

Investment*focus*

May 2009

How the Tight Credit Market Is Augmenting the Investment Opportunity for Private Debt Capital

Executive Summary

While the credit markets are invariably cyclical, the dislocation over the past couple of years has proven to be unusually broad and intense. This crisis has set the stage for a widening gap between the supply of, and demand for, credit capital—a gap that poses significant hurdles for corporate debt issuers.

In this paper, we analyze some of the primary causes of the supply contraction in the traditional leveraged finance markets. These causes include: a retrenchment among banks; a shakeout of the hedge fund industry; and the shutdown of the collateralized loan obligation (CLO) and collateralized debt obligation (CDO) markets.

At the same time, we expect the demand for such debt capital to increase in the years to come. We expect this enhanced demand to come from several areas, including a significant backlog of refinancings; the ongoing borrowing needs of corporations around the world; and private equity funds with a substantial amount of capital waiting to be deployed.

In response to this supply/demand imbalance, we expect a combination of both traditional and non-traditional sources of debt capital to emerge to help fill the gap. This combination solution will likely include roles for pension and sovereign wealth funds; private credit or mezzanine funds; and private equity-led refinancings and restructurings, as well as equitization of defaulted principal.

Within this solution, we believe that private credit capital targeting middle-market issuers represents the most promising entry point for investors. Given their continuing difficulties in accessing the traditional leveraged finance markets, smaller corporations will, in our view, increasingly turn to the private credit markets for capital. As a result, we expect pricing, terms and covenants for these deals to become more attractive to investors.



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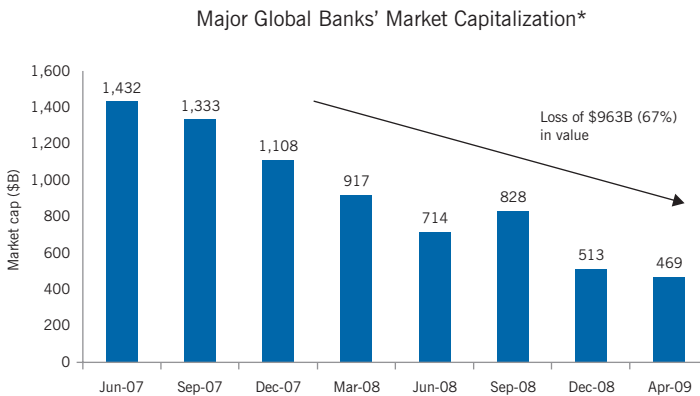
Dwindling Supply of Capital

The ongoing dislocation in the credit markets has proven to be unusually acute in intensity and global in scope. As a result of this dislocation, a supply/demand imbalance has emerged in traditional leveraged finance that we believe will continue—and likely grow—over the next several years.

There are, in our view, three principal causes of the capital supply contraction in the traditional leveraged finance markets.¹ These causes include: 1) a retrenchment among banks; 2) the shakeout of hedge funds; 3) CLO and CDO issuance shutting down.

Due to the global credit crisis, banks are now operating under a new paradigm of increased risk management, capital conservatism and deleveraging. For example, value destruction for 13 of the largest global banks has totaled more than \$960 billion since July 2007 (*Display 1*). As a result, these institutions can no longer provide the significant capital to the market comparable to the 2004–2007 period.

Display 1: More than \$1 trillion in bank equity value has been destroyed

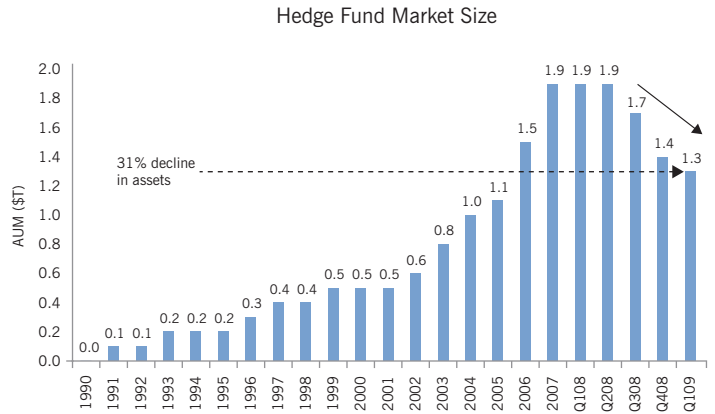


*Chart includes aggregate of: Bank of America, Bear Sterns, Citigroup, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Lehman Brothers, Merrill Lynch, Morgan Stanley, VBS, Wachovia Bank and Wells Fargo.

