MEZZA-NEED: A VITAL DEAL COMPONENT

FEATURE

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MEZZANINE FINANCE

Mezza-need: a vital deal component

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Mezzanine finance has grown from just another subordinated bridging strip to become an essential element in deal structures. In some cases, the ability to access and secure mezzanine financing is the determining factor in whether or not a transaction is completed, especially at the top end. Its availability has gone a long way to stabilising the buyout market over recent years.

Mezzanine has been part of buyout structures for years, but not until recently has its importance escalated to the point of being an essential dealmaker. "Quite simply, deals can no longer be done without mezzanine, or some other form of subordinated debt instrument, at the higher end of the market," says Euan Hamilton, Head of Leveraged Finance at the Royal Bank of Scotland. In general, the mezzanine product is being used more often and people are increasingly comfortable integrating the tranche into deal structures to facilitate transactions. But few professionals would describe it as a market boom, rather than a consistent uphill climb. Held back by a general lack of awareness, investors on both the buy side and the fund side are now realising the benefits of mezzanine and coming to terms with how it works. Mounir Guen, CEO of MVision Private Equity Advisers, describes the profile growth of mezzanine as an investment as "gradual to slow." Although awareness is growing, individual access to mezzanine is basically restricted by its complexity, he says. Since it is intrinsically linked to the corporate performance of the business, there are monitoring and risk assessment procedures that need to be carried out in order for buyers to fully understand the underlying mechanics of mezzanine and be at ease with them. On the fund side, investors have traditionally been drawn away from mezzanine by the shining light of private equity, which offered the better returns and a more consistent historical track record to assess. However, the gap between private equity returns and mezzanine returns has closed considerably – and mezzanine has the added bonus of reduced risk, since it is superior to equity and second only to senior debt on a deal's security scale. Although investors will still opt for private equity if they anticipate a larger pay-out down the track, mezzanine is demanding far more attention.

In top end deals predominantly, but also in the mid-market, mezzanine holds a number of advantages over alternative subordinated debt tranches (like high yield bonds, which are suffering a slump) and equity portions. In a buyout structure, mezzanine has a legal claim over the equity portion which means less risk, and in contrast to high yield bonds it is private rather than publicly listed, which means it is not traded and enjoys minimal volatility. Overall, more and more investors are deciding that mezzanine is worth the extra expense. "It's a balance of cost versus flexibility versus disclosure," says Mr Hamilton.

Flexibility makes mezzanine a good choice for both acquisitive businesses and for recapitalisations – a liquidity source to which many buyout firms turned in 2003. The Focus Wickes recap is a good example, in which Royal Bank of Scotland introduced 'mezzanine notes' – a hybrid of pure mezzanine and high yield bonds, which provided the sponsors with more flexibility. It was a new, different instrument that was publicly-traded and cost more than traditional mezzanine, but which combined the characteristics of both tranches. Candover's buyout of Ontex is another case in point. This involved a creatively structured deal in which the mezzanine was divided into two equal tranches, one with warrants and the other without. Both tranches appealed to different groups of investors and showcased the adaptability of the European mezz market.

"Mezzanine and high yield bonds no longer compete as they once did. The liquidity in both markets – mezzanine in particular – has increased over the years and means that the two have reached an equilibrium. They can now co-exist," says Mr Hamilton.

Unsurprisingly in a growing market, competition among mezzanine providers has been healthy of late, particularly in light of the poor dealflow which the market at large has experienced over the last few years. Firms need to be competent at sourcing opportunities, accessing dealflow and structuring deals. "Ultimately it comes down to the old adage, the better the deal the less accessible it is," says Mr Guen. He says that lone operators are unlikely to be shown anything more than second-, third- or fourth-tier opportunities, and the risk exposure for them can be quite high. But on the other hand, larger providers who are ▸▸

trying to enter a syndicate for big deals need to bring something extra to the group, which can sometimes be difficult.

