THE LEAD
https://theleadpc.com/2022-capital-markets-outlook-third-of-a-series/

2022 Capital Markets Outlook (Third of a series)

THE LEAD | March 3, 2022

This week Churchill's Kelli Marti and Jessica Nels continue their special series on the capital markets outlook for 2022 [link] with a discussion of the unitranche trend.

Once considered a novel concept, the unitranche – a one-stop senior secured financing melding senior and subordinated tranches into one – has captured the attention of private equity sponsors and lenders alike. Both dollars (nearly $25 billion in issuances in 4Q21) and market share (36% of middle market LBO financings in 2021, up from 10% in 2016) are growing at a remarkable pace.

The one-stop's popularity to finance M&A activity is driven by several compelling attributes. A single tranche eliminates inter-creditor negotiations and documentation. It also allows private credit managers with expanded hold positions to provide increasingly jumbo-sized unis executed by a small lender club.

This approach eliminates the need for a traditional, and often lengthy, syndication process. Thoma Bravo's Stamps.com LBO was supported by a $2.7 billion uni which was reportedly distributed among only four lenders. As a private credit issuance, it further eliminates the need for a public debt rating; like the syndication, a costly, time consuming, and distracting proposition.

Unitranches ultimately provide certainty of execution, confidentiality, and increased flexibility – all critical to PE buyers (and sellers) in the current period of public market volatility. Sponsors also prefer to smaller lender groups to ease the negotiations for future potential amendments.

Given the inherently higher debt-to-ebitda leverage of a combined senior/junior structure, investors often wonder whether unis carry higher credit risk? A key mitigant is the growing cash equity component of market capital structures.

According to Refinitiv LPC increased issuance has been accompanied by record average purchase price multiples; now 14x at 4Q 2021. This is translating to cash equity close to 50% of the capital structures, meaning a conservative LTV at just over 50%, providing enterprise value cushion for lenders.

Two other recent uni phenomena are also worth noting. Covenant-lite one-stops, also once dismissed by direct lenders, have reached unprecedented levels in both the large cap and middle market segments with nearly $35 billion in issuance in 2021. Compare that to less than $1 billion issued in prior years.

The mega-tranche also made headlines last year. Content partner DLD has tracked $50.7 billion in U.S. jumbo unitranche financing since September 2019 and $39.6 billion in 2021 alone.

These variants of the unitranche are offered to sponsors to arbitrage direct lending and the broadly syndicated market by providing competitive solutions as each market competes to put money to work.

And what chunks of money it is! With cash flowing briskly back into retail loan funds and private credit investors increasingly attracted by its attractive attributes, expect unitranche financings to be prominent features of the buyout financing landscape in 2022.