The Middle of the Stack

Most projects do not fail for want of senior debt or for want of equity. They fail in the gap between the two.

Why the gap exists

Senior lenders advance against a conservative view of value and cash flow, and they have become more conservative as capital rules and portfolio discipline have tightened. Equity is expensive and, for most sponsors, scarce. The result is a funding layer — often the difference between what the senior lender will advance and what the project requires — that neither party is willing to occupy.

That gap is where private credit has grown, and it is where a great deal of the structuring effort in any transaction is concentrated. Filling it well is often the difference between a project proceeding on acceptable terms and not proceeding at all.

The instruments

Mezzanine debt sits behind the senior facility, contractually subordinated, usually secured on a second-ranking basis or on the shares in the borrower. It carries a higher coupon, frequently with a portion accruing rather than paid in cash, and it behaves as debt: fixed obligations, defined maturity, limited upside.

Preferred equity sits in the equity column but ahead of common equity in distribution. It typically carries a preferred return and a redemption right rather than a maturity date. Because it is not debt, it does not consume senior debt capacity or breach leverage covenants — the reason it is often the instrument of choice where the senior facility has already been documented.

Hybrids and participating instruments blend the two: a lower coupon in exchange for a share of the outcome, or a fixed return with an equity kicker on exit. These are negotiated rather than standard, and their economics depend entirely on the specific downside they are being asked to absorb.

What the middle layer actually costs

The headline cost of junior capital is invariably higher than senior debt, and sponsors routinely reject it on that basis alone. That comparison is the wrong one. The correct comparison is between the blended cost of a stack that includes the junior layer and the cost of the alternatives: more common equity, a smaller project, or no project.

Measured properly, a junior tranche that preserves sponsor ownership and allows the project to proceed at full scale is frequently the cheapest capital in the structure, because the equity it displaces was the most expensive money available. The arithmetic favours the junior layer far more often than instinct suggests.

Points that decide the outcome

- Intercreditor terms. Standstill periods, payment blocks and enforcement rights determine what the junior lender can do in a stress, and therefore what it charges.
- Cash pay versus accrual. Accruing coupons preserve liquidity during construction and compound; the exit must be modelled against the accrued balance, not the drawn amount.
- Control rights. Consent thresholds, board observation and reserved matters are usually more contentious than price and matter more in a downside.
- Exit mechanics. Redemption triggers, refinancing rights and change-of-control provisions frequently constrain the sponsor's future options more than the coupon constrains present cash flow.

Sequencing

The middle of the stack should be designed at the same time as the senior facility, not after it. A senior facility documented without contemplating a junior layer will typically prohibit one, and reopening it later is slow, expensive and occasionally impossible. The cost of that sequencing error is paid in equity dilution, and it is entirely avoidable.

The cheapest capital in a structure is rarely the one with the lowest coupon.