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Enhancement of the Business Environment in the Southern Mediterranean

Pre-feasibility Study: Structuring and Managing a Mezzanine Fund for Egypt

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ABBREVIATIONS AND ACRONYMS

AFDB	African Development Bank
CIB	Commercial International Bank
CMA	Capital Market Authority
DFI	Development Finance Institution
EEC	Engineering Export Council
EBESM	Enhancement of the Business Environment in the Southern Mediterranean
EFSA	Egyptian Financial Supervisory Authority
EIB	European Investment Bank
EIF	European Investment Fund
EJBA	Egyptian Junior Businessman Association
EPEA	Egyptian Private Equity Association
GoE	Government of Egypt
IDWB	Industrial development and workers bank
IMC	Industrial Modernisation Centre
LPA	Limited Partnership Agreement
MF	Mezzanine finance
MSME	Micro, small and medium enterprises
NBE	National Bank of Egypt
QNB	Qatar National Bank
SBA	Small Business Act for Europe
SFD	Social Fund for Development
TA	Technical Assistance
TDMEP	Trade and Domestic Market Enhancement Program

1. Background

On 26 September 2016 the EBESM ("Enhancement of the Business Environment in the Southern Mediterranean") project organised a stakeholder meeting in Cairo to review key issues in the field of access to finance for micro, small and medium enterprises (MSME) in Egypt. One of the issues singled out by participants was mezzanine finance. A presentation[1] on the subject and the subsequent discussion confirmed the interest of Egyptian stakeholders to explore further how to develop this financial instrument. To that end and in line with the orientation of the Small Business Act for Europe (SBA) it was decided to organise technical consultations with development finance institutions and private equity firms in Europe that dispose of experiences in the use of mezzanine finance.

Subsequently, the EBESM project negotiated a programme of visits with BPI France (Banque Public d'Investissement), SIPAREX (both in Paris) as well with the EIF (European Investment Fund) and the EIB (European Investment Bank, both in Luxembourg). The Egyptian delegation was made up of four high ranking professionals with long-standing and varied experience in business finance and promotion: Dr. Amr Taha, SBA coordinator and Deputy Director of the IMC (Industrial Modernisation Centre), Ms. Ghada El Gohary, Director Financial Services (IMC), Ms. Gihan Farid, Head of Corporate integration, EGBANK and Tarek Shash, Head of Planning and International Cooperation at the newly established MSME Development Agency. The delegation was accompanied by the Senior EBESM Expert, Dr. Bernd Balkenhol.

The consultations took place from 19 to 21 September 2017 and had as their objectives to identify good practices of institutions in the EU in this domain with a view to guide and inspire the design and creation of a future mezzanine finance instrument and fund in Egypt.

Consultations were completed after the study tour in Cairo with relevant players to confront European good practices with the institutional landscape in Egypt and in particular with the non-banking financial ecosystem.

2. Context

The current environment for SME finance in Egypt is characterised by several features:

First, in April 2017 the PM Decree 947/2017 created a new Agency for the Development of Medium, Small and Microenterprises (serial nr. 19/2017). Article 3 of this decree spells out the functions and powers of the new agency. These include "providing the necessary funding to the enterprises for start-up or for

[1] EBESM, Mezzanine Finance for SMEs, 26 September 2016. See: http://www.ebesm.eu/posts/improving-access-to-finance-for-msmes-in-egypt

capital increase" (section 7) and "providing and facilitating access to the necessary funding to the enterprises for start-up or to increase its capital" (section 8).

Secondly, there is some mezzanine finance already taking place in Egypt, albeit on a limited scale: Beltone, GroFin and The Arab African International Bank. The broader private equity community is organised in the Egyptian Private Equity Association (EPEA). There is an Equity Finance Sector Institute, as well. Lastly the NILEX stock exchange is designed to facilitate generally the capitalisation and investments in SMEs in Egypt.

Thirdly, in November 2016 the Government of Egypt (GoE) launched an Egyptian Pound 200 billion (approximately EURO 10 billion) refinancing facility for bank lending to SMEs featuring an interest rate cap at 5% (and to industrial companies at 7%). In addition, the GoE is considering a portfolio quota of 20% for SME lending in commercial banks' portfolios.

There is a widespread feeling that there is a market for non-bank financing instruments for SMEs in Egypt but that this market is not yet organised.

One of the reasons may be the lack of a clear legal definition of main mezzanine finance instruments (warrants, subordinated debt, etc.).

