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FOLO unitranche falls out of fashion as super senior debt becomes scarcer – analysis

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The first out, last out (FOLO) unitranche structure helped expand the direct lending industry in Europe over the last several years, with its cheaper blended rate of super senior term loan provided primarily by banks, and unitranche from funds. But the availability of FOLOs has been decreasing, with some banks and direct lenders taking a more selective approach to the structure, according to several market sources.

While the move is not homogenous amongst European and UK banks, many have become much pickier when it comes to providing the super senior term loan for FOLOs as well as super senior RCF lines in general for unitranches, said the sources.

In particular, HSBC, which was one of the most active banks in the space, has pulled back significantly, and is only doing them selectively when it generates other fee-paying business or for relationship reasons, according to several sources.

But the selective approach is not exclusive to HSBC, with many banks polled by *Debtwire* saying they now only provide the facility if the margin or fees are higher, if it gives them a chance of bagging a future deal via a refinancing, if it brings ancillary business or for relationship reasons. Many are also shying away from the Libor/Euribor+ 275bps-300bps range – eyeing higher returns.

“The other day we were offered +350bps by a bank to do a super senior on a deal. What’s the point of doing it at that level? It’s the same as a TLA,” said a direct lender.

While the shift for some banks is COVID-19-related, with the economic turmoil putting a squeeze on liquidity for some banks and making them re-evaluate their risk-return model, for other banks it is a more long term trend that has been going on for the last year or even longer.

The bank squeeze

The motivations for the market pull-out vary, with many sources citing the fact that from a capital provision standpoint, some banks have the same hold requirements for super senior as they have for standard loans.

At 3% or less, it provides a good risk adjusted return, but the overall return on investment can be skimpy.

“We can’t do it at the moment in terms of costs of funding, it just doesn’t meet our returns. Deposit rates are high at the moment so it just doesn’t make sense to do a 3% super senior piece,” said a banker.

Although it depends on the bank’s own ratings system and the way it assesses loss given defaults to calculate capital provisions – many have to consider the rating for the overall FOLO facility, and not just for the super senior piece.

Others, however, have the same probability of default as plain senior debt, but are able to record a lower loss given default for the super senior debt, which impacts the amount of money banks need to hold against the facility.

"It depends on whether the bank buys into that argument, some banks have an issue that it's a relatively new product and there's not a lot of history of default. We've had a few defaults on them, but they've been benign. I don't think there's any regulatory guidance on this specific point," commented a second banker.

"We use the same methodology that ratings agencies use to rate RCF facilities so it comes out one or two notches higher than the unitranche. If you're rating it the same as the unitranche then that's going to be a problem," added a third banker.

For the clearers in particular, with large corporate books, the mass RCF drawing wave of the start of the lockdown, coupled with a lack of refinancing and M&A activity, may have left them further capital constrained. Although much of that RCF money has started flowing back in, it still means they must make sure they are looking at the best risk-return opportunities, particularly if they are having further issues in the portfolio.

"If you have surplus capital you are happy to go down the risk return road. But if you are capital restrained then it all needs to add up," said a third banker.

Another factor which may be contributing to this is the fact that many banks may be shooting themselves in the foot by helping those who are ultimately their competition – the private debt funds – to increase their presence.

"When you do a first out, where you're not really in control, who are you really helping here?" said a fourth banker.

"If it's an important sponsor and client, we'll do it. But we won't do it if Permira or Ares come to us just to help them," added the third banker.

And ultimately this is a point of contention for many banks. With FOLOs usually structured so that covenants are triggered earlier on the unitranche than the super senior debt, and a number of other provisions keeping banks largely out of the conversation, this is not a position many banks are comfortable with.

"What you find is that you only get a call after they've already struck a deal with the unitranche," said the first banker.

And ultimately, if a bank went through a default on the facility that resulted in money loss, this could also have led to a change of heart, although there is no evidence this has happened yet.

The fund perspective

But it is not just the banks who are impacting the lack of FOLO activity in the market. Many direct lenders have also been pulling away from them.

The increase in complexity in the deals at a time of economic uncertainty and issues in the portfolio is seen as the main driver for this move, according to sources. Having a layer of super senior debt

in the structure when you are trying to restructure a deal is not ideal.

Another factor is that most funds have lower hurdles to hit than before, and therefore don't need FOLOs to boost returns.

"Funding costs have come down to the vast majority of the funds so not as relevant as it used to be. Funds who need margin of 7% upwards use the FOLOs to compete with the 5.5%-6.5% guys, but a lot of funds have now raised money at lower cost," said Floris Hovingh, partner and head of alternative capital solutions at Deloitte.

Private equity firms have not been requesting FOLOs as much as before either, which is also contributing to the lack of relevance for the structure at the moment, according to sources.

In Germany, however, the FOLO is still strong, with Berenberg becoming the main crusader in the provision of these facilities given their ability to offer lower pricing.

Other banks in the region that provide super senior facilities are also still open for business, as is the case with many of the Dutch banks. Some Belgian banks, however, have also been reassessing their stance on the subject, according to sources.

Tapping new sources of super senior

An alternative provider of super senior term loans in FOLOs has also emerged in the form of LPs. Some funds, in particular the Universities Superannuation Scheme, a large UK-based pension fund, have been taking pieces of the facilities, particularly the larger ones, because at 3%, it provides good returns for pension funds.

The practice, however, throws up some questions around potential conflict of interest if there is a default that impairs the super senior, where the provider is an LP to the unitranche provider, alongside banks on a pari passu basis.

"For the banks, it raises other challenges, our biggest protection is we have independent rights of acceleration. We understand they have the first say but if value starts to break in the senior then we get on the table. If we can't accelerate because people in the super senior are aligned with the unitranche provider, then we have a problem. A big problem," said the second banker.

"Banks worry too much, a pension fund or insurance company serves their own investor, not the GP!" countered a direct lender.

The one stop shop solution

A final development as banks become more reluctant to provide super senior term debt in FOLOs as well as super senior RCF in general, could be the proliferation of funds willing to provide the undrawn facility themselves. Such a move has already taken place in the US - although funds struggled when RCFs were withdrawn quickly earlier this year - and could expand in Europe. Currently, only three or fund funds can offer the one-stop shop solution.

"That will be the holy grail as you won't have the dynamic where you need a bank to do it in particular in the current tricky environment. Not many funds can do it but there's a differentiation where those funds who manage to provide the RCF can give the one stop solution," added Hovingh. "I think some of the funds will start

structuring RCFs on a pari passu basis with appropriate pricing - it needs 3% upfront fee, margin in line with the unitranche for drawn amounts. You have seen this already in the US market."

Berenberg and USS declined to comment.

A spokesperson from HSBC said: "We continue to support transactions that demonstrate resilience and strong growth potential with HSBC UK supporting new transactions throughout 2020 to date. The economic outlook is directly impacted by the uncertainty around the extent and impact of the pandemic. Despite this, new opportunities are emerging and HSBC UK continues to work with Private Equity to deliver financial solutions, including Super Senior facilities, and services to meet the needs of the companies they invest in to grow and develop."

by Mariana Valle, Oscar Geen and Karis Hustad

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