The Case for Junior Capital (Part Three)

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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.”