Finding the Line: Senior Stretch vs. Unitranche (First of Two Parts)

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On a fourteen-hour flight from Seoul, we sat next to the head of a very successful private credit shop. Besides discussing the relative viewing merits of *Bohemian Rhapsody* versus *Saving Private Ryan* (there was plenty of time for both, plus *X-Men: Days of Future Past*), the subject turned to trends in the capital markets.

“By the way,” our friend said, “here’s a topic you should tackle in your newsletter: What’s the difference between senior stretch and unitranche debt? We get that question from investors all time, and I have no idea how to answer it. Would be a real service to the market if you could come up with something.”

That question has indeed bedeviled credit participants, particularly as issuer leverage has risen steadily since well before the financial crisis. Back in the early 2000’s when middle market first-lien (in a mezz or second-lien structure) was 3-ish times debt-to-ebitda, you could “stretch” a senior-only financing to 3.5x, maybe 4.0x.

Over the past seven years, according to Refinitiv LPC data, all-senior midcap leverage for private sponsored club deals rose from 3.4x to 4.2x. During that same period, first-lien leverage (with mezzanine) increased from 3.2x to 4.0x. Similarly, first-lien leverage (with second lien) was up from 3.7x to 4.5x.

Compare that to unitranche leverage. Back in 2013 single-tranche debt was 4.9x; today it stands at 5.3x. All these metrics represent the highest levels recorded since the Great Recession.

For all middle market LBOs, LPC reported first-lien leverage (the data includes all-senior, senior stretch, and unitranche) of about 4.6x. Unitranche LBO leverage for midcaps was 5.7x, just a shade under large cap first-lien leverage of 5.75x (see our *Chart of the Week*).

A quick survey of top middle market loan arrangers was revealing. “First-lien and second-lien market leverage is readily identifiable,” one capital markets chief told us. “To get to a stretch senior number, you need to factor in loan-to-value and leverage, although it’s an either/or proposition.

“Unitranche in this market is probably over 5.5x leverage or over 60% LTV. Traditional senior is somewhere in the 4.0-4.5x leverage range or 40% LTV. That puts senior stretch at five-ish times leverage or LTV of 50-60%. Call it 55%. Over that, it’s uni.”

Another leading direct lender agreed. “Senior stretch should be 5x, give or take. But every case is different. It’s really a gray area. You have to adjust for size. For issuers below $10 million ebitda, you have to discount leverage by at least a quarter-turn. Companies above $40 million probably can stretch a quarter-turn more.”

A third top-tier cap markets pro weighed in. “We give greater weighting to LTV,” he said. “If the purchase price multiple is 7-8x, that’s not a business we’re going to lever six times. So a 4.5x financing for a 7.5x deal is really a unitranche.

“Of course,” he added, laughing, “calling it senior stretch sounds better.”

Next week we cover how senior stretch and unitranches are being priced in today’s market.