Unitranche Versus Syndicated Leveraged Loans

Unitranche Leverage Increases, Covenants Erode, but Pricing Holds in Fitch's Portfolio

Unitranche Faces Competition: Despite broad financial market volatility at the end of 2018, demand and supply for the unitranche product remains robust. Since 2014, negative benchmark rates in the eurozone and the introduction of the Solvency II capital regime for European insurance companies have contributed to a surge of capital into European leveraged loan funds, segregated managed accounts and collateralised loan obligations (CLOs). These additional non-bank funding sources for arranging banks and financial sponsors have introduced competitive pressure on unitranche providers, including downward pricing and covenant-"loose" or "lite" bullet structures.

Constrained Bank Lending Boosted Unitranche: Unitranche was introduced as a non-bank, non-securitised loan product by institutional direct lending platforms within the private debt market to provide alternative financing solutions to European small to medium-sized leveraged buyouts during the credit crisis. The instrument effectively blends senior and subordinated debt into one facility, providing financial sponsors with higher leverage than syndicated loan structures and typically lower costs than senior and subordinated debt structures.

Median Unitranche Leverage Increases: Fitch Ratings' European leveraged credit portfolio includes 32 unitranche deals closed between 2013 and 2018. The product provides over a turn and a half of additional leverage compared with what is available in syndicated and club-style bank loan structures of similar size (the median is nearly 7.0x EBITDA against 5.0x, on a fully drawn basis). The higher leverage indicates smaller equity contributions from financial sponsors for unitranche structures than for syndicated loan structures.

The median leverage for LBOs and refinancings using unitranche is also about half a turn higher than in our previous analysis in February 2018, which was based on 29 unitranche deals between 2013 and 2017. Fitch believes that 2018 represented peak leverage and peak funding conditions in the broader leveraged finance market, which also suggests a peak in leverage for unitranche.

Unitranche More Expensive than Loans: For borrowers, the median blended interest margin spread of 712bp among Fitch's unitranche deals has increased (665bp in our previous analysis). It remains around 200bp to 250bp higher than on syndicated loans of similar size. Unitranche often includes both cash-pay and PIK components while lenders are protected against negative base rates through Libor/Euribor floors up to 1%.

Covenant Protection Being Eroded: Unitranche covenants have weakened since 2014 in response to rising assets under management among direct lending platforms without a corresponding increase in addressable investments, and competition from banks and institutional loan providers in the club and syndicated markets. Sixty percent of unitranche deals in 2015 had a full set of four maintenance covenants, whereas only around one-third of unitranches had such protection in 2018. The proportion of unitranche deals with a full set of covenants remains higher than for syndicated loans of similar size, as less than 15% of such deals had a full set of maintenance covenants in 2018.

Dividend Recaps Rare in Unitranche: In contrast to larger "club style" and broadly syndicated transactions, unitranche borrowers are typically smaller, less diversified and with more volatile earnings so that undertaking dividend recaps is more challenging for sponsors. Fitch believes that the appeal of unitranche continues to lie in the bespoke documentation, confidence in execution at underwriting and availability of acquisitions/capex lines that support growth and M&A strategies.

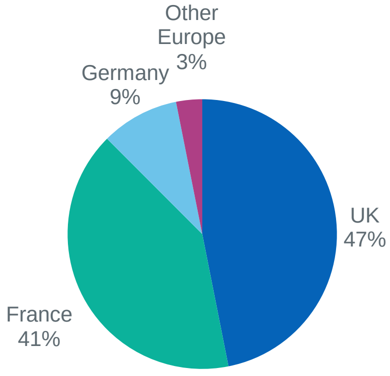
Most Unitranche at 'b−': Unitranche borrowers below EUR200 million continue to exhibit weaker fundamental credit quality than syndicated loans of similar size. Most of the unitranche borrowers in Fitch's portfolio have a credit opinion of 'b−*,' compared to just half of syndicated loan borrowers. Execution risk in business strategy is higher for small unitranche borrowers. The higher cost of debt also leads to weaker interest coverage ratios and highly levered bullet structures translate into higher refinancing risk at maturity.

Lower Expected Recoveries: Fitch continues to expect recoveries on unitranche debt to be lower than for senior secured leveraged loans of less than EUR200 million. This is due to both lower going-concern enterprise values (EVs) resulting from typically smaller and more vulnerable business models and a trend toward larger RCF facilities, typically ranking ahead of unitranche on enforcement proceeds.

