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Cyrille Conseil and Axel Potthof Discuss Opportunities in the Global Bank Loan Market



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Mr. Conseil is an Executive Vice President and portfolio manager. He manages PIMCO's US dollar bank loan exposure representing in excess of \$5 billion under management. He joined PIMCO in 1998 as a senior member of the credit research team, previously having worked in the High-Yield Group at Moody's Investors Service. Mr. Conseil has over fifteen years of investment experience and holds a bachelors degree in economics with a concentration in finance from The Wharton School of the University of Pennsylvania, and an MBA in finance/international business from Columbia University Graduate School of Business.



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Dr. Potthof is a Senior Vice President and a portfolio manager for PIMCO Fixed Income Portfolio Management in Munich. He is a member of PIMCO's Global High Yield team where he is responsible for European High Yield and Bank Loan portfolios. Dr. Potthof joined the group in 1998, previously working as an assistant researcher at the University of Hagen and for Deutsche Bank AG. He published several fixed income articles and contributed a paper on Fundamental Credit Research to a Handbook of Portfolio Management. Dr. Potthof has fifteen years of experience, holds a Master's degree in Business Administration from the University of Mannheim, Germany, and a Ph.D. (summa cum laude) from the University of Hagen, Germany.

Cyrille Conseil and Axel Potthof manage PIMCO's exposure to the U.S. and European bank loan market. In the interview below, Mr. Conseil and Mr. Potthof explain where bank loans fit within the overall corporate debt market and discuss PIMCO's global outlook and strategy in the sector.

Q: Could you give us a brief overview of the U.S. and European bank loan market? What types of borrowers tap the bank loan market and what types of investors purchase bank loans?

Conseil: The bank loan market – or “leveraged loan” market as it is sometimes known – is comprised of debt from companies with below-investment-grade credit ratings. Bank loans are typically secured with a lien on the company's assets. They also rank senior to the company's other debt and therefore generally offer higher credit ratings, or less risk and more collateral backing, than high yield bonds. Companies tap this market predominantly to fund leveraged buyouts.

Until early this summer, demand for bank loans had been exploding, driven mainly by the underwriting and investment in collateralized loan obligations (CLOs). These structures generally aggregate bank loans, slice the group of loans up into various tranches ranging from high credit quality to low credit quality, and then sell them to investors. The higher-rated tranches are entitled to the least risk in the event of defaults or multiple defaults, while the

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lower-rated tranches have the most risk. Over 60% of the demand for bank loans has traditionally stemmed from CLOs and similar structures.

Potthof: The situation is very similar in Europe where CLOs and other structures also generate a lot of demand. This institutional investor base is, however, still smaller in Europe than in the U.S. Banks still command a large share in this market of up to 50%. A third group of investors is hedge funds and real money investors. We at PIMCO, for example, consider bank loans an attractive potential addition to our total return and high yield portfolios, and we also have dedicated bank loan portfolios.

Q: How has the bank loan market been affected by recent credit market turmoil?

Conseil: The bank loan market was overpriced heading into the credit crisis because the growth of the CLO market created a technically-driven source of demand for these assets, often without regard for fundamentals or spread levels. With this backdrop, we saw the balance of power swing to the advantage of borrowers – mostly private equity firms that were seeking financing to buy companies. During this period of heavy demand, risk spreads on bank loans grew tighter and tighter. For example, a U.S. deal would start at a spread of 225 basis points over LIBOR, but by the time the deal actually priced, strong demand would drive the spread lower and the borrowers could get even better terms.

Potthof: The situation was slightly different in Europe, where spreads remained a bit wider. Here, a typical deal would start at around 250 basis points over LIBOR and eventually price at 225 to 237.5 over LIBOR. The other phenomenon we observed during this period of overheating was that heavy demand led buyers to accept weaker safety provisions known as covenant protection, giving rise to the “covenant lite” phenomenon. Although still senior and secured, loan packages often did not have basic, traditional maintenance provisions. “Covenant lite” reached Europe later in the market cycle, so we have very few of these bank loans outstanding here.

