

THE FRANK J. FABOZZI SERIES

SELL

TRADE

LEVERAGED FINANCE

*Concepts, Methods, and
Trading of High-Yield Bonds,
Loans, and Derivatives*

STEPHEN J. ANTCHAK, DOUGLAS J. LUCAS, FRANK J. FABOZZI

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Leveraged Finance

*Concepts, Methods, and
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STEPHEN J. ANTCZAK
DOUGLAS J. LUCAS
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SJA

To my wife Jennifer, my son Brian,
and my parents Norbert and Diane—
you have each taught me so very much over the years

DJL

To my wife Elaine, and my sons Eric and Benjamin

FJF

To my wife Donna, and my children
Francesco, Patricia, and Karly

Preface

Over 80% of my portfolio is sitting in T-bills. This cannot continue. I know that the economy is under extreme pressure and the fundamental backdrop is terrible for almost all asset valuations, but I cannot justify holding government securities paying 0% to my investors. They can do that on their own. I do not need an asset that is perfectly safe, what I am looking for is something that offers attractive risk-adjusted return potential. What in your market fits this profile? Leveraged loans? Triple-A CLO tranches? Anything?

*—A portfolio manager of a large equity fund, January
2009*

This book was written during one of the most trying times in the history of the global financial markets. The financial crisis that began in 2007 has prompted unprecedented volatility in asset valuations and has left many economies across the world in recession. Given such an extreme investment environment, market participants may have to employ nontraditional approaches when making investment decisions in order to maintain an appropriate risk-return profile. We believe that the leveraged finance market can be a very important tool in this regard.

This book will not attempt to predict the future of the financial markets or the ultimate outcome of the financial crisis. Rather, the purpose of this book is to help readers understand the principles of the leveraged finance market. In this book, readers can learn about the tools available in the leveraged finance market, how they are related to assets and investment opportunities in other markets (such

as the equity market), and how to apply these concepts in the real world.

As can be seen from the quotation above, many nontraditional leveraged finance investors have questions about the technicals and the opportunities in this market. This book provides both, and can be of assistance to those participants as they come up the learning curve of a new market. This book can also help existing leveraged finance market investors looking for a refresher on the basic principles or as a desk reference for putting ideas into action. This book can also be useful for anyone outside the financial industry looking for an understanding of these dynamic markets.

As this book goes to print, the financial markets remain under extreme pressure. However, we are confident that it will not last forever. Those investors with the knowledge and skill to participate in the leverage finance space stand to benefit from the many opportunities that the current environment is creating. It is our hope that the contents of this book will help investors identify and take advantage of these opportunities.



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Stephen J. Antczak
Douglas J. Lucas
Frank J. Fabozzi

About the Authors

Stephen J. Antczak is an Executive Director within the UBS Fixed Income Research Department, and currently heads the Leveraged Finance Strategy team. He has worked in a strategy capacity for over 14 years across a broad range of markets, including the cash and synthetic government markets, the investment-grade corporate market, and the high-yield bond, loan, and derivative markets. His research is widely followed by both institutional and retail investors, and is often cited by various media outlets and in academic forums. In addition to providing commentary on leverage finance, he has developed proprietary models for identifying and taking advantage of dislocations within and across various asset classes. Mr. Antczak also has extensive experience in portfolio creation, optimization, and hedging. Prior to joining UBS in 2001, Mr. Antczak was a senior strategist at Merrill Lynch, and has also worked at the Bureau of Labor Statistics as an economist. Stephen graduated from the University of Michigan with a B.A. in economics, and an M.B.A. in business economics. He was awarded Chartered Financial Analyst status in 1999.

Douglas J. Lucas is the Group Managing Director and Manager of Ratings Research at Moody's Investor Service since November 2008. Prior to that, he was an Executive Director at UBS and head of CDO Research. His CDO team was ranked #1, #2, and #3 from 2005 through 2008 by Institutional Investor. His prior positions include head of CDO research at JPMorgan, co-CEO of Salomon Swapco, and analyst at Moody's Investors Service. While at Moody's, he authored the rating agency's first default and rating

transition studies, quantified the expected loss rating approach, and developed the rating methodologies for collateralized debt obligations and triple-A special purpose derivatives dealers. He is known for doing some of the first quantitative work in default correlation. Mr. Lucas, the coauthor of several books in structured finance, served two terms as Chairman of the Bond Market Association's CDO Research Committee and has a B.A. magna cum laude in Economics from UCLA and an M.B.A. with Honors from the University of Chicago.

