

Systemic Risk in Loans?

The press has marked the pace of growth and other developments in the US leveraged loan market as a source of systemic risk, suggesting this potentially sets the stage for another financial crisis and subsequent bailout. While we acknowledge that lenders have been accepting higher leverage and borrowers receiving more generous terms than previously, and that the risks in some segments have increased, we do not agree that this represents a broader threat to the economy or financial system.

In our view, improving US syndicated loan fundamentals, an investor base that is less dependent on short-term financing and fund flows than in the past, expectations that default and recovery rates in the next downcycle will yield positive returns, and structural differences between US leveraged loans and subprime mortgages, the main culprit in the debacle that occurred a decade ago, make leveraged loans a far more resilient asset class if and when conditions turn sour. In the paragraphs below, we discuss these factors in greater detail.

General improvement in credit fundamentals

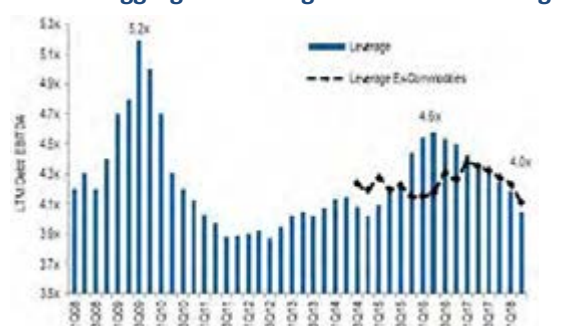
It is worth noting that the loosening of standards referred to above has generally been confined to new offerings, particularly those associated with private equity deals. In many cases, once the issues become seasoned, borrowers are working to improve financial performance, generate free cash flow, and delever balance sheets. Consequently, we have seen a steady improvement in credit metrics over the past several years. As indicated by the following three charts, sub-investment grade borrowers have done a good job improving profitability, decreasing leverage, and boosting interest-coverage capability.

Profit Margins Have Improved...



Source: Wells Fargo Credit Research

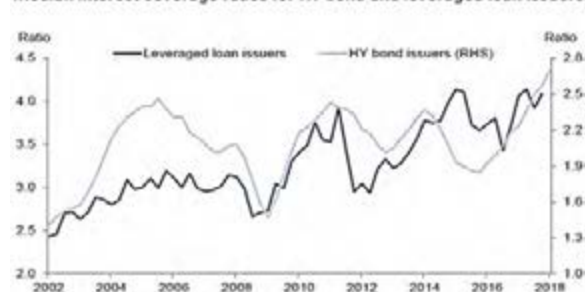
...While Aggregate Leverage Has Been Declining...



Source: JP Morgan Credit Research

...and Debt Service Coverage Has Increased

Median interest coverage ratios for HY bond and leveraged loan issuers:



Source: Goldman Sachs research

Composition of the U.S. leveraged loan investor base

Heading into 2008, large regulated financial institutions, notably banks and insurance companies, were among the biggest holders of subprime mortgage securities, which were at the epicenter of the global financial crisis; their exposure to leveraged loans represented only a fraction of their mortgage security exposure. Nowadays, banks have even less exposure to leveraged loans, owing mainly to their aggressive shift away from relying on balance sheets to an originate-and-distribute model. While it is always possible that banks will be left holding the bag with respect to some of the loans they have underwritten, they have historically proven successful in managing this risk and the related fallout.

Other structural elements, including how the investor base is funded, have also evolved over the past decade. Prior to the crisis, investment vehicles drawing on large amounts of short-term, mark-to-market financing were among the biggest operators in the space. Hence, once prices began to fall in earnest, margin calls often forced this group to sell, exacerbating the slide and promulgating a vicious circle of margin calls leading to liquidations and still-lower prices. This downward spiral was one of the key reasons why loan prices really hit the skids in 2008 and early-2009.

These days, loan buyers include CLOs, which account for approximately 60% of the market, global institutions such as insurance companies, pension funds and banks, which account for roughly 25%, and retail mutual funds, which comprise the

U.S. AND EUROPEAN BROADLY SYNDICATED LEVERAGED LOANS

remainder. With the exception of the latter group, the current stable of investors tends to have a long-term perspective and access to stable sources of capital. CLOs, for example, enhance returns using non-mark-to-market financing with terms that are far longer than those of the loans they own, eliminating the maturity mismatches that can lead to problems. By their nature, the payouts from these structures are based on the cash flows generated by underlying holdings; CLOs are not forced to sell assets simply to repay this financing.

