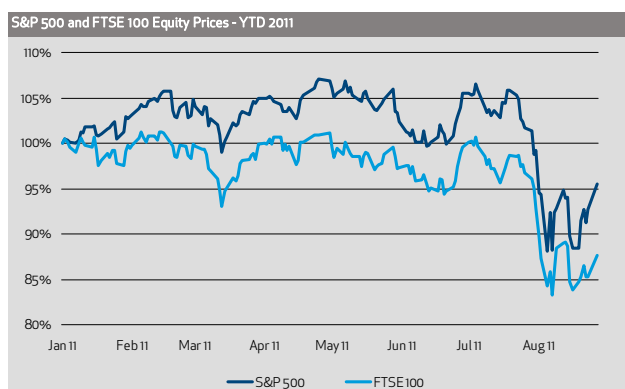


# Market Update

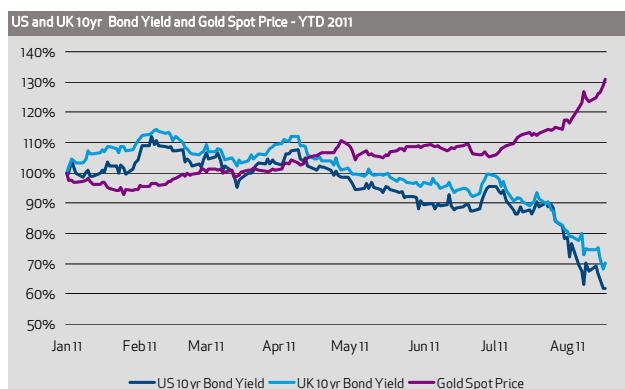
## Introduction

According to Napoleon Bonaparte, leaders are dealers in hope. If this is the case the capital markets have given a damning indictment of European and US political principals during the month of August.

The month started with the US Congress passing a debt ceiling bill on 2 August and finished with another uninspiring summit between the leaders of France and Germany. The charts below examine movements in the equity markets, bond yields and gold prices since the start of the year and the sharp reversals in August:



Source: Bloomberg (31 Aug 2011)



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Far from dealing in hope, it appears the timid political response to the sovereign debt situation has resulted in fear (sales out of risk assets) and uncertainty (the rally in gold signals protection versus inflation, the rally in bond yields signals deflation concerns).

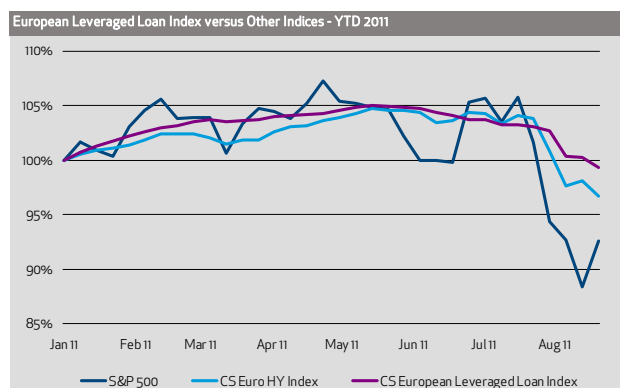
## The European Loan Market

While the capital market movements outlined in the introduction have been well covered in the financial press, the change in yields in the European loan market has not been commented on to the same degree. The purpose of this note is to:

1. Outline the recent changes in yield
2. Explain the fundamental and technical reasons for these changes; and
3. Provide our outlook for the market

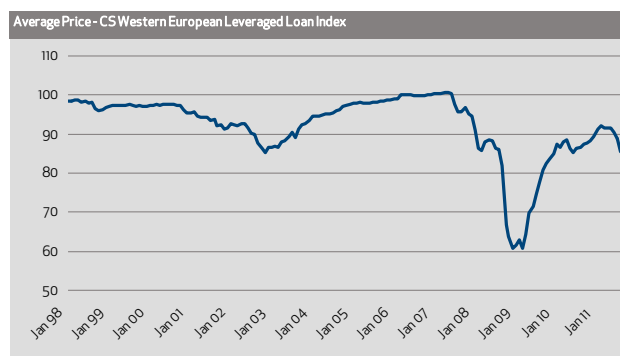
### 1. Recent Movements in Loan Market Yields

