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The third way

Growth capital mezzanine players are still few in number in Asia. Will struggling equity markets and tighter credit conditions open up the market for these alternative capital providers?

IHH GLOBAL ISN'T TAKING ANY CHANCES. The hospital chain, which is controlled by Malaysia's Khazanah Nasional, has lined up cornerstone investors to cover more than 60% of its $2 billion IPO. It is likely to be one of Asia's largest listings of the year, joining the ranks of Felda Global Ventures and Haitong Securities, but those two relied on cornerstones to pick up only about one third of their offerings. IHH knows it is up against an increasingly unfriendly market, and is taking appropriate precautions.

The list of Asian IPOs that have been abandoned in recent months is long and distinguished. Graff Diamonds, Formula One, Hyundai Oilbank and China Yongda Automobile Services are the highest profile cases in a string of failures. As of June 1, 46 companies have withdrawn or postponed offerings worth a total of $7.7 billion, according to Thomson Reuters.

Investors are pulling out of equities with a vengeance, spooked by uncertainty in the euro zone, the weak state of the global economy and concerns that the China growth story won't be there to shore up demand. Lower public market valuations are welcomed by mainstream PE firms, but what of specialist mezzanine providers?

Companies that were preparing for IPOs suddenly find themselves without the expected resources; others face debt refinancing issues in a tough credit environment. Growth-oriented mezzanine funds are a natural port of call for firms in need of capital to tide them over.

Industry participants say their phones are ringing more frequently, but this doesn't guarantee a favorable response.

"Although we are seeing deal flow, I would have to say the quality isn't appearing right now," says Stephane Delatte, who heads up CLSA Capital Partners' mezzanine fund in Singapore. "It might be a function of the current macro environment. People are looking for refinancing or they want to take out existing investors, but these situations aren't easy, with the business struggling operationally."

Excessive leverage is a common problem. In the last fortnight, Delatte was visited by a company that raised funds from a private equity investor three years ago and then saw its business go through a downturn. The leverage on the original deal was 3x but the company's EBITDA tumbled and it failed to pay down the debt. As a result, the leverage ratcheted up to 5x and out of CLSA's comfort zone in this instance. Restricted due diligence and industries facing significant headwinds are also frequent turn-offs.

Long term, short term

"It's an interesting time, but reading the risk profile is very important," adds Chris Chia, managing partner of Kendall Court Capital. "What we do is not a cyclical business – there will always be a group of people that won't be able or prefer not to get traditional forms of financing, depending on factors such as the size and the complexity of the business and the investment."

Capital is a commodity and it will always be available from multiple sources, although liquidity and cost inevitably vary. Growth mezzanine providers are competing against the equity and debt markets, commercial banks and corporations, depending on their remits.

However, the crux of Chia's remark is that the short-term opportunities presented by stumbling capital markets or tighter monetary policy aren't as significant as more enduring factors. Broadly speaking, in Asia these are twofold: inefficiencies in emerging economies' banking systems that deny small- and medium-sized enterprises (SMEs) access to growth capital; and a hesitancy among entrepreneurs to dilute their ownership by selling large amounts of equity to investors.

The mezzanine package of debt plus an equity kicker is attractive option for companies caught in this kind of bind. They get capital that might not otherwise be available in return for a relatively small portion of ownership, and business growth is fast enough to meet interest payments on the debt. "What excites people the most is realizing that we don't require 30% of the equity," says Joseph W. Ferrigno III, managing partner of AMCG.

While the opportunities in this niche seem compelling, there are relatively few pan-Asian participants. Strip out the short-term players – funds that focus on subordinated debt in leveraged buyouts or 3-6 month commitments to M&A transactions and pre-IPO deals – and the mezzanine growth capital space is populated by AMCG, CLSA, Darby Asia and Kendall Court. A few banks, notably UOB, DBS, Credit Suisse and UBS, provide financing from their balance sheets.

This may be tied to the breadth of what these operators do and the extent to which other capital providers can cover parts of the market.

Generally speaking, to qualify for mezzanine support, a company must have at least $200-300 million in annual revenue and $15 million in profit. Beyond that, roles are difficult to define. CLSA dismisses pre-IPO deals out of hand but UOB will look at them in certain circumstances; AMCG won't touch real estate; Credit Suisse and UBS will be asked to provide working capital to a company in return for securing its IPO mandate.

Financing structures, though they fit

Growth capital-oriented mezzanine funds in Asia

Fund	Manager	Launch date	Assets (US$m)	Status
Darby Asia Mezzanine Fund	Darby Asia Investors	2002	-	Disinvestment
MezzAsia Capital	CLSA Capital Partners	2002	112	Final close
Kendall Court Mezzanine (Asia) Fund I	Kendall Court Capital Partners	2004	90	Final close
Darby Asia Mezzanine Fund II	Darby Asia Investors	2005	254	Final close
Development Partners Fund	Development Principles/ FMO/Value Partners	2005	86	Final close
Asia Strategic Capital Fund	AMCG	2007	-	First close
Kendall Court Mezzanine (Asia) Bristol Fund	Kendall Court Capital Partners	2009	150	Final close
CITIC Mezzanine Fund	CITIC Private Equity	2011	-	Raising

Source: AVCJ Research

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the basic debt-plus-equity rubric, are also highly customized. Kendall Court's Chia says instruments used "range from senior equity to a straight loan," and there is no real template for what comes in between. All kinds of preference shares, bonds, loans, warrants and debentures feature in deal structures, depending on the risk, the client's requirements and the regulations.

