



Mezzanine Method of Financing

interim international
Round Table Talks on 23 October 2003

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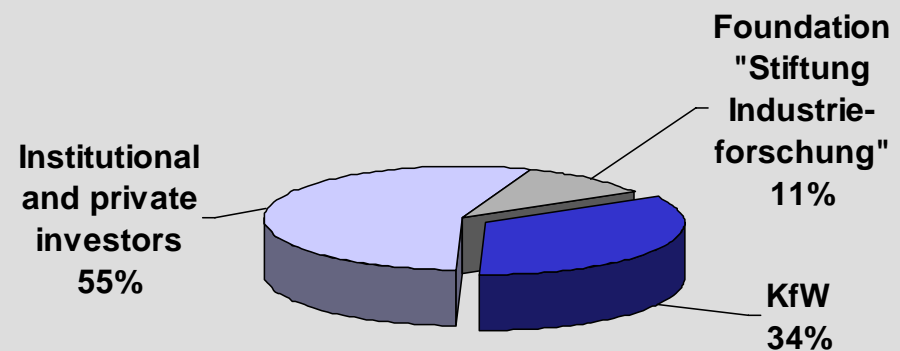
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IKB Deutsche Industriebank AG

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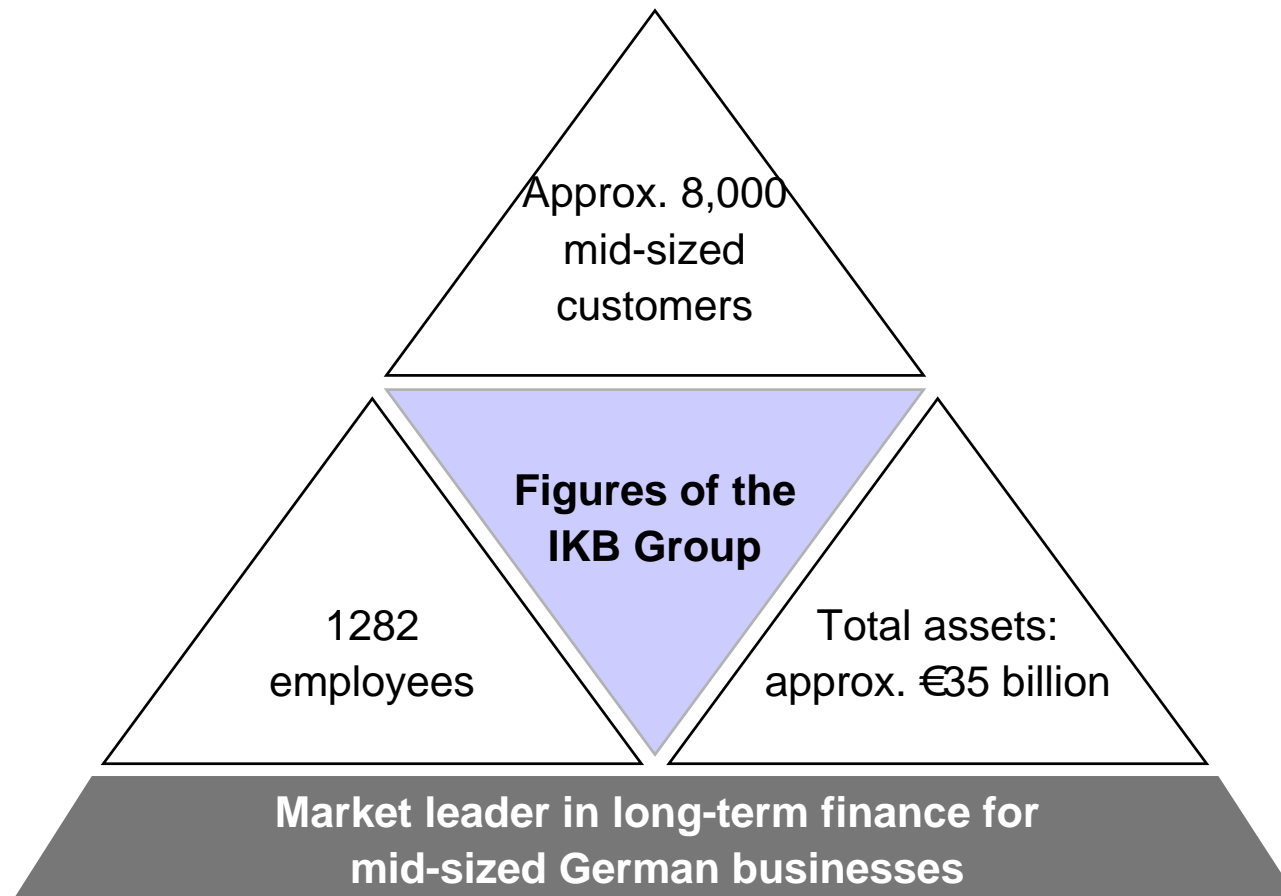
Shareholder structure



