Gulf Capital

The Case for Middle Market Structured Capital

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Gulf Capital – The Case for Middle Market Structured Capital

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EXECUTIVE SUMMARY

In the past decade and since the global financial crisis, middle market structured capital has become a rapidly growing asset class and has grown in significance; it is now widely accepted as an asset class in its own right and is slowly becoming a product of choice by investors.

At Gulf Capital, we believe that middle market structured capital provides both a flexible financing tool for companies and an attractive asset class for investors looking to diversify their portfolio.

Structured capital can be tailored to a broad set of needs of sponsors, entrepreneurs, owners and financial investors. From a business or entrepreneur's perspective, the bespoke structure, pricing and terms of structured capital can reduce overall capital costs by providing additional financing that can enhance equity returns. Structured capital investments can take the form of senior or junior debt, which are typically subordinated and often have convertibility or some other equity linked features.

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

This paper intends to provide a high level overview of the middle market structured capital space, compare returns, benchmark against other asset classes and finally discuss the risks faced when investing in middle market structured capital.

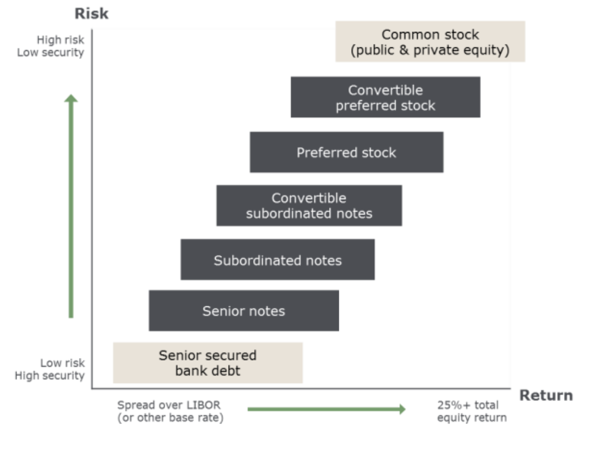
OVERVIEW

The middle market can be split over three distinct segments – core, upper and lower middle market. The segmentation is typically defined by a company's ownership structure, prospects and access to capital. At the core of the middle market, companies have earnings before interest, tax, depreciation and amortization (EBITDA) ranging from $10.0-$75.0 million and are backed by a mix of family and institutional sponsors. At the upper middle market, companies generate $75.0 million or greater of EBITDA and are often publically listed or sponsor backed. The lower segment of the market comprises of companies with EBITDA lower than $10.0 million and are typically family or entrepreneur-owned.

As its name implies, structured capital is a form of capital that embeds many structuring features and typically sits between senior secured bank debt and equity in a borrower's capital structure.

As shown in Figure 1, structured capital can take the form of senior unsecured or subordinated notes, convertible notes or preferred equity instruments.

Figure 1: Capital structure



A FLEXIBLE FINANCING TOOL FOR COMPANIES

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

Structured capital is a flexible form of capital tailored to a broad set of needs of sponsors, entrepreneurs, owners and financial investors. From a business or entrepreneur's perspective, the bespoke structure, pricing and terms of structured capital can reduce overall capital costs by providing additional debt financing that can enhance equity returns. Structured capital is suitable for growth capital, acquisition finance, buyouts and recapitalizations.

THE COST OF CAPITAL

Companies typically use a combination of equity and debt to finance their businesses, and their overall cost of capital is derived from a weighted average of all capital sources, known as the weighted average cost of capital (WACC). Debt financing has a number of advantages over equity with regards to tax efficiency and cost; however, too much debt may result in dangerously high leverage, leading to lenders offsetting the higher default risk with higher interest rates. Figure 2 compares the WACC between different capital structures.

Figure 2: Cost of capital structure

	Cost of Capital (or returns)	Capital Structure (%)	Capital Structure without structured capital (%)	Capital Structure without senior debt or structured capital (%)
Senior Debt	7.0%	45%	45%	0%
Structured Capital	15.0%	15%	0%	0%
Equity	25.0%	40%	55%	100%
WACC		***15.4%***	***16.9%***	***25.0%***

In the endeavor to attain an optimal financing mix, including structured capital in addition to debt has a number of advantages. Structured capital's benefits compared to private equity include:

- flexibility with regard to structure and terms;
- clearly a cheaper alternative than additional equity capital (i.e. more partners);
- correctly positions the balance sheet for growth, or allows for a special dividend to the owners;
- does not require any type of management control rights;
- provides institutional guidance and supports governance (while entrepreneur retains full control of the business);
- board observer seat (vs. full board rights); and
- often only requires interest payments for relatively long periods, which allows companies to reinvest free cash flow into growth initiatives for the business.

