



## The Prospects for Global Senior Secured Bonds

### HIGHLIGHTS

- We expect the high yield bond market to play a key role in refinancing senior secured loans
- High yield bond spread levels should remain attractive as we expect the supply and demand disparity in the loan market to persist
- European senior secured bonds have transformed from a somewhat ignored asset class into a sound alternative for investors looking for the comfort of quality collateral and the characteristics of a bond investment
- The backdrop of an extended low rate environment coupled with declining default rates provides an accommodating environment for the global high yield bond market
- Senior secured bonds offer an improvement in collateral position and additional security in a weakened economy at a relatively small spread concession

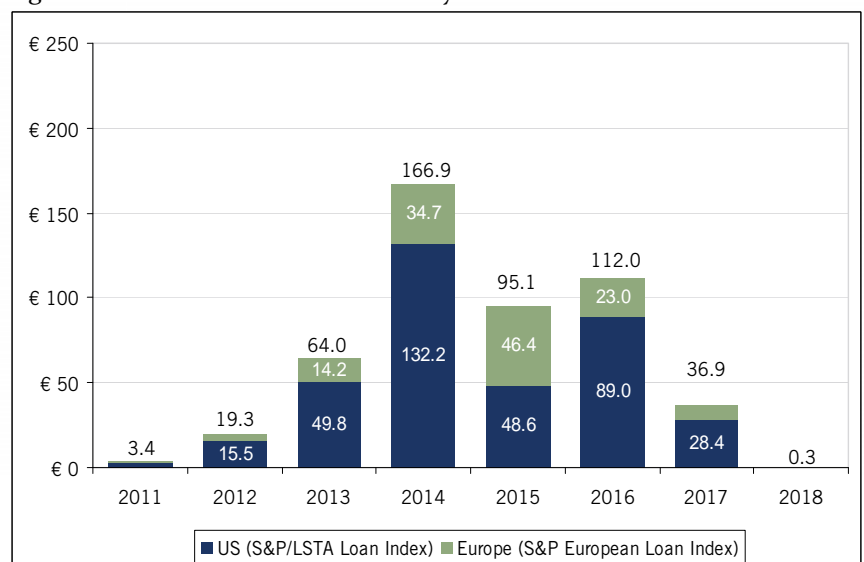
### INTRODUCTION

We believe a holistic approach is necessary when considering opportunities in the high yield market. The high yield loan and bond markets are inter-related and examining them together can provide insights that may not be obvious when considering them in isolation. Our view of the prospects for global senior secured bonds considers the current demand and supply dynamics of the high yield market, which we believe will translate into attractive opportunities for senior secured bond investors. Senior secured bonds are becoming increasingly popular as an additional funding source for global companies that traditionally rely upon bank financing. Commercial banks, especially in Europe, remain capital constrained and a lack of new issuance by CLO vehicles continues to limit traditional liquidity sources. Like the U.S., the European LBO market should encounter significant refinancing requirements over the next several years. Spread levels should remain attractive as we expect the supply and demand disparity to persist.

### MATURITY WALL & CLO REINVESTMENT PERIOD

The current supply and demand dynamics in the global loan market should present attractive opportunities for senior secured bond investors. The relationship between the loan market maturity profile and the CLO reinvestment period in Europe is analogous to the trend in the U.S. bank loan market.

