The Art of Pricing Loans (Third of a Series)

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Pricing flex is a relatively recent phenomenon in the history of leveraged loans.

Prior to 1998 lead arrangers would price loans weeks, sometimes months, before launching transactions into the market. Because many lenders in the syndicate traditionally ended up being relationship banks, underwriters had relatively little risk those banks would flake on a deal if market conditions changed one way or the other.

As time passed, however, buyers became more institutional. The loan market grew to rival the high-yield bond market in size and liquidity. But bonds are typically "best-efforts" (vs. "bought-deal") executions; underwriters won't hold the bonds. If markets move, the leads simply adjust the bond price to the market. Loan arrangers, in contrast, truly underwrite deals. Once pricing is set, that's it. If it's off-market, agent banks are stuck selling whatever paper they can at that price, or it comes out of their pocket.

The Russian debt crisis changed all that. With credit markets shut for months, some banks were hung with underwritten paper and few buyers at any price. Underwriting risk had become asymmetric with banks on the short end. One solution soon appeared: Why not adapt the bond price adjustment feature for loans?

One market leader rolled out a deal which allowed it to adjust the all-in spread without the borrower's permission. It was the first instance of flex in the loan market. But would there be a second? If competitors continued to launch deals without flex, that brave bank could see its market share evaporate. But agents knew a good trend when they saw it. Within days, a second arranger followed suit with copy-cat flex.

Amazingly, issuers and sponsors adapted to the new reality. Flex simply became one more pricing feature to be used as a competitive weapon. Flex "caps" – levels beyond which the arranger could only go with issuer permission – quickly materialized.

In periods of extreme volatility, flex caps were dropped altogether, putting market risk squarely back on the issuer. Of course, private equity sponsors retorted that such terms essentially created a "best-efforts" underwriting, since the arranger was not committed to a market clearing price of any kind. Why pay for underwriting that isn't an underwriting?

Deal terms, including flex, are set before the deal launches. Arrangers must predict what conditions will be when that happens. If markets move before syndication, arrangers may push flex caps as high as allowable under the underwriting agreement.

This can include "structural flex," the ability to move or re-size debt tranches. For example, a larger (relatively cheaper) first-lien term loan can be increased, while reducing the size of the second-lien. Otherwise, the arranger may have to dig into its own pocket and distribute some of its own underwriting fees to move the paper.

As our *Chart of the Week* depicts, flex levels and frequency are as indicative of market conditions as any other loan pricing feature. Higher volatility demands wider flex cushions, and encourages more best-efforts executions.

Next week: our series on pricing continues with a look at middle market loans.

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