Is a mezzanine recapitalization right for your business?

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Owners of middle market companies still in growth mode face a variety of challenges and options in terms of raising capital to fund their continued growth. Likewise, owners of these companies may also be searching for optimal ways to exit their business, when the time is right. The financing levels within a company usually have morphed into the present state and create a need for a fresh, real viewpoint to fund an expansion or a business transition.

In both these instances there are a variety of options available to finance growth or provide shareholder liquidity, including:

- Senior secured debt, or first lien. In this option pricing tends to increase with leverage, is dependent on availability of collateral and is typically the London Interbank Offered Rate (LIBOR) plus 3 to 5 percent.
- Stretch, or second lien debt. Pricing is typically LIBOR plus 8 to 12 percent.
- Subordinated, mezzanine debt. Pricing is typically in the 12 to 15 percent range, with 11 to 13 percent being cash and the remainder payment in kind (PIK). This option may include warrants.
- Preferred equity. Pricing is typically in the 8 to 14 percent range, mostly PIK. This option may also include warrants but is less dilutive than common equity.
- Common equity. This option includes 35 to 40 percent of total capitalization, with a target internal rate of return of 18 to 25 percent.

In addition to the above alternatives, shareholders have other options to grow and achieve liquidity, including:

- Selling to a strategic buyer
- Selling to a private equity (PE) group

- Launching an initial public offering (typically uncommon for middle market companies outside of the technology and health care industries)

While a sale to a strategic buyer usually will offer the highest valuation multiple, it comes at a price as it usually means the selling company experiences a loss of control and replacement of management. It also can mean a loss of jobs and, in many cases, a change in company culture from the legacy business. A sale to a PE group will usually come with a slightly lower valuation multiple than a sale to a strategic buyer, but could have many of the same disruptions and disadvantages similar to a sale to a strategic buyer.

In contrast, a mezzanine recapitalization will generally yield the lowest valuation multiple, but ownership will often maintain control and can capture future business-upside potential. It's important to note, however, a mezzanine recapitalization is generally only accessible to businesses with strong free cash flow and a strong second layer of management.

Mezzanine recapitalization: A closer look

The following is an example of how a mezzanine recapitalization might work if the conditions are right.

Mezzanine recapitalization at work

Example company

- Earnings before interest, taxes, depreciation, and amortization (EBITDA) of $10 million
- No debt outstanding
- Confidence in achieving $15 million of EBITDA by year five

Recapitalization

- Valuation: 7.5x
- Lowest valuation *but:*
  - Retain control
  - Can capture future business-upside potential
  - No escrow
  - Lower fees and expenses

Outcomes

- Shareholders could realize 50 to 70 percent of the equity proceeds of an outright sale, while retaining a majority ownership position and control of the company.
- By using debt to finance the recapitalization, seller is able to achieve partial liquidity for owner and full liquidity for passive shareholders. The seller is also able to reward its management team by increasing the size of the management interests pool.

Recapitalization sources and uses

Sources	$ in Millions	x EBITDA	Uses	$ in Millions	x EBITDA
Total debt	$40	4.00x	Cash to founder	$28	2.76x
Preferred equity	$5	4.50x	Cash to passive shareholder	$14	4.20x
Rollover equity – founder	$23	6.78x	Rollover equity – founder	$23	6.48x
Rollover equity – management	$7	7.50x	Rollover equity – management	$7	7.20x
Rollover equity – passive shareholder	$0	7.50x	Fees and expenses	$3	7.50x
Total sources	**$75**	**7.50x**	**Total uses**	**$75**	**7.50x**

Common equity ownership

Shareholder	Pre-trans	Post-trans
Founder	70%	68%
Passive shareholder	20%	0%
Management	10%	22%
Mezz cap holder	0%	10%
Total	**100%**	**100%**

While a mezzanine recapitalization is not for every business or shareholder group, consider the following when looking at this option for your company:

- You will be operating in a leveraged environment, still owning your own problems, but now have additional ramifications and shareholders. You will now be working with an institutional partner with corresponding governance and covenants, and the expectation that more robust financial reporting may be required.
- You will have the ability to execute on a management plan, driving growth in rollover equity value.
- You will have the ability to possibly increase your growth efforts and surpass growth projections.
- You must plan for future balance sheet refinancing or a complete exit.

Questions? Contact us at RSM's Center for Business Transition.

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