

**Turning the Middle Market Upside Down:
Unitranche Financing in U.S. Middle-Market Leveraged Buyouts**

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Abstract

Since the 1960's, the leveraged buyout (LBO) industry has grown to represent a pillar of American finance. While Henry Ford's management buyout in 1919 is often cited as the "first" LBO, these transactions became big business in the 1980's. In 2015, aggregate private equity deal volume hit \$634 billion, or around 3% of total U.S. market capitalization. The strategy has waxed and waned in popularity over the years, and has often earned a somewhat negative reputation with "Main Street" Americans. Hostile takeovers, "slash-and-burn" management styles, and corporate greed have cast a shadow on an industry largely portrayed to the public by books and movies like 1987's Wall Street and tarnished by scandals such as Michael Milken's conviction for racketeering and securities fraud in 1990. While the streamlining necessary to pay down large debt loads can lead to layoffs and liquidations, LBOs began as a means of providing viable growth and/or exit strategies for hard-working business owners. This paper analyzes the most common forms of middle-market LBO financing.

Method

Due to the limited history of unitranche financing, there is very limited quantitative data on unitranche deals. For this reason, I relied heavily on qualitative data, interviews with industry professionals, and numerous articles for my research. If possible, I plan to analyze further quantitative data post-graduation, potentially with the help of an academic research grant.

Keywords:

Leveraged Buyout (LBO): The acquisition of a target business, typically by a private equity sponsor or management team, which is financed by a relatively small amount of equity and larger portion of debt in order to leverage returns for equity stakeholders; for the sake of this paper, deals financed with more than 60% debt are considered leveraged

Financial Sponsor: A buyer, typically a private equity firm or management team, that seeks financing for an LBO candidate that they plan to acquire

Private Equity: Private equity firms consist of a general partner (GP) or manager which raises capital (dry powder) from limited partners (LP) and uses that capital to invest in leveraged buyouts

Business Development Company (BDC): A pass-through entity created by Congress in 1980 and regulated under the Investment Company Act of 1940 and the SEC with the purpose of allowing individual investors to participate in private equity and debt investments¹

EBITDA: Earnings before interest, taxes, depreciation, and amortization; often used as a cash flow and valuation metric

EBITDA turns: Leverage is often stated in terms of a multiple of EBITDA; most middle market LBOs are levered at 4x-7x, meaning that it would take 4-7 years of operating cash flows to fully repay all principal

Middle-Market: Consists of businesses earning between \$50 million and \$1 billion in annual revenues and EBITDA of up to \$100 million

Lower Middle-Market: Consists of businesses earning between \$10 and \$50 million in annual revenues and EBITDA of up to \$10 million

Unitranche Financing: A form of LBO financing that aggregates first and second lien debt tranches into a single layer with a blended interest rate

Straight Unitranche: “A senior stretch loan that provides 5 to 6x (or more) leverage and replaces the traditional first lien/second lien or senior/mezzanine structure. Lenders share payments on a ratable basis as set forth in the loan agreement.”²

Bifurcated Unitranche: “On the surface, a single credit facility but sliced into first-out and last-out loans. The last-out piece benefits from skimmed interest and other economics. The first-out lender gets payment priority upon the occurrence of certain triggering events. This bifurcation is often set out in an agreement among lenders or AAL.”³

Agreement Among Lenders (AAL): A document which takes the place of the intercreditor agreement utilized in two-document structures; lays out each lender’s rights and claims to collateral

Two-Document Structure: Refers to the two loan agreements signed to document a senior-mezzanine or first/second lien agreement; often involve much more than two documents after including intercreditor agreements, reporting, due diligence, term sheets, etc.

Syndication: The process by which investment bankers raise debt funding from a group of lenders, or syndicate

Broadly Syndicated Loans (BSL): A loan offered by a group of lenders, referred to as a syndicate, that contribute pooled capital to one borrower; broadly syndicated loans are typically arranged, or syndicated, by an investment bank, then split up between multiple lenders and often traded in a liquid market

**Turning the Middle Market Upside Down:
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Introduction

History of the Leveraged Buyout

When most people hear the name Bear Stearns, their minds go to the subprime mortgage crisis that eventually led to the greatest recession since the Great Depression of the 1930's. Founded in 1923 and ultimately sold to JP Morgan Chase for a mere two dollars a share in March of 2008, the former securities giant had employed numerous prominent figures such as Alan "Ace" Greenberg, legendary hedge fund manager John Paulson, former SBA administrator Aida Alvarez, and even actor and director Jon Favreau. However, of all the investment bank's famous alumni, WWII veteran and financial pioneer Jerome "Jerry" Kohlberg, Jr. may have been the most influential character in the volatile 85-year history of The Bear Stearns Companies, Inc.

Jerry Kohlberg began his career at Bear Stearns in 1955 and led the company's corporate finance division for much of the 1960's and '70's. In 1964, Kohlberg helped "savvy businessman" O. Wayne Rollins raise a large amount of debt to acquire Orkin Exterminators in the first of what Kohlberg called "bootstrap deals"⁴, which Orkin claims was "the first-ever leveraged buyout".⁵ Kohlberg would go on to complete many of these deals at Bear Stearns, focusing on relatively small, low-growth companies with owners who would rather sell to a financial sponsor than to their competitors. He saw these deals as a means of offering liquidity to entrepreneurs and business owners that may have had difficulty exiting their business otherwise. Jerry "favored small, friendly deals initiated by pull-up-a-chair talks"⁶ as opposed to the oftentimes aggressive, even hostile takeovers which later characterized the mammoth industry that began when he founded

Kholberg Kravis Roberts and Co. with his two Bear Stearns mentees Henry Kravis and George Roberts in 1976.

KKR would go on to become a Wall Street titan synonymous with deals now known as leveraged buyouts (LBO). LBOs provide a means of extracting value from low-growth businesses through an acquisition financed by a relatively small amount of equity and large amounts of debt. If a company generates stable, predictable cash flows, financial sponsors can use these cash flows to pay down debt and build equity, much like a homeowner builds equity by paying off a mortgage. Even without material growth in the underlying business, private equity sponsors can achieve impressive returns simply by repaying debt and exiting the business after a few years (typically 3-5). If the sponsor can successfully improve the business by cutting costs, selling off less profitable segments, or growing EBITDA, these returns can be amplified significantly. While this leverage allows sponsors to realize large gains, the extra risk translates to higher interest rates on the “leveraged” debt used to fund the deals.

Overview of Financing Structures

LBO financing often comes from many different sources and involves complicated structuring, securitization, and underwriting, which will be further outlined later. Larger deals are the most complex, as they require more capital than any one lender can provide. Traditionally, banks and institutional investors fund the most senior debt (secured with a first lien on the target’s assets or cash flows), high yield bonds make up most unsecured debt, and the lowest levels (referred to as mezzanine) are funded by mezz funds or other non-bank lenders. Middle market deals usually only require two or three tranches of debt and do not utilize bonds, as sponsors often value flexibility more so than low costs of capital since they are borrowing much less and are working with smaller, less established businesses.

In the aftermath of the 2008 financial crisis, banks became less willing to finance leveraged deals, and many institutional investors went belly-up. This led to the rise of non-bank lenders such as business development companies (BDC), especially in the middle market. As these lenders gained market share, they developed an alternative financing method that offers more flexibility and quicker closings by combining all debt into one tranche with a blended interest rate. This paper compares unitranche and traditional financing structures in U.S. middle market leveraged buyouts.

