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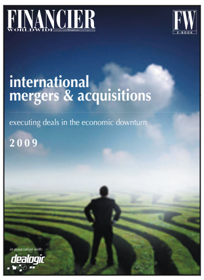

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2009 International Mergers & Acquisitions

executing deals in the economic downturn

FW E-BOOK

Mezzanine finance in Central & Eastern Europe

BY CLAIRE SCOTT-PRIESTLEY

Mezzanine finance is subordinated debt finance that ranks in priority behind senior debt but ahead of trade creditors and equity. The market for mezzanine finance in Central and Eastern Europe (CEE), similar to many other markets, has been growing steadily in recent years. However, like many other types of finance, it has been impacted by the effects of the global credit crunch in the last couple of years.

Impact of the credit crunch

The collapse in the global banking system has resulted in a dramatic decrease in overall bank lending. This lack of liquidity in the markets has had a fundamental impact on the number of leveraged transactions occurring in the region.

According to Dealogic, 114 financial sponsor buyouts took place in CEE during 2007 with an aggregate value of $7.64bn. Equivalent buyout activity plummeted in the first half of 2009 to 17 deals with a value of $280m.

Ben Edwards, managing partner of Syntaxis Capital, explains that "the credit crunch has meant that larger buyouts have slowed down dramatically, and that includes for mezzanine players too, because there is little bank debt available and no one is prepared to underwrite amounts in excess of their approved final holds".

Nicholasd Kabcenell, managing director of Darby Overseas Investments, reinforces this view explaining that larger buyout transactions are not occurring because of a lack of equity investors and a lack of senior debt. In addition, recapitalisations have not occurred for similar reasons. However, "smaller, more bi-lateral transactions continue but at a slower pace."

There has also been a notable decrease in the number of exits within the region in the last few years. Dealogic statistics reveal that there were 28 financial sponsor exits in CEE during 2007 for an aggregate value of $3.9bn, as opposed to seven exits with a value of $254m in the first half of 2009.

The IPO markets have largely dried up and strategic sales are frequently offering the only viable exit route. Such sales, in turn, are restricted by prospective buyers facing difficulties in raising the necessary finance. Secondary sales have increased with the arrival of more private equity firms in the region and may offer an alternative exit route.

The days of the mega-deals funded by inexpensive, covenant-lite debt appear to have passed and, as Mr Edwards explains, the market is experiencing "a much reduced appetite for risk from senior banks." This has had a knock-on effect on the strategies and investment decisions of private equity funds and mezzanine providers operating in CEE.

Recent trends

While buyouts are slow, it seems that those deals that are being done involving senior debt are largely being done on a club basis. Chris Buckle, managing director of Mezzanine Management Central Europe, noted that "it's very difficult to do a large transaction without senior lenders and without a syndication market, but mid-cap and smaller transactions can still happen because there is still some local bank leverage around or the gap can be completely filled by the mezzanine funds. Local presence is important in sourcing mid-cap and smaller transactions, hence the need for a substantial regional office network."

As mezzanine is cheaper than equity and it makes sense to leverage up a transaction, the mezzanine funds are finding that they are being approached to do standalone deals, which do not include any senior debt and are purely mezzanine funded. Mr Edwards comments "we are looking at opportunities in companies where we would be, in essence, providing the equivalent of senior debt and additional financing for growth and expansion where there is no senior term provider." This could be an attractive option to sponsors because the mezzanine debt can be refinanced if the markets pick up, but if the credit markets are less receptive then the company simply supports a long-term non-amortising instrument.

Mezzanine investors generally expect to make their returns by way of two methods. They charge an upfront fee and a margin, which is always split between cash pay and a rolled-up PIK interest payable at the end of the term. In addition, many will demand a warrant, or equity kicker, which constitutes the funder's right to realise equity at a stipulated price within a stipulated timeframe on an exit event.

