Mezzanine and Junior Capital (Private Credit)

Interview preparation summary · PC track

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INT.CM.1.a · Junior capital, instruments and returns

Place junior capital in the capital structure, state a tranche's attach and detach points in turns of EBITDA, and explain why a sponsor uses it instead of more senior debt or more equity.

Junior capital is the layer between senior debt and the sponsor's equity. Senior lenders will usually lend only to a level of leverage at which they are comfortable on cash cover and recovery, and the sponsor does not want to fund the rest of the price with equity, which costs it more than debt. A junior tranche fills that gap. Describe a tranche by its attach point (the leverage through the senior debt, where the tranche starts to be at risk) and its detach point (the leverage through the tranche, where the next layer takes over). A 60m tranche above 120m of senior debt on 40m of EBITDA attaches at 3.0x and detaches at 4.5x, and it is repaid in full only if enterprise value covers everything ranking ahead of it as well. Its cushion is the equity beneath it. For the sponsor the attraction is a smaller equity cheque and little or no loss of ownership, at a price above senior debt. The right measure of that price is the rate on the new money, not the blended rate across all the debt, because the senior lenders would not have lent the extra amount at the senior rate. The usual mistakes are to treat junior debt as sitting beside senior debt, to confuse the size of a tranche with its attach point, and to forget that senior lenders restrict junior debt through the intercreditor terms.

WORKED EXAMPLE: ATTACH, DETACH AND CUSHION FOR A 60M JUNIOR TRANCHE

Hallam Print Group is an invented company with EBITDA of 40m that a sponsor is buying at 8.0x, so for 320m. The financing is 120m of senior debt at 9.0%, 60m of junior debt at an all-in 13.5% (cash plus PIK) and the rest in equity. State the attach and detach points, how far value can fall before the junior is hit, and what the junior debt costs. Ignore transaction costs and fees.

Answer: The tranche attaches at 3.0x and detaches at 4.5x; value can fall 43.75% (from 320m to 180m) before it loses anything. Blended debt cost is 10.5%, but the cost of the 60m of new money is 13.5%.

> **Interview tip:** Give the attach and detach multiples first, then say that the junior is covered by the equity beneath it, and always quote the cost of the extra layer, not the blended cost.

INT.CM.1.b · Junior capital, instruments and returns

Distinguish subordinated mezzanine, second lien, holdco PIK notes and preferred or structured equity by ranking, security, cash or PIK terms and investor protections, and choose between them for a given company.

Four instruments fill the junior layer, and they differ mainly in what they are a claim on. Subordinated mezzanine is a loan of the operating group that is contractually subordinated to the senior debt, usually with a cash coupon, a PIK element, a long bullet maturity, a fee and often warrants; it may carry a second-ranking charge over the same assets or no direct security at all, depending on the market. Second lien is secured on the same collateral as the first lien but ranks behind it for proceeds, usually with a higher cash coupon, shorter terms and less in the way of equity features. Holdco PIK notes are issued by a holding company above the operating group, so they are structurally behind every claim in the group, and the interest accrues rather than being paid, which makes the claim grow. Preferred or structured equity is equity: it ranks behind all debt, pays a dividend that is often paid in kind, has a liquidation preference and usually has no creditor remedies. In general, the further down and further from the assets, the higher the price and the more equity upside is asked for. Choose by what the senior documents allow, what the company can pay in cash, how much structural subordination the investor will accept and what the sponsor values most.

WORKED EXAMPLE: OPCO JUNIOR DEBT AGAINST HOLDCO PIK FOR THE SAME 30M

Calder Marine Services is an invented group with 100m of senior debt and 30m of existing mezzanine, both at the operating company. A sponsor wants a further 30m. Option A is new junior debt at the operating company, ranking equally with the existing mezzanine. Option B is 30m of holdco PIK notes. In a downside the group is worth 140m. Compare the recovery on the new 30m under each, ignoring costs and accrued interest, and say what that means for pricing.

Answer: Option A recovers 66.7% (20.0m) of the new 30m and option B 33.3% (10.0m) in a 140m downside, so holdco PIK must be priced well above opco junior debt.

