State of the U.S. loan market

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Presentation outline

- Definitions and history of the U.S. loan market
- Current state of the loan market
  - Volatility
  - Low prices
- Pressure points
  - Deleveraging
  - Defaults
  - Devil in details
  - Borrower access to capital
- Outlook for the loan market
  - Volatility
  - Issuance
  - Spreads

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Syndicated loans

- Loans to corporations
- Large (at least $20 million; often more than $500 million)
- Syndicated (held by at least three banks or non-bank institutions)

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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 issuance: $658 billion
- 2008 issuance: $319 billion

Leveraged loan market

- Loans to companies rated < BBB-/Baa3 or unrated & with a spread >= LIB+150 bps
- Divided into bank (pro rata) and institutional segments
- 2007 issuance: $689 billion
- 2008 issuance: $294 billion

Institutional loan market

- Leveraged loans structured to be sold to institutional investors (which include mutual funds, CLOs, insurance companies, hedge funds, etc)
- 2007 issuance: $426 billion
- 2008 issuance: $69.6 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: $442 billion

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

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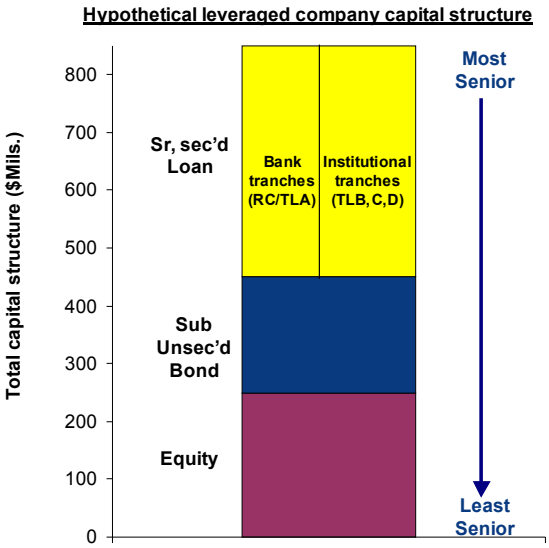
U.S. high yield bond vs. leveraged loan characteristics



Characteristic	Leveraged loans	High yield bonds
Seniority	Senior	Sr. or subordinated
Security	Secured	Unsecured
Covenants	Maintenance covenants	Incurrence covenants
Pricing	Mostly floating rate	Mostly fixed rate
Callability	Minimal call protection	Call protections, premiums
Lenders	Banks, investors	Investors
Recovery (RGD)	Higher, more consistent	Low, variable
Trading (downside)	Less downside volatility	More downside volatility
Trading (upside)	Less upside volatility	More upside volatility

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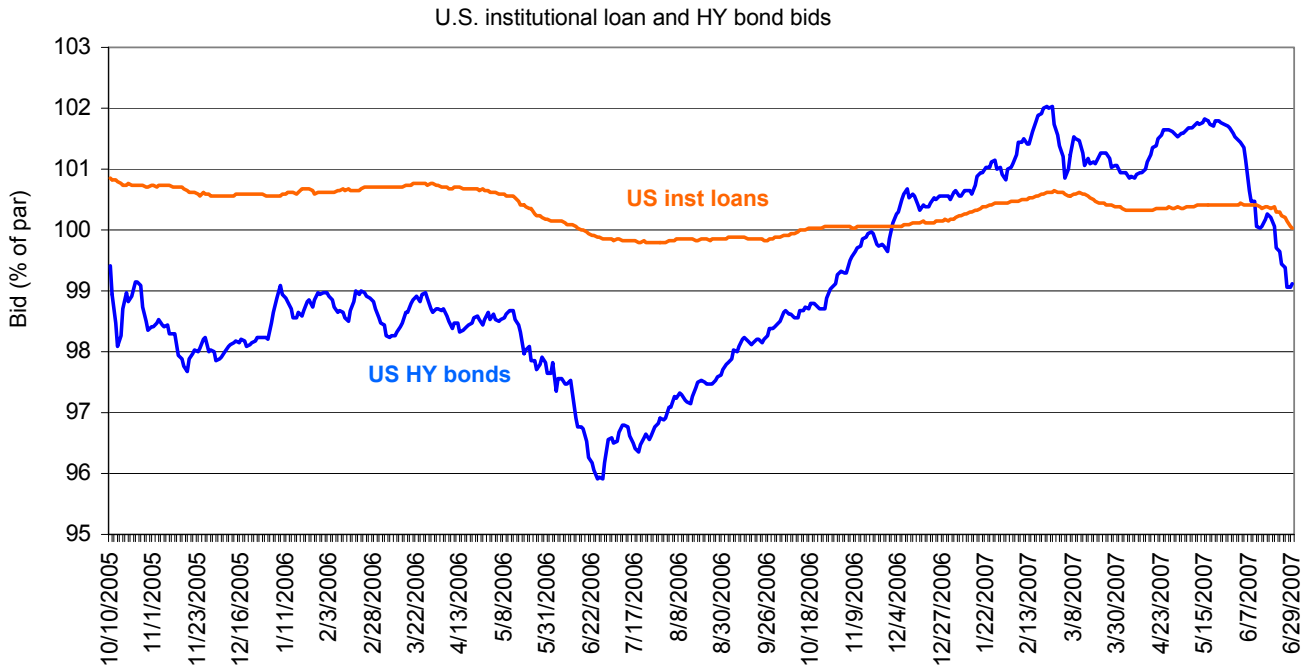
Historical context: Leveraged loan prices very stable



- Historically, institutional loan prices are very stable
- In turn, loans can be put into leveraged vehicles

Source: Reuters LPC Merrill Lynch;
LSTA/LPC MTM Pricing

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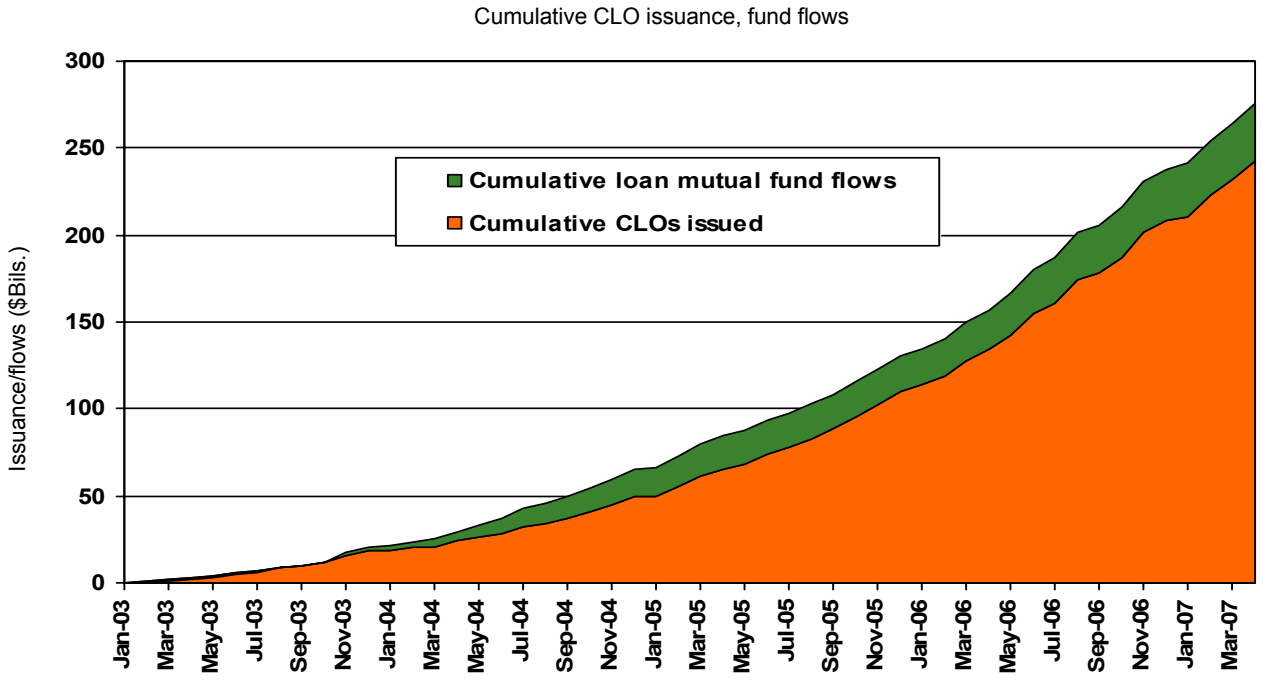
Money comes into the asset class…



