

# Investor Letter

## "The Case For Leveraged Loans"



**Alan Burke,**  
Chief Executive

In 2004, the then Fed chairman, Alan Greenspan added another phrase to go with his 1996 "irrational exuberance" comment when he coined the term the "bond market conundrum".

Greenspan was referring at the time to the apparent contradiction that US long term bond yields appeared to be staying unnaturally low despite rising short term interest rates, something that didn't conform to orthodox economic theory and which puzzled him and other economists at the Fed greatly.

Hindsight of course tells us that Greenspan's "conundrum" of 2004 was just symptomatic of some of the pressures and imbalances that were building in the world's financial architecture at that time with US trade deficits being recycled by foreign central banks and other investors back into US financial assets. These policies helped fuel the US credit and housing boom, the consequences of which we all have to live with today.

I am reminded of this piece of recent history by another "conundrum" much closer to home which is - Why has the asset class of European leveraged loans not become a much more commonly accepted institutional asset class?

In a world with at least \$50tn of institutional assets, why does institutional investment in European leveraged loans constitute less than €100bn today? In fact, given that €75bn of the €100bn of institutional capital invested in the European leveraged loan asset class today is in the form of CLOs, the likelihood that the average non-CLO institutional investor is invested in the European leveraged loan asset class today is extremely low.

This conundrum, like all conundrums is not easily answered. The most likely culprits for the lack of historic institutional demand for the asset class are possibly a lack of knowledge and a degree of fear, which tend in our experience to go hand in hand when it comes to investing.

My task in this newsletter is to give the investment case for European leveraged loans using the disciplines of value investing and in doing so, hopefully to help resolve the "conundrum".

The format for this letter is:

1. A brief discussion on the value investing approach to Risk and Return
2. A description of the European leveraged loan asset class (investors already very familiar with the asset class may want to skip straight to Section 3)
3. A detailed look at the Risks and Return profile of the European leveraged loan asset class using a value investing framework.

### 1. Value Investing and Risk and Return

Regular readers of our newsletters will know that we are avid fans of the approach of Warren Buffett to investing, to the point that we are fully paid up members of what Charlie Munger, Berkshire Hathaway's 86 year old Vice Chairman, describes as "the cult".

This is not just because of an incredible track record which turned a \$100 investment made by Buffett himself in his original partnership in 1956 into a personal fortune of \$50bn today, but also because his approach to investing is one of logic and common sense which has applicability for investors across all asset classes, including leveraged loans.

Buffett is a self-acknowledged pupil of the father of value investing, Benjamin Graham, with whom he worked in the early part of his career and who was a very successful investor himself.

Graham in his classic book, Security Analysis (1934), describes an investment as:

## "The Case For Leveraged Loans"

"An investment operation is one which upon thorough analysis promises *safety of principal* and *an adequate return* (emphasis added). All other operations are speculation".

Almost 80 years on, Graham's definition of investing is still almost too perfect to be tampered with. The only clarification to add is that safety of principal refers to safety of principal *in terms of original purchasing power*. The object of any investor is to protect and if possible grow the purchasing power of the capital entrusted to them, something which comes into sharper focus in inflationary times.

The structure of Graham's definition of an investment with safety of principal coming *before* adequate return is no accident, as protection of the downside is the bedrock on which value investing is built. Graham did not believe the mantra about Risk and Return necessarily being related but saw them as distinct factors to be separately analysed in assessing the merits of any investment opportunity.

### 1) The nature of Risk

Value investors describe Risk as being the possibility of loss of capital. This is at variance with the definition of Risk still used in most finance courses today, in particular Modern Portfolio Theory which equates Risk with price volatility or describes Risk as the Standard Deviation of Return. Apart from the fact that the empirical evidence is increasingly coming to discredit key aspects of Modern Portfolio Theory (such as Risk and Return always being correlated), Graham's definition of Risk intuitively makes much more sense to us as risk averse investors who care about capital preservation.

The nature of Risk in investing was also examined by Seth Klarman of the Baupost Group (\$22bn AUM) in his book *Margin of Safety* (1991). Klarman is another celebrated value investor and Ben Graham disciple with an incredible track record (he has outperformed the S&P 500 by over 10 points a year over the past 20 years).

Klarman describes one part of Risk in any investment as being "inherent to the nature of the investment". For example, a dollar invested in a biotechnology stock is inherently more risky than a dollar invested in a utility. However, the second element that creates Risk in an investment comes from the price paid for the asset. Buying even an inherently safe investment at the wrong price, also creates a Risk of loss of capital for an investor.

Klarman, like Graham and Buffett advocates a focus on the Risk rather than the Return element of the equation when assessing investment opportunities. In practice, this is achieved by always investing with a "Margin of Safety", a term first referenced by Graham in *Security Analysis*.

Investing with a Margin of Safety involves purchasing an investment at a sufficient discount to estimated fair value as measured by estimated future cashflows such that in an uncertain world, the price paid allows for negative scenarios to

occur while still ensuring that an investor receives at least the original investment back.

The reason why safety of principal is so important to value investors and should be to all investors can be illustrated by a simple mathematical example. Suppose we have two portfolios A and B each containing five equally weighted assets. In Portfolio A, in year 1 each of the five individual assets earned a 7% return with no losses. In Portfolio B, 4 of the assets earn a 10% return, while the fifth one has a negative 10% return. Which Portfolio is the better investment at the end of Year 1?

