1
Introduction

For as long as some sort of trade-centered economy and society has existed for mankind, people have been financing those activities, either directly or through the sort of intermediaries that we now know as banks or financial institutions. Historically, there have always been two types of financing available for businesses which are trying to raise capital to fund their activities.

That sounds somewhat simplistic but 'debt' and 'equity' have always been the fundamental financing classes tapped into by businesses, despite the many investment vehicles most businesses have access to.

We begin this section by looking at the characteristics of debt and equity and then conclude by defining the scope of the mezzanine product group.

1.1 THE BI-POLAR WORLD OF FINANCE

There are many different ways in which businesses can raise money, the primary ones being 'debt' and 'equity.' As I mentioned above, that sounds somewhat basic, and I guess it is, looking at the many product choices firms have these days. However, the two groups point at a fundamental difference as we know it in corporate finance. Let's first look at the characteristics of both groups and then at the individual products that are included in these groups. After that, we will look more closely at the hybrid or mezzanine product group.

Although debt and equity are often characterized by referring to the products that feature their characteristics, i.e., stocks and bonds, the true nature of the difference lies much deeper; in the nature of the cash flow claims of each product.

The first big distinction has to do with the debt claim, which entitles the holder to a contractual set of cash flows to finance the repayment of the principal amount as well as the interests on a period-to-period basis. An equity claim, on the other hand, only holds a residual claim on the cash flows of the firm, i.e., after all expenses and other commitments are honored.

This is the fundamental difference, although the tax code and legal qualifications have contributed to the creation of further distinctive characteristics between both groups.

The second distinction, which can be seen as a direct consequence of the first distinction, is a logical result of the contractual claim that debt holders have versus the residual cash flow claim of equity holders. Debt claims have priority over equity claims, hence the qualification of equity owners as residual cash flow owners. That is true for both the principal amount and interest payments, and is valid until the instrument reaches maturity, even in the case of a bankruptcy or liquidation of the firm (claim by the debt holders on the firm's assets).

The tax laws in most countries make a distinction between the tax treatment of interest versus dividends. Interests paid are tax deductible when paid by the borrowing firm and are therefore cheaper on a net (after tax) basis. Dividends, however, are not tax deductible, as they are considered to be paid out of net cash flows.

Additionally, debt instruments have a fixed maturity, i.e., the principal amount becomes due at a certain point in time, together with the interests which have not yet been paid. (We will ignore, for the time being, perpetual bonds, which are, in essence, 99/100 year renewable instruments). Equity instruments are perpetual or infinite, i.e., they continue to exist until the firm decides to buy them back and retire them, or to liquidate the firm completely.

Lastly, because equity owners are the residual cash flow owners, they are given control over the assets of the firm and its operational direction. Debt investors usually have a more passive role, often with no power of veto over major decisions in the firm. However, in recent years debt owners have done a pretty good job of getting their foot in the door, by using positive and negative covenants in their loan agreements to have (some level of) control over major transactions that would impact their position in the firm, often by making their investment more risky (i.e., due to increased leverage) or by damaging their chances of being repaid.

In short, debt is characterized by a contractual claim on the firm, benefiting from tax-deductible interest payments, with a finite lifetime and a priority claim on cash flows in both going concern situations and bankruptcy or liquidations. Equity, on the other hand, has a residual cash flow claim on the firm, is an infinite security, where dividend payments do not come with tax deductibility, has no priority, but provides control over the management and assets of the firm (in theory). Securities that have characteristics of both are termed hybrid or mezzanine capital, a definition which we will refine later in this chapter.

Figure 1.1a brings the categories and characteristics together but requires some explanation. Starting from the debt and equity positions we have already discussed (which make up boxes 1 and 3), the figure substantiates those two financing classes by indicating which types of instruments can be classified as being either debt or equity and further introduces the hybrid capital category (box 2) with an indicative set of products included.

For the sake of completeness, and to provide a level playing field, I will review most of the products mentioned at this stage. Additionally, all terms are explained in the glossary, which can be found at the end of this book, and which includes a review of all technical terms used in this book, regardless of whether they have already been explained in the core text.

Box 1, which reflects the debt products, includes the following instruments:

(1) Bank debt or loans which are fixed-income instruments with a fixed or floating interest rate and a pre-determined maturity. Often these loans are secured and therefore repayment is secured by collateral.
(2) Leasing, which is a form of asset financing where banks or specialized leasing institutions provide the financing for a specific (im)movable asset. The asset also serves as collateral in case the lessee (the person who has requested the finance) is unable to meet the lease payments. Two main categories exist, i.e., financial (or capital) and operational leases. In an operational lease, the lessor (or owner) transfers only the right to use the property to the lessee. At the end of the lease period, the lessee returns the property to the lessor. In case of a financial lease, the lessee has an option to acquire the asset (often at the end of the lease contract). Technical criteria distinguish operational from financial leases, and there are numerous accounting implications that are beyond the scope of this book. The distinction is also under review by the IASB (accounting body governing IFRS/IAS statements) which has been in its final phase for some time now (at the time of publication). For our purposes the distinction matters less as both types involve the lessee making payments to the lessor, which include a repayment of the loan underlying the asset

Figure 1.1a The financial spectrum

purchase by the lessor. The lease payments include much more, i.e., insurance, depreciation, maintenance costs etc.

(3) Commercial paper: when companies want to raise debt they traditionally have two options, they raise bank debt or issue a corporate bond (which can be listed or raised through a private placement). In both cases the firm will face significant costs, either because of the fees that come with bank debt or in terms of the capital raising fees it will have to pay to the investment bankers raising capital for the company. In case of bank debt those expenses can be as significant as 3–6% of the amounts looked for. In the case of a bond this can be anywhere between 3 and 7% depending on the investment bank one uses, the region where capital is raised and the amount sought. A cheaper alternative for organizations is to raise debt directly in the market through commercial paper. Commercial paper is

an unsecured instrument that allows companies to raise short-term debt (quite often the maturity will not exceed 270 days or nine months) often to finance current assets such as inventory, account receivables and other short-term liabilities. Because this type of instrument is unsecured, it can only be used by significantly creditworthy companies. In practice, the instrument is open to companies with an A credit rating or higher.

(4) The next category in box 1 is junior debt, which can be qualified as those instruments that are 'junior' to other debt obligations a company has. That is, they are ranked lower on the repayment schedule than the more 'senior' debt instruments a company has committed to. They are also often unsecured.

(5) Subordinated debt: Subordinated debt (which is mostly unsecured) is debt that is ranked lower than other debt instruments a company is committed to. In that sense they are also 'junior' as a debt instrument and aren't backed by a security. Subordination can happen in two ways: the first is contractually – the loan contract will explicitly indicate that the interest and principal of this instrument will only be repaid after all other senior instruments have been repaid first. The subordination can also happen structurally – when the conditions and maturity of the loan have been structured in such a way that all other loans will be repaid before the structurally subordinated loan will be repaid. That can happen because the maturity of the loan is further in the future than all other loans and/or the interest is rolled up towards the instrument's maturity. In the meantime, all other senior lenders will be repaid.

(6) High-yield bonds (aka junk bonds) are debt instruments with a poor credit rating (in practice a non-investment grade rating which comes down to BB+ (S&P and Fitch), Ba1 (Moody) or lower categories.