Narration

Traditional LBO Financing

When an individual wishes to purchase a house, their first order of business is to get pre-approved for a mortgage loan so that they will be ready to make an offer once they find an attractive property. Acquisitions work in a similar way, as sponsors must assure sellers that they can raise the money necessary to close the deal in a timely manner. Investment bankers make billions of dollars every year by facilitating this process and connecting borrowers to lenders. Financing structure fluctuates significantly based on deal size, but large deals have many stakeholders and the process can be somewhat confusing. The next few pages break down each tranche of debt used to fund a traditional LBO. It is important to note that while an LBO may incorporate all of the products discussed below, most do not, and the complexity of a deal is often directly proportional to its size. This paper focuses on middle market LBOs, which often utilize only two or three tranches of debt, and sometimes only one.

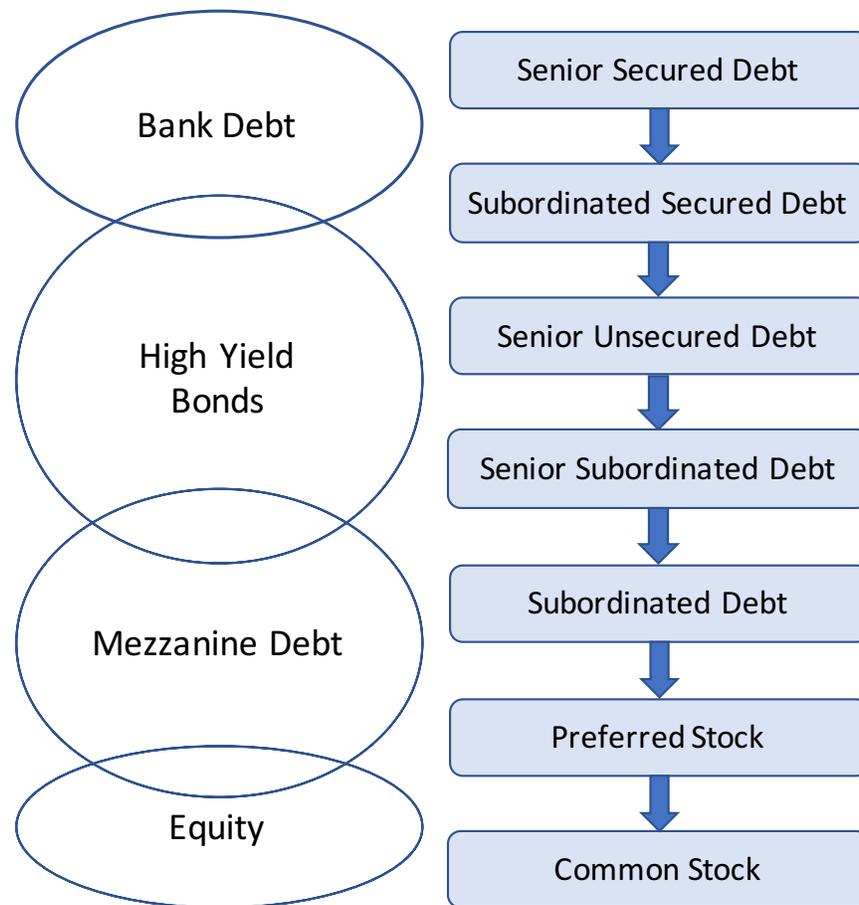


Figure 1. Typical LBO structure in large, broadly syndicated deals. (Rosenbaum & Pearl, 2009)

Bank Debt

As mentioned previously, the most senior level of debt usually comes from commercial banks and institutional investors. On larger deals, the lead investment bank will form a syndicate with other banks to spread the risk between multiple parties. These syndicated loans are referred to as “Term Loan A’s” (TLA), and often come in conjunction with an unfunded revolving credit facility for working capital needs. TLAs are also referred to as amortizing loans, because they require principal amortization throughout the life of the loan. They hold a first lien security interest in the target’s assets or cash flows, and have a term of between four and seven years. Since these

loans carry lower interest rates, they are less attractive to institutional investors, who prefer non-amortizing loans with higher coupons and longer maturities.⁷

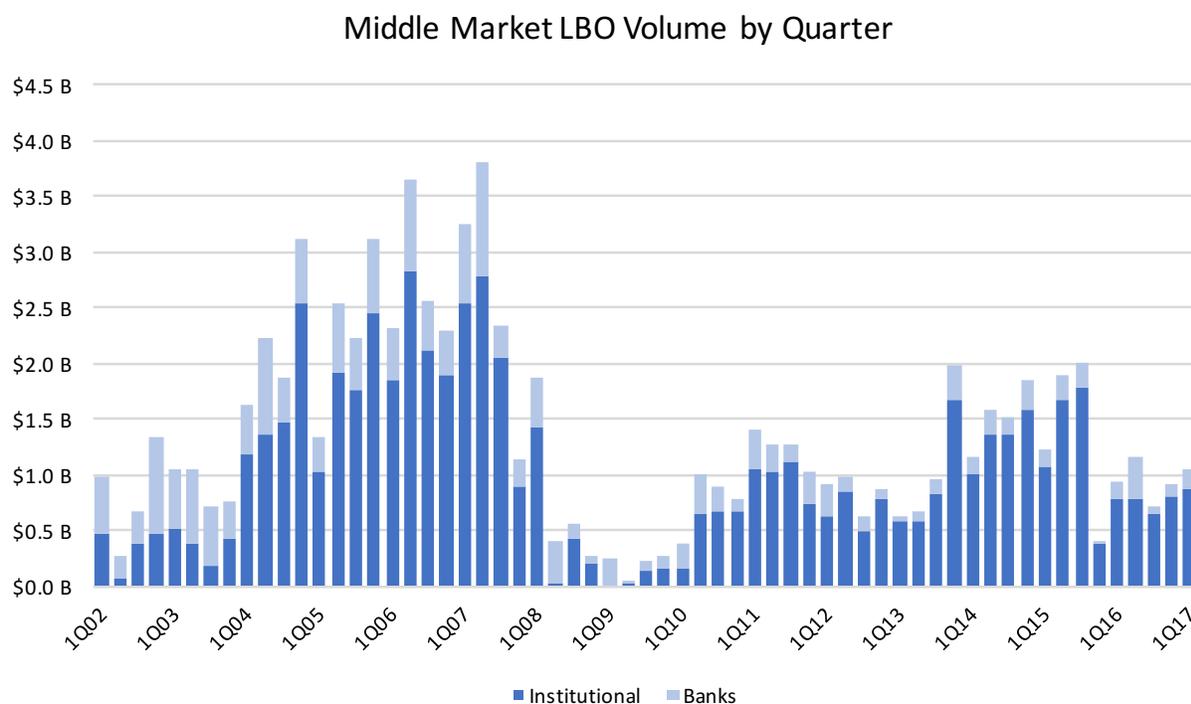


Figure 2. Middle Market LBO Volume by Quarter. Note: data only covers broadly syndicated, upper market deals. Direct lending deals in which debt is not publicly traded are much more difficult to find data on. (LCD: An offering of S&P Global Market Intelligence)

Investment banks sell “Term Loan B’s” (TLB) to institutional lenders such as loan mutual funds or CLOs rather than commercial banks. These loans are more prevalent than TLAs in LBO financing for a few reasons. First, leveraged loans come with greater risk than regular commercial loans, making them less attractive for banks. Second, this extra risk makes them more attractive from a return standpoint for institutional investors, and allows investment banks to charge higher fees for underwriting and selling them. These loans amortize at a marginal rate (typically 1% of principal annually)⁸, meaning they pay mostly interest over the life of the loan and almost all principal is repaid upon maturity. They typically have a tenor of around seven years, as banks prefer their loans mature first and institutional investors prefer longer maturities and higher

coupons. Although banks do not usually hold TLBs for long, both TLAs and TLBs fall under the umbrella of “bank debt”. Bank debt simply denotes senior tranches that often include restrictive covenants, amortization, and strictly cash interest, which lower tranches do not always require.