Year 1 Annual Return	Portfolio A	Portfolio B
Asset 1	+7%	+10%
Asset 2	+7%	+10%
Asset 3	+7%	+10%
Asset 4	+7%	+10%
Asset 5	+7%	(-10%)
<b>Total</b>	<b>7%</b>	<b>6%</b>

Portfolio A beats Portfolio B, despite 4 of its 5 assets underperforming those in Portfolio B. However, if the loss on the one negative Portfolio B asset were to be 100%, then the other four portfolio B assets would have to earn 33% average returns each in order just to match the return on portfolio A.

Furthermore, in the scenario whereby Portfolio B suffers a 100% write off on one of the assets in Year 1 and the other assets in Portfolio B continue to earn 10% per annum and all Portfolio A assets continue to compound at a steady 7% per annum, then it would take 9 years of continuous compounding for the value of the remaining assets in Portfolio B to pass the return of Portfolio A. Loss of principal matters hugely, particularly when compounding is factored into account.

### 2) The nature of Return

The second part of Graham's definition of an investment is less well defined. An investment must have promise of safety of principal and *an adequate return*.

"Return" for most risky assets cannot be measured precisely in advance – Return is only knowable with any certainty at the end of the investment's life. While this is definitely true of classic risky assets such as equities, it is also true of so called risk free assets when Return is measured in real terms rather than a nominal basis. Investing in a non-inflation linked government bond today promises a known nominal Return if held to maturity (assuming one believes in the creditworthiness of the government in question) but in the absence of certainty regarding future inflation levels, the real Return on such an investment like all investments is unknowable in advance.

## "The Case For Leveraged Loans"

An adequate Return for Buffett is dependent upon the Return available on other risky assets. If the Risk side of the equation has been well covered off through a thorough downside analysis, then the investment with the highest probability weighted Return should be chosen from all of those available. The notion of opportunity cost essentially dictates the "adequate return" hurdle for Buffett investments.

All well and good but how does any of this relate to the asset class of European leveraged loans?

Well, three basic tenets from the world of value investing are helpful in assessing the absolute and relative merits of European leveraged loans as an asset class namely:

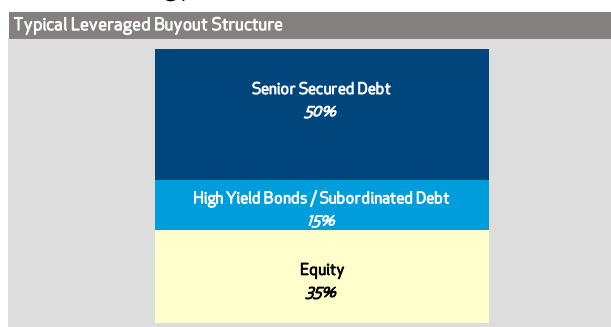
- The starting point in assessing the attractiveness of the asset class of European leveraged loans is in assessing its Risk in terms of the potential for a loss of the purchasing power of original capital invested
- In an uncertain world, an investment in the European leveraged loans asset class must be made at a price that ensures a sufficient "Margin of Safety" that ensures that the investment can withstand a range of adverse consequences and still result in protection of capital
- The potential Return available on leveraged loans must be assessed relative to other equally conservative investment opportunities available at that time in order to ensure that Returns are attractive both in an absolute and also a relative sense.

## 2. The European Leveraged Loan Asset Class

### Overview

A leveraged loan (also known as a senior secured leveraged loan) is a corporate loan that is rated sub-investment grade by one or more of the main rating agencies. Leveraged loans in Europe have historically been used predominantly to part fund leveraged buyouts made by private equity firms.

Typically between 50% and 65% of the total capital requirement for a leveraged buyout will consist of leveraged loans with the remainder being made up of a combination of subordinated debt or High Yield Bonds and equity. Leveraged loans have a first lien charge over the cashflows and assets of the business being purchased.



Leveraged loans sit at the top of the capital structure and also benefit from a number of other attractive features that further enhance the security of their position including:

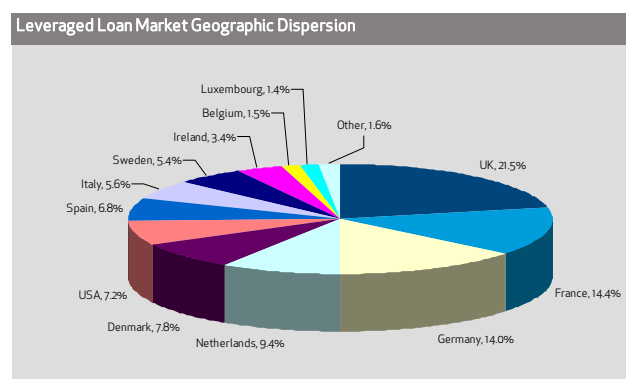
- Comprehensive independent due diligence reports are made available to lenders prior to investment including financial, market, legal, pension due diligence, etc;
- Financial covenants exist to pass control of the business over to senior lenders in the event of material underperformance to plan;
- Prohibitions exist on acquisitions, dividends to owners, disposals, or pledging security to other lenders without the consent of existing senior lenders;
- Detailed monthly management accounts, annual budgets and access to management are made available to lenders to facilitate monitoring the investment.

