



**Seix  
Investment  
Advisors LLC**

## **FINDING OPPORTUNITIES IN THE HIGH YIELD BANK LOAN MARKET IN 2009**

**A Discussion Paper from Seix Advisors**

*January 2009*

### **Introduction**

This paper is derived from our belief that the sell-off in bank loans during 2008 represents a rare opportunity to invest in this sector, with exceptional return potential. After a period of unprecedented re-pricing, attributable to falling demand and an overhang of supply, the bank loan market remains significantly undervalued as we enter 2009. In what will remain a challenging environment, credit research becomes increasingly important and the key to capitalizing on this opportunity.

We begin with a brief summary of bank loan characteristics and the market's recent history. We then discuss our approach to this asset class which is a natural extension of our high quality, high yield style. Finally we look more closely at the current value opportunities as the supply/demand equation improves and investor focus shifts toward fundamentals.

### **What are Bank Loans?**

High yield bank loans are made primarily to companies that are below investment grade and they possess the following key features:

- Floating rate debt typically benchmarked off 3-month Libor, with minimal interest rate risk.
- Senior in the capital structure to high yield bonds and therefore showing lower default and higher recovery rates.
- Highly restrictive covenants relative to financial ratios and further debt issuance that provide investors with enhanced credit protection.

It is also worth noting that these loans have low or negative correlations to interest rates, while most major sectors of the fixed income market, including Treasuries, agencies, mortgage-backed securities, and corporate credit have positive correlation (*see Figure 1*).

Figure 1

**KEY BANK LOAN PERFORMANCE CHARACTERISTICS**

*Low Correlation To Other Asset Classes*

**17 Years Ending 12/31/08**

(January 1992 – December 2008)\*

<b>Index</b>	<b>CSFB Lev Loan</b>	<b>LB Agg</b>	<b>LB Credit</b>	<b>LB MBS</b>	<b>LB TSY</b>	<b>LB High Yield</b>	<b>DJ REIT</b>	<b>S&amp;P 500</b>	<b>Russell 2000</b>	<b>NASDAQ</b>
CSFB Lev Loan	<b>1.00</b>									
LB Aggregate	<b>-0.01</b>	1.00								
LB Credit	<b>0.18</b>	0.93	1.00							
LB MBS	<b>-0.10</b>	0.92	0.79	1.00						
LB Treasury	<b>-0.22</b>	0.95	0.81	0.86	1.00					
LB High Yield	<b>0.67</b>	0.26	0.49	0.14	0.00	1.00				
REITs	<b>0.52</b>	0.14	0.26	0.05	-0.03	0.59	1.00			
S&P 500	<b>0.41</b>	0.08	0.24	0.07	-0.12	0.60	0.43	1.00		
Russell 2000	<b>0.43</b>	-0.03	0.15	-0.07	-0.21	0.62	0.55	0.75	1.00	
NASDAQ	<b>0.29</b>	-0.03	0.13	-0.05	-0.18	0.52	0.30	0.81	0.85	1.00

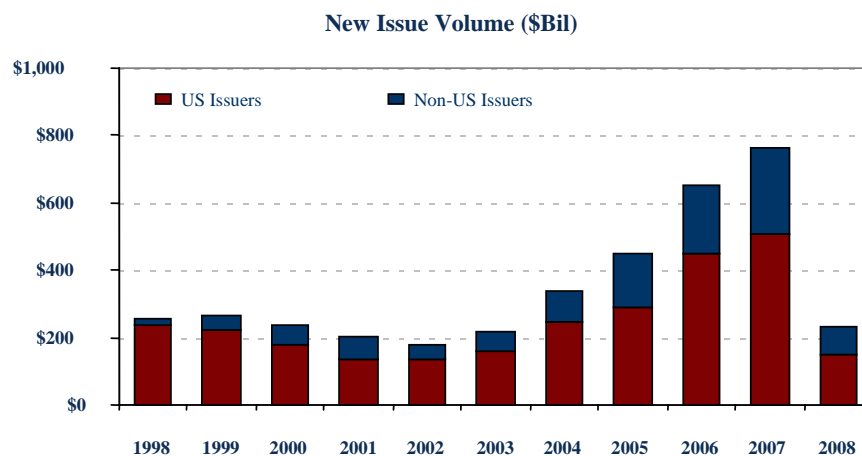
\*Since Inception of the CS Institutional Bank Loan Index (1/1/92)

Data Source: LehmanLive, Credit Suisse & Bloomberg

The market for high yield or leveraged loans has expanded rapidly in the past four years. Loan volume in 2007 was almost four times larger than high yield bond issuance. The total size of the market, as measured by CSFB exceeded \$1 trillion in 2007 and secondary trading totaled \$324 billion, roughly double 2004 volume. Today almost 90% of bank loan issuance is rated by Standard & Poor's and/or Moody's. The Credit Crisis of 2008, however, had a dramatic impact on supply (*see Figure 2*). This creates a favorable environment for investors as we enter 2009.

