Loan Amend-and-Extends Revisited

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**High Yield &
Leveraged Loan Strategy**

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Introduction

Since the last time we addressed amend-and-extends,[1] loan prices have surged toward par. Although higher prices reduce the potential upside in extension candidates, many compelling opportunities exist, whether in the loan tranches of issuers that have executed an extension or in correctly identifying future extension. In general, when choosing between the stub and extended tranches, investors need to consider the credit outlook, relative tranche economics, and breakevens based on repayment speeds. Extended tranches provide the option of earning higher carry through either Libor floors or sweetened coupons. However, given that most extended tranches are trading over par, there is negative convexity, as loans with little call protection could be taken out at par and refinanced at lower spreads. Alternatively, staying in the unextended stub tranches that still trade under par provides investors a better convexity profile, as the option of early repayment may be more valuable in an improving economic environment.

This article highlights the relative value in the stub and extended tranches of a few issuers that have already extended their loans. Generally, we expect extended tranches that are trading under par to outperform the stubs, provided that the latter are not called inside the breakeven point and the credit outlook is positive. We also update our list of extension candidates by employing the criteria from our prior publication.

Approximately $36.9bn in U.S. institutional loans were extended in 2009, generally resulting in better valuations for the original loan after the extension announcement. Fifty-five institutional revolvers and 40 term loan extensions were launched, with 47 and 37 approved, respectively. The average revolver was extended 2 years for a spread increase of 162bp and an associated amendment fee of 32bp. The average term loan was extended 2.2 years, for a spread increase of 166bp and an amendment fee of 29bp (Figure 1).

Figure 1: 2009 Summary of Institutional Extensions Launched and Approved

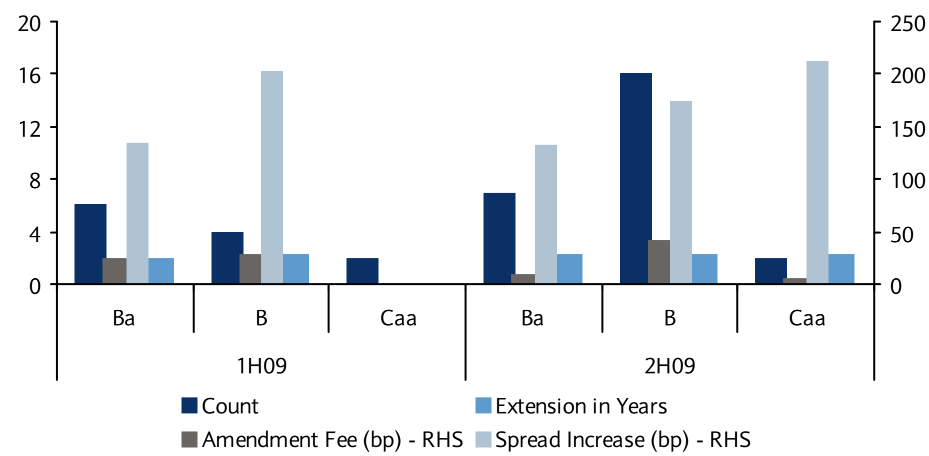
	Launched	Approved	Including a Libor Floor	Average Extension (Years)	Average Spread Increase (bp)	Average Amendment Fee (bp)
Revolvers	55	47	13	2.0	162	32
Institutional	40	37	12	2.2	166	29

Source: S&P LCD, Barclays Capital

[1] Please refer to our previous article on loan extensions, "Loan: Amend and Extends" (*U.S. Credit Alpha*, July 31, 2009), for loan extension mechanics, candidate screening criteria, and CLO indenture restrictions and managerial incentives.

