



Private Credit Solutions Mezzanine Financing in Emerging Markets

EMERGING MARKETS PRIVATE EQUITY ASSOCIATION • MAY 2014



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EMPEA is *the* global industry association for private capital in emerging markets. We are an independent non-profit organization. As EMPEA celebrates our 10th anniversary in 2014, we have over 300 member firms, comprising institutional investors, fund managers and industry advisors, who together manage more than US\$1 trillion of assets and have offices in more than 100 countries across the globe. Our members share EMPEA's belief that private capital is a highly suited investment strategy in emerging markets, delivering attractive long-term investment returns and promoting the sustainable growth of companies and economies. We support our members through global authoritative intelligence, conferences, networking, education and advocacy.

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Private Credit Solutions

Mezzanine Financing in Emerging Markets

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A Letter from EMPEA Consulting Services

Dear Reader,

EMPEA is delighted to present this special edition of *Private Credit Solutions: Mezzanine Financing in Emerging Markets*, our first in-depth look at the role that private credit plays in supporting the development of small- and medium-size companies across the emerging markets, and in offering institutional investors a means of accessing this growth. This inaugural private credit report takes a deeper look in particular at mezzanine, an instrument that occupies the space between debt and equity in a firm's capital structure, and offers entrepreneurs a financing option with fewer restrictions than pure debt and less ownership dilution than pure equity.



Over the last few years, we have witnessed a surge in interest in emerging markets private credit. Growing numbers of private equity and hedge fund managers have expanded into this space in the quest to become more diversified asset managers, and new entrants have emerged seeking to offer a solution to countless businesses in desperate need of financing. Amidst heightened competition, the sophistication and variations in financing structures have increased, as has the diversity in the markets in which they are deployed. Institutional investors are increasingly seeking to better understand how private credit can offer emerging market exposure with tailored risk mitigants, including built-in exits and upside potential. Our latest *Global Limited Partners Survey* reveals that nearly half of all surveyed participants have or want to have exposure to this asset class.

With this report, we tackle the broad and murky topic of mezzanine finance—and with few mezzanine transactions structured the same, this segment is frequently and easily misunderstood. While mezzanine finance has evolved into a US\$100 billion industry in developed markets, it remains nascent in emerging markets. Our analysis shows that mezzanine fund managers constitute 3% or less of each emerging market region's private equity landscape, most of which are also still very much in the process of developing. As such, the amount of research and thought leadership devoted to this subject to date has been limited. We hope that this publication serves as a step toward a broader conversation on many of the key questions top of mind for industry participants, such as: what is mezzanine and how is it distinguished from private equity? What is the risk/return profile of mezzanine investing in emerging markets? Where does emerging markets mezzanine fit in institutional investors' portfolios? And how does the practice of mezzanine differ across markets?

We believe that private credit can play a critical role alongside private equity in filling the acute financing gap besetting so many emerging market-based companies. And while this report focuses on just one slice of this universe, EMPEA considers the development of other private credit strategies, such as direct lending and distressed/special situations, equally important in fostering a vibrant private capital ecosystem. The release of this report coincides with the launch of EMPEA's Private Credit Council, which aims to provide a forum for our members to exchange information and best practices on private credit investments in emerging markets and to also advise EMPEA on issues impacting the community in order to help us identify and execute related priority content, programs and initiatives.

This report also marks the first syndicated report undertaken by EMPEA's new Consulting Services team, which is dedicated to providing bespoke research services to our members on the topics of greatest importance to them. We look forward to working with many of our other members on similar initiatives in the future.

As always, we welcome any feedback you may have at consulting@empea.net.

Sincerely,

A handwritten signature in black ink that reads "Nadiya Satyamurthy".

Nadiya Satyamurthy
Senior Director, Consulting Services
Emerging Markets Private Equity Association

What is Emerging Markets Mezzanine Financing?

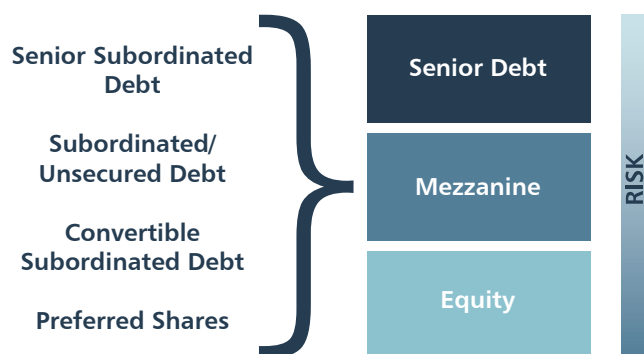
Access to finance is one of the most prevalent challenges facing countless entrepreneurs and business owners across the emerging markets. Local banks have traditionally focused their lending on only a handful of large companies—in part, because they view smaller firms as having insufficient assets or collateral—while the global financial crisis and subsequent introduction of new capital adequacy requirements have resulted in many of the international banks scaling back their emerging market activities in recent years. Even when bank debt is available, it is often short term in nature and does not provide the type of patient capital small- and medium-size companies need to grow. While private equity is one viable option to bridge this gap, entrepreneurs are sometimes hesitant to go this route due to a reluctance to give up equity in their companies. In such cases, another alternative exists: mezzanine financing.

The Space In-Between

Encompassing a wide range of debt and equity positions that can be structured in a variety of ways, mezzanine is a complex sub-asset class. As one veteran of the industry explains, “The only absolutes we know are that we’re not senior debt and we’re not pure equity.” Mezzanine refers to the level of financing that sits above equity and below senior debt in the capital structure—in other words, in the event of a default, mezzanine investors stand in line behind all senior obligations but in front of equity holders—and is priced according to its position (see Exhibit 1).

The various structures that mezzanine investors employ include secured subordinated debt, convertible subordinated debt and preferred shares, and through combinations of various instruments (see sidebar on *Constructing the Mezzanine Return*), these providers are able to move up and down the capital structure (from what some industry participants refer to as “debt plus” to “equity minus”) to achieve a desired risk/return profile. This flexibility in structuring deals enables mezzanine investors to create a blend of downside protection and upside participation tailor-made to each investment opportunity, for instance by matching the structure to the cash flow profile of the firm.

Exhibit 1: Mezzanine in the Capital Structure



Constructing the Mezzanine Return

Although the structure of a mezzanine deal varies by transaction, there are a number of commonly used instruments that drive an investor’s return. These instruments can generally be divided into those that are *contractual* and those that are *performance-based*. This distinction is important as it helps delineate the key sources of risk and return in a given deal and throughout a portfolio.

Contractual

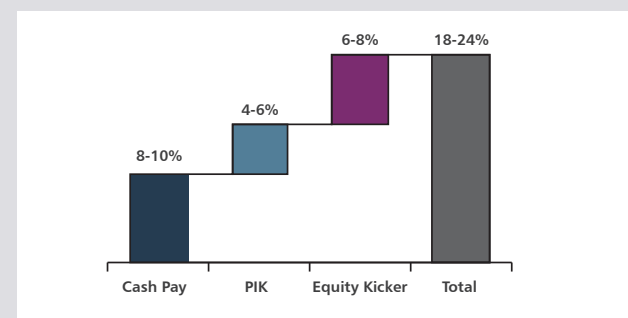
Cash Pay: The core of any mezzanine investment is a debt product that pays a negotiated interest rate, or cash pay, on a regular basis (annual, semi-annual, quarterly, etc.). The cash pay depends on the specifics of the investment but is typically set at a spread above a base rate, such as Libor or Prime. In our data set on 109 mezzanine investments in emerging markets, this rate ranges between 5% and 21%.

Payable in Kind (PIK): Commonly used alongside subordinated debt, a PIK loan is a debt instrument on which the interest is not paid out during the tenure of the investment but instead accrues to the principal, which is repaid at the end of the life of the loan. One benefit of this structure is that it enables a portfolio company to postpone payment on a portion of its debt, reducing the near-term financial burden on the business.

Performance-based

Equity Kicker: The term equity kicker can refer to a variety of mechanisms through which an investor acquires an equity stake in the portfolio company. Common equity kickers are warrants (allowing for the purchase of equity in a company at a fixed price until a set point in time) and conversions (allowing for the conversion of a bond to equity). Equity stakes held by mezzanine investors can be monetized either through a put option agreed to between the investor and the portfolio company, or through the sale of a holding during an IPO or strategic sale. Investors can also achieve upside in returns through equity-like instruments, such as profit sharing structures, which guarantee the investor a dividend based on a percentage of the company’s revenues, EBITDA or other measurement of performance.

Exhibit 2: Illustrative Components to Mezzanine Returns



Together, each of these various instruments contributes to the overall returns of a mezzanine transaction. Exhibit 2 illustrates how the returns on a mezzanine investment might be generated, with contractual returns in blue and performance-based returns in purple. Deals that are purely contractual are sometimes referred to as “warrantless,” while deals with an equity interest are referred to as “warranted.”

Mezzanine in Emerging Markets

Since its genesis in the United States in the 1980s and expansion into Western Europe the following decade, mezzanine in developed markets has matured into a US\$100 billion dollar industry. Initially driven by interest from insurance companies but now supported by a range of institutional investors, mezzanine financing in the West is used by companies for a multitude of reasons, including as growth capital, for restructurings or recapitalizations, and as part of leveraged buyout packages.

In contrast, mezzanine finance in emerging markets is fairly young and less commoditized. Parts of Central and Eastern Europe, Asia and Latin America were home to a few mezzanine investments in the 1990s, yet the number of firms offering the product was tiny. While the universe has gradually and marginally expanded in these regions and has begun to develop in parts of the Middle East and Africa in recent years, there remain very few dedicated mezzanine specialists operating in these markets. Further compounding the slow speed at which the industry is developing is the fact that in many of these countries, the credit, private equity and capital markets are all also themselves still in the process of developing.

Mezzanine investing in emerging markets is markedly different than its developed market counterpart. As Rahul Bhargava, Managing Director and Partner of Southeast Asia-focused fund manager Leafgreen Capital explains, “Mezzanine in developed markets is about filling a gap in the capital structure. In our part of the world, mezzanine is about filling a funding gap. Perhaps a more appropriate label is structured growth funding. It’s about supporting good companies, typically in the mid-market, that are not able to access traditional bank funding; not able to access the bond or IPO markets because of their size and depth; and, not wanting to take private equity just yet because of the level of dilution and terms.”

This funding gap is widespread across all emerging market regions and serves as the lead driver of mezzanine activity. In Central and Eastern Europe, for example, Franz Hörhager, Founding Partner of Mezzanine Management, states, “The main factor pushing companies in our markets to seek mezzanine financing is the lack of SME bank debt available in the region. So many institutions in Central and Eastern Europe are owned by Western banks that have suffered under Basel III, which forced them to cut the balance sheets of their subsidiaries. And even the banks that are still present in this space are quite hesitant to get into the ‘riskier’ deals.”

Institutional vs. Traditional Mezzanine

In recent years, a stratification of the mezzanine industry in the United States and Western Europe has emerged. At the larger end of the spectrum sits “institutional mezzanine” or sizable financing solutions often led by credit institutions that underwrite a significant chunk of a deal and distribute the mezzanine component to other credit investors. Many of these transactions are focused on

infrastructure or real estate deals, and are often used to complement the funding provided by senior lenders and boost returns for equity providers. At the other end of the spectrum is “traditional mezzanine,” which either represents a “sponsored” deal (where a mezzanine provider works with one or more investors—whether financial or corporate—to offer a comprehensive financing package to a company) or a “non-sponsored” or “sponsorless” deal (where a mezzanine investor lends directly to a company).

Mezzanine financing in emerging markets—and the core focus of this report—is about sponsored and non-sponsored transactions. Ben Edwards, Managing Partner of Syntaxis Capital, a mezzanine provider focused on Central Europe and Turkey, notes, “In most emerging markets, mezzanine investing is traditional mezzanine. We work one-on-one with companies, both in partnership with a private equity firm and directly with the entrepreneurs. We structure a mezzanine loan that fits their specific business plan and overall objectives, and typically we have active involvement with the company’s Board. It’s hands-on at the operational level, in contrast to what one sees in the larger mezzanine segment such as the high-yield market in the United States.”

