

The Babson Staff Letter



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Beyond the Bard — The Investment Attraction of Bank Loans

Thomas M. Finke

Introduction

Just a few minutes after the curtain rises on *Hamlet*, Polonius, one of Shakespeare's most memorable minor characters, takes center stage and delivers a speech to his son, Laertes, chock full of all sorts of parental advice, including one of the Bard's most quoted lines: "To thine own self be true." Tucked away a few lines earlier is another nugget of wisdom:

Neither a borrower nor a lender be,
For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry.

Polonius might have to re-think his position on financing if he were aware of what is generally known as the "bank loan market," a growing and increasingly more efficient segment of the fixed income market.

Bank loans are financial commitments extended by banks and other financial institutions ("lenders") to

corporate entities ("borrowers"). Lenders' commitments provide borrowers with key sources of funds for working capital, business investment and expansion, and the funding of corporate buyouts and other financial transactions. With new issue volume typically exceeding one trillion dollars per year, bank loans are a major source of financial liquidity in the economy. Indeed, the availability of bank loans is a key factor in promoting or restraining economic growth.

This Staff Letter provides an introduction to the bank loan market, which has evolved dramatically over the past twenty years as financial markets and the credit area in particular have grown increasingly sophisticated and capable of segmenting risk and return across ever more diverse asset classes.

Banks: Evolving Role in Capital Markets

Banks used to be a primary conduit between the suppliers and users of capital. Investors deposited cash in the banks and, after investigation of the borrower's creditworthiness, banks would lend that cash to a corporation at a rate based on their creditworthiness. Only the very largest of non-bank investors and those able to tolerate higher risk could go directly to the credit markets, lending money directly to mostly large, stable companies through corporate bonds and private placements.

However, the development of a broader, more diverse bond market—enabled by new technology, changes in securities laws, and an increasing sophistication of institutional investors—eroded the large and easy profits the banks once enjoyed. Borrowers became able to access capital directly in the public

markets, avoiding banks for all but the most minimal lending services.

As a result, borrowers got better rates, less stringent terms, and a broader base of investors for their debt. More importantly, as the middleman was removed from the equation, enormous costs were eliminated and greater efficiencies in the market realized. Indeed, this "disintermediation" helped fuel the economic booms in the '80s and '90s.

For their part, banks responded by increasing the amount they would lend individual companies. As the risk on their balance sheets grew, they took a page from the bond market and began to "syndicate" their corporate loan exposure to other banks. Thus the syndicated loan market was born.

Big money center banks such as J.P. Morgan and Bank of America would put together mega-size loan packages for corporations, organizing syndicates of other banks that would subscribe to a portion of the loan. Syndication would allow the lead bank to lay off most of the risk of the loan. These deals were competitive with what borrowers could get in the bond markets and they allowed banks to hold onto their franchise as a lender to companies. They also spawned an aftermarket in bank loans as investment

banks, insurance companies, and other sophisticated investors began to invest in these loans.

Bank lending basically falls into two categories: investment grade and leveraged loans. Today, both categories are underwritten and broadly syndicated by the largest commercial and investment banks. Both markets deserve some analysis and understanding. Each market is critical to the overall liquidity and viability of US credit markets.

Investment Grade Loans—Banks' Bread-and-Butter Business

Defined as loans or commitments to lend to companies rated "BBB-/Baa3" or better, investment grade loans accounted for almost a trillion dollars in new issue volume in 2003. Investment grade loans are designed as corporate credit facilities that large commercial and investment banks extend to borrowers. These facilities often serve as liquidity facilities for large corporate borrowers to back up their commercial paper programs (corporate-issued short-term debt).

Investment grade loans are typically revolving credit facilities, which means the borrower may "draw" upon the capital only when it is needed. Such "revolvers," as they are familiarly known, function as "corporate credit cards." Because in many cases borrowers do not need or choose to tap into their revolvers, they are required to pay commitment fees on any unused balance.

