



# Investment Outlook

A Commentary on the US Bank Loan Market

December 2008

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## Why Consider Loans Today?

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### US Bank Loans Could Provide a 17%<sup>1</sup> Annualized Return (Unleveraged)—Is this a Rational Market?

Regardless of what you call the behavior of the global market, there is little doubt the equity and fixed income markets have raised the level of angst among investors. **Due to the global contraction of credit, the bank loan market—once the staid and steady—has performed as erratically with average loan bids down 32% year to date.**<sup>2</sup> While we forecast the challenges currently facing the economy are likely to persist for some time, Invesco believes bank loans are an investment allocation that may excel through the market turbulence and offer a very compelling risk reward potential.

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### Bank Loans = Senior Secured Corporate Credit Risk

Bank loans are an important feature of a high-yield company's financing plans and generally account for about two-thirds of total debt capital. Bank loans are senior to other forms of capital and typically secured by all of the company's assets. Bank loan proceeds are used to refinance existing debt, to fund a leveraged buyout or acquisition, or for corporate purposes, such as working capital.

These loans have been sold to institutional investors in meaningful size since the mid '90s. These institutional bank loans are structured for larger companies—either public or private—such as Community Health Systems, TXU, Discovery Channel, NASDAQ or Regal Cinemas. At a fund level, bank loans become part of many diversified portfolios which are actively managed and traded—with daily pricing coming from independent pricing services and daily market making conducted by every major commercial and investment bank.

**Over the past several years, CLOs have been the largest investors in bank loans. Although with current yields in the mid-teens, Invesco sees participants that are more non-traditional entering the market. These participants include equity funds, foundations and endowments, public and corporate pension plans and high-yield mutual funds.**

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<sup>1</sup>Invesco Estimate. Please see Page 4—Current Bank Loan Economics for assumptions.

<sup>2</sup>Average bid of S&P/LSTA Leveraged Loan Index 31-Dec-2007 versus 30-Nov-2008.

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All references to Invesco refer to Invesco Senior Secured Management, Inc. All data is as of 30-Nov-2008 unless otherwise stated. Source: Invesco, unless otherwise stated.

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### Understanding the Risk—Defaults and Recoveries

Institutional bank loans are typically made to below-investment-grade companies. These companies are leveraged and there is a risk that each company may default on its bank loan obligation. While defaults are still well below the last cycle's levels, Invesco does not see the currently low default rate of 2% as sustainable. Given the weak economic backdrop, highly leveraged LBO deals in cyclical industries, and tighter liquidity conditions, the pace of defaults is likely to climb.

#### While US Bank Loan Defaults are on the Uptick, They are Still Below Historical Highs

Lagging 12-Months Default Rate by Principal Amount



Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index. As of 30-Nov-08. Comprises all loans, including those not tracked in the LSTA/LPC mark-to-market service. Vast majority are institutional tranches. Default rate is calculated as the amount default over the last twelve months divided by the amount outstanding at the beginning of the twelve-month period.

To minimize the impact of defaults, a typical bank loan portfolio is diversified by number of borrowers and industry concentration. To control the impact of loss in the event of default, loan documents often restrict the borrower's ability to take on more risk via investments, mergers, acquisitions and additional leverage. The loan agreements often contain strict performance requirements, giving lenders the right to repayment in the event of a breach and enable lenders to exercise control to avoid problems that are more serious later. Performance requirements typically account for debt service coverage, leverage, tangible net worth, cash flows and capital expenditures.

While the market expects defaults to increase, it is important to underscore defaults do not mean an investor will lose all of its investment. In the event of default, historical recovery studies confirm the advantages of bank loans' claim on the borrower's assets over bonds and equity.