Faced with a legal void one of the rare mezzanine finance (MF) actors in Egypt, GroFin, operates its private equity and MF investments out of Mauritius. Once such instruments are legally recognised in Egypt, then – according to GroFin - a stand-alone MF operation would be feasible given the size of the market. A related issue in the organisation of the financial market in Egypt is the absence of a central credit risk registry, which is all the more relevant in view of the practice in mezzanine finance to forego conventional forms of collateral.

3. Issues identified in the course of the consultations

A- Mezzanine finance in comparison with other financing instruments

Mezzanine finance is a hybrid instrument with elements of bonds and elements of equity. Most common in MF are subordinated loans with a tenure of 6 to 8 years[2], with the first years being without amortisation and just quarterly interest cash payments at a rate of 3 to 5%. The principal is reimbursed at the end ("bullet" arrangement") with an accrued interest of 5 to 7%. The cash part of interest payments is similar to a loan transaction, while the accrued interest part is more similar to equity.

A third source of remuneration in MF is the option to convert the bond into equity ("warrant" or convertible bonds[3]). However, mezzanine financiers do not really want to own equity; they rather cash in the difference between the initial and the accrued capital value.

[2] In practice SMEs often reimburse well before the agreed tenure, often after 4 to 5 years already.
[3] The variant used by SIPAREX.

MF is riskier than lending, but less risky compared to equity finance. The risk level is reflected in the pricing: in France bank loans are currently at 2 to 4%, MF comes at 10 to 12% and equity usually has an internal rate of return of 20%.

B- Business models

BPI France is the number one public lender and public investor in France. It is a development finance institution owned by the French State and the "Caisse des Dépôts". Debt and equity operations are strictly separated: "BPI France Finance" versus "BPI France Investment". As a development finance institution BPI[4] France Investment seeks not to displace private retail actors, whether banks or private equity firms. Moreover, it does not directly invest MF in companies, but via 321 specialized intermediary funds[5].

The resources for mezzanine funds and equity deals in general are BPI's own – in contrast to its guarantee operations for which the resources are provided by the government and for its lending BPI raises capital on the market.

SIPAREX is a limited partnership. It is a private equity firm. It has 15 partners who own 51% of the capital of the managing company, whilst institutional investors, including BPI France, own the other 49%.

Lastly, the **European Investment Fund** is a supranational development finance institution. It operates like a fund of funds, whether debt or equity, i.e. it does not directly provide MF to companies, but via local, regional, sectoral or national funds. Mezzanine finance is practiced by some of these national equity funds: IFE (France), South Bridge (Greece), Beachbrook (UK), Ocando (Spain), Riverrock (Germany) and others.

C- Legal and regulatory environment

According to SIPAREX there is no specific regulator for mezzanine finance in France, nor are there dedicated rules and norms in the regulatory and legal frameworks. BPI France Investment as a whole is under the supervision of the AMF ("*Autorité des Marchés Financiers*") which also reviews the structure, management, risk management and legal aspects of the mezzanine funds that SIPAREX proposes to set up.

Basel II and III rules require minimum equity positions for bank lending to SMEs. Depending how mezzanine finance is classified in the balance sheet, whether as debt or equity, it can make it easier for banks for comply with the Basel rules, an important attractive feature for banks.

[4] Key figures for 2016: 80,000 SMEs accompanied; euro 13,6 billion direct funding and euro 8,4 billion bank loans guaranteed (http://www.bpifrance.fr)
[5] Similarly, on the lending side BPI France Finance always acts in partnership with private banks, whose portion of a loan is often guaranteed by BPI France Finance with up to 70%.

D- Fiscal aspects

There are indirect subsidy elements in mezzanine finance to the extent that long term investors in SMEs can benefit from preferential tax rates.

E- Assessment of the MF market size

SIPAREX invests every year euro 2 billion in SME private equity, a small portion of which is MF which reaches less than 1% of SMEs in France[6].

Similarly, the EIF invests euro 1,9 billion on average per year. MF funds make up roughly 5% of this total. Specialized MF funds like IFE (France), South Bridge (Greece), Beachbrook (UK), Ocando (Spain), Riverrock (Germany) etc. have asset sizes between euro 100 and 300 million. These funds do on average 10 to 15 deals per year, either in SMEs (less than 250 employees in the EU definition) or in small midcaps (less than 500 employees). As mezzanine finance needs liquid markets there are rarely dedicated MF funds in EU accession countries with their infant stage capital markets.

