Payden&Rygel
Research

A Primer on Syndicated Term Loans

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Limited prospects for economic growth, high unemployment rates and low interest rates in the developed world seem to offer little for the yield starved investor. And despite central bank pledges to keep interest rates low for the foreseeable future, many investors fear a sharp rise in rates due to inflationary winds or fiscal woes.

Despite these challenges, opportunities remain. In the "hunt for yield", finding income opportunities means considering lesser known market sectors. For this reason, we provide a primer on a thriving asset class: syndicated term loans. As an alternative to the more familiar fixed-rate high yield bond sector, syndicated term loans offer investors an opportunity to simultaneously purchase higher credit quality, hedge against rising interest rates, and maintain a diversified portfolio.

What are Syndicated Term Loans?

Simply put, a syndicated term loan is a private debt obligation negotiated between lenders and corporate borrowers. These corporations (usually rated below investment grade) strategically issue syndicated term loans as a "less expensive and more efficient" means of funding business operations. [1]

For the purposes of this primer, our focus will be on the Syndicated Term Loan B market, the market in which institutional investors primarily operate.

Unlike a traditional line of credit, borrowing corporations depend on a group of lenders to provide a syndicated term loan. With multiple investors involved the issuer hires an investment or commercial bank to structure the loan. In turn, the bank, or the arranger, canvasses the market for potential investors. By conducting surveys, distributing company specific informational documents, and speaking with investors, the arranger and issuer gather feedback on market demand—both in terms of price and quantity. With sufficient information gathered the deal is then syndicated out to investors and subsequently trades in the secondary market.

The borrowers tend to be the same companies that issue high-yield bonds, which is why these instruments are often referred to as "high yield loans." In the same vein, syndicated loans are also called "leveraged loans" due to the leveraged nature of a typical borrower's balance sheet.

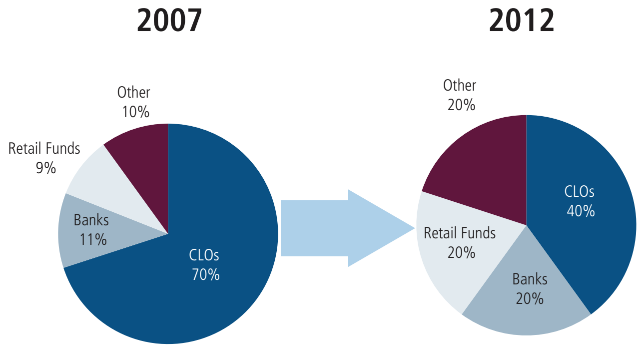
Who Invests In Syndicated Term Loans?

Typical investors in syndicated loans consist of banks, finance companies and institutional investors. The largest institutional investors in the loan market are structured vehicles known as collateralized loan obligations (CLO), but their dominance has declined since the financial crisis of 2008.

CLOs are special-purpose vehicles set up to hold and manage pools of leveraged loans. CLOs were the dominant investors in the syndicated loan market prior to the financial crisis of 2008. They comprised roughly 70% of all primary loan market activity going into

[1]"A Syndicated Loan Primer." Standard and Poor's (Sept. 2006), pg. 7

2007, but today make up approximately 40% of the market.



With the once robust demand from CLOs all but non-existent during and immediately after the crisis, the loan new issuance market came to a halt. CLO structures, however, performed well during the crash. As the market continues to evolve, the new issue market for syndicated loans has resumed its pre-boom (2005-2007) strength, and the CLO machine has picked up again in 2012.

The other large institutional investors in this market are "prime rate funds." These funds gained their name because they were originally sold to investors as an equivalent to money-market funds that would approximate the prime rate. Also, hedge funds, high-yield bond funds, pension funds, insurance companies, maintain strategic allocations to the syndicated loan market.

Credit Quality: Capital Structure and Covenants

With their senior status in the capital structure and more exacting financial covenants, syndicated loans offer stronger credit quality relative to high-yield bonds.

