



# Bank Loan Market Update

## A Commentary on the US Bank Loan Market

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<sup>1</sup> S&P/LSTA Leveraged Loan Index (all loans).

<sup>2</sup> Bids Wanted in Competition or general sales lists.

All references to Invesco refer to Invesco Senior Secured Management, Inc. All data is as of February 27 2009 unless otherwise stated. Source: Invesco, unless otherwise stated.

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## “Is The Wait Over?”

The bank loan market rally that we reported in our last commentary has shown sustained momentum with year-to-date gains through February amounting to 8.22%<sup>1</sup>. Loan performance has been driven by a reversal of the extraordinary technical pressures during the fourth quarter 2008 that drove the average bid level of the bank loan market to an all-time low of \$.60 on 17-December-2008. The technical reversal is underpinned by a lack of new issue activity, the end of market value fund deleveraging and BWIC<sup>2</sup> activity, and inflows of new money into the bank loan market. The new money is most visibly evidenced by seven straight weeks of inflows into bank loan mutual funds—according to AMG, year-to-date inflows totaled US\$565 million. Beyond the AMG data, market participants report new institutional monies coming into the asset class.

With technical factors now seemingly in balance, or even positive for the first time in more than six months, Invesco believes that investors should explore entering into the bank loan asset class at price points in the US\$.65 to US\$.70 context. We highlight that the current trading levels are both several points and several months away from the recent lows, but can still offer a significant “technical dislocation” premium as the market transitions back to its historically fundamental story.

### Negative Market Factors 2008 “Technical Storm”

#### Portfolio Unwinds and TRS Deleveraging

- US\$12.4 billion of BWICs in 2008
- US\$8.3 billion of Prime Fund outflows

#### Limited Demand Growth from Traditional Channels

- Prepayments less than 10%
- Collateralized loan obligation growth halted

#### Dealers on the Sidelines

- Concern over balance sheet management at year-end

#### CLOs and “Deep Discount” Effect

- Increased restrictions on trading activity with 70% of the bank loan market trading below US\$0.80

#### Weakening Fundamentals and Market Sentiment

#### Prices Hit All-time Lows in mid-December

- S&P Flow Names trade down to US\$63.53 on 16-Dec-2008
- S&P/LSTA Leveraged Loan Index average bid of 60.33 on 17-Dec-2008

### Positive Market Factors Early 2009 Catalysts

#### New Issue Market at a Standstill

- No new supply with only US\$2.6 billion of new issue institutional volume YTD through February

#### Hedge Fund and TRS Programs Stabilized

- Only US\$783 million BWICs through February
- Hedge funds now less than 20% of the institutional loan market

#### 17% Yield Profile and Price Stabilization Pulling Money off of the Sidelines

- Value equity investors
- Distressed investors
- Prime fund inflows of US\$565 million

#### Fed Stimulus

- Dealers now making active markets

#### Price rebounds through February

- S&P Flow Names trading at US\$72.7 as of 26-Feb-2009
- S&P/LSTA Leveraged Loan Index average bid of 65.05 on 27-Feb-2009

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### What is the Value of the Loan Market's Technical Dislocation?

It is difficult to pinpoint an exact value on the dislocation in the bank loan market, but the following table attempts to illustrate how one would derive its value. The secondary market is currently trading at a discounted spread to maturity of Libor+1476 bps. Bank loan defaults are expected to increase, so below we have factored in a default assumption of 15% per annum with an estimated 75% recovery—amounting to a 375 bps credit loss. Between 1997 and 2007, bank loan spreads have exceeded the historical loss-given-default spreads by 243 bps. Since using historical spreads in today's environment is probably less applicable, our analysis below doubles the historical risk premium. Using this example, one can assume the market is pricing in the technical dislocation around 615 bps.

<b>Current Spread Over Libor</b>	<b>1476</b>
<b>Credit Losses*</b>	<b>(375)</b>
<b>Adjusted Risk Premium</b>	
Historical Risk Premium	(243)
Market Adjustment	(243)
<b>Value of Technical Dislocation</b>	<b>615</b>
For Illustrative Purposes Only.	

### Drivers of Value

Invesco believes market fundamentals and individual credit performance will be the main drivers of value going forward. On the fundamental front, weak macroeconomic conditions, declining corporate earnings and limited access to capital are likely to drive market default rates into a 10% to 15% context through the end of 2009 and into the mid to upper teens through the end of 2010. We believe that even at these default levels, the recovery profile of the asset class at current trading levels offers a significant excess risk premium.

The matrix below highlights returns on the broad market at different default/recovery levels: we highlight returns at the market's historical recovery level of 80% but also highlight returns at a 75% recovery level as we believe that: asset de-valuation, lack of capital for exit financing and, higher levels of secured leverage in 2006 & 2007 vintage deals will result in lower recoveries in the current cycle. There is no manager bias built into the matrix so there should be potential for an upward performance surprise on an actively managed fund vs. the market.

