

# A reference guide to corporate credit



## Goldman Sachs Credit Strategies Fund Education Series

As part of our educational series on the Goldman Sachs Credit Strategies Fund, this guide provides a broad overview of the corporate credit markets.



**Asset  
Management**

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## Introduction

Over the past several years, in response to the mortgage crisis and resulting economic turmoil, investors exited the equity and fixed income markets in a “super flight” to the highest quality U.S. government guaranteed Treasury instruments.

By the beginning of 2009, the result was a “frozen” corporate credit market with historically low prices, historically high yields and, in our view, a significant and multi-year investment opportunity.

It is within this dislocated market – and in credit cycles to come – that the Goldman Sachs Credit Strategies Fund, a closed end interval fund\*, can serve as a discerning eye for investors, seeking attractive income and capital appreciation potential through a carefully selected spectrum of corporate credit securities.

The goal of this reference guide is to provide investors with a deeper understanding of the corporate credit markets, and how they work. We examine the types of corporate credit risk available to investors, where each type stands in the corporate capital structure, current valuations and risk premiums, what happens in default and bankruptcy, and the implications of investing in credit at today’s discounted valuations.

\*As a closed end interval fund, the Goldman Sachs Credit Strategies Fund will make quarterly offers to repurchase 5% to 25% of its outstanding shares at NAV to provide liquidity to investors. Quarterly repurchases will occur on the third Friday in the months of March, June, September and December.

For more information, please contact your Financial Advisor.



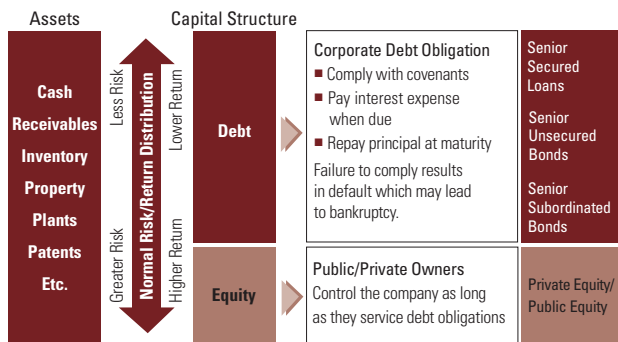
## What is Corporate Credit?

Corporations borrow money in the capital markets to finance a wide variety of activities, from everyday operating expenses to new plants and equipment, or acquisitions of other companies. Investors lend money to corporations by purchasing debt (bonds and loans) backed by the corporation's credit. Debt comes in a number of different forms, depending on the corporation, its reason for borrowing and its capital structure. The relationship between a borrower and its lenders is governed by a contract that establishes the terms of the bond or loan. These terms generally include the borrower's obligations and various restrictions on borrower activities for the protection of the lender ("covenants"). Should a borrower violate key contractual terms, creating "an event of default," the lender will have the eventual right to demand full repayment, which can result in bankruptcy for the borrower.

### The Corporate Capital Structure

The capital structure defines the way a company finances its assets. A typical capital structure consists of equity (public or private) and debt (bonds and loans). Within the corporate capital structure, debt is senior to equity, which means debt investors have a higher claim on the corporation's assets. A corporation's debt can be further structured to provide different levels of seniority to different types of debt, as illustrated in *Exhibit 1*. Normally, risk and return potential are highest at the bottom of the capital structure and lowest at the top of the capital structure.

#### Exhibit 1: The Corporate Capital Structure: How Companies Finance Their Assets



Source: GSAM

The data shown is for informational purposes only, is completely hypothetical and is not indicative of the characteristics/returns of any particular security or offering.



## Types of Corporate Credit

Corporate credit comes in a wide variety of forms, from senior and subordinated bonds to bank loans to hybrid securities that combine elements of debt and equity. In this guide, we focus on three major categories: bank loans, corporate bonds and convertible bonds.

### Bank Loans

Bank loans, sometimes referred to as “leveraged” loans, are typically the most senior part of a company’s capital structure. Unlike most bonds or equity, bank loans are secured by corporate assets. Bank loans also tend to have much more restrictive covenants compared to bonds, which typically provide bank loan investors with more structural protection relative to other creditors. Prior to 2007, bank loans had consistently posted positive annual total returns with low volatility, even through the 2001-2002 credit cycle when credit generally underperformed.

The historically resilient performance of leveraged loans as an asset class as measured by the Credit Suisse Leveraged Loan Index, combined with an easy credit environment, spurred the expansion of the market between 2004 and 2007. During that period, the leveraged loan asset class roughly doubled in size, significantly outpacing the growth rate of high yield bonds, which was less than 5% as measured by the Merrill Lynch High Yield Master II Constrained Index. According to Credit Suisse, as of March 31, 2009, the bank loan market, at about \$1.6 trillion in market value outstanding, is actually larger than the \$900 billion high yield bond market. The growth of bank loans was fueled significantly by demand from structured credit products, hedge funds and financial buyers who generally relied on borrowed money to invest in the asset class. The collapse of leverage since mid-2007 has caused massive selling from this investor base, creating extremely volatile technical conditions for leveraged loans.