Update on Fitch's Unitranche Portfolio

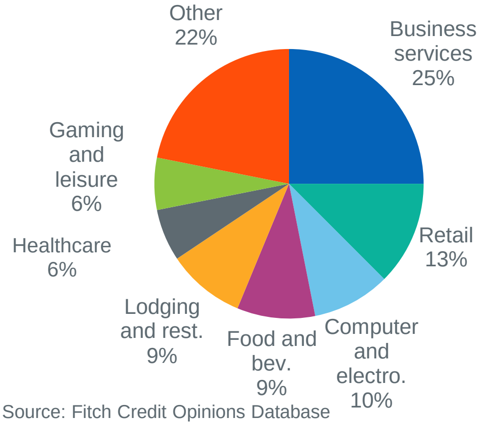
The following analysis of European unitranche facilities (primarily below EUR200 million) is based on 32 direct lending transactions to which Fitch assigned a private credit opinion between 2014 and 2018. Fitch's portfolio now includes 3 more transactions than in our previous publication on the topic (Unitranche Versus Syndicated Leveraged Loans – February 2018). The private debt managers providing the unitranche facilities have requested these confidential opinions from Fitch. They represent a third of Fitch's leveraged credit opinions among 100 borrowers with less than EUR200 million in debt over the period. The remaining two-thirds are syndicated or club transactions.

Unitranche Portfolio Split by Country
Deals over 2013-2018



Source: Fitch Credit Opinions Database

Unitranche Portfolio Split by Sector
Deals over 2013-2018



Source: Fitch Credit Opinions Database

The sample is spread across various sectors but with a relative concentration on business services, retail, healthcare and computer/electronics, as shown above. France and the UK are the most heavily represented geographies in our portfolio, which is consistent with their importance in LBO activity and leveraged loan issuance in the broader European market. The portfolio concentrates on private-equity-backed businesses (75% of the portfolio) with vintages of 31% of unitranche deals completed in 2015, 22% in 2016, 25% in 2017, and 9% in 2018.

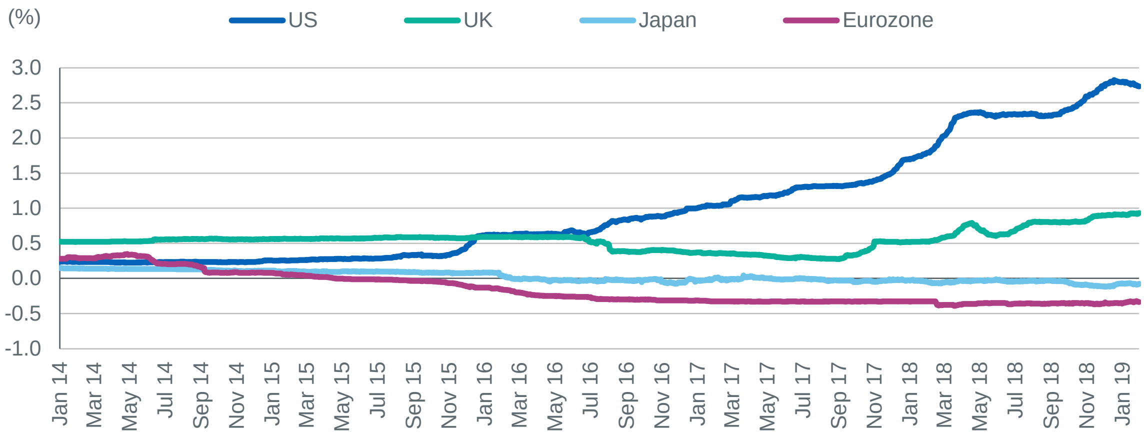
Since 2013, unitranche has become an increasingly popular product for private-equity owned small and mid-sized companies (SMEs) in Europe to raise debt away from the traditional banks and syndicated loan markets. Active fundraising has supported the growth of the asset class. Preqin[1] estimated that direct lending funds focused on Europe raised around USD22 billion in aggregate capital in 2017, and Fitch believes 2018 will reflect continued growth. Deloitte[2] estimates that in the past 12 months to June 2018, direct lending deal flow – of which unitranche has been the dominant structure – increased by 34% year-on-year in Europe.

Unitranche blends a senior loan and second lien or mezzanine facility into one single debt tranche. From a borrower's perspective, unitranche aims to simplify the capital structure and accelerate the financing process as the transaction is documented under one facility agreement. It also typically involves only one lender, and the lack of broader syndication requirements largely insulates the product from potential adverse market conditions and volatility affecting leveraged loans and high-yield bonds.

However, since 2014 the introduction of negative benchmark rates and lower funding costs generally have spurred European banks to return to club and broadly syndicated leveraged lending with increasingly attractive terms to meet the competitive threat of unitranche.

