Mezzanine finance

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Mezzanine finance has been widely used in the United Kingdom recently in the financing of management buy-outs and other large corporate transactions. This article[1] briefly describes the circumstances in which it is used, and considers its prospects.

Mezzanine finance is used in the financing of major transactions, such as company acquisitions and large investment projects. It comprises *middle-ranking* financial instruments—such as subordinated debt and preference shares—which form the central layer of a financing package that also includes equity and senior-ranking debt. As such, it offers investors an intermediate rate of return and carries a corresponding intermediate risk.

Although middle-ranking financial instruments have long been used, the *specialist* provision of mezzanine finance developed in the 1980s, following the sharp growth in management buy-outs (MBOs). This article describes the circumstances in which mezzanine finance is used and outlines the terms on which it is provided. It focuses on the United Kingdom, but also refers to its use in continental Europe and the United States.

Uses and characteristics of mezzanine finance

Most large corporate financial transactions—such as buy-outs and major capital expenditure projects—are funded using a combination of finance provided by their sponsors and finance from other sources, such as banks and venture capitalists. The challenge is to obtain a blend of different types of finance that meets the objectives of the two sources. The sponsors will be concerned mainly about keeping the overall cost of finance to a minimum, and the external financiers about the viability of the planned transaction—in particular, the likelihood of its providing them with a competitive return on their investment.

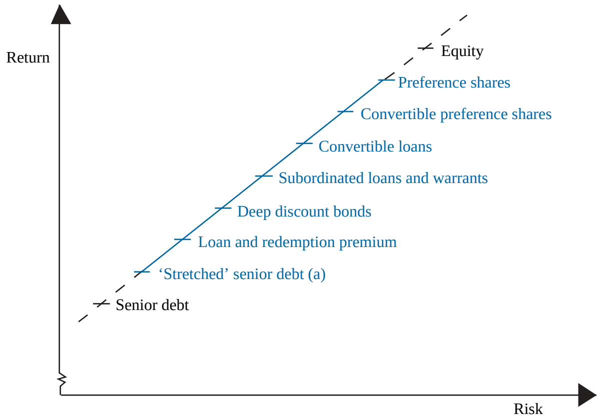
Most corporate transactions can be satisfactorily financed by a suitable mix of equity (share capital) and senior-ranking debt—that is debt which has first claim on a borrower's income and assets for repayment. But the availability of mezzanine finance or (as it is sometimes called) intermediate capital widens the range of financing opportunities. In particular, it offers scope for the overall cost of finance to be reduced by allowing a closer correspondence between risk and return and the preferences of different types of investor. This is usually the main motivation for using mezzanine finance; but the fact that (unlike equity) mezzanine instruments do not carry ownership rights can be as important a consideration for some sponsors—for example, the owners of a private business seeking to expand its capital base while retaining full ownership and management control. Mezzanine finance came to prominence in the 1980s, when it was widely used in the financing of MBOs; these grew rapidly in number during the decade. The management teams involved usually did not have sufficient resources themselves to buy outright the businesses that they were either already managing or planning to manage; they had to include other investors. Their main options were to raise equity from venture capitalists or senior debt from banks and other types of lending institution, such as insurance companies. But it often proved impossible to find all the finance needed from just these sources.

The management teams generally had a preference for senior-ranking debt rather than equity, because it was less expensive. The amount of senior debt that could be raised was invariably limited, however, by the fact that potential lenders had to be confident that their loans would be well secured and repaid on schedule. The availability of equity was similarly constrained: investors had to be assured that the MBO would generate sufficient earnings both to service the planned borrowing and give them the returns they expected. Where these two forms of finance left a financing shortfall, managements were prompted to consider types of finance which, in terms of risk and return, spanned the divide between secured debt and equity. For many MBOs, adding an intermediate layer of finance was the key to finding a viable financing structure.