> **Interview tip:** Say that the instruments differ by what they are a claim on and by who is ahead of them, then show the recovery at one value for two of them.

INT.CM.1.c · Junior capital, instruments and returns

Calculate the return on a junior position from its cash coupon, PIK accrual, fees and warrants, give the IRR and money multiple, and show how an early repayment changes them.

A junior lender's return has four parts: a cash coupon, a PIK coupon that is added to the balance, up-front and call fees, and a warrant or equity kicker that pays only if the equity is worth something. In a typical structure the cash coupon is charged on the opening balance, including PIK already capitalised, so the balance compounds. The yield to maturity is found from the cash flows: the amount funded net of the fee at the start, the cash coupons, and the capitalised balance, any call premium and the warrant proceeds at the end. Warrants usually have a nominal strike, so their value is the lender's share of the equity value at exit. They can add several points to the IRR in a good outcome and nothing in a bad one, which is why they are the speculative part of the return. An early repayment has two effects that point in opposite directions. The IRR usually rises, because the up-front fee and any call premium are earned over fewer years and the warrant is realised sooner, but the money multiple falls and the lender must find somewhere to reinvest. That is why mezzanine carries call protection. The usual mistakes are to add the coupons and the fee into a yield, to forget that PIK compounds, and to quote an IRR without the multiple.

WORKED EXAMPLE: IRR AND MULTIPLE WITH PIK, WARRANTS AND EARLY REPAYMENT

A fund lends 50.0m of mezzanine to an invented company: 8% cash interest and 5% PIK on the opening balance, a 2.5% arrangement fee (so the fund pays out 48.75m), a six-year bullet, and warrants over 4% of the equity at a nominal strike. Find the IRR without warrants, and with warrants if the equity is worth 400m at exit. Then find the IRR and the money multiple if the loan is repaid after three years at 102% of the balance with the equity then worth 250m.

Answer: About 13.6% without warrants and 16.8% with them at a six-year exit (2.26x); repaid after three years it is about 20.0% but only 1.67x.

> **Interview tip:** Always give the IRR and the money multiple together, and say how much of the return is contractual and how much depends on the warrants.

INT.CM.2.a · Downside, intercreditor terms and underwriting

Build a recovery waterfall for a junior tranche, find its value breakpoints, and calculate recovery and loss given default at different enterprise values.

A junior tranche is repaid only from what is left after enforcement costs and everything ranking ahead of it, so its recovery is a thin slice of the value that moves sharply with enterprise value. Build the waterfall in order: take enterprise value at default, deduct the costs of the process, pay any super senior or revolving debt that is drawn, pay the senior debt, and give what remains to the junior tranche up to its claim, with the rest going to the equity. The junior claim is the balance at default, which includes any PIK that has accrued and unpaid interest. The two breakpoints are the enterprise value below which the junior recovers nothing (costs plus senior claims) and the value above which it is repaid in full (those plus its own claim), each grossed up for costs if they are a percentage of value. Between them recovery climbs from nothing to par over a narrow band of value, so a small change in value is a large change in recovery. Loss given default is 100% less the recovery rate. The common mistakes are to ignore costs, to leave out accrued PIK, to forget a drawn revolver and to use the entry multiple as the value at default.

WORKED EXAMPLE: MEZZANINE RECOVERY AT FOUR ENTERPRISE VALUES

An invented group has a drawn super senior revolver of 20m, a senior term loan of 90m and mezzanine of 40m. Enforcement costs are 5% of enterprise value. Find the mezzanine recovery at enterprise values of 110m, 130m, 150m and 160m, and the values at which recovery starts and is complete.

Answer: Recovery is 0%, 33.75%, 81.25% and 100% at 110m, 130m, 150m and 160m, and the mezzanine is in the money only between about 115.8m and 157.9m.

> **Interview tip:** Quote both breakpoints and the width between them, and say that the loss given default of a junior tranche is far more sensitive to value than a senior loan's.

