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Split-Collateral Unitranche

Most people will be familiar with conventional unitranche, an established and important part of the European mid-market financing landscape.

In this briefing we look at how some of the features of conventional unitranche could be combined with split collateral structures and developed to offer an alternative funding solution to companies operating and growing (either organically or acquisitively) in the speciality finance sector.

Conventional Unitranche – a Recap

- The RCF typically comprises up to 25 per cent. of the capital structure, so term lenders maintain 66 2/3 per cent voting control
- The RCF provider will have independent acceleration rights for certain "material" events of default
- RCF and term lenders vote as single class on most decisions
- RCF acceleration is subject to standstill and consultation obligations
- · Prepayments go against term loans first
- · Term lenders have option to purchase RCF post default
- RCF, ancillaries and hedging are usually super senior for recoveries

Divergence from Conventional Unitranche

In conventional unitranche, both the RCF and the term lend will be cash flow (EBITDA) lends, but speciality finance borrowers could explore the option of replacing the cash flow RCF with a receivables backed borrowing base facility, familiar to speciality finance market participants. However there will be a number of areas of divergence which will need focus from all parties, including those listed below.

Split–Collateral/Priority – In this new arrangement, it is possible the two lenders will operate a 'split-collateral' structure, where each lender will take separate security over the same pool of assets, but with varying priority rights. This is a clear departure from conventional unitranche, where security is shared, but the super-senior RCF position is created through the application of proceeds.

The RCF provider (providing the speciality finance facility) would take first-ranking security over the borrower's assets specific to the nature of a speciality finance lend (ie the receivables and related bank accounts). The term lender would take first-ranking security over the borrower's remaining assets. Each lender would then take second ranking security over the other lender's first ranking security i.e. the term lender's security would rank second over the receivables and bank accounts and the RCF provider would have second ranking security over shares, IP, real property and other assets.

Whether the RCF provider is granted any further security will be a negotiated position depending on the advance rate. If the advance rate is relatively low (for example 25 per cent.), the RCF provider may well be happy with a comparatively light covenant package, with very specific security, on the grounds that in an enforcement scenario, their exposure is small relative to the value of the receivables. As the advance rate grows however, so does the risk.

Servicing – One of the biggest differences between conventional unitranche and this structure will be how servicing is dealt with. In speciality finance deals, breach of terms relating to the servicer will have a variety of negotiated outcomes, including a drawstop, the ability to replace the servicer/step into the servicer's shoes, and calling an Event of Default under the speciality finance facility agreement.



In our new structure, there will be tension on at least two fronts in relation to the servicer:

- 1. some form of credit support is taken in respect of the servicer, ranging from negative pledge granted by the servicer, through assignment of the servicing agreement to full step-in rights. It should be noted that the value, and cash flows the servicer creates for the group will be important for the term lender, but the RCF provider will see the servicer and the servicing arrangements as intrinsic to its assets, and crucially to the preservation of those assets in an enforcement scenario; and
- 2. the trigger for the servicer termination/step in rights alluded to above may be heavily negotiated. Hair trigger events relating to the servicer resulting in Material Events of Default (see below) will not be palatable to one lender, where that results in control of the servicer moving to the other lender.

In this new structure, having a back-up servicer is likely to be an attractive option to all parties, hardwiring an independent third party post Material Event of Default, but this may have a knock-on effect on the value of the term lender's security.

Account Bank – An account bank agreement is clearly a common feature of speciality finance structures, in particular where the accounts are held with a bank outside of the lenders. Regulating the various waterfalls (see below) is a key component of any speciality finance deal, and a RCF provider will be focussed on ensuring that collections under the speciality finance facility are run through the correct waterfalls.

Waterfalls – Revolving period waterfalls, term-out waterfalls and post-event of default waterfalls have, to a large extent, found a degree of market standardisation over the last few years, subject to deal specifics and asset-class nuances. A term lender will be keen to ensure that in a distressed scenario, its exposure is moved up, or indeed into, the post Event of Default waterfall. The term lender's interest will remain subordinate to the RCF provider's.

