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SPECIALISTS IN HIGH YIELD AND SPECIAL SITUATIONS INVESTMENTS

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Second Lien Loans

A Complex Yet Potentially Compelling Investment Opportunity

> Second lien loans typically offer higher yields than more traditional high yield debt instruments

> Such higher yields come at a price, and accordingly the risks require careful evaluation

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... the current low yield environment has investors searching for higher yielding investment opportunities.

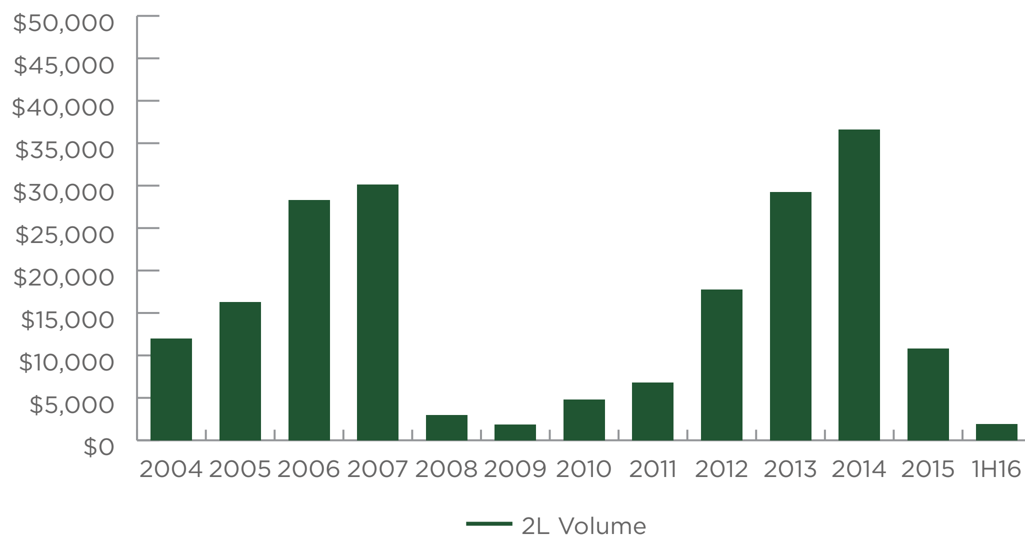
Introduction

The leveraged credit market offers several investment options, with high yield bonds and first lien loans being the most well known and largest segments of this market. However, wedged between these two asset classes is a less known and we believe underappreciated source of financing to large and middle market companies alike, namely the second lien loan market. Second lien loans, as their names suggests, have a junior (second in priority) claim on the collateral of an issuer. As a result, investors interested in pursuing this type of investment have to not only understand the credit worthiness of the issuer, but also the rights and remedies afforded against such collateral as set forth in the applicable loan documents. The pages that follow include information about this market as well as some of the many considerations that an investor must account for when attempting to properly assess the risk and reward profile of these often misunderstood investment opportunities.

A Brief History

Second lien loans originally evolved in the leveraged credit market as a source of rescue financing for businesses requiring capital infusions to sustain their operations. As such, providers of second lien financing could garner higher interest rates from borrowers that had over-collateralized first lien obligations while providing creditors with comfort that their newly deployed second lien capital was adequately protected upon a default. Since that time, the second lien loan market has matured and become a more permanent, albeit cyclical, component of the high yield debt market, with proceeds predominately used for leveraged buy-outs and dividend recapitalizations. According to S&P Leverage Commentary & Data (“S&P LCD”), prior to 2004, second lien loans accounted for less than 1% of the overall leveraged loan market, had fewer than $2 billion principal amount outstanding, and new issuance was meager at best. Merely two years later, the growth of hedge funds and other non-traditional credit investors fueled a buildup in new second lien issuances. Primary market activity for second lien loans averaged greater than $20 billion per year from 2004 to 2007, before falling dramatically between 2008 and 2010 in connection with the contraction in leveraged lending generally. New issue activity for second lien loans experienced a resurgence from 2011 to 2015, as the current low yield environment has investors searching for higher yielding investment opportunities. Today, the second lien loan market has approximately $50 billion principal amount outstanding. However, given the rapid growth in the leveraged loan market generally, second lien loans still only account for about 4.5% of the overall leveraged loan market.

