The Case for Junior Capital (Last of Four Parts)

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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."