Figure 1: Global Loan Market Maturity Schedule



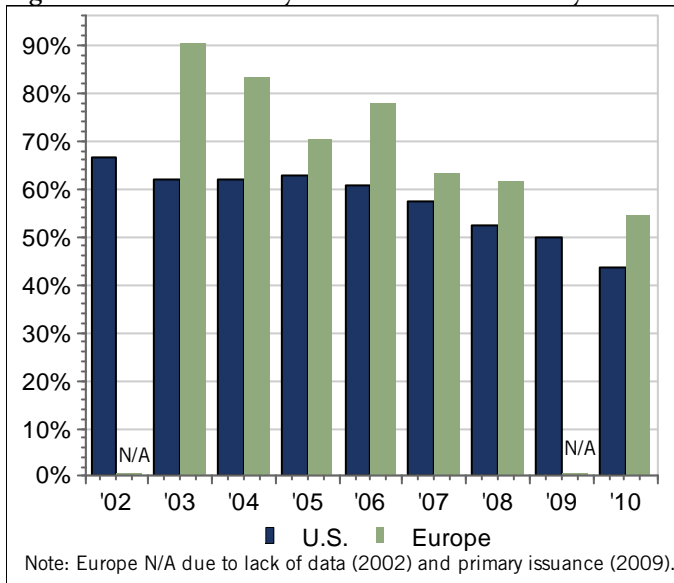
Source: Standard & Poor's/LCD and Babson Capital.



Between 2005-2007, high demand by CLOs and other structured vehicles buying senior secured loans drove record issuance in the below investment grade loan market. While some of the maturity wall has been extended by the recent increase in bond issuance, the maturity schedule picks up in earnest over the next few years with refinancing risk concentrated in 2014-2016 time period (Figure 1). It is noteworthy that the maturity profile is represented by the S&P leveraged loan indices, which serve as a proxy for the broader global leveraged loan market. Thus, actual loan maturities would be greater than what is implied by the indices.

Structured vehicle demand accounted for nearly 91% of European leveraged loan issuance in 2003, falling to 55% in 2010 (Figure 2). In the U.S., a similar trend existed as demand fell from 67% in 2002 to 43% in 2010. Slowing demand from the dominant buyer in the institutional loan market coincides with an expected increase in new supply to refinance maturing loans. Additionally, the mix of loan market investors is diversifying as retail funds in both the U.S. and European markets showed the strongest inflow growth in 2010. While structured vehicle demand is expected to recover gradually, deal economics remain problematical with AAA European CLO spreads currently trading in the range of 225-260 bps versus approximately 25 bps before the credit crisis.

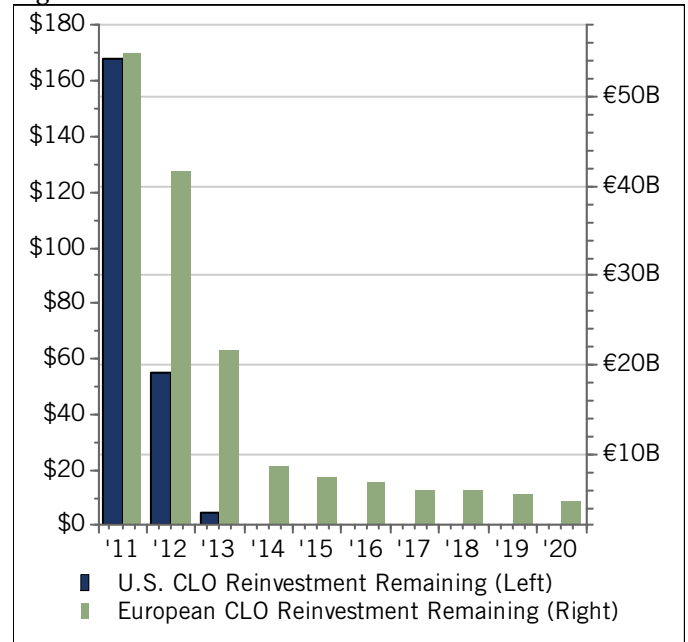
Figure 2: Global Primary Loan Market Demand by SIVs



Source: Standard & Poor's/LCD and Babson Capital.

