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Bullish on loans

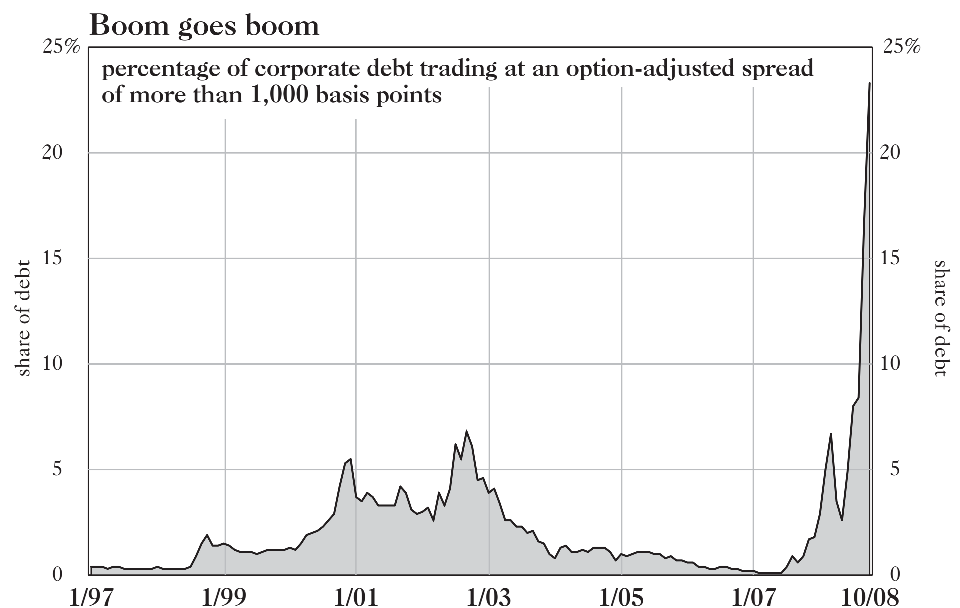
The opportunity cost of safety is making daily new highs. Gold yields nothing, Treasury bills only slightly more. All the while, promised returns are climbing on investment-grade corporate debt, junk bonds and tradable bank loans—not to mention residential mortgage-backed securities, which this publication frequently mentions. The question before the house is whether the promises are any good. More than a few will prove to be, we judge. Tradable secured bank debt looks especially promising.

On the eve of the 1929 Crash, Benjamin Graham, an up-and-coming value investor, and Bernard M. Baruch, the white-haired Wall Street eminence, were clucking over the excesses of the Coolidge bull market. Graham, observing that people were borrowing call money at 8% in order to speculate in stocks yielding 2%, predicted that, before the cycle was over, the same people would be passing up the opportunity to borrow at 2% in order to invest in stocks yielding 8%. He was a prophet.

So, too, in 21st-century credit. The same investors who could not take down enough leveraged loans, junk bonds and residential mortgage-backed securities at tiny spreads over the cost of financing now stand back in horror. They will have no part of the same loans or securities yielding, in some cases, 10 percentage points more than they did in 2006 and 2007. "Corporate bond markets are priced for the worst default climate since the Great Depression," M. Christopher Garman reports in the October 3 issue of *Leverage World*. "On both a number-of-issues and a volume basis, near 16% of all corporate bonds are trading at distressed levels of 1,000 basis points or more. This sums up nearly $327 billion of speculative grade bonds alongside $187 billion of investment grade securities trading at these very-noninvestment-grade levels." If distressed issues default at the customary rate of 23.5%, Garman goes on, the implication of a 16% distressed rate is that more than 5% of the corporate bond market will default. Four percent defaulted in the 2002 downdraft, but you have to go back to the early 1930s to find a 5%-plus casualty rate.

For ourselves, we take this embedded forecast with a grain of salt. In general, the credit markets discount nothing; rather, they exaggerate. Well do we remember the prophesies of hyperinflation that were implicit in the Treasury yields of the early 1980s. What is the message of a 15% long government bond? the world wanted to know. The then-Treasury secretary, Donald T. Regan, correctly replied that the message was that bond traders didn't know what they were talking about.

