

Leveraged Loans: A Primer

December 2012



In today's market environment of low rates and slow growth, we believe that leveraged loans offer a unique diversification option for fixed income portfolios due to their imbedded rate hedge and senior status in their issuers' capital structures.

The leveraged loan is a senior secured corporate loan to a high yield company. It is a typical component of a high yield company's capital structure and ranks ahead of the company's unsecured high yield bonds. The loan is a non-investment grade, floating-rate debt instrument issued at a spread over LIBOR and syndicated to multiple lenders in a manner similar to a bond offering. Initially predominantly held by banks, leveraged loans have been sold to non-bank institutional investors in meaningful size since the mid '90s. Currently the size of the U.S. leveraged loan market is \$635 billion, which is spread across approximately 1,500 issuers. We believe the key advantages of leveraged loans are as follows:

<p>Strong current income, amongst the best in fixed income</p>	<p>Loans offer a stable source of current income, which rises with underlying interest rates due to the floating-rate component of their coupons. In the current low interest rate environment, many new issue loans are structured with LIBOR floors, which set the level of LIBOR at a certain level. Before even factoring in potential upside from a rise in rates, current income on loans compares favorably to other fixed income alternatives.</p>	<p>Yield Across Fixed Income¹</p> <table border="1"> <thead> <tr> <th>Asset Class</th> <th>Yield</th> </tr> </thead> <tbody> <tr> <td>High Yield</td> <td>6.5%</td> </tr> <tr> <td>Lev Loans</td> <td>6.4%</td> </tr> <tr> <td>Inv. Grade</td> <td>2.0%</td> </tr> <tr> <td>5-yr Tr.</td> <td>0.5%</td> </tr> <tr> <td>TIPS</td> <td>-1.5%</td> </tr> </tbody> </table>	Asset Class	Yield	High Yield	6.5%	Lev Loans	6.4%	Inv. Grade	2.0%	5-yr Tr.	0.5%	TIPS	-1.5%						
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<p>Strong risk/reward in credit</p>	<p>Leveraged loans offer attractive relative value versus both high yield and investment grade bonds.</p> <ol style="list-style-type: none"> 1) Yields on loans and high yield bonds are currently very similar even though loans offer investors more downside protection given their senior position in a company's capital structure. Over time, loans have historically experienced significantly less volatility than high yield bonds with movements in the equity market. 2) While loans have higher leverage than investment grade (IG) bonds, hypothetically tranching up a loan into an "IG-like" component and a "2nd priority" component demonstrates that the latter component sufficiently compensates investors for taking incremental risk in the form of leverage. This analysis suggests that loans offer better risk-adjusted compensation than IG. 	<p>Yield vs. Volatility²</p> <table border="1"> <thead> <tr> <th>Asset Class</th> <th>Yield to Worst / Maturity</th> <th>Beta (volatility to equity markets)</th> </tr> </thead> <tbody> <tr> <td>Leveraged Loan</td> <td>6.24%</td> <td>~0.15</td> </tr> <tr> <td>High Yield</td> <td>6.78%</td> <td>~0.35</td> </tr> <tr> <td>IG</td> <td>2.05%</td> <td>~0.05</td> </tr> </tbody> </table> <p>Beta of S&P = 1</p>	Asset Class	Yield to Worst / Maturity	Beta (volatility to equity markets)	Leveraged Loan	6.24%	~0.15	High Yield	6.78%	~0.35	IG	2.05%	~0.05						
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<p>Downside protection via liens and covenants</p>	<p>Unlike other fixed income classes, loans have a 1st lien claim on underlying assets and also benefit from contractual covenants which seek to ensure the solvency of the business. These protections can include maintenance of financial ratios, limitations on shareholder friendly activities, and control of cash flows. Because of their inherent security and seniority features, loans have offered investors significantly higher principal recovery on defaults than high yield bonds (70% vs. 41%)</p>																			
<p>Insulated from interest rate risk and outperform in periods of rising rates</p>	<p>Leveraged loans have a distinct advantage over other fixed income classes in periods with rising interest rates. For securities like high grade bonds or Treasuries, which have fixed coupons, there is significant interest rate risk which can erode prices and hurt total returns. In periods when Treasury yields are rising, loans have been superior performers.</p>	<p>Total Return During Rising Rate Environments³</p> <table border="1"> <thead> <tr> <th>Asset Class</th> <th>Q1 '99 - Q1 '00 [rates up +1.73%]</th> <th>Q1 '05 - Q2 '06 [rates up +1.53%]</th> </tr> </thead> <tbody> <tr> <td>Lev. Loans</td> <td>4%</td> <td>6%</td> </tr> <tr> <td>High Yield</td> <td>2%</td> <td>4%</td> </tr> <tr> <td>Inv. Grade</td> <td>1%</td> <td>1%</td> </tr> <tr> <td>5-Yr Tr.</td> <td>1%</td> <td>0%</td> </tr> <tr> <td>TIPS</td> <td>2%</td> <td>2%</td> </tr> </tbody> </table>	Asset Class	Q1 '99 - Q1 '00 [rates up +1.73%]	Q1 '05 - Q2 '06 [rates up +1.53%]	Lev. Loans	4%	6%	High Yield	2%	4%	Inv. Grade	1%	1%	5-Yr Tr.	1%	0%	TIPS	2%	2%
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¹Data as of November 30, 2012. Source: Credit Suisse, Barclays, JP Morgan. ²Data as of November 28, 2012. Source: JP Morgan. ³Source: Credit Suisse, Barclays.

