

Mezz financiers aim to offer Asian businesses shelter from the rain

With firms struggling to finance existing debt or raise capital, increasing numbers are likely to tap mezzanine finance for funds. Although relatively expensive, these deals allow business owners to access liquidity without diluting their common stock. But while more deals are coming, it will be a trickle rather than a flood. Pamela Tang reports.

It is said that banks only offer you an umbrella when it's sunny. Over the past six months, it has begun to rain pretty heavily in Asia.

Companies have increasingly found themselves in need of finance. And with equity markets largely out of favour and highly volatile, turning to banks made sense. Until recently business owners in Asia could reliably expect to gain funding from their banks, but now most requests are being met with flat refusals.

It has left many businesses casting around for funding options, as they struggle to finance existing debt or raise capital to expand. Increasing numbers are likely to turn to mezzanine financing.

This funding method is a hybrid of debt and equity, typically structured as debt plus a right for the lender to take an equity stake in the borrowing business. The stake, when exercised, can allow lenders to enhance their future returns or to take a stake if their debt isn't paid back in time.

The funding is expensive against most other debt channels, and for that reason did not appeal to companies when commercial banks were dangling low interest rate loans and IPOs were being snapped up by hungry retail and institutional investors. Only companies that had reached their senior debt limit or could not tap stock markets would consider it.

But as the markets have soured, the tables have turned.

On January 30, Asia Mezzanine Capital invested US\$40 million in the Anhui YingLiu Group, a China-based steel components parts manufacturer. And on the same date, CLSA Mezzanine Management announced the successful delisting and privatisation of Midsouth Holdings via a US\$85 million financing facility which, combined with equity committed by the deal sponsors, was used to acquire the firm's outstanding shares.

"We're seeing a lot more companies that need capital and can't get it from the equity market or the debt market," says Joseph Ferrigno, managing partner at direct investment fund Asia Mezzanine Capital Group in Hong Kong. "We would expect that by year-end more financing and investments will be done using mezz-type structures than last year."

FREEDOM AT A COST

Mezz finance deals are typically structured as either an unsecured or subordinated (junior) note, or as preferred stock issues, and they frequently involve greater leverage levels than would be countenanced even in high-yield bond deals.

Add into that the fact that banks and senior bond holders would be paid first in the event of a company defaulting on its debt, and it's not sur-



prising that mezz financiers ask for a higher return on their debt than vanilla loans or bonds.

Business owners have to pay more than traditional bank debt. Mezzanine funds typically seek annual returns of 20% on their investments and some are asking for even higher returns in this environment.

Mezz financiers like to sugar-coat this extra cost, arguing that entrepreneurs may pay more for the capital but it gives them the funds they need to expand in difficult times or acquire rivals at reasonable valuations.

The truth is that the mezz financiers are charging them more because they can. After all, borrowers who are seeking mezz funds evidently don't have many other choices.

"Customers are happy with higher pricing because we're still providing them with the necessary help and it works out for them," says Wilson Wan, head of leveraged and structured finance at Boci Asia, the investment banking arm of the Bank of China. "In most cases, our customers can get much higher returns from their investments and are more than happy to share their gain."

While mezz financing is relatively expensive, the deals allow business owners to raise money without having to dilute their common stock as much as would be the case if they raised cash in the public or private equity markets.

Mezz funds take equity stakes through shares or warrants that can be converted into shares upon exercise, but because they do not seek controlling stakes in companies, they will typically ask for less equity than private equity funds.

The agreements with business owners can range from mezz lenders taking a small equity stake through instruments that can be converted at

a specific or at any time, or for the entrepreneur to regain the equity stake at the end of loan.

Such flexible agreements would appeal to entrepreneurs who are unwilling to cede company control.

“In this current market, mezzanine financing is more suitable for many owners who are worried about dilution,” says a private equity executive in Singapore. “They want to keep control while raising the money, so we think that mezz financing would be the most suitable.”

Mezz financiers also tend to offer more flexible funding than a bank would.

“It can be flexibility in terms of [the] repayment schedule where there can be less cash pressure in the initial years of the operation or it can be structures where the cash component of yields can be adjusted,” says Stephane Delatte, managing director of the mezzanine fund at CLSA Capital Partners in Singapore.

