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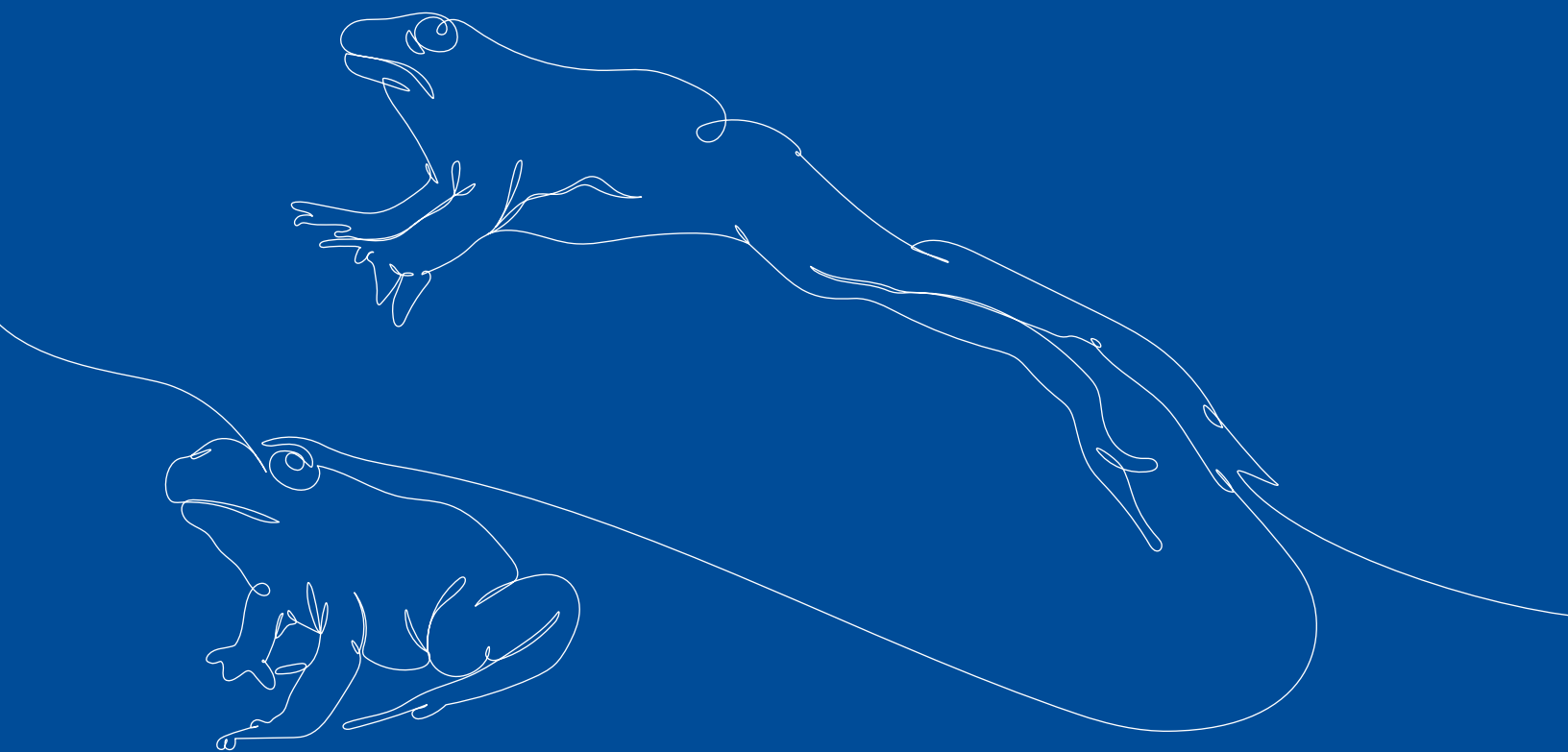


Prudential Private Capital Insights

Transformational Capital:

Enabling Companies to Leapfrog to the Next Level

The Prudential Private Capital
Guide to Mezzanine Financing



Prudential Private Capital



Contributors

Dianna Carr



Dianna Carr-Coletta is the Managing Director of Prudential Private Capital's Corporate and Project Workouts group and oversees the management and restructuring of non-performing investments. Prior to this role, Dianna led a Chicago-based Corporate Finance team responsible for marketing, originating and managing private placement and mezzanine investments in Michigan and Wisconsin. She joined Prudential in 2000.

Dianna received a BA from Michigan State University and an MBA from Northwestern University's Kellogg School of Management.

Matt Harvey



Matt Harvey is a Managing Director in our Alternatives Group and oversees originating and underwriting Direct Lending investments, managing the portfolio, supporting our fundraising efforts, and leading the team that supports Direct Lending efforts. He joined Prudential in 2003.

Matt received a BS from DePaul University.

Mark Hoffmeister



Mark Hoffmeister is a Managing Director focused on Corporate Mezzanine. He joined Prudential in 1987.

Mark received a BA from the University of Wisconsin at Madison and an MS from the University of Wisconsin at Madison's School of Business. He holds the Chartered Financial Analyst® designation.

Julie Langdon



Julie Langdon is a Director in Corporate Finance for Prudential Private Capital, located in Chicago. She is part of a team responsible for marketing, originating and managing private placement and mezzanine investments in Michigan and Wisconsin. She joined Prudential in 2013.

Julie received a BS from the University of Virginia and an MBA from the University of Virginia Darden School of Business.

Steve Szejner



Steve Szejner is a Managing Director focused on Corporate Mezzanine. He joined Prudential in 1999.

Steve received a BS from Boston College and an MBA from Northwestern University's Kellogg School of Management. He holds the Chartered Financial Analyst® designation.

