

Why Mezzanine Matters

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It's popular sport at loan conferences to kick the mezzanine asset class. After the credit crisis, when some investors in sub debt took a licking, the common theme heard among market players was, "Is Mezz Dead?" Today the refrain is "Is Mezz Still Dead? And yet, in conversations with practitioners, it seems mezz is alive and well.

The cause for concern is clear: unsecured credit took the brunt of lower valuations and dented cash flows during the Great Recession. Since then, financing tools such as second lien and unitranche have taken share from mezz; they provide lower cost, prepayable alternatives.

But both anecdotal and empirical evidence suggest that traditional mezzanine arrangers have been active. According to Thomson Reuters, almost \$3 billion in sub debt has been deployed so far this year. Private equity sponsors say mezz offers "patient capital," a critical virtue in uncertain times. Mezzanine also requires no amortization, and has looser financial covenants than senior secured.

Since it is unsecured and subordinated, senior secured loan buyers prefer to have mezz rather than second lien below them in capital structures. In the event the borrower needs to conserve cash, sub debt interest payments can be turned off.

Company size also matters. Issuers larger than \$30 million ebitda can access a broader range of financing options. But for the traditional middle market mezz arrangers have had a busy year, particularly those with long-established sponsor relationships.

Some PE firms prefer mezz to unitranche in their buyouts. One managing partner told us, "Our companies tend to be smaller and more cyclical. I want someone below the senior to provide a cushion in case we need it." He added, laughing, "I'd rather have the two debt providers fighting with each other, than with us!"

With deal volume down in the overall market, small funds have an easier time staying busy. "I only need to do three or four deals a year and my LPs are happy," one manager of a Midwest fund told us. His fund raised \$400 million late last year and already half has been deployed.

Still, mezz terms have adjusted to the competitive landscape. Cash coupons have drifted down to 11% from 12%, with an additional PIK component of 1-3%. Warrants, once common, have disappeared except for the smallest borrowers; they have been replaced by equity co-investment. Call protection remains a key return factor for investors – and a bête noire for sponsors. Call premiums average 103, 102, and 101 in years one, two and three.

Mezz yields point to another pressure point for sponsors. As PE returns have declined from pre-crisis levels, sponsors look to their debt partners to share the pain. If the GP is earning 15% on equity risk, how can sub justify 12-14%? In some cases, that's pushed mezz funds into second lien investments with slightly lower returns, though most managers say LPs frown on that investment style drift.

The outlook for mezzanine is brightening. Prequin reports 62% of investors globally have targeted mezzanine as a strategy, second only to direct lending. This popularity is reflected in fundraising which, at \$4 billion, is more than special situations, distressed debt or venture capital.

Perhaps the next question should be “Why does mezz still matter”.