LOOMIS | SAYLES

MANAGER INSIGHT

MARCH 31 2022

# Loomis on Loans

## A quarterly look at data and topics in the syndicated loan market

### RATES HAVE BEEN RISING. CAN COMPANIES TAKE THE HEAT?

We are often asked: how will rising rates affect the capital structures of the companies to which we are lending? Are interest rate hikes likely to cause a strain? We have looked at that answer in the past when rates threatened to rise, and the simple answer for most of the credits we follow is: no, rising rates are generally not a problem. In this edition of Loomis on Loans, we lay out how to look at some of the impacts of the rising rate question.

First, we think it is important to note that rates do not rise in a vacuum. In general, rates should be rising when the economy is relatively strong and growing. If that is the case, then company cash flows should be rising with rates, offsetting some or even all of the effect of rates on profitability. In addition, most borrowers in our market hedge rates (at the request of their lenders, if for no other reason), so there should not be a one-to-one relationship between rising rates and greater interest expense on the income statement. Further, companies facing rising rates can modify their spending in various ways if they are expecting interest rates to squeeze their cash flows. But we must also recognize that if rates rise TOO much, recession risk can rise and reduce earnings. We will assume in the examples below that rates rise, there are no offsets, but they do not rise so much that a recession is triggered.

The most important question we think about is whether a capital structure is adequately capitalized. Is the company's balance sheet built to withstand what the world is likely to throw at it, including rising rates? In the pandemic, we saw that most balance sheets could take the pain caused by fluctuating demand. Default rates were very low among the relatively large companies that issue broadly syndicated loans.

### LOAN MARKET QUICK TAKE

| S&P/LSTA INDEX | Q1 2022 RETURN (%) | PRICE | 3-MO PRICE CHANGE | NOMINAL SPREAD (BPS) |
|---|---|---|---|---|
| "All" Leveraged Loan Index | -0.10 | 97.60 | -1.04 | 370.84 |
| BB Index | -0.17 | 98.46 | -0.79 | 289.05 |
| B Index | 0.03 | 98.00 | -1.08 | 399.00 |

*Source: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, as of 3/31/22*

**Past market experience is no guarantee of future results.**

Here is a generic capital structure we would view as adequately capitalized, along with various metrics that prove the point:

## SCENARIO 1: PROPERLY CAPITALIZED COMPANY TODAY

| | | (MILLIONS) | RATE | INTEREST EXPENSE | TERMS | SOFR |
|---|---|---|---|---|---|---|
| 40% | Loans | $2,000 | 4.00% | $80 | S+350 +50 Floor | 0.05% |
| 20% | Bonds | $1,000 | 5.25% | $53 | 5.25% fixed coupon | |
| 40% | Equity | $2,000 | | | | |
| | Enterprise Value | $ 5,000 | | $133 | | |

### SCENARIO FOR CASH FLOW

| | | | |
|---|---|---|---|
| EBITDA | $450 | 6.67 | Leverage |
| CAPX | $100 | | |
| Interest Expense | $133 | 3.38 | Interest Coverage |
| Other | $50 | | |
| Free Cash Flow | $167 | 5.57% | % of debt |

*Source: Loomis Sayles. This is for illustrative purposes only.*

This capital structure looks reasonable: the leverage vs. the enterprise value, the percent of debt in loans, the interest coverage, and the free cash flow (we might like to see a little more of that but that's not an unusual number these days). Note that the interest rate on the loan is S(Secured Overnight Financing Rate (SOFR))+350 +50 basis points of floor. So with SOFR at 5 basis points currently, the company is paying the floor plus 350 basis points of coupon spread. If the Fed raises rates at 25 basis points per meeting, the floor will be exceeded after two meetings, and the rate will float above SOFR until SOFR falls below 50 basis points again.

Now let's look at this company's metrics if rates rise by seven 25 basis points rate hikes, but nothing else changes except what the equity market thinks (in this case, a big overreaction to the downside, maybe fearing a recession).

## SCENARIO 2: PROPERLY CAPITALIZED COMPANY AFTER 7 RATE HIKES

| | | (MILLIONS) | RATE | INTEREST EXPENSE | TERMS | SOFR |
|---|---|---|---|---|---|---|
| 50% | Loans | $2,000 | 5.30% | $106 | S+350 +50 Floor | 1.80% |
| 25% | Bonds | $1,000 | 5.25% | $ 53 | 5.25% fixed coupon | |
| 25% | Equity | $1,000 | | | | |
| | Enterprise Value | $4,000 | | $159 | | |

### SCENARIO FOR CASH FLOW

| | | | |
|---|---|---|---|
| EBITDA | $450 | 6.67 | Leverage |
| CAPX | $100 | | |
| Interest Expense | $159 | 2.84 | Interest Coverage |
| Other | $50 | | |
| Free Cash Flow | $142 | 4.72% | % of debt |

*Source: Loomis Sayles. This is for illustrative purposes only.*

Interest coverage drops from 3.38x to 2.84x, but free cash flow remains ample. This balance sheet is built to withstand rising rates.