Figure 3 below outlines the differences between senior bank debt, structured capital and private equity financing and Figure 4 outlines the differences between terms for different capital solutions.

Figure 3: Capital structure differences

	Senior Debt	Structured Capital	Private Equity
Benefits	▪ Cheapest way to raise money	▪ Long term financing option ▪ Flexible structure and terms – ie non amortizing ▪ Non-dilutive capital	▪ Long term financing option ▪ Growth accelerator ▪ Access to networks / reach
Typical Structure	▪ Amortizing Term Loan – capital repaid during term ▪ Senior ranking and with security	▪ Junior capital between senior debt and equity ▪ Can be structured to be more/less equity or debt-like ▪ 5-7 year credit instrument with cash coupon between 8.0-10.0% and equity warrants (or conversion rights)	▪ Direct equity ownership stake in a business
Pricing / Expected Returns	▪ 4.0-8.0% ▪ Floating rate coupon	▪ 15.0-18.0% IRR ▪ Fixed rate, Payment in Kind (PIK), plus equity kicker	▪ 25.0%+ IRR ▪ Cash dividends
Investment Horizon	▪ 2-5 years	▪ 5-7 years	▪ 5-7 years
Considerations	▪ Stringent lending criteria ▪ Strict covenants ▪ May lack flexibility	▪ Cheaper than equity	▪ Equity is considered the most expensive form of capital ▪ Dilutive – impacts shareholding structure for entrepreneur

Figure 4: Capital solution terms

	Senior Bank Loans	Structured Capital	Equity
Security	▪ Secured by hard collateral	▪ Share pledges	▪ None
Ranking	▪ Highest	▪ Middle/Low	▪ Low
Covenants	▪ Tight	▪ Flexible	▪ None
Term	▪ Short term/on demand	▪ Long term/patient	▪ Patient/indefinite
Coupon	▪ Floating (cash)	▪ Fixed (Cash + PIK)	▪ Dividend
Equity upside	▪ None	▪ Warrants ▪ Conversion Options ▪ Income Participation	▪ Shares
Prepayment	▪ Yes, with penalties	▪ Non-call/some penalties	▪ None
Investors	▪ Banks	▪ Private capital	▪ Private capital
Recovery	▪ High	▪ Medium/Low	▪ Low

A DIVERSIFYING ASSET CLASS FOR INVESTORS

Inherent differences in the nature of various asset classes mean it is prudent to combine them in a portfolio, regardless of the prevailing economic and market conditions.

As a diversification play for traditional asset allocation, structured capital is perceived as having superior protection vs. traditional bonds with equity-like returns, and is gaining traction with investors in this low interest rate environment. As an example, according to the 2017 Preqin Global Private Equity and Venture Capital Report, 57.0% of investors surveyed plan to increase their allocations to private debt in the coming year, with 62.0% increasing in the longer term. This suggests the asset class has become more appealing, and is set to play a more prominent role within the portfolios of institutional investors going forward.

The current uptake in structured capital investing in the global investment community is noticeably driven by the diminishing yields in traditional fixed income markets, particularly investment grade bonds, which is motivating investors to explore alternatives to reinforce the average returns of their portfolios.

In addition to demand from global private equity investors, demand for private debt is also increasing among pension funds, insurance companies and endowments who value high-yielding assets in which they can invest for the medium to long term. For insurance companies and pension funds, structured capital investing provides a level of protection and return which meet their yield requirements.

A PRIVATELY NEGOTIATED AND HIGHLY CUSTOMIZABLE INSTRUMENT

With structured capital, each instrument is a privately negotiated credit instrument, having a cash yield component, a minimum floor return (internal rate of return (IRR), multiples of money (MoM)) and a target all-in return to participate in the growth of the company.

The debt component of such investments is typically structured to create current income and the equity component creates opportunities to generate additional capital gains. By combining the contract claim of a debt instrument with the potential capital gains from equity-linked instruments, Gulf Capital believes that investors can earn attractive returns while at the same time limiting downside risk.

Whilst the structure of a structured capital deal varies by transaction, there are a number of commonly used instruments that drive an investor's return. These returns can generally be divided into those that are:

- contractual - cash pay and/or PIK; and
- performance-based – or 'equity kicker,' which is linked to performance and/or value; the equity kicker can be payable in cash at the maturity of a loan or at a prepayment event, or can be structured as detachable warrants.