Source: Capital IQ

Other key suppliers of capital to leveraged finance borrowers—hedge funds—have also seen their funding capacity dwindle in the last couple of years. Not only have assets under management for these firms shrunk dramatically—they are down approximately 27% since their peak in 2008 (*Display 2*)—but a number of the leveraged finance investments commonly pursued by these funds in recent years can no longer be enabled by inexpensive and plentiful bank financing.

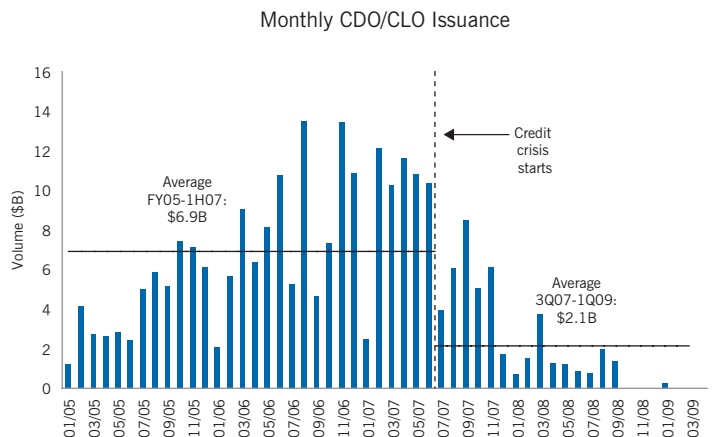
Display 2: Hedge fund growth based on assets under management has slowed



Source: Hedge Fund Research

In addition, the CLO and CDO markets have both been effectively shut down. At their peak, CLOs alone accounted for more than 60% of leveraged loan supply.² However, with market participants of all kinds reducing and repricing credit risk, CDO and CLO formations have declined precipitously. By the end of 2008, issuance for the two asset classes combined had fallen approximately 85% from its peak in November 2006 (*Display 3*)—and it is unclear to us at this stage when, or to what extent, this market will come back. Taken together, these factors have markedly squeezed the volume of capital available for corporate debt issuers.

Display 3: CDO and CLO issuance has evaporated



Source: S&P LCD

¹Leveraged finance assets include leveraged loans and high-yield bonds of borrowers/issuers that are rated below investment grade.

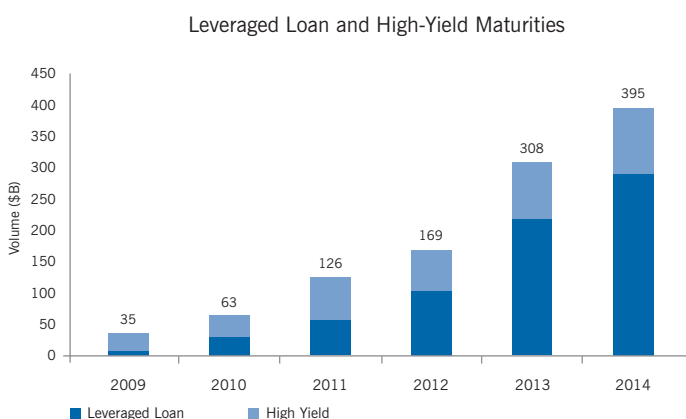
²Source: S&P LCD

Rising Demand

Against this backdrop of dwindling supply, we expect demand for leveraged finance capital to surge in several years. Key drivers of this increase, in our view, include: 1) a refinancing overhang; 2) continuing demand for traditional corporate borrowing; and 3) substantial uninvested private equity capital waiting to be deployed.

