



**December 16, 2010**

## **Are Warrants Evil?**

Once upon a time, they were inseparable – subordinated debt and warrants. They always went together. After all, subordinated debt was risky. It had no collateral, didn't receive principal payments until all the senior debt was repaid, and senior lenders could stop the subordinated debt's interest payments in the event of a default. So, in order to get the returns these providers needed to justify the risk, they received warrants.

But as competition grew, mezzanine providers discovered they could win deals away from their brethren if they offered rate only alternatives. Private equity investors heralded these new terms and believed that offering a mezzanine lender 12% cash and, in lieu of the warrant, a 2-4% payment-in-kind (PIK) component, life would be good.

In fact, nowadays, private equity firms find that offering a subordinated lender a warrant is a sign of weakness. They resist warrants at all costs, and sometimes to their own detriment.

But warrants accomplish more than simply providing the lender with a way to increase their yield.

First, a warrant gives the borrower an opportunity to decrease their contractual interest obligation. It's simple math – 12% cash interest plus a modest warrant yields less interest expense than 12% cash interest plus a two to four percent PIK component. When things are going well, the PIK component (which needs to come due in five years for tax purposes) often gets lost in the shuffle. But calculate the PIK component when the company's fortunes start to wane and see how much that additional interest burden eats in to the equity returns. A \$20 million subordinated note with a four percent PIK requires almost \$4.5 million in additional interest payments in year five. Yet, the proceeds from the exercise of a warrant, which is often only one to two percent of the equity, may wind up being a lot less than this amount. If things go awry, isn't a private equity firm better off with a 12% contractual rate rather than 16 percent? And if the warrants yield a higher value,

*Continued ...*



so will the private equity firm's remaining equity stake.

But more importantly, warrants tend to align the interests of the lender and borrower. Instead of having the mindset of another lender in a rate only structure, the subordinated debt lender holding warrants often acts as an advocate for the equity, particularly when things go sideways. When a lender doesn't receive warrants, he also has no upside and, therefore, thinks like a lender, not an owner. The best possible outcome is for him to get his money back. So why consent to an increase in the capital expenditure covenant and allow the company to expand its capacity? Or agree to an add-on acquisition that will improve the earnings? Warrants give the holder some upside so they are more willing to help the company grow, prosper, and improve the equity value. Are private equity returns so thin that giving up this modest amount of equity is the distinguishing characteristic between a good or bad deal for the sponsor?

Today, particularly for financings above \$10 million, rate only sub debt deals are the norm. But private equity firms should take a look at the warrant alternative and gain a few new friends in the process.

*Ronald A. Kahn helps buyout firms secure debt for acquisitions and related transactions. Reach him at [rkahn@lincolninternational.com](mailto:rkahn@lincolninternational.com)*