Default rates in leveraged loans are likely to be comparable to high yield bond default rates, given the significant overlap (many issuers raised money in both markets), aggressive lending by banks from the 2004 to 2007 period and generally higher leverage employed by

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. Please see additional disclosures.

companies during this period. When corporations default on loans, recovery rates are typically higher, given the loans' senior position in the capital structure, but will probably be below the asset class's historical recovery rate of 70%.

## **Corporate Bonds**

While borrowing through the bank loan market has grown, most corporate borrowing continues to be done through the corporate bond market. Corporate bonds tend to have fewer restrictive covenants compared to bank loans, and generally are not secured by any of the issuer's assets. There are two major categories of corporate bonds:

### **■ Investment Grade Corporate Bonds**

The term "investment grade" refers to bonds issued by companies or institutions with credit ratings of BBB- or higher. The investment grade sector is by far the largest area of the corporate credit market, having doubled in size since 2000 to about \$4.8 trillion as of May 26, 2009, according to Barclays Capital. Historically, investment grade corporate bonds have offered investors modestly higher yields compared to government bonds as compensation for higher default risk. Investment grade defaults tend to be rare because the rating agencies generally reduce the credit rating of companies at risk of default to below investment grade. As a result, investment grade bonds tend to offer lenders the weakest covenants. Financial sector issuers represent a significant proportion of the investment grade market and generally require investment grade ratings, as their businesses are confidence-based and require access to low cost capital.

### **■ High Yield Corporate Bonds**

High yield bonds are rated below investment grade, and typically expose investors to more speculative credit risk while compensating them with higher yields. The ratings agencies assign below investment grade ratings when the risk of default is perceived as relatively high, after considering factors such as business risk, liquidity and balance sheet leverage. Bonds issued by highly-leveraged companies generally offer enhanced covenants compared to investment grade issues: when an investment grade company is

downgraded as a result of deteriorating performance or a leveraging event (such as an acquisition or leveraged buy-out), these so-called “fallen angel” securities can be more vulnerable to event risk due to the lack of covenants. According to Credit Suisse, fallen angels are currently about 25% of the roughly \$933 billion high yield market as of March 31, 2009; this percentage is expected to increase as the economic downturn should cause significant downgrade activity. Defaults in the high yield market reached an annual peak of 10-13% in the last two credit cycles, but are expected to be higher in the current cycle based on a worse economic and financing environment, and higher leverage resulting from the frothy valuation and liquidity conditions that preceded this downturn. Historically, the amount an investor would recover following a default on a high yield bond averaged about 35% of the original face value. In this cycle, the recovery rate is likely to be lower due to the same factors that stress the default rate. Furthermore, in recent years, high yield borrowers financed themselves with a higher proportion of bank debt, which generally have a security interest in some or all of a borrower’s assets.

## **Convertible Bonds**

Investment grade and high yield corporations can also raise money by issuing convertible bonds, which give investors the option to swap into shares of a company’s common stock. This conversion option provides holders with positive exposure to rising stock prices. To the extent that the shares do not perform, holders can potentially manage their downside exposure through the bond’s fixed income value, also referred to as the “bond floor.” Within the corporate capital structure, convertible bonds are considered debt and are therefore senior to equity. The size of the global convertibles market is about \$450 billion, with financial, health care and technology firms as the largest issuers.

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## Credit Derivatives

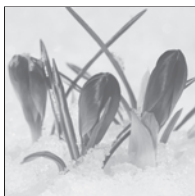
Investors can also access corporate credit through credit derivatives, such as credit default swaps and credit default swap indices, which work as insurance mechanisms against credit risk.

### Credit Default Swaps (CDS)

Credit default swaps are a financial instrument designed to transfer the credit exposure of fixed income securities between parties. Typically, the buyer of credit protection agrees to pay a premium to the seller of credit protection. In return, the buyer gains the right to transfer the credit risk of their fixed income exposure to the seller. In practical terms, a CDS works similarly to an insurance policy. Transactions are settled through the exchange of physical securities or cash. Amounts exchanged vary, depending on whether a credit event occurs during the life of the contract.

### Credit Default Swap Indices (CDX)

The CDX North America Investment Grade Index is a portfolio of equally weighted single-name credit default swaps of 125 North American investment grade corporate entities. There are similar CDX indices for bank loans and high yield corporate bonds. Some of the most common users of CDX indices include asset managers, hedge funds and bank proprietary trading desks. Asset managers commonly use CDX to gain or hedge credit exposure because positions can be taken much more quickly and cheaply than is possible by buying or selling an equally diversified basket of corporate cash bonds.