The leveraged loan market in Europe grew rapidly over the period 1997-2007 and is now estimated to be €300bn in size. By way of comparison, the better known European High Yield Bond market only has today approximately €100bn of bonds outstanding. The main players in the European leveraged loan market are as follows:

Investors	€
Commercial and Investment Banks	200bn
CLOs	75bn
Other Institutions (predominantly hedge funds)	25bn
<b>Total</b>	<b>300bn</b>

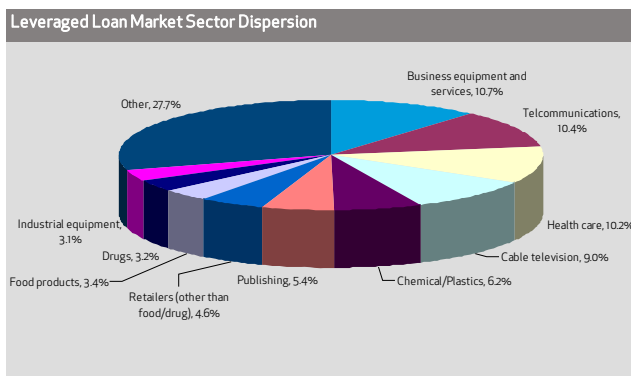
The European leveraged loan market also contains a large number of very significantly sized borrowers. The average borrower in the Avoca portfolio for example has annual Revenues of €2.2bn and annual EBITDA of €400m and would be large enough to be a constituent of the FTSE 100 if it were publicly quoted.

The market is also well diversified by sector and geography as can be seen from the following graphs:



Source: S&P/LCD

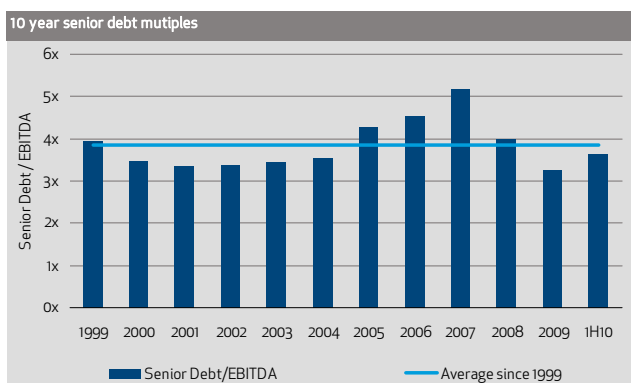
# "The Case For Leveraged Loans"



Source: S&PLCD

## Lending Multiples

Lending multiples (measured as senior Debt/EBITDA) in the market have tended to vary over time depending on the availability of capital, the level of interest rates and the point in the credit cycle and have moved as follows over the past decade:



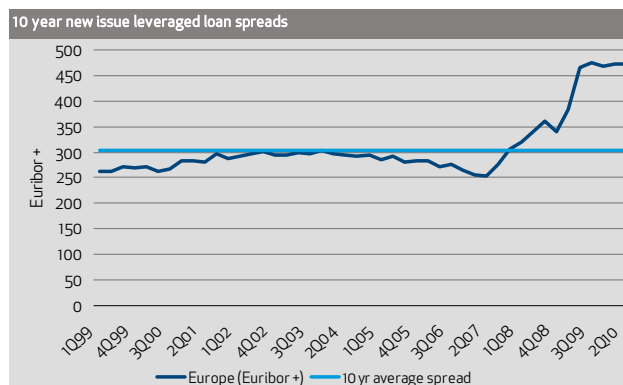
Source: S&PLCD

Current senior debt lending multiples are approximately 4x EBITDA, in line with their historic average. Given that Avoca estimates capital expenditure, working capital and other cash outflows equal approximately 20% of EBITDA, a 4x Debt/EBITDA multiple equates to about 5x debt-to-annual free cashflows.

## Spreads

European leveraged loans are one of the few asset classes whose return is Euribor based (i.e. floating) rather than fixed in nature. Borrowers can choose to rollover loans for periods from one week to one year with the median borrower in Europe typically choosing to roll on a three month Euribor basis.

The spread on European leveraged loans has historically been less volatile than lending multiples (underwriters of leveraged loans in Europe have tended to compete in winning underwriting mandates on leverage rather than on spread). The average spread on new issue European leveraged loans over the past decade has been as follows:



Source: S&PLCD

New issue spreads were consistently in the range Euribor +250-300bps for the 10 years preceding 2007. Since the capital markets dislocation in 2007 and the credit crisis in 2008, new issue spreads have increased towards an average Euribor +450/500bps today.

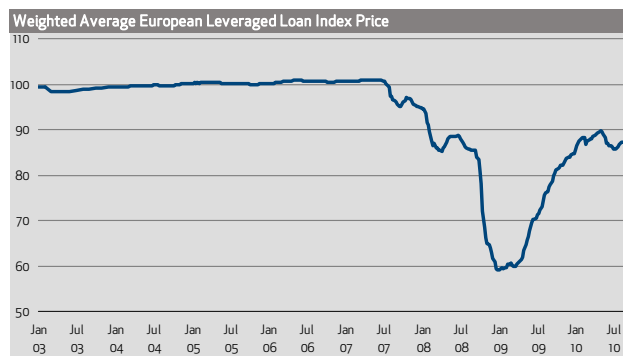
## Liquidity and Price Volatility

As new leveraged loan issuance grew in the mid 2000s, the investor base in the asset class evolved. Institutional investors (predominantly CLOs and hedge funds) grew market share from less than 7% in 2000 to over 55% in 2007. The number of institutional loan managers in Europe also grew substantially during that time and today numbers approximately 100.