Figure 5 provides an example of actual terms of a bespoke structured capital loan to a middle market company that Gulf Capital invested in and Figure 6 provides an illustrative example of how returns work in general.

Figure 5: Actual terms

Actual terms:

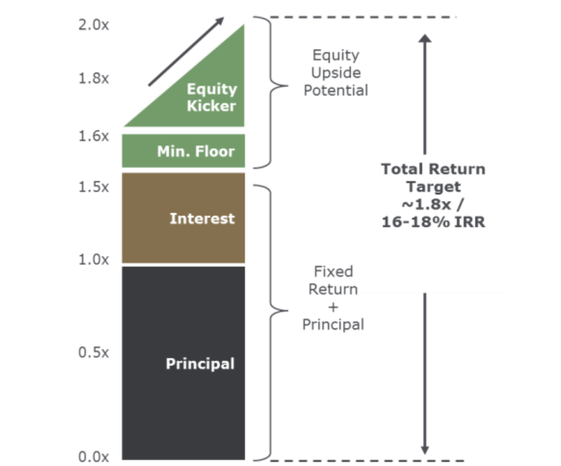
- 3 year bullet
- 11.0% p.a fixed interest cash coupon, payable quarterly
- 2.5% upfront fees
- minimum floor return higher of 17.0% IRR and 1.5x MoM
- Equity kicker equal to 4.5% of equity value at exercise
- Put option exercisable at pre-agreed valuation subject to a floor total return
- Financial Covenants - leverage (debt/EBITDA), debt service coverage, interest coverage, and capex
- Board representation (observer)
- Personal guarantee from the co-founders
- Internationally accepted[1] documentation, plus offshore share pledges

Actual structure:

- 3 year bullet

Loan	Interest	Floor	Warrants	Expected Total Return
$25.0 million	11.0% p.a	17.0% IRR 1.5x MoM	4.5%	20.6% IRR

Figure 6: Returns



DOWNSIDE PROTECTION WITH EQUITY UPSIDE

Gulf Capital believes that investments in middle market structured capital offer investors the opportunity to earn attractive risk-adjusted returns when compared with other alternative investments.

<u>Cash yielding nature</u>

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

- high cash coupon payable periodically.
- upfront fees.
- call protection for early pre-payment.

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

<u>Low volatility</u>

Structured capital instruments historically have generated the lowest volatility of returns 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.

Figure 7 provides a comparison of returns and variances across a number of global asset classes.

<u>Downside protection</u>

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, structured capital investors rank ahead of equity holders and have share pledges as security.

<u>Predictable cash distribution</u>

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

Figure 8 provides a sample cash flow of a structured capital loan.

Figure 7: Returns & variance across global asset classes – a look through the cycle[2]

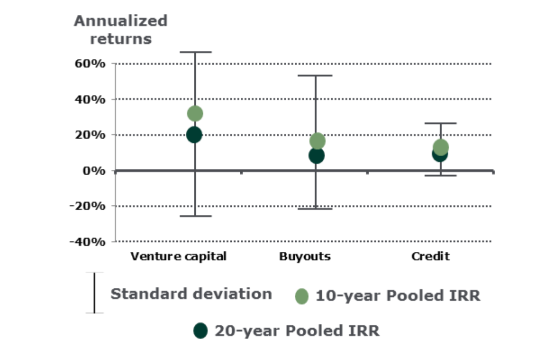
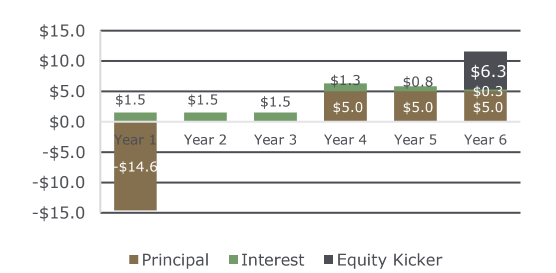


Figure 8: Sample cash flow of a structured capital loan targeting 17.0% IRR



Assumptions:

- Principal: $15.0 million
- 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] London Market Association (LMA)

[2] 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

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Gulf Credit Partners
Gulf Capital

THE RISE OF ALTERNATIVE INVESTMENT STRATEGIES IN THE MIDDLE EAST AND AFRICA

For investors looking to add alternative asset exposure in the Middle East, the selection of managers has historically been constrained to a handful of firms with limited track records and unfocused strategies.

