FOCUS

Repricing Loans – Where's the Call Protection?

Gautam Kakodkar
+1 212 412 7937
gautam.kakodkar@barcap.com

Bradley Rogoff, CFA
+1 212 412 7921
bradley.rogoff@barcap.com

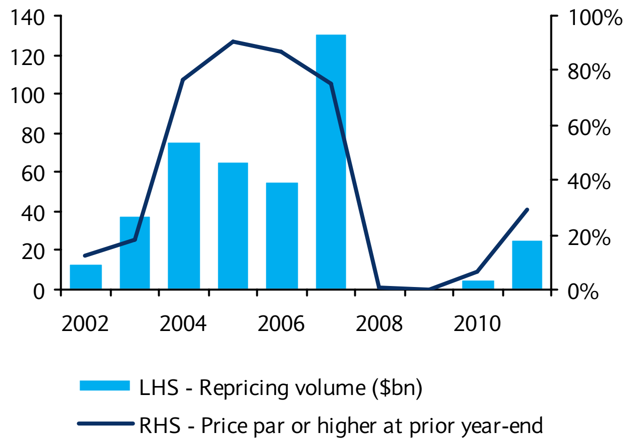
www.barcap.com

Reprint from 11 February 2011, *U.S. Credit Alpha*.

Repricings have gathered momentum, with sponsor-related issuers revisiting burdensome funding terms in some of their recent vintage loans. We expect this opportunistic refinancing to continue as long as the primary market remains open and yields continue to compress. With a large percentage of loans trading over par, investors have been rightly concerned about the limited upside in loans, as well as the downside risk of repricings. While we are not negative on the asset class given the strong demand technical, we think that the upside in leveraged loans has been greatly diminished and that investors may want to rotate out of likely loan repricing candidates. We also expect high yield accounts that bought loans in 2H10 to be net sellers of the asset class. A consideration for CLO investors is that the repricing of collateral spreads will result in downward pressure on CLO equity, but tighter AAA spreads could offset this effect.

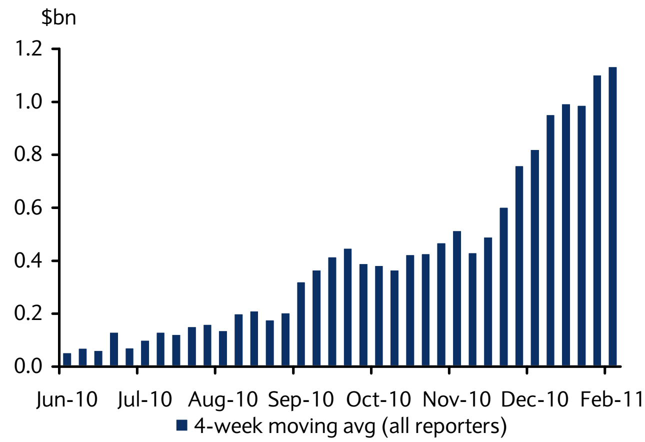
Loan repricings have become the mantra as issuers queue up to improve pricing and/or loosen covenants on loans that were issued or amended with higher coupons and Libor floors during relatively stricter primary market conditions in 2008-10 (Figure 1). A combination of factors, including the red-hot primary and secondary markets, as well as incremental demand from loan mutual funds, has created the perfect backdrop for issuer-friendly deals. Year-to-date, loan mutual funds (weekly and monthly reporters) have experienced a net inflow of $5.9bn, and total assets under management are $48bn (Figure 2). Once a smaller share of the loan market, these funds now account for about 10% of outstanding institutional loans, filling the partial void created by the diminishing appetite from secondary CLOs. The past repricing waves in 2004 and 2007 were also accompanied by a large percentage of loans trading over par and a robust primary market and were executed as amend-and-restates, as well as new syndications. However, at that time, the 101 soft-call protection was not as prevalent in the loan market as it is today.

