Loomis on Loans

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

BUILDING GOOD-DECISION PORTFOLIOS IN AN AGING CREDIT CYCLE

Each year, hundreds of companies approach the loan market seeking financing for their operations. The challenge for loan managers is choosing which loans to incorporate into their portfolios. Most loans have features in common such as seniority in the capital structure, floating interest rates, and typically short average lives. But each loan is unique, and the credit risk associated with each loan requires careful consideration.

MYTH: As the business cycle ages, the leveraged loan market is filled with riskier loans that managers simply cannot avoid, including ones with poor covenants, weak structures, or low recovery prospects.

REALITY: By using a **disciplined credit process**, managers can avoid and/or manage risks associated with owning a portfolio of loans.

LOOMIS' TAKE: We are in the **good decisions business**, which means we painstakingly choose our portfolio of 250 loans (out of a universe of 1,400+ loans) by making thousands of decisions. If we make good credit decisions, good outcomes will follow more times than not.

We use four factors to decide which loans merit a spot in our portfolios: fundamentals, technicals, structure, and macroeconomic risk (see next page for more detail).

We assess these factors across all risk periods and all companies. This discipline helps us stay out of credits that are weak or overly speculative, buy good-but-volatile credits after the volatility has been absorbed, and build portfolios of credits we believe are winners. No loan is irreplaceable in a portfolio; our credit process guides us on when to buy, and when to leave a troubled loan behind.

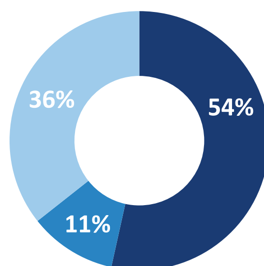
Continued on the next page.

LOAN MARKET QUICK TAKE

S&P/LSTA Index	YTD 2019	1-Year	Price	3-Mo. Price Change	Spread
"All" Leveraged Loan Index	6.79%	3.10%	96.34	-0.5%	L+349
BB Index	7.82%	4.05%	99.35	0.6%	L+265
B Index	6.73%	3.22%	96.94	-0.2%	L+380

Source: S&P Capital IQ, as of 9/30/19.

Investor Share of Institutional Leveraged Loans Outstanding (as of September 30, 2019)



Source : Credit Suisse as of 9/30/19.

The third quarter of 2019 continued what has been a trend since the start of the year: favoring higher quality and more liquid loans. Year-to-date returns are historically strong. Fundamentals appear to be slowing, but are on average still positive, with leverage at 5.2x and interest coverage at 4.0x. Outflows from retail investors have continued but have been offset by new CLO issuance.

BUILDING GOOD-DECISION PORTFOLIOS IN AN AGING CREDIT CYCLE (Continued)

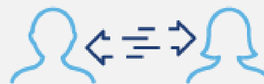
How do we decide which loans merit a spot in our portfolios? Here are the four factors on which we base our decision.

FUNDAMENTALS

(cash flow, value, qualitative factors)

Will the company grow?

Companies are selected for our portfolio if they do not have operating issues that require unreasonable cost slashing or outsized growth to make the credit story work. We scrutinize the level and stability of a company's cash flows, and we establish our view of the company's enterprise value. We assess both the experience of the company's management team, and any concerns associated with a company's sponsor (owner).



TECHNICALS

(trading risks)

How will the loan trade?

We consider the size of a company and the size of the loan. Both impact trading liquidity. We also think about who else might buy the loan (e.g., domestic or foreign institutions, CLOs, retail mutual funds). For example, a low single-B rated loan held mostly by CLOs may face selling pressure after a downgrade.

STRUCTURE

(covenants and organization)

How can the loan change?

Structural/covenant issues with a credit agreement can turn an otherwise-good credit into a riskier credit after lenders have already invested. Large restricted payment capacity, excess collateral leakage, ability to add first lien debt after the deal has closed, and portable capital structures are all examples of legal levers a company's owner can pull to extract value for itself to the detriment of credit quality.

MACROECONMIC

(global and domestic risks)

Which risks impact the loan?

Regulatory issues or headlines may affect the loan. This does not mean we would never buy a loan with headline or regulatory risk. If these issues are isolated technical catalysts, we may avoid volatility by waiting to buy the loan in the secondary market. We also consider the overall risk environment before purchasing a loan. For example, we may choose to reduce our holdings of lower-quality loans if we anticipate a risk-off period. These loans often trade down further when a risk off period actually happens. Finally, we consider credit and industry cyclicality. For example, a late-cycle bet on a cyclical business often leads to excess volatility, because the credit is already at peak performance. A better entry point for this type of credit is after a cyclical dip.

Investing involves risk including possible loss of principal.

Please see Key Risks on the next page.

Past market performance is no guarantee of future results.

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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.

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