Senior Loan Webinar: Preparing Your Clients for a Rising Rate Environment using Floating Rate Loans

Presented by:
Dan Norman
Managing Director and Group Head
ING U.S. Investment Management
Senior Loan Group
What are Senior Loans?

- **In general, senior loans are ...**
  - Extensions of credit to non-investment grade corporate borrowers originated by major banks
  - Issued by mid- to large-sized companies to finance acquisitions and other growth initiatives
  - Senior in the capital structure; secured by a first priority lien on a borrower’s assets
    - First priority on borrower’s cash flows
    - Collateral typically provides higher recoveries
  - Floating rate with coupon return comprised of a nominal credit spread over LIBOR
    - Rates reset every 45 - 60 days on average
  - Structured to typically include financial maintenance covenants
    - First to the negotiating table in the event of a breach
    - Unique ability to increase nominal credit spreads
  - Structurally less liquid (longer settlement times) but actively traded in an established secondary market

- **Large, syndicated loans to non-investment grade companies**
- **Secured by the borrower’s assets**
- **Rank highest in a borrower’s capital structure**
- **Floating rates of interest**
Current Investment Thesis: An Income Investor’s “Wish List”

- Strong value proposition relative to other income-producing options
- Seniority in the capital structure
- Attractive yield, with upside participation in rising rates
- Strong fundamentals and low default rates
- Covenants and security

Bottom Line: One of the only asset classes to check all the boxes
Representative Large-Cap Issuers

Note: The logos on this page are trademarks and service marks belonging to the respective companies shown below.
Senior in the Capital Structure

Seniority and Collateral for Senior Loans

<table>
<thead>
<tr>
<th>Borrower Assets</th>
<th>% of Borrower Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (in certain cases)</td>
<td>40-60%</td>
</tr>
<tr>
<td>Receivables</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
</tr>
<tr>
<td>Plant &amp; Equipment</td>
<td></td>
</tr>
<tr>
<td>Property (including real estate)</td>
<td></td>
</tr>
<tr>
<td>Intangible Assets (patents, trademarks)</td>
<td></td>
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<tr>
<td>Downstream guarantees from a holding co.</td>
<td></td>
</tr>
<tr>
<td>Upstream guarantees from subsidiaries</td>
<td></td>
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</tbody>
</table>

Pledged to

<table>
<thead>
<tr>
<th>Borrower Liabilities</th>
<th>% of Borrower Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Secured Loans</td>
<td>Paid First</td>
</tr>
<tr>
<td>Senior Unsecured Notes</td>
<td>Paid Last</td>
</tr>
<tr>
<td>High Yield Bonds</td>
<td>20-40%</td>
</tr>
<tr>
<td>Preferred/Common Equity</td>
<td></td>
</tr>
</tbody>
</table>

Source: ING U.S. Investment Management

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Index Historical Returns

- Prior to 2008, returns had been consistently positive, a hallmark of the loan asset class

- 2008 and 2009 returns reflect unprecedented technical volatility

- 2011 returns driven largely by renewed technical stress

- 2012 return tracking to wide-end of historical average

S&P/LSTA Index \(^1\): Total Returns by Year
January 1, 1997 to June 30, 2013

1 - The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. Investors cannot invest directly in an index. 
Source: Standard and Poor’s LCD and S&P/LSTA Leveraged Loan Index

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S&P/LSTA Index Loan Price and Spread History

Nominal and secondary spread data excludes all facilities in default. Nominal spread shows the excess spread over LIBOR, and includes LIBOR floors (where applicable). For the secondary spread chart, loan spreads are to 3-year call. The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. **Investors cannot invest directly in an index.** Three year maturity assumption: (i) all loans pay off at par in 3 years, (ii) discount from par is amortized evenly over the 3 years as additional spread, and (iii) no other principal payments during the 3 years. Discounted spread is calculated are based on the current bid price, not on par.

Source: Standard and Poor’s LCD and S&P/LSTA Leveraged Loan Index

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A Compelling Income Opportunity

High yield bonds have historically yielded more than senior loans

On average, high yield bonds have yielded 2% more than loans since 2000

Today, the yield difference is less compelling at only 1.25%

Historical Difference in Yields Between High Yield & Senior Loans
January 1, 2000 to June 30, 2013

High yield bond yields are less compelling today relative to loans

Average: 2.0%
6/30/13: 1.25%

January 31, 2000 to June 30, 2013. Yield is defined as yield to worst for high yield bonds as represented by the Credit Suisse High Yield Index and discount margin to 3 year call plus 3 month LIBOR for the Credit Suisse Leveraged Loan Index. Source: Credit Suisse
A Hedge Against Fixed Rate Risk

- Protection against market value loss in a rising rate environment
- Participation in rate increasing via rising yields
- Relatively low volatility compared to other investment options

