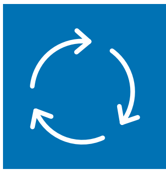

▲ From left: Gus Atiyah, Marilyn Adler, Rafael Castro and Matt Shafer

DealMAX Panelists Discuss Alternative Financing Solutions

The availability and cost of debt capital has led investors to seek different options. Panelists discussed some of these tactics at ACG's annual DealMAX conference.

Rising interest rates, the collapse of several regional banks in the spring and other market headwinds have made new lending capital hard to come by for middle-market portfolio companies. Several speakers at DealMAX's Alternative Financing Solutions panel, held on May 9 in Las Vegas, presented options for companies and sponsors, including fund-level loans, SBIC financing, preferred equity and continuation funds.

GUS ATIYAH: Marilyn, how do you see this current environment differently from previous challenging down cycles?

MARILYN ADLER: I see three major changes in the current environment. The first is that interest rates have jumped so quickly. This jump in interest rates poses a bigger challenge to companies that are small. A lot of companies want some flexibility when we try to work with them.

The second challenge is the pull-back by the banks. It used to be: "Go get bank financing, they're cheaper than we are. We're the backup plan." Now the banks have really cut back and pulled in. Mizzen has found many companies have come to us and said, "We just wanted to have surety when we close the deal. We're happy to pay the higher rate." So this has been a good market for alternative lenders. Mizzen is seeing a lot of deal flow.

The third challenge is more special situation deals due to COVID. Mizzen is finding that most bigger credit funds don't want to focus on companies with under $10 million in EBITDA. Some of these companies were negatively impacted by COVID and their EBITDA dropped significantly. I joke around and call it "dumpster diving." Pass me anything that's too small in terms of deal size or EBITDA. Mizzen saved a number of companies during COVID that were impacted and didn't expect it.

ATIYAH: Rafael, what are you seeing right now in terms of differences today from the previous down cycle and challenges that clients have?

RAFAEL CASTRO: Let me start by introducing NAV lending. NAV loans are a relatively new form of financing in the market. It's when a lender makes a loan based on the unrealized value of a private equity fund. This is typically used by funds that are further along in their life cycle. The dry powder is spent and you have additional needs for capital. It's still a relatively new form of financing, so there is not that much to compare it with.

Obviously, you have the challenges on liquidity and valuation. I think the biggest challenge is supply. Banks generally don't like doing NAV loans; they only do it for certain clients. One of the few banks that actively participated in the NAV lending space was SVB [Silicon Valley Bank]. So now you've got a major competitor that's out of the market. The only players that are still in the NAV lending market consistently are funds like ourselves, which are few and far between.

We think of ourselves as a very cheap form of equity substitution. Unlike Marilyn, we're not thinking about what's the debt to EBITDA ratio at portfolio company X. We're thinking more about what's the overall value of the portfolio? How many remaining assets are there? What does the diversification look like?

ATIYAH: Matt, from where you sit, can you also answer the question about challenges?

MATT SHAFER: Our perspective on this market is informed by being a lender, an owner and a secondaries investor. What we're seeing today across

Moderator

GUS ATIYAH is a partner at law firm Shearman & Sterling, where he is the lead industry coordinator for the private capital practice. He focuses on all aspects of private finance transactions, including leveraged finance, buyouts and debt restructurings.

Panelists

MARILYN ADLER is a managing partner at New York-based Mizzen Capital Management. She manages a credit fund focused on lending to lower middle-market companies with $1 million to $10 million in EBITDA.

RAFAEL CASTRO is a partner and co-founder at Hark Capital, a New York-based firm focused on providing net asset value (NAV) loans to private equity funds based on the value of their unrealized portfolio. Castro is responsible for origination, execution and monitoring.

MATT SHAFER is a managing director and global head of direct private equity at Northleaf Capital Partners, an investment firm headquartered in Toronto with $22 billion in commitments raised across private equity, private credit, secondaries and infrastructure. Shafer leads the origination and monitoring of Northleaf's direct PE investments.

all these perspectives is very different from anything that we've seen before. I've never seen a time where there was so much concern, yet company performance was so good. The good news is that the underlying performance of the assets across our portfolios is healthy. Companies are continuing to grow.

At the same time, there are these two big things that the market needs that disappeared overnight. Number one is capital to support company growth and number two is capital to deliver liquidity to LPs. The other big factor is that the market is much larger since the GFC [global financial crisis]. So we're dealing with something where there is enormous scale, and there is a need for capital both for portfolio companies and for delivering liquidity to investors. Those are the biggest challenges that private equity managers face.

ATIYAH: During the great financial crisis, the system was broken. It didn't matter if you were a high-quality name or a low-quality name, the system was just busted. In the current environment, the velocity of change in the cost of capital has caused a significant pause. It's caused valuation gaps. It's caused folks to be a little more stressed. It's a more challenging time for finding different financing solutions. But there's still plenty of liquidity. It's available. The system is functioning. There's a lot of debt capacity to lend. Being open and nimble is critical. This feels like a pause. And while the machinery is still there and working, there is a dislocation.