F- Structure, institutional setting and governance

BPI has no distinct unit for mezzanine finance, but dedicated teams.

SIPAREX has 15 partners who own 51% of the capital of the managing company, whilst institutional investors, including BPI France, own the other 49%. This managing company takes care of the multiple private equity and MF funds, by sectors, regions and firm size.

The EIF is a fund of funds. It expects MF funds to be on shore. It looks in its due diligence for the qualifications and experience of the investment management team, the proposed deal flow, the active pipeline, track record and strategy. A single investment in such funds should not exceed 15% of the total. This means that in the proposal at least 7 deals must be proposed. In such funds EIF becomes a limited partner. It concludes a Limited Partnership Agreement (LPA) with the fund concerned.

G- Target market

The required general profile for SMEs to be considered for mezzanine finance is: solid track record, growth prospects, demonstrated profitability, expansion, scope for leveraged buy-outs, potential mergers and acquisitions. Typically, SMEs suitable for MF are companies that reach the limits of their bank lending capacity. They are profitable, cash generating businesses that can sustain a high level of leverage.
Sectoral preferences of BPI in larger caps (between euro 2 and 260 million): digital, eco technologies, biotechnologies, industry; and in smaller caps (i.e. between euro 0,4 and 4 million) creative industries, tourism, manufacturing.

[6] There are equity funds for smaller SMEs in France (like AUDACIA and A+ Finance), usually by way of preferred equity.

Ticket sizes: BPI France goes for unlisted SMEs with up to 250 employees and up to euro 50 million turnover. Out of the 7000 applications for private equity per year BPI France eventually takes up 200 (3%). SIPAREX runs mezzanine finance for deals between euro 3 and 30 million, i.e. the segment of large mid cap to corporate. For start-ups it uses venture capital solutions and straightforward equity for small cap SMEs (i.e. sales below euro 10 million) with deals in the range between euro 1 and 3 million.

H- Services

The main mezzanine finance instruments are warrants: options that confer the right to buy or sell equity at a certain price before expiration (also in EIF supported funds warrants are the most common MF variety). Subordinated loans are also widespread in EIF funds.

Mezzanine finance is usually collateral-free, necessarily so because banks as senior creditors manage to hold any assets that can be collateralised. Moreover, intensive due diligence and close monitoring are effective means to ensure compliance of the SME owner with the MF deal.

MF confers usually the right to a non-voting seat on the board of a company, which gives the mezzanine financier the possibility to influence to some extent major changes in the business model and assets. “Significant strategic events” (SIPAREX) typically need to be approved by the mezzanine finance partner. Still, only equity owners have a say in the replacement of the CEO, not the mezzanine financier.

I- Performance of MF funds/instruments

BPI France claims to have only very low default rates. The institution could not quantify the exact share of SMEs reached on the total population of SMEs in France.

J- Exit options

Buy-backs (SIPAREX)

K- International contacts

While there has not been anything by way of joint work on mezzanine finance, BPI France cooperates with several guarantee funds in Africa and the Near East, including with the Credit Guarantee Corporation in Egypt. Similarly the EIF has had contacts with the CDC in Egypt, however, not specifically on mezzanine finance.

SIPAREX has had some contacts with Beltone in Egypt.

4. Best practices, lessons learnt, factors of success

In the course of the consultations the following lessons emerged that may be instructive for endeavours in Egypt to integrate MF as an instrument in SME promotion:

- Proximity, decentralisation: BPI France's presence with 45 offices all over France.
- Finance +: a whole range of support services are actively promoted by BPI France, such as training, networking, referral services, mentor programs, advisory services. It was found that the availability of these non-financial services ensured commitment of SME's owners in the long run.
- Cost covering approach: companies have to pay for part of the costs of non-financial services; BPI France cross-subsidises.
- Crowding in by DFIs is fine in situations where private investors sit on the side-lines and wait and see. DFIs can thus open up market niches and demonstrate the viability of mezzanine finance. As a general rule, however, DFIs should restrict themselves to a subsidiary role, they should not substitute themselves for private investors.
- Markets must be liquid.
- You need solid professionals to manage MF stakes in funds. SIPAREX, for example, mixes people with banking and private equity backgrounds to constitute mezzanine finance teams. The formers are strong in credit appraisals, whilst the latter are strong on the assessment of up-side valuations. Alignment of interest is key: hence the need for a performance – based part of the salary of staff handling MF. MF managers should have a financial stake in the company they invest in. The EIF also emphasised the importance of human resources in MF.
- Governance in MF has to be clear: stay away from one man shows.
- Be careful and prudent in drafting detailed provisions in limited partnership agreements.
- To be attractive to investors MF promoters need to have a simple, straightforward message. The strategy has to be clear (SIPAREX).
- Avoid conflicts of interest: set a MF up as a limited partnership, clearly separating the investment portfolio from the management company.

