Second Thoughts (Second of a Series)

THE LEAD | January 22, 2015

It’s a bird! It’s a plane! It’s an Eastern Airlines plane!

We thought we were having flashbacks from rum-soaked Acapulco trips we took back in the 1970’s, but turns out the iconic “Wings of Man” brand is making a comeback of sorts. Beginning with charter flights, Eastern is re-launching aviation service in March. No mention whether Orson Welles will be revived for TV commercial voice-overs.

Such visitations from the past reminded us of another resurgence we’ve noted recently, although this venerable friend never stopped flying: mezzanine debt.

As we covered last week, second-lien loan volume has tailed off in the face of market volatility and concerns about high leverage. While certainly not absent from new issuance, secured debt that’s subordinate to first-lien term loans is ceding ground to unsecured subordinated debt, especially in traditional middle market financings.

While seconds were soaring during much of the recent bull loan market, for many middle market private equity sponsors the popularity of mezz has never wavered.

For one thing, mezz funds don’t jump in and out of the market depending on business cycles, interest rates, or leverage. They raise long-term capital from institutional investors who understand the product and appreciate the track record of the manager.

By its very nature – being subordinated to senior debt, requiring no amortization, and having PIK interest – mezz is patient capital. This flexibility and predictability makes it easier to partner with private equity clients in restructurings or turnarounds.

Also, by virtue of junior capital often investing alongside the GP in the equity, interests and incentives between the two parties are better aligned.

Unlike hedge funds, credit opportunity funds, and BDCs, who toggle between first and second-lien looking for higher yield, traditional mezz funds invest exclusively in subordinated debt. That’s all they do. It might seem boring in toppy, frothy markets, but when volatility scares lenders away, sponsors will take boring all day long.

Finally, mezz pricing doesn’t swing with vicissitudes of the market. It’s been 12% cash pay and 2-4% PIK since the Truman Administration. That allows investors and managers to take the long view. In markets like the current one, that’s a distinct advantage.

Speaking of flashbacks, it’s worth reprising comments from one mezz vet dating to the last market hiccup: the June 2011 Greek debt crisis. Back then he told us:

”Since I started mezzanine investing in 1993 we’ve been through three recessions, irrational exuberance, interest rates all over the map, second lien markets surging and collapsing, banks thriving and bailed out, CLOs

taking over leveraged lending, now struggling to raise funds, and high yield opening and closing dozens of times. And they say our market is dying?"

Next week: We wrap up our second-lien series with an outlook for 2015.

Attention Subscribers! Our State of the Capital Markets – Fourth Quarter 2014 Review and First Quarter 2015 Outlook is now ready for download. Click here to our access timely data and expert commentary.