Moody's published a comprehensive study of ultimate recovery rates for roughly 3,500 defaulted loans and bonds issued since 1987 by over 720 non-financial US corporations.<sup>3</sup> Moody's found that defaulted loans recovered an average of 82% of par value, while defaulted bonds recovered an average of just 37%. Interestingly, loan recovery rates have a right-skewed distribution, while bond recovery rates have a left-skewed distribution according to Moody's. **In fact, a majority of defaulted loans recovered 100% of their value. Defaulted bonds, in contrast, recovered less than 25% of their value more often than not.**

<sup>3</sup> Moody's Ultimate Recovery Database: Special Comment, April 2007



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### Expectations in the US Vary for Default and Recovery Rates

|                   | LTM FYE 2009<br>Default Rate* | Ultimate<br>Recovery Rate |
|-------------------|-------------------------------|---------------------------|
| Moody's           | 10.4%                         | 82%                       |
| Standard & Poor's | 7.6%                          | 79.5%                     |
| JP Morgan Chase   | 10%                           | <70.5%**                  |
| UBS               | 9%                            | 72%                       |

\* Based on Par Amount

\*\* Based on trading levels 30 days post default

- Prediction for a drastic rise in Trailing Twelve Month Default Rate underscores importance of credit selection
- Second lien loans have a negative influence on recovery levels in this credit cycle
- Invesco's investment bias continues to lean towards senior credits with strong recovery profiles; placing Invesco's bank loan funds in, what we believe, an advantageous position relative to the broader market

Source: Moody's, Standard and Poor's, JP Morgan Chase, UBS. As of 24-Nov-2008.

### Bank Loan Prices Today—Unprecedented Opportunity

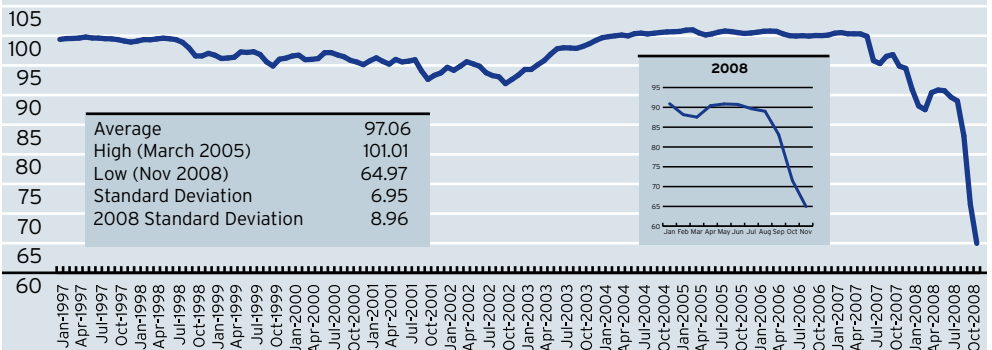
The tendency of fear to outweigh reality during financial crises has been evidenced most notably over the past year among high quality bank loans. To be sure, there is plenty to be anxious about in the overall credit environment, from rapidly rising defaults rates to the overall liquidity squeeze of traditional borrowers.

However, the average price of a US bank loan is trading at 65% of par. This trading level provides an opportunity to purchase loans below the 20-year average recovery rate of 82% as tracked by Moody's Ultimate Recovery Database.

Assuming recovery of 82% and loans trading at a 65 price, the entire market could default and we would still expect positive returns. Meanwhile, during the last credit cycle, the default rate peaked at 7.5%.

### US Bank Loan Bids Have Witnessed An Unprecedented Decline

Average Bid of US Leveraged Bank Loans



Source: Standard and Poor's LCD and S&P/LSTA Leveraged Loan Index. Excludes all facilities in default. Jan 1997 through Nov 2008.



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Many market participants—both traditional and non-traditional—have wondered whether valuations in the senior secured corporate loan markets may have moved a bit too far out of line with fundamentals. For example, the implied default rate in the loan market is currently hovering near 35% well above historic highs and trading levels below the average recoveries of 82% there appears to be a disconnect between the market price and the ultimate value of the bank loans.

