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# Private Equity Challenge - Gelpeixe,

# and an individual contribution on mezzanine financing

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**Abstract**

Four students collaborated to create this work project, which takes the form of an Investment Committee Paper and proposes the leveraged buyout of Gelpeixe, a frozen food firm based in Portugal. An effective value creation plan supported by the best capital structure was devised, following a thorough examination of the business and the industry, returning an IRR of 25.5% and a Money Multiple of 3.0x over the course of five years. Additionally, an individual contribution is included, delving into the topic of mezzanine financing.

**Keywords:** Private equity, Leveraged buyout, Gelpeixe, Acquisition

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## Group Contribution – Investment Committee Paper Summary

### Company profile

Located in Loures, Lisbon, Gelpeixe is a Portuguese leading manufacturer of frozen and deep-frozen fish products, established in 1977. In addition to numerous distinctions as a SME Leader and the SME Excellence Award by IAPMEI (first place in 2009 and 2012, and third place in 2013), the company's leadership position in the market, its proven management, and several competent professional teams all contributed to the establishment of Gelpeixe's reputation, which is now backed by ongoing expansion and high standards. Over 3,000 consumers are already being served by the firm, which currently employs over 150 employees.

The firm now has a daily production capacity of 40 tons thanks to the recently finished expansion of its primary facility in Loures. The business provides a large selection of more than 400 goods and exports 20% or more of its sales to more than 20 nations, on four continents. High-growth European markets like Spain, Poland, and Belgium are the key sales destinations; other important countries to consider include Macau and Angola.

<u>Business model and value chain</u>

The majority of Gelpeixe's fish and seafood purchases come from foreign fishing firms with strong ties to South Africa, Scotland, India, and Alaska. State-owned Docapesca is primarily in charge of providing national harboring supplies. Fish, shellfish, and mollusks from high-seas fisheries are processed and frozen, which account for the majority of the business's sales. After being sliced into pieces, the raw fish and seafood are placed in drained net-weight bags and deep frozen. Gelpeixe keeps its finished goods in storage before selling them to four different types of customers: large wholesalers, who make up the majority of Gelpeixe's sales; large distributors; HORECA (hotels, restaurants, and catering); fishmongers; small shops; and exports for every kind of international customer.

As previously mentioned, the factory now has a maximum production capacity of 40 tons per day, a total area of over 10,000 $m^2$, a capacity for cold storage of 29,000 $m^3$, two production units, and a total of eleven lines after the most recent of five expansions during the factory's existence was put into place. In order to function more efficiently, Gelpeixe also conducts operations in the areas of logistics, distribution, and research and development, all of which are aimed at meeting customer needs and developing new products.

As mentioned above, once implemented the most recent expansion of Loures' factory, the fifth expansion during its existence. It now has a maximum production capacity of 40 tons per day, a total area of over 10,000 $m^2$, a cold storage capacity of 29,000$m^3$, two production units and a total of eleven lines. For efficiency purposes Gelpeixe operates other activities beyond production, including, logistics, distribution, and research, both focused on responding to client's needs and developing new products. Mindlab is the laboratory at the center of Gelpeixe´s research.

Product portfolio

Selling a wide range of products, Gelpeixe produces a substantial number of products sold under large wholesalers' brands, having strong supplier relationships with all of the largest wholesalers in Portugal (e.g., Continente, Pingo Doce, Auchan, Lidl). Gelpeixe owns two brands (GELPEIXE and DELIDU) further segmented into five distinct sub-brands, which account for around 20% of sales. GELPEIXE focus on frozen fish, GELPEIXE Chef pre-cooked fish meals, GELPEIXE Gourmet is directed to seafood, GELPEIXE Professional is directed to HORECA clients selling products in bulk, DELIDU Chef is a sub-brand recently created, and offers a broad selection of non-fish products and pre-cooked meals.

Management team

The effective and knowledgeable management team of Gelpeixe is one of its most important assets. Since 1977, the company has been owned and operated by the same family. The company's numerous successes over the years, including its ongoing internationalization, diversification of its product offering, and development of its own brands, have been made possible by the management team's strong, knowledgeable, and capable leadership.

The key members of the team are Manuel Tarré as co-founder, President, CEO, and President of the Portuguese Frozen Fish Industrial Association since 1994, which demonstrates his experience, knowledge, and significance in this industry; Lídia Tarré as Vice-Chairman, CFO & Marketing Director, daughter of Manuel Tarré, Gelpeixe's third generation, while accumulating the positions of Board member of the Family Business Association, and Portuguese Chamber of Commerce, and Industry. Nuno Rodrigues as Vice-Chairman, Commercial Director & Procurement Director, has been with the company for over 30 years, has experience in different sectors, and is responsible for the company's supply and sales strategy as well as conducting the international expansion planning.

