

Defining Distressed Debt

Though there is no universally recognized definition of distressed debt, bonds are technically considered to be distressed when they trade 1,000 bps over similar duration Treasuries. Similarly, loans trading 1,000 bps over LIBOR or for less than 75 cents on the dollar are considered to be distressed. This debt could be private or public, senior or junior, secured or unsecured.

The market categorizes a company’s debt as distressed if it is perceived that the company will have or currently has insufficient cash flow to service its debt and a debt modification or restructuring appears imminent. This typically occurs when there is market consensus that a company will be unable to make a scheduled principal or interest payment in the near term. Even if a near-term payment default is not expected, debt can also be considered distressed if the company’s leverage ratio significantly exceeds that of its peers, or if there is a high likelihood that the company will violate its financial covenants.

In the investment community, the state of default broadly includes payment defaults, covenant defaults and bankruptcies. Figure 1 below shows the historical default rates and the volume of defaults thus defined. Default rates for this downturn have exceeded those of the last downturn with high yield bonds hitting 10.3% and high yield loans 12.6% in 2009, and 8.6% and 6.5%, respectively, for 2000/2001. Likewise, the total par...
The technical definition of distressed debt essentially relies on the efficient functioning of the market— which is presumed to accurately discount all available credit information into prices. The problem with this assumption is that the 1,000 bps benchmark may not be appropriate for all market environments. For example, during the worst of the recent credit crisis, bond and loan prices dropped dramatically as significant technical pressure in the form of forced selling resulted in historically low prices for assets relative to their fundamental value and ultimate recovery values. Loan prices, in particular, had historically been very stable even through market troughs. Figure 2 illustrates how at the worst of the credit crisis at the end of 2008, 65% of all non-defaulted loans were trading below 70. This was not to say that more than 65% of issuers were then distressed, but market technicals were such that loan prices plunged to levels not seen before. Hence, it is important to note that the definition above is more appropriate for a normally functioning market, characterized by willing, not forced, buyers and sellers of assets.

Another way of looking at distressed debt is to consider the valuation of the company’s balance sheet. At the time the company is capitalized, whether it is via a private-equity sponsored leveraged buyout or a strategic acquisition by a competitor, the historical cost of acquisition is reflected in the company’s balance sheet. Figure 3 on the next page is a simplified depiction of a company’s balance sheet at inception. The left side depicts the cost or value of the firm’s assets at the time of acquisition, and the right side reflects the sources of capital to acquire the assets in the form of the firm’s liabilities and the owners’ equity.

Numerous factors may impact a company and cause it to become distressed. For example, a slowdown in the economy may impact the revenue generation of the company by significantly reducing its ability to generate cash flow. As the uncertainty of future cash flow increases, the discount rate used to value expected cash flows is also increased to account for the greater perception of risk. The combination of lower projected future cash flows and greater discount rates results in a reduction of the total enterprise valuation and the market value of the assets of the company shrinks as depicted in Figure 4 on the next page. This results in a company’s economic value being less than the debt component of the capital structure. Potential solutions include a reduction of the amount of debt and the transfer of the equity interests to those debt holders whose claims were reduced, effectively resulting in a restructured balance sheet. Investing in the debt of the company just before or during the restructuring process is essentially distressed-debt investing.
THE CAUSES OF DISTRESS

Loans and bonds become distressed for a number of reasons, but there are generally four underlying factors that lead to distress. The first is a **cyclical downturn**, where a company faces financial pressures due to a recessionary environment; revenues can fall and profitability becomes dependent on the company’s ability to reduce expenses. A company that has significant fixed costs will have more difficulty in rightsizing its costs than if its costs were largely variable. A second cause of distress is a result of **dramatic secular industry change**, usually resulting from technological changes that present an opportunity for significant reductions in labor costs, or regulatory changes that have drastically negative impacts on the company. Third, **poor management teams** that make poor strategic decisions often result in financial distress. The fourth cause is a **lack of capital market liquidity**. Generally, all of the above lead to an **over-leveraged capital structure**, which may require voluntary debt exchanges or reductions in the debt burden. These reasons for distress are not mutually exclusive, and in some cases, can work in tandem to push a company into distress.

