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Mezzanine financing back in vogue
12% yields tempt investors, but some warn against overindulgence

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Pensions & Investments
June 11, 2012

Investors are showing a growing appetite for mezzanine, but some industry insiders warn they should be picky eaters.

Mezzanine financing is seen as filling the gap between what banks can lend and what private equity firms want. Banks, together with collateralized debt obligations and hedge funds, aren't providing enough money now for the average leveraged buyout, industry executives say.

“In this environment, strategies such as mezzanine and direct lending should become more attractive,” a white paper by consulting firm Towers Watson & Co. released last month said.

A super-sized amount of loans made between 2005 and 2008 needs to be refinanced, and mezzanine yields of 12% make an attractive option for refinancing, the paper noted. Mezzanine lenders are in a position to get better terms for the loans they extend, making it more likely mezzanine managers and those who invest with them will both gain current income as well as make money on the loans.

Pension funds that have launched searches for mezzanine managers this year include the $5.1 billion Chicago Municipal Employees' Annuity & Benefit Fund, which seeks a manager to run $75 billion, and the $3 billion State-Boston Retirement System, which wants a firm to manage up to $10 million.

Officials at the $31.3 billion Tennessee Consolidated Retirement System, Nashville, plan to invest the pension fund's newly increased private equity allocation, doubled to 10% by May legislation, in mezzanine, among other strategies.

These investors will have plenty of opportunity. There were 63 mezzanine funds looking to raise $25 billion in the first quarter, Alex Jones, senior analyst at Preqin, London, an alternative investment research firm, said in an e-mailed response to questions.

But the strategy is not for the faint of heart. Mezzanine relies on a strong pipeline of buyouts, noted Towers Watson's white paper. Private equity fundraising is still fairly low and the European sovereign debt crisis could cause LBO transaction activity to remain low.

“The second half of 2011 and first half of 2012 have relatively been slow for the large market LBO deals. However, the middle market continues to be active,” said **Theodore L. Koenig**, president and CEO of Chicago-based debt investment management firm **Monroe Capital LLC**. Big leveraged buyouts needing large amounts of mezzanine have not been getting done, Mr. Koenig said.

The result of the low amount of LBOs is a $40 billion overhang of mezzanine capital raised for buyouts of all sizes over the past several years that has yet to be invested, Towers Watson noted.

Still, there should be enough opportunities for the capital raised and being raised.
“To the extent that the banks seem to be hesitant to lend, we think there is an opportunity for mezzanine,“ said Bradley Morrow, a New York-based senior private markets consultant for Towers Watson Investment Services, a research subsidiary of Towers Watson & Co., who co-authored the report.

But not all mezzanine managers are alike.

“From an investor standpoint, it's important to find mezzanine managers that earn the high fees that they are charging by producing alpha instead of just being a lender,” Mr. Morrow said.

They do that by getting involved with the companies to which they lend to help improve their performance, he explained.

Thomas Haubenstricker, CEO of New York Life Capital Partners LLC, New York, agrees there remains ample opportunity for both existing mezzanine funds and new ones.

“The lack of senior debt financing, and volatility of the high-yield market, creates additional demand for mezzanine financing among many buyout sponsors. And so we continue to see a pickup in attractively priced deals from our sponsors relationships,” Mr. Haubenstricker said.

Even so, mezzanine is higher-risk capital than senior secured private debt because it is unsecured and the historic returns have not been as good, Mr. Koenig said.

Returns have not been stellar, especially in view of the private equity-like 1.5% to 2% management fees and 20% performance fees that could cut into the returns, according to the Towers Watson paper. Towers Watson recommends adding mezzanine as part of a multistrategy credit mandate, rather than a stand-alone investment.

All of this will make it more difficult to raise mezzanine funds in the future, Mr. Koenig said.

Need for loans

Still, there is a growing need for loans for private equity firms and others because companies are having trouble getting loans.

Indeed, the second largest private equity fund raised in the first quarter was a mezzanine fund — Blackstone Group's GSO Capital Partners subsidiary, according to Preqin. In March, the firm closed the $4 billion GSO Capital Opportunities Fund II, its second mezzanine fund. It took 12 months to raise the fund, which was oversubscribed, Beth Chartoff, senior managing director and head of marketing and client relationships, said at the time.

“It's extremely difficult for companies to get committed financing to finance acquisitions and leveraged buyouts,” Ms. Chartoff said.

Investors in the GSO fund included the $156.8 billion Florida State Board of Administration, $83 billionState of Wisconsin Investment Board, $24.1 billion Indiana Public Retirement System and the $50 billion Massachusetts Pension Reserves Investment Management board.

“There are so few mezzanine providers that have fund sizes that can comfortably hold $150 million to $200 million of mezzanine debt positions,” Ms. Chartoff said. “We saw there was a real need for one-stop shopping for upper-middle-market companies.”

Also in Preqin's top 10 in terms of private equity capital raised in the first quarter was New York Life Capital Partners, which closed the $980 million NYLIM Mezzanine Partners III in April.

Another manager that closed a substantial mezzanine fund within the last 12 months was KKR Asset Management, the private equity firm's debt investment subsidiary, which closed $1.023 billion KKR Mezzanine Partners I in August.

The fundraising environment for mezzanine funds is tougher than it was before the economic meltdown, when billions were needed to finance the LBO boom, said New York Life Capital Partners' Mr. Haubenstricker. Fundraising has fallen significantly since the heady days of six or seven years ago. But he said he is not discouraged by the decline in fundraising. “Historically the good mezzanine funds have generally delivered mid- to- upper teens returns to investors,” he said.