

INTERMEDIATE DANGER

News that ICG's bad loan provisions have rocketed is proof that mezzanine is not immune to recession. But with money in their pockets and an expanding market opportunity, mezz houses could still come out of the credit crisis on top.

WORDS **SAMUEL BARTON**

MEZZANINE PROVIDERS WERE MEANT TO BE one of the credit crunch's winners. A rapid decline in the availability of senior financing increased demand for subordinated debt, and a heady fundraising environment meant mezz houses were flush with capital, ready to put to work.

Indeed, just a year ago it seemed that, despite general market deterioration, everything was going mezzanine's way. Fast forward 12 months, however, and it is clear that mezzanine firms are as susceptible to recession as anyone. Look no further than UK-listed mezzanine specialist ICG.

In the first half of 2008, ICG's profits were soaring, with the firm launching a £1bn (€1.1bn) recovery fund and £500m new credit facility to provide it with sufficient resources to capitalise on the market opportunity.

Two weeks ago, though, it shocked the market with an interim management statement that triggered a 30 per cent fall in the firm's share price. Chief executive Tom Attwood said he expected provisions for bad loans to increase markedly in 2009, revealing that the default rate had risen to about four per cent of ICG's £3bn under management, and could reach up to ten per cent in the coming months.

"Clearly, mezzanine providers will encounter problems," says John Clifford, head of mezzanine at Investec. "If any business is struggling because of senior debt, then by definition the mezzanine

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is not going to be a nice place to be."

"If you take 40 per cent off company valuations, you do wonder if the mezz will still be in good shape," agrees Hugh Brown, global head of corporate finance at PricewaterhouseCoopers. "If you have mezzanine sitting on top of five or six times Ebitda of senior debt, then any impairment on price means it will be out of the money."

In fact, the poor conditions for completing new buyouts – combined with the woeful economic environment – means that, like most buyout houses, mezzanine lenders are likely to spend the majority of 2009 looking inwards.

"The mid-market could be okay, because the leverage levels were lower, but the larger

syndicated transactions will have problems and there will be write-offs," says the head of mezzanine at one European investment house. "The market has been pretty bad. I think everyone is just going to concentrate on their portfolio."

"The big issue out there is what's happening in people's portfolios," agrees Rory Brooks, co-founder of MML Capital. "Everyone will face issues. There's a huge furore about valuations, and we are seeing people being forced to write down assets markedly, even though their trading may be up."

There are rumours that Goldman Sachs has written off a SKr2bn mezzanine tranche in Nordic Capital portfolio company Thule, for example, while mezz lenders have also taken a hit on UK retirement home builder McCarthy & Stone.

Restructuring opportunities

Like private equity firms, mezzanine houses have been battling a lack of deal flow. But most are optimistic that 2009 will present restructuring opportunities, providing financing for companies that cannot command the senior multiples at which they have borrowed in recent years.

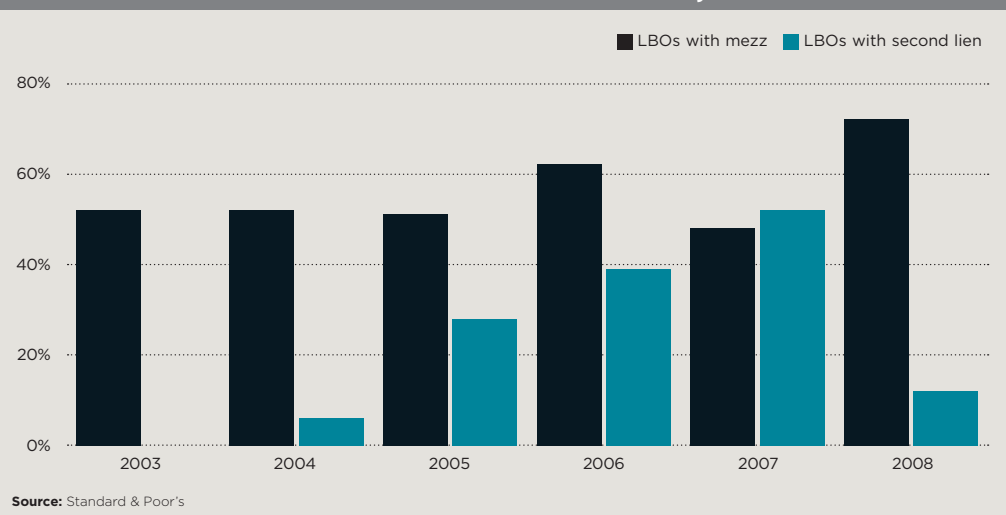
"There will be more incidents of companies with inappropriate financing structures needing to be restructured – almost certainly with mezz involved," says David Wilmot, head of mezzanine at Babson Capital Europe. "Private equity sponsors are proactively looking for distressed sellers and that will generate deal flow."