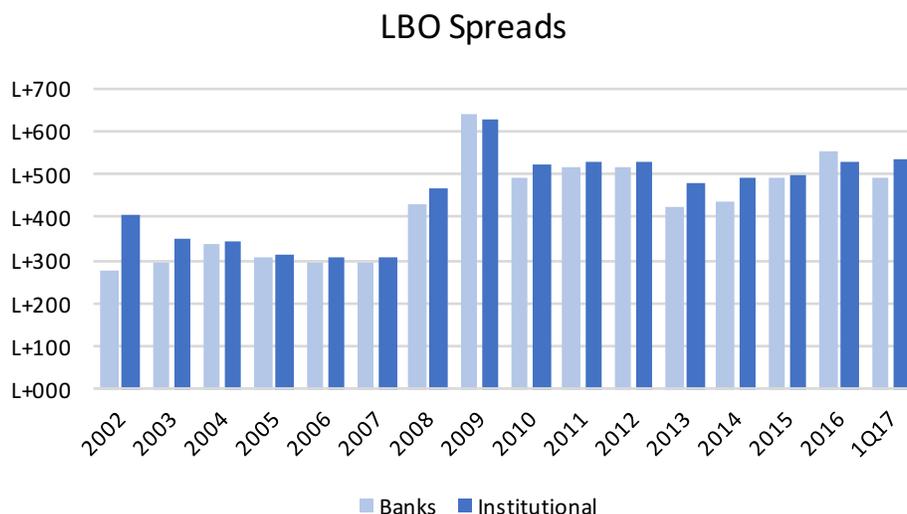


Figure 3. MM LBO pricing spreads above LIBOR for senior tranches. (LCD: An offering of S&P Global Market Intelligence)

Subordinated Secured Debt

Also known as “second lien debt”, this product has gained popularity among sponsors over the past decade or so, as it offers a lower-cost alternative to other means of junior debt financing such as high yield bonds or mezzanine debt. Second lien loans provide borrowers with better prepayment options, less paperwork (because they are not publicly registered like high yield bonds), and smaller minimum requirements, as high yield bond issues typically require at least \$125 million of principal to facilitate liquid trading⁹. Middle market LBOs utilize second lien loans much more often than high yield bonds because the deals are not usually big enough to necessitate that much debt capital, and because sponsors value the flexibility that they offer. These

loans carry less restrictive covenants than bank debt, but can still limit the operational flexibility of the target company post-close.

High Yield Bonds

In 1988, KKR completed the famous leveraged buyout of RJR Nabisco, Inc., represented in the book and movie Barbarians at the Gate. This title comes from a line from Ted Forstmann, founder of private equity firm Forstmann Little and Co., in which he labels Henry Kravis' proposed financing "phony junk bond crap", and pleads with RJR Nabisco CEO F. Ross Johnson to help him "push back the barbarians from the city gate". This "phony junk bond crap" still provides a significant portion of the financing on bigger deals.

High yield "junk" bonds gained popularity in the period leading up to the savings and loan crisis, in which they played a large part. Savings and loan institutions offered attractive interest rates on savings accounts and used deposits to fund mortgage loans for working-class Americans. However, the high interest rate environment of the 1970's led many savers to move their funds from S&Ls into money market funds, which offered better liquidity. As these institutions struggled to remain solvent, they turned to riskier investments such as high yield bonds to cover their losses.¹⁰ The collapse of the S&L industry significantly detracted from the popularity of high yield bonds among institutional investors. However, high yield bonds still serve a vital role in LBO financing. Investment banks often sell these bonds through a private placement to cut down time to close, but later register the loans with the SEC to facilitate a public market for the debt. Middle market deals do not usually meet the size requirements necessary to justify a high yield bond issuance, so while these securities represent a vital piece of larger LBO financing structures and share features with products used in the middle market, they are not directly applicable to this thesis.

Mezzanine Debt

Subordinated debt makes up the last tranche before preferred and common stock, and therefore carries the highest risk profile. Due to size limitations, this type of debt makes up the piece of most middle market deals that might be financed with high yield bonds on larger transactions. Subordinated loans carry high interest rates and often include a “paid-in-kind” (PIK) toggle, in which a portion of the interest accrues to the principal balance rather than being paid in periodic installments. Mezzanine debt refers to a hybrid product which blends subordinated debt and some equity components (often warrants or preferred stock), referred to as “equity kickers”. Mezzanine debt allows sponsors to stretch on purchase price with capital that costs slightly less than equity, although rates are routinely in the double digits even in today’s low rate environment. Specialty finance companies such as mezz funds and BDCs play in this area of the capital structure, and although it can be extremely risky, a properly managed portfolio of mezzanine investments can yield exceptional returns over the long run.

Middle Market LBO Structure

Middle market LBOs range in value anywhere from \$100 million to a few billion dollars, depending on prevailing market conditions, valuation multiples, and where the limits are set. Some larger middle market deals may even be big enough to warrant high yield bond issues, although financiers that focus on the middle market typically avoid these LBOs. As with larger deals, there are many options available to middle market sponsors, but most deals only incorporate one or two rather than all of them. This paper will focus mostly on deals in the lower-to-core middle market, and focus on three typical financing structures in this area.

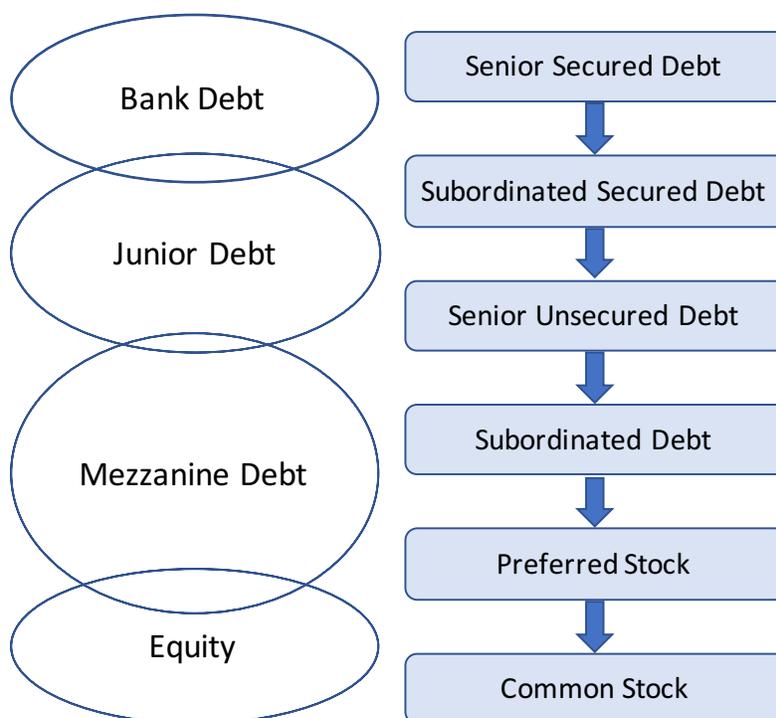


Figure 4. Middle Market LBO Structure Overview (Student Research)

Traditionally, middle market deals were done just like other LBOs—a sponsor identified an attractive target, reached out to their investment banker, and the investment banker utilized their network to bring along lenders for each tranche of the debt after reserving the senior tranches for their own commercial bankers. These deals fall into two main categories: senior-subordinated/senior-mezzanine and first and second lien.