- Loan assets under management soared
- New investors came on line, including CLOs, Loan mutual funds, Hedge funds, Institutional accounts, TRS programs

Source: J.P. Morgan, Lipper

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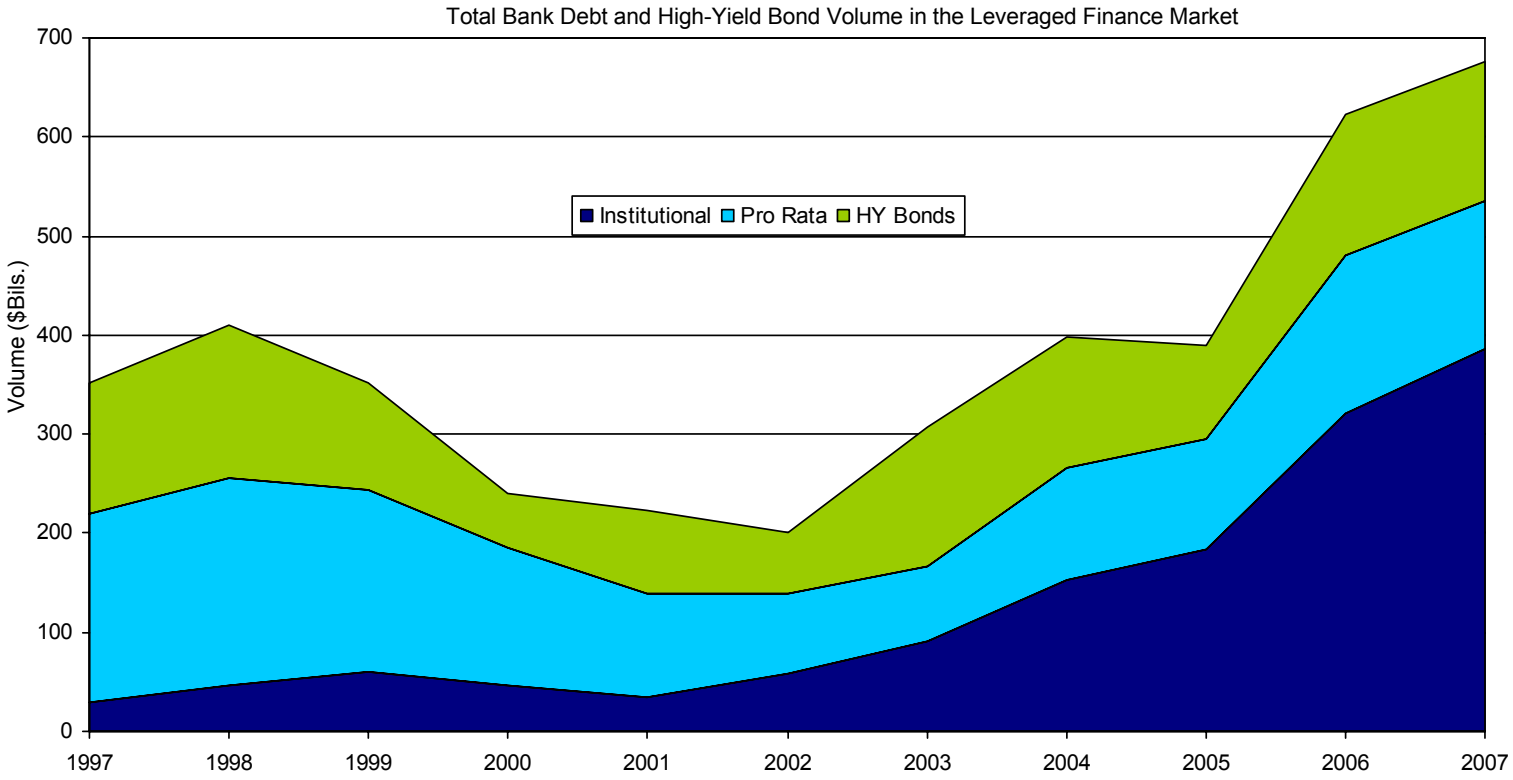
More leveraged finance comes from loans (1)



Source: S&P/LCD and Merrill Lynch Global High Yield Strategy

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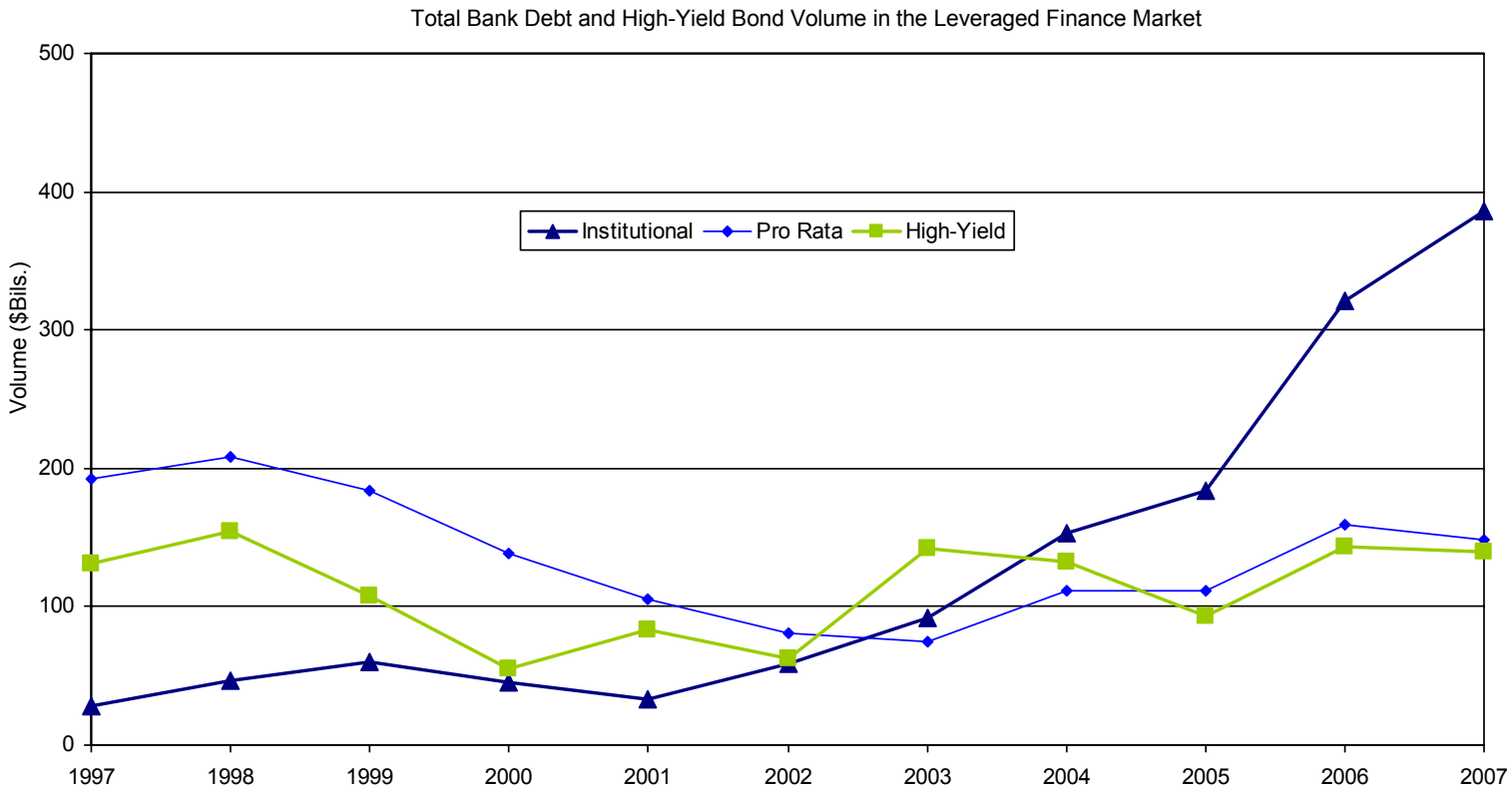
More leveraged finance comes from loans (2)



