PennantPark

Are Floating-Rates A Good Thing?

April 2024

In this uncertain interest rate environment, what can investors make of floating-rate loans?

- Floating-rate loans are those that are structured with yields set above a specified risk-free reference rate, usually LIBOR or SOFR
- Floating-rate loans can provide a hedge against fixed-income bonds, which are inversely affected by rate fluctuations (as rates rise the value of a bond declines)
- Floating-rate loans provide an inverse relationship between rate movements and interest coverage, as rates go down, interest coverage (loan protection) increases

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In today's environment, everyone is trying to determine what will happen to interest rates. Will the Fed keep rates higher for longer? Will they start decreasing rates over time? What does each decision mean for a portfolio of floating-rate loans?

As a refresher, floating-rate loans have their yields set to a specified amount above a reference rate, usually London Interbank Offered Rate (“LIBOR”) or Secured Overnight Financing Rate (“SOFR”). If interest rates increase or decrease, the loan yields will move in tandem, while providing current income above the risk-free rate. Most floating-rate loans are held to maturity and have minimal interest rate risk. Interest rate risk (also known as duration risk) is when a fixed rated loan or bond value deteriorates with interest rate fluctuations.

Rising interest rates result in higher interest payments for the borrower in a floating-rate loan. In today's rate environment, senior secured core middle market floating-rate loans are generating high double-digit yields[1]. When interest rates decrease, floating-rate loans still offer yields over traditional fixed-income securities, as their yields are set above the risk-free rate. In the core middle market, first lien loans spreads have historically been set to 500+ bps above the SOFR[2].

Traditional fixed-income securities have an inverse relationship to the risk-free rate. As the risk-free rate increases, the value of the fixed-income security decreases, and vice versa. As such, traditional fixed-income securities are exposed to significant interest rate risk. For this reason, floating-rate private credit funds can act as a complement to an investor's fixed-income portfolio, providing a hedge against interest rate risk.

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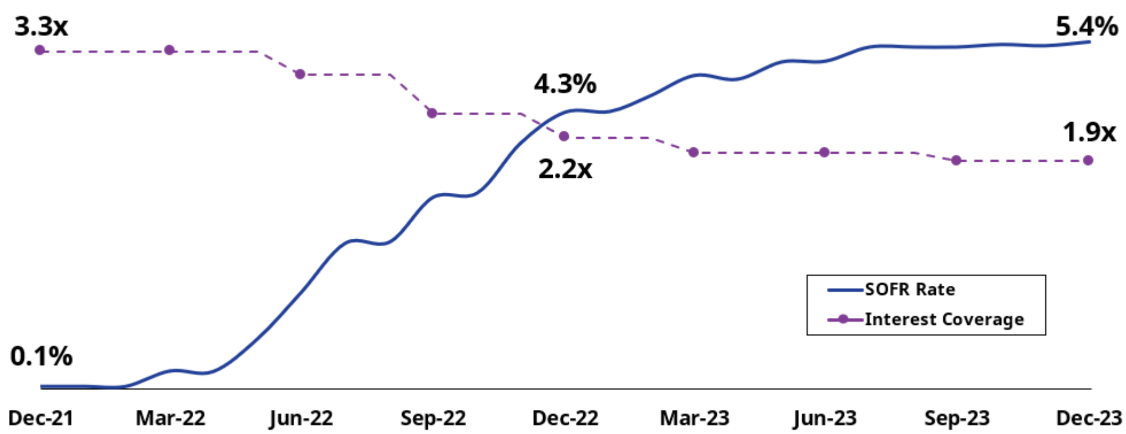
1. *BofA Q4 2023 Chartbook – 2024*
2. *LSEG LPC's Middle Market Connect – 4Q2023*

As demonstrated by the following graph, floating-rate loans also benefit from an inverse relationship between the risk-free rate and the loan's interest coverage ratio. The higher a loan's interest coverage ratio, the greater the likelihood that the borrower can pay the contractual interest rate, and the lower the risk of payment default.

Risk-Free Rate vs. Portfolio Interest Coverage



Note: Sensitivity analysis based on quarter-end SOFR. Past performance is not necessarily indicative of future results. Invested capital is at risk.

At PennantPark, we seek to invest in floating-rate loans in the core middle market. We target loans with lower leverage, higher yields, stronger covenant packages, and greater recovery rates, as compared to the upper middle market / broadly syndicated loan market.

	Core Middle Market	Upper Middle Market
EBITDA	$10 to $50 million	$50 million and greater
New Issue Pricing	First Lien: SOFR + 5.50% to 7.00% Second Lien: SOFR + 8.00% to 10.00%	First Lien: SOFR + 4.00% to 6.00% Second Lien: SOFR + 6.50% to 8.00%
Leverage	First Lien: 4.0x to 5.5x Second Lien: 5.5x to 6.5x	First Lien: 5.0x to 7.5x Second Lien: 6.0x to 9.0x
Covenants	Usually stronger; total net leverage, interest coverage, etc.	Covenant lite or one covenant set at wide levels
Equity Contribution	45% or more	35% or more
Due Diligence Process	In-depth and comprehensive; typically 6 – 8 weeks	More limited information; typically 2 weeks or less
Reporting	Usually monthly	Usually quarterly
Lender Group Size	1 to 4 lenders	5 or more lenders
Equity Co-Investments	Common	Less common

Note: Past performance is not necessarily indicative of future results. Invested capital is at risk. This table depicts our descriptions of middle market trends and characteristics based solely on the Manager's current opinion and observations of internal transactions, which is subject to change in the future without notice. Refer to the Important Notices at the end of this presentation for additional information.

We believe conservative underwriting provides ample downside mitigation. Even in today's high-rate environment, PennantPark investments have a high average interest coverage ratio of 1.9x. We welcome a conversation; please contact invest@pennantpark.com or the professionals listed below.

Contact Us

About PennantPark:

PennantPark is an independent middle market credit platform founded in 2007 by private credit industry veteran Art Penn (most recently Managing Partner at Apollo Credit). As of April 2024, PennantPark has invested $20B in over 700 private credit transactions since its inception. We have $7.2B in AUM today from some of the world's largest and most sophisticated institutional investors. The Firm is headquartered in Miami with additional offices in New York, Chicago, Houston, Los Angeles, and Amsterdam. PennantPark primarily invests in the core middle market, defined as companies with earnings of $10 million to $50 million. Our industries of focus include business services, government services, healthcare, consumer, and software/technology. The firm offers its investment strategies through a range of public and private fund structures.

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