THE THIRD LAYER

Mezzanine is an important element in structured debt arrangements, explains Will Spinney

Most treasurers that work in medium to large enterprises with multiple banks try to ensure that these banks are *pari passu*. This principle means that the banks 'stand level', or have an equal claim to any recovery of money. It helps bank relationships and is broadly common sense. There are usually some exceptions, however, and they typically happen when local debt is taken on by a subsidiary, often overseas, whereas most debt is at the parent-company level. In that case, the lender would be 'closer' to the cash-generative assets of the firm, or at least some of them.

The main reason why companies borrow is to improve their return on equity, ie the 'leverage' effect. The higher the leverage, the higher the return on equity, and so one financial strategy is simply to lever up as high as possible. The improvement in return on equity can be enormous.

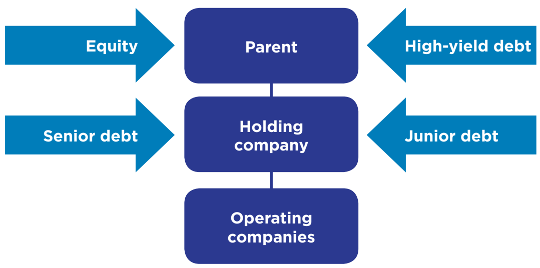
At these high and therefore risky levels, commercial banks will simply not lend, whatever the prospective return. Yet there are investors who will take the equity risk to seek the high reward. There are also investors who will take a middle line – some risk for a higher reward than banks, but less than equity.

This is done by adding a third layer of capital to the traditional forms of debt and equity. It is often called 'mezzanine' but is also referred to as subordinated debt, or junior debt, although these must be used carefully, as they are relative terms. This language also allows the concept of senior debt, which is usually provided by a bank.

The order of payment on default becomes bank, then mezzanine and then equity, and the expected rewards of each investment are respectively low, medium and high. Debt is always legally senior to equity but for other instruments the relative seniority (or subordination) must be designed carefully. There are three ways to achieve these structures:

Method	Description
Structurally	Structural seniority can be achieved by lending directly to the cash-generative subsidiaries, rather than to a parent company.
Contractually	Lenders can agree between themselves as to who gets paid out first.
Security	A lender can take security over real assets, inventory, receivables, patents, share certificates and even contracts etc to get direct access to the assets of a failed business.

In reality, these structured situations use all three techniques as shown in the following example:



In this example, there are four layers of capital. The high-yield debt is structurally junior to all the other debt as it is in the parent. Both the senior debt and the junior debt will take security, but they will also agree contractually that the senior debt is paid out first. There will also be cross-guarantees to allow the security to operate properly. It is clear that implementing an arrangement such as this is quite complicated, as both commercial and legal issues must be settled at the same time.

Layered debt is more common than might be expected. The volume of high-yield deals now being undertaken is a reflection of the popularity of the structure, since almost all of the deals will have some senior debt in their structure. It is normal that private equity deals and high-asset companies, such as property companies and transport companies, will have very complicated structures with all kinds of debt, often structured asset by asset. Layered debt can also be found in large quoted companies in the form of 'hybrid' debt. This debt is structured to be junior so that the senior debt is rated more highly, thus preserving a target rating on the majority of the debt.

This approach highlights how these deals are put together. In a private equity deal, for example, senior debt is maximised (being the cheapest), junior debt is also maximised (being next cheapest), then the price is plugged with equity and, as long as the expected returns sit OK with investors, the deal will work.

There are some side effects associated with these sorts of structures, and life can be hard for a treasurer working with them. There is little financial flexibility (for example, for M&A) and any downturn in prospects is rapidly felt. Suppliers go even further down the queue, so this can affect the trade credit that is available. Loud squeals may also be heard from pension schemes and even customers.

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