Chart 1 outlines the main varieties of mezzanine finance available; the form taken depends on the particular features of the transaction being financed. In some cases, it comprises a subordinated loan paying a relatively high interest rate. In others, it takes the form of preference shares accompanied by protective covenants to reduce risk, or even a combination of financial instruments that together offer a middle return/middle risk position. It is, perhaps, only in the context of MBOs that some standardisation has emerged: here mezzanine finance usually takes the form of a subordinated loan allied to an 'equity kicker'. The loan commands an interest rate of Libor plus 3%–4% and the return on the 'kicker' is linked to the success of the business

(1) The Bank is grateful to the mezzanine financiers who helped in the preparation of the article.

Chart 1
Forms of mezzanine finance



(a) 'Stretched' senior debt begins to be repaid once other senior debt has been fully repaid.

being financed. There are a number of varieties of 'kicker': the most common are warrants, but preference shares convertible into equity and 'back-end fees'—payable when the related mezzanine loan is paid off—are also used. At present, mezzanine financiers typically expect an annual return in the range of 16%–20%, compared with about 10% for senior-ranking lending and 25%–30% for equity. Mezzanine finance may be provided by a single lender but, in larger transactions, it is usually syndicated.

As subordinated lenders, mezzanine financiers undertake detailed due diligence, paying particular attention to the quality of a borrowing company's management and its projected cash flows; indeed mezzanine finance is sometimes described as lending against cash flow. Mezzanine financiers are also active investors: they monitor closely the performance of companies in which they have invested, and often appoint an observer to a company's board or offer support and advice in other ways. In these respects, they are more like venture capitalists than senior-ranking, bank lenders.

The ideal profile for a borrowing company is one with experienced management, well-established products, low borrowing and predictable cash flows. These requirements mean that start-up companies and others without much of a track record need to be able to demonstrate exceptional prospects to receive serious consideration from mezzanine financiers. The need for detailed due diligence, the cost of which is largely invariant to the intended size of investment, rules out the provision of mezzanine finance to small firms; most mezzanine financiers will not supply less than £1 million, and prefer to commit at least £2 million.

Mezzanine loans typically have a maturity of seven to ten years, with repayment scheduled to begin after the senior-ranking debt has been repaid. But the expectation is that the lending will be repaid before maturity. In the case of buy-outs, for example, it has been common for mezzanine loans to be repaid after some three to five years, once the equity investors have realised their investment by a trade sale, flotation or refinancing. As mentioned above, mezzanine financiers regard it as especially important that a borrower's projected cash flow should be more than adequate to service its borrowing. They might contemplate allowing interest to be rolled up in the early years of a loan, but only if they are confident that this is not a sign of underlying weakness.

Mezzanine financiers usually take a second charge over a borrower's assets in support of their lending. This improves the likelihood that some of a loan will be recovered in the event of the borrower's insolvency, by entitling them to any remaining proceeds from the sale of charged assets after the first charge-holder—normally the senior lender—has been repaid. Perhaps more importantly, a second charge also allows the provider of mezzanine finance to influence events should the borrower default. The borrower is, furthermore, required to observe a range of financial covenants, which are jointly agreed with the senior lenders. More generally, relations between senior and mezzanine lenders are governed by a *deed of priority*. This applies, for example, if a borrower defaults, when the mezzanine lenders would be obliged to observe a standstill period to allow the senior lenders to decide how to deal with the situation—that is whether to appoint a receiver or to attempt a financial rescue.

Mezzanine finance in the United Kingdom

Mezzanine finance was introduced into the United Kingdom in the 1980s by American banks active in the financing of MBOs. As it became widely used, a number of British and overseas banks, among other investors, began to arrange and participate in mezzanine facilities for MBOs and other types of leveraged transaction. This business was then regarded as relatively low risk, but offering the prospects of good returns and quick exits. Subsequently, however, a number of the high-profile deals suffered collapses, with the mezzanine lenders sharing in the large losses. This led a number of firms to withdraw from mezzanine lending. It also encouraged a more cautious approach to leveraging; and since the late 1980s the bad debt experience on deals financed has generally been quite good.

