



M E K E T A I N V E S T M E N T G R O U P

BOSTON MA
CHICAGO IL
MIAMI FL
PORTLAND OR
SAN DIEGO CA
LONDON UK

MEZZANINE DEBT

Todd Silverman, CFA, CAIA
Mark Watson
John Haggerty, CFA
Frank Benham, CFA, CAIA

MEKETA INVESTMENT GROUP
100 Lowder Brook Drive, Suite 1100
Westwood, MA 02090
meketagroup.com

October 2018



WHAT IS MEZZANINE DEBT?

Private debt is a component of many institutional portfolios and fills an important role, with distinct characteristics from other private asset classes. Compared to other private market vehicles, private debt can offer relatively stable returns and reduced risk across market cycles. This is due largely to debt's senior position in the capital structure relative to equity and the ability for management to write in covenants to structure and protect their investments. Investors have a variety of different instruments to choose from in the private debt universe, all with unique return profiles, which can be beneficial to an investor's portfolio.

Mezzanine debt is one such popular instrument that sits on the balance sheet at the "mezzanine" level, above shareholder equity but subordinated to all senior bank debt. Thus, if a company fails, mezzanine investors will be repaid from the proceeds of the liquidation only after the senior lenders have been made whole. Mezzanine loans are therefore considered to be higher risk loans, especially since most are unsecured by asset collateral, but investors are compensated for these risks through higher interest rates and transaction fees. While primarily a debt instrument (i.e., a loan), mezzanine financing may also include equity-like features, including options and warrants, which typically make up 15-25% of the total return.¹

Because of its higher return potential, mezzanine debt is a core component of most private debt portfolios that can typically make up around a quarter or more of the overall allocation.² Compared to other popular private debt vehicles, mezzanine is somewhat riskier than direct lending but typically not as risky as distressed debt. This placement makes it a somewhat balanced choice for investors who are seeking higher return potential with a moderate degree of risk.

In practice, mezzanine debt is most commonly used to finance leveraged buyouts executed by private equity firms in what are known as "sponsored transactions." In this scenario, the private equity firm will bring in a mezzanine debt provider to help build out the acquired firm's capital structure and lower the cost of capital.

WHO NEEDS MEZZANINE DEBT?

Mezzanine debt borrowers are typically, though not always, small and mid-sized companies that have the potential for growth, but are unable to borrow additional funds from commercial banks and are unable or unwilling to issue more stock. There may be a number of reasons why the company is unable to borrow from more traditional sources. It may already have borrowed all that banks are willing to lend, the company's operating history may be too short, or available collateral may be inadequate. The fact that a company does not qualify for a commercial loan does not always imply that it is a poor quality credit, but rather that it simply cannot meet the higher lending standards of commercial banks.

¹ See Figure 3.

² See Figure 1.

Mezzanine debt lenders realize that they represent one of the only options available to some corporations seeking additional capital. As a result, they can command a relatively high price for their loans. A mezzanine loan typically carries a coupon between 10% and 13%, and, in rare cases, can be as high as 15-18%, in the form of cash or a combination of cash and PIK ("payment-in-kind") interest. In addition, mezzanine lenders often demand an "equity kicker," historically via a warrant giving the lender the option to acquire stock at no cost or an otherwise favorable price. Today, warrants have become much less common but the lender may be given the option to "co-invest" in the company's equity at the time of the loan. Thus, mezzanine lenders view their loans as a hybrid investment that pays a high coupon, but also carries the prospect of some degree of equity participation if the company prospers.

Mezzanine debt is not the only private, non-bank credit option companies have and direct lending options such as first lien, second lien, and unitranche loans represent alternative sources of debt financing. Like mezzanine, all three of these debt instruments allow companies to raise debt capital from private structures outside of banks or bonds. First lien debt is at the top of the capital structure while second lien debt ranks behind the first lien but ahead of any mezzanine debt and equity. A unitranche loan resembles first lien debt in that it is also at the top of the capital structure but typically creditors demand higher leverage multiples and it is the only debt in a company's capital structure.