Senior-Subordinated

A senior-sub deal involves a senior tranche from a bank or institutional lender with a first lien security interest in the assets of the target company and a subordinated tranche funded by a non-bank lender. Oftentimes this second tranche will come from a mezzanine lender, and include equity

Senior-Subordinated Structure

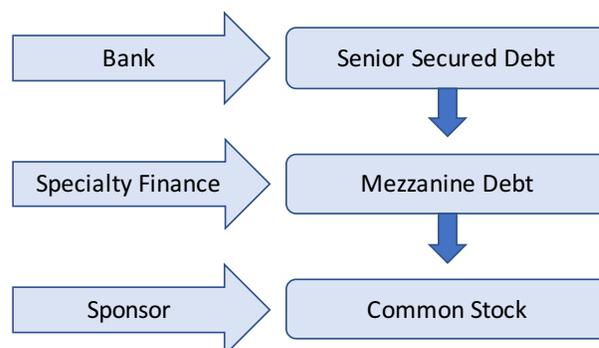


Figure 5. Senior-subordinated structure. (Student Research)

kickoffs. While mezzanine debt carries a high interest rate, it is non-amortizing, unsecured and typically includes a provision for PIK interest. For these reasons, banks may feel more comfortable with more turns of senior leverage because they still have the sole claim on a company's assets in the event of a liquidation. Non-amortizing partial PIK loans also offer more flexibility to the target company and encourage the mezzanine lender to take a more active role in assuring the success of the LBO, which provides senior lenders with more security than a second lien loan. If senior secured debt makes up a larger portion of total leverage, the weighted average cost of capital (WACC) of a senior-sub deal may actually be lower than other structures, even after accounting for the higher interest rates tied to the mezzanine tranche. In the past, most middle market LBOs were done using a senior-sub structure.

First and Second Lien

However, around the turn of the century, second lien loans became more and more prevalent due to their lower cost when compared head-to-head with mezzanine debt. Second lien loans work like a second mortgage on a house—during a liquidation, lenders receive proceeds from the sale of collateral only after the first lienholder has

been fully repaid. Also like a second

mortgage, second lien loans provide borrowers with more leverage than the first lienholder can or wishes to offer. For this reason, industry professionals often refer to these structures as “senior stretch” facilities, because they allow sponsors to stretch on pricing to win deals while still paying

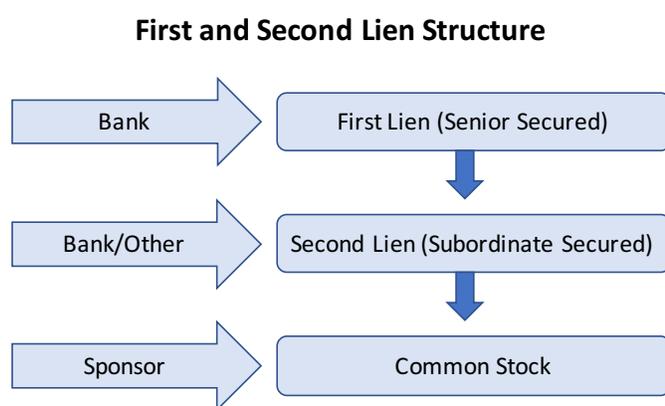


Figure 6. First lien/second lien debt structure. (Student Research)

an interest rate closer to that of the senior tranche. They carry floating rates typically based on LIBOR, plus a premium of 9-11%, denoted as L+900-1100.¹¹ Although cheaper than mezzanine debt, second liens detract from the sole ownership of collateral by senior lenders. Second lienholders also have less incentive to work with borrowers in the event of a downturn, leading to higher default rates which may in turn cause banks to lend less. This pushes up the second lien percentage of total debt, and can sometimes lead to a higher overall cost of capital depending on the deal. Of course, the perceived riskiness of each deal plays a huge role in determining how much each lender is willing to contribute and at what price.

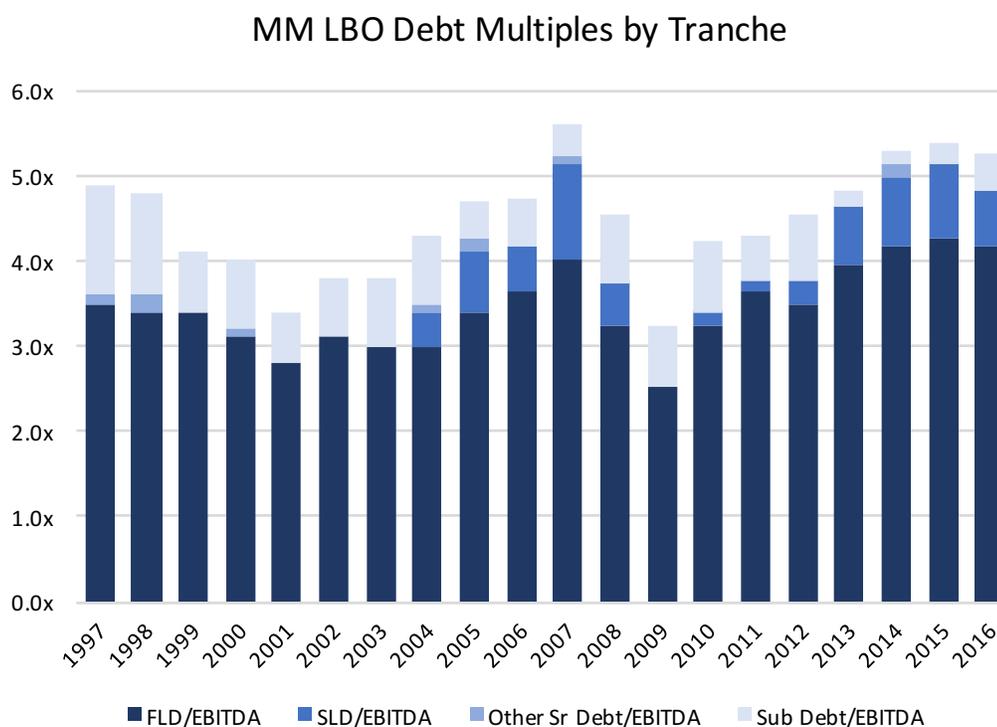


Figure 7. MM debt/EBITDA multiples by tranche. (LCD: An offering of S&P Global Market Intelligence)

Division

Although both senior-sub and first and second lien financing have many pros and cons, they share one common flaw. Each structure requires at least two lending parties, and oftentimes multiple lenders contribute to each tranche. This involves significant paperwork, legal counsel, intercreditor agreements, and perhaps most importantly, time, all of which cost money. Investors measure private equity general partners on two main measures—internal rate of return (IRR) and total cash return multiple. When LPs commit their money to a private equity fund, they expect the general partner to quickly and prudently allocate their capital to profitable deals. The longer it takes a sponsor to close a deal, the lower their IRR, all else held equal. Additionally, large groups of lenders mean more covenants to comply with and more financial reporting requirements, which limit operational flexibility, take time, and ultimately cost money. To combat this, non-bank lenders such as mezz funds, specialty finance companies and BDCs developed an alternative to the traditional model of LBO debt structure.

