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BOX

STRATEGIES FOR ADVISORS FROM ADVISORS

MONEY IN THE MIDDLE

BY **Ken Stern**, *an investment and insurance planning advisor with Creative Planning Financial Group in Toronto.*

Mezzanine financing offers a new opportunity for portfolio diversification.

AS a conscientious retail investment advisor, I'm always on the lookout for ways to improve portfolio diversification for my clients.

Bonds or fixed income, the traditional choices, do provide a modicum of diversity but they've been around forever and have limitations. It used to be an advisor could achieve the desired diversification, along with a modest return, from the fixed-income portion of a portfolio. However, with today's low interest rates, and the fact that there's very little incentive to use longer maturities to boost returns, I've been searching for something better.

The quest has led me to an innovative solution to the diversity dilemma: mezzanine financing, a category of asset-backed securities that up until now hasn't been readily available to retail investors. But what is it and why do some companies use it?

Cash is the lifeblood of any business. It's required to finance the gamut of activities from rent, hardware acquisition and labour to materials and inventory purchase. Cash is also crucial to corporate acquisitions, succession planning, management buyouts, and leveraged buyouts. The problem is our ultra-conservative Canadian banks will often lend only a portion of the cash growing companies need. So where does the additional money come from?

One alternative for companies needing financing is senior debt. This is fully collateralized debt coming from the first lien against current and long-term assets, such as any property the business owns, its production plant, or its equipment. It's called senior debt because in the event of bankruptcy or liquidation of assets, the holders of this debt get paid first. Typically, senior debt is held by the bank and so-called senior loans normally don't entitle the lender to obtain any stock options or warrants. Therefore, buyers of senior debt generally don't benefit from any appreciation of the value of the business.

One Flight Up

Mezzanine financing, by contrast, is used exclusively by private companies; often to fund some of the less traditional financing needs such as business expansion, raising cash to smooth a succession planning scheme, or for management buyouts. It's sometimes known as private-placement or high-yield debt and it serves as an additional financing opportunity that sits between the bank funding and traditional equity investors.

If you think of the ground floor of a building as representing a company's basic bank financing, the first floor would represent senior debt. Mezzanine financing fits exactly where you'd think it would—on the mezzanine between the ground floor and the first floor. It's a hybrid of debt and equity financing, and often gives lenders the right to convert to an ownership or equity interest in the company if the loan isn't paid back on time and in full. In terms of structure, it's usually subordinated to debt provided by a senior lender such as a bank.

An obvious advantage to mezzanine financing is the interest is tax-deductible. It's also treated like equity on a company's balance sheet, **continued on page 10** continued from page 9 and often makes it easier for the company to obtain standard bank financing. To attract mezzanine financing, a company usually must demonstrate a track record within its industry segment, have an established reputation and product, a history of profitability, and a viable expansion plan for the business (e.g. acquisitions, initial public offerings, etc.).

At the higher-risk end of mezzanine financing, interest rates are often in the 20%-to-30% range; however, for more secure, lower-risk loans, rates can fall as low as 12%.

Prudent Underwriting

As far as I can determine, only one company, Toronto-based ROI Capital, provides the general retail investing public with access to this type of product. The firm is only five years old, although the principals of ROI have been involved in mezzanine financing on the institutional side for many years. Their first retail offering was a Labour Sponsored Investment Fund (LSIF) that invested strictly in mezzanine financing—instead of the venture capital and start-up equity typically favoured by the fund.

Last year, the company launched two offerings modelled after pension funds that include private placements as a key asset class. In addition to the assets found in a traditional balanced fund, both ROI pension funds allocate between 15% and 20% to mezzanine debt. Since ROI is a highly specialized firm, it outsources management of the fixed income and equity portions of its Canadian Pension Fund to Sceptre Investment Counsel. The Global Pension Fund outsources to two other highly ranked global institutional money managers. The mezzanine component embedded in these funds acts as a steadying hand when measuring risk.

In early 2007, the company also launched a private-placement fund, a pure play on mezzanine financing that's managed completely by ROI. That product is only available to accredited investors through an offering memorandum.