In the mid-2000s, when significant appetite for alternative investments in the Middle East first developed, almost no fund managers existed to meet the demand. First-time teams were assembled by various sponsors. As a result, Limited Partners—almost exclusively from within the region—had no track records to evaluate and were forced to choose their investments based on name recognition, such as local banking or commercial groups.

Now however, Limited Partners can assess the performance of these managers against earlier promises. Exacerbated by the challenges that arose in the aftermath of the global financial crisis, many of these first-time funds failed to source sufficient investment opportunities and simply withered away. Others failed to meet return expectations, either due to overpaying for deals, neglecting to manage relationships with family founders or struggling to secure exits. A select few asset managers in the Middle East were able to deliver on promises of both deployment and returns, and the market has now rationalized around them.

Our region has come a long way in terms of sophistication. Today, the major firms in the region embrace the concept of creating value in companies rather than relying on multiple expansion or financial engineering. At the same time, the financial markets have evolved, allowing for increased complexity in capital structures and a greater variety in financial instruments.

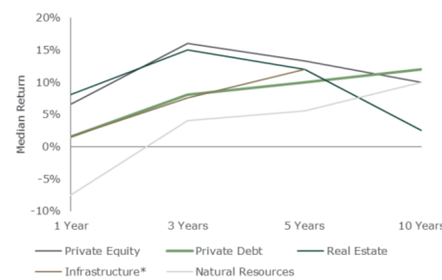
BENCHMARKING RETURNS VIS A VIS OTHER ASSET CLASSES

Structured capital has produced truly better risk-adjusted returns as measured against other alternative asset classes. From 2002 to 2012, direct lending funds showed much lower volatility of returns than buyout funds (standard deviation of c. 5.0% vs. 17.0% for buyout funds), while median net returns (measured in IRRs) were more similar to buyout returns (c. 11.0% for direct lending vs. 13.0% for buyout).

In general, investors have found that they can trade a marginal reduction in total returns for a significant increase in certainty of those returns.

Figure 9 shows the horizon pool returns of private capital funds by asset class.

Figure 9: Horizon pool returns of private capital funds by asset class



** Insufficient data for 10 year infrastructure horizon*

RISKS FACED WHEN INVESTING IN MIDDLE-MARKET STRUCTURED CAPITAL

There are a number of risks involved when investing in middle market structured capital. Firstly, structured capital 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 structured capital 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, the 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 structured capital is unsecured (share pledges in some cases are the only available security) so in a bankruptcy scenario, there is no recourse to any tangible asset for recovery.

Gulf Capital believes that risk management is a fundamental area of focus for structured capital-focused funds. To mitigate these risks, Gulf Capital employs a number of strategies including:

- assessing the value of downside protection offered by the covenant package;
- carefully reviewing the country-specific legal limitations that impact the deal's security package and structure the investment around it; and
- the regular oversight of portfolio performance, active portfolio monitoring, identifying early signs of performance deterioration and intervening quickly and constructively.

In addition to the above, consideration should also be given to the overarching risks which are faced by many in emerging markets jurisdictions, including:

- political risk;
- regulatory risk, including frameworks that are not in tune with international standards;
- currency risk; and
- compliance risk (corruption, politically exposed person (PEP), anti-money laundering (AML), combating the financing of terrorism (CFT)).

STRUCTURED CAPITAL VARIANCES BY REGION

There are a number of main differences in structured capital investment activities across the United States (US), Europe and emerging markets. While the size of the emerging markets is smaller than the US and Europe, the returns available for investors can be significantly higher than the developed markets.

Premiums of at least 300bps-500bps above developed market peers are seen in emerging markets, while typical transactions entail much less leverage risk (exampled by 3.0-3.5x in the Middle East and North Africa (MENA) vs. 5.5x in developed markets). The higher premiums are driven by:

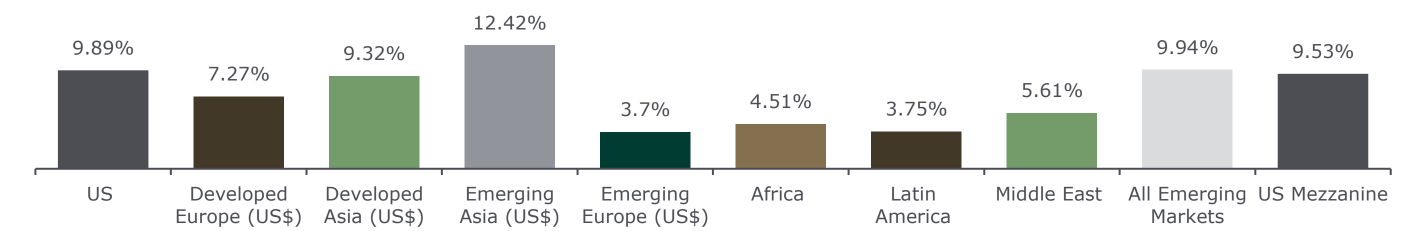
- reduced competition of funds able to negotiate with borrowers on a bilateral and proprietary basis;
- lack of robust intermediation; and
- typical emerging markets-perceived risks including FX, regulatory and liquidity.