Marilyn, starting with your particular debt product, what are you seeing as the challenging things to look out for as you're approaching clients with debt options?

ADLER: When COVID hit, Mizzen saw a lot of companies that were doing really well for years suddenly have negative EBITDA that got thrown into the workout groups at banks. We saw a situation where these companies needed capital to be able to keep operating even though they were in a difficult situation.

For example, our credit fund invested in four sleepaway camps that were shut during COVID and the banks threw them in restricted operations. They wouldn't give them any additional capital to keep their staff and reopen. Mizzen invested $14 million subordinate to the banks. But we were able to get a guarantee of some real estate from the owners. They were able to reopen. They had the two best summers ever and paid the fund back.

We love companies that are small and looking to do roll-ups. But I've had companies say that they want to sell, but they're not getting the valuations they want. People are worried about a recession, so they're going to keep operating and look to sell next year.

ATIYAH: I think that valuation gap exists in all segments of the market. It's because of the velocity of change in the cost of capital. Now, if you were giving advice to someone who wants to borrow capital in this environment, are there common pitfalls to avoid?

ADLER: Mizzen is looking at things like customer concentration and supplier concentration. You need to be as organized as possible. We also do background checks on the CEOs and it's been incredible. Some people are just not forthright with you about their past. Where we've gone through diligence and the background reports came in and it's like, "Did you forget to tell us you were arrested?" So just be as forthright as you can with a lender because they're going to find it on the background report.

ATIYAH: Matt, on the equity side of the financing solutions, what are some of the typical scenarios that you're seeing?

SHAFER: Private equity managers want to grow portfolio companies. They want to keep doing acquisitions, but we can only get 4.5x leverage right now. They used to be able to get 5.5x. That's a great opportunity for preferred equity. And we think of that as either expensive debt or cheap equity, depending on how you look at it. What we find is that the cost of capital is not irrelevant, but if it allows the sponsor to continue their roll-up strategy and benefit from synergies and multiple arbitrage, they are willing to give a very good return to that instrument.

As for the fund liquidity toolkit, continuation vehicles are a great solution. They allow private equity owners to hold their assets for longer, crystallize carry and also deliver liquidity to LPs. And they tend to come with growth capital in the form of unfunded commitments. It has really become an important part of this whole toolkit that's available for liquidity needs. I don't expect they will go away. I think usage will grow.

CASTRO: Matt, would you mind touching on the changes in perception among LPs and GPs from several years ago to now?

SHAFER: I think there was a little bit of a taboo around continuation vehicles and the whole market went on a journey. Fifteen years ago, it was taboo to sell your LP stakes in the secondaries market. And now everybody recognizes this is healthy for the market. The ability of an LP to sell out of a commitment helps that LP make further commitments to the industry. Continuation funds have had a similar trajectory over the past decade, starting out as something only used by more marginal managers and now becoming a mainstream part of the industry used by the best managers for their best assets.

Continuation vehicles do create legitimate issues for LPs, and I'm sympathetic to that. It's forced LPs to make calls that they didn't think they'd have to make when they signed up for a fund. This puts pressure on limited resources. There are also conflict issues that need to be looked at in every deal. These are legitimate concerns that need to be listened to, but the LP community is increasingly accepting this solution.

ATIYAH: Rafael, on the NAV product, how's it going to be appropriated? If someone can't go to Marilyn or they talk to Matt and preferred equity isn't the right thing for them, where do you step in?

CASTRO: Ten years ago, in 99 out of 100 conversations with GPs, I would describe what we do, and it would blow their minds. It's very hard to sell a product that people don't know exists. Certainly, in the last three years, that's changed. As we walked into the lockdowns and COVID, there was a lot of growth and education for alternative finance solutions. And while that didn't immediately translate into deal flow, we fast-forwarded three years. The market has become educated and interest rates went up. If you were getting 5.5x leverage, now that's only 4.5x. Now you've got a full turn of equity that you need to cover. Let's say that you're on year eight of the fund and you've got very limited dry powder. What do you do?

A lot of LPAs [limited partner agreements] are now being written keeping in mind that maybe this fund will need a small NAV loan in the future; maybe we need to adjust the provisions. My advice to any sponsors out there is: If you're raising a new fund, engage your fund counsel about NAV lending and have them at least be educated and thoughtful about it. Otherwise, you're looking for amendments later when you're trying to close a deal.

ATIYAH: That's a great point: having the foresight to plan the plumbing of the fund to account for that as an option. When people come to us and want to do a product like this and they find that the LPA doesn't provide for it, it raises issues of getting amendments. That becomes a cost of looking at this product. Planning ahead and maintaining flexibility—especially in this environment—for all kinds of financing solutions is important advice. //

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> **MARILYN ADLER**
> *Managing Partner, Mizzen Capital Management*