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ASSET MANAGEMENT

Investing in Debt: Opportunities in Leveraged Loans

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Executive Summary

As institutional investors reconsider their relative allocations to equities and fixed income in the wake of the global financial crisis, we believe they should consider the attractive opportunities presented by investing in secured loans. While institutions with allocations to corporate sub-investment grade credit have traditionally focused on the high yield bond market, secured loans may provide exposure to a similar universe of corporate issuers but with advantages over high yield bonds. Unlike high yield bonds, the loans generally have the following features:

- Are secured by the operating assets of the borrowing company
- Present a higher expected recovery rate in the event of default
- Show lower secondary market price volatility
- Offer the duration advantages of a floating rate asset class
- Provide access to private monthly management accounts
- Involve protective covenants that provide more timely and more forceful control over borrowers

Despite the recent problems with leveraged loans, secondary market prices of loans have now recovered following the unwinding of excessive leverage. Consequently, we believe the unprecedented drop in loan prices in 2008 and 2009 is unlikely to be repeated because the overly leveraged investors have been removed from the market. The new issue market for loans is re-opening, and we consider terms for new deals to be much more favourable with respect to potential returns and the strength of lender protection through security, leverage and covenant packages. The forthcoming vintage of loan origination is likely to provide more favourable return for the lowest risk that has been seen in the market for some time. We believe investors can achieve attractive returns with low volatility by investing in a secured asset class without the need to leverage their investment.

In the following article, we explain our view of how the US and European leveraged loan markets work and examine their evolution from the introduction of the single European currency through to the recent credit crisis. Considering the outlook for the market, we argue the potential benefits institutional investors could derive from an allocation to leveraged loans.

Rethinking Asset Allocation Choices

Shifting from equities

Recent volatility in the equity and bond markets is causing many institutional investors to review their asset allocation choices. A breakdown in confidence in the traditional view that over the long term equities will deliver steady

growth that exceeds inflation may have led a number of them to reduce their allocation to equity markets and look for other asset classes that may provide a more predictable return profile.

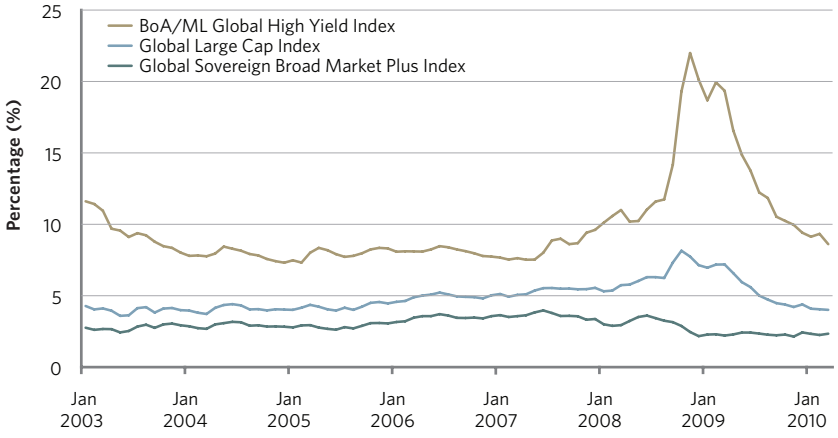
The fixed income markets have been a major beneficiary of this shift. Determining expected return in the equity markets requires forming a view of likely growth in earnings and profits over the investment horizon, which is very hard to do. By contrast, returns from fixed income (assuming the intent is to hold to maturity) are defined at the point of investment by the coupon and knowledge that the principal is expected to be returned by contract at maturity. Rather than take a view on equity market growth, the investor must analyse the risk of default of the issuer and the expected loss following default. Each of these risks can be estimated through detailed credit analysis, particularly in the case of corporate credit where the investor has access to detailed financial information on the borrower.

Investment grade corporate bonds had initially been considered the new safe haven, and certainly this is an asset class that provides transparency and liquidity. However, as more money flows to this asset class, spreads are compressing.

Asset classes within fixed income

Within the fixed income universe there are a variety of asset classes for investors to consider. The major asset classes are government bonds, investment grade corporate bonds and sub-investment grade corporate bonds and loans. Exhibit 1 shows the yields on these different categories of credit since 2003.

Exhibit 1 – Yields on Global Fixed Income Asset Classes



Source: Markit Hub, BofA Merrill Lynch

Government bonds generally deliver slim returns and may no longer be the risk-free universe they were once regarded. Ballooning budget deficits and levels of national debt in the US, UK and parts of continental Europe give investors many more issues to consider before investing in sovereign debt. Investment grade corporate bonds had initially been considered the new safe haven, and certainly this is an asset class that provides transparency and liquidity. However, as more money flows to this asset class, spreads are compressing. Their yields may not compete with those promised by the equity market, so by switching from equities to investment grade corporate bonds, asset allocators face a yield deficit that may need to be made up. At this point many investors may begin to consider the higher returns on offer in the sub-investment grade market.

Consider loans, not just high yield bonds

Most investors consider high yield bonds as the only instrument available to them within the sub-investment grade corporate space. However, the US leveraged loan market is almost as large as the high yield bond market at $800bn of loans outstanding;[1] while in Europe, most companies borrow predominantly via bank loans rather than by issuing bonds.

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Loans have historically been the domain of the banks. Loans are not securities, and do not clear through a standardised clearing system. They settle through the physical execution of legal documents and require a higher degree of administration than a corporate bond. They are based on a floating interest rate, so Euribor/Libor settings and terms need to be noted. Lenders regularly have to respond to requests from borrowers for waivers to various terms of the loan documentation.

For these reasons, institutional investors, particularly in Europe, seem to have been slow to embrace loans as an asset class. However, over the last 10 years the emergence of asset managers specialising in loan investment has made the asset class more accessible to less specialised investors.

How Senior Secured Loans Work

When a company borrows from a bank, it typically does so via a loan. The loan is a bilateral agreement between the lender and the borrower. Banks are keen to lend to investment grade corporates and do so at rates typically lower than those available to the same company in the bond market. The banks aim to make up the difference by selling other services to the company like foreign exchange, derivatives and advisory, all of which command high fees and which companies often source only from banks that agree to provide them with loan financing.

The sub-investment grade market is very different. In Europe, the majority of sub-investment grade borrowers are, or originally were, the subject of private equity-sponsored leveraged buyouts ("LBOs"). In the US, private-equity-backed LBOs account for approximately half the market. In these deals margins are higher to reflect the greater leverage applied to the businesses through the buyout and the absence of the corporate banking dynamics that drive traditional corporate facilities tighter. These are what are often referred to as "leveraged loans".

In a typical deal, a private equity sponsor would put up between 30% and 70% of the purchase price of the business, then arrange an underwriting for a syndicated bank loan to finance the balance. A number of the larger banks (for example, JP Morgan, Bank of America, Deutsche Bank, RBS) specialise in underwriting this sort of loan. Once the private equity firm wins the bid for the company, the underwriting bank seeks to syndicate the loan to other banks and to institutional investors. Whilst bank buyers may further syndicate their position, institutional investors will generally retain the loan as their investment.