- IKB is a special bank for long-term corporate finance.
- IKB has decades of expertise in the banking sector.
- The shareholder structure of IKB guarantees independence.
- The bank has extensive, long-standing connections to companies and associations.

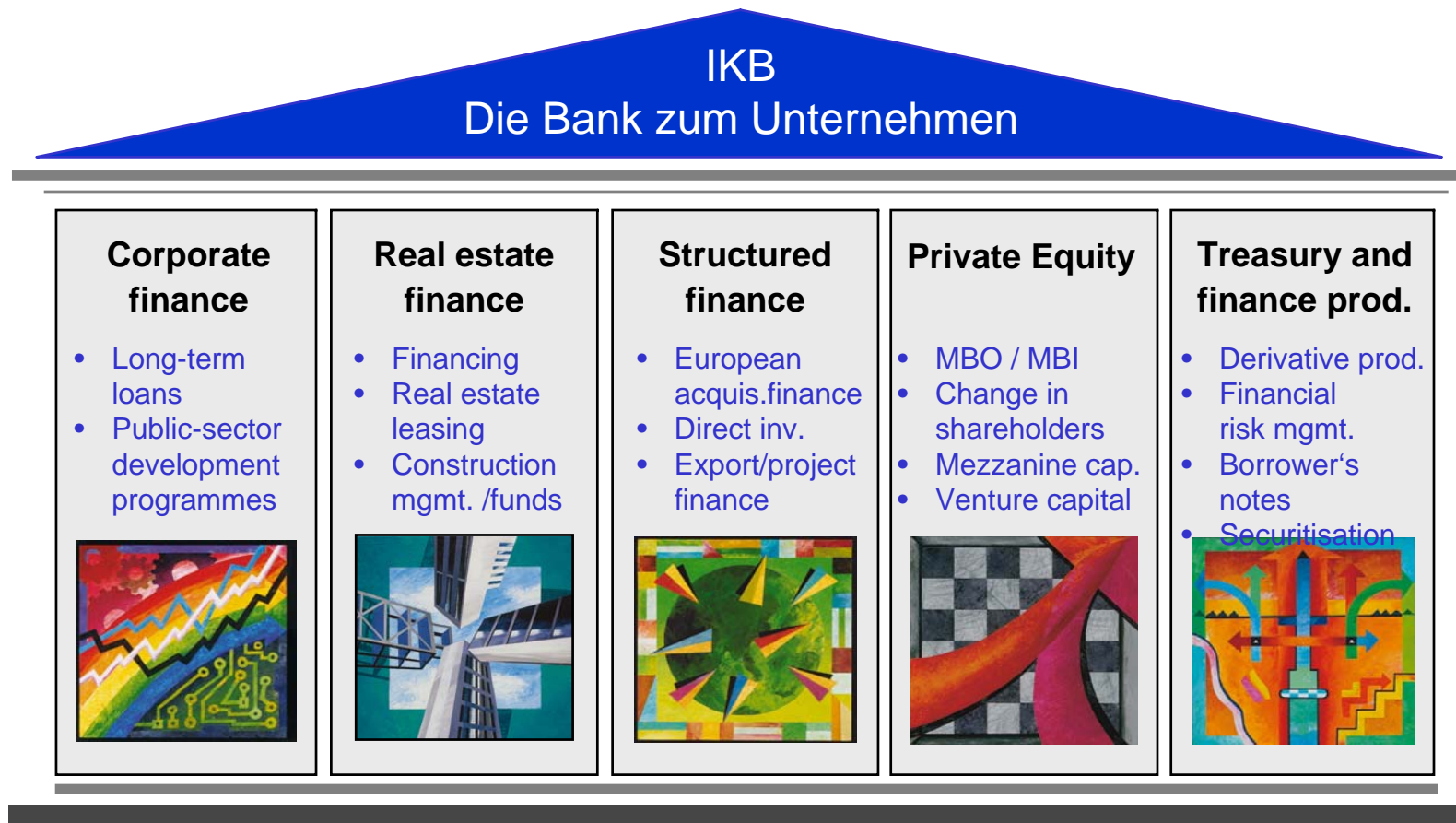
Figures of the IKB Group

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Business segments of the IKB Group

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Definition of mezzanine capital

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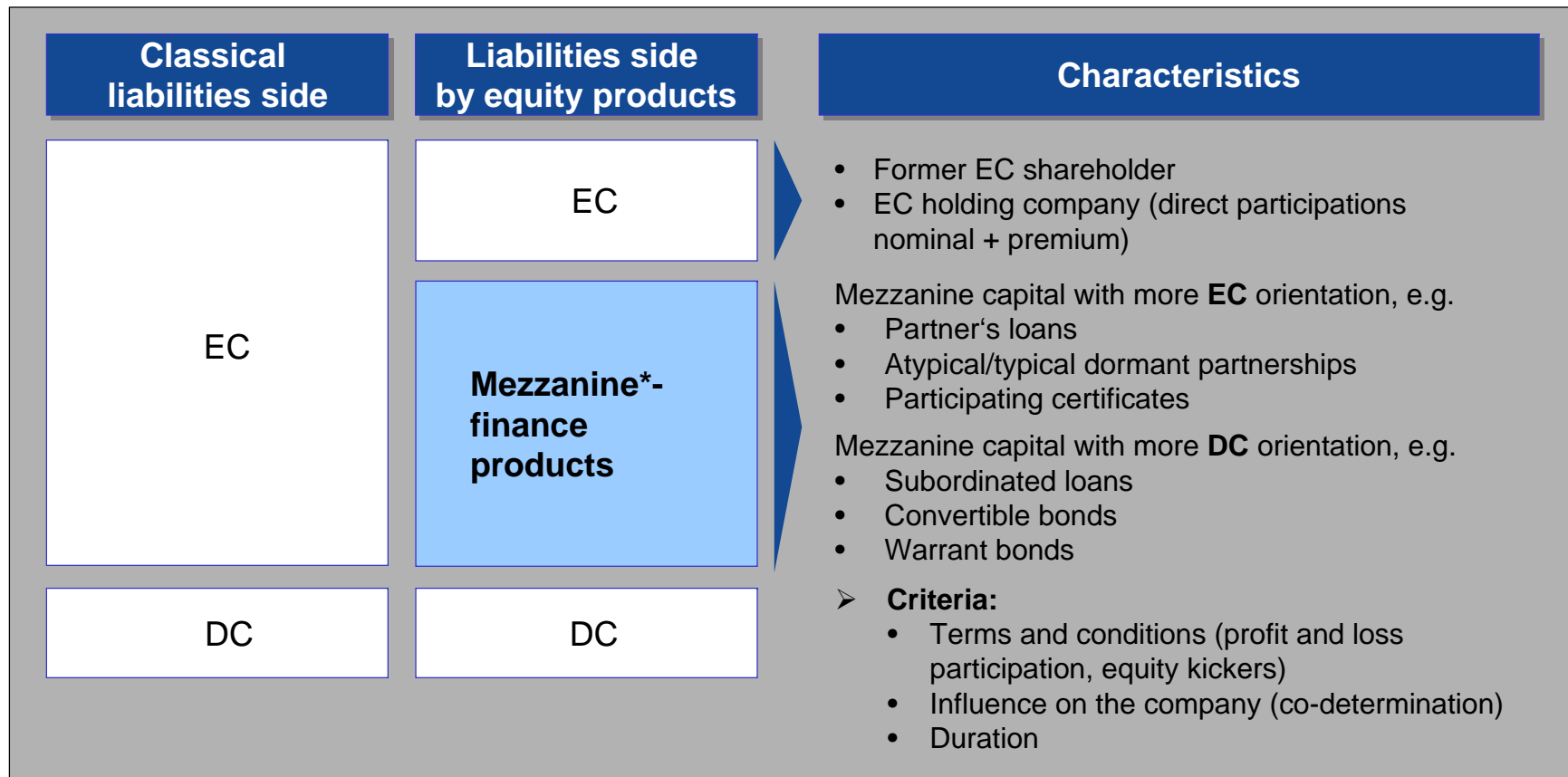
- There is no definition of the term mezzanine capital either in economics or in jurisprudence.
- The word 'mezzanine' is actually a term used in architecture and means intermediate storey. Applied to financing aspects, mezzanine capital forms an intermediate (economical) form between equity and debt capital.
- Despite the ability to clearly allocate it legally to either equity or debt capital, it always has characteristics of the other kind. In other words: mezzanine capital (when considered on its own) is capital that is not provided by partners/shareholders but more or less strongly has near-equity attributes.

