Crush financing roadblocks with a mezzanine loan

When business buyers don't have the cash to make an acquisition, they traditionally turn to banks for help. But the credit crunch of the past few years means that these types of loans are extremely hard to come by.

If you've struck out with primary lenders (or they're willing to give you only a portion of the amount you need) and your target has already rejected the idea of seller financing, it's time to consider mezzanine debt. This type of financing gives companies the opportunity to obtain the capital they need and avoid some of the drawbacks associated with traditional debt or equity financing.

Layered loans

Mezzanine financing works by layering a junior loan atop a senior (or primary) loan. It combines aspects of senior secured debt from a bank and equity obtained from direct investors. Sources of mezzanine financing can include private equity groups, insurance companies and buyout firms.

Unlike bank loans, mezzanine debt typically is unsecured, so the cost of obtaining financing is higher than that of a senior loan. The cost, however, generally is lower than what's required for an equity investment, which, to compensate investors for increased risk, must offer the potential for higher gains.

Structurally speaking

The primary advantage of mezzanine financing is that it can provide capital when you can't obtain it elsewhere. That doesn't mean mezzanine debt is an option of last resort, though. Many companies prefer it because it offers flexible structures. If, for example, you're uncomfortable giving up any equity interest (and partial control of your company), you can choose to pay a higher interest rate instead. Although structures vary, most mezzanine instruments share the following characteristics:

Term of between five and 10 years. During the loan's term, you repay only interest. Repayment of principal typically is deferred, based on your financing needs and cash flow projections.

High interest rate. Rates generally range between 10% and 15%.

Investor participation. Most mezzanine instruments allow the lender to participate in your company's success — or failure. Generally, the lower your interest rate, the more equity you have to offer. Lender participation usually takes the form of warrants with put options, which enables the lender to purchase a certain amount of ownership at a relatively low price. At the end of the loan term, you may be required to repurchase the lender's stock.

Mezzanine financing has some disadvantages, however. Primary among them is the higher expense. And although some lenders are relatively hands-off, they retain the right to a significant say in company operations. What's more, mezzanine financing can make an M&A deal more complicated because it introduces an extra interested party to the negotiation table.

Exploring your options

Mezzanine loans aren't for every company contemplating an acquisition, but high-growth companies with strong earnings potential and proven management typically make the best candidates. If you're having trouble getting bank financing and prefer not to dilute your equity, talk to your M&A advisor about this option.