Figure 1: Loan Repricing Activity



Source: S&P LCD, Barclays Capital

Figure 2: Loan Participation Fund Flows



Source: Lipper, Barclays Capital

It is evident from current repricing terms that issuers are back in the driver's seat. Recall that Warner Chilcott pulled its repricing amendment in January 2010 after meeting significant lender opposition. The amendment had asked for a 25bp spread and Libor floor reduction in exchange for a 12.5bp fee and the addition of a 101 soft call. The loan was trading just above par at that point. Despite threatening a yank-a-bank, the issuer did not manage to get the sufficient 51% majority vote required to pass the amendment. This is in sharp contrast with current trends, with issuers managing to strip covenants, reduce the spread and/or shave the Libor floor, remove or reduce the soft-call protection, and shrink or eliminate OIDs. Issuers have not shied away from paying the 101 soft-call pre-payment penalty to lock down significantly lower interest rates. On average, double-B and single-B rated issuers with sponsor support have launched repricing deals reducing spread by 104bp and cutting the Libor floor by 47bp (Figure 3). Issuers have used both amend-and-restate strategies (as with Warner Chilcott) and more formidable loan-for-loan takeout approaches to extract greater concessions. The former requires an approval process from a majority of lenders (usually 51%), whereas the latter avoids the consent path and tilts the negotiating leverage further toward the issuer (although some filing fees are incurred).

The Gymboree transaction is notable in that the issuer is looking primarily to strip covenants, in contrast to other recent deals that have been straight repricings (spread and/or Libor floor reductions) of fresh-vintage higher-coupon sponsor-related loans. To avoid triggering the 101 soft call, the new covenant-light loan was initially offered at the same yield as the existing loan, which equates to a par offer and a 12.5bp spread increase. However, this was subsequently changed to a spread reduction of 50bp, leading to a positive NPV and justifying a 101 payout. TransUnion and NBTY are other issuers seeking covenant-light deals. Some transactions, such as Burger King and Phillips-Van Heusen, are cross-border deals involving euro tranches as well. DineEquity and Regal Entertainment are the first non-sponsored deals of this repricing wave.

Figure 3: Loan Repricings Complete or Pending in 2011

				Original				New					Difference	
Issuer	Loan Rating	Size ($bn)	Vintage	Libor Spread (bp)	Libor Floor (bp)	Maturity	Call	Libor Spread (bp)	Libor Floor (bp)	Maturity	OID	Call	Libor Spread (bp)	Libor Floor (bp)
Spectrum Brands	B/B2	0.68	May-10	650	150	2016	101	400	100	2016	TBD	101	-250	-50
SunGard	Ba/Ba3	0.48	Sep-08	375	300	2014	100	350	0	2014	100	101	-25	-300
Vertafore	B+/B1	0.55	Jul-10	500	175	2016	100	375	150	2016	100	101	-125	-25
Phillips-Van H	BBB/Ba2	1.00	May-10	300	175	2016	100	300	100	2016	100	TBD	0	-75
Interactive Data	B+/Ba3	1.30	Jul-10	500	175	2017	101	350	125	2017	100	100	-150	-25
Burger King	BB-/Ba3	1.85	Oct-10	450	175	2016	101	325	150	2016	100	101	-125	-25
TransUnion	BB-/Ba3	0.95	Jun-10	475	175	2017	100	325	150	2018	99	101	-150	-25
Gymboree	B+/B1	0.82	Nov-10	400	150	2017	101	350	150	2018	100	101	-50	0
Dunkin Brands	B+/B1	1.25	Nov-10	425	150	2017	101	300	125	2017	100	100	-125	-25
Tomkins	BB/Ba2	1.70	Sep-10	450	175	2016	101	300	125	2016	TBD	101	-150	-50
Mutiplan	B/Ba3	1.30	Aug-10	475	175	2017	101	325	150	2017	100	TBD	-150	-25
inVentiv	BB-/Ba3	0.53	Jul-10	475	175	2016	101	325	150	2016	TBD	TBD	-150	-25
Transdigm	BB-/Ba2	1.55	Dec-10	350	150	2016	100	300	100	2016	TBD	101	-50	-50
NBTY	BB-/Ba3	1.50	Sep-10	450	175	2017	101	325	150	2017	100	TBD	-150	-25
Sedgwick	B+/NR	0.40	Sep-10	400	150	2016	101	350	150	2016	100	101	-50	0
Cedar Fair	BB-/Ba3	1.20	Jul-10	400	150	2016	100	300	125	2016	100	TBD	-100	-25
DineEquity	BB/Ba2	0.90	Oct-10	450	150	2017	101	TBD	TBD	2017	TBD	TBD	TBD	TBD
BWAY	B+/Ba3	0.49	May-10	375	175	2017	100	350	150	2017	TBD	101	-25	-25
Regal Ent	BB-/Ba2	1.25	May-10	375	NA	2016	100	325	TBD	2017	TBD	TBD	-50	TBD
Average													**-104**	**-47**