## Credit Ratings

Independent rating agencies, such as Moody's and Standard & Poor's (S&P), assign credit ratings to most corporate credit securities, indicating the agency's view on the credit quality of the issuer or security. These ratings fall into two broad categories: investment grade and speculative grade (or high yield).

### Exhibit 2: Credit Ratings Reflect the Stability of the Issuer's Cashflows

| <b>Investment Grade</b>  | <b>Moody's</b> | <b>S&amp;P</b> |
|--|----------------|----------------|
| Highest quality, minimal credit risk                                   | Aaa            | AAA            |
| High quality, low credit risk  | Aa             | AA             |
| Upper-medium quality, low credit risk                                  | A              | A              |
| Medium quality, moderate credit risk, some speculative characteristics | Baa            | BBB            |
| <b>Speculative Grade ("High Yield")</b>                                |                |                |
| Substantial credit risk  | Ba             | BB             |
| High credit risk   | B              | B              |
| Very high credit risk  | Caa            | CCC            |
| In or near default, but with some prospect of recovery                 | Ca             | CC             |
| Lowest rating, typically in default, little prospect for recovery      | C              | D              |

Source: Moody's, S&P

Credit ratings primarily reflect the agency's view on the stability of the issuer's cashflows, based on a variety of factors. While the key factors can vary somewhat by industry, the agencies generally focus on factors such as:

- **Business profile:** How diverse are the company's products, customers and regional exposure? What is the company's position in its industry?
- **Size and stability:** What are the company's revenues? How stable is the company's revenue growth?
- **Costs and profitability:** What is the company's profit margin? What is its average return on assets?
- **Financial policies:** What is the company's liquidity? Does it have large amounts of debt relative to its earnings?
- **Financial strength:** How much does the company pay in interest relative to its earnings? How much cashflow is the company generating relative to its debt?

Traditionally, credit ratings have been used as a measure of evaluating corporate credit risk; however, a high credit rating does not guarantee that an issuer will not default. A company's credit rating can change, sometimes rapidly, as the agencies upgrade companies viewed as more stable and downgrade those viewed as less stable. Credit ratings are also an inexact science and disagreements among the agencies about a company's rating are not unusual. A company that has been assigned different ratings by different agencies is said to be "split-rated."



## Valuations and Risk Premiums

When compared to government bonds, corporate credit securities can offer investors a higher yield to compensate for higher risk, lower liquidity and other factors, such as different tax treatment. This yield premium is also known as the “spread” and is simply the difference between the yield on the corporate security and the yield on a government bond of the same maturity. For example, if the yield on a five-year Treasury note is 5% and the yield on a five-year corporate bond is 6%, the spread is 100 basis points (one basis point is 1/100 of one percent).

**What determines risk premiums?** When a corporation raises capital by issuing (selling) a bond to the market, the interest rate (or “coupon”) on that bond is set based on investor demand. If demand is high, the corporation can raise the money it needs by offering a modestly higher interest rate relative to government bonds. But if investor demand is low, the corporation needs to offer an increasingly higher interest rate until it is able to attract enough buyers and raise the necessary amount of capital.

Once a bond is issued, its price and yield fluctuate in the open market. If investors perceive that the company is very stable, they may be willing to pay more than face value for a bond. For example, an investor might be willing to pay \$1,100 for a bond with a face value of a \$1,000. Paying a premium for the bond reduces the bond’s yield because the investor will only get back \$1,000 when the bond matures. As a result, the bond’s spread relative to Treasury yields declines. On the other hand, if investors perceive that the company is less stable, they may only be willing to pay \$900 for a bond with a face value of \$1,000. Paying a discount increases a bond’s yield because the investor will still get back \$1,000 (assuming no default), which ultimately increases the yield on the bond and widens its spread to government bonds.

**The main component of corporate risk premiums is default risk**, or the risk that the corporation declares bankruptcy and defaults on its debt. Because of the seniority of debt in the corporate capital structure, bond investors will often recover part of their investment even in cases of default, and bank loan investors tend to recover a higher percentage because loans are typically secured by assets of the borrower.

**Liquidity risk is another key component of credit risk premiums.** Government bonds are more standardized and more liquid than corporate credit. This means that corporate credit investors bear more risk of not being able to sell in a timely fashion without incurring a significant loss.

