The Advisor – Winter 2010

Mezzanine or Sub-Debt Financing

In this newsletter, we continue our recent theme of alternative sources of financing by discussing mezzanine or sub-debt financing. The main characteristics of this type of financing are as follows:

1. It will sit in second position behind a primary lender who will have a first right on all of the assets of the company in the event of a bankruptcy or liquidation. But it will rank ahead of equity holders in the same scenario.
2. As a result of being in second position, the sub-debt lender's risk of non-payment is greater. The interest rate charged by a sub-debt lender is therefore higher than the lender who is in first position.
3. Sub-debt lenders sometimes take back "equity sweeteners" known as warrants, or options which provide them with the ability to purchase equity in the company at a favourable price in order to enhance their overall rate of return.
4. Repayment terms can often be more flexible when compared to a traditional bank loan. Interest only for a period of time, cash sweeps (i.e. excess cash after all other obligations are paid) or balloon payments are some of the options sub-debt lenders may provide.

Sub-debt lenders will look for the following criteria in order to lend to target companies:

1. A strong management team;
2. A mature, established business;
3. A history of profitability. If the company is in a turnaround stage, at least six months to a year of profitability is usually required;
4. Strong, predictable cash flows; and
5. The ability to add additional debt on the balance sheet.

Sub-debt lenders are sometimes known as "cash flow" lenders since they rely on a company's cash flow (and not their security position) to repay the amount that is owed to them. They will use a formula tied to cash flow to determine how much money can be lent to a customer. A proxy often used for a company's annual cash flow is EBITDA (earnings before interest, taxes, depreciation and amortization). Sub-debt lenders will advance anywhere from .5 to 1.5 times a company's EBITDA depending on how strong the five criteria cited above are met.

One of the great advantages of sub-debt is that it's cheaper than equity. It also imposes discipline on the management team to be diligent in the operation of the business in order to generate the cash flow required to repay the debt. And the interest paid on sub-debt is tax deductible.

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The main drawback to sub-debt is that if too much is lent and it becomes difficult to service, it could result in the bankruptcy of the company.

Some of the reasons companies use this type of financing include:

1. Working capital for growth. Management may wish to expand into new markets or spend money on research and development to improve existing products or create new ones.
2. Acquisitions. Management may wish to acquire a client, supplier or customer.
3. Leveraging of intangible assets such as goodwill to grow the business in other areas; or
4. Shareholder buyouts.

A shareholder buyout can take place in a number of different scenarios. An owner of a privately owned company may wish to sell the business to his children and they can use sub-debt to finance the acquisition. Or an existing management team may wish to purchase a company from the owner. This type of transaction will be discussed in more detail in our next newsletter.

Aries Advisory Group can help you and your management team to source sub-debt financing. We can assist you in compiling and preparing the financial forecasts and all other due diligence information for potential lenders to review. We can then assist in the negotiation of a loan agreement with the chosen lender. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.

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