There is a tradeoff between sponsored and non-sponsored deals for emerging market mezzanine fund managers. While participating in sponsored deals brings many advantages, such as the opportunity to leverage the resources of private equity investors while conducting due-diligence on a target company and in supporting a firm should the business falter, there are also drawbacks. In addition to negotiating the terms of the intercreditor agreement with the senior lender, a mezzanine investor in a sponsored deal must negotiate with the equity sponsors its contractual returns and equity participation, which may temper its overall return.

Chris Chia, a Managing Partner at Asia-focused structured equity/mezzanine provider Kendall Court Capital Partners, explains why his firm only does non-sponsored deals. “[In sponsored deals] you’re sandwiched. The private equity guys want to cap your upside and not share any equity because you’re both swimming in the same lane and trying to maximize returns. And then the banks do not want to share the downside with you (especially in an undeveloped intercreditor regime), so you are left feeling like an orphan in the structure. I’d much rather go directly to the companies that are looking for growth capital.”

Regardless of whether a transaction is sponsored or non-sponsored, much of the mezzanine financing in emerging markets is committed to small- and medium-size companies that are cash flow positive and looking for financing to fuel growth, fund acquisitions or recapitalize. The companies are attracted to mezzanine because it offers long-term capital without heavy equity dilution, and can be adapted to each business’s unique situation. It is precisely this flexibility that is the sub-asset class’s key strength: the ability to weight debt and equity instruments with a bespoke approach to ensure an alignment of interests with the portfolio company. ●●

The Risk/Return Profile of Mezzanine in Emerging Markets

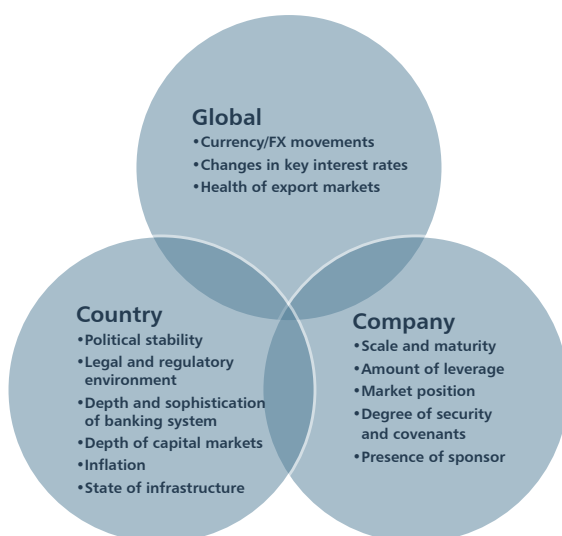
Mezzanine fund managers often claim to provide 80% of the returns of private equity with 50% of the risk. Though these numbers are just estimates, they get at the heart of the challenge for mezzanine investors: a risk-adjusted pricing and payment profile. Luc Albinski, Managing Partner at Vantage Capital, a South Africa-based investment and financial services group that has raised two mezzanine funds to date, notes, “The risk that we are taking, and an assessment of that risk, is as important to us as the return. What we sell to our LPs is the fact that we are not just chasing returns, but rather we are seeking the best possible ratio of return to risk—and that is a much more challenging target than one of simply striving to achieve a return somewhere between senior debt and private equity. You could get that return but be taking completely insane risks in order to achieve it.”

In general, the risks facing emerging market mezzanine investors are not that dissimilar from those facing their private equity counterparts. They must contend with a variety of global, country and company-specific risks (see Exhibit 3 for a sampling). However, this particular sub-asset class is designed to offer investors a less risky profile than equity, and as such, mezzanine investors can employ a number of tools to optimize their targeted level of risk in any given transaction.

Mitigating Risk Through Mezzanine

Some of the factors that drive the level of risk in a mezzanine transaction include the strength of security, the ability to influence a business through covenants, the terms driving self-liquidation, and the presence of a committed investor in sponsored transactions. Each of these factors can attenuate stresses at the global, country and company level. A more detailed look at each of these features is summarized below.

Exhibit 3: Consideration of Risks for Emerging Market Mezzanine Investments



Security

Contractual security on a mezzanine loan is a key factor in reducing the risk of an investment. While mezzanine debt can be either asset- or cash flow-based, the security on asset-backed debt is traditionally second or third lien. Depending on the mezzanine investor’s position relative to senior banks, security on the assets of a portfolio company can, to varying degrees, protect its invested capital in the event of a default or bankruptcy. Though mezzanine debt is by definition subordinate to senior debt in the capital structure, the dearth of senior lenders in many emerging markets has resulted in mezzanine investors sometimes being the only debt providers in a deal, giving them the ability to secure senior rights to the assets of the target company or to combine a second lien position on assets secured by banks with first lien rights that do not fall within the bank security pool.

One institutional investor with experience investing in emerging markets mezzanine observes, “Traditionally mezzanine funds haven’t had the experience of standing first in line for a security buffer as they were obviously behind senior debt. However, in the last two years in a handful of the more developed emerging markets, we have seen these firms manage to structure deals with a senior type of security while still achieving mezzanine debt returns. So the risk-adjusted return has been further enhanced in the ‘new normal,’ as opposed to three to five years ago, dependent of course on the assessment of the underlying business risk. This is definitely an attractive quality for the strategy.”

Regardless of whether a mezzanine investor holds first or second lien, an obvious question arises as to whether this security can be enforced given the nascent state of legal systems in many emerging markets and the wide-spread lack of well-developed bankruptcy codes. One fund manager advises, “You have to make sure that the structures you put in place are adequate in terms of enforcement. In many markets, this means that the enforcement needs to be as far outside the court process as possible, for instance, by being able to avoid foreclosures and sell your assets through an auction.” Another mezzanine investor notes, “When we have had to rely on built-in remedies, they have worked—not painlessly, but they have worked. While the equity might have been wiped out, we were preserved.”

Robert Graffam, Senior Managing Director at Darby Private Equity, recalls a transaction where relying on built-in remedies was the case. “We did a deal in Mexico ten years ago with a company focused on long-distance telephony. It sold calling cards to the Mexican population in America so that they could call home. This used to be a very attractive segment of the market but, in the years after we invested, rates on calls between Mexico and the United States dropped from 19 cents to 3 cents per minute. The industry disappeared. Nevertheless, we recovered our money, and the reason we could do this was we had a first mortgage on the company’s fiberoptic cable. Though negotiations were acrimonious at times, we enforced our rights and sold the assets to Telmex. The important thing for mezzanine investors is that they have a remedy should something bad happen, or if a company is underperforming or violating covenants.”

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The Risk/Return Profile, *continued*

While the security on a debt is an important risk mitigant, many fund managers stress that relying solely on such security is a mistake, and instead argue for cultivating a strong relationship with the company and all other interested parties before a deal is inked. As part of this process, many mezzanine investors often request to sit as observers on Boards and financial, audit and/or risk committees. Syntaxis's Edwards explains, "Our investments offer downside protection through security—not because we ever plan at the outset to go down the enforcement route, but because it gives us a seat at the table when things need fixing. In this way, we can protect our position, often by providing new money, but on terms that work for all the other parties involved. Achieving consensus is crucial, especially because we operate in markets where the bankruptcy regimes and courts are often still developing."

Covenants

Covenants negotiated with a portfolio company are an important tool mezzanine investors use to exercise control. Often mirrored after the documents put in place by senior lenders, certain covenants are triggered when a company undertakes a prohibited action, such as raising new debt or selling existing assets, while others stipulate certain performance requirements, such as meeting cash flow or EBITDA targets, or opening an agreed-upon number of new stores within a certain time period.

If a company breaches the covenants of a deal, the mezzanine investor often has the contractual right to force a partial debt prepayment, intervene in the company's operations (e.g., changing capital expenditures or dividend policies), or adjust pricing based on an increased risk profile. As Vantage's Albinski puts it, "Covenants are important because they ensure that if things are not going to plan, you will be able to exercise significant pressure to get the company to take remedial action to address the problems, to restructure the debt, or to prepay some of it through an equity issue."

However, having covenants that are too numerous or too strict imposed on a company can have the opposite of their intended effect. Syntaxis's Edwards notes, "In the markets where we operate, it's often the banks that pose the biggest risk. Because they are still building their leveraged finance capabilities, they sometimes straightjacket a company by imposing a huge number of sometimes meaningless obligations and covenants. Imagine you're working with a management team that has identified an opportunity to buy a bunch of secondhand assets at a fantastic price that will increase production and the value of their security, but to do it the banks need to agree to a minor amendment. It may make sense for the company and the value of the business, but ultimately the bank might say no because it only sees the downside, and that's probably after charging a fee to consider the request. Having an unsupportive bank continually involved in a company's operations to the point where management is constantly looking over its shoulders can be soul-crushing for teams and clearly not good for the value of businesses."

Does Risk Mitigation Actually Work?

Case Study: Efekto Care

Country: South Africa



Business Description: Efekto Care sources, packages and distributes various plant protection, plant nutrition and home care products. Efekto Care has a 70% to 80% market share in the plant protection market through its Efekto brand, and a 50% to 60% market share in the plant nutrition market through its Wonder fertilizer brand.

Investment Details: In 2011, Vantage Capital invested ZAR87.5 million (~US\$12 million) in the buyout of Efekto Care by Ascendis Health and Management, a South African health and care brands company. The proceeds of the investment were used to bolster Efekto Care's working capital, and to finance capital expenditures as well as Efekto's bolt-on acquisition of Avima (a pesticide company). Vantage secured an 18.4% equity stake in Efekto Holdings and a further equity option to acquire a 5% or 10% shareholding in Efekto Holdings, Ascendis Health or any shareholder of Ascendis Health in the event of a listing or sale of shares.

In July 2013, Vantage exited through a senior debt refinancing (since Ascendis Health sought to list itself on the JSE) and received a settlement of ZAR150 million, which together with interest generated a rand-denominated IRR of 51.7% (1.9x money) in 21 months.

Sources of Risk:

- **Competitive Landscape** – International companies could enter the South African plant protection or plant nutrition market, eroding market share;
- **Company Risk** – Inadequate financial and stock control systems could lead to lost sales and poor working capital management; and,
- **Macroeconomic Risk** – Garden and home-care products are discretionary expenditures, which get cut during periods of soft economic conditions.

Risk Mitigants: The Vantage facilities were secured by sureties from Ascendis Health (the equity sponsor), Coast2Coast Investments (Ascendis Health's parent company) and all wholly-owned subsidiaries of Coast2Coast Investments. Vantage had a first-ranking claim over Efekto Care's trademarks, which were independently valued at ZAR80 million, in addition to second-ranking claims over all other assets. Vantage also had financial covenants, observer seats on the Board and audit committee, and super-voting rights in the event of default.

“Our investment helped Efekto Care fund growth, and at the same time was a spectacular success for us: 52% IRR and 1.9x in 21 months”

— Luc Albinski, *Managing Partner, Vantage Capital*

Self-Liquidation

Capital preservation is a core component of the mezzanine investor’s value proposition. Unlike traditional private equity, where committed capital is locked into a deal until a liquidity event occurs, mezzanine investments are self-liquidating, removing a potential bottleneck should M&A or IPO markets become less favorable.

If risk is defined as the potential permanent loss of capital, the self-liquidating nature of mezzanine debt helps gradually to reduce risk throughout the life of the investment, as the cash pay on mezzanine debt reduces the capital exposure from the moment the investment is inked. According to Vantage’s Albinski, “If you are earning a 20% cash return, after the first year you have received 20 cents on your dollar back, and after the second year, almost half of your capital has been returned. Typically, problems in a portfolio company won’t surface in day one or year one; it may take several years for issues to arise, by which time you may have much of your loan already repaid leaving your net capital exposure at risk significantly reduced.” Even when there is no financial distress, a company may show modest or no growth in earnings; a mezzanine investor will be protected in this scenario, in part, by the cash pay and PIK components.

The equity component of mezzanine deals can also be self-liquidating if a put option is obtained, providing an investor with a guaranteed sale of their equity stake back to the company. Of the 56 deals with disclosed information regarding put options studied for this report, 71% included a put option on the equity kicker. This self-liquidating feature was one of the key drivers in the early growth of mezzanine in emerging markets, as many investors believed in the growth opportunity that emerging markets offered but were not convinced that proper exit avenues existed.