Note: Some new pricing is indicative. Source: Creditflux, Bloomberg, S&P LCD, Barclays Capital

What's in a Soft Call?

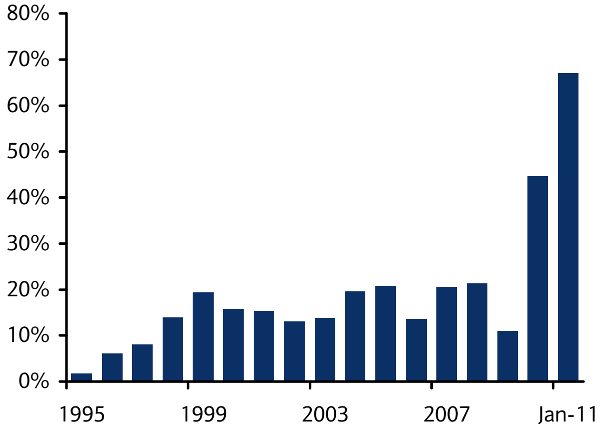
Typically, loans have no call protection, making them attractive pre-payable debt for leveraged companies. A soft call is a provision that is more prevalent in recent loan issuance. The long-run average of the presence of call protection in institutional loan issuance is 15%, reaching 44% in 2010 and at 67% in January 2011 (Figure 4). The most common is a 101 call protection premium for one year, although we have seen variants such as a step-down level over two or three years. Most recently, repricings have also included a meager six-month provision (Tomkins) or call protection removal (Interactive Data), while some have added the provision (Burger King). Generally, *a soft call requires a company to pay a premium or fee on any portion of its term loan that is amended to reduce the total yield or that is refinanced with debt that has a lower total yield.* In contrast, hard call protection requires a company to pay a premium on all voluntary pre-payments.

As highlighted by the Dunkin case, a 101 soft-call premium currently provides little deterrence against a refinancing. Issuers have been willing to pay a premium before the call protection rolls off to take advantage of the demand for leveraged loans and negotiate issuer-friendly terms. The positive NPV from a spread reduction justifies a premium takeout.

Loans Have Traded Down on Repricing Announcements

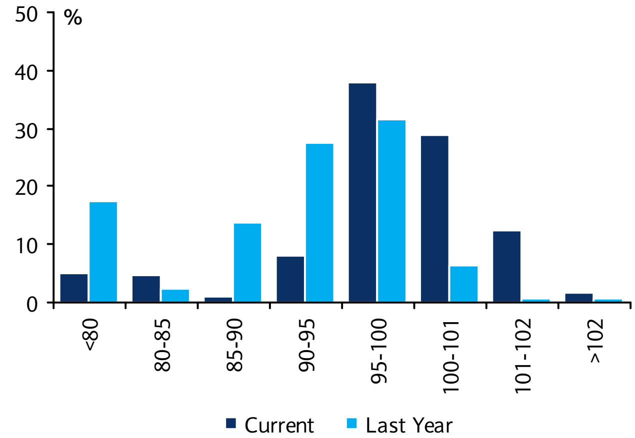
Whereas loans have traded down on repricing announcements, they have not been huge spread-moving event for bonds. Overall, repricing reduces the cost of debt funding for the credit. Investor caution is justified, as the loan rally has resulted in a large percentage of loans trading above par and/or their call price. By par, 29% of the Barclays Capital Loan Index trades at $100-101, 13% trades at $101-102, and 2% trades above $102 (Figure 5).

