

# Mezzanine loans – beyond traditional financing

31 July 2023. | Legal Alerts No. 15 | Characteristics of mezzanine loans

This text presents a concise insight into the world of mezzanine loans; a hybrid institute created from the need to seek alternative financing to traditional bank loans. As its name suggests – a mezzanine loan is located between two “layers”, i.e., between senior loans and equity, and can be considered as a hybrid of these two forms of financing.

## Introduction

Mezzanine loans developed during 1980s and are most widespread in the USA and in the UK, while other European countries still lag behind them.

The position of the mezzanine lender is specific in case of debtor’s bankruptcy and liquidation, since then it will collect its claims secondarily, that is, only after the claims of the first-rank creditors have been settled.

A mezzanine loan that has not been settled upon maturity is “converted” into equity and allows the lender to enter the debtor’s ownership structure. This procedure will usually be carried out by means of a warrant, which gives the lender, at a pre-determined price, the right to take over the shares, quantity of which is pre-determined, in case of non-payment of the obligation upon maturity. Taking this into account, the practice is that there is no collateral in mezzanine financing, which also shortens and simplifies implementation and use of this form of financing and makes it more attractive to debtors. However, the interest rate, which is higher than usual, and with which the lender compensates for the absence of a collateral, should not be ignored.

The institute's flexibility enables different agreements to be made, so it is possible, for example, to agree that the lender can convert part or the whole of the loan amount into capital at any time with a warrant.

## Usage

During the period after the banking crisis of 2007 and 2008, when it was difficult for debtors to get new (traditional) loans, mezzanine loans became an

interesting alternative – and since then there has been an increase in their presence.

They are most often used when looking for additional sources of financing for acquisitions that are largely financed by debt and for the previously mentioned management buyouts.

They are also used as a “bridge loan” to secure payment of another loan obligation, whereby a short-term loan is taken to settle some current obligations based on an earlier loan. Mezzanine loans are also commonly used in large real estate and infrastructure projects.

Creditors who offer the possibility of providing mezzanine loans will usually not, due to unprofitability of such lending, be inclined to make smaller investments in newly established companies, start-up companies and SMEs, so it is often the case that creditors for mezzanine loans set a minimum amount of loan of one million euros or more. They are more inclined to lend to companies with experienced management, high levels of growth and stable and predictable cash flow, and the criteria that companies must meet for this type of financing are somewhat stricter than those present in bank loans. In general, it can be concluded that mezzanine loans are not acceptable for companies with a bad market position, which are in the process of restructuring or it is highly likely they will need to restructure, as well as highly indebted companies.

In short, from the range of possible uses of mezzanine loans, the following groups can be singled out as the most interesting:

- acceleration of company growth, expansion to new markets, project financing, real estate;
- refinancing of the company's existing loans in order to reduce dependence on superior loans;
- financing of MBO and LBO.

Common to all these forms is their flexibility, the possibility of combining individual mezzanine financing institutes in order to achieve the desired solution.

### Structure

When financing a single transaction, a mezzanine loan usually occupies up to 15% of the total debt, which reflects its secondary nature compared to "classic" borrowing.

The absence of collateral and existence of subordination in relation to superior lenders has undoubtedly influenced the fact that the interest rates for mezzanine loans are somewhat higher than for other forms of financing and are on average between 10 and 20%, and exceptionally even higher - up to 30%; depending not only on the creditworthiness of the borrower, his financial success, but also on the duration of the loan. However, a mezzanine loan will be a more favorable option than seeking financing through equity capital, and it should be borne in mind that with mezzanine loans there is no "dilution" within the borrower's ownership structure, since the primary motivation of the lender is to make a profit based on an interest rate of loan.

### Emergent forms

Considering the aforementioned flexibility of mezzanine financing, it is not uncommon for the contract to specify, for example:

- participation of the mezzanine lender in the debtor's profit; or
- although it is not prevalent, it is also possible to agree on a consultation with the lender regarding the adoption of individual business decisions.

In practice, another instrument of mezzanine financing is often mentioned, namely convertible bonds, which allow the holder, within a contractually defined period, to acquire shares or ownership in a company instead of settling the obligation based on the convertible bond. Furthermore, a closely related instrument, with one significant difference, is a bond with warrants. The distinguishing feature from convertible bonds is that the warrant is detachable from the bond, and therefore can circulate independently from the bond in legal transactions.

### Presence in Croatia

Although this type of financing is rare in Croatia, at the global level, mezzanine loans are experiencing significant resurgence on a global scale. This is supported by the data published for this year by McKinsey (*McKinsey global private markets review 2023*), which states that the funds collected for mezzanine lending in the past year amounted to 46 billion dollars, i.e. 2.4 times more than in the year before that and the growth of 238% in the last five years, which represents historical maximum for this type of financing. It is to expect that the popularity of mezzanine loans will grow in the incoming period - bearing in mind the stricter lending conditions in combination with the expected growth of interest rates and on the other hand - more flexible conditions for mezzanine loans.