Park Square

Park Square Perspectives, Volume 3:

Junior Capital Solutions: Capturing Outsized Risk-Adjusted Returns

December 2023

Park Square Perspectives: Junior Capital Solutions

Capturing Outsized Risk-Adjusted Returns

There have been numerous articles in the press in 2023 describing **private credit's "golden moment"** as floating rate credit structures benefit from a rising rate environment and a "lenders' market" with highly attractive terms and structures on offer. While private market deal flow has been slow in the past 12 months, impacted by higher rates and a gap in buyer and seller expectations, the near-term outlook is promising as the syndicated loan market reopens and activity ramps up.

Junior capital has a key role to play, providing a capital efficient and flexible buyout funding solution for private equity sponsors. In addition, with company balance sheets under pressure from the elevated rates, it is becoming increasingly apparent that a number of high-quality businesses will need to reduce their cash interest burden by refinancing with junior capital solutions, and we expect it will be a very attractive environment for junior lenders over the next few years.

We believe junior capital offers compelling absolute returns and a high complexity – or illiquidity – premium for higher quality, more defensive businesses. Returns are predominantly floating rate and contractual in nature. The relative value of sitting in a preferred position in the capital structure in large, high-quality businesses with a substantial margin of safety has arguably never been higher. This ability to earn a mid-teens net return with a floating rate instrument represents very attractive relative value.

Reopening of syndicated loan market supports junior capital opportunity

Private market deal flow has been muted over the last 12 months, with M&A at YTD Q3 2023 at a 13-year low. There are promising signs that the syndicated loan market is slowly re-opening, CLOs are warehousing, and banks have largely cleared the backlog of hung syndications that hindered underwriting over the past 18 months. This higher volume of deal activity is good news for junior lenders whose capital typically sits behind a syndicated senior loan.

Providing solutions for large European companies

We believe that large companies with €100m or more of EBITDA represent one of the most interesting areas of the market for junior capital. Larger companies tend to be more diversified from a geographic, product offering and customer stand-point, and also benefit from top tier management teams.

Additionally, larger businesses tend to have more ready access to capital markets. Unitranche is less present in this segment, as typically these larger companies can access senior financing at cheaper rates than smaller businesses. Broadly syndicated senior loans ('Term Loan Bs' or 'TLBs') issued by these larger companies receive attractive credit ratings and commensurately lower funding costs.

Specifically in Europe, we tend to see a large number of interesting first-time buyouts, where capital markets are less developed, and the barriers to entry are high given the difficulties of operating across multiple jurisdictions.

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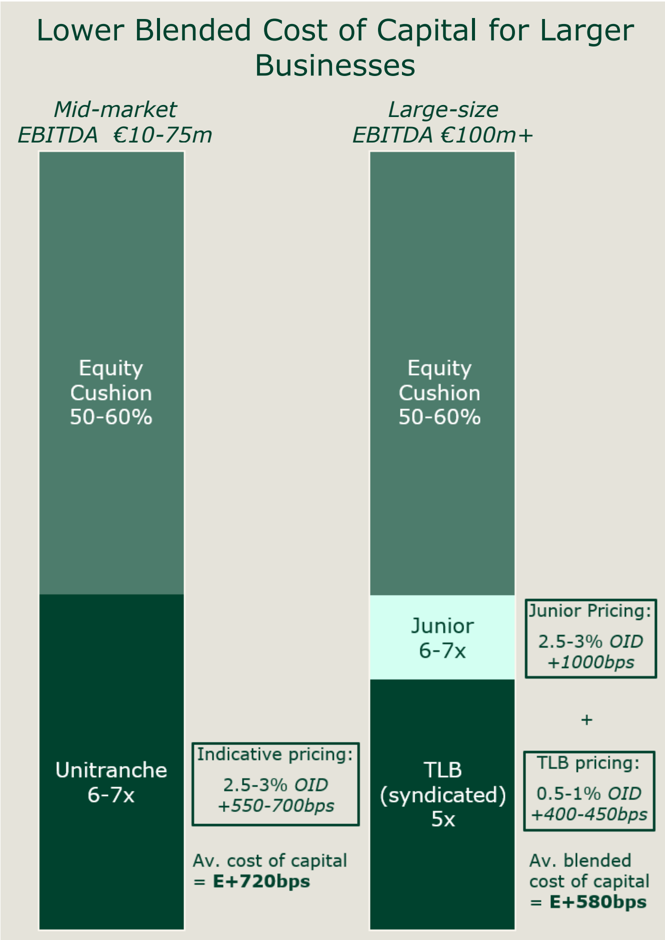
An efficient buyout funding solution for larger borrowers

As base rates increase and investors become reacquainted with time value of money, sponsors are placing greater scrutiny on financing costs as they move to preserve returns traditionally expected by LPs. 'One stop' unitranche financings have come to dominate middle market transactions (EBITDA €10-75m).