Figure 4: Call Protection Presence in New Issue Institutional Loans



Source: S&P LCD, Barclays Capital

Figure 5: Barclays Capital Loan Index Price Distribution by Par (%)



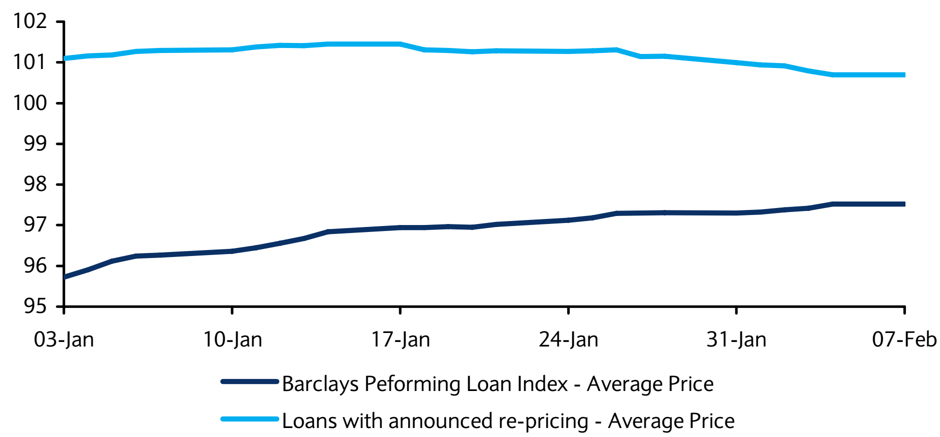
Source: Barclays Capital

To demonstrate the downside risk of a repricing, for illustrative purposes, let's consider single-B rated Arizona Chemical's $470mn term loan (L+500, 1.75% Libor floor), which currently trades at $101.375. The loan was issued with a 101 soft-call premium for year one. In this situation, if the sponsor/issuer chooses to reprice the existing loan, investors would be confronted with a lower return from the combined instruments. In a scenario where the spread/Libor floor is reduced by 100/50bp in one month, investors would earn a one-year carry of 5.4% instead of the original 6.75%. A 101 takeout would result in a 37.5bp loss on the current price, although the new loan may trade back up to 101. This demonstrates that the curve-adjusted yield to maturity of 7.6% likely overstates the realized return because of the imminent call and repricing.

Given the percentage of loans trading over par and the subsequent potential for repricing, we believe most of the price appreciation expected for 2011 has already occurred. Loans have returned 2.5% year-to-date, and most of the residual performance this year will likely be driven by carry, with a modest contribution from prepayments. As such, we reaffirm our carry plus return forecast of 5-7% for 2011. Investors should be wary of loans trading over par and consider screening for potential repricing candidates. While we expect issuers to target 2008-10 issuance to reduce spreads, covenant stripping from the most-recent vintages should be more modest because issuers already have reasonably loose covenants packages in place.

Loans with announced repricing transactions have underperformed the Barclays Capital Performing Loan Index by 2.3% in price terms since January 2011 (Figure 6). Given the limited upside for call-constrained loans trading over par and the potential downside risk of repricing, we think that investors should consider selling loan repricing candidates.

Figure 6: Loan Price Performance



Note: Loans with announced repricing shown in Figure 3. Source: Barclays Capital

Screening for Repricing Risk

We consider the following primary factors when evaluating repricing candidates:

- Higher coupons – Spreads >= 375bp and Libor floors >= 150bp are likely to be targeted for a spread trimming, given that primary spreads and Libor floors have been clearing tighter recently
- Price – Above par and/or the call price
- Size – Tranche size > $400mn. Larger tranches potentially offer more liquid trading opportunities
- Vintage – Issued or amended in the 2008-10 timeframe
- Higher-rated companies – Double- and single-B rated companies are more likely to be able to execute a repricing
- Sponsor-related – Companies with sponsor support are more likely to be proactive in this process