As a result of this growth, the size of lending syndicates expanded and secondary market liquidity increased rapidly from what had been a "take and hold" market.

The secondary market for leveraged loans in Europe is now quite active with daily two way markets (€2m-20m quotes per name) in over 100 of the most liquid names ("flow names") and regular market making for another 150 or so of the estimated 600 borrowers in the market. Secondary market trading volume in European leveraged loans over the last 12 months was in excess of €60bn.

Up until 2007, secondary market prices for leveraged loans in Europe were extremely stable as can be seen below.



Source: S&PLCD

## "The Case For Leveraged Loans"

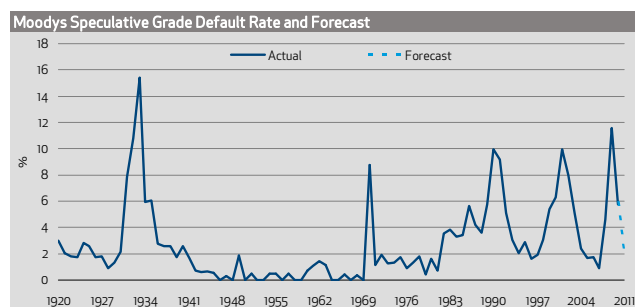
The underlying price stability was primarily driven by the position of leveraged loans at the top of the capital structure (which should naturally lead to lower inherent volatility) and also by a lack of liquidity driven by the "take-and-hold" mentality of the bank dominated lender base as described above. European leveraged loans up until 2007 were a 'par' market and pricing was not materially impacted by movements in other capital markets or general macro-economic conditions.

However, with the shut-down of the securitisation market in mid 2007 and the collapse of Lehman in 2008, banks and some mark-to-market vehicles became forced sellers of leveraged loans at a time of constrained capital availability globally. As a result, the once stable European leveraged loan market (that over the previous 15 years had, on average, not ever fallen below 98%) saw prices reduce to less than 60% by March 2009.

The price volatility in the market in 2007-2008 was predominantly due to the forced unwind of leveraged mark-to-market funds rather than solely a reflection of poor underlying trading performance or outlook at the individual corporate level as we will see below. Loan prices in Europe have recovered today to the high 80's (low to mid 90's for the more liquid "flow" names).

### Defaults and Recoveries

The extreme nature of the current default cycle can be seen by looking at global speculative grade defaults since 1920.



Source: Moodys

Defaults for sub-investment grade lending have averaged 3-4% over the long term with significant periodic spikes as can be seen from the graph above. The recent default cycle which peaked at 12% annual defaults last year was the highest since the Great Depression in the 1930s. However, as we have outlined in previous publications, the recent default experience in the European loan market was predominantly concentrated in cyclical industries. The following table shows the five sectors that accounted for c.60% of defaulted debt since 2007:

Sector	% defaults by amount since 2007
Construction and Building Materials	15.6%
Retailing	12.7%
Real Estate	12.1%
Automotive	8.7%
Chemicals	8.6%
<b>Subtotal</b>	<b>57.8%</b>

Source: S&P LCD / Avoca estimates

Historical hard data on recoveries for senior secured debt in the European market is limited. However, a recent report by Moodys outlined a comparison of recoveries on defaulted senior secured debt versus other debt layers in the US from 1988 to Q2 2010 and we believe this is a good proxy for the European leveraged loan recovery experience:

Debt Instrument	Recovery Rate
Loans	80.7%
Senior Unsecured Bonds	40.3%
Subordinated Debt	28.6%

Source: Moodys, 'Hard Data for Hard Times', 21 July 2010

The senior secured nature of the loan asset class benefits debt investors significantly, with c.40% better recovery than that experienced by unsecured bonds. With average annual defaults over the cycle of 3-4% and recoveries of 80% or so, the annual loss rate for senior secured loans should be in the region of 60-80bps per annum, substantially less than the average gross lending spread of 300bps or so historically earned by the asset class.

### Transparency

In comparison to the US leveraged loan market (which is 80% publicly rated), the European market was historically a predominantly private market and only 30% or so of the market is publicly rated today.

This may lead some to view the asset class as relatively opaque. However, transparency between lender and borrower in the European leveraged loan market in Europe is extremely high. For example, Avoca receives monthly management accounts (detailed profit and loss, balance sheet and cashflow information as well as management commentary) within 30 days of month end from 150 of our 180 borrowers with the remainder reporting quarterly. This level of detailed performance information is not available to any other investable asset class globally other than private equity.

It should be noted that the European leveraged loan market is slowly evolving towards a US publicly-rated model. This change is being driven by the rating agencies (for example S&P will now provide only a public rating to deals in excess of €1bn) as well as investor demand for more loan level rating transparency.

## "The Case For Leveraged Loans"

Avoca is committed to providing investors access to as great a degree of the underlying information on borrower level performance as possible including monthly summary Revenue and EBITDA performance by sector, monthly Revenue and EBITDA indices, private ratings dispersion information and independent market values and pricing trends on all underlying loans.

Further details regarding the history and background of the European leveraged loan market (including a comparison with its larger cousin, the US leveraged loan market) are available to investors on the Avoca website at [www.avocacapital.com](http://www.avocacapital.com).

