

# PRIVATE EQUITY

# international

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## Mezzanine

# Much ado about mezzanine

**Mezzanine is going strong, even though times are tough. What is the attraction to the buy-side, who invests in mezzanine, and why are they buying it? Robin Burnett reports.**

The European mezzanine debt market is undergoing something of a renaissance. Patchy deal flow in the LBO market over the past couple of years notwithstanding, mezzanine issuance volumes and its overall importance as a funding source have continued to increase markedly. According to the PRICOA Mezzanine Monitor, compiled by Initiative Europe, €4.2bn of mezzanine was invested across Europe in 2001, more than in any other year. Its success is partly due to the continuing difficulties, perceived or otherwise, in the European high yield bond market, but it is also driven by an increasingly widespread belief among financiers that mezzanine offers a unique, and highly attractive, risk-return opportunity.

Mezzanine's success has also had an effect on the buy-side. According to those who know the market well, institutional awareness of the product is improving rapidly, even so mezzanine remains far from a commodity item. For many investors it still is something of an acquired taste and may well be for some time. So who invests in mezzanine, and why do they buy into specialist mezzanine funds?

"Our mezzanine investors form a very broad church," says Tom Attwood of Intermediate Capital Group. "We have seen a significant increase in the number of enquiries we get. The public markets over the past six months have been horrible. There has therefore been a significant increase in interest in alternative asset classes and mezzanine and sub-investment grade debt in particular."

## A nice little earner

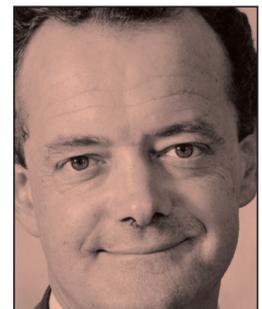
But the rise in appeal is as much about the poor performance of other asset classes as it is a result of the intrinsic qualities of the mezzanine product itself. Andrew Sealey of Campbell Lutyens, the placement agent, provides some background: "Some time ago mezzanine was

considered the poor cousin of the private equity funds. Now its risk adjusted nature is much more relevant. Mezzanine has performed well over the cycle and is therefore going to be more important going forward."

Simon Wakefield, of SEB Merchant Banking, says: "Conventional wisdom has it that private equity needs to develop a yield 3 to 5 per cent over the underlying public equity market as a risk premium for illiquidity. A poor private equity fund could produce negative returns. However, although a good mezzanine fund will provide a return of 20 to 25 per cent net, a poor one should still yield greater than 10 per cent, depending upon interest rates."

But there is more to mezzanine than absolute return. The way returns are generated and distributed to the investor is also key, particularly in today's cash hungry world. Mezzanine funds typically provide regular cash distributions throughout their life. Says Wakefield: "The current return generated by mezzanine funds is attractive to investors relative to private equity funds where the return is generated all at once, out in the future."

Another strength is that the mezzanine product provides good returns with a lower beta, or statistical variation in returns, than many other alternative investment types. And because it more closely resembles debt than equity in a financing structure, the correlation to other classes is low, giving the institutional manager one of the aspects desired most in investment strategies: diversification. "Diversification potential is important to institutional investors," observes Mounir >>



**Attwood:  
broad church  
of investors**



Guen of MVision, the placement agents. “Managers want to have different pockets of exposure. Mezzanine is a part of this.”

### Not many defaults

The defensive nature of the instrument is next on the list of features that investors currently focus on. “There haven’t been many mezzanine defaults in Europe,” says Christine Vanden Beukel, a London-based partner at GSC Partners. And even where things do go wrong, the legal

### Wakefield: positive qualities in difficult times

position of the mezzanine investor is superior to that of the equity. As a result, “you don’t need to mark down the mezzanine investment nearly as much in the down times as you do with private equity,” says Wakefield.

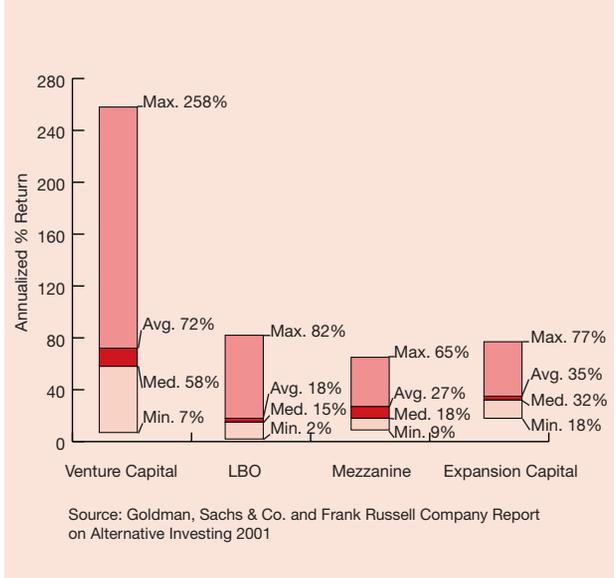
So who buys it? Some historical perspective is helpful in understanding the evolution of the mezzanine product in Europe. “It’s a changing market that can’t be looked at in a static way,” says Campbell Lutyens’ Sealey. “Historically the yield characteristics of the product have primarily attracted banks and insurers.”