Ignorance is rampant today because the market, or broad segments of it, defies understanding. There was confidence enough in the intricacies of financial engineering when the typical asset-backed structure fetched par. Panic set in at around 50, however, and paralysis hardened at 30. Today, the chastened fiduciaries would sincerely like to understand what they invested in, but the experience of losing large sums of money has impaired their capacity for concentrated study. "No one knows who owes this money," Eric R. Dinallo, the New York state insurance superintendent, was quoted as saying in Saturday's *New York Times* about the settling up of Lehman-related credit default swaps, "how

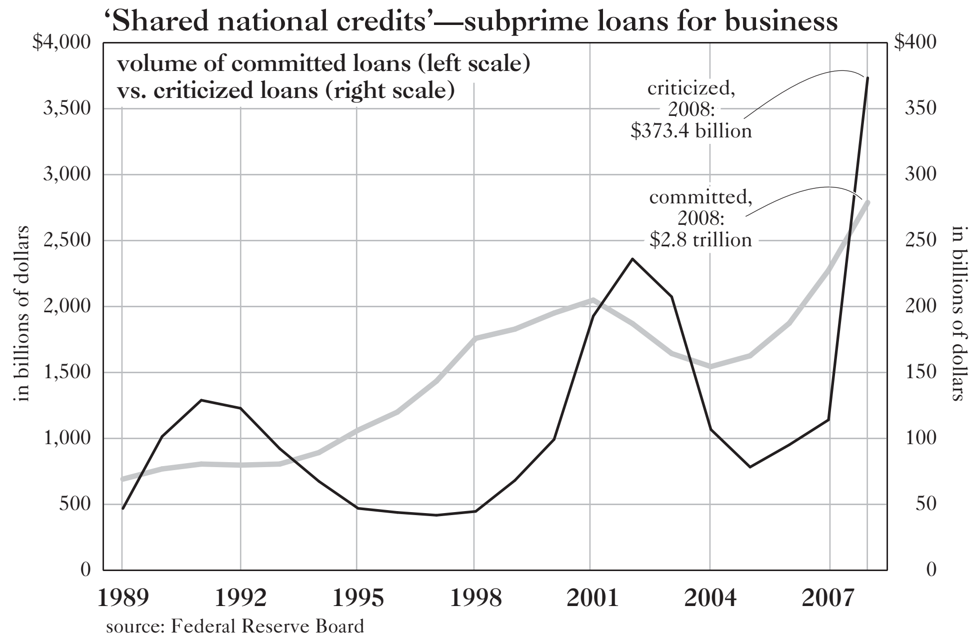


much each counterparty owes, or whether any of these counterparties will now be in trouble themselves, with further potential problems for the financial markets."

These days, impossible things seem to happen all the time. Martin Fridson, scholar, author and money manager, relates that the minus 8.3% return recorded by junk bonds in September was 4.55 standard deviations below the historical mean of 0.65%. "Based on the standard deviation of 1.97%," Fridson relates in the same issue of *Leverage World* in which Garman holds forth, "statistical theory predicts that a return of minus 8.3% or lower will occur only once in every 27,777.8 years. In this instance, however, theory must give way to reality."

It does not promote airy confidence in the future that so many black swans are traipsing around Wall Street at the same time. Possibly, as Fridson suggests, the markets just aren't deep enough. Or, as we suspect, the people aren't. Whatever the source of these persistent affronts to statistical law, a wrenching adjustment is under way. The days do run together, and it is easy to forget (though Fridson has not forgotten) that in the ninth month of 2008 occurred the biggest American bank failure (Wamu), the collapse of the stand-alone broker-dealer business model, the bankruptcy of Lehman Brothers, the virtual nationalization of Fannie Mae and Freddie Mac, the quasi-virtual nationalization of AIG, the enactment of the Paulson Plan to spend up to $700 billion on orphaned assets and/or on the institutions that propagated them, and, on the next to the last day of the month that wouldn't seem to end, the biggest absolute point drop in the Dow Jones Industrial Average (followed within weeks by the biggest absolute point advance in the Dow Jones Industrial Average).

Paper money is faith-based, says *Grant's*. Then how much more so is credit, which is the promise to pay paper money? Today, most financial promises trade at a discount to par, many deservedly so, some not. How to distinguish one from the other? Security analysis provides only part of the answer, for the sheep of one macroeconomic setting are the goats of another. Low-yielding Treasurys are the perfect fit for a global debt deflation, but not for a new inflation.



source: Federal Reserve Board

Moderate leverage is harmless enough in a boom, but look out in a bust. Value investors, your editor included, put small stock in economic forecasting. No one can predict the future, we say. Yet it's the nature of tomorrow's macroeconomy that will finally determine the viability of the non-Treasury wing of the American debt markets.