The Sponsor

Sponsored mezzanine investments can further mitigate risks in a transaction, as the resources that strategic or financial sponsors bring to a deal can reduce the financial burden on mezzanine investors while enhancing due diligence and monitoring. Furthermore, a strong sponsor can bring to bear financial and operational resources should the business falter and require additional backing. “Typically, a private equity firm will have significant additional capital that they can deploy into a transaction if the company is not meeting its targeted profits and needs more support,” notes one industry participant, “This makes the quality of the sponsor a key risk criterion for us when evaluating investments.”

Participation in sponsored deals can reduce the exit risk for mezzanine investors as well. Whereas in direct deals the mezzanine investor must shoulder the burden of arranging an exit for the equity position, the presence of a sponsor can amplify the likelihood of a liquidity event.

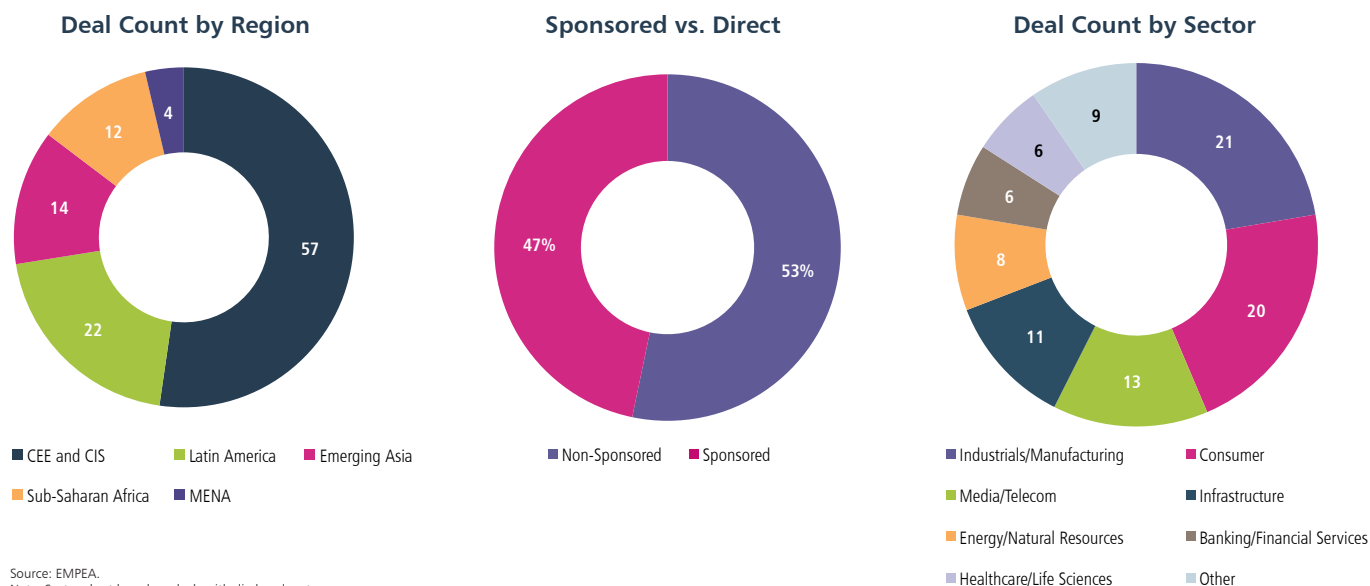
The Track Record of Mezzanine in Emerging Markets

The Data

EMPEA collected constituent investment and performance data from a number of mezzanine fund managers relating to 109 transactions. The data include a blend of fully exited, partially exited and unrealized transactions. Exhibit 4 provides a breakdown of the data set’s demographics by region, sector composition and whether the deal was sponsor-backed or direct to company.

Of the 50 sponsored deals, 33 occurred in Central and Eastern Europe and the Commonwealth of Independent States;

Exhibit 4: Data Set Demographics



Source: EMPEA.
Note: Sector chart based on deals with disclosed sectors.



INNOVATIVE FINANCING ACROSS GLOBAL EMERGING MARKETS

In 2009, one of Turkey's entrepreneurial families sought long-term financing in order to expand the family's bottled water business. Darby made a mezzanine and equity investment in the company to allow it to build a modern factory and launch new products. The Darby investment combined with the expertise of the Darby team facilitated the company's rapid growth while allowing the family to remain in control during a major expansion phase. By 2013, the company had grown to become one of Turkey's leading branded bottled water companies and Darby's stake was acquired by a multinational.

Darby — partnering with growth businesses across the emerging markets.

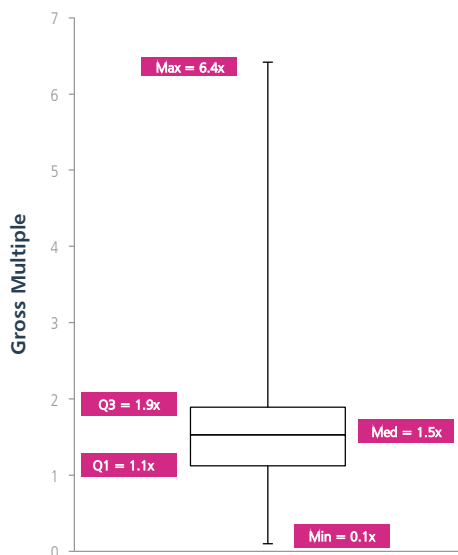
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The Risk/Return Profile, *continued*

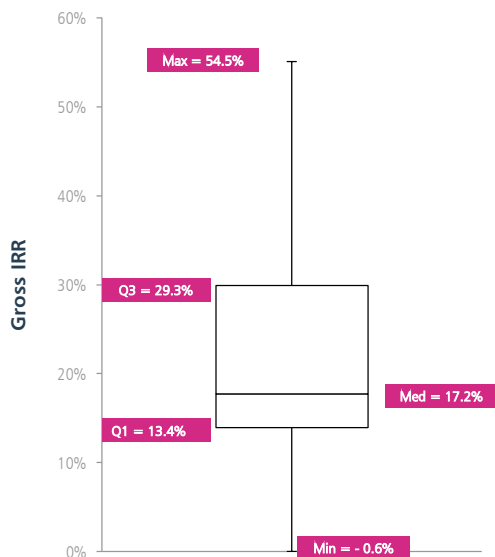
however, 81% of the region's sponsored deals occurred between June 2003 and September 2008, which speaks to the private equity industry dynamics in the region in the years leading up to the global financial crisis. This finding implies that mezzanine in emerging markets is now more of a direct form of financing than the aggregate data might suggest.

Exhibit 5: Performance of EM Mezzanine Transactions
Gross Multiples on Realized Deals



Source: EMPEA.
Note: Incorporates ~ 75 transactions; excludes outliers.

Exhibit 6: Performance of EM Mezzanine Funds
Gross IRRs at Fund Level



Source: EMPEA.
Note: Incorporates ~ 10 EM-dedicated mezzanine funds with vintage years between 1999 and 2011.

Deal-level Returns

Examining approximately 75 realized transactions—and excluding outliers—the median emerging market mezzanine deal returned a 1.5x gross multiple, with the middle 50% of deals delivering between 1.1x and 1.9x money (see Exhibit 5). Indicative of mezzanine's risk/return profile, the minimum return achieved a 0.1x return on capital, while deals incorporating substantial equity kickers achieved gross returns upwards of 6.4x. We acknowledge that there may be some bias in this data set and that not all mezzanine transactions are guaranteed to achieve positive returns.

Fund-level Returns

At the fund level, we received realized gross IRR data for approximately 10 emerging market-dedicated mezzanine funds from vintage years between 1999 and 2011. The median fund delivered a gross IRR of 17.2%, with the middle 50% of funds delivering between 13.4% and 29.3% (see Exhibit 6).

Debt Component Returns

Amongst the data set, 34 deals contained details on both the duration and rates tied to the debt components utilized in the transaction. The range of tenors was diverse on a regional basis: average duration was longest in Latin America at seven years, with tenors approximately half as long in Central and Eastern Europe and the Commonwealth of Independent States (see Exhibit 7). The average interest rate tied to debt financings was 540 basis points higher in Sub-Saharan Africa than in Emerging Asia.

In general, investors are compensated for taking on greater duration risk—not surprising given the shape of the standard yield curve—but perhaps not as much as one might expect (see Exhibit 8). The relationship between duration and yield exhibits an extremely weak correlation (R-squared of 0.07), suggesting that mezzanine fund managers do, indeed, work with companies to structure bespoke financing packages suited to corporate objectives and local financing conditions.

Exhibit 7: Debt Component Characteristics

	AVG. DURATION (YEARS)	AVG. ANNUAL INTEREST RATE (%)
Asia	4.6	10.4
CEE and CIS	3.7	11.3
Latin America	7.0	12.0
MENA	4.3	11.1
Sub-Saharan Africa	6.5	15.8

Source: EMPEA.
Note: Arithmetic mean, not weighted by deal size; floating rate notes were pegged to base/reference rates as of 4/14/14.

Risk/Return Profile, *continued*

What is clear in analyzing this data set is that each emerging market transaction is unique as various combinations of instruments have been employed. In discussing this dynamic, Amjad Ahmad, Senior Managing Director and Head of Alternative Investments at NBK Capital, a Middle East and North Africa-focused alternative investments fund manager explains, “Mezzanine structures in our market can vary significantly from one deal to the next. The asset class is not as structured as it is in developed markets; mezzanine is fairly new to both the region and business owners, so structuring and pricing is innovative with no two identical instruments. Our typical structure is a subordinated note with some kind of equity participation. Depending on the jurisdiction, we have structured preferred shares, warrants, sharia-compliant notes and simple profit participation. Security is usually a pledge of shares with additional security in the form of second lien on key assets; at times we can secure first lien if available. Overall, the structuring and pricing is more aggressive than developed markets given the lack of a transparent and structured market for these instruments.”

Another trend evident in the data set is that mezzanine strategies in emerging markets have evolved over time. Kendall Court’s Chia shares the drivers behind his firm’s evolution, “When we got started between 2004 and 2007, we approached mezzanine in a very structured debt-type manner, where we wanted 20% plus fixed debt returns on everything. In 2008-2009, when the global financial crisis hit, our strategy had to change because we started to see this structure as counterproductive to growing businesses by compressing their net income and making it more difficult for them to get cheaper sources of funding. So we started to switch to more of an equity bias;

Exhibit 8: Cash Pay on Mezzanine Financings Returns on Debt Components (2006-2013)



Source: EMPEA.

in the past, 80% to 90% of our returns would come from contractual obligations, and now maybe 40% of the returns will come from the debt side and we’re willing to take more of an equity view on the remaining 60% of the pie.”

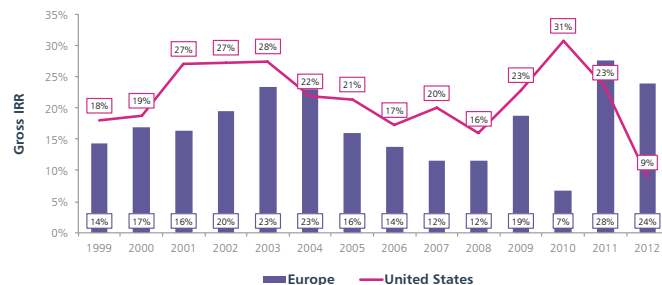
The diversity of structures, approaches and markets may leave institutional investors considering investing in emerging markets mezzanine with a number of questions. The next section of the report seeks to provide some answers, as a number of limited partners share their views on and experience with the sub-asset class. ●

A Closer Look at Mezzanine Performance in the United States and Europe

In the United States and Europe, where mezzanine finance has existed decades longer than in emerging markets, the track record suggests that returns for mezzanine have historically been fairly robust. According to data from CEPRES, on average, the median gross IRRs between 1999 and 2012 in the United States and Europe

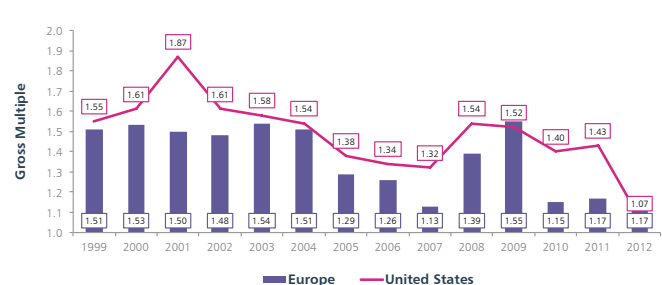
have been 21.5% and 17.4%, respectively. Median gross multiples during the same time period have averaged 1.4x in Europe and 1.5x in the United States, though they exhibit a downward trend in recent years.