1) Strong current income, amongst the best in fixed income

Leveraged loans have unique features that offer investors stable and attractive income streams in both high and low interest rate environments. Coupons for leveraged loans are set as a spread above a base rate like LIBOR, allowing investors to capture the benefit of higher coupons when interest rates rise. On the other hand, the inclusion of LIBOR floors in most new leveraged loans protects investors against a fall in interest rates (or a sustained low rate environment such as the one we are in currently). As of October 2012, the average LIBOR floor for a leveraged loan was around 150 basis points, implying that a hypothetical loan with a spread of 300 basis points would pay out interest at an annual rate of no less than 4.5%.

Even with 3-month LIBOR at historic lows, current income on loans compares favorably to other fixed income alternatives, and there is future upside as rates rise, unlike with fixed-rate asset classes.

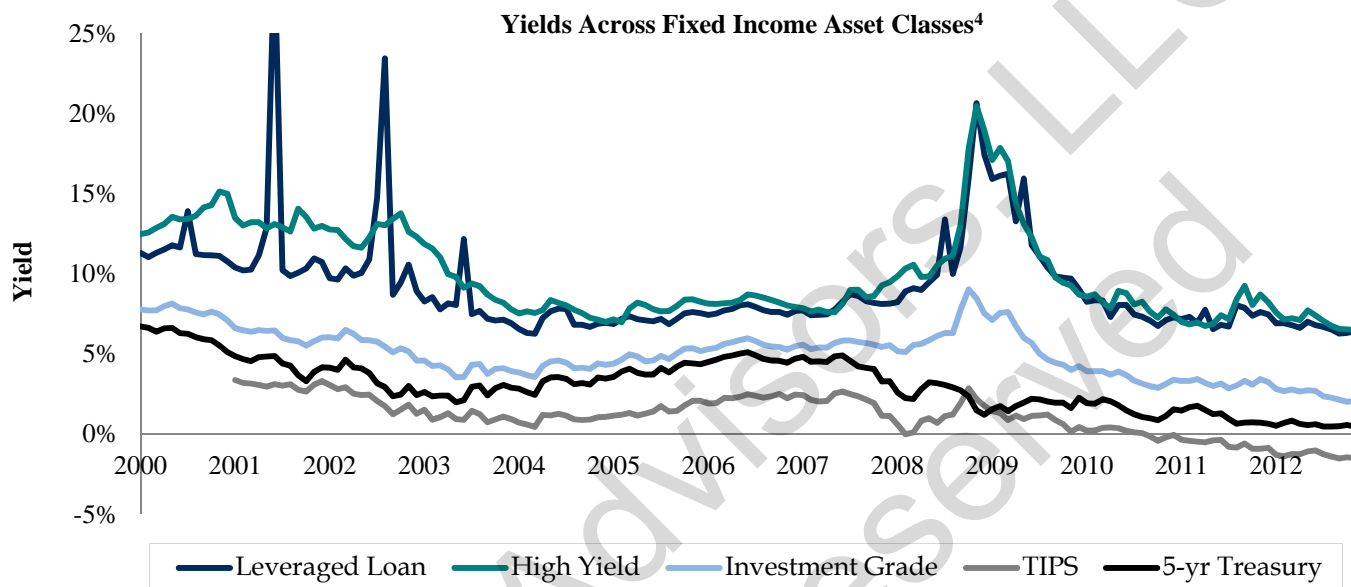


Figure 1: Despite low short-term interest rates, loans generate strong current income vs. other fixed income classes
Note: Yield measured as Yield-to-Worst for bonds and Yield-to-Maturity for bank debt

2) Strong risk / reward in credit

Offers greater insulation from equity market volatility than high yield

Diversification into leveraged loans can help protect investors from volatility in traditional equity markets. Because of their senior secured position, leveraged loans are backed by collateral and are buffered by other junior claims. As such, leveraged loans have better protection than high yield bonds against downswings in the equity market. “Beta” is a ratio that measures how sensitive a security’s price is to changes in the market; a beta closer to zero indicates that returns to a certain asset