and declining rents. Highly leveraged assets may be difficult to refinance or even to sell.

A major development providing additional protection to mezzanine lenders is the availability of "title insurance" covering the pledge of a membership interest in a partnership or LLC, which, as mentioned above, may be either investment property or a general intangible according to Revised Article 9 of the Uniform Commercial Code. The mezzanine lender's ability to enforce the validity and priority of its security interest can be both complex and challenging.

Perfection of a security interest in the ownership of a partnership or LLC can be accomplished by:

1) filing the appropriate UCC-1 Financing Statement in the appropriate jurisdiction,
2) by taking possession of the "collateral" if the interest is certificated or otherwise subject to a Control Agreement (such as a Deposit Account), or
3) by control if the security interest is deemed investment property. Control is generally considered the strongest method of perfecting the security interest in a pledge of a partnership or LLC membership interest.

In certain cases the mezzanine lender may improve its position by the manner in which it treats its security interest in the pledged collateral. At the request of the mezzanine lender, a partnership or LLC can "opt-in" to Article 8 of the Uniform Commercial Code and elect to have its interest therein treated as securities.

Perfection would then be by three-way Control Agreement between the borrower, lender and the partnership or LLC. In addition to the use of a Control Agreement, the filing of a UCC-1 Financing Statement is always recommended.

Protecting the Bridge

Attachment, perfection and priority of the mezzanine lender's security interest over other secured or intervening parties can be insured by the use of UCC insurance, available from the nation's largest title insurance underwriters. This form of insurance has been widely embraced by leading mezzanine lenders primarily for the benefit of shifting the responsibility for the proper perfection of the lender's security interest in the collateral to a large insurance company for relatively modest costs, and for the value a "second set of eyes" such insurance underwriting represents.

UCCPlus Insurance Protection was introduced as a valuable component of mezzanine financing by Fidelity National Title, Chicago Title and Ticor Title insurance companies in late 2001. UCCPlus insures mezzanine and asset-based loans secured by non-real estate assets for attachment, perfection and priority. Coverage extends to validity, enforceability, fraud and forgery; and provides for the costs of defense in the event of a claim. abfj

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Sprink returned to the FNF family in early 2002, having previously served in a senior management capacity from 1996-1998. Most recently he served as the director of the UCC Insurance Division for the First American Corporation, managing the successful introduction of UCC insurance nationally.

He has extensive experience in real estate and commercial banking, as well as the credit industry. Sprink has a degree in business management from San Diego State University.

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