Commitment fees range from 5 to 25 basis points (or bps, which are hundredths of a percent) per annum. If, however, the borrower opts to draw down funds from his credit facilities, he pays the lender borrowing spreads of 25 to 125 basis points over LIBOR (London Interbank Offered Rate—a key, global interest rate benchmark) on the funded portion.

Investment grade loans are typically low-yielding, and large commercial banks remain the primary underwriters of and investors in these high-grade loans. Banks rationalize their involvement in such low yield business by believing it often leads to other more profitable fee business from their corporate loan clients.

Such activities might include investment banking (e.g., bond underwriting), cash management, and trust services. In essence, the lending relationship serves as a loss leader as it helps facilitate a broader relationship. [Note: Banks do not directly tie the provision of a corporate loan to their explicitly receiving other business from their clients. Such practice is known as "tying," and it is illegal.]

Direct institutional investment in syndicated investment grade loans is limited because of the lack of yield and the potentially unfunded (or "un-drawn") status of many of these loans. However, the introduction of a strategy known as "credit default swaps" has provided institutional investors with a vehicle to participate in the investment grade loan market. (For a discussion of derivative investment products such as credit default swaps, see the September 24, 2004 *Babson Staff Letter*, "Structured Credit Products: Finding New Ways to Spread Risk and Capture Return".)

This emerging derivative market allows the primary lenders to hedge their large corporate loan exposures by, in essence, purchasing default insurance from other banks or institutional investors on individual credits or baskets of loans. The overall underwriting income the big banks receive for a loan commitment, and the fees on the commitment, provide the means for purchasing the credit default protection. This trade is attractive to the institutional investor since the return on the default swap is higher than what they would earn owning the loan outright. It may also be booked at lower capital levels.

Leveraged Loans—Redistributing Risk and Return

Borrowers in the leveraged loan market are comparable to issuers in the high yield bond market: both have below-investment-grade credit profiles, which are a function of their use of leverage (a.k.a. debt) to finance corporate activities. The major underwriters of leveraged loans are, as with the investment grade segment, large commercial banks.

Major investment banks and finance companies also play a significant role in this market. These institutions distribute the risk to both smaller banks and institutional investors through loan syndications. Indeed, the syndicated leveraged loan market has emerged as the primary source of debt capital for leveraged buyouts and other debt-reliant financial transactions.

Because the risk of default on interest and principal payments is higher in the leveraged loan segment of the bank loan market than in the investment grade segment, lenders include a variety of restrictions on and demand a higher rate of return on such loans.

Leveraged loans are floating-rate instruments and are priced at a premium to LIBOR ranging from LIBOR + 125 basis points to LIBOR + 400 basis points or more, as credit quality weakens. These instruments include both revolving credit facilities and fully-funded term loans.

Some term loans may require amortization of principal, whereby the lender reduces his exposure to default by receiving principal payments throughout the duration of the loan. Others are structured similar to bonds, whereby a *de minimus* amount of amortization occurs prior to a balloon payment at the end of the term loan's legal life.

Leveraged loans are governed by credit agreements, enforceable by law, that provide stringent financial and non-financial covenants. Borrowers may be required to maintain certain financial and debt ratios, minimum levels of cash and working capital, and continued employment by key executives.

To protect the lender in case of a borrower's bankruptcy, leveraged loans are typically senior secured instruments that have legal priority over unsecured and subordinated claims. Such security often includes a blanket lien on physical assets and an assignment of subsidiary stock.

Unlike bonds, leveraged loans are typically prepayable at par (little or no call premium or make-whole) at the borrower's option. Leveraged loan issuers will pursue prepayments as a result of generating excess cash flow, seeking improved pricing as market conditions change, or to pursue additional financial transactions (acquisitions, etc.).