Floating Rate vs. Fixed Rate Cumulative Performance During Periods of Rising Interest Rates

Source: Morningstar; Standard and Poor’s LCD; Credit Suisse; Bloomberg
Better Risk-Adjusted Returns vs. High Yield, Particularly in Rising Rate Environments

### Price as a % of Par Value

- **Senior Loans**: 97%
- **High Yield Bonds**: 102%
- **Investment Grade Bonds**: 106%

### Performance During Rising Interest Rates

<table>
<thead>
<tr>
<th>Period of Rising Rates</th>
<th>Change in US 2-Year Treasury Yields</th>
<th>Senior Loans</th>
<th>Investment Grade Corporate Bonds</th>
<th>High Yield Bonds</th>
<th>US Government Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feb-94 - Dec-94</td>
<td>+312 bps</td>
<td>9.33%</td>
<td>-6.27%</td>
<td>-3.41%</td>
<td>-5.09%</td>
</tr>
<tr>
<td>Mar-96 - Jul-96</td>
<td>+61 bps</td>
<td>8.56%</td>
<td>-0.51%</td>
<td>5.01%</td>
<td>-0.28%</td>
</tr>
<tr>
<td>Nov-98 - May-00</td>
<td>+227 bps</td>
<td>5.17%</td>
<td>0.22%</td>
<td>2.11%</td>
<td>0.68%</td>
</tr>
<tr>
<td>Jul-03 - Jul-06</td>
<td>+365 bps</td>
<td>6.35%</td>
<td>2.39%</td>
<td>8.73%</td>
<td>1.66%</td>
</tr>
<tr>
<td>Apr-08 - Jun-08</td>
<td>+72 bps</td>
<td>18.02%</td>
<td>-2.72%</td>
<td>7.23%</td>
<td>-7.44%</td>
</tr>
<tr>
<td>Nov-10 - Mar-11</td>
<td>+25 bps</td>
<td>11.16%</td>
<td>-2.09%</td>
<td>11.22%</td>
<td>-5.57%</td>
</tr>
<tr>
<td><strong>Average:</strong></td>
<td>+177 bps</td>
<td><strong>9.76%</strong></td>
<td><strong>-1.50%</strong></td>
<td><strong>5.15%</strong></td>
<td><strong>-2.67%</strong></td>
</tr>
</tbody>
</table>


Note: (1) Senior Loans, Investment Grade Corporate Bonds, High Yield Bonds and US Government Bonds are represented by the Credit Suisse Leveraged Loan Index, BarCap US Investment Grade Corporate Bond Index, BarCap US High Yield Index and BarCap US Government Bond Index, respectively. Sources: ING, Credit Suisse and Barclays Capital.
The S&P/LSTA Leveraged Loan Index is an unmanaged total return index that captures accrued interest, repayments, and market value changes. **Investors cannot invest directly in an index.** S&P/LSTA Index lagging twelve-month default rate comprises all loans, including those not tracked in the LSTA/LPC mark-to-market service. Vast majority are institutional tranches. Issuer default rate is calculated as the number of defaults over the last twelve months divided by the number of issuers in the Index at the end of the prior period. Principal default rate is calculated as the amount defaulted over the last twelve months divided by the amount outstanding at the end of the prior period.

Source: Standard and Poor’s LCD and S&P/LSTA Leveraged Loan Index

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In a default scenario, recoveries are dependent on collateral

Defaults do not automatically trigger a loss of value

In fact, senior secured loans generally rise in price and value during the restructuring process

Average Corporate Debt Recovery Rates Measured by Time of Default and Ultimate Recovery
1987 to 2012 (Data as of December 31, 2012)

<table>
<thead>
<tr>
<th></th>
<th>Time of Default</th>
<th>Ultimate Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Secured Loans</td>
<td>66.0%</td>
<td>80.6%</td>
</tr>
<tr>
<td>Senior Secured Bonds</td>
<td>51.6%</td>
<td>63.7%</td>
</tr>
<tr>
<td>Senior Unsecured Bonds</td>
<td>37.0%</td>
<td>48.6%</td>
</tr>
<tr>
<td>Subordinated Bonds</td>
<td>31.5%</td>
<td>28.5%</td>
</tr>
</tbody>
</table>

1 - Time of Default recovery is measured by trading prices at the time of default. Ultimate Recovery is the value that a creditor actually receives at the resolution of the default, usually at the time of emergence from bankruptcy. To calculate the ultimate recovery, each nominal recovery value at the time of emergence is discounted back to the last time interest was paid using the instrument’s pre-petition coupon rate. Loan Ultimate Recovery Rate information is obtained from the Moody’s Ultimate Recovery Database, which includes over 3,500 loans and bonds from more than 700 U.S. corporate defaulters.

