

FINANCING STRUCTURES

Senior or unitranche: it's PE firms' pick

If a dozen private equity firms are vying for a given widget maker in an auction process, chances are there are a dozen different opinions about what an optimal capital structure and financing package might look like. Given that backdrop, direct lenders have a better shot at winning deals with a suite of debt products, says Twin Brook Capital Partners partner **Rich Christensen**

Q What are the most common financing structures in today's lower middle-market?

Rich Christensen: For the most part, they're either unitranche or senior-subordinated debt structures. Keep in mind, we're predominantly focused on borrowers with \$25 million EBITDA and below. We see first lien-second lien structures as more prevalent in the broadly syndicated market-\$40 million-plus EBITDA companies. The unitranche structure has gained popularity in recent years as compressed closing timelines have placed a premium on the certainty and ease of dealing with a single lending party.



Rich Christensen

unitranche products losing to syndicated (rated) deals in this sector of the market. In the sub \$40 million EBITDA market where covenants still exist, unitranche products are a competitive offering to a first lien-second lien tranche and we see sponsors/issuers making their decision based on a number of factors, including leverage (oftentimes a first lien-second deal can get higher leverage than a unitranche), interest in the second lien tranche (can be harder to place this debt), and the need for speed and certainty to close. Sub \$20 million EBITDA businesses would generally utilise mezzanine debt instead of second lien.

Q There was a point where unitranche loans seemed to replace the first lien-second lien deal structure. Is this still the case?

RC: Today, for deals that are rated and broadly syndicated, it is generally less expensive to issue first lien-second lien loans versus unitranches. In addition, there are fewer lender protections (financial covenants), in upper middle market structures which adds to the appeal for issuers choosing first lien-second lien arrangements over the unitranche. The syndicated market is also accustomed to repricing activity, which the unitranche market is not as receptive to, so we see

Q How do senior-mezzanine and first lien-second lien financing arrangements differ?

RC: Second lien debt is secured with a lien on the assets - although behind in priority to the senior lenders. Subordinated debt is unsecured, so, from the senior lender perspective, this form of junior capital is more favorable because of the payment subordination rights and the absence of any lien in favour of the junior lender (versus second lien debt holders who maintain a priority over the trade and other unsecured creditors). Second-lien debt will be priced at a discount to mezzanine or subordinated

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debt and at a spread over LIBOR versus a fixed rate coupon in the mezzanine market. Generally, a first lien-second lien structure carries more risk to the senior lenders and is more favorable to the junior debt holders over a senior-mezzanine deal structure.

Q How do senior-stretch loans and unitranche differ?

RC: Senior stretch deals are defined as “in between senior and unitranche leverage”- oftentimes a half-turn or three-quarters of a turn below where a total debt multiple would be on a unitranche. In terms of an overall cost of capital, senior stretch loans have a lower interest rate spread than unitranche structures and would typically lack any call protection. Outside of the pricing and total leverage considerations, there are largely no differences in structure or documentation between a senior-stretch and unitranche facility and we think both structures have very similar advantages to our clients.

Q What could make those more attractive than a unitranche?

RC: Senior-stretch loans are certainly priced at a discount to a unitranche, with the interest rate spread somewhere between the more traditional senior and unitranche rate. Interest rate pricing really depends on the leverage and how much of a discount the final structure represents to the unitranche. We see them used in lieu of unitranches when the sponsor is not looking to put maximum leverage on a transaction or maybe the sponsor has more capital to put to work, so they want to over-equitize the company on the front end. This structure can also work well as part of a buy-and-build strategy, where the sponsor wants a more conservative capital structure up front and would look to lever the

company up over time. In other cases, we have sponsors who want to put their own mezzanine debt in as part of their equity structure, so that might be part of a senior-stretch as well.

Q Does the competitiveness of the deal market dictate one preferred financing structure over another?

RC: In a market that demands speed from buyers who need to minimise lender processes on their side, unitranches have become a popular alternative to more traditional two-party debt structures. However, sponsors will often opt for senior-subordinated debt structures because they have good relationships across both senior and junior debt providers and are comfortable coordinating multiple tranches in the debt structure. These days, sponsors will ask lenders for term sheets highlighting both options. Ultimately, it comes down to certainty, speed, flexibility and price.

Q Do more competitive credit managers have unitranche capabilities?

