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

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So far in our unitranche series we've examined the structural variations of this increasingly popular financing tool for leveraged lenders and sponsors. This week we look behind the curtain at the dynamics between lenders in the unitranche itself.

For some unitranche options, one debt provider alone mimics the leverage that would be offered by both first and second lien (or senior and sub) lenders at a blended pricing of the two debt layers. Size is less a limiting factor today as one-stop credit solution suppliers can underwrite and hold $250 million or more, distributing the paper within various vehicles under their control.

The unitranche can also be bifurcated behind the scenes into first-out and second-out term loans with different lenders providing each piece. Unlike a multi-tranche financing with separate credit and security agreements (and distinct security interests), the relationship between unitranche lenders is governed by one document called an Agreement Among Lenders, or AAL.

The AAL is outside of the credit and security agreement between the unitranche provider and the borrower, and is negotiated by the lenders. The main purpose of the AAL is to clearly outline the intercreditor terms and conditions. As we discussed last week, because so many unitranche alternatives exist, each AAL is unique.

First each tranche must be clearly defined. If an ABL revolver is involved, it is typically included in the first-out loan and everything else is second-out. If there are other debt layers, each must be distinguished in terms of rights and provisions relative to the others.

Sharing of the economics is straightforward. Unitranche is a synthetic blend of first-out and second-out costs to the borrower – higher than the first-out and lower than the second-out typically receive alone. Accordingly, the first-out lender must pass along a share (or "skim") of the blended rate to the second-out lender. The amount of skim depends on how leveraged the first-out is, thus how much risk is borne by that lender.

Interest and principal payments are shared *pari passu* unless a "waterfall trigger event" occurs. Triggers include payment or covenant defaults under the credit agreement, and bankruptcy. In those cases payments or liquidation proceeds go first to the first-out.

Voting rights may the most important, and heavily negotiated, of AAL provisions. In general, consent of both required (i.e. majority of) first-out and second-out lenders is necessary to amend or waive the credit agreement. When the second-out is over-weighted relative to the first-out (the "upside-down" unitranche), that lender might have more favorable rights than the first-out. The same is true of buyout rights.

A complete analysis of all AAL permutations is beyond the scope of this commentary, but we will be working to aggregate expert opinions for our readers on this timely topic.

Given the growing complexity of unitranches, it is crucial to have a high level of trust among first-out and second-out participants. As one attorney puts it: Know your lender!

Next week we continue our series by looking at the universe of unitranche players.