Foremost among the drivers of demand for capital is the flood of refinancings that we expect to occur within the next five years. Indeed, almost \$1.1 trillion in leveraged loans and high-yield bonds are scheduled to mature between 2010 and 2014, and these deals will need to be refinanced or restructured in some capacity (*Display 4*).

Display 4: Leveraged loan and high-yield refinancings could top \$1.1 trillion through 2014



All forecasts are subject to change at any time and may not come to pass due to changes in market or economic conditions.

Source: Credit Suisse

On top of the maturing debt already in the pipeline, conventional corporate borrowing demand—for acquisitions, capital expenditures and the other standard operational requirements of corporations—will continue apace, thus creating further demand

for capital. As an indication of the kind of transaction flow that we could see from this area, non-leveraged-buyout, non-refinancing volume alone averaged \$76 billion per year over the last five years—totaling \$380 billion for the time period.³

Finally, private-equity sponsors throughout the recent asset bubble have raised a substantial amount of capital—more than \$470 billion, according to industry estimates⁴—that will need to be deployed over the next five years in the form of leveraged buyouts (LBOs) and other investments. Even relatively modest levels of leverage would result in a marked increase in demand for debt capital.

Given these powerful demand drivers, we expect the supply/demand imbalance to remain considerable—and likely grow—over the next five years.

Framing the Solution

With traditional suppliers of credit capital severely diminished, and a near-record outlook for demand, the leveraged finance market faces a significant challenge. As a result, the market in broad terms needs one, all or a combination of the following events to occur: 1) new pockets of capital to emerge; 2) the flow from traditional suppliers to meaningfully increase; or 3) non-traditional suppliers to step up their activity.

Given the magnitude of the projected demand for capital in the leveraged finance markets, the most likely solution, in our view, involves a combination of both traditional and non-traditional sources of capital stepping up to fill what we see as a growing supply/demand disparity.

Large pension funds and sovereign wealth funds (SWFs) represent one source that could potentially bridge the gap. By shifting a substantial portion of their current allocations from equities or alternative investment assets into traditional leveraged finance vehicles, such as loan or high-yield funds, these institutional investors could certainly help fill the supply pipeline, given their substantial asset bases (*Display 5, next page*).

³Sources: Morgan Stanley and S&P LCD

⁴Source: Preqin

Display 5: SWFs offer an abundant source of capital...

World's 10 Largest Sovereign Wealth Funds

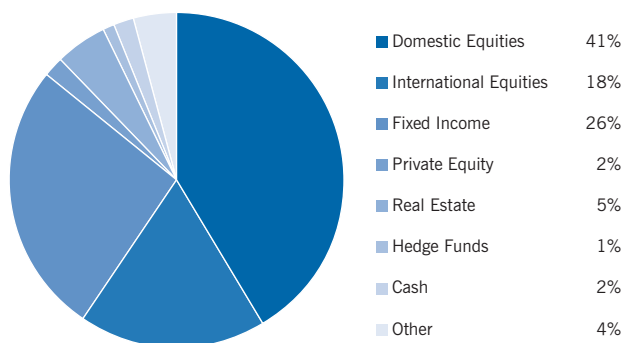
Country	SWF Name	Assets (\$B)	Inception
UAE-Abu Dhabi	Abu Dhabi Investment Authority	627	1976
Saudi Arabia	SAMA Foreign Holdings	431	N/A
China	SAFE Investment Company	347	N/A
Norway	Government Pension Fund	326	1990
Singapore	Government of Singapore Investment Corp.	248	1981
Russia	National Welfare Fund	220*	2008
Kuwait	Kuwait Investment Authority	203	1953
China-Hong Kong	Hong Kong Monetary Authority Investment Portfolio	193	1998
China	China Investment Corp.	190	2007
Singapore	Temasek Holdings	85	1974

Source: Sovereign Wealth Institute estimates as of April 2009.

*Includes the oil stabilization fund of Russia.