Financial performance

Gelpeixe's financial performance has been steady in recent years both top and bottom lines. The constant performance was affected by 2020's negative covid-19 pandemic shock. Regardless of that, the company was able to increase sales and profit margins in 2021. In terms of revenues, the company has experienced steady growth, with a c.1.7% CAGR, it being relatively higher considering only pre-covid years, at c.3.3% CAGR.

Stable absolute COGS in the last few years have contributed to gross margins between 17% and 20%. The decrease in external supplies and services costs since 2018 is mainly explained by a reduction in energy costs, after Gelpeixe underwent the installation of a large solar plant, contributing to an EBITDA margin increase from 3.6% in 2019 to 6.4% in 2021.

In addition to expanding its asset base, Gelpeixe's €5 million investment in manufacturing development had a substantial influence on its investing cash flow from 2017 to 2019. Regarding free cash flow, it's important to take into account the consequences of the COVID-

19 pandemic in 2020 and 2021, which reflected as lower inventory in 2020, freeing up more cash, and a subsequent net working capital investment in the following year.

Gelpeixe has generated an average cash flow from operating activities of c.€2.3m while keeping low net debt, with exception for the contracted loans which supported its capital investment.

**Market Overview**

<u>Frozen Food</u>

Changes in consumer preferences and growing disposable income across the globe are setting the pace for the frozen food market expansion and are foreseen to keep doing so in the next decade.

The worldwide frozen foods market size is expected to grow annually by 5.9% during the 2021-2027 period. The upward expected trend of this market is supported by several distinct factors, mainly relative to the change in consumer habits. First, the rapidly growing consumer awareness of online retailing coupled with the digitization of the retail industry is fueling the market growth over the forecast period. Secondly, increasing popularity of online grocery shopping among the working population among with an increase in disposable income, in the middle class and in the preference for frozen products all act as catalyst factors for the frozen food market growth. There are other factors of minor importance such as (1) longer shelf-life products, (2) less time for cooking among the working population and (3) increased demand for convenience food.

Narrowing the view into the Portuguese food market, it must be highlighted that in 2021 Frozen foods were the most chosen category by Portuguese consumers, largely driven by the pandemic and the demand for products with a larger useful life span. This uprising demand during the pandemic lead to a historical growth of 17.6% of the Portuguese frozen food segment, compared to the average of 8.1% during the last decade (2011-2021). Market trends in Portugal are in line with global market shifting. Notably, rising innovative solutions being introduced in the market, with the launch of new dishes and new snack varieties. Another major food trend in the national economy are products of natural origin, designed for consumers reducing meat consumption both for health and sustainability reasons. In Portugal alone, 9% of adults are already veggies. Most of the latest brands that are developing or investing in this market have opted for frozen products as the main sales channel.

Macroeconomic Growth Drivers

The European Union will fund Portugal with €393 million until the end of 2027 to promote sustainable fisheries, following previous similar successful initiatives. Besides the shift in consumer habits and enterprises, a partial drive of the frozen food market is lead by national and international funding packages. Namely for the seafood frozen segment, the *Ocean 2030 (Mar 2030)* program must be highlighted. The Ocean 2030 outline is currently in the last negotiation phase to fund c.€393m until the end of 2027. Portugal is expected to fund an additional amount of c.€148m from national funds, to provide in total c.€541m to the Portuguese economy. Companies that operate in the sector of commercialization and transformation of fishing and aquaculture products, according to the pre-approved Ocean 2030 fund, will benefit from €132m in funding (c.24% of the total funding approved). The remaining c.€409m will be allocated primarily towards the promotion of sustainable fishing and improving security and work conditions of fishermen. It is expected that companies operating in the fishing and aquaculture divisions will benefit from these external funds to scale their operations and drive-up revenues. The *Ocean 2030* has already had a previous edition named *Ocean 2020*. From the beginning of *Ocean 2020* until the end of Q3 2022, the fishing and aquaculture sector have benefited from 7.208 approved funded projects. This represents a total deployment of c.€736m of public (€509m) and private (€227m) capital toward the industry. From 2009 to 2015, preparation of fishery and aquaculture products grew c.11%. Since the implementation of the Ocean 2020 Program, the sector grew c.53%, indicating good prospects for the Ocean 2030 funding plan.

Competitive Dynamics within the Portuguese Landscape

The preparation of fishery and aquaculture products market is highly consolidated with c.71% of sales deriving from players that operate in the industry for more than 20 years. Currently there are sixty-five companies operating in the national market and their sales total an amount of c.€485m. The industry has low barriers to entry but newcomers to this market rarely succeed. Only 29% of the companies have been operating in this market for more than 20 years. Even though, these companies represent more than two-thirds of the total revenues. Most companies are spread across the west coast of Portugal, being the prime zones the Lisbon and the Northwest coast. This dispersion is predictable since companies install their headquarters close to their suppliers due to operating and logistics constraints It is important to highlight that while only c. 28% of companies are on the Northwest coast, the region represents c. 40% of national sales. An explanation for this phenomenon is that most distributors are settled in this specific region.