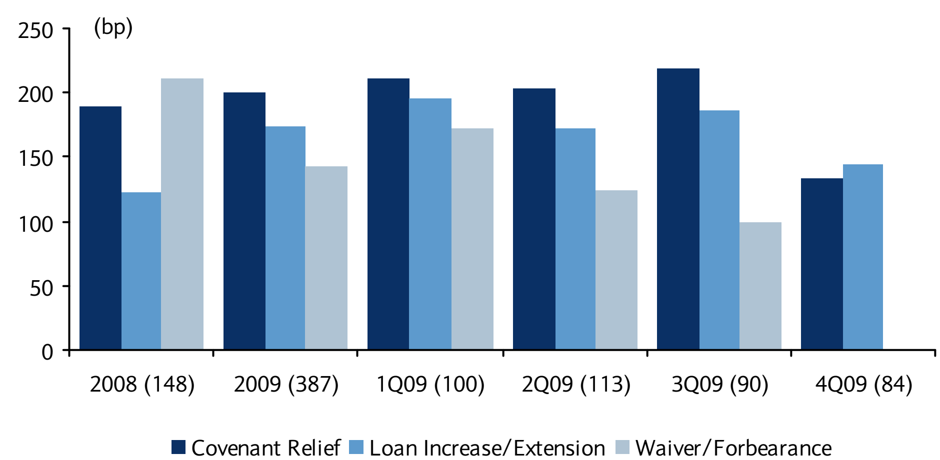
Extensions were typically associated with par paydowns of existing tranches, some form of covenant relief, and Libor floor additions. Sponsors were actively involved, launching 60% of the amend-and-extends undertaken. For a sufficient spread increase, loan extensions, covenant amendments, and waivers were successfully completed and provided stressed companies with some runway. Even some lower quality companies were able to complete amend-and-extends in 2H09 (Figure 2). With the loan market rally and the opening of the primary markets, the spread increase offered for amendments has declined (Figure 3). Increasing investor appetite has caused new issue spreads to compress, and deals are often being reverse flexed. We have also recently seen secondary loans re-price lower, especially the expensive DIPs from last year's vintage, to the chagrin of lenders. Downward re-pricing of existing extended tranches could dampen amend-and-extend activity.

Figure 2: Institutional Amend-and-Extends by Quality—1H09 versus 2H09



Note: Data for CCC loans in 1H09 are not available. Source: S&P LCD

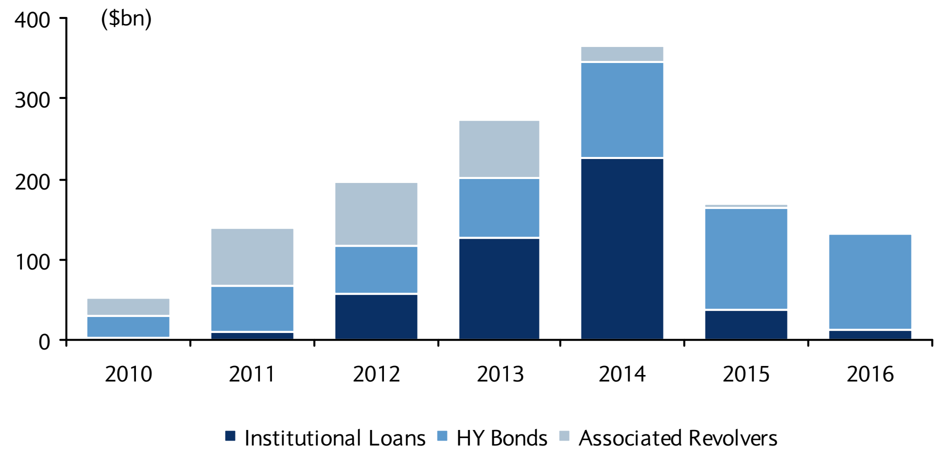
Figure 3: Amendment Spread Increases



Note: X-axis displays year/quarter and number of amendments in parenthesis. Data for Waiver/Forbearance are not applicable in 4Q09. Source: S&P LCD