...and public plans can raise private-equity allocations

US Public Pension Fund Average Allocations



Source: MSIM Public Fund CIO Survey, August 2008

Given the current relative scarcity of capital from traditional capital sources, non-traditional funding providers—such as credit opportunity and mezzanine⁵ funds—could play a greater role as

well. In particular, these private funds could provide capital when companies seek to exchange, restructure or equitize existing debt.

As discussed earlier, we also expect private equity sponsors to deploy its significant uncalled capital to facilitate the refinancing of modestly over-leveraged companies.

Regardless of the solution, we expect a significant degree of losses of principal and the equitization of debt to occur as companies are either unable to restructure their debt or cannot access new sources of capital. According to our estimates, we expect about \$300 billion in credit losses to occur from 2010 to 2014, and more than \$75 billion in equitizations, based on estimates of 45% cumulative defaults, 50% recovery on loans with one-third equitization, and 20% recovery on high yield with two-thirds equitization.

Benefits of Private Capital

Given that a combination solution is, in our view, the most likely scenario to develop in response to the continuing relative scarcity of credit, we believe that the most promising opportunity for investors within that regime is new private credit capital⁶ focused on middle-market issuers.

In our view, a number of issuers over the next few years will be unable to access the traditional leveraged-loan or high-yield markets for capital. One key reason is size. The public high-yield market has undergone a transformation in recent years from one characterized by small transactions by middle-market companies to one dominated by large deals. High-yield investors have shunned smaller transactions in favor of the liquidity offered by larger transactions, as the strategy of the core buyer universe has evolved from buy and hold to mark-to-market. The focus on liquidity has become even more pronounced during times of volatility.

Between 2002 and 2008, the average size of a high-yield transaction increased from approximately \$250 million to almost \$830 million.⁷ Deals of \$200 million or less comprised the majority of public high-yield new issues between 2002 and 2004, but by 2008 represented just 20% of the new-issue market by number of issues and less than 10% by volume. As a result, small- and middle-market corporates have had difficulty commanding investor attention due to their size, exacerbating the lack of liquidity of their debt.

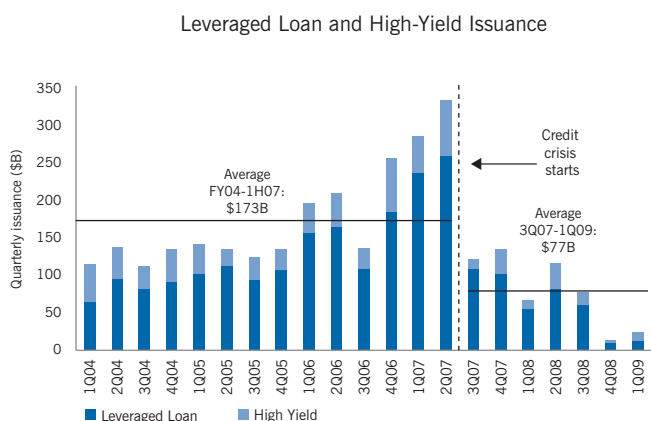
Further highlighting the inability of smaller issuers to access traditional lines of leveraged capital, leveraged loan, high-yield and

⁵Mezzanine debt is typically employed by corporations and financial sponsors to finance LBOs, recapitalizations, refinancings, acquisitions and other private equity and corporate transactions. Mezzanine investments generally take the form of senior unsecured notes, senior subordinated notes, second-lien debt and preferred stock. Mezzanine is usually structured and placed with a limited number of investors, making it an illiquid investment that is intended to be held to maturity. The majority of mezzanine debt is generally non-callable for one to five years. Mezzanine investments are often structured with warrants or an equity co-investment of 5% to 10% of the total invested capital. The vast majority of returns are generated by contractual current income, while long-term capital appreciation is achieved through payment-in-kind (PIK) interest and equity components.