### 3. Assessing Risk and Return for the European Leveraged Loan Asset Class

#### Risk profile of European leveraged loans today

What is the Risk associated with investing in European leveraged loans today?

Risk for any investment is the risk of ultimate loss of original capital, measured in purchasing power terms. For European leveraged loans today the question then becomes - if we lend to a corporate borrower at 4x current EBITDA (or 5x free cashflow), what is the Risk that ultimately we will not get our money back?

The intrinsic or fair value of any asset is the discounted value of all future cashflows flowing from that asset. If we assume a no growth scenario in which free cash flow generated by a company stays constant in perpetuity this can be written mathematically as:

$$V = FCF/R$$

Where

- V = Value of the company
- FCF = Free Cash Flow of the company (≈EBITDA less capital expenditure, working capital and tax)
- R = Discount rate or cost of capital expressed as a percentage

Rewriting this slightly by letting  $1/R = C$  (Capitalisation rate) then the formula becomes:

$$V = FCF * C$$

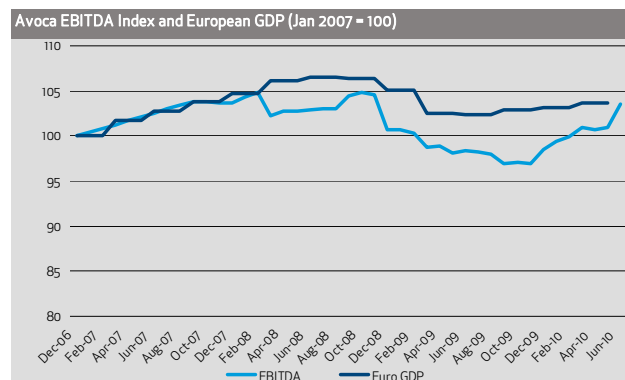
In other words the value of the asset (under the above assumptions) is its annual free cash flow to the owner of that asset multiplied by an appropriate Capitalisation rate (otherwise known as a multiple).

Using Klarman's approach to analysing investments, the Risk of loss of capital for an asset can be looked at in terms of both its inherent riskiness (which corresponds to the potential for a permanent reduction in annual FCF generated by the company) and the price or multiple paid for that asset (which corresponds to the Capitalisation rate, C above). Risk is obtained either by

buying an asset that has a high potential for a permanent reduction in Free Cash Flow or by paying too high a multiple for those cashflows.

#### 1 Risks of permanent reduction in Free Cashflow

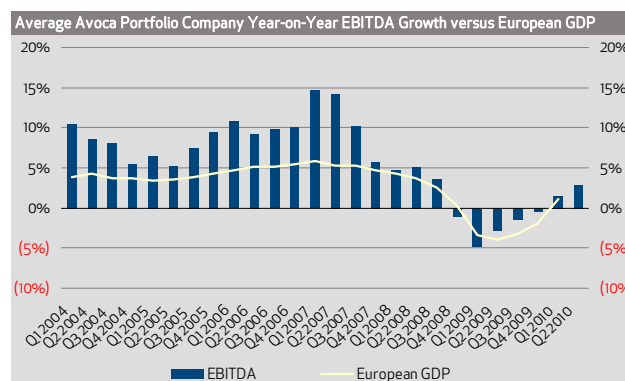
How volatile are the Free Cash Flows of a leveraged buyout? We have had a perfect environment to test how volatile Free Cash Flows can be through the economic cycle given the extreme macro-economic conditions through which leveraged buyout companies have had to operate over the past three years. The following chart shows how EBITDA (a proxy for Free Cash Flow) for the average Avoca portfolio company has performed over the past three years (1 January 2007 = 100).



Source: Avoca Deal Database and Bloomberg

The EBITDA performance of the average Avoca portfolio company has been relatively stable despite operating in the worst macro-economic environment since the 1930's. Average EBITDA on the Avoca index declined from 100 in January 2007 to the mid 90's by the middle of 2009 and has since recovered to 103 or so. Average EBITDA of the European leveraged loans in the Avoca portfolio has broadly tracked GDP over the past 3 years.

Going back over a slightly longer period, we can see that EBITDA for the average Avoca portfolio company has had quite a strong correlation with movements in GDP over the past six years.

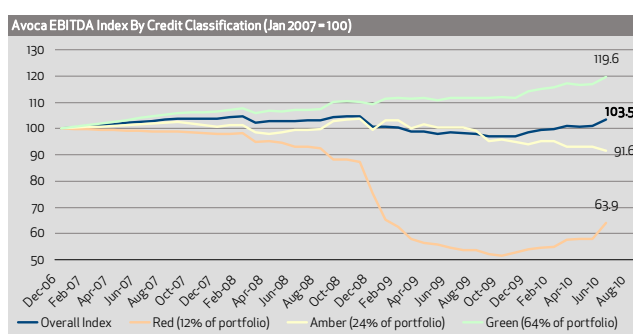


Source: Avoca Deal Database and Bloomberg

## "The Case For Leveraged Loans"

For the period from 2003-2006, portfolio company EBITDA grew at roughly twice the level of European GDP. This was partially due to exposure to faster growing overseas markets and also due to operational leverage. The EBITDA growth rate increased to 3x GDP in the boom period of late 2006 and 2007, before falling back to broadly track GDP since then.