Consistent with a 5-7 year reinvestment cycle, CLOs issued during the market peak are approaching the end of their reinvestment window (Figure 3). The closing of the reinvestment window during the 2012-2013 time periods occurs just before the heaviest refinancing wave in the loan market (2014-2016). To the extent that CLOs are unable to fill the gap, we would expect new funding sources and new investors to step in and fill the void. The supply/demand imbalance that exists in the loan market is expected to continue and should translate into issuers paying higher costs to refinance debt. Private equity firms and creditworthy issuers can still access the market in advance of any refinancing risks materializing, however, the importance of motivating new investors to provide liquidity suggests new issuance needs to remain attractive. The solution to the refinancing issue is expected to involve several markets including senior secured loans, senior secured bonds, unsecured high yield bonds and equity.

Figure 3: Global CLO Reinvestment Window



Source: Standard & Poor's/LCD and Babson Capital.

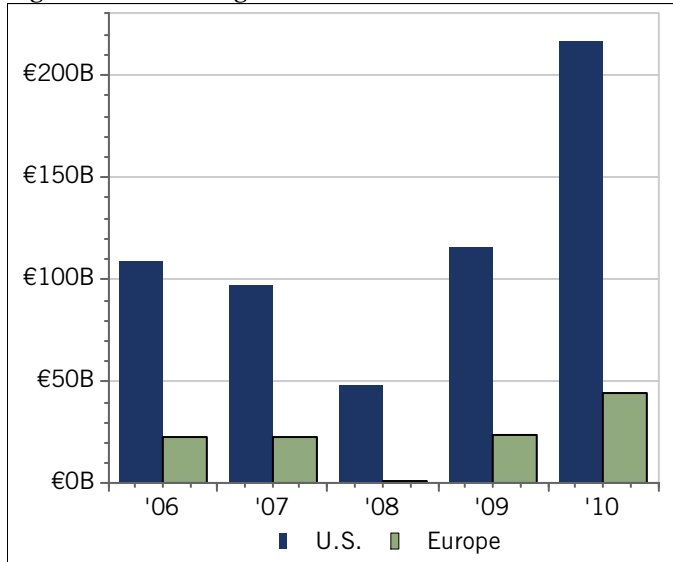
### IMPACT ON HIGH YIELD BOND MARKET

We believe the market will need multiple sources of capital to address the supply and demand imbalances facing the leveraged loan market. In particular, we expect the high yield bond market to play a key role in



refinancing senior secured loans. As a testament to this, global high yield bond issuance (as measured by the U.S. and European markets) in 2010 was up over 80% from 2009 levels with growth fairly evenly split between the U.S. and European markets and volume nearly doubling from 2006 levels (Figure 4).

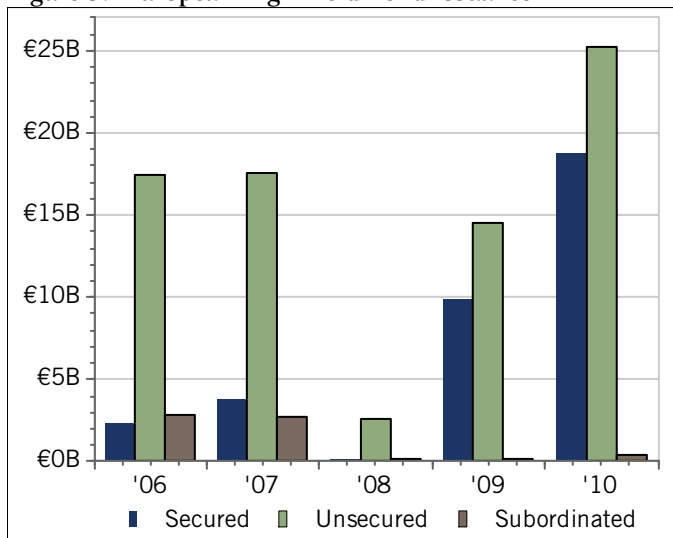
Figure 4: Global High Yield Bond Issuance



Source: Standard & Poor's/LCD and Babson Capital.