In the summer of 2007, the machine came to a screeching halt when concerns about subprime mortgage loans had a contagion effect on all structured products, including CLOs. Bank loan aggregators that were looking to sell structured products realized there was little demand, so they stopped buying loans; in fact, many became sellers of these types of loans. At the same time, fast money buyers such as hedge funds and others started getting margin calls and began selling CLOs and other structured products at a discount in the market. On the supply side, U.S. banks had committed to financing a huge pipeline of leveraged buyouts – something like \$200 billion worth - but had not yet sold the loans into the marketplace. So demand was seriously impaired and there was a big overhang of supply, which has led to a repricing of bank loans and the high yield bond market. The supply overhang is smaller in Europe, both on an absolute and a relative basis, with a pipeline of €50-60 billion, so the effects are a bit less pronounced.

Q: Why did the concerns about subprime mortgages have an effect on the market for bank loans? What is the connection?

Conseil: The linkage is that buyers of collateralized debt obligations (CDOs) backed by subprime mortgages are often the same investors who tend to own CLOs backed by bank

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loans. Rising concerns about subprime led to significant losses in the lower-rated tranches of structured products with subprime exposure, leading many of these investors to demand higher risk premiums on all structured products or to exit the market for structured products altogether. All of a sudden, bank loan deals in the pipeline could not get priced or cleared and some banks chose to unwind or freeze the structures. The overall effect was that a lot of CDOs and loans were being sold in the market.

Q: If the volatility in bank loans has been driven mostly by technical supply and demand factors, how are the fundamental underpinnings of the market holding up?

Conseil: Despite all of the technical supply and demand issues that severely impacted the markets, the fundamentals underlying the U.S. and European bank loan markets are still healthy. We do not believe that a prolonged period of economic weakness is likely, and so we don't expect significant pressure on borrowers' ability to service their debt. Defaults on bank loans are still historically low, both in the U.S. and Europe, at less than 1%. We certainly see default rates increasing, mainly because the current default rate is so low that it can only go higher. But fundamentals continue to provide a sound backdrop for this market.

Q: If the bank loan market has solid fundamentals, does PIMCO see the recent sell off as an opportunity to invest at more attractive prices?

Potthof: Yes, we see some potentially significant opportunities in the bank loan market, particularly in well-secured first-lien loans where historical recovery rates have hovered above 80% in the U.S. In Europe, the recovery rate is closer to 70% because European law doesn't include a provision like Chapter 11 in the U.S., where a company can continue doing business under protection from lenders. If a European company files for bankruptcy, the next step is usually liquidation, which reduces the value that lenders receive. Even in an environment of increasing defaults, we think recovery rates will remain high in the U.S. and in Europe.

With the U.S. housing market in recession, we certainly expect some slowdown in the U.S. economy. That will threaten some sectors of the market, such as homebuilders or retailers that are particularly susceptible to slower consumer spending. The European economy has a relatively low direct exposure to the U.S. housing market, and is more dependent on other European countries and Asia. Unless the entire global economy was seriously affected, any U.S. slowdown should therefore have limited impact on the European economy, and we expect European companies to continue generating stable earnings and cash flow.

Conseil: But we do not believe the U.S. is heading for a crash that would cause default rates to rise to an unmanageable level. And companies often remain current on bank loan interest payments even in the event of a default on their high yield bonds. If a company declares bankruptcy, bank debt recovery rates typically stay very high because bank debt is at the top of the capital structure and collateral asset coverage should cover a substantial portion of the debt. So the risk/reward tradeoff at current levels is pretty attractive given this fundamental outlook.

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Q: In the wake of the supply and demand shock that we've seen over the summer, where do you expect potential opportunities to be most pronounced for investors?

Potthof: We think one of the best ways to take advantage of current bank market is to participate in the pipeline of upcoming loans. These loans are likely to come at attractive prices even compared to where the secondary market is trading. At some point, banks will need to push these deals out the door to shed the concentrated risk. So the issue is the price at which banks are willing to unload these loans.

Conseil: Since most of these deals are already underwritten, the money is fully committed and all the terms are negotiated. The question is whether the borrowers will get the money from the bank or from investors. So the mechanism banks have to improve the attractiveness of the loan is to discount the price out of their pocket. Different banks have thresholds of pain that they are willing to bear, and so negotiation is a big factor when we are looking at these deals in the market right now. The borrower gets 100 cents on the dollar at whatever spread was previously negotiated, but that spread might not be sufficient for the investor since the environment has changed, and the bank will have to suffer that loss. Typically these days, we're looking at discounts in the ballpark of four percentage points – around 96% of par – and that comes out of the bank's profit.