Secondary factors that should also be considered:

- Covenant-heavy – Loans with onerous maintenance covenants are more likely to be queued up for a strip down
- Call protection levels and roll-off timeframe – Not a major criteria, given that issuers have been willing to pay the early redemption premium in exchange for a lower spread
- Recent bond issue – If the company did a recent bond issue that priced tight, it may be more inclined to use that benchmark to justify a loan repricing

Screening the institutional loan issuance universe, we identified the following loans (covenant-lights included) that meet the primary criteria above and could potentially benefit from a repricing:

Figure 7: Potential Candidates for Loan Repricing

Issuer	Launch Date	Rating	Size ($mn)	Spread (bp)	Libor Floor (bp)	Call Price	Call Roll-Off Date	Bid Price
Intelsat Jackson	Dec-10	BB-/B1	$3,250	375	150	101	Dec-11	101.25
Language Line	Dec-10	B+/Ba3	$525	450	175	102	Dec-11	101.25
Syniverse	Dec-10	BB-/B1	$1,025	375	150	101	Dec-11	101.38
Advantage Sales	Dec-10	B+/NR	$875	375	150	101	Dec-11	100.50
ConvaTec	Dec-10	B+/Ba3	$500	425	150	NA	NA	100.88
BNY ConvergEx	Dec-10	B+/B1	$610	375	150	101	Dec-11	100.00
Arizona Chemical	Nov-10	B+/B1	$470	500	175	101	Nov-11	101.38
Amscan (Cov-Lite)	Nov-10	B/B2	$675	525	150	101	Nov-11	101.00
PETCO (Cov-Lite)	Nov-10	B/B1	$1,225	450	150	101	Nov-11	101.00
MedAssets	Oct-10	BB-/Ba3	$635	375	150	101	Nov-11	101.63
Getty Images	Oct-10	BB-/Ba3	$1,270	375	150	101	Nov-11	101.50
Fifth Third Processing	Oct-10	BB-/Ba3	$1,575	400	150	102	Oct-10	101.00
Goodman Global	Oct-10	B+/B1	$1,500	400	175	101	Oct-11	101.13
GenTek	Oct-10	B/B1	$425	500	150	102	Oct-11	101.25
Brickman (Cov-Lite)	Sep-10	B+/B1	$550	550	175	102	Oct-11	102.25
Advance Pierre Foods	Sep-10	B+/B1	$835	525	175	101	Sep-11	101.25
United Components	Sep-10	B/Ba3	$425	450	175	101	Sep-11	101.50
Graham Packaging (Add-on)	Sep-10	B+/B1	$913	425	175	101	Sep-11	101.00
Visant	Sep-10	BB-/Ba3	$1,250	525	175	101	Sep-11	100.50
Toys 'R' Us (Cov-Lite)	Aug-10	BB-/B1	$700	450	150	101	Aug-11	101.00
Warner Chilcott	Aug-10	BB/Ba3	$1,020	425	225	101	Aug-11	101.00
Pinnacle Foods (Add-on Cov-Lite)	Aug-10	B/B2	$442	425	175	101	Aug-11	101.00
Fairmount Minerals	Jul-10	BB/B1	$550	450	175	101	Aug-11	101.25
Altegrity (Add-on)	Jul-10	B+/Ba3	$400	600	175	101	Jul-11	102.50
DynCorp	Jun-10	BB/Ba1	$565	450	175	101	Jun-11	100.00
Michael Foods	Jun-10	BB-/B1	$790	450	175	101	Jun-11	101.00
Aspect Software	Apr-10	B+/Ba3	$500	450	175	NA	NA	100.00
Universal City Development	Apr-10	B+/Ba2	$900	375	175	101	Apr-11	100.75
Revlon	Feb-10	B+/Ba3	$800	400	200	101	Mar-11	101.00

Source: S&P LCD, Bloomberg, Barclays Capital

Is CLO Equity Too Rich?