1 Credit Suisse Leveraged Finance Update, May 3, 2010.

The loan is actually a collection of facilities ranking *pari passu (on equal footing)*, typically consisting of a revolving credit facility, an amortising term loan A (TLA), and bullet maturity term loans B and C (TLB, TLC). Banks participate across all the tranches while institutional investors focus on the TLB and TLC parts, which are termed the "institutional tranches".

Loan investors are used to performing more detailed due diligence on companies that are less well known and may have shorter operating track records. Typically this will be the case when a private equity sponsor is seeking financing for a new LBO.

A public rating is generally not required to ensure a successful syndication of the loan. Loan investors are comfortable forming their own view of the credit quality of the borrower through extensive due diligence. However, in the US and in some cases in the European market, the loan may be publicly rated and in many cases may have been privately rated. Typically borrowers in this market, were they to be rated, would in our opinion obtain sub-investment grade ratings in the BB to B range.[2]

Very well known issuers such as Wrigley's, Citco and Amadeus are represented in the loan market, with other companies ranging from high street retailers such as Michael's stores, J Crew and Boots, to large chemicals companies like Celanese and Ineos. Cable and telecommunications companies such as Crown Castle, Virgin Media or NTL and many other businesses from a variety of different industries, also use the loan market.

Leveraged Loans vs. High Yield Bonds

High yield bonds and leveraged loans are issued by very similar sorts of businesses. Most high yield bond issuers will also have a bank loan in place, but not all borrowers via bank loans will want to or be able to access the high yield bond market.

The success of a high yield bond issue typically depends on the ability to build a large and diverse pool of investors. This requires the borrower to be well known and have a business that is easily understood to a wide range of investors. It also requires public disclosure of key financial information and typically a public rating.

Loans are different. They will often be syndicated to a smaller group of investors, each taking a slice of the loan. Loan investors are used to performing more detailed due diligence on companies that are less well known and may have shorter operating track records. Typically this will be the case when a private equity sponsor is seeking financing for a new LBO.

2 All references to rated bonds in this paper are based on Standard & Poor's nomenclature.

Leveraged loans are secured on the assets of the operating company, in contrast to bonds, which are generally unsecured and issued at the holding company level. This is why they are often referred to as "secured loans". This gives lenders a priority claim on the assets of the business in the event of a default.

In addition to this, there are some fundamental differences between the two forms of borrowing. Loans typically have the following characteristics that bonds generally do not:

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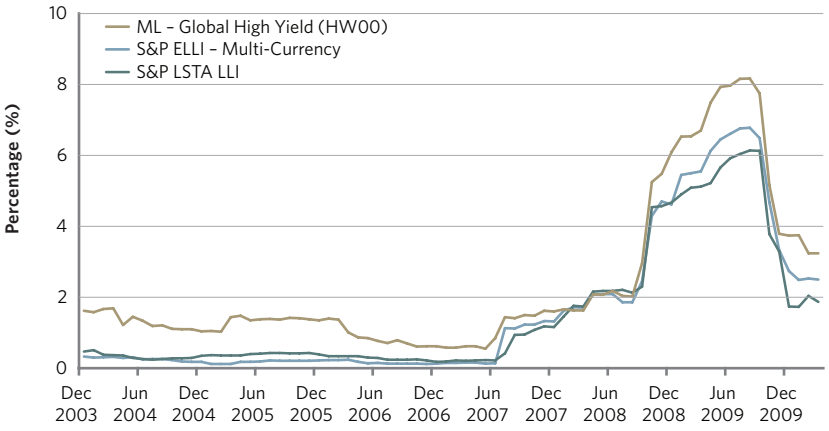
Higher recoveries

As a direct consequence of their secured nature, if the borrower defaults, recoveries under the loan generally will be greater than recoveries under the high yield bond, unless there is a senior claim and inadequate asset coverage. Typically loan recoveries have been between 50% and 100%, while recoveries on bonds have been between 0% and 50%. Specifically, between 1982 and 2009, average global corporate debt recovery rates on first-lien bank loans were 65.6% while the comparable figure for senior unsecured bonds was 36.6%.[3]

Lower secondary market price volatility

Since it is nearly always the case that a default results in a lower loss to the secured loan lender than will be experienced by the high yield bond investor, it follows that signs of potential stress will have a greater effect on the price of the bond in the secondary market than they would on the loan. The loan market will therefore exhibit lower volatility in secondary market pricing than the high yield bond market. Exhibit 2 illustrates the annual volatility of monthly returns for the loan market and the high yield bond market.

Exhibit 2 – Loan vs. High Yield Volatility



Source: Standard & Poor's, BofA Merrill Lynch, Markit Hub

3 "Corporate Defaults and Recovery Rates 1920 – 2009," *Moody's Investor Service*, February 2010.

A loan investor has access to more detailed information on a timelier basis than a high yield bond investor and should therefore be able to make more informed investment decisions.

Floating rate asset class

Loans typically pay a floating rate of interest made up of a Libor or Euribor base rate, plus an additional margin to compensate for credit risk. Bonds, by contrast, are typically fixed rate instruments with a maturity of 7 to 10 years. The credit spread is built into the fixed rate as a margin over a government bond of a similar maturity. Since they have a higher duration and the yield curve is positive, bonds pay a higher coupon than loans.

The long duration of the bond is of value to an investor, like a pension fund, who is trying to match longer-dated liabilities. However, the longer duration of bonds over loans also makes their values more sensitive to movements in the yield curve. If interest rates rise or fall, the secondary market price of the bond will fall or rise, respectively, by much more than that of a loan in the same situation, contributing to the greater volatility of bonds vs. loans as demonstrated in Exhibit 2.

If interest rates rise, the loan investor may also benefit from a higher Libor/ Euribor reset on the next coupon roll date; if rates decline, the reverse is true.

Access to private, monthly, management accounts

In Europe, loans are private instruments; and in the US, a large proportion of the market is private. The lender receives monthly management accounting from the borrower detailing current trading, revenues and expenses. Bonds are public, so investors are restricted to trading on the basis of publicly available information and are denied unrestricted access to management and their projections.

A loan investor has access to more detailed information on a timelier basis than a high yield bond investor and should therefore be able to make more informed investment decisions.

More protective covenants

Both loan and bond documentation contains restrictive covenants. Loan documents contain covenants that, amongst other things, limit the ratio of debt to earnings and require a minimum level of interest coverage to be maintained. These covenants are typically tested quarterly by the agent bank, and if they are breached, senior lenders may decide to enforce their security and take control of the borrower. Bond covenants are not typically tested on a regular basis but instead are generally reviewed only when the borrower plans to take on new debt or pay an equity dividend.

