

Mezzanine Q&A: Joseph W. Ferrigno III

Joseph W. Ferrigno III, Managing Partner of Asia Mezzanine Capital Group, shares some personal reflections on the history and current state of mezzanine in Asia Pacific

Q: How do you characterize mezzanine as an asset class? What are some of its distinguishing features?

A: For investors, the relative degrees of effective downside protections and optionality for the sharing of equity returns upside, and the likely achievement of superior of risk-adjusted returns, are the most distinguishing features.

To elaborate, a little of the history of mezzanine in finance and investment. According to Merriam-Webster, 'mezzanine' is traced back to the French who borrowed it from the Italians, 'mezzano,' – based on a Latin word, 'medianus,' meaning 'middle' or 'median.' Its use in English probably began around the early 1700s when it was applied to an intermediate story of a building.

On the Continent, 'mezzano' may have been used much earlier to describe a financing method used for the Fourth Crusade by the Venetians during the early 13th century. European financiers also employed mezzanine capital agreements to obtain shares of explorer takings during the beginning of the first era of globalization – the 15th-17th centuries – when captains and crews of the 'Black Ships' from Spain and Italy risked extraordinary perils to bring back riches from the Orient.

In modern finance and investment, 'mezzanine' is rather loosely used to refer to any of a nearly infinite number of ways that debt and equity elements of a financing/ investment can be combined to satisfy needs for public and private companies and sovereigns and for investors/lenders. A variety of profiles of perceived risk/expected returns are possible. Mezzanine is in the eyes of the beholder.

Q: How do you see the current environment for mezzanine investing in Asia Pacific? How has this been affected by the global crisis?

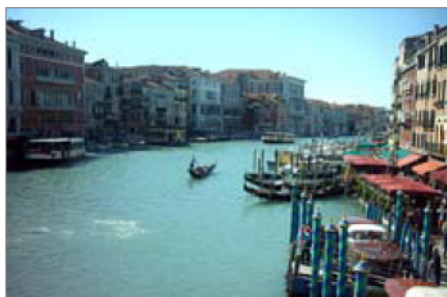
A: The demand, globally and in Asia, for mezzanine capital investments of all types is directly affected by the general availability of debt in the banking and non-banking systems – and of equity in the relevant equity capital markets. During the credit boom, commercial and investment banks, and hedge funds, were highly active in providing mostly shorter-term mezzanine-type loans, usually without equity participations, to a variety of good and bad borrowers in Asia.

Most mezzanine fund investors, wisely, did not compete with these players, even though they lost many opportunities as a result. Since the credit bust, those shorter-term, higher-risk players have been less active. It's the local equity markets that have limited opportunities for the longer-term more cautious mezzanine investors this year.

I believe that a sea change may be occurring with the developed-world economies beginning to come out of recession, as central bankers are able to gradually withdraw the extraordinary level of liquidity which they pumped into their systems. If history is an indicator, they will probably again get things wrong and withdraw liquidity and increase interest rates prematurely. This will drive good companies to



Joseph Ferrigno



Venice, home of some of the earliest mezzanine investors

seek alternative financing sources, which will be the opportunity which people like us have been waiting for now for some time.

Q: How does mezzanine operate in the Asian investment environment? How does it function in relation to regional corporates, and private equity firms?

A: Compared to the developed world financial markets, there are significant differences in the Asian investment environment. Not surprisingly, due to the complexity of mezzanine, and the relatively limited knowledge of mezzanine methods by Asian company managements, and, in some cases, even their advisers, and private equity firms, mezzanine fund GPs and other providers have to educate. What we have found is that once our type of longer-term strategic mezzanine capital is explained, it is interesting to many companies and PE firms because it minimizes equity dilution, leverages returns and is longer-term in nature. As you know, most Asian company owners and PE firms would rather have debt than equity, to preserve their equity ownership levels.

Another difference is that in Asia, there are no standard mezzanine loan agreement conventions and customary provisions. Each situation is unique and requires time to negotiate and close.

The function of mezzanine capital for regional corporate and private equity firms is similar to that in the developed markets, i.e. a substitute or complement to senior debt and/or public or private equity.

Q: What are some of your personal reflections as a veteran Asian mezzanine investor on the development of the discipline in the region? What point has it reached?

A: Mezzanine investing certainly does require discipline in order to achieve the superior risk-adjusted returns which are the basic rationale for investors to make mezzanine-type investments. In my experience, not just in Asia, but globally, sound credit principles and practices were abandoned in all types of lending. We know what happened as a result.

Q: What do you see as the prospects for mezzanine investment in the medium to long term in Asia?

A: I think the opportunities are likely to be good to very good over the medium to long term, as the credit and equity markets normalize. Huge government borrowing will cause inflation and interest rates will have to be increased, and excessive levels of liquidity signii That will be good for the mezzanine investors which can demand higher returns from better-quality borrowers.