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MEZZANINE FINANCING FOR ENTREPRENEURS

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THE BENEFITS OF MEZZANINE FINANCING FOR ENTREPRENEURS

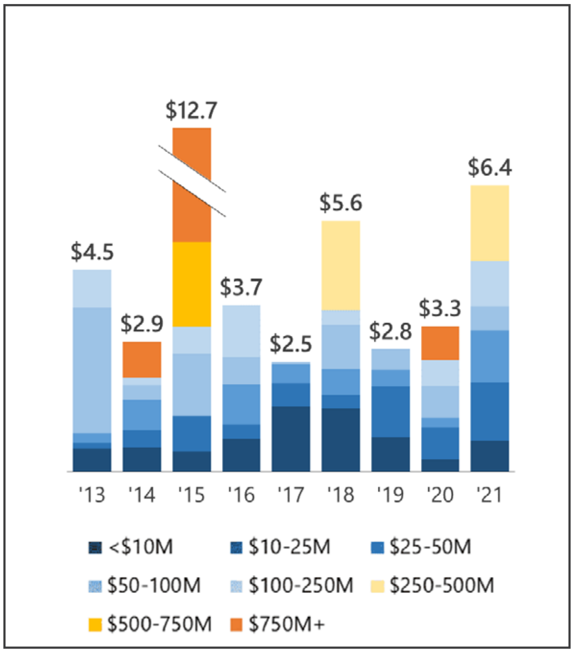
Introduction to Mezzanine Financing

Mezzanine financing can allow entrepreneurs to unlock doors to substantial growth for their business. It also offers a patient outlook on financial performance and flexibility to craft an appropriate investment structure to fit the financing needs of the company and goals of the entrepreneur. Mezzanine financing typically refers to an investment in the form of subordinated debt in combination with a minority preferred equity component. It is applied to cash flowing businesses for a variety of purposes, including to finance control buyouts, fuel growth, provide financial diversification for shareholders, and to support ownership succession.

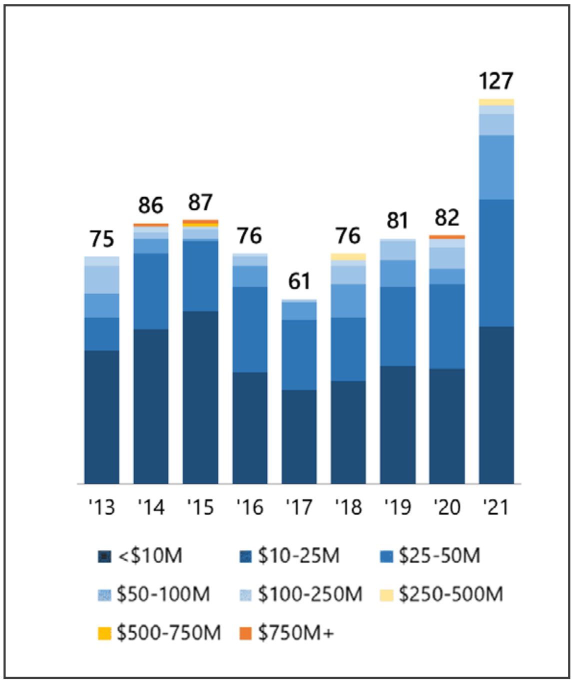
According to data from Pitchbook, $6.4 billion was invested via mezzanine financing in 2021, compared to $3.3 billion, $2.8 billion, and $5.6 billion in 2020, 2019, and 2018, respectively. For deal sizes under half a billion, 2021 marked a record amount of total mezzanine capital invested, but mezzanine has also been a significant piece of recent mega deals, like last year's $1.7 billion buyout of golf equipment manufacturer, TaylorMade, which included $430 million of mezzanine financing. While mezzanine deal counts have proven to be stable over the past decade, a record deal count was reached in 2021, with 127 deals as reported by Pitchbook, underscoring the growing popularity of the financing option.

Mezzanine financing remains an important financing alternative for entrepreneurs to consider, given its unique benefits and complementarity with other financing alternatives. The benefits are compelling particularly for entrepreneurs in the "lower middle market," or what we see as the range of company enterprise valuations roughly between $5 million and $100 million.

