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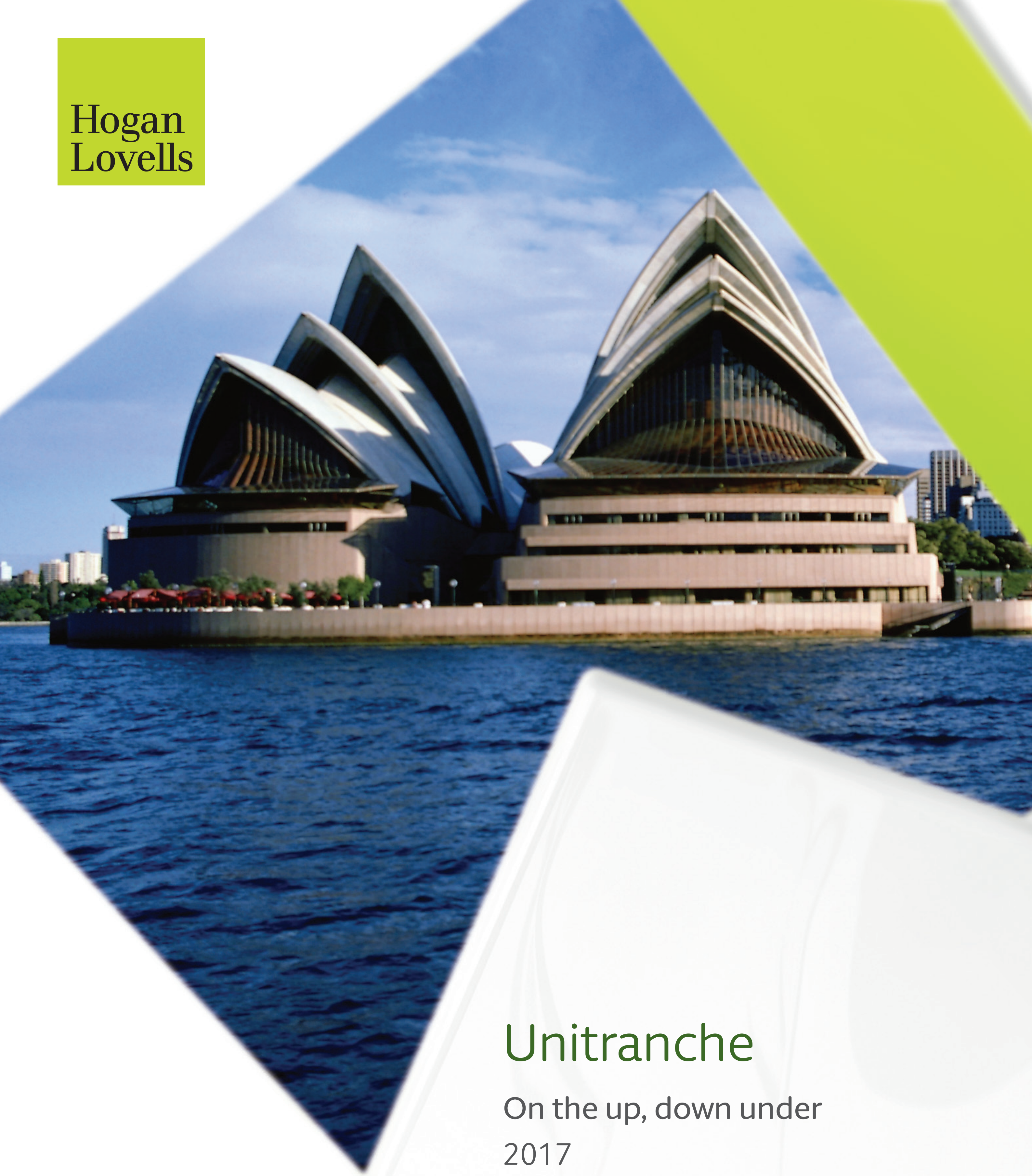

Unitranche

On the up, down under

2017

Unitranche facilities have been a feature of the European and U.S. markets for a number of years, and have recently been making their mark in Australia. In this article, we provide a brief introduction to unitranche, focus on the intercreditor issues which can arise when it is combined with a revolving credit facility, and look at how unitranche has evolved in Europe and is currently developing in Australia.

