Top Ten Myths About Private Credit (Fifth of a Series)

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Here are the next two fables in our continuing special series on myths of private credit:

Myth #5: "No one uses mezzanine debt anymore."

As we detailed over four years ago (link), private sub debt regularly gets kicked around at conferences for being "dead." This has particularly been the case since the advent of the unitranche, which has certainly disintermediated a share of senior/junior two-tranche financings.

Yet mezz (or whatever you want to call it – sub or junior debt, second lien, PIK notes) has been a feature of the private capital landscape for decades and remains as active as ever. Why? In part because of its use as a private equity substitute. Being so-called "patient capital," mezz is often deployed in the lower end of the middle market below senior debt tranches with more cyclical, first-time, or situational borrowers.

For traditional middle market PE shops, mezz is helpful both in extending leverage (when all-senior structures won't fly) and providing a cushion with senior debt. As one partner put it, "If there's a problem, I'd rather have them fighting each other than me."

It's also popular with institutional investors seeking higher yields. These coupons have averaged in the 10-11% range, not including a PIK component of 1-2%. That's stellar compared to new issue public sub debt yields now below 6% (per LevFin Insights). According to Preqin data, more mezzanine funds were raised in 2019 than for any private credit strategy other than direct lending and special situations.

And while the volume of junior sub debt used by midcap private equity sponsors in 2019 was off 32% to $2.8 billion, it has been relatively steady at an average of $3.75 billion over the past seven years, as tracked by Refinitiv LPC (*Chart of the Week*).

Finally, the junior portion of LBO balance sheets has expanded as EV multiples have increased faster than total debt multiples. While more creativity is required today in junior capital solutions, many sponsor structures need paper alongside the common.

Myth #6: "Structures are weakening because it's late in the market cycle."

Financing terms are indeed more aggressive, but that's something that could have been said about sponsor finance at anytime in the last seven years. For example, the middle market began sporting covenant-lite structures in 2011, barely a year after the end of the Great Recession!

We view issuer-friendly terms as less a feature of market timing than a result of supply/demand technicals. It's also true that recently minted managers, with no track record through a downturn, have less experience differentiating among deals with riskier terms.

? Next week: Myth #7: “High leverage and weak structures will make senior recoveries worse than 2009.”