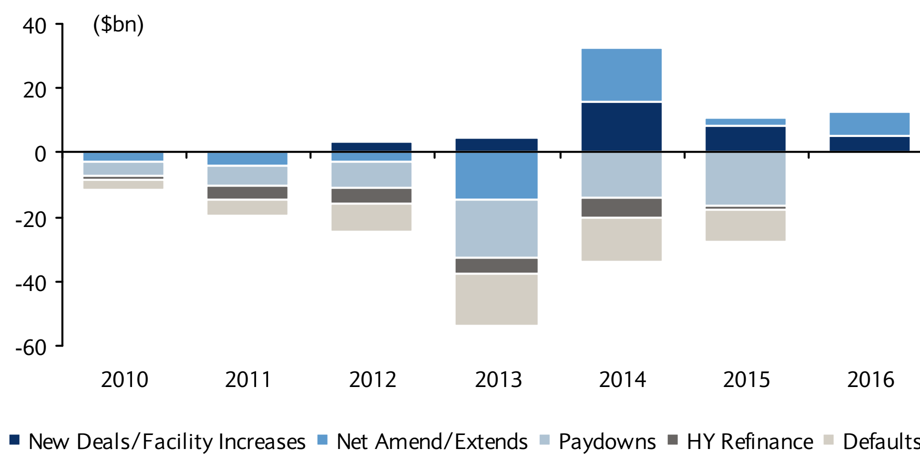
Loan maturities are modest over the next two and a half years, so there is time to undertake the extension trade of the $412bn of loans and $254bn of bonds maturing between 2012 and 2014. **Although high yield bond takeouts, paydowns, loan issuance, and defaults are expected to address a portion of the maturities, we believe loan extension is an important tool, allowing the market to push out the loan refinancing cliff.** As discussed in our *U.S. Credit Market Outlook* (December 12, 2009), the performing institutional loan market has been dramatically reduced (by 18%), to $470bn from $582bn, with defaults accounting for 41% of the decline and the rest coming from paydowns. Maturities in 2010-11, consist of only $87bn in bonds and $14bn in institutional loans. However, further out, institutional loan maturities are concentrated, with $412bn in 2012-14, while their associated pro rata revolvers mostly expire in 2011-13. In contrast, high yield bond maturities are more evenly laddered over the next few years (Figures 4 and 5).

Figure 4: The Leverage Finance Maturity Wall



Source: S&P LCD, Barclays Capital

Figure 5: Institutional Loan Maturity Changes in 2009



Source: S&P LCD, Barclays Capital

CLO Participation in Extensions

CLOs have actively participated in the extensions and will continue to play an important role in refinancing the loan maturity wall. Indenture restrictions and managerial incentives have been determining factors in gauging CLO interest in extending loan maturities.

As discussed in our article "Loan Demand from Secondary CLOs" (*U.S. Credit Alpha*, January 15, 2010), CLO deals will face trading restrictions after the reinvestment period because of the failure of either coverage tests or the MDC (Moody's downgrade condition). However, we believe there is nothing to prevent CLOs from participating in loan extensions. **While there has been some debate about whether or not CLOs past their reinvestment period can participate in loan extensions, our interpretation of most deal indentures is that they can**. In fact, many CLOs that are past their reinvestment period have already participated in loan extensions. The higher the spread increase offered, the greater the participation in rolling from the stub to the extended tranche.

Managerial incentives are also aligned. **We find that loan amendments, which allow for an extension of loan maturities in exchange for higher yields, have been widely accepted by CLO managers.** From a sample of 30 loans that were extended in 2009, CLOs chose to convert 50% of their exposure from the old into the new loans. We believe the conversion percentage would have been higher had the issuers offered to extend a greater portion of the original loan.

Stub and Extended Tranche Performance Post-Extension

As discussed in our previous article, "Loan: Amend and Extends" (*U.S. Credit Alpha*, July 31, 2009), loans usually jump a couple points in price after the extension announcement. Also, upon extension, the extended tranche trades 2-3pts higher than the stub tranche. From an investor standpoint, we saw the best trading opportunity as owning the loans and shorter-dated discount bonds of loan extension candidates that are likely to be eclipsed by the extended loan maturity.

We now go a step further, analyzing the tradeoff between the stub and the extended tranches. We studied the relative post-extension performance of the stub and extended tranches of a representative sample of loans (Figure 6). In our sample, the stubs rallied from an average price of $95 to $98, while the extended tranches rose from $97 to $100. **Decomposing the price and coupon returns for the tranches from the extension date through January 20, 2010, we see that the extended tranche outperforms the stub as a result of the higher carry (Figure 7).** This will remain true unless the stub is repaid before a breakeven point. In our base case, we assume that the breakeven point is the repayment period in which we are indifferent between owning the stub tranche and an extended tranche that is repaid in three years. The stub tranche will have to be repaid under 1y to be able to outperform an extended tranche that is called in 3y (Figure 8). Another caveat is that because most extended tranches are trading over par, there is negative convexity, as the loans could be taken out at par and refinanced at lower spreads. This phenomenon was exemplified this week as Warner Chilcott proposed repricing its loan to L+325bp (1.75% floor) from L+350 (2.25% floor).