Enforcement, Drawstop and Standstills – The term lender will be keen to restrict the RCF provider's ability to accelerate or enforce its security, and the RCF provider retaining its broad discretion to reduce availability or to stop funding altogether may be problematic.

Mirroring conventional unitranche, the RCF provider's rights may only be triggered by certain breaches, the Material Events of Default, which may include in this structure:

- payment default in respect of the speciality finance facility;
- · a breach of the borrowing base;
- breach of a performance covenant;
- breach of the eligibility criteria (subject to certain thresholds);
- an insolvency event; or
- a significant risk to the receivables.

As for conventional unitranche, the parties may agree that, following a Material Event of Default, the RCF provider may only enforce after a certain period of time has elapsed, but during that period, the speciality finance facility is drawstopped. It is worth noting that the time periods may be shorter than in conventional unitranche as erosion of the RCF provider's security could occur very quickly.

Option to cure – If the RCF provider has implemented a drawstop or is considering enforcement due to a Material Event of Default, it could be agreed that the term lender can 'cure' the Material Event of Default by extending a short additional term loan. Such 'cure' could be applicable to a borrowing base breach, and used to pay down the speciality finance facility exposure.

Option to purchase – The term lender may also have an option to purchase the debt owing to the RCF provider at par, for example following a Material Event of Default or upon the expiry of a standstill period.

Again, whilst this is a very common term in conventional unitranche, there are potential issues here. Due to the monitoring and management that such a speciality finance facility requires, it may be difficult (or even impossible) for the term lender to provide a speciality finance facility. Whilst the RCF provider may be content to be paid out by the term lender, the term lender should carefully consider the practicalities of actually exercising this option. Ultimately, the term lender may need to find another RCF provider to fund the working capital.

Competing interests

The RCF provider and a term lender may have very different priorities and exit strategies in a split collateral structure. These competing interests need to be carefully considered and then balanced in the intercreditor agreement (ICA) between the two lenders.

This process can be made much easier if both sides in the negotiation have a clear understanding of what is most important to the other lender in such a structure and why.

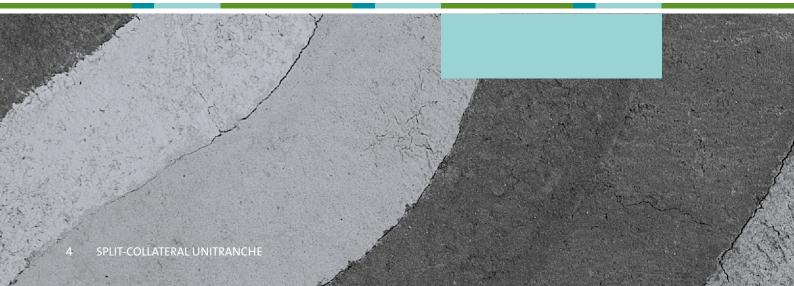
What is important to the RCF provider?

The RCF provider makes its decision to underwrite the deal mainly on the basis of the borrower's receivables. For this reason, in a distressed situation, the RCF provider needs to be able to move quickly in order to protect the value of the assets which make up its collateral. In addition, the RCF provider will want to retain a wide discretion (as is usual in speciality finance facilities) to:

- i. stop the borrower from continuing to draw under its facility;
- ii. collect in the outstanding receivables until the speciality finance facility is fully paid down; and
- iii. enforce over the receivables.

What is important to the term lender?

The term lender's concerns may be different. It may be more focused on preserving the value of the business as a whole, so that it can be refinanced, restructured or sold as a going-concern. The term lender will be concerned that a dramatic reduction of availability under the speciality finance facility would create an immediate cash flow problem for the business, and this may also reduce the ability of the term lender to engage any potential buyers or funders of the borrower's business, hence the potential paring back of rights in line with the Material Events of Default discussed above. Of course, it should be noted that any sale will likely result in a change of control and a mandatory prepayment of the speciality finance facility. If the term lender is likely to try to sell the business as a going concern, they will need to be conscious of replacing the RCF provider and the speciality finance facility or making sure the RCF provider consents to any change of control.