Yield to Maturity Varies Based On Default Rates and Recoveries - Loans at 70 <sup>3</sup>								
Indicative Yield to Maturity								
	85%	80%	75%	70%	65%	60%	55%	50%
<b>5%</b>	14.15%	13.90%	13.65%	13.40%	13.15%	12.90%	12.65%	12.40%
<b>6%</b>	13.97%	13.67%	13.37%	13.07%	12.77%	12.47%	12.17%	11.87%
<b>7%</b>	13.79%	13.44%	13.09%	12.74%	12.39%	12.04%	11.69%	11.34%
<b>8%</b>	13.61%	13.21%	12.81%	12.41%	12.01%	11.61%	11.21%	10.81%
<b>9%</b>	13.43%	12.98%	12.53%	12.08%	11.63%	11.18%	10.73%	10.28%
<b>10%</b>	13.25%	<b>12.75%</b>	<b>12.25%</b>	11.75%	11.25%	10.75%	10.25%	9.75%
<b>11%</b>	13.08%	<b>12.53%</b>	<b>11.98%</b>	11.43%	10.88%	10.33%	9.78%	9.23%
<b>12%</b>	12.90%	<b>12.30%</b>	<b>11.70%</b>	11.10%	10.50%	9.90%	9.30%	8.70%
<b>13%</b>	12.72%	12.07%	11.42%	10.77%	10.12%	9.47%	8.82%	8.17%
<b>14%</b>	12.54%	11.84%	11.14%	10.44%	9.74%	9.04%	8.34%	7.64%
<b>15%</b>	12.36%	11.61%	10.86%	10.11%	9.36%	8.61%	7.86%	7.11%
<b>16%</b>	12.19%	11.39%	10.59%	9.79%	8.99%	8.19%	7.39%	6.59%
<b>17%</b>	12.01%	11.16%	10.31%	9.46%	8.61%	7.76%	6.91%	6.06%
<b>18%</b>	11.83%	10.93%	10.03%	9.13%	8.23%	7.33%	6.43%	5.53%
<b>19%</b>	11.65%	10.70%	9.75%	8.80%	7.85%	6.90%	5.95%	5.00%
<b>20%</b>	11.47%	10.47%	9.47%	8.47%	7.47%	6.47%	5.47%	4.47%

\*Default x (1-Recovery Rate) or 15%x (1-75)=375 bps

All data as of 27-February-2009 unless otherwise noted.

3 Source: Invesco. This presentation is meant to show indicative performance of a model portfolio based on certain key assumptions. The model portfolio may or may not be able to be achieved. Holdings and industry weightings of an actual portfolio may differ significantly from those of the model. Accordingly, investment results and volatility may differ significantly from those identified. Past performance is not an indication of future results. This presentation shows gross performance results before deducting management fees or administrative expenses. Performance results will be lower after deducting such management and administrative fees.

#### Key Assumptions

Index Spread (Libor+)	2.70
Average Purchase Price (% par)	70.00
Index Maturity (yrs)	4.55
3-Month Libor (%)	1.23
Current Pay in default (%)	50

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### How Can Portfolio Selection Help?

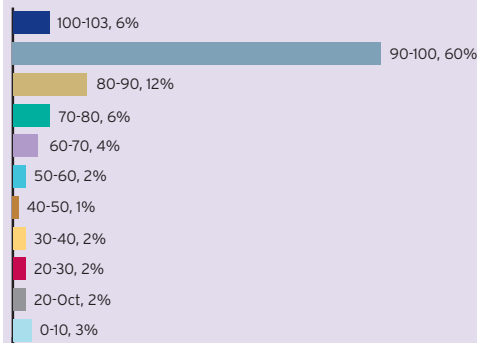
To provide some additional context around the notion that manager bias can provide an upside surprise on returns we need to look no further than the recent price distribution of the market. The following charts look at the price distribution at year ends 2002, 2006 and 2008. In 2002, the market was recovering from the last recession, but note that the two-thirds of all bank loans were trading at 90 or above. Fast forward to the end of 2006 which shows over 90% of the bank loans trading at 90 or above, and even 35% of all loans trading above par. In today's environment, reflective of the year end 2008 chart, 90% of all bank loans are trading below 90, with nearly 40% of the market trading below 60.

Invesco has not noted a time when there was more dispersion in the pricing of individual assets, which we believe, creates opportunity to pick certain credits around optimal fundamental research with a bias towards the higher recovery.

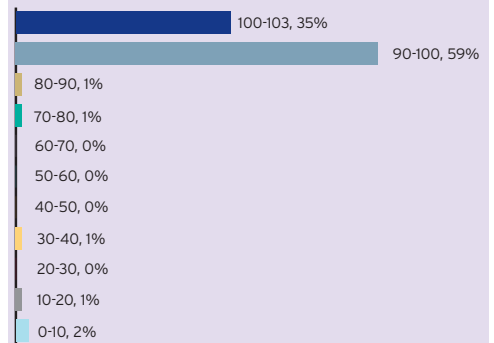
All data as of 27-February-2009 unless otherwise noted.