Figure 6: Sample Universe of Institutional Loans Extended in 2009

Issuer	Announce Date	Extension Date	Stub Size $mn	Extended Size $mn	Stub Coupon L+	Extended Coupon L+	Stub Maturity	Stub Maturity
Cablevision	5/12/09	5/21/09	2,400	1,100	175	325	3/28/13	3/28/16
Graham Packaging	5/13/09	5/21/09	600	1,200	225	425	10/7/11	4/7/14
Atlantic Broad	5/21/09	6/5/09	119	325	225	475	9/1/11	6/1/13
Rockwood	5/28/09	6/9/09	136	946	275	425	7/30/12	7/30/14
SunGard	5/28/09	6/9/09	1,700	2,500	175	363	2/28/14	2/28/16
Georgia-Pacific	6/16/09	6/26/09	4,400	1,000	200	325	1/27/13	12/27/14
Select Medical	7/27/09	7/31/09	265	385	200	375	2/1/12	8/24/14
Cedar Fair	7/28/09	8/4/09	639	836	200	400	12/1/12	12/1/14
West Corp	8/10/09	8/19/09	1,300	1,000	238	388	10/1/13	7/24/16
Jarden	8/12/09	8/18/09	124	600	175	325	1/1/12	1/24/15
Par Weighted Average					**221**	**395**	**5.3y**	**3.2y**

Note: Extended tranches with Libor floor include Graham Packaging (250bp), Atlantic Broadband (200bp), and Rockwood (200bp). Select Medical has recently done an IPO to take out some debt; Graham Packaging is planning an IPO to repay some term loan debt; Jarden recently issued subordinated bonds to repay some debt; Cedar Fair is seeking $1.25bn in new loans to take out existing debt at par in connection with its LBO by Apollo; initially, Cedar fair was attempting to keep existing loans in place by amending its change-of-control provision, which was triggered by the LBO. Source: Barclays Capital, S&P LCD, Creditsights. **Barclays Capital is acting as financial advisor to Apollo Global Management on the potential acquisition of Cedar Fair by an affiliate of Apollo Global Management.**

Figure 7: Aggregate Performance of the Stub versus Extended Tranches

	Coupon Return Stub	Price Return Stub	Total Return Stub	Coupon Return Extension	Price Return Extension	Total Return Extension
MV Weighted Average	1.3%	4.2%	5.5%	2.3%	3.5%	5.8%

Note: Market value weighted aggregate of sample universe; assumes 15% prepayment rate of stub and extended tranches from the extension date until January 20, 2010. Source: Barclays Capital

Figure 8: Relative Value of Stub and Extended Tranches

Repayment Year	Stub Tranche Yield to Call	Extended Tranche Yield to Call
0.5	**6.3%**	5.3%
1	4.7%	5.2%
2	4.0%	5.2%
3	4.3%	**5.7%**
Maturity	4.3%	6.6%

Note: Yield to call on tranches is the market-value weighted yield to call for our sample set from January 20, 2010, until called, using matched-maturity swap rates. Source: Barclays Capital

The Stub versus Extended Tranche Trade-off

Investing in companies that have already executed amend-and-extend programs presents an interesting trade-off. When analyzing the relative value of the stub and extended loan tranches, investors need to consider the credit outlook, relative tranche economics, and breakevens based on repayment speeds.

- Credit outlook—generally, if investors are bearish on the credit, they should stay in the unextended stub, thereby limiting the downside in the case of credit deterioration or default. Bullish investors should generally prefer the extended tranche economics;

however, negative convexity exists if the loan is priced over par. So in some cases, bullish investors may prefer the stub, which could get repaid early with free cash flow.

- Relative tranche economics—extended tranches benefit from higher carry through either Libor floors or sweetened coupons, although the value of the floor declines in a rising rate environment. Meanwhile, the stub tranche provides better convexity, i.e., lower dollar price. As a result, speed of repayment is a critical element determining the relative value of the tranches.