As stated previously, the market is fairly concentrated on a few players. Around 20% of the companies in this industry generate c.75% of the overall revenues. There is a minimal risk associated with new competitors joining the market and gaining considerable market share. Around 23% of the companies that operate in the industry have entered the market in the last 5 years, but these companies only represent c. 3% of total revenues.

Despite the Portuguese market being mostly consolidated in three big players, there is still a significant range of competition from smaller uprising players. According to its market size and business characteristics, the following companies were identified as Gelpeixe's peer group: (1) *Pescanova*, (2) *Frijobel*, (3) *Coelhos & Dias* and (4) *Gialmar*. Given the importance of other competitors, the following companies were identified as its extended competitors: (1) *Luís Silvério & Filhos*, (2) *Mar cabo*, (3) *Biofrescos* and (4) *Beiragel*.

*Gelpeixe* has an estimated 8% to 12% of the market share and is jointly with *Pescanova* and *Frijobel*, one of the big players in the industry. The largest players in the industry seem to be overperforming, being able to provide higher returns on equity and assets; this comes as a consequence of past capital expansions and the ability to scale production.

**Investment Thesis**

As previously stated, both the frozen foods and frozen seafood market is going through a dramatic revitalization growing at more than a 5% annual rate through 2027. In Portugal, the latter is undergoing a profound expansion with double digits growth. One of the leaders in the frozen food sector – the highest-growing sector in Portugal – is *Gelpeixe*.

*Gelpeixe* counts experienced management with proven leadership and substantial industry knowledge. The latter bequeaths *Gelpeixe* a 40-year legacy and pioneer position which enables stable and strong customer relations while leaving *Gelpeixe* well positioned to win public funds. Moreover, *Gelpeixe* has one of the largest diversified frozen food platforms and an unmatched product portfolio. The extensive and diversified product portfolio is in accordance with ISO 9001 and ISO 22000 and has the IFS Food Standard with the highest possible classification.

*Gelpeixe* also has an extensive track record of creating value from the sector, including four decades of steady income while driving significant growth. The company possesses a high and reliable cash generation granting potential production capacity increase to meet market demand

<u>Value creation levers</u>

*Gelpeixe's* historical performance and success, combined with the frozen seafood industry growth in Portugal, suggests the company should thrive in years to come. Our investment thesis is based on three pillars: Accelerating market growth, Buy-Build, and Internationalization.

Firstly, our cornerstone pillar, leveraging the accelerating market growth, will enable investors to profit from the frozen food's market tailwind growth. This market at a global scale should create new demand, boosted by recent market trends at a macro level. Moreover, a combination of strengthening existing customer relationships and establishing new ones as the company enters new markets will help leverage positive global trends.

In fact, the company should reinforce the strengthening of strategic existing customers. One should be able to accomplish the latter by renegotiating existing customer contacts (ie. Continente, Pingo Doce, and Auchan) for longer terms settlements that contribute to potential margin improvements and predictable future cash inflows. Also, in line with the company's current strategy, *Gelpeixe* ought to continue celebrating new partnerships with large international distributors and wholesalers. Partnering with international distributors allows access to new geographies, benefitting from the rapid international market growth (relative to the Portuguese market). One should expect double digits growth (10.9% annual growth) expected in international revenues from 2023 to 2025 resulting from increased sales in the largest European markets (Spain, France, Germany, United Kingdom, and entry into the Italian market) and execution of the internationalization strategy.

Secondly, we considered a Buy & Build strategy using *Gelpeixe's* well-positioned platform. The latter would allow *Gelpeixe* to establish a large platform within the frozen food segment in the Iberian region and internationally, well suited to reinforce the company's leadership.

Although we examined a plethora of potential add-on transactions, only one company seemed to have the best strategic and financial fit within *Gelpeixe's* current operations. Through comprehensive screening and careful target selection, using current infrastructure and geographical footprint as decisive factors, *Gelpeixe* will pursue its first major acquisition: Sorymar. This firm has above-par margins relative to the Iberian market and revenues close to €10m. In addition, Sorymar is the largest and most modern freezer in the Basque Country and one of the most important in Spain while exporting more than 50% of its production to an excess of 20 countries. Hence, this add-on would allow *Gelpeixe* to boost revenues and *Gelpeixe's* margins, as bundling and leveraging customer relationships can create significant synergies. It would also complement the internationalization strategy by entering new geographic markets, namely in Africa and Eastern Europe, while reinforcing *Gelpeixe's* presence in Spain, and providing an alternative to “Mercado da Saudade”. Lastly, it would allow Gelpeixe to leverage a large Spanish production plant into country-wide distribution and leadership of the Basque region while complementing *Gelpeixe’s* product portfolio.