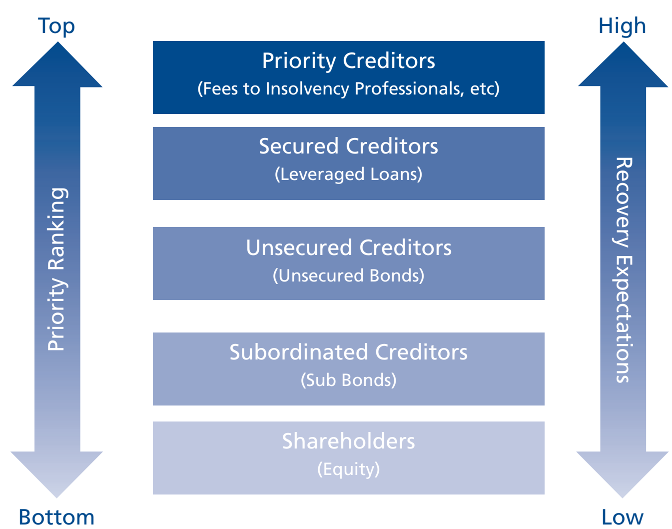
I. Seniority in Capital Structure

Because issuers of syndicated term loans often tend to be the same cohort that issues high yield bonds, specifying the differences between the two asset classes is important. While non-investment grade companies (i.e. firms rated double-B-plus and below) issue both bonds and loans, they differ in terms of structure, investor protections and recovery in the event of default.

In the capital structure of a borrowing corporation, position matters for investors. If a company files for bankruptcy, senior creditors of the company must be repaid first. Even as debt obligations are senior to equity, loans are usually superior still to bonds.

Loans offer investors a more senior position in the capital structure because they are secured. That is, the borrowing company offers tangible assets (property, plant, and equipment) as collateral to secure the loan. Because the syndicated loans are secured with a first-lien on the assets of the borrowing company, investors are better positioned to recover principal in a credit event.

Typical High Yield Capital Structure



In the case of an issuer default, the secured nature of the loan offers investors a natural floor. From 1989 to 2009, when a company defaulted and entered bankruptcy, secured lenders boasted a higher recovery rate—71% compared to unsecured lenders who recovered an average of 43.5% over the same period.[2] In the past 2 years, leveraged loan default rates averaged below 2%. [3]

See the example using HCA, the largest hospital operator in the U.S.:

[2] Barclay's Global Research and Investments. "Compass" (July 2012), pg. 18

[3] S&P Capital IQ.

as of 12/31/2012	HCA Secured Term Loan B	HCA Sr Unsecured Bond
Rating	BB, Ba3	B-, B3
Size	$2.4 billion	$500 million
Expected Recovery	80%	40%
Coupon	Libor + 325 = 3.55%	8.00%
Final Maturity	5/1/18	10/1/18
Price	$100.5	$115.75
Yield	3.45%	4.81%

II. Covenants

Senior status in the capital structure is not the only credit advantage syndicated loans offer relative to high-yield bonds. Because of the higher risk of default on the loans they make to non-investment grade rated companies, underwriters of leveraged loans include a series of standard covenants that dictate how borrowers can operate and finance themselves. These covenants differ from those associated with high-yield bond issues as they must be met not only upon issuance, but typically quarterly.

Credit agreements for a leveraged loan include several covenants which become part of the legally binding loan contract into which the borrower and lender enter. The extent and stringency of the covenant package vary depending on the borrowing company's financial risk.

Amidst the variety of syndicated loan covenants, nearly all stipulate particular ratios that must be met by the corporate issuer. For example, commonly used loan covenants require the borrowing company to:

- Maintain a minimum level of cash flow or EBITDA (earnings before interest, taxes, depreciation, and amortization), relative to specified expenses such as interest, debt service, or fixed charges
- Maintain a maximum level of debt relative to either equity or cash flow (total debt-to-EBITDA is most common)
- Maintain a minimum ratio of current assets to current liabilities (current ratio)
- Limit capital expenditures to a certain amount

Covenants such as these are known as "maintenance covenants." They allow the lender to ensure (on a quarterly basis) that the corporate borrower "maintains" these critical measures of financial health. A failure to meet the requirements of maintenance covenants results in a technical default.