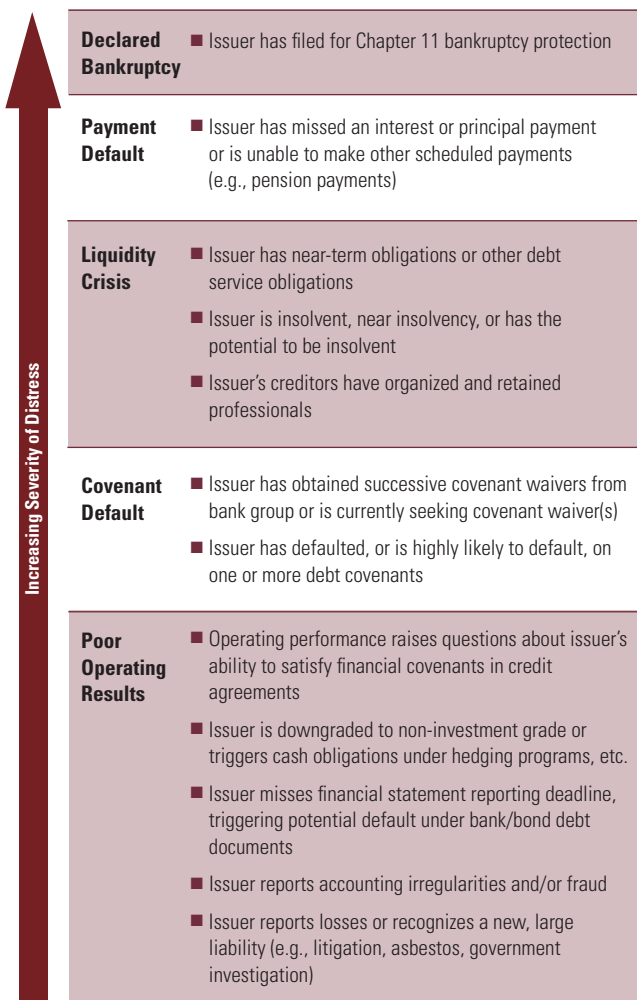
**Technical market factors that affect supply and demand are another element of corporate risk premiums.** For example, in 2008, the reduced availability of financing forced many hedge funds and other leveraged investors to sell corporate credit securities. Forced selling created an imbalance in supply and demand that caused risk premiums to increase even if default risk was unchanged.



## Default and Bankruptcy

A number of signals can indicate whether a corporation is at risk of defaulting on its debt payments or going into bankruptcy, as illustrated in *Exhibit 3*. A default can occur upon a breach of a covenant, even without the corporation missing an interest or principal payment.

### Exhibit 3: Signals and Degrees of Distress



Source: GSAM. For illustrative purposes only.

While default and bankruptcy often go hand-in-hand, default can also occur without leading to bankruptcy. In a typical default situation, bondholders will form a creditor committee to negotiate what happens next with the company. These negotiations will generally lead to either an out-of-court debt restructuring or a bankruptcy filing. Out-of-court restructurings are most likely when the claimants are relatively small in number and well organized, and the company is in financial, but not economic, distress. In other words, if a company is likely to remain a going concern or creditors are concerned that business operations will suffer to a greater extent in bankruptcy, claimants may pursue an out-of-court restructuring because this option tends to be less costly and faster than a formal bankruptcy filing.

In cases where there are many unorganized claimants and the company may require more time to emerge as a going concern, a formal bankruptcy filing is more likely. In the US, corporations have two choices in filing for bankruptcy: Chapter 11 and Chapter 7. In a Chapter 11 filing, the company seeks to remain a going concern after reorganization, whereas a Chapter 7 filing results in liquidation. In most cases, companies that declare Chapter 11 bankruptcy are reorganized and later emerge from bankruptcy as a going concern. Historically, liquidation has been significantly less common than reorganization, but could become more frequent given the current macro environment and restricted access to liquidity.

Corporations pursuing an in-court restructuring option have three options: a pre-packaged bankruptcy, a pre-negotiated bankruptcy, and a traditional Chapter 11 filing.

- **A pre-packaged bankruptcy** – The restructuring plan is negotiated and approved by all creditors prior to filing Chapter 11. This can be a quicker option than a traditional Chapter 11 filing or a pre-negotiated bankruptcy. Pre-packaged restructuring plans are usually approved within 30-45 days of the company declaring Chapter 11.
- **A pre-negotiated plan** – Falls in the middle, as the plan is negotiated, but not voted on, prior to the Chapter 11 filing, and is generally confirmed by the court within 60 to 120 days after the filing.
- **A traditional Chapter 11 filing** – Tends to be a 12-18 month process and can be costly due to fees and the potentially adverse impact on the company's relationship with its customers and vendors.