Finally, to highlight the importance of choosing less volatile sectors, we have split the EBITDA performance of the Avoca portfolio over the past three years between our Green (64% of portfolio), Amber (24%) and Red cases (12%).



Source: Avoca Deal Database

The above shows that while overall the portfolio has performed well, if we had been unlucky (or foolish) enough to choose all Red cases (which mainly consist of cyclical sectors), then the overall EBITDA volatility of the portfolio could have been substantially worse than that we actually experienced.

In conclusion, the underlying Free Cash Flows for a carefully selected European leveraged loan portfolio have historically broadly tracked movements in GDP. The *inherent* Risk in terms of free cashflow downside for a carefully selected portfolio of leveraged loans is not excessive.

*Is the strong 2008/2009 EBITDA performance of the European loan market repeatable if we have a double dip recession?*

One of the most frequently asked questions from investors when they are presented with the above data is "companies appear to have done a good job in 2009 mitigating the effects of the recession but was this a one off benefit due to the effects of cost cutting?"

The following table shows the change in the Avoca Revenue and EBITDA Indices and Gross Margin for 2008 and 2009:

	2008	2009
Annual change in Revenue Index	+0.4	-1.2
Annual change in EBITDA Index	+0.6	-0.3
Average Gross Margin	50.9%	51.9%
Change in Average Gross Margin	+0.5%	+1.0%

The analysis shows that Avoca companies, on average, largely offset what were relatively small reductions in Revenue in 2009 by increasing Gross Margin. Our bottom up analysis of the 180 companies in our portfolio suggests that the 1% increase in Gross Margin was roughly split 50/50 between lower Raw Material costs and labour cost savings.

In our view, the key to the above performance lies not so much in the cost side of the equation, but the fact that the Revenue side of the equation was quite stable. This reflects the fact that Avoca was predominantly invested in companies with strong market positions and pricing power operating in stable sectors.

While even such inherently strong companies would no doubt be somewhat impacted by a double-dip recession, we believe these characteristics of pricing power and ability to protect the top line (together with good control of the cost line) and position at the top of the capital structure should mean that European leveraged loan investors should not be unduly concerned by the impact of a possible double-dip recession on fundamentals.

Finally for those whose outlook on the macro-economic environment is particularly bearish, in order to illustrate the robustness of European leveraged loans cashflows during a period of severe macroeconomic dislocation, we can look at the following simple mathematical example:

EBITDA =	100
Capital expenditure, working capital, tax etc. =	20
Free Cashflow =	80
Senior Debt/EBITDA =	4.0x
Total Debt/EBITDA =	5.0x
Total cash interest cost (5 yr Euribor + 5%) =	7%

If we assume that EBITDA declines by a continuous 10% per annum with no recovery during that period, then over the five year duration of the loan, cashflows and net senior debt multiples would evolve as follows:

Year	1	2	3	4	5
EBITDA	100	90	81	73	66
Capex, etc.	(20)	(20)	(20)	(20)	(20)
Free Cashflow	80	70	61	53	46
Interest	(35)	(32)	(29)	(27)	(25)
Net Cashflow	45	38	32	26	20
Original Senior Debt	400	355	317	285	259
Closing Senior Debt	355	317	285	259	239
Senior Debt/EBITDA	4.0x	3.9x	3.9x	3.9x	3.9x

Despite a cumulative 35% or so reduction in EBITDA over the period, the senior debt/EBITDA multiple remains constant at the end of Year 5 at c.4.0x. A 35% reduction in EBITDA is considerably harsher than what actually occurred in the Avoca portfolio over the past two years (and is actually more in line with what happened the bottom decile of our portfolio i.e. the cyclical credits).

## "The Case For Leveraged Loans"

### 2 Capitalisation Rate

The Capitalisation rate is essentially the multiple that investors are prepared to pay at any given time for a set of Risky cashflows.

As we have seen above, historically the average Senior Debt/EBITDA multiple for European leveraged loans issued over the past 10 years has ranged between 3.0x and 5.5x and currently stands at 4.0x.

We can assess the appropriateness of, and Risk associated with, this Capitalisation rate in both an absolute sense and a relative sense.

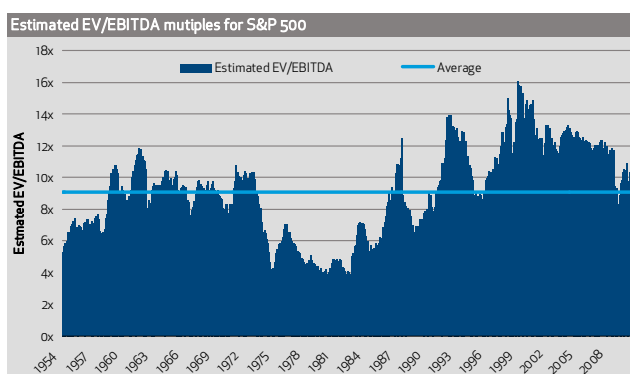
#### a) Absolute

In absolute terms, a 4.0x EBITDA multiple roughly corresponds to a 5.0x multiple of Free Cash Flow. If we believe that current Free Cash Flows are broadly sustainable over the medium to long term, this 5x capitalisation rate equates to a 20% discount rate or cost of capital (given that  $C=1/R$ ).

With 10 year government bonds in most developed countries currently yielding less than 3%, this intuitively seems a very conservative discount rate. Put another way, in a downside scenario where you as a senior lender take over the business, after 5 years owning a business at a 20% free cash flow discount rate you would have all of your money back in nominal terms and still own a performing business.