In box 3, which is the equity box, one can find common equity, the mother of all equity instruments. Equity provided by private equity firms and venture capital firms fits into this category as well. Warrants, once converted, entitle the holder to a certain pre-determined stake, in most cases, in the equity of the firm which issued the warrants. A warrant can therefore be qualified as an instrument that entitles the holder to purchase or receive common equity in the warrant's issuing company. Contingent value rights are like an option where the holder of the rights is entitled to buy additional shares in the issuing company when certain events happen, under pre-determined conditions and pricing. This often happens after an acquisition or restructuring, where shareholders of the target company can acquire additional shares in the acquiring company (if, for example, the value of the shares of the acquirer drops below a certain point before a certain date).

Finally, in category two, the instruments that have characteristics of both debt and equity either simultaneously or subsequently are listed. In Chapter 2 we will discuss extensively each of these instruments and compare their technical characteristics. For now it is sufficient to understand that each of the products included in box 2 will have, with varying degrees of intensity, characteristics of debt and equity and consequently their risk profile will be very different. Some will be hardly any different from a normal debt instrument as included in box 1 and others will show extreme similarities with the equity product group in box 3. What is striking, though, is that almost all are packaged in what qualifies legally as a debt instrument (with the exception of preferred stock), despite their significantly higher risk profile, a risk profile that sometimes hardly differs from an equity instrument.

In the wider context of financing options, mezzanine qualifies as an external source of funding as categorized in Figure 1.1b.

Forms of financing			
Internal financing		External financing	
Funds from business activities: •Retained profits •D&A •Reversal of provisions	**Funds from the release of capital:** •Sales of assets (divestitures)	**Equity:** Capital contribution from existing equity holders Capital contribution from new equity holders Private equity Public equity (IPO, Secondary offering)	**Debt:** •Banks (loans) •Capital goods leases •Suppliers (credits) •Customer (advances) •Bonds
		Mezzanine financing	

Figure 1.1b Financing options for companies
Source: Credit Suisse economic research

1.2 DEMARCATION OF THE PRODUCT GROUP

Now that we have the categories in place, we are left with the grueling task of finding the demarcation line as precisely as possible and defining it as accurately as possible.

We could do that by looking at the reality of how the instruments are used, positioned or otherwise, but that would prove to be a mixed bag as well, and further, would not really help us develop a clearer picture of the product group.

Looking at the legal qualification would force us to drag many hybrid instruments back into either the debt or the equity category, mostly the former, hence the need for a separate category of hybrid capital.

The above issues have left those wishing to define the product group in the difficult position of having to describe the product group by its characteristics. Though I don't want to go out on a limb here, I will take on the challenge of breaking down the individual characteristics, to see where the rough edges are or question marks could be placed.

By looking at the mezzanine product group as a whole, the following characteristics can be identified:

- The individual products *are all unsecured products, i.e., there is no collateral and/or firm lien on some or all assets of the borrowing firm*. Second lien loans are an exception to this criterion, but aren't strictly part of the mezzanine group.
- All the products carry a compensation scheme which includes the provision that *(at least part of) the compensation is dependent on the future profitability of the firm (or, by extension, the return on equity or economic value creation of the firm)*. This one raises some additional

questions. Products like junior debt, subordinated debt or unsecured debt all tend to be unsecured in their positions, but otherwise do enjoy the equity kicker that many other mezzanine products do. So some discretionary judgment is needed. On the one hand, these products are legally debt just like most other mezzanine products. On the other hand, they are also unsecured just like all the other mezzanine products. Where they deviate is that they do not directly enjoy the equity uptick that other products have built into their mechanics. It could be argued, however, that the higher spread that is built into the compensation scheme intrinsically includes that equity component. The counterargument is that an increased spread cannot reflect equity performance, it can only reflect higher risk patterns absorbed by the instruments, and in no way can it reflect the potential up- or downside that equity exposure can bring. So you could either argue that they belong to the debt product group (if you overweight the legal debt qualification) or that they are positioned in the outer space of the mezzanine cosmos (if you overweight the unsecured position and the higher overall risk profile they have relative to their peers in the debt group). One could say that there is a difference when defining mezzanine products *sensu lato* and *sensu stricto*.

- *Some products are finite and others are infinite in nature. Besides the perpetual loans and non-redeemable preferred shares, all products are finite in nature*.
- *Most of the products (except for preferred equity) are debt instruments (in their legal qualification)*, which raises the question about the semantics of the term mezzanine capital versus the term mezzanine debt. Nevertheless, most of the products have a risk profile much closer to equity than their legal qualification initially suggests.

So, you can see for yourself that the jury is still out on some of these products in terms of their qualification, or at least that there is a mixed bag of characteristics within the mezzanine product group. An alternative way of looking at the product group is through its risk profile, which we will do in Section 1.4.

The historical distinction between debt and equity doesn't make our life a lot easier. In fact, you might wonder if there is a justification for treating debt and equity in such different ways. In particular, the different tax treatment has raised many questions among scholars, none providing a compelling argument for why the difference emerged, nor for why we should keep the distinction intact, especially since the differences trigger specific behaviors among market participants. Given the (lower) net cost of debt there is an inclination among market agents to use (too) much debt to fund their activities. That in itself is not evil, but raises the fixed cost levels in the firm (as they are fixed commitments). In days of poor economic performance or market volatility, or just lower levels of liquidity in the banking sector, that situation can trigger issues for firms operating high levels of debt, as the 2008 financial crisis demonstrated.

Furthermore, as a country you can wonder if it is so attractive to have a lot of thinly capitalized firms in your economy, as they pose an intrinsic risk to other market participants through enhanced counterparty risk when dealing with them. Many countries have therefore introduced 'thin capitalization rules' in their tax code, which essentially are there to cap the amount of deductible interests a firm can deduct for tax purposes in any given period. The technical way that is determined differs slightly for each country, but the rules either put a nominal cap on the amounts of interests that can be deducted and/or put in place maximum debt/equity relations for any given period. For example, if your debt to equity ratio is higher than 3:1, the interest due on any debt amount above the 3:1 ratio is no longer deductible for tax purposes, making the instrument more expensive on a net basis.

However, only one country in the world went as far as abolishing the distinction between debt and equity for tax purposes. That country is Belgium. In 2007 (yes, before the financial crisis) the Belgian government introduced what is known as the 'notional interest deduction.' The mechanism allows for the tax deductibility of an artificial dividend from the equity side of the financing mix. They don't look at the effective dividends (which are not tax deductible) but at an artificially constructed dividend based on the T-bond rates in that period increased by a certain spread. The level of the spread is then based on certain conditions. This way an equity investment holds the same benefits as a debt investment.

Besides the significant impact the introduction of this rule had on the budget, the government intended to ensure a better capitalized economic environment in the country. That is pretty understandable as the country enjoys major inbound investments every year, and is often the prime location for overseas investors to locate their European holding (and consequently Belgian holdings capitalize many subsidiaries in other European countries). Consequently, the capitalization of that holding determines the economic strength of its subsidiaries in Europe, especially when the economic tide shifts. Since 2007, the rule has been adapted a few times to remove possible abuse situations and non-intended usages within international tax planning schemes.

Going even beyond that, questions can be raised about the true nature of an equity or debt instrument. All too often we look at the legal characteristics of the product to judge its nature. In most cases that is fine, but there are some exceptions that might make you wonder. If one provides a loan (in legal terms) to a firm which is in such a desperate economic state that it almost certainly will not be able to pay back the loan and interests due, one can wonder if the legal qualification is still adequate.

