19 YEARS OPALESQUE

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DIVERSIFICATION MATTERS

This European mezzanine debt strategy offers equity-like returns with downside protection

B. G., Opalesque Geneva for *New Managers*:

Mezzanine financier SIG-i operates in a relatively uncrowded space by proactively manufacturing financing solutions as an alternative to traditional debt and equity instruments. Its **European Special Situations/ Mezzanine Strategy,** which deployed €200m between 2016 and 2020, generated returns in the mid-teens. Fund I is now closed, and Fund II, for which the firm is fund-raising, is about to launch - and now is a perfect time for such a strategy.

SIG-i provides junior debt and senior equity financing. "Broadly, one can classify the junior private debt landscape into capital preservation, return-maximisation, and special situation strategies," co-founder Jakup Topp explains to Opalesque. "We think it is a good time to be launching a new fund employing our strategy of mezzanine debt focused on capital appreciation or return-maximisation and special situation credit strategies."

SIG-i Capital AG is a specialist provider of alternative credit financing to medium-sized companies in Europe, based in Zug, Switzerland. Before co-founding SIG-i in 2019, Jakub Topp was a Managing Director and the Head of Special Investments Group within the Global Markets Division of Credit Suisse AG in Zurich.

He will present at Opalesque's next webinar, **Diversification Matters, episode 3**, on Wednesday 31st August (details below).

Topp further defines special situations as complex situations, "which call for a thorough understanding of the fundamentals and innovative structuring. An alternative definition in the industry refers to distressed debt opportunities which will also likely fare well in the current market environment. There is another class of mezzanine debt which focuses on capital preservation (i.e. preference for fixed return and security over upside participation) and thus tends to have a negatively skewed return profile. Such strategies may be better suited for the early recovery stage in the economic cycle. There is also a distinction between sponsored and sponsor-less deals (we tend to get involved with the latter). In our view, the already competitive sponsored mezz debt market may fare worse than the sponsor-less segment as private equity deal-making is likely to dwindle on the back of declining and uncertain equity valuations and reduced supply of low-cost senior debt."

The price of risk now

There are opportunities in the price of risk which has generally increased in the market with both equities and bonds selling off in H1-2022.

"Many of our peers are likely to face headaches with legacy assets as borrowers struggle to refinance loans on

palatable conditions," he continues. "This will divert the energy of our competitors away from making new deals. We have the fortunate position of launching our fund II unburdened by legacy asset problems. The significant drop-off in high yield bond issuance in Europe and the US - a distant proxy for the opportunity set we hunt in - is a manifestation of this repricing of risk and reshuffling in investment appetite. At the same time, higher energy prices and general inflation may well squeeze consumer budgets and depress real economic spending in Europe and beyond. In the environment of lower growth, recession or even stagflation the importance of applying a tested method for selecting, structuring and managing investments will be of more importance than ever in the last decade."

More investment opportunities

Anecdotally, he adds, the managers at SIG-i are seeing a marked increase in the supply of attractive investment opportunities as summer is drawing to a close.

"In our "neck of the woods" we often compete for deals against equity - companies looking for junior finance choosing between drawing mezzanine debt and issuing shares. As equity valuations in the private markets have taken a hit and investor appetites have markedly reduced, we witness companies courting mezzanine financiers like us."

A typical investment example would start with a company that is looking for funds to acquire a significant competitor, he explains. The acquisition can be in a large part financed with relatively cheap senior bank debt. But a meaningful equity contribution is needed. In comes SIG-i. The borrower can contribute about half of the needed equity, and SIG-I's second-lien loan provides the remainder. The borrower can then make the purchase.

Compelling alternative to equity

Mezzanine/special situation credit investments are a compelling alternative to traditional equity, Topp says. "One way to make the comparison is by visualising a payout profile of equity versus return-maximizing mezzanine debt with a value of the company at exit shown on the x-axis and the return to investors shown on the y-axis. The equity payoff is an upward sloping line starting at zero and ascending at a 45-degree gradient. Investors can lose everything in exchange for a potentially unlimited reward. The mezzanine debt payoff is like that of a long call option, for those familiar with options strategies. Investors participate on the upside (to a slightly smaller extent than equity investors, thus at a lower gradient) whilst enjoying downside protection from their ability to recover at least part of the principal through senior secured position relative to equity in the waterfall."

Mezzanine financing is a hybrid of debt and equity financing that gives the lender the right to convert the debt to an equity interest in the company in case of default, generally, after venture capital companies and other senior lenders are paid. In terms of risk, it exists between senior debt and equity.