Unitranche financing—an introduction

Produced in partnership with Lee Federman

Unitranche facilities have become one of the main financing options available to both financial sponsor-backed and non sponsor-backed borrowers in the European leveraged loan market. These financings originally became popular in the US mid-market in 2005 and since 2012 have their share of the European mid-market year on year.

This Practice Note explains what unitranche facilities are, outlines the advantages and disadvantages to borrowers, and explains in detail their key characteristics.

See Practice Note: Acquisition finance—introductory guide for more general introductory information on acquisition and leveraged finance. For an explanation of some of the terms used in this Practice Note, see: Glossary of acquisition finance terms and jargon.

What is a unitranche facility?

Typically, a unitranche facility is a single tranche term loan with a blended senior/junior interest rate. It is usually documented in a single loan agreement.

Unitranche facilities are generally provided by non-traditional lending entities ie private debt funds and other alternate credit providers, and are provided in amounts ranging from between €10m right up to €2bn. At the larger end of the scale, debt funds regularly compete against the high yield and European Term Loan B markets for the most high profile and complex transactions, including large public to private financings.

On a typical unitranche financing, a debt fund will pair up with a commercial bank which will provide the borrower with a revolving credit facility and potentially certain other treasury services including hedging. Debt funds do not typically provide working capital facilities. The revolving credit facility is documented in the same loan agreement as the unitranche facility and the intercreditor dynamics between the revolving credit facility lenders and the unitranche facility lenders are set out in a separate intercreditor agreement. Generally, debt funds will be require a full guarantee and security package, similar to those put in place in the bank market.

Advantages and disadvantages for borrowers

Advantages for borrowers

Unitranche facilities offer borrowers a range of benefits, including:

- more flexible terms than in traditional loan structures—these can often include a number of European Term Loan B features, such as grower baskets, carry forward basket allowances, debt incurrence covenants (see Practice Note: Leveraged finance—financial covenants) and more operational flexibility under the covenants (see Practice Note: Negotiating general undertakings in acquisition finance transactions). Most direct lending deals are 'covenant loose' comprising a single net leverage covenant tested on a quarterly basis often with significant add-backs to EBITDA and generous equity cure rights
- bespoke terms tailored to the individual borrower’s needs
- simpler decision making as most transactions are bilateral or otherwise with a small club of lenders
- given the buy and hold strategy adopted by the debt funds, syndication risk is eliminated as well as the need to negotiate market flex
- speed of execution—closing the transaction is often quicker and less costly as a result of the small number of transaction participants, fewer documents and the absence of a syndication process

- less onerous debt service requirements—in particular as a result of a very limited, if any, amortisation, no excess cash sweep and a generally more relaxed approach to mandatory prepayments.

Disadvantages for borrowers

There are, however, some disadvantages from a borrower perspective, in particular:

- higher interest margins
- call protection essentially locks borrowers into this expensive financing for a minimum period in which they are unable to use excess cash to reduce the debt through making Voluntary prepayments
- if an Agreement Among Lenders (**AAL**) is used instead of an Intercreditor Agreement, it may be unclear to the borrower how lender decisions are taken
- higher margins—given the advantages outlined above, typically this is more expensive debt although the pricing differential to bank debt is reducing all the time. Direct lenders seek to mitigate the pricing differential through being creative as to how they achieve their yield and will often offer borrowers the ability to capitalise or PIK some of their cash-pay margin
- call protection—borrowers are locked into a unitranche financing for a minimum period so as to mitigate debt fund's refinancing risk. Compensation for lost yield usually takes the form of a prepayment fee, makewhole premium or a combination of both
- equity investment—some direct lenders also seek to hold equity in their borrowers in the form of warrants which may not always be popular with borrowers. Debt funds will also require a board observer in some circumstances which allows debt funds access to more information on to the management of the borrower group

Key characteristics of unitranche facilities

First loss/second loss facilities

A variation of unitranche financings is the establishment of first loss/second loss platforms either between a debt fund and a bank or between different debt funds. These structures allow banks or other debt funds to hold a portion of the unitranche debt, on a basis that, in an enforcement or an insolvency scenario, the bank is repaid its sub-tranche of the unitranche debt prior to the debt fund (it ranks second loss in the waterfall of enforcement proceeds).

The reduced risk for the First Loss/Second Loss Facility enables it to be priced at a lower level which in turn allows borrowers to receive the benefit of a lower blended interest rate for the unitranche facility.

Intercreditor agreement

The RCF usually ranks super-senior vis-a-vis the unitranche and will take priority in payment upon enforcement. However, it is worth noting that because the unitranche is usually the largest piece of the capital structure, unitranche lenders customarily retain the ability to trigger acceleration and enforcement, thus protecting their position.

For detailed information about intercreditor agreements in European unitranche financings, see Practice Note: Intercreditor issues on European unitranche deals. See also Article: Intercreditor considerations for super senior lenders in unitranche financings (2016) 4 JIBFL 213.

For information about typical provisions in intercreditor agreements, see Practice Note: Intercreditor agreement—key provisions.

Agreements Among Lenders

Unitranche financings are sometimes provided by a group of lenders rather than by a single lender via a bilateral facility. Alternatively a debt fund may originate the unitranche financing with the borrower and sell down its participation to other debt funds. In unitranche financings where there are multiple lenders, they often agree to receive lower/higher pricing between themselves to reflect the lower/higher risk they are taking. In this situation, a separate and bespoke agreement among lenders (**AAL**) is negotiated to regulate the relationship between the unitranche lenders in relation to return, risk and enforcement rights.

An AAL differs to an Loan Market Association's (**LMA**) intercreditor agreement primarily due to the fact that the borrower is not a party to it and hence not bound by or aware of its terms. This creates a tension in a restructuring scenario where, unlike in a senior/mezzanine structure, the borrower does not have an appreciation of where control rests or indeed where the value may break.

The AAL bifurcates the unitranche debt by distinguishing between 'First Out' (ie senior) lenders and the 'Last Out' (ie junior) lenders. First Out lenders usually receive a lower proportion of the blended unitranche margin payable under the facility agreement but will be first to receive interest and (upon satisfaction of certain conditions) principal (re)payments. Cash interest is generally paid to the First Out lenders and PIK interest is allocated to the Last Out Lenders, in each case, pro rata to their participation. First Out lenders have control of any enforcement process, an arrangement which is similar to how senior lenders are treated in a standard senior/mezzanine structure. Voting decisions are based on the majority of both First Out and Last Out (junior) unitranche lenders.

Both senior and junior unitranche lenders will typically benefit from 'rights of first offer' and each set of lenders has the option to purchase the other’s debt in certain situations such as following insolvency, non-payment acceleration, or failure to consent to specific amendments.

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