#### b) Relative

While definitely a non-believer in the Efficient Market Hypothesis, one of the more logical places to assess the current relative Capitalisation rate of the European leveraged loan market is to compare it with publicly quoted equity markets. The Enterprise Value/EBITDA (EV/EBITDA) multiples for the S&P 500 since the 1950s is as follows:



Source: Bloomberg and Avoca estimates

Current EBITDA multiples in the public equity markets average over 9x LTM<sup>1</sup> EBITDA and have not (in the past 50 years) ever

<sup>1</sup> LTM means Last Twelve Months

been lower than the 4x EBITDA multiple at which lenders lend to the European leveraged loan market today.

Capitalisation rates across asset classes could always in theory go substantially lower than they are today or have been in the past (the corollary being that discount rates could go appreciably higher). However, in such a scenario, with a Capitalisation rate less than half that of current equity markets, the downside Risk for European leveraged loans in terms of the multiple of cashflow paid is appreciably lower than comparable public equities.

Looking at the current Capitalisation Rate for European leveraged loans both in absolute and relative terms, we believe that the Risk of loss of original capital in a portfolio of cautiously selected leveraged loans today is very low.

#### Return profile of European leveraged loans today

The secondary market for European leveraged loans is currently priced at 87 and is yielding Euribor +600bps or so to maturity, with approximately 50% of that return coming from cash yield and the remainder through the "pull to par" effect. New issue leveraged loans in Europe are currently issued at 98-99 and are yielding Euribor +500/550bps, the majority of which is current yield.

The total expected gross Return available from buying a combination of new primary and secondary European leveraged loan opportunities today equates to an all-in return of 7-8% (given 5 year Euribor today is approximately 1.75%). In our experience, this Return exceeds the liability growth hurdles for most institutional investors which tend to be of the order of 5-6% per annum. With annual cash income of 6% plus for new primary loan purchases, this also meets the return hurdles for most investors who have regular income needs.

Relative to other asset classes, the potential Return available on leveraged loans today is also very interesting. For example, GMO's 7 year annual return forecasts (which historically have been very accurate) show the following comparisons across asset classes:

Asset	Real Return	Nominal Returns
<b>Avoca Estimates</b>		
European Leveraged Loans	4.5% - 5.5%	7.0% - 8.0%
European High Yield	5.5%	8.0%
Long Term Historical US Equity	6.5%	9.0%
<b>GMO Forecasts</b>		
US High Quality Equity	6.1%	8.6%
Emerging Market Equity	5.5%	8.0%
International Large Cap Equity	4.1%	6.6%
US Large Cap Equity	1.9%	4.4%
Emerging Market Bonds	1.4%	3.9%
US Govt Bonds	0.2%	2.7%

Source: GMO / Avoca estimates. Inflation adjustment based on GMO estimate of 2.5%

## "The Case For Leveraged Loans"

The Returns available on leveraged loans today at 7-8% are comparable with GMO forecast returns for most other risky asset classes while arguably having significantly less downside.

While, it is true that European leveraged loans are not as liquid as some of the other asset classes listed above, they are not as illiquid as some other alternative investments which require capital to be locked up for years (e.g. private equity). Given the much lower downside risk in leveraged loans than most other risky asset classes, we believe current Returns offer exceptional relative value to investors today.

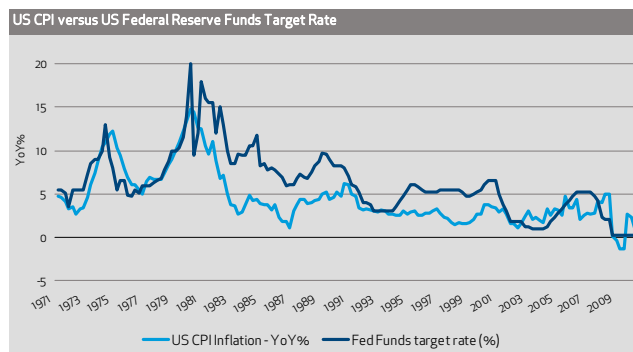
This currently attractive Return is also one that we believe is unlikely to disappear in a hurry for investors. The European loan asset class is likely to be a capital constrained asset class over the next number of years due to the probable Basle III led withdrawal of commercial bank capital from the sector and the fact that the other large current investor in the asset class, CLOs, are likely to shrink as an asset class over the next 5 years. The European leveraged loan asset class is likely to be a fertile one for Return seeking investors for much of the coming decade. The detailed outlook for the medium term Supply/Demand dynamics within the European leveraged loan sector are discussed in detail in another Avoca Newsletter "One Bite At A Time" also available on our website at [www.avocacapital.ie](http://www.avocacapital.ie).

### The impact of Inflation and Deflation on Return

As economists continue to argue over whether inflation or deflation is the more likely path for the global economy, we believe leveraged loans will continue to perform well in either scenario. For a detailed analysis of why we come to this view, readers should refer to our previous newsletter "The Great Debate", but for completeness we summarise these views here.