Despite sharing the broad label of private credit, mezzanine debt has important differences from these other direct lending options. The first important difference is mezzanine's lack of collateral interest, meaning that first lien, second lien, and unitranche are typically secured by a company's assets while mezzanine is not secured. By virtue of its lack of security, mezzanine debt is junior to these other debt instruments while remaining above equity. Another key difference is that the other debt instruments discussed above are typically priced at a spread over a floating base interest rate while mezzanine generally carries a fixed coupon rate that does not fluctuate with changes in base interest rates. Generally, mezzanine debt also has longer contractual duration and lenders are more likely to request that a portion of their investment be in the form of equity to capture potential upside.³ Collectively, these differences serve to make mezzanine debt riskier for lenders and thus more expensive for the borrower.

From a lender's perspective, an ideal candidate for a mezzanine financing deal is a well-managed company with strong, positive cash flow and a near- to medium-term need for growth capital.⁴ The positive cash flow is important so that the company can service the relatively high interest payments on the mezzanine loan. For this reason, mezzanine lenders generally will not make loans to startups, research & development operations, or companies with negative or unpredictable cash flow.

It is also important that the company's need for capital be temporary. The mezzanine lender needs to see an "exit strategy" that will enable the mezzanine loan to be repaid in five to eight years. The exit strategy may be a planned public offering, the substitution of additional senior bank debt for the mezzanine debt, or the private sale of the company.

³ <http://www.cyprium.com/2007/03/the-evolution-of-second-lien-lending-and-its-impact-on-mezzanine-capital/>

⁴ Typical terms are between five and eight years.

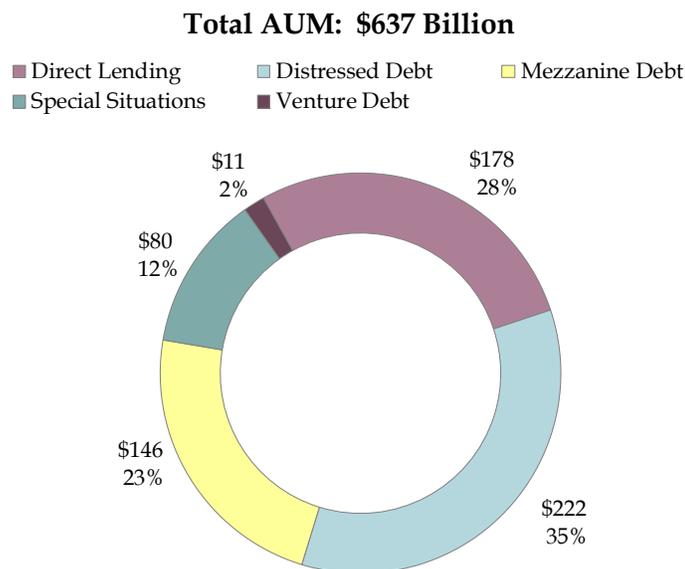
Finally, mezzanine lenders look at the potential for growth. Unlike a bank lender, whose loan is secured by some form of collateral and a first call on the proceeds of any liquidation, the mezzanine lender is usually protected only by cash flow and earnings growth. Therefore, mezzanine lenders want experienced and entrepreneurial management, a clear business plan, and a solid product or service.

WHO ARE MEZZANINE LENDERS?

Insurance companies and private merchant banks originally filled the role of the mezzanine lender. These institutions are not subject to the same regulatory requirements as commercial banks and have different relationships with their customers. An insurance company can create a highly diversified portfolio of mezzanine loans that will provide a relatively high return potential with very little company-specific risk.

Like insurance companies and merchant banks, pension funds and endowments have long investment horizons and often do not require a high degree of liquidity. For institutional investors, the relatively high returns offered by mezzanine lending can be attractive. This has led investors to commit a significant portion of their private debt portfolios in mezzanine debt. As of June 30, 2017, 23% of closed-end private debt was allocated to mezzanine debt, as measured by assets under management (“AUM”).

