The Case for Junior Capital (Part One)

By Randy Schwimmer

It's been a while since we felt the need to reiterate the case for junior capital.

Back in December 2015 the senior debt market was in full swing recovery from the Great Recession. Interest rates were at rock-bottom lows, and senior spreads were near their post-GFC tights. Unitranche financings was growing in popularity – and size with mega-tranches – sporting leverage over seven times Ebitda for the better issuers.

"Mezz is dead," we heard repeatedly. Not for the first time, and probably not the last.

In our four-plus decades of private debt participation and observation, this is a regular occurrence. When senior debt managers are putting extra foam on the latte, it's assumed no one is drinking coffee black. We made that point in our first "Why Mezz Matters" column over seven years ago (link).

Long-time junior lender practitioners spoke of the benefits for all parties having junior capital layered between sponsor equity and first lien debt. They also told us of specialized origination targeting sponsors in more challenged sectors in need of flexible capital. Or simply sponsors' preference to bifurcate capital structures and maximize flexibility for the long-term.

In the Covid spring of 2020 when senior lenders dramatically shrank the leverage they were willing to offer, mezz lenders jumped in to supplement the gap, offering commercial terms with conservative structures and excellent yields to their investors.

Credit conditions improved in 2021 following central bank and fiscal interventions, yet junior capital remained a significant factor in midcap sponsored financings. Private equity buyers, sensitized to business challenges such as supply-chain disruptions and volatile commodity costs, sought "patient capital" for which cash interest could be turned off to preserve liquidity.

That dynamic was replayed over the past year with the Fed's epic rate tightening that doubled interest expenses. Sponsors of highly leveraged companies sought cash-pay instruments that could be flipped to "payment-in-kind" if interest coverage dipped at or below 1:1.

Today all-in senior credit yields are at double-digit levels normally reserved for sub debt. But as we'll discuss in the next few weeks, mezz yields are also on the rise accompanied by more conservative structures. No surprise that a handful of blue-chip middle market private equity firms have established their own junior capital platforms to complement their core capabilities.

What experienced private market players know, but is sometimes forgotten by casual observers, is that mezzanine capital has for decades played an important role in providing solutions in both challenged markets and pressured borrowers. If recent volatility is any indication, the next few years will likely remain challenged in both expected and unexpected ways.

The Case for Junior Capital (Part Two)

We continue our discussion this week on why private mezzanine is going from strength to strength amid current economic and market conditions.

"We did zero mezzanine deals last year," one junior capital provider told us. "This year we've already done half-a-dozen. We're getting calls from sponsors that don't typically use mezz. Deal flow is up significantly, particularly for PIK deals given what's going on in the senior market. We're trying to pick our spots. If the use is just to pay senior cash interest, that's an easy no."

“Our high-water mark for investment activity occurred during the peak of aggressive senior debt market conditions, and we have experienced an uninterrupted growth trajectory in junior capital activity since 2011," our Head of Private Equity and Junior Capital, Jason Strife, told us. “Middle market deal flow was soft versus the same period last year. However, our closed deals were up over 20%. Despite decline in buyout activity and broader M&A activity, we had many unique opportunities to capitalize on the market’s dislocation, with high quality businesses.”

What’s behind those unique opportunities? “The mix skewed towards add-on acquisitions for our portfolio companies,” he said. “Our sponsors are looking to avoid triggering MFN [most-favored nation] provisions. These are designed to protect existing lenders for some period against borrowers raising incremental capital in the same tranche at higher pricing.

“Given senior debt market spreads have widened out by about 200 bps over the past few months, it’s more cost efficient for sponsors to layer in a piece of junior capital or structured capital rather than re-price the entire senior facility.”

The MFN issue is helping a Chicago-based lender deploy junior capital. “We’re in one deal across the capital structure – senior, junior, and equity co-investment,” they reported. “The sponsor needed incremental financing for an acquisition. The agent wouldn’t waive the MFN so the sponsor used incremental mezzanine and equity. We priced the new mezz 1% higher and waived the MFN on the existing mezz, avoiding a reset of pricing across the board.”

The same market dynamics favoring terms for senior debt investors are helping buyers of junior debt and structured capital. “We’re getting 100 – 200 bps higher all-in spreads with a half to full turn of lower leverage with higher equity cushions. And that’s improving quarter-over-quarter.”

A more opportunistic junior capital lender also weighed in on today’s opportunity set. “Due to our high return hurdles we focus on hairier stuff, more non-sponsored transactions. But now we can achieve those returns with sponsor-backed businesses. Honestly, we’re trying to soak up as much second-lien, mezz, and PIK preferred as we can.”