Conversely, sponsors arranging larger company buyouts, tend to look to a traditional, combined syndicated senior/junior financing as a cost-efficient solution.

The senior part of the capital structure is provided by TLBs, offering debt at margins of 400-450bps, up to 5-5.5x EBITDA exposure.



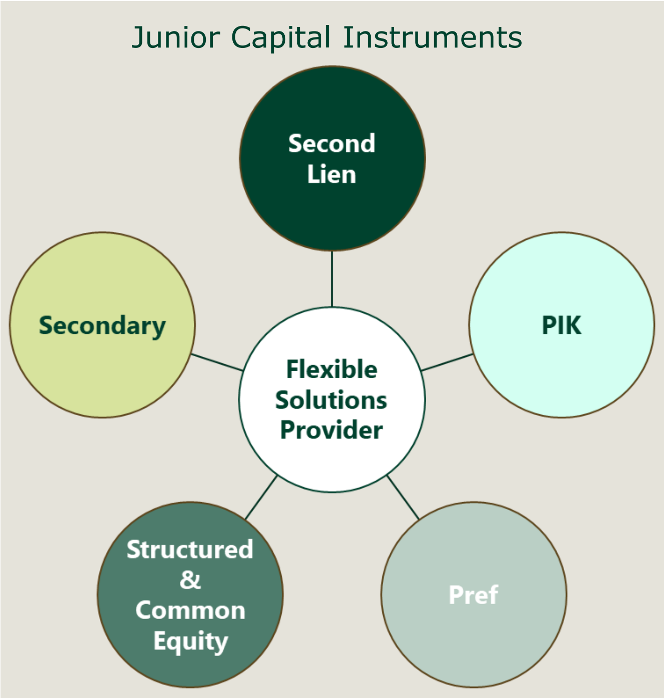
Attractive yields across instruments

Often the role of the junior capital investor is to be a solutions provider in the middle of the capital structure as sponsors pursue leveraged buyouts. Junior capital practitioners address opportunities using a range of debt and hybrid instruments including second lien debt, PIK debt and preferred or structured equity. They may also co-invest in common equity.

Each instrument has different risk/return characteristics related to their seniority, level of subordination and other protections. The lender's added value lies in tailoring appropriate solutions relative to the risk of the underlying company. They may target particular instruments at different times in the market cycle.

Primary junior capital has, on average, offered a blended return of around 10% over the risk-free rate, while preferred and common equity offer prospective IRRs in the mid-teens and above[1].

There is also an opportunistic secondary market which can provide significant value at times of market dislocation.



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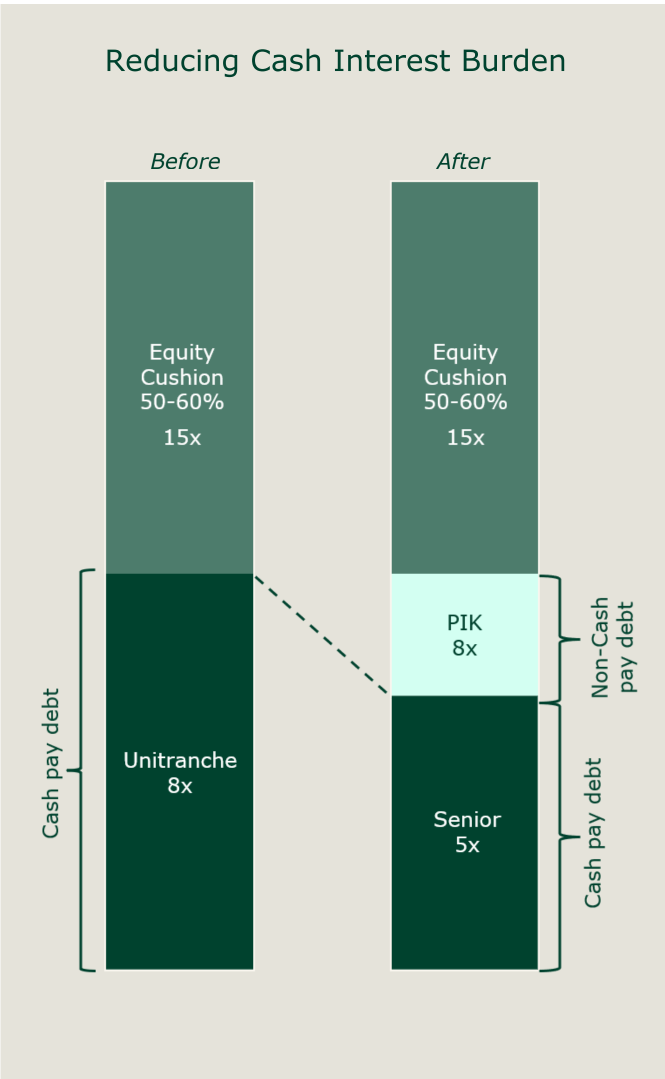
Non-cash pay: Helping good companies delever balance sheets

