Growth mezzanine: Paying their dues

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Growth capital situations can provide a healthy source of deals for established mezzanine investors, but high barriers to entry will pose challenges for newcomers

For Asia's small and medium-sized enterprises (SMEs), success can often become a gateway to even greater headaches. Such businesses are still beholden to traditional banks for the majority of their financing and can easily find their growth outpacing the speed at which these institutions are willing to provide capital.

The traditional solution has been to raise a round of equity investment, but SME owners, unhappy about the prospect of ceding control to outside investors, are increasingly looking to alternate forms of capital to meet their financing needs. One option is mezzanine finance, and providers such as United Overseas Bank (UOB) are eager to tap this source of deal flow.

"Our basic pitch is, look, how long do you need this capital for? If they need the capital to build a factory, then typically they will only need it for two to three years," says Wee Yap Yeo, head of mezzanine for UOB. "The moment the factory is completed and they're generating cash flow, they can go back to the bank and borrow against that cash flow. So if they borrow money from us, they only need to pay for those two or three years."

Such situations have grown to become one of UOB's main business segments in Asia, and several other mezzanine providers have found the growth capital market equally attractive. But despite the healthy deal flow, successful participants in the space remain limited, which observers attribute to the necessity of extensive on-the-ground networks for finding attractive proprietary deals and the risks inherent to some Asian markets. Unless they are willing to make the required investments in time and resources to overcome these challenges, new growth mezzanine players will struggle to enter the market.

Evolving strategies

When the first wave of mezzanine providers opened in Asia, their investment approaches tended to focus on providing subordinated debt to support private equity firms in the region with leveraged buyouts. This approach mirrored that of successful mezzanine investors in developed markets, and it was hoped that their Asian counterparts would perform equally well.

"ICG [Intermediate Capital Group] clearly came in with that in mind, and that's the way they advertised their entry into Asia," says Stephane Delatte, who formerly headed CLSA Capital Partners' mezzanine fund in Singapore and is now CIO at Pierfront Capital, a Temasek Holdings-backed credit fund. "At CLSA that was part of our thesis as well, but the reality is the Asian private equity market is a little different from the US and Europe, and they've been using less mezzanine than was hoped for."

Given the relatively few opportunities in the PE buyout space, mezzanine providers were forced to innovate. A number of the operators that originated the asset class have found success pursuing transactions where they work directly with company management and owners, without the participation of a private equity sponsor.

ICG is among the firms that took an early position in the growth mezzanine space. The London-listed GP began investing in Asia Pacific in 2001, introduced sponsorless deals to its European funds in 2008 following the global financial crisis, and rolled out the strategy to all its regional offices a few years later.

Sponsorless deals – called corporate transactions internally – have since become one of the three pillars of the firm's strategy, alongside traditional mezzanine and restructuring situations for companies facing more serious balance sheet issues. ICG has lent its support to deals as varied as the merger of two Australian bus companies, the restructuring of South Korean plastics company Yudo China Holdings, and the management buyout of Australia's Everlight Radiology.

"The attraction of sponsorless or corporate deals is that you can strike unusual transactions because there's not a functioning, liquid market for that product in the way that there is for US high-yield bonds, for example," says Ryan Shelswell, the head of Australia at ICG who was tapped to head the firm's Asia operations earlier this year. "There's a precisely priced market for that with well-known providers, whereas if you want our kind of deals there's us and a few others."

Achieving deal flow like ICG's is not an easy proposition, however, and the asset class presents high barriers to entry for newcomers. Successful operators tend to be long-established in the region, capable of drawing on deep networks of industry contacts for deal flow, and with the resources to invest in additional capabilities should they be required.

ICG, for example, has four offices in Asia that are all predominantly staffed by local professionals. Singapore's Kendall Court has a comparable history, while regional banks like UOB and OCBC can source transactions through their existing financial services portfolios. Compared with these investors, an outside operator will have few options to make its mark.

"Certain managers may suggest to investors that they can originate debt on a proprietary basis and their strategies are therefore very different from the more competitive sponsor world," says Raj Makam, a managing director with US-based Oaktree Capital. "But it's not easy to get a good level of deal flow on that basis since it requires a great number of people on the street which very few managers possess."

Makam notes that many of the sponsorless deals he hears of come through boutique investment banks, regional banks or other intermediaries, which means multiple people have probably already had a chance to look at the transaction.

Pick your markets

In addition to established local networks, mezzanine investors tend to have strong preferences about which jurisdictions they operate in. Developed markets are typically perceived as offering favorable creditor rights, such as Australia, New Zealand, South Korea and Japan, while emerging markets like China, India, and most of Southeast Asia are believed to present higher levels of risk.

Most regional mezzanine providers have exposure to the developed economies, but participation in developing markets tends to vary. ICG focuses on Australia, New Zealand, Singapore and South Korea and considers deals in Malaysia and Indonesia when approached by sponsors. It has no operations in mainland China and India due to a perceived lack of creditor protections.

Pierfront has investments in India, where it has supported renewable energy developer Greenko, and in the Merdeka mine in Indonesia, along with developed markets in Asia and worldwide. However, the firm tends to demand more protection from borrowers in riskier markets.