class are not closely related to returns in the overall equity market (here defined as the S&P 500). As seen in the table below, leveraged loans are noticeably more insulated from overall equity markets than the high yield bond asset class, despite currently yielding similar returns.

	Investment Grade	Leveraged Loan	High Yield	S&P	Levered Equity
Beta (S&P)	-0.01	0.16	0.34	1.00	1.29
Yield	2.05%	6.24%	6.78%	N/A	N/A

Figure 2: The seniority and security of leveraged loans helps protect loan prices from volatility in equity markets⁵

⁴ Source: Credit Suisse, Barclays, JP Morgan. ⁵ Source: JP Morgan, Barclays, Credit Suisse

Strong relative value to Investment Grade bonds

Leveraged loans bear more risk than traditional investment grade loans because they are issued by below investment grade companies, but we believe investors are fairly compensated for assuming this risk by the high incremental return offered by loans. To illustrate the point, consider the case of two hypothetical companies, each with enterprise values of \$100 million:

- Company A is a typical high grade issuer. It has a \$20 million investment grade bond outstanding that represents 20% of its total capitalization (the average for investment grade issuers) and pays a coupon of approximately LIBOR + 1.55% (also the market average).
- Company B has a leveraged capital structure. Its senior secured loans total \$45 million (a market average 45% of its total capitalization), and it pays a market average coupon of LIBOR + 5.44%.
- Company A wants to make its capital structure and total coupon payments identical to those of Company B. Company A will thus have to issue \$25 million of additional debt.
- However, if Company A's total coupon rate were to equal Company B's (LIBOR + 5.44%), the coupon rate on the incremental \$25 million of debt would have to be LIBOR + 862.