Finally, our third and final strategy consists of internationalizing the company’s operations. Increasing international demand for *Gelpeixe’s* products, boosted by the buy and build strategy, to rapidly leverage existing customer relationships

A targeted approach to current and new markets should accelerate *Gelpeixe’s* international footprint and pursue the current management's internationalization goals. For that we analyzed the current macroeconomic environment in the frozen food market in each continent, thus concluding that Europe is the most attractive market, mainly due to a demand surge given population growth, rapid urbanization, and rise in consumer awareness of the associated benefits. In Europe, we examined the 5 largest markets – Germany, the UK, France, Italy, and Spain – and concluded that *Gelpeixe* should extend its sales network to Italy while consolidating its sales network in the largest geographies with the highest growth, existing established distributor network and with a trade deficit.

To sum up, we have selected three main strategies that are the most appropriate methods to create value for *Gelpeixe* given its current platform. The expected rapid growth of the frozen food segment aligned with a strategic international expansion could elevate *Gelpeixe* position overseas and capture additional revenue opportunities, amplified by Sorymar’s acquisition.

**Forecasts and Business Plan**

Gelpeixe’s revenue forecasts rely on the different segments’ relevant market analysis and growth drivers. As for the case of the fish and seafood segment, Gelpeixe’s overall forecast is relatively conservative in comparison to the European seafood markets (expected to grow at a CAGR of 7.4%), as the majority of the company’s sales will happen at a domestic level, where growth is forecasted to be slower. Regardless, international sales are expected to grow initially at a double-digit rate due to its strategic goal of international expansion, namely in Europe.

The pre-cooked meals segment performance will be mainly driven by international demand. In recent years, Gelpeixe has made investments in new foreign client relationships for this brand, entering the market there right away as the category was introduced. Like the seafood market, this industry should profit from positive European trends.

The leading driver for top-line growth, together with a strong internationalization strategy, is the horizontal acquisition of Sorymar, in 2024. The Spanish business, with significant recent capital growth and high production capacity, enables Gelpeixe to expand its regional markets and have a significant position in the Iberian market. To increase total top-line revenue, it should take advantage of global trends and cooperative customer relationships.

However, the seafood category continues to be the one that propels sales to higher levels, accounting for around 2/3 of organic revenue. Overall, the pre-cooked meals segment should have a higher CAGR as the great majority of sales occur abroad. Besides, the firm had been operating entirely on 1-shift work weeks and 60% of total capacity; an increase to 2-shifts per week to raise the top-line should make use of the remaining capacity. Over time, overall output will increase due to the ability to explore higher production capacity.

Since Sorymar will account for about one-third of the total EBITDA in 2027 due to synergies from the acquisition and its capacity to produce better margins, its operational returns will enable a large rise in EBITDA – it results in several cost synergies, including procurement, administrative restructuring, energy optimization, and overhead extra efficiencies.

The corporation appears to be managing operations effectively, having focused efforts in recent years on optimal energy efficiency and staff management, since operating expenditures continue to be comparable to sales. Because of this, the overall cost structure is mostly unchanged, while the key factor driving top-line growth, foreign demand for Gelpeixe's brand, can result in somewhat improved margins and 200 basis points higher organic EBITDA.

As a result of the aforementioned impacts, EBITDA increases at a 9.9% CAGR from 2021 to 2027, increasing twofold, and reaching 8.1% of sales at the end of the anticipated period.

The evolution of capital expenditures is one of the key variables influencing free cash flow under this projection. Due to recent increases in production and freezing capacity at both Gelpeixe and Sorymar, maintenance costs make up the majority of capital expenditures over time. Depreciation increases steadily in the absence of significant asset purchases.

Even though it is backed by a loan that covers 60% of the purchase price (€5.1m), the €8.4m acquisition of Sorymar also affects the company's free cash flow in 2024. Besides, as the company's top-line and operational requirements increase, net working capital extra expenditures must be funded over time, requiring investment.

All in all, the incorporation of Sorymar and solid revenue growth are the main drivers to higher cash generation, and as such, free cash flow to the firm strengthens.

A management compensation package is created to retain a management team with unrivaled knowledge and power in the sector. Manuel Tarré, the current CEO and President of the Board of Gelpeixe, is currently 70 years old and has co-founded and managed this family business for more than 40 years. He has no plans to continue in these roles following the takeover. However, his extensive knowledge of the business and the sector is extremely valuable, therefore it is decided that he must remain in charge for an additional 18 months during the transition. In this manner, the acting management team should continue to possess the necessary expertise.

The management team's planned compensation package for Gelpeixe is composed of a 10% equity participation in Sweet Equity with a €300k investment, 2.2% equity at admission, and 10% equity vesting at exit; an anti-dilution clause, known as a "ratchet clause", that ensures that the management's ownership position won't be reduced following any stock infusion supported by the sponsors; and a variable performance bonus with a €500k ceiling determined by an EBITDA-related objective.

