

Club Deal Evolution: Innovation in Multi-Tranche Finance

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For lower middle market companies seeking to finance growth, acquisitions, or recapitalization, there is a general perception that banks are no longer the primary lender of choice; that they have been forced to cede market share to “non-bank lenders” due to a combination of regulatory constraints, diminished ability to hold loans in portfolio, and a need to arrange “club deals” to remain competitive. It’s true, banks participating in club deals seek to remain competitive at the senior debt level in terms of pricing, however for more complex lower middle market deals they generally have tougher underwriting criteria, require shorter loan amortizations, impose more stringent covenants, and have greater financial reporting requirements. Well capitalized non-bank lenders active in the sector tend to be more flexible when it comes to complex or “challenging” transactions; culminating in banks hemorrhaging market share as lower middle market companies seek adequate financing.

A viable alternative for lower middle market companies has been Unitranche finance, a so called “hybrid loan structure” combining senior and subordinated loans, into a single, blended debt instrument. The concept essentially combines first lien and second lien debt into one credit facility, with a blended interest rate falling between the interest rates of the senior and subordinated debt. Under the unitranche structure, a single lender usually provides the entire credit under a single set of documents, with a single interest rate and maturity term (typically five to seven years); with a one-time lump-sum repayment of the entire loan at maturity. The two most noted advantages of unitranche finance are simplicity and convenience, however this comes at a price; rates for unitranche loans typically run fifty basis points (0.50%) to one hundred and fifty basis points (1.50%) higher than the weighted average of the two components that comprise the structure.

Notwithstanding, unitranche finance is seen as an alternative for companies that might have difficulty securing traditional bank finance. Unitranche facilities are more common in the lower middle market and are typically offered by non-bank lenders and specialty finance companies. The main beneficiaries of unitranche finance are borrowers with annual revenues ranging from \$10 million to \$150 million, with EBITDA (Operating Cash Flow) greater than \$2 million. However, “single-lender” unitranche deals are most common in lower middle-market transactions for companies with annual revenues ranging between \$10 million and \$50 million. While unitranche structures tends to be a little more expensive, borrowers benefits from more streamlined negotiations and greater flexibility in terms. Lower middle market borrowers have generally been willing to pay the premium above what they would have paid to a traditional banking institution.

The disadvantages of unitranche finance are that (i) unitranche lenders usually seek non-call/early prepayment protection for the first 12 to 24 months of the life of the loan, with most lenders including a “make-whole” provision in the credit agreement for the first two years, so that any interests and fees that are due during this period can be paid alongside the other prepayment amounts. And (ii) unitranche lenders typically require a pledge of shares in the borrower’s company, with the aim of gaining control should an enforcement event occur. Lastly, but perhaps most significantly, (iii) the symbiotic relationship relationship between Asset Based Lenders (revolver lenders) and Business Development Company / Credit Funds (term lenders), who so successfully partnered to provide split-lien unitranche finance, is starting to fray over lien fighting

A split-lien (or split-collateral) unitranche structure is one in which the revolver lender only has priority with respect to the revolver collateral (accounts receivable and inventory), and the term lender has a blanket priority lien over all other collateral, which typically entails general intangibles. The gray area is general intangibles, such as IP and customer lists, being in the middle of a tug of war over lien rights. Standard practice used to specify ABL firms got all the assets, so the revolver lender was first in the waterfall of payment and collateral, and the term lender was second. Recently, however, term lenders have started pushing for IP and general

intangibles while carving out the A/R and inventory for the revolver lender. In response, ABL firms are starting to make this a sticking point in negotiations; this is creating cracks in this market.

Another disadvantage is that unitranche lenders normally do not usually provide working capital finance for companies; most unitranche lenders are simply not equipped to administer revolving line of credit facilities, one which virtually all banks offer and routinely administer. Some unitranche lenders do offer lines of credit within the unitranche structure, however because they generally lack the experienced administrative staff and systems to manage revolving credit facilities, they usually “participate” the revolver out to a bank of their choosing, rather than a bank of the borrower’s choice. Notwithstanding, realizing early on that as a way to hedge and offer a competing product, enterprising banks have taken the initiative and collaborated with Credit Fund (term lenders) to overcome constraints set by leveraged lending guidelines and capital requirements, to meet lower middle market borrower needs.

