Seller Notes and Mezzanine Debt – How and Why Are They Used?

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There are two sources of junior debt capital that can be used in addition to senior debt and equity for buyouts and recapitalizations of closely held companies. These sources of capital are often utilized because senior lenders typically provide 50% or less of the purchase price for a company. In addition, financial buyers seek to realize appropriate returns and have limits on the amount of equity they can invest in a transaction. According to GF Data Resources, financial buyers structured transactions by investing 33% – 37% of the purchase price in equity since 2010. The use of seller notes or mezzanine debt to bridge the gap between senior debt and equity can increase value for sellers and enhance returns for buyers.

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The following table shows how a typical buyer could structure a transaction valued at 5x – 8x EBITDA. (See Chart 1)

Seller notes are generally used for transactions that have unique credit characteristics such as small size, significant customer concentration, high capital intensity, additional growth capital needs, cyclicality or seasonality, or less predictable earnings performance.

These notes are deeply subordinated promissory notes that bear an interest rate of 6% – 10%. Scheduled principal payments, and in some cases, interest are due in one to two years after the term of the bank debt and have little or no rights relative to the senior lender.

If the seller has confidence in the business and the buyer, seller financing can be a useful tool in bridging a value gap. There are a number of benefits to using seller notes in a transaction. In addition to allowing buyers to justify higher purchase prices, seller notes can accelerate a closing, as negotiating the terms of seller notes is far less complicated than with mezzanine debt. Seller notes can also be structured to defer gains, as transactions that meet installment sale treatment don't require payment of the taxes on the gain on sale associated with the notes until the debt is retired. Given the current low interest rates and expected stock market returns, seller notes can be attractive to sellers who know the company, are comfortable with the credit and have few other investment choices that can yield such high fixed returns.

However, there are some disadvantages. The deeply subordinated nature of the debt provides sellers with little recourse if the cash flows of the company are insufficient to service the debt. Also, sellers may sometimes be hesitant to lend money to their former companies, as they don't control the company after the transaction.

Lastly and probably most importantly, given the fixed yield and priority in payment, there is an inherent interest alignment conflict with the seller and the buyer. In many cases, a reason for the sale includes bringing the company to the next level of growth. This often requires increasing the risk profile of the business, which does not benefit a fixed return investor who in many cases is still a significant member of the board and management team. Therefore, many buyers are interested in the sellers rolling into the equity and seeking institutional mezzanine providers.

Mezzanine debt (or subordinated debt) is typically provided by a third party lender, not the bank or a private equity firm. For companies with less than $50 million in cash flow, the largest source of mezzanine debt is from mezzanine funds or insurance companies. Larger transactions can be more broadly syndicated. The largest mezzanine transactions receive ratings from the ratings agencies and are called high-yield debt, or junk bonds. In the current market, these larger transactions can have yields as low as 6%.

Mezzanine debt is typically unsecured, with little to no amortization. Smaller transactions, less than $10 million, can have a second-lien on company's assets and may have a cash flow sweep component. A majority of mezzanine debt has both a current coupon, deferred interest and some form of equity participation. Larger, high-quality transactions have a current coupon and may have deferred or payment-in-kind (PIK) interest that can be paid or deferred (PIK toggle). Covenants are set back from the senior

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debt and are less restrictive. These securities usually have stronger "negative" covenants, which can prevent acquisitions, distributions, or other activities that could adversely impact the credit characteristics of the debt.

Mezzanine debt typically carries 10% – 12% current interest, often a 2% – 4% PIK interest and/or equity warrants for 5% – 15% of the company. In some cases mezzanine investors also participate in equity in lieu of warrants. Transactions supported by financial sponsors often get significantly better pricing than those of entrepreneurially owned companies. Financial sponsors are often able to raise mezzanine debt without warrants because mezzanine lenders view private equity funds as less risky than entrepreneurially owned companies. This is due to their ability to alter poor operating performance through their financial and operating resources. Entrepreneurially owned companies (or non-sponsored transactions) have fewer outside resources, which is reflected in the cost of capital.

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As the earlier example demonstrates, in middle market transactions with EBITDA less than $10 million, total debt is typically 3.5 - 4.0x EBITDA. For larger transactions, total debt can reach 5.0x EBITDA.

For a financial sponsor, the benefits of using mezzanine aside from leveraged returns include a more patient level of capital between the senior debt and common equity (steady hand); no one party controls the largest share of the capital; and the availability of additional capital for growth or add-on acquisitions. (See Chart 2)

In conclusion, equity investors seek certain target returns on capital or investment and seller notes or mezzanine debt provides less expensive capital than equity, allowing buyers to pay higher prices.

Seller debt is an attractive way for buyers to structure transactions and, given low interest rates, can be an attractive place for a seller to invest. However, when sellers are unwilling to utilize seller notes, mezzanine debt can also be appealing.

Mezzanine debt is a complicated security. The nature of any lender or partner is very important, and the cheapest transactions are often not the best overall deal. It is important to have strong professionals who are experienced in negotiating and structuring these securities on your team.

CHART 1

Capital Source	EBITDA Multiple	Percentage of Capital
Bank Debt	2x – 3x	40% – 50%
Seller Notes/Mezzanine Debt	1x – 2x	10% – 25%
Equity	2x – 3x	30% – 40%
Total	5x – 8x	100%

CHART 2

	Seller Notes	Mezzanine
Terms		
Interest Rate	6%-10%	10%-12% plus 2%-4% PIK, plus possible equity participation for small or non-sponsored deals
Maturity	1-2 years after senior	5-7 years
Advantages	Allows buyers to pay higher prices	Allows buyers to pay higher prices
	Less complicated than mezzanine	Raises equity investors' return
	Can accelerate speed to close	More patient capital than seller notes
	Can defer gains	Potential source for additional capital
	Attractive current return for sellers	
Disadvantages	Little recourse for seller note holders if performance suffers	Significant negative covenants for new owners
	Seller note holder has no control	Higher interest burden
	Non-alignment of interest with owners	

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