In the post GFC period (2009-2012), Park Square generated outsized returns for its LPs by helping high-quality, indebted businesses to unpick their expensive pre-GFC capital structures. We foresee a similar opportunity in the coming months and years, as businesses with expensive, highly-levered capital structures adjust to a higher base-rate world. For example, they may choose to refinance an 8x unitranche facility, priced at +650bps with a 5x senior loan (+450bps), and add a non-cash pay-in-kind (PIK) facility to help manage cashflow coverage. Park Square is an expert at arranging and structuring such facilities.



Continuation solutions

A more difficult market environment is leading to longer hold periods for private markets. This trend creates increased demand for partial liquidity solutions that Park Square is well positioned to provide. Sponsors typically want to hold on to their highest quality assets which creates attractive opportunities to provide great companies with non-cash pay securities at mid-to-high teens returns, often with equity-linked upside alongside a contractual minimum return. This enables sponsors to provide their LPs with liquidity and fund future growth. We anticipate this to be a significant market theme in the coming years.

Secondary market opportunity

Alongside traditional primary deal flow, Park Square has pursued a flexible investment strategy throughout its 19-year history. During times of periodic market volatility, the secondary market often presents attractive investment opportunities. Funds with capital markets capabilities are able to acquire the dislocated debt of performing assets which is often traded over-the-counter. In addition, the secondary market opportunity is counter-cyclical to primary M&A-driven deal flow, so managers who are able to capitalise will likely see consistent and robust investment pace throughout market cycles.

Cov-lite positive for junior lenders

Most European senior loans (TLBs) are now "cov-lite". This reduces the rights of senior lenders by providing fewer opportunities to force a senior-friendly restructuring. We believe the presence of "cov-lite" loans is extremely positive for junior lenders.

"Cov-lite" reduces the potential for capital structure instability in temporary periods of stress. In addition, senior lenders have common restrictive covenants which include anti-leakage provisions, helping to ensure shareholders cannot extract value ahead of debt. In our view these factors reduce the likely scale of junior capital losses through a future default cycle.

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Margin of safety

The capital structure graph below shows the development of valuations and capital structures of Park Square deals over a nine-year period versus the market. Recent years have seen an increase in buyout multiples, whereas debt multiples have remained broadly stable.

In Park Square deals, the average level of equity contribution has increased from 39% in 2015 to 69% in 2023. For recent vintages this implies the value of the company would have to fall by more than half for the value of the debt to be impaired.

Conversely, the market data shows us that equity cushions and leverage levels have remained largely stable, with values between 40-50% and 5-6x over the same time period.