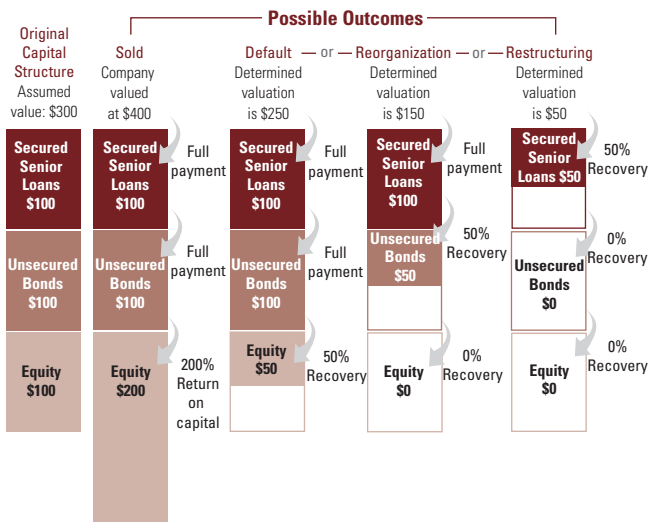


## The Spectrum of Outcomes

When a corporation does default or declare bankruptcy, the recovery and return potential of different asset classes are determined by the corporate capital structure. *Exhibit 4* provides some hypothetical examples of possible outcomes for equities, unsecured corporate bonds and secured senior loans if the company is sold, defaults, reorganizes or restructures.

As the chart illustrates, equity investors have the greatest upside potential, but also the greatest risk. As owners, equity investors benefit in a scenario where the corporation is sold for more than its original enterprise value. However, in scenarios where the corporation is valued at less than its original enterprise value, the owners (equity investors) take the first losses while creditors (including bond and loan investors) are generally only required to take losses after the equity investors have been wiped out.

**Exhibit 4: The Spectrum of Outcomes**



Source: GSAM

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## Distressed Credit: Buying at a Discount

Investing in distressed corporate credit – traditionally defined as a bond or loan trading at a 10 percentage point risk premium over comparable government bonds – provides an opportunistic way for investors to potentially benefit from the senior status of loans and bonds.

When a company is in distress, investors uncomfortable with increased risk will often sell that company's bonds and debt at progressively discounted prices. For investors that are less risk-averse, purchasing corporate bonds at discounted prices can provide two important benefits.

First, buying a corporate bond at a discounted price can increase return potential. This is particularly true for bonds that avoid default. For example, assume an investor pays \$65 for a bond with a face value of \$100 and a coupon of 6%. In this case, the new investor receives a 6% coupon on \$100 (the face value) rather than the purchase price of \$65. If the corporation does not default, the investor will also receive the original \$100 face value when the bond matures, even though the investor paid only \$65, as illustrated by *Exhibit 5*.

### Exhibit 5: Buying at a discount can increase return potential...

| A. Par Purchase                                       | Time of purchase | Year 1     | Year 2     | Year 3     | Year 4     | Year 5       |
|---|------------------|------------|------------|------------|------------|--------------|
| Principal at Purchase Price (\$100)                   | (\$100)          | -          | -          | -          | -          | -            |
| Interest Payments                                     | -                | \$6        | \$6        | \$6        | \$6        | \$6          |
| Return of Principal at Nominal Value                  | -                | -          | -          | -          | -          | \$100        |
| <b>Total</b>  | <b>(\$100)</b>   | <b>\$6</b> | <b>\$6</b> | <b>\$6</b> | <b>\$6</b> | <b>\$106</b> |
| <b>Return (Assuming repayment at Par at maturity)</b> |                  |            |            |            |            | <b>6%</b>    |

| B. Discount Purchase                                  | Time of purchase | Year 1     | Year 2     | Year 3     | Year 4     | Year 5       |
|---|------------------|------------|------------|------------|------------|--------------|
| Principal at Purchase Price (\$65)                    | (\$65)           | -          | -          | -          | -          | -            |
| Interest Payments                                     | -                | \$6        | \$6        | \$6        | \$6        | \$6          |
| Return of Principal at Nominal Value                  | -                | -          | -          | -          | -          | \$100        |
| <b>Total</b>  | <b>(\$65)</b>    | <b>\$6</b> | <b>\$6</b> | <b>\$6</b> | <b>\$6</b> | <b>\$106</b> |
| <b>Return (Assuming repayment at Par at maturity)</b> |                  |            |            |            |            | <b>17%</b>   |

Source: GSAM. For illustrative purposes only.

Second, buying a corporate bond at a discounted price can provide a greater cushion against default. Using the same example as above, if the corporation defaults, the discounted purchase price may still be below the recovery value of the bond due to the seniority of the bond in the corporation's capital structure. *Exhibit 6* illustrates such a scenario, assuming the corporation defaults and the bondholder recovers \$70 rather than \$100 in principal. In fact, the bondholder earns a positive return even if the recovery value is below the purchase price, as income from the coupon payments may make up the difference between the purchase price and the recovery value. Using the example in *Exhibit 6*, if the recovery value in year five is about \$35, the bondholder would still break even as the annual coupon payments offset the recovery value (\$35 recovery value plus five annual coupon payments of \$6). By purchasing the bond at a discounted price, the investor puts less principal at risk.