Exhibit 9: Median Gross IRRs, Realized Transactions



Source: CEPRES.

Exhibit 10: Median Gross Multiples, Realized Transactions



Investor Perspectives on Mezzanine: An LP Roundtable

EMPEA interviewed a blend of industry professionals to capture LP perspectives toward mezzanine funds in emerging markets. In this LP roundtable, the participants share their candid commentary on mezzanine's risk/return profile, how it compares to traditional private equity, what deters them from committing to a mezzanine manager and more.

The participants—who asked to remain anonymous—include senior professionals from a family office, a foundation, an international finance institution, a fund of funds, an investment consultancy and a placement agency. As a group, the participants have worked with fund managers active in each emerging market region.

What factors led you to begin committing capital to mezzanine funds in both developed and emerging markets?

Foundation: We have no mezzanine exposure in developed markets because the capital structures in private equity deals are less favorable than they are in emerging markets. For example, in developed markets, mezzanine is sitting in the middle of the capital structure between equity and senior debt; when an investment goes into a restructuring, mezzanine is in a relatively weak negotiating position. We find that the return profile in developed markets may be attractive from an IRR perspective, but not from a multiple perspective, largely because they tend to miss out on the equity upside.

In emerging markets, however, this is less the case, and the risk/return profile is much more attractive. One of the funds in which we are invested has a base contractual return between 15% and 20% with equity kickers (or warrants) attached. A key difference from developed markets is that while investments may legally be a mezzanine piece in the capital structure, in practical terms it can be closer to being senior. This fund manager often is the only lender so it has a much better opportunity to negotiate terms, to the point of getting seniority on collateral in certain cases. It's attractive to get mezzanine returns with senior debt terms.

Family Office: I would agree with that perspective. We did not look at many mezzanine funds in Europe or North America because the product is more of a commodity—it's much more standardized. Additionally, the banks are more dominant in those markets and the overall returns are not attractive.

While we are invested in a private debt manager in Asia and a venture-related debt fund in the United States, we only have one pure mezzanine commitment—and that's to a manager in Africa. To be honest, we were not looking for mezzanine investments in the region, but we liked the strategy, the market and the competitive landscape. We also thought it would be a good entry for us into the region—to invest in a product that has a bit more downside protection and is less risky than a pure equity play.

From an asset allocation perspective, where does mezzanine fit within your portfolios?

Family Office: We're not very rigid in our approach. We simply view it as a private markets opportunity, and we allocate roughly 20% of our portfolio to private company investments—be they through private equity (inclusive of venture capital, growth equity and buyouts) or credit-related strategies. We are completely flexible across strategies, so everything is bottoms-up and opportunistic.

Foundation: For us, it's within our private equity bucket. We define an asset class by the characteristics of the underlying investment. The fact that there is a significant component of returns that can come from equity leads us to put it in private equity.

Fund of Funds: From a fund of funds perspective, we find that mezzanine can be quite complementary to our private equity exposure. In particular, it gives us a greater degree of predictability in terms of what the return outcome will be on a deal-by-deal basis—provided that each of the transactions is structured appropriately—and it also provides our portfolio with a cushion through a flatter J-curve.

What's interesting is that our investors see the merits of looking at mezzanine as an addition to their portfolio, but more recently they are looking to us for pure private equity exposure. That said, our investors would allocate to a mezzanine fund through their debt bucket. They look at it as an alpha generator overlaid on a traditional bond portfolio.

How does mezzanine stack up against pure play private equity? How important of a factor is the downside protection on offer?

Foundation: Lending strategies in emerging markets are very competitive against private equity, since most of the private equity returns we've seen have not been superior to those in the Western world. We certainly try to understand the risks a fund is taking, but we don't invest based on a technical risk/return metric. If we find a lending manager that does mezzanine or senior, an important aspect is to understand how thorough the underwriting process is. If this is combined with an attractive return profile, we will invest.

Placement Agent: Large institutional LPs tend to look at a firm's return profile, so instead of looking at the downside protection, they ask, "why should I go for a lower return if these companies are growing 4% to 6% per annum?" You might as well go for the action. The downside can tip the scale, but only when there's sufficiently attractive upside.

IFI: To play devil's advocate, I think mezzanine is attractive once it starts hitting 15% to 20% IRRs. But this can be difficult to achieve even with straight equity funds. I'm also a bit skeptical that mezzanine investors can sustainably get both upside and downside; after all, there's no such thing as a free lunch. I'm sure such deals have been done, but I'm inclined to think that relying on the naiveté or lack of sophistication on the part of sponsors is not a sustainable strategy.

Investment Consultant: I don't entirely agree; I think the risk/return profile is attractive. We are keen on mezzanine and think it fits nicely into an asset allocation strategy. A number of our clients that have gone into mezzanine understand it slightly better than private equity, and the risk profile is more palatable to groups of trustees that do not want to embrace the perceived risk of private equity funds. Our advice to clients is that we can model a diversified portfolio that can meet their return objectives, and that mezzanine has a role to play because of its risk/return structure.

Fund of Funds: Downside protection is important and mezzanine debt can work extremely well, but there are times when it can unravel. A cautionary example of this would be the global financial crisis. We saw mezzanine managers with anywhere between 1.5x to 2x collateral cover, but it was tied to property. Well, along came the crisis and valuations got re-rated; all of a sudden that 2x coverage dropped down to 1x. And then the senior debt holders, who were ahead of the mezzanine managers in the capital structure, began executing fire sales, which hit valuations even harder. So those who were left standing second or third in line ended up recouping 70 cents on the dollar. Granted, that's a drastic example, but I think investors need to be careful when choosing their managers to ensure that they're sophisticated enough to structure deals well.

What skillsets should LPs look for in a mezzanine fund manager? Are they qualitatively different than those they should seek in a traditional private equity fund manager?

Fund of Funds: The skillsets are vastly different. In the mezzanine space we prefer to see people with significant debt capital markets, debt structuring and banking experience. We also like to see lawyers who know how to structure agreements appropriately to secure the liens. In private equity, on the other hand, we like to see a blend of entrepreneurs, industry specialists, perhaps some engineers—people that can add value to a

“A key difference from developed markets is that while this fund may legally be a mezzanine piece in the capital structure, in practical terms it is much closer to being senior. It's attractive to get mezzanine returns with senior debt terms.”

—Foundation representative

company and manage problems if and when they arise. I'm not saying that private equity fund management is easier, but personally, from an IQ perspective, I think mezzanine is a bit more difficult. A group of entrepreneurs can run a private equity fund successfully because they know how to run businesses; but when it comes to engineering the capital structure of a firm—primarily at the debt level—I would prefer an experienced mezzanine debt financier.

Family Office: I agree. Whether it's a private equity deal or a mezzanine deal, it's always important to structure the transaction well; but it's even more important to structure the terms and the legal agreement the right way with mezzanine. What we like about our private equity funds is that they're active managers of the underlying portfolio companies throughout the holding period of their investments. Mezzanine, on the other hand, is more limited; the manager is kept informed but is not as active as a private equity player, so it's critical to do the right things up front when structuring the deal.

What typically deters LPs from committing to emerging market mezzanine funds? Are there any key pain points?

Foundation: In most cases it's due to limited transparency; in other cases, we see managers with strategies that are too opportunistic. We look for a repeatable process in both private equity and mezzanine. In some instances, we've looked into mezzanine managers but they were taking on too much equity risk versus debt risk; and some have had very aggressive strategies putting too much leverage into a deal while lacking the appropriate underwriting for the transaction.

Investment Consultant: This may be a function of the dynamics of our market, but one of the key inhibitors is the size of the local investor base. We don't have a lot of institutional investors that have sufficiently large pools of assets to build private equity—let alone mezzanine—programs. So, for example, if an investor puts US\$100 million into a fund, that could be upwards of 2% of their assets. This effectively serves as a barrier to entry.

Finally, how do you see mezzanine in emerging markets evolving over the next three to five years?

Family Office: In general, I think private debt and private credit are attractive. As we all know, the banks are pulling back; there simply is space in emerging markets for other forms of credit aside from the big banks. We would certainly like to add more private credit products to our portfolio in the future.

“The skillsets are vastly different. In the mezzanine space we prefer to see people with significant debt capital markets, debt structuring and banking experience.”

—Fund of Funds representative

Fund of Funds: I see mezzanine continuing to grow. With the new Basel capital adequacy rules rolling out over the next few years, banks will continue to be under pressure; so there will be an opportunity for niche, specialized lenders to emerge. Africa, in particular, will be a lot more exciting over the foreseeable future from a mezzanine perspective because the banks are not skilled enough to provide structured finance or mezzanine facilities just yet—they are still mostly involved in vanilla senior lending.

Placement Agent: I believe private credit will have a much more important position in investors' portfolios going forward. Two of the emerging market credit funds we're working with manage 3x to 4x portfolios; a firm that can provide a 3x gross return with full downside protection and potential upside participation will garner attention. Investors are looking for yield and they are no longer as content with minority stakes in their pure private equity allocations. Investors today are open to choice and mobility in the capital structure, so they will want to retain a degree of flexibility and not be locked into one rigid structure. ●



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The Scale of the Emerging Markets Mezzanine Industry

As highlighted on previous pages, the mezzanine industry in emerging markets remains fairly small. The competitive landscape to date has been comprised of (1) dedicated mezzanine specialists; (2) private equity firms that have raised focused mezzanine funds; (3) private equity firms that have made ad hoc mezzanine investments through their private equity funds; and (4) banks and (less frequently) hedge funds that have provided mezzanine financing to select companies. For the purpose of analyzing how much money has been raised for mezzanine in emerging markets over the last several years, we have included only the first two categories in Exhibit 11.

Coming off of a peak of nearly US\$1.9 billion raised in 2008 just prior to the onslaught of the global financial crisis, emerging market-dedicated funds have witnessed a slowdown over the last several years. Many of the mezzanine funds that have recently closed are targeting Emerging Asia, which may not be surprising given the explosive growth in private equity across the region over the previous decade, and indeed may be a harbinger for the sub-asset class's coming of age. In 2013, Hony Capital closed its China-focused Hony Capital Mezzanine Fund with RMB1 billion (US\$163 million) in capital commitments, while the prior year saw CITIC Private Equity Funds, Everbright Private Equity and Darby Private Equity all close on their most recent Asia-focused mezzanine vehicles. In fact, in the last two years, 75% of the capital raised for emerging market mezzanine funds has been earmarked for Emerging Asia.

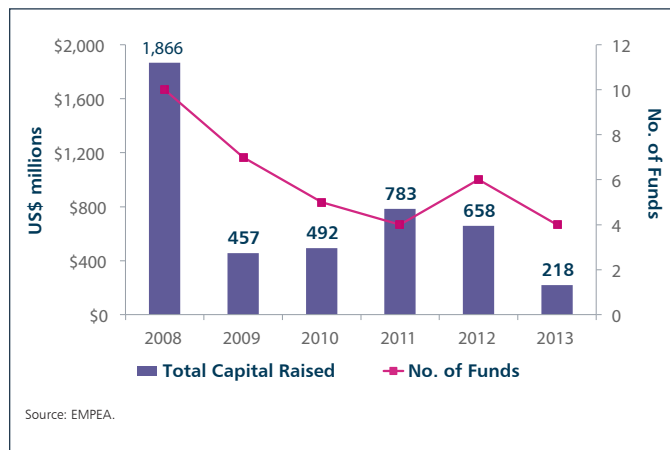
Several key factors currently hinder greater development of mezzanine in emerging markets, including a lack of understanding of the product amongst emerging market entrepreneurs. Nicholas Kabcenell, head of Darby's mezzanine investment platform in Central Europe notes, "One of the challenges we've faced as a firm doing mezzanine for 15 years is that the product is often misunderstood by investee companies. The growth stage firms we look at start out seeking either additional cheap bank-like debt or minority equity. Many of these companies learn eventually that they can't get any more debt and they can't get minority equity as many private equity investors insist on a controlling stake. As such, a core part of our business and marketing efforts is focused on educating prospective borrowers. In time, many of these companies come to understand the benefits of patient, long-term capital and the value-add that an experienced partner can provide."

