Gulf Credit Partners

Insights into Private Debt Investing

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Investing in Private Debt

Alternative finance providers are progressively expanding globally as a source of capital for mid-market private sector companies and private equity looking for long term access to finance. Although adoption varies by country, the emergence of an investor pool looking for yield has opened a new market for mid-sized companies to be supported by institutional investors in the absence of a rating.

Small to mid-sized companies do not have the same access to financing as large corporates. We believe that there is a real need for a non-dilutive alternative financing sources in the Middle East and North Africa (MENA) region as entrepreneurs may not be big enough for a financial sponsor, don't fit the requirements of local banks, or need bespoke structuring solutions that match the needs of a business.

Private debt investments can take the form of mezzanine debt which are typically subordinated and may have convertibility features.

For investors, private debt investing offers the opportunity to achieve attractive risk-adjusted returns while benefiting from greater downside protection than pure equity investing.

In this paper Gulf Credit Partners discuss investing in mezzanine debt in the MENA region, focusing on our experiences of private debt investing in mid-market private sector companies.

What is Mezzanine Debt?

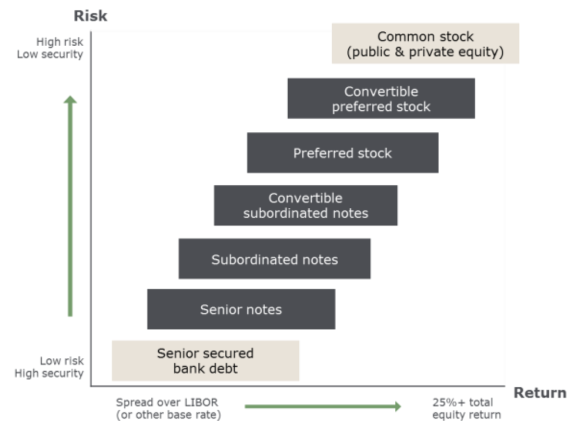
As its name implies, mezzanine debt is situated between the senior secured bank debt and the equity in a borrower's capital structure.

Mezzanine debt is privately negotiated and typically used to finance leveraged buyouts, recapitalizations and corporate acquisitions. It is also an alternative to private equity for companies seeking growth capital. Naturally junior in credit standing, mezzanine debt provides additional capital beyond senior secured debt.

As shown in figure 1, mezzanine debt can take the form of senior unsecured or subordinated notes, convertible notes or preferred equity instruments.

Mezzanine debt is flexible capital tailored to a broad set of needs of sponsors, entrepreneurs, owners and financial investors. From a business or entrepreneur's perspective, mezzanine debt can reduce overall capital costs by providing additional debt financing that can enhance equity returns.

Figure 1: Capital Structure



Why Private / Mezzanine Debt in MENA?

The private debt market and by extension mezzanine debt, is nascent in the MENA region. We believe that it is poised for substantial growth for the following reasons:

i. It is a natural partner to private equity investors in more established markets such as Western Europe and the U.S. and is therefore expected to play an important role as private equity investors look for debt to leverage their acquisitions;

ii. It is a flexible instrument that can fund growth capital. This is much needed in the MENA region and is an attractive non-dilutive financing tool for Small & Medium size Enterprises (SMEs) or corporates seeking to grow their businesses or can also be used to refinance existing debt that banks may not be able to meet; and

iii. Non-bank providers of credit in the Middle East represent only 10.9% of the total funding provided in the market. The same ratio in the developed markets of North America and Europe is 79.0% and 53.0% respectively. This highlights the growth potential over the long term of alternate credit providers, particularly as new banking regulations take shape and lower liquidity flows into the banking system as a result of the expected prolonged period of lower oil prices.

The only other alternative for mid-market private sector companies or entrepreneurs looking for long term capital is equity, which is dilutive and may come with a number of restrictions or can be seen as a company selling a stake too early.

How do Returns Work?

As the name implies, mezzanine debt instruments are privately negotiated and typically structured to create 'current income' and 'equity upside'. While the structure of a deal varies by transaction, there are a number of commonly used instruments and structural features that drive an investor's return.

These returns can generally be divided into those that are:

i. Contractual - Cash pay and/or Payment in Kind (PIK); and

ii. Performance-based – or 'equity kicker' linked to performance and/or value but payable in cash at the maturity of a loan or at a prepayment event.

By combining the contractual claim of a debt instrument with the potential capital gains from equity-linked instruments, investors can earn attractive returns while at the same time limiting the downside risk.

What are the Benefits of Investing in Private / Mezzanine Debt?

Gulf Credit Partners believe that investments in private debt and/or mezzanine debt offer investors the opportunity to earn attractive risk-adjusted returns when compared with other alternative investments.

