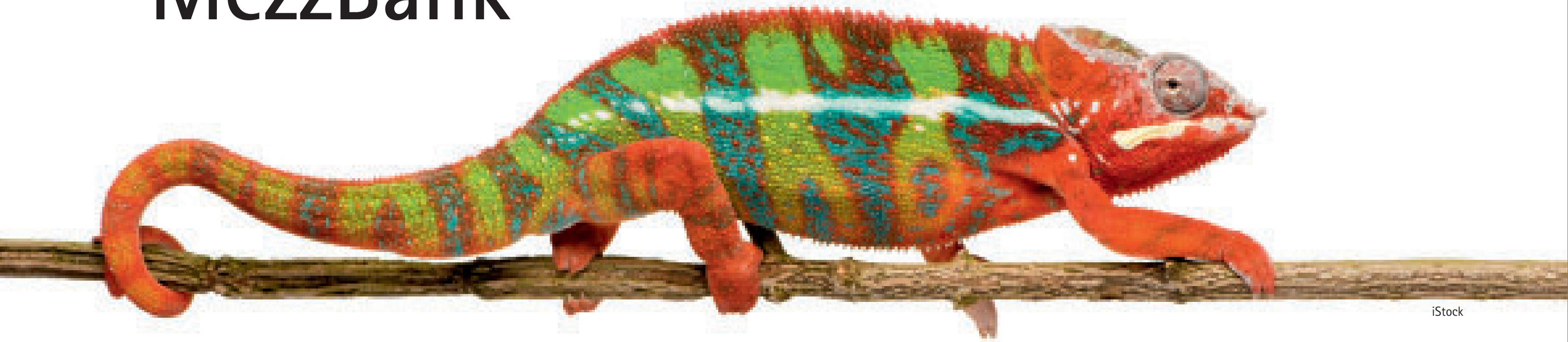
MezzBank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While long-term bank credit is still scarce, mezzanine capital is hesitantly stepping in to help fill the gap by taking on new roles.

By Armin Haeberle

The mezzanine market in emerging Europe is far from healthy, but it is not dead. While the market remained relatively subdued in 2010, an estimated EUR 400 million in mezzanine capital is expected to flow into emerging Europe again this year, according to Przemek Szczepanski, founding partner at Syntaxis Capital, a junior capital provider dedicated to central Europe. While this figure is still 30 per cent down from an estimated EUR 600 million in the peak years 2007 and 2008, the structural landscape of the mezzanine market is also changing.

"In 2007, more than two thirds of the deals were leveraged buy-outs," says Mr Szczepanski. "Nowadays, deals that inject necessary capital into growth companies but do not change their ownership make up at least 50 per cent of the deal flow." And of the remaining deals, strategic investors, rather than financial engineers, make up the bulk of the volume. Without all the hot money sloshing around, dedicated players and buy-to-hold investors now dominate the picture. This means that deals are fewer and with considerably lower leverage but are of arguably higher quality. The market now focuses on companies with sound growth, clearly documented assets and predictable cash-flows, rather than on companies with high potential that may – or may as well not – yield super-returns in a distant future.

While it is still the "worst fund-raising environment ever," as one player puts it, not all is lost for the industry. Franz Hoerhager, founding partner of Mezzanine Management in Vienna, says that none of the companies in his group's portfolio have gone under, but to achieve this, his team had to engage in a lot of creative deal structuring and intense fire-fighting. Even though banks seem to be slowly coming back into the game again, the inter-bank market in emerging Europe is still tainted with distrust, making long-term credit arrangements very hard to come by. Out of necessity, mezzanine providers have, therefore, not only become pretty flexible in terms of interest payments to support their portfolio companies, but even ventured into practices aimed at substituting bank business. "In one case, we bought into a company at five times Ebitda and with no senior bank debt above," Mr Hoerhager says. In effect, the mezzanine investor replaces the bank as the main provider of credit.

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The case is still exceptional, but telling. With no bank credit in sight, the portfolio company accepted the generous but pricy injection by Mezzanine Management. This comes at a cost. As a rule of thumb, a market participant says, you can expect to get bank credit with a margin of 300 base points (bps), while mezzanine capital will cost you between 400 and 500 bps, plus the equity kicker that mezzanine is all about. "All in all, mezzanine will cost you about 8 per cent cash interest these days, while a bank credit comes in at about 6 per cent," the market participant adds.

One reason why mezzanine providers can arrange such deals is that they do not need to refinance their funding immediately. "As long as we have funds available, this leaves us with more flexibility than a normal bank," Mr Hoerhager says. At the moment, he has three more cases similar to the one mentioned above. But clearly such costs of capital are too high to be the sole source of funding for most companies. Hence, the deal allows the company to look for a bank that is willing to substitute up to 50 per cent of the mezzanine facility with senior bank debt, without any penalty fees applying to the portfolio company from the side of the mezzanine provider.

In some way, the shortage of long-term bank credit means good business for mezzanine investors. They can venture into areas normally occupied by banks and reap extra returns on it. But from a macro-economic perspective this is not sustainable, a provider admits. It is high time long-term bank credits make a return – the MezzBank-solution is simply too limited and too expensive. ||

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