



# Senior Bank Loans

## The Market Opportunity in Senior Bank Loans

The global financial crisis has manifested itself in the fixed income markets with historically high levels of volatility and credit spreads. For senior bank loans the credit crunch has caused all-time high yield spreads, rising implied default rates, forced selling in excess of demand by traditional Collateralized Loan Obligation (CLO) funds, and an abatement in new loan issuance. Prices of senior bank loans are testing levels around \$0.60 to \$0.70, which translates into current yields above 15% and loan default rates of 23%. The financial markets seem not to be differentiating between credit qualities and are pricing credit assets indiscriminately. Specifically, we believe that the deterioration in loan prices has far outpaced the deterioration in underlying fundamentals—even in light of the worsening global economic environment—and that senior bank loans offer an attractive opportunity for investors with intermediate-term investment horizons. There are several vehicles available to investors interested in investing in senior bank loans such as separate account portfolios, commingled funds, open-end mutual funds, closed-end mutual funds, and finally CLOs.

## What is a Senior Bank Loan?

Senior bank loans (also called syndicated loans or leveraged loans) are loans typically made to non-investment grade commercial borrowers by a bank, syndicated, and participated out to other banks or institutions. Simply put, senior bank loans are similar to privately placed, floating rate, high yield debt instruments but are positioned at the highest level of a company's capital structure. In the event of default, holders of these loans have the senior claims to the defaulted company's assets and/or cash flows subject to the loan's restrictive covenants.

Senior bank loans have typically been structured to include maintenance and incurrence tests which require periodic reviews of specific operating and credit measures such as total borrower indebtedness and interest coverage ratios, among others. In recent years, however, the market has seen a preponderance of new issues of so-called "covenant-lite" loans, which have incurrence tests but few or no maintenance requirements. Most loan investors perceive covenant-lite loans as lower in quality than loans with more stringent credit terms. Credit terms within the loan's credit agreement serve to 1) preserve the value of the underlying loan's collateral, 2) dictate the use of excess cash flow, 3) dictate the company's financial reporting requirements, and 4) attempt to control the effect of external business risk on the company's ability to repay its loans outstanding.

The credit agreement that accompanies a loan may include a revolving line of credit and one or more term loans. If, for example, one term loan ranks higher than another term loan (with

respect to collateral and credit support), contractually it is typically placed in what is called the Senior Secured Bank Loan tranche. In the event of a default or bankruptcy, investors in the most senior secured bank loan piece are paid before lower-ranked bank loan tranches or other creditors. However, there are exceptions. First, while wages are a general unsecured claim, as a practical matter they usually get paid immediately for fairly obvious reasons – unpaid employees don't make for a good business. Also, in some circumstances, particular vendors will be deemed "critical" to the ongoing business and will be paid during the Chapter 11 bankruptcy process.

Another distinction among bank loans is whether they are "pro rata loans" or "institutional loans." Pro rata loans are usually revolving lines of credit that are distributed to banks, whereas institutional loans are typically five- to seven-year term loans sold to institutional or non-bank investors.

Investors must be aware that although there are managers who structure senior bank loan portfolios without leverage at the portfolio level, the underlying senior bank loans are already "levered" in that they have been extended to companies with existing outstanding debt obligations. Managers who do utilize leverage in structuring portfolios therefore add another level of complexity and risk to a senior bank loan portfolio.

### **Bank Loans vs. High Yield Bonds**

Unlike high yield bonds, bank loans are positioned at the most senior level of a company's capital structure, are generally secured by tangible and intangible assets, and have relatively short maturities. Furthermore, because they have floating rates, they offer inflation protection and have interest rate duration not greater than their reset period. High yield bonds usually do not have restrictive covenants and cannot be called at par, whereas bank loans contractually must be repaid at par or 100% of the amount outstanding. According to market participants, many non-investment grade companies have had close to 70% of their debt in the form of bank loans and the remainder in bonds.

Currently, senior bank loans are inexpensive from a relative value perspective. Historically, loans have had less volatility than high yield bonds, higher recovery rates<sup>1</sup> (82% vs. 38%), and a history of solid risk-adjusted returns<sup>2</sup>. It is our contention that senior bank loans presently represent an investment opportunity superior to high yield bonds.