The jurisprudence in many countries has responded to these situations by denying the deduction of the interest, re-qualifying the loan to equity and/or re-qualifying the interest to a 'deemed dividend.' In order to do that, the legal system needs to allow the tax authorities to ignore the legal reality of a business transaction in favor of the economic reality underlying the business transaction.[1] Whether a legal system allows the economic theory doctrine to be applied is often a matter of legal principle in that jurisdiction and the answer often needs to be derived from other parts of the law beyond the tax code. In countries which do not have an economic theory in place, the tax authorities will have to turn to the 'abuse of law' provisions in their tax codes and argue that the participants in the deal were intending a different outcome to the one the legal qualification would normally imply. That is an uphill battle for tax authorities and disputes are therefore mostly settled out of court.

I think it is fair to temporarily conclude that the debt to equity spectrum is a diamond with many angles, which are colored differently depending on your perspective.

1.3 POSITIONING AND USE OF MEZZANINE FINANCE

Maybe we will get some further answers when looking at the reason why mezzanine finance exists to begin with and for what purposes it is used. When looking at the transactions for which mezzanine finance is used there is a long list of transactions that keep coming up.

[1] In The Netherlands this line of thinking originated from the 'bodemloze put' theory based on a number of historical court cases. It refers to the idea that if you throw money into a bottomless pit you will never see your money again despite the legal claim you might have according to the instrument.

On that list are:

- Funding M&A activity (industry related or not) or funding organic growth and spin-offs.
- Restructuring or reorganization of the business.
- Funding the acquisition of portfolio companies by private equity firms (LBOs or otherwise).
- Management buy-ins/outs.
- Internationalization.
- Succession planning.
- Project finance.
- Change of strategic direction.
- Providing 'bridge' financing to portfolio companies on their way towards an IPO (when owned by a private equity firm).
- Recapitalizations.
- Funding the introduction of new products or service groups, plant expansion or the development of new distribution channels.
- Overall refinancing of activities or financing overall growth ambitions.

It is fair to say that mezzanine financing often comes on the radar for management or business owners if there is no sufficient collateral that would justify bringing in additional senior secured debt, or where the visibility of future cash flows is blurred or prone to many externalities. Added to that list are limited profitability or a deviant corporate risk profile.

It is also fair to say that, given its deviant evolution, mezzanine is looked at differently in the US versus Europe. The US, with its more mature and developed capital markets, has developed a mezzanine group that is seen as a variation on publicly traded bonds (convertibles etc.) and therefore can be called public mezzanine. On the other hand, in Europe, where bank lending has played a more critical role in corporate funding, a private mezzanine market has been developing which tends to be closer to debt financing (subordinated and participating loans etc.). Other critical differences are discussed throughout the book.

First, however, let's consider the life stages of a company and the primary ways of financing in each of the individual stages (Table 1.1).

Firms always have to decide whether they will finance their operations going forward using internal or external sources. Internal financing is often preferred, given the cost of, or access to, external funding, but it is not always realistic given the cash flow generation of the firm or the level of funding needed.

It is fair to say that reality is not as clinical and sharply distinct as reflected in the chart below. Transitions are smoother or less defined and firms may have many ways to reinvent themselves in order to fight off the decline of their product group(s). That can range from introducing new product groups and/or services, to making acquisitions into (un)related industries and offloading certain asset groups that have a higher stand-alone value or are no longer core to the business strategy.

The availability and cost of debt and equity also have an impact on how funding activities will arise. The recent financial crisis of 2008 and the emerging equity gap[2] could push

[2] McKinsey Global Institute, 'The emerging equity gap,' October 2011.

Table 1.1 Financing the individual life stages of a company

External funding needs	High, unconstrained	High v-a-v firm value	Moderate v-a-v firm value	Declining v-a-v firm value	Low as opportunities are rare
Internal financing	Low or negative	Low or negative	Low relative to financing needs	High relative to financing needs	Higher than funding needs
External financing	Owner's equity Bank debt	VC/ Common stock	Common stock, Warrants, Convertibles	Debt	Retire debt, stock buy backs
Growth stage	Start-up	Expansion	High growth	Mature growth	Decline or re-up
	Venture Capital/ Private Equity	**Initial Public Offering**	**Ad. Equity**	**Bonds/C. Bonds**	

the cost of financing up, although some of that will be offset by historically low interest rates applied to the market both in the US and in Europe; interest rates have been hovering around 0–1% for a number of years now and are expected to stay there for at least a few more years, although in early 2013 central banks were starting to prepare the market for the fact that quantitative easing will end at some point. This might happen more unexpectedly than the average market participant would envisage. Pricing in the secondary government bond market already seems to hint that increased interest rates are expected. In emerging markets interest rates are higher, mainly as they are fighting (somewhat) higher levels of inflation, whereas throughout 2011–2012 the main theme was fighting deflation in the US and Europe.

One thing is clear: in cases where senior debt is not an option (or is not sufficient to cover the whole funding need), mezzanine is a plug variable (it plugs the gap between debt and equity). It allows a firm's debt financing to grow, without the owner losing control over company assets. That, however, carries an intrinsic risk, whereby the owner tries to avoid a (further) dilution of their equity stake at any cost, but burdens their company with so many priority debt claims that he or she literally erodes the residual cash flow generating ability of the underlying assets for the equity owners. It is often emotional reasons which make smaller companies turn to mezzanine financing as a less costly (relative to bringing outside equity into the firm) but (partly) fixed cost option, often with no – or only temporary – dilution of their equity stake.

The consequence is that, from a risk perspective, mezzanine products all sit between the layers of senior debt and pure equity. They should therefore, in a risk-return world, trigger higher compensation than senior debt and a lower return than common equity. These often difficult questions about pricing deserve a full chapter later on in the book (Chapter 4).

When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity needed in the business. As equity is the most expensive form of capital and dilutive to existing shareholders, it is common sense for owners or majority stakeholders to aim to create a situation that comes at the lowest cost possible and is least dilutive when the business comes to be expanded.

The following example in Table 1.2 illustrates the latter point:[3]

Table 1.2 Reducing the cost of capital

Financing structure before mezzanine			After mezzanine	
	US$	Cost of capital (%)-Assumptions	US$	Cost of capital (%)
(Senior) bank loan	3	5	6	5
Mezzanine loan	0	0	2	12
Debt Capital	**3**	**5**	**8**	**6.8**
Equity Capital	**3**	**20**	**3**	**20**
Total Capital	**6**	**12.5**	**11**	**10.4**

The advantages and disadvantages of mezzanine finance can be summarized as shown in Table 1.3:[4]

Table 1.3 Advantages and disadvantages of using mezzanine finance

Advantages	Disadvantages
• Remedies financial shortfalls and provides capital backing for implementing corporate projects; • Improves balance sheet structure and thus creditworthiness, which can have a positive effect on the company's rating and can widen the room for maneuver as regards financing; • Strengthens economic equity capital without the need to dilute equity holdings or surrender ownership rights; • Tax-deductible interest payments and flexible remuneration structure; • Greater entrepreneurial freedom for the company and limited consultation right for mezzanine investor.	• More expensive than conventional loan financing; • Capital provided for a limited term only, in contrast to pure equity capital; • More stringent transparency requirements.

1.4 THE RISK–RETURN CONUNDRUM

From a balance sheet point of view, mezzanine finance is positioned between senior secured debt and common equity. It is therefore subordinated to senior debt claims but junior to common equity claims, although the latter isn't a claim in the full sense, but only an entitlement to the residual cash flows produced by the firm. Figure 1.2 is a visual representation of the risk–return continuum of the mezzanine space. It is best to ignore the vast variety of instruments listed, but to realize for now that the mezzanine continuum spans the risk–return matrix between senior secured debt and common equity, the two instruments listed at either end of

[3] 'Mezzanine finance – A hybrid instrument with a future,' Credit Suisse, Economic briefing, 2006, p.10.
[4] Ibid. p. 9.