[1] 2018 Preqin Global Private Debt Report.
[2] Alternative Lender Deal Tracker Autumn 2018

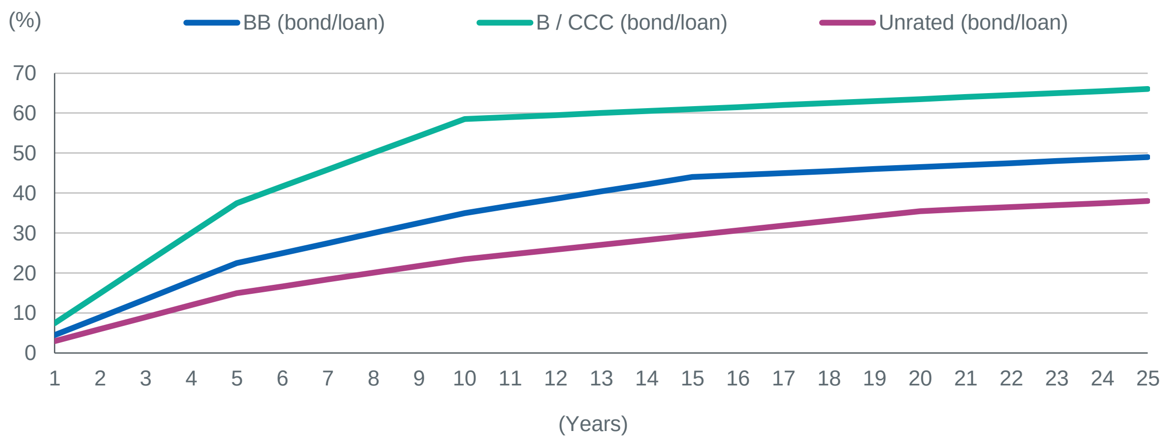
3-Month Interbank-Offer Rates



Source: Fitch Ratings, Bloomberg

Complementing renewed risk appetite from banks are the impact of lower funding costs for European CLO managers and the rapid formation of European loan funds and segregated managed accounts (SMAs). The latter are generally unleveraged with lower return requirements. They have benefited from a surge in capital from European insurance companies that have lower capital charges for unrated debt than publicly rated speculative-grade assets under Solvency II, as the chart below indicates.

Unrated Exposures Carry Lower Capital Charges



Source: EIOPA

Consequently, arranging banks and competing private debt platforms have offered financial sponsors increasingly generous terms including higher leverage, cheaper pricing in fees and coupons, covenant-lite documentation and no prepayment penalties. We compare the key terms and characteristics of unitranche financings with those of 68 club and syndicated leveraged loans of similar size (ie below EUR200 million) in our credit opinions portfolio.

Comparing Features of Unitranche with Syndicated Loans

Unitranche Appeals to Smaller Issuers

In Fitch's portfolio, borrowers with unitranche remain smaller than those with syndicated leveraged loans below EUR200 million. The median EBITDA of unitranche issuers has been EUR12 million in deals completed over the period 2013- 2018, less than half the size of sub-EUR200 million club style leveraged loan borrowers (EUR28 million EBITDA).

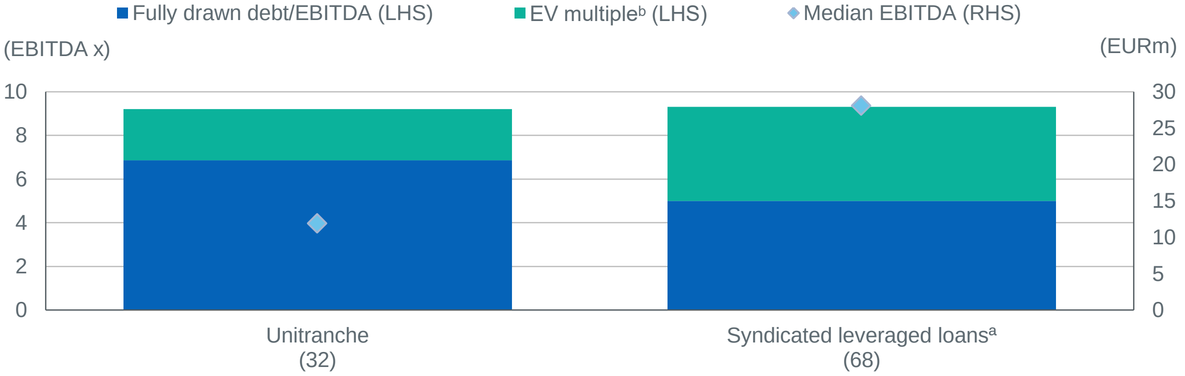
The median unitranche facility size, in turn, has been EUR52 million. Fitch has not rated any unitranche in excess of EUR250 million, even though the instrument has been used in some larger transactions in the European market, including UK-based Zenith in March 2017 where the unitranche loan exceeded EUR500 million. Under benign debt capital market conditions, unitranche faces competition for larger borrowers, as they can access other sources of financing, including broadly syndicated term loan Bs and high-yield bonds.