Essentially, financial distress occurs when a firm is unable to pay back its existing debt in accordance with its contractual obligations. In most instances, financial distress is experienced by highly leveraged companies that cannot generate adequate cash flow from operations to service their existing capital structure. From another perspective, they are neither able to maintain leverage at current levels to allow for a recapitalization at maturity, nor take advantage of other strategic alternatives such as a merger or acquisition that could result in a full debt repayment.
DISTRESSED-DEBT RESTRUCTURINGS – THE LEGAL PERSPECTIVE

Balance sheet restructuring is an integral part of the process of distressed-debt analysis. It is important to understand the restructuring process due to its impact on the company’s liabilities and hence the distressed debt held by the investor. There are basically two approaches to the process: in-court and out-of-court. In-court restructuring refers to the formal process of Chapter 11 under the United States Bankruptcy Court while out-of-court reorganization refers to voluntary agreements between the distressed company and particular creditors. Out-of-court restructurings are generally preferred as Chapter 11 cases are time-consuming and expensive. However, depending on the circumstances, a Chapter 11 filing may be preferable if the company has significant claims or legacy liabilities that are unlikely to be satisfied even with reasonable levels of cash flow. Bankruptcy does, however, carry the risk of harming the business because of the negative signal a bankrupt business sends to customers, vendors, and key employees.

OUT-OF-COURT RESTRUCTURING

In an out-of-court restructuring, the company and any of its creditors that may be required to modify debt repayment terms negotiate a change in the terms of existing obligations or complete a voluntary exchange of financial interests. In an exchange, the original debt instrument is exchanged for a new consideration that could include a combination of a debt instrument with a reduced principal amount, some type of equity, and/or cash. In the balance sheet example above, the bondholders could agree to eliminate all debt in exchange for equity. This particular exchange is called an “all-equity exchange.” Such a complete “equitization” or debt-free solution is often advisable for firms that are not generating stable cash flow or are likely to require additional capital infusions in the future. In essence, the out-of-court restructuring typically begins with a negotiation that ultimately leads to an agreement by the participants on the terms of a deal.

Out-of-court restructurings require negotiations between creditors and the company. Often, significant holders of each class of debt are organized to negotiate the restructuring on behalf of the debt holders in their class with similar constituents of other creditor classes. If the loan is made by a single or small group of lenders, then the participants are self-evident. In the case of a large syndicated loan, the loan agreement will specify an “agent,” who receives special compensation to perform such duties, although other lenders can also get involved. In the case of bonds, the representative will typically be a small group of significant bondholders who form an informal bondholder committee.

IN-COURT RESTRUCTURING – BANKRUPTCY

In-court restructurings are better known as bankruptcy proceedings. It is common for firms to send many signals or warnings to the market preceding a bankruptcy filing, making it an expected occurrence in many instances. Many holders of prepetition bankruptcy debt claims end up not wanting to remain invested in distressed situations for structural reasons related to investment vehicles, a lack of understanding about the process or prospects for total return, or a combination of the above. As a result, original creditors who fear losses and want to mitigate them or avoid the bankruptcy process are often willing to sell those claims, often at substantial discounts. It is this opportunity that gives rise to distressed-debt investing.
Savvy distressed-debt asset managers will identify early on which companies or industries are likely to end up in financial distress or bankruptcy and what that implies for the value of any particular class of debt. The asset manager needs to identify and evaluate potential investments on a total rate of return basis using an appropriate discount rate. The implied value as determined by the manager is compared with the trading levels of the distressed security to identify potential investments. Proper analysis also requires having a strategic plan or a view that is focused over months or even years into the future, depending on the investment objective. The key is not necessarily to time the “bottom” but rather to buy what is available based upon underlying fundamental value and the manager’s view of the final outcome for the company’s longer term prospects. Generally speaking, at the time of the actual default, the future path of the company and the treatment of various creditor classes may have already been determined. Due to the uncertainty of the process, the ability of the asset manager to negotiate and manage the restructuring process is vital to be able to realize value and returns through distressed investing.

As mentioned, a restructuring through bankruptcy can be complex, time consuming, and expensive. However, it is often the most efficient path to value creation for distressed investors. The bankruptcy proceeding starts when an appropriate petition is filed with a bankruptcy court. In most cases, the petition is filed by the debtor and is known as a “voluntary petition.” In some cases, three or more creditors may have grounds for filing an “involuntary petition,” but the debtor confronted with such an action is likely to file its own petition and be granted control of the case.

The petition will typically seek protection under the provisions of Chapter 11 of the Bankruptcy Code, though Chapter 7 is also a possibility. Chapter 11 allows the existing management to reorganize the debtor as a going concern, while Chapter 7 anticipates that a court-appointed trustee will supervise the liquidation of the debtor's assets. Both management and creditors tend to prefer Chapter 11. Management would prefer Chapter 11 because it allows them to keep their jobs and at times allows them to extract premium wages based on the theory that they must be provided extra incentives to remain in a higher risk business. Creditors generally prefer Chapter 11 because they expect that the assets will be worth more as a going concern than if sold in a fire-sale auction.