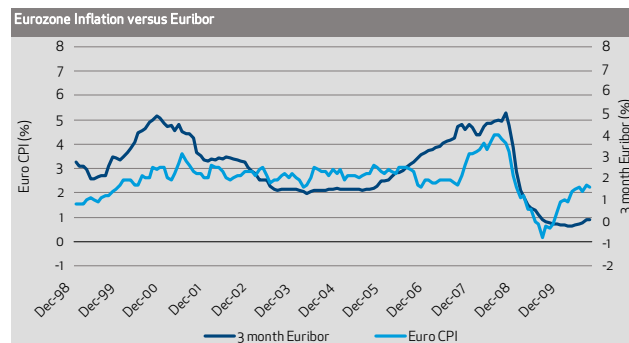
#### Inflation

Central bankers have, in modern times, done a reasonably good job at containing consumer price inflation (less well in controlling asset price inflation). Looking at the US first (with its longer data set), the graph below looks at the correlation between the US Federal Reserve Target Rate and CPI inflation since 1970 and suggests that US Libor over the past 40 years has been a good proxy for inflation.



Source: Bloomberg

As the Euro has only been in existence for approximately 12 years, the historical data is relatively short. However the graph below indicates that the ECB has been pro-active in altering the Euribor level to manage inflation risks (note also the period from early 2006 to 2008 when Euribor was raised ahead of a forecast increase in the CPI level).

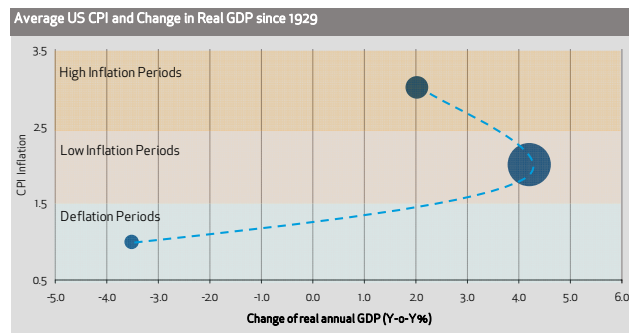


Source: Bloomberg

Historic data from both the US and Europe shows that Euribor and Libor have been good proxies for changes in the general price level. In an inflationary environment, investors in the leveraged loan asset class will do significantly better than those in fixed income who will see their real returns eroded by the increase in prices.

#### Deflation

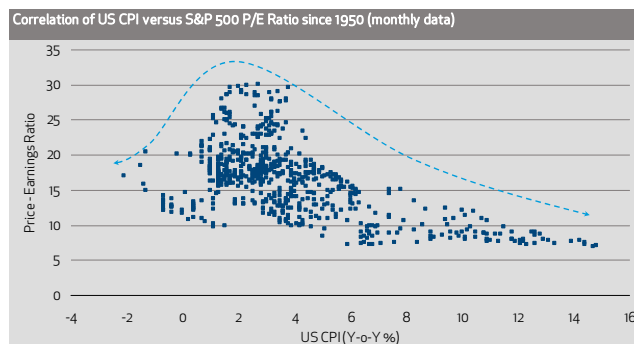
As readers of our last Investor Letter may remember, our analysis showed that deflationary periods, not surprisingly, tend to be associated with significant adverse reductions in aggregate demand.



Source: Bloomberg. The size of the bubbles represents the number of years in each sample. The analysis excludes 1941-42.

Contracting aggregate demand and reducing price levels are detrimental to equity investors (and subordinated debt lenders). In a deflationary environment, the real burden of debt principal increases and valuation multiples contract as shown in the graph below.

## "The Case For Leveraged Loans"



Source: Bloomberg

In comparison to equities and subordinated debt, senior secured lenders in periods of deflation benefit from the following:

- Senior secured ranking – equity, subordinated debt and High Yield Bonds are subordinated to senior lenders' interests in the capital structure and this provides protection against multiple (and potential EBITDA) contraction; and
- Zero bound Euribor – as Euribor can not fall below zero, senior lenders' real return would be in excess of the spread on offer (currently 500-550bps for new issues)

These factors ensure senior secured lenders' Risks are minimized and Returns remain attractive in times of general price reductions.

### Conclusion

In this paper we have examined the European leveraged loan asset class from the point of view of a classic value investor. We believe it can be objectively demonstrated that European leveraged loans currently offer:

*Safety of Principal* – by choosing senior secured loans in companies with stable cashflows and good pricing power and purchasing them at a low capitalisation rate, such as that available today, investors can minimise the risk of loss of original capital;

*To maintain the purchasing power of original principal* – Leveraged loans as a Euribor based product allow investors to earn good returns in periods of either high inflation or deflation. There are very few investment products available today that hedge both of these tail Risks well; and

*A (more than) Adequate Return* – New issue leveraged loans are currently yielding Euribor + 500-550bps per annum. Given the low downside risk nature of the asset class, we believe this all-in return of c.7-8% is not only adequate, but attractive relative to most other risky asset classes today.

The conundrum described earlier that has kept European leveraged loans below the average institutions radar is one that has been a mystery to those of us who have been investing in the asset class over the past 15 years and have seen its capacity to deliver stable returns to investors through the cycle while at the same time protecting investors from some of the key risks faced in today's uncertain environment such as inflation and deflation risks.

If the average institutional investors' Holy Grail is strong Diversified Risk Adjusted Return with good downside protection then this asset class is very well placed to meet that demand. Unlike most conundrums this one at least is one that the rational behaviour of self interested investors should resolve over the coming years.

**ALAN BURKE**  
CHIEF EXECUTIVE  
AVOCA CAPITAL