Institutional Investors and the Leveraged Loan Market

The growth of institutional investment in the leveraged loan market has been significant. In 1994 institutional investors represented 24% of the new issue market; in 2003 this percentage had grown to 67%. Indeed, activity in the leveraged loan market is mostly driven by the supply of capital coming from institutions. The institutional market includes the following investment vehicles and managers:

Collateralized Loan Obligations (CLOs) are securities backed by actively managed pools of leveraged loans, divided into categories or tranches by credit quality. These structures are typically managed by institutional management firms and insurance companies. Investors in CLOs traditionally have included foreign and domestic insurance companies and banks, but pension funds, large foundations and endowments, and high net worth individuals have recently begun to increase their participation in CLOs.

Mutual or "Prime Rate" Funds, one of the original sources of institutional investment in the leveraged loan market, have experienced significant inflows in the last two years from investors seeking higher yielding floating rate returns. These funds are primarily purchased by individual investors.

Insurance Companies' General Investment Accounts have increasingly invested in leveraged loans as a means of diversifying their fixed income portfolios. Such loans often provide duration shortening, high-yielding assets to counterbalance longer duration, lower-yielding bonds.

High Yield Mutual Funds, like insurance companies, have upped their investments in leveraged loans as a means to lower fixed income portfolio duration, as well as to employ cash. Mutual funds might buy large, highly liquid syndicated loans when inflows are strong and sell them when outflows occur. Because loans typically have less price volatility, such investments provide an efficient method of managing cash.

Hedge Funds, similar to high yield mutual funds, are more recent participants in the leveraged loan market. Hedge funds employ leverage (by themselves borrowing money to invest from commercial and investment banks) to generate attractive absolute returns on portfolios of leveraged loans. In the current low interest rate, low default environment, leveraging long positions in these loans is a popular hedge fund strategy.

Separate Accounts, portfolios established for individual institutional investors such as pension funds, foreign banks, foundations and endowments, typically invest \$100 million or more with a loan manager to create a portfolio structured specifically to meet the investor's needs and risk tolerance. Like other fixed income investors, separate account clients are attracted by the higher-yielding, low duration, floating-rate characteristics of leveraged loans.

About the Author

Thomas M. Finke
Tom is head of Babson Capital Management's U.S. bank loan team and is based in Charlotte, NC.

Putting Leveraged Loans to Work

Leveraged loans finance myriad corporate activities. One important use is for mergers and acquisitions (M&A). Companies readily use leveraged loans, along with other high yield debt, to finance corporate acquisitions. The availability of loans and bonds lowers the overall cost of corporate acquisitions. In a typical acquisition, the loan component of the transaction can be as much as 50% of the capital structure or more.

These loans are also used for leveraged buyouts (LBOs). By the very nature of the transaction, borrowers issue loans and bonds to effect the buyout of equity shareholders. Similar to other M&A transactions, debt improves the cost effectiveness of LBOs and increases the purchasing power of private equity firms.

Leveraged loans help finance capital expenditures as well. Business investment is critical to economic growth. As a result, the availability of loans to finance capital investment is crucial in certain indus-

tries such as automobiles, telecommunications, and energy. The leveraged loan market is an important source of capital for companies looking to purchase equipment, build plants, or generally invest in any business development.

As mentioned above, leveraged loans are typically senior secured in a borrower's capital structure. As a result, the instance of default (versus other speculative grade asset classes) is far less. Also, when leveraged loans actually default, their recoveries are typically much greater than for high yield bonds.

Furthermore, the secured nature of leveraged loans results in far lower price volatility than high yield bonds. In short, leveraged loans deliver competitive total returns versus other asset classes and with lower instance volatility.

Conclusion

The development of the bank loan market parallels the growth and diversification of credit markets. In particular, the ability of large commercial and investment banks to underwrite and syndicate large leveraged loans has transformed the US capital markets. Indeed, the private equity industry would not have developed in the 1990s without the leveraged loan market.

Today bank loans represent an attractive alternative market for many institutional investors. Whether they seek exposure via the investment grade default swap market or directly in the leveraged loan market, bank loans are a legitimate fixed income alternative.

We think Polonius would approve.

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One Memorial Drive, Cambridge, MA 02142 ▪ 1500 Main Street, Springfield, MA 01115 ▪ Tel. (617) 225-3800 ▪ www.babsoncapital.com