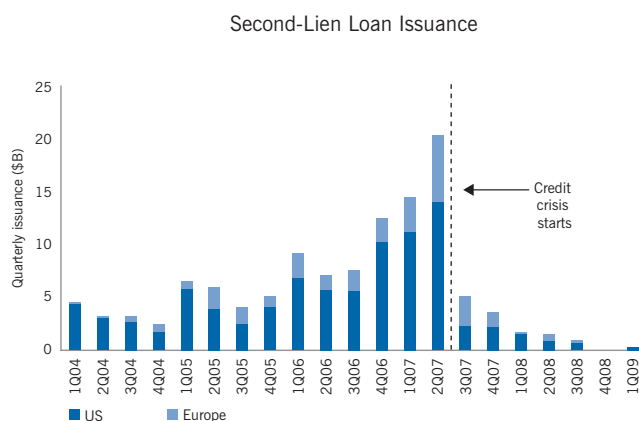
⁶Traditional leveraged finance involves “public credit” and “private credit.” The former refers to loans and bonds that have been syndicated to a broad group of investors and are usually freely tradeable in the markets. Public credit is generally arranged by an investment bank and then sold to investors. Private credit, on the other hand, involves a limited number of investors that negotiate all deal terms directly with the borrower/issuer. There is no public market for the debt, and it is usually held to maturity by one investor or a limited number of investors. Mezzanine debt is a traditional example, where a small number of investors negotiate the pricing and terms of a deal, and hold the debt to maturity because there is no public market.

⁷Sources: Morgan Stanley and S&P LCD

Display 6: Leveraged loan, high-yield and second-lien loan new issuance volume has plummeted



Sources: Morgan Stanley and S&P LCD

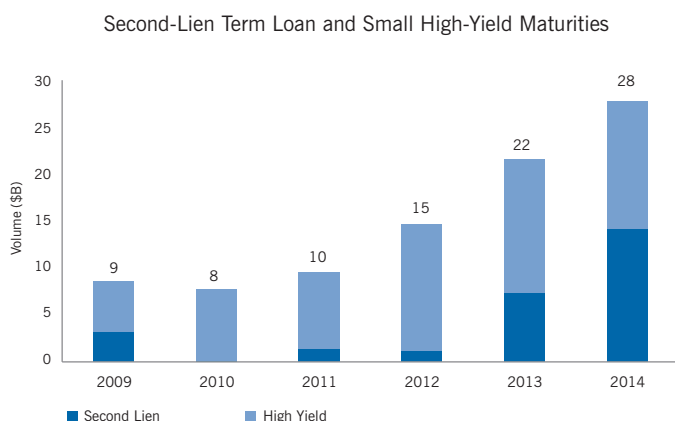


Source: S&P LCD

second-lien loan issuance has dropped significantly from their peak levels in mid-2007 (*Display 6*).

In addition, more than \$70 billion of public high-yield debt with tranche sizes of \$250 million or less is scheduled to mature between 2010 and 2014—on top of \$24 billion in second-lien loans maturing during that time period, according to our research (*Display 7*). With the public high-yield market becoming less accessible to smaller issuers, we expect an increasing number of refinancings for companies with less than \$1 billion in aggregate value to turn to credit or mezzanine funds in the privately negotiated market as this high-yield debt matures.

Display 7: The volume of maturing second-lien term loan and small high-yield issues is increasing



Small high-yield issues include transactions of \$250 million and less, from issuers with less than \$750 million in total debt. All forecasts are subject to change at any time and may not come to pass due to changes in market or economic conditions.

Sources: S&P LCD and Capital IQ

Another important reason for smaller issuers to opt for non-traditional capital sources is that these companies often have particular requirements that the public debt markets—with banks’ current inability or lack of appetite to provide risk capital in the form of bridge loans or mezzanine financing—are unable to meet.

One of these requirements is certainty of financing. In private transactions, investors typically negotiate directly with issuers or financial sponsors to provide committed financing. Unlike in most public deals, a material change in the credit markets will not release investors in a privately negotiated transaction from their contractual commitment, or allow those investors to increase the agreed-upon yield or spread. This provides smaller issuers and financial sponsors seeking capital for their LBO bids with certainty on pricing, terms and structure.