5. Post-technical meetings consultations in Egypt

Despite the active support and relay of the IMC, and due to constraints related to the Ramadan and summer periods and various feasts, it was not possible to organise a focus group meeting to include the views of the beneficiaries (public-private) of this financial instrument as initially foreseen; the mission however organised extensive consultations with relevant stakeholders on a one-to-one basis, which proved even more relevant for discussing issues in depth at this early stage of the project of mezzanine funds creation.

In the framework of the consultations, the above recommendations have been discussed with the key stakeholders in Egypt, such as the Egyptian Financial Supervisory Authority (EFSA) that reports to the Ministry of Investment, the National Bank of Egypt (NBE) which is the largest bank in the country, the CIB and QNB (private banks), GroFin that disposes of hands-on expertise in mezzanine finance in other parts of the region, Citadel (equity investors), the Junior Businessman Association (EJBA) and other actors committed to SME finance and promotion in Egypt.

To facilitate the exchange of views, discussions were organised around the following issues:

- What is market for mezzanine finance in Egypt?
    - Is the financial market liquid enough?
    - How large is the segment of suitable SMEs and midcaps?
    - What are the experiences of Beltone, GroFin, Arab-African bank in this regard?
- Does Egypt need modifications in the legal and regulatory framework to encourage MF?
- Are there any fiscal incentives attached to MF?
- What is the ideal profile for the institutional host for mezzanine finance
    - Assuming it is set up as a DFI?
    - Assuming it is largely provided by private operators?
    - In view of the need for proximity to clients?
- Are there enough qualified MF specialists in Egypt?
- Is there a need for more sensitization on the issues through professional associations?

The outcome of the consultations is briefly described hereafter:

The **MSME Development Agency** consultations (Director) showed a limited interest in being the champion for a mezzanine-type innovative financing instrument. The rationale is that the Agency is currently developing its new strategy (being the result of a merger) and that no decision has yet been taken on how such an innovative financing tool could be sponsored. The management stressed that such an instrument requires long-term funding which is not readily available and that the cost of mezzanine finance for SMEs might be too high notably in comparison to the 5% Central Bank initiative. Last, the instrument appears too sophisticated for the market, except for large transactions with large firms.

Consultations with the **EU-MSME project** brought out that mezzanine financing – although not a silver bullet - could be a great complement to what exists as it would strengthen the capital adequacy ratios of often undercapitalised SMEs, hence allowing banks to extend senior loans. The experts met also stressed that the initiative in this field are embryonic and that the amount of funding dedicated to this activity are extremely limited (about 20-30 million USD). They confirmed that the organisation of a decent security package is among the biggest challenge to the development of mezzanine finance. There is therefore a need to discuss complex instruments (e.g. warrants, convertible bonds) if we want to see the market flourish. This could be done, but it would take a lot of efforts at the regulatory level, which in turn requires the involvement of a vast array of stakeholders (e.g. MoF, CBE, EFSA); these efforts could be supported under the Component 2 of the EU-SME Project that is dedicated to regulatory reform (although the project work plan does not address access to finance issues).

The fact that offshore mezzanine funding is provided through different jurisdictions (e.g. Mauritius) is not an adequate answer as this will not allow the industry reach a significant volume likely to impact positively on access to finance for SMEs. One may note that what happened in the venture capital industry in the mid-90s can be taken as a precedent (in 1998, following the new law “95”, many onshore venture capital funds where created.)

Consultations with the **EFSA** brought out that non-banking activities of the Financial Supervisory Authority are focusing on factoring, leasing and micro-insurance. The inclusion of mezzanine financing raises a problem as it falls under three supervisory authorities: The Central Bank (once all senior loans have been reimbursed, the junior loan becomes senior and therefore is regulated by the CBE), the EFSA as hybrid instruments are “non-banking” instruments and the Capital Market Authority as convertible instruments (into equity) would find a “natural” exit on the exchange markets. It remains that the instrument is needed and would be welcome in two to three years when the macroeconomic challenges and the related uncertainties (e.g. floatation) are lifted. It would therefore be recommended to use the outcomes of the present policy assignment to organize dialogue with relevant stakeholders and prepare them to be ready in 24 months.