Exhibit 1: Cyclical by Nature: Second Lien Loan New Issue Volume ($MM)



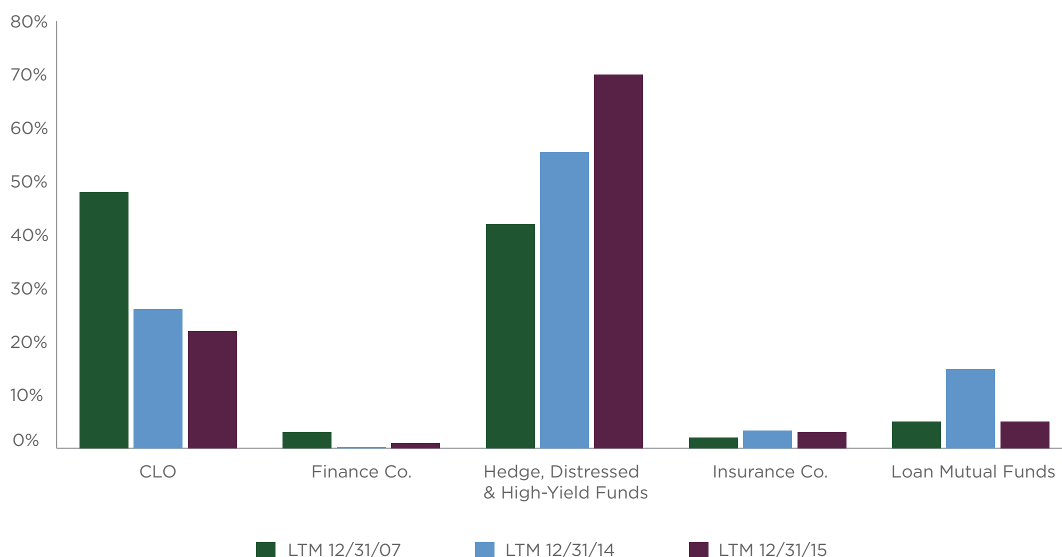
2L = Second Lien Loan Volume
Source: S&P LCD, as of June 30, 2016

The investor base for second lien loans has remained unchanged over the past decade; capital has primarily come from hedge funds and distressed, high yield and loan investors (collectively "Special Situations Investors") and Collateralized Loan Obligations ("CLOs"). However, the degree to which each investor group has been involved in this market has shifted rather dramatically. As one can see from Exhibit 2, which compares investor base participation in second lien new issue activity between 2007 and 2014 (as the peak years of new issue activity during the last two cycles), CLOs have significantly scaled back their participation in primary second lien loan issuance over the last decade while interest from Special Situations Investors, other than loan funds, has increased. Separately, loan funds have scaled their participation back from peak levels that averaged approximately 15% of new issuance from 1Q14 through 1Q15, most likely in an effort to reduce exposure to less liquid positions in the face of increasing outflows. More recently, as primary market activity for second lien loans has declined, Special Situations Investors, other than loan funds, have increased their relative share of new issue activity.

CLOs have reduced their investment in second lien loans as a result of increased regulatory scrutiny on such products, including new "risk retention" rules issued under Dodd-Frank (US) and European Union legislation; these regulations have likely curtailed the supply of capital allocated from CLOs to the second lien loan market for the foreseeable future. Accordingly, it appears that Special Situations Investors will become the primary source of capital for second lien loan originations moving forward. While the promise of higher yields entices investors to allocate to this often underserved segment of the leveraged credit market, investors must consider several factors distinct to second lien loans before diving in, certain of which we will discuss below.

... since 2004, the average second lien loan new issue has carried a spread over LIBOR of approximately 790 basis points.

Exhibit 2: Investor Base – Buyers of Second Lien Loan Primary Deals



LTM = Last Twelve Months
Source: S&P LCD, as of June 30, 2016

Assessing the Risk Profile of Second Lien Loans

The merits of any investment are best assessed in connection with its shortcomings. Investors that participate in the second lien loan market are often attracted to the higher current income (in the form of yield spread over LIBOR[1]) relative to first lien loans and oftentimes high yield bonds, as well as to the protections afforded by holding a secured claim on a borrower's collateral; however, liquidity of second lien loans is often constrained and the short duration of call protection (typically 2-3 years) puts a cap on capital appreciation. According to S&P LCD data, since 2004, the average second lien loan new issue has carried a spread over LIBOR of approximately 790 basis points. Such spread has also been, on average, about 360 basis points higher than the average spread over LIBOR provided by first lien loans. Over that same period, the average second lien loan's yield at issuance when issued was 9.65%, or 1.27% in excess of that offered by a new issue high yield bond. In addition, this average yield differential was 2.74% from 2013 to 2015. These spread and yield differentials include compensation for a number of risks (and in particular, liquidity risk and structural/legal risk) that a second lien investor bears.

