PE HUB Wire

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## Mezzanine Gets Another Chance To Shine

For the last 18 months, we've been extolling the virtues of unitranche debt. This structure has gained substantial popularity over the last few years as an ideal replacement for the cash flow senior debt that banks and CLOs no longer supplied as eagerly to the middle market following the 2008 credit crisis.

With the ability to combine both the senior and junior portions of the capital structure in to a single debt instrument, the unitranche structure provided similar leverage to a traditional senior cash flow/mezzanine structure, with the same weighted average cost of capital, yet with often more favorable terms for amortization, prepayment penalties and covenant packages.

But all this may be changing - and mezzanine may, once again, be the beneficiary.

Much of the capital for the unitranche structures has been provided by hedge funds, credit opportunity funds, and, business development companies (BDCs). These institutions found the opportunity to provide unitranche structures an ideal way to compete with both senior debt and mezzanine providers. As the sole capital provider, they could speak for the entire capital structure, thus touting an increased certainty of close. It also gave them a blended interest rate that enabled them to provide a suitable return to their own capital providers and had the added benefit of allowing them to put more money to work in a single transaction.

But the recent decline in the stock market has resulted in the average BDC's stock trading at 80% of its net asset value. As a result, a BDC's ability to raise additional capital and redeploy those funds in to unitranche structures is questionable. According to BB&T Capital Markets, BDCs raised over $4.0 billion in equity between January 1, 2010 and September 15, 2011. We believe this translates in to BDCs making approximately $300 million to $400 million in middle market loans per month, much of it in the form of unitranche debt. Of course, many of the BDCs do still have availability under their debt lines. But, so long as their stock continues to trade below book value, it is only a matter of time – and we believe that could be as short as 60 to 90 days – that a good amount of the capital provided by BDCs for unitranche structures will disappear.

Hedge funds and credit opportunity funds, while still having capital to deploy, also now have a growing number of attractive alternative investment opportunities that could result in their decreasing interest in funding middle market unitranche structures. These funds have always had the flexibility to redirect capital to the most favorable risk return yields.

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Given the investment opportunities resulting from difficulties in the larger senior debt syndication loan market, increased opportunities arising from broken high yield financings, and increased yields in the secondary market, funding the primary issuance of middle market unitranche loans may not be as attractive to hedge funds and credit opportunity funds as it once was.

And therein lies the chance, yet again, for mezzanine to take center stage.

Given concerns surrounding a BDC's ability to raise additional funding, alternative opportunities to deploy capital for hedge funds and credit opportunity funds, and no additional senior debt coming to market, the logical place for borrowers to turn to make up for this shortfall in capital is to the mezzanine funds. These funds continue to have significant capital available, despite the recent volatility in the equity and debt markets. And because the unitranche structure often crowded mezzanine funds out from investing during the last 18 months, many of these funds may be behind in deploying capital and eager to make up for lost time.

But we've seen this movie before and mezzanine funds have had a history of squandering their newfound popularity. Concerns about the economic environment make investing today challenging and, in the past, mezzanine funds have tended to avoid making investments in uncertain times. Yet an analysis of fund returns shows that investing wisely in just these periods has produced the highest IRRs for investors. Unfortunately even the decline in mezzanine rates in the last year to roughly 14% today are still higher than the unitranche alternative but, until BDC share prices rebound or hedge funds and credit opportunity funds run out of attractive investment alternatives, mezzanine could have the chance to shine once again.

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