

Banks hit the 'sweet spot'

50 Unglamorous unleveraged bank loans are suddenly de rigueur for the long-term investor. **David White** investigates

In a global economic crisis that has been triggered by banks and bank lending, should pension funds possibly consider investing in European or US bank loans?

The answer is they 'quite possibly' should for a number of key reasons say asset managers specialising in this corner of the market.

First, bank loans are not quite what they sound. They are not loans to banks or even bank-issued mortgages, but loans by banks to mid and large cap corporates, usually with below investment grade credit ratings.

Second, bank loans now offer a better risk/reward profile than other forms of corporate debt, notably high yield. The recovery rate in unsecured high yield bonds is between 45-50 cents on the dollar, compared with the bank debt rate of around 70 cents.

Investing in bank loans has changed direction dramatically as a result of the credit crisis. A year ago, investor interest in bank loans was focused on highly leveraged bank loans, such as collateralised loan obligations (CLOs), which offered returns in the high teens and twenties. The CLO market has now effectively collapsed. Interest is now growing in the less glamorous market for unleveraged bank loans.

This is because the current environment has created a gap between the market's pricing of the risk of bank loan defaults and the actual risk of these defaults. This gap has developed largely because the market has refused to factor in the cushioning effect of the collateral and debt seniority that investors acquire when they invest in bank loans.

In other words, the market does not accept that unleveraged bank loans

are better protected than other kinds of corporate debt such as high yield.

Promoters of unleveraged bank loan investing say that institutional investors such as pension funds, that have the investment horizon and patience to exploit this gap, can tap a much-needed source of current income and capital appreciation, with the promise of a double-digit yield to maturity.

In the past, unleveraged bank loan investment has been seen as little more than an alternative to a traditional fixed income allocation. However, it has virtues which appeal to pension funds. As a floating-rate note type of investment, it acts as a hedge against duration; and as an asset class, it has a low correlation with other asset classes.

The unleveraged bank loan's simpler, net asset value (NAV) style of valuation also makes it easier to value than complex structured investments such as CLOs. It also benefits from more liquidity than a structured investment.

Its drawback has been relatively modest yields compared with leveraged bank loans. But current market conditions have made investing in unleveraged bank loans far more attractive, says Greg Stoeckle, head of fixed income, New York, and managing director of the bank loan group at Invesco.

The attraction of unleveraged bank loans is that they have been over-sold by the market and that their current valuation does not reflect fundamentals, says Stoeckle. "Bank loans are a historically range-bound asset class

that has been typically traded around par on a historic basis. In the US, we have traded at LIBOR plus 360-365bps. That's been the historic average over an extended period of time.

"Today, the market is now trading at about LIBOR plus 1,200-1,300bps. A significant correction and re-pricing of risk, a de-leveraging of the market and a host of technical factors have pushed pricing levels in the secondary market far below what most investors would consider reasonable fair value.

"There is a huge gap in the risk premium afforded to investors, and that type of a risk premium has never been witnessed before in the bank loan market place."

A key characteristic of bank loan investment, Stoeckle says, is the level of protection that investors can expect in the event of default. Bank loans are generally 'collateralised' by the borrower's assets, such as a factory or factory equipment.

"The underpinning characteristic of the bank loan market is that it is a secured asset class. We tend to have full collateral packages, a full pledge of all the value of the underlying corporate issuer," he says.

Bank loans also rank as senior debt in the capital structure.

"This means that in most cases a substantial amount of junior capital sits below the bank debt," says Stoeckle. "Whether it takes the form of equity, subordinated debt or unsecured debt, there's always a cushion that can absorb deterioration in value before the bank debt suffers any type of loss."

For this reason, bank loan defaults do not necessarily translate into losses for bank loan investors. Historically, default rates have been low, Stoeckle points out. "The historical default rate on the bank loan market is 3% and the peak default we have seen was in the last cycle, in October 2002, when it was just shy of 8%."

Although default rates are likely to go higher this time, with a default rate of 10% or more, this still does not weaken the argument for bank loan investment, he says. "We think that the pace of those defaults will not erode the excess risk premium in the market place.

"If the entire bank loan market defaulted today, and an investor held that market through a work-out period to a recovery, I would still expect a positive IRR on an investment in bank loans, relative to the current trading levels in the market place."

A key factor will be recovery rates. According to Moody's research into more than 700 defaulted issuers over the past 20 years, the long-term recovery rate on defaulted bank debt is 82 cents on the dollar.

Yet the market takes a shorter-term view of recovery rates, says Stoeckle. "They want to know where the bank

loan or any defaulted debt is trading 30 days after default. From a trading perspective, the historical number for this is around 70 cents on the dollar."

Stoeckle argues that even this pessimistic view of recovery rates would leave investors with a respectable LIBOR plus 2.7% return. "A 3% default rate and a recovery rate of 70 cents on the dollar – meaning a loss of 30 cents on the dollar – would give 90bps of expected loss on a bank loan portfolio over an extended time frame.

"Subtract this loss from the historical risk premium of around 36bps, with LIBOR plus 360, equals LIBOR plus 270bps as the loss-adjusted yield for the market place."

Setting a much higher default rate against the current risk premium for unleveraged bank loans – between 1,200 and 1,300bps – still results in near double-digit returns for investors, he says. "If one poses a 10% default rate to take account of the deteriorating environment and multiplies this by the same 30 cents of loss in event of default, the result is 300bps of expected loss.

"If you subtract those 300bps from the LIBOR plus 1,200 that the market is currently trading at, you're still getting LIBOR plus 900 as a loss-adjusted yield for the market place. This is very compelling compared with any previous performance of the unleveraged bank loans market.

Pension funds are natural investors in bank loan investment. The attraction of bank loans for pension funds is twofold, says Stoeckle: current income and capital appreciation.

"Pension funds are looking for current income, and there's a steady, quarterly distribution from bank loans that provides that current income stream. Based on the pricing levels – current LIBOR rates, current market spreads and effective yield levels – the gross quarterly distribution on a bank loan portfolio should be somewhere between 6.5-7%.

"Looking at a mid-term investments of three years plus, I would expect two things to happen. I would expect the credit markets to have gone through the worst of the cycle and to have begun to move back towards a correction mode.

Capital appreciation would be achieved in a number of ways, he says. "Bank loans have unique properties in terms of things like excess cash flow sweeps. Excess cash flow sweeps mean that, as companies generate cash flow, they are under an obligation to offer some of that cash flow in the form of debt reduction."

The effect of today's trading conditions has been to bring unleveraged bank loans up to the level that leveraged bank loans were a year ago. Until recently, investors would need to gear their investments at least two to three times to get to a return of 10% per annum – something that unleveraged bank loans can almost guarantee today.

In this sense, the credit crisis may have created a 'sweet spot' for unleveraged bank loan investment.



Stoeckle: 'more attractive'

Expected returns (IRR) on unleveraged and leveraged loans

Purchase price (%)	No leverage (%)	3 times leverage (%)
80	11.44	27.87
81	11.06	26.80
82	10.69	25.74
83	10.32	24.67
84	9.95	23.60
85	9.59	22.52
86	9.23	21.44
87	8.88	20.36
88	8.54	19.26
89	8.19	18.16
90	7.86	17.06

Source: Credit Suisse

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