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# Bank Loans: Market Dynamics Poised to Deliver Attractive Risk-Adjusted Returns

## Executive Summary

Despite a very significant run-up in loan prices following the credit meltdown in 2008, we continue to find significant risk-adjusted potential returns available within bank loans. This thesis stems from four key factors: the dramatic decline in default risk, the possibility of rising interest rates, a changing supply-demand equation and the remaining portion of the much-discussed "maturity cliff." We will discuss these factors in detail below, in the context of how we see the bank loan market performing over the next 24 to 36 months.

Before discussing these specific issues, it might be helpful to recap the recent history of the loan market.

The institutional loan market, as it exists today, was largely formed in the period beginning in the late 1990s. Institutional investors, attracted by healthy spreads and first-lien protection, began to displace commercial banks as the predominant provider of bank loans. This trend accelerated with the burgeoning collateralized loan obligation (CLO) market, which saw US \$100 billion<sup>1</sup> in volume in 2006, and came to occupy **about 50%** of a loan market that had grown larger than the High Yield Bond market by 2007.<sup>2</sup> The perceived lack of volatility in loans (both actual and, to some extent, imagined) also led a large number of investors to put very significant leverage against their holdings of loans, making the entire asset class more volatile than most observers understood.

Therefore, when the credit crisis arrived in full force in September 2008 and the forced unwinding of leverage took center stage, loan portfolios were liquidated rapidly, and loan prices plunged to unheard of levels, with frightening speed. This caused a **22.95%** loss for the fourth quarter of 2008, and a **29.10%** loss for the year.<sup>3</sup> Given that the loan market had never seen even a single year with negative returns,<sup>3</sup> this came as a stunning shock to the market.

As 2009 opened, loans were trading at prices far lower than investors had ever experienced. As the year progressed, more investors recovered their confidence, and loans turned in a dramatic **51.61%** return.

In the 16 months since 2009 ended, loans have had a very steady march toward pre-2007 price levels<sup>4</sup>, and have produced steady and attractive returns along the way: **10.13%** in 2010, and **3.07%** so far in 2011<sup>5</sup>.

<sup>1</sup> Source: Credit Suisse 2011 Leveraged Finance Outlook and 2010 Annual Review, 20 January 2011

<sup>2</sup> Source: Deutsche Bank Leveraged Debt Capital Market Update, 6 May 2011

<sup>3</sup> Source: S&P/LSTA Leveraged Loan Index December 2008 Review

<sup>4</sup> Source: Standard & Poor's Leveraged Commentary and Data, 4 January 2011

<sup>5</sup> Source: Standard & Poor's Leveraged Commentary and Data, 27 April 2011

FIGURE 1 Lagging 12-Month Loan Default Rate



Source: Standard & Poor's Leveraged Commentary and Data, April 2011

## The Dramatic Decline in Default Risk

Default rates have dropped steadily and rapidly since 2010. From a high of 10.81% in November 2009, the rate dropped to 4.02% by June 2010, and to 1.11% by March 2011. Very few observers expect much increase any time in the foreseeable future. A slowly recovering economy, more-than-sufficient liquidity and a lack of exposure to particularly difficult industries (commercial real estate, publishing, etc.) all combine to provide a relatively attractive outlook.

An equally important but less prominent headline is the increase in loan recoveries when defaults do occur. Over the long run recoveries have tended to be about 70% for loans, versus about 44% for high yield bonds. In 2008 and 2009 loan recoveries dropped to the 50% to 60% range, as a number of leveraged companies were found to be worth far less than imagined when they ran out of liquidity to fund operations. Since then, recoveries have returned to close to their historical average.<sup>6</sup>

Assuming that defaults settle in at about 2% annually, with recoveries at 65%, total loss from credit events would equal 70 basis points. Measured against current spreads of 417 basis points, this provides another look at why investors appreciate the risk-adjusted yields for this asset class.