Characteristics of mezzanine capital

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- Lower ranking compared to other creditors in the event of insolvency
- Senior ranking compared with the “true“ equity capital
- Temporal limitation of the provision of capital (usually 5 to 10 years)
- Flexibility and versatility as regards the arrangement of the terms of the contract and
- Tax deductibility of interest as operating expenses under commercial and tax law (Note: no deductibility under business tax for atypical dormant partnerships)

Overview of mezzanine capital



EC = equity capital; DC = debt capital

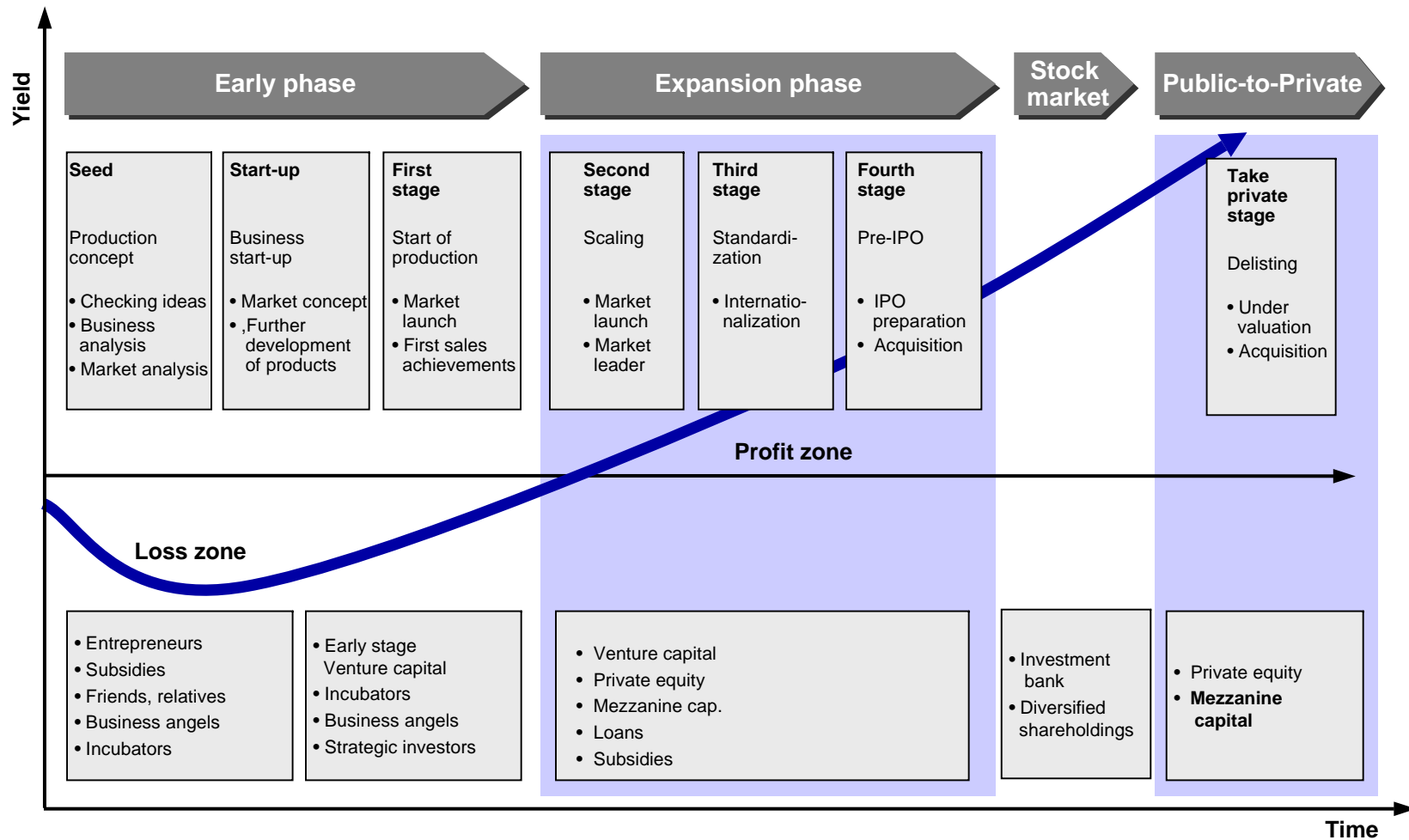
Overview of mezzanine capital (I)

Capital Criteria	Subordinated loan	Seller's loan	Typical dormant partnership	Convertible bond	Profit participation	Atypical dormant partnership
Compensation for lender	Fixed	Fixed	Fixed and variable	Fixed and right of conversion	Fixed and variable	Fixed and variable (equity kicker)
Expected yield for lender p.a.	Approx. 10 – 16 %	Approx. 10 – 16 %	Approx. 12 – 16 %	Approx. 10 – 16 %; for conversion approx. 20 – 30%	Approx. 12 – 16 %	Approx. 12 – 18 %; with equity kicker \geq 20%
Lender's right to obtain information and give approval	Position as creditor, usually with veto rights	Position as creditor	Contractual rights of approval and control	Position as creditor; after conversion position as partner/shareholder	Contractual rights of approval and control	Position as co-entrepreneur, contractual rights of approval and control