While amend-and-extends and covenant amendments have been beneficial for CLO asset spreads, the repricing of loans will have an adverse effect on portfolio income. The reduction in the CLO arbitrage would cause front-end equity returns to shrink. Hence, the recent run-up in CLO equity could be dampened somewhat by the prospect of a downward repricing of loan portfolios.

While it is unclear what percentage of the loan universe will be repriced, we note that approximately 20% by par of the Barclays Capital Loan Index trades over par, is single or double-B rated, was issued after 2008, and has a current coupon (including Libor floor) greater than 525bp. CLOs within their reinvestment periods (and passing OC/CCC tests) could opt to receive a paydown and buy another loan, or convert/roll their exposure to the new loan (if they are allocated). CLOs that convert/roll into the repriced loan will lower their weighted average spreads (WAS), but the weighted average life (WAL) will remain unaffected, since the new loan is of a similar maturity. We believe that even CLOs outside their reinvestment periods will be able to participate in these repricings. Similar to an amend-and-extend transaction, the mechanics of a repricing could be interpreted as a cash-less conversion of the original obligation, which is not typically constrained by reinvestment criteria. A less likely, draconian view would be to consider this a pre-payment, in which case reinvestment would be disallowed if the restricted trading condition has been triggered (based on tranche rating downgrades), which is true for most CLOs.

Using the Barclays Capital Loan Index as a representative proxy for CLO portfolios, we analyzed the drop in equity returns if B/BB asset spreads were trimmed by 50bp. We assume that repricing spread reductions are offset by amend-and-extends and above par paydowns are modestly accretive. In legacy structure secondary CLOs, we found that if 20% of the loan portfolio were repriced, first-year equity returns would drop by 1%. In the newer vintage, lower leveraged CLOs, the effect is less pronounced. If 20% of the loan portfolio were repriced, first-year equity returns would drop by less than 1%. In addition, as AAA CLO spreads continue to tighten from the current 155bp level, the asset-liability arbitrage could become more favorable. In general, the repricing of collateral spread will result in downward pressure on CLO equity, but lower AAA spreads could offset this effect. Secondary CLO equity currently trades with a high-teens yield.

Analyst Certification(s)

We, Gautam Kakodkar and Bradley Rogoff, CFA, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

Important Disclosures

For current important disclosures regarding companies that are the subject of this research report, please send a written request to: Barclays Capital Research Compliance, 745 Seventh Avenue, 17th Floor, New York, NY 10019 or refer to https://ecommerce.barcap.com/research/cgi-bin/all/disclosuresSearch.pl or call 212-526-1072.

Barclays Capital does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that Barclays Capital may have a conflict of interest that could affect the objectivity of this report. Any reference to Barclays Capital includes its affiliates. Barclays Capital and/or an affiliate thereof (the "firm") regularly trades, generally deals as principal and generally provides liquidity (as market maker or otherwise) in the debt securities that are the subject of this research report (and related derivatives thereof). The firm's proprietary trading accounts may have either a long and / or short position in such securities and / or derivative instruments, which may pose a conflict with the interests of investing customers. Where permitted and subject to appropriate information barrier restrictions, the firm's fixed income research analysts regularly interact with its trading desk personnel to determine current prices of fixed income securities. The firm's fixed income research analyst(s) receive compensation based on various factors including, but not limited to, the quality of their work, the overall performance of the firm (including the profitability of the investment banking department), the profitability and revenues of the Fixed Income Division and the outstanding principal amount and trading value of, the profitability of, and the potential interest of the firms investing clients in research with respect to, the asset class covered by the analyst. To the extent that any historical pricing information was obtained from Barclays Capital trading desks, the firm makes no representation that it is accurate or complete. All levels, prices and spreads are historical and do not represent current market levels, prices or spreads, some or all of which may have changed since the publication of this document. Barclays Capital produces a variety of research products including, but not limited to, fundamental analysis, equity-linked analysis, quantitative analysis, and trade ideas. Recommendations contained in one type of research product may differ from recommendations contained in other types of research products, whether as a result of differing time horizons, methodologies, or otherwise.