Source: S&P/LCD and Merrill Lynch Global High Yield Strategy

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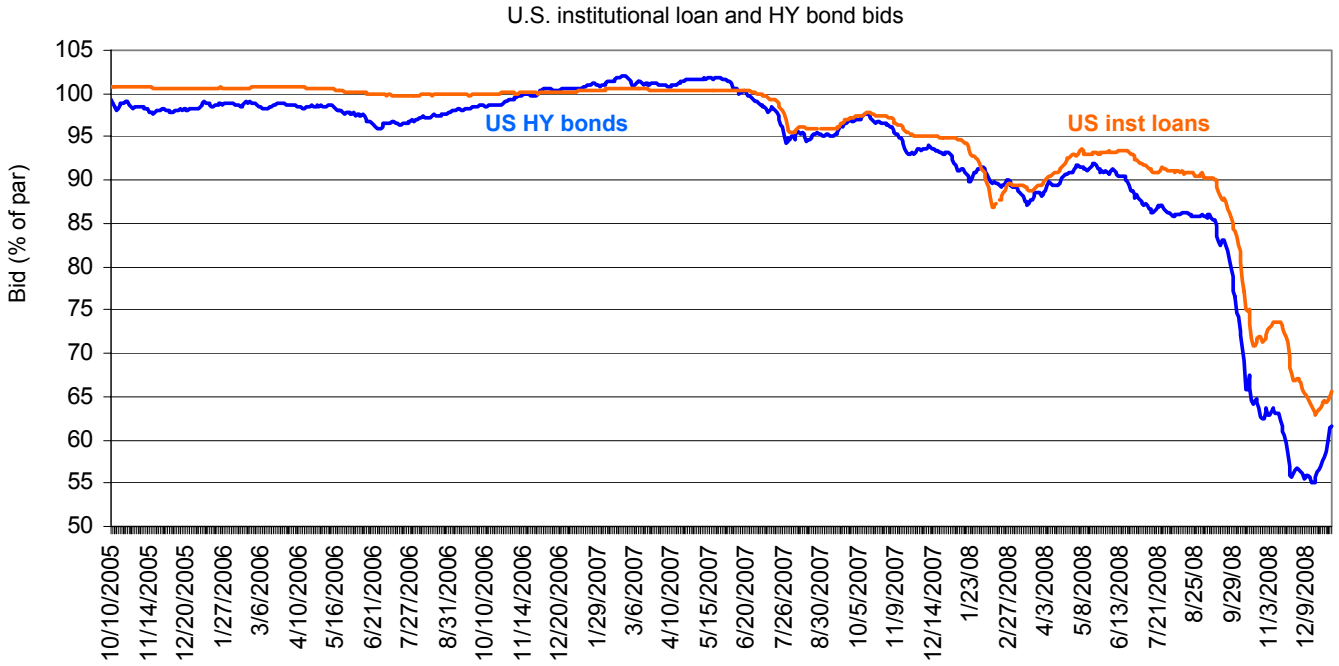
In LTM, loan prices nearly as volatile as HY bond prices



- In last 12 months, institutional loan prices have been nearly as volatile as HY bond prices
- Puts considerable stress on vehicles (like TRS) structured for a low-volatility asset class

Source: Reuters LPC Merrill Lynch;
LSTA/LPC MTM Pricing

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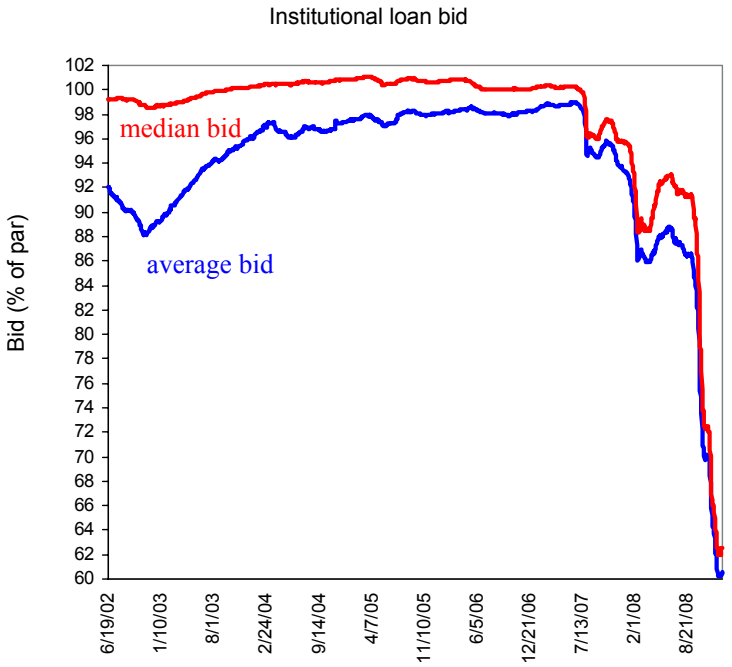
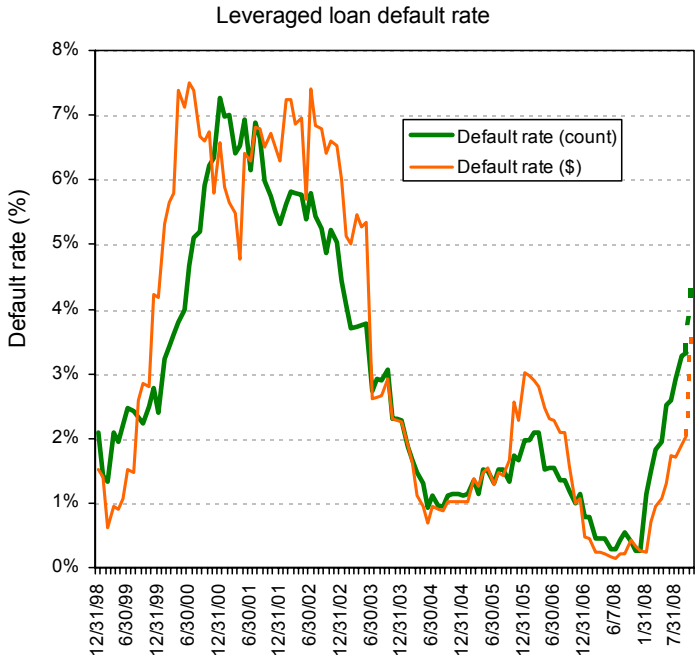
Loan prices fall *before* defaults climb





- Default rates have climbed, but remain well below peak of last cycle
- Loan prices well below last downturn
- This dichotomy initially represented a deleveraging, not defaults
- However, default rates are increasing materially

