

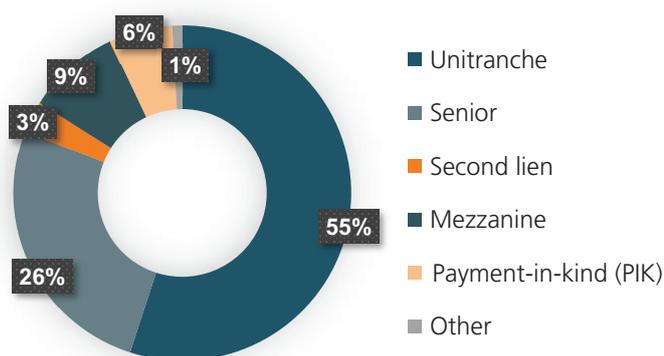
November 2018

Rise of unitranche financing in the Danish mid-market?

Following the 2007 credit crunch and the subsequent financial crisis, unitranche facilities have become a significant financing option in Europe. A recent survey shows that unitranche financing now accounts for around 55 % of the funding for primary European mid-market.

We are now beginning to see the first unitranche facilities appear in the Danish mid-market and Kromann Reumert have been advising on several of these structures. Below, we provide a brief introduction to unitranche financings and some of the advantages and challenges seen in the Danish market.

Funding structure – European Mid-Market deals



Source: Deloitte Alternative Lender Deal Tracker Summer 2018. For the purpose of the deal tracker, Deloitte classify senior only deals with pricing L+ 650 bps or above as unitranche. Pricing below this hurdle is classified as senior debt.

Although it is difficult to determine whether the survey gives the full picture of the funding sources in the European mid-market, the survey indicates that unitranche lending is a significant funding source in the European mid-market.

The Nordic market appears to be behind Europe in this trend, which may be due to the fact that the deals in the Nordic market have been smaller than in the larger markets in Europe and due to a well serviced loan market in the Nordic region, which have both offered a competitive bank market and various other alternative sources of funding such as direct lending from pension funds.

What is unitranche financing?

In LBO financing, sponsors may be required to raise both senior and junior debt to fund the acquisition of a target in the mid-market. In a traditional LBO financing structure, such debt is usually provided in separate tranches: (i) a senior facility (e.g. term loan A) which is made available by one or more commercial banks and (ii) a junior/mezzanine facility (e.g. term loan B) which may be provided by an institutional investor such as a pension fund or debt fund.

A unitranche simplifies the traditional LBO capital structure by replacing the separate senior and junior/mezzanine tranches with one single tranche, i.e. a single/uni' tranche facility. The unitranche facility combines the senior and junior debt into one tranche and carries an interest rate reflecting the weighted average pricing of both senior and junior/mezzanine debt.

In most cases, the unitranche facility is accompanied by a super senior tranche provided by a commercial bank which includes financing products that require bank services (loan servicing/management, treasury functions, borrower reporting and monitoring structures etc.). Accordingly, the super senior tranche will usually include traditional banking facilities, such as revolving, overdraft, guarantee, hedging, capex and/or acquisition facilities. In the European market, the super senior tranche will most often be documented in the same facility as the unitranche facility, but the super senior facility may also be documented by a separate facilities agreement and we have seen such alternative structures in the Danish market.

LBO debt	Traditional LBO capital structure	Unitranche LBO capital structure
Senior Debt	Senior facility including senior term loan (e.g. term loan A) and revolving credit etc. provided by one or more banks	Unitranche facility including (i) senior and junior debt (combined in one term loan tranche) provided by an institutional lender and (ii) super senior revolving credit etc. provided by bank
Junior Debt	Junior/mezzanine facility which may be provided by institutional lender (e.g. term loan B)	
Equity	Equity provided by sponsor and any re-investing sellers etc.	Equity provided by sponsor and any re-investing sellers etc.

Who provides unitranche facilities?

Unitranche facilities are often provided by a sole alternative lender rather than a bank. Unitranche lending is viewed as an attractive investment by several alternative finance providers which may offer an interesting risk/return ratio. Due to the risk profile of unitranche debt (i.e. the element of the junior debt), unitranche lenders will often take greater interest in the borrower's business and may also require a more active monitoring of the business than other lenders.

Particularly lending funds such as Ardian, Ares, Babson Capital, Bluebay, GE Capital, ICG, Macquarie, Highbridge, Hayfin and Alcentra are active in the European market.

How is unitranche financing documented?

In unitranche financing, all facilities are usually documented in one single loan agreement including (i) the super senior tranche and (ii) the unitranche facility. Accordingly, the super senior and unitranche facilities will have a common set of representations, undertakings and events of default. In some cases, the unitranche lender may require stricter financial covenants than the super senior lender considering that the unitranche lender is more exposed. Such requirements may give rise to discussions with Danish banks acting as super senior lenders.

Usually, only one set of guarantees and security will be granted in favour of a common security agent holding it on behalf of the various finance parties and there will typically be an intercreditor agreement regulating the rights of the different creditor groups (including the super senior lender, the unitranche lender, hedging providers, shareholder lenders and intra group lenders).

We have seen cases in the Danish market, where the super senior facility and the unitranche facility are documented separately. Such structures will provide the super senior lender with a separate documentation, which it may enforce but the relationship between the creditors is still be regulated by an intercreditor agreement. In these cases, there will typically also be an alignment of representations, undertakings and events of default in the two sets of facility agreements.

Unitranche financing may offer more flexible terms than traditional LBO financing. This is partly because alternative lenders may be willing to accept different risk profiles than those usually accepted by banks.