Unitranche Leverage Over a Turn and a Half Higher than Syndicated Loan Structures

In our previous publication, we highlighted that unitranche transactions carried (on a median basis) a turn higher leverage than leveraged loan transactions below EUR200 million in our portfolio. Private-equity backed SMEs operating at the lower end of the market may struggle to secure sufficient financing at attractive terms from traditional bank lenders and syndicated loan markets. Unitranche, however, enables them to achieve higher leverage.

In the chart below, Fitch's enlarged portfolio of unitranche deals shows that the product provides over a turn and a half of additional leverage on a fully drawn basis (nearly 7.0x EBITDA against around 6.4x in our previous report) than would otherwise be available for borrowers in the syndicated leveraged loan market of similar size (around 5.0x). With nearly 7.0x total debt to EBITDA, unitranche is able to stretch leverage to match what is available to borrowers seeking to raise more than EUR200 million in the broadly syndicated loan market.

Median EBITDA, Leverage and EV Multiples in Deals Below EUR200m Debt
2013-2018, primary market LBO/SBO/TBO/QBO and refinancings



[a] Includes a few club deals
[b] Applies to LBO, SBO, TBO, QBO only
Source: Fitch Credit Opinions Database

Unitranche More Expensive than Syndicated Loans

Unitranche's higher total leverage tolerance allows private-equity sponsors to meet rising EVs in their LBO transactions (around 9x EBITDA between 2013 2018), while protecting their return targets.

Typical LBO/SBO/TBO Capital Structures with Unitranche, Excluding Refinancings (2013-2018)

	Amount at Closing (EURm)	(x) EBITDA (EUR12m)	(%) Capital structure	Median pricing	Libor/Euribor floor	Median tenor
Super senior revolver/facility	5	0.4	4	362bp	-	6 years
Unitranche facility	52	4.3	45	712bp[b]	0.5%-1%	7 years
Total debt[a]	**57**	**4.7**	**49**			
Equity	58	4.8	51			
Total capitalisation	**115**	**9.5**	**100**			

[a] Excludes facilities for capex and acquisitions
[b] Blended cash-pay and PIK
Source: Fitch Credit Opinions Database

Unitranche facilities in Fitch's portfolio exhibit a median seven-year tenor and are non-amortising loans like term loan B (TLB) facilities, but unlike the term loan A provided by banks that typically sits alongside the TLB in bank-driven leveraged lending and LBO structures below EUR200 million debt. This provides unitranche borrowers with additional cash-flow flexibility but deleveraging may be slower, leaving them exposed to higher refinancing risk.

The unitranche median pricing structure typically blends the interest rate of a senior loan and a mezzanine facility. In Fitch's portfolio (including LBOs and refinancings), we found that the median blended interest margin spread of 712bp often includes both a cash and a PIK component and that lender returns are protected against negative Libor/Euribor rates by a 0.5% to 1% floor. Return prospects are also occasionally boosted by equity warrants which, in addition to the PIK element, are reminiscent of European mezzanine in 2004-2006.

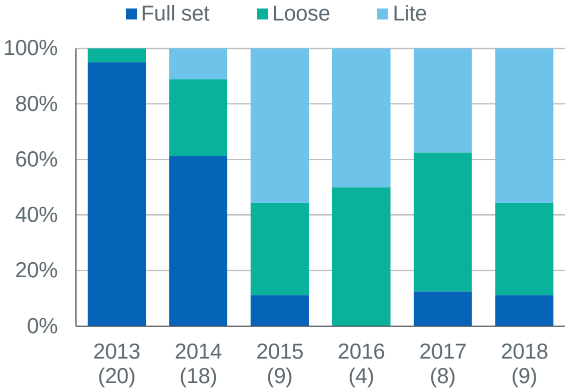
In comparison, senior secured syndicated leveraged loans of similar size are priced 200bp to 250bp cheaper but with floors typically at 0% and no warrants. Contrasting further with prevailing term loan B documentation, unitranche still offers lenders with prepayment protection as most unitranches in our portfolio feature a non-call period or make-whole provisions.

Besides the unitranche debt itself, which represents over 50% of the total capitalisation of unitranche deals in Fitch's portfolio, over half of structures include an acquisition and/or capex facility ranking pari passu with the unitranche and usually priced at the same level. However, revolving credit facilities (RCFs) also feature prominently, and as they are provided by banks, typically rank super senior on enforcement proceeds. Their higher ranking in the waterfall in case of default means that they priced lower than unitranche, around 350bp-400bp.