Unitranche Financing

Simply put, unitranche financing does exactly what its name implies. Lenders combine all layers of debt into a single tranche with a blended interest rate. Borrowers sign one set of documents and pay interest to one lender. This allows for quicker closings, simpler reporting processes, and sometimes less stringent debt covenants. Middle market unitranche loans are typically non-amortizing, utilize PIK interest toggles, and include equity kickers. This form of financing has exploded in popularity over the last five to ten years, and according to industry professionals, is only just now starting to mature as an alternative means of funding deals. According to research done by private credit experts at Proskauer, unitranche facilities are now offered across the entire middle market, ranging anywhere from \$10 million to \$500 million.¹²

In May of 2016, private equity firm Thoma Bravo utilized a \$1.075 billion unitranche facility syndicated by Ares Capital in its acquisition of QLIK Technologies.¹³ This puts unitranche lenders in position to compete with high yield bonds and other forms of financing for deals that were historically too large for so-called finance companies (i.e not banks). In Europe, intense competition from banks has kept growth in check¹⁴, but in the aftermath of the 2008 crisis, U.S. banks have had a difficult time clinging to market share in mid-sized deals. Before delving into the pros and cons of unitranche when compared to other means of LBO financing, it is important to note the two main types and what distinguishes between them.

Straight Unitranche

Straight unitranche facilities truly come from one lender or syndicate. In “club” deals, lenders share payments on a ratable basis set forth in the loan agreement. Essentially, a straight unitranche loan is a senior stretch loan which provides five or six (or even more) turns of leverage as an alternative to a senior-sub or first and second lien structure.¹⁵ Otherwise known as “senior stretch unitranche”, these deals take their name from the idea that a senior lender essentially stretches their collateralization requirements by lending more turns than they could under a strictly asset-based facility at an interest rate which reflects the added risk. While prevalent in Europe, these types of unitranche facilities only account for a minority of deals in the U.S., primarily in the lower end of the market.

Bifurcated Unitranche

While appearing to borrowers as a single credit facility, these structures split up the principal into first-out and last-out tranches. The most prevalent type of unitranche in the U.S., bifurcated commitments have essentially flipped the typical middle market LBO process on its head, as more and more last-out lenders (primarily BDCs) actually source the deals, then go find

a bank or other lender to supply the first few turns of debt. This contrasts with the old process wherein a bank sources deals from a network of sponsors and then finds junior lenders to fill out the lower tranches of debt.

For a number of years we have seen lots of players entering the market, and a lot of complexity around structures, and we are now starting to see a bit of settling out and more of our clients are doing the whole capital structure themselves, or bringing in a partner to do an “upside-down deal”. Our clients are really yield-driven, so when they find good deals with strong management teams in great industries they want to keep it. So they will give away the first turn or two, but they are largely holding the risk themselves. (Stephen Boyko, Proskauer 2015)

Last-out lenders essentially borrow the first turn or two from a first-out lender (usually a bank) to lever up their returns in the same way that a private equity sponsor leverages the buyout (hence the name leveraged buyout) to maximize theirs. An agreement among lenders (AAL) sets forth the specific claims of each party. Typically, the first-out lender receives all proceeds from the sale of collateral in the event of a liquidation (up to the amount of principal invested), while the last-out lender pays a portion of each interest payment to the first-out lender. First-out tranches generally amortize, so in the event that the deal goes sour down the road, the collateral securing the first-out tranche is much more likely to cover the remaining principal balance. AALs essentially seek to “pull the structure apart to replicate a two-document structure, such as a first lien, second lien transaction, where some of the lenders take first lien risk and others take second lien risk.” (Antosyk & Boyko, Proskauer 2016) The borrower still receives one loan agreement and provides one suite of financial due diligence and reporting documents, but the AAL takes the

place of the intercreditor agreement used in a two-document structure. Other forms of unitranche take the place of other deal structures, such as senior-sub and split-collateral. However, bifurcated unitranche makes up the largest portion of transactions, and an explanation of every type of unitranche structure goes beyond the scope of this paper.

Unitranche Summary

In summary, unitranche offers an alternative means of financing with some advantages over more traditional structures, especially in the middle market. Its explosive growth in this space provides clear evidence of its newfound popularity, but if it is such a wonderful product, why does anyone still do deals any other way? There are some important concerns among borrowers and lenders alike which need to be addressed. The rest of this paper argues that unitranche financing is the future of lower middle market LBO financing, and has the demonstrated potential to extend much further up the food chain than that.

Proof

While simplicity itself makes the job of sponsors, lenders, and lawyers easier, unitranche financing offers much more than just a shortcut through paperwork. Sponsors enjoy speedier closings, less syndication risk, more operational flexibility, motivated lender partners, and perhaps even a lower total cost of capital in some cases. Lenders often achieve higher returns than they could from senior secured debt, although with similar collateralization, and may exercise more control than they could have through a structure involving multiple investors with different return objectives, timelines, and risk tolerances.

Borrower Benefits

Sponsors willingly pay a premium for unitranche structures because they reap substantial benefits by doing so. While lenders get a slightly higher coupon and presumably better security, sponsors save millions of dollars and hundreds of hours in legal, documentation, and banking fees, plus due diligence and reporting. These and other factors give sponsors operational flexibility and allow them to focus on the ultimate success of the LBO which should result in higher returns for all stakeholders.

Simplicity

It goes without saying that paying one lender one interest rate and letting them sort out the rest saves time and money. Investors can think of a bifurcated unitranche deal as a system by which one lender borrows from another to invest loan proceeds at a higher rate (the unitranche coupon rate), as opposed to a target company borrowing different sums from different lenders at different rates. This reduces the initial expenditures needed just to draft the loan documents and intercreditor agreements.

(Traditional structures) required a lot of documentation, because (borrowers) have to have a documentation set with the senior lender...a set of documents with the mezzanine lender, and...an intercreditor agreement which is between the two lenders, so you've got three broad groups of documents. That's extra work, right? Three documents; go pay the lead lawyers three fees. (Unitranche only requires) one set of documents with the borrower (and) no intercreditor agreement because it's all coming from the same place, so (sponsors) are only paying for one set of (documents) instead of three. (Robert Dodd)

Mr. Dodd went on to explain that “the wrinkle is that typically the coupon...on unitranche debt is...slightly higher than the weighted average coupon if you did it in two tiers,” but that in some cases, the initial savings can make up for the incrementally higher explicit cost of debt. “In simplistic terms, with the unitranche versus senior-sub, you are trading off simplicity versus cost—and to be clear...cost is not just coupon. If you have to pay for three sets of documentation, that has a cost. You have to take into account more than just the coupon.” (*Ibid.*)

Speedier Closing

As competition for attractive businesses grows, private equity firms must assure a company’s owners that they can raise the necessary funding in a timely manner. In a traditionally financed buyout, bidders must arrange funding from multiple sources in order to offer an attractive price to the company’s current owners. In a unitranche deal, this process happens much more quickly. Normally, a sponsor must conduct due diligence, reach out to an investment bank, wait for the investment bank to find lenders, wait for those lenders to conduct their own credit analysis, and negotiate loan agreements for each tranche. If a sponsor or investment bank can go directly to a unitranche provider and negotiate one agreement, they can submit a fully financed bid much earlier than competitors who are using a slower process. Not only does this cut down on the time between fundraising and investing, but it gives sponsors an edge in winning the best deals, which could lead to better returns and less risk on each transaction.