Source: LSTA/LPC MTM Pricing, Standard & Poor's LCD

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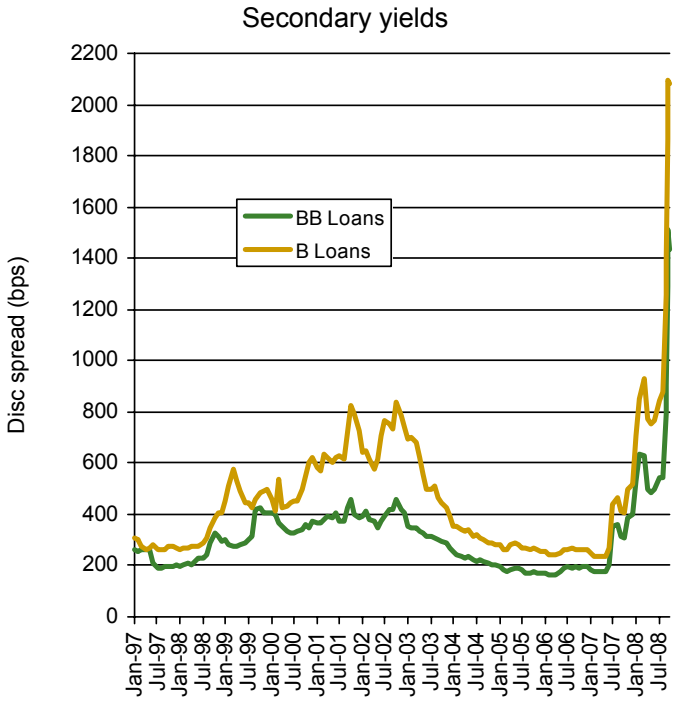
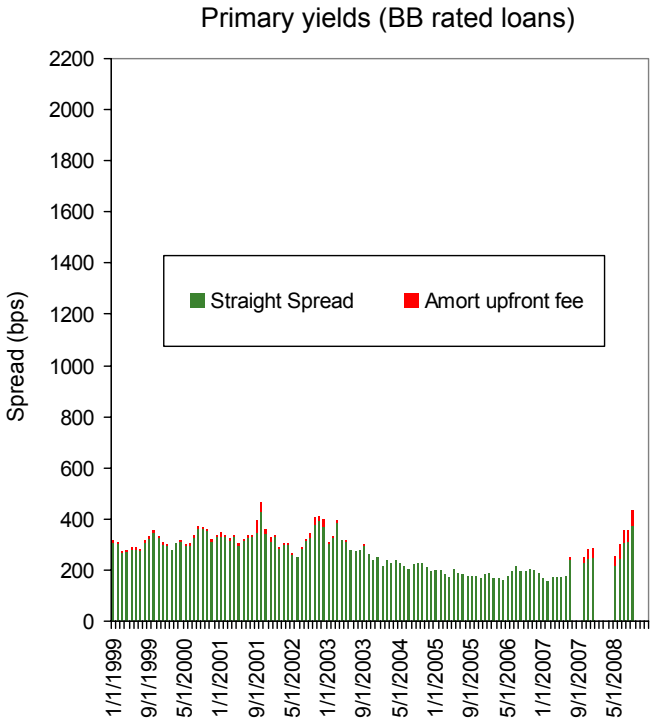
Secondary market spreads vastly outstrip primary spreads, limiting issuance

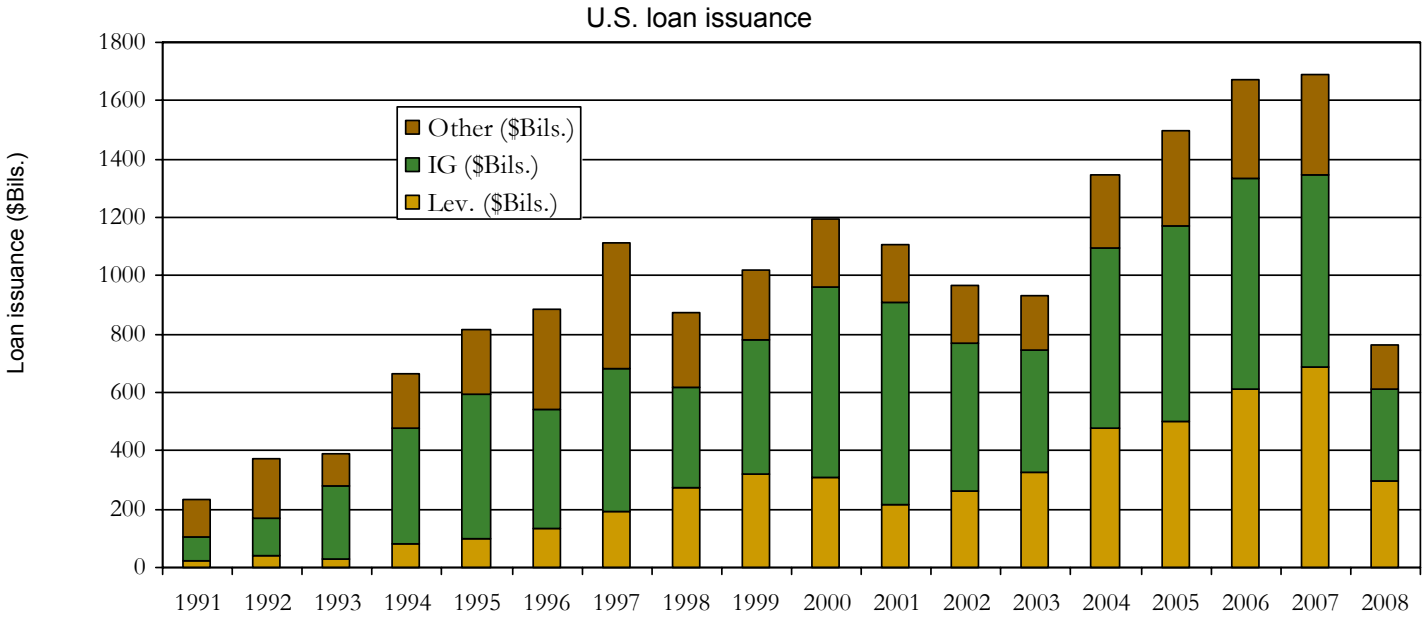




- Secondary yields are at record highs
- Before primary shut down, yields were high
- Until secondary stabilizes, primary market will not be able to compete

Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index

Overall loan issuance contracts materially



- On annualized basis, all loan issuance is down materially
- Issuance ($764B) is lowest year since 1994
- In 2009, only issuers that must tap market (necessary refinancings, DIPs, exits, some M&A) likely to emerge

Source: Reuters LPC

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Looking forward

- Credit quality
- Ability to refinance
- Supply & Demand
- Ability to lend
- Where do spreads, fees go?
- Where does issuance go?
- What does the asset class look like?