NEED TO BE SELECTIVE

As the two deals seen this year so far reveal, business owners are taking an interest in the concept of mezz financing.

But while more deals should be forthcoming, it's likely to be a trickle rather than a flood. Mezz finance companies typically invest in companies that have potential to grow quickly and generate stable cash flows with the funding injection. But the souring global economy has made it much harder for companies to do this.

“There are higher risks than before, and so you have to be very selective on what you want to be involved in,” says Wan.

As a result, mezz lenders are placing an enormous emphasis on checking into a company's current cash flow positions, working capital requirements and potential bad debts and receivables. Mezz financiers argue that they conduct much more extensive due diligence processes than banks would. These typically include background checks on the business owners and their senior managers.

Some mezz lenders in Asia are going one step further by asking for collateral up front, effectively making the financing senior in nature. That's a departure from common practice in the US and Europe, where lenders accept that companies have sizable amounts of senior debt that will be paid ahead of mezz financing.

“We are not like traditional mezz funders in developed economies like the US and Europe, which primarily rely on cash flows. We never lend without collateral and so are senior-secured more often than not,” says Dennis Wuisan, a partner at mezz financier Kendall Court Capital Partners in Jakarta.

CAUTIONARY US TALE

Given the problems that mezz companies have suffered elsewhere, this cautious attitude is understandable.

In the US, mezzanine lenders who helped to finance the US commercial property boom are knee-deep in problems and likely to have lost billions of US dollars, according to media reports. The losses are set to balloon as the commercial property sector corrects further.

Mezzanine financiers say that only hedge funds have ventured into Asia's commercial property segment, but they nonetheless acknowledge that the experience of the US acts as a cautionary tale.

Such lenders in Asia are already seeing stresses to their portfolio as the world experiences its worst downturn in decades. “No one is insulated from this crisis and all are affected in one way or another,” says Wuisan. “The key is working through these situations and managing them effectively to

ensure that the right measures are put in place to weather this storm.”

There are ways to manage this, all of which involve some form of restructuring. Several commonly-used ways involve extending the grace period for repayment, changing the cash interest into payment in kind or entering into some form of debt-to-equity swap.

The swap can give shareholders a call option that allows them to buy back the shares from the mezz lender later at a higher internal rate of return. This would ensure that the business owner's equity isn't diluted when the company rebounds.

Others say that provisions in some mezz loan agreements allow mezz financiers to step in when there is an indication that cash flow will fall to an unacceptable level.

“We are able to get involved in the management of the company before it goes into default, which is one of the benefits from the point of view of the investor and lender versus common equity,” says Ferrigno.

UMBRELLA SERVICE

The mezz financing industry has experienced its own shake-out in the past year. The handful of traditional mezzanine funds that remain in Asia continue to operate but other participants, such as hedge funds and banks, appear to be bowing out.

This could partly be because leveraged buy-outs have fallen off a cliff. This sort of activity had sustained many mezz financiers – dedicated funds, hedge funds or banks – in 2006 and 2007 when corporate business was scarce. According to data provider Dealogic, there have been only three leveraged buy-out loans in Asia-Pacific ex-Japan executed since September, worth US\$660 million.

Commercial banks with leveraged finance arms have also cut back significantly, save for a few backed by strong balance sheets. One that has bucked the trend is Boci, which started its leveraged financing arm in May 2007.

“We were fortunately born at a time when things were not too sour and weren't hurt by the subsequent events,” says Wan, who heads the unit. “When things became sour, we were one of the few that were still providing strong support to the market and that's why people come to us.”

Unlike their banking counterparts, mezzanine finance companies in Asia may well be willing to offer umbrellas to firms that otherwise stand to get very wet in these soggy markets. You may see more business owners reaching out for one. ▲

PUBLICISED ASIA DEALS YTD

January 30: Asia Mezzanine Capital invested US\$40 million in the Anhui YingLiu Group, a China-based steel components parts manufacturer. The proceeds of the investment will go towards expanding the company's production capacity and debt refinancing.

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