

## Mezzanine capital: last man standing?



*Even as deal flow across Asia remains slow, mezzanine funds have seen increased opportunity to step into the gap left by the withdrawal of other debt providers.*

Two recent deals have highlighted the changing role of mezzanine capital in the Asia Pacific.

In the first, Asia Mezzanine Capital arranged \$40 million in mezzanine capital for Chinese steel component part manufacturer, Anhui Yinglue Group. The deal, which was announced in January, saw Asia Mezzanine provide \$25 million out of its Asia Strategic Capital Fund.

In the second, also announced in January, CLSA Capital Partners' mezzanine management arm led a consortium of investors including AXA Private Equity in financing the \$85 million privatisation of Singapore-listed Midsouth Holdings.

Both deals were led by the mezzanine investor and both reflected a move away from mezzanine's limited pre-economic crisis role of a provider of expansion capital to its new role of being sometimes the only source of liquidity available.

Mezzanine providers are quick to point out though that the deals are not pouring in – deal flow is as slow for mezzanine players as it is for GPs in general and for exactly the same reasons.

However, when companies have no choice but to seek fresh financing, that's when the opportunities for mezzanine become apparent – as highlighted by the two deals above.

Sources close to the Anhui Yinglue deal said it originated out of a "busted IPO". With China's stock markets all but closed to new issuances, companies that received short-term financing to tide them over before they listed are now being forced to seek alternative forms of capital.

Also relevant in the pre-IPO opportunity set is the nature of these

companies' previous financiers: the hedge funds and investment banks that as Joseph Ferrigno, managing partner of the Asia Mezzanine Capital Group, says were providing "mezzanine finance on silly terms without performing proper due diligence".

Now many of the hedge funds have disappeared and the investment banks have closed the principal fixed income desks that were looking at these sorts of deals, leaving more opportunities for the mezzanine players.

Companies themselves are becoming more averse to short-term lenders. Simon Sham, a managing director in Darby Mezzanine's Hong Kong office, which concentrates on expansion capital, says: "I think more companies are looking to replace their short-term working capital lines with longer-term funding and therefore where they may have had 50/50 short-term and long-term financing before, they may now want to have 75 percent long-term and 25 percent short-term."

While the move to a more long-term outlook definitely helps the mezzanine cause, it is perhaps the lack of availability of senior debt in Asia at the moment that has changed things most for mezzanine players.

Before the crisis, there wasn't much call for mezzanine in the buyout space, as Chris Heine, managing director of ICG in the Asia Pacific, states: "There was simply so much leverage that there wasn't a place for mezzanine in the capital structure – you could get away with other forms of debt, or you could inject more equity."

However, as CLSA's Midsouth deal shows, times have changed.

Delatte comments: "From a structural perspective, there was no senior lender. CLSA provided the sole tranche of debt, structured with a strong equity upside. We are looking at a number of deals where there's no senior lender per se, just us in the structure."

Mezzanine is also stepping in to replace senior debt on deals that have already been done, as Heine continues: "We're supporting sponsors in some businesses where, for example, they actually will use mezzanine to replace some of the senior [debt] because the business is still trading well – it's just trading slower than the bank base case."

The secondaries debt market should also provide rich pickings to mezzanine funds, with returns to be made in senior or subordinated debt assets.

The increased opportunity set for mezzanine providers has been reflected in changing LP attitudes to mezzanine funds.

Stephen Temple, a partner at Asia Mezzanine Capital Group, comments: "When we were raising capital for our second fund during the last couple of years, our target returns in the high teens, low twenties weren't really interesting enough to some LPs.

"Now everybody's appetite towards risk has changed and expectations on returns are not as high as they were; they're focusing more on risk/return profiles and they're seeing mezzanine as a potentially more conservative entry into Asian markets." ■