Banks in general (e.g. NBE, CIB) welcomed the initiative and expressed the view that such facility would very complementary to the existing lines and would not face any absorption capacity problems if well targeted. Companies indeed structurally lack of equity base and are reluctant to open their shareholding base to external / professional investors. Mezzanine financing could strengthen the balance sheets of borrowers facilitating access to traditional loans. Still the issue package would need to be carefully studied, that bank credit officers should be trained on the new approach and that the existence of such financing should be widely disseminated.

EJBA stressed the potential of associating these innovative financings to the **“plug-and-play” industrial zones** that can provide a coordination platform for access to finance, infrastructure development and the provision of professional services. The extension of mezzanine financing (riskier) would be easier due to the deep knowledge of industrial zone manager of the companies hosted on the site. A new programme could be oriented towards increasing efficiency through capex, quality enhancement, innovations, etc. A lot of productive assets are underused (EJBA) and could be more profitable if support through a value chain lens were applied, notably the financing value chain, of which mezzanine financing is part.

Another option could be to link the **mezzanine financing to value chain** enhancement programmes (GroFin, EEC). The origination of value chain files by banks is often done by contacting lead firms and promoting packages through them towards their feeding industries; these firms could be proposed mezzanine financing more efficiently as they present a better risk profile. This would also exacerbate the complementarities between banks and non-banks the additionality of the new MSME Agency being still to be demonstrated.

One of the key issue will be the **cost of funds**. Factoring and leasing companies experience already this difficulty, and are suffering from **high costs of financing** (EFSA). The new law on non-banking instruments (in preparation) will foster the development of innovative factoring and leasing companies by proposing to give a privileged access to the 5% CBE line. If this access is provided for leasing and factoring, this could be a precedent for a mezzanine fund.

Risk sharing is also critical and new schemes are under preparation (CGC Consult) that could develop specific risk coverage for mezzanine financing that is by definition carrying a greater part of the risk. Several settings could be envisioned either through the existing guarantee company or directly (pool of funds backing a first loss guarantee mechanism for example, NBE, CIB).

A solution to the cost and risk issues would be to have the mezzanine instrument financed under a **sovereign loan** (benefitting from a guarantee from the CBE) guarantee. This loan could be usefully complemented by technical assistance assisting borrowers and lenders to think "mezzanine".

If mezzanine is applied to **value chain enhancement**, technical assistance (TA) is critical. The business linkage approach requires not only consulting at the level of the end beneficiaries, but also extra-efforts in aligning stakeholders and gathering them. The type of consulting required is very hands-on and non-academic; innovative approaches should be considered. TA would be very much needed at the level of financial intermediaries for 1) banks which don't have the capacity to handle TA internally (QNB), but also at the level of non-banks, the value chain approach being most probably new for most of them.

This could take the very simple form of **awareness campaign** on the existing schemes at branch levels (including but not limited to the mezzanine finance), and how they can be articulated to address the needs. Sector analytical work would also be beneficial and could be organized in coordination with the sector representative organizations (AlexBank, consultant). Sectors prone to mezzanine financing are agribusiness, retail and distribution, infrastructure, engineering, quarrying as well as the chemicals and building materials sectors.

6. Conclusions and recommendations

A- Conclusions

There is clearly a market for mezzanine finance in Egypt; although difficult to appraise, some benchmarks in Jordan, Mauritius or Europe indicate that the market could be between EGP 5 to 10 billion (approximately €250m - €500m), i.e. an annual production of €15 to 30m. This amply justifies the creation of a new fund, all the more so that it will act as a catalyst and exert a leverage effect on other traditional financings.

The market for mezzanine finance is very liquid but the cost of fund is too high for developing such an instrument at rates that are acceptable for SMEs. Indeed, the premium for mezzanine finance being higher than for senior loans, the borrower's final rate would be between 20 to 25%. This is due to macro-economic imbalances and the crowding out of productive lending by the public sector (T-bills at 16%). The situation is nevertheless expected to improve following the floatation of the EGP, which will give the opportunity to envision the development of innovative financing tools within 2/3 years.