#### Exhibit 6: ...and provide a greater cushion against default

| A. Par Purchase                        | Time of purchase | Year 1     | Year 2     | Year 3     | Year 4     | Year 5      |
|--|------------------|------------|------------|------------|------------|-------------|
| Principal at Purchase                  |                  |            |            |            |            |             |
| Price (\$100)                          | (\$100)          | -          | -          | -          | -          | -           |
| Interest Payments                      | -                | \$6        | \$6        | \$6        | \$6        | \$6         |
| Recovery at \$70                       | -                | -          | -          | -          | -          | \$70        |
| <b>Total</b>                           | <b>(\$100)</b>   | <b>\$6</b> | <b>\$6</b> | <b>\$6</b> | <b>\$6</b> | <b>\$76</b> |
| <b>Return (Assuming \$70 recovery)</b> |                  |            |            |            |            | <b>0%</b>   |

| B. Discount Purchase                   | Time of purchase | Year 1     | Year 2     | Year 3     | Year 4     | Year 5      |
|--|------------------|------------|------------|------------|------------|-------------|
| Principal at Purchase                  |                  |            |            |            |            |             |
| Price (\$65)                           | (\$65)           | -          | -          | -          | -          | -           |
| Interest Payments                      | -                | \$6        | \$6        | \$6        | \$6        | \$6         |
| Recovery at \$70                       | -                | -          | -          | -          | -          | \$70        |
| <b>Total</b>                           | <b>(\$65)</b>    | <b>\$6</b> | <b>\$6</b> | <b>\$6</b> | <b>\$6</b> | <b>\$76</b> |
| <b>Return (Assuming \$70 recovery)</b> |                  |            |            |            |            | <b>10%</b>  |

Source: GSAM. For illustrative purposes only.



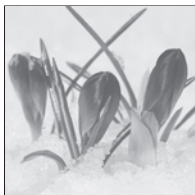
## Conclusion

### **A paradigm shift in fixed income investing.**

The changing market dynamics since mid-2007 have had a significant impact on the fixed income markets. The massive deleveraging of balance sheets has challenged traditional understanding of correlations between various asset classes and have effectively changed the risk/return profile of the credit markets in particular. As a result, the paradigm in fixed income investing has shifted to one that delineates this asset class into two distinct categories: government securities and non-government securities (i.e., credit markets).

As we emerge from the depth of the credit crisis, we see both continuing challenges and opportunities for fixed income investors. We believe that the corporate credit sector offers a compelling case for investors who can withstand short-term volatility. However, given the complexities of today's investment landscape, we believe that a deep understanding of, and execution within, the credit sector is critical to capitalizing on these new opportunities.

This reference guide provides a broad overview of the corporate credit markets and highlights different types of corporate credit risk as well as other important considerations when evaluating credit as a new asset class, including current valuations, risk premiums, default and bankruptcy.



## Learn More

The following GSAM publications can help you further explore the intricacies of Credit, as well as expand your understanding of fixed income investing.

- Credit Strategies Fund Brochure (June 2009)
- White Paper: The Corporate Credit Markets: Themes for 2009 (February 2009)

**For more information, please contact your Financial Advisor.**



## Behind the Industry Jargon

**Amortization:** Debt repayment.

**Mandatory:** A pre-defined schedule of debt repayment on specific dates when the loan/bond is issued.

**Optional:** The company may elect to repay debt through available cash, proceeds from asset sales, etc.

**Bankruptcy:** The status of a firm that has been legally judged either to have debts that exceed assets or to be unable to pay its bills. Formal bankruptcy may result in reorganization and continued operation of the firm or it may require liquidation and distribution of the proceeds. In each instance, a trustee is appointed to supervise the process and prevent loss to the creditors.

**Chapter 7:** The chapter of the Bankruptcy Code providing for liquidation.

**Chapter 11:** The chapter of the Bankruptcy Code providing for reorganization of a company's financial and contractual obligations.

**Covenant:** Terms in a debt agreement written to protect the lender's claim by prohibiting certain acts and requiring others.

**Financial covenants may be maintenance or incurrence covenants:**

- **Maintenance:** The issuer must comply with (maintain) certain covenant levels on a quarterly or annual basis.
- **Incurrence:** The issuer must comply with certain covenant levels only upon the occurrence of certain events, such as subsequent issuance of debt or the acquisition of another company, etc.

