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Economy leads lenders down the middle of the road

As banks clamp down on lending, mezzanine investing steps into gap

Sacramento Business Journal - by Robert Celaschi Correspondent

As last year's subprime mortgage debacle has evolved into this year's widespread credit crunch, mezzanine investors find themselves in a sweet spot.

As the word implies, mezzanine players fit in the middle: They lend money to companies when banks aren't willing, but don't take big chunks of equity as a venture capitalist would. They often work on 10-year cycles, eventually liquidating the investments and distributing the money back to the investors.

Where a bank might be willing to lend as much as twice the cash flow of a business, mezzanine funds will go up to four times, said Brad Triebsch, a principal at the **Central Valley Fund**. "And, unlike a bank, we do not ask for a personal guarantee."

Free to take more risks with their money, mezzanine investors also demand a higher return. And with banks tightening their lending criteria, companies that need capital are more willing to pay the price.

"It really started ramping up in the fourth quarter of '07," Triebsch said. His fund had anticipated doing perhaps four deals in all of 2008. It ended up participating in three deals in the first quarter alone.

"The credit crunch has helped us quite a bit as people are less able to do businesses with banks," he said. "It's like working at the packinghouse after a freeze: There's a lot of fruit to sort."

That's allowing mezzanine investors to be choosier as well. Central Valley Fund, founded in 2005, has $55 million contributed by **Wells Fargo Bank**, the California Public Employees' Retirement System, some Central Valley banks and a group of rich investors.

"Right now deal flow is very strong," Triebsch said.

Done deals

One of Central Valley Fund's first-quarter deals was to help **Skylight Capital** of San Francisco acquire **Bonney Plumbing** in Sacramento. Central Valley Fund supplied $3.75 million of the capital to aid future expansion.

"A year ago I think you could get senior debt to the extent you needed, but now you can't get cash-flow-based financing, especially at this small size range," said Collin Hathaway, managing partner at Skylight Capital. While his firm could have supplied the extra capital itself, it was attractive to bring in a mezzanine player, Hathaway said. Central Valley Fund understood the nuances of the Sacramento market and was able to help with due diligence.

Hathaway noted that a year ago, an acquisition deal could be done with only 15 percent to 20 percent equity. Now deals can require twice that.

"For people who don't have access to a sufficient amount of capital, it just means they can't do deals or they are really relying on mezz players," he said.

Central Valley Fund's second recent deal was a preferred stock investment of $2.75 million in **Source Holding Delaware LLC**. The Los Angeles company provides logistics and inventory control to Mexican and Latin American manufacturers that import into the United States.

The third deal was a $3.35 million investment in **Ultra Gro LLC** of Madera to fund a buyout by a management team.

Opportunity in a downturn

Mezzanine deals typically are straight debt, but they sometimes can be equity positions or a combination of the two.

DCA Capital Partners in Roseville focuses on the private equity side.

"You have people generally looking to raise money for different reasons in this type of market," principal Curtis Rocca said. Some need to shore up the balance sheet because their lenders are getting nervous. Others see a market downturn as a time to exploit a relative strength in the market. Even if business isn't great, it might be worse for a competitor and provide the opportunity for an acquisition at a discount.

"We're seeing both of those," he said. "I don't know that it's necessarily more deals, it's just different motivations for deals."

But for DCA it's still a good time to be in the game.

"I'd much rather be deploying capital today than two years ago. I think valuations are more reasonable, and you are competing against more rational financing sources," Rocca said. "As an investor with a five- to seven-year time horizon, it's far more attractive to be employing capital at what you perceive as the bottom."

Mezzanine investors also play a role in putting together larger deals.

Hamilton Lane is an independent financial institution that places institutional money into private equity funds. The Philadelphia company has been a partner of CalPERS since the early 1990s.

"We've come off of a market where our client accounts have had a lot of very strong distribution because they have been selling their companies," said Paul Yett, managing director for Hamilton Lane's West Coast operations in San Francisco. "With the credit crisis there has been a shift, where the 'sell' opportunity has gotten more limited. So the managers switch to 'buy' mode."

These are managers of funds with less than $2 billion in capital, acquiring businesses of $50 million to $500 million.

"The challenge in this market is getting the debt financing to put the deal together," Yett said. "That actually creates a lot of opportunities for mezzanine players. They can substitute for what the senior lenders and banks have been doing. They tend to do it at a higher cost, but that tends to be good for us as we invest in them."

One hang-up is that the buying and selling of companies is showing symptoms similar to those that surfaced as the residential real estate market began to turn sour.

"I think there remains a disconnect between sellers and buyers," Yett said. Sellers had been getting relatively high prices for their companies compared to cash flow and earnings, and many think they still should. A lot of deals get delayed as investors go through their due diligence and hold discussions with the business owners.

How long can this go on?

While many borrowers are anxious to see banks get more liberal with their loans, mezzanine lenders want to get as much out of the current market as they can.

Rocca isn't ready to call this the bottom yet. Retail and construction services seem to have stabilized for the past four or five months, he said, but there are other signs of future trouble, including higher prices for food and fuel, and high levels of credit card debt and auto loans.

"For us it definitely affects the sector, but we are long-term investors. As long as we believe the company has an operating model and a management team that can weather this downturn, we are willing to look at all industry sectors that are going to be well-positioned over the next five to seven years," he said. "We are not necessarily interested in investing in what is hot today."

"Economists we have talked to expect this to continue through 2009," Triebsch said.

Yett said he's heard the same predictions. "I can't tell if there is any science behind that or, because markets change in that period of time, there's safety in saying that," Yett said.

One change that's already happening, however, involves private-equity commitments that hadn't yet been funded when the credit market tightened up.

"Those deals are now getting done and beginning to work their way out of the system," he said.

The mezzanine funds won't go away when banks finally do loosen up their lending. Triebsch says he remains very bullish on the Central Valley "primarily because of the entrepreneurs we invest in." A dedicated work ethic tends to stay stable through economic cycles, and that's what he looks for in an entrepreneur more than an eye-catching invention.