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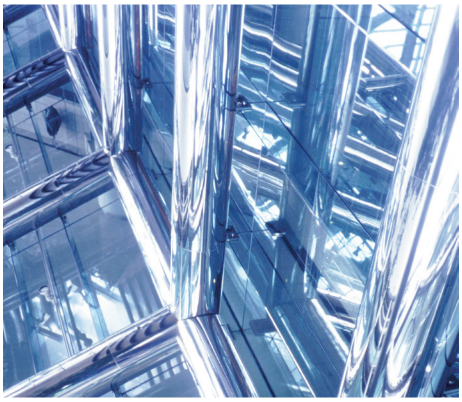
Keeping it simple – the Unitranche demystified



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One of the main exam strategies available to the struggling pupil is to pepper an essay with long words, giving complex names to simple ideas. Are you proposing to consider both sides of an argument, or are you viewing the problem through the lens of Hegelian dialecticism? You might be struggling with your English exam – but will your teacher really know whether you understand your own casual deconstructive observation that "*il n'y a pas de hors-texte*"? Probably not. And if I were fortunate enough to be sitting my own GCSEs again, I would probably see whether I could throw in a few references to "Unitranches".

The only problem would be that everyone else would be doing the same thing. Although the term has been used to describe finance offerings in one way or another for almost a decade (albeit only latterly in Europe, to any significant extent), it enjoyed a surge in popularity during the first half of 2013, when we scarcely spent a week without hearing the term used or reading an article around it. Overuse of a term, of course, strips it of any real meaning; there is no need for a fancy new name for a capital structure that involves just a single layer of debt. We could call it, for example, a "loan". But is there anything really going on here? Is the term ever used to denote something meaningful? Yes, it is – and properly used, it in fact signifies something that is the model of simplicity.

A sponsor contemplating an acquisition or leveraged refinancing based on a traditional financing structure may, depending on the leverage multiples involved, need to raise equity, senior debt finance and junior (second lien or mezzanine) debt finance. A unitranche aims to replace the second and third of those layers, and possibly a portion of the first, with a single debt injection provided at a blended cost. The result is a simpler capital structure.

There is no reason in principle why a unitranche could not be underwritten and syndicated in a similar manner to a traditional senior loan, but that would require a broad base of willing investors in 'stretched' senior debt. In practice, and subject to what follows regarding 'retranching', unitranches have tended to be provided by a single lender and can usually be viewed hand-in-hand with direct lending, so that there is a direct relationship between one lender and one borrower.

As a result of the fact that unitranches are usually not designed to be marketed to a potential syndicate, they can be highly bespoke. The party negotiating the credit documents with the borrower is also the party that will own the risk going forward and they can, therefore, negotiate with both eyes on the credit, rather than one eye each on

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the credit and the market. There is no pressure for the documents to resemble other recent documents for similar transactions, meaning that the borrower may well find it easier to negotiate tailored provisions around their individual needs, rather than trying to fit into an off-the-rack product. Nevertheless, because of the nature and investment goals of the institutions that commonly provide unitranches, some characteristic features are often found:

- bullet repayment, with no amortisation. The direct-lending providers of unitranche loans, in common with traditional mezzanine or high yield investors, are often more concerned with putting their money to work at an agreed coupon for an agreed period than they are in the gradual return of their capital prior to maturity.
- call protection. For similar reasons, unitranches often include 'make whole' features and premia payable on prepayment.
- tailored covenants. Unitranches may include incurrence covenants, maintenance covenants, or a mixture of the two. A unitranche may have no traditional financial maintenance covenants, for example, or it may mix one or more maintenance covenants with incurrence-based negative undertakings around debt and security.
- a combination of cash and PIK margins, or PIK-toggle features, again tailored to the individual needs of the relevant business.
- no syndication. As discussed above, the borrower will commonly benefit from the absence of a syndication process – meaning no flex risk, and no need to assist in or pay for a marketing programme.

One of the advantages for a borrower of engaging a unitranche provider is that their future consents and waivers process will be streamlined. Subject to what follows, it is commonly the case that the original lender will intend to hold the debt until maturity (although the loan agreement will include ordinary transfer provisions as a protective measure). This means that the borrower will normally have a single point of contact for waiver and amendment requests, and that point of contact will be the only person in the entire (term) debt structure whose approval will be required (with no need to go out to a syndicate, or to obtain the approval of both senior and mezzanine lenders).

One nuance to the above is that the unitranche lender will often retain a right to 'retranche' the loan. Retranching will involve converting the unitranche into "first-out" and "second-out" pieces, with the former usually transferred to another lender. The retranching will usually be done behind the scenes, so that, for example, the borrower continues to pay the agreed coupon on the entire loan, with the two lenders then allocating that amount between themselves in agreed proportions. The first-out will recover first from the proceeds of any enforcement; the coupon paid to them will therefore be lower and, as the rate paid by the borrower on the entire loan is unaffected, the returns on the second-out are increased. The second-out will ordinarily be sized so as to continue to control all waiver and amendment issues, so that the position of the borrower is unaffected, although bilateral agreements may of course be entered into between the first-out and second-out lenders on whatever terms they may agree. The transaction may be structured so that the borrower shares some of the benefit of a retranching, in that it may be permitted to prepay all or a portion of the first-out at par from free cash flow (whereas prepayments would otherwise be subject to premia, as described above).

First-out segments of unitranches can be a good opportunity for senior lenders to participate in the unitranche structure, since they can offer relatively low-risk opportunities to put money to work in a structure where there is substantial debt cushion behind them. Traditional banks may also be involved in such structures by providing any revolving and/or hedging facilities that may be required. Revolving facilities, and hedging arrangements, may rank pari passu with, or super senior to, the unitranche, and may be subject to caps agreed with the unitranche provider.

Unitranches may not be for everyone. For one thing, if an all-senior package is available at the same leverage multiple, it is likely to be a cheaper option. Additionally, borrowers with plans to de-lever through cashflow generation may find the call protection regimes unworkable (although specific negotiation of those regimes may well be possible). But if you are considering launching an LBO offer or a leveraged refinancing, and a unitranche provider believes that it can cover several layers of your capital structure at an equivalent blended cost of capital, potentially reducing the required equity cheque, with a bespoke covenant regime, no syndication costs or flex risk and a single contact both for timely deal execution and on-going covenant compliance issues, then they are probably worth at least speaking to.

The unitranche may well be a useless reference in your business studies exam, for it does not denote a product of complex financial engineering: it is simply a loan from one party to another. Keep it simple – consider the unitranche.