Within the European high yield bond market, senior secured bonds exhibited the strongest growth in 2010 as issuers continue to broaden their financing sources (Figure 5). The senior secured segment of the high yield bond market comprised 42% of new issue volume in 2010.

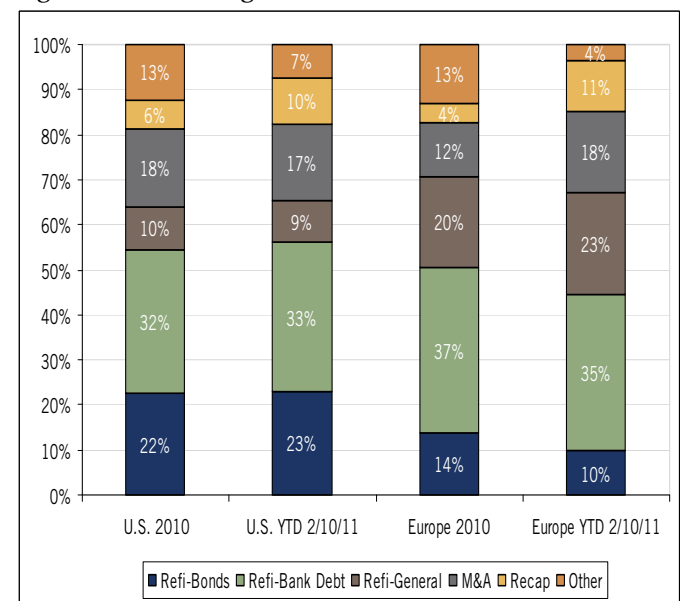
Figure 5: European High Yield Bond Issuance



Source: Standard & Poor's/LCD and Babson Capital.

Furthermore, 35% of European high yield bond issuance proceeds and 33% of U.S. high yield bond proceeds in 2011 were used to refinance bank debt (Figure 6). A combination of institutional and retail mutual fund inflows has created much of the demand for high yield bonds.

Figure 6: Global High Yield Bond Use of Proceeds



Source: Standard & Poor's/LCD and Babson Capital.

In particular, the growth of senior secured bonds as a financing option has been notable over the last few years. Senior secured bonds have developed into a hybrid between the senior secured loan market and the traditional unsecured bond market, especially in Europe. Senior secured bonds have transformed from a somewhat ignored asset class into a sound alternative for investors looking for the comfort of quality collateral and the characteristics of a bond investment. One of the notable characteristics that the senior secured bond market now affords investors is the improvement associated with security and collateral packages. Indeed, many of the recently issued senior secured bond offerings carry similar covenants to that of the loan market, providing investors within the asset class greater downside protection. This is often reflected in pledges over the hard cash generating assets of the firm. Prospects for the senior secured bond market remain favorable with attractive security features, improving liquidity and growing new issuance.

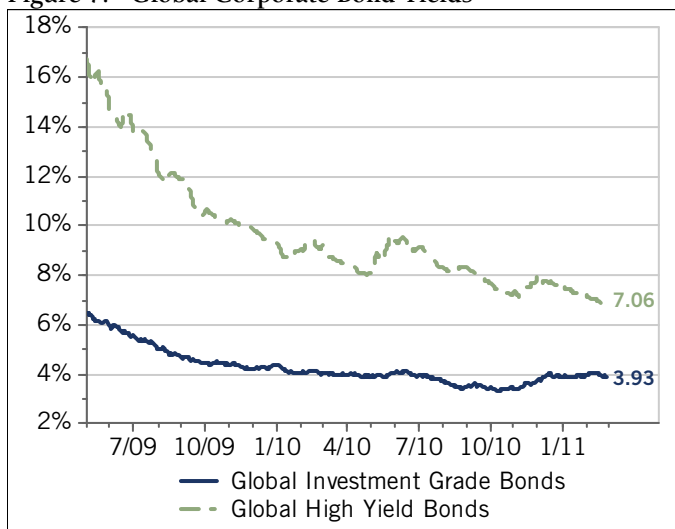


### OUTLOOK FOR GLOBAL HIGH YIELD BONDS

Although market consensus is for GDP growth in Europe to lag U.S. and broader global growth projections, a sluggish growth environment in Europe would still be supportive of corporate profit growth and continued deleveraging. In addition, peripheral risks such as those worrying investors in the sovereign and banking sectors should continue to bolster demand in the corporate sector as credit fundamentals appear more attractive. As the refinancing wave gains strength, we would expect global high yield bond issuance to continue to be robust.