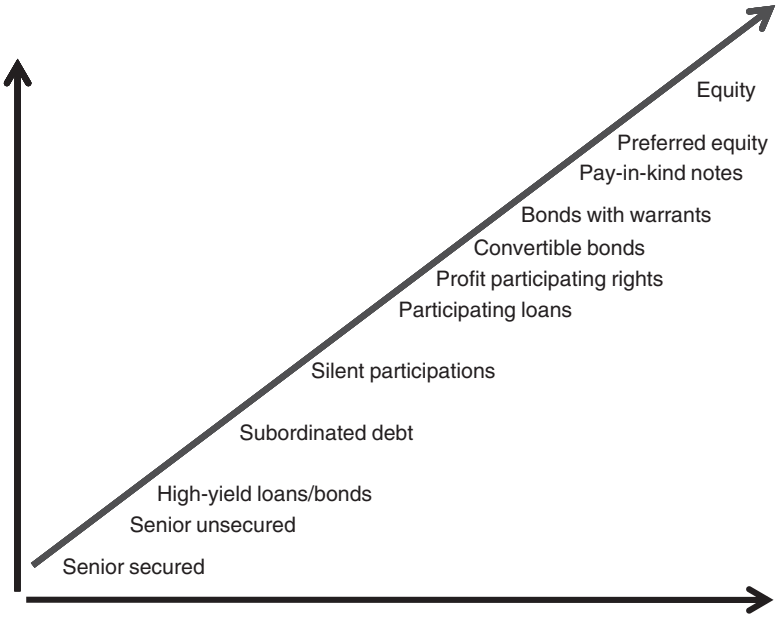

Figure 1.2 The risk–return paradigm
Source: Adjusted from CS economic research

the risk–return matrix indicated. Also note that the pecking order indicated in Figure 1.2 is essentially a default order. This means that the risk–return order could be altered through the use of covenants in each of the products which would make the product under review less or more risky and consequently change its position in the matrix. As represented here, it reflects the typical risk–return ranking of a plain vanilla product group.

In recent years, mezzanine products have seen increased attention due to the altogether limited availability of credit, the lower valuations attached to certain assets on the balance sheet, or the unwillingness of banks to fund certain current assets with senior debt due to structural weakness in terms of liquidity terms under (dis)stressed situations.

To be more specific:

- Accounts receivable, inventories and even certain fixed assets such as real estate are given a much lower valuation, or not accepted as collateral any longer;
- Lending against goodwill and/or other intangibles is even harder; and
- Banks and other FIs have tighter caps on how much exposure they can tolerate within a specific firm, sector or country (see Figure 1.3a/b).

The question then becomes: 'How much debt is too much before mezzanine emerges as a potential financing tool?' We could opt for a simple pragmatic answer here, but first let's define the parameters of the answer we are looking for. Financial institutions will generally see an end to how far they can travel with a firm in terms of lending. This can be based on bank-specific criteria such as total loan mass (per client or region), total loan mass in a specific industry or maximum loan mass to a specific firm. Most of the time this is a problem only in emerging economies with firms showing high growth prospects and which rely heavily

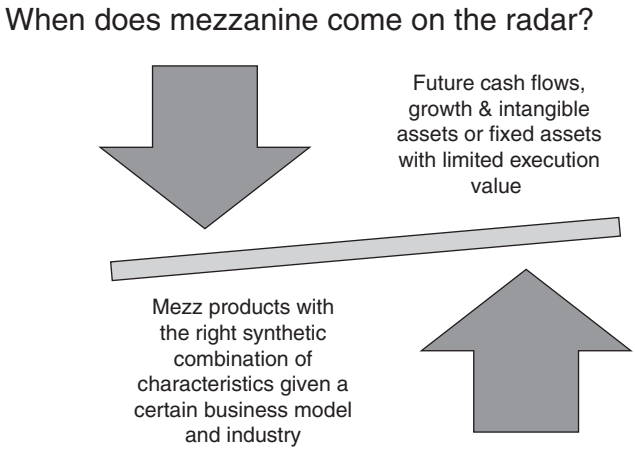

Figure 1.3a When does mezzanine finance come on the radar?

Company balance sheet	Equity & Liabilities	Financing instruments
Assets	Liabilities	•Bank loans •Bonds •Supplier credits •Customer advances
	Liabilities	
	Mezzanine	•Subordinated loans •Silent participations •Participating loans/rights •Preferred shares •Convertible bonds with warrants
Fixed assets	Mezzanine	
	Equity	•Retained profits •Stock •Capital contributions from equity holders •Private equity
	Equity	

Figure 1.3b Mezzanine capital versus debt and equity

on senior bank debt to execute their business model. However, with Basel III on the horizon (most of it to be implemented by 2019 as it stands in early 2013), and with higher capital ratios included in the rules, banks will have a narrowed platform to provide lending to corporates and the real economy in general. They will most likely channel their funding to government bonds, as they do not require risk capital, in contrast to normal corporate or personal lending loan banks.

On most occasions, however, the problems that arise are firm-specific. Banks and non-bank financial institutions ('NBFIs') are willing to lend to firms and organizations under the condition that they have some sort of guarantee backing their lending arrangement in a structural way, in case of default on the loan. That is easily understood, as it is not much different

than you or I buying a house and getting a loan from the bank for which the bank will require a first lien mortgage on the property being financed. However, they are willing to lend in line with the market value of the property, potentially even adding funds to pay for renovations such as a new kitchen or bathroom. The pain is in the word 'potentially,' as most banks in most countries will cap the amount of extra funding they are willing to provide for the simple reason that if you default they will encounter a funding exposure; i.e., they lent you more that the market value of the property, most likely even with the renovations. This is very likely to be true when the costs and transfer duties have been included in the loan amount as well.

Until a few years ago, banks had the benefit of assuming that the value of a house will go up over time. Now that the world has painfully illustrated that this is not necessarily always the case, with varying degrees of intensity across the world I must add, banks have become very conservative in estimating the execution value of the property (i.e., the market value under stress, if you like).

So the market value of assets has become more volatile and insecure in recent years, and from their side banks have become more restrictive in lending terms, unless there are assets with an execution value close to their actual lending exposure providing backing.

Although these numbers, percentages and estimations vary somewhat over time and geography, Figure 1.4 attempts to provide some insight into the parameters that banks use when judging the execution value of an asset.

The figure shows that, just as your bank now requires you to have some money to put down as a deposit when you buy a property (often 20%), the situation is quite similar when you finance assets for a firm. They will consider your actual free cash flow to estimate your ability to repay, and are, to a certain extent, willing to see how your future cash flows will improve and include that information in their calculations. However, even that will reach its limit at some

Assets	AB lending
Cash & securities	100%
Receivables	70–85% based on quality (backward looking default rates)
Inventory	45–65% of normal liquidation value (NOLV)
Equipment & real estate	Lower % NOLV (around 70% of NOLV for equipment and approximately 80% for real estate)
Intangibles: patents, etc	Low % of DCF valuation (royalty stream focused)

Figure 1.4 Collateral value of assets

point. At that point your banker will tell you that there is very little they can do, unless there is more collateral they can turn to, either within the firm or based on the private wealth of the owner(s). From a market perspective (and driven by regulation) it is clear that banks will only focus on asset-based financing and firms will be in increased need of cash flow-based financing. Intuitively that makes sense, i.e., when you lend capital to a firm they will turn that capital into assets, which will be converted into cash flows at some point, which then will be partly used to repay the interest on and principal of the loan. Nevertheless, finance is not necessarily as rational as you would expect, especially not in cases where you have a regulator breathing down your neck and increasingly regulating how your balance sheet should look, which is the case for most licensed banks these days.

