CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

April 2010

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"What About the Debt Burden?" by Ray Dalio, Bridgewater Daily Observations, April 13, 2010

Looser credit standards prior to the credit crisis enabled private equity firms as well as many nonfinancial companies to borrow freely; as a result, we are two years away from facing a mounting wall of maturities. As the wall of maturities grows closer, companies are beginning to proactively address the debt burden, as the ability to refinance is largely a function of the economic environment.

While the liquidity crisis has been alleviated, the debt burden remains; Americans now have about as much debt as they had before. However, the easy lending conditions that led to this debt build-up no longer exist, raising refinancing risks going forward. While the market is currently taking these maturities in stride, harder questions loom for lenders, such as whether or not to extend loans to borrowers that are less creditworthy than initially perceived. There are three obvious pressure points in the forward debt maturity calendar: (1) construction & development (C&D) loans, (2) high-yield loans and bonds that mature from 2012 to 2014, and (3) a steady flow of commercial real estate (CRE) loans maturing between 2012 and 2017.

Refinancing risks in 2009 and 2010 have been limited by several factors. In 2009, the overwhelmingly majority of $3.1 trillion in maturing debt was investment grade, with just 3% in the form of higher-yielding loans and bonds. In 2010, maturing debt volumes have been lower than they were in 2009, and also of relatively high quality. Two exceptions are the increases in maturing C&D and CRE loans, though the latter are on average highly seasoned.

C&D refinancing will be a challenge in 2010 and beyond for several reasons. Many of these loans originated during 2006–07 and are already underwater. Of outstanding C&D loans, 15% are currently recognized as nonperforming, but this number should increase further during 2010–11. Modifying these troubled loans will be difficult, as many lack the combination of equity and income to transition into more permanent first-lien mortgages. Further, many of the smaller banks that initially extended these loans have capital deficiencies and are less willing or able to roll the loans.

A second pressure point will come from the steady flow of CRE loans that originated from 2005 to 2007 and mature from 2012 to 2017. More than half of these loans will come due between 2012 and 2014, and it is likely that nearly 30% of all existing CRE debt will need to be rolled in the next two years. In addition, nearly one-third of the outstanding CRE debt maturing from 2012 to 2014 is held by collateralized loan obligations (CLOs), which will have little ability to roll debt after their reinvestment periods end over the next couple of years. While all maturing CRE loans face deteriorating conditions that could affect their refinancing prospects, the non-C&D loans maturing over the next couple of years should be among the best of all loans outstanding, due to their seasoning and the potential for these properties to still have positive equity remaining.

The last major pressure point that exists concerns the high-yield bonds and loans that are set to mature from 2012 to 2014. More than half of all

high-yield debt outstanding will come due over this three-year window. Some issuers have already proactively extended their debt maturities, converting two- or three-year bank debt into longer-term loans. However, these debt swaps, as well as ongoing amendments and extensions, have not materially altered the crush of maturities looming. Ultimately, if sponsors do not want to add more equity to their portfolios and/or the economic environment does not improve, many of these companies could still face involuntary or voluntary restructurings in the years ahead. From a timing standpoint, it is important to recognize that the ability to successfully restructure or work out a potentially troubled loan will be based on the value of the equity in the property or company at the time the cash flow breaks, not at the time of maturity.

We are a long way from permeating the debt bubble, but we have successfully alleviated cause for immediate concern and pushed it off until a later date. This year and next are reasonably light rollover years, and if the markets are going to get ahead of the refinancing crush set to begin in 2012, a lot of debt restructuring will need to occur this year and in 2011. However, this is all manageable for the economy as a whole as long as the Federal Reserve and Treasury do their parts.

"Bridging the Refinancing Cliff" by Fitch Ratings, March 22, 2010

The imbalance between expected supply and demand for leveraged loans over the next five years is smaller than the absolute debt maturities imply. Absent catastrophic economic conditions or a peak in interest rates, much of the refinancing demand from leveraged borrowers can be satisfied by a combination of amend & extend (A&E) agreements, bond for loan takeouts, and increased capacity within the leveraged loan market (including a revival of CLOs). Based on historical leveraged loan and high-yield bond activity, overlaid with moderate forward-looking assumptions, the remaining gap could be as small as $50 billion to $100 billion. There are risks to this relatively optimistic perspective, which include the risk of a double-dip recession and how equity market valuations affect the willingness of lenders and investors to provide capital for refinancing.