This key difference between bonds and loans allows loan investors the right to modify the terms of their agreement on an ongoing basis. If a borrower knows that he risks breaching a covenant, he must seek a waiver from the lenders and will most likely be asked for a fee or wider loan margin in return.

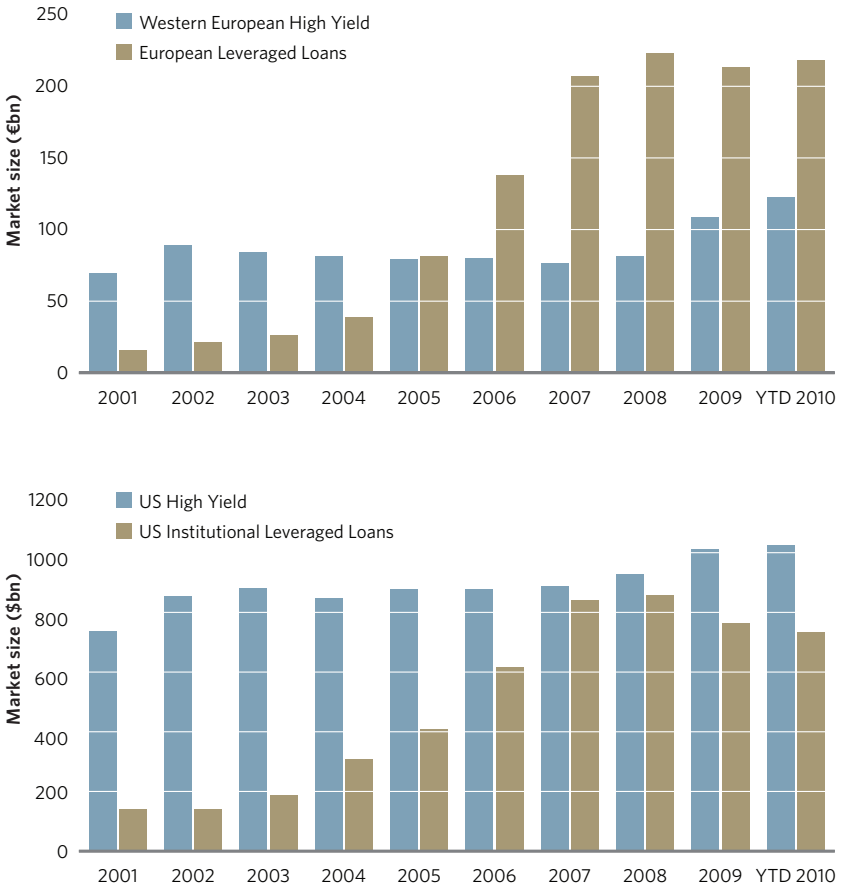
Size of the market

Exhibit 3 shows the evolution of the loan market and the high yield bond market since 2001. For the European market, the graph shows that since 2005, the loan market has overtaken the high yield bond market in notional amounts outstanding. Data for the loan market include only the institutional tranches,

which are those held by non-bank investors and traded freely between holders in the secondary market. This contradicts conventional wisdom in Europe, which is that the bond market is deeper and more liquid than the loan market. In fact the loan market is bigger, even when considering only the institutional tranches. In the US, both the loan and the high yield bond markets are much larger, with loans outstanding representing around 75% of the high yield bond market.

The access a lender has to private information on the borrower is very important to the credit process. With access to this information, credit analysts can form a clearer view of how a company is trading.

Exhibit 3 – Evolution of the Loan and High Yield Markets



Source: Credit Suisse Leveraged Finance Strategy Update, May 3, 2010 (data as of March 31, 2010)

Better information available to the lender about the borrower

The access a lender has to private information on the borrower is very important to the credit process. With access to this information, credit analysts can form a clearer view of how a company is trading. Perhaps more importantly, the lender can monitor compliance with the loan covenants and if there is a risk that a covenant may be breached, can assemble the senior lending group to approach the company and its private equity sponsors and require them to take action to address the situation. The power the senior lender holds results from the ultimate sanctions they can use if a covenant is breached and remains unresolved. Through the security package, senior lenders may seize ownership of the operating assets of the company, forcing out the equity investors, and thereby protecting the lenders' interests in the company's assets.

Bond holders are typically unsecured and do not have this right. Nor do they have timely access to the information that would lead them to conclude that a senior debt covenant has been breached. They rank lower than the junior secured lenders when it comes to allocating residual value in the business following default and take whatever is left after secured lenders have been fully repaid.

While the US leveraged loan market has been well established for several decades, the concept of a "European loan market" is a fairly new one and one that was impossible to contemplate prior to the introduction of the euro in 1999. Prior to this, the market was dominated by local banks lending in their local currencies to leveraged buy-outs (LBOs) in their region.

Restructuring process

In practice, senior lenders rarely seek to take control of the business through enforcing their security. They are unlikely to have the specialised skills required to run the business. So the rights of senior lenders are typically used to pressure the equity sponsors to address shortfalls in business performance. Investors in distressed debt are an exception to this trend. They are likely to have a great deal of experience taking a company in and out of bankruptcy and may well exercise their rights specifically to take control of the business.

Once a potential covenant breach is identified, the senior lenders typically form a restructuring committee to communicate with the borrower and its equity sponsors. They may request an independent business review, based again on access to material, non-public information. The committee may hear plans for restructuring put forward by the business, submit its own plans for acceptance by the majority of senior lenders and approach alternative providers of capital to the business if the existing owners show reluctance to propose a solution. Ultimately the senior lenders vote on the approach to adopt.

This is in contrast to an investor in a high yield bond issued by the same company. They may not have access to the same level of information as the senior lender and may not enjoy as much influence over the final restructuring outcome.

Evolution of the Loan Market

While the US leveraged loan market has been well established for several decades, the concept of a "European loan market" is a fairly new one and one that was impossible to contemplate prior to the introduction of the euro in 1999. Prior to this, the market was dominated by local banks lending in their local currencies to leveraged buy-outs (LBOs) in their region. Following the introduction of the euro, this situation persisted, but a number of banks emerged to dominate the leveraged finance scene. These banks made a business out of originating and syndicating leveraged loans, but also retained large proportions of the deals they arranged, making banks the dominant participants in the market. This was in marked contrast to the US, where banks had long since been dis-intermediated from the process, arranging deals, but then selling them on to institutional investors, predominantly insurance companies and mutual funds. As a by-product of this, it became market practice for a US borrower to obtain a public rating when borrowing through the loan market.

In Europe, institutional involvement in the loan market only started to become significant once the appetite for collateralised loan obligations ("CLOs") grew between 2003 and 2007 (Exhibit 4). However, in this case private equity deal sponsors resisted the call for public ratings on loans. In their place, CLOs obtained private shadow ratings, which allowed the CLO liabilities themselves to be publicly rated, while enabling the underlying loans to maintain their private status.