From a balance sheet perspective, Figure 1.5 reflects how that conundrum looks. It should be added here that for specific transactions, like M&A, most banks require an equitable intervention of about 25–30% on behalf of the acquiring firm.

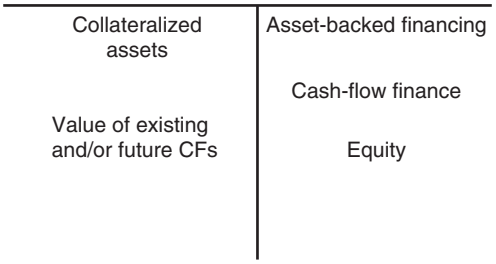

Figure 1.5 How much debt is too much debt?

Given the banks' position, mezzanine has developed distinct characteristics and is guided by specific features that differentiate the product group from other financial instruments on the balance sheet spectrum. In Table 1.4, I have tried to bring together some of the most important features compared to other financial products. That being said, throughout this book I will pay significant attention to the possible risk profiles, and formulate a structured way of assessing that risk for each of the different positions in which mezzanine finance can be considered. With respect to the criteria included, in particular regarding the pricing components, it needs to be highlighted that those are obviously sensitive to geographically different demand/supply relations and the overall state of the financial markets and interest rates. This helps to explain why some of the bandwidths indicated could appear relatively wide at first glance.

In general terms, it can be stated that the fixed interest component in mezzanine products tends to be larger in the US than in Europe, whereas my market observation is that the equity kicker tends to be larger in Europe than in the US, although total compensation patterns are quite alike across both continents, which has been true across the normal macro-economic cycles. In periods of distress, spikes can be observed in yields. One of the most extreme examples of this phenomenon was in the early days of the 2008 financial crisis when liquidity dried up and available equity was almost non-existent: some mezzanine funds in the CEE region, a region heavily impacted in the early days of the crisis, were able to put their product in the market at yields in the first decile only, and often far above the actual equity return at that point in time. These are usually temporary phenomena. Similar situations have been observed in the past in emerging markets, often also centered around periods of economic distress and/or financial imbalance. It must be said that it is only during the last 10 years

Table 1.4 The major categories in the debt spectrum

Feature/Product[5]	Senior secured	Junior secured	High-yield	Mezzanine	Private equity
Rank	Senior	Structural Subordinated	Contractual Subordinated	Structural/Contractual Subordinated	Junior to all other debt/products
Term	5–7 years	5–7 years	Up to 10 years	5–8 years	N/A
Coupon	Cash	(Fixed) cash	(Fixed) cash	Cash pay & PIK (fixed)	Dividends
Pricing					
Upfront fees	1–2%	1–2%	None	2–3%	Varies
Interest rate	B+200–300bp	11–14%	11–15%	8–15%	N/A
PIK warrants all-in pricing	N/A	N/A	N/A	4–8%	20–25%+
	N/A	N/A	N/A	Always (almost)	
	B+350–500 bp	12–15%	9–11%	14–25%	
Covenants	Extensive	Extensive	Incurrence test	Maintenance, variety of tests, cross defaults with senior lenders	N/A
Security	1st lien	2nd lien	Unsecured	Unsecured/Secured	N/A
Prepayments	In principle ok, w/o premium	In principle ok w/o premium	Call premium generally very expensive	Expensive call premiums particularly Y1–3	N/A
Providers	Banks, NBFIs, asset-based lenders and alternative asset managers	Specialized AB lending firms	Institutional investors, larger FIs	Banks, insurance companies, Mezz funds and PE firms	PE firms, large FIs

[5] Excluded here are bridge loans. Bridge loans are short-term bridging finance for specific purposes taken out temporarily in anticipation of subsequent definitive (capital market) financing. Once the relevant transaction has been completed with the aid of the bridge loan, the long-term financing is structured using various financing instruments (e.g., bond issue, new stock issue, syndicated loan, etc.). Bridge loans are used most frequently in acquisitions (acquisition bridge financing).

that commercial mezzanine capital has found its way into emerging markets, an area that, until then, was the exclusive territory of development banks or supranational development agencies.

Although it is a rather general statement, it is still fair to say that in most situations I have encountered in practice, the mezzanine lender was exposed to a risk profile much closer to common equity than to senior secured debt. That in itself is probably not shocking, given the fact that many senior lenders have been very liberal in providing finance during the pre-2008 crisis period and, as such, firms considering mezzanine lending often already had steep levels of senior debt on their balance sheets. To provide some indication: the average bank debt/EBITDA in the US in 1995 was 3.3×, in 2002 2.4× and in 2007 5.1×, while non-bank debt hardly came down from its average 1.5× EBITDA across the last two decades.

What was more remarkable was the fact that when it came to the choice of product, or the way the product or individual components of the compensation were structured, it did not necessarily reflect the often deeply subordinated nature of the position of the mezzanine product used in each case. See Table 1.4.

Now that we are aware of the risk–return structure that comes with a variety of products as discussed, including the wider variety of mezzanine products, high-yield and leveraged loans make the seniority spectrum of the financial instruments look pretty much as shown in Table 1.5:

Table 1.5 The risk spectrum for financial products on a balance sheet

Highest security
Leveraged (bank) loans
(a) Senior secured loans, (b) High-yield bonds (c) unsecured loans
Convertible securities
Preferred equity
Common equity
Highest security
Lowest security

Somewhat of a maverick product which has not yet been mentioned is the stretched senior, characterized by a partially secured position often with a first lien on specific assets, tight covenants with a fixed coupon based on an adjusted prime rate. Although it is still used it is often pushed out of the market by more recent unitranche products which are faster to execute, less bureaucratic and simpler to use (see also Chapter 11).

That hybrid character of mezzanine finance will stick with us throughout this book. Practically, I have often encountered the difference in perspective between the lender and the borrower with respect to mezzanine products. This distinction often comes back to their individual positions in negotiations. Talking of negotiations, it can be said that every mezzanine book or course should come with a negotiation course, as it is often so crucial to the end result. As mezzanine finance is, in essence, legal or contractual finance (as the covenants are so important, in that they have to reflect the particularities of the case in question), what is agreed upon is often more a reflection of the relative negotiation power and alternatives of each party, rather than the academically most adequate choice of product.

Borrowers often look at mezzanine capital as (expensive) debt (as they are concerned about the extent to which they should charge the free cash flow their firm produces) whereas lenders

are often more concerned about the risk to which they expose their capital. There is often a deep rift between the legal qualification of the instrument (as legal debt) and the fact that the risk exposure is often closer to equity risk, given the fact that mezzanine instruments are superseded by a significant amount of senior debt and that they have to agree to contractual subordination. This often leads to the difficult situation that, because of the different appreciation of the same facts, the rift seems deep, sometimes too deep.

In this type of situation, I tend to break down the facts. Rather than looking at the higher total return of the mezzanine product, I break the total cost pattern down. On the one hand, there is the interest income (sometimes limited to the level of interest for a similar debt interest with the equity uptick included). One could argue that this is the firm's cost for bringing mezzanine funding on board. On the other hand, there is the cost to the existing shareholders, which can emerge as a temporary dilution of their shareholding or an additional interest charge (which burdens the existing shareholders' cash flows).