Frank J. Fabozzi is Professor in the Practice of Finance and Becton Fellow at the Yale School of Management. Prior to joining the Yale faculty, he was a Visiting Professor of Finance in the Sloan School at MIT. Professor Fabozzi is a Fellow of the International Center for Finance at Yale University and on the Advisory Council for the Department of Operations Research and Financial Engineering at Princeton University. He is the editor of the *Journal of Portfolio Management* and an associate editor of the *Journal of Fixed Income* and *Journal of Structured Finance*. He earned a doctorate in economics from the City University of New York in 1972. In 2002, Professor Fabozzi was inducted into the Fixed Income Analysts Society's Hall of Fame and is the 2007 recipient of the C. Stewart Sheppard Award given by the CFA Institute. He earned the designation of Chartered Financial Analyst and Certified Public Accountant. He has authored and edited numerous books on finance.

CHAPTER 1

Introduction

In the credit market, banks, and brokers raise debt capital for corporate rate entities that need funds for a variety of reasons such as working capital needs, merger and acquisition activities, share buybacks, and capital expenditures. Capital can be raised via various debt instruments, but primarily through bonds and loans.

One segment of the overall credit market, the leveraged finance market, is comprised of market participants (i.e., issuers and investors) with somewhat unique needs. With regard to issuers, these unique needs result from the fact that they have, or desire to have, a proportionally large amount of debt relative to a “normal” corporate capital structure. An issuer in the leveraged finance market is usually considered more risky than a company with a more balanced capital structure and, as a result, has a relatively low credit rating. Issuers in the leveraged finance market are companies that issue debt and have a credit rating below investment-grade (below BBB-/Baa3).

Of course, investors in the leveraged finance market expect that with more risk comes more return potential. Investors range from hedge funds to insurance companies, but the one common thread shared by all leveraged finance investors is that they all have relatively high return objectives. In the past, the assets within the leveraged finance market fell into one of two categories: cash bonds or cash loans. But this has changed. With the introduction of products such as credit default swaps, synthetic indexes,

and tranching of the indexes, leveraged finance investors have many tools to work with and assets to consider.

This book attempts to tie the various pieces that comprise the leveraged finance market together. Its 14 chapters are divided into five parts:

- Part One: The Cash Market

- Part Two: The Structured Market

- Part Three: The Synthetic Market

- Part Four: How to Trade the Leveraged Finance Market

- Part Five: Default Correlation

PART ONE: THE CASH MARKET

Part One addresses the cash markets, which include high-yield bonds (also referred to as speculative-grade or junk bonds), and leveraged loans.

Chapter 2 focuses specifically on the *high-yield bond market*. This market segment has been evolving dramatically, which makes understanding the basics of this space so important. This chapter provides an overview of the high-yield space, details some specific changes in the landscape, such as bond structures and the size and growth of the market. It also addresses topics such as ratings transitions, risk and returns, and recovery prospects in the event of default.

Chapter 3 focuses on the *leveraged loan market*. A leveraged loan is one extended to a speculative-grade borrower (i.e., a borrower rated below investment-grade, or below BBB-/Baa3). When market participants refer to “loans,” they generally mean broadly syndicated (to 10 or more bank and nonbank investors) leveraged loans. They also typically mean senior secured loans, which sit at the topmost rank in the borrower’s capital structure, and generally, they mean larger loans to larger companies.

Loans are a key part of financing packages by companies rated below investment-grade. Debt capitalization for a typical credit in the leveraged finance space is about 65% to 70% loans and 30% to 35% bonds, although variations can be significant. The investor base in the leveraged loan market has been in flux since the end of 2007, with a number of nontraditional investors looking to get in (e.g., equity funds, distressed investors, private equity) and others trying to trim exposure (e.g., select hedge funds). In

Chapter 3, we provide an overview of the loan market, with topics including a description of a typical loan, changes in market dynamics, and a discussion of emerging trading strategies.