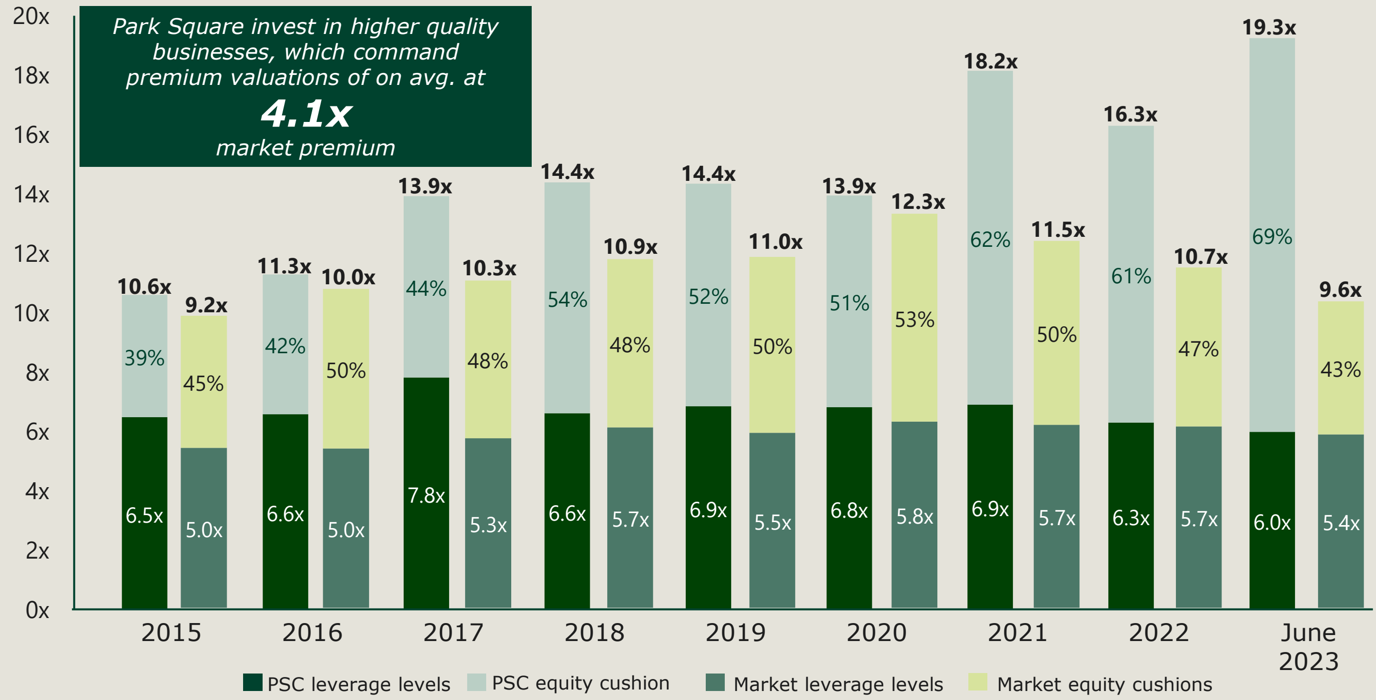
On average, a "Park Square Deal" has an EV of 4.1x higher than the market. We believe this demonstrates our investment philosophy of selecting the highest quality assets.

Extremely low loss rates

In a default and restructuring scenario, holders of junior capital are generally exposed to greater losses than senior debt. The high-yield bond market (consisting mainly of subordinated debt) offers a statistical proxy of potential loss rates by analysing its 30-year history. Moody's worst ever trailing 5-year annualised default rate is 6%, while its worst ever trailing 5-year annualised recovery rate is 30%[2].

While sourcing, negotiating and structuring deals is key to avoiding defaults, proactive monitoring and active, early engagement with companies that may be underperforming is essential. Park Square's junior capital team has been investing together over 19 years and has been through several default cycles. The firm's long-term track record shows an annualised junior loss rate of just 13bps[3] since its founding in 2005, demonstrating the experience and expertise needed to successfully navigate through defaults.

Stable Leverage and Rising Equity Cushions in Recent Park Square Deals[4]