This pattern can then be judged by the owner/shareholders on its pros and cons relative to their (perceived) BATNA or WATNA ('Best or Worst Alternative To a Negotiated Agreement') which is often another mezzanine provider, another attempt to convince bankers to provide an additional layer of senior debt, or on the other side, growing at a slower pace, waiting for the execution of the transaction under review or bringing a full (minority) equity investor on board. Ultimately there will always be a trade-off of some sort. As Stuart Diamond's 2010 book *Getting More*[6] clearly illustrated, it is often better to try to understand each other's position and hammer out a solution based on that understanding and empathy, rather than to push through a solution aggressively which (slightly) benefits one party over the other.

The mezzanine provider, when assessing their risk exposure, will land somewhere between that of senior debt holders and equity owners. They are therefore looking for (total) compensation that is somewhat in line with that risk exposure. Further analysis on this topic will be provided later.

From this perspective, it can be argued that mezzanine finance is like 'borrowed equity.' However, there are two big distinctions to be made. The first one is that there is no loss of control over the firm for existing shareholders. Bringing in new equity owners would change the voting distribution or dilute their existing shares. That dilution can then be limited (and temporary) as the biggest chunk of the returns comes in through interest income. Secondly, most arrangements provide for a buy back (or pre-emption right) of the equity stake obtained by the mezzanine lender in the process of the deal; an arrangement that the lender is also willing to engage in, as they have no intention of looking to become a permanent shareholder. Therefore, they will be looking for either a natural liquidity moment or an artificially created liquidity moment. The interests of the lender and borrower coincide. The only question will be at what cost this needs to happen (see Chapters 3 and 4). Voting rights, if managed incorrectly, can lead to different shareholder coalitions, making this a feature to watch in the overall structuring of the deal. If opponents inexorably stay with their point of view, it is time to run for the exit. Being willing and able to walk away from a deal and straight into the sun is a skill that everybody in this field needs to master.

[6] Stuart Diamond, *Getting More: How to negotiate to achieve your goals in the real world*, Crown Business, 2010.

1.5 PROVIDERS OF MEZZANINE FINANCE

It can be said that, historically, there have been two categories of mezzanine finance providers developing, known as sponsored and non-sponsored financiers. The *non-sponsored financiers* are banks, financial institutions, institutional investors, endowments and specialized mezzanine boutiques and funds, etc. The *sponsored financiers* are often private equity firms which provide mezzanine finance to their portfolio companies, either to carry out their plans or to bridge the path towards an IPO, hence the wording 'bridge financing.' This distinction has also led to the terms 'sponsored deal' and 'non-sponsored deal,' hinting at their different backgrounds.

In 2013 the market is constructed as shown in Figure 1.6 in terms of market participants. Funds here include both independent providers of mezzanine finance and sponsored funds which provide finance to their portfolio companies.

A special word can be dedicated to the development banks which have been providing equity and quasi-equity capital to firms in emerging countries since long before commercial capital arrived in those countries. They now are often the front runners in the countries included in the OECD category 1 and 2 lists of least developed countries. Commercial capital has arrived in the countries included in categories 3 and 4, although with varying degrees of intensity.

1.6 THE MARKET FOR MEZZANINE PRODUCTS

The market for mezzanine providers has known its booms and busts just like the private equity and hedge funds sphere. Mezzanine providers raised $86.4 billion globally between 2005 and 2010, with the majority of the capital raised by US-focused funds and other providers, followed by Europe and Asia. The capital raised stood at $62.5bn, $19.2bn and $4.7bn respectively. 2008 proved to be the most prosperous year in the period for the mezzanine private equity market, during which nearly $31bn was raised. This was largely due to the final closing

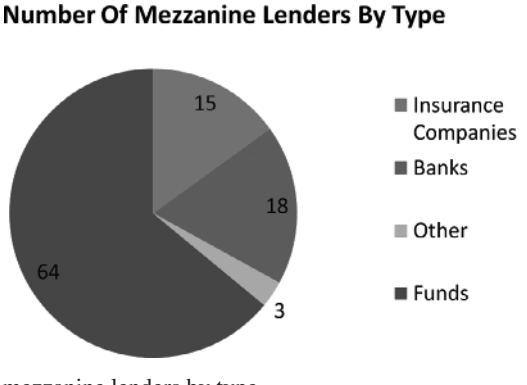

Figure 1.6 Number of mezzanine lenders by type
Source: Lincoln Partners

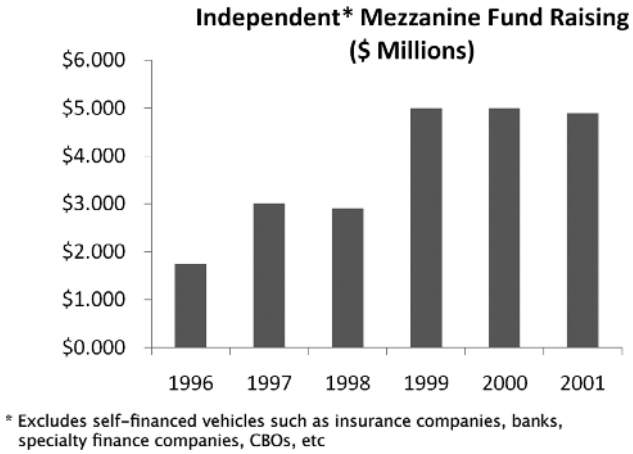

Figure 1.7 Independent mezzanine fundraising
Source: Private Equity Analyst

of GS Mezzanine Partners V that year. The fund managed by Goldman Sachs Private Equity Group raised, in total, $20bn of which $13bn was equity commitments and the remaining $7bn leverage.[7]

These are significant numbers, especially when being compared to the fundraising numbers of the period 1996–2001, as shown in Figure 1.7.

The geographical distribution is still somewhat skewed, as 66% of the fund managers in the market with a mezzanine fund are based in North America, 25% in Europe and the remaining 9% across Asia and the Rest of the World.

This situation is mirrored when judging the investment distribution, as 66% of the funds mainly focus their investments in the US, a further 21% focus on Europe and the last 13% primarily target opportunities across Asia and the Rest of the World.[8]

Within the leveraged loan spectrum, which we consider here separately from the pure mezzanine fundraising position, the following picture (see Figure 1.8a and b) has unfolded during the last 10 years; the typical picture of an unstoppable rise until 2007–2008, then a sharp decline, followed by a swift and rapid revival, but with weak intermezzos, as was the case during H2 of 2011. Remarkably enough, the market for leveraged and in particular high-yield ('HY') loans has known a significant renaissance since late 2010. This is particularly due to the fact that investors globally have been looking for investible fixed-income instruments with higher yields than the average government or corporate bond offered. As those investors have been shying away from equities for a long time, despite the massive rally that equities have known since 2009, the place they landed was in the middle, i.e., mezzanine loans and in particular the liquid leveraged and HY loan market.

[7] Preqin 'Funds in Market publication,' 2010.
[8] Preqin 'Funds in Market publication,' 2011.