Figure 2

**RECORD SUPPLY WEIGHS HEAVILY ON MARKETS**



Source: S&P LSTA

The implosion of the collateralized debt obligation (CDO) market that followed the sub-prime mortgage crisis in the late summer of 2007 impacted the collateralized loan obligation (CLO) market and resulted in a significant drop in demand for bank loans since CLOs had become a major buyer. At the same time, a supply overhang created by the large volume of unplaced LBO activity, negatively impacted by the shut-down in credit markets, pushed loan prices lower. This trend accelerated when certain market value CLOs hit triggers and were required to sell collateral compounded later in the cycle by hedge fund de-levering adding further technical selling pressure. However, as we discuss later in this paper, technical selling and supply pressures began to abate and stabilize at the end of 2008.

## How to Manage a Bank Loan Portfolio

Our history of focusing on the higher quality end of the high yield bond market leads us naturally into the bank loan sector, since loans are senior in the capital structure to high yield bonds. Our targeted universe is primarily BB and strong B rated loans and we seek liquid issues with a typical size greater than \$100 million. Within this universe we adhere rigidly to five investment tenets, or mandatory factors, in our company-specific research. Equally important, we have a clearly defined set of diversification and risk management principles.

Before analyzing our approach in detail, we would highlight two further aspects of our history that lend weight to our investment process in the bank loan sector:

- **Industry-specific research.** We have always believed in deploying very seasoned credit analysts, some of which have had actual experience in the industries they are covering. Our health care analyst, for example, is a M.D., and our chemical analyst previously worked in the chemical industry. Practical, real-world experience of this kind confers a deep understanding of the key drivers of a particular industry, both now and in the future.
- **Access to company management.** Because we have accumulated significant assets in the high yield sector, we have good access to the executive ranks within corporate issuers, whether bonds or loans. (We estimate that around 50% of issuers are the same in both categories). Further, the experience of our industry analysts implies that in one-on-one meetings with company executives they know to ask the right questions and put the answers into proper historical context.

In our decision-making process we seek evidence of the following mandatory factors in all companies where we might invest:

- ***Improving free cash flow*** leading to de-leveraging. We like to see cash flow 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.*** As indicated earlier, our industry analysts are well placed to assess the caliber of the executive suite.
- ***Access to capital.*** We look for clearly defined sources of liquidity, such as available bank lines and cash on the balance sheet, 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.*** We do not necessarily expect a company 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.

At this point we should briefly discuss our view on loan covenants. These typically place a limit on the amount of leverage or, in the case of asset disposals, covenants can ensure that proceeds are used to pay down debt (see first factor above). Covenants may also dictate a coverage ratio between cash flow and fixed charges such as interest payments.

Before the sub-prime 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. We refer to these as incurrence covenants, which allow an issuer to exceed the specified ratio of leverage to cash flow as long as no additional debt is 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 and we do not expect to see a return of “cov-lite” loans.

## **Where are the Risks?**

Effective risk management is an integral part of managing the bank loan portfolio. It 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 the use of maintenance covenants, as described above, and liquidity checks in the stock, bond, or loan market to ensure that market signals are not out of line with our particular thinking at the time.

Other key risks are as follows:

***Default risk,*** which can be mitigated through industry-specific credit research, as mentioned earlier. We have never owned a loan in our portfolio that defaulted at the time we held it.

***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.

**Structure risk.** The typical capital structure has first lien loans in the most senior position followed by second lien loans, various categories of bonds in descending order of seniority, and finally equity. Structure risk can be mitigated by purchasing first lien debt which offers more extensive asset coverage and greater liquidity.