Liability in the event of insolvency	No, but subordinate ranking to creditors	No, but possibly subordinate ranking to creditors	No, but subordinate ranking to creditors	No, but possibly subordinate ranking to creditors	No, but possibly subordinate ranking to creditors	Yes
Balance sheet equity	No	No	Depending on arrangements	Only after conversion	Depending on arrangements	Yes

Overview of mezzanine capital (II)

Capital Criteria	Subordinated loan	Seller's loan	Typical dormant partnership	Convertible bond	Profit participation	Atypical dormant partnership
Economic EC in rating process	Yes	Yes	Yes	Only after conversion	Yes (if arranged as such)	Yes
Company rating	Not necessary	Not necessary	Not necessary	Necessary upon entry	Not necessary	Not necessary
Participation in losses	No	No	Usually yes	No	Usually yes	Usually yes

Areas of application



Yield elements (I)

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- The total yield of all versions of mezzanine capital can ultimately be broken down into an interest and a kicker element.
- Both components have a diametric relation to one another in terms of their measurement: one lower (relatively safe) interest element must be compensated by a very much higher (relatively unsafe) kicker element.
- Within a mezzanine finance transaction it is possible for there to be different rankings and deadlines for individual tranches. The more subordinated and long-term the mezzanine tranche is structured, the higher is the premium.

