Private Credit and Business Cycles (Second of a Series)

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Timing in private credit investing is an important part of decision making for asset managers. Having a view on where we are in the business cycle and how close we are to the next downturn helps frame decisions on specific credits, particularly those in more cyclical industries.

In mezzanine investing, timing is essential. 2006 sub debt fund vintages were excellent, but if you were investing mezz in 2006, you might have had a rough ride.

Preston Walsh, a partner at PNC Mezzanine, talked to us recently about the firm's upcoming annual survey of mezzanine investors. The 2016 version will be unveiled at the May 17-18 Atlantic Conferences Symposium on Mezzanine and Middle Market Debt Finance. [link], but Walsh gave us a sneak preview of the results.

"The deal flow was certainly off from 2105, but for mezzanine deals it was challenging," he told us. "Sponsors are certainly looking for opportunities. Bankers are getting maximum valuations on companies deemed to be attractive. The ones that don't fit that description come with issues. The survey will show that."

Why the slowdown? "Companies that rebounded quickly from the recession have already been sold," Walsh said. "Other companies are taking a long time to regrow equity value. The last couple of years have had very slow growth economically. The auto sector, for example, has flattened out. Companies are challenged finding a growth path."

Is that reflected in your portfolio performance? "It's been a mix," he says. "Some borrowers are reporting record Ebitda, a few need covenant amendments. Industrials have experienced a recession particularly in segments such as energy, while auto is flat but strong and aerospace is showing robust numbers."

What about disintermediation from unitranche? Walsh agrees sponsors have refinanced mezz with stretch senior in 2015. "It's about doing the next thing which adds value for them in a low-growth environment. That has slowed considerably since year end."

Regarding mezz overall, Walsh says pricing has stabilized. "Coupons are in the 11-13% range with equity kickers to get you to a mid-teens return." He also thinks senior leverage has backed up approximately one-quarter turn. That means more mezz opportunities with less aggressive capital structures. "Risk/return parameters are better today than last year for deals that get done," he said.

Do you finance non-sponsored companies? "Of the five transactions we did last year, two were in support of independent sponsors and one was directly with an owner-operator. The trend has skewed more towards non-funded-sponsor transactions over the past couple years for traditional mezzanine investors."

We ask Preston where the competition is coming from. "It's different with every deal."

Finally, what can we expect at your presentation at next week's Symposium? "We have 50-70 respondents to our survey which we've been doing for twelve years now," he says. "We have really good metrics showing what people are doing in real time."

"In general buyout financing trends have been stable," Preston concludes. "It will be very interesting to see what happens if and when the Fed tightens rates."

For further insights from Preston Walsh and other leaders in middle market debt finance, join us at the 23rd Annual Atlantic Conferences Symposium on Mezzanine and Middle Market Debt Finance. [link]