

CASH FLOWS

Mezzanine Capital Flows Appear to be Changing

There is a song lyric, "When life looks like easy street, there's danger at your door." This certainly applied to investors placing mezzanine capital, which has been an important source of growth and liquidity for independents during the past 15 years.

Mezzanine capital has undergone gradual and episodic changes during this period, most recently with the collapse of **Enron Corp.**, which led to tighter credit standards applied to other mezzanine financiers, such as **Mirant**, and recently by the exit of **Shell Capital**. The demise of **Shell Capital** and **Enron** is significant because they follow a decade-long shift of mezzanine capital away from money-management firms that dominated during the early 1990s, toward energy-company affiliates since then.

Could these recent events portend a reversal of the 10-year flow of mezzanine capital away from money managers? It helps to develop a historical perspective of trends driving mezzanine capital flows.

Think back to 1989. Oil was in the midteens, the gas bubble hadn't popped, commercial banks were tight, and private-equity funds were a novel concept. Thus began an outstanding five-year mezzanine investment period, which eventually ended in 1993 with new technologies and a flood of capital.

Mezzanine funds were controlled by money managers, including **TCW**, **Rimco**, **First Reserve** and **EnCap Investments**, and by life insurance companies. The latter funded mezzanine debt directly and through limited-partner commitments to the money managers.

Flash forward to 1999. Oil was still in the midteens, gas had fallen below \$2 per thousand cubic feet and bankruptcies were common. Thus began another stellar, but shorter, mezzanine period, ending last year—but this time, mezzanine capital was controlled by energy-company affiliates, including **Enron**, **Shell**, **Utilicorp (Aquila Capital)**, **Duke** and **Mirant**, not by money managers. Even **EnCap** was acquired by **El Paso Corp.**

Cosco Capital Management has traced the disappearance of mezzanine money-management firms in the 1990s to four factors that may now, in fact, be reversing. These include the massive shift of retirement savings from defined benefit plans (pension funds) to defined contribution plans (401-Ks and mutual funds); tighter life-insurance

company regulations; the emergence of private equity; and low inflation.

Retirement savings. The shift of retirement savings from traditional pension plans to employee-directed 401-Ks caused a 17-fold increase in equity mutual-fund assets, from \$248 billion in 1989 to \$4.2 trillion at the peak in February 2000, before declining to \$3.4 trillion in 2001. During this time, pension- and mutual funds alike pursued popular stock-indexing strategies that favored large capitalization stocks for their liquidity.

This trend profoundly affected mezzanine funds. First, it reduced the pension-fund capital available to money managers for private placement into mezzanine-fund limited partnerships. Second, it increased the capital available to common-stock issuers, some of which used a portion of these funds for mezzanine investment. Third, it created unsustainable demand for large-cap growth stocks. While these first two effects partially explain the shift of mezzanine capital from money managers to energy-company affiliates, this third factor may suggest that these fortunes could easily reverse.

Could it be that the collapse of **Enron**, with its unsupportable stock price, and **Utilicorp's** buyback of **Aquila**, represent an underlying loss of momentum for stock issuers and the reversal of capital flows back to value-oriented funds organized by money managers?

Insurance company regulations. A few years after the junk-bond and real-estate excesses of the late 1980s, insurance-company regulators tightened the risk-based capital standards applied to insurance-company investments in oil and gas mezzanine funds. Previously, mezzanine investments were matched with loss reserves consistent with debt rated BB or B, but afterward, mezzanine investments were treated as equity, thus requiring much higher loss reserves that reduced their investment appeal. This forced insurance companies to seek higher returns through other strategies such as private equity.

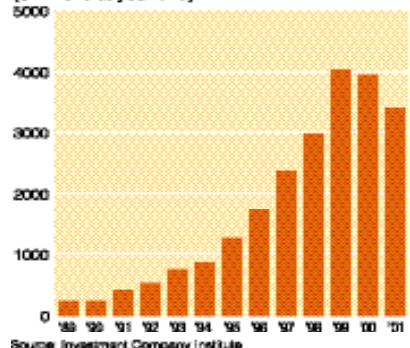
Today's regulatory response aims at investment excesses affecting public stocks and 401-Ks, and this could affect stock issuers providing mezzanine capital.

Emergence of private equity. During the 1990s, pension funds and insurance companies allocated growing amounts of capital to private equity funds, including buyout and venture-

capital funds, whose exit values were buoyed by high retirement contributions to equity mutual funds. Institutional allocations to private equity grew from less than 2% in 1990 to as much as 10% in some portfolios by 2000.

With this trend, successful oil and gas money-managers, such as **First Reserve** and **EnCap**, had incentive to abandon

Assets of Equity Mutual Funds
(\$ Billions at year-end)



mezzanine strategies in favor of private equity. However, with the current low ebb in public equities, disproportionately high allocations to private capital may trigger the search for alternative investment styles, potentially renewing interest in mezzanine funds.

Low inflation. During the late 1980s, investors used oil and gas mezzanine funds to offset the effect of inflation on fixed-income portfolios. But as memories of inflation waned, mezzanine funds lost out to higher-performing private-equity funds. This, too, may change.

Some prominent investment professionals now expect public-equity markets to deliver single-digit returns this decade. They are concerned that a long-term struggle against global terrorism and anti-Americanism may drag on the economy and build inflationary pressures.

If so, demand for inflation hedges could trigger capital flows back to oil and gas mezzanine funds, while low stock-market returns may diminish funds available to stock issuers with mezzanine affiliates.

Finally, there is, perhaps, one direct piece of evidence that mezzanine fortunes may be shifting to money managers. **TCW** closed a \$500-million fund last year, the first in a few years. Stay tuned, for the funds, they are a-changin'.

—William E. Weidner, *Cosco Capital Management LLC*