Table A
Leading UK mezzanine finance arrangers(a)

1 January 1990–31 March 1995

	Number of deals	Total amount invested (£ millions)	Average amount invested (£ millions)
3i	22	72	4
Intermediate Capital	17	210	12
NatWest Markets	10	54	5
Legal and General/Mithras	9	92	10
First Britannia	4	42	11
Samuel Montagu	4	20	5
Phildrew Ventures	4	13	3
Chase Manhattan	3	24	8
Kleinwort Benson	3	19	6
Bank of Scotland	3	7	2
Others	32	228	7
Not known/(duplication)	(9)	(87)	
Total	**102**	**694**	**7**

Source: *KPMG Corporate Finance*, 1 April 1995.

(a) Qualification: deals of £10 million or more; firm led in at least three deals.

Table A lists the main mezzanine financiers currently active. There are three independent specialist firms, whose capital

Mezzanine finance outside the United Kingdom

The mezzanine finance market in the *United States*, which originated in the 1960s, is more developed than the United Kingdom's. Its general characteristics are much the same, though there is more extensive use of mezzanine finance for general corporate financing. There is also a limited secondary market on which private mezzanine debt is traded; there is no UK equivalent of this. The most important difference, however, is that in the United States mezzanine finance exists alongside, and indeed is overshadowed by, high-yield debt or *junk bonds*—middle-risk, middle-return securities which since the early 1980s have become an important form of corporate finance. These are similar to mezzanine finance in many ways, but offer the additional advantage of liquidity.

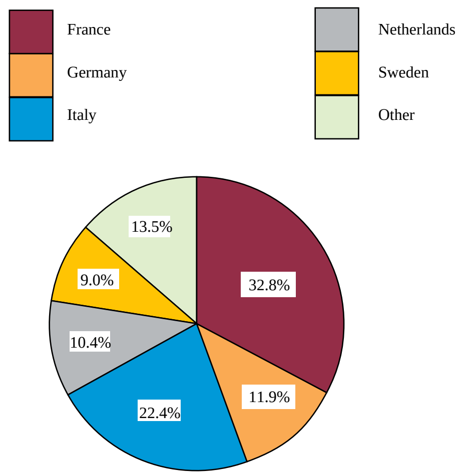
Chart A
Continental European and UK MBOs(a)

Source: KPMG.

(a) MBOs of £10 million or more.
(b) Figures for first six months annualised.

In *continental Europe* the use of mezzanine finance, having lagged behind that in the United Kingdom, has grown strongly in recent years, driven by increases in the number of MBOs. In 1985, there were just three MBOs, but by 1993 there were almost as many as in the United Kingdom—see Chart A. The main mezzanine providers are British and American firms—for example, almost half of Intermediate Capital Group's portfolio is continental European. As Chart B shows, France has been the largest market. But there, as elsewhere in Europe, the use of mezzanine finance has been held back by an unfavourable legal framework; for example, it is difficult for a lender to take security directly over assets.

Chart B
Continental European buy-outs using mezzanine finance, 1987–93(a)



Source: KPMG.

(a) MBOs of £10 million or more.

To date, there have been comparatively few MBOs in Germany, but it is thought to be a market of considerable potential, as growing numbers of the middle-sized *Mittelstand* firms founded in the post-war period face succession problems. This has, however, been a difficult market for foreign firms to penetrate, because of the close relationship between German banks and their corporate customers. In recent years, however, these relations have loosened and increasing numbers of investment opportunities have begun to appear.