Covenant Erosion but Less than in Syndicated Loans

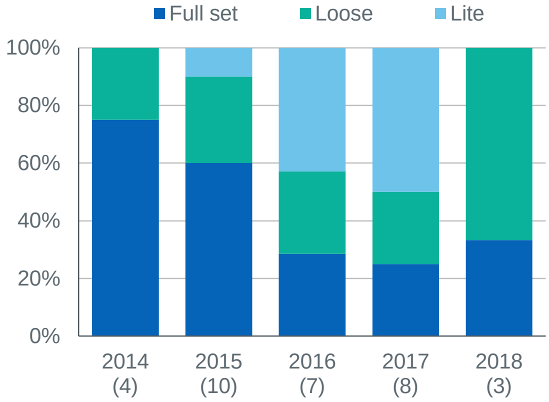
While leverage and pricing are higher for unitranche than for syndicated loans, covenant protection for lenders remains stronger, at least judging by the presence of maintenance financial covenants in the unitranche agreements. Nearly 60% of unitranche deals in 2015 had a full set of four maintenance covenants when less than 20% of syndicated loan documentation had such protection. However, unitranche documentation in 2017 and 2018 shows some covenant erosion (only a third of deals had a full set of covenants in 2018) but not as much as in syndicated loans (less than 15%). In the charts below, covenant-lite captures either the absence of covenants or the presence of only one. Fitch has so far not seen any unitranche structure without any maintenance covenant.

Covenants in Syndicated Loans
As % of total number of deals below EUR200m debt over 2013-2018



Source: Fitch Credit Opinions Database

Covenants in Unitranche
As % of total number of deals over 2014-2018

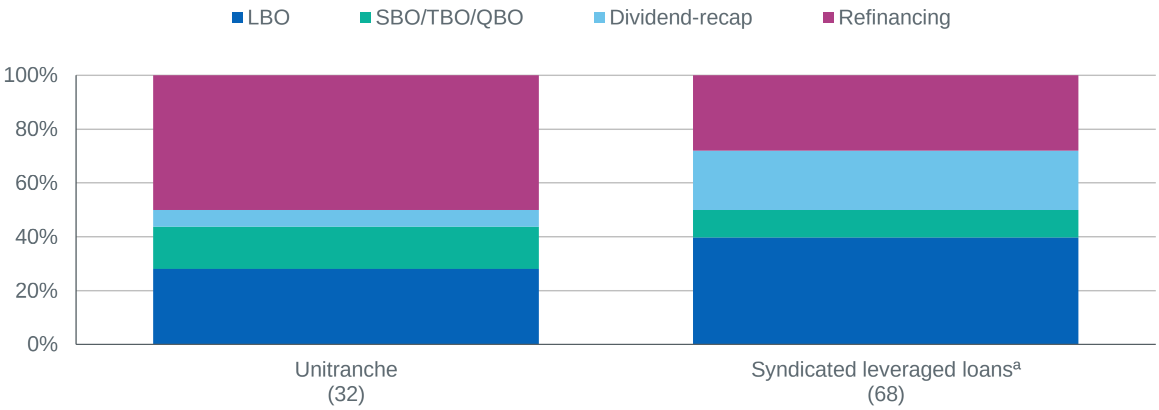


Source: Fitch Credit Opinions Database

Fewer Dividend Recaps in Unitranche

Fitch has recorded only 6% of dividend recapitalisations financed by unitranche over 2013-2018, even if 75% of unitranche deals came from private-equity-owned businesses. This contrasts with around 22% of dividend recaps in the sample of syndicated loans below EUR200 million over the same period, as seen in the chart below. Unitranche borrowers are typically smaller, less mature businesses than those financed by syndicated loans and therefore with more volatile earnings and cash flow that make the rationale for a dividend recap more challenging.

Use of Proceeds in Transactions With Debt Below EUR200m



[a] Includes a few club deals
Source: Fitch Credit Opinions Database

In addition, borrowers attracted by unitranche financing primarily seek to refinance (50% of unitranche issuance in Fitch's portfolio over 2013-2018) possibly less flexible legacy bank loans. They also expect flexible documentation to pursue organic and acquisition-led growth as bullet maturities enable borrowers to spend cash flow on bolt-on acquisitions or expansion capex instead of debt reduction.

Median Financial Metrics and Credit Quality

Weaker Credit Metrics in Unitranche than Syndicated Loans

Unitranche borrowers in Fitch's portfolio are smaller than those with syndicated loans, roughly half the EBITDA size, as seen in the table below. They also exhibit higher financial leverage on an EBITDA and funds from operations (FFO) basis. Given the higher interest cost, coverage ratios and free cash flow (FCF) margin in unitranche are weaker than in deals with similar ratings using syndicated loans.