**Typical Covenant:**

- **Senior leverage:** senior debt / EBITDA, amount of senior debt as a multiple of annual cash flow generation; Total leverage: total debt / EBITDA, amount of total debt as a multiple of annual cash flow generation; Interest coverage: EBITDA / annual interest expense, amount of cash flow generation as a multiple of annual interest expense; Lien and Debt Limitations; Restricted Payment limitations, limiting payments (cash or other assets) a company is able make to related parties, including its equity holders.

**Debt restructuring:** An exchange of one or more new debt issues for outstanding debt issues. Creditors that have trouble making interest and/or principal payments often restructure their debt to reduce the size of the interest payments and to extend debt maturity.

**Debtor-in-possession (DIP):** A company who has filed a bankruptcy petition, but remains in control and possession of the company's property, e.g., a company that continues to operate its business through Chapter 11 proceedings.

**Default:** Failure to abide by the terms of an agreement, including the breach of covenants or the failure to pay interest or principal when due.

**Technical default:** Failure to abide by covenants (leverage covenant, reporting requirement to stay current on financial reports, etc).

**Payment default:** Failure to pay interest or principal when due.

**Default interest:** The incremental interest rate the debtor incurs while a default is continuing. Default interest is generally not incurred through a bankruptcy.

**Default rate:** The annual rate of technical or payment defaults resulting in a filing for bankruptcy, experienced by an identified portfolio of companies or basket of debt issuances.

**DIP financing:** Debtor-in-possession financing available to a company that has filed Chapter 11 to fund operations while the plan or reorganization is being executed. DIP financing is generally the most secure form of debt, taking priority over pre-petition debt and other claims.

**Distressed credit:** Loan/bond that trades at a significant discount (>50% discount) to par, indicating a strong probability of debt restructuring, default or bankruptcy.

**EBITDA:** Annual operating earnings before interest, taxes, depreciation and amortization. Used as a proxy for annual cash flow generation of the business.

**Equity market capitalization:** For public companies only = (market equity price) x (total shares outstanding).

**Exit financing:** Financing that allows the debtor to emerge from Chapter 11 by typically replacing DIP financing.

**Face value:** The nominal value of a loan/bond. Also can be thought of the principal amount that will be owed at maturity or upon acceleration. The face value is the amount on which interest payments are calculated.

**Financial Leverage:** Debt / EBITDA, amount of debt as a multiple of cash flow generation:

**Notional/face value:** Leverage calculated based on face value of the debt / EBITDA; used to show how much total debt claim there is as a multiple of cash flow generation of the company.

**Market:** Leverage calculated based on market value (price X face value of the debt) / EBITDA; used to show how much debt claim there is based on current market price of the debt as a multiple of cash flow generation of the company.

**Net leverage (debt – cash) / EBITDA:** Used to show if available cash is used to repay debt, how much debt claim there is as a multiple of cash flow generation.

**Liquidation:** A sale of a debtor's property with the proceeds to be used for the benefit of creditors.

**Par:** 100% of face value or 100 cents on the dollar.

**Plan of Reorganization:** A debtor's detailed description of how the debtor proposes to pay creditors' claims over a fixed period of time following the exit from bankruptcy.

**Pre-petition:** Refers to the period of time preceding a Chapter 11 filing. It also typically is used to identify claims that existed prior to the filing date.

**Post-petition:** Refers to the period of time following a Chapter 11 filing. It also typically is used to identify business transactions that accrue on or after the filing date.

**Recovery rate:** The percentage of face value of a claim that is recovered post bankruptcy:

**Trading recovery:** For many investors who are not set up for seeing a company through bankruptcy reorganization, which in some cases may take years, the recovery is often determined through an auction process (buyer vs. seller of defaulted debt) within 30 days of filing for bankruptcy.

**Realized recovery:** In a Chapter 7 liquidation, the asset monetization proceeds that is used to repay debt as a percentage of debt.

*Example: If the company's assets are sold for \$150 and there is \$80 of secured debt and \$140 of unsecured debt, the secured debt gets repaid fully first, so recovery is 100%, and the unsecured debt receives the residual  $(\$150 - \$80) / (\$140)$ , so recovery is 50%*

In a Chapter 11 reorganization, the Plan of Reorganization will determine the valuation of the company and what each class of debt will receive with respect to its pre-petition claim (new secured debt, new unsecured debt or new equity). Ultimate recovery will depend on the performance, post-emergence from bankruptcy, of the new class of debt and/or equity received.

**Secured debt:** Debt obligation backed by a mortgage, pledge of collateral, or other lien; debt for which credit has the right to pursue specific pledged property upon default.

**Stressed credit:** Loan/bond that trades at a discount to par that historically would imply default/bankruptcy, but currently trades at a discount more for technical reasons, such as supply/demand imbalance, cash yield, etc.