Aggregate US Mezzanine Deal Value*
($ in billions)



US Mezzanine Deal Count*



Mezzanine Financing's Place in the Capital Structure

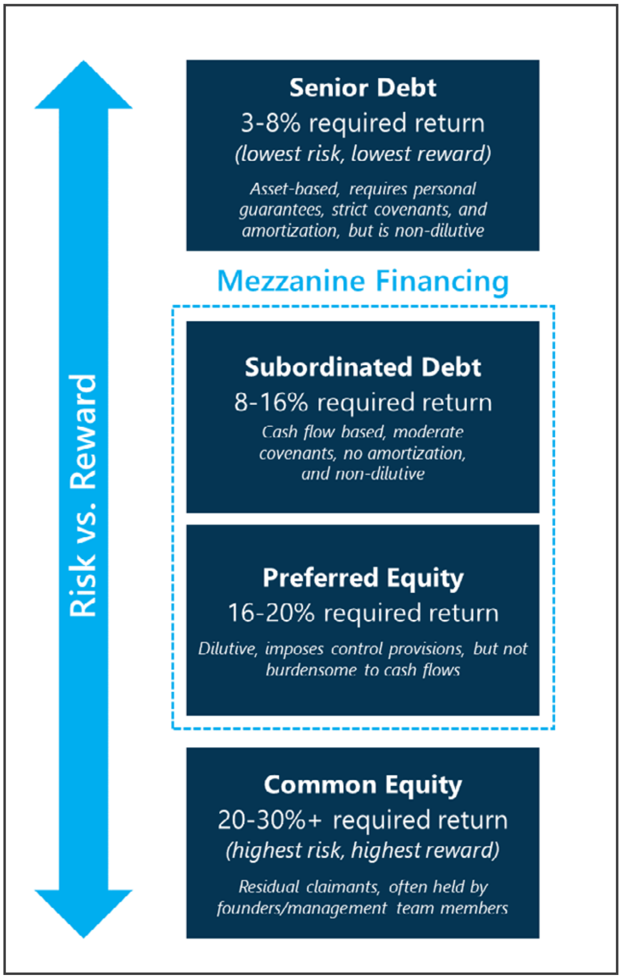
Mezzanine capital – subordinated debt and preferred equity – sits in the middle of the capital structure or "capital stack" (the mixture of the various types of external funds used to finance the business) in a junior position relative to senior debt and in a senior position relative to common equity. When considering mezzanine financing, it is helpful to compare the costs and benefits to other available financing options such as senior debt financing or full equity financing.

* *Source: Pitchbook*

Mezzanine vs. Senior Debt

Senior debt is lent to companies by commercial banks. It holds the most senior and least risky position in a company's capital structure because it requires collateral in the form of asset liens, has the first claim on assets in a liquidation event (a sale of the business or bankruptcy), imposes covenants to limit significant capital expenditure and financing decisions, and requires debt service expenses and leverage metrics to remain within defined parameters. While subordinated debt is more expensive than senior debt, it affords much more flexibility to a business owner in exchange. Subordinated debt comes with more relaxed covenants and a longer-term view on business performance which means more cooperation and support when times are tough. Subordinated debt lenders are cash flow oriented and don't typically require collateral coverage, so a large asset base or asset appraisals are not required. Subordinated debt also does not require personal guarantees, making it a good avenue to reduce personal financial exposure to the business.

The Capital Stack



An additional layer of flexibility and patience offered by subordinated debt is the zero-amortization feature that is typically offered, which unlocks additional and potentially critical cash flows that can be used to reinvest in the business to fuel growth. The principal amount of a subordinated loan is often paid down in full at the sale of the business or when the term of the note is reached, which is typically five years or more.

Mezzanine vs. Pure Equity

The "cost of capital" for senior and subordinated debt is straight-forward to calculate from the perspective of a business owner – it is the annual interest rate paid to the lender. The cost of capital for equity can be more complicated to both understand and calculate due to the wide variety of business risk profiles influenced by unique management teams, industry dynamics, financial trends, and of course how much debt the equity holders sit behind in the capital stack.

For lower middle market businesses, equity investors will typically require 20% or higher expected returns on an equity investment as compensation for the industry, regulatory, and economic risks, the idiosyncratic risks specific to the company, and the notion that they are "residual claimants" in the capital structure and are required to wait for debt investors to be made whole before participating in returns. This required rate of return will be "baked in" to an equity investor's financial models to approximate the equity value of the company, which will determine the percentage equity ownership that their investment buys them. Pure equity investors will typically impose strong control provisions even when purchasing a minority ownership share in the company to mitigate the risks borne by a full-equity investment.

While mezzanine financing typically includes an equity piece, it is often a smaller piece of the total investment relative to the subordinated debt component and is included to solidify strategic alignment with the entrepreneur and management team and to provide the investor with a taste of the equity upside potential.

So, while interest rates for subordinated debt of between 8% and 16% might come with some initial sticker shock, it can still be much less expensive than the true opportunity cost of giving up a percentage of the precious equity ownership in the business.