Figure 1: Private Debt Assets under Management by Category⁵



Over the past two decades, a number of private mezzanine lending firms have been established specifically to serve institutional investors. The institutions provide the capital, and the mezzanine lenders find the borrowers, perform the necessary credit analysis, and

⁵ Nuveen, data as of June 30, 2017. In billions, includes only closed-end fund assets tracked by Preqin.

supervise the loans. In return, the mezzanine lenders charge the institutional investors a management fee and take a share of any profits above a set return to the investor.

Because they focus on the same types of smaller companies, private mezzanine firms often work closely with private equity partnerships. The private equity investors supply the equity capital while the mezzanine lender supplies the debt. Despite the potential for equity participation, successful mezzanine lenders approach their deals as first and foremost debt investments and apply a high level of credit analysis to each.

EXPECTED RETURNS

Each mezzanine deal is the result of a unique negotiation process between the company and the lender. Most mezzanine lenders price their individual loans to achieve a total expected return of between 10% and 12%, annualized, on a net-of-fees basis. Note that this has not been the return achieved historically,⁶ as the below table shows, largely attributable to credit losses within mezzanine debt portfolios. Due to limited upside potential and the ability for complete loss of principal, Mezzanine debt has an asymmetric risk/reward profile and, as a result, the ability to limit credit losses tends to be paramount in generating attractive returns. Nevertheless, mezzanine debt performance compares favorably with that achieved by broadly syndicated loans, high yield bonds, and middle market loans. We expect that mezzanine debt will continue to provide a premium over these other debt instruments in the future.

Figure 2: Mezzanine Performance vs. Other Private Debt (1998-2017)⁷

	Mezzanine Debt ⁸	Broadly Syndicated Loans ⁹	High-Yield Bonds	Middle Market Loans ¹⁰
Annualized Return	9.08%	4.90%	6.74%	6.24%
Standard Deviation	6.99%	8.50%	10.12%	6.98%
Sharpe Ratio	1.02	0.35	0.47	0.61
Mezzanine Debt Correlations	--	0.46	0.44	0.45

Mezzanine debt returns are cyclical. When credit is tight, mezzanine debt should yield more, improving total returns for new loans. When credit is loose (such as during expansionary central bank policy regimes), effective spreads should narrow and mezzanine debt should yield less, diminishing total returns for new loans.

The expected return usually consists of several components, the largest of which is the coupon. Interest payments are generally monthly and often do not include any principal repayment,

⁶ Sources: VentureXpert Mezzanine Debt sub-universe and Barclays High Yield Index from January 1991 to June 2010. Over the roughly twenty-year period, the number of mezzanine debt funds increased from 13 to 50.

⁷ Nuveen, *Private Debt: The opportunity for income and diversification with illiquid assets*.

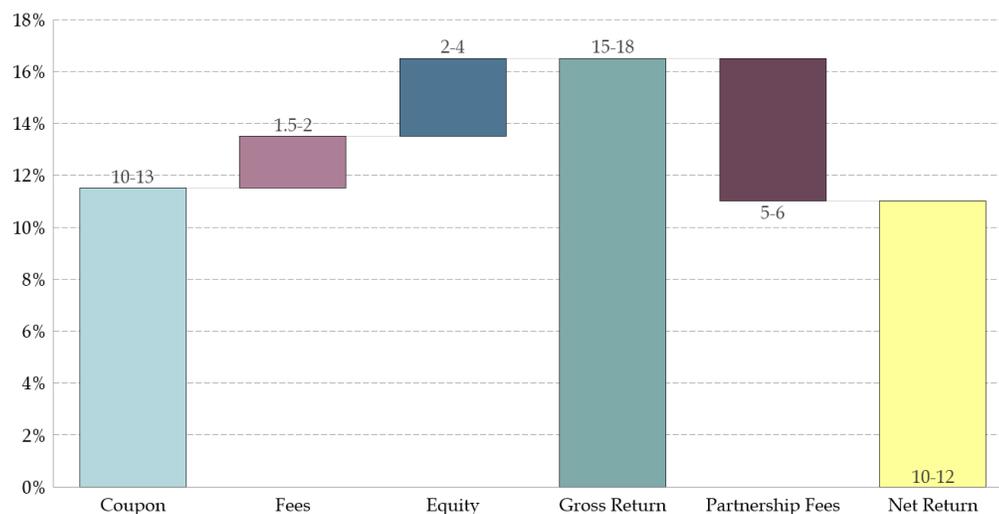
⁸ Mezzanine debt reflects internal rate of return (IRR) for mezzanine funds tracked by Cambridge Associates