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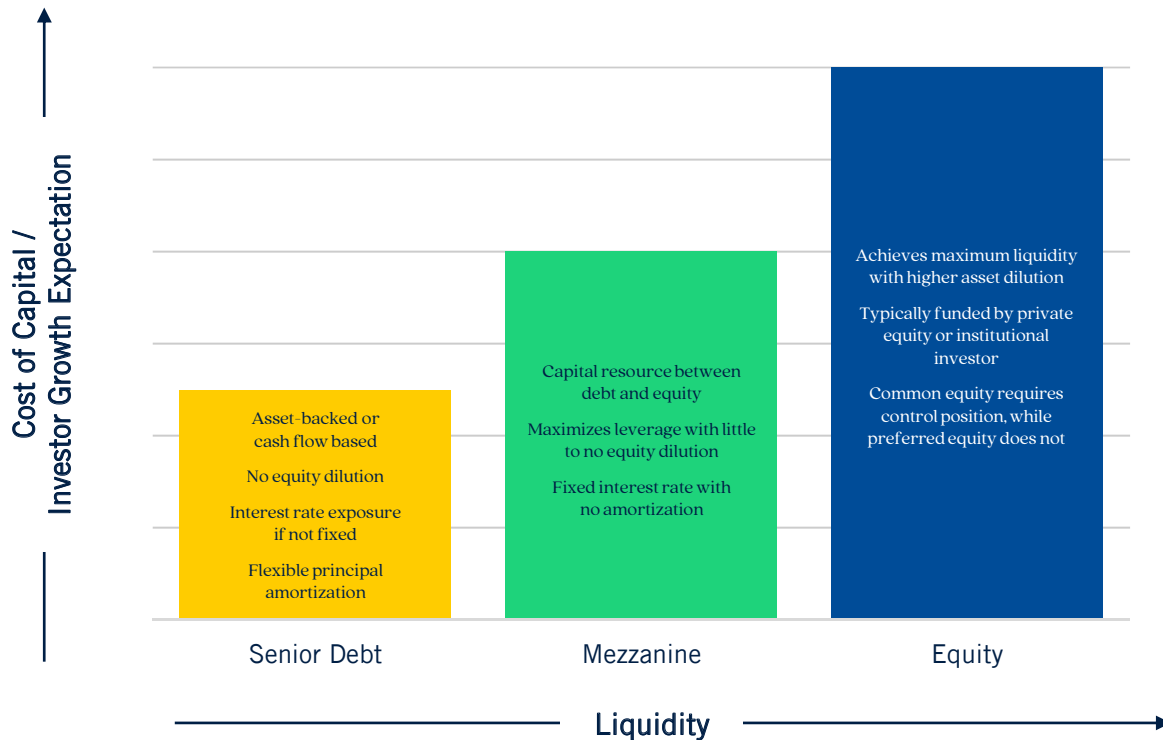
What is Mezzanine Financing?

Mezzanine financing is a capital resource that sits between (lower risk) senior debt and (higher risk) equity that has both debt and equity features.

Companies use mezzanine financing to achieve goals that require capital beyond what senior lenders will extend.

When companies have maximized their senior debt borrowing capacity, seek to preserve future senior debt capacity and need additional capital to pursue growth opportunities (e.g. acquisitions, large capital programs) or for shareholder activity (e.g. **distributions, shareholder buyout**) they are typically left with two options: **raise outside equity or utilize mezzanine financing.**

Mezzanine financing can be viewed as either expensive (i.e. higher coupon) debt or cheap (i.e. less dilutive) equity, since mezzanine carries a higher interest rate than the senior debt companies would obtain through their banks, thus, reflecting a greater risk than senior debt. However, it is substantially less expensive than equity in terms of overall cost of capital. More specifically, mezzanine financing is less dilutive than raising additional equity to satisfy a capital need, ultimately allowing existing owners to maintain control. Mezzanine is patient capital that enables companies to pursue opportunities from a long-term strategic approach, which may not have seemed feasible otherwise.



So, What is Mezzanine Financing Exactly?

Named for its place in the capital structure, mezzanine financing is a form of junior capital that sits between senior debt financing and equity, and is a means by which companies can access capital beyond what they're otherwise able to achieve on a senior basis. Mezzanine financing is also the last stop along the capital structure where owners can raise substantial amounts of liquidity without selling a large stake in their company.

Mezzanine typically comes in the form of 'subordinated debt' or 'preferred equity' with a fixed-rate coupon or dividend. Mezzanine may have some participation rights in the common equity of a business but is materially less dilutive than common equity.

Although mezzanine is more expensive to borrow on a coupon basis than senior debt, it is also more patient.

Although mezzanine financing is more expensive to borrow on a coupon basis than senior debt, it is also more patient, typically carrying a longer term until its final maturity (up to 7-8 years) and is interest-only with no amortization prior to maturity. This element of 'patience' affords a business time to process the growth event or shareholder activity as well as build senior capacity (via increased retained cash flow) to refinance the mezzanine capital over time.

For many businesses, mezzanine is not viewed as permanent capital, but instead, solution-oriented capital that serves a specific purpose, and can later be replaced with lower cost capital, i.e. senior debt.

Mezzanine financing is usually unsecured and subordinated to a company's senior debt (both structurally in terms of its right of repayment, and time subordinated with a longer dated maturity as well as no scheduled principal amortization prior to maturity; this leads most senior lenders to consider mezzanine financing as 'equity-like,' patient capital sitting behind their facilities. In the event a company is facing liquidity constraints, the senior lender can pause (or 'block') current interest payments on mezzanine debt. These features typically provide a company's banks or senior lenders with comfort in their senior position, and as a result, mezzanine financing is often preferred by first lien senior lenders relative to second lien loans or other debt alternatives.

It is common for a private equity firm to provide capital in exchange for majority or complete ownership of a company in situations where mezzanine can be used instead, such as an acquisition or ownership transition. Rather than giving up control of the business, companies can turn to a mezzanine-supported recapitalization, or 'minority recapitalization,' as an attractive alternative.

Mezzanine financing is ultimately a way for companies to grow faster than they could otherwise on a senior basis alone and also execute an ownership or management transition while allowing existing stakeholders to increase their ownership interest.

“My immediate family previously only owned 18% of Polar. Today, using mezzanine and equity, we own 100% of a company that’s grown from \$8 million to more than \$500 million in revenue.”

- Ralph Crowley, CEO, Polar Beverages

Mezzanine Pricing & Payment Structure

Mezzanine financing is more expensive than senior debt and cheaper than equity, but is a relative hybrid of the two. Therefore, it is priced as a blend of both senior debt and equity. Mezzanine is most commonly subordinated debt (or subordinate to senior debt) with maturity occurring a year after the senior debt. It is typically structured to include a mixture of contractual interest – cash and payment-in-kind (PIK) and nominal equity (warrants). As mentioned earlier, it often has a bullet maturity with no amortization during the life of the loan.

Companies will often utilize senior debt capacity that is built up over time to refinance the mezzanine loan prior to maturity, reducing the cost of their debt capital in the process. However, the longer maturity and lack of any required amortization of the mezzanine loan also provides important capital structure ‘patience’ for the business to process the financing event (such as integrating an acquisition).

Mezzanine Financing Pros and Cons

For a company considering introducing mezzanine financing to their balance sheet, it is wise to weigh the pros and cons to determine whether mezzanine is the right fit for their business.