“We often look for some recourse overseas in our structuring, rather than pure domestic onshore, in some of those emerging markets,” Delatte says. “Obviously when we’re dealing with Norway, Singapore or Australia, that’s a non-issue, but in emerging markets we’re trying to find some way to de-risk that through collaterals that are offshore and uncorrelated with the particular asset we’re looking at.”

Legal issues are only one dimension of the risk for creditors in Asia: lenders must also be prepared for interference by other stakeholders on a variety of pretexts. For example, a lender that is higher in the capital structure might have a personal relationship with management and favor them in an adverse situation, or a government may decide to keep the company afloat for the benefit of employees, disregarding the lenders’ contractual guarantees.

Moreover, mezzanine providers must be prepared to turn down deals that don’t meet their investment thesis. Kendall Court, for instance, is averse to any hint of distress in a potential investee, even to the point of rejecting refinancing opportunities. Chris Chia, the firm’s managing partner, explains that turning to mezzanine, which is typically more expensive than bank debt, in this scenario creates the impression of desperation.

“We’ve seen situations where people say, ‘We’ve got a debt maturing and we need to roll over. But the guy doesn’t want to roll over, so would you help us take him out?’ says Chia. “I say, ‘What’s the bank charging you? And how do you then justify taking more expensive debt to take out 6%?’ That seems counterintuitive to me.”

Special delivery

One notable dimension of the growth mezzanine play is that while such semi-distressed opportunities are unpalatable for mezzanine investors, many see the reverse – special situations or distressed investors moving into providing debt for growth situations – as more plausible. Amitava Guharoy, Asia Pacific market leader for transaction advisory services at EY, sees the transition as natural for special situations investors that have already set a company back on the path toward growth and believe they can continue to help it after it comes out of distress.

“These are assets that have had to restructure under certain pressures, but they are on the growth curve or they’ve come out of it,” says Guharoy. “They’re still being funded by a quasi-debt instrument, or an instrument which is structured as debt but uses a quasi-equity instrument. So I see some of the special sits funds using their ability to finance debt to get into this space.”

These providers could be another source of competition for mezzanine investors in Asia, though participants caution that they are likely to face the same challenges as established providers. Success for special situations investors, as with established players, will depend on their ability to source proprietary deals through strong local networks.

While the growth mezzanine sector remains challenging for newcomers, those that do manage to establish themselves will find customers that are increasingly aware of the advantages that their products offer, particularly for SMEs that have fewer and fewer alternatives for financing.

"Equity will always be there, the IPO markets have been doing very well, but obviously those are larger-size deals. At the lower end we're seeing a proliferation of structures like convertible bonds and preference shares," says Kendall Court's Chia. "Borrowers are becoming more comfortable about the bells and whistles that come with these structures, if only because their other sources of funding are not as readily available, or it may not be an optimal time or size for an IPO."

SIDEBAR

India: The rule of NBFCs

Avendus Finance sees itself as a big fish in a growing pond. The non-banking finance company (NBFC), which is operated by Avendus Group, wants to make a name for itself as a provider of growth mezzanine and other flexible capital solutions to India's vibrant community of small and medium-sized enterprises (SMEs).

Last year the company advised on $250 million worth of deals, of which it underwrote $150 million, including a INR600 million ($8.8 million) structured debt facility for Krishna Institute of Medical Science (KIMS) to scale up its medical school business. CEO Sandeep Thapliyal believes the firm and its peers have only scraped the surface.

"It's a massive opportunity, as it should be in a large economy like India. It's just that as a country we've started late when it comes to structured finance solutions, and specialized outfits that can offer this kind of flexible solution," he says. "Even now, after this market has been developing for seven or eight years, it still only accounts for about $2-3 billion of underwriting a year, which is nothing given the context of the economy."

NBFCs like Avendus Finance have long been the primary providers of financing solutions to this underserved market because they operate at a lower cost than India's public-sector banks and are less tightly regulated. They can therefore afford to cater to geographies and sectors that would be unprofitable for their larger brethren.

The institutions have also begun to compete with private equity firms and private lenders in India, offering themselves to SME borrowers as a source of cheaper capital that does not involve giving up a stake in the business. In addition, NBFCs can enlarge their capital pools through leverage, unlike managers of third-party capital.

This is not to say that there is no place for private equity and credit funds in India's lending market, and PE firms have not stood still as these institutions made inroads with their target companies. KKR bought Avendus' parent in 2015 and operates two other NBFCs in India, while several other GPs including Everstone Capital and Actis Capital have set up their own NBFCs.

For the institutions themselves, private investors are both competitors and potential partners in their flexible financing solutions. Avendus, for instance, joined Everstone last year in an $85 million deal for nutraceutical player OmniActive Health Technologies – the PE firm provided the equity component and

Avendus underwrote the debt portion. Thapliyal believes the growing market will offer many more such opportunities.

“There is always a chance for collaboration or partnership, because a lot of times the transaction size is such that it’s not possible for one entity to underwrite on its own,” says Thapliyal. “And therefore you do need to look for co-investors that can come along with you and participate in the transaction.”