MEZZAZINE AND UNITRANCHE DEBT EXPLAINED

By Mark Vernallis, FocusCFO

Not too many years ago mezzanine debt was only available to large corporations, often in $20 million minimums. Today, companies with EBITDA in the $2+ million range can take advantage of this type of funding. Both mezzanine and unitranche debt facilities are most often funded by non-bank financial institutions.

Mezzanine Debt

Mezzanine debt is subordinated debt. Typically, a company's capital stack is comprised of the following:

- Trade payables
- Senior bank debt and mortgages
- Equity (and retained earnings)

Mezzanine debt ranks below senior bank debt in liquidation priority but above equity. In the right situations, often in an acquisition scenario, mezzanine debt can add great value. Below are some aspects of mezzanine financing that can often make the difference between doing a deal or not.

Mezzanine Debt as Temporary Equity

Equity is the most expensive part of your capital stack. Not only is it expensive but when you sell equity you have given that portion of the businesses' upside away forever. A double whammy. But having mezzanine debt in your capital structure allows the company time to improve its leverage situation and refinance the mezzanine debt later with less expansive bank debt, without having to give away equity ownership. For private equity forms and those active in the acquisition markets mezzanine debt if often the bridge to an exit.

Mezanine Debt Cost and Structure

Interest rates on mezzanine debt are often in the low-to-mid double digits. The higher coupon is normally offset by a very favorable amortization schedule. Mezzanine lenders like to keep their outstanding's high, the opposite of banks, to maximize their interest yields. Terms are usually 5-years with a very large balloon at the very end. Also, mezzanine debt often carries a relatively small 'equity kicker' for the lender in the form of warrants.

Downsides

While there is a lot to like about mezzanine financing there are drawbacks. It is a completely separate capital raise, so a lot more work. Also, there are inter-creditor issues and making sure all the parties are comfortable is critical. But in the right situations mezzanine funding can be a great benefit.

Unitranche Financing

Unitranche financing is becoming more popular. It is basically a marriage of senior bank debt with mezzanine debt. The big benefit is one-stop shopping for the borrower. So rather than having both senior and subordinated (mezzanine) debt lenders there is one funder that accepts the entire credit risk. The interest rates are a blending what might have been expected with senior and mezzanine facilities. And an equity kicker would be typical. There is also a perceived benefit of only have a single lender when trouble mounts since the borrower does not have to manage two lenders with often very different objectives.

The amortization schedule is somewhere between a sole senior facility and mezzanine loan, but still with a significant balloon at the end.