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Middle Market Embraces Unitranche Loans

As companies prioritize simplicity and low risk of execution in financing, facilities that combine senior and mezzanine debt are gaining in popularity again.

Vincent Ryan

Middle-market companies and leveraged buyout firms are returning to the recent past with a hybrid loan structure that simplifies the use of subordinated debt and may lower firms' cost of capital.

First created in 2005, a unitranche facility is a faster way to borrow than the traditional structure that uses senior and mezzanine debt and that requires the direct involvement of multiple lenders. In a unitranche facility, a single lender, usually a specialist in business development financing, provides the entire credit and works with the borrower. Then that lender slices up, or "tranches," the loan for other investors.

"Historically, you went to a senior lender — a bank — and then you went to a mezzanine fund and maybe another capital provider, and then you had two or three lenders in the same credit, which added a lot of complexity," says Ted Koenig, chief executive of Monroe Capital, a private investment firm.

With a unitranche deal, one lender provides the entire credit with a single set of documents. The advantages to the borrower are the availability of a one-stop shop for financing and reduced risk that the deal will fall apart. Monroe Capital has done 12 of these transactions in the past six months.

Unitranche facilities are used in refinancings, recapitalizations, or dividend transactions: any financing where the borrower wants speed and minimal hassle. But in the current merger-and-acquisition climate they are particularly suited to financing a buyout.

"When there are not a lot of M&A transactions going on and each seller is being pursued by multiple bidders, the buyer can't afford to fail — so certainty of execution is a key aspect," Koenig says.

Last October middle-market private-equity firm Wynnchurch Capital wanted to finance an acquisition of Fabco Automotive, a supplier of specialty gearbox, axle, and transfer case products. The complex transaction was a corporate carve-out from a publicly held company. Wynnchurch settled on a unitranche facility for a couple of reasons, says Neel Mayenkar, the firm's vice president.

"The unitranche product over the long run generated a better cost of capital because the entire loan was amortizing [over time] as opposed to a typical senior and mezzanine debt deal, where the senior debt amortizes but the mezzanine debt does not," says Mayenkar. "In a traditional deal, you have this high-priced [mezzanine] note that stays out there a long time."

Second, he says, in a unitranche structure the borrower doesn't have two creditor agreements and doesn't have to negotiate with two different parties. "[The deal] didn't require as much micromangement as it would have had I had to talk to two different lenders the whole time," says Mayenkar. "I was able to focus more on the deal and the diligence."

The lenders in a unitranche facility have their own agreements that establish the economic and voting arrangements among them. The borrower is charged a "blended" interest rate: one that falls between the rate charged by the senior lender and the subordinated lender. Because the mezzanine debt provider takes on more economic risk, its gets a higher rate.

Koenig says that because of the efficiency of such an arrangement, Monroe Capital can get the borrower a blended rate lower than what a typical deal composed of senior debt and subordinated debt would charge, "and I don't necessarily need the warrants that a subdebt player would require, so there is less dilution to the company."

The upfront interest rate of the Wynnchurch deal was competitive, says Mayenkar, but down the road is where the economics pay off. "By year three of the transaction, [fewer] dollars of interest are flowing out under this structure," he says. Mayenkar cautions, however, that the economics for other borrowers will depend on such things as the cash-flow characteristics of the business and how it envisions paying down the debt.

As Wynnchurch executes add on acquisitions to the Fabco Automotive platform, as they did in April, the unitranche facility will have another benefit, Mayenkar says. "If we had gone the route of two different lenders, a mezzanine shop and a senior shop, we would have had to make sure they were both supportive of the growth strategy," he says. Monroe Capital financed $43 million of an add-on acquisition by Fabco in April.

To be sure, borrowers aren't flocking to unitranche financing. But use of the structure has picked up in the past two years, according to a search on S&P Capital IQ.

One potential drawback of unitranche facilities is that the borrower typically is not aware of the intercreditor agreements that govern the loan and what size portion the different lenders own, according to a paper by Practical Law Co., an online publisher for attorneys. “That could make life difficult for the borrower if it needs additional financing or a covenant waiver,” Practical Law says.