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Multibank Small Business Mezzanine Funds

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One of the primary goals of part 24 investment authority is to benefit small business through equity or debt financing. The provision of gap financing for small businesses through the establishment of intermediary mezzanine funds is one method of accomplishing this goal.

Mezzanine capital is a familiar term for larger companies and is a form of investment with risks and returns between those of secured bank loans and equity investments. Traditional mezzanine funds provide subordinated debentures with warrants to purchase stock. Several multibank small business mezzanine funds now provide a similar type of capital for smaller companies – but with changes that are appropriate to their smaller deal sizes.

The Ohio Mezzanine Fund, Ltd. (the "Fund") is a market-oriented intermediary which is structured as a limited liability corporation (LLC) with the investor banks sharing their equity ownership. The Fund has raised $9 million from local banks that provided equity investments of $50,000 to $250,000, depending on bank size and lines of credit on a 6:1 ratio (e.g. six dollars of debt to one dollar of equity investment in the Fund). Some banks make their equity investments through their subsidiary CDCs, while providing the lines of credit from the bank itself.

The Fund makes gap or mezzanine loans ranging from $100,000 to $750,000 that are subordinated to bank loans of $100,000 to $2 million to $3 million. The Fund always requires that a commercial lender provide senior financing to match or exceed the amount of the mezzanine loan from the Fund. The Fund's returns are structured to be mid-way between those of secured commercial bank loans and the venture capital funds. Currently banks look for overall returns of 10 percent to 11 percent on loans and venture capitalists seek returns of 30 percent to 35 percent plus. The Fund seeks investments that will generate returns of 18 percent to 25 percent which include an application fee, interest on the mezzanine loan of 3 percent to 4 percent over prime, and a success fee which is a negotiated percent of revenues.

The Fund's investor banks include Bank First National, Bank One, Charter One Bank, KeyBank, FirstMerit Bank, Huntington National Bank, and National City Bank.

"National City Bank has used subordinated financing from the Ohio Mezzanine Fund for several business clients requiring capital for growth or acquisitions" said Fritz Heintel, Vice President of National City Bank. "It provides financing for a niche in the market between conventional bank loans and equity investments. The bank's board members are pleased to have the bank as an investor in the Fund, and to serve on the Board and Investment Committee."

The Fund's investments provide working capital for fast-growing firms, finance management buyouts or acquisitions of companies by individuals or other companies, and finance re-structurings or re-financings. The Fund takes more risk than commercial banks by making unsecured loans without collateral. Unlike venture capitalists and private investors, the Fund does not dilute the equity or participate in the management of the companies in which it finances – which is attractive to privately held firms. Typically the bank's senior financing includes term loans and credit lines, which are disbursed as a percentage of inventory and receivables. A bank may refer a customer to seek mezzanine financing for one of several reasons, including a collateral shortfall, high leverage, revenue concentration, age of the company, and others.

Although privately organized and market oriented, the Fund is a unique working partnership of local banks and local economic development financing groups. It helps serve a public purpose of providing flexible financing to small businesses and creating jobs for low- and moderate-income persons. Representatives of nonprofit business financing organizations including the Greater Cleveland Growth Association serve on the Board.

As previously mentioned, the Fund is structured as a LLC, and the investor banks are the owners or members. Each bank appoints one representative to the Board of Managers, which in turn, appoints an Investment Committee of senior lenders and credit officers, who make the investment decisions. The Fund was organized and is professionally managed by Mezzanine Capital Management, Inc. (MCM) under a long-term administrative contract. MCM markets the Fund, structures and prepares investment proposals for the Investment Committee, manages the portfolio, and administers the Fund. The board meets quarterly and the Investment Committee meets on call. The Fund is structured more like a small bank than a venture capital fund as the investor banks control the board which has all decision-making authority. In addition, the credit culture is more like commercial lending in a bank than like equity-investing in a venture capital fund.

The Fund has made 19 loans totaling $9.6 million since the end of 1996, which has leveraged $27 million of senior bank loans and $7 million of equity or other subordinated debt for a total of $43.6 million of investments in small businesses.

The benefits to the participating banks include reduction of risk from the pooling of funds for a specific credit niche, access to mezzanine capital for business clients, loan referrals from companies seeking mezzanine financing, market returns on the lines of credit and equity investment, favorable publicity, and CRA benefits.

The Southern Dallas Development Fund (SDDF) in Texas has a similar structure but is CRA-oriented with most investments targeted for lower-income areas of Southern Dallas, smaller deal sizes and lower return requirements on its investments. The participating banks include Adams Centre National Bank, Bank of America, Bank of Texas, Bank One, Bank

United, Chase Manhattan Bank, Comerica Bank, Compass Bank, Northern Trust Bank, U.S. Trust Company of Texas, and Wells Fargo Bank. The Fund started lending in 1992, and has made 87 loans totaling $5.8 million, which has leveraged $6.3 from financial institutions. The nonprofit Southern Dallas Development Corp., which receives administrative funds from the City of Dallas and other sources, and which has a board representing local government, community organizations, bankers, and businesses, manages it. "SDDF has really helped Chase increase our lending to businesses in Southern Dallas.," said Larry Conley, Senior Vice President of Chase Manhattan Bank.

Small and mid-size businesses are a profitable market segment for banks, even the very large banks, in part due to their deposits and cross-selling opportunities. Multibank small business mezzanine funds offer a successful way for banks to provide supplemental financing to valued small and mid-size business customers.

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