Median Credit Metrics

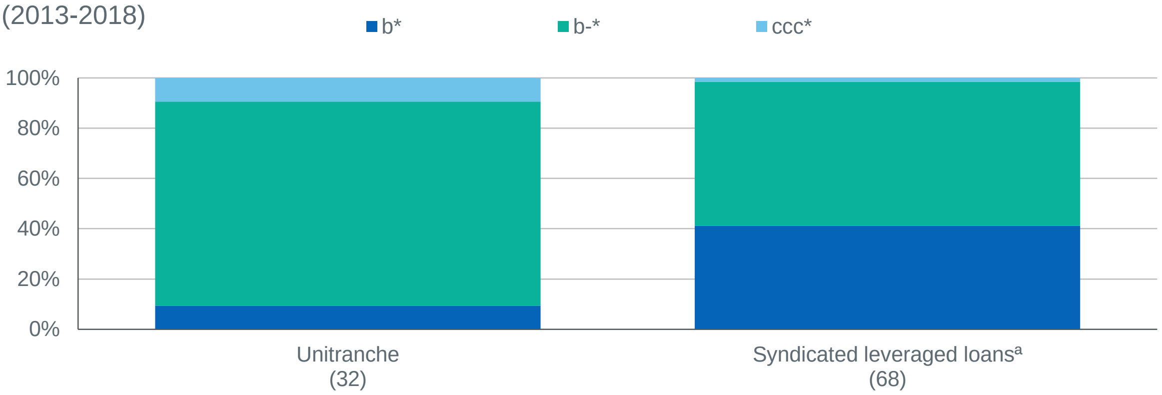
	Unitranche loans			Syndicated loans below EUR200m		
As of December 2018	**b***	**b−***	**ccc***	**b***	**b−***	**ccc***
Number of transactions	< 5	20	< 5	8	20	< 5
Net sales (EURm)	87	124	196	241	113	129
EBITDA (EURm)	21	14	7	37	18	9
EBITDA margin (%)	23.9	14.3	8.6	15.6	14.4	5.6
EBITDA/cash interest (x)	3.4	2.9	1.2	4.8	3.0	0.5
Total debt (incl. PIK[a])/EBITDA (x)	5.7	5.0	13.9	1.0	4.5	9.7
FFO lease-adj. gross leverage (x)	6.5	5.0	10.4	4.9	5.5	9.1
FCF margin – year 1 (%)	0.9	-0.2	-3.1	5.0	-0.9	-3.4

Note: This table does not constitute a prescriptive grid to determine ratings but rather it is a descriptive summary of the latest statistics in Fitch Ratings' credit opinions portfolio
(*) denotes a credit opinion
[a] In case PIK instrument is considered as debt according to Fitch Ratings' methodology
Source: Fitch Credit Opinions Database

Majority of 'b−*' Credit Opinions Also Driven by Operating Profiles

Given weaker median financial metrics than for syndicated loans, Fitch's credit opinions on unitranche over 2013-2018 have primarily clustered at the 'b−*' level, whereas syndicated loans show a more balanced distribution of 'b*' and 'b−*' borrowers.

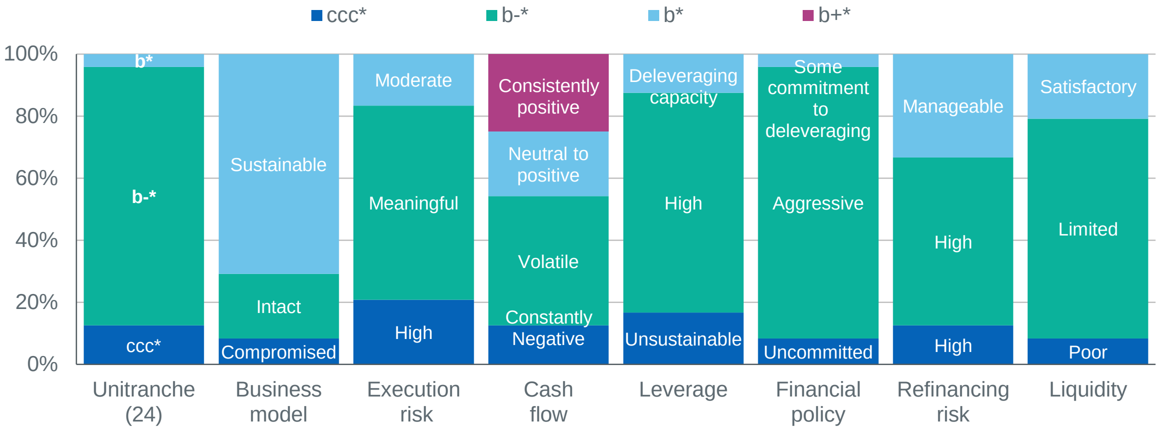
Distribution of Fitch Issuer Default Credit Opinions At Deal Closing
As % primary market LBO, SBO, TBO and refinancings with total debt below EUR200m (2013-2018)



The lower case and (*) denotes a credit opinion
[a] Includes a few club deals
Source: Fitch Credit Opinions Database