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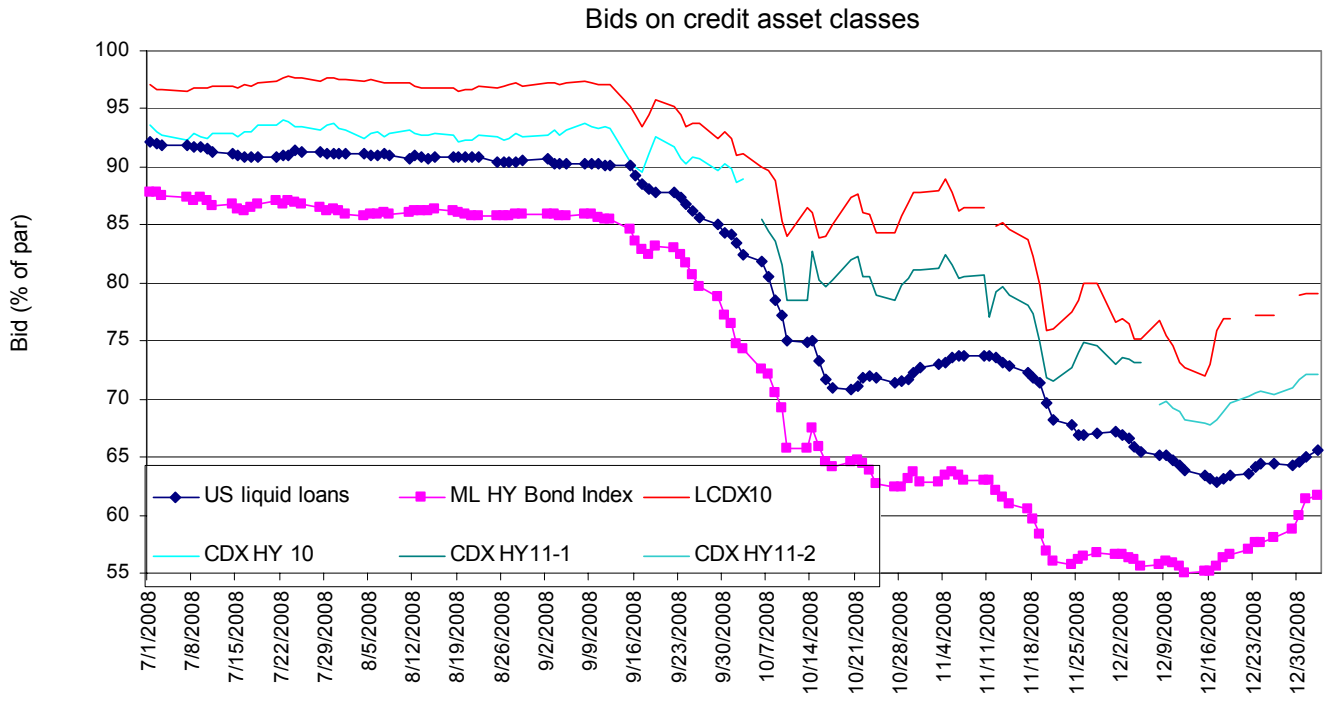
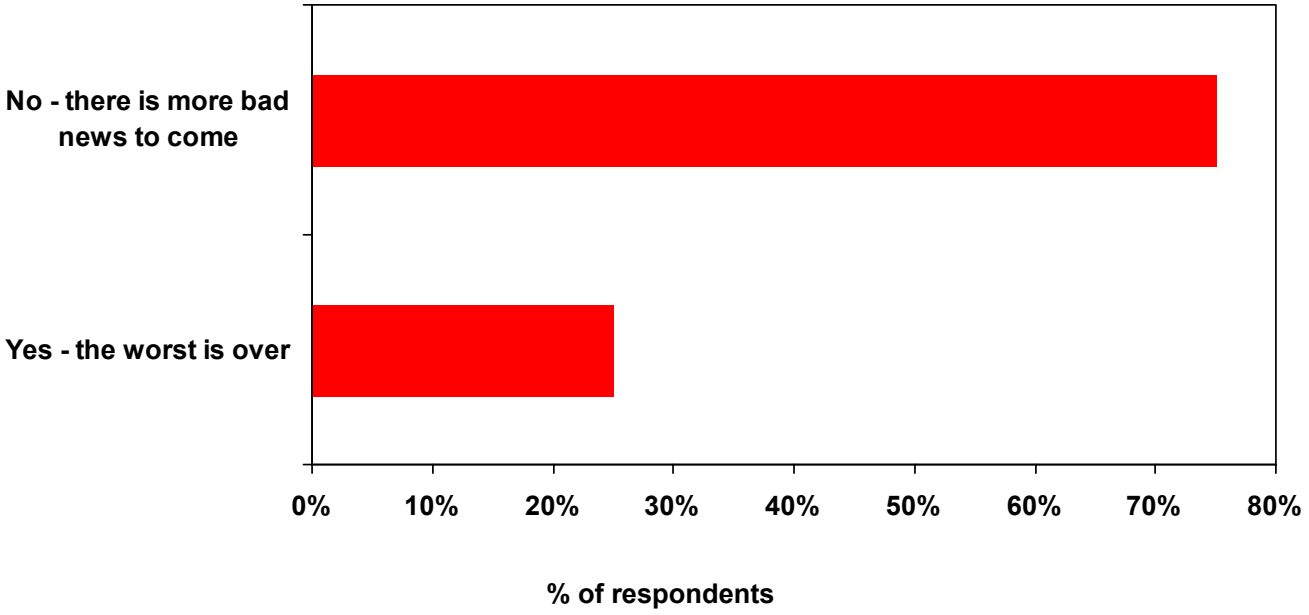
Credit markets rally back (a bit) in late December



- Credit assets suffer sharpest drop on record
- Slight recovery at year-end 2008, first days of January 2009

Source: Thomson Reuters LPC Merrill Lynch; LSTA/LPC MTM Pricing

Thomson Reuters LPC Lender Survey
Has the loan market reached a bottom?



- Leverage unwind continues
- Recession is in the early innings
- Need to get through defaults which have not yet peaked; covenant violations will increase
- CLO problems are just beginning; more BWICs expected; no new vehicles are being raised