**Valuation, Capital Structure and Returns**

Gelpeixe is valued at an Enterprise Value to EBITDA multiple of 7.4x after taking into account previous comparable transactions and current public comparable firms trading multiples, resulting in a total Enterprise Value of €28.8m.

Considering multiple factors, such as the firm size, the total leverage level, corporate governance, geographic diversification, cash flow stability, and existing asset base, the decided debt structure for this transaction included different types of debt financing. Senior debt, composed of three different tranches, should be financed by banks within the Iberian space, with past expertise in similar transactions and the capability to leverage the deal up to a maximum of 3.5x EBITDA. The interest rates margin on the senior loans should range from 275bps to 350bps. Besides, the deal should also include a subordinated debt facility, composed of a mezzanine loan, financed ideally by a specialized private lender also in the Iberian space.

The total use of funds will be €29.4 million, of which €28.8 million is used to buy the business for 7.4x EBITDA and the rest is devoted to financing, arrangement, and due diligence fees. A fixed return instrument worth €11.7 million will accrue interest at a rate of 8.0% annually and, to retain the management team, a sweet equity instrument of 10% over ordinary shares will be deployed. Overall, the total equity contribution will amount to 47.0% of the transaction value.

The investment scenario LBO model produces a money multiple of 3.0x and an IRR of 25.5% from a 5-year holding period, ending in 2027. The model forecasts stable covenant enforcement, as Net Debt/EBITDA, interest, and debt service coverage enjoy significant headroom.

Sorymar's acquisition is the primary driver of value creation, adding an extra €16.7 million to equity investors through the improved top and bottom-line synergies and increased cash flow generation. Gelpeixe's organic revenue should also have a substantial influence as a result of the internationalization strategy and the rapid market expansion since it adds €8.3 million to the equity value. Finally, the financial engineering connected to the loans backing the transaction at entry, which contributed to €5.0m, is one of the biggest sources of value.

According to a sensitivity analysis, the holding period is crucial in determining the optimal returns. Even if the IRR is not the highest after a holding time of 5 years, the money multiple (3.0x) suggests that it is the best combination, since it still generates a 25.5% IRR.

Another important factor is the exit multiple; if the Sorymar purchase is successful, a greater multiple may be used upon exit, which would greatly increase returns for equity holders. It is obvious how the Sorymar acquisition, one of the key factors in this deal, significantly affects total returns and serves as a potent weapon to increase money multiples.

**Exit and due diligence**

Four different exit options were studied, considering each one's feasibility and perspective of higher returns for investors, and two of them were highlighted as highly recommended. The first one, selling to a strategic buyer, was deemed one of the most attractive. The rationale for this deal would encompass an acquisition from a larger player looking for an opportunity in the Iberian market, with solid growth prospects, and for the possibility to expand into new markets and experience significant synergies. The existence of a wider range of interested buyers and the fact that strategic sales usually lead to higher exit values favor this exit option, even though it may last longer to close, due to strategic due diligence, than others.

There are multiple European players with a history of M&A that could make sense for this transaction. The two key selected targets are Nomad Foods and Frosta. Both companies are experienced acquirers in the food industry, specializing in frozen food and food retail companies and currently presenting a high degree of strategic fit with Gelpeixe. Inclusively, Nomad Foods has in the past acquired Iglo, one of Gelpeixe's current most important customers, having therefore further strategic interest in this transaction.

The second strategy to be considered is a secondary buyout, this is, selling to a private equity firm looking for small-sized companies in the European retail market. Private equity firms still have opportunities to add value to Gelpeixe by entering new segments and expanding into broader markets, and, for some funds, there is even the possibility of adding to existing portfolios. This type of transaction usually drives a faster sale process, and, commonly, there is plenty of interest for companies with high cash generation, such as Gelpeixe. However, high interest from financial institutions could bring down the valuation and returns for these funds.

The top two candidates for a secondary buyout are PAI Partners and Ardian. Both of them are based in France, they have past expertise investing in the Iberian market, and are able to leverage know-how and synergies from current investments in the food and retail industry.

Beyond the existing analysis, further due diligence is required to mitigate unforeseen risks and liabilities. In particular, extensive commercial and financial due diligence is required, to analyze further the feasibility and success probability of strategic M&A, the internationalization strategy, and the market's forecasted growth. It is crucial to analyze the precision of existing financial forecasts and valuations, especially in an unstable macroeconomic environment. Besides, it is important to conduct complete due diligence at operational, legal, and ESG levels.

## Individual Contribution – Pedro Penas

### Mezzanine Financing

Mezzanine capital is a tier of a company's capital structure that lies between equity and debt. Mezzanine capital financing may take the form of both an equity or debt investment, whether it is, for instance, a preferred stock equity injection, or a subordinated, unsecured loan. Usually, mezzanine investors can enjoy higher returns than the more conventional forms of debt financing, such as bank loans and high-yield bonds, since mezzanine financing providers can subordinate this capital to other creditors and are often less liquid than the beforementioned debt providers, thus bearing more risk.

