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The Art of Pricing Loans (Last of a Series)

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Last week we noted the coincidence between "Pi Day" and the birth date of Albert Einstein, but pondered any ? connection with that other March 14 celebrity, Billy Crystal. One astute TLL reader (and keen observer of the pop scene) solved that riddle for us: Https://m.youtube.com/watch?v=ohmha1NsQRU. Well done.

In closing out our series on loan pricing, we also promised our readers a brief primer on key ingredients of pricing itself. Let's start with the most obvious: Libor spread.

Term loans are priced with a set spread over Libor, say 400 bps. But which Libor? The borrower typically can choose among several options as detailed in each credit agreement, ranging from 30 to 180 days. Revolving credits carry both a Libor spread (on the drawn amount) and a commitment fee (on the undrawn amount) of 50 bps for leveraged borrowers.

A related mechanism is the Libor floor. Born of the credit crisis, floors were introduced by arrangers as a subsidy to lenders when Libor plummeted from 4% to near zero. Floors were set initially around 2-3% so that when combined with actual Libor, the overall yield stayed relatively steady. As markets loosened and underwriting became more competitive, floors tightened. Despite fears they would disappear altogether, with the exception of some bank-only facilities for less-leveraged companies, that hasn't happened. Floors are around 1% today.

A third component of pricing is upfront fees. These are the share of the underwriting fee – paid from the borrower to the arranger – passed along to the syndicate banks (or in the case of "best efforts" executions, paid directly to the lenders by the borrower). Upfront fees are market-dependent. Immediately post-crisis that percent was in the 2-3% range, significantly higher than the 0-1% range we're at today.

Many institutional investors are unable to take income as fees without triggering significant "originator" tax issues. That's where OID comes in.

Originally a feature of the bond market, the mechanics of OID, or original issue discount, are simple. Instead of coming out of the arrangers' pocket, the "fee" is paid by the issuer as a discount to the original financing. For example, a $100 million loan with a 99 OID means the borrower gets $99 million and the syndicate receives $1 million.

Once terms are settled and allocations to each account are communicated, the loan is free to be traded in the secondary market. Depending on current market pricing, the price/value of the loan "on the break" may be up or down from the initial 99 OID. Secondary activity on the name could be at 100 (par) or even higher.

Where new and existing issues trade is a key indicator of market tone closely scrutinized by arrangers. Like canaries in the capital markets coal mine, secondary prices help establish clearing pricing for newly structured transactions.

As a footnote, upfront fees for middle market deals tend to be higher relative to broadly syndicated ones. Private equity sponsors often seek to club up smaller loans with relationship lenders. Ensuring their participation costs more than a general syndication.

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