Syndication/Execution Risk

Even after sponsors receive commitments from all the lenders in a traditional structure, they run the risk that one or more of the lenders fail to make good on their commitment when the time comes to pay up. This risk decreases substantially if the deal structure requires little or no syndication. It also transfers the risk of intercreditor issues onto the last-out lender rather than the

sponsor or target company. When asked why Data Device Corporation (DDC) opted for a \$515 million unitranche facility to refinance their prior first and second lien structure, Andy Steuerman, senior managing director and head of middle market lending at New York-based Golub Capital “said that the structure provided the borrower and Behrman Capital, its private equity owner, with certainty of execution.” (Golub Capital Closes \$515MM Uni Deal)

Due Diligence

The LBO process involves thorough analysis of the company’s financials, detailed research of the industry, important macroeconomic factors, background checks on senior management, performance forecasts, and more. Analysts, associates, and vice presidents at commercial banks and buy-side institutions such as PE shops, private debt funds, and BDCs spend most their time on this type of research and modeling. Each stakeholder conducts their own analysis of the target company, and ultimately the fewer stakeholders there are in a deal, the fewer dollars of salaries and wages go towards analyzing the same deal.

Reporting and Compliance

Between the closing date and repayment of principal, the sponsor and target company provide periodic updates to other stakeholders regarding the performance of the business. Lenders use these reports to gauge the performance of their investment, and if necessary, to quantify any impairments to the original loan. BDC investors closely analyze the performance of each portfolio company to determine how the BDCs stock should trade, and the BDC’s credibility hinges on the integrity of their valuation practices.ⁱ In a unitranche deal, portfolio companies only need to draft one suite of reports for one lender with one set of expectations. Additionally, while middle market

ⁱ In his book Fooling Some of the People All of the Time, renowned hedge fund manager David Einhorn recounts the tale of his frustratingly drawn out fight to expose the fraudulent valuation practices of Allied Capital. Ultimately bought out by Ares Management for only \$3.47 per share, Allied provides investors with a sobering example of the consequences of negligent or falsified write-down practices.

unitranche deals almost always involve some sort of debt covenants, one set of covenants may be easier to comply with than multiple sets from different lenders. This may allow for greater flexibility, because unitranche lenders often work closely with sponsors and may be easier to work with in the event of an unforeseen setback.

Lender Involvement

In a senior-sub deal, mezzanine lenders have far more skin in the game than senior secured lenders. If the LBO ends in bankruptcy, odds are the senior lender will get most if not all of their money back, whereas the mezzanine lender may end up empty-handed. This encourages the senior lender to put their interests above the long-run health of the business, possibly at the expense of junior lenders. When the senior and junior tranches come from the same lender(s), the interests of debt and equity holders more closely align. Unitranche lenders may extend more leniency in the event of a technical default or restructuring, because they would rather miss a few interest payments or loosen covenants than lose all of their unsecured principal. In unitranche deals where multiple lenders contribute funds (bifurcated or syndicated), the joint lien incentivizes them to work together to ensure the success of their mutual investment.

Payment Structure

While unitranche debt may carry a higher total coupon than its senior-sub counterpart, it may carry a lower cash debt service cost each period for two reasons. First, unitranche debt is sometimes non-amortizing, and often requires less amortization than senior secured debt. Second, unitranche debt often includes a paid-in-kind (PIK) provision that allows borrowers to accrue a portion of each interest payment to the principal balance rather than actually paying it out each period. These provisions ultimately lower the annual cash expenditures used to service debt, allowing the target company to invest those funds elsewhere.

One of the biggest reasons that highly levered companies are considered risky is that large debt-related expenses can add significant financial stress to their business. Leverage forces companies to reevaluate their assets and expenses. According to Michael Lewis' famous book Liar's Poker, (quoting private equity mogul Joe Perella) "Every company has people sitting around who do nothing for what they get paid...if they take on a lot of debt, it forces them to cut fat.' The takeover specialists did for debt what Ivan Boesky did for greed. Debt is good they said. Debt works." (Lewis, 1990). "Cutting fat" only gets a business so far, however. When sponsors can put off principal and interest and work with creditors that also hold a mezzanine and equity stake in the company, their chance of success increases dramatically. Only time will tell whether this decreased stress translates to lower default rates, but it makes perfect sense why a sponsor would pay a small premium for it.

Benefits to Lenders

Many of the characteristics that make unitranche attractive to sponsors also benefit lenders. Decreased cost, complexity, and restrictiveness increase the sponsor's chance of a profitable exit, which in turn increases the lender(s)' chances of principal recovery and an adequate return. Additionally, borrowers benefit from the added security of a first lien coupled with an incrementally higher coupon rate. Finally, "upside-down" deals give last-out (mezzanine) lenders an opportunity to source deals and bring in their own senior lenders, giving them more leverage than usual in pre-closing intercreditor negotiations.

Summary

Clearly, unitranche debt offers many advantages over traditional financing structures. Simplicity, savings, added security, quicker closings, decreased execution risk, increased

operational flexibility, and the alignment of stakeholder interests all increase the likelihood of a successful leveraged buyout. However, like any investment, unitranche does not come without its own unique risks.

Refutation

Every buyout deal has specific characteristics that make one structure more suitable than others. Asset-heavy companies may own more hard collateral to borrow against than companies with smaller balance sheets, and may obtain better terms from an asset-backed structure like a first and second lien rather than a senior secured loan and a cash-flow based mezzanine tranche. On the other hand, companies with fewer hard assets such as a staffing firm or other services provider likely do not have a significant pool of hard assets to back more than one secured tranche of debt, but probably have wider EBITDA margins than, say, a manufacturer. These distinctions make sense, but if unitranche products exist that replace both two-document facilities with one document and provide sponsors with quicker closings and less execution risk, why would anyone still use the old structures?

Table 1. Current pricing and leverage trends in middle market leveraged deals. (Bain Capital, Lincoln International 2016)

	Pricing	Multiples
Senior Secured	L+475-575 LIBOR Floor: 100-150	3.0x-4.0x EBITDA
Unitranche	L+750-850 LIBOR Floor: 150	4.0x-6.0x EBITDA
2 nd Lien	L+900-1100 LIBOR Floor: 200	1.0x-2.0x EBITDA
Subordinated	Cash: 11.0% - 12.0% PIK: 1.5% - 2.5% Total: 12.5% - 14.5%	1.0x-2.0x EBITDA
Equity	N/A	30% - 40% of Total EV

Pricing

While it may not be obvious, these numbers show that sponsors pay a premium for the simplicity of unitranche credit facilities. A simple scenario analysis illustrates clearly that given these metrics, unitranche often comes with a higher explicit cost of capital.

Table 2. First/second lien pricing compared to unitranche. (Student Calculations)

	Pricing	Leverage	Weight
First Lien	7.00%	4.0x	66.7%
Second Lien	12.00%	2.0x	33.3%
WACC:	8.67%	6.0x	100.0%
Unitranche:	9-10%	6.0x	N/A

As shown, the coupon on unitranche facilities usually exceeds the weighted average coupon of typical two-document structures. Triangle Capital is a BDC headquartered in Raleigh, North Carolina which specializes in unitranche, mezzanine, second lien and equity investments in lower-to-core middle market LBOs. On their Q4 earnings call, CFO Steven Lilly explained how sponsors are “willing to pay a premium for one structure that might afford...incremental flexibility from an operational perspective with (a) portfolio company”.¹⁶ Robert Dodd, a sell-side equity analyst at Raymond James who covers BDCs, noted on the same call that while Triangle’s unitranche securities held a higher position on the balance sheet of larger firms on average when compared to their second lien notes, they priced only 80 basis points lower. This seemingly disproportionate difference between risk and yield indicates that unitranche borrowers do pay a premium for the flexibility and simplicity of the product, although up front savings may counteract the higher coupon.