However, a greater awareness of what mezzanine offers—the asset side of its equation and not just the liabilities—may unlock the door to more partnerships as this financing vehicle may sometimes be better suited to a firm's strategy and/or situation than other sources of capital. As NBK Capital's Ahmad explains, "We try to be pragmatic and base our approach on achieving the business owner's goals while providing the right return for the level of risk we are taking. In many cases, business owners are seeking equity capital while they are reluctant to offer a significant stake, appropriate minority rights and/or Board seats. They are in essence seeking mezzanine but are not aware of the product. Mezzanine has its advantages in such cases as it reduces dilution for current shareholders and eliminates the need for extensive structuring around minority rights and in particular exits. The product is well suited for growth capital opportunities."

In addition to the entrepreneurs, a lack of familiarity, as well as general disinterest, within pockets of the limited partner community has also restrained a more rapid development of emerging markets mezzanine. Several of the fund managers that we interviewed for this publication commented that they have found numerous institutional investors to be generally uninterested in risk-adjusted returns. One notes, "They just want you to colonize Mars and get the highest returns possible when investing in an emerging market." Another fund manager remarks, "I have had investors say to me that if I go to China, which is already a high-risk play, I want the maximum upside. After all, this is my mad money."

Nonetheless, several institutional investors have embraced emerging markets mezzanine, including insurance companies and development finance institutions, which like its ability to offer access to a growing segment of an economy while minimizing volatility in returns, particularly in the post-financial crisis world. Mezzanine Management's Hörhager, comments, "There was a time when people thought mezzanine returns were not good enough and they would only go for equity, but people have become more realistic and changed their views. When markets are hot, people are often just focused on returns and want to make a killing. In difficult times, especially after the crisis in the years between 2009 and 2011, investors are more focused on protection of capital. This has given mezzanine a revival and we now get many unsolicited calls. We offer a relatively safe product with an attractive return."

Exhibit 11: Emerging Markets Mezzanine Fundraising, 2008–2013



“When markets are hot, people are often just focused on returns and want to make a killing. In difficult times, especially after the crisis in the years between 2009 and 2011, investors are more focused on protection of capital. This has given mezzanine a revival and we now get many unsolicited calls.”

—Franz Hörhager, *Founding Partner of Mezzanine Management*

While development of the asset class has been slow, several signs point to the potential for a brighter outlook going forward. Institutional investor interest is growing—in EMPEA’s latest *Global Limited Partner Survey*, nearly half of the surveyed respondents want to have exposure to private credit, inclusive of mezzanine—but as noted in many of our conversations with LPs on the subject, a key barrier for them is the limited number of funds in this space. However, several mezzanine funds are now being launched across a number of emerging markets that have historically offered little to no financing products beyond plain vanilla debt, public and private equity, including in parts of Africa beyond South Africa, the Middle East and some of Latin America’s more frontier markets. These new funds are joining a small but active base of established mezzanine investors in actively deploying capital across the

emerging markets (see Exhibit 12). One institutional investor cautions, “I think several of these guys are going to get hurt along the way because they have still got to experience something called time.” But regardless of how they fare, this rise in the number of new fund launches is a critical step in building the skill sets and track records that these markets need to attract funding.

The following pages take a deeper look at each emerging market region to give our readers a better sense of some of the particular dynamics affecting mezzanine investment in each of these markets. In addition, some of our members who have pioneered mezzanine in their respective regions share in their own words more on the history, challenges and opportunities of mezzanine investing in emerging markets. ●●

Exhibit 12: Sampling of Recent Mezzanine Investments in Emerging Markets

FUND MANAGER	COMPANY NAME	COUNTRY	SECTOR	INVESTMENT AMOUNT (US\$M)	INVESTMENT DATE
Adobe Capital	FINAE	Mexico	Banking/Financial Services	N/A	January 2013
Alta Ventures Mexico	Clip	Mexico	Banking/Financial Services	2	November 2013
Asia Mezzanine Capital Group	Chevalier International Holdings	China	Industrials/Manufacturing	30	May 2013
Darby Private Equity	China F&B Group	China	Consumer	N/A	December 2013
Darby Private Equity	Bioerix	Uruguay	Technology	N/A	September 2013
Darby Private Equity	Alta Rail Technology	Brazil	Technology	15	April 2013
ICICI Venture Funds Management	Jyoti Structures	India	Energy/Natural Resources	31.6	September 2013
Kendall Court Cambridge Investment Manager	Merdeka Serasi Jaya	Indonesia	Mining	80	February 2014
Mezzanine Management Central Europe	Bella Bulgaria	Bulgaria	Industrials/Manufacturing	18.5	August 2013
NBK Capital	Al Rowad	Saudi Arabia	Consumer	27	October 2013
Reliance Private Equity	Khadim India	India	Industrials/Manufacturing	14	September 2013
Resource Capital Funds	Forbes and Manhattan Coal	South Africa	Energy/Natural Resources	6	September 2013
Small Enterprise Assistance Funds (SEAF)	Alzani II	Georgia	Energy/Natural Resources	3	May 2013
Syntax Capital	BIK Brokers	Poland	Financial Services	N/A	September 2013
Vantage Capital	Kgoro Central	South Africa	Real Estate	16.1	June 2013
Vantage Capital	Genser Energy	Ghana	Energy/Natural Resources	15	March 2013
XSML	Cotrama	Democratic Republic of the Congo	Services	N/A	November 2013

DEG's Perspective on Emerging Markets Mezzanine

A Conversation with Joachim Schumacher, Senior Director



Why should private pools of capital, such as pension funds, endowments and family offices commit to emerging market mezzanine funds?

On why they should commit to emerging markets, these economies demonstrate strong long-term growth based on a number of competitive advantages, including resources, demographics, increasing

trade, and a growing middle class with consuming power. At the same time, the lack of risk capital is much more pronounced than in developed markets. Emerging markets are less efficient, so there is an ability to arbitrage between perceived and actual risks. I personally believe that over the past five decades this arbitrage opportunity has been a significant contributor to DEG's bottom line.

On why they should commit to mezzanine, I'd make two points. First, a large portion of the growth dynamics in emerging markets is driven by owner-managed companies, which you cannot buy on a stock exchange; and oftentimes there are difficulties accessing these companies with traditional private equity because owners are reluctant to cede control. Unlike developed markets where buyouts are used to align interests between the investor and owner, emerging markets primarily consist of growth capital deals, which can create challenges when attempting this alignment. Many of our family-owned and -run portfolio companies tell us that they were very happy to receive risk capital that did not interfere as much with their decision-making, strategy and vision as private equity would have, which leads us to believe that mezzanine in emerging markets can provide a good menu of options for structuring deals that balance the interests of owners and investors.

Second, you can de-risk your investment faster with mezzanine structures. For example, you can have a cash coupon, regular interest or principal payments resulting in a scheduled amortization of your principal. With small- and mid-size companies where you have higher exit risk, sometimes having regular payments can also increase the firm's financial discipline. You have a preference over the equity investors in the capital structure, and from a portfolio perspective, the J-curve of a mezzanine fund is much less pronounced, enabling you to smooth your cash flows. This makes mezzanine an attractive option for entering a new market or balancing volatility. Finally, with mezzanine you can make a more conscious decision on how exchange rate risk is allocated among the company and investors by choosing your currency, and because you have a repayment schedule, it is easier to hedge some of this risk than with an equity stake.

How has DEG's experience with mezzanine funds led the organization toward its long-term belief in the sub-asset class?

We are an investor in 12 mezzanine funds with a total exposure of more than US\$200 million. We also have a direct investment mezzanine portfolio of more than US\$1 billion. We invested in the first mezzanine funds in Eastern Europe, China and India; and our portfolio is performing well. If you look at our transactions that are closer to equity mezzanine than debt mezzanine, the overall return is just slightly below that of our equity portfolio. And my perception is that the risk is significantly lower. For example, following the financial crisis, we saw private equity funds in some of our South African investments taking large haircuts whereas, in the mezzanine position, we felt comfortable and had a relatively strong negotiating position.

For commercial LPs that are considering commitments to emerging market mezzanine funds, what distinguishing characteristics or skillsets should they look for in a manager?

The teams that we have backed have equity experience, but they also have to have a credit track record. I believe it is more difficult to find a good mezzanine manager than it is to find a good credit or private equity manager because you have to think upside while protecting the downside; and it is very tricky in mezzanine not to get caught in a trap where you sacrifice more return than you mitigate risk. It's also helpful if they have a private equity network, since sponsored deals can be an easy way to generate deal flow.

In my experience with mezzanine, it's also very useful to be able to play the entire risk/return curve. Fund managers have to earn their carry, which can often lead to equity-style mezzanine, but we like to see structures that balance the interests of owners and investors.

Looking forward, what are the prospects for mezzanine in emerging markets?

If you look at the evolution of financial markets in emerging markets, my sense is that credit markets come first, then the equity markets, and mezzanine is the last segment to develop. My thesis is that as these markets mature, you will have more active players, more people gaining experience in different types of financings, and increased competition in the debt and equity markets—these are catalysts for the mezzanine sub-asset class. The largest bottleneck to its development is to convince owners to accept the value proposition of mezzanine, which can take a long time. However, the potential for mezzanine is significantly higher than anything you see in the markets today. ●●

DEG, member of KfW Bankengruppe (KfW banking group), finances investments of private companies in developing and transition countries. As one of Europe's largest development finance institutions, it promotes private businesses to contribute to sustainable economic growth and improved living conditions.



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NBK Capital Equity Partners Fund I (closed): USD 250 million private equity fund focused on acquiring both minority and majority stakes in growing middle market companies across the MENA region.

NBK Capital Equity Partners Fund II (raising): USD 300 million private equity fund focused on acquiring both minority and majority stakes in growing middle market companies across the MENA region.

NBK Capital Mezzanine Fund I (closed): USD 158 million credit fund focused on providing tailored credit financing to growing middle market companies across the MENA region.

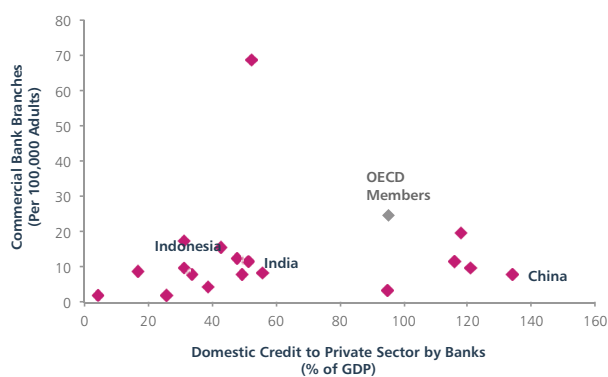
Emerging Asia



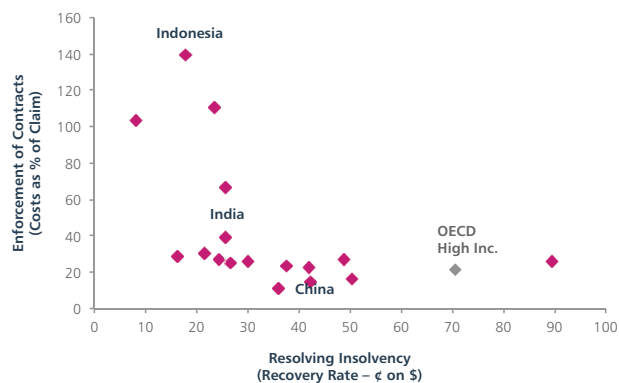
COMPETITIVE LANDSCAPE

of Known Mezzanine Fund Managers as a % of Private Equity/
Private Credit Managers in Region 2.6%