Yield elements (II)

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- The kicker component can appear in different forms, namely as
 - a subscription right or an option (warrant) for a corporate bond,
 - a virtual option agreement which defines an as-if participation (virtual equity kicker or phantom warrant),
 - a right to convert the mezzanine loan into equity (conversion privilege) and
 - a premium payment upon maturity of the mezzanine loan (back-end fee) depending on the increase in value as a going concern.

Covenants (I)

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Legal Covenants:

- Seat on the advisory board or supervisory board for the mezzanine investor,
- No sale of major assets without the approval of the mezzanine investor,
- Right to obtain information, participate, control and terminate concerning certain company occurrences.

Financial Covenants:

- Interest coverage ratios (total interest cover, debt cover),
- Equity and debt ratios (equity ratio),
- Performance ratios and
- Free cash flow developments.

Exit Covenants:

- Provide for cases where the Management or main partner/shareholder does not want to list the company on the stock exchange after a period agreed in advance (going public) or does not give its approval to the sale to a strategic investor (trade sale).
- One possibility for an exit covenant is when the mezzanine investor receives shares in the company after a certain period via the equity kicker agreement and can sell these shares to former partners/shareholders via a put option after an independent valuation is carried out.

Pros and cons of mezzanine capital

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Advantages

- Equity equivalence
- No or little capital dilution
- Reduction of the regular finance costs
- High flexibility
- Smart money
- Tax optimization
- Easy to combine with other finance products

Disadvantages

- High capital growth potential
- Minimum volumes
- Limited in time
- Higher financing costs than for conventional debt capital
- Diverging interests

Financing with mezzanine capital

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Ideal candidates should (I):

- have experienced manager(s),
- not be subject to rapid technological progress,
- have a strong market position,
- operate at a profit,
- have an advanced internal and external reporting system,
- be willing to meet the high disclosure requirements of mezzanine investors.

Ideal candidates should (II):

- have a balance sheet structure with sufficient potential to include mezzanine capital,
- have positive, stable and easily predictable operative free cash flows (FCFs),
- earn acceptable margins,
- offer the possibility of exiting within the next 3 to 8 years,
- have a transparent legal structure and
- have quantifiable liabilities.

Financing with mezzanine capital

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Frequent faults made on the way to financing with mezzanine capital:

- Unprofessional inquiry
- Attempt to establish competition between mezzanine investors
- No or poorly prepared business plan / restrictive provision of information
- Attempt to conceal problematic areas / areas of risk
- Unrealistic ideas about the value as a going concern

