Lead Left Interview – Michael J. Hall (Part Two)

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This week we continue our conversation with Michael J. Hall, managing partner at Yukon Capital Partners. Yukon provides mezzanine capital to middle market businesses with a focus on deals controlled by private equity sponsors.

Second of two parts – ***View part one***

The Lead Left: *How did equity co-investments get started?*

Michael J. Hall: It wasn't always a feature, it became popular later. Warrants early on were more prevalent. Tacking on warrants became associated with "risk." Now of course warrants are a rarity, but co-investments are quite common. That separates the sponsored from the non-sponsored assets.

TLL: *Did that attract LPs into deals as well?*

MH: LPs, whether of senior or sub funds, are always looking for side-by-side investments. Insurance companies are the biggest LPs for mezz funds. They can be very aggressive with co-investments. Plus it gives them an opportunity to learn the business directly. They act now as originators and investors.

TLL: *And I suppose allows the GP to take on more exposure?*

MH: Yes, it lets them punch above their weight class by committing to more than they would hold.

TLL: *What's the view of mezz versus unitranche and other senior debt options?*

MH: From the issuer's perspective, mezz lenders are paid to endure. Their clients are sponsors who are looking for simple senior and junior debt solutions.

TLL: *Is unitranche a cheaper alternative?*

MH: Hard to say. It's a great SBIC product for sure. Sponsors aren't always sure it's cost competitive with senior and junior capital alternatives. But it's awfully easy. There are no intramurals.

TLL: *Meaning no need to worry about standstills or blockages or intercreditor agreements.*

MH: That's right. Mezz is a specialist product to help sponsors execute a strategy. It's hard, for example, for a BDC to be a specialized product. They don't invest in equity, which means it doesn't matter what's going on in the PE investor's mind. As mezz with co-investment rights, incentives are aligned.

TLL: *Where do you think the mezz asset class will be in five or ten years?*

MH: Well, the asset class has been around for twenty-five years, so it's proven to be reasonably stable. There may be wobbles, but it won't fall down.

***TLL:** Is a downturn closer than we think?*

MH: I think we're closer to the middle than the 7th or 8th innings. Economics was always a weird science for me. This hasn't been a quick recovery. So I think we'll have a longer expansion.

***TLL:** How about interest rates?*

MH: Nowhere to go but up. It will still take two years to get back to pre-crisis rates. We are armed with the best credit data in a generation. We know what the bottom looks like. We can measure that and price that. That's one good thing the Great Recession gave us – uncommon data.

***TLL:** What's the outlook for PE?*

MH: It's a professionals-only game. You can't do nothing and sell a few years later at a profit.

***TLL:** Top PE firms shouldn't care about a slow economy, right? They grow businesses regardless of cycles.*

MH: That's easier said than done. The longer term opportunity is that businesses will have to be sold. The Great Recession didn't kill companies, they're just not trading.

Contact: Michael J. Hall
mhall@yukonpartners.com
Phone: (612) 435-7802
Website: http://yukonpartners.com/