“It’s an incredible time to get mid-teens returns at 5x leverage or less. There’s a lot of demand for junior capital to preserve the senior credit facilities that are attractively priced. It’s like rewinding the clock 20 years for the junior capital market.”

The Case for Junior Capital (Part Three)

This space has covered at length the investor-friendly changes in senior debt terms since the Fed began its rate hiking regime in March 2022. We recently spent time speaking with junior capital providers about the state of mezz terms today.

“Junior capital spreads have widened out 50 to 100 bps from the end of last year to the end of the first half of 2023,” a top NYC manager told us. “At the same time leverage has declined one-quarter to one-half a turn of Ebitda. That’s a similar dynamic to what we’ve seen in the senior debt market. It’s simply a function of how much debt borrowers can handle.”

How about equity cushions in new LBOs? “Purchase price multiples are still elevated,” another manager reported. “Cash equity percentages have remained healthy, even rising slightly as sponsors have focused on prudently capitalizing businesses in the face of rising rates.”

Other elements of junior capital pricing are at or better than pre-hike levels. “Closing fees and OID have been very stable at around 3.0% this year,” a Chicago-based direct lender said. “That’s up from an historic norm of 2% to 2.5%.

"We're also seeing improved call protection. Non-calls for year one were virtually non-existent from late 2020 through 4Q 2022. Now we're getting that plus three years of call protection on most of the deals we're doing."

What about PIK toggle options? Junior capital managers have been more flexible with the combination of PIK and cash they have been willing to provide. "Our sponsors are keenly interested in flexible structures that allow them to toggle to a more non-cash-pay component, if needed," they said.

Other bankers agreed. "We saw that being played out in a public way against the backdrop of higher rates with the now-dead Cotiviti deal," one told us. "The $5.5 billion unitranche reportedly had a PIK option for a large part of the debt. There are increasing opportunities to get creative and provide borrowers the ability to conserve cash to service interest expense in this period of high SOFR rates."

Our own junior capital team has participated in this trend. One colleague told us, "We've closed a couple of deals this year with a 13.0% coupon, comprised of 10.0% cash and 3.0% PIK. The borrower has an option to pay only 7.0% in cash in exchange for a coupon bump of 1.0%, bringing the total coupon of 14.0%."

How has your underwriting changed with these tougher interest rate conditions? "We've always done cash flow modeling focusing on fixed charge coverage and interest coverage ratios," he said. "But in this environment, we're focusing on opportunities with over one-to-one FCCR's in downside scenarios."

The Case for Junior Capital (Last of Four Parts)

In early 2020, just before Covid came crashing down on our heads, we were in the middle of a *Lead Left* series called "Ten Top Myths About Private Credit". Myth #5, published on February 20, was "No one uses mezzanine debt anymore."

We felt compelled, after a decade of increasingly aggressive senior and unitranche financings, to point out how private equity sponsors had never stopped using junior debt as "patient capital" to help stretch leverage and provide a cushion to banks and other senior lenders.

The near-term environment offers many opportunities for both investors and issuers. Our team expects junior capital coupons to remain at or above current levels: "We want to make sure there's an adequate spread relative to senior rates. We also think leverage will stay at these levels as recession concerns linger."

There's also upward bias on deal volumes heading into 4Q as sponsors feel pressure to generate LP returns. "It's a circular problem for firms," one banker noted. "They aren't selling businesses, so until they do investors won't have the cash to re-invest in successor funds."

This dynamic has led to the significant growth of secondary market transactions, including continuation vehicles, as a way to return capital to investors and rebalance portfolios.

"Even with elevated costs and banks more conservative, companies still seek growth capital," Jason Block, partner and CIO of Freedom 3, said. "We have a quality pipeline with almost twice as many opportunities as we saw in each of the last two years. There is great appetite for junior capital.

"Good companies still need liquidity on the balance sheet," he told us. "Given the recessionary pressures in the economy and the looming 2024 potential rematch of an election, we find management teams and owners share our view about planning for contingencies now."

Others looked at continued high interest rates more than a slowdown as a source of concern. "Investors will certainly exercise restraint," our head of private equity and junior capital, Jason Strife, said, "so we're anticipating lighter market activity until conditions improve. Bankers tell us there's a considerable backlog waiting to come to market. One top middle market bank has a backlog of 100 books they anticipate bringing to market when confidence returns."

Private equity owners and founders are certainly seeking realizations but don’t want to endure meaningful discounts on enterprise value for businesses. This has led to longer investment hold periods than the norm, a trend likely to continue for a while.

Finally, the relevance of junior capital to overall direct lending franchises is firmly established. As Strife put it, “I bet the market would be surprised to learn we’ve done junior capital, in some form, with nearly 75 PE sponsors in our portfolio of ~105 relationships.”