Historically, the maturity profile of leveraged loans and high-yield bonds has been relatively even, reducing problems when issuers refinance debt maturities. This will change over the next five years, as the leveraged loan market sees an unprecedented concentration of loan maturities. This is related to the collapse of the CLO market, creating significant overhang in the credit markets. Leveraged loans worth $770 billion, almost 90% of the outstanding total, will mature during the next five years, including $600 billion from 2012 through 2014. There are four sources that should meaningfully smooth the contour of the refinancing "cliff": loan refinancing, A&E agreements, bond for loan takeouts, and mandatory prepayments.

The leveraged loan market could potentially absorb $425 billion of this refinancing cliff, assuming that leveraged loan volumes average between $250 billion and $350 billion per year from 2012 to 2014, and that 45% of the total volume is used to refinance loan maturities. These estimates, far from being aggressive, are based on issuance levels from 1998 to 2003, prior to the dramatic expansion of the structured finance market. One of the drivers luring new and existing lenders back to the market is the floating rate nature of the loans, which could prove attractive in a rising interest rate environment.

Complicating the picture is the pending amortization of many CLOs, which helped fuel the growth of the leveraged loan market. Leveraged loan issuance more than doubled between 2003 and 2007, fueled by demand from soaring CLO issuance. These CLOs featured five-year investment periods, with some extending to seven years

during the peak of the market. As they enter non-investment periods from 2012 to 2014, this will curtail their ability to purchase new loans or help refinance existing loans. CLOs today hold over 50% of all outstanding leveraged loans, including over half of the loans that mature between 2012 and 2014. Primary CLO issuance is not completely dead, however, and could in fact recover if transaction economics become attractive again.

The second factor that will help ease the refinancing risk for leveraged loans is A&E agreements, which reached $60.6 billion in 2009. Assuming these volumes average $75 billion through 2014, this could shave another $135 billion from the refinancing cliff. This estimate assumes an average extension of two years, so A&E agreements reached in 2013–14 will have the biggest impact. Two things need to happen to make this estimate reasonable. First, lenders need to agree to support loan valuation by offering A&E agreements in exchange for covenant modification and higher pricing. Second, A&E volumes could intensify if CLOs are permitted to participate in these agreements while in their amortization periods. A relatively large volume of these agreements could come from a small group of borrowers; just seven companies (including TXU Corp., Ford Motor Co., HCA Inc., and others) have almost $100 billion of loans coming due in 2013–14.

The high-yield bond market is the third potential source of financing for leveraged loan borrowers, and could absorb almost $80 billion of the refinancing cliff, assuming annual high-yield issuance volumes of approximately $125 billion from 2010 to 2014. Annual high-yield bond issuance volumes averaged $110 billion over the past ten years and reached as much as $150 billion in peak years. Future uses of proceeds should be more diverse than in 2009, when approximately 75% of all high-yield issuance was used for refinancing. Fitch assumes 50% of high-yield proceeds from 2012 to 2014 will be used for refinancing bonds and "growth financing," 30% will be used for other corporate purposes, and the remaining 20% of issuance could be used to refinance leveraged loans.

The final source of financing that Fitch believes will help mitigate the pending wall of leveraged loan maturities is mandatory and voluntary prepayments, which could reduce outstanding loan balances by up to $55 billion. Up to 7% of loans could be repaid yearly. Four percent of the repayments would come from amortization, excess cash flow sweeps, and voluntary prepayments, while asset sales and equity sweeps could reduce the loans by the remaining 3%, in line with historical averages. These estimates could even prove conservative if a strong equity market during this time resulted in initial public offering exit strategies for a large number of leveraged buyouts.

Material risks to this relatively optimistic forecast include the possibility of a double-dip recession and the trajectory of the equity market, which will impact valuations and thus the willingness of lenders and investors to provide capital for refinancing. Weighing all of these considerations, however, the refinancing cliff from 2012 to 2014 is far less precipitous than the absolute debt levels suggest. Markets have historically adapted to supply and demand mismatches with product introductions, unique market variations, and adjustments to pricing and terms. The longer-term portion of the maturing loans will be largely absorbed by a combination of A&E agreements, an improving loan and CLO market, and an expanded high-yield market. Each of these sources will help ensure that defaults are not likely to exclusively bear the burden of the funding gap. ■

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