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Borrowers Scale Back Prepayment Penalties

Despite everyone's prediction to the contrary, the financing pendulum has definitely swung back in favor of the borrower. Go back a mere 24 months when lenders called private equity groups and said "Sorry, I know I gave you a term sheet but the world has changed and our pricing has gone up - if you want our money, you need to pay us more." And borrowers did, thinking it was the only way to get funding.

Wow – don't lenders wish they could relive those days! Because when things started to improve, even slightly, borrowers hit the phones and found a lender to refinance their credit at a cheaper rate and with less stringent terms.

Or could they???

Interestingly, there was one provision in loan agreements that often made it difficult, if not impossible, for borrowers to refinance and that same term is being heavily fought over again today – the prepayment penalty. This seemingly innocuous provision, often not more than a sentence in a multi-page loan document, precludes a borrower from repaying the loan without also paying a fee for doing so.

The prepayment amount, similar to interest rates or lending multiples, varies widely, and for financings put into place during times of lending scarcity, like 2008 and 2009, often includes some period of make-whole, or no-call. The make-whole provision requires a borrower prepaying a loan to also pay the full amount of interest a lender would have expected for a given period of time, even if the debt was no longer outstanding. As you can imagine, paying a make-whole, on top of interest for a new loan, makes certain refinancings prohibitive today.

So when lending conditions started to improve, borrowers, particularly private equity firms, bemoaned a lenders requirement for a prepayment penalty. They suggested it tied their hands and inhibited their ability to sell a company when an unexpected suitor showed up with a big purchase price. Worse yet, if the sponsor simply didn't like their lenders any more, the prepayment penalty precluded them from getting divorced and moving on to the next financing source.

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Interestingly, high yield debt usually has a five year no-call making it extremely costly to repay (although these financings often have reduced prepayment requirements for a change in control, thus making a sale of the company possible). In essence, high yield investors are saying that, they know their money is cheap, but if you want it, you're going to have to keep it for a long time.

But today, providers of Term Loan B, syndicated senior loans, and mezzanine debt seem to be much more insecure than their high yield brethren. Loans, which just a mere 24 months ago had a make-whole for some period of time, today often have year 1 prepayment penalties that rarely exceed 3% of the outstanding amount of the loan and are often as low as 1%. And after year 1, prepayment penalties often drop precipitously and are usually gone by the end of year 3.

Finding, diligencing, negotiating, documenting and closing a loan is still a time consuming proposition. And, for a lender, the idea that a more passionate rival may show up at any minute and they'll be cast aside is not a pleasant one – particularly for groups that don't have recycle provisions for their capital.

So it's just another indication of how far the pendulum has swung back when borrowers demand minimal or no prepayment penalty and a slew of lenders gladly step up to play.

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