Keeping the Entire Capital Stack in Mind

In practice, for lower middle market businesses with healthy cash flows, the interest rate differential between mezzanine debt and senior debt often results in a straightforward financing approach: load up on asset-based senior debt as available from senior lenders and, to the extent there is a need for more capital, seek a mezzanine lender who will provide a balanced and tailored capital solution in the form of a combination of subordinated debt and equity. This strategy will ensure the business is not over-burdened with leverage and interest expenses while steering clear of too much equity ownership dilution pain for the entrepreneur compared to a full equity infusion.

Interest Tax Shield

More than a century ago, the US Federal Government made the decision to allow corporations to deduct debt interest expenses from its taxable income. This provision has largely stood the test of time despite several attempts to limit its efficacy. The latest attempt was successfully passed in the Tax Cuts and Jobs Act of 2017, which limits the total amount of interest expense deductibility to 30% of adjusted net income. Although the bill passed successfully, significant leverage is needed for interest expenses to reach this threshold. Nevertheless, this “tax shielding” benefit of debt interest payments remains a key factor for the financing decisions of business owners.

For example, a profitable business that holds a $3 million subordinated loan with a 12% cash interest rate is paying an effective interest rate of 7.56% assuming a tax shield at the highest current marginal federal tax rate of 37%. In other words, the business avoids paying $133,200 per year in income taxes due to the ability to deduct interest expenses from taxable income. Thanks to this long-standing policy upheld by the US Federal Government, this tax shielding effect offers a significant benefit to the entrepreneur to hold interest-bearing debt – a feature that is not available for equity capital.

We currently operate in a political environment with a high degree of uncertainty around the corporate tax regime – whether or not corporate tax rates will increase, when such an increase would be effective, to what degree, and for which types of corporate entities. A potential near-term increase in effective corporate tax rates means the tax shielding effect of senior and subordinated debt interest expenses could become even more valuable.

Current Landscape of Mezzanine Investors

Similar to the rapidly growing and far-reaching landscape of traditional private equity investors, mezzanine investors come in many shapes and sizes, and each addresses a particular mix of deal size, ownership dynamic, industry, and geography. Mezzanine financing packages supporting mega-deals are provided by global behemoths like Madison Capital Funding and Golub Capital, while lower middle market businesses seeking a strategic partner in addition to their mezzanine capital approach funds like Charter's very own Charter Growth Capital Fund to secure the funding to take their business to the next level.

Charter’s Mezzanine Offering: Charter Growth Capital Fund

Launched in 2019, the Charter Growth Capital Fund (CGCF) seeks to invest mezzanine capital to support businesses at an inflection point of growth requiring significant capital, professionalization, and a well-defined growth strategy. Specifically, CGCF invests in Great Lakes-based companies earning annual EBITDA of between $500,000 and $5 million, primarily in sectors including distribution, healthcare, manufacturing, business services, and industrial services. Through our investing, we create long-term partnerships with the leaders at our portfolio companies and bring strategic value beyond our capital through our team’s collective experience in private investing and M&A and robust network of advisors and companies in the Great Lakes region. With CGCF’s successful showing of deploying fund capital into promising businesses even despite the pandemic, the second installment of the fund, Charter Growth Capital Fund 2, remains on the horizon to allow our team to continue supporting the growth of promising businesses.

CHARTER Capital Partners

About Charter

Founded in 1989, Charter Capital Partners is a premier investment banking firm headquartered in Grand Rapids, Michigan. We offer a comprehensive range of investment banking advisory services, including buy-side and sell-side M&A, succession planning, business valuation and capital raise.

Charter was named one of the top 100 most referred middle-market advisory firms in the US, according to a survey of 1,000 private equity firms, strategic acquirers, and family offices compiled by Axial, a network of middle market investors, advisors, and CEOs. Our mission is to deliver superior professional guidance throughout the complete business lifecycle.

About the Author

AJ Ebels, Senior Associate

AJ has been with Charter Capital Partners since he started as an intern in 2016. In his current role as Senior Associate, he focuses on due diligence, deal execution, portfolio monitoring, and fund management activities for the Charter Growth Capital Fund, the Michigan Accelerator Fund, and Charter's numerous other venture capital and private equity investments. He also contributes as a deal team member for Charter's mergers and acquisitions practice, having worked on deals across the manufacturing, industrials, technology, and consumer sectors. He also leads internal technology and software initiatives for the firm.

AJ is currently pursuing his MBA from the University of Chicago Booth School of Business in the weekend program with concentrations in Finance, Economics, and Entrepreneurship. AJ graduated from Grand Valley State University in 2017 with a BBA in Finance and Business Economics and was a graduate of the Frederik Meijer Honors College.

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