PART TWO: THE STRUCTURED MARKETS

Part Two takes a look into the structured market, focusing on one type of collateralized debt obligation—*collateralized loan obligations* (CLOs). *Collateralized loan obligations* (CLOs) have been around for over 20 years and until September 2007 bought two-thirds of all U.S. leveraged loans. A CLO issues debt and equity and uses the money it raises to invest in a portfolio of leveraged loans. It distributes the cash flows from its asset portfolio to the holders of its various liabilities in prescribed ways that take into account the relative seniority of those liabilities.

In Chapter 4, we look at the general CLO market characteristics and their relationship with leveraged loans. A CLO can be well described by focusing on its four important attributes: assets, liabilities, purposes, and credit structures. Like any company, a CLO has assets. With a CLO, these are usually corporate loans. And like any company, a CLO has liabilities. With a CLO, these run the gamut of equity to AAA rated senior debt. Beyond the seniority and subordination of CLO liabilities, CLOs have additional structural credit protections, which fall into the category of either cash flow or market value protections. Finally, every CLO has a purpose that it was created to fulfill, and these fall into the categories of arbitrage or balance sheet. In this chapter, we look in detail at the different types of assets CLOs hold, the different liabilities they issue, the two different credit structures they employ, and, finally, at the two purposes for which CLOs are created.

Chapter 5 runs through collateral overlap among CLOs. If you are an investor in the leveraged finance market and have the feeling that you've seen a CLO's collateral portfolio

before, it's because you probably have. CLO portfolios, even from CLOs issued in different years, tend to have a lot of underlying loan borrowers in common. This is in part the result of loan repayments causing CLO managers to continually be in the market buying loans for their CLOs. Also in this chapter, we look at collateral vintage, and find that different vintage CLOs have similar collateral. In this chapter, we first present several measurements related to collateral overlap and single-name concentration. We look at collateral overlap between individual CLOs, between CLO managers, and between CLO vintages. Next, we look at the most common credits across CLOs and across CLO managers. Finally, we look at the relative risks of collateral overlap and single-name concentration.

Chapter 6 addresses the resiliency of CLO returns to defaults and recoveries. With the help of Moody's Wall Street Analytics, we analyze 340 CLOs issued from 2003 to 2007. We tested CLOs in the worst default and recovery environment U.S. leverage loans have experienced since the inception of the market in 1995. On average, every vintage and rating down to Ba2 returns more than LIBOR, even if purchased at par. We also tested CLO debt tranches in a "Great Depression" high-yield bond default and recovery scenario. On average, Aaa, Aa2, and most A2 tranches still return more than LIBOR, even if purchased at par.

We also discuss distressed loan prices, overflowing triple-C buckets and CLO returns. When market participants model CLO returns, they focus primarily on defaults and recoveries. But since the recent dislocation in the credit markets, two other factors demand attention: the size of the CLO's triple-C asset bucket and the price at which the CLO reinvests in new collateral loans. This chapter looks at the separate and joint effects of reinvestment prices and triple-C buckets on different CLO tranches. Then, it goes through each CLO tranche and looks at the joint effects.

PART THREE: THE SYNTHETIC MARKETS

Part Three introduces the relatively young *synthetic markets*, which include *credit default swaps* (CDS), the traded credit indexes, and index tranches. Credit default swaps enable the isolation and transfer of credit risk between two parties. They are bilateral financial contracts which allow credit risk to be isolated from the other risks of an instrument, such as interest rate risk, and passed from one party to another party. Aside from the ability to isolate credit risk, other reasons for the use of credit derivatives include asset replication/diversification, leverage, yield enhancement, hedging needs, and relative value opportunities. Like Part One, we start with the basics.