In this iteration of unitranche finance the banks and credit funds define their relationships within the credit agreement via a payment waterfall set forth in the Agreement Among lenders (“AAL”); these transactions are being done in a split-lien fashion in which the inter-creditor agreement defines the waterfall. While the collaboration between banks and credit funds, like any relationship, is in constant flux (as is the collaboration between ABL lenders and Credit Funds), for banks collaboration with other market participants could represent a more efficient approach to meeting emerging customer needs. Well capitalized non-bank lenders active in the sector tend to be bigger participants in club deals (or in junior structures); the collaboration of such institutional lender / investors in the lower middle market has undoubtedly improved market liquidity and increased efficiencies.

In the current economic landscape, many lower middle market companies have become aware that they simply can’t rely on just one type of lender or credit facility; dynamic shifts in the economy have increased the need for more flexible financing options. Hence the recent evolution in the “club deal”, which is now about more than money, it is focused on finding the right financial partner, with right expertise and relationships in a particular sector to more fully serve emerging customer needs. One of the big drivers behind the evolution is multi-tranche finance, the ability of banks to place capital alongside other institutional lender / investors on a specific collateral assignment basis. It is a mode of finance that works best when lender / investor interests and strategies are pre-aligned. Multi-tranche financing gathers lenders together to negotiate and come up with favorable terms that minimize conflict and do not overly burden borrowers.

When these lenders confer and agree on a deal, they can offer a significant amount of senior and multiple classes of debt, that customizes risk. It is pertinent to note that banks, who can be integral in this form of finance, are experienced in developing intercreditor agreements with term / subordinated debt lenders, often having standardized agreements in place with some credit fund / term debt providers. These standardized intercreditor agreements can remove potential complexity and reduce legal fees. Multi-tranche financing is defined by such relationships; specifically defined by three or more tranches, associated with specific lender / investor facilities, and dedicated (or specific) collateral assignments. When historically low interest rates on bank loans are combined with the higher cost of credit fund term or subordinated debt, the blended cost of capital to a borrower in the current interest rate environment is often less than rates offered on unitranche loan structures.

Working with an innovative lender is essential for lower middle market companies to get access to the flexibility they need to grow and succeed. To meet lower middle market borrower needs in the new economy innovative lenders are providing viable alternatives to traditional lending models, and collaborating to connect growing companies to efficient ancillary channels of lower middle market finance. Multitranche finance accommodates such collaboration through hybrid structures, such as a combination of asset-based and cash-flow-based lending, wherein the borrower obtains a cash flow based a revolving credit line, an asset-based revolver (supported by its receivables and inventory), along with a non-revolving equipment acquisition line of

credit / term loan, in one credit facility, together with a mezzanine or subordinated debt facility.

Under such structures, many senior lenders opt to retain the hybrid asset-based and cash flow based revolving lines of credit, together with the non-revolving equipment acquisition line of credit / term loan, while the mezzanine / subordinated debt facility typically involves collaboration with a mezzanine / subordinated debt lender. In other scenarios and the cash flow based revolving lines of credit together with the non-revolving equipment acquisition line of credit / term loan is retained, while the asset-based line of credit (supported by receivables and inventory) and the subordinated debt facility then involve collaboration with an asset based lender and subordinated debt lenders, respectively. As with unitranche and traditional club deals, intercreditor agreements harmonize the sets of documents into a single document, the Agreement Among Lenders (AAL), which addresses intercreditor rights and obligations.

The advantages of multi-tranche finance for lower middle market borrowers is clear; they can enhance their working and growth capital to fuel business plans and help maintain a competitive edge. Efficient execution of a multi-tranche deal require coordinated decision making in which third party intermediaries become particularly useful. For lenders, a third party intermediary is useful in avoiding implicit creation of a partnership, and to avoid lenders from inadvertently acting as guarantors to one another. A Multi-tranche deal is essentially a collection of bilateral loans between a borrower, a bank or senior lender and two or more or non-bank lenders; the art of the deal is to synchronize lender interest, monitoring, and enforcement, while optimizing borrower access to capital and liquidity. It is accordingly critical to coordinate who shall be lending and advancing on which assets, what type of loans are viable in each case, and how to combine these loans into an efficient Multi-tranche solution.

Hermes Capital Partners is actively involved in the capital markets on a daily basis, and have in depth experience in all aspects of lower middle market finance. The Hermes team has well over thirty years collective experience in lower middle market banking and finance, and is adept at coordinating and arranging multi-tranche deals. We endeavor to understand each borrower / company's particular history, value proposition, and financing circumstances and requirements. We have experience in helping growth companies seeking greater liquidity or expansion capital, as well as companies under pressure from their existing bank or junior lender. Hermes Capital Partners works with banks and non-bank lenders and lower middle-market companies across all industries located in the Western United States.

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