## Rising Interest Rates

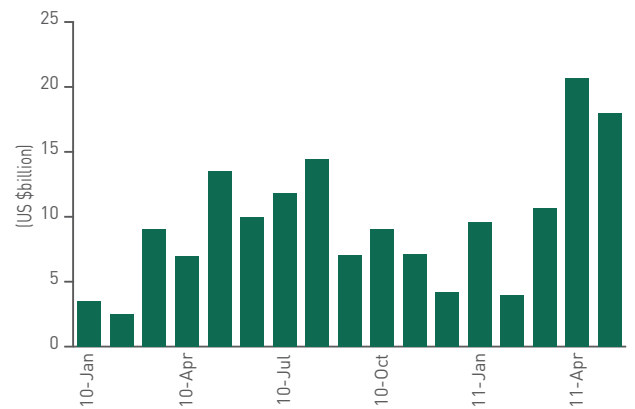
The coupons for bank loans are set as spreads above LIBOR. While spreads for most credit products remain at relatively wide levels, LIBOR rates dropped to near-record lows in early 2010 and have stayed there with very little

<sup>6</sup> Source: Credit Suisse Leveraged Finance Perspectives, 8 April 2011

<sup>7</sup> Source: Deutsche Bank Leveraged Debt Capital Market Update, 6 May 2011

<sup>8</sup> Source: Standard & Poor's Leveraged Commentary and Data, 18 March 2011

FIGURE 2 Merger & Acquisition Forward Calendar



Source: Standard & Poor's Leveraged Commentary and Data, April 2011

movement. With massive economic stimulus in the US and in many other countries only recently having ended, and with commodity costs rising sharply, the prospect of inflation is growing more likely. Central banks in many countries are considering raising interest rates, and it seems probable that LIBOR will see some lift in the next 6 to 12 months.

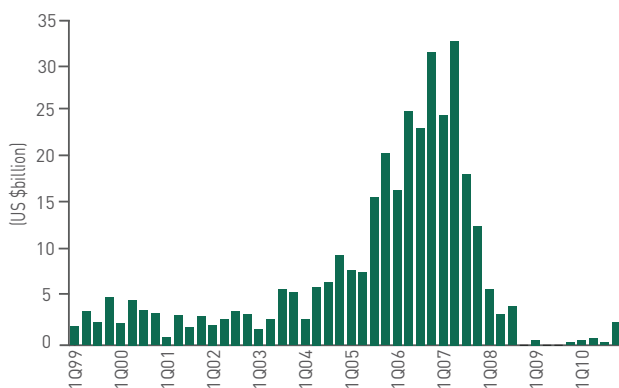
## The Changing Supply-Demand Equation

There are a number of variables at play in the loan market and the net effect of these should keep spreads at historically wide levels over the next 24 months.

First, the supply of new loans appears to begin growing again. **Almost 65%** of bank loans come about from some type of recapitalization, generally led by a private equity sponsor.<sup>7</sup> With new transactions at very low levels since the 2008 financial crisis, private equity sponsors have significant unused capital. Coupled with a recovering worldwide economy and more confidence in risk-taking, this should provide a healthy growth in the supply of bank loans available for purchase.

Second, there are several factors on the demand side which we believe will combine to produce a modest net reduction in capital targeted for this asset class. On one hand, there has been a significant and steady inflow into retail funds which purchase loans. These inflows have taken the funds' share of the loan market from about 5% to 30%.<sup>8</sup> This trend does not seem to be abating, as there are at least 10 new funds being launched.

FIGURE 3 CLO Volume



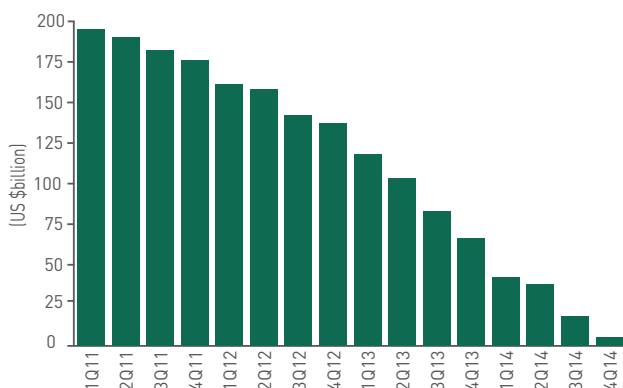
Source: Standard & Poor's Leveraged Commentary and Data, April 2011

At the same time, there seems to be significant new demand from pension funds and other large institutional investors which heretofore had not been involved in the bank loan market.<sup>9</sup> There are no methods for measuring these flows precisely, but our own experience, and that of firms like ours bears out this trend.

However, the largest source of demand for loans has come from the hundreds of CLOs which were issued between about 2003 and 2007 as shown in Figure 3. Many of these vehicles will soon reach a point in their lifecycle when they can no longer reinvest their cash flows, and they will become net sellers of loans as shown in Figure 4.

The net effect of these factors is difficult to predict precisely. However, the sheer scale of the run-off of existing CLOs is so significant that we believe it will lead to a modest overall decline in investable funds, and an opportunity to enjoy continued wide spreads even as default risk stays low.