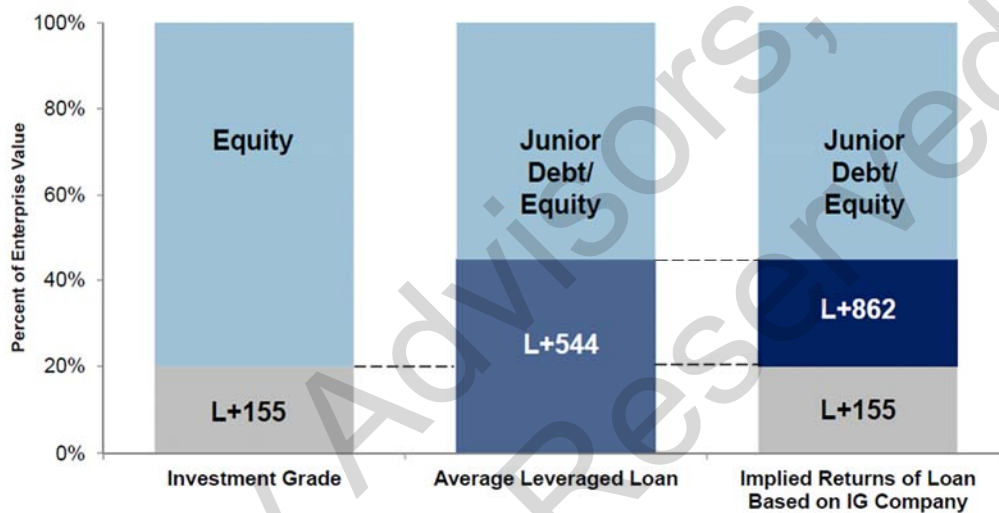


Figure 3: The implied coupon rate on the incremental leverage of a non-IG company is high

3) Downside protection via liens, covenants and other features

Loans contain several features which help protect investor capital. Credit agreements for loans contain provisions, termed “covenants,” which dictate how a borrower can operate. Covenants vary between each individual loan, but they frequently involve (a) the maintenance of certain financial ratios; (b) restrictions on activities such as acquiring new companies or divesting cash out of the company; and/or (c) requirements for mandatory prepayment upon certain events such as asset sales and excess cash generation. In total, these covenants provide boundaries that seek to ensure the solvency of the company and its ability to service debt payments. In exchange for these covenants, issuers typically have more flexibility to prepay portions of the loan voluntarily on a pro-rata basis to lenders.

In the event of a default, the senior secured claim of the leveraged loan gives the creditor a first-in-line claim to the collateral that supports the loan (“security”) and a priority claim above the unsecured debt (“seniority”). Because of their inherent security and seniority features, leveraged loans have offered lenders an average principal recovery rate of 70% since 1995 on issues which default; recovery rates on high yield bonds averaged only 41% during the same time period.⁶

⁶ JP Morgan. Recovery rates are issuer-weighted and based on price 30 days after default date.

4) Insulated from interest rate risk and outperform in periods of rising rates

Leveraged loans have a distinct advantage over other fixed income classes in periods with rising interest rates. For securities like high grade bonds or Treasuries, which have fixed coupons, rising interest rates create price erosion. Leveraged loans, however, have variable rate coupons that insulate their prices from rises and falls in interest rates; the duration of the S&P/LSTA loan index in March 2012 is near zero. The low duration properties of leveraged loans make them superior performers in rising rate environments; over the past 15 years, in periods where Treasury yields have been rising, annualized returns on leveraged loans have exceeded those of high yield bonds by approximately 70 basis points and those of investment grade bonds by over 400 basis points.