It's sobering to reflect that our financial rivets were popping while nominal GDP was still strongly on the upswing; in the 12 months to June, it rose by 4.1%. Would-be buyers of distressed debt securities might pause to reflect how few of America's banks, corporations or households could make ends meet if growth—nominal growth, never mind the inflation-adjusted kind—stopped or contracted. This country is capitalized for prosperity, not recession, and emphatically not for Great Depression II, about which there is so much breezy talk. Top to bottom, 1929-33, America's nominal GDP fell by 46%. The wonder is that any bank stayed open, though most did. The commercial bank census of 1934 counted 15,348 living and breathing institutions, compared to 24,970 in 1929. "The worst financial crisis since the Great Depression" has ripened in a time of moderate growth in the top line of the U.S. economy.

A just-published report by the four federal banking regulators on the quality of lending in 2007 may put a fright into any who had managed to stay calm. The subject of the report is syndicated loans, a.k.a. "shared national credits," defined as loans of $20 million or more held by three or more federally supervised institutions. The report finds that 13.4% of the $2.8 trillion of such credits incurred the criticism of federal bank examiners. "Criticized" credits are the sum total of loans marked (in ascending order of distress) "substandard," "doubtful" and "loss," as well as those found to be shaky enough to warrant concern for the future; this category is called "special mention." The report finds that, out of the $2.8 trillion SNC universe at year-end 2007, $154.9 billion was substandard, $5.5 billion was doubtful, $2.6 billion was loss—and $210.4 billion rated special mention. The grand total of criticized credits was $373.4 billion, up by 227% from the prior year.

"Examiners continued to identify an inordinate volume of syndicated loans with structurally weak underwriting characteristics, particularly for credits supporting M&A transactions of highly leveraged companies," the report says. "Nearly all these credits were underwritten prior to the disruptions in the credit market in mid 2007." Boom-time lending practices were the source of the weakness, the report singling out "liberal repayment terms, repayment dependent on refinancing or recapitalization, and nonexistent or weak loan covenants." It seems that 2007 was almost as poor a vintage in corporate lending as it was in mortgage lending. "In fact," the report adds, "56% of the 2007 vintage credits included in this

year's underwriting review were criticized [as] special mention or substandard compared with 21% last year. In addition, most of the 2006 vintage credits that were analyzed during the 2007 SNC review remain outstanding, and the criticized percentage of those credits has increased to 33%."

So much for the view from 10,000 feet. On the ground, things can seem a great deal worse and/or a great deal better. Barring a depression, we judge, opportunities abound in senior secured loans to—of all things—leveraged businesses. At this writing, loans are priced at 75 cents to 78 cents on the dollar. Compare, urges Craig Russ, vice president and portfolio manager at Eaton Vance, Boston, the "intrinsic recovery of a defaulted bank loan"; it is, or has ranged to, 70 cents to 80 cents on the dollar. "So prices are suggesting that 100% of the market could default, and your recovery should equal where it is trading today," says Russ. "The worst default rate recorded in the asset class was about 8% in 2001 and 2002."

So acute was the panic last week that loans yielded more than junk bonds. On Thursday, the average discounted spread of the S&P/LSTA index was Libor plus 1,262 basis points (assuming a four-year repayment). That was 68 basis points higher than the average high-yield, option-adjusted spread of Libor plus 1,194. Senior to bonds, loans, by rights, trade richer than bonds, and they did so in the brutal credit bear market of 2001-02. Not lately, though. Practitioners could hardly believe their eyes.