FIGURE 4 CLO's in Reinvestment Period



Source: RBS, April 2011

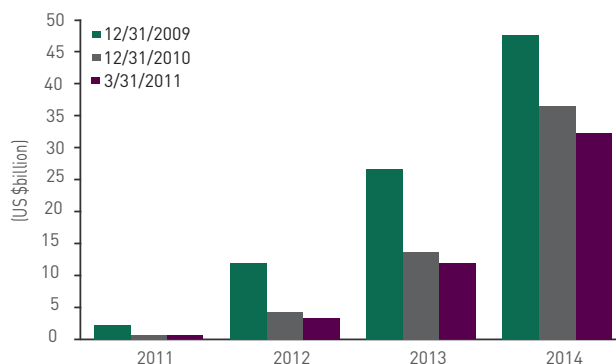
## The "Maturity Cliff" of 2012-2014

Much has been made of the so-called "maturity cliff," which refers to the fact that the overwhelming share of the aggregate bank loan market was composed of loans with maturities within a fairly narrow window, from about 2012 to 2014. This condition arose largely because most loans have maturities of about seven years, and most of the existing loans were issued between 2005 and 2007.

Many observers cited this situation as a looming problem, as there wouldn't be enough capital to meet the huge volume of maturities. However, we had (and more emphatically still have) a different viewpoint on this issue. In our opinion, this situation would provide a tremendous investment opportunity, as otherwise healthy companies would have to raise capital to refinance their upcoming loan maturities. In our view, this would give credit-savvy investors the chance to obtain wide yields from healthy credits, while the providers of junior capital to these companies bore the risk of successfully meeting the maturity conditions.

In the past 18 months or so, since this situation was first widely commented on, almost 59% of the maturity cliff has already been refinanced, as shown in Figure 5. With a robust high-yield market and a selective but available IPO window, companies have steadily reduced the size of the maturity cliff. Today, by most estimates it is down to only about US \$210 billion as shown in Figure 6. This number is manageable given the size of the capital pool theoretically available to meet it. However, we also think that it will continue to present those investors who can accurately sift through these candidates to find the healthy companies with real opportunities for extra yield.

FIGURE 5 Distribution by Year of Maturity

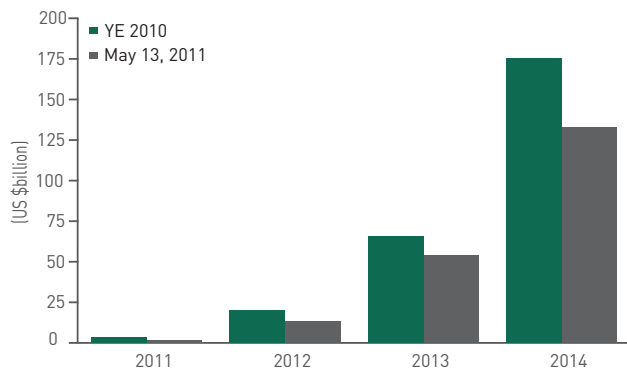


Source: Standard & Poor's Leveraged Commentary and Data, April 2011

<sup>9</sup> Source: Standard & Poor's Leveraged Commentary and Data, 18 March 2011

FIGURE 6

## Maturity Cliff Through 2014



Source: Standard & Poor's Leveraged Commentary and Data, 18 April 2011

## Conclusion

In our opinion, the bank loan market presents an attractive risk-return profile over the next 24 to 36 months. We believe that default rates will stay low and recoveries will remain near historical averages. In addition, the supply of new loans will be enough to absorb the capital directed at this asset class, while leaving yields in an attractive range. Lastly, it appears that there is at least some prospect that interest rates might rise from current levels, which would provide additional yield enhancement. ■

7 Source: Standard & Poor's Leveraged Commentary and Data, 18 April 2011

### Bank Loan Disclosure

The market value of bank loans ("Loans") will fluctuate with, among other things, changes in market rates of interest, general economic conditions, economic conditions in particular industries, political risks, the condition of financial markets and the financial condition of the issuers of the Loans. In addition, the secondary market for many of the Loans may lack liquidity which could have an adverse effect on the market value of the Loans and the ability to dispose of investments in a timely fashion and for a fair price, as well as the ability to take advantage of market opportunities. Even if such Loans can be disposed of, the prices realized from their sale could be less than those originally paid or less than what may be considered the fair value of such obligations. Additionally, bank loans will be subject to certain transfer restrictions that may contribute to illiquidity.

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