Cash yielding nature

Due to the junior nature of the capital, mezzanine investors generally demand higher returns compared to senior debt. Some of the features include:

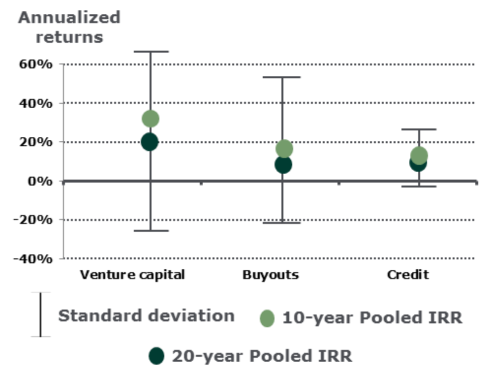
- High cash coupon payable quarterly
- Upfront fees
- Call protection for early pre-payment

Historically, private debt and/or mezzanine investors have targeted annualized gross returns in the mid-teens.

Low volatility

Private debt instruments generate the lowest volatility of returns historically compared with private equity and venture capital. They are often structured with high fixed coupons, usually paid quarterly, which reduce the overall volatility of returns to investors. See figure 2 above.

Figure 2: Returns & Variance across Global Asset Classes – a look through the cycle[1]



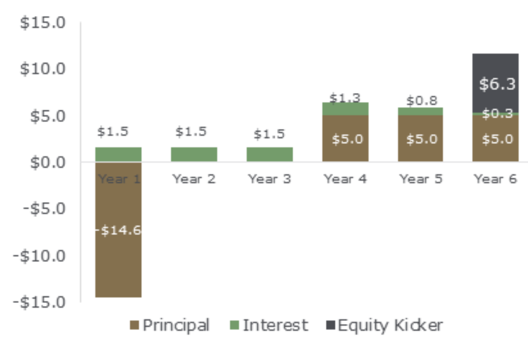
Downside protection

Investments are structured to provide downside protection. Investments are only made after extensive third party due diligence and in-depth internal analysis. A strong set of covenants (financial and other) are established including quite often a board observer status. In addition, mezzanine investors rank ahead of equity holders.

Predictable cash distribution

Investments may be structured with amortizing characteristics providing further stable, predictable cash flows. In addition, private debt investments have a predictability of exit timing and cash flow, with contracted maturity and repayment schedules. See figure 3 below.

Figure 3: Sample Cash Flow of a Mezzanine Loan Targeting 17.0% IRR



Assumptions:

- Principal: $ 15.0m
- Tenor: 6 years (3 years of grace period)
- Arrangement Fee: 2.5%, Cash Interest: 10.0%
- Equity Kicker: Additional payment to reach target IRR of 17.0%

[1] Bain & Co. Global Private Equity Report (February 2012), GC Research. Thomson Venture Economics – Return since inception for partnerships formed in 1969-2002 as of 31 December 2002: Credit signifies mezzanine debt returns

What are the Risks of Investing in Mezzanine Debt?

Firstly, mezzanine debt is junior in the capital structure and typically in a first-loss position after the value of the company drops by more than the amount of its equity.

Second, since mezzanine debt is provided through privately negotiated transactions, it is far less liquid than more public securities if it needs to be sold.

Thirdly, middle-market businesses often face greater risks compared to larger companies. For example, due to their smaller size, loss of a customer or increases in the cost of goods sold may have a larger impact on the borrower's EBITDA than it would on a larger company.

Finally, in most cases mezzanine debt is unsecured (share pledges in some cases is the only available security) so in a bankruptcy scenario, there is no recourse to any tangible asset for recovery.

How does Gulf Credit Partners approach Mezzanine Investing?

Gulf Capital launched its Private Debt Funds to address the lack of flexible capital available to private sector mid-market companies.

The principal focus is the preservation of capital while targeting superior risk-adjusted rates of return. How? By structuring private bespoke credit financing solutions to mid-market companies, private equity buyout investors and management led buyouts. Key elements of our investment strategy include:

i. Invest in defensive and growing industries critical for an economy's growth, such as healthcare, education, industrials, oil & gas servicing etc.;

ii. Invest in companies with predictable cashflows as these our primary source of repayments;

iii. Create downside protection through well thought out structures with principal amortization, low leveraged companies and international best practice documentation with security and structures in creditor friendly jurisdictions;

iv. Deliver on a value proposition that is built upon speed and flexibility; providing event driven flexible capital where either bank financing is not available or entrepreneurs do not want equity dilution of outside investors; and

v. Adopting a hands-on approach similar to private equity in many cases. Through board representation, hiring of key management positions, or developing a strategic plan for a new product or service, we add value to protect our investments and enhance our returns.