Source: Moody’s Investors Service

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What To Consider in a Senior Loan Manager

**Size**
- Smaller funds are nimble and can take advantage of opportunities as they arise

**Access to deal flow**
- With high demand and competition for loan assets, new-issue loans are often oversubscribed

**Portfolio Composition**
- Many senior loan funds have an allocation to cash or high yield bonds for liquidity purposes; target settlement times for senior loans is T+7 but actual times are much longer
- Pure-play senior loan funds have legal access to private information for the purpose of making credit decisions

**Liquidity**
- Open and closed-end senior loan fund offerings are available
- Periodic redemptions allow funds to remain fully invested

Source: ING U.S. Investment Management
Summary

“Senior” Loans
- Loans are at the top of a borrower’s capital structure

Senior Loan History
- The S&P/LSTA Leveraged Loan Index has only had one negative total return year since its inception

Income
- Floating-rate loans provide attractive coupons, have historically wide spreads, and provide a hedge against rising interest rates

Defaults and Recoveries
- Fundamentals are strong, and default rates are below average
- Loans typically gain value post-default due to a first lien on the assets of the borrower

Options for Accessing the Market
- Pure play senior loan funds provide direct access to the asset class

Source: ING U.S. Investment Management
Outlook

Loans going forward
- Loan yields will be driven by rate policy and economic growth
- Coupon clipping year(s) for loans
- Fundamental risk seems manageable
- Base case economic view will result in moderate rise in default rates
- Relative volatility and correlation advantages should fall to loans

But we can’t ignore the headwinds:
- U.S. political situation
- Eurozone struggles
- China growth developments
- Global political unrest/shifts (Middle East/Africa/North Korea)

Loans not immune for headwinds but offer a strong value proposition given the “top of the capital structure” risk profile of the asset class and floating nature

Source: ING U.S. Investment Management
Dan Norman is Managing Director and Group Head of the ING U.S. Investment Management Senior Loan Group. He co-manages the Group with Jeff Bakalar, and he is co-chairman of the Group’s Investment Committee and the Loan Valuation Committee.

Dan has over twenty-five years of investment experience. He began managing senior loan portfolios in 1995 when ING’s predecessor acquired the management rights to ING Prime Rate Trust. Dan became the co-head of ING’s senior loan business in January of 2000 and, with Jeff Bakalar, created and implemented the ING Senior Loan Strategy and the ING Senior Loan Group in January of 2001. Dan is currently a member of the Loan Syndications and Trading Association and International Association of Credit Portfolio Managers Boards of Directors.

Dan has a wide variety of business and investment experience, having begun his career at Arthur Andersen & Co. in 1981. He joined ING’s predecessor in 1992. Dan received his B.A. degree in 1980 from the University of Nebraska and completed the University of Nebraska M.B.A. program in 1981.
Principal Risks

Risk is inherent in all investing. The following are the principal risks associated with investing in Senior Loans (the “Strategy”). This is not, and is not intended to be, a description of all risks of investing in the strategy.

- **Credit Risk:** The Strategy invests a substantial portion of its assets in below investment grade senior bank loans and other below investment grade assets. Below investment grade loans involve a greater risk that borrowers may not make timely payment of the interest and principal due on their loans. They also involve a greater risk that the value of such loans could decline significantly. If borrowers do not make timely payments of the interest due on their loans, the yield on a portfolio invested under the Strategy will decrease. If borrowers do not make timely payment of the principal due on their loans, or if the value of such loans decreases, the value of a portfolio invested under the Strategy will decrease.

- **Interest Rate Risk:** Changes in short-term market interest rates will directly affect the yield on a portfolio invested under the Strategy. If short-term market interest rates fall, the yield on a portfolio invested under the Strategy will also fall. To the extent that the interest rate spreads on loans in a portfolio invested under the Strategy experience a general decline, the yield on such portfolio will fall and the value of such portfolio’s assets may decrease, which will cause the portfolio’s value to decrease. Conversely, when short-term market interest rates rise, because of the lag between changes in such short-term rates and the resetting of the floating rates on assets in a portfolio invested under the Strategy, the impact of rising rates will be delayed to the extent of such lag.

- **Leverage Risk:** The Strategy may borrow money for investment purposes. Borrowing increases both investment opportunity and investment risk. In the event of a general market decline in the value of assets such as those in which the Strategy invests, the effect of that decline will be magnified in a portfolio invested under the Strategy because of additional assets purchased with the proceeds of borrowings.

- **Limited secondary market for loans:** Because of the limited secondary market for loans, a portfolio invested under the Strategy may be limited in its ability to sell loans in its portfolio in a timely fashion and/or at a favorable price.

- **Demand for loans:** An increase in demand for loans may adversely affect the rate of interest payable on new loans acquired by a portfolio invested under the Strategy, and it may also increase the price of loans in the secondary market. A decrease in the demand for loans may adversely affect the price of loans in a portfolio invested under the Strategy, which could cause such portfolio’s value to decline.
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