Mezzanine – going through the roof

Mezzanine finance has had an eventful history, but remains a flexible tool with increasingly varied uses, argues James Davis of Intermediate Capital Group.

Mezzanine finance is a well-established form of long-term finance which combines some of the characteristics of debt and equity. It fills a gap between relatively lower-risk senior secured bank loans and relatively higher-risk equity. Structurally, mezzanine usually takes the form of a non-amortising long-term (typically eight to 10 years) loan, subordinated to senior secured bank loans in terms of security, but usually including cross-default provisions and a second charge over the borrower's assets.

Mezzanine loans are typically structured to include three components of return:

- **cash coupon:** usually a floating rate coupon of approximately 350-400bps over the relevant interbank rate in the currency of the loan;
- **repayment premium**, or **'roll-up'**; and
- **equity warrants:** the intention is usually to exercise these when there is an equity realisation through a sale or flotation, yielding a significant capital gain.

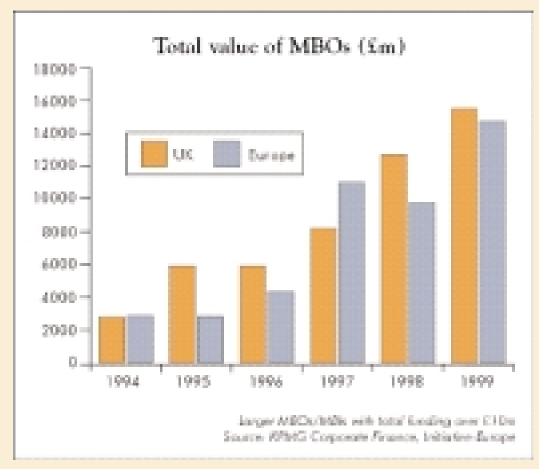
The total overall return sought by European investors on a mezzanine loan is in the region of 15 to 20%. The relative importance of each element (cash coupon, roll-up, equity 'kicker') in this overall mezzanine return can vary widely, and no individual element is indispensable.

Furthermore, mezzanine does not have to be structured as a loan: the use of preference shares or convertibles is possible, and can have significant advantages in terms of regulatory requirements or balance sheet presentation. These features make mezzanine a highly flexible form of finance, which can be tailored to a wide variety of industries, companies and financial structures.

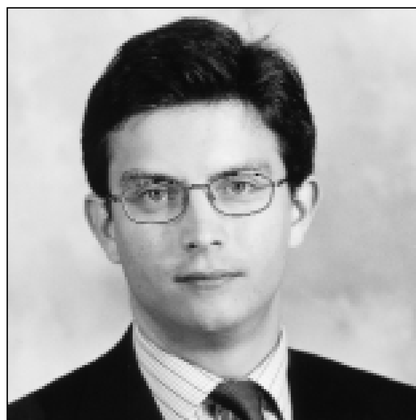
LBOs and the rise of high yield

Historically, mezzanine finance has been used predominantly in leveraged buyouts (LBOs), and this remains the main use for the product. The European LBO market has seen rapid growth in the last few years as M&A activity has increased, and European private equity players have raised massive funds to take advantage of this opportunity. More recently, a number of US private equity houses (notably KKR, Hicks, Muse, Tate & Furst, and Carlyle) have entered the European market aggressively. This has led to rapid growth in the number and size of buyouts completed in Europe, and hence to rapid growth in the demand for leveraged finance products of all kinds, including mezzanine (see *Figure 1*).

FIGURE 1



However, until recently, some market commentators argued that the potential for growth in the mezzanine market in Europe would be restricted by the inexorable rise of the high yield bond. The US has had a large high yield market for many years, and the European market has been fast catching up in recent years (see *Figure 2*). This led to a common belief that mezzanine would never play a leading role in the larger end of the leveraged finance market.



James Davis

Mezzanine and high yield: complementary products

In the event, the high yield market did not emerge as the direct threat some expected: the Russian debt crisis of 1998 led to the complete closure of the high yield market for a number of months, and although it has since recovered, the market now exists in a significantly different form to that anticipated two years ago. The liquidity crunch which marked the crisis in 1998 has left high yield investors reluctant to invest in small, and therefore less liquid, issues. In the US the minimum size for a high yield issue is now around $250m, and the product is not available in Europe in amounts below €100m. Even at the higher end of the market, demand is patchy, and the European market experiences extended periods where issues are simply not feasible.

