Breaking Down the Wall of Debt: The Leveraged Loan Market

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Panel topics

- Brief review of where we have been
- Behind the rally (and retrenchment): The Virtuous and Vicious Cycles
- CLOs and the Refinancing Cliff: Progress…and a few problems
- The Outlook
4 key U.S. large corporate loan market segments

**Investment grade loan market**
- Loans to companies rated ≥ BBB/Baa3 AND with a relatively low LIBOR spread
- 2007 lending: $658 billion
- 2008 lending: $319 billion
- 2009 lending: $229 billion
- LTM 1H10 lending: $279 billion

**Leveraged loan market**
- Loans to companies rated < BBB/Baa3 or unrated & with a high spread*
- Divided into bank and non-bank segments
- 2007 lending: $689 billion
- 2008 lending: $294 billion
- 2009 lending: $239 billion
- LTM 1H10 lending: $304 billion

**Institutional loan market**
- Leveraged loans with non-bank lenders (such as mutual funds, CLOs, insurance companies, hedge funds, etc)
- 2007 lending: $426 billion
- 2008 lending: $69.6 billion
- 2009 lending: $55 billion
- LTM 1H10 lending: $126 billion

**Secondary loan market**
- Market in which loans trade following the close of primary syndication
- Most U.S. loan trading involves leveraged loans
- 2007 trading: $520 billion
- 2008 trading: $510 billion
- 2009 trading: $474 billion

*Traditionally LIB+150, increased to LIB+350 in Q3/09

Source: Reuters LPC for primary lending; LSTA for secondary trading

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Last 12 months have seen a considerable recovery...
...And a retrenchment

U.S. Index bid levels (2000-6/10)

- Loan prices dropped more sharply than in the 2001-2002 downturn
- There were multiple drivers to the downturn
- Loan prices rallied back very sharply in 2009
- Rally continued through April 2010, but then fell victim to global jitters

Source: S&P/LSTA Leveraged Loan Index
After deteriorating sharply, U.S. fundamentals improve

- Loan default rate did hit record high
- Default rate already dropping
- Many companies exiting bankruptcy
- But the recovery is more about technicals than fundamentals

The Virtuous (refinancing) Cycle

1. Record volume of outstanding institutional corporate loans
2. Nearly half are held in CLOs
3. CLO reinvestment periods will end
4. But loans must be repaid
5. The gap between borrowers’ refi needs and CLO refi ability is the refinancing cliff
6. Issuers and bankers focus on paying down the “refinancing cliff”, using HY bonds
7. Repayments go back into CLO wallets
8. CLO money needs to be reinvested now
9. CLOs buy loans in primary/secondary
10. With little supply, this creates excess demand
11. Loan terms become much easier
12. Markets cheer…

But what happens if the Virtuous Cycle Stops?...
U.S. HY bond issuance very strong through April 2010, Declines significantly in May and June

- HY bond issuance revives in 2H09, accelerates in 1Q10
- Proceeds repay loans
- HY issuance drops sharply in May

Source: Thomson Reuters LPC

U.S. HY bond outstandings climb, Loan outstandings shrink

- The market began to address loan maturities
- HY bonds repaid loans, and loans saw other partial/full paydowns
- Inst. loan outstandings declined more than $60 billion in 2009, and another $25 billion through May 2010

Source: S&P/LCD, Merrill Lynch
Technicals (and fundamentals) lead to strong rally

- Loan prices dropped more sharply than in the 2001-2002 downturn
- There were multiple drivers to the downturn
- Loan prices rallied back very sharply in 2009
- Rally continued through April 2010, but then fell victim to global jitters

Source: S&P/LSTA Leveraged Loan Index

U.S. Institutional loan calendar strengthens in 2010

- After a two-year hiatus, the U.S. institutional loan pipeline begins to fill
- And then, PIIGS II strikes…

Source: Thomson Reuters LPC
U.S. loan and HY bond prices slide

- After strong run up, both U.S. loan and HY bids slump
- HY bond prices recovering, loan prices lagging

Source: S&P/LSTA Leveraged Loan Index, Merrill Lynch

U.S. institutional loan and HY bond issuance slumps

- Issuance drops sharply in HY bond market following Euro-jitters
- U.S. institutional loan issuance drops, but market remains open...at a price

Source: Thomson Reuters LPC
Reverse flex dominates 1Q10, upward flex returns in 2Q10
Flexed loan yields much higher

- Following May pullback, U.S. institutional loans flex up (by considerable amount) to clear market

U.S. institutional loan yields retrench in 1Q10, jump in May
(B/B+ rated institutional loans)

- U.S. Institutional yields increase considerably in May, June 2010

Source: Standard and Poor's/LCD
CLOs and the refi cliff dynamic

U.S. Refinancing cliff revisited

- Refinancing cliff has shrunk
- Maturities (through amend & extends) have been pushed off materially