Besides subordinated, unsecured loans, there are other structures that mezzanine financing may take. It can also take the form of second-lien term loans, unitranche loans, or even convertible debt. Laying between debt and equity, and more expensive than senior, secured debt, mezzanine financing is often used as an alternative to equity financing. It is frequently distinguished from other products, like high-yield debt, through the inclusion of an equity participation, typically in the form of warrants, options, co-investment rights, or conversion features.

Mezzanine finance is a crucial capital source that bridges the gap between debt and equity, even if it only makes up a small fraction of a company's total available capital. This gap commonly exists due to distinct reasons, which can relate to senior lenders' reluctance to lend to the company, as they want to reduce exposure to a specific industry or company, or simply that they require certain assets as collateral (as goodwill or other intangible assets). It can also be the case that access to equity is limited, expensive, or that existent shareholders do not want to dilute their stake.

**Use cases**

Investors in mezzanine financing include private equity funds, hedge funds, pension funds, insurance companies, leveraged public funds, and banks that have launched standalone mezzanine initiatives.

Mezzanine funding is a way of facilitating acquisitions and shareholder buyouts; yet, it is used for many different purposes. It is commonly used as growth capital, to help smaller companies accelerate their organic growth, whether it is through the financing of strategic acquisitions, new product lines, capital expansions, or distribution channels.

Mezzanine financing has also a significant role in leveraged buyouts, by private equity sponsors, where funds look to reduce equity financing as a way to enhance the internal rate of return of their equity. Also, in the case of management buyouts, where there are more limitations in terms of equity purchasing, mezzanine financing is a useful tool, similar to shareholder buyouts. Other use cases for mezzanine financing also exist in debt restructurings, where it can be used to repay existing maturing loans, change the existing capital structure, and provide current shareholders with partial liquidity.

The majority of business transactions can be successfully financed by a suitable combination of senior-ranking debt and equity; however, the range of financing options is maximized by the availability of mezzanine finance. By permitting a closer relationship between risk and return and the preferences of various investor groups, it has the potential to lower the overall cost of capital. Although this item is typically the main reason for adopting mezzanine financing, the fact that these instruments do not grant ownership rights (unlike equity) may be just as significant for some sponsors – for instance, a private company's owners looking to increase their financial base while keeping complete ownership and management control.

**Mezzanine financing qualifications**

To qualify for mezzanine financing, companies usually have to be cash flow positive and have an EBITDA of $1 million or higher. However, there are other criteria that lenders take into consideration. Lenders tend to favor non-cyclical industries and keep clear from industries where business models are constantly changing; solid and tested business models are ideal, preferably with recurring revenue – criteria that favor borrowers in most types of debt.

Size is one of the main gauges for mezzanine financing. While the deciding thresholds vary between lenders, they usually take a minimum EBITDA as the main metric. Anyhow, companies should also comply with a minimum revenue threshold. Even though EBITDA is one of the main deciding factors, there are still exceptional cases where lenders will provide funding despite lower EBITDA; this response may be the case for companies with steady and growing recurring revenue and gross margins, and for which there is a well-defined route to profitability in the short-term.

Other factors are still pivotal to funding decisions. Companies with both historical and anticipated growth are favored, and there could be restrictions applied to companies with high amounts of senior debt.

As one of the most flexible forms of borrowing, there are still lenders that may overlook some of these criteria. This can be the case for some equity-oriented mezzanine funds, that prioritize investing in equity over lending. Naturally, these funds demand a larger return on investment, as their investment is riskier, while still less risky than pure equity investors.

**Mezzanine provisions**

The terms set for each mezzanine loan vary across the different qualifications mentioned above. Regardless, there are still several terms that should be included, besides the debt structure. For starters, lenders and borrowers should decide on the amount to be transacted, which will depend not only on the company's size, but also on its revenue profile, its profitability, its existent debt profile, and on other factors. Given these criteria and the lenders' limitations, lenders will decide a minimum and maximum amount to be allocated.

The term of the loan is usually five years or longer. However, it is dependent on the maturity of existent debt facilities in the borrower's capital structure. Should the mezzanine loan be undertaken simultaneously with other senior debt facilities, these same senior lenders usually contend that the mezzanine loans mature posteriorly to the senior debt. In those cases, the mezzanine issuers may agree to extend maturities provided that they are given more flexible optional redemption terms.

Mezzanine loans are commonly structured as "bullet loans", interest-only loans where the full principal amount is due at maturity. Even though many mezzanine instruments carry a cash coupon with a fixed rate, to be paid annually, semi-annually, or quarterly, others feature a floating rate, or even a PIK (pay-in-kind) element, which allows issuers to pay a portion of the accrued interest by issuing new debt. The interest rate is usually higher than other types of debt, from 10% to 14%. These provisions also vary depending on the terms agreed on equity participation and fees, as mezzanine investors typically work to attain a higher internal rate of return on their investment.

