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Zak Summerscale heads up portfolio management and trading for Babson Capital Europe and is also a member of the firm's credit committee. Zak

joined the company in March 2001 from New Flag Asset Management where he was Portfolio Manager for a European high yield fund. Prior to that, he worked for the United Bank of Kuwait as Senior Portfolio Manager in charge of both the US and European high yield funds. He qualified as an ACA with Ernst & Young in 1996. Zak currently serves on the board of the Loan Markets Association (LMA).

FIRM OVERVIEW

Babson Capital Europe Limited ("Babson Capital Europe") is one of the leading investment managers of European senior secured and mezzanine loan funds. The firm is based in London and was established in 2000. Having made its first investment in the European loan market in March 2001, to date Babson Capital Europe manages over €6.7 billion across 17 loan vehicles and managed accounts on behalf of a broad range of institutional investors. The firm has a total of 52 employees, 24 of whom are dedicated to investment origination, analysis, monitoring and portfolio management.

Babson Capital Europe is focused on identifying value within the European loan universe through bottom-up fundamental credit research and technical analysis. The firm has one of the largest teams in the European loan market and extensive experience in fundamental analysis across the LBO debt space. This is reflected in Babson Capital Europe's consistently strong track record across a broad range of senior secured and mezzanine loan funds.

EUROPEAN SENIOR SECURED LOANS

AN OVERLOOKED ASSET CLASS

Zak Summerscale, head of portfolio management and trading at Babson Capital Europe, explains why investors see value in this burgeoning institutional asset class.

EUROPEAN LOANS & INSTITUTIONAL INVESTORS

With a market size of €249 billion¹, inherent downside protection and attractive floating rate returns, it is surprising that European senior secured loans are a relatively novel asset class for many institutional investors. The reasons may lie with the historic composition of the underlying investor base.

The boom in senior secured loans was driven by acceleration of growth in the leveraged buyout market ('LBOs') in 2005-2007, coupled with rapid expansion in the Collateralised Loan Obligation ('CLO') market. The most active loan buyers were therefore either banks (when flush with cash) or CLOs (exploiting the arbitrage against cheap financing from rated notes in the structures). Given the unsatisfied demand from both, there was little need to market to institutional investors, many of whom preferred to buy highly rated paper in structured vehicles than invest directly in loans. Post the summer of 2007 this began to change - it became increasingly difficult to place CLOs due to institutional investors' much publicised troubles in the sub-prime market and the market closed completely post Lehman's bankruptcy in September 2008.

2009 – THE TURNING POINT

However, throughout 2009 the European senior secured loan asset class has received far greater attention from pension funds and consultants alike. Investors are dedicating more time to understanding the asset class characteristics, and sizeable allocations continue to be made.

2009 was a record year for returns in the European senior secured loan market, yet spread compression lags that evidenced in the high-yield bond market. Spreads on both asset classes are broadly similar at present, despite loans being senior, first ranking (the key difference being security over real assets and historical lower loss rate, compared to high-yield bonds). Pricing anomalies have primarily been driven by large inflows to high-yield bond funds given high-yield has become an accepted institutional asset class. However loans are increasingly perceived as a viable institutional product and, with inflows continuing, loans should trade tighter than bonds in the long-term given the structural downside protection.



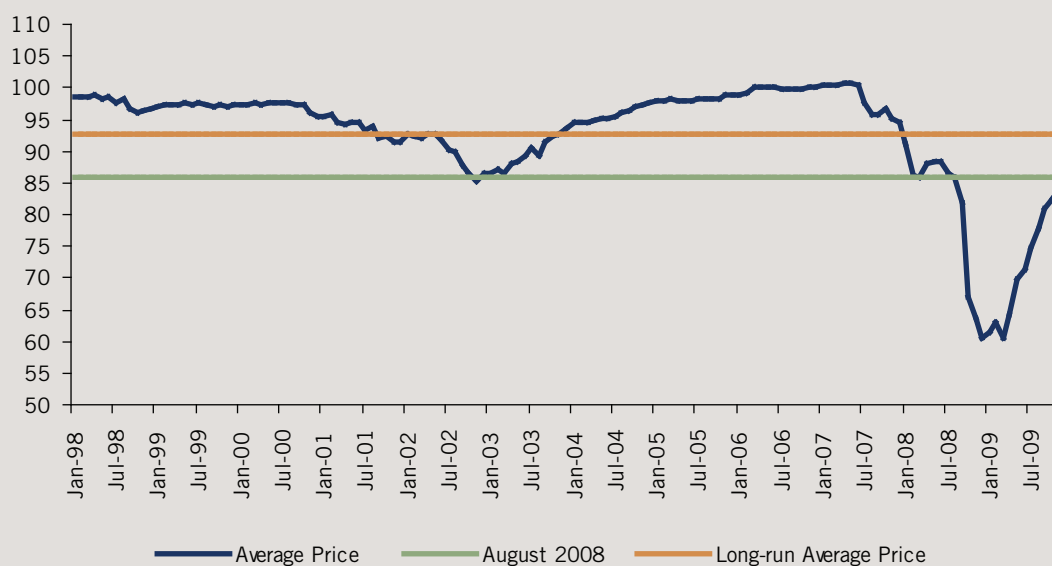
Despite record returns, 2009 was a challenging year for loans from a default rate perspective. This dynamic makes in depth, bottom-up credit analysis key to successful investment. Returns have been largely driven by increases in market value from the dislocation in prices seen in the fourth quarter 2008. On an average loan price basis, the Credit Suisse ('CS') index at the end of November 2009 was still not back to August 2008 levels¹, a clear illustration of the opportunity that prevails in this market.