Depth of Local Banking Systems



Legal Protections



Sampling of Mezzanine Funds in Emerging Asia

FUND MANAGER/SPONSOR(S)	FUND NAME	FOCUS	WEBSITE
Asia Mezzanine Capital Group	Asia Strategic Capital Fund (2007, US\$95 million)	Asia	www.asiamezzanine.com
CITIC Private Equity Funds Management	CITIC Mezzanine Fund I (Fundraising)	China	www.citicpe.com
Crest Capital Asia	The Enterprise Fund I (2006, SGD124 million/US\$74.7 million); The Enterprise Fund III (Fundraising)	Singapore	www.crestcapitalasia.com
CX Partners	CX Partners Intermediate Capital Fund (2014, US\$70 million)	India	www.cxpartners.in
Darby Private Equity	Darby Asia Mezzanine Fund II (2006, US\$254 million); Darby Asia Opportunities Fund III (2011, US\$83 million)	Asia	www.darbyoverseas.com
Everbright Private Equity	Everbright Mezzanine Capital Fund (2012, RMB1 billion/ US\$158 million)	China	www.everbright165.com
Hony Capital	Hony Capital Mezzanine Fund (2013, RMB1 billion/US\$163 million)	China	www.honycapital.com
ICICI Venture Funds Management	India Advantage Fund VII (Mezzanine Fund I) (2007)	India	www.iciciventure.com
Intermediate Capital Group	Intermediate Capital Asia Pacific Fund 2008 (2008, US\$1 billion)	Asia	www.icgplc.com
Kendall Court Capital Partners	Kendall Court Mezzanine Bristol Merit Fund (2008, US\$150 million); Kendall Court Cambridge Fund (Fundraising)	Southeast Asia	www.kendallcourt.com
Phillip Private Equity	Phillip Ventures Enterprise Fund 3 (2010, SGD170 million/ US\$129.7 million)	Asia	www.phillipprivateequity.com

The Mezzanine Landscape in Asia

Simon Sham, Managing Director, Darby Private Equity, Asia



As large buyout funds became active in Asia in the mid-2000s, U.S. and regional commercial banks—and a few dedicated mezzanine funds—participated in several high-profile, non-infrastructure buyout transactions through mezzanine loans, attracted by the large deal size and relatively higher return. At the same time, mezzanine emerged as an alternative form of growth

capital for small and medium-sized companies in the region that had difficulty securing long-term bank financing for growth, but were generally hesitant to accept private equity partners due to concerns over equity dilution. As a result, dedicated growth capital mezzanine funds, hedge funds and several large regional commercial banks became active suppliers of expansion capital to these medium-sized companies using mezzanine structures.

Since the global financial crisis of 2008-2009, however, growth capital mezzanine investing by hedge funds and commercial banks has been significantly curtailed. Today, only a handful of dedicated growth capital mezzanine funds continue to operate actively in the Asian market. We have noticed select private equity funds beginning to offer an investment structure similar to mezzanine, but accepting higher equity risks than traditional mezzanine loans in exchange for a higher expected return.

Looking forward, we believe China continues to offer promising prospects for mezzanine growth capital investment given its large economy and expanding number of mid-sized companies. With credit tightening, many of these Chinese companies that wish to expand their operations have difficulties in securing long-term financing from domestic banks, which are primarily asset-based lenders or focused on state owned enterprises. The uncertain prospect of listing an IPO on the domestic stock exchanges has forced many mid-sized Chinese companies to look for alternative sources of funding, including both private equity and mezzanine capital.

Outside of China, Southeast Asian countries have been gaining favor as growth capital destinations over the past few years, as evidenced by the growth of dedicated Southeast Asian private equity funds—EMPEA data show that US\$2.9 billion was raised for Southeast Asia-dedicated funds in 2013, following US\$4.4 billion in aggregate capital raised between 2010 and 2012. Although investors have become cautious about Indonesia recently, Darby views the country as a leading market for

growth capital in Southeast Asia. We believe tighter local lending conditions will increase the flow of mezzanine investment opportunities in the coming years as many small to mid-sized local companies seek expansion capital. We also see growing demand for mezzanine financing for mid-sized buyout investment opportunities, particularly in Singapore and Malaysia, driven by first- or second-generation entrepreneurs who are nearing retirement and looking to sell their businesses.

With respect to Asia's two largest economies, there are unique regulatory hurdles in China and India impacting mezzanine investors. Direct mezzanine investment by a foreign fund in China is extremely difficult as a government license is required for the extension of loans, and U.S. dollar debt would require additional approval from the State Administration of Foreign Exchange. Therefore, U.S. dollar mezzanine investment in China may only be done via lending to offshore holding companies that have operating subsidiaries in China. The offshore holding companies in turn inject the loan proceeds into their Chinese operating subsidiaries in the form of equity or shareholder loans.

In India, a foreign fund, unless categorized as a "Recognized Lender" by the Reserve Bank of India (RBI), is only legally permitted to invest in an Indian company in the form of equity investments or unsecured rupee-denominated debentures that are mandatorily convertible to equity at maturity. Some foreign mezzanine investors have attempted to replicate the downside protection of a mezzanine instrument by structuring a put option back to the controlling shareholder of the portfolio company, but a recent RBI notification has cast doubt on contractual arrangements that create an obligation on an Indian party to buy securities at a price that results in assured returns for the investor.

While these regulatory issues present challenges to mezzanine investors in China and India, the overall future for the product in Asia is bright. Given the region's anticipated economic growth, the continued reluctance of the banking sector to provide long-term unsecured capital, and the desire of entrepreneurs and family groups to obtain needed long-term growth capital without losing operating control or experiencing heavy equity dilution, we believe mezzanine will play a critical role in the financing of Asia's small- and mid-sized businesses. ●

Darby has been a mezzanine investor in Asia since 2002, having managed three regional mezzanine funds totaling US\$533 million, which have invested in 23 companies across China, South Korea, India, the Philippines and Indonesia. Our initial focus was the infrastructure sector and our first vehicle was active in providing mezzanine loans to infrastructure companies as expansion capital for development of new projects.

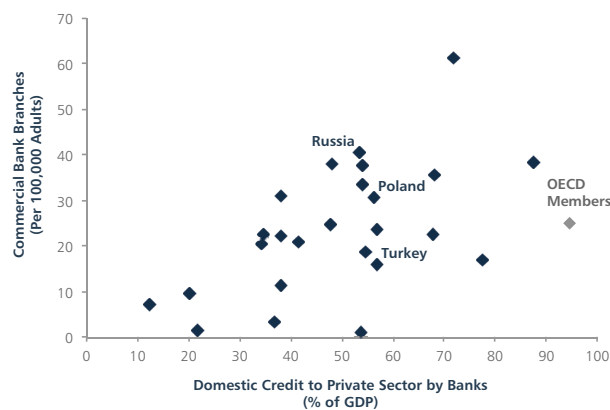
CEE and CIS



COMPETITIVE LANDSCAPE

of Known Mezzanine Fund Managers as a % of Private Equity/
Private Credit Managers in Region 1.6%

Depth of Local Banking Systems



Legal Protections



Sampling of Mezzanine Funds in CEE and CIS

FUND MANAGER/ SPONSOR(S)	FUND NAME	FOCUS	WEBSITE
BPM Capital	BPM Mezzanine Fund (Fundraising)	CEE	N/A
Bulgaria Mezzanine Partners	Bulgaria Mezzanine Capital I (Fundraising)	Hungary	www.mezzanine.bg
Darby Private Equity	Darby Converging Europe Mezzanine Fund (2006, €208 million); Darby Converging Europe Fund III (2011, €140 million)	CEE	www.darbyoverseas.com
Mezzanine Management Central Europe	Accession Mezzanine Capital II (2007, US\$340 million); Accession Mezzanine Capital III (2011, US\$275 million)	Central Europe, the Balkans, Ukraine and Russia	www.mezzmanagement.com
New Russia Growth Private Equity Advisors (NRG)	Volga River Growth Fund (2010, US\$135 million); Volga River Growth II (Fundraising)	Kazakhstan, Russia and Ukraine	www.nrgc.com
Small Enterprise Assistance Funds (SEAF)	SEAF Caucasus Growth Fund (2012, US\$47 million)	Armenia, Azerbaijan and Georgia	www.seaf.com
Syntaxis Capital	Syntaxis Mezzanine Fund I (2007, €118.6 million); Syntaxis Mezzanine Fund II (2009, €124.5 million)	Central Europe	www.syntaxis-capital.com

A Focus on Mezzanine in Central Europe: A Historical Perspective

Ben Edwards, Managing Partner, Syntaxis Capital



In 1981 Bill Gates purportedly said, “640k RAM ought to be enough for anybody,” which, if true, shows that even the best and the brightest can get their predictions wrong. While few would have foreseen the extent to which microchips changed the way we do things today, the development of private equity and leveraged finance—and the mezzanine

sub-segment in particular—in the United States in the 1980’s and Western Europe in the 1990’s, was certainly more predictable (albeit less life-altering). This trajectory carried over to Central Europe at the beginning of the last decade, increasing the ways in which our regional private equity industry was able to create (and sometimes destroy) value over the last 15 years.

The arrival of mezzanine in Central Europe followed much the same path as it did in developed markets, starting with a promising cycle of growth-driven private equity investment, which led to GPs subsequently raising larger funds due to robust investor appetite. To achieve returns in line with those generated in the preceding cycle, managers of these now larger funds looked to lever their investments. Leveraged buyouts emerged, not only because the credit conditions were better for lenders, but crucially, managers were able to achieve these returns in a much shorter timeframe. High profitability encouraged banks to invest in leveraged finance teams, and credit became abundant, leading to greater leverage, increased valuations, higher returns, robust investor appetite, bigger funds, etc. In this environment, mezzanine emerged as a means of increasing leverage (but not necessarily financial risk). The first mezzanine funds dedicated to Central Europe (primarily focusing on markets such as Poland, Hungary, Bulgaria and the Czech Republic) were established in the early 2000s. By the middle of the decade, some of the international fund managers had expanded to the region and local banks were beginning to structure mezzanine financing, increasing the overall level of competition.

Interestingly, the evolution of the mezzanine sub-asset class led to a bifurcation in the market in developed markets. The development of the U.S. high yield and junk bond market in the 1980s and the arrival of independent mezzanine funds in Western Europe ten years later defined the large-cap segment. At the other end lies the lower- to mid-market. The hallmark of the traditional mezzanine players focusing on this latter segment is their equity bias and direct involvement with entrepreneurs and equity funds to finance corporate expansion (not as syndicatees on bank-led deals). In the early years, the bulk of mezzanine investing in Central Europe was in this traditional mid-market segment, which has always been the focus of Syntaxis.

Private equity and leveraged finance markets in the United States, Western Europe and Central Europe experienced similar highs

and lows, with the biggest boom and bust occurring pre-, then post-Lehman. A key difference, however, is that due to its later arrival on the scene, the amplitude of the swings in Central Europe was possibly greater. The promise of high equity returns in Central Europe led private equity fund sizes to double and sometimes treble from 1995-2005, while deals done at greater than 5x leverage levels equalled those in Western Europe (and were sometimes higher due to the “trophy” status ascribed to certain participants’ first big buyouts in the region). The evolution from mid-market mezzanine deals to very large, widely syndicated transactions occurred in an instant.

Post-2008, macro uncertainty, and the fact that most of the lenders active in Central Europe saw the market as attractive but ultimately peripheral, meant that liquidity in the private equity markets disappeared just as swiftly. When pre-crisis structures needed fixing post-crisis, few lenders were prepared to be flexible (being too busy putting out their own fires), with a devastating impact on returns.