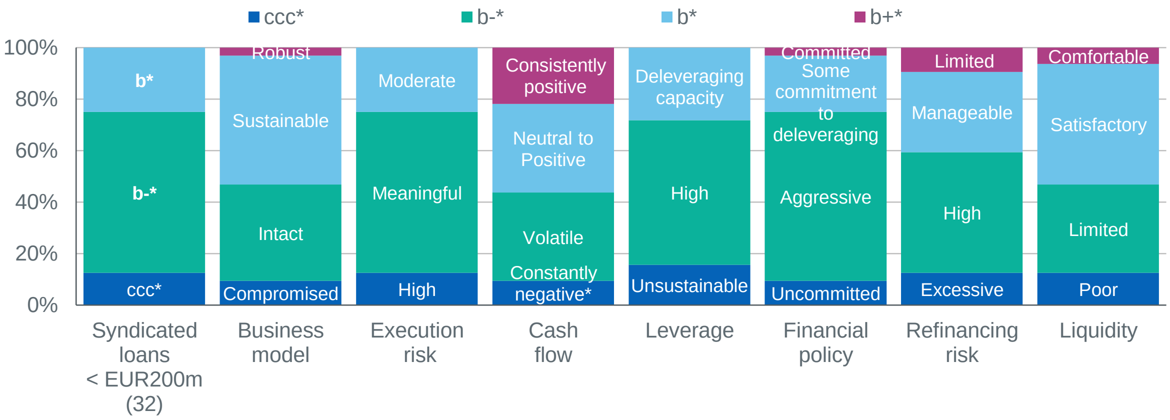
Financial metrics, however, are not solely responsible for weaker credit profiles in unitranche. The smaller size and relative lack of scale limits the ability of unitranche borrowers to absorb adverse market conditions and mitigate risks such as "key man" risk and product, country or customer concentration. This explains why Fitch considers that business strategies for unitranche borrowers tend to have "meaningful" or "high" execution risk (83% of deals), more than their peers in the below EUR200 million syndicated loan portfolio (75%) as shown in the charts below.

Distribution of Differentiating Factors for Unitranche Borrowers Rated b+*' and Below
As of December 2018



Source: Fitch Credit Opinions Database

Distribution of Differentiating Factors for Syndicated Loan Borrowers Below EUR200m Rated 'b+*' and Below
As of December 2018



Source: Fitch Credit Opinions Database

Fitch also considers that financial policy tends to be more conservative in syndicated loans than unitranche deals with 25% of the loan deals showing some commitment to deleverage compared with less than 5% in the unitranche portfolio. Besides weaker financial metrics overall, these qualitative assessments further support credit opinions at the lower end of the 'b*' category for unitranche borrowers.

Default Rate and Recoveries Outlook

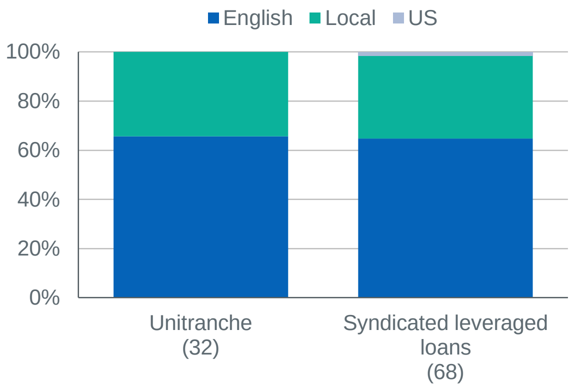
Unitranche Yet to Face a Default Cycle

To date, Fitch has not recorded a single default in its unitranche portfolio. However, the majority of unitranche deals currently exhibit limited financial flexibility and the 'b−*' credit opinions reflect their reliance on either above-average earnings growth expectations to deleverage, or alternatively, lenders having an appetite for refinancing at maturity.

Excess liquidity in the leveraged credit markets will mitigate the possibility of a material increase in default rates in the short term. However, many unitranche borrowers, similar to the broader leveraged credit market, are in sectors exposed to technological, regulatory or macroeconomic disruption, and the agency expects defaults to materialise over the medium term.

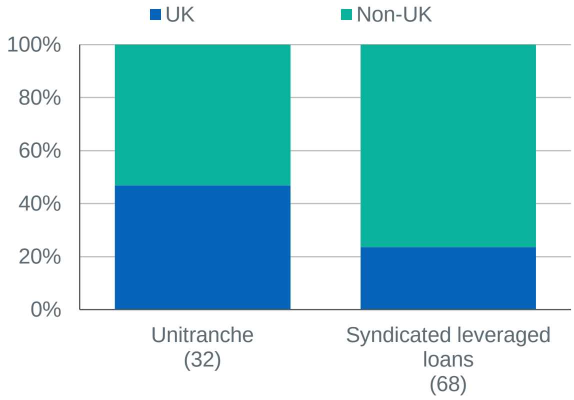
While unitranche facility agreements, like syndicated leveraged loan documentation, are usually governed by English law regardless of the centre of main interest (COMI) of the borrower (see charts below), the structures remain principally untested under various European insolvency regimes, which may raise uncertainty over the interpretation of some aspects of the documentation.

