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Search and Recovery (Last of a series)

THE LEAD | November 28, 2018

As we conclude our special series on leveraged loan recoveries, let's take a look at one structure that is testing the way credit managers think about loan value.

Unitranche financings are so much a part of the middle market buyout landscape today, that it's hard to imagine a time without them. Yet on the evolutionary time scale of LBOs, the one-stop, one-tranche option is a recent arrival.

As we've noted in a *Lead Left* whitepaper, the unitranche was a creature of the credit crisis. When visibility on loan buyers dried up amid 2008-09 market volatility, loan syndicators pulled back on forward underwriting commitments. That left private equity sponsors with a critical tool missing from their kits.

Allied Capital (subsequently acquired by Ares) and GE Antares formed the first unitranche partnership, which circumvented the syndication process. It also eliminated pricing and structural flex, as well as intercreditor issues between senior and junior capital providers. For a while, it was the only unitranche option.

That has changed. Today many direct lenders have joined the game. Most of these are structured as a strip blending the pricing and leverage of a first-lien/second-lien (or mezzanine) alternative.

As our *Chart of the Week* shows, unitranche leverage data for private club deals (as collected by LPC) show a steady level around five times debt-to-ebitda. That goes for the bifurcated unitranche financings as well, though these represent a declining share of the overall one-stops.

Last week we dug into the math behind recovery rates as senior leverage has risen. LPC's most recent private club leverage stands at **4.3x**. We calculated around a **56%** projected recovery – lower than the 77% historic level estimated by Moody's, but well above the Moody's 14% for second-lien recoveries.

So where does that put recoveries for unitranche? There haven't been enough real-life examples to draw reasonable conclusions. But let's use the **61%** figure Moody's has for *projected* first-lien recoveries. 61% of **5.2x** – the average uni-leverage LPC data depicts in our *Chart* – produces a **3.17x** recovery. Are today's unitranches being priced for that expected outcome?

Going to our LPC friends again, their private club data show current unitranche spreads at just a shade under **L+600**, down from L+690 in 2014. Average *first-lien* middle market loan spreads (both syndicated and direct) were **L+558** at 3Q 2016. Unitranche arrangers are pricing *total leverage* where *senior leverage* was priced just two years ago.

As direct lenders head into 2019, the likelihood of a credit reckoning increases. The most experienced managers should be keeping a close eye on how the loan risk/reward dynamic unfolds, and particularly how this could impact recoveries down the road.