As with other asset classes, the European loan market has been impacted by the current macroeconomic uncertainty. However, loan prices have held up relatively well versus other risky assets:



Source: Credit Suisse, Bloomberg

The average price of a European leveraged loan is now c.85 – similar to levels seen in November 2002 (post- Dot com bubble), September 2008 and September 2009 (pre- and post-Lehman collapse). Overall the European loan market is down c.5% since June and is now approximately flat for the year to date:



Source: Credit Suisse

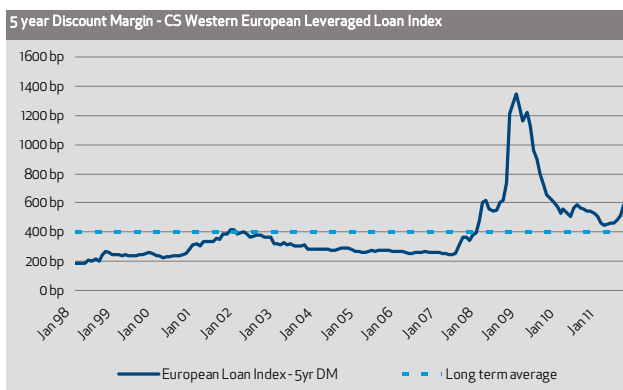
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### 2. Reasons for Change

The following section looks at both fundamental and technical indicators of the recent pricing changes:

#### Fundamentals

As set out in our recent Avoca IA Reviews, spreads in the European loan market have increased significantly in the last three years and are now at c.600bps over Euribor. This is 50% above the long term average of approximately 400bps:

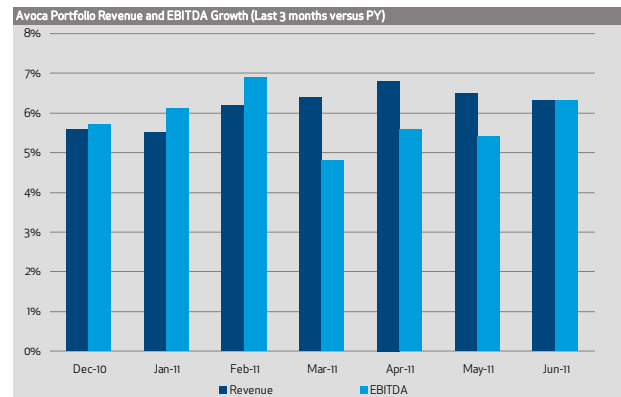


Source: Credit Suisse

There are three points to note about the current spreads of E+600bps on offer:

- Current gross spreads for leveraged loans of E+600bps compare very favourably versus long term (since 1800) nominal equity returns of approximately 8%<sup>1</sup>;
- These spreads imply an average **annual** default rate (to break even) of approximately 25%<sup>2</sup>. Considering defaults in the loan market peaked at 10.5%<sup>3</sup> through the recent crisis, this seems very unlikely; and
- The spreads are c.200bps over the maximum annual default loss rate from the most recent crisis of 450bps in 2009<sup>4</sup>

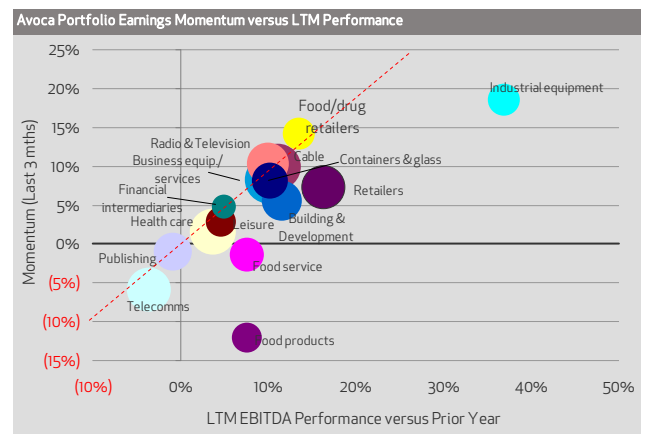
In Avoca we have good visibility on the historic performance of the broad European economy through the monthly management accounts we receive from our 170 portfolio companies. Examining the most recent set of monthly accounts (July 2011) current Revenue and EBITDA growth rates remain above the long term average (albeit they are slowing). The graph below shows the last three month growth rates across the portfolio since the start of the year:



Source: Avoca

The data shows that while top line momentum has slowed in recent months, it remains in the range 5-7% ahead of prior year, well above long term GDP growth rates. EBITDA growth over prior year has also averaged 5-7% during 2011 to date.

Another way to look at the current market is on a sector-by-sector outlook. The following chart, familiar to our IA Review readers, shows momentum (last three months EBITDA growth versus prior year) versus longer term performance (last twelve months). The sectors above the dotted line are exhibiting positive momentum, while those below the line are growing at a slower pace than the last twelve months:



Source: Avoca

The overall picture is one of stable growth with recent 3 month momentum broadly following the same growth trend as 12 month data. Some notable exceptions are:

- *Food products*: Currently being negatively impacted by higher raw material costs
- *Telecoms*: Facing increased competition from cable, increased competitive intensity in mobile
- *Retail*: This sector has performed well through the crisis but growth in earnings (while still positive) has slowed significantly in recent months

<sup>1</sup> Nominal Return on US stock since 1800 – 31 July 2010, Deutsche Bank Long Term Asset Return Study 10 September 2010

<sup>2</sup> Based on current 5 yr US Bond Yield as the “risk-free rate” and an 80% recovery rate (based on “European Leveraged Loans: Robust Recoveries in Recent Downturn”, Moodys, 20 July 2010

<sup>3</sup> ELLI LTM Default Rate (by principal amount) December 2009, S&P LCD

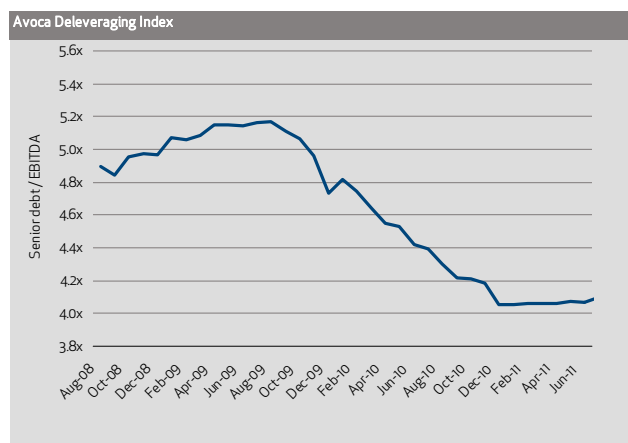
<sup>4</sup> Credit Suisse 2011 Leveraged Finance Mid-Year Outlook and Review, 28 July 2011

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- *Industrial Equipment:* A leading sector out of the recession with strong revenue and earnings, performance is now beginning to (slowly) revert to mean long term performance trends.

We are conscious that consumer confidence indicators in both Europe and US have been low in recent months. The recovery from the most recent recession is fragile and readers of our investor newsletter will know that we have been cautious due to macroeconomic concerns over the last 12 months (in fact our long/short credit hedge funds have been flat/net short for the last three months). However, the data to date suggests that pricing in 25% default rates to breakeven is overly conservative.

This is also underscored by the rapid deleveraging of borrowers (due to low interest rates and stable growth in earnings). This is shown in the graph below which shows the reduction in senior leverage of Avoca names from 4.8x at the start of 2010 to 4.1x currently:



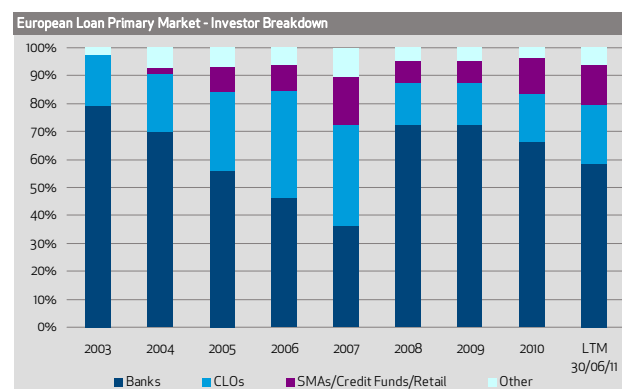
Source: Avoca

This trend should not be surprising. Senior debt will deleverage even in a low or zero earnings growth environment (as the following example shows, which assumes flat earnings and estimates capital expenditure, working capital and tax, etc at 20% of EBITDA):

Year	0	1	2	3	4	5	6
EBITDA	100	100	100	100	100	100	100
Capital expenditure, working cap, etc	(20)	(20)	(20)	(20)	(20)	(20)	(20)
Free Cashflow	80	80	80	80	80	80	80
Interest	(35)	(32)	(28)	(25)	(21)	(17)	(12)
<b>Cashflow post interest</b>	<b>45</b>	<b>48</b>	<b>52</b>	<b>55</b>	<b>59</b>	<b>63</b>	<b>68</b>
Senior Debt	400	355	307	255	200	141	78
Total Debt	500	455	407	355	300	241	178
<b>Original Senior Debt/EBITDA</b>	<b>4.0x</b>	<b>3.6x</b>	<b>3.1x</b>	<b>2.6x</b>	<b>2.0x</b>	<b>1.4x</b>	<b>0.8x</b>
Original Total Debt/EBITDA	5.0x	4.6x	4.1x	3.6x	3.0x	2.4x	1.8x

### Technicals

To understand the technical factors that underline the European loan market, one must understand the market participants involved. The following graph shows the split in investors in the new issuance primary market since 1997:



Source: S&P LCD

The graph shows the continued dominance of banks (c.55-60% of the market) and CLOs (c.25-30% of the market). The separate account, high yield fund and retail fund proportion of the European loan asset class accounts for approximately 10% of the market (c.€25-30bn in total asset under management). The current drivers for each of these key market players are as follows:

#### i) Banks / Investment Banks

At Avoca we have not witnessed any significant selling by banks during the July/August period. This is not unexpected as banks did not engage in panic selling of loans in 2008. However, banks are likely to sell over the medium term in small sizes (as they did in 2008/2009 as prices recovered) as regulatory constraints on both risk-weighted and total assets are imposed.

A potential more immediate impact on the European loan market are the loans and high yield bond bridges underwritten by the European banks in July and early August that remain unsyndicated. The investment banks (currently long these loans) operate an "originate and distribute" model and are unlikely to wish to hold these loans over the medium term.

To estimate this amount of this overhang we have (conservatively) assumed the loan and bond pipelines in Europe for July and August have all remained unsold. This amounts to c.€9bn in total (c.€6bn for loans and c.€3bn for bonds)<sup>5</sup>, accounting for 2-3% of the overall combined loan and bond markets.

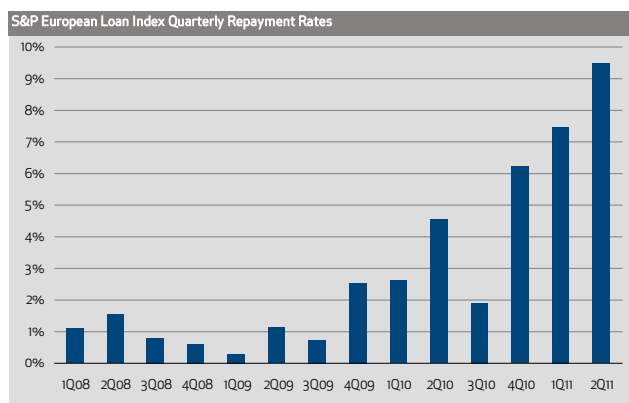
<sup>5</sup> Total Euro equivalent deal sizes for transactions scheduled for July and August in the S&P loan and high yield bond deal pipelines

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### ii) CLOs

CLOs are typically buy-and-hold investors; they benefit from the carry on loans (E+450bps) versus their cheap cost of funding (E+60bps). Also, this leverage is locked in over the medium term, so there is no pressure to dispose of assets. We have not seen any evidence of significant selling by CLO participants recently, nor do we expect to see such selling in the future.