Institutional investors in the leveraged loan market were increasingly drawn to CLOs because they provided cheap, non-recourse leverage with potential annual percentage returns in the high teens.

CLOs are closed-end structures that match the term of the financing to the longest possible maturity date in the underlying portfolio, avoiding refinancing risk and potentially locking in an attractive arbitrage. They require investors to commit to holding their investment to maturity (often up to 12 to 15 years).

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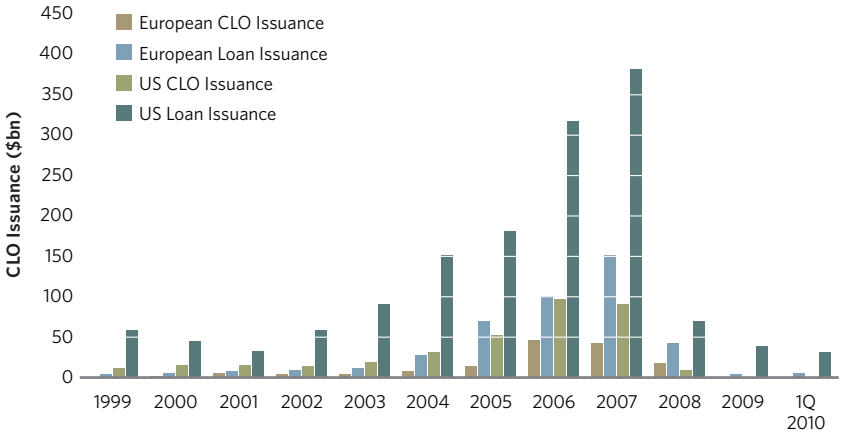
As loans gained acceptance among institutional investors, hedge funds entered the market, seeking the high potential returns achievable via a leveraged investment in the asset class. However, the liquidity requirements of hedge funds prevented them from participating in closed-end structures, so instead they financed their investment in loans through mark-to-market financing lines, with an advance rate based on the mark-to-market value of the loans. The consequences of this strategy were to have a significant impact on the market, as we will discuss later.

Exhibit 4 – Annual Arbitrage CLO Volume and Institutional Loan Volume

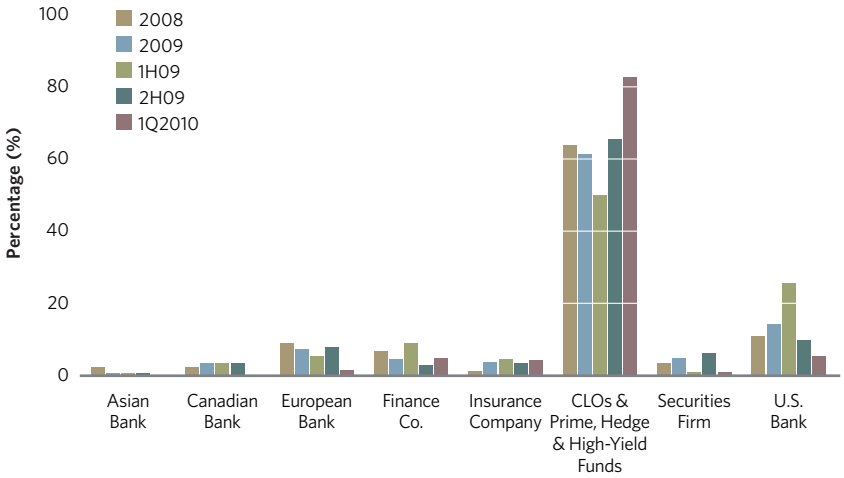


Source: Standard & Poor's LCD Leveraged Loan Review – US/Europe 1Q10

As more investor money flowed into CLOs and credit hedge funds, the demand for loans increased. This resulted in a weakening of deal structures between 2006 and 2007.

CLOs and institutional investors assumed an increasingly larger proportion of loan new issuance, eventually accounting for 56.5% of the demand for primary syndication during 2007, reducing the banks' share of the market to 36.4% (the difference accounted for by securities firms).[4] The primary market for leveraged loans continues to be dominated by CLO buyers, prime-rate, hedge and high-yield funds. Exhibit 5 below illustrates the growing market share occupied by these buying groups and the declining appetite of the US and European banks for new issue loans.

Exhibit 5 – Market Share for Leveraged Loan Primary Market Investors



Source: Standard & Poor's LCD Leveraged Lending Review 1Q10

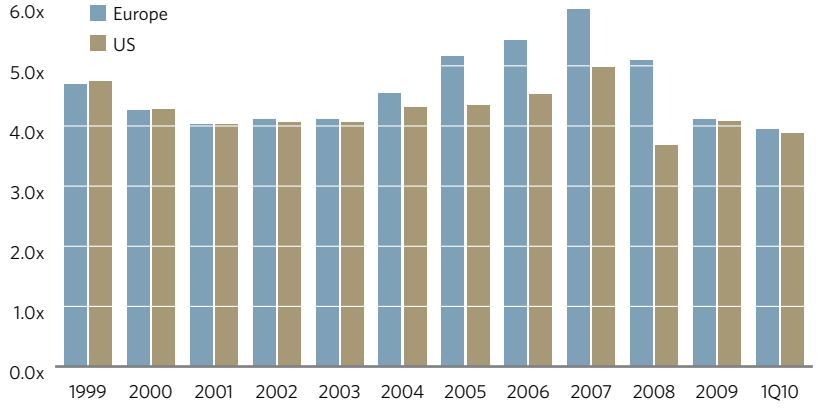
Popularity of CLOs increased loan demand, weakened terms

As more investor money flowed into CLOs and credit hedge funds, the demand for loans increased. This resulted in a weakening of deal structures between 2006 and 2007. The amount of debt senior lenders were prepared to offer increased (Exhibit 6), spreads narrowed from an average of 300 bps over Libor to close to 200 bps and in some cases covenant protection was significantly weakened. The quality of loans on offer was reduced, but underwriting continued, buoyed up by resilient demand driven by investors who were relying on leverage to drive their returns rather than relying on informed credit selection. In Europe, the situation was exacerbated because Icelandic banks were aggressively expanding their balance sheets and building significant exposure to the loan market, financed largely through short- term retail and wholesale funding.

4 Standard & Poor's, "LCD European Leveraged Loan Review," 4Q09, p. 136.

The meltdown in the sub-prime market and bank balance sheets bloated with loans caused a significant sell-off in July and August 2007. The closing of the securitisation market halted the issuance of new CLOs and instantly removed a large part of the anticipated demand for underwritten loans awaiting syndication. These loans remained trapped on bank balance sheets.

