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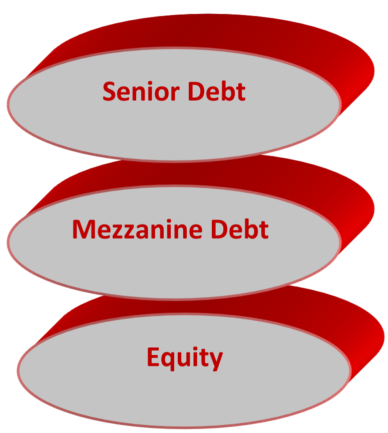
The 3 Tiers of Growth Capital

The private equity market values companies on the basis of a multiple of EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization). To assist you with the basics of most private equity deals, let's use a "three tier" analogy consisting of senior debt, mezzanine debt and equity.



This structure is the most commonly used in the private equity world. This structure is generally used in a leveraged buy-out or a change in control transaction because it allows the equity provider to leverage his down payment to purchase the target company. As you will see, each layer is different and has its own unique characteristics and each layer has its own risk/reward profile.

Senior debt (Low Risk | Low Cost | Short Term | Least Flexible) … provided by banks usually on an asset basis. It is the most senior layer of capital and is secured by the assets and a personal guarantee. Due to its low risk, it is the lowest priced layer in the 3 layer cake and is generally at prime plus or minus a small spread. It is short term money and generally is due in less than 3 years. Banks are generally risk averse and do not have the same risk/reward profile as a business owner. As a result, it is best used for short term needs where the risk of non-repayment is quite low.

Mezzanine Debt (Moderate Risk | Moderate Cost | Long Term | Flexible) … Mezzanine Debt is provided by independent funds and on EBITDA multiple basis. It stands behind the senior debt. It is unsecured by assets and does not require a personal guarantee. This layer carries significantly more risk than senior debt. It is generally priced at 20% per annum. The mezzanine provider charges interest of approximately 12% per annum and takes a small equity warrant in the business ranging from 5 to 20%. The standard mezzanine debt multiple is 4 to 4.5 times EBITDA. Mezzanine loans are long term money. They usually require only interest payments with no principal payments for the first 3 to 4 years. Most mezzanine loans mature in 5 to 7 years. Because mezzanine lenders own a small piece of the business, they tend to share same risk reward profile as the business owner. It is in their own interest to promote growth of the business.

Equity Debt (High Risk | High Cost | Long Term | Most Flexible) … Equity is provided by independent funds and is provided on a multiple of EBITDA valuation basis. As the bottom of the layer structure, it is the riskiest and most expensive layer of capital. Equity is generally priced at 30%+ per annum. It receives no current payment in interest so all of its return is realized on the back end through capital appreciation of its shares. Standard equity valuation is 5 to 8 times EBITDA. Equity has the longest term of all of the layers in the 3 layer cake. There is no obligation on the part of the business to repay the principal unlike a loan. Due to the riskiness of this layer being at the bottom of the cake and having no contractual right to repayment, equity is very expensive capital and usually ends of with greater than 50% of the shares in the company. Because equity providers own a large piece of the business, they are perfectly aligned with the risk reward profile as the business owner. It is in their own interest to promote growth of the business and to facilitate corporate growth through providing follow-on capital if warranted.