BENEFIT STREET PARTNERS Alcentra

FRANKLIN TEMPLETON

# WHY BANK LOANS AND WHY BSP-ALCENTRA?

October 2023

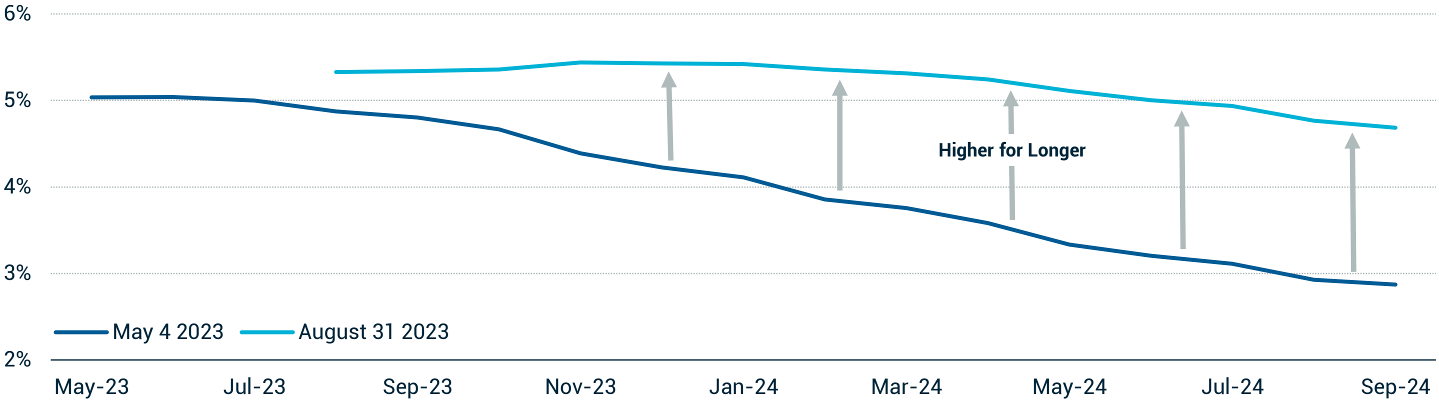
**Compelling Yield Opportunity** — Bank loans offer yields of nearly 10% and **potentially solid total returns**, making them an attractive allocation within fixed income

**Well Positioned for Higher for Longer Market Environment** — Floating rate nature of loans makes this asset class a good hedge against rising rates which are usually detrimental to fixed income returns

**Active Management Matters in the Loan Space** — Current yields compensate for potential uptick in defaults, especially for active managers

## HIGHER FOR LONGER: A CASE FOR BANK LOANS

As inflation pressures gradually ebb and recession risk fades, the prospect of an economic soft landing becomes increasingly attainable, allowing the Federal Reserve to pause its tightening program and hold interest rates higher for longer. In this scenario, bank loans are well positioned to provide high current income and solid total returns. With an average price below $95 and coupons over 9%, bank loans offer yields approaching 10%[1]. Higher coupons can, however, become too much of a good thing if overleveraged issuers can no longer meet their cash needs including operating costs, taxes, and capital investment. Some loan issuers will likely default under the burden of higher interest costs. While valuations appear to compensate for this elevated risk, active management by a seasoned loan investor with deep research capabilities is essential to reap the benefits of high coupons while avoiding credit impairment in an increasingly likely "higher for longer" rate environment.




Source: Bloomberg.