Financing with mezzanine capital

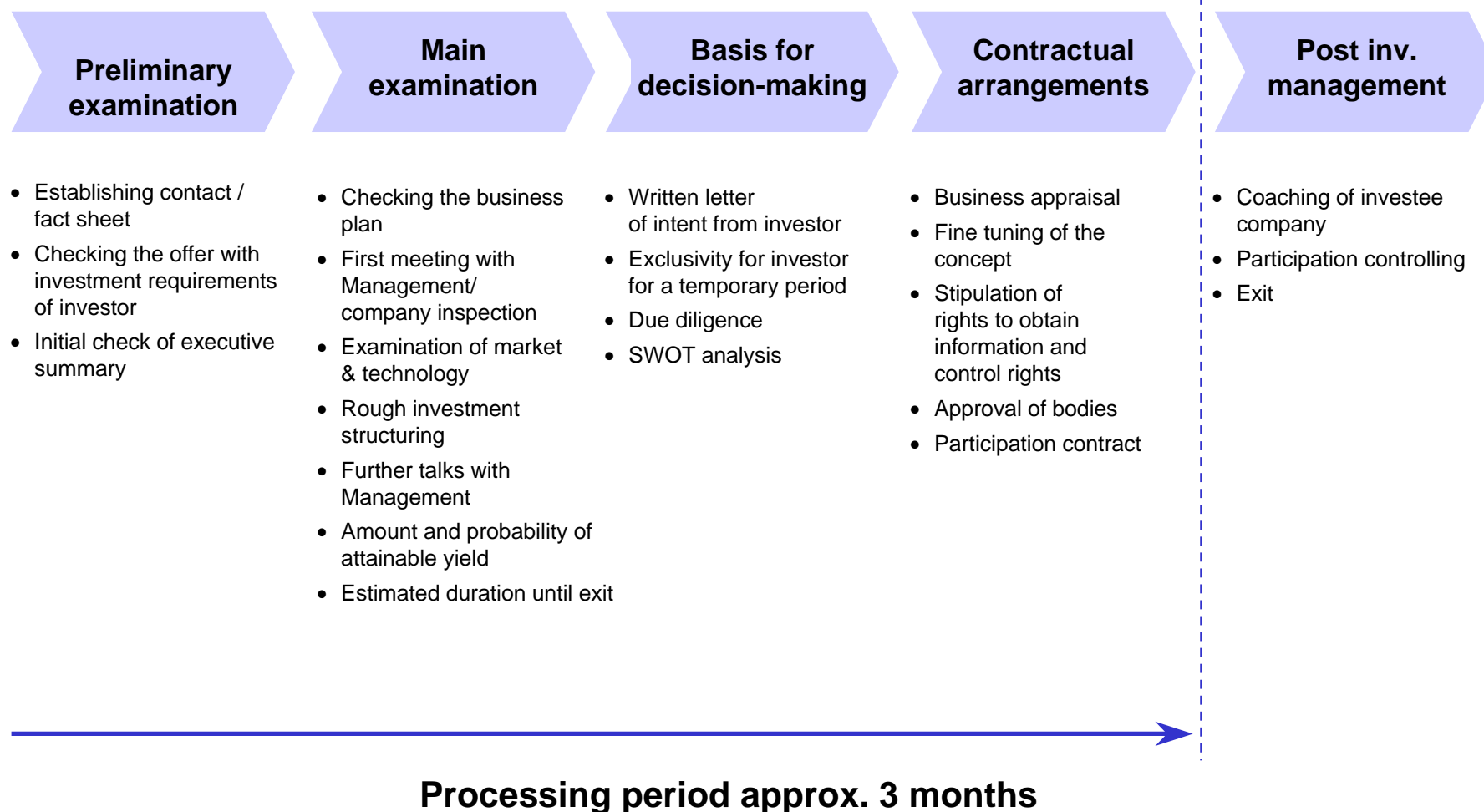
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IKB KfW Funds

Volume	€100 million
Investors	60 % IKB PE / 40 % KfW (PEP programme)
Form of participation	Atypical dormant partnership (with participation in profits and losses [<i>based on percentage of contribution</i>])
Investment period	2 – 3 years (start 12/02)
Number	At least 20 participations in “stable“ companies
Individual exposure	At least €2.5 million - max. €8 million
Sector	Industry mix based on Moody classification, with 20% max. share per sector
Quality	IKB rating level at least 3.5 before and at least 2.5 after participation
Yield	At least 13 % p. a.
Term of funds	5 – 7 years

Development of a mezzanine finance transaction

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Conclusion

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- Viewed overall, mezzanine capital covers a broad array of financing methods.
- The versions eligible to access the capital market (i.e. listed convertible/option bonds) are rarely applied by mid-sized enterprises due to the high minimum volumes required and because a rating for mid-sized companies has not yet been fully established.
- Of significance in practice are subordinate loans, dormant partnerships and profit-sharing rights as mezzanine financing methods.

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