

Look For Opportunities In The High Yield Bank Loan Market

By George Goudelias, Senior Portfolio Manager, Head of Bank Loan Group, Seix Investment Advisors

After an unprecedented decline in the first quarter of 2008, the bank loan sector rallied in the second quarter. Supply pressures are easing as the new issue backlog continues to shrink. On the demand side we are seeing renewed appetite for bank loans, especially from non-traditional buyers, faced with widening spreads, low treasury yields, and continuing volatility in other asset classes.

Historically bank loan prices have moved in a very narrow band. Since bank loans are callable at par at any time, unlike high yield bonds, prices rarely exceed 101 on the upside. And the downside is limited due to the senior position of loans in the capital structure. The accompanying chart showing average loan pricing from 1997 to 2008, illustrates this point (see Figure 1).

The value opportunity we see is derived from the market's extraordinary devia-

tion from this historical pattern which pulled secondary market prices down to the high 80s at one point. Even after the recent rally average prices remain in the low 90s. By way of hypothetical example, let's assume a price of 91 on a loan with a 3.5% spread and Libor at 2.75%. Assuming a remaining life of roughly three years, after which it will be redeemed at par, the potential annual return on that loan is 9.25%.

However, to realize this value requires a high quality approach to managing the portfolio. This implies a target universe consisting primarily of double-B and strong B-rated loans and issues that are liquid: typically greater than \$100 million. Within this universe we adhere rigidly to five investment tenets, or mandatory fac-

tors, in company-specific research:

- Improving free cash flow leading to de-leveraging. Cash flow should be used to pay down debt on the balance sheet, or to re-invest in the company at an attractive rate of return, rather than leveraging up, by buying back shares, for example.
- Seasoned and capable management. From a research standpoint it is important to have good access to the executive ranks of corporate borrowers and sound knowledge of their particular industry in order to assess management accurately.
- Access to capital. Clearly defined sources of liquidity, such as available bank lines and cash on the balance sheet, are essential so that companies can address scheduled amortization as well as near-term maturities. It is also important that borrowers maintain good investor relations in both stock and bond markets, in the event of a need to raise capital.
- Solid asset protection. Loans should have strong asset coverage to protect against downside risk.
- Strong competitive position. The borrower does not need to be the leader in its segment but it should rank among the first three, and clearly demonstrate that it can keep the competition at bay.

Loan covenants also merit close scrutiny. Before the subprime mortgage crisis broke, so-called "cov-lite" loans were popular among issuers and demand in general was so strong that investors were prepared to accept this phenomenon. Specifically, incurrence covenants allowed the issuer to exceed the specified ratio of leverage to cash flow as long as no additional debt was incurred. A maintenance covenant, on the other hand, requires that the ratio be strictly maintained, regardless of debt. In today's climate maintenance covenants are once again the norm in new loan agreements. They also form part of

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Figure 1

Calendar

The staff at IMW has gathered the following items from a variety of sources. The IMW staff believes the information in this section to be reliable, but all information should be confirmed with the various organizations.

Information Management Network

June 24-25: "Southeast Public Employee Retirement Systems Forum" at the Westin Buckhead, Atlanta, Ga. For more information, visit imn.org.

Sept. 22-23: "Foundations & Endowments Summit" at the Arizona Biltmore, Phoenix. For more information, visit imn.org.

Sept. 22-23: "Alternative Investments Summit" at the Arizona Biltmore,

Phoenix. For more information, visit imn.org.

The Opal Group

July 9-11: "Public Funds East" at the Hyatt Regency Newport, Newport, RI. For more information, visit opal-group.net.

July 20-22: "Investment Trends Summit" at the Fairmont Mayakoba, Riviera Maya, Mexico. For more information, visit opalgrou.net.

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effective risk management within the bank loan portfolio.

Risk control begins with adherence to certain diversification principles that include, among others, a limit on industry exposure, with specific constraints on overweight positions, and restrictions on position sizes. These principles also embrace liquidity checks in the stock, bond, or loan market to ensure that market signals are not out of line with the manager's thinking at the time.

Other key risks include default risk, which can be mitigated through industry-specific credit research; interest rate risk, which is minimal since bank loans carry a floating rate, pegged to 1-month or 3-month Libor with an effective duration of 30 days, and structure risk. The typical capital structure has first lien loans in the most senior position followed by second lien loans, and various categories of bonds in descending order of seniority. Structure risk can be reduced by purchasing first lien debt, which offers more extensive asset coverage and greater liquidity.

Remember the Fundamentals

We believe that the technical factors bringing supply and demand back into balance will push average bank loan prices somewhat higher in the short term. Beyond that, much will depend on the

impact of any economic downturn. However, in conclusion it is worth keeping in mind some basic fundamental facts relating to bank loan issuers:

- Even if revenue growth slows, bank loans benefit from their senior position in the capital structure.
- Profitability gains from cost containment that typically accompanies a downturn.
- Traditionally, cash flow has easily covered loan service requirements.
- Defaults remained at historic lows of \$1.2 billion in 2007. Even if the default rate spikes sharply in 2008, it is unlikely to attain levels that would justify an average loan price in the low 90s.

George Goudelias joined Seix Advisors in 2001 as a managing director, senior portfolio manager and head of the bank loan group. Goudelias received both a B.S. degree in Finance and Accounting, and a M.B.A. degree in Finance from New York University.

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that time, lawsuits and other threats loomed over the tobacco industry and CalSTRS decided to pull investments.

Now, the board has unanimously decided to reconsider tobacco investments, and will likely discuss a potential modification of its no-tobacco rules before the end of the calendar year. ■

Odds & Ends

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named **Mark Zinkula** CEO, a new position for the U.S. branch of **Legal General Investment Management**. Zinkula, who currently serves as treasurer and CFO of **Cornell College**, will join LGIMA at the end of the month.

■ **AXA Rosenberg** has launched its new Global Advantage Long/Short strategy. The fund will be weighted 50/40/10 in the U.S., Europe and Japan, respectively. It was designed by **Will Cazalet**, a portfolio manager at the firm.

■ **Gresham**, the mid-market private equity firm, has appointed **Dan Hatcher** as a partner in the firm's investment team. Hatcher joins Gresham from **Ernst & Young**.

■ **Derek Davies** has joined **Deutsche Bank** as head of commodities for Canada, in the firm's global markets division. Davies will report to **Tim Sullivan**, the firm's head of commodities sales and origination in North America. Prior to joining Deutsche, Davies was head of European power, gas, and emissions marketing at **UBS**.

■ **Legg Mason** has named **Ajay Dayal** and **Nuria Ribas-Lequerica** as investment director and fixed-income product specialist, respectively. Prior to joining Legg Mason, Dayal worked at **ABN Amro Asset Management**, while Ribas-Lequerica worked at **Aberdeen Asset Management**.

Odds & Ends is a compilation of reported news from a variety of sources. The information in this section is assumed to be reliable, but all information should be confirmed, as IMW does not guarantee its accuracy.