However, size and market availability are not the only differentiators between

high yield and mezzanine: there are also important structural differences between the two instruments. For instance, unlike mezzanine, high yield typically benefits from strong call protection in the first five years after issuance, and this can prove expensive for equity investors seeking an exit within a five-year time horizon. Mezzanine also has the benefit of being a privately held debt instrument with a restricted and stable syndicate and a strong lead investor.

High yield, by contrast, can have unlimited numbers of investors, and the issuer has no control over their identity, which can prove a significant disadvantage in the event of financial restructuring, acquisitions or disposals. The fundraising process is also simpler in the case of mezzanine, with no need for time-consuming roadshows, and the information requirements are less onerous than is required for publicly-traded high yield securities.

High yield, for its part, has its own advantages. Unlike mezzanine, it is not dilutive of equity, which is attractive for equity investors focused on upside. Covenants are also typically less stringent in high yield documentation, with little opportunity for bondholders to take strong action in anything other than non-payment situations.

Mezzanine, on the other hand, generally incorporates a set of performance and restrictive covenants which differ little from those of banks.

As the relative advantages and disadvantages of high yield and mezzanine have become clearer to borrowers, mezzanine has returned to prominence as a form of financing which is complementary to high yield, rather than being in direct competition with it.

Not all deals are well suited to high yield, and mezzanine is better suited to situations where flexibility is at a premium.

This development is reflected in a strategic re-think among investment banks in Europe, who have begun to raise in-house mezzanine funds to

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complement their high yield capability. Combined with recent fundraising activity by independent mezzanine providers, this development has created unprecedented levels of funding available for mezzanine opportunities in Europe (see *Figure 4*).

Not all of this money will be invested in Europe: indeed, the large US funds, although called 'global' funds, are expected to be invested predominantly in the US. Nonetheless, they add significant weight to a market where larger amounts of mezzanine are being seen in financial structures than ever before (see *Figure 5*).

Competitive environment

Recent US fundraising efforts are just the latest development in a market which has been growing steadily more competitive for a number of years. The key driver in the increased competition in the market has been the drive by the banks providing senior debt for LBOs to provide a complete 'one stop shop' financing solution for their clients. A number of UK banks, such as RBS/NatWest (both in their former incarnations and as the new merged entity) and Bank of Scotland have had a mezzanine capability for a number of years, and the same is increasingly true in continental Europe.

This steady increase in competition has, to some extent, been reflected in pricing. In absolute terms, mezzanine returns have been on a steady downward trend over the last ten years, reflecting similar declines in expected returns in private equity markets. However, a large part of this trend reflects changes in the interest rate environment over the same period, and in terms of spreads to base rates, the picture is very different. On this measure, significant pricing pressure was seen in the period leading up to the Asian and Russian crises of 1998, but has not re-emerged, and mezzanine pricing is currently robust by historical standards (see *Figure 3*).

Competition in the market is not reflected in price alone. Mezzanine structuring is also always under pressure from both borrowers and senior bank lenders. Again, the enormous variety in mezzanine structures makes it difficult to discern trends, but there are particular areas which are hotly debated:

- *use of contractual return rather than warrants* – this enables the equity holder to retain more of the upside, while giving the mezzanine provider a higher proportion of more certain contractual return. In some cases, mezzanine has been structured with a 100% contractual return, although this is a feature only really seen in the largest mezzanine transactions;
- *softening of mezzanine covenants relative to bank covenants* – this allows

FIGURE 2

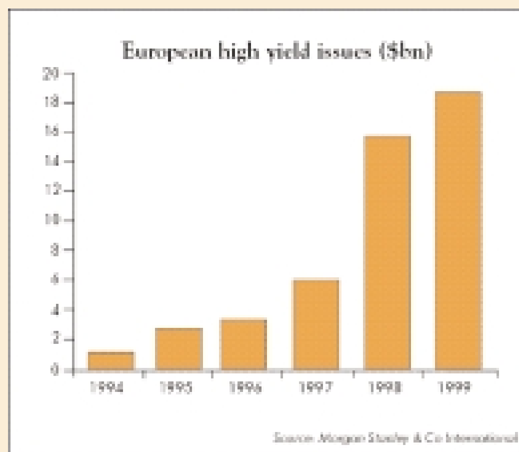
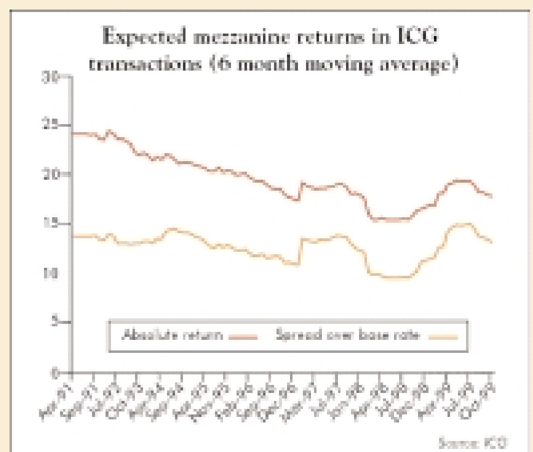