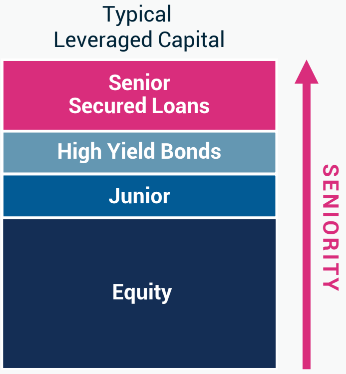
## FROM RECESSION TO SOFT LANDING

In its attempt to rein in inflation, the Federal Reserve hiked rates 11 times over the last year and a half, bringing the Fed Funds rate to a 16-year high of 5.3%[2]. Late this spring, economists widely believed that the Fed's aggressive tightening would choke the US economy into recession before the end of the year. In fact, in early May, Fed Funds Futures were signalling a 100% probability that the Fed would be forced to reverse course as early as July and cut rates 3-4 times before 2024. Over the ensuing summer months, however, the economy, buoyed by strong employment, proved resilient, and today many believe the Fed is on pace to deliver an economic soft landing. Fed Fund futures currently indicate that rates will remain higher for longer, with any Fed action unlikely before next May. Bank loans are well positioned for such an environment.

1 Credit Suisse Leverage Loan Index as of 8/31/23.
2 US effective federal funds rate as of July 26 meeting.

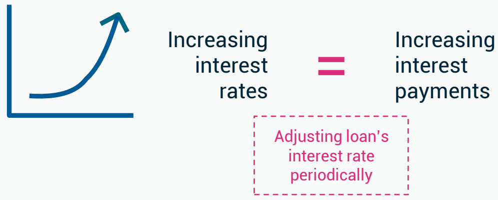
## WHAT ARE BANK LOANS?

### HIGHER RECOVERY RATES



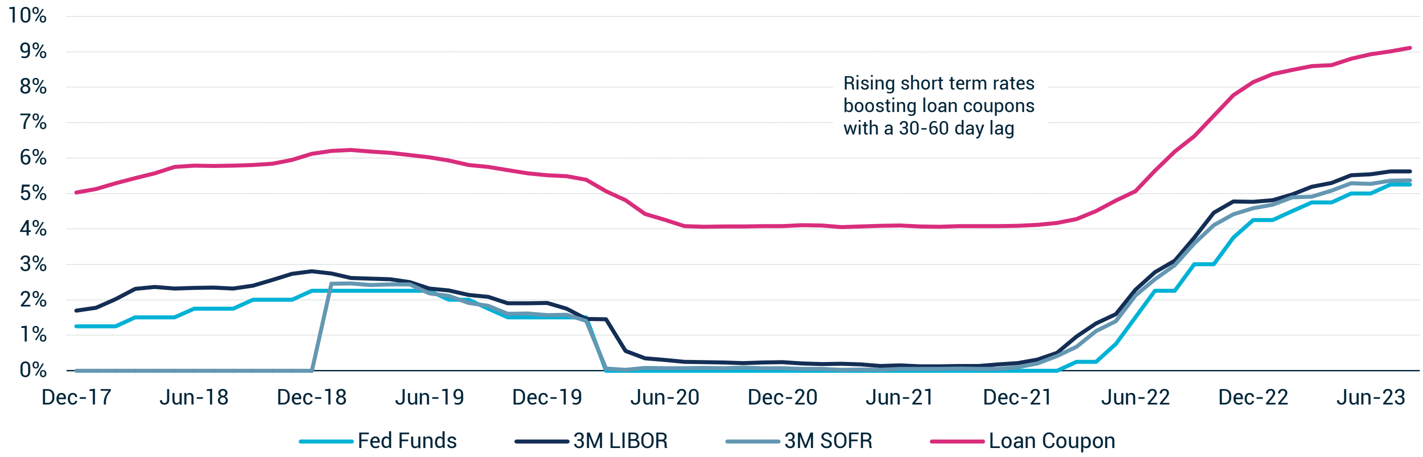

Bank Loans are debt instruments that are secured by the borrower's assets and rank most senior in the capital structure. They have first claim on assets in the event of a default which results in higher recovery rates.

### PROTECTION AGAINST INTEREST RATE VOLATILITY




Secured Loans offer a floating rate of income, with a margin above underlying reference rates like LIBOR or SOFR. They have low duration, giving protection against interest rate volatility.

## HIGHER RATES LIFTED LOAN COUPONS




Sources: Bloomberg, Credit Suisse Leveraged Loan Index.