Non-sponsored deals (which do not involve a private equity investor) can be very hard to access. "You can't just show up with capital" says Mr Guen. "You need to demonstrate an ability to structure the deal and have an ongoing, value-adding involvement with the company." Kevin Murphy, Director and co-founder of Indigo Capital, says that around a quarter of the deals Indigo work on are non-sponsored, which fosters more risk but higher returns in the event of success. "More leverage improves you equity return, but too much leverage makes the structure fragile. You've got to be careful how you do it," he says. Whether a mezzanine provider seeks out sponsored or non-sponsored deals comes down to a combination of in-house decisions and the market opportunities that become available. For example, Indigo completed seven deals last year – and they were all sponsored due to a lack of sponsorless deal opportunities. As dealflow picks up in the mid-market, non-sponsored mezzanine growth is expected, given the attractive returns and the fact that deals are often smaller and therefore non-syndicated. "It's a nascent market with returns closer to equity than the sponsored form of financing," says Mr Guen. "In these instances, mezzanine can fill the gap and has potentially higher return outcomes."

The other talking point is the warrants debate. Warranted mezzanine gives the mezzanine provider a greater equity interest, making it more lucrative. They are standard practice in non-sponsored deals. Warrantless deals are purely contractual and allow the private equity house in a sponsored deal to retain more of the equity. However, as deals increase, private equity houses will be more inclined to hold onto the equity and structure warrantless deals. In structuring and pricing a deal, Mr Murphy says ideally he looks for some kind of exposure to equity and the upside of the business, and therefore doesn't chase warrantless deals. There's a better alignment of interest when you have an equity stake, he says, and your interests can diverge when you need to protect your principle. "Over time, warranted mezzanine is more likely to win out over warrantless," he concludes.

Mezzanine funds

According to AltAssets, an independent private equity research firm, four independent mezzanine providers held a final close in 2003 with a combined total of €1.3bn of commitments compared with only one final close in 2002 worth €1.1bn. There were also two interim closes in the fourth quarter worth a combined €540m, illustrating the momentum coming into 2004. The growth was not massive, but the mezzanine sector was the only one to record an increase in its fundraising in 2003 – its share of total private equity funds raised rose to about seven per cent from four per cent in 2002.

Mezzanine fund managers have had to hit the pavement and work for their fund capital, despite all the recognised benefits of mezzanine. Ultimately, the risk and return profile puts it in an interesting position. The higher security over private equity and high yield bonds is traded off by generally lower returns – and the choice comes down to investor priorities. This limits the mezzanine audience. "Mezzanine is caught between two worlds without the full benefit of either," as Mr Guen surmises.

"There is a strong feeling of fast or famine," says Mr Murphy, intimating that fundraisers are at both ends of the spectrum, either finding it tough to generate interest or fighting off investor demand. Above all, mezzanine fund managers need a strong track record and the solidity of the management team who created it, as well as setting targets in line with the track record, rather than aggressive, unachievable targets. "You can't go from a €200m fund and expect to hit a €2bn target next round," he says.

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"Fundraising is a slow process," says Mr Guen. "But it can be accelerated by attracting big sponsors, having an historic pool of loyal investors, or having a strong fund performance record. Successful fundraisers take advantage of networks and syndicates or offer something that differentiates them, such as the potential for a higher return profile. Those who enter the market with a fresh book and fresh concepts will be on the fund trail for a long time."

Attracting the attention of the industry is the fact that private equity houses have identified the appetite for mezzanine and are looking to diversify into it. Whether or not they will raise dedicated mezzanine funds in the future is largely dependent upon the constitution of their investor base. They will need to persuade investors that mezzanine represents a good investment and that conflict of interest issues – such as PE houses being involved in deals where a rival house is putting up the mezzanine tranche – can be overcome. Some groups in Europe are experimenting and having limited success, but it will take time.

For Mr Guen, it's hard to understand why there are not more debt-oriented pools of capital involved in mezzanine, either directly or through third parties. Institutional investors or investors with large portfolios and large debt holdings are minimal to non-existent in the market. "The holy grail of the mezzanine market is to tap into these pools," says Mr Guen. "High net worth backers should be interested in mezzanine because it sacrifices return potential for cash flow, provided investors pick managers with low or no default rates. Extra return is great, but these investors are driven by access to an annual income." the capital in these funds can be deployed diversely, and History shows that even underperforming mezzanine funds provide decent returns around the 10 percent mark. Capital in these funds can be deployed diversely and provide regular cash returns, giving investors their fixed annual income.

In order to attract these investors, it will take time and education. Low interest rates make return profiles more attractive, and if they remain low it will help. Mezzanine providers believe the time will come when these investors understand the risk profiles of mezzanine and develop faith in the competencies of those managing it.

As Mr Guen confidently asserts: "Mezz has had a moment, but not its moment." ■