Pros:

- A mezzanine-led recapitalization often results in the existing owner retaining majority control of the company, controlling the board, management, etc.
- Mezzanine financing provides more flexibility (looser financial covenants, reduced amortization, fewer restrictions) than traditional bank loans and allows companies to achieve goals that require capital beyond senior debt availability
- It is less costly and less dilutive than a direct equity issuance (institutional equity typically has a return expectation of 20%+)
- With mezzanine, companies have an alternative capital resource to senior debt and equity
- Mezzanine is ‘patient’ capital that supports long-term growth with interest only for up to seven or eight years and no amortization
- There are fewer control type provisions than typical minority private equity

Cons:

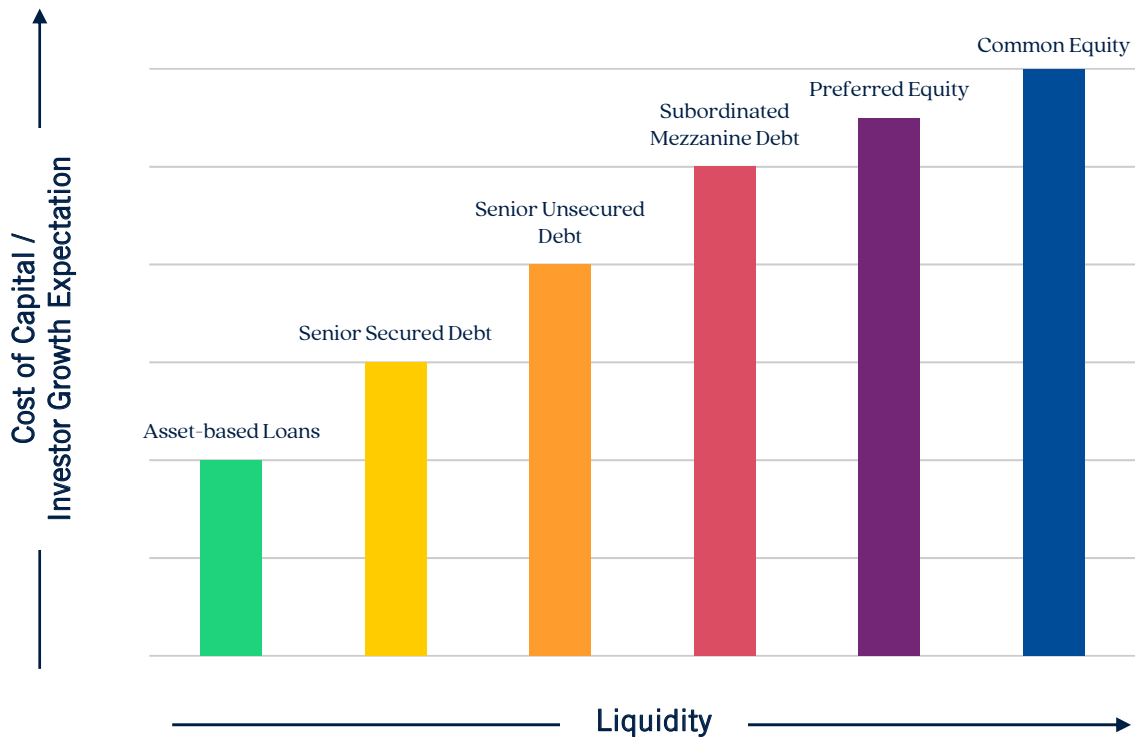
- Mezzanine financing is more costly than senior debt
- Mezzanine financing may involve some equity dilution, which is typically small, and may be in the form of attached warrants or another structure
- Terms for a mezzanine financing include financial covenants and creditor rights
- There is often a prepayment penalty for a period following issuance

How Mezzanine Financing Compares to Other Types of Capital

Learning the benefits and drawbacks of diverse types of capital combined with understanding the total potential availability of capital under various scenarios enables a management team to improve strategic planning at the board level as well as create or quickly respond to opportunities, such as the pursuit of an attractive acquisition target.

The image below depicts the common types of capital available to companies, shown in order of payback priority **with highest priority on top**. As a rule, capital with higher payback priority has lower risk, and therefore, lower return expectations to the investor as well as cost to the company. Capital with lower payback priority has higher risk, and therefore, higher return expectations for the investor and cost to the company.

Types of Capital Available



How Mezzanine Financing Compares to Other Types of Capital

Private, middle-market companies have a variety of types of capital available to them and should optimize their choice of capital based on their objectives. Beyond cash-on-hand, businesses can access the following types of capital and should understand the advantages and associated risks of each:

Asset-Based Loans

These secured, traditional senior debt loans come in two flavors. The first is a 'loan-to-value' note secured by specific plants/facilities or equipment, based on appraisal (commonly referred to as equipment financing). The second is formula-driven and based on metrics, such as the amount of working capital and receivables held by a business. In terms of cost of capital, asset-based loans have the advantage of being relatively less expensive. However, in terms of the amount of capital that can be raised, they are limited by the assets they are based on.

Senior Secured Debt: Secured Asset-Based Senior Traditional Bank Loans

Another type of senior debt is a loan on offer by local, regional and national banks that provide negotiated amounts of capital, secured by a blanket lien on the business. These loans have the advantage of offering potentially more capital than an asset-based loan, which could be at a slightly higher cost.

Senior Unsecured Debt: Unsecured Cash-Flow-Based Senior Traditional Bank Loans

Once a middle-market company demonstrates meaningful scale and stability over a long period of time, they may graduate from secured asset-based loans to unsecured cash-flow based facilities. Regional and national banks will provide negotiated amounts of capital without placing a blanket lien on the business. These loans are typically governed by financial covenants based on earnings and will provide additional flexibility for the business, compared to a senior secured financing.

Subordinated 'Mezzanine' Debt

This type of financing is a hybrid of senior debt and equity. Mezzanine debt is typically unsecured and subordinate in terms of payback priority to any senior debt. Because of the greater risk taken by the investor, mezzanine is more costly than senior debt, but less expensive than equity.

Mezzanine is also typically more 'patient' than senior financing, with no required amortization before maturity as well as a longer dated final maturity than senior debt.

Mezzanine is the last stop along the capital structure where owners can raise large amounts of liquidity without selling a stake in their company. Most companies utilize mezzanine financing to accomplish a specific goal, such as a significant acquisition or ownership transfer by completing a mezzanine-supported recapitalization, or 'minority recapitalization,' and transition to a more conservative capital structure over time.

Preferred Equity

For those companies that require capital and are open to involvement from an outside investor, selling an equity stake in the company is an option. Such a transaction is typically completed by a private equity fund or institutional investor, where capital is exchanged for equity ownership. Preferred equity offers investors greater downside protection through 'debt-like' features, such as a liquidation preference (higher 'first out' position than common equity) as well as a mandatory dividend. In exchange for downside protection, the preferred equity investor will take a lower share of the ownership, allowing existing shareholders to retain a higher percentage of ownership, thereby increasing their potential returns and retaining governance control of the business.

Common Equity

Like preferred equity, common equity also involves selling an equity share of the business and is typically funded by a private equity fund or institutional investor. However, given the greater amount of risk, common equity investors have slightly higher return requirements than preferred equity investors, and they often require a majority, or control, position.

The Role of Mezzanine Financing in a Capital Structure

The key to capital structure strategy is balancing risk and reward.