Potthof: The smaller supply overhang in Europe, which I mentioned earlier, reduces the pressure to provide discounts somewhat. Still, some large transactions will have to be brought to the market in the coming weeks and months, and there we do expect to see some discounts from the banks. Participating in the primary market is only one way of taking advantage of the overhang. We also see opportunities in the European secondary market as loans have become cheaper. Bank loans used to trade above par before the market crisis and stand now around 97% to 98% of par.

Q: Are there distinctions between bank loans and high yield bonds that make one more attractive than the other in the current environment?

Potthof: High yield bonds in the U.S. are suffering from the same pipeline problems that are affecting bank loans, because these mega-transactions often have a very significant bond component as well. In Europe, only a few high yield issues are expected over the next months. However, an increase in supply in the high yield market is possible, as the problems in the loan market lead issuers to restructure the loan deals to create the above mentioned bond component.

Conseil: People are wondering if there is a price at which these bonds can actually clear. And there is a distinct cause and effect here: to figure out the prices at which high yield bonds should be clearing, the high yield bond investor has to watch further upstream in the capital structure to see where the bank loans are clearing. So there is a massive overhang in the high yield market because a lot of existing bonds have to be repriced.

The credit market is like a food chain. Bank loans are at the top of the food chain, so at whatever spread the bank loans end up pricing, the bonds will be priced accordingly with some sort of additional spread. And the attractiveness of bank loans relative to bonds within a company's capital structure will depend on those spreads. This natural relationship has to exist.

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In times when there is irrational exuberance, the spread on bonds relative to bank debt tends to shrink, but in times when people have less of a risk appetite, the spread between bank loans and bonds has to widen considerably.

Q: What are the investment implications of PIMCO's outlook for bank loans?

Conseil: Bank loans in the U.S. secondary market have become cheaper like in Europe and are trading around 95% to 97% of par today, down from a peak of about 101% at the height of the market. From a price perspective, we are now significantly below par and from a yield spread perspective, spreads have widened significantly – between 75 and 100 basis points on average. “Covenant lite” issuers have been hurt the most, while larger, more liquid transactions have been more volatile because they are the easiest to sell.

In the current environment, targeting certain areas of opportunity is more important than targeting specific sectors. We think the biggest opportunity right now is clearly this upcoming pipeline of deals, where we believe we will get very attractive pricing because of the big supply overhang and the demand shortage. But the opportunities will be very deal-specific. In U.S. and European pipelines, there are a range of issuers and credits that will be coming, so our focus will be on the individual credits – the quality of the business, the types of assets and the collateral coverage.

Potthof: Some of these transactions tend to be more cash-flow oriented, which means there would be no hard assets to sell in a liquidation scenario. So it is hard to say that we will focus on any particular sector in the U.S., because at the end of the day, we will have to pick and choose from what is offered. In Europe, for example, we typically prefer non-cyclical sectors with less exposure to economic swings, such as telecom. But in general, we will be focusing on issuers with a lot of hard assets, stable cash flows and the ability to withstand slower growth. And our credit team will certainly look at the entire capital structure to determine whether the compensation is adequate for owning different parts of the capital structure.

Some things will have to be closely watched. For example, the transactions coming in the loan market are pretty sizeable, and therefore the leverage due to bank debt tends to be pretty high compared to traditional norms. In the traditional U.S. market, bank debt was levered, meaning the ratio of senior bank debt to cash flow was perhaps 2.5-3x on average. More recently, that ratio has crept up to about 4x, and for some of these transactions that we've been hearing about, it is creeping up even further. Leverage used to be lower in Europe but it has caught up with the U.S. over the last two years and stands now at similar levels.

Conseil: Of course, some of these companies in the pipeline are faster growing, more stable or have bigger multiple valuations that justify a bigger leverage ratio. The point is that because there is more bank debt ahead of the bonds in more of these transactions, we have to make a decision on the bond side and on the bank debt side about whether we are being adequately compensated. But that is part and parcel of looking at the entire capital structure – the business, the covenant protections; things of that nature all determine the relative attractiveness of the loan.

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Q: Thank you, Axel and Cyrille.

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