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GUEST ARTICLE

Second-Lien Lenders Poised For Return To Stage

By Ronald Kahn and Robert Horak, Lincoln International

It's the Golden Age of Mezzanine—or at least it's supposed to be. The time you mezzanine lenders have been wishing for. A time when senior debt is scarce, causing everyone to need your subordinated debt product; a time when total debt multiples are at near historic lows, yet the returns you're getting for subordinated debt are at lofty levels not seen in years.

But something seems to be awry. With mezzanine at the center of the stage, with all eyes upon you, are you relishing in the limelight and making the most of your newfound notoriety, or are you letting those second-lien lenders, who are lingering at the edge of the stage, make a comeback and take over the show? In fact, isn't the financing environment today nearly identical to the days of 2001 and 2002, which fostered second-lien loans in the first place?

Interestingly, many second-lien providers were forced to leave the game because of concerns by cash-flow senior lenders over the terms of their inter-creditor agreements. It's hard to imagine that it ever made sense for cash-flow lenders to limit their ability to block interest payments or restrict remedies in times of distress.

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And cash-flow senior lenders eventually came to the realization that blockages were necessary when covenant defaults arose and decided to stop playing in the same sandbox as their second-lien friends. Instead, cash-flow lenders once again became best friends with mezzanine lenders, who were only too happy to accept the terms of the intercreditor agreements—with 180-day payment and remedy standstills—and get back in to the game.

But the senior debt market has changed dramatically. Cash-flow lenders are rare, being replaced by the return of asset-based lenders. And while their cash-flow brethren need standstills, asset-based lenders, content that their loans are fully covered by their collateral value, are quite willing to live without standstills and blockages. This is the exact same lending environment that existed in 2002 when second-lien took over the show from mezzanine, and a repeat performance may play out in the future.

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Secondary Market Cooling

Another big issue mezzanine should be concerned about is the rise in S&P's Leveraged Commentary & Data flow name composite index. While this seems counterintuitive, we believe that the significant increase in this index signals the slow down, if not the end, of the buying spree in the secondary market and focuses capital providers back to the direct market. Many of those providers who were enjoying the secondary market are the same players who were so active in the second-lien market. With many selling their secondary positions with a hefty gain, and having nowhere else to deploy their capital, isn't it inevitable that they will return their focus to the second-lien arena, particularly now that their old friends, the asset-based lenders, are running the show?

It's more than likely that the biggest factor affecting the market is that mezzanine rates of return may be too high. For most transactions requiring $5 to $50 million of subordinated debt, most lenders are charging all-in returns of 17 to 19 percent for their investments. Mezzanine lenders are also demanding two, three and sometimes even four years of a no-call, effectively prohibiting a private equity firm from selling its investment during this period. While it was difficult for mezzanine lenders to obtain warrants a couple of years ago, warrants are almost always required by a mezzanine lender today. And while mezzanine providers believe that this rate of return is justified and, in fact, necessary in view of their default risk, private equity firms are very unhappy with these requirements. As tough as the M&A market is, most private equity funds are rarely targeting more than 22 to 25 percent returns on their equity investments.

So, a roughly 300 to 500 basis point spread between the equity and subordinated debt returns is just too narrow for many private equity firms, opening the door for many private equity firms to provide the mezzanine tranche themselves or, more importantly, for a competing product such as second-lien loans. Second-lien loans, priced in the L+800 to L+1200 range (with a 2 percent to 3 percent Liber floor, will significantly undercut current mezzanine products and, once available, become private equity firms' new best friend.

The fact of the matter is, while mezzanine is the only asset class that has the same amount, if not more, capital today as it had prior to the credit meltdown, many providers are reluctant to take advantage of their notoriety, happy instead to stay on the sidelines and see how the general economy develops. While conservative investing is always prudent, studies have shown that the greatest correlation to investment successes is vintage year. Just about any investment made in the 2001-2003 timeframe became an outstanding performer. Multiple expansion alone helped lift the returns on these vintage years to record levels. No less important is the improvement in earnings that eventually occurs when buying at the bottom of the cycle.

So, maybe mezzanine lenders should sit up and realize that, in fact, their Golden Age is here and now. While there are mezzanine investors who believe this is their time, just as many are wilting under the limelight and waiting for a clear sign that the economic winds have shifted to the positive. Perhaps they should consider that these risks have already been factored into today's current conservative capital structure of 3.0x total debt, and their compensation of a generous 18 percent annual IRR is ample reward. Because those second-lien players are just lingering by the stage curtain waiting, once again, to take over the show. ❖

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Reprinted from *Buyouts*, August 3, 2009 • 195 Broadway, 9th Floor, New York, NY 10007 • (646) 822-3043

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