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The Art of Pricing Loans (Second of a Series)

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Call it Bother of the Bride.

The singer/guitarist of a wedding band posts a picture of the mother's blue and black dress on Tumblr. Apparently other band members said it looked white and gold, so she wanted second opinions. Well, she got them – 500 within a half-hour. Then things went viral. Buzzfeed had almost 40 million views at last count. And there was no consensus.

"I see white & gold," Kim Kardashian wrote, joining in the fun. "Kanye sees black and blue, who is color blind?"

Good question. While we wish we could resolve the conundrum (*Lead Left* staffers had a split vote), our attention must turn to a less weighty, but similarly mysterious matter; namely, how do arrangers go about pricing leveraged loans?

In last week's installment, we covered some of the basic drivers such as size of company and deal metrics. This week we look at relative value.

One key benchmark for buyers of broadly syndicated loans (and therefore arrangers) is whether the prospective borrower will also issue bonds, and where they will be priced.

For example, *PetSmart* (B+/B1), one of the larger LBOs in recent years, had both bond and "bank" components. The $1.9 billion eight-year senior note was priced at 7.125% and issued at par. The corresponding $4.3 billion term loan B was covenant-lite with a seven year maturity. Pricing came in at L+400 with a 1% Libor floor and issuance at 99.5%, resulting in an all-in yield of around 5.2%.

This roughly 200 bps bank/bond differential is in line with the overall relative yield gap now being seen between the asset classes (see *Chart of the Week*).

If the loan is a refinancing, then accounts will look to see where existing bonds are trading, if any. Given the benefit of a first-lien security interest on all the company's assets, loan holders expect a lower yield than the bonds afford, but within a range.

Another point of relativity for institutional investors is where similar loans of recent vintage were (or are being) priced. While comparably large, last month's *Dollar Tree* (BB/Ba2) acquisition of *Family Dollar* was better rated and less leveraged; accordingly with a 350bps Libor spread and a 0.75 floor. *Dynacast International* (B/B2), a much smaller, more cyclical, LBO sported L+425bps and 1% floor.

Another factor is where existing credits of like rating are trading. In a bid-only market such as we're in, accounts may struggle to find good assets, but arrangers need to have an eye on secondary prices. This is particularly true during periods of volatility when up or down-drafts can wreak havoc on a syndication.

That leads us neatly to a discussion of what happens when markets move unexpectedly, throwing comps and relative value out the window.

Next week: We continue our series with a tutorial on pricing flex.