Conclusion

Investing in private debt is evolving rapidly as an asset allocation class and relatively new for the MENA region. Recent challenges faced by private sector companies in the region, through a shortfall in bank liquidity and a retrenchment in some areas of the credit markets, reminds us that investors with permanent capital and market experience should be able to take advantage of dislocations to find attractive opportunities and enhanced returns.

Gulf Credit Partners has a demonstrated track record of finding, structuring and investing in the debt of middle-market companies. Regardless of credit and economic cycles, we expect that there will always be middle-market companies and owners in need of a relationship-oriented junior lender.

Gulf Capital's Private Debt History

Gulf Capital launched its private debt division in 2012, through its flagship US$ 221 million GC Credit Opportunities Fund, L.P. (Fund I). Fund I was deployed across eight investments over a period of three years primarily providing growth capital and acquisition finance for mid-market private sector companies in the Middle East and Turkey. In January 2016, Gulf Capital launched its GC Credit Opportunities Fund II, L.P. (Fund II) a US$ 250 million fund which will continue to provide bespoke structured capital solutions to mid-market companies in the Middle East, Africa and Turkey.

Gulf Capital Credit Partners

Walid Cherif | Senior Managing Director, Head

Mr. Cherif is the founder of the private debt business at Gulf Capital. He heads the debt platform since he joined Gulf Capital in 2011. Mr. Cherif has more than 24 years of experience in international finance in emerging markets. He has participated in raising more than $600m of commitments for mezzanine and equity funds as well as structuring and executing several junior debt and structured equity transactions on the investment and divestment sides. Before joining Gulf Capital, he was the head of the NBK Capital Mezzanine Fund (a subsidiary of National Bank of Kuwait) where he made several mezzanine investments in companies operating in the Middle East and Turkey. He currently sits on the investment committee of both funds and on the board of several portfolio companies in the Middle East. Prior to joining NBK Capital in 2007, Mr. Cherif spent ten years at the International Finance Corporation in Washington, D.C., Dubai and Istanbul. Mr. Cherif holds a Master in Business Administration (MBA) in Finance and International Business from George Washington University in the USA, and a Bachelor of Business Administration from the Institut Supérieur de Gestion, University of Tunis III.

Adam Hadidi | Managing Director

Mr. Hadidi joined Gulf Capital in 2011 and holds the position of Managing Director. He has 13 years of international banking and investment experience. He currently sits on the investment committee of both funds. Prior to joining Gulf Capital, Mr. Hadidi worked at UBS in London as Associate Director in its Special Situations team for two years. Prior to joining UBS, he worked as an Associate at MezzVest, a mezzanine fund manager with €2.2bn of assets under management. Mr. Hadidi started his career at RBS in its London in leveraged finance team as an Associate. Mr. Hadidi holds a Bachelor of Engineering (Honors) in Mechanical Engineering from the University of Strathclyde, United Kingdom.

About Gulf Capital

Gulf Capital is a leading alternative asset management firms in the Middle East, investing across several asset classes including Private Equity, Private Debt and Real Estate. The Firm currently manages over US$ 3.4 billion of assets across 10 funds and investment vehicles. Gulf Capital's mission is to grow capital and build value with world-class expertise and best practices to generate sustainable superior performance for all stakeholders. Gulf Capital, which is celebrating its 10th anniversary this year, invests its own capital alongside its fund investors' capital in all of the funds it launches. Gulf Capital has received a number of regional and international recognitions from industry peers and experts. The Firm was awarded the 'Best Private Equity Firm in the Middle East' Award by Banker Middle East Magazine in 2011, 2012, 2013, 2014 and 2015; 'Best Private Equity Firm' in the Middle East and North Africa by Private Equity International and 'Best SMEs Credit Fund in the Middle East' in 2015, as well as 'Best Alternate Investment Firm' in 2016. The Firm is actively involved in real estate development through Gulf Related, its joint venture with the Related Companies, the leading private real estate developer in the United States. Gulf Related is focused on pursuing marquee large-scale mixed-use and residential real estate development opportunities in the United Arab Emirates and Saudi Arabia. Gulf Capital also launched a Private Debt business, Gulf Credit Partners, which offers private debt and mezzanine financing to meet the funding needs of fast-growing companies and to provide acquisition finance across the Middle East, North and Sub-Saharan Africa, as well as Turkey. With its private equity, real estate and private debt initiatives, Gulf Capital is today one of the largest and most diversified alternative asset managers in the Middle East.

For more information about Gulf Capital PJSC, please visit our website at www.gulfcapital.com

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