Specialists in Capital Structure Investing

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The Case for Quality Loans in an Overextending Credit Environment

Loan Managers are Overreaching for Yield Instead of Focusing on Quality

Introduction

The unique characteristics of leveraged loans have earned the alternative asset class an allocation within most modern portfolios. This is well earned; enhancing yield, providing interest rate protection, and diversifying traditional credit portfolios. But as loans become more established (over $1 trillion outstanding, rivaling the size of high yield bonds) and the hunt for yield intensifies, avoidable pitfalls are reappearing.

Current Environment: Weaker Protections from Supply/Demand Imbalance

Loan demand currently outstrips supply. In this environment, larger loan funds face intense requirements to fulfill mandates and maintain/increase the yield of their portfolios. Loan issuers have utilized these dynamics to increase borrowings and loosen credit terms. Due to the supply-demand imbalance, coupons have become lower while the proliferation of loan-only capital structures has increased.

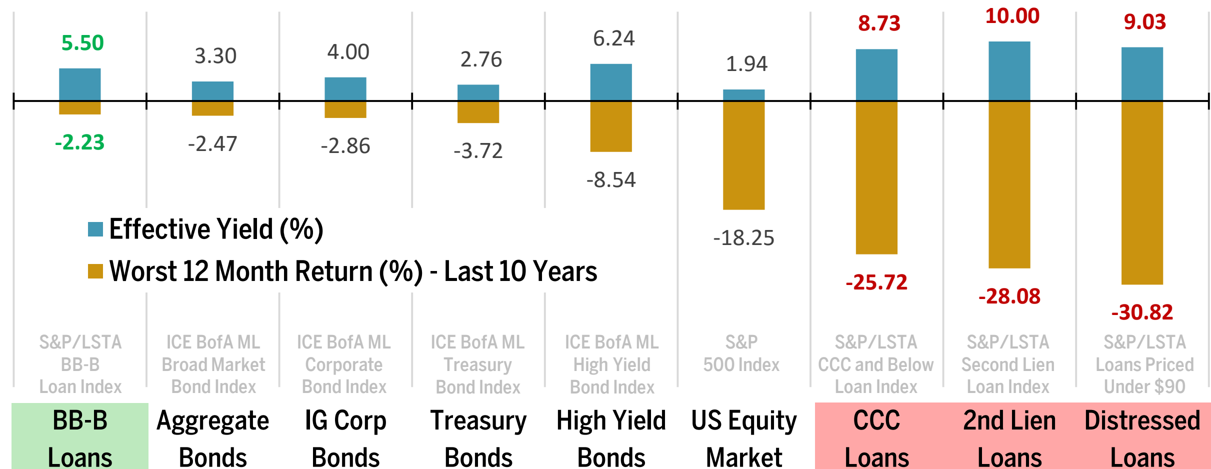
Pressured Purchases: CCC Ratings, 2nd Liens, and Distressed Pricing

Consequently, loan funds have become far less selective, quietly taking larger positions in CCC rated, 2nd lien structured, and/or distressed priced loans (8%, 4%, and 4% of loan market par, respectively) to boost returns. Per Morningstar, loan funds commonly hold 15% to 20% exposure to these factors. These riskier loan characteristics exhibit massive losses in a downturn (see Exhibit 1). Given the increase in secured debt and weaker investor protections (see Exhibit 2), the real danger lies ahead in the form of lower recoveries (see Exhibit 3) when the economy slows and default rates begin to spike (as they always do).

Quality Yield: BB-B Rated Loans

Quality positioning within BB-B rated loans exhibits the rising-rate upside, yield, and collateral protection for which the asset class is known for, without the equity-like volatility for which it is not. As we approach a high point in the credit cycle, optimal risk-return exposure and downside protection should be key considerations.

Exhibit 1: BB-B Rated Loans Exhibit Quality Yield vs CCC, 2nd Lien, and Distressed Loans



As of 8/31/2018, Source: Bloomberg, S&P Global Market Intelligence. Indices are unmanaged and not available for direct investment. Index comparisons have limitations because indexes have volatility and other material characteristics that may differ from a particular investment.