The segment of suitable SMEs and midcaps is rather narrow. As mezzanine finance requires a minimum level of activity and sophistication, the "suitable" SMEs can be estimated to be between 1,500 to 3,000 (although figures are not easy to ascertain due to the absence of MSME unified definition). This base could be enlarged by adopting a value chain approach, mezzanine finance being provided to the 50 – 150 lead value chain firms with the clear obligation to have the benefits of the financing trickling down to SMEs through the supply chain.

As in the case of GroFin, or the private equity industry in general, the mezzanine finance can be organised from abroad through offshore vehicles, but the structural development of this activity requires regulatory reforms allowing the creation of onshore funds. Reforms pertain to the registration of securities, the legal framework for hybrid financial instruments and the tax regime applied to mezzanine transactions. These reforms require the mobilization of the three financial supervisory authorities by engaging them into a technical dialogue. The focus on this new topic might prove difficult as efforts are concentrated on the development of leasing and factoring, but the availability of an attractive line (ideally combining grants and financing) could foster the interest to consider such an instrument. It must be noted that the instrument can be promoted by a special tax regime (waiver of taxes on interests paid) that could be a great incentive at the level of banks and borrower. Such proposal would require the inclusion of the MoF in the working groups.

The ideal profile for the institutional host for mezzanine finance would be a financial institution with a development mandate. The development mandate of the institution should make it eligible to concessionary lines that would mitigate the risk premium and allow proposing an attractive enough rate.

A practical approach would be to launch a mezzanine fund for a cause. This assumes that the fund would be targeted for a specific segment of the SME population in line with the national priorities. Among these priorities: integration of SMEs in large companies supply chains, value chain competitiveness enhancement, clustering and business linkages strengthening.

Attaching a grant to the financing of such a "for a cause" fund would be beneficial. The grant should be designed in such a way that it enlarges the base of potentially eligible companies, support technically the fund manager to appraise the risk through a mezzanine finance lens, provide side technical assistance to assist in the delivery of non-financial support meeting value chain or cluster needs.

B- Recommendations

Based on the above, the following recommendations can therefore be issued:

1. Disseminate the result of the study by the organisation of a roundtable at the Federation of the Egyptian Industry.

2. Undertake a detailed analysis of the legal impediments and draft legal pieces allowing to lift these obstacles.

3. Promoting the establishment of a pilot mezzanine fund "for a cause" among international cooperation (grant + financing)

4. Once secured in principle, engage dialogue with the CBE, the EFSA and the CMA to push the regulatory reform agenda.
5. Identify and formulate the features of the pilot initiative ideally under the form of a blending.
6. Mobilise expertise (TA) to assist the future manager in the start-phase of the instrument.

ANNEXES

Annex 1 – Guidance on the structuring

It would be premature to propose a definite design of such a mezzanine fund, as any fund structure and design must tailored by nature to the “DNA” of its sponsor (and in this case we may consider a bank, the Agency, the IMC which have radically different profiles). It remains, that this appendix reviews the typical terms, primary documentation and key issues that arise in mezzanine financings, that will guide the future structuring of the fund.

A- Background

Mezzanine capital typically refers to a tier in a company’s capital structure between debt and equity, just as a mezzanine in architecture is an intermediate floor between two different floors of a building.

For many years mezzanine investing was primarily a source of funding in a few select areas, such as real estate and growth capital transactions.

The dislocation in the credit markets and the scarcity of capital in 2008 and early 2009, however, led to the increased prominence of mezzanine investing for a broader array of transactions, including a significant percentage of the few leveraged buyouts that closed during that time.

The increased visibility of mezzanine financing during the financial crisis in turn generated additional interest on the fundraising side. A number of financial institutions entered the mezzanine lending space or raised additional capital for existing mezzanine funds.

As the dislocation of the credit markets has receded, non-investment grade issuers have again become able to raise capital by selling both secured and unsecured debt securities in the high-yield market.

B- A COMPETITIVE INSTRUMENT

Nevertheless, even though mezzanine funds compete to a certain degree with the high-yield market as a source of capital for acquisitions and recapitalizations, the outlook for mezzanine finance remains strong, especially in light of recent market volatility:

- Mezzanine investors continue to invest capital in issuers with growth prospects.