ROI operates at the more conservative end of the lending world and undertakes significant due diligence prior to making a loan. Once the money has been advanced, the firm conducts monthly on-site audits to ensure the loan's proceeds are being used for their intended purpose, that the business being financed remains on track, and that none of the covenants in the loan agreement have been breached.

Sample Criteria

ROI applies a number of tests to determine if a company is a good risk. First off, it wants to witness strong and consistent free cash flow over at least the past five to six years, because that demonstrates the company's ability to service debt payments, which in the case of ROI always consist of principal and interest. The lender also wants to see:

- A strong management team. An ideal team would have good operations as well as accounting personnel. An involved and committed owner and operator would also be a compelling factor for lending.
- Asset coverage. Although mezzanine loans are typically secured solely by the cash flows of the business, ROI registers a general security agreement (GSA) on all assets of the company. In a liquidation scenario, any remaining debt to ROI would fall second in priority on all proceeds.
- Skin in the game. Shareholders, especially those involved in operating the companies, must have a stake in the outcome and be directly subject to at least moderate personal financial risk.
- Strong balance sheet. The company should not be over-leveraged, and must boast a debt-to-equity ratio of 2.5 or less. Equity could be in the form of shareholder loans or retained earnings.
- Diversified sales base. Ideally, business risk should be diversified so that no single customer would represent 10% or more of total company sales.

Many companies are in need of this type of financing, but from a lender's point of view it's important to be selective about which deals are accepted. The terms and conditions set by the loan agreements must be strictly obeyed. ROI always employs a general security agreement against both tangible assets such as buildings (which are conservatively valued at close to fire-sale prices) and intangible assets such as the firm's intellectual property. And it takes the cash flow for each loan into consideration. The lender further insists the business owners either have a significant equity interest or own the firm outright. In almost every case, lending agreements are structured to place ROI's claim in the event of liquidation ahead of the interests of the owners.

Investors, of course, are mostly worried about borrower default and the risk of fraud. The lender's insistence on adhering to a regimen of scheduled monthly audits makes fraud difficult for the company to perpetrate and default risk is mitigated by the fact that all ROI loans are structured to include principal and interest, on a fully amortized basis. Loan terms are typically no longer than five years. So, even if a default occurs after two years, 40% of the principal and interest payments of 12% or more per annum would have already been collected.

Or, let's say a company defaults or breaches a covenant after three years of a five-year term. If the loan is called, the company will have already paid back 60% of the principal plus three years worth of interest, so risk to unitholders is constantly being reduced. And, even though the principal has been partially repaid, ROI continues to retain the initial amount of security in full, which reduces financial risk even further. This high capital recovery rate drastically reduces investors' exposure to default over time. It also provides a built-in exit strategy that's not reliant on an IPO or other similar event.

In addition, the company employs an independent investment management committee which must approve all deals. Diversification is achieved by reaching the firm's goal of having between 20 and 30 loans outstanding at any one time, with none representing more than 5% of total debt.

The Advantages

When used as a strategic component of a traditional portfolio, mezzanine financing is an alternative asset class that has no performance correlation to the public stock or bond markets. With no day-to-day market fluctuations, it also boasts a steady return profile that offers the stability of fixed-payment debt with the possibility of higher returns.

And that's the beauty of the instrument. Let's say ABC Ltd. is a solid company that's been in business for 10 years and manufactures advanced digital printers for the publishing industry. It needs money to expand but has already maxed out at its bank, so the company arranges for mezzanine financing.

By using that financing tool, ABC Ltd.'s business, and therefore its ability to repay debt, is not affected by the daily gyrations of the stock or bond markets. This total non-correlation is evinced by the fact that, despite the equity market turmoil experienced this past summer, the private placement fund's net asset value continued to climb steadily.

We have an obligation to continue looking for new and better ideas that will help people reach their investing goals. It's also beneficial when we can create more pension-like investments that offer lower risk without sacrificing much return. Advisors would be well advised to take some time to understand the role mezzanine debt financing can play in providing better, risk-adjusted return for their clients. AE

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