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Assessing Unitranche Financing In Europe And Germany


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Law360, New York (July 31, 2015, 10:03 AM ET) -- In the last few years, unitranche financing has been heralded as the new "trend in European corporate financing" and as an "alternative to traditional bank financing." Unitranche is not really a legal term, but a marketing term. It is an all-senior loan structure that combines senior and subordinated debt into one amount bearing a blended interest rate that would usually fall between the rates for the two types of debt. Unitranche debt is provided by one or more credit funds, on the basis of a single set of documents.

At the moment, there are around 95 active credit funds in Europe. In 2014, around 60 unitranche financings took place in Europe, 13 of which came from the German market. As a result, Germany is the third-largest market for unitranches in Europe, after the United Kingdom and France.

Another increase is expected soon, as just recently the German Federal Financial Supervisory Authority announced changes to its administrative practice according to which lending directly from credit funds is now explicitly allowed, if specific requirements are satisfied.

But, when analyzed, does unitranche financing in the European and German market live up to expectations?

Expectations Toward Unitranche Financing

The expectations toward unitranches were high. For various reasons, it was expected that unitranches would establish itself as a real alternative to bank financing in Europe.

First, it was expected that banks' regulations after the financial crisis, and banks' reservations to lend would create an opportunity for unitranche providers to enter the market.

Second, unitranches were expected to have smaller transaction costs, more transaction certainty, more transaction speed and flexible amortization structures, and to be more flexible with financial covenants than bank financing. Additionally, it was expected that unitranche providers would be willing to accept higher debt-to-equity ratios.

The disadvantages when compared with bank financing have not been overlooked. First, financing costs were expected to be higher. Second, traditional banking services, such as hedging, foreign currency accounts or letters of credit, are not available from unitranche providers.

First Experiences with Unitranche Financing in Germany

Unitranche financing has largely lived up to its expectations.

1. Credit Amounts

Unitranche providers primarily finance medium-sized acquisitions. Additionally, providers are active with refinancing and recapitalization. The financing volumes have been between €20 million and €150 million. To date, higher financing volumes are the exception in the European and German market.

2. Transaction Certainty, Transaction Speed and Transaction Costs

The expectations of significantly higher transaction certainty, more transaction speed and smaller transaction costs have been somewhat realized.

Without a doubt, transaction certainty, speed and costs are advantages when compared with traditional senior mezzanine financings. Instead of banking clubs or syndicates, the borrower must usually negotiate only with one or two unitranche providers. There is no need to consider the syndication market. Together, this accelerates the reconciliation and decision-making process, and creates flexibility.

The expectations towards unitranches as a “one stop shop,” with few financing documents required, has only been fulfilled in a minority of cases.

When the financing volume reaches a certain size, unitranche providers also form small syndicates. They engage external service providers that act as agents or security agents. This enlarges the number of parties, therefore decreasing the transaction certainty, and speed, while increasing the costs.

The number of parties and the complexity of the financing documentation also increase if a bank must be incorporated into a unitranche financing.

Due to the German Banking Act, credit funds are not able to lend directly in Germany, unless permitted under the new administrative practice of the German Federal Financial Supervisory Authority. Additionally, restructuring and loan extension are subject to strict requirements, because the German Banking Act regards both practices as lending. Therefore, in many unitranche financings, banks act as the provider of revolving credit facilities. Banks provide these facilities only on a super senior basis. This requires intercreditor agreements. The negotiations of these intercreditor agreements are difficult due to the lack of a uniform market and standard documents. These absences slow the speed of the transactions.

Meanwhile, the nucleus of these negotiations has become clearer, which is accelerating the speed of the process.

3. Maturity and the Amortization Structure

The analyzed unitranches have maturity periods between five and eight years. The loans have to be repaid at the end of the maturity period in one payment.

As expected, unitranche providers have shown to be flexible concerning the use of surplus cash flow. They allow the utilization of a surplus to finance, for example, more growth or additional acquisitions.

Limited noncall periods, such as is customary in mezzanine financings, are found less often than expected with unitranches. In contrast, unitranches regularly incorporate prepayment fees. These fees are normally charged for prepayments between 12 and 24 months after funding and amounts to between 1 and 3 percent in the analyzed unitranches.

4. Financial Covenants

The expectations with regards to more flexible financial covenant structures and covenant-like aspects have likewise been fulfilled.

Just like banks, unitranche providers appear to make use of the four usual financial covenants: debt-to-equity ratio, debt-service-coverage ratio, interest-coverage ratio and capital expenditure. Unitranche providers most often restrict themselves to two or three of these.

In the analyzed unitranches, the debt-to-equity ratios ranged between 4 1/2 times and 5 1/2 times EBITDA (earnings before interest, taxes, depreciation, and amortization). Currently, the ratios are above those of bank financings, which have a range between 3 1/2 times and four times EBITDA.

In addition, unitranche providers offer higher headroom for the financial covenants.

5. Financing Costs

As expected, the costs of unitranches are higher than the costs of traditional bank financing.

The interest rate of unitranches is determined by Euribor or Libor plus a margin. The margin is around 5.5 to 8 percent. Margin grids are not agreed upon. However, unitranches often contain minimum interest rates (floors), which range between zero and 1.25 percent as well as minimum returns, which guarantee the unitranche provider a minimum rate of return.

Unitranche Financing as an Alternative to Bank Financing

Many of the expectations towards unitranche financing have been met. Unitranche financing in Europe and Germany is indeed already an alternative to traditional bank financing.

At the same time, partnerships between unitranche providers and banks have developed. Banks can, providing traditional services such as revolving credit facilities and hedging, create a surplus. Additionally, banks can operate as agents or as security agents.

The market will have to wait to see if the number of unitranche providers and the buzz it has created continue to increase within the new regulatory environment. For small and mid-sized companies, unitranche financing is badly needed as an alternative to bank financing.

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