- Mezzanine investment opportunities are likely to increase in both frequency and transaction size as private equity sponsors, many of which have raised large funds in recent years, begin to raise financing for acquisitions, notably in emerging markets like Egypt where companies are not prone to open fully their capital, but need access to patient capital

- Mezzanine funds can also offer terms in a buyout context with an expediency and certainty of execution that is difficult for investment banks to replicate. It can play a role of facilitator, notably in the case of transmission (second generation businesses), which is particularly promising due to enterprise demography (most of the successful SMEs where created in the 80s / 90s)

- In addition, as hundreds of billions of EGP of debt raised before the financial crisis to finance leveraged buyouts begins to mature, companies will have a significant need to refinance it, likely generating greater demand for capital and creating situations where mezzanine funds could play an important role.

Against this background, this paper focuses on:

- Typical terms of mezzanine investments.
- Primary documentation.
- Key issues that arise in mezzanine financing transactions.

C- TYPICAL MEZZANINE TERMS

Mezzanine financings tend to be highly negotiated transactions, customized for the particular situation. In the current financing environment, the market for mezzanine capital is fluid and evolving, and even less defined by a rigid set of standard terms.

The more heavily negotiated terms are those relating to:

- Type of instrument.

- Maturity.

- Interest rates and fees.

- Ranking in the capital structure.

- Security.

- Covenants.

- Redemption and call protection.

-Equity participation.

- Transferability.

Creating such a fund for development purposes will require highly trained officers. In Egypt, such profiles exist in the Private Equity industry and investment banks. However, their remuneration package is usually out of reach in a public development context.

It is therefore recommended to foresee some technical assistance during the start up period, that will also allow transferring the know-how to a local team. The local team should be incentivized through a carried interest (commission on success paid when the Fund is wound out) which allows creating loyalty.

D- TYPE OF INSTRUMENT

Mezzanine financings typically consist of unsecured debt or, less frequently, preferred stock. An issuer (that is, an issuer of, or borrower under, the applicable mezzanine instrument) may have a preference for one or the other depending on its capital structure or tax and accounting considerations. Investors may also have preferences based on their investment guidelines or their assessment of the potential investment's risk profile.

In practice, most mezzanine financing takes the form of subordinated, unsecured debt. Initial structuring discussions often focus on whether the debt should be in the form of loans or debt securities, with the investors' view of the likely resale market (bank or bond) driving the result. Mezzanine financings in the form of debt are commonly characterized (and distinguished from similar products such as high-yield debt) by the inclusion of an equity participation, usually in the form of warrants, options and/ or conversion features or co-investment rights associated with the primary mezzanine investment.

In Egypt, the law doesn't provision the framework for warrants and subordinated debt; the very next step will be to align stakeholders on the objective of solving this issue, the EBESM having paved the way for doing so.

E- MATURITY

The maturity of mezzanine debt is typically five years or longer, but the maturity for a particular issue often depends on the scheduled maturities of other debt in an issuer's capital structure.

For mezzanine debt that is incurred at the same time as bank debt (such as at the time of an acquisition or buyout), senior lenders often insist that the mezzanine debt mature later than the bank facility. However, because mezzanine capital tends to have a higher rate of return relative to other debt in the capital structure, some issuers prefer shorter maturities. Conversely, some issuers agree to longer maturities on their mezzanine debt in exchange for more flexible optional redemption terms.

The biggest competitor to mezzanine finance is the T-Bill market that remunerates deposits at 16% per year, which is extremely competitive in the post-devaluation context. The intervention of development institutions (not arbitrating based on financial return but development outcomes is pivotal).

F- INTEREST RATES AND FEES

As in other forms of leveraged debt financings, various permutations of interest rates and fees are used within mezzanine transactions to accommodate the needs of the specific issuer and investors.

While many mezzanine debt instruments feature a cash coupon with a fixed rate, which can be payable semi-annually or quarterly, others carry a floating rate or give issuers an option to pay interest in-kind (by issuing additional mezzanine debt) in certain circumstances.

Mezzanine investors usually target a higher internal rate of return (IRR) on their investment than high-yield or bank loan investors, and seek to achieve their target IRR by a combination of the interest rate, fees and the equity component (see Equity Participation).

Mezzanine preferred equity investments are typically structured with a high fixed-rate dividend, which may be paid in cash or in-kind, and may feature an optional or mandatory conversion into common equity. In addition, to achieve their target rate of return, mezzanine investors may negotiate for different types of onetime or periodic payments, including structuring, commitment or other fees and they may request that mezzanine debt is issued at a discount to par, which has the effect of increasing the instrument's yield. It is also not uncommon for mezzanine investors to be reimbursed for their legal and other out-of-pocket fees.