Governing Law in Documentation
As % of total number of deals over 2013-2018



Source: Fitch Credit Opinions Database

Borrower's Centre of Main Interest
As % of total number of deals over 2013-2018



Source: Fitch Credit Opinions Database

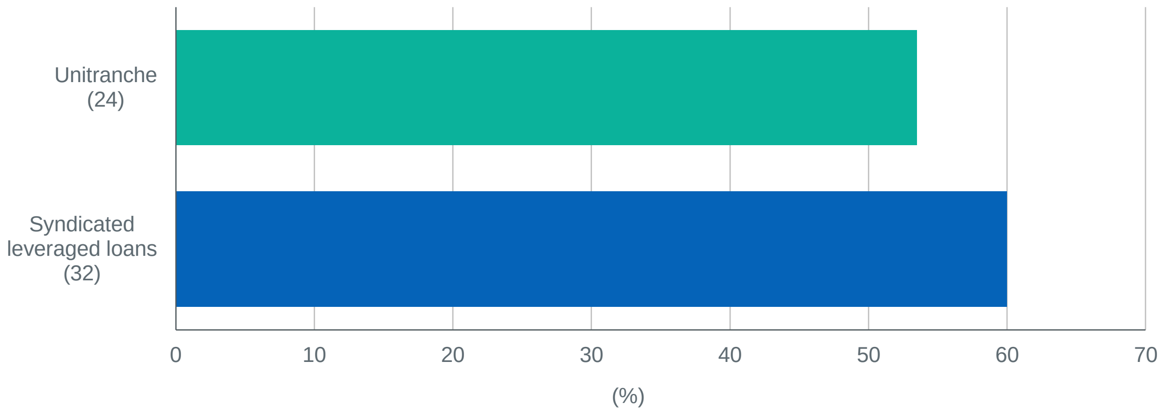
Specifically, from a borrower's perspective, unitranche facilities may appear like one single tranche of debt. However, an agreement among lenders (AAL) which is invisible to the issuer, usually governs the relationship between various "sub-tranches" of the unitranche, which has been negotiated separately to accommodate risk appetite of specific credit investors.

In addition, the presence of an RCF which usually ranks super senior on enforcement proceeds may complicate the ability and efficiency with which unitranche lenders can exercise their claims and rights in various European jurisdictions. Given the relatively small sizes of RCFs in the capital structure, however, Fitch anticipates that value will probably "break" in the larger unitranche facility.

Fitch-Expected Recoveries in Unitranche Lower than in Syndicated Loans

Fitch's recoveries are premised on going-concern restructurings that reflect the principle of priority ranking. On that basis, Fitch expects lower recoveries on unitranche debt (median 53% in the chart below) than in senior secured leveraged loans of less than EUR200 million (median 60%).

Fitch-Expected Median Senior Debt Recovery Rate (%) Upon Default
Unitranche versus syndicated loans below EUR200m as of 31 December 2018



Source: Fitch Credit Opinions Database

Three main reasons support this expectation. First, the smaller size and lack of scale of many unitranche borrowers means that going-concern valuation multiples can be lower than for larger borrowers. Going-concern multiples in Fitch's smaller unitranche deals range from 3.0x-5.0x post-restructuring EBITDA compared with 3.5x-5.5x for larger syndicated deals.

Second, the greater business strategy risks related to “key man” risk and lack of product, customer and geographical diversification also mean that the reduction in EBITDA causing a default is typically higher than in larger deals and result in lower post-restructuring EBITDA. In Fitch’s unitranche portfolio, the median discount to reported EBITDA has declined to 20% compared with 25% on larger syndicated loan transactions.

Third, the available EV distributable to unitranche lenders is reduced by the RCF claim typically ranking first on enforcement proceeds. This is similar to a super senior RCF/senior secured notes structure in the European high-yield bond market and contrasts with a leveraged loan-only structure where the RCF usually ranks pari passu with senior secured loans and therefore shares recoveries in a default scenario. Fitch does not intend to capture the agreement between unitranche providers when calculating its unitranche recoveries.

Fitch believes that the future of the unitranche product will largely depend on its ability to better navigate an economic downturn and credit market correction than the European mezzanine debt did in 2008-2009, as well as generate superior recoveries in a default cycle. High default rates and poor recoveries translating into poor returns for credit funds and their end-investors could compromise future fundraising activity.

Related Research

Unitranche Versus Syndicated Leveraged Loans (February 2018)
Unitranche Versus Syndicated Leveraged Loans (February 2017)

Analysts

Anthony Elia, CFA
+44 20 3530 1807
tony.elia@fitchratings.com

Edward Eyerman
+44 20 3530 1359
edward.eyerman@fitchratings.com

Edouard Porcher
+44 20 3530 1270
edouard.porcher@fitchratings.com