CURRENT YIELD & THE UPSIDE

The CS index currently yields 809 bps over Euribor to an expected life of 3 years¹, far wider than historical levels despite S&P's forecast that default rates peaked in the third quarter of 2009². Credit quality is improving, but default rates are likely to remain higher than average for 12-18 months, attributable to existing issuers over-leveraged balance sheets and wider economic forecasts. Furthermore Europe is not a homogenous legal market, having an experienced team to understand jurisdictional risk is crucial to establishing both security value and remedies to potential covenant breaches or default.

The real upside for loans priced at a significant discount to par will come from repayments expected over the next two years, with trade sales, refinancing in the high-yield bond markets and IPOs providing additional momentum. In the last quarter we have seen full or significant repayments in half a dozen of the larger issuers, with trade sales leading the way for full repayments at par. Numerous LBOs are reportedly exploring IPOs or trade sales and whilst IPOs may not repay all the current debt, they invariably result in fees being payable, leverage reduced and margins increased in line with the new primary market.

FIGURE 1: AVERAGE PRICE EUROPEAN SENIOR SECURED LOANS



Source: Credit Suisse Western European Leveraged Loan Index, All Denominations, Hedged to €; as at 30-Nov-09.



FIGURE 2: EUROPEAN SENIOR SECURED LOAN DISCOUNT MARGIN VS. HIGH YIELD SPREAD TO WORST



Sources: Credit Suisse Western European Leveraged Loan Index, All Denominations, Hedged to €; Credit Suisse Western European High Yield Index Non-\$US-Denominated Bonds, as at 30-Nov-09.

FLOATING RATES & INFLATION CONCERNS

An additional incentive for investors to research the loans space is the floating rate return offered. This proved a major attraction for pension funds in the second half of 2009, as concerns about future inflationary pressure means a floating rate product with yield has real attraction today. Taking 3 year Euribor swap rates, the loan index was yielding 10.2% at the end of November 2009, upward revisions to interest rate expectations would increase this further. This makes an ideal offset for fixed rate bond holdings which would decline in such a scenario, whilst the current spread is attractive even if we remain in a low interest environment.

EUROPEAN SENIOR SECURED LOANS – A STANDALONE ASSET CLASS

The past 18 months prove that senior secured loans are by no means a risk free asset class, but with the right management will produce attractive long-term returns. European loans typically issue monthly management accounts and detailed budget information, providing an informational edge over public debt markets. To extract full value from this information, in depth credit work and a large experienced team is essential for managing the asset class effectively. Our 24 strong front-office team at Babson Capital Europe is exclusively dedicated to secured loans and has been fully occupied over the past 12 months, dealing with the information flow from portfolio companies and taking leading roles in several restructuring negotiations.

European senior secured loans are increasingly considered as a standalone asset class and core component in building credit portfolios. We expect over-time they will be a commonplace allocation for European pension funds, just as US senior secured loans are for US pension funds. Overall, being duration neutral with a historically wide credit spread, the asset class is an attractive choice for investors concerned about inflationary pressures caused by Quantitative Easing and the return to economic growth.

1 Source: Credit Suisse Western European Leveraged Loan Index, All Denominations, Hedged to €, as at 30-Nov-09.

2 Standard & Poor's (Preliminary Default Among Speculative-Grade Western European Companies Increases To 13% In Year To End-September 2009, 04-Nov-09).

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