Now we will look at an overlevered company's situation:

## SCENARIO 3: OVERLEVERED COMPANY TODAY

| | | (MILLIONS) | RATE | INTEREST EXPENSE | TERMS | SOFR |
|---|---|---|---|---|---|---|
| 57% | Loans | $2,000 | 4.00% | $80 | S+350 +50 Floor | 0.05% |
| 29% | Bonds | $1,000 | 5.25% | $53 | 5.25% fixed coupon | |
| 14% | Equity | $500 | | | | |
| | **Enterprise Value** | **$3,500** | | **$133** | | |

## SCENARIO FOR CASH FLOW

| | | | |
|---|---|---|---|
| EBITDA | $300 | 10.00 | Leverage |
| CAPX | $100 | | |
| Interest Expense | $133 | 2.26 | Interest Coverage |
| Other | $25 | | |
| **Free Cash Flow** | **$43** | **1.42%** | **% of debt** |

*Source: Loomis Sayles. This is for illustrative purposes only.*

We would view this balance sheet has too much debt for the amount of cash the business generates. $43 million of free cash flow on $3 billion of debt is running things much too close to the edge, in our view. At 10x leverage the equity market is crossing its fingers and hoping for upside. 2.26x interest coverage is not a terrible number, but the capital expenditures line for this business uses a lot of cash and this capital structure will find it difficult to delever.

Now we apply the same seven 25 basis points of interest rate increases to the overlevered capital structure.

## SCENARIO 4: OVERLEVERED COMPANY AFTER 7 RATE HIKES

| | | (MILLIONS) | RATE | INTEREST EXPENSE | TERMS | SOFR |
|---|---|---|---|---|---|---|
| 65% | Loans | $2,000 | 5.30% | $106 | S+350 +50 Floor | 1.80% |
| 32% | Bonds | $1,000 | 5.25% | $53 | 5.25% fixed coupon | |
| 3% | Equity | $100 | | | | |
| | **Enterprise Value** | **$3,100** | | **$159** | | |

## SCENARIO FOR CASH FLOW

| | | | |
|---|---|---|---|
| EBITDA | $300 | 10.00 | Leverage |
| CAPX | $100 | | |
| Interest Expense | $159 | 1.89 | Interest Coverage |
| Other | $25 | | |
| **Free Cash Flow** | **$17** | **0.55%** | **% of debt** |

*Source: Loomis Sayles. This is for illustrative purposes only.*

Ouch! This scenario shows a market capitalization that has collapsed to a level that predicts bankruptcy, the interest coverage would imply credit downgrades, and the free cash flow is so low it might be hard to raise emergency borrowing. This was a vulnerable capital structure to start, and rising rates could put it over the edge into default (i.e., they might not be able to pay their bills when due). While this company would almost certainly cut its capital expenditures as much as possible to avoid default, that could reduce their ability to compete for business now and in the future.

In conclusion, adequately capitalized balance sheets with reasonable starting interest coverage should be able to withstand the effects of rising rates with relative ease. Three-to-four times multiples of interest coverage and rates rising on only 40% of a company's value by under 2% might be an annoyance to equity holders, but for debt holders it should not be of great concern. On the other hand, overlevered companies, by which we mean companies not able to generate much free cash flow after debt service costs, might be vulnerable to the five-to-eight rate increases the market is contemplating currently. Loans to those companies might face downgrades and selling pressure from CLOs that own the loans. As always, it is the job of managers to separate good credits from bad credits, with "good" defined as those that are robust in the face of the threats they face and "bad" as those that are vulnerable to what is potentially coming down the line.

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## LET'S CHAT

### QUESTIONS OR CONCERNS ABOUT THE BANK LOAN MARKET?

Email Cheryl Stober to learn more.
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## DISCLOSURE

### KEY RISKS

Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Derivatives Risk, Leverage Risk, Counterparty Risk, Non- US Securities Risk, Prepayment Risk, Extension Risk and Management Risk.

*Investing involves risk including possible loss of principal.*

*Diversification does not ensure a profit or guarantee against a loss.*

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