

Adventures in Unrated Debt Investing: *Acting Like An Owner*

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Liquidity is provided in greater amounts and variety each year in the form of junior debt for leveraging companies. This has resulted in a significant amount of junior debt now residing with a large number of unrated middle-market companies. Some investors in such debt are veterans of the subordination arrangements that go along with this style of investing. Other investors have arrived at this adventure in unrated debt investing relatively recently. These newcomers come from backgrounds where they are accustomed to readily available liquidity driven by large pools of equivalently informed and sophisticated investment managers. For those who are newer to this arena of investing—unrated junior debt of middle-market companies—this article offers a framework for protective action against downside risk in what is a relatively illiquid, covenant-light market. For traditional junior debtholders experienced with this market, it presents a viewpoint for choosing behavior in a changing world where uncertainty can cause harm with increasing speed.

CAPITAL STRUCTURE OF A BUYOUT

In a typical middle-market leveraged buyout, the capital structure of the acquired company is 20–30% equity (which is provided by a “sponsor”) and 50–60% senior secured debt (“senior debt”) provided by a bank or commercial lending institution, with the balance provided as “mezzanine” capital,

sometimes as preferred equity but usually as subordinated debt. Recognizing that such non-senior debt comes in various forms, this article will refer to any such non-senior debt as “mezzanine debt” without trying to differentiate the characteristics.

The senior debt will be secured by a first security interest in substantially all of the company’s assets. Sometimes the mezzanine debt is secured by a second position in those assets, sometimes not. The senior debt will be governed by a senior credit agreement and related documents. The mezzanine debt will be governed by a note purchase agreement and related documents. The note purchase agreement will usually be cloned from the senior debt credit agreement in large part and will contain financial covenants similar to those in the senior credit agreement, but set at looser levels. It will also contain events of default similar to those in the senior debt document.

There will also be a subordination agreement between the senior debt and the mezzanine debt that sets forth the terms upon which the mezzanine debt is subordinated to the senior debt. Subordination terms vary, but generally include payment blockage, turnover, and standstill rights in favor of the senior debt. Generally, if the mezzanine debt has a default, there is a cross-default to the senior debt. And when the senior debt has a default, it has the right to block the company from making payments to the mezzanine debt. Typically, that right is unlimited if the senior default is a payment default in respect of the senior debt. If the senior default is any other default, the