First, let's address liquidity risk. Based on S&P LCD data, since 2004, the average size of a second lien loan new issue was approximately $150mm. Prior to the growth of the second lien loan market, deals of this size were predominately originated in the high yield bond market by middle market issuers; however, as the high yield bond market grew, bond deals of this size dwindled. Recently, BofA Merrill Lynch ("BAML") modified its index rules to exclude issuances of less than $250mm from its high yield bond indices where it had previously included issuances as small as $100mm. BAML noted at the time of the change that issuances of less than $250mm in size declined from approximately 23.4% of its BAML Index in December 2005 to 3.5% in December 2015. As many middle market issuers have migrated to the second lien loan market in an effort to secure additional capital, investors focused on the middle

[1] LIBOR stands for the London Interbank Offered Rate and consists of rates quoted in 5 currencies over 7 time periods. For this paper, any reference to LIBOR specifically refers to the 3-month USD LIBOR rate.

market space have followed. The smaller deal size of the average second lien loan limits the number of participants willing to make investments in this market; managers of CLOs as well as larger Special Situations Investors have difficulty building positions in small issuances that can meaningfully impact performance. Therefore, liquidity is limited as fewer investors own a larger percentage of each deal. For long-only investors looking to enhance yields, an investment in a second lien loan will usually be made with a time horizon of 2-5 years with limited opportunities to exit the position outside of a refinancing or maturity. Therefore, second lien loan spreads over LIBOR typically capture an illiquidity premium to reflect the added risk of holding such an investment.

Next, structural considerations, or legal issues, associated with the loan document and intercreditor agreement that are part of any second lien loan transaction add a layer of complexity that many investors do not fully understand and appreciate. A careful assessment of all of the considerations an investor should review in connection with a potential second lien investment is outside of the scope of this paper. Nevertheless, we have chosen two items that we believe are critical to understand prior to making such an investment: (i) what types of rights and remedies a second lien investor will have vis-à-vis the first lien lenders in the issuer, and, (ii) determining whether the second lien investment is subject only to lien, and not payment, subordination.

1. Rights and Remedies – Prior to making an investment in a second lien loan, potential lenders should endeavor to understand their rights and remedies upon an event of default or a bankruptcy. A second lien loan may end up being under collateralized and, as such, a second lien lender may find itself in a position as a secured, partially secured, or unsecured creditor. In most cases, second lien lenders agree to waive certain rights as a secured creditor for a specified period of time, pursuant to an intercreditor agreement governing the relationship between the first lien creditors and the second lien creditors. This "standstill" on taking certain actions allows first lien lenders an opportunity to enforce remedies without interference from the second lien lenders. The duration and scope of these enforcement standstills varies with each transaction and will depend, in part, on the type of issuance (for example, whether the second lien loan was widely syndicated or privately placed). Furthermore, a second lien creditor will often agree to permanent restrictions on certain actions, usually in the context of a bankruptcy. Expertise in these areas will be of great benefit to an investor when negotiating these terms. Importantly, while second lien lenders may forego some of their rights as secured creditors, they often endeavor to ensure that they have the same rights as unsecured creditors in the event that their lien is under-collateralized. Prior to 2007, second lien lenders typically were unfettered by intercreditor agreements from pursuing rights as unsecured creditors, even in a situation where their lien was fully collateralized. However, since 2007, first lien lenders have inserted more restrictive terms in intercreditor agreements, limiting second lien lenders ability to pursue such rights, potentially putting second lien lenders in a disadvantageous position vis-à-vis unsecured creditors.

2. Subordination – Language pertaining to lien subordination is customary in an intercreditor agreement and outlines that second lien lenders agree to subordinate their lien on any collateral to the lien of the first lien lenders. This concept means that proceeds from enforcement on shared collateral will be used to pay the full claim of the first lien lenders prior to any payments being made to the second lien lenders.

Comprehensive due diligence affords lenders the opportunity to identify key issues associated with a borrower's business including ...