Since the Fed began raising rates in 2022, the average bank loan coupon more than doubled from 4.1% to 9.1%. Higher coupons directly benefit bank loan investors by providing higher payouts on their investments. With an average price of $94.54, bank loans provide a current yield of 9.6%[3]. This compares to current yields on investment grade corporate, municipal, and high yield bonds of 4.2%, 4.5%, and 6.7%, respectively.[4]

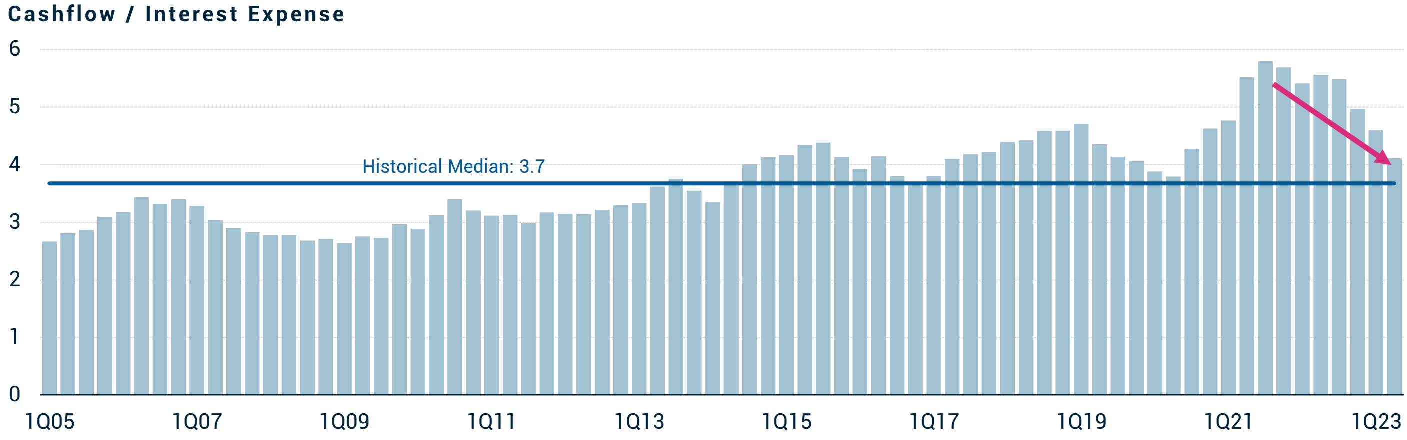
Through August 31, the loan market generated an impressive year-to-date total return of 9.0%[3], outpacing other fixed income asset classes by a wide margin. Coupon income accounted for 6.4%[3] or over two-thirds of that return. With the Fed expected to hold rates at current levels well into 2024, bank loans should continue to provide an attractive income stream.

## A DOUBLE-EDGED SWORD

While high coupons are a boon for lenders, they can be problematic for borrowers, consuming a greater proportion of a company's cashflow and leaving less for operating expenses, taxes, and capital investment. With interest expense relative to overall cashflow increasing, a company has less margin for error.