### **A Brief Loan Market History**

Bank lending has existed since the Medici era, but it wasn't until the 1970's, during the golden era of syndicated loans to Latin American and Eastern European governments by Western

<sup>1</sup> Recovery rate measures the lender's or investor's ability to realize the value in the underlying collateral in the event of default or bankruptcy. Recovery rate or its inverse, loss-given-default risk, measures the potential magnitude of principal loss if the issuer or borrower should default on its obligations. Recovery rates reflect data from 1982 to 2007.

<sup>2</sup> Many investors when considering senior secured bank loans as investments consider the historically low correlation with existing securities in their portfolios which offers the possibility of diversification benefits. Risk-adjusted return is the asset's investment return given its volatility of returns. From 1992 through 2004 (last Moody's study), bank loans returned on average 7% with 4% volatility. Moody's has shown that during this period only cash offered lower risk but with significantly lower returns.



banks, which were swimming in petrodollar deposits, that these loans gained prominence as viable and tradable investment vehicles. This period came to a somber end in the early 1980's as substantial defaults occurred and the Brady Plan, which restructured U.S. bank debt to foreign governments, commenced.

With the rise of mergers, acquisitions, and leveraged buyouts (LBOs), loan syndications became popular once more during the mid 1980's until around 1986 when there was a significant number of events such as the collapse of United Airlines, the loan defaults of Federated and Ames, the Federal Reserve tightening guidelines on banks holding highly-leveraged assets, and of course the stock market crash of 1987.

As corporate borrowings and M&A transactions increased in the 1990's, the senior bank loan market was revived and institutional investors became significant buyers of these loans. The activity in the primary market for loans fed the interest for trading syndicated loans over the last few years. S&P reported that the secondary loan market grew from \$50 billion in 1Q05 to \$142 billion in 2Q08. According to S&P LCD research, institutional purchases had risen to over 70% of syndicated loans in 2007, but fell to 50% in 2008 in the midst of the global credit crunch.

### **Why Senior Bank Loans and Who Invests?**

Senior bank loans are popular for investors because they are a less expensive and more efficient way of spreading credit risk than a traditional individually lent and administered credit facility. Loans are attractive to borrowers because they can negotiate credit terms once and attract multiple, successive sources of cash. Loans are priced using the floating London Inter-bank Offered Rate (LIBOR) plus a spread. LIBOR based-pricing exposes lenders and investors in loans to the fluctuations in the global markets as loans, like any other financial instrument, are priced based on current supply and demand and quoted interest rates. Loans historically have been priced close to par at \$0.90 - \$1.10, but recent market prices were \$0.60 - \$0.70.

The efficiency inherent in a syndicated loan lies in the fact that all lenders share equally in the rights outlined in the credit agreement, where pricing and structuring are handled by one party. The most common types of loans are 1) underwritten where the bank arranging the loan guarantees that the entire loan amount will be funded and 2) "best efforts" underwritten where the arranger attempts to get the loan fully funded but does not guarantee the full amount of the loan. In this current environment, most loans are being arranged on a best efforts basis. Another common type of loan is the "market flex language" loan, where the borrower grants the arranger the flexibility to adjust pricing and size to ensure that the entire loan is sold to investors.

The most prominent institutions buying loans are CLOs, hedge funds, and prime funds which buy loans priced relative to the prime rate. CLOs are securitized structures which pool loans and pay out interest via tranches that are arranged by credit risk. It is worth noting that some CLOs (Market Value CLOs) and Total Return Swaps contain triggers that require CLO managers to post more collateral or sell the underlying loans if the price of the underlying loans go beneath a pre-specified level. And here we are: October 2008 saw

over \$3 billion in loans being auctioned as CLOs experienced liquidity problems and many financial institutions pulled back on Total Return Swaps lines which are effectively credit lines. The end result is, for the most part, a technical problem where sellers outnumber buyers. The technical problems that the secured bank loan market has experienced lately should improve due to the fact that many highly leveraged hedge funds and CLOs that have faced investor redemptions seem to have sold big portions of their higher quality assets including bank loans. This potential improvement in the market does not imply that going forward, given the global slowdown, we may not see fundamental factors affecting this market.

Between late 2007 and late 2008, the buyers of senior secured bank loans shifted. CLOs reduced their share of loan purchases from 57% to 38% while banks increased theirs from 2% to 19%. Hedge funds account for the majority of the remainder of purchases.