In the 1980s, banks were the key source of capital, but later pension funds and insurance companies became interested, particular in the US. Willie Clark, who runs a CDO fund for Royal Bank of Scotland, recalls from his time at Prudential of America: “US Insurers have debt oriented investments, and the higher cash yield plus the longer term ‘kicker’ [provided by mezzanine through investment with warrants] matches their needs very well.”

**“Investors are positively disposed to the product, but many of them have no money to invest”**

The exact constitution of a mezzanine fund’s investors is, naturally, a function of the contacts that the fundraiser has in addition to the attributes of the product and the way in which the fund is structured, leading to some variations in people’s views and experiences. ICG’s Attwood for example, in referring to the firm’s €475m 2000 fund, reels off a list of investors that includes British banks, European banks, European insurers, an investment trust and some

## Comparison of Annualised Net Returns (1998-2000)



private wealth management offices. Vanden Beukel comes up with a similar constitution: “The largest portion of our fund is made up of insurers, banks and some high net worth individuals.”

Mezzanine Management’s third fund, which raised \$530m during 1999 and 2000, was able to attract pension funds. “Our second fund was levered and paid a fixed running coupon and hence was very attractive to insurers and banks, though it didn’t really get us into the pension funds,” says the firm’s Christiian Marriott. “The third fund is an unlevered partnership, investing in a mix of mezzanine and equity instruments, and that probably helped us to build an equal mix of insurers and pension funds, followed by banks, funds of funds and the odd private family office.”

But is it simply a few players committing to every fund in the market, or is there in fact a broad base of potential investors that mezzanine houses can tap? The picture is a little unclear, though the answer does appear to be tentative ‘yes’.

“Mezzanine is new to the general investor and, therefore, more time is required to get comfortable with this asset class and its varied risk-reward profile. Moreover, historical data on performance and overall market returns have been less transparent, or less well-published, than private equity and venture capital returns,” says Guen.

“We usually characterise people who come into mezz funds as having big and diversified alternative asset portfolios,” says Marriott. “There are also a few investors new to >>



**Vanden Beukel: banks go into every fund**

the asset class. Mezzanine is a way for them to dip their toe in – the information they receive gives an excellent view on the wider underlying market from different private equity providers, to senior lenders and other mezz funds.”

However, as GSC’s Vanden Beukel points out, “the banks go into every fund, whereas a lot of the insurance companies and other investors tend to be more specific.” The reason is that banks often differ in their motivation for investing, since they are interested in a fund’s deal flow and the banking business that comes with it.

“The aim in many cases is to educate senior management within the banks, who are often active on the senior debt side,” comments Clark at RBS, which runs its own captive mezzanine operation. “Investment is often targeted towards co-investment opportunities as mezzanine can be difficult to access.” Co-investment is often seen as an important return enhancer and an instrument for investor wanting to grow their exposure.

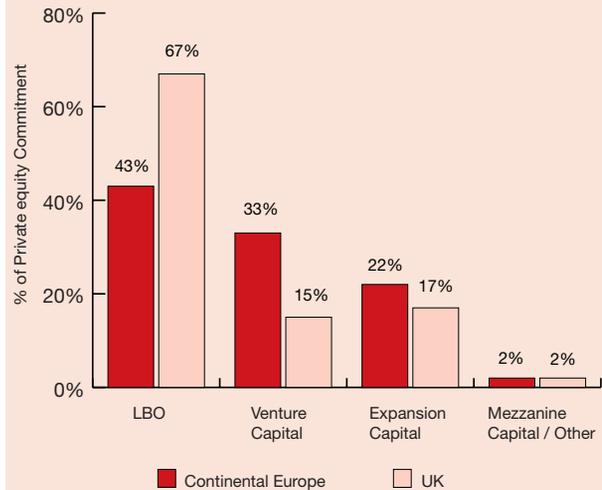
**No easy sell**

No one, however, is in any doubt the current fundraising climate. As Marriott puts it, “it’s an interesting time to be fundraising, and by no means is mezzanine an easy sell, although in a way it’s easier now than during the late 1990s, when a 30 per cent IRR seemed pretty dull and boring to some institutions that were focusing on tech funds.”

