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The Case for Junior Capital (Part Two)

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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."