4 Source: S&P/LSTA Loan Index.

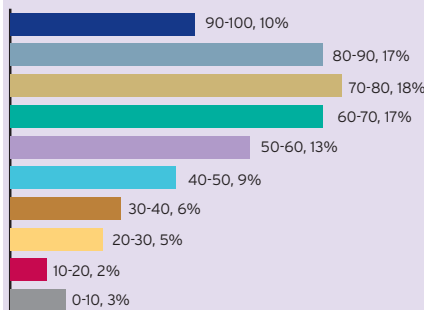
Price Distribution 12/31/02<sup>4</sup>



Price Distribution 12/31/2006<sup>4</sup>



Price Distribution 12/31/2008<sup>4</sup>



### Bank Loans vs. Equities

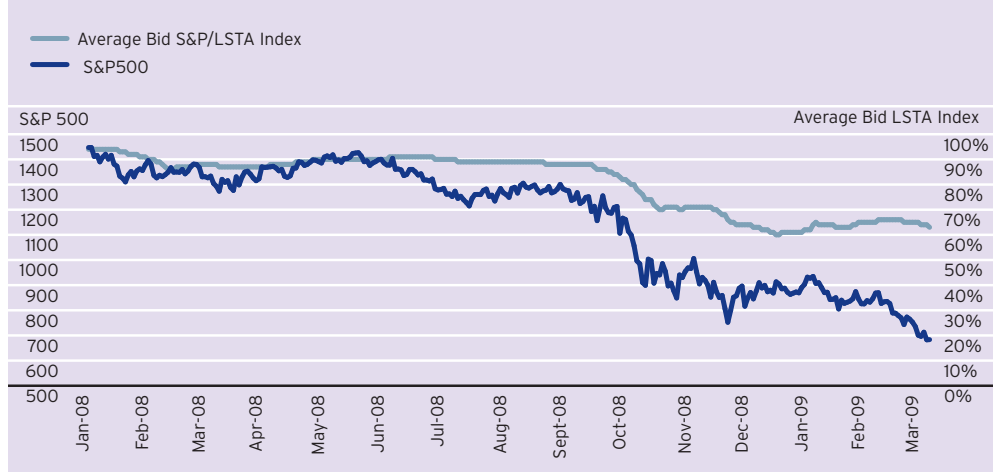
Finally as it relates to timing, we believe bank loans look overwhelmingly attractive against other assets classes but especially so against equities. First, there has been a conclusive decoupling of performance from equities and a reversion of historically low correlation levels to the S&P 500.

The decoupling underscores the differential between the relative safety of current income streams attached to contractual quarterly interest payments on bank loans vs. well publicized declines in dividend pay-outs on the S&P 500. On this latter front we note that effective current yields on bank loans are now running at 6% while 288 companies have either suspended or reduced dividends last quarter - the most since S&P started tracking

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### Bank Loans Decouple from General Market Indices<sup>5</sup>



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5 Source: S&P/LSTA Loan Index, S&P 500 Index 1-January-2008 through 18-February-2009.

6 Source: S&P/LSTA Loan Index.

dividend data. The effective current yield on bank loans plus the prospect for significant capital appreciation to a 17 or 18% all-in yield profile, is well in excess of a relatively muted outlook for equities. We note that seniority and security leave returns on bank loans far less sensitive to earnings changes and multiple expansion than equities.

### Attractive Interest Income vs. S&P 500 Dividends<sup>6</sup>

Interest Income Return		S&P 500 Dividend Yield	
1997	8.34%	1997	1.60%
1998	7.76%	1998	1.32%
1999	7.86%	1999	1.14%
2000	8.87%	2000	1.23%
2001	6.80%	2001	1.37%
2002	4.44%	2002	1.83%
2003	4.41%	2003	1.61%
2004	4.51%	2004	1.60%
2005	5.99%	2005	1.79%
2006	7.35%	2006	1.77%
2007	7.59%	2007	1.89%
2008	4.70%	2008	3.11%
Average	6.55%	Average (1960 - 2008)	3.20%
Average (1997-2007)	6.72%	Average (1997-2007)	1.56%

In conclusion we think the time is now to consider bank loans as part of your investment strategy. The market has finally transitioned away from technical influences but has yet to give back the "technical dislocation" premium. Fundamentals will ultimately drive performance for the remainder of 2009 and into 2010 and while there are admitted concerns on this front these are fully priced into the market with a significant margin for error. Varied trading levels of assets within the market have created perhaps the best opportunity we have ever seen for active credit selection; this makes for a compelling return opportunity on both a stand alone basis and relative to equities. For that matter, bank loans are also very attractive versus any other credit driven strategies, many of which are exposed to duration risk which is not a factor in bank loans.

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