The quarterly measurement of maintenance covenants on syndicated loans is yet another distinguishing feature compared to high-yield bonds. Bond covenants are usually "incurrence" covenants which prohibit borrowers from incurring additional amounts of debt or making restricted payments to the detriment of bondholders. However, the bond issuer must comply with incurrence covenants every time they incur additional debt.

For example, an incurrence covenant typical in a bond indenture might state that a borrower would violate an incurrence test if the company actively added debt that caused it to exceed a certain leverage ratio (debt/EBITDA), but not if EBITDA declined and caused the company's leverage to increase.

Syndicated loan covenants offer improved credit quality because they must be maintained. Not only do such regular check-ups prevent borrowers from irresponsibly adding leverage via incurrence of new debt, but such covenants also protect lenders against operational deterioration. This dual protection provides leveraged loan investors with considerably stronger credit quality, relative to high-yield bond investors.

Payden's View on Syndicated Loans

Term loans are an appropriate fit for a portfolio looking to hedge against rising interest rates. Due to their floating-rate feature, leveraged loans limit interest-rate risk and also exhibit a low correlation to most asset classes, including a negative correlation to treasuries (-0.39 correlation to the 10-year Treasury over the last 15 years)[4]. Compared to other fixed-

[4]Zhang, Jingjing."The Impact of Changes in Competition in the Syndicated Loan Market on Financial Covenant Use" (January 2011), pg. 9.

income asset classes (high yield bonds, corporate bonds, Treasuries, etc.), which pay a fixed rate of interest, the floating feature of term loans creates opportunities to mitigate interest rate risk within the fixed-income investment space. This feature makes loans an appealing investment option with Treasury rates still languishing near historic lows.

On top of being an attractive interest rate hedge, we also view this as an attractive alternative to investment grade debt products. With default risk low and yields near 4%, leveraged loans provide a significant yield pick up over investment grade corporates with a natural floor in the event of credit volatility due to the secured nature of asset class. On the other hand, it is important to note that the issuers of term loans are leveraged companies and are generally more susceptible to swings in the business cycle than a typical investment-grade-rated company. Although they are far less sensitive to movements in interest rates, syndicated loan issues may be very sensitive to changes in the financial health of the borrowing company.

As noted earlier, term loans are generally secured by the borrowing company's physical assets (property, plant, and equipment) and almost always have first-lien priority in the event of default. This is why historically term loans display higher recovery rates and less volatility than their high yield bond brethren. However, investors who are comfortable with the economy and the health of corporate America are likely better served buying bonds over loans due to the yield pickup. If a lender perceives little default risk in a corporate issuer, the incremental yield from the unsecured instrument (e.g. the high yield bond) may better fit an investor's risk/return profile. Unless there is a default, the first-lien priority of a loan investor is moot.

as of 12/31/2012	Barclay's BB Loan Index	Merrill Lynch BB Bond Index
Avg. Yield to Maturity	4.53%	5.12%
Avg. Price	100.45	107.52
Avg. Coupon	Libor + 425 (4.55%)	6.87%
2012 Return	7.3%	14.0%

Conclusion

With over $500 billion outstanding, syndicated term loans are a major component of U.S. capital markets. As an alternative to traditional fixed-rate high yield bonds, this asset class acts as a bridge between private and public debt markets. In occupying this role, syndicated term loan financing has broadened access to capital markets for many corporations around the world.

Particularly in the past decade, exponential growth in the secondary (trading) market changed how institutional investors view and interact with the asset class. This market both enables underwriters to manage their loan portfolios and fosters emergence of specialized investors and traders.

As investors around the world sift through capital markets, the syndicated term loan market has attracted attention. Syndicated loans have proven to be an appealing asset class with low correlations to other assets, low volatility of returns and an attractive risk/return profile compared to many other traditional fixed income investment categories.