Mezzanine investors frequently aim to increase returns by negotiating an "equity kicker". These could take the form of warrants or options to buy a certain amount of the issuer's equity (commonly 1% to 5%). They can also be co-investment rights, where the lenders are given the possibility of investing in the issuer alongside the existing shareholders, or the private equity sponsors. This method would give mezzanine investors the same terms as their co-investors as per existing shareholders' agreements. Besides these, there could still be the possibility of including a conversion feature, allowing investors to convert the entirety or a fraction of their capital into common equity.

Many types of debt are collateralized; which is usually not the case for mezzanine financing. It is usually an unsecured obligation, and it is usually covenant light. It generally includes only basic financial maintenance clauses, such as coverage ratios. What the lenders usually impose are affirmative or negative covenants; the firsts are obligations on the borrower, namely the payment of taxes due, the upkeep of financial records, or the maintenance of proper insurance. On the opposite side, negative covenants restrict the borrower's capacity to take action that may harm the company's ability to repay, such as taking on further debt, paying dividends to shareholders, or selling existent assets. There are even some mezzanine funds that demand direct participation, such as board seats, to be involved in the management of the business.

The quantity and regularity of information the issuer must give to mezzanine investors can also differ significantly. Investors frequently concentrate on obtaining comprehensive reporting and information rights because the majority of mezzanine instruments have limited liquidity, and as such, the issuer must typically deliver quarterly unaudited financial statements, in addition to annual audited financial statements.

Structures may be significantly different, for instance, in the case of mezzanine preferred stock investments. These instruments traditionally include a high fixed-rate dividend, paid in cash or in-kind, and also a required or voluntary conversion into common equity. Once again, to achieve their target rate of return, mezzanine investors may also bargain for distinct one-time or recurring payments, such as structuring or commitment fees, or even the issuance of mezzanine debt at discount from par value (raising its yield).

**Intercreditor relationships**

The crucial link between mezzanine holders and senior and junior creditors is a significant component of any mezzanine transaction. It is frequently a highly negotiated point as to what kind and how much debt mezzanine investors will agree to be subordinated to. In some transactions, mezzanine debt is subordinated to any issuer debt that is not expressly subordinated by the agreed terms. Others state that the mezzanine debt is only subordinated to the credit facility and debt that is greater than a certain amount that is determined on the mezzanine financing closing date.

Payments on the designated mezzanine notes will often be stopped in the event of a payment default on the senior debt, according to the subordination clauses in the debt instruments and the intercreditor agreement. Additionally, holders of the designated senior debt often have the right to notify the holders of the mezzanine debt of a covenant default by sending a blockage notice, which halts payment on the mezzanine debt for a period of up to 179 days. The mezzanine investors frequently set a cap on the total number of blockage notices that can be issued over the life of the mezzanine loan and normally limit the senior lenders to one blockage notice per 365 days.

Senior lenders anticipate that the mezzanine holders will be bound by standstill clauses that restrict their ability to use any remedies, such as filing a lawsuit to recover money due to a default or acceleration, until the senior lenders take action. Some mezzanine financiers bargain to shorten the time of the stoppage. The issuer must make up any missed payments to the mezzanine holders by the end of the payment blocking period, or the investors in the mezzanine have the option of accelerating their debt.

Some senior lenders bargain for complete subordination, which forbids the mezzanine holders from exercising any contractual rights before maturity without the senior creditors' approval. Mezzanine investors typically resist these demands.

**Mezzanine capital in Europe**

Private equity investors have looked to mezzanine finance in Europe, as they did in the US, as a viable source of capital for their acquisitions and recapitalizations. Mezzanine solutions have a long history in Europe, and European instrument terminology is frequently very different from its US equivalents. With a form drawn from the senior secured facility in the relevant transaction, European mezzanine financing often resembles a second-lien bank facility.

Depending on the state of the market, mezzanine financing has been employed more or less frequently in Europe. The capital structure of sponsor-backed enterprises does occasionally use it as a substitute for high-yield bonds, nevertheless. Particularly sophisticated intercreditor arrangements involving European transactions may necessitate considering legal and other deliberations in numerous jurisdictions. Additionally, while structuring mezzanine loan investments, investors must deal with restrictions on the enforcement of guarantee and security claims that are typical in many European jurisdictions, just like with other types of debt financings.

**Investing in mezzanine debt**

The two primary methods for investing in mezzanine debt are: (1) directly negotiating deals with a business or its owners; or (2) contributing to a pooled, private-fund structure that specializes in such investments. Only investors with sizable capital are normally permitted to make direct mezzanine debt investments – relationships with family owners, investment banks, or private equity firms might be used to find these. Whether made directly by an investor or on behalf of a pooled fund, the majority of mezzanine debt investments typically need several weeks to a few months to negotiate and close.