Flexibility is another requirement that smaller issuers will likely seek. For example, compared to the high-yield debt market, structures in private deals can offer more flexibility in prepayment terms, coupon composition, amortization, maturity or covenants.

The lack of public disclosure in privately negotiated deals can also appeal to certain issuers. In such transactions, companies are not required to file with the Securities and Exchange Commission, which allows them to keep financial performance, executive compensation and competitive information private. Issuers can also achieve substantial cost savings by avoiding expenses associated with being a public company.

We also expect the widening supply/demand imbalance to help spur private deals to include improved structures for investors—such as lower leverage, tighter covenants and the elimination of “covenant-lite” and “PIK-toggle”⁸ features. Finally, we expect attractive pricing and call protection to be common in these transactions.

⁸In a PIK toggle, the borrower in each interest period has the option to pay interest in cash or to perform the interest payment in kind.

Investment Risks and Conclusion

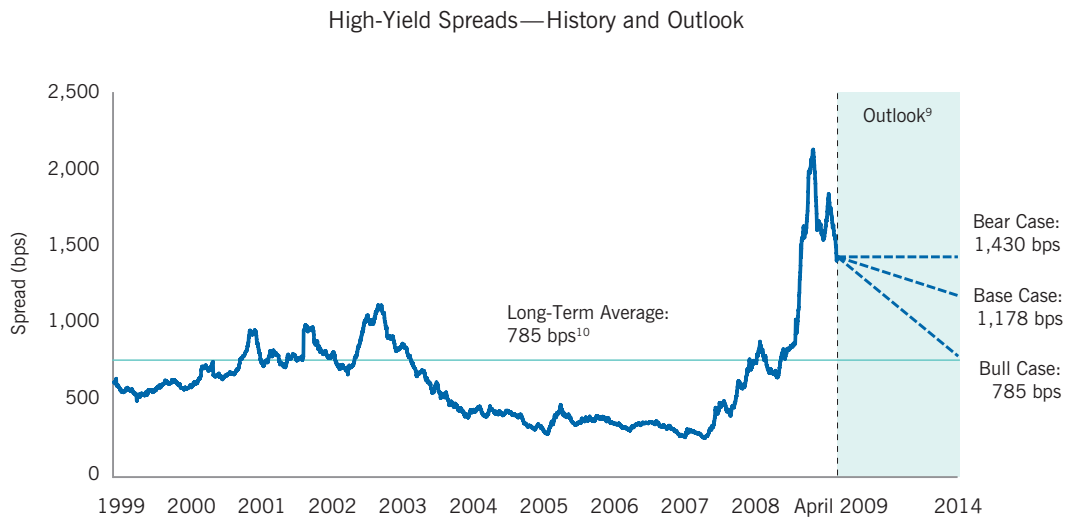
There are, to be sure, several risks involved when investing in this area. While we see the continuing development of a supply/demand imbalance in credit capital, a miscalculation of the extent of that imbalance poses a risk to investors. At the same time, investing in the private credit market too early—if the current recession becomes more protracted and deeper than expected—also represents a risk.

We attempt to gauge the magnitude of those risks in *Display 8* by using high-yield spreads as a proxy. According to our research, each five-year scenario—as shown in the chart—suggests that, for the most part, market imbalances are likely to persist. In the bear case scenario—which foresees a continuation of the current

market environment—the spread remains well above average at 1,430 bps, suggesting that the supply of leverage-finance capital will remain scarce for years to come. The base scenario sees the spread tightening to 1,178 bps, equivalent to 1.5 times the historical average. Lastly, the bull case implies a mean-reverting scenario in which the spread moves back towards its historical averages—indicating that the expected supply/demand imbalance would, for the most part, be corrected by 2014.

Whichever scenario develops, it seems likely that the expected supply/demand imbalance will take time to resolve itself—a situation that, in our view, can be exploited in the long run.

Display 8: High-yield spreads are likely to remain above historical levels



Sources: Barclays US High Yield Aggregate Index and Morgan Stanley Credit Partners estimates

All forecasts are subject to change at any time and may not come to pass due to changes in market or economic conditions. Past performance is no guarantee of future results. The figures are provided by way of example only and do not reflect the performance of any Morgan Stanley investment.