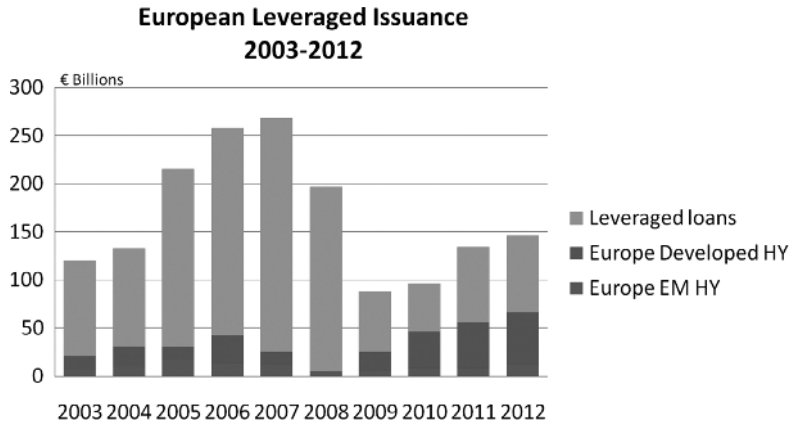

Figure 1.8a European leveraged issuance 2003–2012
Source: Dealogic Thomson Reuters LPC, author's own

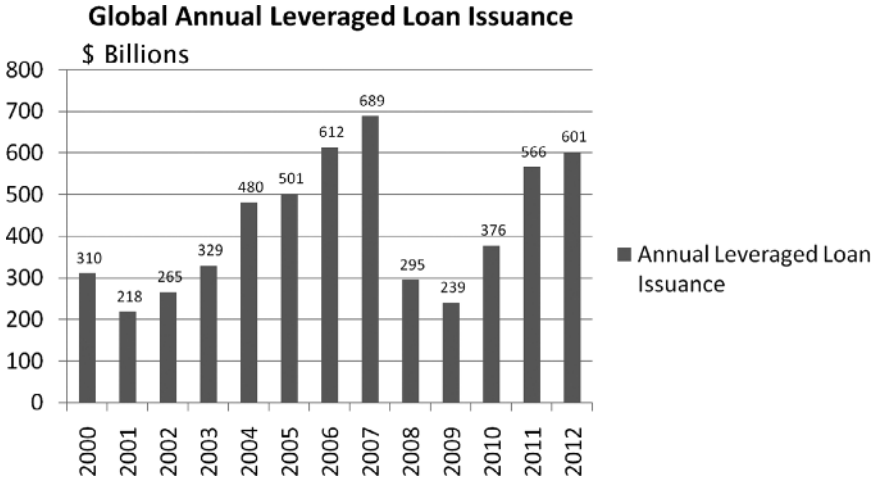

Figure 1.8b Global annual leveraged loan issuance
Source: Thomson Reuters LPC, author's own

The more short-term Figure 1.9 represents those dynamics in Europe for the period 2008–2012, and on a global scale in Figure 1.10 for HY loans and Figure 1.11 for all leveraged loans.

What is more frightening, however, is the wall of maturities we are about to witness starting in 2013–2014, as most of the leveraged loans that were issued in the period 2005–2007 are about to mature and therefore need to either be refinanced or repaid. Although 2011 was the most financially stable year since the 2008 crisis, there are still major concerns out there about the ability of the market to facilitate that upcoming period in terms of liquidity. If one embeds the issues in an economic environment that is still very fragile, one can ask questions about the underlying stability of the economic system and the guaranteed availability of a sizeable and stable level of liquidity that such a refinancing operation would require. That is

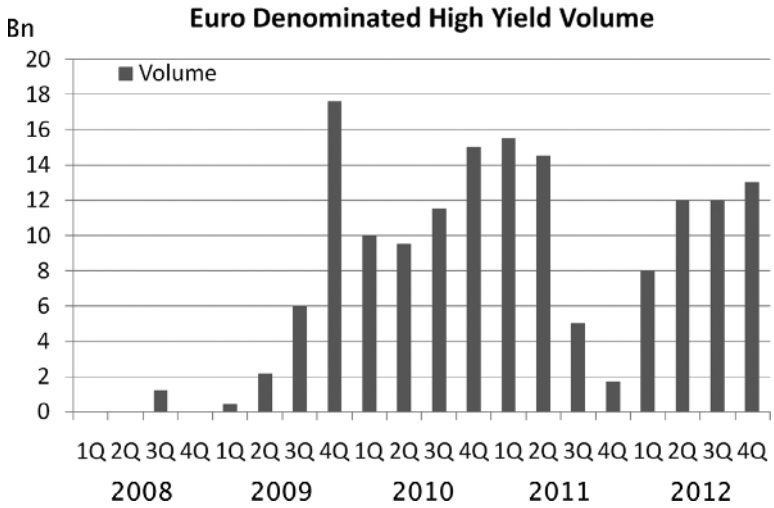

Figure 1.9 Euro-denominated high-yield volume
Source: Thomson Reuters LPC, author's own

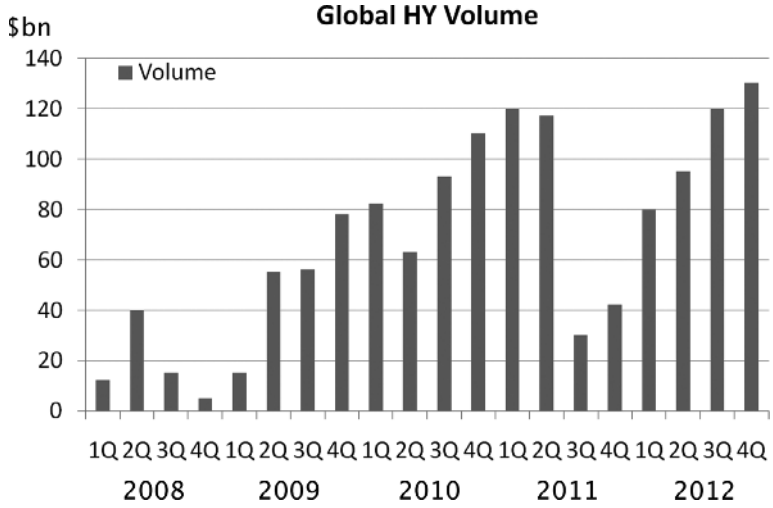

Figure 1.10 Global high-yield volume
Source: Thomson Reuters LPC, author's own

certainly the situation we find ourselves in now; where banks and companies prefer to park billions of Euros at the ECB rather than lend them out to customers or make them available in the interbanking markets, and where at the same time close to a trillion Euros was taken out in the period 2011–2012 via the two long-term refinancing operation ('LTRO') facilities that the ECB made available.

This book's purpose is not to evaluate the policy mistakes that potentially have been or are being made by governments and banks, nor is it the ambition to re-digest everything (and that is a lot) that has been said on this front since 2008, so let's stick to the facts, and what we can observe about that upcoming refinancing wall.