The most popular option for investors to access the mezzanine loan market is through private limited partnerships. This is often accomplished by capital commitments that are pooled together specifically for mezzanine loan investments. These funds are often organized by asset management companies, who also serve as general partners. For the benefit of the partnership, the general partner seeks appealing risk-adjusted returns while maintaining a diverse investment portfolio.

As mentioned before, one of the main benefits of mezzanine financing for investors is the opportunity for an attractive risk-adjusted return. Mezzanine debt investors typically demand higher future returns than senior secured debt investors due to their subordinated or junior position in an issuer's capital structure. Total returns on mezzanine loans often derive from high current coupons (commonly fixed-rate and paid quarterly, mostly in cash), commitment or arrangement fees, and call protection (this is, premium payments if the mezzanine debt is repaid early). In contrast to senior secured debt, mezzanine debt will frequently include an "equity kicker" and, as a result, there is the possibility for profits above and beyond those negotiated by the junior debt investment alone. Historically, blended gross annualized returns for mezzanine investors have been in the mid-teens.

Another potential benefit is associated with the downside protection of private structures. Mezzanine debt is often offered in the middle market through privately negotiated agreements. Instead of being dependent on asset backing, a mezzanine lender's decision is typically based on the issuer's capacity to create free cash flow as well as the industry and business's development potential. Mezzanine debt investors often can do significant private-side due diligence over a four-to-six-week period, as opposed to what is frequently less than a week of limited, public-side due diligence for extensively syndicated loans. Mezzanine lenders have more access to firm data as part of this due diligence, including previous financial records, earnings and audit reports, and environmental or other expert evaluations. This makes it easier for mezzanine debt investors to negotiate terms, comprehend the borrower, and structure loans in a way that is suitable for the underlying company. Additionally, before making an investment, mezzanine debt investors have multiple opportunities to interact with the company's management.

Besides this, mezzanine financing also benefits from reduced volatility from high current coupons. Mezzanine debt is sometimes set up with a fixed coupon that is paid quarterly (mostly in cash). Lenders who subordinated their position in the capital structure are compensated with this coupon. In the current market, coupon rates are near the low end of the historical range, ranging from 11.0% to 12.5%. Still, mezzanine debt is a desirable substitute for other debt products for investors seeking mid-teen gross returns in a low-yield market. Furthermore, the substantial current coupon component lowers the total volatility of returns to investors because mezzanine loan coupons are typically paid quarterly.

It is also important to bear in mind the risks associated with investing in mezzanine debt. Firstly, in the capital structure, mezzanine debt is subordinated and often in a first-loss position when a company's value declines by an amount greater than its equity. Second, if mezzanine debt needs to be sold, it is far less liquid than most public securities since it is given through privately negotiated deals. Finally, compared to bigger enterprises, middle-market businesses may face more idiosyncratic risks. For instance, because of its smaller size, the borrower's EBITDA may be more affected by the loss of a client or increases in raw material costs than a bigger firm would be; in the same line, due to their size and ownership structure, middle-market firms can have management teams that are less qualified or experienced than their public counterparts.

**Current landscape**

Mezzanine activity grew by almost 19% YoY from 304 deals to 363 deals for the last twelve months ending June 30th, 2022. Deals using mezzanine financing grew from 65 to 78 in Q2 2022 compared to Q1 2022. Inversely correlated with the rise in mezzanine transaction activity is the fall in private equity sponsored deal volume, which fell by over 11% from 1,412 deals in Q1 2022 to 1,259 deals in Q2 2022. 46 agreements were buyouts, 14 were minority financings, 14 were sponsor-backed add-ons, and 4 were recapitalizations out of the 78 mezzanine deals that concluded in Q2 2022. The four industries that saw the greatest M&A activity overall during the quarter were IT, Services, Healthcare, and Financial.

## Conclusion

Properties of mezzanine financing make it one of the most flexible capital structure elements in the market, and together with the market's developments in the last decades have increasingly brought it to the spotlight. Resourcing to mezzanine debt to finance buyouts and growth capital has become more popular, especially as more mezzanine funds are created and as more lenders join the market, improving conditions for borrowers, in what is now a competitive industry.

Mezzanine financing has filled a gap in enterprises' capital structure, as an alternative to both traditional debt facilities and more expensive equity injections. The industry for mezzanine financing has not only created new opportunities for large companies as borrowers, but also for small and medium-sized companies, that can find funding at acceptable prices in private markets nowadays. Besides, this industry has also created an opportunity for investors. Not only it has become more common to see asset managers and private equity funds developing their mezzanine debt funds, but a new opportunity has also come up for investors to direct their money to these private pools and obtain high target returns in relatively short periods, compared to traditional senior, secured debt.

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