**Security:** The priority of a claim on the assets of the company (the higher the better) ranked in the following general order (highest to lowest):

*Senior secured > senior unsecured > senior subordinated*

**Sponsor equity contribution:** For private companies only, the amount of cash a private equity firm or private investor paid in the form of equity in order to acquire control of the company.

**Total enterprise value:** Total debt + total equity – cash. Used to represent the total value of the company. Total enterprise value (market) multiple (i.e., total enterprise value / EBITDA) that indicates the number of years of annual cash flow generation required to generate an amount equal to the total enterprise value.

**Total enterprise value (cost):** Total enterprise value where the equity is based on the amount of sponsor equity contribution.

**Unsecured claim:** A claim or debt which is not backed by a claim on any specific property or assets of the borrower.

**Yield to maturity (YTM)** – calculated based on purchase price, coupon, repayment date and repayment amount.

*Example: If an investor purchased a loan/bond today for 60 cents on the dollar (pay 60% of face value) that matures at par (100% of face value) on December 31, 2010 and the yield-to-maturity is 11.1%, then from today until December 10, 2010, the return on the investment is 11.1% on an annual basis.*

### **Goldman Sachs Credit Strategies Fund Risk Considerations**

The Goldman Sachs Credit Strategies Fund is not a money market fund. Investors in this Fund should understand that the net asset value of the Fund will fluctuate, which may result in a loss of the principal amount invested. Investments in fixed income securities are subject to the risks associated with debt securities including credit, liquidity and interest rate risk. The Fund may make substantial investments in securities rated below investment grade. Non-investment grade securities (commonly known as “junk bonds”) are considered speculative and generally involve greater price volatility and greater credit and interest rate risk than higher rated securities. A number of instruments and strategies used by the Fund may involve non-investment grade securities, including without limitation distressed securities, special situations investments and collateralized loan obligations. The Fund may purchase the securities of issuers that are in default. The Fund may also make substantial investments in derivative instruments. Derivative instruments may involve a high degree of financial risk. These risks include the risk that a small movement in the price of the underlying security or benchmark may result in a disproportionately large movement, unfavorable or favorable, in the price of the derivative instrument (i.e., market risk); risks of default by a counterparty, and the risks that transactions may not be liquid. Similarly, securities and other instruments in which the Fund invests are also subject to market risk.

The Fund may invest in and actively trade, securities, derivatives, and other financial instruments using strategies and investment techniques with significant risk characteristics, including, without limitation, risks arising from the volatility of commodity, equity, fixed income, currency and other financial markets, risks arising from the potential illiquidity of securities, derivative and other instruments, the risk of loss from counterparty defaults and the risks of borrowing, including for purpose of making investments, risks associated with originating or participating in loans and risks associated with making investments outside the U.S. No guarantee or representation is made that the investment program of the Fund

will be successful, that the various trading strategies utilized or investments made by the Fund will have low correlation with each other or with the financial markets in which the Fund invest.

The Fund is “non-diversified” under the Investment Company Act of 1940 and may invest a large percentage of its assets in fewer issuers than “diversified” mutual funds. Because of the smaller number of stocks generally held in the Fund’s portfolio, the Fund may be subject to greater risks than a more diversified fund. A change in the value of any single holding may affect the overall value of the portfolio more than it would affect a diversified fund that holds more investments. As an interval fund, the Fund will make quarterly offers to repurchase at least 5% and up to 25% of its outstanding shares. In the event that the number of shares tendered for repurchase exceeds these amounts, shareholders may be prevented from fully liquidating their positions in a timely manner.

### **Additional Information**

**A prospectus for the Fund containing more complete information may be obtained from your authorized dealer or from Goldman, Sachs & Co. by calling 800-526-7384.**

**Please consider a fund’s objectives, risks, and charges and expenses, and read the prospectus carefully before investing. The prospectus contains this and other information.**

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These examples are for illustrative purposes only and are not actual results. If any assumptions used do not prove to be true, results may vary substantially.

No investment is risk free. Fixed income investing entails credit risk and interest rate risk. When interest rates rise, bond prices generally fall. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. High-yield, lower-rated securities involve greater price volatility and present greater credit risks than higher-rated fixed income securities. Investing in distressed loans and bankrupt companies are speculative and the repayment of default obligations contains significant uncertainties. Corporate debt securities are subject to the risk of the issuer’s inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to factors such as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity. Foreign securities involve additional risks, including risks of currency fluctuations and sudden economic or political developments. These risks are heightened in emerging markets.

Derivatives often involve a high degree of financial risk because a relatively small movement in the price of the underlying security or benchmark may result in a disproportionately large movement in the price of the derivative and are not suitable for all investors. No representation regarding the suitability of these instruments and strategies for a particular investor is made.

The portfolio risk management process includes an effort to monitor and manage risk, but does not imply low risk.

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