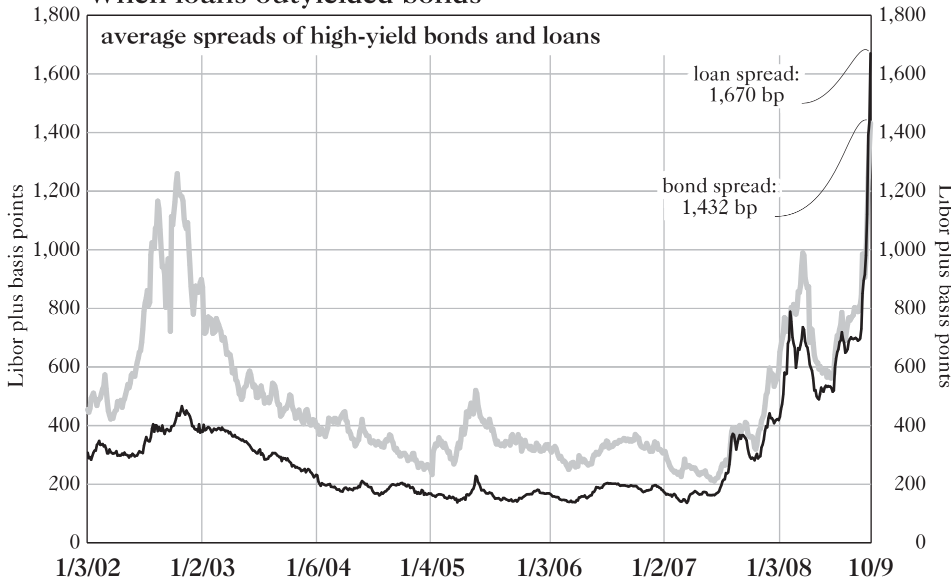
"There are different parts of the loan market, and everything is down huge," Michael Lewitt, president of Harch Capital Management, Boca Raton, says. "And everything is not created equal. The area that's worth looking at is large-cap, non-LBO loans that are still capable of amortizing their debt." Lewitt has some suggestions.

Exhibit "A" is double-B-rated Manitowoc Co., maker of cranes, food-service equipment and marine equipment. It was founded in 1902 in the Wisconsin town of the same name. It had not occurred to Manitowoc's management last spring that the "Great Moderation," as the chairman of the Federal Reserve Board and others were pleased to style the era of low volatility and ultra-high leverage, was ending. So, unsuspecting, the company bought Enodis, a London-listed manufacturer of food-service equipment, for $2.7 billion. To pay for its prize and then some, Manitowoc raised $2.925 billion from a syndicate of institutional lenders, who priced the $1.325 billion term-loan portion of the credit at 98. At an initial interest rate of Libor plus 350 basis points, the indicated yield over a four-year holding period was 6.5%.

Before taking the plunge, Manitowoc was conservatively financed and highly profitable. Its EBITDA in 2007 totaled $587 million (that's earnings before interest, taxes, depreciation and amortization). Its ratio of debt to assets was 7.3%, its three-year average return on assets, 8.7%. Post-acquisition, the debt-to-assets ratio climbed to 52.5%. Annual interest expense at the combined company will amount to $233 million at a Libor rate of 4.6%. By the look of things—necessarily, a backwards look—the new Manitowoc will generate 3½ times more EBITDA than it will pay in interest expense.

Before credit crashed, such a coverage ratio seemed ample. A no more than ordinarily rapacious investment banker might have judged it excessive. But there was a crash, and the Manitowoc term loan is quoted today at 80, down from the 98 offering price, to yield Libor plus 850 basis points, assuming that same four-year holding period. Call its yield 13%.

Exhibit "B" is Flowserve, a top global manufacturer of pumps, valves and seals. It is very profitable and lightly leveraged. Double-B-rated, its debts constitute just 15.1% of its assets. Over the past 12 months, EBITDA of $597 million covered interest expense of $56 million by a factor of 10. Yet a $600 million Flowserve term loan of August 2012 is offered at 90 for an indicated yield (assuming a three-year life) of Libor plus 500; call it 9.5%. To be sure, neither Manitowoc nor Flowserve is to be confused with the U.S. Treasury. Each is vulnerable to worldwide recession, or worse. Yet each seems capable of paying its creditors a rate of interest that may well move higher if the governments of the G-20 print as much money as they are talking about.