Companies commonly finance acquisitions, growth capital, recapitalizations and other business expenditures with external funding sources, rather than relying solely on internal cash flows. Savvier financial leaders adhere to the strategy of tactically optimizing their company's capital structure to support both short-term and long-term business plans, making ongoing adjustments as needed. **Thoughtfully balancing risk (added leverage) with reward (faster growth, accomplishing other business or ownership goals) can provide greater opportunity to maximize ROI.**

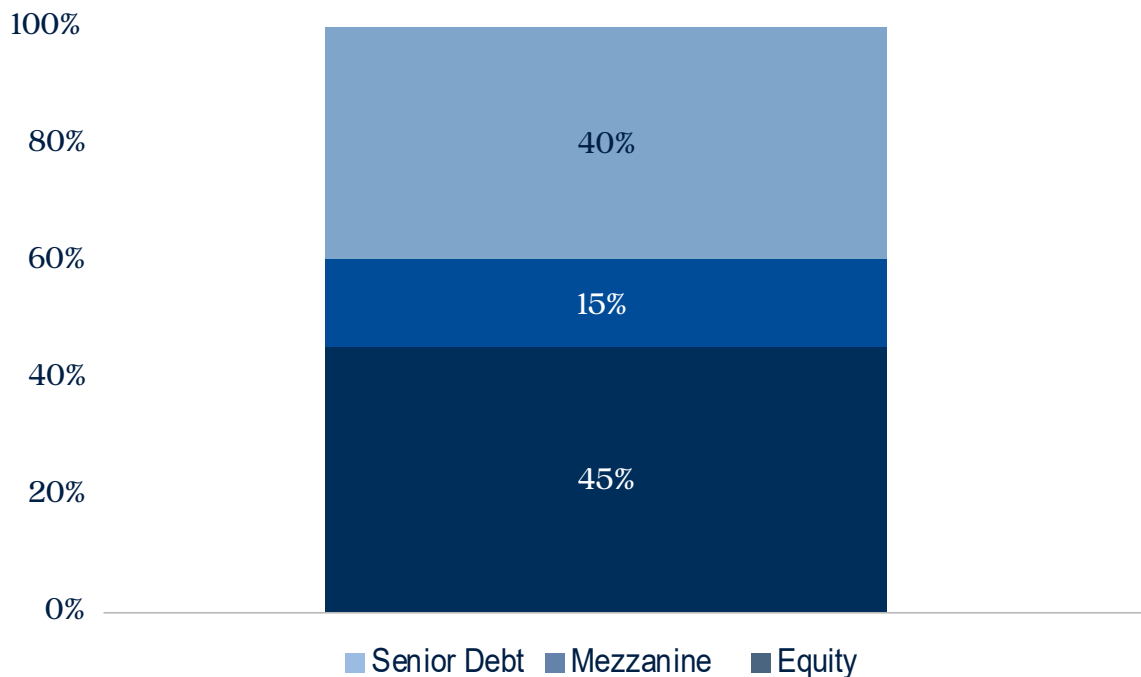
Overview of Capital Structuring

A company's capital structure should be optimized to fit the long-term vision for the business as well as position the company to take advantage of investment opportunities that could arise 3-5 years down the road. Companies that adopt this mindset will implement a capital structure strategy that reserves borrowing capacity for large or near-term expenditures and preserves capital structure flexibility.

The appropriate capital structure for a company fluctuates depending on their overall strategy, the market environment, the competitive environment as well as their short-term (3-5-year) strategic business plan.

As previously mentioned, the hierarchy of a capital structure is based on payback priority; senior layers would be paid first, then mezzanine, with equity paid last. A typical capital structure utilizing this combination of capital might look like the following:

Typical Capital Structure



Source: Prudential Internal

Leverage

When determining how much debt or leverage to take on in terms of the risk/reward spectrum, companies should ask themselves the following questions:

How much debt capacity can my company service?

How much risk am I willing to put on my business?

For a company to implement the capital structure on the previous page, they most likely would have maximized their senior debt borrowing capacity or are trying to preserve future senior debt capacity by adding a temporary layer of mezzanine debt to be used for a specific purpose.

In determining how companies can structure their balance sheets to maximize returns and balance risks, general qualitative factors include:

1. **Operating Leverage** – Defined as the level of fixed costs in a business model; the higher the fixed-cost base, the higher the risk (i.e. variable earnings). Pairing high operational fixed costs with high leverage increases risk.
2. **Cyclical**ity – Defined as the normal variation of demand experienced by a business (vs. seasonality). Pairing highly variable earnings with high leverage increases risk.
3. **Concentration** – Defined as a significant portion of revenue/earnings derived from a customer, product, location or operation. Pairing highly concentrated businesses with high leverage increases risk.

With regards to making decisions on capital structure and leverage, financial leaders are also faced with balancing conflicting objectives of corporate constituents, juggling the goals of the company, the shareholders as well as debtholders:



Capital Structure Strategy Example

The Jones family started the transportation services company, XL Transport, Inc. many years ago. They are interested in buying out their biggest competitor, Large Freight. The acquisition is a great strategic opportunity for XL Transport, but the Joneses don't want to sell equity in the company to complete the purchase. Alternatively, they can use mezzanine capital to fund the transaction, while maximizing shareholder value.

So, the Joneses can either make the acquisition of Large Freight with capital structure Option A (Sell Minority Equity Interest) or capital structure Option B (Raise Mezzanine Capital). Let's see how this plays out:

Current Capitalization

EBITDA	\$25
Valuation Multiple	6x
Enterprise Value	\$150
Less: Current Senior Debt	(\$60)
Equity Value	\$90

Current Ownership

Jones Family	100%
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Target Acquisition: Large Freight

EBITDA	\$20
Multiple	6x
Purchase Price	\$120

Acquisition Funding Needs

Pro Forma EBITDA	\$45
Senior Debt Max Capacity	3x
Senior Debt Pro Forma	\$135
Less: Current Senior Debt	(\$60)
Incremental Senior Debt Avail.	\$75
Additional Funding Need	\$45

Option A: Sell Minority Equity Interest

Pro Forma EBITDA	\$45
Valuation Multiple	6x
Pro Forma Enterprise Value	\$270
Less: Pro Forma Senior Debt	(\$135)
Total Pro Forma Equity Value	\$135
Equity Capital Raised	\$45
% of Company Sold to Investor	33%

Option B: Raise Mezzanine Capital

Pro Forma EBITDA	\$45
Valuation Multiple	6x
Pro Forma Enterprise Value	\$270
Less: Pro Forma Total Debt	(\$180)
Total Pro Forma Equity Value	\$90
Mezzanine Capital Raised	\$45
% Warrants Granted to Investor	2%



Ownership Day 1:

	%	Value
Jones Family	67%	\$90
Equity Investor	33%	\$45
Total	100%	\$135

Ownership Day 1:

	%	Value
Jones Family	98%	\$88
Mezz Investor	2%	\$2
Total	100%	\$90

Capital Structure:

Senior Debt to EBITDA	3x
Total Debt to EBITDA	3x

Capital Structure:

Senior Debt to EBITDA	3x
Total Debt to EBITDA	4x

Please note that all \$ amounts shown above are in millions.

As you can see, with Option A, the Joneses had to forgo 33% ownership stake of the business when they made the equity sale. However, with Option B, where the Joneses utilized mezzanine financing, they only gave up 2% ownership stake, and the value of their holdings was only \$1.8 million less than the value of their final holdings for Option A.