Figure 10 outlines the differences between regions in how structured capital fund managers generate returns and Figure 11 shows returns across regions.

Figure 10: US, Europe and emerging market returns generation[3]

	Europe	US	Emerging Markets
Fund level leverage	▪ Zero or occasionally 1.0x	▪ 1.0x-2.5x on senior debt	▪ Zero or occasionally 1.0x
Current income	▪ historically 50.0% PIK / 50.0% cash pay is standard	▪ Historically 100% cash pay	▪ Majority cash pay with some element of PIK
Origination fees	▪ 2.5% - 4.0%	▪ 1.0% – 2.0%	▪ 2.0% - 3.0%
Origination channels	▪ Sponsor	▪ Generally bank or manager	▪ Sponsor and Advisors
Workout and bankruptcy	▪ Workouts tend to be consensual and amicable	▪ Driven by Chapter 11 proceedings ▪ Automatic tendency to head straight to bankruptcy court	▪ Workouts tend to be consensual and amicable

Figure 11: Cambridge Associates Private Equity & Venture Capital - Fund Index Summary: Horizon Pooled Return (10-Year) [4]



CONCLUSION

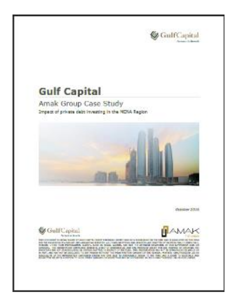
In summary, Gulf Capital believes that middle market structured capital is a flexible financing tool for companies and an attractive asset class for investors to consider when looking to diversify their portfolio. Compared to private equity, structured capital typically has a higher risk-adjusted return and predictable cash flows, and relative to high yield bonds, structured capital has a significantly higher yield, shorter duration and greater investment control.

Current market trends support investing in structured capital in addition to private equity and high yield. Historical performance show the attractive returns of the asset class, but more importantly, we believe that current market conditions, especially in the emerging markets, suggest middle market structured capital is well positioned to outperform in the coming decade.

RELATED READING

- Insights into Private Debt Investing
- Amak Group Case Study: Impact of Private Debt Investing in the MENA Region

gulfcapital.com/casestudies



[3] Source: bFinance Direct Lending: What's different now? March 2017
[4] Source: Cambridge Associates Private Equity Index and Benchmark Statistics Q4 2016. Private indices are pooled horizon internal rate of return (IRR) calculations, net of fees, expenses, and carried interest. The timing and magnitude of fund cash flows are integral to the IRR performance calculation.

Partners in Growth

Gulf Capital - Gulf Credit Partners

Walid Cherif | Senior Managing Director, Head

Mr. Cherif is the founder of the structured capital business at Gulf Capital. He heads the debt platform since he joined Gulf Capital in 2011. Mr. Cherif has more than 23 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 – The World Bank Group 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.

Paul Isaac | Executive Director

Mr. Isaac joined Gulf Capital in 2013 and holds the position of Executive Director. He has 11 years of international banking and emerging markets investment experience. Prior to joining Gulf Capital, Mr. Isaac worked as an Assistant Vice President for NBK Capital Mezzanine Fund for three years. Prior to joining NBK Capital, Mr. Isaac worked at the International Finance Corporation for three years as an investment analyst in the Health and Education Group. He started his career at Citigroup in New York in the Investment Banking Division. Mr. Isaac holds a Masters of Business Administration (MBA) in Finance and Entrepreneurship & Innovation from Kellogg School of Management, Northwestern University, and a Bachelor of Arts (B.A.) in Economics from Northwestern University in the United States.

Gulf Capital's Structured Capital History

Gulf Capital launched its structured capital 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.

About Gulf Capital

Gulf Capital is a leading alternative asset management firm in the Middle East, investing across several asset classes including Private Equity, Structured Capital 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 and 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 and 2017. 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 Structured Capital business, Gulf Credit Partners, which offers structured capital 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 structured capital 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 PJS, please visit our website at www.gulfcapital.com

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