Exhibit 6 – Average Pro Forma Credit Statistics: Total Debt/EBITDA



Source: Standard & Poor's LCD Leveraged Loan Review – US/Europe 1Q10

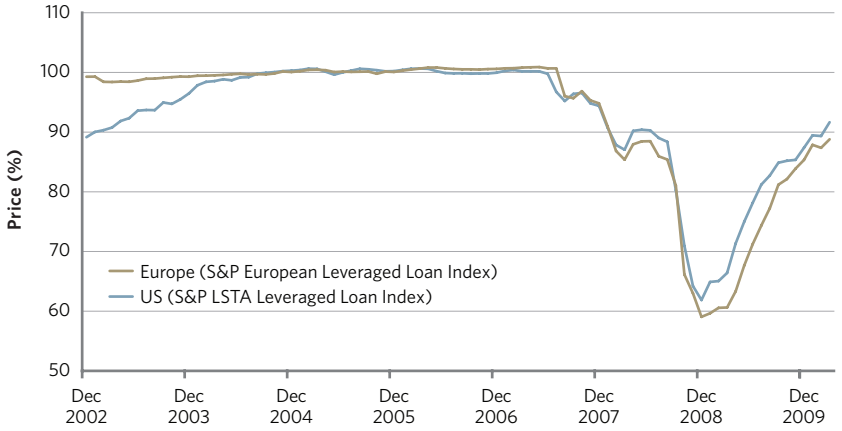
Credit crisis, rapid unwinding of leverage and a precipitous price drop

This was the situation as the credit crisis began in the middle of 2007. The meltdown in the sub-prime market and bank balance sheets bloated with loans caused a significant sell-off in July and August 2007. The closing of the securitisation market halted the issuance of new CLOs and instantly removed a large part of the anticipated demand for underwritten loans awaiting syndication. These loans remained trapped on bank balance sheets.

This sell-off persisted and was accelerated by banks that had provided financing to hedge funds calling in margin as market values declined. The collapse of one particular "award-winning" hedge fund typified the problems. The fund had built up a very successful track record investing in US sub-prime mortgages, but it also had a significant portfolio of leveraged loans. Both positions were financed through margin lines with their prime brokers. When the sub-prime market collapsed, collateral backing the margin lines was called in and the fund was forced to sell whatever assets it could to raise liquidity. Loans were the more liquid and valuable of their assets, so loans took a lot of the selling pressure. As this situation was repeated around the market, the price of loans fell precipitously, in turn triggering the unwinding of more leverage supporting other players in the market. Finally the collapse of some smaller US banks and in Europe, the Icelandic banks, released more loans onto the market, setting off an unprecedented fall in loan prices as illustrated in Exhibit 7.

The collapse in loan prices during 2008 was triggered primarily by an unwinding of the excessive leverage applied to this asset class. It was not directly related to weakness in the underlying borrowers, although this was to follow as the credit crisis took hold and its impact filtered through into the real economy.

Exhibit 7 – Secondary Loan Weighted Average Bids



Source: Standard & Poor's LCD Leveraged Loan Review – US/Europe 1Q10

Thus the collapse in loan prices during 2008 was triggered primarily by an unwinding of the excessive leverage applied to this asset class. It was not directly related to weakness in the underlying borrowers, although this was to follow as the credit crisis took hold and its impact filtered through into the real economy.

During 2009, global demand was impacted by the credit crisis. The auto manufacturing sector, amongst others, was severely affected and dramatically reined back production. This had a knock-on effect on all of their suppliers and related industries. Earnings in auto-related businesses started to show signs of weakness, and the number of leveraged borrowers forced back to the negotiating table with their senior lenders increased. This scenario played out in other troubled industry sectors such as building materials and chemicals.

However, against this backdrop, loan prices enjoyed the strongest rally ever witnessed,[5] on the back of evidence that the sell-off in 2008 and early 2009 had been driven by the unwinding of leverage and an indication that, at their lows, prices had far overshot the price level that fairly represented the level of stress in the underlying borrowers and the likely recovery in any default.

S&P data show that average spreads on BB-rated loans in the secondary market at the end of June 2008 were 1213 bps over Euribor, whereas the US market recorded an average discounted spread of Libor plus 1198bps. By late March 2010, the rally in loan prices had pushed this down to 462 bps over Euribor and 358bps over Libor, respectively. In contrast, the average spread offered on the same quality assets in the new issue loan market had risen to 489 bps over Euribor.[6] We believe the primary markets are now offering better yields than those of the secondary markets for the first time since the crisis. We believe this is partly due to the rally in secondary prices, but also due to investors' ability to dictate more favourable terms on new issues in the post-crisis environment.

5 Standard & Poor's, LCD Leveraged Loan Review – US/Europe 1Q10.
6 Standard & Poor's, "LCD EUR Topical: Secondary, primary loan spreads fall into step," March 2010 and Standard & Poor's, "LCD Quarterly Leveraged Lending Review 1Q10".

With the leveraged investors generally removed from the system, we believe a repeat of the precipitous fall in loan prices witnessed in 2008 and 2009 is highly unlikely, even if corporate earnings remain subdued. The gains in secondary market prices in 2009 are unlikely to be repeated, but with primary markets offering wide spreads and stronger deal structures, we believe the loan market offers the potential for exceptional opportunities.

One interesting side observation from the rally relates to the performance of riskier assets. The rally in prices during 2009 was most remarkable for assets rated CCC or lower. Not surprisingly, managers looking to benefit from a likely rally in loan prices had avoided the riskier end of the market. But this may have caused them to miss out on one of the more vigorous recoveries. Since the most universally accepted benchmark for the leveraged loan market, the S&P ELLI in Europe and the LSTA in the US, contains a representative component of CCC assets, managers who chose to avoid these riskier securities have found that, while absolute returns have been strong, their returns relative to the benchmark have actually been negative. This is hardly fair recompense for having adopted a prudent asset allocation strategy, but also reflects the fact that most CLOs are prohibited from buying CCC assets.

Outlook for Leveraged Loan Market

With the leveraged investors generally removed from the system, we believe a repeat of the precipitous fall in loan prices witnessed in 2008 and 2009 is highly unlikely, even if corporate earnings remain subdued. The gains in secondary market prices in 2009 are unlikely to be repeated, but with primary markets offering wide spreads and stronger deal structures, we believe the loan market offers the potential for exceptional opportunities.

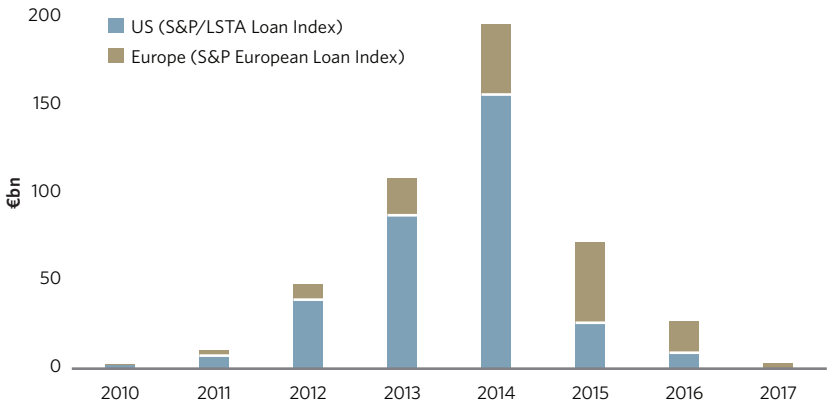
What factors do we believe will affect performance of the market in 2010 and 2011?