RC: Absolutely. Being able to offer a range of debt solutions, whether it is senior with subordinated debt, senior-stretch or unitranche, makes you more competitive across a range of clients and credit opportunities. You can tailor what you’re doing to both the sponsor and the credit. I think credit managers who cannot offer a unitranche, are competitively disadvantaged in this market.

We see lenders that cannot offer what Twin Brook provides. These can be either commercial banks that prefer to be at lower leverage levels or finance companies that cannot provide revolvers or need to partner with another lender to provide the first out component due to their higher yield requirements. All those things make you less competitive.

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Q Recently, the unitranche has been winning favour with some private equity firms over the traditional senior-subordinated debt structure. Is that still the case?

RC: At the end of the day, more traditional two-party senior-subordinated debt structures and unitranches are largely interchangeable from a total leverage and weighted average cost of capital. As the LBO market has continued to become more competitive, speed and certainty to close have become significant competitive differentiators favoring the unitranche over a two-party debt structure. Closing timelines have compressed significantly, so the ease of dealing with one lending party makes a unitranche debt structure compelling. If you have two or three weeks to close a deal, working with one party is a big advantage rather than trying to bring multiple debt parties together - both in terms of lender due diligence and legal documentation requirements. A single unitranche lender can provide commitment papers for the entire transaction - oftentimes with little to no market flex. The sponsor, facing a compressed timeframe by the seller, has this “complete” commitment in hand as opposed to getting commitments from two separate lenders (senior and mezzanine). A unitranche obviates the need for negotiation between multiple lending parties, so from an ease of documentation it has significant advantages as well. You just have fewer parties, so legal documentation of transactions can be streamlined.

Q Do private equity firms come to direct lenders with a specific capital structure in mind, or do the two parties work together to determine the optimal debt arrangement?

RC: For any particular auction process, it's very common for us to provide multiple structuring options for our clients. We will very often propose on both a unitranche and senior-subordinated structure depending on what feels most competitive

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with our clients. We may have a sponsor who is looking for senior with third-party mezzanine for particular reasons – that's a structure they traditionally like or they have relationships in the subordinated debt community that they like to work with. Then we have clients that really like the unitranche structure for reasons we've talked about.

Q Where do equity co-investments come in for senior lenders?

RC: We see equity co-investments as very prevalent in the market and it's something we try and get in most of our transactions. This creates a very diversified investment pool across our loan portfolio and helps enhance overall returns. For us, it's an important component of the overall economics of the transaction.

Q Have equity co-investments ever been the deciding factor in winning a deal?

RC: There are some cases where clients are looking for bigger equity co-investments, but more often I would say that between sponsors and their LPs, there is generally not a shortage of equity interest in these transactions. We have a lot of sponsors that are willing to provide an allocation to the senior lenders, but the ability to provide an equity co-investment is generally not a competitive advantage.

Q Are most of the equity co-investments in common shares, or do they come in preferred shares?

RC: That will vary across different clients in terms of how they want to bifurcate their equity, but we're typically going to invest in a strip that is identical to what is being offered to the other investors. We're looking to invest alongside the equity sponsor in the same securities and on the same terms.

Q How are add-on acquisitions financed?

RC: Virtually all of our credit facilities include provisions for permitted acquisitions and in numerous cases we'll provide a committed unfunded acquisition line at closing to finance future acquisitions. Acquisitions are almost always an important component of a sponsor's growth strategy, so regardless of whether the facility includes a committed financing line at closing, the majority of our facilities will end up being upsized after closing as part of an add-on acquisition financing. If the original LBO has a unitranche structure, the financing package going forward for add-ons will be incremental fundings under the same unitranche structure. If it's a more traditional senior-subordinated debt structure, the add-ons could be financed entirely under the senior credit facility or with some combination of senior and subordinated debt. ■

Richard Christensen joined Twin Brook in 2015 as a Partner in the firm's mid-market direct lending loan business. Prior to joining Twin Brook, Christensen had been with Madison Capital Funding, which is part of New York Life Investments, since its initial founding in 2001. Christensen's primary responsibilities at Madison Capital included client relationship management and new business development, where he focused on originating and structuring transactions with mid-market private equity sponsors. Prior to joining Madison Capital, Christensen held various positions in loan underwriting and portfolio management at Bank of America's Commercial Finance Group (formerly NationsCredit Commercial Corporation) and First Source Financial.

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