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The Junior Secured Tranche B Loan

Banks have significantly curbed lending based on cash flow; now companies are turning to junior secured debt as an alternative.

by Michael T. Newsome

Over the past several years, unacceptable default rates, substandard returns and regulatory pressure have led banks and other senior lenders to significantly curb lending that relies principally upon the cash flow of the business. For growing or restructuring middle-market companies, filling the funding gap between senior secured debt and equity without surrendering control is a challenge. In the void created by the virtual disappearance of cash flow loans, a new tier of junior secured debt has emerged as a supplement to senior debt that provides incremental liquidity and leverage. Although more expensive than senior secured debt, it may supplant the need for even more expensive mezzanine or equity.

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SENIOR LENDERS SHIFT FOCUS

To assure capital preservation, senior lenders have shifted their focus toward more conservative, asset-based credit structures that are underpinned with security interests in assets (collateral). Secured bank financings are purposely structured to leave a value cushion between the amount of the debt and the realizable or fair market value of the borrower's assets. Many companies have experienced a double whammy in the search for adequate debt financing to take out maturing financing arrangements. At the same time that senior lenders have steered clear of cash flow deals and sharpened their reliance on collateral, asset values have been severely eroded during the economic downturn. Bankers are willing to lend against hard collateral, but their take on value is pretty miserly. As a result, senior borrowing capacity for many companies has declined, leaving room for another funding source.

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HOW THE LOAN IS UNDERWRITTEN

This relatively new tier of capital carries a variety of labels—junior secured loan, tranche B loan, second lien loan, or last out participation. As banks have pulled back, new capital sources, such as hedge funds, specialized finance companies, mezzanine lenders, and insurance companies, have stepped in to fill the breach in selected situations where the risk can be reasonably quantified and adequately compensated.

These tranche B, or junior secured loans, meld elements of senior secured term debt, cash flow loans and mezzanine debt. The fundamental credit premise is that there is value in excess of what a senior lender will accept based on the intrinsic value of either the business or its assets. These loans are typically underwritten in one of two ways:

- ***Asset Based***—where the credit decision focuses predominately on the liquidation value of the assets, net of the senior advances, as the ultimate source of repayment; or
- ***Enterprise Value***—where repayment is predicated on the value of the business as a going concern.

In the case of an asset-based underwriting, the junior lender focuses on the adequacy of the cushion between the senior lender's advance and the realizable value of the assets. The junior lender may also consider the value of assets that are not pledged to the senior lender. Junior secured loans tend to be well-suited to situations where the assets are relatively liquid, value is predictable, and the costs associated with liquidation are reasonably quantifiable. Typical situations that may meet these criteria are commodity distributors or retailers where a senior lender is willing to advance 75 to 80 percent of the orderly liquidation value ("OLV") of inventory (net of liquidation costs). A junior lender would, in turn, consider advancing an incremental 10 to 20 percent of the inventory OLV, particularly if other assets, such as trademarks, real estate, or leasehold interests, are available as additional support.

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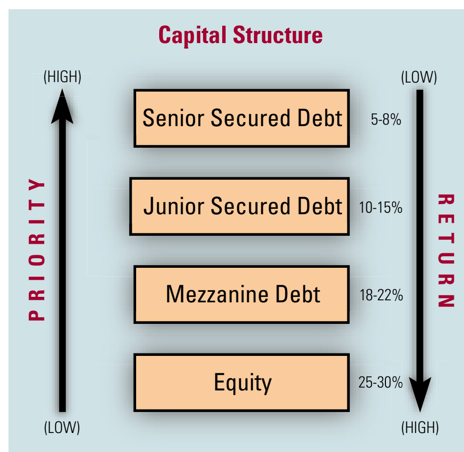
With the enterprise value method, which



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is akin to cash flow and mezzanine lending, lenders consider criteria other than the liquidation value of tangible assets, such as the predictability of cash flow, strength of management, market position and share, and intangible assets (e.g., brand names, proprietary technology, distribution territories, customer base and/or contracts). The junior lender is specifically evaluating the value of the business enterprise as a going concern, based upon most of the factors that an equity investor would weigh. Should the borrower at some point hit a bump in the road, the junior lender needs to have a high degree of confidence that there are readily identifiable and capable prospective buyers for the company, its business units, and/or its strategic assets. Most importantly, buyer interest and value must be sustainable over time, as an unforeseen financial setback that would cause a lender to rely on business value usually does not develop until several years after the original financing is put in place.

HOW THEY ARE STRUCTURED

Junior secured loans are generally structured either as:

- A subordinated lien behind the senior lender[s] on all of the borrower's assets (comparable to a second mortgage on a house); or
- A senior lien on "boot" collateral assets (those assets that the senior lender is unwilling to make a specific advance against). For example, boot collateral might include real property, leasehold interests, or intellectual property such as trademarks.

Junior secured debt is commonly viewed as bridge financing that fills the gap until the borrower can reduce its debt and bolster performance.

In terms of the capital structure hierarchy, the junior lien lender has priority over any subordinated debt, unsecured trade debt and contingent claims (by virtue of its security interests), and equity. Following an event of default, these lenders generally have rights and remedies that are comparable to the senior lender, other than for their secondary interest in the assets. The relationship between the junior and senior lenders is governed by an intercreditor agreement.

In the effort to arrange a junior loan, size matters. The providers of this tier of capital are looking for borrowers that are not large enough to access the public high yield market, but still have scale within their industries or markets. Ideal candidates tend to be firms with revenues north of $100 million, although smaller companies can also access this market under the right circumstances. Junior secured loan borrowers are in reasonably mature industries where cash flow can be focused on debt reduction rather than capital expenditures or growth.

GREATER RISK BRINGS HIGHER PRICE

Obviously, a junior secured loan embodies greater risk than senior debt and is priced to reflect that increment of added risk. Lenders typically seek all-in annual returns in the 10 to 15 percent range (in the current low rate environment). Depending on the lender, these financings can be arranged on a fixed or floating (tied to LIBOR or Prime) rate basis. Loan pricing is more attractive than the 18 to 22 percent returns that mezzanine lenders target. In addition, a junior secured loan generally does not require warrants, so shareholders do not suffer equity dilution.

Junior secured debt is commonly viewed as bridge financing that fills the gap until the borrower can reduce its debt and bolster performance. The typical junior secured loan credit structure has a tenor similar to the borrower's senior debt, but requires little or no amortization prior to maturity. In most cases, it is refinanced within a couple of years without a prepayment premium. As a consequence, this capital is more flexible than mezzanine debt.

THE EXTRA EFFORT COULD BE REWARDING

The incremental risk of junior secured debt has proven to be of little interest to banks. The field of lenders that is willing to provide what is still a niche product is expanding, but the market is not yet as well developed as the mezzanine market. Although it may take some effort to find the appropriate source for the situation, the potential savings relative to other alternatives can be very meaningful. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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