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The Art of Pricing Loans (Fourth of a Series)

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We noted with interest the “Pi Day” celebrations last Saturday. 3/14/15 echoed that mathematical constant (the definition of which escapes us for the moment), spawned dozens of matrimonials, and marked the birth of Albert Einstein. March 14 was also the birthday of Billy Crystal, though we haven’t figured out the ? connection there yet.

Speaking of irrational numbers, we continue our series on pricing loans with a look at the middle market.

As we covered in our first installment, middle market loans – generally defined as issued to companies with less than $50 million ebitda – tend to be syndicated by arrangers who will also hold on to a significant chunk of the exposure. That means mid cap players, unlike bookrunners in the broadly syndicated world, eat their own cooking. Besides being priced “at market,” a deal needs to meet the leads’ own yield requirements.

An increasing number of non-bank lenders are building underwriting capacity by creating diversified pockets of capital within (or alongside) their firms. Any deal they take to market needs to also meet the return hurdles of those vehicles. That’s a good first test to ensure pricing works for other middle market lenders with similar CLOs, BDCs, or separately managed accounts.

Another benchmark is how the loan is priced relative to their large cap counterparts. As our *Chart of the Week* highlights, middle market loans generally carry an “illiquidity premium” over more liquid names. That premium is the offset for the less-deep market funds perceive is available for smaller loans. Depending on market conditions, the differential varies between 50-200 bps. Today it’s around 120 bps.

Historically, middle market spreads follow large cap spreads with a time lag. But as more institutional money has entered the asset class, that lag has diminished. This influx has also caused more correlation between mid and large cap yields, meaning smaller deals will be less insulated by technicals such as oil prices and Fed rate expectations.

As banks with their lower cost of capital reduce on-balance sheet exposure to leveraged middle market loans, non-banks are stepping in with increased capacity. To some extent, the larger hold levels of the top middle market arrangers have removed “market risk” from the equation. Syndications are increasingly club affairs, with pricing agreed to by a smaller set of lenders, rather than a broad range of institutional accounts.

Finally, the enhanced one-stop capability of some middle market lenders is providing private equity clients with more deal pricing options. Besides first and second-lien term loans, unitranches create a blended spread of the alternative senior/subordinated structures. Single tranche pricing must be consistent with the current market for each of the senior/sub components, and competitive with the overall capital cost of two tranches.

Next week: We wrap up our series by looking at the separate components of pricing.