Market Commentary

Split-Collateral Unitranche is a very interesting structure and we think it merits consideration for a range of scenarios:

- To support lenders with sizeable broking divisions, that have historically received no value for the broking cash flows
- In FinTech to extract value for shareholders with IP in underwriting models
- To underpin business models that need flexibility in origination approach and want to pursue a funding structure with less controls
- To assist with the funding of acquisitions

We're seeing two major themes in the market that support creative funding solutions such as this.

Firstly an increase in lending appetite from debt funds, who are becoming more familiar with the asset class and the attractive risk-adjusted returns on offer. This structure therefore enables funds who cannot provide the traditional revolving facilities to participate in the market.

The second is an increase in M&A activity, as businesses reflect on their growth to date and seek to bring on board an institutional backer to accelerate value creation over the next few years. For companies that are exploring such an acquisitive strategy and wish to consolidate within fragmented markets we think this solution could assist with funding platform purchases.

Combining these two themes, we therefore see some alternative funds applying a leverage approach and creating a fresh way of thinking about risk, in structures such as these. This would provide an alternative de-risking solution for new Equity buyers who wish to lock-in greater flexibility / longer tenor or who wish to get acquisition finance on asset backed transactions.



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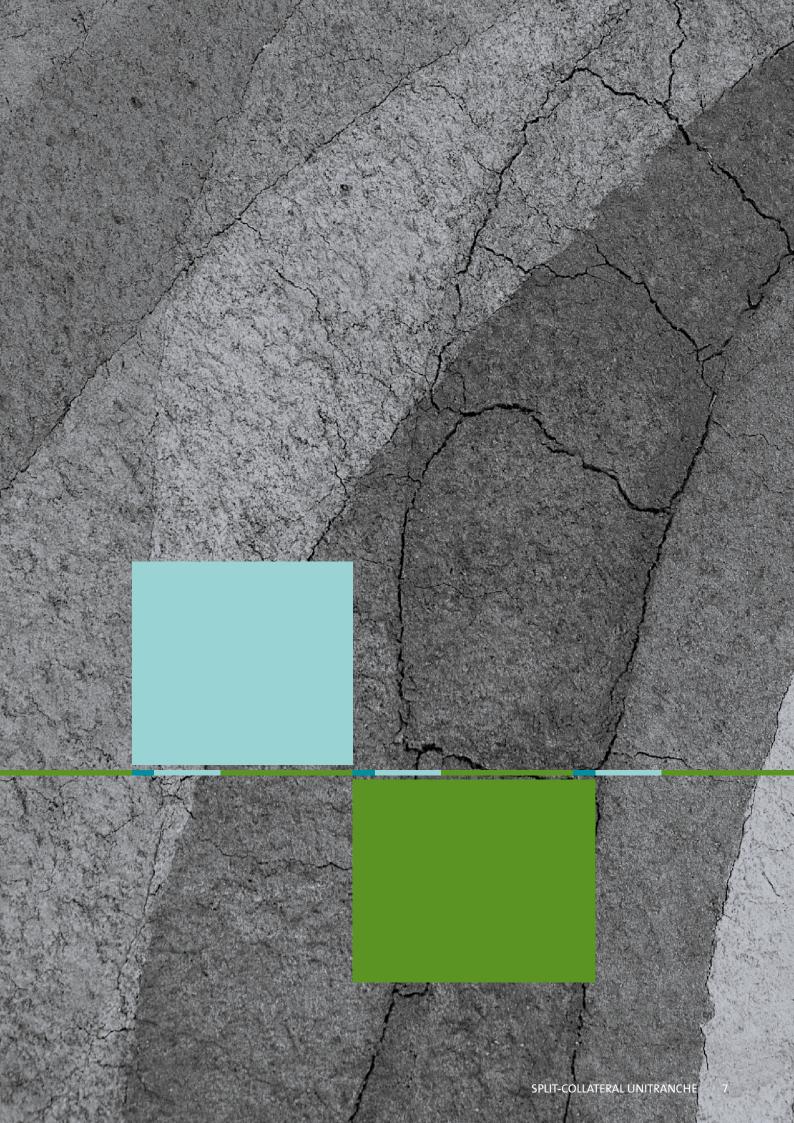


