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## Is Unitranche Still a Unitranche?

We've always been a big proponent of unitranche debt.

With senior cash flow debt still difficult to come by, unitranche facilities have proven to be a very attractive alternative financing technique. We've been pleased by the larger hold sizes of unitranche providers compared to senior debt providers. Fewer parties in the capital structure often results in greater ease when closing the initial deal and with consents and amendments post-closing. And we've been thrilled with the flexibility unitranche providers offer on amortization, prepayment penalties, covenants and other key terms.

But like so many other times in the credit markets, financing structures and products evolve and what was once a unitranche may not be one today.

Until the last few months, we were seeing most unitranche debt priced in the 10-11% range. This rate seemed to give the BDCs and hedge funds, historically the primary sources of unitranche debt, acceptable returns for their own capital providers. But recently we've seen yields for unitranche debt decline to the 8.5-10% range. And therein lies the wrinkle, because this 100-150bp decline in interest rate often results in yields below the returns unitranche providers promised their capital sources.

So, if you are a unitranche provider, and the yield on your security went down to the point where it was less than the minimum you promised your own investors, what would you do? You tranche out the unitranche!

More and more unitranche providers are now suggesting that they need to lay off a first-out piece of their unitranche debt so that their remaining last-out piece has a yield that is acceptable to their own investors. In essence, the unitranche is internally divided into a first-out tranche and a last-out tranche. But when this happens, is a unitranche still a unitranche?!

Granted, the borrower is still a party to only one loan agreement and is interfacing with just one provider. But the creation of a first-out piece may result in terms that

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inhibit the lender that the borrower interfaces with from speaking for the whole facility. And this tranching of the unitranche, while enabling hedge funds to obtain the returns they need to continue providing unitranche facilities, can create other issues for borrowers.

For one thing, we've found this exercise may not be totally transparent to the borrower. Unlike a capital structure where the relationship between traditional senior debt and mezzanine debt is governed by an intercreditor agreement that's disclosed to the borrower, unitranche tranching is often governed by an "agreement among lenders" that may not be disclosed to the borrower. More often than not, it seems that the terms of this type of arrangement are kept confidential by the lenders. As a result, issues like standstill provisions and voting rights may now be unknown to the borrower.

More interesting, is whether there are enough parties willing to provide the first-out tranche to enable traditional unitranche lenders to continue to offer the product. Unitranche debt has become popular because of the difficulty many borrowers have in raising senior debt. But providers of the first-out tranche are often the same capital sources that provide senior debt. For this reason, it will be interesting to see if sufficient first-out debt is even available to allow the unitranche product to remain a viable and competitive financing structure.

Or, maybe, yields just need to go back up...

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