Now, let's look at the performance of XL Transport five years later:

Business Performance Assumptions

5% EBITDA growth per year
Annual capital expenditures and depreciation equal \$5 million
Annual increase in working capital of \$5 million
Tax Rate of 35%
All available free cash generated by the business is utilized to repay senior debt

Capital Structure and Valuation Assumptions

3x senior leverage; 5% interest cost
Scenario A: \$45 million of equity is raised, which owns 33% of the business
Scenario B: \$45 million of mezzanine debt is raised with 12% interest and 2% ownership
No transaction fees or expenses; starting cash balance of \$0
Valuation multiple of 6x in year 5; no dividends paid

Post Acquisition XL Transportation Business Performance

\$ in millions	Year 1	Year 2	Year 3	Year 4	Year 5
EBITDA	\$47.3	\$49.6	\$52.1	\$54.7	\$57.4
% Growth	5%	5%	5%	5%	5%

Option A: Sell Minority Equity Interest

\$ in millions	Year 1	Year 2	Year 3	Year 4	Year 5
Senior Debt	\$116	\$95	\$71	\$45	\$16
Total Debt	\$116	\$95	\$71	\$45	\$16
Senior Debt / EBITDA	2.5x	1.9x	1.4x	0.8x	0.3x
Total Debt / EBITDA	2.5x	1.9x	1.4x	0.8x	0.3x
Ending Jones Family Equity Value	\$219				
Calculated IRR using \$90 million pre-acquisition equity value	20%				

Year-5 Value of 100% Equity

EBITDA	\$57
Valuation Multiple	6x
Enterprise Value	\$345
Less: Net Debt	(\$16)
Equity	\$329
Jones Family Ownership	67%
Jones Family Equity Value	\$219

Option B: Raise Mezzanine Capital

\$ in millions	Year 1	Year 2	Year 3	Year 4	Year 5
Senior Debt	\$119	\$100	\$79	\$56	\$30
Total Debt	\$164	\$147	\$127	\$105	\$80
Senior Debt / EBITDA	2.5x	2.0x	1.5x	1.0x	0.5x
Total Debt / EBITDA	3.5x	3.0x	2.4x	1.9x	1.4x
Ending Jones Family Equity Value	\$259				
Calculated IRR using \$90 million pre-acquisition equity value	24%				
Increased Value to Jones Family	\$40				

Year-5 Value of Mezzanine Capital

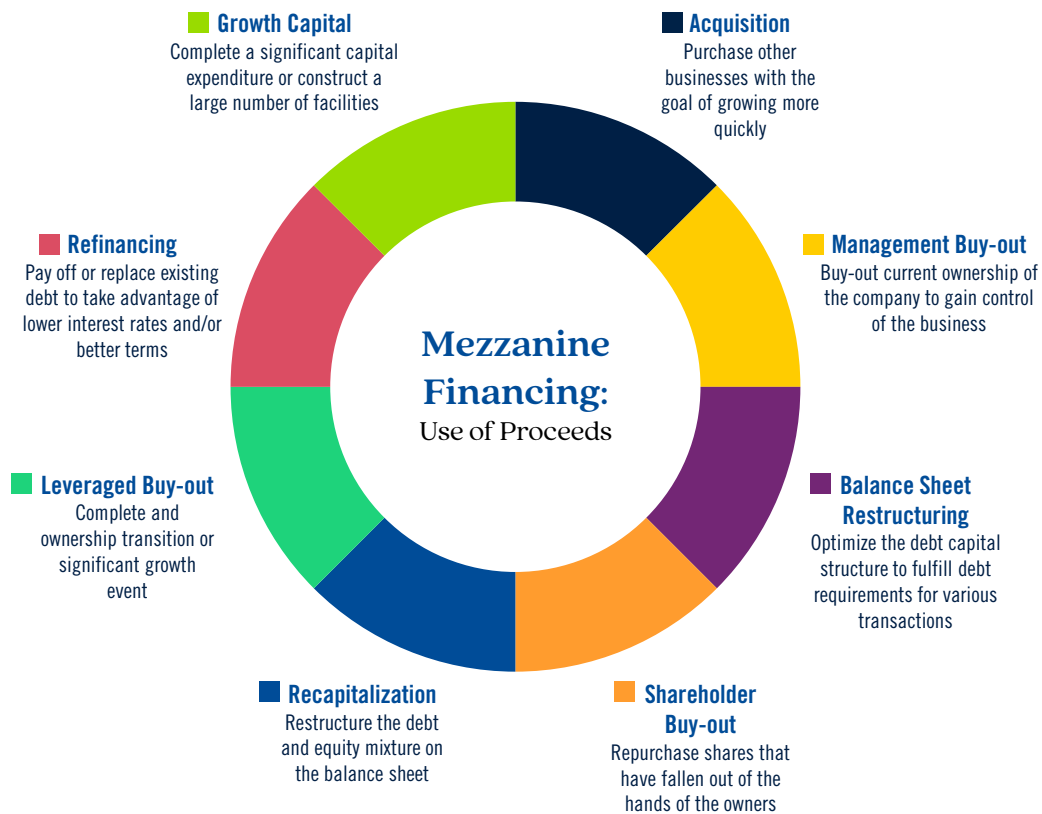
EBITDA	\$57
Valuation Multiple	6x
Enterprise Value	\$345
Less: Net Debt	(\$80)
Equity	\$264
Jones Family Ownership	98%
Jones Family Equity Value	\$259

When developing a capital structure strategy, it's in the interest of the financial leaders of a company to familiarize themselves with the types of capital available to make more tactical decisions about their company's capital structure, better positioning them to accomplish both short-term and long-term goals.

Uses for Mezzanine Financing

Before committing to mezzanine financing, a company should be certain it is the right type of capital to meet its need. As mentioned earlier, mezzanine is not typically used as permanent capital, but instead used as solution-oriented capital, that performs a definitive purpose and can be replaced over the medium-term with a more conservative, less expensive type of financing.

Additionally, mezzanine is a patient source of financing that enables businesses to accomplish their goals for growth, whether it is building a larger production facility or completing an acquisition that cannot be realized with only senior financing.



Mezzanine provides incremental leverage to facilitate a wide variety of transactions.

Here are 8 uses for mezzanine financing:

1 Recapitalizations

Recapitalizations involve raising new capital to restructure the debt and equity mixture on a company's balance sheet, and are an ideal use case for mezzanine financing, especially when owners want to both achieve partial liquidity and maintain control of their business. For example, mezzanine financing can be used in situations where a group of shareholders are seeking partial or full liquidity, while other shareholders seek to remain actively involved in the business.

It is common for a private equity firm to provide capital in exchange for majority or complete ownership of a company in situations where mezzanine, combined with structured or minority equity, can be used instead – particularly if the existing owners are not seeking full liquidity and an exit from their business. Rather than pursuing a new majority equity owner and giving up control, companies may look to that mezzanine-supported 'minority recapitalization.'