Credit Quality

With the popularity of unitranche financing and the emergence of “upside-down” deals, competition for attractive buyouts has grown increasingly fierce. Lenders must offer multiple options to prospective sponsor clients, often including unitranche and traditional debt structures. “I’d say that almost in every case now we are being afforded the opportunity or we’re being requested to provide both the unitranche as well as the senior-sub type structure,” says Lilly. Sponsors certainly understand going into a deal that they will pay a premium if they choose a unitranche structure. A more cynical perspective may see this as evidence that only companies without the underlying credit quality necessary for other structures would seek unitranche financing. Jonathan Bock, a senior equity analyst at Wells Fargo Securities, observed that while great for investors, unitranche may not have the same popularity among sponsors.

Everyone loves unitranche..., and yes it sounds great, we're able to get better pricing, better protection downside, but that's from our perspective as lenders and investors.

...From sponsors or families what we're finding in the bank, term loan and mezz market, or the non-bank term loan plus a second lien there right now is a structural or cost advantage to be moving towards non-unitranche structures given the lack of volatility or given the general lack of volatility, lack of fear in the market, which would imply to us that what's going down the unitranche route is what couldn't effectively have been done by more traditional means. (Jonathan Bock, TCAP Q4 2017 Earnings Call)

It is true that the most highly sought after deals often go to the big banks and utilize the broadly syndicated loan (BSL) and high yield bond markets. However, a source familiar with this line of reasoningⁱⁱ explained that this “mainly relates to size”. It makes sense that the “best” deals go to the big banks and institutions when the quality of a deal is measured by its size—high yield bonds and broadly syndicated loans by definition finance larger deals. The only reason that historical credit scores would matter after a complete recapitalization lies in the volatility of capital markets, rather than in the requirements of senior-sub lenders. In the case of DDC, for example, Steuerman “added that the company’s previously poor credit score also made it a less popular credit”¹⁷ in the BSL and bond markets. When investment banks underwrite a BSL or high yield bond issue, they risk failing to sell the debt for what they paid for it. Private or “direct” lending does not carry the same risks, because the lenders typically hold loans on their books rather than selling them. In the middle market, deals are not typically big enough for BSL or bonds anyway, so this is a non-issue.

ⁱⁱ This source preferred to remain anonymous

Unitranche first sprang onto the scene in the wake of a credit freeze which all but brought bank lending to small companies to a screeching halt. It started in the lower middle market because savvy financiers identified a niche in which they could establish a foothold that would allow them to seize market share from the banks, and they have no intention of ceding that market share now. In fact, deals such as DDC's \$515 million refinancing, GSO Capital's \$625 million contribution to the merger of Italian chemical company Polynt and U.S. peer Reichold,¹⁸ and Ares' Capital's \$1.075 billion facility in support of the QLIK acquisition indicate that unitranche may play a much larger role in future LBOs.

Bankruptcy Risks

Of course, BDCs like Triangle argue that they are “not a lender of last resort”¹⁹, and that the vast majority of unitranche deals could just as easily support more traditional structures. While this may be true, lenders have very limited history to pull from when determining whether to enter into a unitranche agreement. Specifically, skeptics worry that the legal document governing the relationship between lenders, known as the agreement among lenders or AAL, may not garner the same treatment afforded to intercreditor agreements from bankruptcy courts.

AAL Enforcement

Only one unitranche bankruptcy proceeding exists as an indication of how future liquidations may play out. In 2015, RadioShack Corporation filed for bankruptcy with the Delaware Bankruptcy Court. At the time, RadioShack was financed by two separate unitranche facilities. One, a \$585 million syndicated asset-backed facility, was secured by a first lien on the company's inventory and receivables and a second lien on the firm's other assets. Various funds made up the first-out lenders, while an affiliate of Standard General, LP held the last-out position. Additionally, a \$250 million term loan held a second lien on the inventory and receivables and a

first lien on other assets. This loan came from an affiliate of Cerberus Capital (the first-out lender) and an affiliate of Salus Capital Partners (the last-out lender). Without delving into more detail than necessary, Standard General offered a credit bidⁱⁱⁱ for the secured assets, which was ultimately approved, although contested by other lenders. This case ultimately lends credibility to the AAL which lays out the terms of a split unitranche facility, and should give some comfort to investors that courts will uphold these agreements in future unitranche proceedings.²⁰ However, it is important to note that the judge made it clear that he was not ruling on the court's jurisdiction to hear the case, because all parties consented to the jurisdiction. Additionally, the lenders agreed to a settlement of their disputes, which means that the court never made an official ruling on the unitranche issues. Ultimately, while this case does provide some evidence of the viability of an AAL in bankruptcy proceedings, it is nevertheless inconclusive.

Voting Rights

Many bankruptcy disputes center around the rights of each lender to vote on how to handle a liquidation. In first lien/second lien cases (the most comparable to unitranche), courts have sometimes overruled the terms of an intercreditor agreement because they considered them breaches of fundamental bankruptcy rights. For example, if a second lienholder waives the right to vote in the event of a bankruptcy, a court may decide that bankruptcy law gives them that right regardless. In other cases, courts have upheld the clauses that waive or assign the voting rights of junior lenders. It is unclear whether courts will treat unitranche lenders as separate voting entities and uphold the voting provisions laid out in the AAL.

ⁱⁱⁱ A credit bid allows a secured lender to control the sale of collateral by bidding up to the total amount of principal for the assets. This prevents cash bidders from buying the assets at a deep discount and leaving the creditor with less cash than necessary to recover their principal.

Post-Petition Interest

Generally, accrued interest is not paid in a bankruptcy proceeding unless the loan is “oversecured”, meaning the collateral securing the principal is worth more than the principal balance. Interest paid from the difference between the value of the principal and the collateral is referred to as “post-petition” interest. In past bankruptcy proceedings dealing with non-unitranche structures, single collateral granting clauses covering multiple tranches were treated as a single lien across all tranches. This means that in order to award post-petition interest, a court must find that the value of the collateral exceeds the principal of all tranches, not merely the most senior tranche. If this same logic were to be applied to a unitranche bankruptcy proceeding, first-out lenders may receive less post-petition interest than they would have under a first lien/second lien structure, if any at all.

Inconclusive History

When all is said and done, the jury is still out on how and if courts will uphold agreements among lenders the way that they have historically treated intercreditor agreements. AALs are not the first documents that judges have had to interpret with limited prior experience, and the fact that they most closely resemble intercreditor agreements suggests that they should receive the same treatment. Lenders pay highly qualified lawyers millions in fees to draft these documents, and at the end of the day, there is one easy way for lenders to mitigate bankruptcy risks—only invest in companies with solid management, stable cash flows, and proven track records.

Unproven Recovery Rates

Ultimately, all concerns related to the treatment of AALs by bankruptcy courts hinge around one issue—how much money do lenders get back if things do not go as planned? In a

private call, BDC equity analyst Robert Dodd explained why collateralization may not necessarily provide a junior lender with any real added security over an unsecured mezzanine loan.