In the European mid-market, unitranche facilities are usually based on the Loan Market Association's (LMA) leveraged facilities agreement with the necessary consequential changes and adjustments. A new precedent intercreditor agreement for super senior/senior facilities was published by the LMA on 17 May 2018 aimed at inter alia unitranche financing. The new intercreditor agreement is based on the LMA's existing intercreditor agreements but contains certain improvements of the super senior lender's position compared to the super senior/high yield bond documentation, which may ease the discussions between unitranche lenders and Danish super senior lenders. The LMA has not produced a standard facility agreement for unitranche lending and this may still present an obstacle, as the template LMA facility agreement requires significant adjustments in order to accommodate the super senior/unitranche structure.

What are the key characteristics of the unitranche facility?

The terms of unitranche facilities vary considerably from deal to deal, but usually have the following key characteristics:

- **Interest, tenor and amortisation:** Unitranche lenders may be able to offer more flexibility in terms of interest structures, including both traditional floating rates (based on LIBOR or EURIBOR) as well as PIK, PIK toggle, fixed interest and other structures. Similarly, unitranche lenders may be able to offer various tenors and repayment profiles including both long term lending, bullet loans, cash sweep structures and loans with fixed amortisation profiles. If a super senior facility is in place, it will carry its own interest rate reflecting its super senior status.
- **Prepayment/call protection:** The borrower will often be required to pay a premium to the lender (i.e. a “make-whole amount”), if the borrower repays all or part of the unitranche debt within a certain period before maturity (i.e. a ‘non-call period’). The terms of such provisions are often strongly negotiated and vary considerably. However, it is not unusual that prepayments are subject to a 12 to 24 months non-call period. Similar structures are seen in the Danish high yield bond market and direct lending from the Danish pension funds.
- **Covenants:** The LMA’s leveraged facilities agreement – on which unitranche facilities are usually based – includes a full suite of standard financial (maintenance) covenants and other standard covenants. As in other types of financing, these covenants are often negotiated. Due to the more risk profile and that the unitranche lender may be closer to the business than other lenders, the financial covenants may be more customized to the individual business.
- **Ranking:** The super senior facility and the unitranche facility are usually described as pari passu ranking and until an enforcement event occurs both facilities will be entitled to receive payments on a pari passu basis. Any proceeds from enforcement of the common security and other amounts payable to the common security agent will be applied in accordance with a payment waterfall whereby the super

senior facility will be paid prior to the unitranche facility. The financing structure may also include swaps and other derivative transactions, which may rank in the same manner as the super senior facility. The ranking of payments in an insolvency event or an acceleration event has been subject to discussions in Danish unitranche transactions, but the new senior/super senior intercreditor agreement published by the LMA includes certain changes to the parties’ position in these scenarios compared to the position in the super senior/high yield notes intercreditor agreement. The changes may ease these discussions.

- **Mandatory prepayments:** Customary mandatory prepayments from the LMA documentation will often be included in unitranche financings. Preenforcement, the application of mandatory prepayment proceeds from disposals, insurance claims etc. are often subject for negotiation between the super senior lender and the unitranche lender in Danish (and other European) transactions because the super senior lender wants to protect its super senior position.
- **Amendment and waivers:** If the unitranche and super senior facilities are subject to a common facilities agreement, the amendment and waiver provisions in the LMA documentation will usually be adjusted to reflect the interest of the two lending groups. The unitranche lenders will often be majority lenders and will wish to avoid excessive veto rights for the super senior lender, who, on the other hand, will typically require certain minority protections. If the facilities are documented in separate facilities, restrictions on amendment and waivers may be included in the intercreditor agreement. These matters have been subject to some discussions in Danish transactions.
- **Enforcement:** In the European market (and in the new intercreditor agreement published by the LMA), the unitranche lender will initially control enforcement. Any enforcement by the super senior lender will be subject to the occurrence of a Material Event of Default and the expiry of a standstill period. Both the definitions of the Material Events of Defaults and the length of the standstill periods have led to discussions between the super senior lenders and unitranche lenders in the Danish market.

Pros and cons for the borrower

Pros	Cons
<ul style="list-style-type: none"> ➤ A single term facility with the same leverage as a combined senior and mezzanine facility. ➤ Alternative lenders may be willing to consider risk profiles which may not be accepted by banks. ➤ More flexible interest structures may be available. Little or no amortisation and longer tenor may also be achievable. ➤ Front loaded liquidity/shareholder distribution may be available if the Borrower has a strong cash flow, which may be of particular interest to PE funds aiming to optimize their IRR. ➤ Covenants may be customised to the individual borrower's. 	<ul style="list-style-type: none"> ➤ A bank facility in the form of a super senior facility will typically be required and the relationship between the unitranche lender and the super senior lender entails some complex intercreditor issues. Especially in a less developed unitranche market such as Denmark, these issues may give rise to (lengthy) discussions. ➤ Call protection may lock the borrower in an expensive financing relative to the market. ➤ Unitranche lenders may want to be closer to the business due to the risk profile and may have certain requirements to board representation and covenants. ➤ Alternative lenders may be less likely to consider the long-term relationship with the borrower in connection with defaults, waivers, consents and amendments. ➤ Refinancing opportunities with alternative lenders may be more uncertain and costly.

CONTACT



Thomas Kaas
Partner

Mobile: +45 24 86 00 77
Direct: +45 38 77 43 53
tk@kromannreumert.com



Jakob Sonne Rydahl
Attorney

Mobile: +45 20 19 74 19
Direct: +45 38 77 43 18
jsr@kromannreumert.com