Loomis on Loans

Bank Loans: A Tale of Many Markets

Whether it's the best of times or the worst of times, the Loomis Sayles bank loan team has long said that leveraged loans deserve a place in investor asset allocations. As we discussed last quarter, the leveraged loan asset class saw stellar returns when compared to most other asset classes in 2022. This was particularly true for higher-rated loans, as the BB portion of the Morningstar/LSTA Leveraged Loan Index saw a positive return for the year of +2.84%, while the B-Rated Index return was -1.23%.

In this edition of Loomis on Loans, we'll delve into the importance of quality differences, and how investors can look beyond ratings to tailor a portfolio to their individual goals and risk tolerances.

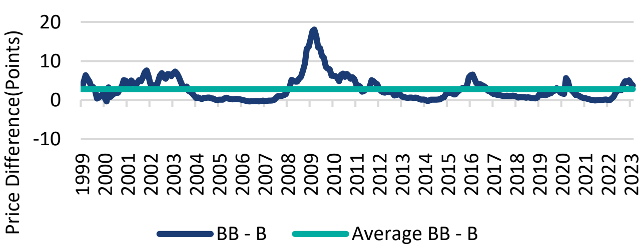
First, we'll take a look at index data, using ratings as a blunt proxy for risk. Using monthly return data from 1999 through February 2023, we can see in the table to the right that the average 12-month return of 4.90% for the Morningstar/LSTA Leveraged Loan Index was largely driven by B-rated loans in the index (5.06% average 12-month return), but that B-rated loans also had been responsible for more of the volatility in returns in the index (4.83% for B-rated loans versus 3.53% for BB-rated loans). The volatility of B-rated loans is even more pronounced when looking at the 3-year period, particularly in risk-off markets such as 2022.

	Morningstar LSTA LL Index	BB Index	B Index	BB/B Index
Avg 1yr Return	4.90%	4.06%	5.06%	4.66%
Avg 3yr Return	4.69%	3.91%	4.85%	4.51%
Avg 1yr Vol	4.14%	3.53%	4.83%	4.14%
Avg 3yr Vol	5.19%	4.32%	6.05%	5.13%
1yr Return/Risk	1.2	1.2	1.0	1.1
3yr Return/Risk	0.9	0.9	0.8	0.9

Source: Morningstar, LCD as of 2/28/23

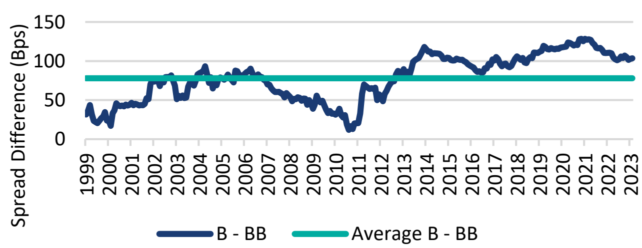
Additionally, the chart on the bottom left shows the historical price gap between BB and B-rated loans, with the average price gap $2.83 higher on average for BB-rated loans, while the chart on the bottom right shows the average spread gap between the two ratings buckets with B-rated loans having an average spread advantage of 78 basis points.

Historical Price Difference BB & B-Rated Loans



Source: Morningstar, LCD as of 2/28/23

Historical Spread Difference BB & B-Rated Loans



Source: Morningstar, LCD as of 2/28/23

LOAN MARKET QUICK TAKE as of March 31, 2023

MORNINGSTAR/LSTA LEVERAGED LOAN INDEX	1Q23 Return	Price	YTD Price Change	Nominal Spread
"All" Leveraged Loan Index	3.23%	$93.40	$0.61	+360
BB Index	2.08%	$97.78	$0.17	+283
B Index	3.81%	$94.21	$1.66	+386

Source : Morningstar, LCD as of 3/31/23

The information presented above is shown for illustrative purposes only. Some or all of the information on this table may be dated, and, therefore, should not be the basis to purchase or sell any securities. The information is not intended to represent any actual portfolio. Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.

Past market experience is no guarantee of future results.

