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Unitranche – art not science

Alcentra's **Graeme Delaney-Smith** looks towards the growth of unitranche to become the financing instrument of choice for European non-sponsor-backed corporates.

Direct Lending to some, private debt to others. This byword for the systemic change sweeping the European market is the most significant shift in financing since the introduction of the first collateralised debt funds of the late 1990's. In a short space of time, an attractive new asset class has emerged within Europe with far-reaching consequences to the lender base and opportunities for borrowers. Significant capital is being raised by established managers and new entrants remain hopeful of finding a niche or foothold in a fast developing marketspace.

The great recession provided the European middle market with the catalyst to end decades of reliance upon the established banking system. The systematic change which started with the European banking crisis is starting to take shape through the efforts of direct lending operations such as that by Alcentra.

Direct lending and the solutions it offers mean different opportunities and risks for investors and asset managers alike. Institutional funds may invest in anything from bank-like senior debt, especially those who find deal origination challenging, to subordinated debt for those with a greater appetite for risk and return. The range of strategies being touted seems endless, but generally, for those seriously predisposed to enlarging the market for self-arranged transactions the instrument of most interest is unitranche.

In simple terms: it is one tranche of debt providing a fully encompassing financing solution for a business. The term unitranche neatly encapsulates the

Alcentra's head of European direct lending and mezzanine investments, Graeme Delaney-Smith

pragmatic nature of the facility while concealing a range of uses, pricing and structuring options.

Why is unitranche such a sought-after beast? For borrowers the instrument is easy to understand and straight forward to implement, it frees cash flows that are not required for debt redemption and its cost is acceptable. For lenders, the opportunity to access 1st lien security for a non-amortising loan with an attractive yield is a compelling risk / reward proposition. For investors, it is an interesting space to invest capital on a floating rate, secured basis for a high relative return, that may or may not be further enhanced by leverage at the fund level.

SIMPLE SO FAR…

Sourcing deals across direct lending with a reasonable prospect of making an investment with the right level of reward and protection is not easy, as many a new entrant will testify. Established investors with a long track-record such as Alcentra have demonstrated the ability to raise capital and deploy it sensibly at a decent rate, both in speed and of return. The exercise is more challenging for newer entrants that have reduced access to market.

In the main, direct lending investments made by established players have been achieved within sensible leverage, covenant and pricing parameters. On occasion, a lost opportunity has returned to market after a more levered, cheaper or looser approach has proven to have little credibility.

Unitranche can provide the benefits of bullet repayment debt to give borrowers some flexibility in a volatile and unforgiving market that remains fragile, thus doing away with the liquidity fears seen in more recent times. This feature is attractive to those businesses pursuing growth opportunities in the form of greater or renewed investment in capex or acquisitions. Thus allowing for an element of self-funding rather than piling on additional debt – what a radical idea!

In other scenarios unitranche allows borrowers to increase the amount of debt in a simple way without requiring the need for mezzanine debt and the associated legal requirements, for solid businesses that can withstand a higher debt quantum.

Institutional loan funds are able to offer a solution in size and tailor covenants specifically to the opportunity and business requirements. They offer a faster route to implementation, don't rely on external market factors as their capital is locked

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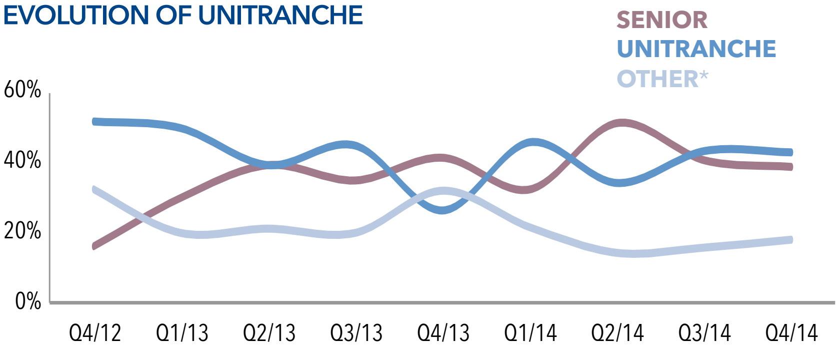
EVOLUTION OF UNITRANCHE



*Other includes 2nd lien, Mezzanine and PIK / other
Source: Deloitte Alternative Lending Deal Tracker

"THE TERM UNITRANCHE NEATLY ENCAPSULATES THE PRAGMATIC NATURE OF THE FACILITY WHILE CONCEALING A RANGE OF USES, PRICING AND STRUCTURING OPTIONS"

Graeme Delaney-Smith, Alcentra

on a long term basis and they are generally not active in secondary markets, have few investment size restrictions nor do they expose the company to syndication-related issues.

Unitranche may cover a range of strategies for lenders; for some it's easy to refer to as a 1st lien instrument, for others it's a stretch to traditional senior debt, and to others it may just replace a fully levered senior and mezzanine structure without the need to subordinate any part of the debt. Ironically, some unitranche instruments have actually been retranched behind closed doors into first-out/first-loss parts to enable a higher return to be achieved on a 'levered' instrument. How that impacts the borrower in case of a future default is yet to be fully assessed in Europe. Unfortunately this development has encouraged some in the market to think that these structures can be constructed as the norm in an effort to reduce the weighted average cost of capital, which of course is ill-considered as the pricing should remain the same across the debt profile. We do not believe these structures will represent a meaningful proportion of the market going forward.

Unitranche is not suitable in all circumstances of course, for example where the business generates significant free cashflow but has no need for further investment. The solution here may be to have a conventional banking solution with amortising debt as part of a term loan A / term loan B structure. Of course, some unitranche providers such as Alcentra are offering solutions to the funding requirements of a business and may be able to construct a bespoke solution to accommodate these instances. So it's not one size fits all and providing unitranche is an art rather than a science.

What is the future of the unitranche market in Europe? Is the unitranche product here to stay or will it be substituted by traditional or new financing instruments? We believe it will continue expanding as the instrument of choice for corporates focused on growth. As the macro economic situation across key European jurisdictions improves, businesses will focus on organic and external growth, which will require an increased use of additional capital and internal cash flows. Unitranche achieves just that. By reducing the burden of debt service, it frees cash flow for expansion. This is true of sponsor-backed businesses, which were the intial users of such instruments. However this will be increasingly true for non-sponsored corporates, that are becoming progressively aware of alternative capital sources, and unitranche in particular. The term unitranche was initially intimidating to corporate borrowers. As they realise that unitranche is just another form of senior debt, they will adopt this instrument as core in addressing their financing needs.

Private debt and unitranche are here to stay. As the European market converges towards the US market, and institutional capital replaces bank capital, private debt instruments will support the growth of the European mid-market, in a more flexible and better adapted manner than bank capital could. ■

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Alcentra is a global asset management firm specializing in sub-investment grade debt markets. With assets under management of approximately $24.1 billion, Alcentra employs 120 people, including 61 investment professionals. Alcentra has a 12-year track record investing in the following strategies: senior loans, high yield bonds, direct lending & mezzanine, structured credit, stressed/distressed debt, and multi-strategy credit. Our investors include pension funds, endowments, insurance companies, banks, and high net worth individuals. Alcentra is owned by BNY Mellon Investment Management and is headquartered in London, with offices in New York, Boston, Düsseldorf and a local presence in Singapore.