"Clearly there are going to be many restructuring transactions, where the balance sheet is overleveraged but the underlying business is sound – these will boost deal flow," agrees Indigo Capital managing partner Richard Collins.

In addition, the demand for mezzanine in those few deals that do come to market will be high – thanks both to the chronic shortage of senior debt and the withdrawal of opportunistic providers such as hedge funds that emerged during the boom years. The disappearance of features such as second lien and payment-in-kind notes, and a return to more traditional deal structures, with warrants and higher coupons, is also proving to be a driver (see graph).

"Players who had got into the market during 2005 to 2007 suddenly found last year that they couldn't operate any more," says Wilmot. "They found themselves short of liquidity, which made

STRUCTURE OF LBOs IN WESTERN EUROPE, 2003-2008



an illiquid investment like mezzanine something that they couldn't hold."

Lenders are also finding that, in contrast to two years ago, when phenomena like one-stop financings meant independent houses often didn't get a look in, almost all deals in the market are coming across their desks. "If intermediaries are trying to find financing, because of the shortage they will call us," says Collins. "Numerous funds have raised money - that's a very useful resource and leaves mezzanine providers in a strong position. We will be taking less risk for more return because of that. The days of mezz being a poor risk for the underlying investor are gone."

This has had the knock-on effect of putting mezzanine houses in a strong negotiating position - in contrast to distressed situations, where they can often find themselves at the mercy of the senior debt holders, and are also rarely in a position to attempt to actively manage a company out of trouble as an equity provider would. "In early 2007, mezz was highly competed for among institutions," says Wilmot. "Now there are a much smaller number of potential providers, and therefore we are looking at ourselves as a cornerstone provider. As a corollary, we then have an ability to influence structure and pricing more directly."

"It's a lot easier to get pricing that's satisfactory to our LPs," adds Brooks. "When it comes to terms and conditions, we can pretty much say: 'here's a document, please sign it'. The pricing dynamic has moved significantly in our favour" (see box).

Slim pickings

Sadly, the stagnant buyout market means that mezzanine providers are seldom able to enjoy this position in the driving seat. The few deals to have closed since last summer include Duke Street's acquisition of medical diagnostics business Biomnis, which included a tranche from Axa Mezzanine, and Investcorp and Barclays Private Equity's acquisition of N&W Global Vending, which included €130m of mezzanine.

Those that remain hungry to put money to work must work hard to source less conventional deals. In addition to restructuring opportunities, areas of interest include take-privates, which are becoming more attractive as a result of low share prices, and corporate disposals, with some also suggesting that less cyclical businesses, where there is good visibility of earnings, are providing deal flow.

Others, including ICG, which is in the process of raising its recovery fund, are looking at discounted senior debt. "Activity revolves around a few primary buyouts, as well as existing portfolios and secondary trading activity - including debt," says the firm's head of mezzanine Steven Clarke. "Our expectations are that buyouts will come from corporate disposals. We're also looking at buying senior debt in the secondary market."