What is unitranche?

A unitranche facility is a single facility which replaces the need for separate senior and mezzanine facilities and carries a blended margin. It tends to be provided by a single lender on a take-and-hold basis.

Where has it come from?

Unitranche began life around 2005 in the U.S. mid-market, and spread into Europe in the wake of the global financial crisis in 2008. European banks were forced to de-lever their balance sheets post-2008, and also saw themselves subjected to more stringent capital adequacy requirements under Basel III. Non-bank lenders, the main providers of unitranche, are outside the reach of Basel III and, having initially taken the opportunity to fill that funding gap, have since seized a large share of the European mid-market.

Non-bank lenders in Australia have long provided subordinated debt, but have recently begun to take a larger market share by providing unitranche facilities. In addition to local non-bank lenders such as Challenger and Metrics Credit Partners, a number of global players such as Barings (formerly Babson), ICG, KKR Credit, Partners Group and Bain Capital (formerly Sankaty) have a well-established presence down under and have begun to look to replicate the success their European and U.S. offices have had with unitranche. The global sponsors that are active in Australia have also contributed to this migration of the product from Europe and the U.S.

What are some of the characteristics of unitranche?

In order to guarantee returns for their investors, debt funds aim to put their money to work for a set investment period. For this reason, there is typically no amortization under a unitranche facility and the lender may forgo the usual cash sweep, factors which suit the debt fund and borrower alike. Further, non-call protection will generally be included to dissuade the borrower from making any early prepayments. This can range from full make-whole provisions to a simple prepayment fee for the first one or two years of the loan.

A key characteristic of unitranche which debt funds point to is its documentary flexibility. This is due in part to the fact that a unitranche lender won't be looking to syndicate the debt, so can negotiate documentation free of any considerations an underwriter might have. This flexibility is perhaps most evident in that unitranche facilities will generally only contain one or two maintenance covenants, set at greater headroom to the base case projections than on a straight senior facility.

What debt funds generally cannot provide is working capital and ancillary facilities. For this reason, they may look to bring in one or more clearing banks (depending on the size of the deal) to provide these on a "super senior" basis. It is in this context that some thought needs to be given to the intercreditor position between the debt fund and bank.

What is a unitranche/super senior structure?

The unitranche and super senior working capital facility will typically be documented in the same loan agreement and will share a common security package. In contrast to a senior/mezzanine structure, there is generally no ability for super senior lenders to switch off payments due to the unitranche lenders. Prior to enforcement, therefore, the unitranche and super senior facilities rank pari passu in terms of payment. Following enforcement, however, the super senior lenders sit above the unitranche in the waterfall in the intercreditor and are the first lenders to receive any recoveries. This super senior positioning in the waterfall acts as a form of compensation for the bank in view of the greater control the unitranche will have over the life of the facilities.

A matter of control

The threshold for "Majority Lender" decisions under the facilities agreement, and "Majority Senior Creditor" decisions under the intercreditor agreement, is commonly set at 66 ⅔% of total commitments, and does not differ from this standard Australian and European position by virtue of the deal having a unitranche/super senior structure.

Because the super senior facility usually makes up a small portion of the overall commitments, the super senior lenders will be unable to block Majority Lender / Majority Senior Creditor decisions and have to accept that the unitranche will retain a large degree of control over the life of the facilities.

The usual unanimous lender decisions offer the super senior some comfort in this regard, but they will also benefit from an additional list of entrenched rights which will require their express consent. These will generally include any consent, amendment and waiver in respect of any matters which relate directly to the utilisation of the super senior facilities and the list of events of default which give rise to the super senior's independent right to take enforcement action (see below). The extent of the entrenched super senior rights will vary according to the balance of power between the unitranche and the super senior, and may be expanded to include additional key provisions of the loan agreement where significant super senior facilities are being provided.

Who drives enforcement?