> Meanwhile, payment subordination means that a junior creditor will not receive any value on its debt prior to payment in full in cash of the senior debt. Payment subordination generally includes the ability of a senior creditor to stop interest and other payments to junior creditors upon the occurrence of certain events (based on certain financial covenant levels or defaults). A second lien lender should be focused on ensuring that the intercreditor agreement is limited to lien subordination only and accordingly does not include any payment subordination terms. By avoiding such payment subordination, a second lien lender may be able to realize on the value of its collateral and receive continuing interest and other ordinary course payments, as well as reorganization securities in the event of an insolvency.

As briefly outlined above, structural risks inherent in second lien loan transactions require higher spreads than first lien loans to entice investors to take a position in such a loan, since second lien investors are taking a junior position to the first lien and are subject to contractual intercreditor restrictions upon a default or bankruptcy. Potential second lien investors should assess these structural risks as well as the creditworthiness of the issuer as part of their business diligence.

We believe that a second lien loan investment requires a deep analysis and understanding of the borrower's prospects and financial health in order to thoroughly understand the risk/reward profile of such an investment in the context of the overall "credit story". Comprehensive due diligence affords lenders the opportunity to identify key issues associated with a borrower's business including, for example, an assessment of its competitive position and an ability to generate the necessary cash flow to service its obligations, as well as management's history of dealing with creditors. In most cases, because of the private nature of second lien loan opportunities, investors typically gain greater access to information when compared to what is available in most high yield bond deals. As a result, investors often obtain granular operating data along with better access to management, enabling investors to leverage knowledge gained through the due diligence process to make a more informed decision. This information is of great use to a second lien lender seeking to identify investments where credit risk is mispriced, attractive liquidity premiums are being offered via investments in solid credits with significant collateral coverage, and/or the complexities of the legal agreements between creditors are misunderstood.

For many investors, such analysis is more than they are willing to bear and they therefore conclude that investments in second lien loans are not worth their time or effort. At first glance, these investors may have a point, as Exhibit 3 below shows that second lien loans have historically experienced lower recovery rates on average relative to both first lien loans and high yield bonds (where such recovery rates are based on the issue's price 30 days after default). However, these statistics simply underscore the importance of not only understanding the credit documents, but also becoming knowledgeable about the borrower's business risk and financial position in an effort to understand the likelihood of a default occurring at all. Informed investors can form a clearer picture as to whether any given second lien loan is an attractive opportunity.

Exhibit 3 – Default and Recovery Rates Since 2008*

	Default Rates		Recovery Rates		
	Loans	High Yield Bonds	First Lien Loans	Second Lien Loans	High Yield Bonds
Annualized average	3.50%	2.70%	61.20%	28.30%	41.00%

Source: J.P. Morgan and S&P LCD

* Average recovery rates for second lien loans prior to 2008 are not available; therefore, all data provided is from January 1, 2008 through December 31, 2015.

A Review of Second Lien Loan Performance

Exhibit 4 shows that during the period reviewed, second lien loans outperformed first lien loans by 0.83% annually; lagged high yield bonds by close to 1.58% annually; and exhibited more volatility than both. The performance of second lien loans presented below is somewhat confusing given the yield advantage relative to high yield bonds outlined earlier in this paper. From an efficiency stand-point, with respect to risk and reward, second lien loans appear efficient relative to first lien loans, as one is compensated for greater risk (in terms of volatility) with higher returns. However, relative to bonds, this relationship breaks down, as second lien loans have exhibited more volatility while providing lower returns. This begs the question; what causes the performance of these two products to deviate from expectations?

Exhibit 4 – Performance and Risk: January 1, 2004 through December 31, 2015

	First Lien Loans	Second Lien Loans	High Yield Bonds
Annualized Return	4.41%	5.24%	6.82%
Standard Deviation[2]	7.26%	11.79%	9.75%
Correlation to Second Lien Loans	0.88	1.00	0.73

Source: S&P LCD and BofA Merrill Lynch

One reason may be that issuers of second lien loans believe that they are operating strong businesses with solid growth prospects, which leads them to take on more financial leverage, i.e., add debt to their balance sheet in order to expand operations. Ultimately, they believe that their expected growth will allow them to de-lever their business in the near-to-intermediate term. As a result, such issuers may naturally gravitate towards the second lien loan market where they can seek to secure debt financing at the cost of higher interest payments but with the flexibility to pre-pay such debt at (or at a slight premium to) par (100). The flip side would be that if an issuer has added too much leverage and expected growth does not come to fruition, the issuer is now in a precarious financial position, which may result in a steep decline in the market value of such second lien loans. As we demonstrated earlier, recovery rates are relatively low for second lien loans and may provide some evidence that when things go bad for the issuers of such loans the value of the collateral diminishes, with market prices subsequently reflecting this information. This potential outcome further heightens the need for lenders to carefully analyze each issuer's credit profile.