Example: HH Global had decided to complete a minority recapitalization, and planned to use the capital received to provide partial shareholder liquidity (including full liquidity for a retiring shareholder), fuel their organic growth opportunities and fund potential acquisitions. Most importantly, the minority recapitalization would provide greater ownership to the extended leadership team, who will be driving the business forward. To facilitate the minority recapitalization, Prudential Private Capital provided HH Global with mezzanine financing as well as senior debt and senior accordion notes, partnering with the company's existing bank, which will continue to provide working capital financing. In the end, the company was able to achieve its liquidity goal, while allowing the current leadership group to increase their ownership stake and position the capital structure with the capacity to continue capitalizing on organic and inorganic growth opportunities.

2 Leveraged Buyouts

In a leveraged buyout, mezzanine financing is often used by the purchasing shareholders, such as a private equity fund or other institutional group, to maximize their available borrowing capacity at the time of the purchase. Leveraged buyouts are typically completed by companies looking to raise large amounts of capital to support an ownership transition or significant growth event.

***Example: Huntington Foam** was looking for a financial partner to support the next phase of their growth, and determined the capital could best be obtained by executing a leveraged buyout. Huntington Foam was then introduced by Prudential Private Capital to a potential equity partner, Mill Point Capital, to help complete the financing package. When the buyout concluded, Huntington Foam received mezzanine financing and senior debt from Prudential Private Capital as well as equity from Mill Point Capital. Ultimately, the company sourced the capital they needed to pursue their ambitious, long-term growth objectives.*

Mezzanine financing is typically used by the current management team of a company to buy out the current owners, such as private equity or other investors, and gain control of the business.

3 Management Buyouts

In relation to management buyouts, mezzanine financing is typically used by the current management team of a company to buy out the current owners, such as private equity or other investors, and gain control of the business. Therefore, this allows the management team to determine the direction of the company, grow the business and benefit from future equity value creation.

***Example:** The institutional investor that had majority ownership of Comm-Works decided to launch a formal sale process to realize its investment after an eight-year holding period. Excited by the opportunity to continue to grow the business, the existing Comm-Works management team negotiated a purchase offer and approached the market via SPP Capital Partners; they were seeking a combination of debt and equity financing to support a management-led buyout. The management team obtained a senior revolving credit facility, senior term loan, senior subordinated notes and preferred equity, from one lender, to supplement their equity contribution in support of the acquisition. The financing package also enabled the management team to significantly increase its ownership position and establish majority control of Comm-Works.*

4 Growth Capital

Using mezzanine financing for growth capital could help companies achieve their goals for organic growth, such as significant capital expenditures, or constructing a large quantity of facilities. Growth capital can also be used to enter new markets by developing new products and/or subsidiaries.

***Example: Interface** was seeking growth capital to help facilitate their strategic organic growth and expansion. The company ultimately received mezzanine financing as well as preferred equity, in addition to a newly syndicated bank facility. With the necessary capital now available to Interface, the company can continue to deliver industry-leading organic growth.*

“Mezzanine could be utilized in any situation in which the need for funds exceeds what the senior lenders will provide.”

- Mark Hoffmeister, Managing Director,
Prudential Private Capital

5 Acquisitions

Mezzanine financing can serve as financing for acquisitions, where companies purchase other businesses with the goal of growing and responding to customers' needs more quickly. Through acquisitions, companies can also access adjacent markets as well as diversify their customer base.

Example: KeHE Distributors, LLC was presented with the opportunity to make a transformative acquisition of one of its largest competitors in the natural and organic food space. To accomplish this acquisition, KeHE needed an amount of junior capital that exceeded the abilities of most middle-market mezzanine investors. The company found a mezzanine financing provider that had the appropriate capital and appetite for the deal. In the end, KeHE received \$80 million junior capital, \$60 of which was mezzanine financing, and were able to make a successful purchase offer.

6 Shareholder Buyouts

Shareholder buyouts can be especially appealing to family-owned businesses who want to increase their ownership stake by repurchasing shares that may have fallen out of the hands of the family; these transactions are often accomplished utilizing mezzanine financing.

Example: After having completed a sizeable acquisition of another bottling facility, Polar Corp., a fourth-generation, family-owned business faced a new challenge – recapitalizing the balance sheet so that it could buy out a minority shareholder and subordinated debt lender who had reached its intended investment time horizon. Polar utilized mezzanine financing and preferred equity, along with a senior credit facility to buy out the shareholder, greatly increasing their ownership stake.

Refinancings using mezzanine financing add flexibility to a company's debt capital structure, better preparing them to seize opportunities like acquisitions and shareholder buyouts.

7 Refinancings

Refinancings are commonly done using mezzanine financing to pay off or replace existing debt to take advantage of lower interest rates and/or better terms.

Refinancings using mezzanine financing add flexibility to a company's debt capital structure, better preparing them to seize opportunities like acquisitions and shareholder buyouts.

***Example: Century Gaming** was looking to establish a set of capital providers that could support the business as it continues to grow. The company's management team largely wanted to refinance existing debt. Century Gaming ultimately obtained mezzanine financing in combination with a senior credit facility to replace the debt they currently had on the books. Adding a patient layer of mezzanine financing will support the growth of Century Gaming for the long term.*

8 Balance Sheet Restructurings

Due to its patient nature, mezzanine financing is also well-suited for balance sheet restructurings. Adding mezzanine financing to a company's balance sheet can optimize their debt capital structure, helping to fulfill debt requirements for transactions, such as acquisitions and management buyouts, while giving the company time to recover from those expenses. It can also satisfy a senior lender's requirement for a junior capital raise or create additional senior debt capacity for a business. A balance sheet restructuring can be done in combination with a larger transaction, such as a full refinancing of the debt capital structure or a growth event for the business; it can also be done as a standalone transaction.

Example: ARCA had planned to acquire CTS Group, an Italian provider of cash recyclers and check scanners, but was challenged by an inability to secure a proper cross-border financing package that would fulfill acquisition debt needs and the structuring requirements of the prospective Italian sellers. ARCA proceeded to secure mezzanine financing as well as senior debt and a revolving credit facility, allowing the company to meet the requirements of CTS Group's sellers and complete the acquisition, better positioning them to achieve their long-term strategic goals.

There are many uses for mezzanine financing, as its patient, solution-oriented qualities make it an ideal capital resource for companies that need capital beyond senior debt, in order to fulfill an immediate need that supports the lasting success of the business.

The Value of Mezzanine Financing

The fundamental characteristics of mezzanine financing benefit companies in a variety of ways, but the value can be largely attributed to it being less dilutive, the flexibility it provides as well as its patient nature.

When raising capital, most business owners strive to minimize the amount of equity they have to give up – mezzanine financing enables them to do this by maximizing total leverage with little to no equity dilution. A mezzanine-led recapitalization typically results in the existing shareholders retaining majority control of the company as well as controlling the board and management.

With mezzanine financing, the investor can provide capital beyond what a bank would typically be comfortable underwriting, thus, providing companies with the flexibility to achieve goals that require capital outside the limits of senior debt.

