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As traditional lending slows, mezzanine debt gains favor

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In the movie "The Bucket List," actor Jack Nicholson, playing a health-care tycoon, rants about mezzanine financing shortly before tossing himself out of an airplane.

Skydiving is a good metaphor for both the borrower and the lender when it comes to mezzanine financing -- it involves a considerable leap of faith.

Mezzanine borrowers are typically privately held companies that have a good long-term outlook, but can't generate short-term cash like a public company. A mezzanine loan is subordinated debt. The only collateral in the event of default is usually in the form of warrants for shares or ownership in the company.

Under such a hybrid arrangement, the borrower's traditional credit lines of bank loans and private equity financing are undiminished. The normal rules of due diligence don't apply, so mezzanine loans can be made quickly. In return for their flexibility and appetite for risk, mezzanine lenders get a high return on their money, typically 15 to 30 percent or more, with a typical payback period of three to five years.

If the current vacuum in the capital markets hasn't yet sucked borrowers onto the ledge of mezzanine financing, they're at least peering out the boardroom windows.

"It's a pretty good time for mezzanine lenders," says Michael Reynoldson, vice president of InvestAmerica in Vancouver. "If a fund has the capital, it's a good time to be investing, but you're going to have to be willing to sit [repayment] out for a few years. The economy in general is slowing, so you can't expect companies to grow as fast."

Portland has a very modest mezzanine lending industry, especially since Tamarack Capital completed its fund and declined to seek another, says Reynoldson.

"They were the only pure mezzanine lender in Portland. We're not a true mezzanine lender, but we're about as close as anyone in the market."

As a "microcap private equity player," InvestAmerica has done four local deals in the last five years.

Strong Oregon companies still have borrowing options, Reynoldson says.

"The good deals, the banks are still going to fund. It's like obtaining a mortgage -- if you're a good credit risk, you're going to get the money, no matter how tight the market is."

Banks are still lending, agrees Robert Jesenik, CEO of Aequitas Capital Management in Portland. But they are making their decisions more deliberately. That slower approach should boost demand for mezzanine financing.

Aequitas operates three funds -- secured debt, equity and mezzanine. The short-term outlook for private equity and mezzanine lenders is especially good, Jesenik says, as the pricing power has switched from the borrower to the lender.

Aequitas seeks returns of 20 to 30 percent on loans made to companies in the lower middle market sector, those with less than \$200 million in annual revenue.

"We tend to focus on manufacturing, business services and IT services," says Jesenik.

Banks also seek out the services of mezzanine lenders when capital markets tighten up. A bank can transfer a portion of risk on an otherwise attractive loan to mezzanine lenders and get the deal done.

Mezzanine financing is genuinely unique, Jesenik says: "Mezzanine, by definition, means we're neither debt nor equity -- we're in the middle, the level between the first and second floors."

The middle is a comfortable position right now, says Ulysses Sherman, a partner in Aspen Capital LLC in Portland. Originally focused on mezzanine loans to the hotel and business service industries, Aspen is directing much of its attention to the real estate market, he says.

"There is very little [traditional] financing available," he says.

Rance Gregory, CEO of NBS Real Estate Capital in Portland, agrees that mezzanine financing is clearly in demand now for real estate investments. That's been especially true since August, and as a result mezzanine lenders should have their best market in five years, he adds.

portland@bizjournals.com / 503-274-8733

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