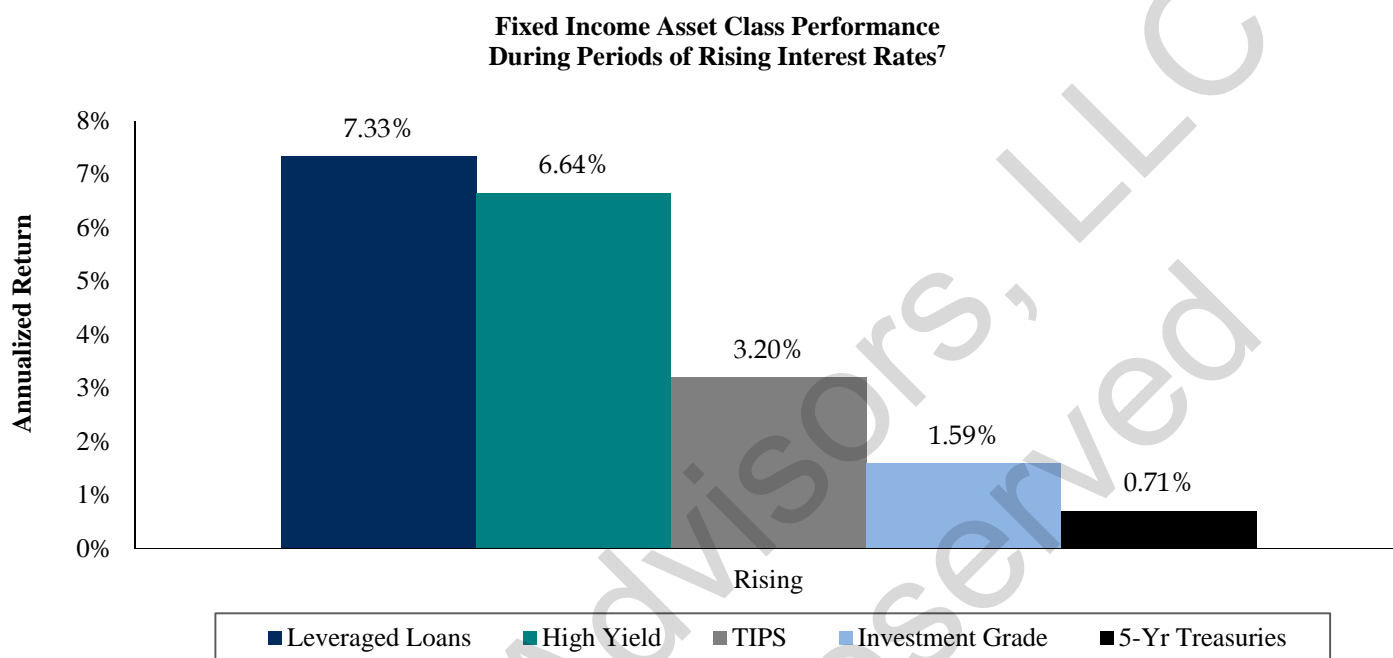


Figure 1: Variable coupon rates give leveraged loans an advantage over traditional fixed-income securities in rising rate environments.⁸

Average Annualized Returns in Rising Interest Rate Environments⁹

Δ Interest Rates	Period	Leveraged Loans	High Yield	Investment Grade	5-Yr Treasury	TIPS
+1.73%	1999 Q1 – 2000 Q1	4.15%	1.56%	1.09%	1.29%	N/A
+1.53%	2005 Q1 – 2006 Q2	6.11%	3.85%	1.12%	0.38%	2.00%

Figure 2: Leveraged loans offer consistently higher total returns in rising rate environments

⁷ Source: Credit Suisse, Barclays.

⁸ Analysis excludes data from 2008Q3 through 2009Q4 due to market dislocation. Data on TIPS is only available since 2002. Interest rates were determined to be rising (falling) if the 3-month rolling average 5-yr treasury yield was greater (less than) that of the previous month. Source: Credit Suisse, Barclays.

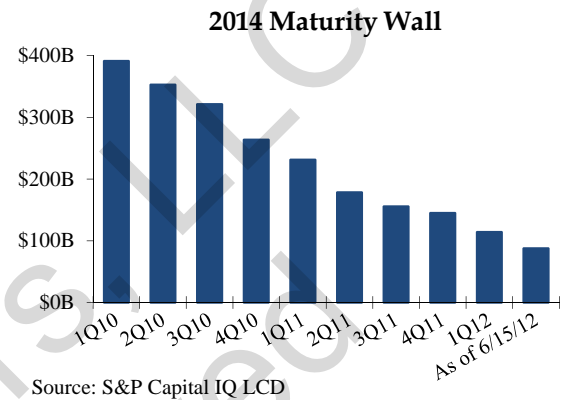
⁹ Source: Credit Suisse, Barclays.