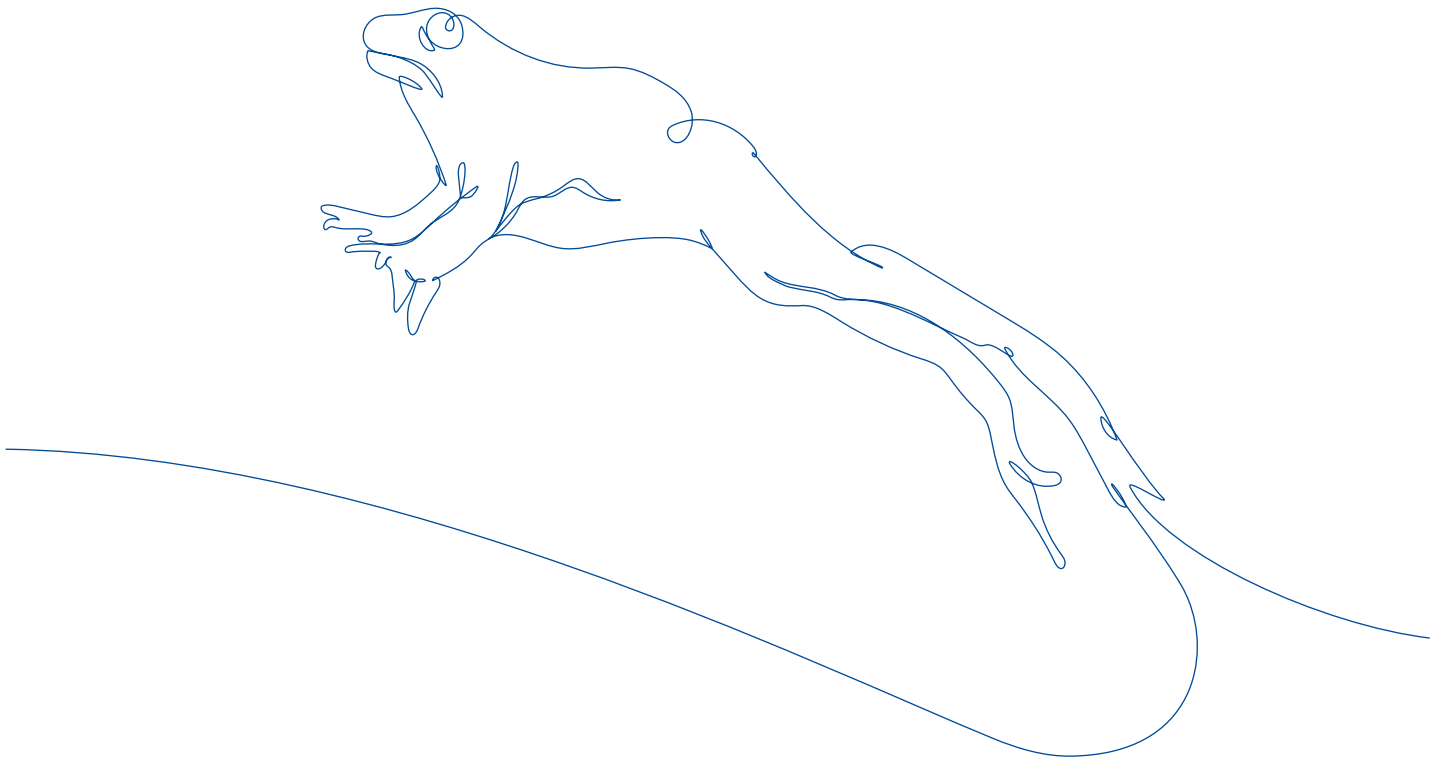
One of the key benefits of mezzanine financing is that it is patient during times of difficulty. Mezzanine financing is subordinate to the senior debt, from a structural standpoint, and does not usually require any amortization prior to maturity. Mezzanine financing also typically has a 7-8-year bullet maturity. This keeps the senior lenders comfortable as well as gives management the time needed to deal with any issues that arise before having to address that maturity.

Ultimately, mezzanine financing allows business owners to maintain control and fund growth goals or other needs beyond what their senior debt capacity will allow, while serving as a patient piece of capital in the background.

“If you have a view that your business is going to be worth more tomorrow, than it is today, then issuing mezzanine capital can create greater value for the shareholders over time.”

- Matthew Harvey, Managing Director,
Prudential Private Capital

What to Expect When You're Raising Mezzanine Financing



Companies seeking to grow quickly, either organically or through acquisitions, or complete other objectives beyond the capacity of available senior financing, such as a recapitalization or shareholder buyout, may utilize mezzanine financing. The process for completing a mezzanine financing transaction might seem overwhelming at first, but mezzanine financing is a useful capital raising alternative that is well-suited for a variety of situations.

Additionally, **working with an institutional mezzanine provider can help companies leapfrog to a new level of sophistication**, with better governance, financial systems and capital structure flexibility, leaving them in a better position than they were before.

Who are the Potential Partners?

To complete a successful mezzanine financing transaction, a company will need to surround itself with a few key players to facilitate the process:

The Investor/Lender

The mezzanine financing investor should act as a partner and spend the time required to fully understand the business as well as structure the financing in a manner that best fits the needs and goals of the business, its owners and the management team. Typical mezzanine providers include mezzanine funds and large institutional investors. It is important to ensure that the transaction opportunity fits within the investment mandate for the investor, such as investment size, business profile as well as investment horizon, and that the investor is aligned with the business owners on supporting the direction and objectives of the business.

Consultants

Mezzanine investors typically hire third-party consultants to assist them in conducting due diligence; this may include reviewing the historical financial results and long-term prospects of the company as well as performing a commercial assessment of the company and its market position. It could also include utilizing a specialist firm to examine specifics of a business, such as its technology position. Ultimately, the scope of this third party due diligence is determined by the nature of the mezzanine investment and will be mutually agreed upon between the investor and the company. A company, management team or ownership group may also hire third-party consultants to help them assess capital structure alternatives as well as provide advice on the financing structure and terms.

Auditors

If a company does not already have audited financials, investors will require annual audits on a 'go-forward' basis.

Attorneys

Both the company and investor will select legal partners to draft documentation. To facilitate a faster and smoother process, it would be in a company's interest to choose a legal partner that has experience with mezzanine transaction documentation.

The process for completing a mezzanine financing transaction can vary depending on the type of transaction and needs of the company, but it generally takes 6-10 weeks.

The Process for a Mezzanine Financing Transaction

1 Initial Due Diligence

During this stage, the investor learns as much as they can about the business via discussions and Q&A with the company's management team, company presentations and data/information requests. This information is used by the investor to determine if the company fits within their investment mandate, to assess the risk level associated with providing capital to the company, to hold preliminary internal discussions on the investment opportunity as well as prepare preliminary feedback to share with the company.