FIGURE 3



the banks more room for manoeuvre in the event of a default. In a traditional mezzanine structure the mezzanine defaults at the same time as the bank debt, and the bank benefits from a period (a 'standstill' period) in which the mezzanine provider is not entitled to demand repayment or enforce security. Banks may also seek to extend the standstill period beyond former market standards; and

- *restricted cross-default clauses* – where before any default on the senior financing documents would automatically trigger a mezzanine default, in some recent deals cross default has been limited to specific cases such as non-payment.

However, mezzanine providers are able to respond to market demand with increasingly flexible structures. For instance, 'pay in kind' (PIK) instruments are increasingly in demand. A PIK is basically a mezzanine loan whose contractual return is made up entirely of roll-up, with no cash coupon. PIKs are particularly appropriate where leverage is already substantial, as they allow shareholders to benefit from additional gearing while giving comfort to senior debt lenders that cash interest coverage is not too tight.

Similar benefits can accrue from structuring mezzanine to allow for short-term (typically cyclical) downturns in trading by allowing one or two years' interest payments to be missed without tripping covenants.

Alternative uses

Although the LBO market is becoming more competitive, there are increasing opportunities for mezzanine providers outside the LBO arena.

Mezzanine finance's flexibility makes it appropriate for a large variety of transaction types:

- acquisition finance;
- development capital;
- recapitalisations; and
- off-balance sheet finance.

Increasingly, mezzanine providers – and in particular independent mezzanine houses – are developing the skills needed to source, structure and execute these transactions on their own, without the involvement of a private equity house seen in an LBO.

Furthermore, the use of mezzanine for these applications is no longer restricted to the private company market: it is increasingly a form of finance which is of interest to listed businesses as well. Many of these businesses, particularly traditional 'old economy' manufacturing businesses, have seen their share prices languish recently, making equity issues extremely expensive, even if their institutional shareholders could be persuaded to participate in them.

Availability of bank debt may also be restricted by existing gearing levels. In these circumstances, mezzanine can be used to finance acquisitions or development capital situations. Structuring the mezzanine as a preference share issue rather than a loan can help by reducing the impact on gearing. Mezzanine has even been used in entirely off-balance sheet structures.

Mezzanine can also be used as a means of finance for taking a public company private altogether, without the involvement of private equity. Where a large portion of the business is owned by one shareholder or group of shareholders, mezzanine can be used to buy out the other shareholders, and return the company to the private arena. This technique has been seen recently in the take-privates of CPL Aromas (financed by ICG) and Epwin (financed by ABN Amro Mezzanine).

Overall, times are good for mezzanine providers and borrowers alike. The market is becoming increasingly competitive, but the inherent flexibility of the product has enabled mezzanine to rise to all of the challenges which have been thrown in its path. The death of mezzanine, often reported, appears more remote than ever before. ■

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FIGURE 4

European mezzanine fundraisers

Fundraiser	Size
Donaldson, Lufkin & Jenrette*	$1.6bn
Goldman Sachs*	$1.5bn
GSC Partners**	$1bn (target)
Intermediate Capital Group***	€374m
Lehman Brothers*	$1bn
Merrill Lynch*	$1.2bn
Mezzanine Management **	$525m

* Global funds
** European funds
***excludes own balance sheet of c. €1.2bn

** Source: Initiative Europe, FT*

FIGURE 5

Some recent European mezzanine deals

Deal name	Deal type	Mezzanine size	Mezzanine arranger(s)
Autodistribution/Finelist	Acquisition finance	FF1.8bn	Goldman Sachs
Elis	Recapitalisation	$130m	Goldman Sachs
Frans Bonhomme	LBO	FF400m	ICG
HLF Insurance Holdings	Acquisition finance	£40m	ICG
MGE UPS	LBO	FF600m	ICG/Paribas
Nycomed Pharma	LBO	NOK1bn	SE Banken
Steiner Industries	LBO	€55m	Merrill Lynch
Takko Modemarkt	LBO	DM200m	ICG
Tata/Tetley	Acquisition finance	£40m	ICG
Vantico (Ciba Polymers division)	LBO	€110m	CSFB/Merrill Lynch

Source: Initiative Europe, Fitch IBCA, ICG