Source: Thomson Reuters LPC Quarterly Lender Survey

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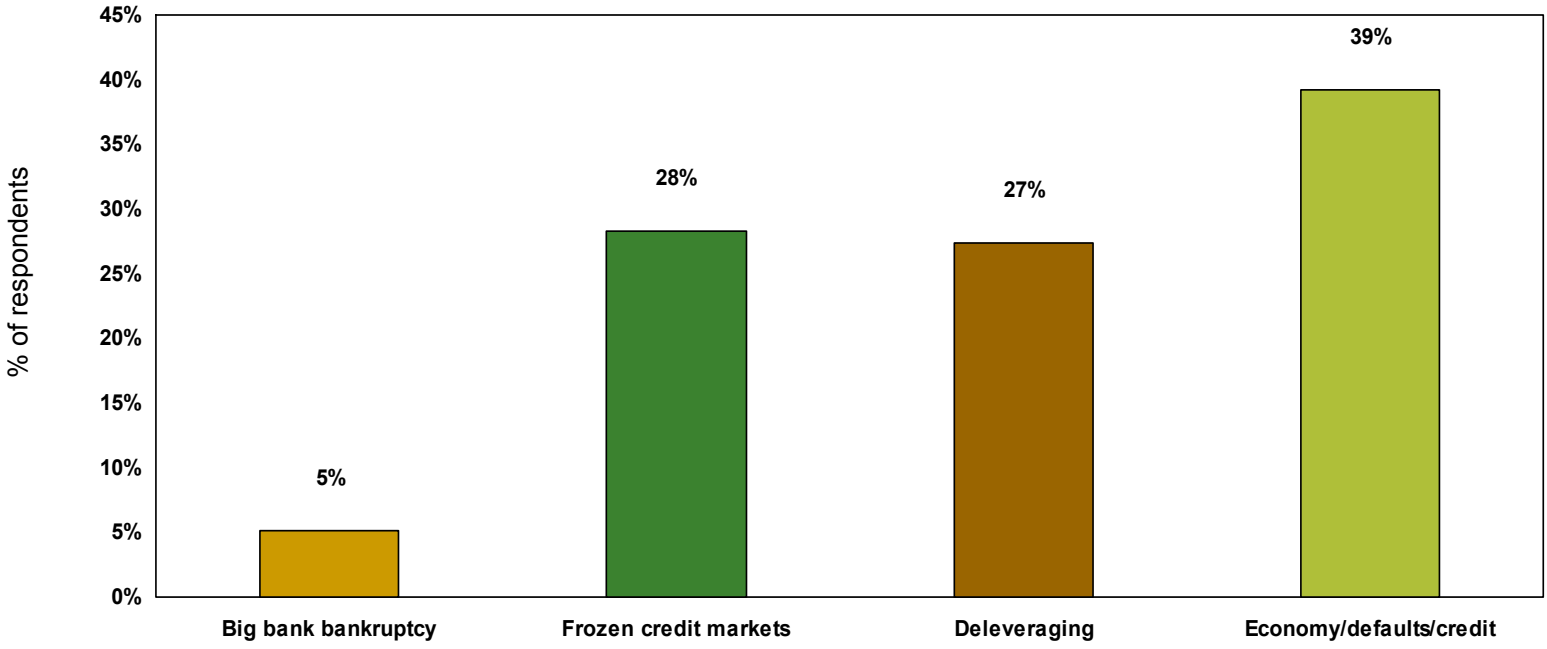
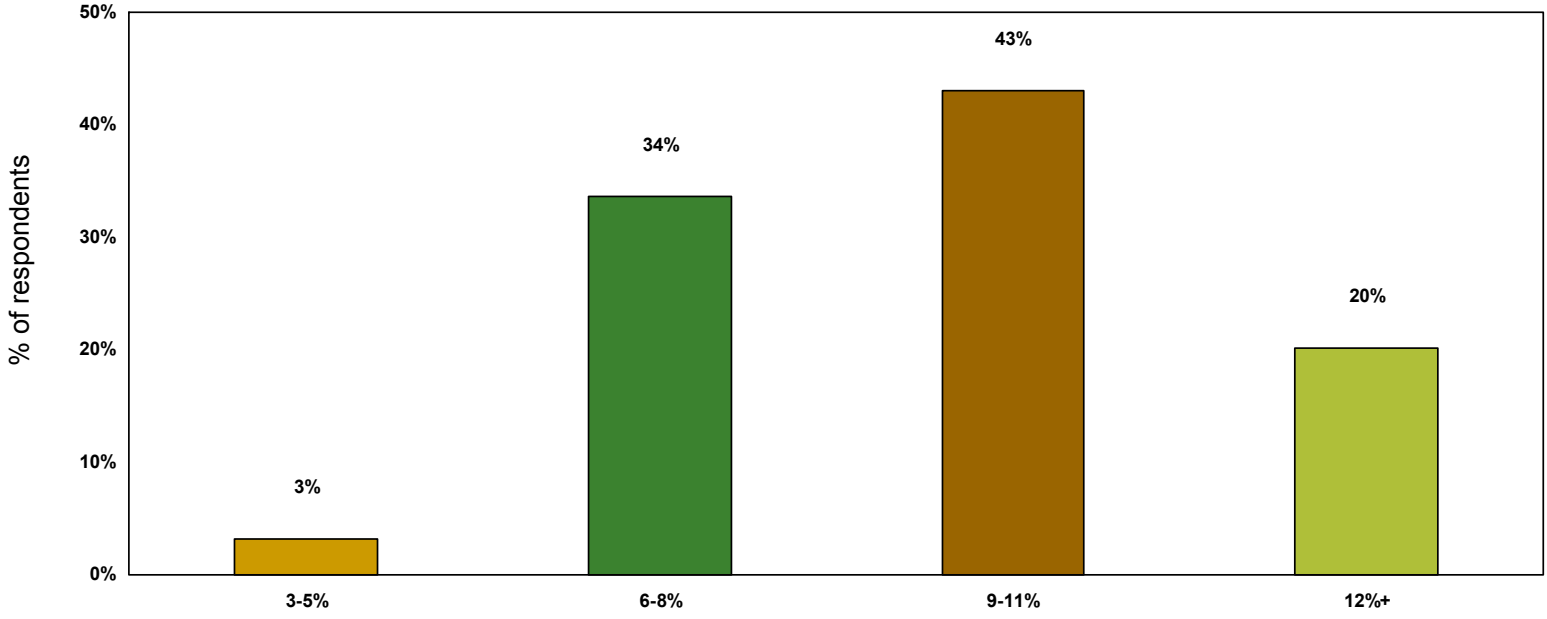
LSTA conference audience poll: What's the biggest risk to the loan market today?



- Biggest concern for LSTA conference audience was the economy, defaults and credit

Source: LSTA Conference Audience Poll – Oct 2008

LSTA conference audience poll: Where will default rates go in 2009?



- LSTA conference audience expected default rates to increase considerably
- More than 60% expect to see defaults above 9% in 2009

Source: LSTA Conference Audience Poll – Oct 2008

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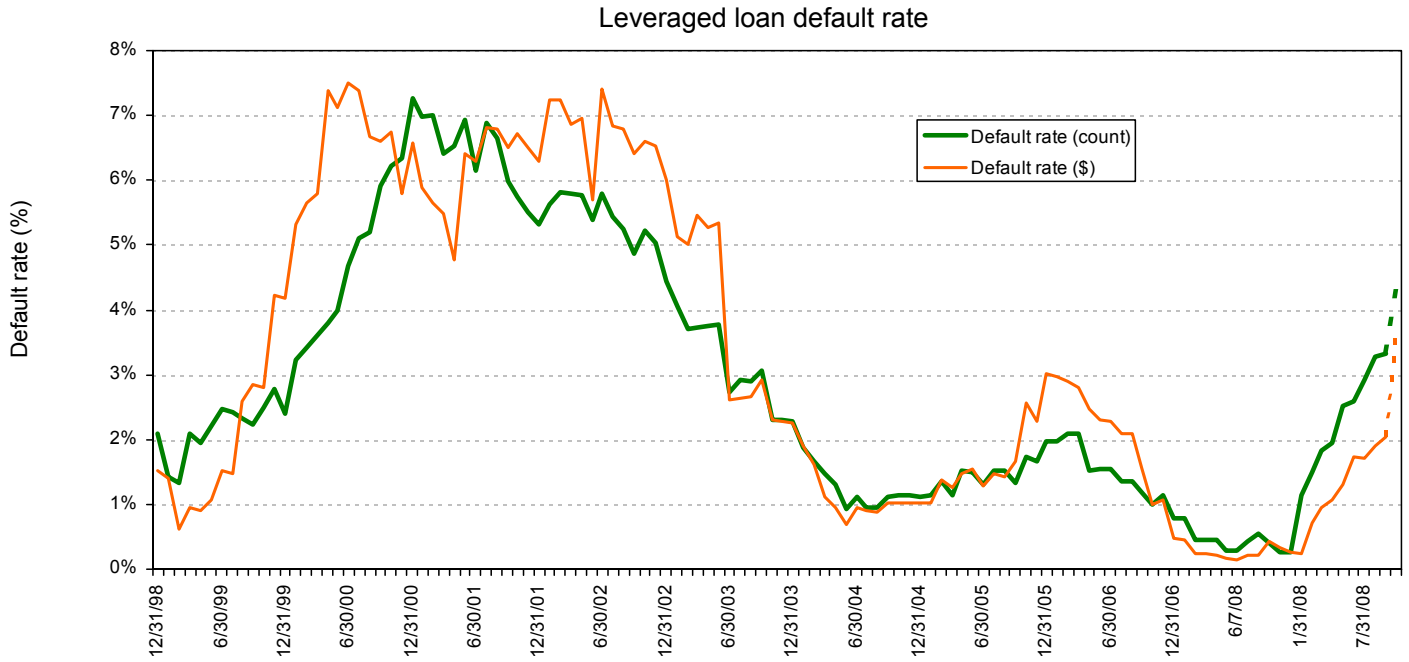
Default rates are climbing



- Initially defaults were defined by small companies
- Defaults becoming materially larger
- Amendments are becoming more difficult
- Loss given default could worsen
- Moody's estimates 10% YE 2009 default rate

