Mezzanine funding combines debt and equity

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In the recent past, private equity investors have flooded Indian businesses looking for value.

An increasing demand for funds by companies has compelled private equity investors to look beyond traditional sources of funding such as initial public offerings (IPOs) or foreign currency convertible bonds, and explore new modes of financing.

One such alternative instrument is mezzanine funding.

Useful tool

Mezzanine debt is a means of financing often used to fund acquisitions, corporate recapitalizations, project finance and buyouts.

Private equity firms raise money through mezzanine debt if they do not have sufficient assets to collateralize and are unwilling to raise additional equity by issuing fresh shares.

This procedure involves the borrower negotiating an arrangement with a lender, where the necessary capital is secured by combining a loan with a stock purchase to the lender.

Such an agreement enables the lender to convert to an equity interest in the company if the loan is not repaid within the stipulated time.

Sometimes, the agreement may specify that the loan be considered as deemed equity for a defined period, providing the borrower with solid financial leverage.

Typically, mezzanine finance is a subordinate loan prioritized as the last option for repayment in the event of liquidation, but ranks higher than common equity.

Furthermore, its loan covenants are usually less stringent than senior debt.

Mezzanine debt is expensive however, because of the increased credit risk, as in the event of a default, it is less likely to be repaid in full.

It is only secured by a prospective right in the equity of the company, and not by the company's tangible assets like property, cash or accounts receivable.

In compensation for the increased risk undertaken, mezzanine debt holders generally demand a higher interest payment or an equity stake in the company.

Investor interests

Mezzanine debt is largely used to finance the completion of a specific corporate project as opposed to generating capital for general growth or production.

Private equity investors have gradually opted for this method of funding owing to its efficiency in providing a borrower with capital in a short space of time.

Before adopting this means of financing, private equity investors assess the future growth of the company by reviewing:

- The management team, which must have a proven record to run the business with high returns;
- Its financial health, which involves a credible past track record;
- Viable expansion plans for the business (the company's growth targets and means to achieve them must be ambitious);
- A timeline of potential returns.

A crucial consideration is also the ability of the investee company to service the debt, and thus due diligence will include a special focus on the cash flows of the target business.

Taking these factors into account, mezzanine investors will tend to refrain from investing in startups.

Learning the ropes

Presently, India's private equity firm ICICI Ventures is in the process of closing the country's first mezzanine fund.

Although Indian corporations have not fully tapped the potential of this model of financing yet, companies eyeing large takeovers are considering financing their acquisitions through mezzanine funding.

For instance, Darby Overseas Investments, the private equity arm of Franklin Templeton Investments, has provided mezzanine funding of US$17.5 million to Bangalore-based Bhoruka Power Corporation, engaged in the renewable energy sector.

Mezzanine debt can be structured in accordance with a company's business plan.

There are no fixed terms, which creates room for flexibility to suit the requirements of the parties involved.

For example, the term of the repayment of the principal amount is usually deferred for several years, and can be tailored to fulfil a borrower's needs.

Primarily, the agreement should contain an option for the conversion of debt to equity in the future.

The presence of both equity and debt components is steadily contributing to the popularity of this mode of financing among private equity investors.

The debt component allows the lender a chance to earn significant interest especially in case of long-gestation investments such as in the infrastructure sector.

On the other hand, the equity component offers the lender equity participation in the company, in the event that a loan is not repaid.

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