There is also the small stimulus - a vague light at the end of a long tunnel - that vendors will eventually return to the market, conscious that

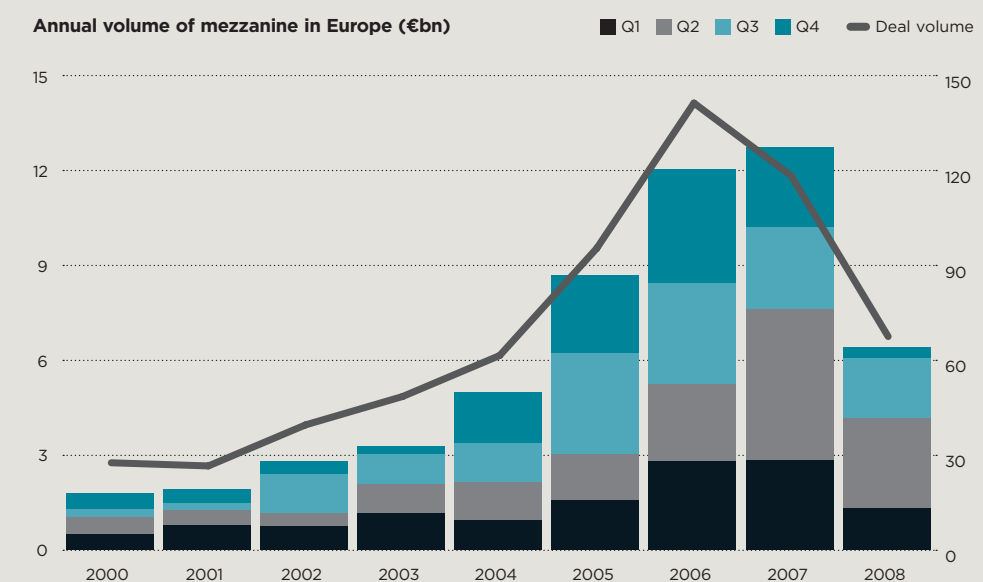
DOWN BUT NOT OUT

The huge shortfall of plain vanilla private equity transactions has, predictably, had a pronounced impact on the level of mezzanine financing. Total funding levels in 2008 fell back markedly to pre-2005 levels, despite a significant increase in the proportion of deals involving subordinated debt, according to research by Standard & Poor's.

Things became worse as the year wore on, with a deathly quiet final quarter, and the outlook for early 2009 is widely viewed to be much the same. "There will be strong demand for mezz towards the end of the year, as there was at the start of 2008," says one provider. "There are just no transactions at present."

Indeed, so few deals are now being done that it is virtually impossible for lenders to reach a consensus on how average pricing of mezzanine tranches has moved, though most agree that spreads have increased by between 100 and 200 basis points during recent months, and are now likely to be close to their peak.

"Senior and mezz have become more expensive, but it hasn't changed hugely," says John Clifford, head of mezzanine at Investcorp. "A 17 to 18 per cent IRR on five times leverage is far less preferable to a 19 to 20 per cent IRR on two times leverage. However, there comes a point where if you push up the pricing too much, it becomes less attractive than doing the whole equity funding yourself."



Source: Standard & Poor's

they cannot hold off selling for ever. "Everyone is realising that valuations are not going to go back up to 2006 prices quickly," says Clifford. "But you can't put off selling forever. There are reasons people sell that are not related to getting the right price - there will be more deals towards the end of the year."

It is this eagerness to get back in the game that will stand mezzanine houses in good stead during 2009 - even if opportunities are limited in the first half of the year. As well as a new-found lack of competition from other institutions, restructuring opportunities and a return to traditional deal structures, the asset class also benefits from growing appetite from battle-scarred LPs.

According to research by placement agent Almeida Capital, released last month, 55 per cent of LPs now state an interest in investing in mezzanine funds - up from 46 per cent last year. "It is a good risk/return proposition in the current market," agrees Wilmot. "Leverage has come down, and mezz is a good producer of cash on a

periodic basis - as opposed to at the end of the deal. There are signs of growing interest."

The head of one mezzanine house, currently on the road, says that while decision-making is slower as LPs wait to see how valuation issues pan out, interest has never been higher.

"Mezz has always held an attraction to investors as the J-curve is much shorter," adds Collins. "Some LPs have recognised that the next couple of years will be a very good time for mezz, and those that have been raising funds have been doing well."

With LP support behind them, those mezz providers whose existing portfolios avoid the worst ravages of recession will be in pole position to capitalise on an expanding market opportunity in the year ahead. There will undoubtedly be challenges, but mezzanine could be a credit crunch winner yet. ●

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