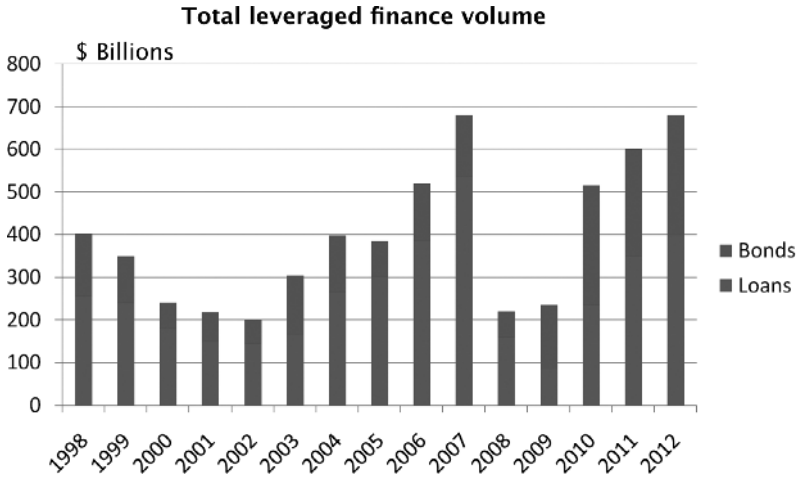

Figure 1.11 Total leveraged finance volume
Source: Standard & Poor's LCD, author's own

In Figure 1.12 the refinancing needs for European leveraged loans and high-yield loans per year for the period until 2021 are displayed. These needs peak in the period 2014–2016, which makes sense as most of these instruments have a maturity of about eight years and most of the issuance was in the period 2005–2007. Figure 1.13 does pretty much the same, but for the upcoming US loan maturities.

Having solidified our starting point, drawn some demarcation lines and assessed the market and its players, it seems that we are pretty well positioned to move on to the next chapter, in which we will look more deeply into each of the products and their characteristics.

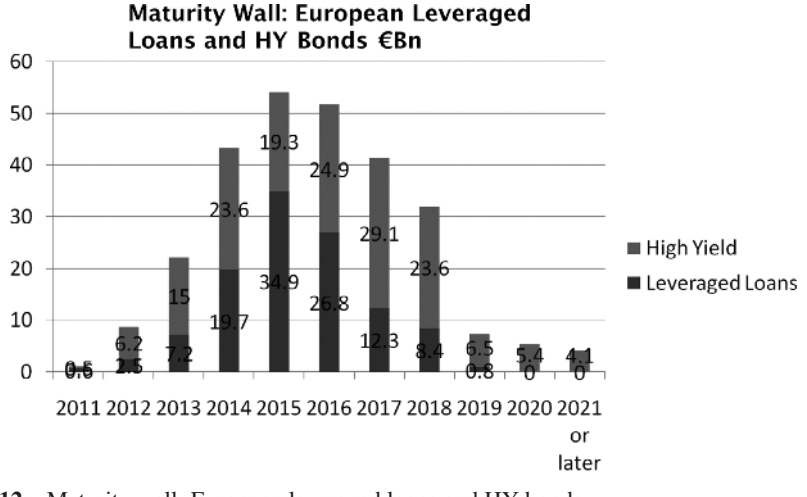

Figure 1.12 Maturity wall: European leveraged loans and HY bonds
Source: Lipper

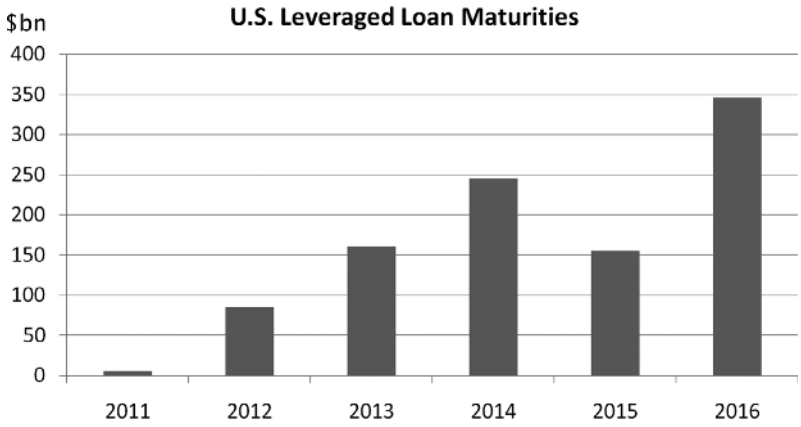

Figure 1.13 US leveraged loan maturities
Source: Bloomberg LP

In Chapter 3, I will also have to touch on issues that deal with modern financial theory and more specifically the funding cost of each product and the implications it has for the borrower, i.e., the cost of capital for the company and the impact of choosing a mezzanine product. Obviously, the fact that most compensation structures are made up of an equity component on the one hand and a debt component on the other will make our analysis somewhat more complicated. Nevertheless, it is one of the most important features when considering mezzanine as a funding tool, both as a lender and as a borrower.

This is especially true given what I mentioned before: that often the compensation structure and total compensation levels are not in sync with the product's risk exposure given its position on the balance sheet and the volume of senior debt already in place. At the risk of jumping the gun here, my observation is often that, because most professionals who are dealing with this have a debt capital markets ('DCM') or lending background, the inclination is to build a mezzanine product out of a senior lending template, which forces you to start off on the wrong foot. This invariably implies that the compensation is structured as a bottom-up process, built on the basis of a base rate (often the cost of funding or an interbanking rate of some sort). This does not necessarily provide a compensation structure and level reflecting the actual risk that the mezzanine product absorbs, as I will go into in more detail later. This partly has to do with the fact that mezzanine risk is much wider in its intrinsic DNA than typical lending risk. Whereas typical lending risk is all about the risk linked to the ability of the borrower to repay, mezzanine risk also absorbs certain risks that we can consider to be equity risk (or equitable risk) which requires us to think about the operational, business and strategic risks that are inherent to the business we intend to invest in. It is very difficult, if not impossible, to reflect those risks as a spread on a base rate. It also leaves an open question about the total return target one needs to aim for given the risk profile. What that risk profile is will be determined by your cash flow waterfall on the one hand but also the equity structure you intend to use on the other. A top-down approach therefore seems more appropriate than a bottom-up approach with respect to return modeling for mezzanine products. I will flesh this out a little further in the next two chapters. The next chapter will foremost be devoted to an extensive review of the product group, the dos and don'ts of each product and some of the contractual or legal aspects that are worth focusing on when considering a mezzanine investment.

To conclude the chapter, a last few words about the mezzanine market. The traditional investible market has been the upper-tier SME market. Although normally highly rated companies, they still have to fulfill strict criteria: a sound track record, stable cash flows and an experienced management team. Suppliers of mezzanine to lower-tier SMEs have been predominantly angel investors, although the largest need for mezzanine can be found in that part of the market.[9] There are also clear limitations to the use of mezzanine due to the life phase the company is in (seed, start-up) as most, if not all, of the mezzanine product group is not equipped to absorb business risk or outright failure of the business model and its product/services. Also in certain restructuring and turnaround situations the product group is less adequate, as cash flows can be volatile or difficult to forecast.

In practice, many obstacles and requirements remain for firms trying to get access to the mezzanine market; these have been well summarized by the Credit Suisse research group – see Table 1.6.[10]

Table 1.6 Requirements and obstacles for mezzanine financing

Requirements	Obstacles
• Possibilities for funding from own resources have been exhausted and loan financing is either insufficient or not available; • Strong market position based on products/technology and market shares; • Healthy financial position and good earning power with steady profit growth where possible; • Focused business strategy and positive long-term development prospects; • Positive, stable cash flows that can be forecasted reliably; • Appropriate finance and accounting function, and open information policy; • Quality and continuity of corporate management.	• Inadequate earnings/cash flow; • High leverage; • Low equity resources; • Volatile business performance; • Weak market position and negative development prospects; • Restrictive information policy; • Inadequate finance and accounting function; • Start-up/little business experience; • Quality and experience of management inadequate.

[9] See further: 'Mezzanine finance; final report,' Roundtable between bankers and SMEs, EC, Enterprise Publications, 2010.

[10] 'Mezzanine finance – A hybrid instrument with a future,' Credit Suisse, Economic briefing, 2006, p. 11.