Since the downturn in leveraged buyout activity, private equity firms now appear to be concentrating more on running their portfolio companies and to holding on to their investments for longer. Before the credit crisis, there was often a rapid rotation of portfolios and early debt-refinancing. Now, there is a renewed concentration on value creation in businesses by way of cost control, revenue and growth initiatives, and capital preservation. This focus on value creation is positive for mezzanine funders taking an equity upside on deals by way of warrants. Longer holding periods will also mean greater returns from the PIK.

Mr Buckle explains that "the way that mezzanine is structured, we make a significant part of our return over the long term from the equity kicker so we are a more patient lender generally. Our instruments are not so draining on cashflow because they have bullet repayments." As mezzanine lenders usually share in the equity upside, they are often also seen as being more flexible than senior lenders. Mezzanine lenders are often prepared to permit equity cures, allowing the sponsor to repair a breach of debt covenant by injecting more equity funding into the company, where senior lenders may not. Sponsors understand the benefit of having their interests aligned with the mezzanine fund whereas, frequently, the interests of the sponsors and senior lenders are not aligned.

Many CEE mezzanine funds have reserved capital to support portfolio companies by way of add-on acquisitions, reflecting a renewed focus on development of portfolios. According to data from Thomson Reuters, approximately 51 percent of all closed deals in the first quarter of 2009 were add-on acquisitions, which amount to a 40 percent increase on the same period in 2008. A number of these add-ons are distressed businesses, which complement existing portfolio companies and which could see a minor investment result in a notable increase in a portfolio company's value when the market becomes more stable.

Investment strategies have generally adjusted to accommodate more buy-to-hold investments.

With regard to the specifics of new deals or term sheets currently being negotiated, Mr Edwards observes that "documentation has become more robust for lenders generally". Pricing is increasing while leverage multiples are declining. As the tenure for mezzanine loans has always been one year longer than the most junior senior debt, we may see mezzanine tenures reducing as senior debt tenures become shorter. Non-call structures are also returning, as lenders who are prepared to take the risk in the current climate expect to reap the reward. Mr Kabcenell believes that "there is a possibility of true non-call for a year or two with a greater premium for a couple more years after that. With a renewed focus on credit fundamentals, covenants can also be expected to become tighter.

Future prospects in CEE

An additional consequence of the credit crunch has been a reduction in the number of mezzanine providers in CEE. Mr Kabcenell explains that "a number of players came into the market in the last couple of years; hedge funds and even some banks would take mezzanine positions but many of them have now left the market for the long term and so the supply and demand balance should improve in favour of the specialist providers, like Darby."

With regard to locations that are attracting interest for mezzanine investment within CEE, it seems that the first and second wave accession countries are the most attractive. Recent surveys have shown that Poland, the Czech Republic, Slovakia and Romania remain the focus of attention for many investors. Reasons cited for this interest included the size of their economies and their relatively sound macroeconomics. The countries listed as being more unattractive include Russia, Ukraine, Hungary and the Baltic States, where the depth of recession and fragile economies seem to overcome low valuations and high potential growth opportunities.

Industries that appear to be of interest include food, telecoms, construction, healthcare, alternative energy and infrastructure. Cyclical businesses that have been most exposed to the downturn, such as retail and heavy-duty manufacturing, are less attractive. However, many CEE-focused mezzanine funds are generalist funds that will consider all opportunities, with a focus on low leverage, proven cash flows, strong management and attractive valuations.

Mr Buckle explained that Mezzanine Management believes "Central & Eastern Europe will bounce back fairly quickly and relatively strongly because all of the underlying benefits of CEE are still there – the lower costs, the lack of investment in the past, the catch-up with Western Europe, the EU funded investments in infrastructure, the skilled and flexible labour force, etc."

The credit crisis has clearly resulted in a crisis of confidence for many investors in CEE and there is an increased level of conservatism within the region. Now that the credit boom is over, the markets should slowly stabilise and a more realistic and sustainable position may emerge going forwards. With the lack of available liquidity, the departure of some of the newer mezzanine players from the region, and the general flexibility offered by mezzanine as a product, specialist CEE mezzanine lenders now have an opportunity to flourish.

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