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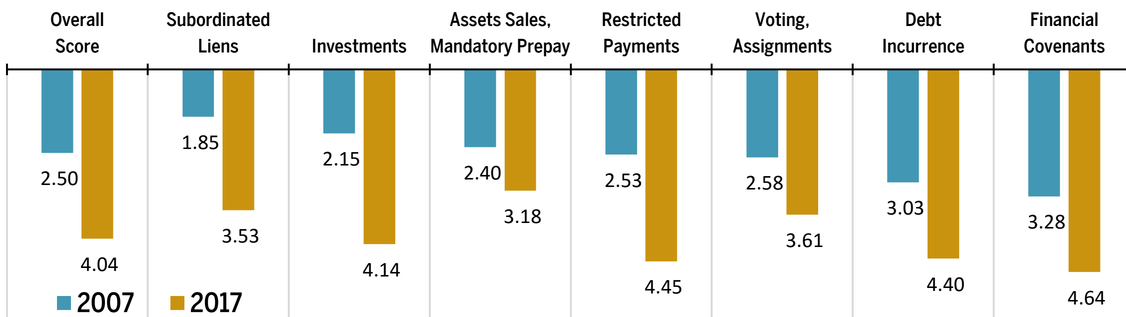
Debt Structures are Deteriorating Amid Demanding Borrowers

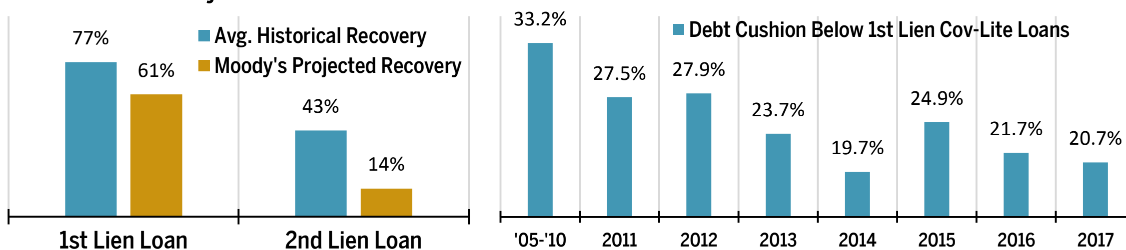
Loan issuers are taking advantage of supply-demand dynamics and pushing for looser terms, creating bad structural precedents within the market (see Exhibits 2 and 3). An example of this behavior includes the proliferation of covenant-lite structures, representing 79% of all loans vs 17% in 2007. Additionally, loan only capital structures now represent 25% of total deals vs the 2005-2010 average of 5%.

Exhibit 2: Moody's Loan Covenant Quality Ratings Have Weakened Across All Categories since 2007



Source: Moody's Investors Service, Scores: Scale from LCQ1 (strongest) to LCQ5 (weakest).

Exhibit 3: Recovery Rates will be Lower in the Next Downturn Amid Reduced Debt Cushions

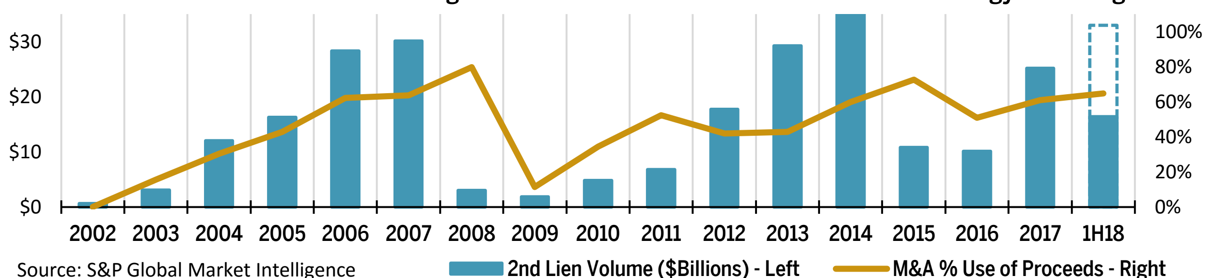


Source: S&P Global Market Intelligence, Moody's Investors Service

2nd Lien Volume, Usage, and Characteristics Exhibit Warning Signs

2nd lien loans currently represent 10% of all loan issuances, 4% by par. Increased volume, leverage, and private equity utilization of 2nd lien loans places fundamentals at pre-crisis levels. 61% of 2018 volume has financed M&A activity (62% in 2007), while 22% financed dividend payments/recapitalization to equity holders (12% in 2007). As a result, 2nd lien deal leverage has reached a record high 5.4x (3.9x in 2007). Borrowers are taking advantage of easy market conditions to fund growth and dividend payments with leverage that could be difficult to repay or refinance in the event of a downturn.

Exhibit 4: 2nd Lien Volume and M&A Usage at 2007 Pre-Financial Crisis and 2014 Pre-Energy Crisis Highs



Source: S&P Global Market Intelligence

As of August 31, 2018. Source: S&P Global Market Intelligence, Moody's Investors Service.
Past performance is no guarantee of future results.