Mode of entry

According to Ferrigno, AMCG gets involved when a company requires capital to go in a new strategic direction or pursue a build-out. This is a broad explanation of what often become highly nuanced situations.

Coming in after an IPO has been pulled and there is no money available for planned acquisitions or participating in a Series C round because the founders don't want to dilute much more of their stake are relatively straightforward mezzanine opportunities. Ferrigno takes it a step further. "We recently met with a guy from a major buyout fund who wants financing for portfolio companies," he says. "The PE firm doesn't want to put in any more equity but it doesn't want to hold back the companies' development. Our kind of mezzanine growth capital fills the gap."

This is not the only way mezzanine performs a service for traditional private equity investors. In a leveraged buyout, much of the projected cash flow is locked down by lenders in order to repay the debt, often leaving little in the company's strategic reserve. Mezzanine can play a quasi-equity role, providing capital for expansion.

The nature of mezzanine participation varies still further in response to geographical peculiarities. In China, for example, offshore loans secured against onshore assets remain a concern. "Unless you have a presence onshore and are able to do direct lending, you cannot recreate the same level of security by being an offshore lender," says CLSA's Delatte. "You have to take the view that collateral must be offshore and, as a result, seek businesses with less leverage than you would normally go for because you are one level removed from the assets."

Ideally, loans are made to the owners of an offshore company that controls the onshore operating business and receives a share of the profits through dividends. The collateral is essentially shares in this offshore vehicle, but it is possible to go deeper. CLSA invested in a Singapore-listed Chinese firm through a bond issue, using a separate infrastructure business, also owned by the offshore company, as security. CLSA took comfort from the fact that, if the company defaulted, it would be relatively easy to realize value from the infrastructure assets.

This approach is par for the course in Southeast Asia, where entrepreneurs tend to own multiple businesses. Only 1-2 of these companies might need financial support, so the others can be used as a counterweight. Even if the pledged assets aren't sufficient to cover the collateral, standard equity investments – where the entrepreneur is just a passive shareholder – can be used instead, according to Wee Yap Yeo, head of mezzanine capital at UOB.

Yeo recalls putting together an acquisition financing package for an entrepreneur who wanted to buy a PE firm's 25% stake in his business. The entrepreneur only owned about 10% of the listed company, so the structure had to meet his significant capital needs without stretching beyond UOB's risk profile.

> **"There is always a need to educate potential portfolio companies on the structures, terms and benefits of a mezzanine capital investment"** – Joseph W. Ferrigno III

"The CEO had a separate business in the same space, so we took a security charge over that asset and agreed that, after 12 months, he would arrange for the listed company to buy this business," Yeo says. "That transaction was used to take us out, so we were assured of an exit."

As a commercial bank, UOB can claim to have an edge over independent funds in that it has a ready-made deal network. Many potential customers already have a corporate or retail banking relationship with the Singapore-based lender and are referred to the mezzanine department when appropriate. This has more of an impact in Southeast Asia, where UOB has 485 branches, than in China, where it has only 10.

Denied access to a broad-based referrals system, growth capital mezzanine players must rely on their own networks. Up to one third of deals come from PE firms and the chances of participation tend to be higher because most PE investors know what their mezzanine counterparts are looking for. Beyond that, word-of-mouth is the single biggest driver of business.

"There are many reasons why people might be interested in what we have to offer, but awareness of this type of capital is very limited in Asian countries," says AMCG's Ferrigno. "There is always a need to educate potential portfolio companies on the structures, terms and benefits of a mezzanine capital investment."

Some countries in the region are more open to mezzanine solutions than others. Attitudes are strongly influenced by perceptions of interest rates on loans that exceed standard bank rates versus the value placed on equity dilution. China and Indonesia are good examples.

While Chinese small- to mid-size companies often find domestic banks don't meet their needs, some entrepreneurs baulk at a debt instrument with a coupon in the high teens. Compromise positions usually involve a lower interest rate but a larger portion of equity warrants. This attitude can be traced back to a stable domestic lending environment – in the last six years, the country's one-year benchmark lending rate has shifted no more than 120 basis points above or below its current level of 6.31%.

Indonesia is markedly different. In January 2006, the lending rate was more than 12% and it is only since late 2010 that some semblance of order has been restored. "If Indonesian corporates are borrowing from commercial banks, they are paying 6-7%. In a Singapore context, they pay LIBOR plus 100-200 basis points, which is less than 3-4%. We are seeing people pay at least high teens to low 20s, depending on the equity position," says UOB's Yeo.

This also means there is more competition from other sources. Hedge funds and the investment units of family conglomerates are willing to lend rather than take equity, and one domestic GP – Quvat Management – even has a sideline mezzanine business. According to a source familiar with the firm, entrepreneurs are happy to take out a $35 million loan at 17% if their revenues are growing at 25% year-on-year.

Enlightenment?

For growth capital mezzanine to break through into something more like the mainstream in Asia, patience is required. The difference between mezzanine and hedge funds is longevity and the impact this has on alignment of interest, but few funds or SMEs have been around long enough to see beyond the cycle they are currently in. Global markets haven't helped either, offering up cheap credit and equity market bubbles in recent years.

Perhaps most damning of all is that rapid growth in many of the region's emerging economies has encouraged short-termism. Awareness and acceptance of mezzanine solutions – which are by definition more conservative and reliant on credit assessment than much of growth capital – is therefore limited because there has been little call for them. Why would a Chinese entrepreneur choose a financing package he doesn't fully understand when a local VC is promising a quick 20x return?

It's possible that an extended period of market volatility may change this thinking.