



LEHMAN BROTHERS

# Western Asset Arbitrage

collateralized Loan  
obligation proposal

TheCaseSolution.Com



LEHMAN BROTHERS

# Western Asset Arbitrage

collateralized Loan  
obligation proposal

TheCaseSolution.Com



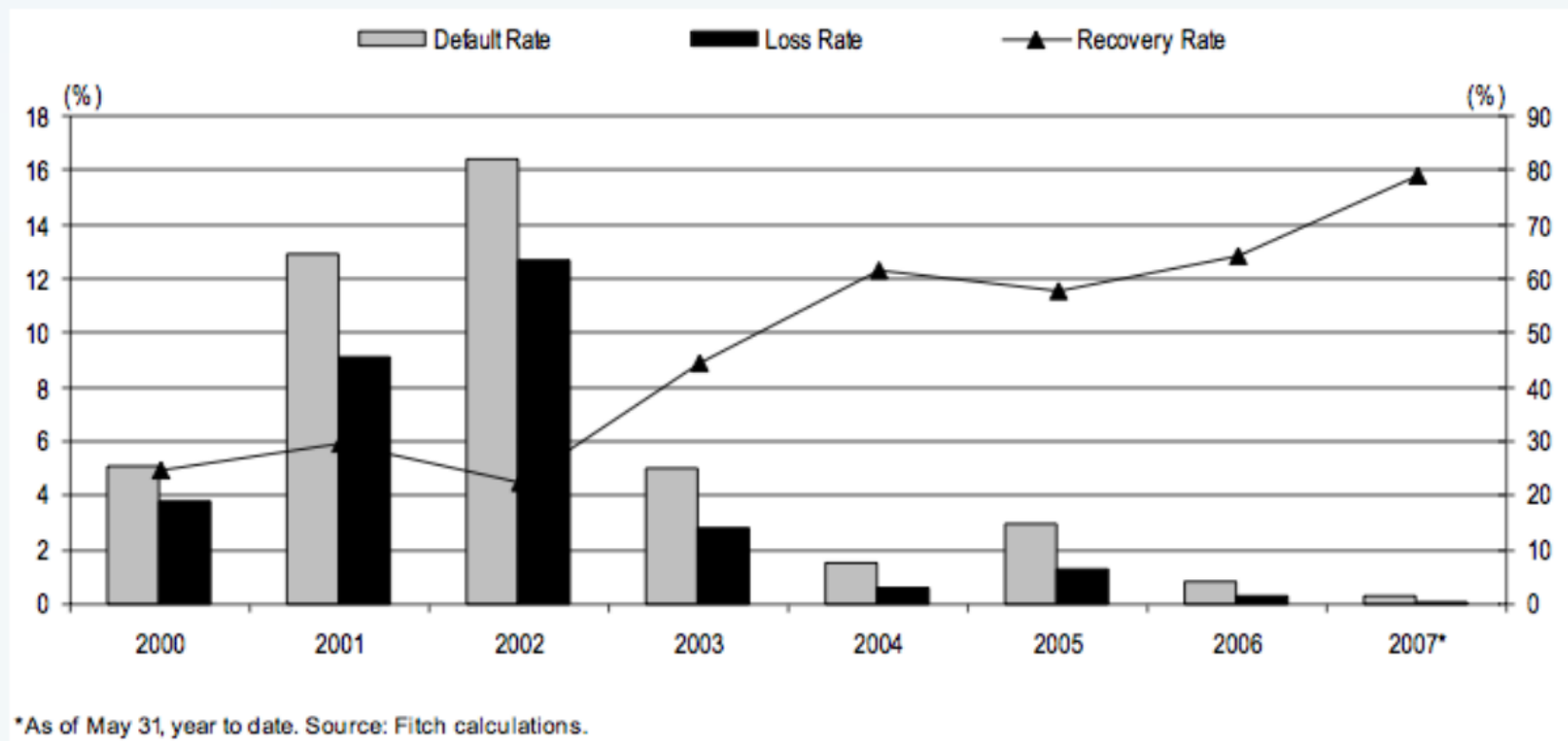
## Subprime, CLOs and Spillovers

- The worst is yet to come in the subprime mortgage market as we expect continued deterioration in the subprime loan performance well into 2008
- The worsening subprime market will put spread pressures on CLOs but the net impact should be contained and relatively modest due to credit fundamentals of the two NOT being interdependent
- Liquidity in the subprime sector has evaporated with feedback effects to CLOs but the only consequence should be that CLO spreads will widen
- challenge would be to widen loan spreads to restore CLO equity arbitrage

# Corporate Credit Outlook

- strong corporate growth coupled with historically low default rates and high recovery rates
- introduction of Leveraged Loan credit derivatives index (LCDX) on 22 May means there is now a highly liquid tool to hedge your loan portfolio
- we expect the LCDX to plunge over the next few months should the credit markets deteriorate but it should NOT be a cause for concern
- credit events are expected to increase with lower recoveries BUT most of the transactions have sufficient excess spread to overcome the corporate credit deterioration
- the US automotive sector carries the largest exposure to the credit deterioration following the chapter 11 filing of Delphi and Dana as well as the downgrade of Ford Motor and General Motors
- Leveraged buyouts are trending which introduces new risks

# Fitch U.S. High Yield Default Index: 2000-2007





## Covenants decline amidst surging leveraged loans issuance

- The percentage of leveraged loans containing a coverage covenant of any type dropped to 44.3% from 68.1% in 2006 and below the 1996–2006 average of 78.1%
- The percentage of loans containing leverage covenants of any type fell to 51.1%, down from 69.6% in 2006 and below the 1996–2006 average of 72.8%
- Along with the general demise of covenant packages has been the growth of specific “covenant-lite” loan issuance
- In 2007 through May, \$47 billion of “covenant-lite” transactions have come to market; more than twice the level of “covenant-lite” issuance in all of 2006