We do see evidence of increased cash accounts in CLOs. This can be seen by the significant repayments flowing to the European loan market over the last three months (with more expected to follow). The loan market index has witnessed a 25% annual repayment rate over the last twelve months:

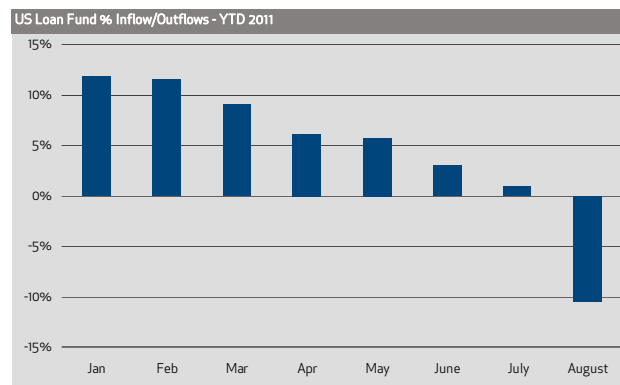


Source: S&PLCD

This high prepayment rate has created pent up demand among CLOs with many managers waiting for stability in the market before investing at current attractive yields. If we assume (conservatively) that 5% of the approximately €100bn of European CLO assets are held in cash, that would indicate c.€5bn of cash waiting to be deployed. We believe this is a reasonable estimate for cash levels given large recent repayments such as Nycomed (€4bn), Phadia (€1bn) and ProSieben (€1bn). By way of comparison, Avoca expects to have cash levels in its CLOs of 4-5% by the end of September, our highest ever cash balance level.

### iii) Separate Accounts / High Yield Funds / Retail Funds

Given the private nature of the European loan market, it is difficult to gather accurate data on inflows and outflows from these funds. However, as equity markets have shown recently, the sense of uncertainty has been equally felt on both sides of the Atlantic, so US funds flow data is a good proxy.



Source: S&PLCD, Lipper

US loan funds showed net outflows of 10% in August as fearful investors sought to redeem units in liquid funds ahead of the end of Q3 2011.

Using these outflows as a benchmark for the c.€25-30bn of retail/separate account hedge fund assets in Europe, this would assume a potential outflow of c.€2.5-3.0bn (or 1%) into the secondary market.

Anecdotal evidence suggests that much of the loan selling in August came from these types of (typically US) funds. However, the size of estimated outflow from these sources versus the size of the overall market and the cash levels held by participants such as CLOs suggests the current reduction in secondary prices reflects a mark down of prices by cautious buyers (such as banks/CLOs) rather than any deluge of selling.

### 3. Outlook

Given the very uncertain macroeconomic outlook, it would be foolhardy to predict with total confidence that prices will not reduce further in the short term. However, a close examination of the asset class shows the following:

- 1) European loans held up relatively well in August versus other asset classes
- 2) Fundamental performance of underlying borrowers remains above long term GDP growth rates currently.
- 3) Borrowers are deleveraging
- 4) The current market technicals would suggest there is no evidence of a large scale mis-match between potential sellers and an availability of capital to invest in the asset class.

## Market Update

Investors can currently obtain average spreads of E+600bps in the secondary market. This provides investors with the rare combination of:

- 1) High probability of current capital preservation (default outlook remains benign and historic recoveries on default for the asset class are on average c.80%);
- 2) High current income (cash spreads are high at E+400bps); and
- 3) Floating Rate exposure (no duration risk).

Over the medium term, the market offers investors, in our view, a very attractive proposition with limited downside for investors who can take some potential mark-to-market volatility.

Given the profile of the asset class, we expect institutional and retail capital to continue to be attracted to the loan market. The trend of increased institutional capital witnessed in 2010 and 2011 to date should continue at the current return levels. These inflows, high cash reserves among CLOs and potential low primary issuance should, in our view, result in spread tightening over the medium term (notwithstanding potential price volatility over the short term).

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