INT.CM.2.b · Downside, intercreditor terms and underwriting

Explain the intercreditor terms a junior lender negotiates (standstill, payment blockage, turnover, purchase option, release and consent rights, a cap on senior debt) and the junior covenants it asks for, and say when to walk away.

A junior lender gives control to the senior lenders in return for a price, so the intercreditor agreement is where its rights are won or lost; counsel drafts it, and the investor must know what to ask for and why. A standstill stops the junior from accelerating or enforcing for a period after a default, so the senior lenders lead. A payment blockage stops cash payments to the junior while a senior payment default continues, usually for a limited time, and the blocked interest remains owing. Turnover requires the junior to hand over to the senior any recovery it receives outside the agreed order. A purchase option lets the junior buy the senior debt at par plus accrued interest when the senior lenders accelerate, so it can control the outcome instead of watching a sale. Release and consent terms govern when the senior can sell collateral and release the junior's claim, and a fair value protection requires a proper sale process. A cap on senior debt stops the senior growing ahead of the junior without consent. Junior covenants are usually set with more headroom than senior ones, with information rights, cross-default and limits on leakage to the sponsor. Walk away when the structure removes control, such as an uncapped senior debt, unlimited blockage and no purchase option, because no coupon pays for that.

WORKED EXAMPLE: WHAT A PURCHASE OPTION IS WORTH WHEN THE SENIOR LENDER FORCES A SALE

An invented group has senior debt of 100m, with 1.5m of accrued interest, and mezzanine of 40m. The senior lenders accelerate and plan a quick sale that would raise net proceeds of 110m. The junior lender believes an orderly sale would raise 140m. The intercreditor agreement gives the junior a purchase option at par plus accrued interest. Compare the junior's position with and without using it.

Answer: Without the option the mezzanine recovers 8.5m (21.3%); with it, an orderly sale at 140m gives 38.5m (96.3%), and even 120m gives 18.5m (46.3%).

> **Interview tip:** Explain each intercreditor term by what it does to timing and control, and give one number that shows why it matters.

INT.CM.2.c · Downside, intercreditor terms and underwriting

Underwrite a junior position by testing total leverage through the tranche, cash and total interest cover including PIK accrual, leverage drift, a downside and refinancing, and make and justify a decision, including when to decline.

Underwriting a junior position starts from the same tests as senior lending but applies them through the tranche and with less margin for error. Total leverage is measured through the junior detach point, not at the senior debt. Interest cover is tested twice: on cash interest, which shows whether the company can pay, and on total interest including the PIK accrual, which shows how fast the claim is growing. Because the balance compounds, leverage drifts upwards if earnings are flat, so test leverage at the end of the term as well as at the start. Then examine what lies around the tranche: the senior lender's terms (its margin, amortisation, covenants and whether it may increase), the sponsor and the equity beneath the tranche as a share of the price, the quality and cyclicality of the earnings, and the way the debt will be refinanced, since a bullet junior loan usually relies on a sale or a refinancing. Run a downside in which earnings fall and see whether cash is still positive and where leverage ends up. Finally decide the amount, the price and the conditions, and be willing to decline. Typical reasons to decline are too little equity beneath the tranche, cyclical earnings with high total leverage, uncapped senior debt and no control in a default.

WORKED EXAMPLE: UNDERWRITING A 70M JUNIOR TRANCHE THROUGH A DOWNSIDE

A sponsor is buying an invented company with EBITDA of 55m for 9.0x, or 495m. The financing is 165m of senior debt at 8.5% cash, 70m of mezzanine at 11% cash and 3% PIK, and 260m of equity. Find total leverage through the tranche, cash and total interest cover, the leverage after three years of PIK accrual with flat earnings and senior debt, and the same measures in a downside where EBITDA is 40m. Ignore amortisation.

Answer: Leverage through the tranche is 4.27x, cash cover 2.53x and total cover 2.31x; after three years leverage is 4.39x, and in the 40m downside cover is 1.84x and leverage 6.04x, so the risk is refinancing rather than payment.

Interview tip: Say that you test cover on cash and on total interest, and that you test leverage at the end of the term because PIK makes it drift upwards.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.