Source: LSTA/LPC MTM Pricing, Standard & Poor's LCD

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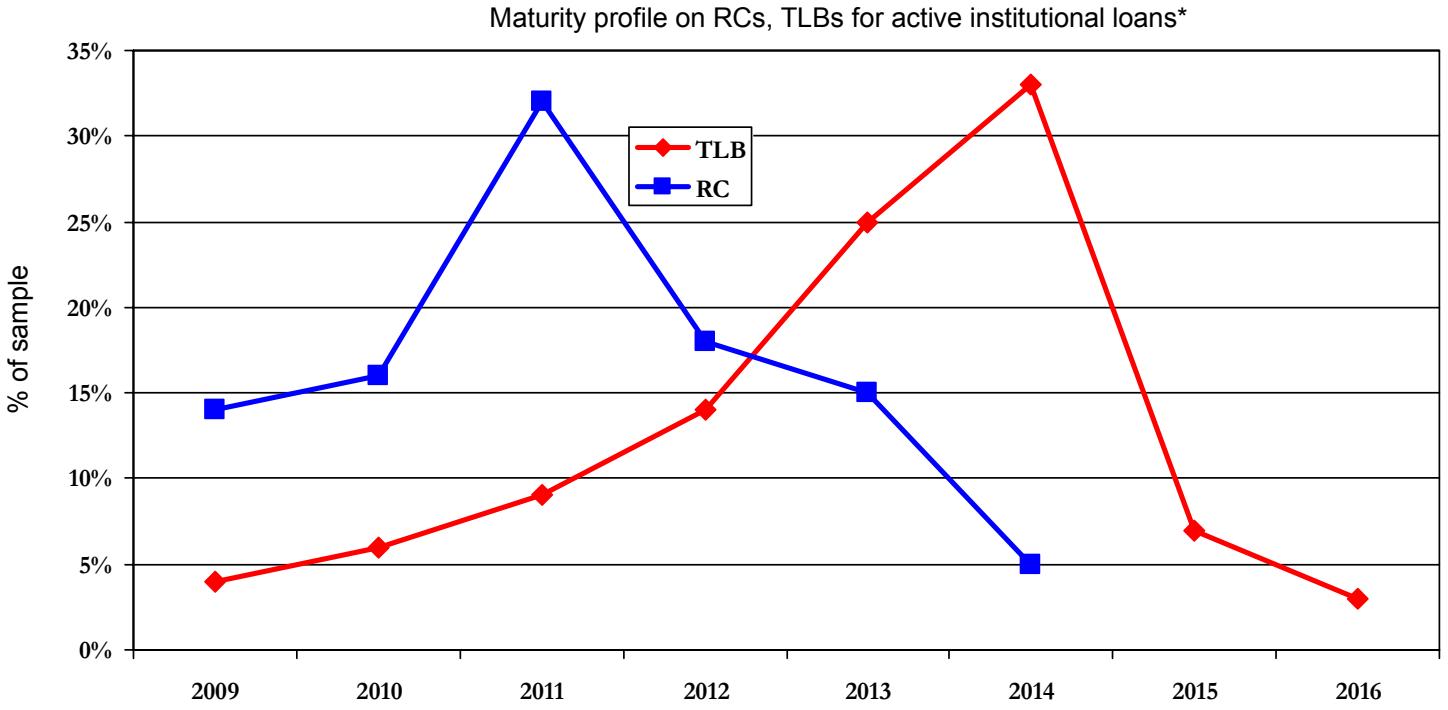
Refinancing pressures may emerge
Distribution of institutional loan maturities

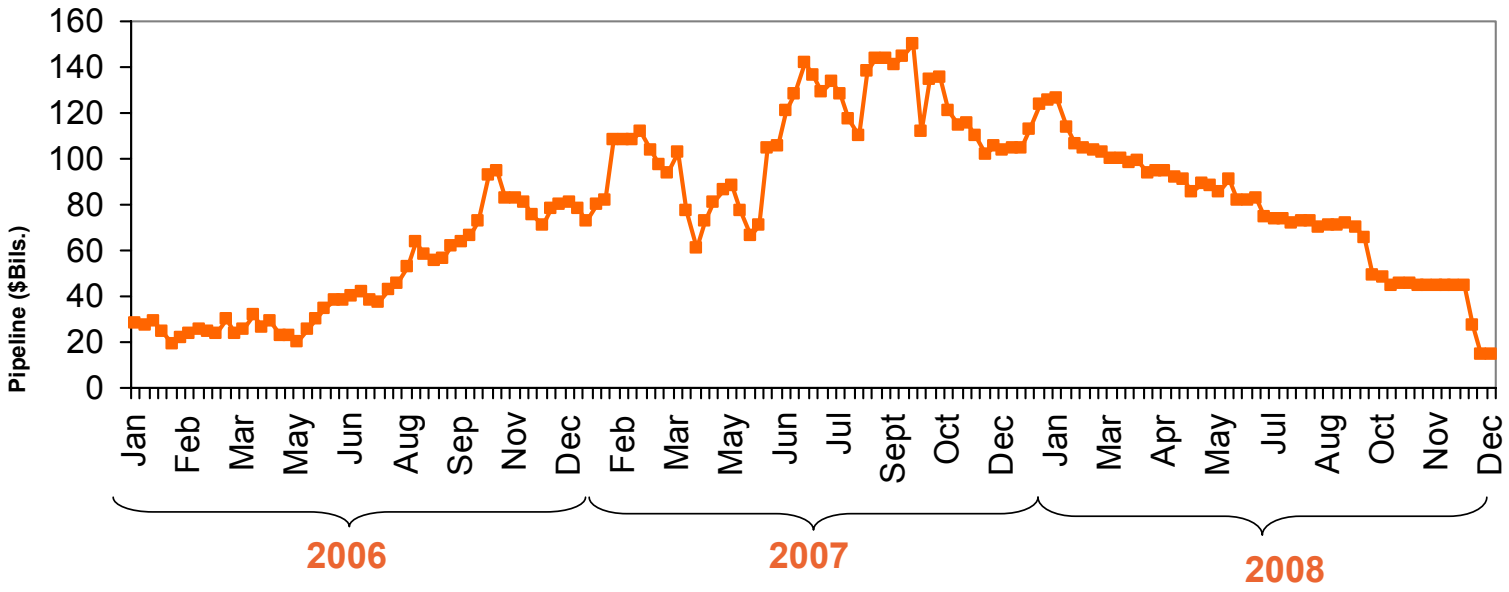


- TLB maturities peak in 2014
- RC maturities peak in 2011
- Most RCs "should" be refinanced in 2010 – which may lead to pressure

Source: LSTA, Thomson Reuters LPC

*Includes only credit agreements filed with SEC

Traditional "supply" declines materially
U.S. institutional pipeline



- The new issue market has shrunk dramatically
- However, other forms of supply – like portfolio sales – increased materially
- Demand remains lacking