Chapter 7 discusses credit default swaps. The CDS market has grown tremendously since 1996 in terms of both trading volume and product evolution. The notional amount of outstanding CDS rose from \$20 billion in 1996 to over \$54 trillion through the first half of 2008. In terms of product evolution, the market has developed from one that was characterized by highly idiosyncratic contracts taking a great deal of time to negotiate into a standardized product traded in a liquid market offering competitive quotations on single-name instruments and indexes of credits. We begin the chapter with a brief introduction to credit default swaps on specific corporate issuers, including how they work, who uses them, and what are they used for.

Also in Chapter 7, we discuss the *credit indexes*. Predefined, single-name CDS contracts are grouped by market segment, specifically the high-yield bond segment (the high-yield index is denoted CDX. HY) and the loan segment (index denoted LCDX). The core buyers and sellers

of the indexes have been index arbitrage players, correlation desks, bank portfolios and proprietary trading desks, and credit hedge funds. Increasingly, greater participation by equity and macrohedge funds has been observed. These investors are looking for the following from the indexes: a barometer of market sentiment, a hedging tool, arbitrage and relative value positioning, and capital structure positioning.

Understanding the credit indexes is critical for Chapter 8, which covers *index tranches*. Similar to the proceeding chapters in Part Three, we walk through the basics of the market, and how and why it came into existence.

PART FOUR: HOW TO TRADE THE LEVERAGED FINANCE MARKET

Part Four reviews how investors can trade within the leveraged finance market.

In Chapter 9, we assess return prospects in the high-yield market during economic downturns. In order to do so, we examine the relationship between economic growth and valuations during the five most recent recessions prior to the current downturn. In particular, we evaluate the performance of each heading into, during, and following the official recessionary period. In addition to looking at the performance at the broad market level, we review the performance at the sector level and across rating categories.

Chapter 10 provides a framework for credit analysis of corporate debt and explains how credit analysis is more than just the traditional analysis of financial ratios. This is particularly true when evaluating high-yield borrowers.

Chapter 11 introduces “the basis,” that link between the cash markets (bonds and loans) and the synthetic markets (CDS and indexes). Understanding the basis is important for many reasons. For one, it serves as a simple reference point between the valuations of each market. As such, it can guide an investor as to where to find attractive value when looking to add or reduce exposure to a particular issuer. Also in this chapter, we walk readers through gauging the basis and how to construct basis packages to take advantage of dislocations between the cash and synthetic markets.

Chapter 12 takes a look at how much investors should be paid to take risk. In this chapter, we present four types of

risk: single-name credit risk (i.e., compensation for exposure to a particular issuer); curve risk (i.e., compensation for long/short positions on the same issuer's credit curve); basis risk (i.e., compensation for long/short combinations expressed in the cash and synthetic markets, expanding on the topic addressed in Chapter 11); and capital structure risk (i.e., compensation for long/short combinations among different liabilities of the same issuer).

PART FIVE: DEFAULT CORRELATION

Part Five addresses *default correlation*. Default correlation is the phenomenon that the likelihood of one obligor defaulting on its debt is affected by whether or not another obligor has defaulted on its debts. A simple example of this is if one firm is the creditor of another—if Credit A defaults on its obligations to Credit B, we think it is more likely that Credit B will be unable to pay its own obligations.

Chapter 13 covers the basics of default correlation. In this chapter, we provide a not overly mathematical guide to default correlation. We define default correlation and discuss its causes in the context of systematic and unsystematic drivers of default. We use Venn diagrams to picture default probability and default correlation, and provide mathematical formulas for default correlation, joint probability of default, and the calculation of empirical default correlation. We emphasize higher orders of default correlation and the insufficiency of pair-wise default correlation to define default probabilities in a portfolio comprised of more than two credits.

Chapter 14 looks at empirical default correlations using company- and industry-specific issues that could lead to default. In this chapter, we explain the calculation and results of historic default correlation. We show that default correlations among well-diversified portfolios vary by the ratings of the credits and also by the time period over which defaults are examined. We describe two major problems in measuring default correlation and therefore implementing a default correlation solution: (1) There is no way to distinguish changing default probability from default correlation; and (2) the way default correlation is commonly