

Insight

Junior capital has been integral to Crescent Capital's activities since the firm was founded in the early 1990s by former Drexel Burnham Lambert investment bankers Mark Attanasio, Robert Beyer and Jean-Marc Chapus, *writes Andy Thomson*.

At the time, the firm's junior debt business complemented its syndicated loan and bond investment efforts. It went on to raise its first institutional mezzanine fund in 1995 - the same year it was acquired by TCW Group, which had just seen a certain Howard Marks depart for Oaktree Capital Management.

By the time Christopher Wright joined Crescent in 2001, the firm was raising its third mezzanine fund alongside a small distress-focused fund and a capital markets business. Wright, managing director and head of private markets at the Los Angeles-headquartered fund manager, insists the firm had only one product: a senior subordinated note with upfront fees, a coupon, call protection and an equity kicker with co-investment in the equity.

"Prior to the global financial crisis, our junior debt business was tied to a functioning syndicated loan market," says Wright. "The sponsors would come to the banks for a loan, and we would do the private junior debt. Today, there continues to be a symbiotic relationship between banks and private lenders, but the growth of the private credit space has allowed sponsors more options to finance or refinance credits."

“As it appears that we're in a higher-for-longer rate environment, the PE playbook is going to have to change”



Strategy Crescent Capital eyes junior debt revival

In terms of the range of products private credit firms now provide, Wright says it's a "dramatically different" market.

But, in a sense, things have come full circle. In the ultra-low interest rate environment of recent years, senior debt strategies have dominated private debt fundraising.

Now, in a period of rapidly rising rates, junior capital finds itself again

in the spotlight. Payment in kind has become especially popular, but not for the same reason as during its past heyday in the wake of the global financial crisis

"After the GFC, PIK was needed because company performance was declining," says Wright. "Today, portfolios in general continue to perform just fine - revenues are up, EBITDA is up - but they are cash constrained. Fixed charge and interest charge coverage is coming down and PIK is increasingly in favour as a solution for that."

Wright adds that PIK is being put to three main uses: a PIK toggle to amend an existing document, adding a layer of PIK to provide

The fundraising tempest is easing

'I think next year will be a better year for fundraising because this year we've been in the eye of the storm,' says Wright

He says it is not just the much-hyped denominator effect that has hampered LP allocations but also capital constraints caused by the lack of realisations.

"The cash constraint and denominator effect are getting relieved over time, and we're seeing greater allocations to private credit because it's taking share from private equity and [traditional] fixed income," notes Wright.

"With the democratisation of alternatives, we continue to get capital from institutional investors, but there's been a big drive to get capital from retail investors through an education process that started a while back and has been growing. The wave is getting stronger, and I think there's going to be a significant secular trend of capital raising from retail investors."

liquidity and pay down cash-pay debt and using PIK to support M&A.

"The usage of PIK is becoming more and more important, and I think we're still at the very early stages," says Wright. "You are seeing some deals get done, but as we move out in time under this base rate environment, we're going to see more and more use of PIK to alleviate cash interest restraints."

Maturity wall

Helping to further furnish the opportunity set is a looming maturity wall comprised of loans written in a completely different environment from the one they will face at refinancing.

"Throughout my career, there has been constant talk about an approaching maturity wall, and it never really seems to have hit. We've not had this sort of trajectory in base rates in the past, so I think things are going to be different this time," says Wright. "In fact, we've begun to see seasoned public issuers like Finastra and Hyland Software turn to the private credit markets to address pending maturities."

He says it will be interesting to see how many of the maturing loans can be refinanced by the syndicated market. Unsurprisingly, perhaps, he believes private credit firms could play a major role, offering creative and flexible solutions beyond the wit of the banks in exchange for concessions from private equity sponsors.

He sees the multi-billion refinancing of Finastra in August as a sign of things to come. "The sponsors need to put more equity in for the lenders to provide leverage and in return, they get partial PIK optionality. That's an early indication of the playbook that will be routinely used down the road."

While refinancings represent

an opportunity set that excites many in the market, the overall M&A market has been subdued.

Operating mainly in the sponsored buyout market, sponsor dealflow is an important driver of Crescent's activities.

"Whenever you have volatility, you have a divide between buyers' and sellers' price expectations," says Wright. "We see this with every bout of volatility. But it will reconcile over time as people get more comfortable with the direction of travel in relation to Fed decisions, inflation and the geopolitical environment."

Wright does not believe that the market has yet 'settled' in relation to the still-elevated level of private equity valuations versus the dramatic increase in the cost of finance, so he falls short of predicting a strong fourth quarter for the M&A market. He does expect an improvement next year, however.

But while Wright sees M&A overall making a recovery, he thinks the era of the buy-and-build strategy may be on the wane. This period, he says, saw high multiples being paid for businesses with relatively modest organic growth on the basis of delivering a big boost to EBITDA through a succession of small acquisitions. "Buy-and-build works great with low rates," says Wright, "but it can get a little more challenged when your cost of capital soars. As it appears that we're in a higher-for-longer rate environment, the PE playbook is going to have to change."

In addition to junior capital, Crescent has set its sight on NAV finance due to increasing constraints on the banks. Not insignificant in this context was the acquisition of a 51 percent stake in Crescent by insurer Sun Life in January 2021. "We're seeing insurance companies get into fund finance more and more," says Wright. ■

