



A Publication
of the
New Jersey
Technology
Council
and the
Education
Foundation

NEW JERSEY TECHNEWS

www.njtc.org • December 2004 / JANUARY 2005 • Vol 8 Issue 10 • \$3.50

HIGH-TECH DOLLARS AND SENSE

Mezzanine Capital – it is not just for buyouts and acquisitions anymore

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Private equity is generally segmented into three categories: venture, buyout, and mezzanine capital. Each of these segments of capital has very distinct uses, risk profiles and return objectives. Venture Capital is equity capital provided to young, high growth companies. Buyout Capital is provided to medium to large companies to facilitate Management Buyout (MBO) or Leveraged Buyout (LBO) transactions. Lastly, Mezzanine Capital is used to bridge the gap between equity and senior debt on buyout transactions and acquisitions. Or is it?

The economic slowdown and recession of 2000-2002 and the "popping" of the Internet Bubble in 2000 had far reaching and significant impacts on the entrepreneurial and venture capital communities. The consequences of this downturn were more than highlighting flawed "dot-com" business models; the downturn strangled the tail end of the entrepreneurial/venture capital life cycle, the "Liquidity Event."

While IPOs are the sexier and higher profile form of liquidity event, the lifeblood of our industry is merger and acquisition (M&A) activity. For the five

year period 1998-2002, U.S. M&A activity decreased 45 percent in terms of the volume of transactions per year and decreased 72 percent in terms of the total deal value per year. The impact of the decrease in M&A activity was compounded by a steep decrease in valuation multiples paid by strategic buyers from approximately 8.8x EBITDA in 1999-2001 to approximately 6.1x in 2002-2003, for transactions in the \$100 million to \$249 million valuation range.

While both the IPO and M&A markets have shown modest signs of improvement in 2003 and the first half of 2004, most entrepreneurs and venture capitalists have come to expect longer holding periods to exit and lower valuations when compared to the 1998-2000 timeframe.

As entrepreneurs, management teams, and investors watch their businesses mature on the vine during these longer holding periods, they should consider using mezzanine capital in two non-traditional ways: 1) as a source of growth capital and 2) as a source of liquidity.

Before exploring these two options, it is important to understand how mezzanine capital works and where it fits within the capital structure of a corporation. Mezzanine Capital is layered between senior debt and equity. It typically takes the form of subordinated debt with warrants. The subordinated debt usually has a five-year maturity with deferred or no amortization of principal. Interest of 10-14 percent is paid on a current basis.

So why should mezzanine capital be attractive to growth and expansion stage companies?

For maturing, profitable companies, this hybrid capital has significant advantages to both senior debt and equity capital.

Many high growth companies funded in the late 1990s and early 2000s had probably predicted or forecasted a lucrative IPO or strategic exit would have occurred by now. Instead of sipping drinks out of a pineapple on the beach, these entrepreneurs and managers are still coming to the office each day to follow their passion and execute on their dream. Despite a recession, a stock market crash, and a generally abysmal business climate from 2000-2002, these professionals have managed to build real businesses – with customers, revenues, and earnings. It may have taken more, and often highly expensive, equity capital and longer than anticipated, but they have turned their vision into a reality.

With no acceptable liquidity event on the horizon, wouldn't it be great to have the capital required to continue to grow the business at those high double-digit growth rates you and your stakeholders expect without suffering significant dilution, or to take some chips off the table to diversify your assets or afford you some liquidity? Well, perhaps using mezzanine capital in a non-traditional way is the answer. Mezzanine capital, when used in the right circumstances, can be a highly effective and efficient source of capital. Be sure you give it the appropriate consideration as you map out your business's next steps.

Mezzanine Capital is layered between senior debt and equity.

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