The backdrop of an extended low rate environment coupled with declining default rates provides an accommodating environment for the global high yield bond market. The declining interest rate atmosphere has pushed down yields in the global investment grade market attracting high grade investors to the below investment grade space in search of additional yield. While the spread between global investment grade and high yield corporate bond yields has compressed since the financial crisis, the yield pick up still remains attractive (Figure 7).

Figure 7: Global Corporate Bond Yields



Source: FactSet and Babson Capital as of 2/28/11.

Based on observations of broad indices, the U.S. high yield market is more mature and 5x larger than the European high yield market in terms of market value, however, the European high yield bond market has more than tripled in size in the last two years (Figure

8). Additionally, the number of issues in the broad European index has grown 53% over that time period compared to a 26% increase for the U.S. index. This growth has improved liquidity in the market and given more comfort to investors and issuers to utilize the high yield bond market when contemplating

Figure 8: Size of U.S. and European HY Bond Markets



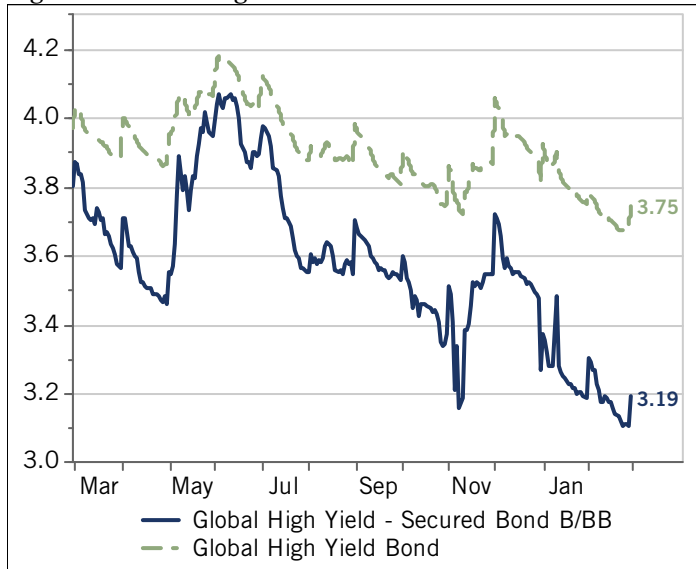
Source: FactSet and Babson Capital as of 2/28/11.

investment and financing options.

Duration is another factor that investors are concerned about, especially in an extended low interest rate environment where most market participants feel the next move in interest rates will be up. The inverse relationship between interest rates and bond price movements suggests investors would be cautious in a rising rate environment by lowering duration and taking less price risk. Coupon rate and maturity are two of the primary factors that affect duration. In general, the higher the coupon rate, the lower the duration and; the shorter the maturity, the lower the duration. As it applies to global high yield bonds and the senior secured bond segment in particular, we can see duration levels have been declining for most of the past year (Figure 9). Recent new issuance of senior secured bonds show favorable duration characteristics as they have typically carried high coupons and have 3-4 year non-call provisions. To the extent investors are concerned about being in a fixed rate investment during a period of rising interest rates, we believe the duration characteristics of the global senior secured bond market remain favorable.