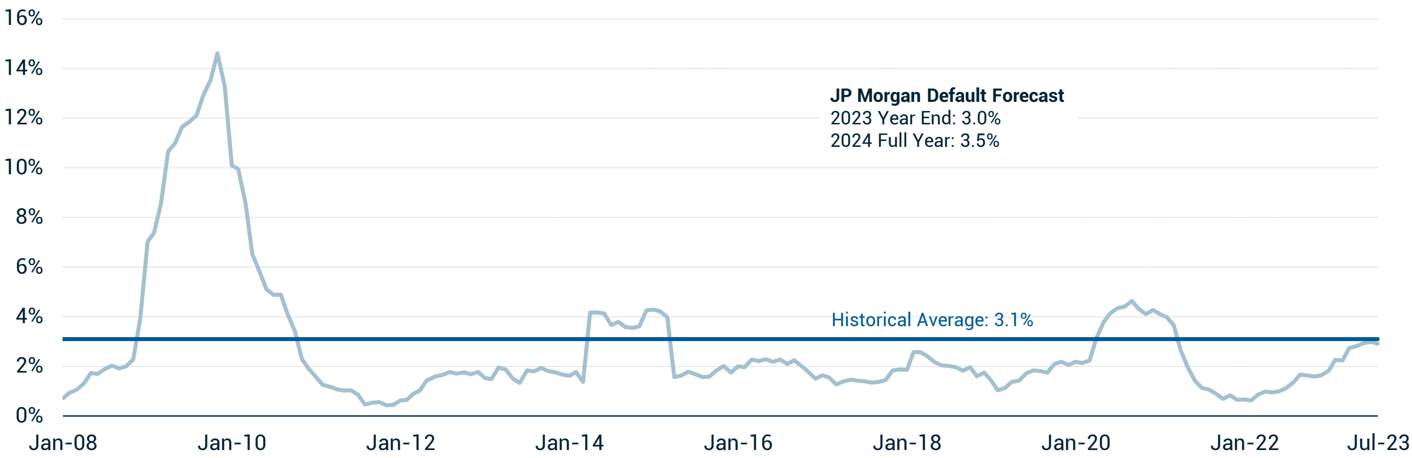
Interest coverage, the ratio of a company's cashflow to its interest expense, deteriorated over the last two years, falling to 4.1x[5]. Fortunately, coverage is declining from record high levels and only now approaching the historical median of 3.7x[5]. Coverage is expected to continue declining as coupons reflect the most recent Fed hike and companies' interest rate hedges roll off.

3 Credit Suisse Leverage Loan Index as of 8/31/23.
4 Current yields as of 8/31/23 for S&P US Investment Grade Corporate Bond Index, ICE US Broad Municipal Index, Credit Suisse High Yield Index.
5 PitchBook/LCD Current Credit Stats as of Q2'23.




Source: PitchBook | LCD

Some highly leveraged loan issuers have already begun to feel the pressure of higher rates. After troughing at near historical lows in 2022, the default rate for loan issuers rose to 2.9% in August, approaching the long-term average of 3.1%. JP Morgan forecasts defaults to tick higher to 3.0% by year end and rise modestly to 3.5% for 2024[6]. An economic soft landing could result in a lower default rate, and active portfolio management could mitigate higher market default risk.




Source: JP Morgan.

## LOAN VALUATIONS ARE ATTRACTIVE

Even as defaults are expected to rise in the coming year, loan valuations appear to be compensating investors for this risk. With an average price over five points below par and a 3-year discount margin (spread over SOFR) of 556 basis points[7], loans are at the cheap end of historical valuations.

Assuming a forward default rate of 3.5% and a below historical average recovery rate of 50%[8], the loan market would experience a default loss of 1.75% over the next twelve months. This default loss represents a relatively small portion of the loan market's 9.6% current yield[7]. Given these default assumptions and assuming short term rates, prices, and spreads all remain constant, we forecast a loan market return of 7.9% over the next year[8]. Of course, there are both downside and upside risks to this return forecast, but it demonstrates that the high level of current income being generated by loans can offset meaningful principal loss from defaults. For example, all else equal, default loss would have to spike to 5.40% to offset coupon returns and reduce the loan market's current yield to 4.27%[9], the yield of the 10-year US Treasury bond at the time of this writing.

6 JPM Default Monitor, August 2023.
7 Credit Suisse Leveraged Loan Index.
8 Views are those of Alcentra - BSP.
9 Bloomberg as of September 5, 2023.


Source: Credit Suisse Leveraged Loan Index.

## CONCLUSION

The Fed appears to be winning its fight against inflation even as the economy demonstrates previously unexpected resilience. The odds of a soft landing have improved over recent months and markets now signal that short-term rates will likely remain higher for longer. Bank loans should perform well against this backdrop. With prices below par and a current yield of 9.6%, loans offer attractive value even in the face of moderately higher defaults. Using JP Morgan's 2024 default rate of 3.5% and a recovery value of 50%, we forecast a loan market return of 7.9% over the next year, all else equal. While valuations are compelling, active management remains critical to avoid defaults and optimize the benefit of higher loan coupons.

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