APPENDIX: DEBUNKING COMMON CONCERNS ABOUT LEVERAGED LOANS

Some observers have highlighted two potential developments that could have an adverse effect on the leveraged loan market: (1) a “maturity wall” in 2014 and (2) a gap between supply and demand for loans caused by a build-up of “dry powder” among private equity firms (e.g. new deals will involve issuance of leveraged loans, increasing supply) and the decline in Collateralized Loan Obligation (CLO) activity post-2008 (e.g. these special-purpose vehicles bought pools of loans and were a major source of demand). We believe that both of these events do not represent substantial threats to the market and actually may create profitable opportunities for institutional non-bank lenders.

Maturity Wall

Refinancing activity over the past ten quarters has dramatically reduced the amount of principal coming due during the next two years, lowering the risk of near-term market disruptions. In Q1 of 2010, nearly \$400 billion of leveraged loan obligations were set to mature between 2012 and 2014; market observers worried that the simultaneous refinancing of these obligations could trigger market instability. Fortunately, the 2012-14 “maturity wall” has been reduced by an average of \$33.7 billion per quarter over the last ten quarters, with a balance of only \$87.6 billion as of June 15, 2012. Most of this reduction occurred through new issuances.

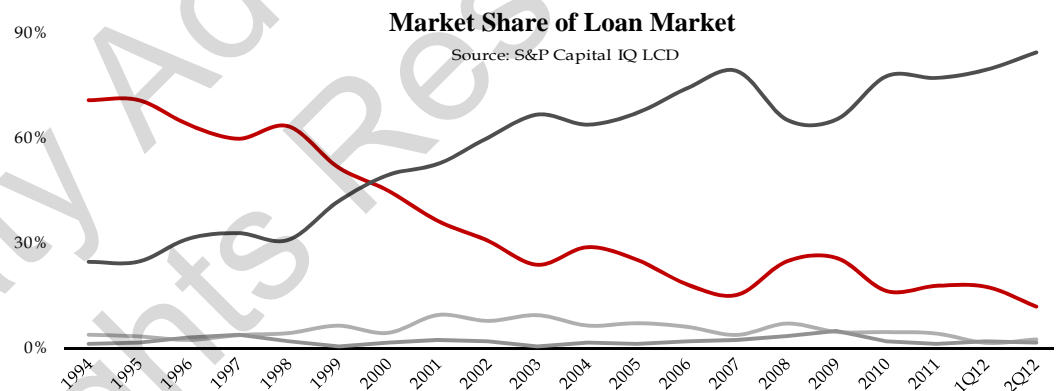


Supply & Demand

We believe that greater demand for leveraged loans from institutional investors, who have largely stepped in to fill the void created by a decrease of CLO issuance, will be able to meet the increased supply of leveraged loans stemming from the likely increase in LBO activity and other sources.

First, the desire to protect against rising interest rates is expected to drive strong demand from institutional investors. With yields on 5-year Treasuries under 1%, interest rates do not have much more room to fall.

Second, loan demand from retail investors – funneled through unlevered institutional investors like mutual funds and ETFs – has picked up substantially. In 2011, inflows from retail investors to bank loan mutual funds totaled \$9.2 billion.¹⁰ The launch of a leveraged loan ETF by Blackstone and State Street is expected to drive retail awareness and interest even higher. Low yields on government bonds and uncertain equity increase the appeal of leveraged loans to a class of investors that was previously not involved in the sector.



The notable rise in institutional investors introduces an element of stability to the market by providing a floor for loan spreads. As this new buyer is an unlevered one (as opposed to CLO vehicles), we do not expect market spreads to return to the lows seen in 2006 and 2007 where 4-year discount margins declined below L+250. With that said, we are seeing a rebound in CLO activity with new issuance at \$46 billion YTD. While this does add to the market some levered buyers who can accept lower spreads on new loan deals, CLO activity is still well below 2006-2007 levels where new issuance was approximately \$90 billion.

¹⁰ S&P LCD.

Please consider the following:

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