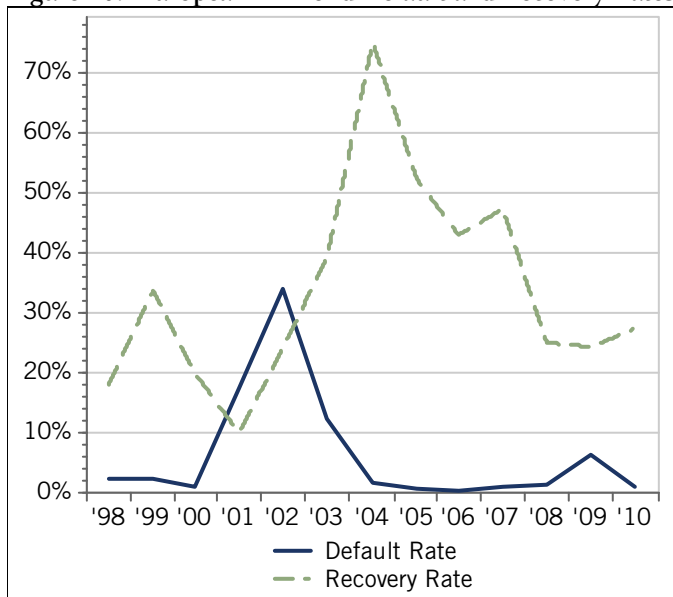
Figure 9: Global High Yield Bond Duration-to-Worst



Source: FactSet and Babson Capital as of 2/28/11.

Although the depth of the high yield bond market in Europe is not on the same level as the U.S., available historical data reveals similar recent trends in default and recovery rates (Figure 10). Default rates for

Figure 10: European HY Bond Default and Recovery Rates



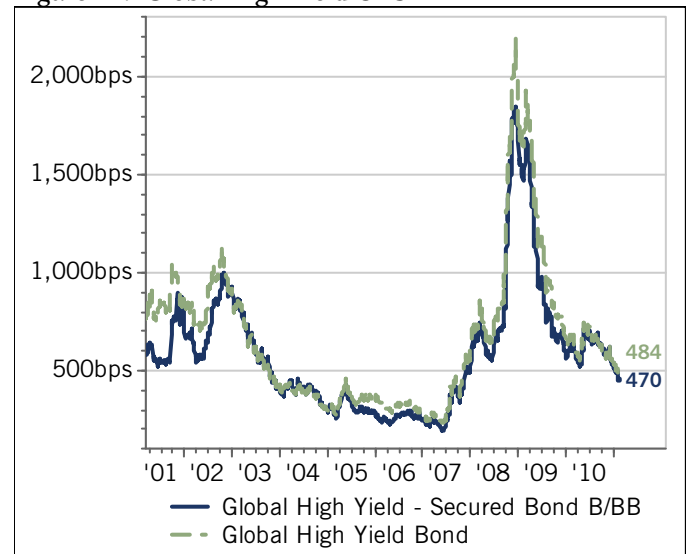
Source: Credit Suisse and Babson Capital.

European high yield bonds were 1% in 2010 vs. 1.5% in the U.S. market. The consensus market outlook is for default rates to remain under 2% in 2011, providing a rather benign environment for default risk to negatively impact performance. Recovery data is much more variable for the European high yield bond

market and it is important to note that the underlying universe includes all levels of security enhancement in arriving at an average rate. While specific data remains elusive, it would be intuitive to believe senior secured bonds would offer recovery rates at the high end of the range.

Using the global high yield bond index as a proxy, senior secured bond spreads are currently trading fairly tight to the overall index (Figure 11) at 14 bps. Over the last ten years, the spread has averaged 74 bps. The relatively small spread concession seems appealing considering the improvement in collateral position and additional security in a weakened economy.

Figure 11: Global High Yield OAS



Source: FactSet and Babson Capital as of 2/28/11.

**CONCLUSION**

Overall, we believe the senior secured segment of the high yield bond market is compelling based on attractive relative spread levels, the technical supply/demand imbalance facing the high yield market and the quality collateral position investors can attain.

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