Babson Capital Leveraged Finance Market Overview and Commentary

Babson Capital

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U.S. Market Overview, Recap and Key Themes of 4Q08

The U.S. leveraged loan market remained volatile in 4Q08, as economic news and developments continued to weigh on all capital markets. The return on the Credit Suisse Leveraged Loan Index ("CSLLI") in 4Q08 was (22.93)%, which dragged the annual return for 2008 to (28.75)%. The biggest movements came at the beginning of the quarter when the index returned (13.03)% in October, the largest single month loss since the inception of the index. The negative tone continued for the remainder of the quarter as returns for November and December were (7.89%) and (3.78%), respectively.

Through December 2008, new-issue volume was $150.5B, a 71.9% decrease from year-end 2007. Fourth quarter volume was the lowest quarterly volume on record, with only $10.7B in new-issue, an 86.3% decrease from 4Q07.

On a transaction basis, 32 deals were completed in 4Q08, compared to 129 in 4Q07 and 84 in 3Q08. Only 361 new-issue transactions were completed in 2008. That is the lowest level in the history of the U.S. leveraged loan market. The previous low was 430 in 1997, the first year S&P tracked the market.

As the market pulled back and secondary prices declined, yields on bank loans widened to unprecedented levels. With LIBOR at 1.83%, the spread on the CSLLI at 270 bps, and the market-weighted price on the CSLLI at 68.25, the market's 3-year and 4-year yield to maturities[1] were 26.53% and 21.32%, respectively.

From a structural perspective, the market began taking a more conservative approach in 2008. At December 31, 2008, senior leverage for loans stood at 3.0x, with total leverage at 3.6x. At 2007 year-end, senior leverage and total leverage stood at 4.4x and 4.5x, respectively.

As anticipated, 2008 brought with it the first annual increase in defaults since 2005. The trailing 12 month default rate by number of issuers and outstanding principal ended the year at 4.35% and 3.75%, respectively. In 4Q08, 13 companies tracked by the CSLLI either committed payment default or entered bankruptcy. Most notably, Tribune, which had outstanding $7.6B in loans and $1.2B in bonds, defaulted on December 8, accounting for 31.5% of 2008's total default volume by principal amount outstanding. The energy, media and telecom, and consumer non-durable industries were all hit hard with defaults in 4Q08. These three industries experienced 9 of the 13 defaults in the period. In all, 2008 has 51 total defaults on $24.0B in principal outstanding.

There was $5.7B of BWIC activity in the quarter, with $3.3B coming in October alone. Although BWIC volume tapered off as the quarter progressed, the high volume at the beginning of the quarter was enough to keep pressure on prices throughout the remainder of the quarter.

As the market enters 2009, credit fundamentals are expected to replace market technicals as the center of attention, as most forced selling pressure appears to have passed. We expect to continue to see increasing defaults, amendments and credit downgrades for the remainder of the year and into 2010.

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Middle Market

The Middle Market loan space was not immune from the effects of the global credit crisis. Total middle market loan volume was down over 70% in 2008 , from $28.7B in 2007 to $8B in 2008. By year end 2008 Babson Capital believes new issue middle market spreads were in the L +500-750 range (regional/local bank deals at the lower end of the range and institutional deals at the upper end of the range) with 2-4% OID. Leverage multiples for first lien debt were 3.2x in 2008 compared to 3.7x in 2007.

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Note: Market data cited above from Credit Suisse Leveraged Loan Index or S&P
[1] YTM = (LIBOR + SPREAD +((PAR / MARKET)^(1/N)-1)) / MARKET
Source for volume and leverage is S&P
Source of Middle Market Loan Data is Babson Capital Management
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