Source: S&P/LSTA Leveraged Loan Index
Our cliff analysis in July 2009…
… And what the cliff looks like now

- Original cliff has $576B of loans (red)
- If half B-, all CCC's and D's default out, cliff shrinks to $421B (blue)
- If loans default out and HY paydowns occur, cliff shrinks to $344B (green)
- If loans default out, HY paydowns occur and loan maturities are extended, cliff remains at $344B, but flattened (purple)
- ACTUAL RESULT: Cliff larger, but shape reflects estimates

How the refi cliff has changed
By ratings

- Charts show refi cliff by rating (assuming loans must refi one year prior to contractual maturity)
- In 2009, the refi cliff was fairly front loaded
- In 2010, refi cliff is smaller – and more back-ended
Negative bias: Better quality companies are doing A&Es

- It is the better rated companies that have been doing most of the Amends-to-Extends
- B+ and better cos account for 53% of A2Es, and just 30% of index
- This could leave weaker companies facing an earlier refinancing

Source: S&P/LCD, LSTA

CLO issuance buoy institutional loan growth
Both markets stop in 2008

- Institutional market growth enabled by CLO growth
- Severe dislocation in CLOs and institutional loan market in 2008
- CLO issuance stops, but existing CLOs still recycle paydowns into loans

Source: Thomson Reuters LPC, S&P/LCD
As we discussed last year:
CLO reinvestment period will end, reducing CLO demand

CLO issuance vs. CLOs going static

Theoretical CLO reinvestment capacity

- CLO issuance peaked in 2007 (Outstandings in red)
- CLO reinvestment periods range 5-7 years (Blue reflects “frozen” amt of CLOs as reinvestment ends)
- As reinvestment periods end, CLOs will no longer be able to buy new loans
- In turn, “re-investible” dollars will decline
- Blue line reflects MAXIMUM “reinvestible” CLO dollars – eg, if all loans in CLOs are repaid
- In reality, reinvestible dollars will be much lower

Source: LSTA, S&P/LCD, Intex, Wachovia

The Cliff Refined: Refinancing needs of loans in CLOs
Vs estimated CLO refinancing ability

Maturity profile of CLO loans vs. CLO refi capacity

- Assumes roughly 52% of performing loans are in CLOs based on size of CLO market and default rates
- Refinancing gap between loans held by CLOs and CLO refi capacity is smaller
- There remains a nearly $100B gap in 2012
- Manageability may revolve around health of HY bond market, revival of CLOs and ability to attract new investors

Source: S&P/LSTA Leveraged Loan Index, LSTA, Wells Fargo, Intex
CLO performance:
U.S. CLOs heal as they delever and loan market recovers

- Price levels on CCC loans fell sharply in the downturn
- In combination with increasing CCC/D share, this pressured OC ratios
- As loan prices recovered, more CLOs moved out of OC violation

Source: Standard & Poor's LCD, S&P/LSTA Leveraged Loan Index, Wells Fargo, Intex

CLO performance:
U.S. CLO AAA notes remain relatively well rated

- Nearly all securitized products have seen their AAA tranches downgraded
- However, as of November 2009, 95% of CLO liabilities originally rated AAA remain rated A or better
- More than 90% of SF CDO AAs are rated below IG
- True CF CLOs have not suffered uncured EODs

Source: Wells Fargo, Moody's Investor Service
Some CLOs put on review for upgrade

CLOs likely to revive; Unlikely to be the force they once were

- There is roughly $250B of outstanding CLOs
- Assuming 10x leverage, this suggests approximately $25B of equity
- With lower leverage, overall size of CLO market would shrink even assuming robust equity demand

Source: LSTA, Wachovia, Intex

CLO outstandings and estimated equity component

With less leverage, total size of CLOs shrinks

- Assumes 5x leverage
**Regulatory (and other) challenges**

- Investors are (relatively) happy with CLOs and new issue is beginning to emerge; however, regulations pose a threat to CLO revival
- Regulatory reform legislation
  - Actively managed third party CLOs are very different from the static ABS deals that were targeted in the risk retention plank; however, they are likely to be captured
  - Either the “securitizer” or the “originator” will need to hold up to 5% of the credit risk
    - Securitizer may be the structurer (who is just an agent of the manager and may exit the business rather than hold 5%)
    - Some CLO managers can find a way to hold 5% of the equity slice, but many cannot; almost none can hold a vertical pro rata slice
    - “Originator” – who makes a loan and sells it *directly or indirectly* to an ABS (CLO) may have to retain 5% of the loan. This may force changes to trading docs to prohibit sales to CLOs; it may disrupt the entire trading market.
- FATCA
  - Requires CLOs to provide tax identification on all investors beginning 2012 or withhold 30% of passthru income.
  - CLOs often don’t know their investors, and indentures may prohibit withholding
  - CLOs may not be able to participate in new loans or A&E deals after March 2012
- Reg AB
  - More disclosure requirements, but may be workable

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*Source: LSTA*