The wall of refinancing and the default outlook

The rapid growth in loan issuance between 2005 and 2007 has resulted in a significant volume of loans outstanding in the market. Ultimately these loans will approach maturity and need to be repaid or refinanced.

Leveraged loans have typically been structured with a maturity of 7 to 9 years, so the loans raised between 2005 and 2007 will be due to be refinanced between 2012 and 2016. The greatest refinancing pressure is expected to occur between 2013 and 2015 (as shown in Exhibit 8). How will this be achieved now that CLOs cannot be counted on to buy the loans?

Exhibit 8 – Current Loans Outstanding Maturity Schedule



Source: Standard & Poor's LCD European Weekly Topical, January 20, 2010

Much has been made of the risk of increased defaults posed by this pending wave of refinancing. If the capital markets are not open to allow refinancing of these facilities, then the borrowers may default. In reality, however, borrowers have been swift to address the issue.

Much has been made of the risk of increased defaults posed by this pending wave of refinancing. If the capital markets are not open to allow refinancing of these facilities, then the borrowers may default. In reality, however, borrowers have been swift to address the issue. The simplest solution is an "amend to extend" execution in which the lenders agree to extend the maturity of the existing facility in return for a lift in margin. Recent examples of borrowers who have successfully extended the maturities of their debt include Virgin Media, UPC, Telenet, Yell and Smurfit in Europe, and a wide array of companies have done the same in the US.

Others have turned to the bond markets to raise longer-dated capital with which to repay loan facilities. During the first 10 months of 2009, €14.3 billion was raised in the bond market and according to S&P, 14% of this was specifically earmarked for the refinancing of bank debt. During 2009, the US market saw $164 billion of new issue high yield bonds.[7] Other borrowers have sought to raise equity capital through an IPO, with some of the proceeds reserved for the same purpose.

All of these solutions require the consent of senior lenders and the request for consent is generally accompanied by a margin uplift and consent fee. So the threat of refinancing is actually becoming a virtue for the market, reinforcing the trend toward higher margins on loans and lower leverage.

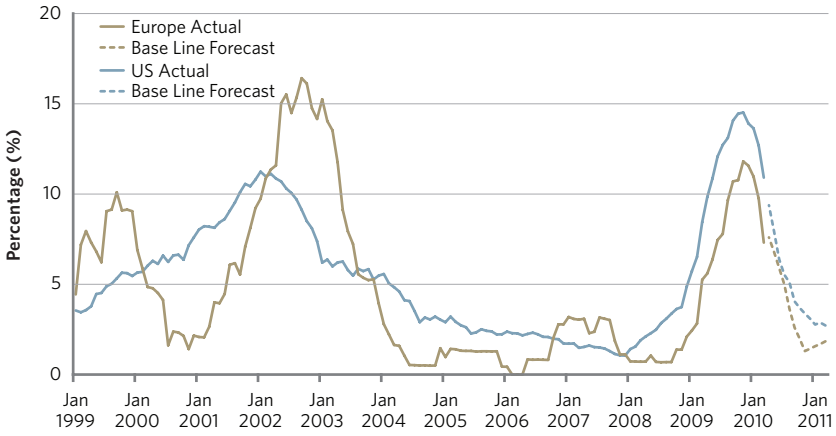
There is still risk in the refinancing wall, but the risk declines with each new loan, bond or equity capital raise. By the time 2014 arrives, we believe it will be only the weakest who will hit the wall and trigger default.

As a result, rating agency expectations of future defaults have moderated considerably over the last few months. In a recent report, Moody's recorded annual speculative grade default rates for the US and Europe combined of 13% for 2009. This is triple the level recorded in 2008 of 4.4%; however, in the same report Moody's forecast that the default rate for 2010 will fall sharply to 3.3%.[8] S&P are less optimistic, forecasting 8.7% for the end of 2010.[9] Exhibit 9 illustrates historic and forecast speculative grade default rates in Europe and the US.[10]

7 Standard & Poor's, January 2010.
8 Moody's Investor Services, February 2010.
9 S&P Ratings Direct Global Credit Portal, April 2010.
10 Moody's Investor Services, March monthly default report, 8 April 2010.

In Europe in particular, the high yield market has also proven to be a very unreliable source of LBO financing. Concerns about Greece and other European sovereigns in general have introduced volatility into the high yield market and slowed the pipeline of new issuance.

Exhibit 9 – European and US 12 Month Trailing Speculative Grade Actual and Baseline Forecast Default Rate



Source: Moody's Investor Services, Monthly Default Report – March 2010 – Excel data; April 8, 2010

An attractive opportunity in the primary market for leveraged loans

Increasing volume in the primary loan market is predicated on a few key factors. High yield has dominated leveraged finance new issuance during 2010.[11] However, high yield is unlikely to replace secured loans as private equity LBO sponsors' leverage instrument of choice. We believe it has certain disadvantages for the issuer over a secured loan:

- A requirement for a public disclosure of financial information and typically a public rating
- A time-consuming and expensive investor roadshow
- The inclusion of non-call periods and pre-payment penalties limit the sponsors' flexibility
- A lack of reliability – the market shuts down rapidly at times of market stress
- Large, diversified pools of investors with whom negotiation of subsequent amendments is difficult and costly

Many companies that can access this market have done so and have used the proceeds to repay outstanding bank debt and extend their maturities. This is positive in that it relieves the refinancing burden the loan market would otherwise bear, but it is not suitable for all circumstances. Many successful companies currently financed through bank loans do not fit the profile for a successful high yield bond issue.

In Europe in particular, the high yield market has also proven to be a very unreliable source of LBO financing. Concerns about Greece and other European sovereigns in general have introduced volatility into the high yield market and slowed the pipeline of new issuance.

11 Standard & Poor's, LCD European Weekly Topicals, June 8, 2010 and Standard & Poor's Leveraged Loan Review – US/Europe 1Q2010.

The loan market provides LBO sponsors with a more consistent source of financing with a universe of investors used to dealing with private information and the complexities of financing a business that may not have previously existed in the form being financed. So as LBO activity increases, we believe the loan market will provide more of the financing required than the high yield bond market.

