ARC

Q4 2022 Leveraged Finance Market Overview

January 23, 2023

Q4 2022 & FY 2022

STABILIZING MARKET WITH AN IMPROVING SUPPLY/DEMAND OUTLOOK

Global leveraged finance issuance reached 12-year lows in 2022. Initially high expectations resulting from a record breaking 2021 and a strong January gave way to disappointment as geopolitical issues, supply chain delays, labor shortages, a European energy crisis and inflation fears caused unforeseen volatility and a weakening global economy. As the year progressed, credit conditions tightened, secondary pricing fell precipitously, new issuance pricing increased, and volumes declined.

The following trends impacted the leveraged loan market in 2022: (i) rising costs of debt, (ii) decreasing liquidity, (iii) credit downgrades outnumbering upgrades, and (iv) volatility in the loan and bond secondary markets. Rating agencies and industry experts anticipate a shallow economic recession in early 2023, and therefore, heightened credit stress during that time.

Dwindling liquidity emerged as the most pressing concern, especially for B- issuers; while debt maturities pose little to no concern as record issuance levels in 2021 allowed borrowers to push out maturity walls. No asset class generated positive yields for the year, but in line with history, leveraged loans performed relatively well.

SUPPLY: LOAN ISSUANCE REACHES 12-YEAR LOW

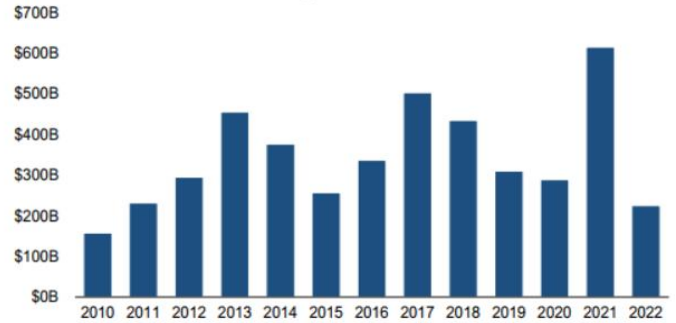
2022 issuance declined to a 12-year low of $436 billion, far behind the all-time high of $800 billion issued in 2021.

Quarterly loan issuance declined for a sixth consecutive quarter in 4Q22 to $59.7 billion, $35.7 billion of which was institutional loan issuance (TLB's etc.), up from $21.2 billion in 3Q22. The remaining pro-rata issuance (TLA combined with RCF) declined by more than half in 4Q22 to $24 billion.

Institutional activity for the quarter was driven by refinancings and buyouts. M&A activity, which typically serves as a major catalyst for loan issuance, declined to $12.8 billion, its lowest quarterly output since 2010 as deal conditions eroded.

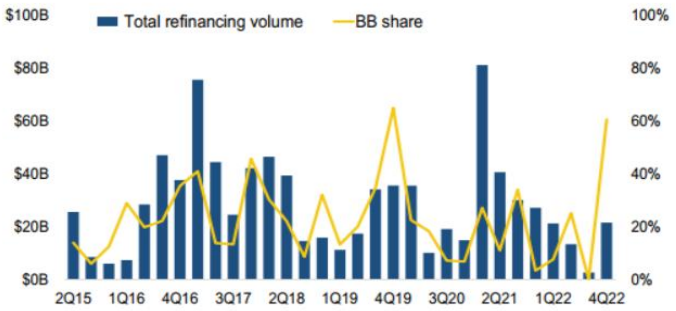
The declines in issuance levels can be attributed to inflated costs of capital and deteriorating credit conditions making borrowing more difficult, expensive and deal terms less favorable for borrowers.

Chart 3: US institutional leveraged loan volume



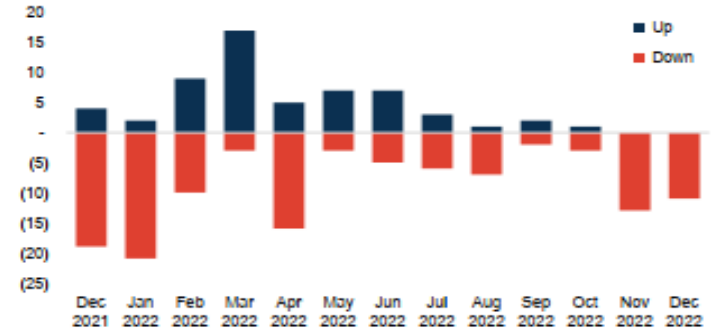
Data through Dec. 31, 2022.
Source: Leveraged Commentary & Data (LCD)

Chart 4: Refinancing-related loan volume & BB rated borrower share



Data through Dec. 31, 2022.
Source: Leveraged Commentary & Data (LCD)

Chart 13: Count of upward to downward flexes



Data through Dec. 31, 2022.
Source: Leveraged Commentary & Data (LCD)