**“A poor mezzanine fund should still yield greater than 10 per cent”**

Many of those keen to invest in funds now are struggling to find the money. Some of the banks are in the process of exiting private equity either partially or wholly due to volatility of returns, poor performance and capital weighting issues, and insurers are becoming more cautious due to losses on their public equity portfolios and general solvency considerations. “Mezzanine’s qualities are revealed in difficult times and therefore potential investors are

**Commitments by Region 2001**



Source: Goldman, Sachs & Co. and Frank Russell Company Report on Alternative Investing 2001

positively disposed to the product, but many of them have no money to invest,” laments Wakefield.

There are nevertheless several funds in the market at present. Hutton Collins is pounding the pavements to drum up interest in their first fund. Most observers are intrigued by the offering, but some question whether current circumstances are conducive to a target of €600m, although €115m have already been pledged by Abbey National Treasury Services. Others on the fundraising trail include London-based Indigo Capital, private equity house EQT which has brought in new stuff to build a mezzanine business, and Accession Mezzanine Capital, the Mezzanine Management affiliate aimed at investment in central and eastern Europe which was launched in early 2001 and held a first closing a year later at €76m. Originally targeting €150m, this now seems an uphill task though a “three-figure” final closing is expected some time in the first half of next year.

“Compared to when Accession was conceived, a lot of institutions have issues in their portfolios at the moment, so in many cases their private equity allocations are tapped out,” comments Marriott. “For some of them this fund was easier to say no to than, say, a Western European buyout fund. For example, the private equity team at one a bank thought that it was a great idea, but the bank’s investment committee simply didn’t buy into taking exposure to the region.”

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## Lower returns?

Sealey sounds a note of caution to mezzanine fund managers generally: "The expectation is for lower returns from private equity as well as public equities going forward. Mezzanine returns are also heading lower which at the fund level raises other issues. With lower gross returns the level of fees charged by funds is becoming more of an issue for investors."

But Sealey is generally positive about the future of mezzanine: "Volatile markets mean institutions are being more conservative and are reviewing their long term liabilities in the context of recent returns. The balance between equity and fixed income, which mezzanine is to an extent closer to, is part of this review. There are now a number of firms with long track records of mezzanine investment in both the US and Europe. As transparency improves, there will be more interest in this asset class."

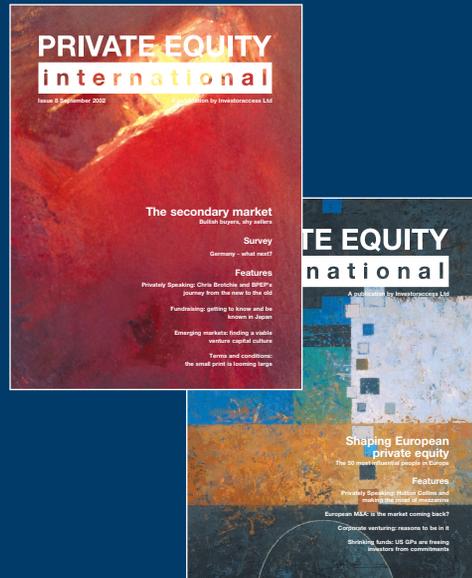
But will mezzanine ever become part of the mainstream asset allocation mix? There are rumours in the market that a number of large fund managers including Goldman Sachs and Harbourvest are currently thinking about raising dedicated mezzanine funds, an indication that investor interest is indeed on the rise.

Such newcomers could play a role in tapping existing pockets of institutional money which practitioners regard as a natural fit for mezzanine that are not participating yet. Comments MVision's Guen: "There are large pools of fixed income money. The question is, how to introduce mezzanine to them, which has not been done. The reasons are part regulatory, part taxation of the income, but the bigger question is their practice of not participating in indirect investments. Is this a changeable guideline, i.e. are they not chartered for indirect investment, or is it changeable habit?"

Others see the future growth in mezzanine as not necessarily being dependent on underlying investor supply of capital, but more on sponsor demand. "The influence from the high yield market may ultimately be a constraint on growth," says Andrew Sealey. "High yield returns are lower, and if good times come back the high yield market will be there at the upper end. If mezzanine moves up the scale of deal size, then returns must fall in order to compete."

Interest in mezzanine is possibly at an all time high at the moment. But whether the asset class can take the next step and grow out of its niche is an open question. What remains of primary importance both to investors and managers in the short term though is demonstrating in real terms the healthy risk reward balance that everyone expects. Ultimately, as Marriott at Mezzanine Management points out, "the bottom line is still deals happening and then deals going well." In the end, that's really all that matters. ♦

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