Non-financial services (in the form of technical assistance) could be attached to the fund that will pilot the instrument in Egypt with a view to reduce the operating costs, the legal and structuring fees.

G- RANKING IN THE CAPITAL STRUCTURE

A key consideration in structuring a mezzanine financing is determining the position of the mezzanine debt in the issuer's capital structure. In some situations, mezzanine investors agree to invest in a preferred equity instrument that is junior to all debt in the capital structure. For mezzanine investments structured as debt, senior lenders generally expect that the mezzanine debt is subordinated to the credit facility and possibly other senior lenders, such as high-yield bondholders.

Therefore, mezzanine debtholders typically agree to be contractually subordinated to existing and certain future holders of senior debt of the issuer.

Less commonly, this subordination can take the form of structural subordination, where the mezzanine debt is issued by a holding company whose operating subsidiaries do not guarantee the mezzanine debt, while the other debt is issued by an entity that is closer to the assets in the corporate structure and is guaranteed by some or all of the operating subsidiaries of the issuer.

As a result of this structural subordination, in a bankruptcy or other liquidation of the operating company, cash or other assets will only be distributed to the holding company to satisfy its obligations after all other liabilities of the operating company are satisfied.

In Egypt, the Bankruptcy Law is under elaboration. Although not much is disclosed on the draft law at this stage, it is believed that the treatment of creditors post-bankruptcy will be tackled according to international practices. This will definitely be a positive point to envision the launching a Mezzanine fund.

H- SECURITY

One of the defining characteristics of mezzanine debt is that it is typically unsecured. In those instances where mezzanine debt is issued on a senior basis at the same level with other debt of the issuer, the remaining senior debt is secured, so the mezzanine debt will be effectively subordinated to any secured debt of the issuer to the extent of the value of the collateral securing that senior debt.

In the context of Egypt, this will require that development capital is mobilized; beyond the lower financial expectations of such investors, we could also envision a risk sharing mechanism whereby the development partners would take the first losses on their share.

I- COVENANTS

Covenant packages used in mezzanine debt financings are usually based on high-yield style covenants or bank facility covenant packages. In the former case, the covenants are typically incurrence-based only (though they may include financial maintenance covenants), whereas in the latter, the covenant package often includes some maintenance covenants.

If the issuer has an existing senior bank facility, or is entering into a new bank facility in connection with the mezzanine debt investment, the mezzanine debt covenant package may be largely based on the covenants in the credit facility.

In that case, the "baskets" and financial maintenance covenants are typically at least 25% to 30% more permissive than the corresponding provisions in the senior credit facility. Senior lenders often join the issuer in pushing for this additional flexibility to ensure that a breach or default under the senior credit facility does not immediately result in a similar breach or default on the mezzanine side requiring the senior lenders to invoke (and rely on) their contractual standstill rights.

Key negative covenants in mezzanine debt may include limitations on:
- Incurrence of debt.
- Restricted payments.
- Liens.
- Change of control transactions.
- Asset sales.
- Affiliate transactions.

Affirmative covenants may include those relating to:
- Financial reporting.
-Maintenance of insurance.
- EFSA compliance.

Covenant packages in many recent mezzanine transactions, especially those providing financing for acquisitions by financial sponsors, often look fairly similar to incurrence-based covenant packages in marketed high-yield debt instruments.

Again, the project would benefit from the backup of a European mezzanine fund manager (through a TA contract) to ensure that this highly technical issues are taken into account right from the start and transferred to the team over time.

CONCLUDING REMARKS

In conclusion:

- The fund should be a minimum size of EUR30m to ensure sustainability and a proper level of diversification
- The structuring would benefit from development finance providers
- These investors should invest at least 30% pf the paid-up capital to provide comfort to other (private) stakeholders
- Part of the commitment could be in the form of a cushion used to cover the first losses of the fund (up to a ceiling to be defined)
- The know-how doesn’t exist in Egypt (or with professionals whose compensation package is so high that they can only work on large transactions)
- Non-financial services are therefore critical to structure, establish and run the fund, prior to transferring the know-how over time (est. 0.8 MEUR / year over 3 years)
- The local team should be incentivised on the fund profit (carried interest)
- Further dialogue should be undertaken to ensure that the legal framework is further reformed to ensure the possibility to secure creditors rights.

Annex 2: List of consulted parties in Egypt

Institution / Firm	Place	Name	Title	Nb.	Email
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