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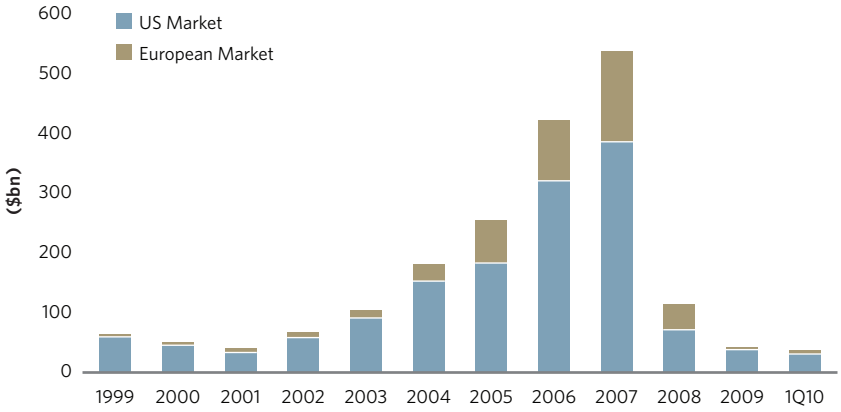
But for the new issue pipeline to grow, arranging banks need to be confident that the facilities they underwrite can be successfully syndicated into a much changed universe of loan investors.

Changing universe of loan investors

In the middle of 2007, investors in loans were typically CLOs, prime, hedge and high-yield funds as well as banks. New issuance of CLOs has now mostly ceased, leveraged credit funds have had their leverage diminished and banks are staring into an increasingly uncertain environment with respect to capital ratios and balance sheet growth. This, coupled with a reduction of new LBO activity, contributed to a sharp reduction in primary loan issuance during 2008 and 2009 (Exhibit 10).

Exhibit 10 – Global Leveraged Loan Volume



Source: Standard & Poor's LCD Global Leveraged Lending Report 1Q10

We believe a number of factors may be leading to the recent resurgence in the leveraged loan new issue pipeline:

- Accelerating loan repayments triggered by bond refinancing and LBOs are delivering cash to existing CLOs, whose structure encourages them to re-invest quickly in new issue loans
- Private equity sponsors with cash to invest but with reduced access to leverage have chosen to finance acquisitions initially through equity, aiming to refinance at a later date as debt becomes available, triggering an increase in LBO activity and resulting leveraged loans
- In the face of an increasing requirement for loan financing, terms on new issue loans have been improving to levels that appeal to institutional investors without the need to apply additional leverage

The influx of new institutional money to the loan market is offsetting the reduction in bank participation and may further grow to offset the declining participation of CLOs in the market as they reach the end of their investment period.

The delicate balance of these three factors may have led to a pick-up this year in the primary loan pipeline and led to the conclusion by some that 2010-vintage loans are likely to provide some of the most attractive risk/return opportunities in recent history. This, in turn, may be attracting institutional investors to the market on an unlevered basis, seeking stable, single-digit returns from a secured asset class that can potentially deliver those returns with low volatility and low risk.

The influx of new institutional money to the loan market is offsetting the reduction in bank participation and may further grow to offset the declining participation of CLOs in the market as they reach the end of their investment period.

Strengthening in new issue terms

The strengthening trend has already begun and recent new issues in the secured loan market have demonstrated improved terms on new loan financings.

Private equity LBO sponsors are now providing more of their own money (between 40% and 60% of the purchase price), which by definition reduces the amount of leverage in deals. According to S&P, the average equity contribution by sponsors to deals in 2009 was 53.1% for Europe and 51.91% for the US. This compares with averages of 33.6% and 32.91% at the peak of the market in 2007.[12]

The average leverage multiple for new issue European leveraged loans during 2009 stood at 3.4x EBITDA for senior debt and 4.2x EBITDA for total debt. This compares to 4.1x senior and 5.2x total in 2008 and 5.3x senior and 6.1x total at the peak of the market in 2007. Similarly, at the end of 2009 the average leverage mulitiple based on EBITDA for senior debt in the US was 3.7x and 4.1x in terms of EBITDA for total debt. In the US, these figures were 4.4x and 5.0x respectively at the peak of the market in 2007.[13]

Covenant packages have been strengthened and financial terms have been improved. Recent secured loan issues have come at spreads of 350 bps to 500 bps over Euribor/Libor, have offered up-front discounts of up to 2% and in some cases have provided floors on Euribor/Libor, which set an interest rate for the level of Euribor/Libor. This compares to spreads of 200 bps to 325 bps with no up-front discount or Libor floors prior to the crisis.[14]

12 Standard & Poor's, European Private Equity Report, March 2010 and Standard & Poor's LCD Leveraged Loan Review, US/Europe 1Q10.
13 Standard & Poor's, January 2010.
14 Standard & Poor's LCD Leveraged Loan Review, US/Europe 1Q10.

S&P's summary data on secured loan deals from the first quarter 2010 shows a trend toward issues with wider margins, lower leverage and higher contributions by private equity LBO sponsors.[15] In Exhibit 11 we summarize a sample of recent new issues that illustrate this trend along with two notable exceptions. These are IMS Healthcare and Virgin Media. The first was a large cross-border deal, deriving much of its demand from the tighter US market and the second a strong BB credit, neither typical of run-of-the-mill issuance.

If the better known borrowers are refinanced in the high yield bond market and the less well known, but strong performing borrowers are refinanced in the loan market, we believe there will remain a universe of borrowers still struggling to access capital markets. These are the weaker, more levered borrowers who fail to fit the criteria of the high yield market.

Exhibit 11 – Recent New Issue Loans

Borrower	Allocation	Country of Issuance	Senior Loan Margin	Issue Price	Senior Leverage	Industry
Lamar Advertising	April 2010	US	300bp Libor Floor	99.50	3.2x	Billboard Advertising
Dealer Computer Services	April 2010	US	350bp Libor Floor	99.25	3.8x	Software
Affinion	April 2010	US	350bp Libor Floor	99.00	1.9x	Affinity Programs
CF Industries	April 2010	US	300bp Libor Floor	99.50	1.1x	Fertilizers
Spotless	March 2010	EUR	500bp	99.00	4.0x	Cleaning products
Matalan	March 2010	EUR	500bp	99.00	1.0x	Retailing
Virgin Media	March 2010	EUR	375bp (TLB)	99.00		Cable Services
Anchor Glass	February 2010	US	400bp Libor Floor	99.00	3.1x	Containers
Dole Foods	February 2010	US	325bp Libor Floor	99.00	2.2x	Food Products
IMS Healthcare	February 2010	US	300bp 1.75% Libor Floor	99.00	3.5x	Pharmaceuticals and Healthcare
Marken	February 2010	EUR	500bp (TLB)	98.00	4.7x	Clinical Logistics

Source: Standard & Poor's LCD Leveraged Loan Review – US/Europe, 1Q10, May 2010.

Opportunities in stressed and distressed

If the better known borrowers are refinanced in the high yield bond market and the less well known, but strong performing borrowers are refinanced in the loan market, we believe there will remain a universe of borrowers still struggling to access capital markets. These are the weaker, more levered

15 Standard & Poor's LCD Leveraged Loan Review, US/Europe 1Q10, May 2010.

borrowers who fail to fit the criteria of the high yield market. For these borrowers, access to the capital markets is not a given. To the extent that they do not solve their issues through improved performance, the company will likely be forced to restructure via a recapitalisation of its balance sheet. Depending on a variety circumstances (stakeholder composition, jurisdiction, business model, etc.), this may take place either through the courts via bankruptcy proceedings or outside the courts via a negotiated settlement.

