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The Case for Junior Capital (Part One)

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It’s been a while since we felt the need to reiterate the case for junior capital.

Back in December 2015 the senior debt market was in full swing recovery from the Great Recession. Interest rates were at rock-bottom lows, and senior spreads were near their post-GFC tights. Unitranche financings were growing in popularity and size with mega-tranches, sporting leverage over seven times Ebitda for the better issuers.

“Mezz is dead,” we heard repeatedly. Not for the first time, and probably not the last.

In our four-plus decades of private debt participation and observation, this is a regular occurrence. When senior debt managers are putting extra foam on the latte, it’s assumed no one is drinking coffee black. We made that point in our first “Why Mezz Matters” column over seven years ago (link).

Long-time junior lender practitioners spoke of the benefits for all parties having junior capital layered between sponsor equity and first lien debt. They also told us of specialized origination targeting sponsors in more challenged sectors in need of flexible capital. Or simply sponsors’ preference to bifurcate capital structures and maximize flexibility for the long-term.

In the Covid spring of 2020 when senior lenders dramatically shrank the leverage they were willing to offer, mezz lenders jumped in to supplement the gap, offering commercial terms with conservative structures and excellent yields to their investors.

Credit conditions improved in 2021 following central bank and fiscal interventions, yet junior capital remained a significant factor in midcap sponsored financings. Private equity buyers, sensitized to business challenges such as supply-chain disruptions and volatile commodity costs, sought “patient capital” for which cash interest could be turned off to preserve liquidity.

That dynamic was replayed over the past year with the Fed’s epic rate tightening that doubled interest expenses. Sponsors of highly leveraged companies sought cash-pay instruments that could be flipped to “payment-in-kind” if interest coverage dipped at or below 1:1.

Today all-in senior credit yields are at double-digit levels normally reserved for sub debt. But as we’ll discuss in the next few weeks, mezz yields are also on the rise accompanied by more conservative structures. No surprise that a handful of blue-chip middle market private equity firms have established their own junior capital platforms to complement their core capabilities.

What experienced private market players know, but is sometimes forgotten by casual observers, is that mezzanine capital has for decades played an important role in providing solutions in both challenged markets and pressured borrowers. If recent volatility is any indication, the next few years will likely remain challenged in both expected and unexpected ways.