A tactical financing instrument

The right mezzanine can be the better equity solution

During the last few years, mezzanine capital has gained a mixed reputation. On the one hand, as an attractive and highly flexible instrument to find financing even in complex situations. On the other hand, as an instrument which disappointed investors' return and performance expectations as well as companies' expectations as an equity surrogate.

Currently, mezzanine capital is especially known from the refinancing discussion surrounding the so-called Standard Mezzanine Programs, e.g. PREPS or H.E.A.T. Furthermore, mezzanine facilities are often associated with the financing of LBOs. Hence, mezzanine capital is seen as an "on-top" financing instrument for private companies. However, in the form of convertible bonds, mezzanine is also often used by public companies.

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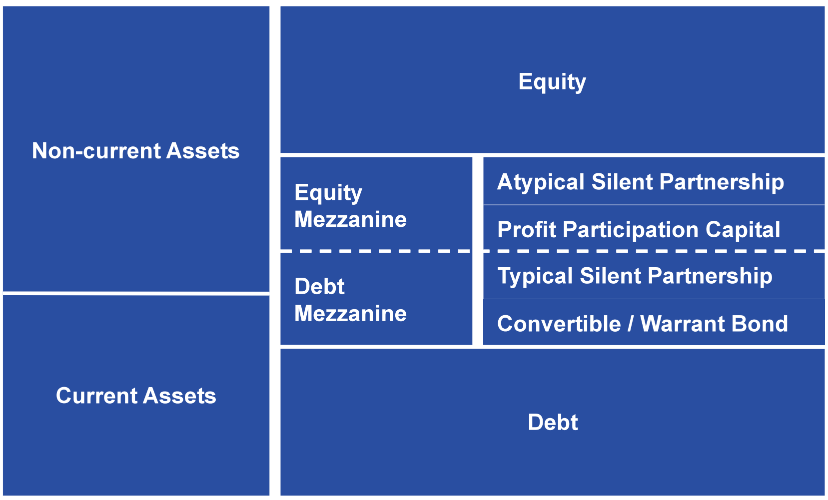
Definitions

Mezzanine can be structured as debt, equity or hybrid. The definition depends on the actual structure and the respective GAAP. The most important characteristic of each alternative mezzanine structure is its high flexibility. Therefore, mezzanine facilities are perfectly suited to be "tactical" financing instruments.

Debt mezzanine

Typically, "debt mezzanine" can increase the financial leverage of a company by approx. 1.0x EBITDA. While senior debt is currently in general capped at approx. 3.0-3.5x EBITDA, "debt mezzanine" provides additional "on top" financing capacity raising the maximum leverage up to 4.0-4.5x EBITDA.

Figure 1: Potential Manifestations of Mezzanine Capital



Sources: FCF Fox Corporate Finance GmbH

Equity mezzanine

"Equity mezzanine", however, provides a company with an increased equity base. Although mezzanine investors require a risk premium for assuming equity risk, market experience has shown that such mezzanine risk premiums are usually still significantly cheaper than the cost of "classic" equity. In addition to the cost of capital advantage, "equity mezzanine" entails several other benefits. One of the most important is the ability to avoid dilution for existing shareholders. Especially for public companies, a necessary capital increase at a low valuation can be onerous as existing shareholders will be significantly diluted. A company could partially overcome this dilution by issuing convertible bonds. However, the success of such a structure depends on the conversion price and the larger size requirements of most convertible investors. Mezzanine capital such as "Genussscheine" helps to avoid such a dilution. Furthermore, in contrast to "classic" equity investors who like to exert some form of influence on a company's strategy as an active shareholder in the "passenger seat", mezzanine investors are usually more flexible and take a passive approach from a "backseat" or "silent shareholder" position.

Moreover, the investment horizon of these "silent shareholders" is highly flexible, enabling both early and late repayment. The most elegant refinancing solution is certainly amortization using corporate cash flows. Other options include a later refinancing with senior debt and/or a future capital increase at a higher valuation. Regardless of the sources of refinancing, mezzanine can be a temporary and as such a "tactical" financing instrument at the discretion of a company.

Recent transactions have shown that mezzanine facilities can cover ranges from EUR 3.0 up to 300 million. While smaller facilities are generally provided by single funds, larger transactions can be structured through a group of mezzanine funds or direct investors. Given the need by both institutional and retail investors to find attractive investment opportunities in the current market environment, there is significant demand for mezzanine instruments.

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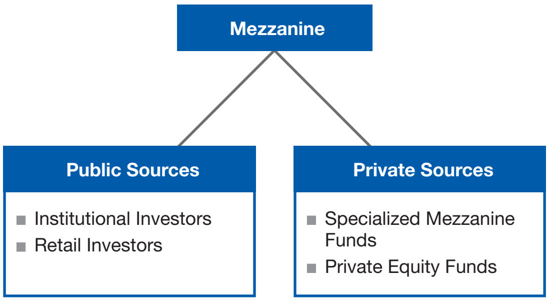
Figure 2: Sources of Mezzanine Capital



Sources: FCF Fox Corporate Finance GmbH

Pros & cons

Both types of mezzanine investors have distinct pros and cons. The preferred route ultimately depends on the individual needs and objectives of a company. Issuing a mezzanine facility directly to a group of direct investors enables a company to structure the transaction in its preferred way. In addition, a company can exclude certain investors if sufficient demand can be generated. However, there are also potential downsides with such an approach. Depending on the number of investors addressed in a placement, a prospectus might be required. The most important risk is the market reception, as investors might not be willing to invest at the proposed terms. It is therefore important to sense the demand well ahead of a "public" road show in order to avoid disappointment as a failed placement could add additional pressure on the share price.

If a public mezzanine offering is not desired or if the amount of work is disproportionate to the potential proceeds, a company should individually approach mezzanine funds in a private transaction. The clear advantage of a mezzanine fund approach is the confidentiality and greater transaction certainty. A transaction will only be announced once it has been signed, thus effectively excluding market risk. Additionally, the transaction size can potentially be increased at short notice, depending on the mezzanine fund's capability. However, advantages of private transactions also have associated costs. A particular downside of just one investor is the relative strong negotiation and control position compared to a group of institutional and/or retail investors as a single investor will exert more influence to manage and protect his investment.

Conclusion

Overall, it can be stated that the possible applications of mezzanine capital are vast. The ultimate success of mezzanine financing depends on the specific needs of the respective company and the chosen mezzanine structure. Mezzanine facilities are especially interesting if used as a tactical or intermediate financing solution to "bridge" a need for capital. Currently, the high liquidity in the capital market translates into sufficient volumes of mezzanine financing and number of mezzanine investors, making it an attractive option compared to alternative financing solutions.

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