### Current Bank Loan Economics

Bank loans are floating rate and typically issued at a spread over LIBOR. The return is generated from the interest payment (LIBOR + the spread) less any loss in the event the borrower defaults on its obligations (default rate x [1-recovery]). **With a 65% par purchase price (assuming defaults recover 50%)—79.5% of the portfolio could go into immediate payment default and the portfolio would still breakeven.**

|                                      | US\$1 million Performing Loan (5 year life) Purchased at 65 | US\$1 million Loan Purchased at 65. Defaults Immediately with 50 recovery |
|--------------------------------------|---|---|
| LIBOR <sup>4</sup>                   | US\$21,600  | 0   |
| Credit Spread (250 bps)              | US\$25,000  | 0   |
| Current Income (per annum)           | US\$46,600  | 0   |
| Purchase Price                       | 65.0%   | 65.0%   |
| Effective Current Yield <sup>5</sup> | 7.2%  | 0.0%  |
| Principal Appreciation <sup>6</sup>  | US\$350,000   | US\$-150,000  |
| Current Income                       | US\$233,000   | 0   |
| Total Income                         | US\$583,000   | US\$-150,000  |
| Total Return                         | 89.7%   | -23.1%  |
| Simple 5 year Average                | 17.9%   | -4.6%   |

<sup>4</sup> 3-Month LIBOR rate as of 10-Dec-08.

Source: Bankrate.com

<sup>5</sup> [(LIBOR+Spread)/Price]

<sup>6</sup> [Par-Cost] for Performing Loan. [Recovery-Cost] for Defaulted Loan.

<sup>7</sup> Global Crossing and Iridium used for illustrative purposes only.

### Why Invest Now?

Several factors are likely to exert an upward influence on US bank loan price levels. For new entrants into the asset class, potential loss given an event of default may be limited.

- 1) New entrants can buy into the asset class at average prices not seen since the formation of the market.** With a low cost basis, recovery potential is even more attractive since historical recovery rates are measured as a percentage of par.
- 2) Cash-on-Cash Returns.** A current pay portfolio of bank loans can yield LIBOR +500 (or 7.17%). Assuming current price levels and a maturity of 5 years (repayment at par), yield to maturity could equate to 17.94%, or LIBOR+1578.
- 3) The market may be cyclical, but the originators have long-term memories.** In the last credit cycle (2001), most of the defaults were by asset-lite companies. For example, names such as Global Crossing (15.4% recovery) and Iridium (4.1%)<sup>7</sup> were arguably “business plans” that were able to take advantage of a frothy market and raise debt financing instead of venture capital or private equity. Companies may be heavily levered today, but by-and-large they are beyond the “business plan” stage and have tangible assets supporting their bank loans.
- 4) Distressed money and private equity funds waiting on the sidelines.** While recoveries ultimately depend on negotiation, litigation, etc., many holders prefer not to take part in the workout process. As such, post-bankruptcy prices in the secondary market may be an appropriate recovery metric for many investors. **In addition, given how sharply**



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**distressed funds have grown in recent years, that bid may be stronger than it has been in the past.** Additional distressed and private equity capital on the sidelines may result in an increased willingness and ability of junior claimholders to preserve recovery prospects through capital injections (i.e., essentially take out senior portions of the capital structure at par to control the bankruptcy process).

**5) Diversification.** A pool of diversified bank loans has a historically low correlation to other asset classes.

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### Conclusion

This type of market mis-pricing has historically proven to be an excellent buying opportunity for investors in the bank loan asset class, while also avoiding the same risks that equity investors assume for being “too early” with being at the top of the capital structure. Moreover, since the development of bank loans as an asset class in the early 1990s, bank loans have demonstrated resilience through other periods of financial turmoil, avoiding the types of losses that inflation can levy on traditional fixed income portfolios. Invesco believes bank loan strategies can offer a tactical opportunity in the near term through the credit market dislocation, as well as long-term diversification for investors within their overall asset allocation. Portfolio benefits can be achieved with bank loans, providing very attractive current income and the opportunity for price appreciation.

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