RESTAURANT FINANCE MONITOR®

Volume 26, Number 10 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

October 20, 2015

How Mezzanine Lenders/Investors Approach the Restaurant Industry

By Dennis Monroe

This is the last in a series of three articles examining the reasons why lenders and investors like the restaurant industry. The first article was about equity investors, drawing insight from three private equity funds that have a long-time investment history in the restaurant space. The second article explained why banks continue to enter the senior lending world for restaurants, particularly franchise chain restaurants. To round out the series, this article is about mezzanine financing. Mezzanine financing is somewhere in between equity and senior debt and presents its own set of issues.

This last article turned out to be problematic. The first two were easy to write because there are plenty of investors wanting to invest in the restaurant space, and there has been a rush of new bank lenders. Mezzanine lending can take a number of different forms and is basically high-yield debt with in most cases, some type of equity participation. Further, mezzanine lending/investing is normally used to fill a gap between equity and senior debt.

I spoke with three mezzanine lenders for this article: (a) Marquette Capital Partners, a strong historic lender in this space that also does other types of lending; (b) Yukon Partners, a new entrant into this space; and (c) a long-time overall mezzanine lender/investor. Two of the three with whom I spoke agreed to be quoted: Maggie Yanez, vice president at Marquette Capital Partners, and David Sampair, an associate at Yukon Partners. The third declined.

All three interviewees emphasized at present there is a lower need for mezzanine financing, because the senior lenders are stretching themselves to provide higher leverage. What used to be a senior loan equal to 3 to 3.5x EBITDA (earnings before interest taxes depreciation and amortization) is now closer to 4 to 4.5x EBITDA.

Further, equity players are getting more creative by using preferred equity products which are a hybrid and look a lot like mezzanine financing. Consequently, there have not been a lot of mezzanine deals in the last few years. In addition, some of the traditional mezzanine lenders are looking more like senior lenders with what is called unitranche financing, where all pieces of the financing continuum are provided—equity, high-yield debt and senior debt.

One of my interviewee experts said their company was looking for a correction in the senior debt market. If the correction comes and senior lenders back off to lending at 3 to 3.5x EBITDA, and if GE goes out of the marketplace, this might create the demand for mezzanine products.

Yanez pointed out that historically the restaurant industry (mostly franchise, chain restaurants) has attracted mezzanine lenders because it offers definable cash flow. Normally, if the senior debt is at a fairly low interest rate (which it currently is), there is room for another slice of financing, which is normally 1 to 1.5x EBITDA. These mezzanine positions are normally subordinate to the secured senior debt or are unsecured. Personal guarantees, once prevalent, seem to be going away.

In addition to definable cash flow, mezzanine lenders/investors like the potential for an upside. This upside is usually taken in the form of a warrant or a right to buy the stock at the value the company had at the time of the mezzanine investment.

In today's marketplace, with individuals looking at alternative investors as an option for their self-directed IRAs, mezzanine-type products can be very desirable. The problem right now is that it is not a question of supply; it is a question of demand from the borrower/target.

Mezzanine usually has the same maturity as senior debt. If the senior debt has a balloon of five years or is due in five years, normally the mezzanine debt also will have a due date of five years. Most mezzanine lenders are taken out in two ways. One is to refinance the senior debt (ideally once cash flow has grown sufficiently large to merit a senior debt loan that can take out the existing senior debt and the mezzanine). Secondly, if there is a real growth story, the mezzanine lender may want to convert their mezzanine position to equity and then look for another buyer or an IPO.

At times franchisors have used mezzanine financing or partnered with a mezzanine lender to create a fund normally used to remodel facilities, buy new equipment mandated by the franchisor or invest in technology. These are all assets which can be problematic to finance if there is senior debt and a first position. All such arrangements could be problematic if there is senior debt in place. Not surprisingly, I am aware of several programs from franchisors that are right now in progress.

David Sampair had an interesting comment. Yukon Partners are historically mezzanine lenders, and a few years ago did a large QSR deal; but instead of acting like a straight mezzanine lender, they actually led the whole financing process, helping to secure a senior debt syndication, and then providing preferred slice/mezzanine financing. David stated their preference is to provide mezzanine financing for long-term relationships rather than just offer a stand-alone product.

In summary, mezzanine financing has been a part of the whole restaurant package. Because of the position that senior lenders are taking and the availability of private equity, the use of mezzanine financing right now is at a low point. The mezzanine lender may be a dinosaur of the past in the restaurant industry because of the position senior lenders are taking. However, like everything in the restaurant space, this is a cycle. I am sure that if we experience the correction, mezzanine financing will be back in vogue. Let's just wait and see.

Next month it's time to tackle financing remodels.

Dennis Monroe is CEO of Monroe Moxness Berg, P.A., a law firm that specializes in financial transactions for multi-unit restaurant companies. You can reach him at (952) 885-5962, or by email at dmonroe@mmblawfirm.com.