If you look at the historic credit loss rates on second lien since the '80's...the recovery rate on second lien is very similar to mezzanine...So while those things get talked about differently—people say well second lien is senior secured, and mezzanine is not, it's unsecured—but historically they have very similar recovery rates. So frankly, I don't care what you call it, I care how much money I get back if things go wrong...The legal structure is just an indicator of how that might work. (Robert Dodd, Phone Conversation 2017)

Unfortunately, unitranche data does not go back to the '80's—in fact, as Mr. Dodd also pointed out, “unitranche has only been a major part of the market during a pretty benign period in the credit cycle.” This means that while we can accurately weigh the risks of senior-sub deals based on decades of historical data through periods of both economic expansion and contraction, we cannot do the same with unitranche. Theoretically, unitranche loans should be better secured than mezz or second lien loans. In theory, second lien loans should also have lower credit loss rates than mezzanine debt, but according to Mr. Dodd, the data says otherwise.

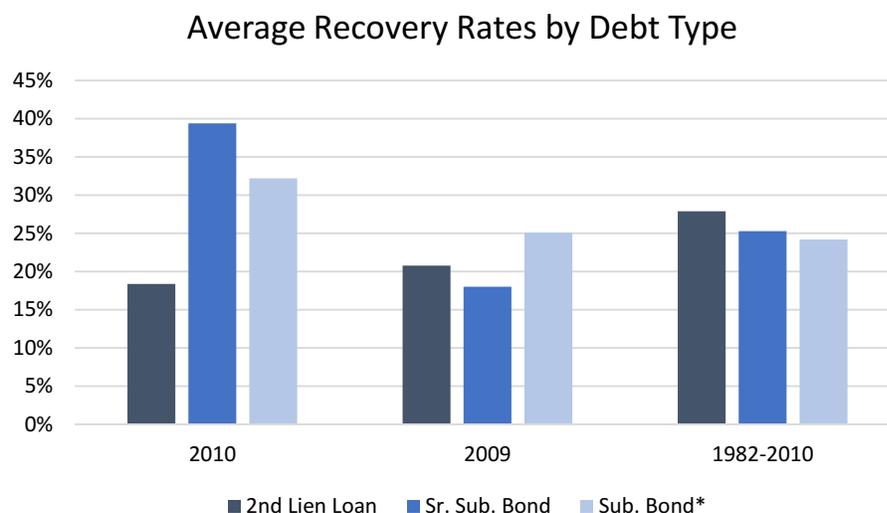


Figure 8. “Average Corporate Debt Recovery Rates Measured by Post-Default Trading Prices”, broadly syndicated corporate loans/high yield bonds; not perfectly indicative of direct lending trends (Moody’s, 2011)

Hypothetically, if you were Triangle (Capital), and you were historically a mezzanine lender, unitranche *should*, should, giving no opinion, should have a higher recovery rate than pure mezz...because 75-80% of a unitranche structure is effectively first lien, and so that should have a higher recovery rate than just the mezzanine piece. (Robert Dodd)

This makes sense, although it fails to account for an important aspect of most U.S. middle market unitranche structures. BDCs do not always hold the entire debt portion of a deal on their books. Instead, they sometimes bring in a first-out lender to finance the first turn or two of leverage in order to lever up their returns as the last-out lender. Time will tell whether the difference between a last-out lender in a unitranche structure and a second lienholder or mezz lender goes beyond legal terminology and translates to higher recovery rates.

Conclusion

Clearly, each form of LBO financing has its own merits and drawbacks. Traditional structures do typically offer a lower weighted average coupon and have a more robust history on which to base expectations. Unitranche, on the other hand, is simpler, cheaper up front, faster, and more flexible. “What’s the old saying with a car? You can have reliable, fast, cheap: pick any two. You can’t have everything at once. In simplistic terms, with unitranche versus senior-sub, you are trading off simplicity versus cost.” (Robert Dodd)

While unitranche does have one arguable disadvantage in that it costs slightly more than the alternatives, it has also only been around for a few years. Right now, BDCs have no incentive to lower the coupons they charge, because for one, sponsors seem quite willing to pay the higher price, and secondly, most unitranche lenders would be just as happy in a mezzanine or second lien position at an even higher rate if clients reject unitranche offers. If credit conditions change and competition demands lower pricing on unitranche, its brief history demonstrates that providers have no problem compressing yields to win deals. Coupons on middle market unitranche debt have compressed from double digits in the wake of the crisis to between 8-9%, indicating that when necessary, finance companies have no problem competing for attractive investments. Herein lies the root cause behind BDCs’ domination of banks in recent middle market deals—like the products they offer, they are extremely flexible, whereas, like the products *they* offer, banks are rigid and highly regulated. Bank depositors do not want their money in high-risk, high-return investments. BDC investors welcome and expect management to put their capital to work.

Structure Comparison

This table provides a quick review of the main selling points for unitranche financing, juxtaposed with those of competing structures. It is important to note that besides cost, all the risks of unitranche relate to the fact that it is simply too new of a product to draw data-driven conclusions. When I asked him what two-document structures had to offer besides a potentially lower cost of capital, Robert Dodd responded “well that’s basically it. You’ve got more paperwork, more complexity, but a lower cost of capital,” and he was quick to point out that “cost is not just coupon,” meaning that even at higher explicit rates, unitranche may offer better overall value to sponsors due to up-front savings.

At the end of the day, the only party that has not benefitted from the emergence of unitranche in the middle market is the banks, who would rather own a true first lien than a “first-out” tranche of a unitranche deal given the same interest rate, if for no other reason than that it puts the ball in their court. Unitranche, and bifurcated

Table 3. Benefits comparison: Unitranche vs. two-document structures (senior-sub & FLD/SLD)

Unitranche	Two-Document
Simple: One Lender, One Rate	Lower Coupon
Less Documentation & Lower Upfront Costs	Diversified Creditor Base
Quicker Closing	More History on Court Cases, Default Rates, Recovery Rates
Less (if any) Syndication/Execution Risk	...
Quicker Closing	...
Less (if any) Syndication/Execution Risk	...
Less Time/Money Spent on Due Diligence	...
Lower Debt Service Costs (PIK; Non-Amortizing)	...
Alignment of Stakeholder Incentives	...
Better Risk/Return Profile for Lenders	...

unitranche in particular, has truly turned the middle market upside down, taking the power away from the banks and placing it in the hands of BDCs and private debt funds. Ultimately, unitranche passes risk up the balance sheet, as sponsors receive the same financing with better terms and a similar net cost of capital (after accounting for front-end savings) while junior lenders lever returns in either direction and senior lenders trust that in the event of a default, courts will honor the terms of the AAL.

The Future of Middle Market Leveraged Loans

So unitranche offers better terms to sponsors, better security to non-bank lenders, and saves everyone the hassle of extra paperwork, but is it here to stay, or just “the current preferred flavor of ice cream”? (CEO Ashton Poole, TCAP Earnings Call) Only time will tell, but many professionals hold a “secularly positive view” on the future of unitranche. (Anonymous source) Even its proponents offered entirely different reasons as to why unitranche has a bright future in the middle market. Robert Dodd “think(s) unitranche is a late cycle financing vehicle, and early in the cycle you’re probably going to shift more towards senior-sub structures, but I don’t think unitranche is a one-time thing this cycle. I think it is going to be a permanent part of the (credit) cycle.” He views unitranche as more useful in looser credit markets where lending is more competitive, whereas another analyst (who prefers to remain anonymous) claimed that “unitranche is a favored product when there is more volatility.” Unitranche actually arose during a period of extreme volatility in early part of the credit cycle, yet has thrived as the cycle has advanced and conditions have improved. Investors should always approach new financial products with cautious skepticism. However, every piece of evidence over its brief history points to the conclusion that unitranche lending is indeed the future of lower middle market leveraged buyouts.

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