⁹Spread Outlook based on the following assumptions: Bear Case equal to current; Base Case equal to 150% of the Long-Term Average; Bull Case equal to the Long-Term Average.

¹⁰Long-Term Average based on 10-year average spread, excluding “credit bubble” period from 2004-1H2007.

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(Extremely helpful)

Morgan Stanley Investment Management Publications

Following are recent thought-leadership papers covering a range of investment issues:

Accessing Investment Opportunities In a Real Estate Recession

May 2009—We believe that the most severe economic crisis since World War II is creating the most compelling commercial real estate opportunities in a generation. In this paper, we examine the causes of the ongoing market correction, quantify the impact of the crisis to date, and compare the current real estate recession to past market downturns. Due to the unique combination of events that precipitated the current slowdown, investors could have the chance to purchase the debt and/or equity of real estate at what we view as historically attractive terms.

Minimum Target and Maximum Shortfall Risks

April 2009—One often hears that an investor needs to move toward a riskier stance in order to satisfy its return objectives. But exactly how much risk must that investor accept to have a good chance of reaching even a modest target return? In this paper, we find that target returns and shortfall risks can have very different probabilities of fulfillment. We also suggest that investors might be surprised by the beta level they must accept to have a reasonable probability of achieving a specific return goal.

Planning for a More Sustainable Fiscal Future

April 2009—David Walker has long been an authoritative voice of reason in any discussion about US budgetary and economic policy issues. Adapted from the former US Comptroller General's keynote address at the recent Morgan Stanley Institutional Investor Conference, this paper outlines Mr. Walker's view that the US has strayed from many of the tenets of the country's founding fathers. In response, he proposes a "Grand Bargain" that embraces federal budget controls; Social Security, health care and tax reform; and an aggressive government-private sector collaboration to drive the effort.

Finding Opportunities in Senior Loans Amid Increased Volatility

March 2009—The continuing market volatility represents a challenge to investors—but it has opened up substantial opportunities as well. One such opportunity, in our view, is the

senior loan market. In this paper, we provide an update of our report from last fall that reflects MSIM's latest thinking amid rapidly evolving events. For example, while defaults have been rising, given the current pricing of loans in the secondary market, we believe that investors are being offered a significant cushion. Placing into context other fundamentals such as corporate leverage and issuer performance, this paper suggests that senior loans represent a compelling story for investors.

Portfolio Liquidity and Fund-Level Betas

February 2009—Recent market turbulence has brought the importance of portfolio liquidity to the top of the agenda of many institutional investors. This paper analyzes and addresses this issue, providing a framework for how investors should approach a portfolio's liquidity needs. The paper shows that a fund's liquidity requirement will generally depend upon a number of complex factors, including the specific composition of assets, endogenous and exogenous commitments over various time horizons, the strength and resilience of the sponsor, and—perhaps most critically—the level of net inflows or outflows.

Navigating the Recession: Identifying Tactical Opportunities amid the Slowdown

February 2009—In the wake of recent asset price declines, investors are seeking options for rebalancing their allocations and deploying capital in the coming months. This paper provides a macro-economic view of the markets through the eyes of three senior portfolio managers. It also looks at some of the underlying fundamentals from both a current and historical perspective, and drills down on select themes that investors should consider over an intermediate-term time horizon.

The Infrastructure Opportunity: Repair, Build and Stimulate

February 2009—As the world grapples with a severe economic slowdown, government spending on infrastructure appears on the rise, creating opportunities. Our analysis suggests that a total \$41 trillion will be needed by 2030 to build and repair infrastructure globally, a level of spending that, in our view, creates an attractive secular case for investing in infrastructure.

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Leveraged finance investments have significant risks as a result of business, financial, market or legal uncertainties. The current turmoil in the global financial system has heightened the risks associated with such investments, and it is possible that an investment in leveraged finance could result in significant losses during this economic cycle.

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