Combining statistics on the fundamentals of over 400 loan-issuing companies we track at Loomis Sayles, we are able to evaluate many attributes behind the ratings. Looking at the snapshot to the right, in addition to the pricing and spread trends we've already identified, we see that first lien and total leverage typically increase as companies get smaller and rating quality declines. Interest coverage, a hot topic as interest rates have escalated over the last year, generally decreases, though it remains robust even at the lower end, while the 'value pad' (the proportion of firm value beneath first-lien loans) declines with rating quality, a trend that has emerged in recent years as we've seen more loan issuance at the lower end of the ratings spectrum. However, a nearly 50% value pad beneath our lower-rated B and Below loans is still an encouraging figure to see, in our view.

SUMMARY STATISTICS OF LOANS COVERED BY LOOMIS SAYLES

Summary Statistics	BB	BB/B	B and Below
Spread	300	363	432
Price	98.55	96.57	93.15
36-month Yield	354	498	782
1st Lien Leverage	2.9x	4.0x	4.8x
Total Leverage	3.8x	4.8x	5.8x
EBITDA	1,087	725	466
Enterprise Value Multiple	9.52	10.37	11.28
Interest Coverage	6.13	4.22	2.81
Value pad	64%	56%	49%

Source: Loomis Sayles as of 2/28/23

But we go beyond basic fundamentals when assessing credit quality, too. For almost all of the loans we cover we assign an overall composite score of each individual issuer based on our view of long-term default risk and current valuations updated on a quarterly basis. The overall composite score is calculated using sub-categories such as 'loan coverage by enterprise value', 'normalized EBITDA margins', and 'earnings direction', as examples, allowing for increased granularity in relative ranking of loans within our portfolios. The below tables show a sample of select factors we consider in this analysis grouped by ratings bucket of the loans we own. For example, for 'loan coverage by enterprise value' category, the BB-rated loans we own collectively generate a score of 3.50 based on a scale of 1-5.

Long-Term Default Risk	Range	BB Score	BB/B Score	B and Below Score
Loan coverage by Enterprise Value	1 - 5	3.50	3.00	2.57
Normalized EBITDA margins	1 - 5	3.25	3.10	3.29
Earnings cyclicality	1 - 5	2.75	3.00	3.29
Industry position	1 - 5	4.00	4.00	4.00
Sponsor Reputation	1 - 3	2.50	2.30	2.14

Valuation	Range	BB Score	BB/B Score	B and Below Score
Liquidity	1 - 5	3.50	3.20	3.00
Fair value model	1 - 5	3.25	3.30	3.29
Earnings direction	1 - 3	2.50	2.30	2.29

Source: Loomis Sayles as of 2/28/23

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Summarizing at a higher level, we can describe portfolios more generally in terms of our views on default risk and valuation. The tables below show our summary of default risk and valuation by ratings bucket, and gives us a way to describe at a high level our views on the makeup of the loans we own from a fundamental and valuation perspective. For example, of the BB-rated loans we own, 80% have a lower risk of default (left table) and 31% are attractive from a valuation standpoint (right table), in our view.

Summary of Portfolio Default Risk by Rating Bucket	BB Score	BB/B Score	B and Below Score
Lower	80%	64%	53%
Average	19%	34%	44%
Higher	1%	1%	3%

Summary of Valuation By Rating Bucket	BB Score	BB/B Score	B and Below Score
Attractive	31%	40%	45%
Fair	68%	60%	55%
Expensive	1%	1%	0%

Source: Loomis Sayles as of 2/28/23

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With access to all of this data, we believe we can help loan investors find their own level of desired risk, and thereby help minimize or maximize exposure to certain characteristics. Some investors might choose to lean into the technicals at the low end of the market with some level of credit discrimination, rather than just trying to be riskier than the risky end of the market. Some might choose to be more ratings/benchmark-focused, but look deeper at the attributes that get them a yield advantage, for example. And some might want to be in very high-quality loans based on metrics that are meaningful to them, regardless of the models the ratings agencies use.

Given varying investor preferences, we believe the loan market should not be lumped into a single market any more than the market for stocks and bonds is. When we see a general reference to "loans," we believe the bigger picture is being missed – that loans can be purchased to meet individual investor's preferences, and loans that don't fit can be avoided.

At Loomis Sayles, we have always been focused on our credit research skills as a differentiator and driver of our performance. We believe investors can choose more of what they want and less of what they fear by looking beyond loan indexes.

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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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Sources: Morningstar, Bloomberg

IMPORTANT DISCLOSURE