[2] Standard deviation is a measure of the volatility of the stated returns.

In addition, when comparing the performance of second lien loans to high yield bonds, one also needs to consider the limited call protection afforded to second lien loans, and its negative effect on total returns. For example, a typical second lien loan might be issued with a three year call schedule where it would be callable in the first year at a 3% premium to par, then a 2% premium in year two, down to a 1% premium in year three, and thereafter callable at par. Alternatively, high yield bonds are typically issued with a "no-call" period that is several years long (e.g., a bond with an eight year maturity might have a three year no-call period), and then once callable, the call premiums applicable to bond issuances are usually much higher than those paid on second lien loans. From an issuer's perspective, the decision to issue a second lien loan rather than a bond is influenced by several factors, one of which is optionality to pre-pay (i.e., the issuer is willing to accept shorter maturities and higher coupons associated with a second lien loan in order to secure the prepayment option at lower call premiums). As a result, the upside potential for a second lien lender, in terms of price appreciation in the event that the borrower's credit profile materially improves, is limited, resulting in performance that is driven by coupon income and therefore often lags that of high yield bonds.

Conclusion

Second lien loans pose a complex puzzle for investors. The many intricacies associated with the credit documents and their small relative issue size result in many investors ignoring this segment of the leveraged credit market entirely. We believe that this lack of attention creates market inefficiency, and therefore investment opportunity, for those that take the time to understand these situations. For investors that undertake the necessary diligence, an investment in a second lien loan can potentially offer an attractive opportunity to enhance the portfolio's overall yield while simultaneously holding a secured position in the capital structure. However, such investor must be discerning, as it is clear that not all second lien loans are created equal.

Appendix

BPS: Stands for basis points. A basis point is one one-hundredth of one percent (0.0001).

Callable: A callable debt instrument (e.g., bond or loan) is one that can be redeemed by the issuer of such instrument prior to its maturity.

Call Protection: A call protection is a protective provision of a callable debt instrument prohibiting the issuer from calling back the debt instrument for a period early in its life.

Correlation: A statistical measure of how an index moves in relation to another index or model portfolio. A correlation ranges from -1 to 1. A correlation of 1 means the two indexes have moved in lockstep with each other. A correlation of -1 means the two indexes have moved in exactly the opposite direction.

Dividend Recapitalization: When a company incurs a new debt in order to pay a special dividend to private investors or shareholders. This usually involves a company owned by a private investment firm, which can authorize a dividend recapitalization as an alternative to selling its equity stake in the company.

Leveraged Buyout: A leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition.

Long Only: Long only is a feature or policy of many mutual funds, it refers to a policy of only holding “long” positions in assets and securities.

Spread: The yield of a bond minus the yield of the government bond that matches the maturity (or appropriate call date) of the bond.

Disclosures

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The BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Please note that one cannot invest in the index.

The Standard & Poor’s Leveraged Commentary & Data (S&P LCD) S&P/LSTA Leveraged Loan Index (LLI) covers the U.S. loan market. The index reflects the market-weighted performance of institutional leveraged loans in these respective markets based upon real-time market weightings, spreads and interest payments. All of the index components are the institutional tranches (Term Loan A, Term Loan B and higher and Second Lien) of loans syndicated to U.S. loan investors. The LLI series currently calculates total return daily with an inception date of 1 January 1997. Total return is the product of two components: interest income return and market value return.

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DDJ Capital Management's goal is to consistently produce attractive long-term investment returns, while minimizing downside risk for our investors, which include:

- Corporate pension accounts and public retirement plans
- Endowments and foundations
- Insurance companies
- Other institutional clients

The underpinning of DDJ — a disciplined investment philosophy, coupled with a commitment to exhaustive credit research — has remained constant since our founding in 1996. Our highly skilled team is steadfast and focused on executing our strategy to identify strong risk-adjusted investment opportunities in the leveraged credit markets.

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