Capital Structure Comparison

	SPECIALITY FINANCE SENIOR/MEZZ	CONVENTIONAL UNITRANCHE	SPLIT-COLLATERAL UNITRANCHE
Documentation (facilities)	Separate documentation	Same document	Could be either, but having a single document may be advantageous.
Covenants	Mirrored terms with extra headroom in the mezzanine covenants.	RCF covenant introduced for the benefit of the RCF Provider only to be included in the Material Events of Deafult. Limited RCF provider consent rights.	Similar in structure to conventional unitranche, but the instead of an RCF covenant, there will be a borrowing base covenant (and possibly performance and eligibility covenants). Enhanced information undertakings, access and audit rights also may be requested. The term lender may also request a theoretical 'total advance rate' covenant, which would look to protect the term lender in situations where the borrower's only assets of value are the receivables.
Security	Shared security, enforcement of which is subject to the ICA, and will include standstill periods.	Shared security, enforcement of which is subject to the ICA, and will include standstill periods, material events of default and material enforcement action.	Split collateral pool with first and second ranking charges. Standstill periods to apply in respect of any second-ranking security.

Conclusion

The speciality finance market continues to evolve and this product may offer an interesting alternative to what is currently on offer. Intercreditor positions will inevitably vary from deal to deal and a 'one size fits all' approach will likely not work. The interplay between commitment quanta, advance rates and security package will mean it will be a while until we see a product that the speciality finance market participants recognise as a market standard, but that does not mean that using this product should be viewed as challenging. Those term lenders and RCF providers which work together to develop mutually acceptable solutions may benefit from the competitive advantages similar to those that developed the conventional unitranche product.



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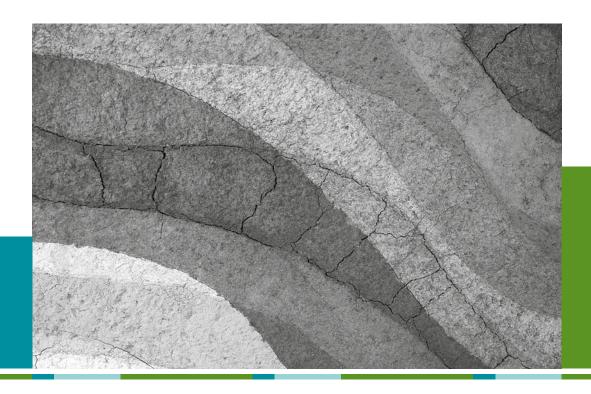
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Selected experience

SPECIALITY FINANCE AND FORWARD FLOW

BUY TO LET LENDER

Acting for the funder in relation to a forward flow agreement and associated equity investment in a buy to let mortgage lender

NORTON FINANCE

Advising the lender on its funding to first and second mortgage lending provider Norton Finance

CRX MARKETS

Advising CRX Markets in relation to its SPV through which it purchases receivables from, among others

Vattenfall and Nestlé

ABL

LIBERTY HALL CAPITAL PARTNERS LLP

Acted on the acquisition of Bromford Industries, a leading supplier of fuel efficient engine components, fabrications and assemblies for the global aerospace and power generation industries

INVESTEC

NFT buy out financing from Investec involving an integrated loan and asset based lending product

VEHICLE FINANCE COMPANY

Acting for the lenders in relation to their funding of a car, motorbike and van finance company

MONEYBARN

Advising Octopus Investments on its funding to motor finance company Moneybarn

PRIME REVENUE

Advising Prime Revenue in relation to its supply chain finance programs

H.I.G WHITEHORSE

Acted on the refinancing of IGM Resins which was funded by an ABL from Deutsche Bank and a unitranche facility from H.I.G. WhiteHorse

UK BUY-OUT

UK buy-out financed by a £22m unitranche facility and a £5m super senior ranking receivables financing facility



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