The key document in a bankruptcy is the **plan of reorganization**, which is a comprehensive legal document that discusses what will happen to the debtor, its assets, and all constituent liabilities, including equity interests, upon the debtor's exit from bankruptcy. From a distressed asset manager's standpoint, the plan details the status of various claims and how they will be treated or paid. Cooperation between management and creditors in formulating this plan of reorganization is key. In cases where there is significant cooperation, the tentative plan can be worked out ahead of time and be ready to be voted on at time of the bankruptcy filing. This is commonly referred to as a “**prenegotiated**” Chapter 11 filing. In particularly well-planned cases, the creditors will vote on the acceptability of the plan prior to the filing. This is called a prepackaged plan and can reduce the time needed to complete reorganization to less than 45 days. On the other hand, when there is no cooperation and no consensus has been reached, it is referred to as a “**free-fall**” Chapter 11, which can often lead to a lengthy (1-3 years) and expensive reorganization.

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1. To approve the plan, either 66.67% by debt volume and 50% by number of each class of debt holders is needed.
Stabilizing Operations and the Role of DIPs

Following the filing of a Chapter 11 petition, the company will still need operating liquidity in the near term, especially where the debtor has little cash on hand at the time of filing. A couple of events take place at this point to move the company along as a going concern, starting with the automatic stay. The automatic stay essentially freezes all creditors in their prepetition position and gives the debtor some “breathing room” and some financial flexibility. For companies with insufficient liquidity, the execution of a debtor-in-possession (DIP) facility also takes place at this time, with the approval of the bankruptcy court. The DIP facility allows the lender a super-priority interest in previously encumbered assets of the debtor so that the lender can have greater assurance of repayment. This is often referred to as a priming lien. To prevent undue impairment of the original secured creditor’s position, the granting of the super-priority lien will require the debtor to show that the original creditor is adequately protected. However, to avoid the risk of being primed, many prepetition secured lenders will offer to become DIP lenders. One benefit of becoming a DIP lender is that the prepetition lenders are able to obtain certain protections and other structural features that provide further protection of their prepetition claims. Recently, some DIP providers have been able to effectively convert their prepetition claims into post-petition claims as a condition of providing the DIP, in a process commonly called a rollup. This rollup process effectively improves the recovery of the prepetition debt holders that participate in the DIP by “rolling up” their prepetition claims to the top of the priority list of claims during bankruptcy (see Figure 5 below). Prepetition lenders who do not participate in the DIP would end up with their claims lower down the waterfall, and are hence incentivized to provide the DIP to the company.

**Figure 5: Example of a Rollup in DIP Provision**

![Diagram showing the rollup process in a DIP provision](source: Babson Capital)
Developing the Business Plan
After filing for bankruptcy, management would attempt to stabilize the debtor’s day-to-day operations. At the same time, the management team and its financial advisors work to develop a new business plan and a new capital structure, if this has not already been pre-determined. Although the plan of reorganization is largely within management’s control, since bankruptcy court approval must still be obtained for any transaction out of the ordinary course of business, and creditors can oppose such actions, the debtor will typically consult with the agent bank and, possibly, the formal committee of unsecured creditors\(^2\) as it develops a strategy for the plan of reorganization. The secured lenders, who are involved in negotiating the plan of reorganization, are usually represented in court by the agent bank that originally syndicated the loan. Common reorganization actions include downsizing of the labor force, closing unprofitable facilities, selling non-core lines of business and renegotiating various contracts.

The Importance of Valuation
A critical component of the formulation of a plan of reorganization is the development of a valuation. The going-concern enterprise valuation forms the basis of how the respective classes will be treated. This valuation is often the subject of intense debate because it has significant implications for the “pie-splitting” exercise. To the extent creditor parties cannot agree on the treatment of their respective classes, the court hears respective arguments on the debtors overall enterprise value. Generally, the senior creditors have an incentive to argue for a lower valuation so that they can receive a higher probability of full recovery on their asset class. A lower valuation justifies the argument for equity ownership in exchange for the senior debt, partial or whole, during the bankruptcy process. It has to be noted that the plan valuation can be very different than the actual future value. Alternatively, junior or subordinate creditors generally have an incentive to argue for higher valuations so that they can achieve a larger proportionate share of the economic value of the debtor company. The above points reinforce the potential strategic benefit of being a sufficiently large holder so that one can obtain a position on the steering committee and thus be an active participant in the process.

Once a plan of reorganization has been negotiated, it has to be voted on by holders of impaired claims and interests. Once the votes are tallied, and a number of procedural factors are satisfied, the confirmation hearing takes place, the plan is confirmed, and the company exits bankruptcy.

