PGIM
India Mutual Fund

The Future In Focus

Pivoting from uncertainty to opportunity.

2021 BEST IDEAS - PART 3

'Bridging The Gap,' In Good Times And Bad

PGIM PRIVATE CAPITAL

‘BRIDGING THE GAP,’ IN GOOD TIMES AND BAD

In times of economic uncertainty, when some senior lenders may be looking to lower their levels of risk, mezzanine lenders who are ready to “bridge the gap” in a company’s capital structure may see a large opportunity within the mezzanine product category.

But during a pandemic?

The grave uncertainty that was caused by the COVID-19 crisis left many companies teetering on the brink of a cash-flow crisis, including plenty in the middle-market arena. Mark Hoffmeister, a Managing Director at PGIM Capital Partners (part of PGIM Private Capital), recalls many hours of corporate counseling in the earliest days of the outbreak.

“In the very beginning, we were staying in constant contact with our portfolio companies on a daily basis, extending an olive branch and letting them know that, if they envisioned cash-flow problems, we would delay interest payments without penalty,” he said.

While the pain was acute for nearly every company at the beginning of the outbreak, some small to mid-size firms have not only stabilized their operations but have actually outperformed their business plans, under unusual circumstances. Hoffmeister tells of a portfolio company that specializes in high-end cookware, with a model based on in-home cooking demonstrations.

“Sales fell by 60% in April and we were bracing for the worst,” he said. “So, we came up with the idea of doing demonstrations online, realizing that no one would be able to taste or smell the food. Well, they made the pivot, and it took off. Their sales, on a month-over-month basis relative to last year, are well above plan. And now going forward this is another leg of the stool for this company to grow.”

Hoffmeister said that while he hasn’t seen a full return of the deal pipeline, companies that are stable and that will see operations improve when a COVID-19 vaccine is available can go to market today. Likewise, there will be many companies that stabilize further in coming months but remain behind their plans. In those cases, senior lenders may want to reduce their exposures but not exit entirely, another opportunity for mezz lenders.

THE APPEAL FOR INSTITUTIONAL INVESTORS

Mezzanine financing provides institutional investors with an alternative to investments in traditional forms of senior debt or equity capital. There’s potential for higher contractual yield relative to traditional senior debt investments and greater stability relative to traditional private equity investments. As a result, many institutional investors view mezzanine funds as having an attractive risk/return profile, offering downside protection and current income.

Another appealing aspect of the mezzanine category is its ability to provide investors with significant diversification from private equity investment return characteristics; the mezzanine market, unlike PE funds, is not solely reliant on leveraged buyout transactions to deploy capital. In addition to financing change-of-control transactions, mezzanine financing can also be used for refinancing, recapitalization, growth financing, and acquisitions. These non-buyout transactions can pose less risk than an LBO as there is less pressure for rapid growth or change of business strategy in pursuit of value creation.

Additionally, mezzanine returns can match or exceed those of private equity returns in a challenging environment. The priority position of mezzanine debt in a capital structure allows for the possibility of a restructuring where the mezzanine holder receives substantial value while existing equity is meaningfully diluted.

Finally, unlike many private equity investments, mezzanine investments are usually not as dependent upon an outright sale to generate liquidity. This is especially attractive given the volatility of the M&A and IPO markets and a greater sensitivity to valuations in equity investment. Mezzanine investments can be monetized via refinancing, recapitalizations, sales, merger events, or public offerings.

PCP'S APPROACH

PGIM Capital Partners leverages PGIM Private Capital's strong and proprietary middle-market investment capability through its 14-office global network and experience in managing a private capital portfolio of more than $90 billion. PGIM Capital Partners has a wide range of deal flow sourced through PGIM Private Capital's direct prospect calling efforts, strong agent and equity fund relationships. This global network allows PGIM Capital Partners to capture inefficiencies in the middle market and generate premium returns.

To achieve strong and consistent returns, PGIM Capital Partners places emphasis on companies with strong value-added businesses and management teams with demonstrated track records and who have a meaningful economic stake in the company's success. It seeks to avoid the cyclicality of leveraged buyout auctions through experience with a variety of transaction types and is capable of managing non-sponsored investments.

PGIM Capital Partner's unique access to a wide range of origination sourcing channels provides increased diversification and closer relationships with key decision-makers among borrowers, enhancing investment returns and improving downside protection.

IMPORTANT INFORMATION