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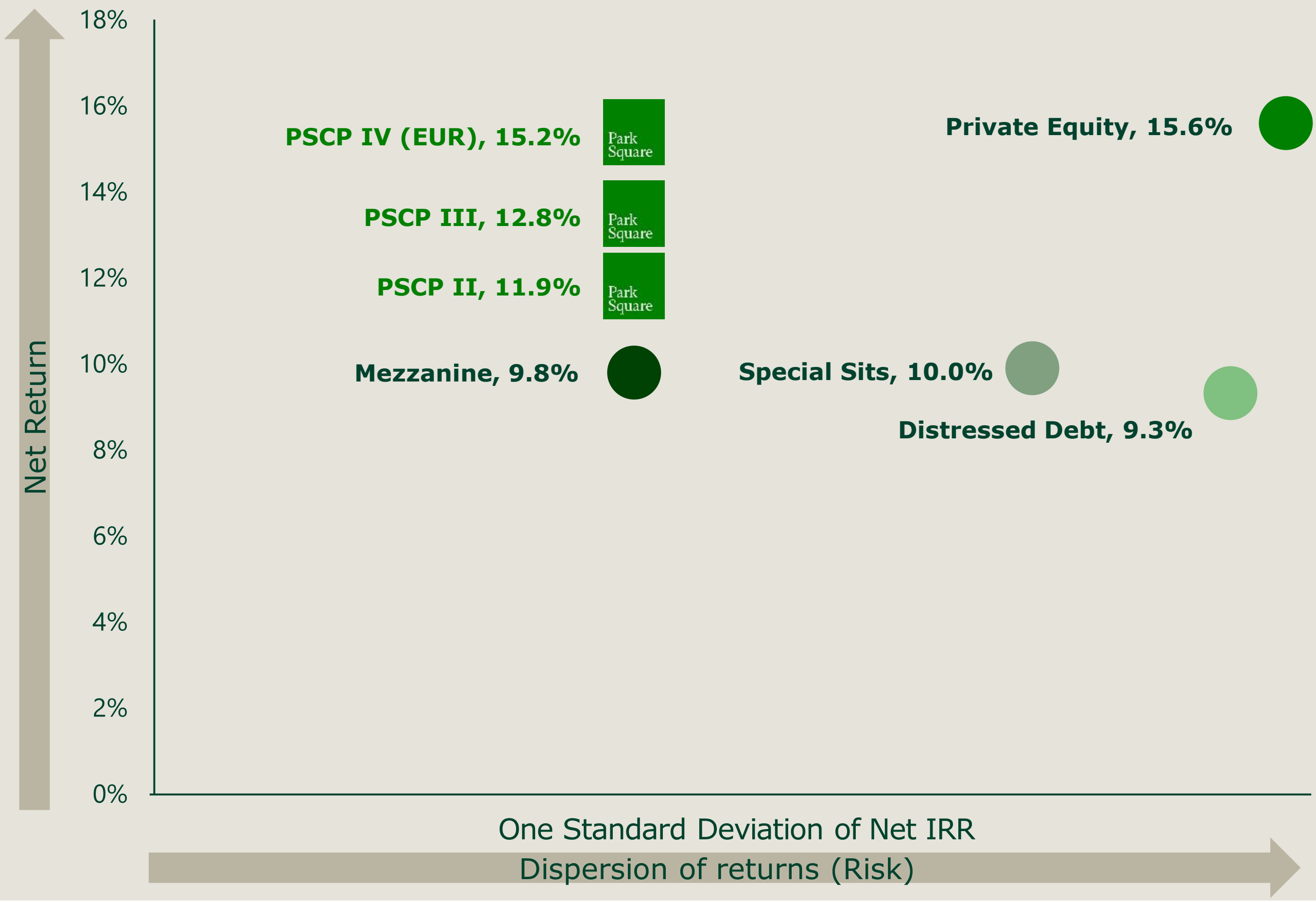
A less crowded market

Though Europe is home to some notable junior lenders, there is a clear contrast between it and the US market where specialist junior lenders have faced a larger number of competitors. While the demand from European companies for mezzanine capital solutions has grown in line with transaction activity and valuations, there are relatively few Europe-based managers with the necessary experience, specialisation and size to address junior lending opportunities.

Relative value

The chart below shows the dispersion of return outcomes across funds in different private market asset classes. Junior capital (or 'Mezzanine') funds exhibit less than half the dispersion in returns than double-digit return seeking funds in other asset classes. We believe this is largely due to the predominantly contractual, recurring nature of the returns available. European junior capital offers a unique risk-return proposition. Park Square LPs have historically accessed 12-14% net IRRs[5] via contractual returns, derived from large, defensive businesses with significant equity cushions.

Risk vs Return for Global Private Debt Strategies vs PE vs PSCP Funds (2005-2018)[6]



Endnotes

(1)	Park Square's historical investment data.
(2)	Source: Standard & Poors.
(3)	Loss rates as at 30 September 2023 and are based on total invested of $22.9bn ($13.7bn in senior, $8.3bn in junior and $0.9bn in equity; includes co-investment vehicles) over 18.7 years in junior and 16.4 years in senior. Past performance does not predict future returns.
(4)	Multiples shown are multiples of EBITDA. Percentages shown are percentages of total capitalisation; market statistics from LCD report (note that EV/EBITDA multiples are from different data set vs leverage multiples).
(5)	Past performance does not predict future returns.
(6)	Source Preqin, X axis shows +/- range of returns from one standard deviation from the mean for each strategy. Sample sizes: PE (Buyout) 3,319 funds, Mezzanine 518 funds, Special Sits 304 and DD 330 funds. (1) Net IRR figures as at 30 September 2023, standard deviation for PSCP II, III and IV (EUR) are not meaningful and shown for illustrative purposes only.

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