\(^2\) A committee of unsecured creditors, recognized by the court, is formed to represent all unsecured creditors.
DISTRESSED-DEBT INVESTMENTS – OBJECTIVES AND STRATEGIES

The investment objective is always to achieve the highest possible risk-adjusted return. In practice, there are constraints to the pursuit of that objective. Not all investors have the same tolerance for risk; some institutional investors tend to be relatively risk averse, while absolute return investors are usually willing to accept more risk. Another constraint is that many institutions may neither want to deal with the complexity nor spend the time on distressed-debt reorganizations. Given these constraints, there are three categories of investment opportunities presented by distressed companies: discount-value investments, activist investments, and control investments. The categories are mainly determined by the level of distress in a company, and the relative amount of procedural work and active negotiation required by the asset manager.

Figure 6 depicts historical returns of distressed debt vs. default rates. It has to be noted that the returns are not representative of any one strategy discussed here in this paper and past performance is no guarantee of future returns. Also to be noted is the relationship between default rates and returns of distressed debt. If any, the relationship is a lagged one where returns remain high as defaults fall after the end of the recession.

As can be seen from Table 1, distressed debt is fairly highly correlated with high yield bonds and leveraged loans, presumably as the triple-C components of those indices exhibit the closest characteristics to the underlying fundamentals of distressed debt. Equity markets are less correlated to the distressed-asset class and the investment grade and aggregate indices are not correlated at all. As such, some investors consider distressed debt an asset class that offers attractive return and diversification potential.

FIGURE 6: COMBINED DEFAULTED BANK LOAN & BOND RETURNS VS. DEFAULT RATES

Source: Returns - Altman-NYU as of November 30, 2009; Default Rates - JP Morgan as of December 1, 2009
Discount-value investments tend to be debt that is mispriced relative to competitors’ and other comparable issuers’ due to a misunderstanding of the company’s situation by the market or due to extreme market forces, similar to those experienced in late 2008 and early 2009. This might be the case even with a good management team and a strong business model behind the company. In the short term, there may be a need for a capital infusion due to short-term liquidity constraints. The total enterprise value would tend to exceed total debt and/or senior debt, and hence the debt that trades at a significant discount to par is what offers asset managers attractive risk-adjusted returns. Perhaps the underlying business is cyclical and the implied “market” valuation fails to take this into account (for example, LTM EBITDA is cyclically depressed and the leverage multiple might be lower on a more normalized long-term EBITDA). Alternatively, the asset manager might believe that the firm will delever by repurchasing its bonds at a discount and that will drive prices up. In either case, the asset manager does not have to be actively involved with the company to drive returns. If purchased, the bond or loan should, over time, rise to its fair value, at which point it can be sold, resulting in an attractive return.

Discount-value investments are ideal for distressed-debt asset managers who prefer not to become involved in the Chapter 11 reorganization process, if they can avoid it. They seek investment opportunities that, in their view, are either likely to avoid bankruptcy or can be sold for a profit before any potential filing. The passive involvement of discount-value investments fit that requirement well.

The key point is that while the company may face short-term headwinds or liquidity constraints, a full recovery would be expected without the company having to go through a restructuring process. The asset manager’s focus in this strategy is establishing a fair market-value target based on the issuer’s fundamentals. Once acquired, the asset manager monitors the holding to make sure that fundamentals are stable. The exit from the investment takes place when the principal is paid down, refinanced at par, or sold in the secondary market as the loan price rises over time. The investment return comes from both the coupon as well as capital appreciation over a time horizon of six months to two years.

In activist investments, the price discount is a result of technical and/or fundamental pressures. The company, being unable to service its capital structure with its operating cash flow, may be in default or facing an imminent default. In such cases, the company may require a liquidity injection and/or deleveraging of the capital structure. Activist investments can be found in both Chapter 11 and non-Chapter 11 situations.