Source: Thomson Reuters LPC

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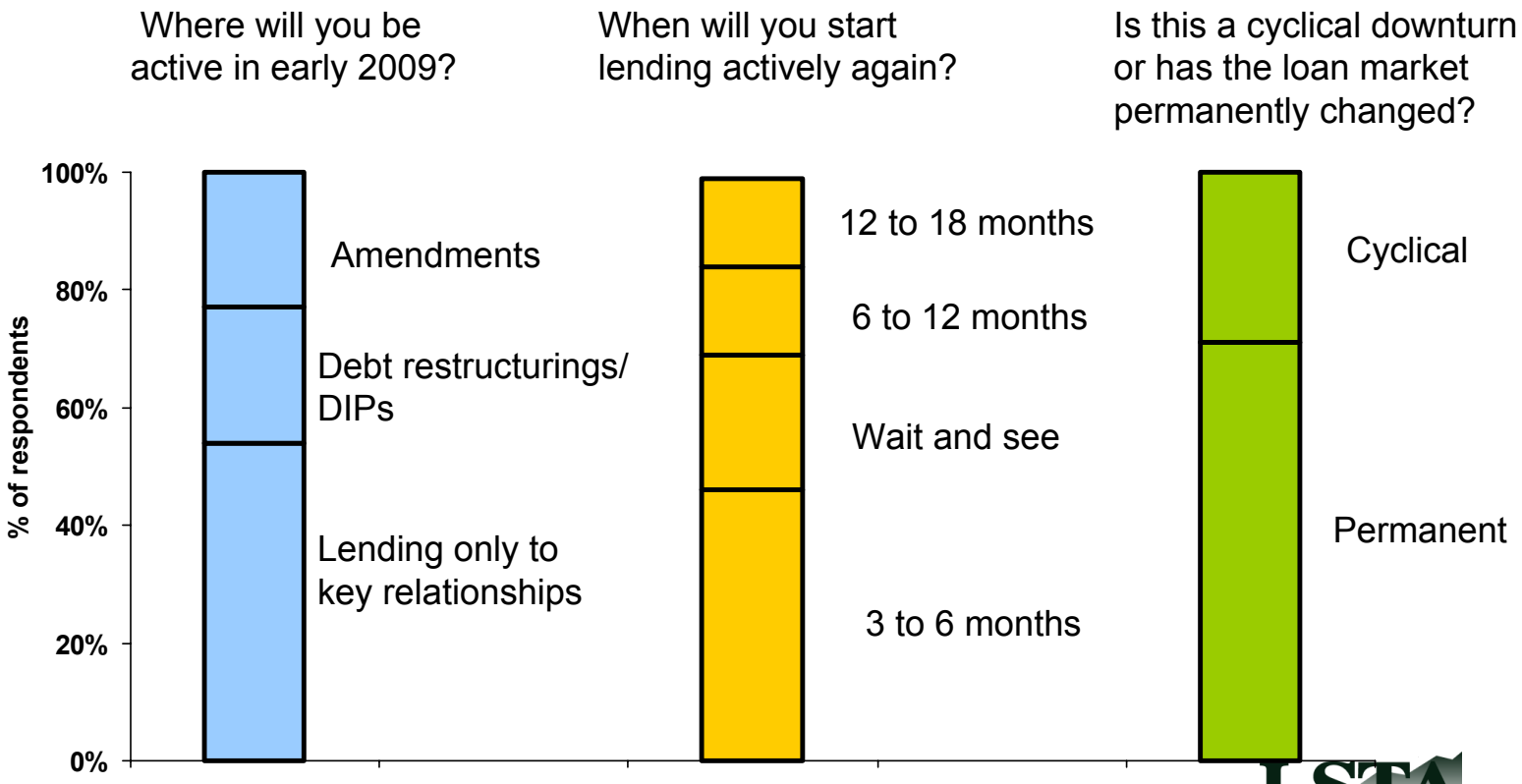
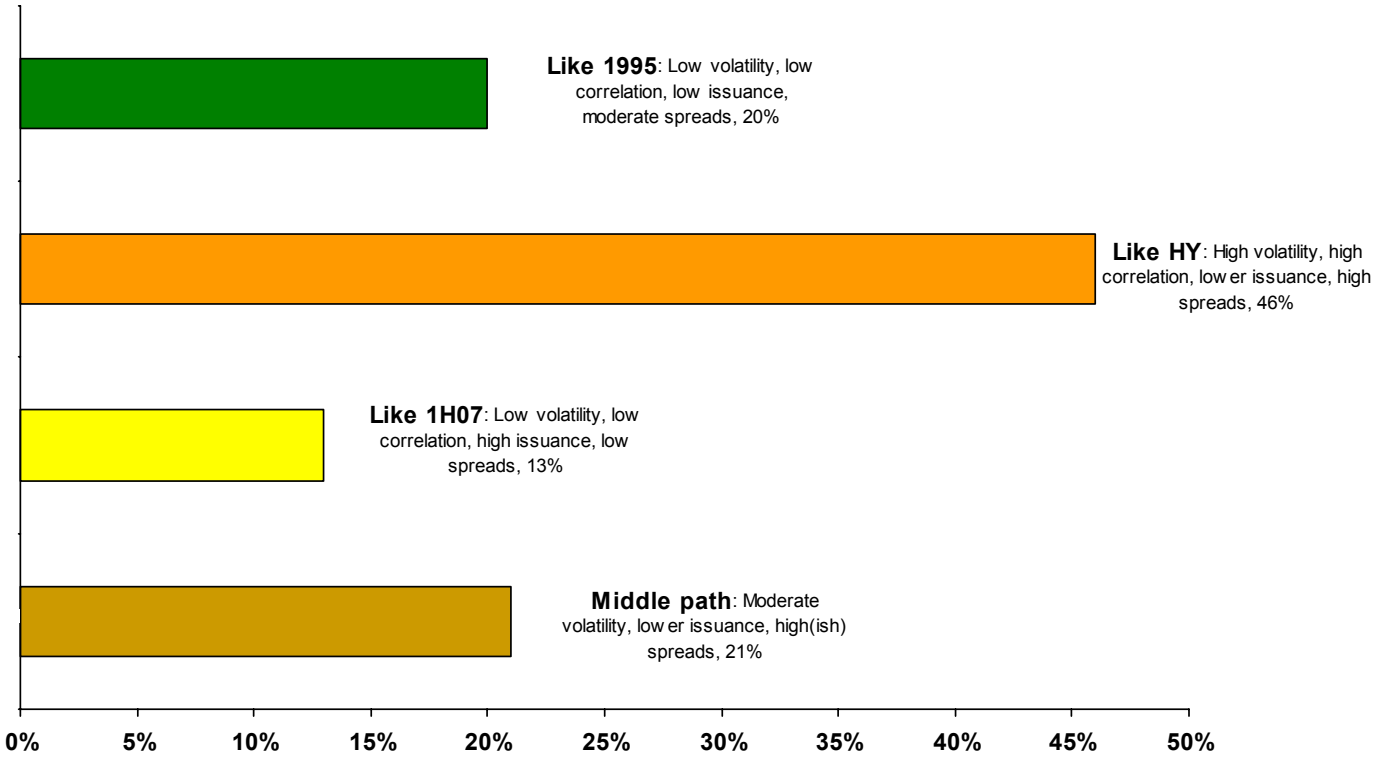
Thomson Reuters LPC Lender Survey



Source: Thomson Reuters LPC Quarterly Lender Survey

LSTA conference audience poll: What will the leveraged loan market look like in 2 yrs?



- Nearly half of LSTA audience believes loan market continues to behave like HY bonds

Source: LSTA Conference Audience Poll – Oct 2008

Presentation recap

- Loan market is dislocated
- Secondary market
  - Prices are volatile and depressed
  - Depressed prices are a function of deleveraging, lack of buyers – and increasingly defaults
  - Though dislocated, secondary loan market continues to function
  - Once a bottom is established, investors expected may come in
- Trouble spots
  - Defaults
  - Access to capital for refinancing, DIPs, exit financings
  - Structures that rely on outdated conventional wisdom
- Outlook
  - Non-traditional investors see considerable value – assuming they can find a bottom
  - As long as secondary prices are low, structuring new deals remains difficult – and borrower demand for loans may be limited
  - Defaults are rising, and DIP financing is becoming more difficult – impact on recovery given default
  - Loan market will probably remain more volatile than it has been historically – which leads to wider spreads, lower issuance, tighter structures
  - New standards are being developed to mitigate foreseen and unforeseen risks

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