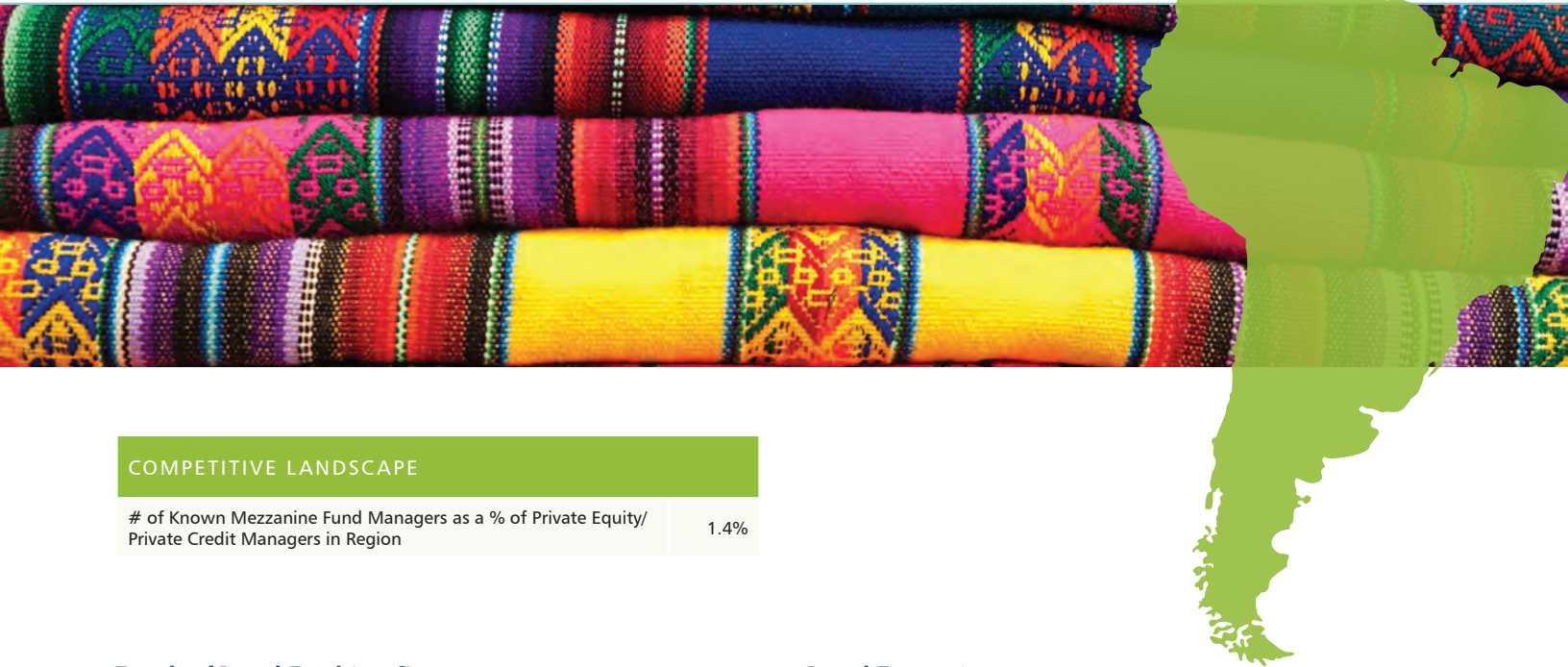
One thing the credit-crunch and euro crisis did was to differentiate those stronger companies from their weaker rivals. As such, for many remaining industry participants, the competitive marketplace is now much more attractive; their positions are solidified, and consolidation opportunities remain relatively abundant. This is a feature we are seeing in our portfolios and in new deals across industries, most notably in Poland—which is dominating current activity due in part to its size, stability and relatively advanced stage of development, as well as to entrepreneurs’ mentality toward buying and selling businesses—but also in the Czech Republic and parts of the Balkans.

Additionally, the relative lack of liquidity has meant that the investments we see are particularly compelling. With less buy-out equity capital available in the lower- to mid-market segment, entrepreneurs looking to expand are not necessarily selling out, while the relative lack of bank finance means that we can often originate opportunities to provide senior-secured financing at low leverage levels, and with equity upside.

Samuel Goldwyn advised, “Never make forecasts, especially about the future.” But in this instance I am prepared to take the risk. We think the Central European private equity market will generate highly attractive returns going forward, especially in the mezzanine segment in which we are active. Our economies (Poland in particular) are recovering quickly—for the right reasons—underpinned by favorable demographics, while the relative scarcity of alternative capital means that leverage levels and valuations remain relatively low. These all point to an appealing risk/return opportunity, a forecast that even the great movie mogul might have been comfortable making. ●

Syntaxis Capital is a leading provider of mezzanine finance for mid-market buyouts and similar transactions in Central and Eastern Europe. To date, the firm has raised two mezzanine funds for the region with aggregate commitments of approximately EUR245 million.

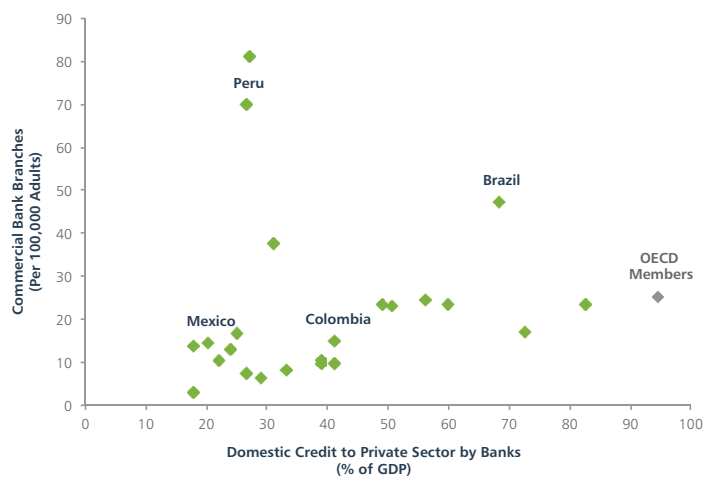
Latin America



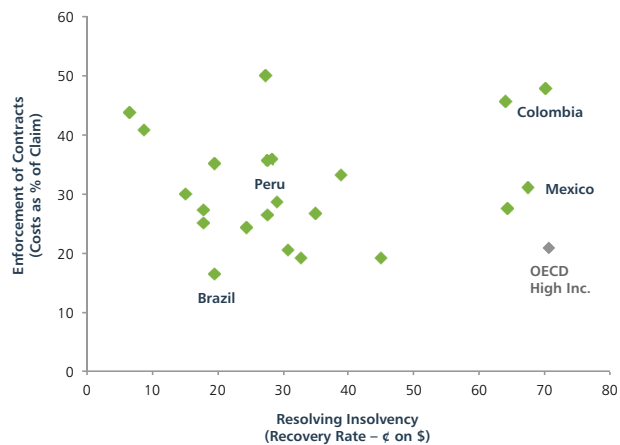
COMPETITIVE LANDSCAPE

of Known Mezzanine Fund Managers as a % of Private Equity/
Private Credit Managers in Region 1.4%

Depth of Local Banking Systems



Legal Protections



Sampling of Mezzanine Funds in Latin America

FUND MANAGER/ SPONSOR(S)	FUND NAME	FOCUS	WEBSITE
Adobe Capital	Adobe Social Mezzanine Fund I (Fundraising)	Mexico	www.adobecapital.org
Capital Indigo	Fund Indigo 1 (Fundraising)	Mexico	www.capitalindigo.com
Darby Private Equity	Darby Latin America Mezzanine Fund II (2009, US\$87 million)	Latin America	www.darbyoverseas.com
Darby Private Equity	Brazil Mezzanine Infrastructure Fund (BMIF) (2008, BRL388 million/ US\$236 million)	Brazil, Infrastructure	www.darbyoverseas.com
LAP Latin American Partners (formerly EMP Latin America)	Central American Mezzanine Infrastructure Fund (2008, US\$150 million)	Central America, Colombia	www.latinamericanpartners.com
Neo Investimentos	Capital Mezanino Fund (2009, BRL50 million/US\$28.7 million)	Brazil	www.neoinvestimentos.com.br

The Evolution of Mezzanine Financing in Latin America

Rick Frank, Managing Director, Darby Private Equity, Latin America



Mezzanine investing across Latin America has had a relatively short history with a limited number of participants. Darby traces its involvement in this market back to 1999, with the organization of one of the first U.S. dollar-denominated pan-Latin American mezzanine funds. Darby has set up one of the only two local currency mezzanine funds in Latin America to capture country-specific opportunities—in a Brazilian fund focused on infrastructure—but the pan-regional mezzanine opportunity across Latin America remains relatively untapped.

While active in the region, hedge funds and commercial banks generally have not been consistent providers of subordinated financing in the region, although deals have been completed from time to time. As a result, mezzanine remains a relatively unknown product for prospective investee companies in Latin America, and therefore an educational process is often required to explain the characteristics and benefits of mezzanine to entrepreneurs, particularly in comparison to private equity. At first glance, potential investee companies in Latin America often view U.S. dollar mezzanine structures as “expensive debt” compared to local bank financing packages. In addition, some investee companies may be concerned with the currency risks associated with U.S. dollar-denominated debt. Despite the relative stability of the region’s currencies in recent years—indeed, real appreciation against the dollar in some cases—the memories of sharp devaluations still linger. From a fund manager perspective, long-term hedges are typically cost prohibitive, so mezzanine investors often seek to find companies with a natural hedge such as exports or contracts denominated in U.S. dollars.

Nevertheless, through dialogue and education, potential investee companies come to understand key benefits of a mezzanine structure compared to typical bank financing: the flexibility to provide long-term capital—up to seven years or more—and a much less demanding principal amortization schedule. These characteristics fit well with the long-term capital needs of fast growing mid-market companies in Latin America. Since portfolio company owners may be exploring relationships with private equity funds or other equity providers, they also come to appreciate the fact that mezzanine capital provides a lower level of equity dilution and loss of business

control—an important consideration for family-owned businesses. That said, many mid-market companies appreciate the benefits that an experienced global investment partner can provide, including corporate governance enhancements, access to global networks, management inputs and assistance in crafting a business strategy. Active mezzanine investors can play a role as a business partner via board membership or observer rights, and provide other value-added services that a typical bank lender does not.

Within the evolving commercial landscape of Latin America, we continue to see excellent opportunities for investing in mid-cap companies. The larger markets of Brazil, Mexico, Colombia and Peru have a rapidly growing middle market, which lacks access to the capital markets and is significantly underserved by the local lending community when compared to developed markets that can provide 3x to 5x more domestic credit to the private sector as a percentage of GDP. In addition, smaller markets such as Ecuador and Uruguay are showing great promise and have produced high-quality investment opportunities that offer higher average expected returns compared with better known countries in the region. The private equity community is also growing in the region, but in our view the greatest amount of capital has tended to flow to firms that focus on larger buyout transactions, so the flow of growth capital to mid-market companies continues to be constrained. Compared to other parts of the world where there are regulatory and legal obstacles to investing mezzanine capital, the regulatory framework in the region has not hindered our ability to deploy capital. Therefore, we expect the need—and the demand—for growth capital mezzanine to be robust for the foreseeable future. ●●

Darby has been a mezzanine investor in Latin America since 1999, having managed three mezzanine funds totaling US\$519 million, which have invested in 23 companies across Brazil, Mexico, Colombia, Peru, Bolivia, Uruguay, Ecuador and Argentina.

“From a fund manager perspective, long-term hedges are typically cost prohibitive, so mezzanine investors often seek to find companies with a natural hedge such as exports or contracts denominated in U.S. dollars.”