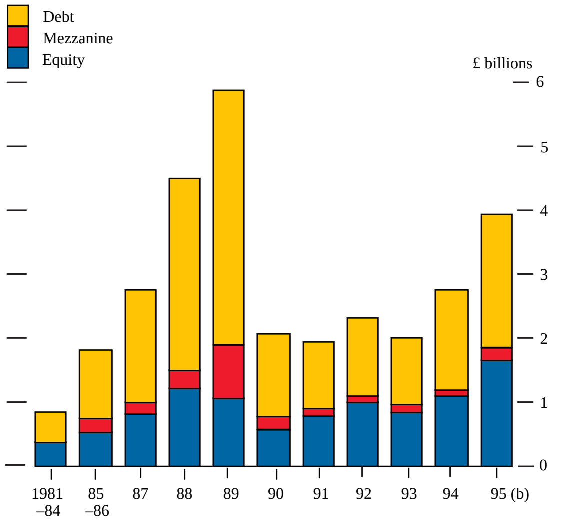
comprises equity subscribed by shareholders, loans from banks and funds placed by other financial institutions. The others are divisions of venture capital firms or banks, and usually offer mezzanine finance as part of a wider financing package which also includes equity and senior-ranking debt. Such 'strip' financing can, however, produce conflicts of interest for the lender and when this happens, the firm concerned may cede the leadership of a mezzanine syndicate to another participant. Generally, firms offering strip financing guard against conflicts of interest by organising their mezzanine lending separately from their other financing operations.

The specialist nature of mezzanine finance is reflected in its quite limited use. It is estimated that, between 1990 and the end of March this year, a total of £694 million was provided in 102 transactions (see Table A). The financing of MBOs was by far the most important area of use, accounting for roughly 75% of the total invested. The other two main areas of application were the financing of private businesses and of large capital expenditure projects.

The use of mezzanine finance in MBOs

Activity in the MBO market peaked at about £6 billion in 1989; since then, it has been running at about £2–3 billion a year (see Chart 2). The 1989 total was, however, inflated by a few very large transactions, and (as Chart A in the box above shows) the number of MBOs was quite stable during the subsequent recession—reflecting increased sales of

Chart 2
Value of UK MBOs(a)



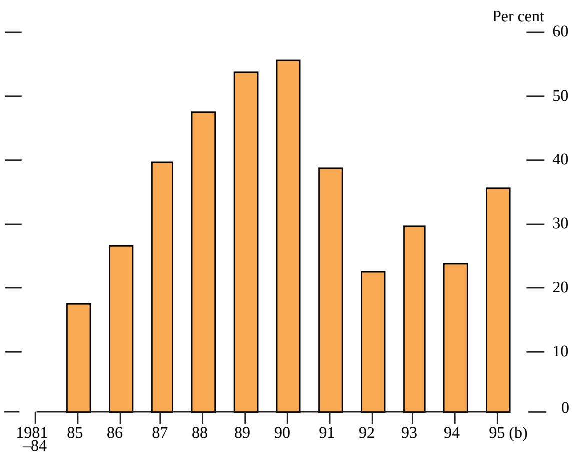
Source: KPMG.

(a) MBOs of £10 million or more.
(b) Figures for first six months annualised.

businesses by receivers and hard-pressed companies—before increasing sharply during 1994.

Roughly 33% of the MBOs since 1990 have used mezzanine finance. The proportion has shown no clear trend in recent years (see Chart 3); this is mainly because of intense competition from banks and venture capitalists, as well as a trend towards smaller MBOs which can usually be financed using just senior debt and equity. In addition, there has been a tendency for companies selling subsidiaries to provide some of the finance needed. Such *vendor finance* usually takes the form of a subordinated loan or a residual equity stake and, in many deals, has been an alternative to mezzanine financing. The box opposite offers a brief description of vendor finance.

Chart 3
Percentage of MBOs using of mezzanine finance(a)



Source: KPMG.

(a) MBOs of £10 million or more.
(b) To 31 March.

In the transactions in which it is used, mezzanine finance accounts for some 12%–15% of overall financing; this relatively small contribution reflects its role as a supplement to equity and senior-ranking debt (see Chart 2).

Other applications

In recent years, many providers of mezzanine finance have sought to become less dependent on MBOs by diversifying into new fields of lending. One promising area is the *financing of 'middle-market' firms*. The borrowers are typically private companies that need funds for expansion: their owners are unwilling to concede a dilution of their equity but they have insufficient assets to support further conventional bank borrowing.