Taking any action under the (AP)LMA acceleration clause is a Majority Lender decision, meaning the unitranche will be able to accelerate the facilities or enforce security without super senior consent. More significantly for the super senior, they could find themselves unable to take enforcement action following an event of default if the unitranche decide not to do so.

Where a business is struggling, the unitranche and the super senior may also have contrasting views on enforcement strategy. Given the super senior sit at the top of the waterfall and will generally constitute a small portion of the capital structure, it would take a drastic drop in the value of the business for them not to be paid out in full on enforcement. Consequently, from a purely financial perspective, they may be less inclined to wait before taking action. The unitranche will have a far greater exposure and will only begin to receive recoveries once the super senior have been paid out, meaning they will be more incentivised to maximise recoveries, even if that means waiting for a period of time.

The compromise that is reached is that the super senior will have the ability to take independent enforcement action following the occurrence of certain "material" events of default. The list of such events of default will vary from deal to deal, but will generally include as a minimum non-payment of amounts owing under the super senior facilities, insolvency events and breach of a financial covenant which operates solely for the benefit of the super senior. This super senior financial covenant may simply be a leverage test set at greater headroom to the general leverage test, a leverage test in respect of drawn super senior facilities only, or a minimum EBITDA threshold that the business has to satisfy. Whatever the exact nature of the covenant, it is not designed to allow the super senior a foot in the door before the unitranche can take action, but rather to act as a form of backstop which allows them to take action in the event that the business is significantly underperforming. By this time, the general financial covenants will already have been breached and the unitranche will have had sufficient opportunity to take the lead on enforcement by virtue of commanding the majority vote.

Once a "material" event of default has occurred, the super senior will be subject to a standstill period before they can take any action. This period is generally agreed as a range, with the more serious events of default (such a non-payment or a breach of the super senior financial covenant) resulting in a shorter standstill, and is not dissimilar to what is seen on senior/mezzanine intercreditiors.

During the super senior standstill period, or even whilst any event of default is continuing, the unitranche will generally benefit from a right to acquire the super senior facilities in full, thereby removing a creditor whose views on enforcement may differ from their own, and taking control of the entire capital structure. In practice, the bank providing the super senior facilities on any given deal is also likely to be providing the secured hedging. Given it will only have a vote under the intercreditor agreement in its capacity as hedge counterparty in limited circumstances, the bank will be eager to avoid becoming an "orphan hedge", meaning where it has been discharged as lender, but continues as hedge counterparty. For this reason, if the unitranche exercise their right to purchase the super senior liabilities, the super senior lender may insist that its hedging liabilities are transferred to another institution as part of that process.

Assuming the super senior standstill period has expired, and the unitranche has not exercised its right to purchase, the super senior may still be prevented from taking enforcement action if the unitranche in the meantime have done so themselves. To avoid a situation where the unitranche are not progressing enforcement sufficiently quickly, the super senior will often look to negotiate "step in" rights which allow them to take control of the process from the unitranche if sufficiently material enforcement action has not been taken, or if they have not been paid off in full within a specified period following the commencement of the enforcement action. This period would generally be six/nine months.

Should the super senior ultimately end up controlling enforcement, there are likely to be "fair value" protections for the unitranche as the junior creditor in respect of any asset or liabilities sale. These protections are typically similar to what a mezzanine lender might request.

Hedging

The generally accepted position is that a portion of the secured hedging liabilities will rank super senior in the waterfall, with the remainder ranking pari passu with the unitranche and, occasionally, a certain amount ranking junior to it if a large amount of hedging is permitted to benefit from the transaction security. Given that the super senior lender will hope to provide the transaction hedging, it is incentivised to negotiate for as large as possible a portion of the hedging to rank super senior. Conversely, the unitranche will be looking to limit the super senior hedging liabilities so that its own recoveries are not eroded. This limit is typically achieved by referring to a financial cap, in excess of which any hedging exposures will be paid out alongside the unitranche (or perhaps even after it).