Lending further weight, the US loan market investor base, which includes hundreds of participants across the globe, is more diversified than it was 10 years ago. Even CLOs, which represent the single largest investor category, are funded by hundreds of different holders of their debt and/or equity securities. Under the circumstances, the impact any value impairment in the loan market caused by a spike in defaults or realized trading losses would end up being spread across a large group with direct or indirect exposure through CLOs.

The Impact of an economic downturn on defaults and recoveries

With default rates near historic lows, they will invariably increase if and when the economy heads south. In some cases, the presence of more forgiving loan terms likely means at least some defaults will be avoided because borrowers will have more leeway to work through problems.

That said, the loosening of covenant protections over time suggests that recoveries from defaulting businesses will fall below the 80% average of the last 25 years. Assuming default rates during the next

downturn are more akin to what we saw during 2001-2002 than seven years later – that is, 5-6% annually over several years rather than 9% in one year – and recoveries match the 65% longer-term average, realized losses in what has become a \$1 trillion market could be in the vicinity of \$40-50 billion.

While losses of this magnitude should not be taken lightly, they pale in comparison to those seen during the global financial crisis, when the red ink flowing from \$2.25 trillion of shoddily-constructed residential mortgage securities and related derivatives reached nosebleed levels. In addition, realized losses in the US leveraged loan market during the next economic downturn will be diffused across a much larger pool of investors, none of which is likely to have a sufficient level of exposure to pose a systemic threat to the US financial system.

There are other reasons why current circumstances provide a measure of reassurance. For one thing, existing loans yield a current return of approximately 6% and generate interest of roughly \$60 billion annually, which is significantly above the potential loss totals referred to earlier. Should events unfold as suggested, the loan market would end up delivering positive returns – interest income less realized losses – during the next recession. Looked at differently, if recoveries were to remain at 65%, defaults would have to exceed 17% per year for the market to produce negative returns. Even if recoveries were to fall to 40%, defaults would have to rise above 10% to generate sub-zero performance.

Lending further weight, most loan portfolios are actively managed, affording managers increased opportunities to trade out of problematic positions

and limit downside risk. While such activities can lead to realized losses, they can mitigate the red ink associated with retaining exposure through a restructuring. Under the circumstances, the losses often end up being passed around like a game of hot potato, limiting the impact that problem situations can have on any single holder or group of investors.

U.S. leveraged loans are not sub-prime mortgages

The financial press is quick to compare leveraged loans to subprime mortgages, suggesting the former will suffer the same fate as the latter did during the financial crisis should conditions turn sour. We believe this analogy is unwarranted, however, and that key differences between the two are being overlooked. For one thing, loans have more robust structures than subprime mortgages, including significantly higher equity cushions at the time of issuance. Moreover, subprime mortgages included large interest-rate step-ups after three-five years, leaving most homeowners with little choice but to refinance or cough up significantly more each month, which caught many of them wrong-footed.

In contrast, because leveraged loans typically pay LIBOR plus a fixed margin for the life of the obligation, company treasurers can more easily accommodate rising interest payments without being compelled to refinance. The loan market also affords greater transparency. Loan terms generally include ongoing financial reporting requirements and covenants that serve as a leading indicator of borrower wellbeing, which is not the case for mortgages. Finally, as noted above, loan portfolios can be actively managed, allowing for better risk management than is typically available when investing in subprime obligations.



U.S. leveraged loans are not private credit

Many commentators associate the perils of private credit with burgeoning activity in the loan market, but there is a distinct difference between the two markets. In the latter case, the issuers are large corporations with diversified revenue streams and experienced management teams. Private credit borrowers, in contrast, tend to be smaller firms; they have less room for error and fewer resources to draw on to address problems or manage capital structures.

In addition, while the US leveraged loan investor base is, as noted earlier, relatively broad and diverse, private credit lender groups tends to be

small in number, limiting liquidity and participants' ability to reduce exposure and/or trade out of positions when risk profiles deteriorate. With the appropriate relationship between risk and reward, lending to small companies can be a profitable endeavor, but investors in this segment must have sufficient resources available to work-out problems when they arise.

Conclusion

As fundamentally-driven loan investors, our objective is and always has been focused on selecting opportunities that allow us to create and manage well-balanced portfolios. Overall, we believe that US leveraged loans continue to offer attractive

returns with acceptable risk, but recognize that credit selection has become even more critical as the odds of an end of a decade-long economic expansion increase. In our view, now is not the time to be reaching for yield; there will be opportunities for asset rotation and generating upside down the road. That said, our cautious outlook does not mean we share press concerns that the leveraged loan market is an accident-in-waiting. As noted earlier, structural and other factors strongly suggest that this segment will not pose a systemic threat to the financial system if and when the economy falters.