### The Mechanics of Senior Bank Loans

The secondary loan market remains archaic in many ways when compared to the trading and settlement process of other financial assets. When an investor buys a loan the ownership is attained either via an assignment of the loan or a participation in the loan. When a loan is assigned, the buyer becomes the legal lender of record and attains all the legal rights and powers under the credit agreement of the loan. An assignment requires the approval of the loan borrower. With participation, by contrast, a buyer receives the right to repayment, but the original lender continues to legally have all the rights and responsibilities for collecting from the borrower and transferring such amounts to the buyer participant. In participation, borrowers do not need to give consent. Most CLOs and institutional investors acquire loans via assignment. The entire assignment process is one that is long and laborious as loan re-documentation and negotiations have to be performed by the parties involved. Loan assignment is generally preferred because ownership of the loan is specific and clear.

### Historical Recovery Rates

Most of the rating agencies have done extensive studies showing the advantages of the bank loan lender's senior claim that accompanies a senior secured loan. The table on the next page shows the findings compiled by Moody's and UBS in recovery rates of defaulted assets from 1982 through 2007.

Type of Asset	Recovery Rate
Bank Loans	82%
Sr. Secured Bonds	65%
Sr. Unsecured Bonds	38%
Sr. Subordinated Bonds	29%
Subordinated Bonds	27%
Jr. Subordinated Bonds	15%
All Bonds	37%

Investors in bank loans focus on the fact that loan amounts decline or amortize over time so maximum losses on “defaulted” loans could potentially shrink. Case history also shows that many companies, even in a bankruptcy situation, will continue to make payments on their senior bank loans and yet be in a defaulted situation with other lenders. One must be cautious, however, about extrapolating historical recovery rates to the current environment. Imprudent lending—especially for highly leveraged buyouts—was rife in the lead-up to this crisis. Lax covenants may make it harder for lenders to force borrowers into bankruptcy, thereby protecting collateral. Further, in the current economic environment, the value of collateral may also be in decline. Consequently, it is more important than ever to use an experienced credit manager who can dissect loan covenants and analyze the assets backing loans.

Our view is that a reasonable outlook for senior bank loans is that default rates may reach levels of 10% to 12% in the coming year. This translates into a possible return range of 8% to 10%. As the credit markets heal themselves, we believe that the higher rated assets such as senior bank loans should be among the first to experience market pricing improvement and liquidity, but this may take 3 to 5 years to play out.

### Primary Risks

The risks in the senior secured bank loan market have been amplified by the generous credit terms that banks have extended to borrowers during the last few years. Fundamentally, the number of participants in the market ebbs and flows and the quality of a loan and its structure are highly dependent upon the arranger, the quality of the credit agreement, how strong the credit covenants are, etc. A number of other risk factors must also be considered:

1. **Borrower Credit Risk:** There is always the risk that a borrower is unable to repay the loan or make interest payments. A buyer must adhere to a very disciplined and strict ongoing credit analysis process. The key to building a bank loan portfolio lies in understanding all the risks involved in lending—in effect being a very sophisticated lender during every part of a market cycle.
2. **Imperfect Information, Inefficient Asset Pricing, and Illiquidity:** Because the secondary market remains relatively small, the ability to trade and move out of loan positions may be difficult and cumbersome.
3. **Business and Industry Market Risks:** There is the risk that a change in the borrower’s business fundamentals or in the borrower’s industry could negatively affect the market value of collateral.

### The Bottom Line

Notwithstanding the current market issues we have seen with banks freezing their lending, continued hedge fund redemptions, and CLO un-windings or closings due to leverage trigger events, senior secured bank loans appear to offer the opportunity to generate attractive risk-

adjusted returns. With their current prices implying default rates never before experienced, we believe bank loans deserve consideration as part of a well-diversified portfolio. As we have witnessed in today's turbulent financial markets, loans are obviously not risk-free, but reviewing the product offerings of opportunistic yet prudent managers appears worthwhile. Investors should consider an allocation to loans in the context of the overall portfolio. An investor with a high allocation to hedge funds may not wish to add a distinct allocation to bank loans because many multi-strategy and credit-oriented funds are allocating significant sums to bank loan opportunities already. However, an investor with a high allocation to fixed income may find bank loans an attractive way to improve the portfolio's expected return.

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