source: Standard & Poor's LCD

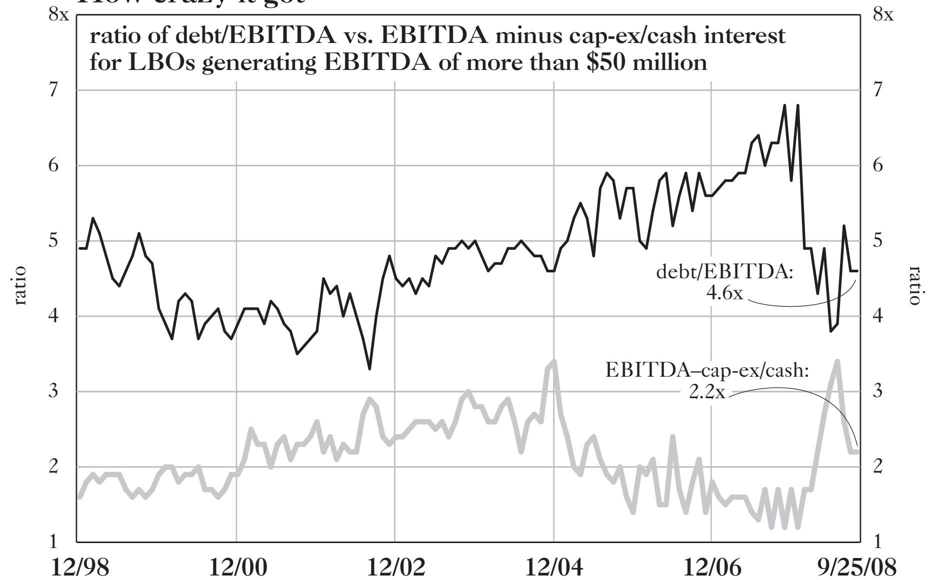
Nothing that's happened in the stock market is more shocking than the collapse of the leveraged loan market (as the over-the-counter market in tradable senior bank debt of mainly speculative-grade companies is called). Stability was its calling card. With its floating interest rate and senior claim in bankruptcy, a liquid bank loan was supposedly a claim for all seasons. Not for 11 consecutive years, starting in 1997, had the market failed to deliver a positive return.

In the old days, in an especially volatile day's trading, loan prices might move by three-eighths of a point. Standard & Poor's LCD, the authoritative specialty news wire, would sometimes run a headline to the effect that loan prices had moved by all of one-half of a point. The pulses of knowledgeable readers would not race, however, as the facts under the headline would usually

disclose that the rise or fall had occurred over the course of a dull five days. On October 9 came news that prices had dropped by $3\frac{1}{2}$ points in just two days. "The secondary loan market continued its downward spiral—or as some market participants call it, a death spiral. . . ," S&P reported. It seems a very long bet that the 11-year streak of positive annual returns will stretch to 12, Tuesday's rally notwithstanding.

Doubters have their hands up. Could not the very lapses in underwriting condemned by federal bank regulators explain the low prices? To a degree, but in last week's panic selling, good loans plunged with the not-so-good. Something else is at work, Steven Miller, managing director of Standard & Poor's LCD, points out. In the great debt frolic, not only were the corporate borrowers leveraged—these are, after all, "leveraged" loans—but so were many of the investors. "In this cycle," Miller writes, "unlike cycles past, the problems [that] loans face have not only come through the front door in the form of aggressive credit statistics and weaker structure. They've also sneaked in the back through the massive application of leverage." How massive? Perhaps 9.2 times, he speculates. A great unwinding there has already been, Miller goes on, and it may not be over: "[T]he best guess appears that there remains $40 billion to $50 billion in mark-to-market accounts, split between $10 billion to $15 billion or so in market value collateralized loan obligations [CLOs] and perhaps another $30 billion to $35 billion in hedge funds."

How crazy it got



source: Standard & Poor's LCD

There is, of course, risk. However, the Eaton Vance Senior Income Trust (EVF) has a current yield of 11.8%—i.e., Libor plus 715 basis points. It is trading at a 15.6% discount and owns loans trading, let us say, at 80 cents on the dollar. It follows that an investor is buying those loans at 68 cents on the dollar, i.e., 80 cents on the dollar for the assets times 84.5 cents on the dollar for the shares in the fund.

"The average discount on net asset value for EVF since 1998 is 3.4%," colleague Dan Gertner points out. "If the loans return to par and EVF returns to its historical discount of 3.4% over the next three years, investors would receive the 11.8% current yield plus 9.7% price appreciation each year, for a total return of 21.5% annually."

The editorial line of this publication is that the derangement in money and credit will ultimately produce inflation. If, however, we are wrong about that, or if a lengthy deflation precedes the next great inflation, the tantalizing values on offer in bank debt and investment-grade bonds will likely become a great deal more value-laden. Possibly, this extraordinary upheaval marks the close of the era of unchecked money printing and universally accessible credit. But we hew to the belief that, before very long, Treasurys will be seen as the "toxic" class of fixed-income security. Mortgages—and well-secured senior bank debt—will come to seem a great deal safer even than the emissions of the U.S. government.

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