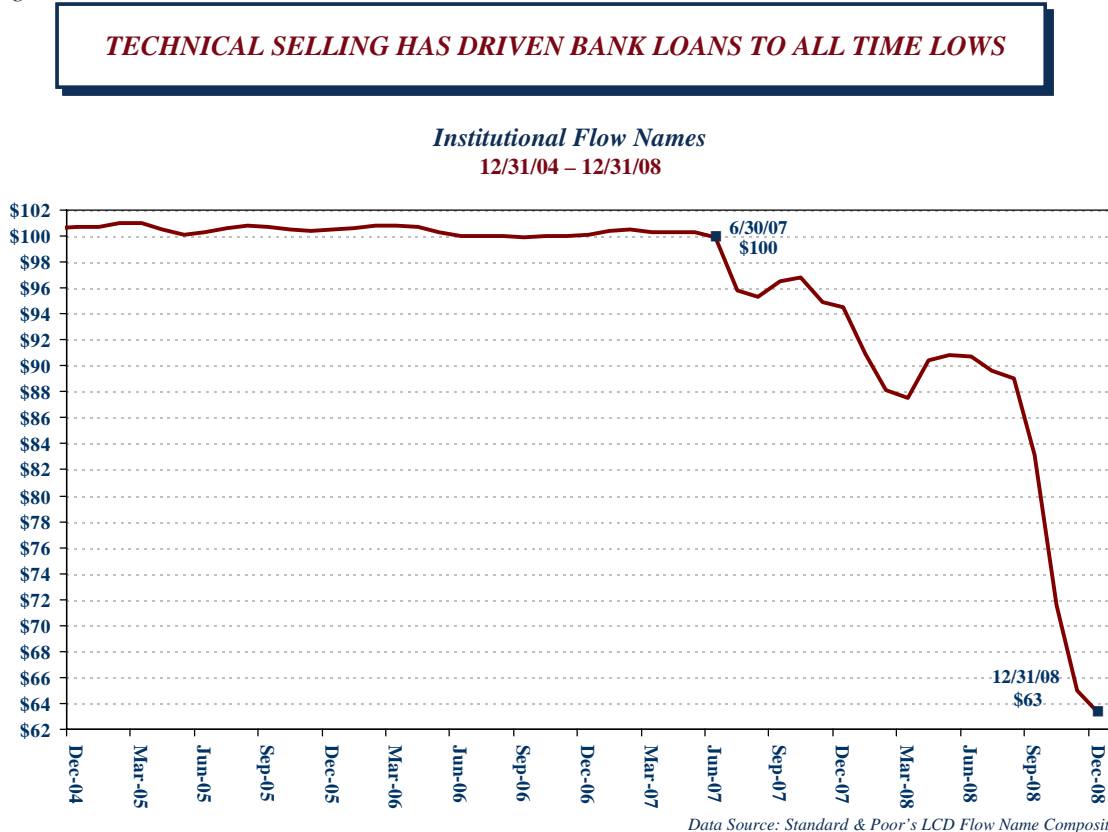
**Leverage.** Our bank loan portfolio is un-levered, which avoids the potential risk that leverage poses.

## Finding Value in Today’s Market

2008 saw unprecedented declines in the price of bank loans. Although the bank loan sector rallied strongly in the second quarter of 2008, bank loans fell sharply in September/October to establish new lows in November. As we begin 2009, supply pressures are easing; technical selling by hedge funds and other Wall Street institutions has abated and balance sheet risk reduction trades are working to shrink the new issue backlog. On the demand side we are seeing renewed appetite for bank loans, especially from non-traditional buyers faced with low treasury yields and continued 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 given their seniority, the downside for high quality loans is limited. The accompanying chart showing average loan pricing from 1997 to 2008, illustrates this point (see Figure 3).

Figure 3



The value opportunity we see is derived from the market's extraordinary deviation from this historical pattern which pulled secondary market prices down to the low 60s at one point. Most of the selling pressure has been technical in nature as banks and hedge funds were forced (or chose) to dump the bank loan holdings seemingly regardless of the price realized. An overhang of supply from 2007 kept supply/demand out of balance putting further pressure on prices. Many of the big deals that were weighing on the market (for example Bell Canada) have been pulled shrinking supply and big, bank debt driven LBOs are a relic of the past. As a result, the new issue market is beginning to open and new transactions are coming to market with sensible covenant provisions. These developments are positive for the Bank Loan market.

As the technical selling pressure seems to be drawing to a close, distressed selling has been replaced by opportunistic buying. Although the traditional buyers of Bank Loans (CLOs) are largely absent from the market, new entrants are entering and with the reduced supply this will be favorable for the supply/demand equation.

Although there are signs the bank loan market is stabilizing, average prices remain near historic lows. The fundamentals of Bank Loans remain in place. The seniority of the position in the capital structure and the fact that current prices are close to historic recoveries, suggest that many Bank Loans will be prime candidates for a sharp recovery. At current levels, Bank Loans offer a particularly attractive opportunity. By way of hypothetical example, let's assume a price of 70 on a loan with a 3.5% spread and Libor at 1.75%. Assuming a remaining life of roughly three years, after which the loan will be redeemed at par, the potential annual return on that loan is 15.25%.

## **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% in 2007 but spiked up to 5.3% in 2008. A doubling of the 2008 default rate would match the previous peak level of around 9% reached in both 2001 and 2002.
- Current prices reflect worst case scenarios.
- Solid credit research will be key as the market stabilizes and begins to differentiate on credit quality.

