What Price Would Be Nice (First of a Series)

THE LEAD | February 25, 2015

News reached us this week of a new Dr. Seuss book to be published July 28th. “What Pet Should I Get” was apparently written by the legendary children’s author some fifty years ago, but thought to be lost. Mrs. Seuss discovered the manuscript (and two others) while she was “cleaning out his office.” Her husband died in 1991.

As someone who cleans their office religiously every eleven years, we can attest to the exhilaration of finding “Oh-*there*-it-is!” gems. Though not of the rhyming variety, we recently uncovered a column we had written some time ago on the art of pricing a deal.

We say “art,” though pricing leveraged loans is often portrayed as a science by practitioners on the sell-side, particularly to their private equity clients. The truth is that determining where to set spreads, fees, and Libor floors at syndication is a black box. But let’s take a look at some of the factors we’ve found in our experience go into that box.

First are comparables, or “comps.” In capital markets lingo, these are recent transactions (like our Select Deals in the Market) sell-siders scrutinize when pricing new deals to be launched. The question, of course, is whether Deal A is truly comparable to Deal B. Considerations include ebitda size, rating, leverage, quality of the sponsor, size of the financing, and industry.

Ebitda is our favorite indicator, and most often ignored. Too often sponsors who have great success getting cutting-edge terms for a global issuer throwing off $180 million of cash flow, then expect similar terms for their $18 million widget manufacturer. Not only are risks several levels higher for the latter, but buyers of the paper are different.

Ratings are also a big determinant. While the vast majority of broadly syndicated loans are single-B variety, institutional buyers clearly discriminate among B1/ B+, B2/B, and B3/B- credits. There could be a 100 bps swing in spread within that group, since default risk escalates as issuers go down the single-B scale.

Because middle market lenders are buy-and-hold investors, portfolio liquidity is less important. Smaller borrowers usually don’t need public ratings. Their leveraged loans are generally viewed as single-Bs, so other factors come into play to establish pricing.

Higher leverage means higher risk, but frothy markets don’t always distinguish pricing-wise between a five times total debt-to-ebitda deal and a five-and-a-half or even a six times deal. Experienced asset managers dig into the credit to figure out what the relative risk is.

Sponsor quality is of utmost importance. Not all GPs are alike, in terms of fund size, track record and experience with specific sectors. All these elements determine whether a PE firm will earn the best terms for a given transaction.

Similarly all industries are not created equal. Six times leverage should not be priced the same for oil field services as for transaction processing. Although competitive pressures often push arrangers into off-spec terms for cyclical companies.

As the Cat in the Hat creator would say: From there to here, and here to there, funny things are everywhere.

Next week: our loan pricing series continues comparing large cap and middle market.