ASHBURTON INVESTMENTS

The benefits and risks of investing in mezzanine debt

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Mezzanine debt sits between the senior debt and the equity in a company's capital structure. It is typically used by mid-market private companies to finance leverage buy-outs, acquisitions, expansions, recapitalizations, and BEE transactions. Growth companies are best suited to mezzanine debt where shareholders wish to avoid the high cost of equity and the dilution that occurs when an equity deal is consummated.

The benefits of investing in mezzanine debt can include the following:

- **Regular cash distributions**
  The core of mezzanine is a debt instrument which has a negotiated interest rate somewhere in the mid-teens. The mezzanine lender will typically insist on a portion, if not all, of the interest being paid in cash and generally on a quarterly basis. These returns can then be regularly distributed to investors.

- **Potential high total returns**
  Due to the fact that mezzanine debt is subordinated to senior debt and usually only has second ranking security over the company's assets, it attracts higher returns. These returns are made up of an interest rate on the mezzanine loan and an equity kicker (being a share in the increase in the value of the company) in order to achieve total returns in the late teens or early twenties.

- **Low volatility due to the high contractual return**
  Approximately 60%-70% of the return from a mezzanine investment is generated from the contractual interest component, with the balance being generated from the equity kicker. The high interest coupon, which is priced around 15% and mostly paid in cash, reduces the overall volatility of returns to investors. Even if there is no return generated from the equity kicker, the investment should still return a high contractual interest return.

- **Downside protection**
  As most mezzanine transactions are privately negotiated transactions, these transactions are tailor made to suit the company's growth and cash flows as well as to protect the mezzanine investor's investment. The investor achieves downside protection on a mezzanine investment through:

  - thorough due diligence and structuring of the mezzanine investment;
  - ensuring significant shareholder "skin in the game";
  - obtaining security (at least second lien);
  - financial covenants, and;
  - monitoring of the company's performance, including receipt of the monthly management accounts, board materials, discussions with management and shareholders and taking an observer seat on the company's board.

  Greater access to the company's information allows the mezzanine investor to detect a potential event of default earlier and to be proactive in protecting the investment prior to a default occurring.

  As with all asset classes, there are however some downsides to investing in mezzanine debt. These potential downside risks include:

- **Lack of liquidity**
  An investment into a mezzanine instrument is a long-term investment and is hard to sell or liquidate prior to its maturity. While there is a quicker return on capital, as compared to a private equity fund, due to the contractual interest payments and the self-liquidating nature of the equity kickers, investors have very limited alternatives in terms of exiting the investment before its due date.

- **Protected only to the extent there is equity or other guarantees**
  Mezzanine debt is generally subordinated to the senior debt in a company and will usually only have second lien security over the assets. In the event of a default, the mezzanine investor is only protected to the extent that the value of the company does not decline by more than the amount of its equity and other guarantees provided to the mezzanine lender.

- **Mid-market companies have lower governance and typically less seasoned management teams**
  As mezzanine investments are mostly made into founder or family owned companies, these companies tend to not have the seasoned management teams that are found in large corporations. Due to their size they often also have a lower standard of governance and financial reporting. The mezzanine lender adds value to the issuer by actively being involved in improving the company's governance and reporting as well as supporting merger and acquisition activities.

Conclusion

Given the low current yields of senior debt and the poor performance of the equity markets over recent years, mezzanine debt offers investors a compelling alternative to traditional assets on a risk-adjusted return basis.