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Lead Left Interview – Michael J. Hall

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This week we speak with Michael J. Hall, managing partner at Yukon Capital Partners. Yukon provides mezzanine capital to middle market businesses with a focus on deals controlled by private equity sponsors.

The Lead Left: *Mike, how long has Yukon been around?*

Mike Hall: In February, 2008, Bill Dietz and I left Norwest Mezzanine to start Yukon. But we've both been doing this a long time.

TLL: *Define "a long time."*

MH: Well, just to put it all in context, the first mezzanine funds were created separately in the late 1980's by Churchill Capital and Rice Capital.Their founders, Hap Fauth, Mike Hahn, and Don Rice, have a friendly competition as to who came first. But their funds were started to fill a void between high yield bonds and institutional loans.

TLL*: What kind of loans?*

MH: Mostly they were private placements done by insurance companies. Then they got into high yield as well. Those issues would dip down into the middle market occasionally – usually in the form of a 144A. But over time bonds became more of an institutional product, given the need for a large float, etc.

TLL: *It's tough for high yield to do smaller deals.*

MH: The larger the execution, the tougher it is be focused and thoughtful. Intellectual capital is less fleeting in private mezz funds. You also end up working on few things with more senior people.

TLL: *How did the mezz product evolve over time?*

MH: The first funds were very small, under $100 million. And those were considered big at the time. They started as SBIC funds. Deals were very small, with mezz tranches standalone with bank lenders. Today junior capital is surrounded by other products – unitranche, first lien, and second lien, etc. And that's chipped away at the yield for mezz, especially for the larger end of the middle market.

TLL: *What about banks? How did they like having junior capital below them?*

MH: In the early 1990s the senior lenders were very aggressive. They would capture the lion's share of the leverage, and mezz lenders would end up with as little as half-a-turn. The S&L crisis put a stop to that. Since then lenders have become smarter, more disciplined.

***TLL:** What was the next phase?*

MH: Next came the bifurcation of the market. That was the subject of an excellent paper done by Ron Kahn and Susan Wilson when they were at Mesirow Financial. The thesis was that the market became divided between the sponsored market, and the higher yielding, non-sponsored market.

***TLL:** Who were the non-sponsored players?*

MH: Merit Capital is the oldest and probably most well-known. They were formerly William Blair Mezzanine and have been around since '93. Falcon is a more recent fund, but has raised almost $1 billion. Peninsula is another big firm with $400 million of capital. These are all 'pure play' mezz investors.

***TLL:** Then came the bull market period after 2001.*

MH: And the small mezz funds got bigger and looked at larger transactions. Some turned into more credit opportunity style funds with leverage to allow them to get yield, but very competitive to the issuer. Their large debt tranches started to compete against high yield.

***TLL:** And things started getting frothy.*

MH: Witness the birth of holdco notes, PIK toggle features, and covenant-lite structures. All that good stuff. Firms like GSO and Sankaty expanded the junior capital reservation with lots of different assets and different managers. And you saw the rise of big BDCs like Apollo, Ares, Allied, and American Capital.

***TLL:** What about banks? They never got into the picture with junior capital.*

MH: Not directly. Some like PNC and Key spun out separate businesses, but tough to do on balance sheet, given the regulatory issues. And of course after 2008, lenders stopped lending almost altogether.

To be continued the week of July 28

Contact: Michael J. Hall
mhall@yukonpartners.com
Phone: (612) 435-7802
Website: http://yukonpartners.com/