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The Unitranche – What it is, and Why it Matters (Second of a Series)

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A senior risk officer we know read with interest the first of our multi-part series on the unitranche product [link]. "What's interesting is how quickly these one-stop financings have become the product of choice for borrowers," he told us. "The unitranche is a real paradigm shift for borrowers and lenders, thanks to its ease of execution."

Our friend's observation has been echoed by many observers of the leveraged loan market. A product that began as a by-product of the credit crisis has become a permanent feature of the capital landscape. No longer just a hyper-stretched senior loan, unitranches now replicate many financing options for the issuer – senior debt/mezzanine, first- lien/second lien, even ABL/term debt – all under one document.

Lincoln International publishes a helpful guide to these alternatives [link], but the simplest is a small RC and unitranche term loan. The provider lends through the total leverage (say, five times ebitda) in the structure. Other lenders may participate in the tranche via an Agreement Among Lenders (AAL); a topic we'll cover later in our series.

A variant would be a term loan bifurcated into first-out (at perhaps 3.5x leverage) and last-out (through five times). In this case, each tranche has separate treatment under the repayment waterfalls, along with separate voting rights, remedy standstills, and so on – all governed by the AAL.

For companies like distributors or retailers with greater working capital needs, a split collateral unitranche may be employed. An asset-based RC is secured by a first-lien on receivables and inventory, while a term loan has a first-lien on the other assets, and a second-lien on current assets.

One interesting permutation is the so-called inverted, or "upside-down", unitranche. This involves a much smaller low-leverage first-out, and larger second-out. Because it's well within even a significantly discounted enterprise value, the first has few rights from a voting perspective. The last-out carries most of the risk so seeks to control the debt.

The suite of available unitranche structures is dizzying. Proskauer's Bill Brady reports seeing a hybrid involving an ABL split collateral deal that included term loans A, B, and C, carving term collateral into first, second, and third liens. Each tranche had its unique risk and return considerations. "The sophistication of the unitranche today provides an opportunity for lenders to be creative," he says. "It's really about starting from a blank canvas, if you can get all parties to agree. The opportunities to craft creative solutions and structures are virtually limitless."

In whatever its form, each unitranche should offer roughly equal terms of all-in pricing and total available leverage to the issuer. That takes balancing between yield demands of each of the unitranche components. The larger the second-out piece, for instance, the lower yield imposed on the first-out to maintain the same interest costs.

All this borrower optionality now requires significant legal engineering. Unlike early unitranche intercreditor agreements, building an AAL that clearly defines buyout rights, application of proceeds in a bankruptcy, and pricing no longer runs only five pages.

Next week continue our unitranche series by examining the intercreditor document – the Agreement Among Lenders (AAL).