As the requirement to refinance reaches its peak between 2014 and 2015, we believe the debt of those companies that have not successfully refinanced will experience significant price volatility in the secondary market. This volatility provides an opportunity for informed stressed and distressed investors to source assets at below their fair value either in anticipation of a recovery, or to allow them to drive through balance sheet restructurings that result in a valuable equity stake in the business.

These situations may provide fertile ground for distressed investors. Debt in these businesses will be volatile in the secondary market as original investors without the stomach for uncertainty look to sell out of the situation. This may provide an opportunity for informed investors to build positions in the companies they believe offer the prospect of recovery, or those that are likely to go through a more distressed restructuring process where the objective is to end up with equity sourced at a discount to intrinsic value.

This is expected to be an enduring opportunity. As S&P recently commented: "We anticipate that the steady stream of debt restructurings that we have seen recently will persist over the next two years".[16] Exploiting these opportunities entails a higher degree of uncertainty than investment in performing loans. Returns are likely to be more volatile. But we believe the returns are potentially much greater than those achievable in the performing loan market.

Visibility of future defaults

In our opinion, as 2014 approaches, a pick-up in defaults should be expected as the weakest companies run out of options for restructuring their businesses. However, these will not be randomly observed across the loan market. We believe the companies that will ultimately default between 2014 and 2015 as a result of impending loan maturities are the companies already experiencing high levels of earnings stress and who are already getting considerable attention from the workout committees formed by their senior lenders. So while defaults may increase, investors building their portfolios now should be able to avoid the weaker names and concentrate on the strong credits, now paying attractive margins in the primary market.

Opportunities for Institutional Investors

In our opinion, unlevered institutional funds will gradually replace CLOs as the dominant non-bank participants in the loan market. Banks' share of the market is also likely to fall as regulatory capital constraints make it expensive for them to hold these assets on the balance sheet. In the face of reduced capacity in the market, the few borrowers that are able to will likely turn to the high yield market to refinance outstanding loans, but most will likely continue to rely on the loan market, offering more attractive terms to refinance maturing capital structures.

16 S&P Ratings Direct Global Credit Portal, April 2010.

We believe institutional investors should consider an allocation to the loan market. Loans may offer investors equity-like returns from a secure, floating rate debt product with an active primary and secondary market and should be considered a core component of any asset allocation strategy.

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For those companies that are over-levered and whose business model is potentially impaired, especially in a lower demand environment, this will be, in our opinion, the time that defaults will likely rise again. However, the universe of borrowers likely to fall into this trap may be easily identified as they are often already engaged in extensive negotiation with their senior lending group.

We believe the loan market presents two significant opportunities for institutional investors based on their asset allocation requirements and desired outcomes: generating high single-digit returns with low expectations of volatility through an unlevered allocation to the loan market; and taking advantage of an enduring opportunity in stressed and distressed credit to achieve mid-teens returns. This may be achieved by sourcing undervalued debt in the secondary market and awaiting market revaluation or ultimate redemption at par, or by taking a controlling stake in a part of the capital structure which will allow influence over the restructuring process, resulting in gaining a valuable equity stake in the business at an attractive entry price.

Both strategies must incorporate a highly selective investment approach backed up by detailed corporate credit and valuation analysis and specific expertise in the industries in which the borrowers operate.

New loans are being offered on greatly improved terms, providing wider margins and stronger deal structures. As mentioned, in our opinion, 2010-vintage loans are likely to provide the best risk/return profile the market has seen for several years.

We believe the next few years will also prove a fertile environment for experienced stressed and distressed investors as over-levered companies fight to re-engineer their balance sheets in order to prosper in a more difficult economic environment.

We believe institutional investors should consider an allocation to the loan market. Loans may offer investors equity-like returns from a secure, floating rate debt product with an active primary and secondary market and should be considered a core component of any asset allocation strategy.

For absolute returns, investors should consider the greater returns that are possible through informed investing in the stressed and distressed credit market.

By allocating capital to specialised managers, experienced in dealing with the operational complexities of the loan market, and with established credit expertise in the field, we believe investors can access the opportunities in this market more effectively.

Paul Hatfield, Chief Investment Officer

Paul joined Alcentra in May 2003 as a portfolio manager and is now global Chief Investment Officer. Paul has 22 years' experience in leveraged finance and prior to joining Alcentra, was a senior analyst for the CDO operations of Intermediate Capital Group. Between 1995 and 2001, Paul worked at Deutsche Bank, originally in London for the Leveraged Finance Team. At this time, Deutsche (Morgan Grenfell) were the leading underwriter of European LBOs. Paul originally trained as a chartered accountant in the audit division of Arthur Andersen, and before joining Deutsche, built up a successful portfolio of mezzanine and development capital loans with FennoScandia Bank, the London operation of a Scandinavian consortium bank. Paul graduated from Cambridge University with an MA in Economics.

Simon Perry, Managing Director, Business Development

Simon is a Managing Director at Alcentra, responsible for the Business Development Team for EMEA ex Japan. Prior to joining Alcentra in 2009, Simon was involved in the development of the European CLO market, heading the European CLO business at UBS Investment Bank; he held similar roles at CIBC and Natixis. Simon was also part of the cross-asset class derivatives marketing team at CSFB. He is a graduate in mechanical engineering from Bath University.

Index Definitions

The Bank of America/Merrill Lynch Global Sovereign Broad Market Plus Index: The Global Broad Market Index tracks the performance of investment-grade public debt issued in the major domestic and Eurobond markets, including Global bonds. Sub-indices include Global Government Index, Global Broad Market Non-Sovereign Index, Global Broad Market Quasi-Government Index, Global Broad Market Corporate Index, and Global Broad Market Collateralized Index. An additional index is the Global Large Cap Index.

The Bank of America/Merrill Lynch Global High Yield Index (history starting December 31, 1997): U.S. dollar,Canadian dollar, sterling and euro-denominated fixed rate debt of corporate issuers domiciled in an investment grade rated country (i.e., BBB or higher foreign currency long-term debt rating). Individual bonds must be rated below investment grade (i.e., BB or lower based on a composite of Moody's and S&P) but not in default; must have at least one year remaining term to maturity; a minimum face value outstanding of $100 million, C$50 million, 50 million pounds silver, or 50 million euros; and have available price quotations.

S&P LSTA LLI is a daily total return index that uses LSTA/LPC mark-to-market pricing to calculate market value change. On a real-time basis, the LLI tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the LLI represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers.

The S&P European Leveraged Loan Index (ELLI) is a multi-currency index that covers the European leveraged loan market back to 2003 and currently calculates on a weekly basis.

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