⁹ Represented by the S&P/LSTA Leveraged Loan Index as a proxy for broadly syndicated loans.

¹⁰ Loans to companies with EBITDA of \$50 million or less within the S&P/LSTA Leveraged Loan Index.

which is deferred to a “balloon” payment at the end of the note.¹¹ In addition to the coupon, the lender may charge an up-front fee (points), or in rare cases negotiate a periodic royalty payment calculated as a small percentage of the company’s revenues or profits. With the royalty arrangement, the mezzanine lender participates directly in any growth during the life of the loan. And finally, some mezzanine loans include the right to acquire equity in the business.

Figure 3: Components of Mezzanine Debt Return (%)¹²

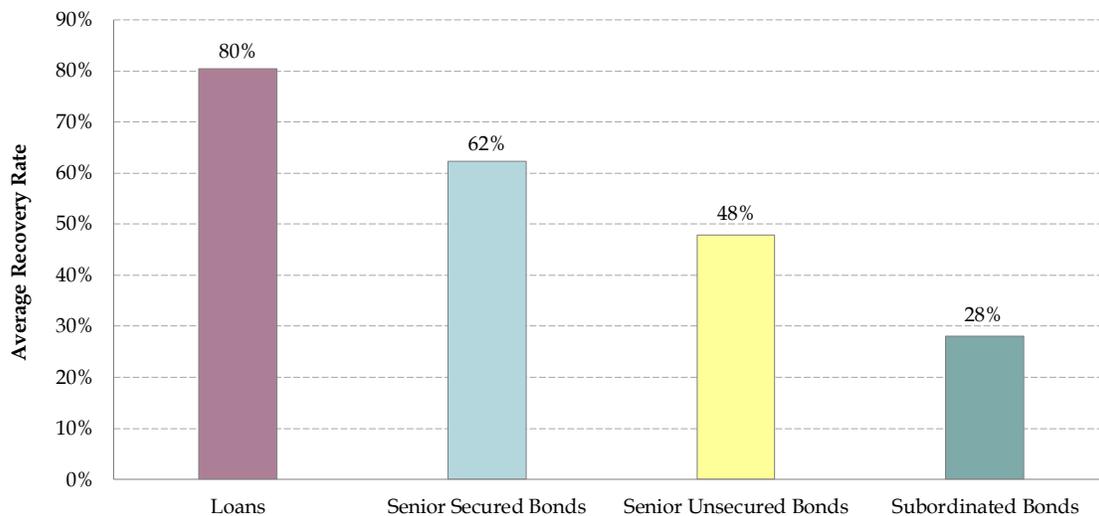


RISKS

The risks of investing in mezzanine debt funds are similar in scale to investing in public equities. Unfortunately, as pure mezzanine debt funds are rare and reporting on them is scarce, there is no readily available and reliable source of default and recovery data for mezzanine debt. However, based on the characteristics of mezzanine borrowers, one can expect the default rate to be higher than for the credit market as a whole. If a borrower goes into default or suffers bankruptcy, the senior lenders (commercial banks) are made whole first from any remaining assets. After the senior debt is retired, the mezzanine lenders have a call on remaining assets, followed by the equity stakeholders. This leads to a relatively poor recovery rate for mezzanine lenders. While there is limited data, the impact a lender’s position in a firm’s capital structure has on recovery rates can be approximated by looking at corporate recovery rates. As shown in Figure 2, loans that are near the top of the capital structure, enjoy significantly higher recovery rates than those at the very bottom (80% compared to 28%).