2 Preliminary Feedback

The investor shares verbal feedback on their investment appetite and potential structure with the company to determine if it fits within the company's goals, objectives and expectations. This stage enables both parties to decide if there is a 'meeting of the minds' on the potential financing, in which case, this feedback can be formalized and expanded upon in the next stage.

3 Indivative Terms

Typically, the investor requires a meeting with their investment committee to formally discuss the opportunity before providing a term sheet. Afterwards, the investor sends a term sheet to the company to add further detail to the preliminary feedback provided in the prior stage. The term sheet specifies the economic terms and structure as well as the investor's rights and requirements associated with providing capital; it also delineates the relationship between the different participants in the company's capital structure, including the provider of the senior debt, mezzanine investor and equity owners. The term sheet generally begins as a 'high-level' or preliminary document, with additional detail and refinement provided over time, as the investor completes further due diligence, and the company and investor negotiate a transaction structure.

While the primary purpose of the third-party due diligence is for the investor, the company will often take advantage of this opportunity to further 'professionalize' their business.



4 Confirmatory Due Diligence (Business Documentation)

Once a general agreement has been reached on the transaction terms, and the company confirms that they would like to proceed with the proposed financing, the investor finalizes their due diligence process; this typically involves the use of third-party consultants, as previously mentioned, to help assess the financial, operational and commercial position of the company. While the primary purpose of the third-party due diligence is for the investor, the company will often take advantage of this opportunity to further 'professionalize' their business and to ensure that the findings of the consultants are useful to the management team.

Following completion of Confirmatory Due Diligence, the investor presents all findings to their investment committee.

5 Commitment Letter

After receiving the investment committee's approval on the financing, the investor provides a commitment letter to the company, confirming the economic terms of the financing agreement. The term sheet is finalized at this stage.

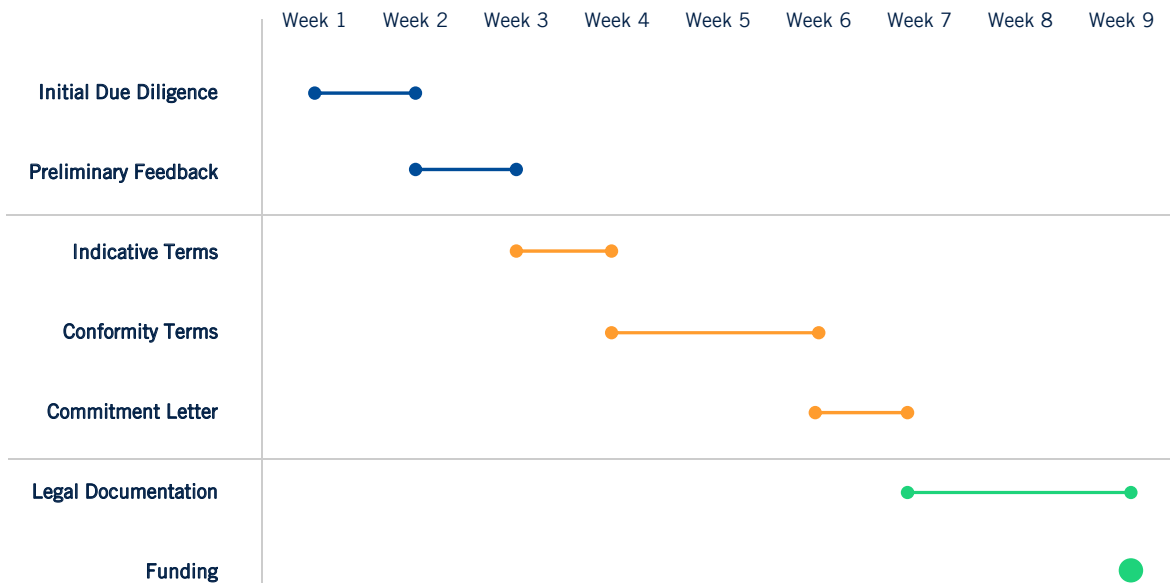
6 Legal Documentation

Legal partners for both the company and the investor are selected, and the transaction legal documentation is completed. During this stage, any remaining business terms are negotiated. If mezzanine financing needs to be expedited, legal documentation can begin at the same time as the Confirmatory Due Diligence stage.

7 Funding

Once legal documentation is finalized and the transaction documents have been signed by all parties, the investor transfers capital to the company.

Typical Mezzanine Investment Timeline



While the process for evaluating and completing a mezzanine financing transaction may appear to be daunting, working with an experienced investor will help simplify this process as well as ensure efficient transaction execution, providing companies with the capital resources needed to accomplish their goals.

Mezzanine Financing Case Study: MooreCo

MooreCo Completes a Management Buyout Utilizing Mezzanine

For MooreCo, Inc., providing customers with the highest quality products is of utmost importance. Headquartered in Temple, Texas, MooreCo is a leader in the educational and commercial markets for visual communication products, technology support equipment and furniture. With state of the art equipment, highly trained employees, and excellent logistics and shipping systems, MooreCo has established a widely-recognized reputation for quality and reliability. Most recently, MooreCo integrated Vanerum Stelter from Belgium into its family of brands, expanding their product offering into the architectural and design marketplace.

In late 2016, Greg Moore, President and CEO of MooreCo, sought a financial partner to support the management buyout of MooreCo from Webster Capital as well as the recapitalization of the company. Working closely with the management team to assess their needs, Prudential Private Capital structured a one-stop financing solution incorporating senior debt, subordinated debt and structured equity.

The management team at MooreCo opted to partner with Prudential Private Capital based on its long-term, relationship-based investment strategy and ability to craft a one-stop financing solution that met the team's goals. Westlake Securities, a Texas-based investment banking firm, served as financial advisor and placement agent on the transaction.

The completion of the transaction will enable MooreCo to explore future growth opportunities as well as strengthen its position in existing markets.

Prudential Private Capital



There are many important considerations for a company when determining whether to issue mezzanine financing. When choosing a lender or investor, some key characteristics to look for are:

- They are a sounding board to the financial leaders within a company – the mezzanine financing provider can help brainstorm and provide an honest opinion on which types and combinations of capital would best fit the needs of the business
- Because mezzanine financing supports long-term growth, it is vital for the mezzanine financing provider to have the capacity to grow as a financial partner as well as have the knowledge and experience to help a company navigate through challenging times
- They are relationship-oriented rather than transaction-oriented. It's important that the mezzanine financing provider show interest in supporting the long-term strategies of the companies they finance as well as work to understand the needs of the businesses and how they function
- The mezzanine financing provider is fast-acting, responsive and has access to key decision-makers within their organization
- They have a demonstrated track record of delivering mezzanine capital throughout market cycles and the calendar year
- They follow through on their commitments
- The mezzanine financing provider has in-depth experience investing in a variety of industries and can tap into that experience when approaching the needs of your business

Ultimately, it is most important to find a mezzanine financing provider who will be a strong partner that supports the goals of your company. If you're interested in issuing mezzanine financing, Prudential Private Capital is here to help. Please visit prudentialprivatecapital.com for more information.