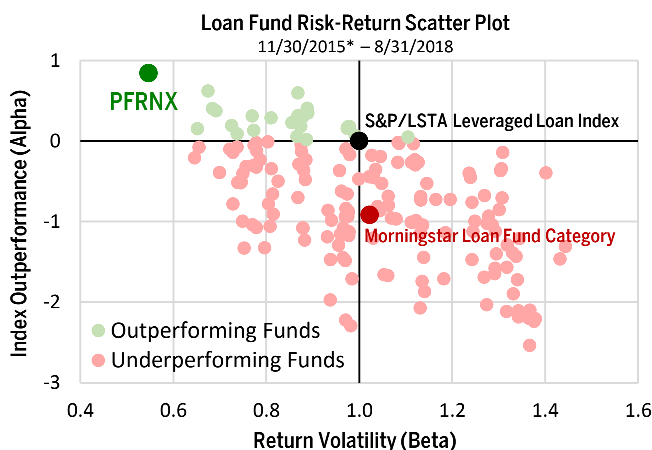
BB-B Loan Fundamentals Remain Favorable, Providing Upside-Downside Balance

Unlike CCC rated, 2nd lien, or distressed loans, BB-B rated loans remain well under 5.0x debt/EBITDA and have historically exhibited return durability. While participating in the current market upside, BB-B rated loans protected capital through the most recent crisis (July 2014 – February 2016 oil price crash), falling only 3.8% and recovering 2 months later. CCC and below rated loans fell 29.9%, needing 12 months to recover. This balance has resulted in BB-B rated loans achieving the highest 5 year Sharpe ratio (1.57) of all asset classes featured in Exhibit 1.

Targeting Quality with Penn Capital's Defensive Floating Rate Income Fund ("PFRNX")

PFRNX utilizes fundamental, bottom-up research to target undervalued and quality names within the BB-B rated universe. Per Morningstar, PFRNX remains the only loan mutual fund with zero exposure to CCC rated, 2nd lien, or distressed loans. PFRNX targets inefficiencies with a disciplined, high conviction approach to amplify the optimal features of BB-B rated loans. The result has been top ranked performance (see Exhibit 5), no defaults since its inception, and a strategy well positioned for potential market downturns.

Exhibit 5: PFRNX Leads Morningstar's Bank Loan Mutual Fund Category with Quality Focus



Strategy Exposure	Penn Capital (PFRNX)	Mstar Loan Category	S&P/LSTA Loan Index
# of Holdings	185	546	1,304
BB or Higher	63.0%	40.8%	40.9%
B Rating	37.0%	48.4%	50.9%
CCC or Below	0.0%	10.9%	8.3%
2nd Lien	0.0%	5.3%	3.5%
Distressed	0.0%	5.1%	3.7%

Source: Morningstar Direct, *PFRNX Inception: 11/30/2015

Managers Overextending for Yield While Ignoring Risks

As seen in Exhibit 5, only 14% of loan funds were able to outperform the S&P/LSTA Loan Index. This is partly attributed to a lack of capacity constraint and reliance on low conviction macro exposure to drive returns. Per Morningstar, bank loan mutual funds currently average 546 loan holdings. At that level of broad exposure, active loan selection doesn't add value. Managers instead seek lower quality, higher yielding names to move the needle. The category averages 11% exposure to loans rated CCC or below, increasing to 16% when including 2nd lien and distressed names. Interestingly, Exhibit 5's non-quality underperformance was over a benign/bullish period, not a downturn in which they would likely fare considerably worse.

Conclusion: the Importance of Style and Capacity Integrity

Approximately 50% of all loan issues are $500mm or less. A larger, non-capacity constrained manager would need to own around 20% of a $500mm issue for a meaningful position. In doing so, the manager sacrifices liquidity, unable to unload that 20% in a downturn event. In practice, large managers simply ignore this half of the market, choosing to hold 500+ of the largest loans to adequately deploy capital. Further return enhancement is then only achieved through the reduction of quality. A fund exercising capacity and style integrity can target smaller issues, maintain higher liquidity, focus on quality, and target inefficiencies as a source of alpha, as opposed to lower quality names.

As of August 31, 2018. Source: S&P Global Market Intelligence, Moody's Investors Service, Morningstar.
Past performance is no guarantee of future results.

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A redemption fee of 2.00% will be imposed on redemptions or exchanges of shares owned for 90 days or less. The total annual operating expenses of the Fund are 1.83% and net expenses are 0.66% for the Institutional share class. The Fund's advisor has contractually agreed to waive its fees and/or pay for operating expenses of the Fund to ensure that total annual fund operating expenses (excluding any acquired fund fees and expenses, taxes, interest, brokerage fees, certain insurance costs, and extraordinary and other non-routine expenses) do not exceed 0.64% for Institutional Class shares. This agreement is in effect until October 30, 2018.

The Fund's advisor is permitted to seek reimbursement from the Fund of fees waived for a period of three years from the date of the waiver or payment to the extent it does not exceed expense limits.

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