¹¹ If the company wishes to repay the mezzanine loan prematurely, there may be a pre-payment penalty that guarantees the lender at least a minimum total return on the investment.

¹² Figure 3 represents an approximation of mezzanine returns based on anecdotal experience and assuming no credit losses.

Figure 4: Corporate Debt Recovery Rates Measured by Ultimate Recoveries (1987-2017)¹³

Furthermore, mezzanine debt funds are relatively illiquid. If a mezzanine borrower experiences difficulties, the mezzanine lender cannot readily sell the bond at a loss, but is forced to attempt to help the borrower work out the company's problems.

FUND CHARACTERISTICS

Mezzanine debt funds are structured similarly to private equity funds. They are typically closed end limited partnerships with a five-year investment period, a ten-year life, and are subject to term extensions (usually up to two one-year extensions). Mezzanine debt general partners charge the same types of fees commanded by private equity general partners. Most mezzanine debt firms charge an annual management fee of 1.5% to 2% of committed capital, plus a share of any return above a specified threshold, or "carried interest." Over the past few years, some mezzanine debt managers have started to migrate towards a management fee on invested rather than committed capital, which should reduce the overall impact of fees and, in particular, the outsized impact of fee drag typically seen early in the life of a partnership. Typically, mezzanine debt general partners also receive 20% of any return earned by the fund after the limited partners have achieved at least an 8% base return.

SELECTING MEZZANINE DEBT FUNDS

Ideally, an institutional investor should invest with experienced mezzanine debt managers that have demonstrated strong prior returns and conservative underwriting standards, typically through low historical loss ratios. An institutional investor should also evaluate the quality of the investment team and firm resources, depth of independent credit analysis and transaction due diligence, market segment or industry expertise, and the firm's network of private equity sponsor relationships. In evaluating funds that do not typically partner with

¹³ Moody's, *Annual Default Study: Corporate Default and Recovery Rates, 1920-2017*.

private equity sponsors, additional emphasis should be placed on the investment manager's ability to provide ongoing operational support, as well as workout experience.

SUMMARY

Mezzanine debt provides an opportunity to earn equity-like returns that are driven primarily by coupon income. Further, because the drivers of returns and the risks differ from those of equities, such an investment offers greater diversification for a private markets portfolio. For these reasons, we recommend that long-term investors consider mezzanine debt funds for a portion of their private markets allocation.

DISCLAIMERS

This document is for general information and educational purposes only, and must not be considered investment advice or a recommendation that the reader is to engage in, or refrain from taking, a particular investment-related course of action. Any such advice or recommendation must be tailored to your situation and objectives. You should consult all available information, investment, legal, tax and accounting professionals, before making or executing any investment strategy. You must exercise your own independent judgment when making any investment decision.

All information contained in this document is provided "as is," without any representations or warranties of any kind. We disclaim all express and implied warranties including those with respect to accuracy, completeness, timeliness, or fitness for a particular purpose. We assume no responsibility for any losses, whether direct, indirect, special or consequential, which arise out of the use of this presentation.

All investments involve risk. There can be no guarantee that the strategies, tactics, and methods discussed in this document will be successful.

Data contained in this document may be obtained from a variety of sources and may be subject to change. We disclaim any and all liability for such data, including without limitation, any express or implied representations or warranties for information or errors contained in, or omissions from, the information. We shall not be liable for any loss or liability suffered by you resulting from the provision to you of such data or your use or reliance in any way thereon.

Nothing in this document should be interpreted to state or imply that past results are an indication of future performance. Investing involves substantial risk. It is highly unlikely that the past will repeat itself. Selecting an advisor, fund, or strategy based solely on past returns is a poor investment strategy. Past performance does not guarantee future results.