Banks have already shown some interest in this market. They have, for example, begun to provide mezzanine-like instruments—such as the 'equity overdraft' or 'royalty overdraft', in which interest payments are linked to profits or sales. Banks' branch networks help them to identify and approach those middle-market companies that are candidates for mezzanine finance; persuading their owners to use it may, however, be difficult, as few may be aware of mezzanine finance, and they may initially baulk at its high cost compared with mainstream bank lending. In addition, the skills and training of many branch bankers may not always fit them for the detailed due diligence and active monitoring required for mezzanine lending. For all these reasons, there is likely to be a role for specialist providers of

Vendor finance

Vendor finance can be particularly helpful in MBOs, where the management team purchasing the business often has an informational advantage over the vendor about the value of the company. By retaining a stake in the business, the vendor can recognise this advantage and share in any subsequent unforeseen upturn in value. Some sellers like to retain a stake in their former subsidiaries for other reasons. Buyers may, however, be reluctant to accept this, particularly if the two companies will be competitors.

Vendor finance takes a number of forms: most common is a residual equity stake or a subordinated loan note (usually bearing minimal interest, few covenants and a long maturity). It is often an alternative to mezzanine finance, but one that is usually offered on less onerous terms. In some cases, it can be regarded as deferred payment.

The use of vendor finance depends very much on the particular circumstances of a deal, and the needs and bargaining strengths of the parties involved. As a result, trends in vendor finance are unclear. But there is little sign at present that it is a long-run competitive threat to mezzanine finance, though it has been a significant source of finance at certain periods (in 1991, for example, it was the source of 15% of finance for MBOs valued at over £10 million).

mezzanine finance to middle-market firms. They may, however, need to improve their marketing in order to make a real impact on the market.

Although to date mezzanine finance has not been used widely for the financing of *large capital projects*, this is seen to be a particularly attractive field for expansion. It has been suggested, for example, that mezzanine finance could play a significant role in the financing of infrastructure projects within the Government's Private Finance Initiative. One difficulty, however, is that these projects often entail some rolling-up of interest, to which mezzanine financiers are reluctant to agree.

Other possible uses that have been raised for mezzanine finance include *bridging finance*—whereby funds are committed to a deal for a short period until permanent refinance is arranged—and *property development.*

Prospects

To date, mezzanine finance has been used mainly in company buy-outs. Buy-out activity has shown no sign of diminishing; indeed, at present it is probably on an upward trend. It is not at all certain, however, that this will lead to an increased use of mezzanine finance, since most recent buy-outs have been modest in size and could be adequately financed using just equity and senior-ranking debt. In addition, mezzanine financiers face intense competition from senior-ranking lenders (banks) and equity investors, which are currently well endowed with funds for investment. Banks' capital resources have increased as the recession has ended, and a number of equity houses have recently raised new funds. There is also no shortage of available mezzanine finance (two of the independent specialist providers were floated in 1994).

There is a risk that the intense competition to provide capital to companies may erode mezzanine financiers' standards of due diligence. It is particularly important that mezzanine finance is not used injudiciously as a substitute for equity, as happened in certain deals arranged in the late 1980s. The subsequent failure of some of those deals, however—with investors bearing large losses—has led to a more cautious attitude towards highly leveraged financing structures.

A number of mezzanine financiers are seeking to diversify away from lending for buy-outs. There would seem, for example, to be considerable untapped demand for mezzanine finance among private companies whose shareholders are reluctant to concede a dilution of ownership. Mezzanine finance may also be helpful to those companies with good long-term prospects that have emerged from the recession heavily indebted and consequently face difficulty in raising additional senior debt; however, it continues to be a financing technique that is relatively little known among business people. A further area of potential may be continental Europe, where a large number of privately owned businesses might be candidates for buy-outs. UK-based mezzanine lenders would seem to be well placed to expand into these markets.