<table>
<thead>
<tr>
<th>TABLE 1: 10-YEAR DISTRESSED DEBT CORRELATION TO TRADITIONAL ASSET CLASSES</th>
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<tr>
<td><strong>BARCLAYS U.S. AGGREGATE</strong></td>
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<tr>
<td>Barclays U.S. Aggregate</td>
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<tr>
<td>Barclays U.S. Corporate High Yield</td>
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<td>CS Leveraged Loan Index</td>
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<tr>
<td>S&amp;P 500</td>
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<tr>
<td>Altman-NYU Combined Default BL &amp; Bond Index</td>
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</table>
A **non-Chapter 11 activist investment** is one where the asset manager believes that although the firm is in financial distress, it has options such as note buybacks, private debt exchanges, or public exchange offers for avoiding the in-court restructuring process. These options exist when the target firm’s financial distress is largely a function of over-leverage and it has a reasonably simple capital structure and/or significant cash. The asset manager, by being involved, may be able to increase the probability of a value-enhancing, out-of-court resolution. The asset manager may acquire a large block of the distressed bonds and then, by organizing the other noteholders, approach the firm with various restructuring scenarios to reduce leverage. Activist investments often times provide an element of control after the restructuring process, through minority shareholder rights or through partnerships with like-minded investors. The key point to note is that for the asset manager to have credibility in working with management or organizing other holders, the asset manager needs to accumulate a fairly significant position, or be aligned with like-minded investors who form a majority constituency.

In **Chapter 11 activist investments**, the capital infusion is usually done through DIP financing. This type of financing helps provide working capital through bankruptcy or reorganization until the balance sheet restructuring is complete. In most cases, the reorganization and restructuring would require extensive negotiations by the senior-secured debt holders with the other capital constituents (second lien, unsecured bond, and equity) of the company. The prepetition senior-secured debt and the DIP are both considered to be activist distressed-debt investments. It is worth noting that the DIP has to be paid out in full before exiting bankruptcy, either in the form of cash or equity or a combination.

Exit from the investment takes place when the company is recapitalized or is sold. Hence, returns for such investments come mostly from capital appreciation of the purchased debt or restructured securities. The investment horizon tends to be between 18 months and three years.

The last type of distressed-debt investment is **control-debt investment**. The cause of distress might be similar to activist investments and the required action also includes rescue financing and deleveraging of the capital structure. The restructuring process could be either in-court or out-of-court. However, the key difference is that the company often requires significant liquidity, for both the DIP and exit from bankruptcy, and requires extensive operational and management reorganization, steered in many cases by the majority holders of the distressed secured debt. Generally, control-debt investors seek economic and operational control of the company through independent or shared ownership of more than 50% of a particular debt class or ownership of equity. They are extensively involved in the company’s operations via a “board of director control” position after the financial restructuring. The goal is to gain a position of influence in the restructuring process during which the securities are converted into a controlling-equity stake through the bankruptcy process. Returns are mostly from capital appreciation, but with greater return potential due to the upside provided by the equity of the company. However, the time horizon tends to be much longer due to complex operational issues and can span more than three years. Since the exit from the investment is also contingent upon a third-party sale or an IPO, the time horizon can be extended out even further and overall positions are generally less liquid than those purchased under other distressed strategies.
**TABLE 2: DISTRESSED DEBT STRATEGIES**

<table>
<thead>
<tr>
<th></th>
<th>DISCOUNT VALUE</th>
<th>ACTIVIST</th>
<th>CONTROL</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cause</strong></td>
<td>■ Cyclical factors, technical market forces, or moderate fundamental pressures</td>
<td>■ Fundamental pressures leading to default or imminent default</td>
<td>■ Fundamental pressures leading to default or imminent default</td>
</tr>
<tr>
<td><strong>Required Action</strong></td>
<td>■ Wait for cycle to turn back up</td>
<td>■ Capital infusion</td>
<td>■ Capital infusion</td>
</tr>
<tr>
<td></td>
<td>■ Capital restructuring</td>
<td>■ Capital restructuring</td>
<td>■ Capital restructuring</td>
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<tr>
<td></td>
<td>■ Operational restructuring</td>
<td>■ Management change</td>
<td>■ Management change</td>
</tr>
<tr>
<td><strong>Returns</strong></td>
<td>■ Coupon</td>
<td>■ Coupon</td>
<td>■ Capital appreciation</td>
</tr>
<tr>
<td></td>
<td>■ Capital appreciation</td>
<td>■ Capital appreciation</td>
<td>■ Equity upside potential</td>
</tr>
<tr>
<td><strong>Investment Horizon</strong></td>
<td>■ Six months to two years</td>
<td>■ 18 months to three years</td>
<td>■ Three-plus years</td>
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**CONCLUSION**

Loans and bonds of over-leveraged companies typically become distressed in cyclical downturns, especially when there is a lack of capital market liquidity. Distressed-debt restructurings can be very technical as they are deeply entrenched in legal processes and extensive creditor negotiations, especially if the restructuring process involves Chapter 11 proceedings. Depending on the investment objective, there are broadly three categories of distressed-debt investment opportunities: discount value, activist and control. As the names imply, the types vary based on asset-manager involvement in enhancing returns. We hope this White Paper helps shed some light on the fundamental concepts of distressed-debt investing.
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