Loomis on Loans

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

ESG AND THE EVOLVING LEVERAGED LOAN MARKET

May 2021 brought a new milestone to the leveraged loan market. Leveraged Commentary & Data (LCD), a division of S&P Global Market Intelligence, introduced a new data set, its ESG Leveraged Finance Tracker. This database contains comprehensive statistics on loans across the U.S. and Europe that have an ESG (environmental, social, or governance) component. Since mid-2019, only 13 loans have been issued in the U.S. that met these guidelines. However, six of those were launched in the first half of 2021, so we believe ESG in the loan market is here to stay. In this quarter's edition of Loomis on Loans, we'll be looking at developments across the loan market, and how we've begun adopting ESG at Loomis Sayles and within our strategies on the bank loan team.

WITHIN THE LEVERAGED LOAN MARKET

The loan market is embracing ESG through performance metrics, issuing loans for ESG-related purposes, and encouraging information sharing around these topics. Here are a few ways that's happening.

Sustainability Linked Loan Principles: These loans have economic incentives to encourage the borrower to improve its sustainability according to certain predetermined metrics. If these performance indicators are met, the borrower can benefit from decreased interest payments on their debt. Borrowers can work with outside organizations like the Sustainability Accounting Standards Board (SASB) to determine which metrics are meaningful for their particular organization.

Green Loan Principles: This framework was developed to "facilitate and support environmentally sustainable economic activity," according to the Loan Syndications & Trading Association (LSTA) and its partnering organizations. These loans are distinguished by four core components: use of proceeds for environmental concerns; process for project evaluation and selection; management of proceeds; and reporting. These steps are meant to ensure the integrity of the green loan market as it matures.

Social Loan Principles: Similar to the Green Loan Principles, the Social Loan Principles aim to "facilitate and support economic activity which mitigates social issues and challenges, and/or achieves positive social outcomes." They also adhere to the same four core components, but instead are aligned for social purposes such as affordable housing and food security.

LOAN MARKET QUICK TAKE

S&P/LSTA Index	YTD Return (%)	Price	3-Mo. Price Change	Nominal Spread
"All" Leveraged Loan Index	3.28	98.37	0.82	370.13
BB Index	1.58	99.24	0.10	278.88
B Index	3.15	99.30	0.41	400.10

Source : LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index, as of 06/30/21.

Past market performance is no guarantee of future results.

ESG Diligence Questionnaire for Borrowers: The LSTA has created a standard ESG form that borrowers can include alongside other due diligence materials, such as proposed budgets and rating letters, when syndicating a loan to investors. This document will standardize the information available to investors across companies within the same industry, and includes details on revenue percentages attributed to various business lines.

ESG Diligence Questionnaire for Managers: Just released in June 2021, the LSTA has also released an ESG questionnaire for bank loan managers to describe the ESG efforts they employ in managing their strategies. There is a focus on how ESG is included within the investment process, but also within initiatives at the firm level, such as a commitment to workplace diversity in hiring and beyond.

TRACKING THE TECHNICALS

Technical factors have a material impact on the way loans trade, so we think it's important to understand how changes in these factors may impact our portfolios. Some of the questions we ask are, "Do technical factors in the loan market seem relatively strong or weak?" and "Are any factors changing or trending?" To understand and monitor these factors, we developed a "technicals tracker" to uncover short-term positive or negative signals and long-term trend changes that may impact our portfolios.

Our technicals tracker is comprised of three components: CLOs, Retail, and Other. We score each segment according to influential factors, which we describe below. The three segment scores drive an overall score which is weighted proportionally to each segment's representation in the loan market. The results indicate an individual segment's status of "Decreasing," "Good (no change)," or "Great – increasing," as well as a corresponding overall score.

The overall tracker score is heavily weighted to the CLO segment score, because CLOs comprise a large portion of loan market ownership. Among other factors, new issuance, cost of capital, leveraged loan index pricing, and default rates impact the CLO segment score. The Retail segment score is determined by short-term loan fund flows, yield changes, and loan ETF flows. Finally the "Other" segment score is based on changes in loan trading volume, short-term pre-payment rate changes, and hedging costs for foreign investors.

Fundamental credit decisions are at the heart of our investment process, but we also understand the importance of technical factors on our market. The signals embedded in this tracker do not trigger investment decisions, but rather help guide our trading decisions within our various management strategies. This technicals tracker is one in a series of proprietary tools we use as a system of checks and balances to help ensure that we are making the most thoughtful decisions possible about both individual credits and portfolio construction.

WITHIN LOOMIS SAYLES AND THE BANK LOAN TEAM

Loomis Sayles has been a signatory to the UN PRI since 2015, and is committed to ongoing ESG implementation across all strategies, including understanding our impact on climate change.

Loomis Sayles believes that ESG issues impact our goal of seeking superior long-term risk-adjusted returns. Loomis's Credit Research team analyzes the inherent risks and opportunities of ESG factors as part of our fundamental research and investment processes. Our analysts are focused on developing ESG scores for our bank loan holdings, as well as a path to meaningful engagement with bank loan issuers. As a first step, our analysts are reaching out to issuers to see how they are thinking about ESG within the context of their business. In the second step, our analysts continue to engage with the issuers to understand how they are following through on those initiatives, whether it's installing a solar panel on their headquarters, cutting carbon emissions, increasing paper recycling, or establishing formal sustainability goals. Given the pandemic, our analysts have also discussed issuer actions as they relate to the operations (social) and management of liquidity (governance).

Simultaneously, the bank loan team has worked to integrate ESG data into our investment process. We are focused on ESG factors that can significantly increase loan default risk and/or price volatility, and have added an ESG check for new issues and quarterly reviews done by our team. We also expect our analysts to highlight such risks, and support the use of ESG questionnaires in new loan syndications. While systematic ESG comparisons by external rating agencies are growing, they remain limited for loans given the typical borrower size and level of ESG-factor disclosure, so we treat ESG factors as ad hoc risks.

EXAMPLES OF ESG CONSIDERATIONS IN OUR TEAM'S PORTFOLIO DECISIONS

We have passed on all primary-market loans to coal mining companies over the last few years, due to long-term environmental considerations both fundamental and technical.

We have always passed on payday lenders due to perceptual and regulatory risks.

We hold a negative view on founder-controlled companies as they may lack external moderating influences on governance.

ESG factors have generally influenced our investment decisions, but the market is evolving in ways that are even more conscious of these risks and opportunities. We expect continued progress in this arena.

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Questions or concerns about the bank loan market? Email Cheryl Stober cstober@loomissayles.com to learn more.

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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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