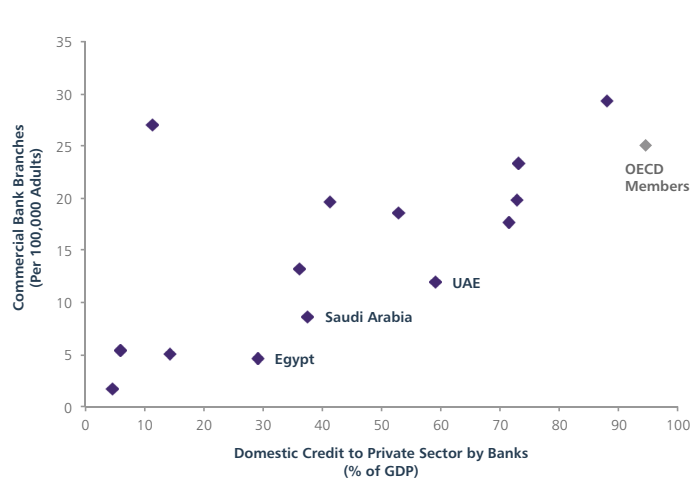
Middle East and North Africa



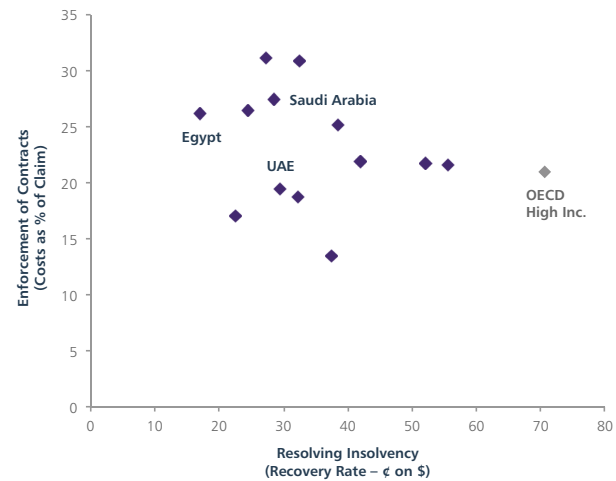
COMPETITIVE LANDSCAPE

of Known Mezzanine Fund Managers as a % of Private Equity/
Private Credit Managers in Region 1.2%

Depth of Local Banking Systems



Legal Protections



Sampling of Mezzanine Funds in the Middle East and North Africa

FUND MANAGER/ SPONSOR(S)	FUND NAME	FOCUS	WEBSITE
CDG Capital	Fonds CapMezzanine (2008, MAD350 million/US\$47.5 million)	Morocco	www.cdgcapital.ma
CORECAP	Corecap Islamic Private Equity Fund (CIPEF) I (2007, US\$150 million)	MENA	N/A
EMP Global	Arab Infrastructure Investment Vehicle (AIIV) (Fundraising)	MENA, Infrastructure	www.empglobal.com
Gulf Capital	GC Credit Opportunities Fund I (Fundraising)	MENA, Turkey	www.gulfcapital.com
NBK Capital	NBK Capital Mezzanine Fund I (2008, US\$157.4 million)	MENA	www.nbkcapital.com

Bespoke Financing: A Perfect Fit for an Imperfect Market

Amjad Ahmad, Senior Managing Director, Alternative Investments, NBK Capital



While scouring the MENA region for private equity investments in 2006, we quickly realized that companies were starved of credit. In some instances, businesses had no bank facilities, while in others the facilities the companies had were inadequate (e.g., short term in nature, carrying excessively high interest rates and/or highly restrictive covenants).

In addition, the local private equity industry was developing and increased the need for sophisticated capital structures to finance the growth of portfolio companies. This prompted us to launch the first private credit fund in the MENA region, NBK Capital Mezzanine Fund I, which focuses on providing flexible financing to middle market companies.

The evolution of the mezzanine product and our mezzanine fund in the MENA region is a familiar story of credit financing in many emerging markets. Financing for small- to medium-sized companies is inaccessible and inefficient due to a lack of appropriate coverage for such businesses, local banks' rigid lending practices—including a focus on asset-based lending—and an inadequate banking infrastructure to handle non-traditional financing. In our region, the primary customers for banks tend to be large local conglomerates (synonymous with family groups and high net-worth individuals) and government-related entities. This ecosystem has led to a situation where only one in five small- to-medium-sized companies has access to credit. While these companies are deserving of financing and have ample capacity to service debt, their capital structures are sub-optimal and generally overcapitalized. Couple this financing inefficiency with a healthy dose of growth in the region and an attractive opportunity to fill the gap emerges.

While the opportunity is clear, capturing it has posed a challenge for a variety of reasons. First, intermediaries in the region are fairly weak, with few reputable players possessing the requisite skills to study capital structures and propose optimal financing solutions; as a result, most investments are unstructured and require an introduction to cash flow-based lending for both the intermediary and borrower. Second, many companies, after exhausting their possibilities for bank debt, seek passive equity where shareholders are reluctant to provide basic minority protection rights and are averse to substantial dilution. In such cases, it looks like credit, talks like credit, and walks like credit but is packaged as equity. Patient, long-term and flexible financing presents a viable alternative in such transactions. Finally, the private equity industry has not driven significant sponsored deal flow in mezzanine, as the number of fund managers has declined substantially post-crisis due to negative performance and many

“As the region’s markets develop further and continue to grow, we anticipate more favorable conditions for mezzanine investments.”

of the investments have been growth capital rather than buyouts.

All of these factors result in an investment model that differs from developed markets, yet provides an attractive risk/return profile given the market inefficiencies. During the last several years, we have spent considerable time educating the market regarding the application of mezzanine and talking to countless corporates regarding the use of the product effectively. While time consuming, the proprietary nature of these discussions has allowed for innovative and lucrative structuring options leading to positive outcomes both for NBK Capital and the recipients of mezzanine financing.

Since the launch of our credit fund in 2008, we have tailored several bespoke financing structures in support of growing SMEs, including convertible preferred shares for a wastewater treatment company in the UAE, a sharia-compliant subordinated debt instrument for an education company in Saudi Arabia and a profit-sharing subordinated loan for a fish farming company in Turkey. The combination of long tenors, tailored amortization, sensible covenants and creative equity participation structures has benefited companies tremendously while providing attractive returns for our investors.

As the region’s markets develop further and continue to grow, we anticipate more favorable conditions for mezzanine investments. Across the region, governments are embracing regulatory and market reforms to stimulate private sector growth to drive higher employment, which has led to increasing demand for growth financing. We have begun witnessing a gradual improvement in the use of sophisticated financing structures evident not only through our experiences, but also in the debt capital markets of the UAE and Turkey specifically. While we do not believe that there will be a convergence of emerging and developed markets in the near future, the present inefficiencies will continue to drive opportunities for innovative credit providers in the MENA region. This will be positive for investors seeking strong returns, companies looking to finance growth and countries working to diversify their economies. ●●

NBK Capital is a leading alternative investments firm specializing in growth capital in middle market companies throughout the Middle East and North Africa region. The firm launched its first mezzanine fund in the region in 2008 with US\$157.4 million in capital commitments.

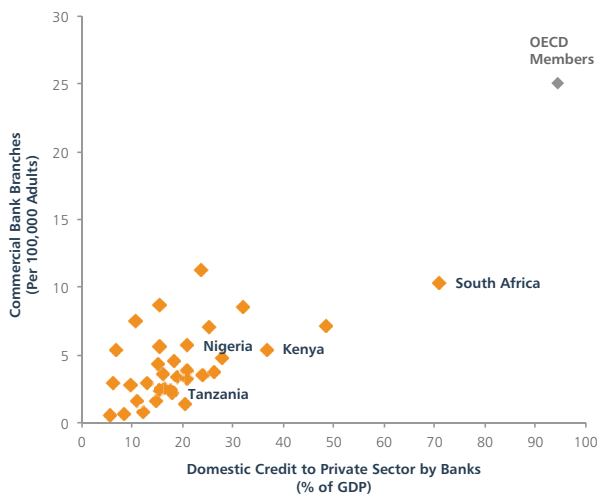
Sub-Saharan Africa



COMPETITIVE LANDSCAPE

of Known Mezzanine Fund Managers as a % of Private Equity/
Private Credit Managers in Region 1.9%

Depth of Local Banking Systems



Legal Protections



Sampling of Mezzanine Funds in Sub-Saharan Africa

FUND MANAGER/ SPONSOR(S)	FUND NAME	FOCUS	WEBSITE
46 Parallels	46 Parallels Fund I (Name Unknown) (Fundraising)	Sub-Saharan Africa	www.46parallels.com
Greylock Capital Management	Greylock Africa Opportunity Fund (Fundraising)	Sub-Saharan Africa	www.greylockcapital.com
Helios Investment Partners	Helios Credit Opportunities Fund (Fundraising)	Sub-Saharan Africa	www.heliosinvestment.com
Jacana Partners	Jacana Mezzanine Fund	Sub-Saharan Africa	www.jacanapartners.com
Makalani	Makalani Fund II (Fundraising)	South Africa	www.makalani.co.za
Sahel Capital	Fund for Agricultural Financing in Nigeria (FAFIN) (Fundraising)	Nigeria, Agribusiness	www.sahelcp.com
Vantage Capital	Vantage Mezzanine Fund I (2007, US\$100 million); Vantage Mezzanine Fund II (2010, US\$185 million)	Sub-Saharan Africa	www.vantagecapital.co.za
XSML	Central Africa SME Fund (CASF) (2010, US\$19 million); African Rivers Fund (ARF) (Fundraising)	Central African Republic, Democratic Republic of the Congo, Burundi, Rwanda, Uganda	www.xsml.nl

The Risk/Return Profile of Mezzanine in Sub-Saharan Africa

An Interview with Vantage Capital's Luc Albinski, Managing Partner, and Johnny Jones, Associate Partner



Luc Albinski

How should potential investors evaluate mezzanine investments in Sub-Saharan Africa?

Johnny: Returns are only half the equation. The returns in our first fund, which was deployed between 2007 and 2008 (a difficult vintage), are on par with private equity, but our investors took on significantly lower risks to achieve them. An investor cannot just look at returns on an absolute basis; he or she has to look at the risk profile of a transaction too. What is the value of the collateral? What is the leverage level? What is the periodic cash servicing? What is the strength of the covenant regime? Since our investments are designed to deliver annual cash yields of 10 to 16%, capital is returned throughout the investment period, thereby reducing risk.



Johnny Jones

Luc: When we engage with private equity sponsors on the potential sell-down of some of their mezzanine positions, we typically find that the pricing may be more or less in line with the returns we are looking for, but they usually have less-than-adequate protections—be it the security, the debt covenants, or the cash flow waterfall—to make us comfortable with the level of risk that we would be taking if we went ahead and purchased their mezzanine assets without first significantly rewriting their agreements. Unlike private equity, we spend 80% of our time assessing risks and structuring for downside scenarios.

Vantage has expanded beyond South Africa. How do you assess risk and execute deals in other markets?

Luc: It's not an exact science. There are some countries that have a risk profile that is arguably slightly better than South Africa, such as Botswana, and there are others that are significantly riskier, such as Mozambique or Nigeria, and there are some in-between, such as Ghana. Then there are the more exotic countries found in the bottom quartile of IFC's "ease of doing business index" that we leave to our competitors: we consider mezzanine investing in such markets to be an oxymoron! But of course we would consider limited exposure to high-risk African countries if we were backing a regional player with businesses across a diversified basket of markets.

Johnny: We only invest local currency in South Africa; when we look at any other African market, we invest hard currency—either U.S. dollars or euros. With our hard currency-denominated loans, we are in a better position to protect our returns against adverse currency fluctuations. As we invest in markets outside South Africa, we seek an additional return premium for the risks we are taking. But we also seek to adapt our deal structures to the local regulatory and legal environments. Each of these markets has its own legal and tax regime that can impact the ability to enforce our fund's debt and equity rights, including guarantees and put rights.

Luc: We look at all of the various components (e.g., leverage, covenants, cash pay, etc.) of any transaction in order to develop a composite view of its relative riskiness. Then we look at all of those factors within the context of the country in which the company operates. For instance, it wouldn't make sense for us to invest in the Democratic Republic of the Congo as a mezzanine investor because we would consider that country to be so far up the risk curve that the risk you are taking by just going there pushes you into equity territory. The country ranks 167th out of 189 in terms of resolving insolvency and there would be significant challenges for our fund to enforce its lender rights in a default scenario.

What is the key thing investors should know about committing to a Sub-Saharan Africa mezzanine fund?

Johnny: In Sub-Saharan Africa, investors can find attractive risk-adjusted mezzanine returns that are competitive globally. Mezzanine allows investors to side-step the high valuations that private equity firms can be exposed to in a crowded marketplace, while gaining exposure to fast-growing African countries in a risk-mitigated format. We deploy capital into select countries in the region that are experiencing high economic growth rates, significant government reforms, and a rapidly expanding middle class. In contrast to the U.S. and European mezzanine investors, however, we enjoy lower senior and mezzanine debt leverage ratios, and oftentimes an opportunity to acquire a senior position in the capital structure through first lien security rights.

What is the outlook for mezzanine in Sub-Saharan Africa over the next five years?

Luc: Mezzanine is in its early childhood, and will continue to grow in Sub-Saharan Africa. In five years' time, we should see the emergence of a more competitive environment, with several players seeking to fulfill the demand for expansion capital from small- and mid-sized businesses. We currently see more than one hundred requests totaling over US\$1 billion in mezzanine funding annually, and we expect this amount to increase substantially over the medium term, particularly amongst borrowers in infrastructure-related and consumer-facing industries. ●●

Vantage Capital is a black investment and financial services group, which manages a number of Sub-Saharan Africa-focused funds.



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