- Convexity due to repayment speed—function of call protection, proximity to par, capital structure, and size of tranches

  - Given that most extended tranches are trading over par, there is negative convexity, as these loans could be taken out at par and refinanced at lower spreads if they have no call protection.

  - Staying in the unextended stub tranches that still trade below par provides investors a better convexity profile, as the option of early repayment may be more valuable in an improving economic environment and a robust primary market.

  - Relative sizes of the stub and extended tranches may determine repayment speeds. The smaller the tranche, the more likely it will be repaid earlier.

Calculating the breakeven repayment point and evaluating the stub and extended tranches based on these criteria is helpful in determining relative value. Our base case breakeven is determined by calculating how soon the stub tranche will have to be repaid to earn the same return as an extended tranche that is repaid in three years. Figure 9 illustrates the breakeven points for a sample of loans.

- Graham Packaging stub ($100, $600mn, L+225bp, 10/2011) is less attractive than the extended tranche, which is trading over par ($101.25, $1.2bn, L+425bp, 250bp Libor floor, 4/2014), because the breakeven requires immediate repayment of the stub. Despite the negative convexity of the extended tranche and the dearth of bonds in the capital structure that need to be refinanced, the extended tranche will probably not be repaid before the stub.

Figure 9: Stub versus Extended Tranche Breakeven Points

	Graham Packaging		Sungard		Jarden	
Repayment Year	Stub Tranche Yield to Call	Extended Tranche Yield to Call	Stub Tranche Yield to Call	Extended Tranche Yield to Call	Stub Tranche Yield to Call	Extended Tranche Yield to Call
0.25	2.5%	1.7%	14.4%	12.1%	10.2%	1.5%
0.5	3.3%	4.2%	9.0%	8.8%	6.9%	3.2%
0.75	3.3%	5.0%	7.0%	7.4%	5.5%	3.6%
1	3.3%	5.4%	5.9%	6.8%	4.8%	3.7%
2	NA	6.0%	4.5%	5.9%	NA	4.1%
3	NA	6.3%	4.6%	6.2%	NA	4.8%
Maturity	3.4%	6.4%	4.9%	7.1%	4.0%	5.8%

Note: Breakeven analysis assumes that the base case for extended tranche repayment is three years and uses matched-maturity swap rates. Source: Barclays Capital

- SunGard stub ($97, $1.7bn, L+175bp, 2/2014) is less attractive than the extended tranche, which is trading under par ($98, $2.5bn, L+363bp, no Libor floor, 2/2016), because the breakeven of the stub is inside 1y. Also, there are bonds in the capital structure that need to be addressed ahead of the loans.

- Jarden stub ($98, $124mn, L+175bp, 1/2012) is more attractive than the extended tranche, which is trading over par ($101, $600mn, L+325bp, no Libor floor, 1/2015). The negative convexity of the extended tranche, the relative size of the tranches, and the dearth of near-term bonds inside the stub loan maturity indicate that the stub will probably be repaid inside the breakeven of 1y.

Potential Candidates for Loan Extensions

Given the favorable loan performance after the extension announcement and the discount to par with which many loans still trade, extensions still provide upside to investors. We screened the loan universe for candidates (using criteria outlined in our July 31, 2009 article, "Loan: Amend and Extends," *U.S. Credit Alpha*) and identified several names that are likely to attempt a loan extension (Figure 10). Although some of these candidates may attempt or have already done a partial refinancing, they still have sizeable near-term loan maturities, and there is still potential upside in the loans through either an extension or a paydown.

Figure 10: Potential Candidates for Loan Extensions

Issuer	1st Institutional Term Loan Maturity Date	Total Size All Institutional Tranches ($ mn)	Price ($)
Supervalu	2011	1,530	98
Dean Foods	2012	3,147	98
Infor Global Solutions	2012	4,648	94
Reynolds & Reynolds	2012	2,135	96
Hertz	2012	1,612	98
Toys R Us	2012	800	99
Avis Budget Car Rental	2012	778	98
Freescale	2013	3,380	90
Michaels Stores	2013	2,280	92
Carestream Health	2013	1,750	95
Neiman Marcus	2013	1,598	93
Burlington Coat	2013	865	95
Sally Beauty	2013	864	98

Source: Barclays Capital

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