An eye to the future

A relatively recent evolution of unitranche in Europe has been first-out / last-out structures. Under these structures, the unitranche is essentially split into two tranches, the first of which (the first-out) is paid out first on enforcement alongside the super senior working capital facility. This first-out tranche of term debt would typically be provided by a bank and would receive a lower margin to reflect its super senior status, whilst a debt fund would generally take the more remunerative last-out tranche of the capital structure. Sponsors will tend to favour such structures over traditional unitranche in order to lower their overall cost of capital. Because the overall size of the facilities ranking super senior on such deals is likely to be greater than where only a super senior working capital facility is being provided, the super senior lenders may benefit from enhanced rights. The "material" events of default which give rise to independent enforcement rights, along with the entrenched consent provisions, may be more extensive, and the first-out lenders may also benefit from the right to block the payment of interest to the last-out following a non-payment of first-out facilities, or any voluntary or mandatory prepayments during the standstill period. Voting will typically remain as a majority across all commitments, but may require a majority of both the first-out and last-out lenders should the first-out facilities be particularly sizeable.

In Europe, the trend has been for this bifurcation of the term debt to be set out in the principal finance documents, meaning the borrower benefits from transparency on both pricing and voting. In the U.S., however, the arrangement is often set out in a separate "Agreement Amongst Lenders", the precise details of which will generally not be disclosed to the borrower. Some Agreements Amongst Lenders have made their way into the European market, though typically only where a U.S.-based debt fund has been involved and has imported its preferred structure.

A further recent development in Europe (again following the U.S.) has been the combination of asset-based lending (ABL) and unitranche facilities. The ABL and unitranche will typically be documented in separate loan agreements and will benefit from priority security over separate asset pools (the ABL having first recourse to receivables and inventory, and the unitranche to shares and other remaining assets).

On such deals, the key intercreditor negotiating points will be around what restrictions (if any) there around each creditor's ability to take action in relation to their priority collateral - including standstill rights and/or consultation obligations.

Both first-out/last-out and ABL/unitranche structures ensure that banks are not left on the side-lines by the rise of unitranche. Arguably, they show that the market has recognised that debt funds, and unitranche, have become a major force, and that banks' interests may be best served by adapting to accommodate and work alongside their non-bank counterparts.

If the rise of debt funds and unitranche facilities continues in Australia and the banks find themselves losing market share, we would expect to see similar structures evolve as a response.

In summary

Unitranche/super senior structures are in their infancy in the Australian market, but with a number of global debt funds and banks already familiar with these structures, they are likely to become more common. Whilst these institutions will likely be guided by arrangements their overseas offices have entered into, on any given deal the balance of power will always be swayed by the comparative sizes of the two debt classes. At the inception of any transaction, careful consideration of the intercreditor relationship will ensure that the financing package can be delivered swiftly to the borrower.

Hogan Lovells have been at the forefront of the development of the unitranche market in Europe since its inception in 2008 and continue to advise many of the leading direct lenders on the financing of leveraged finance transactions throughout the continent. Recent transactions include:

- advising **Permira** and **Investec** as the unitranche and super senior lenders on the refinancing of the debt facilities of the Autovista Group;
- advising **Avenue Capital**, **Northleaf Capital** and **HSBC** on the financing for the acquisition by Vitruvian of the aviation data services business of AXIO Aviation and OAG;
- advising **Ares Management** and **Santander** on the financing for the acquisition of Timico Techologies by Lyceum Capital;
- advising **Barings** on the unitranche facility to support the acquisition of Michell Instruments by Battery Ventures;
- advising **Alcentra** and **RBS** on the financing of Equistione's acquisition of Apogee Group;
- advising **Ares Management** in connection with their financing of Montagu's acquisition of Oasis Records; and
- advising **CVC Credit Partners** on their financing of Equistone's acquisition of Willerby Group.

Hogan Lovells are uniquely placed to capitalise on this European experience as private debt grows in Australia, having already advised ICG on the first-ever Australian dollar denominated and Australian law governed Term Loan B facility for Iron Mountain's acquisition of Recall Australia. The team is also currently advising the financiers on one of the first unitranche facilities to be consummated in the Australian market.

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