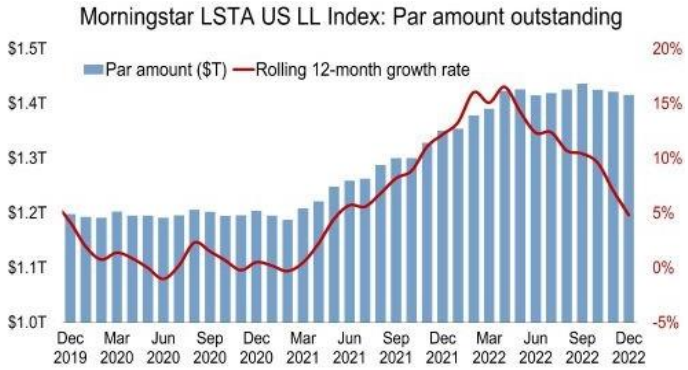
PRICING FLEXES FAVOR ISSUERS

Low secondary trading levels contributed to deals coming to market with large discounts. Cautiousness among underwriters and relative stability in Q4 resulted in an imbalance of flex in favor of issuers.

ISSUANCE & MATURITIES: UNITED STATES

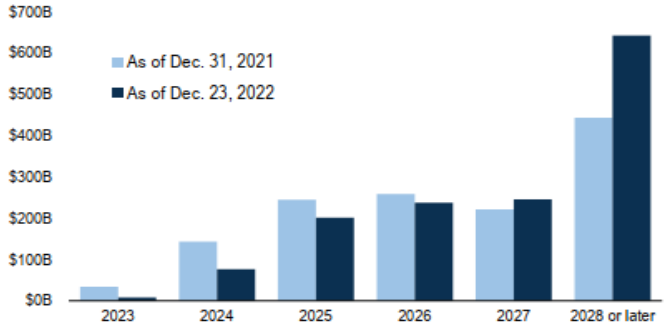
The LSTA US Leveraged Loan Index par amount outstanding declined consecutively each month in 4Q22 as new issuance failed to keep pace with amortization and repayment. For Q4, outstanding loans declined by $20.5 billion. This was the largest quarterly decline since a $26.9 billion in 4Q09. While the 4Q22 decline represented a large dollar amount, it was small when compared to the $1.42 trillion in par outstanding as of year-end 2022 (~1.4%). The current par amount outstanding in the market also remains substantially above 2019 and 2020 levels as most of the growth realized in 2021 remains in place.

Issuers have been actively managing their maturity walls, resulting in a significant reduction of maturities in 2023 and 2024. ARC believes the current maturity wall is likely to insulate many issuers from recent credit spread increases and liquidity challenges.



Data through Dec. 31, 2022.
Sources: Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index

Chart 6: US leveraged loan maturity wall



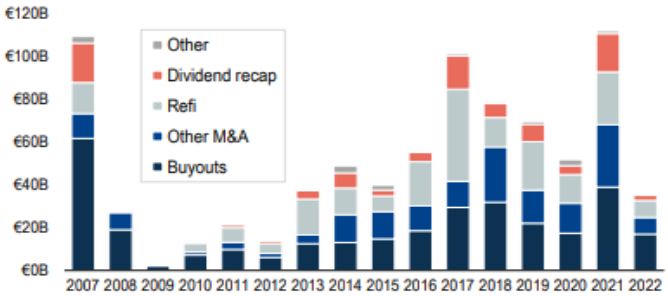
Source: Morningstar LSTA US Leveraged Loan Index; Leveraged Commentary & Data (LCD)

ISSUANCE & MATURITIES: EUROPE

Leveraged loan issuance in Europe totaled €61.6 billion in 2022, the lowest annual issuance since the Eurozone debt crisis in 2012 of €36.5 billion, but not terribly far off from 2019 and 2020 totals. Buyouts and refinancings supported the majority of issuance in 2022. Like in the US, M&A issuance dwindled to its lowest levels since 2013 by 4Q22 and is expected to remain depressed for the time being.

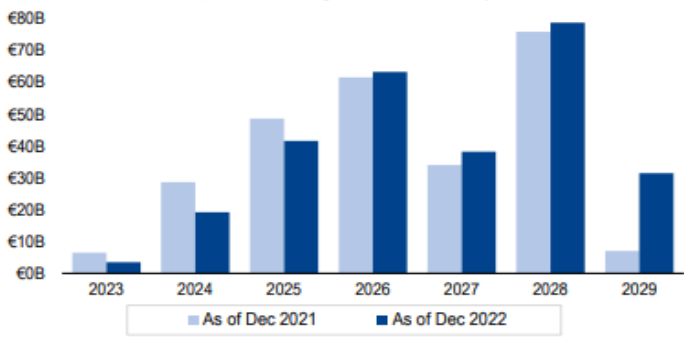
Issuance for 2023 is shifting towards refinancings as sponsors focus on pushing out 2025 maturities. Bankers indicate that Europe has reached a state of stability, and, if maintained, can create a healthy ecosystem for a "refinancing-led recovery" in 2023.

Chart 3: Annual European institutional loan volume by deal type



Data through Dec. 31, 2022.
Source: Leveraged Commentary & Data (LCD)

Chart 10: European leveraged loan maturity wall



Data as of Dec. 31, 2022.
Sources: Leveraged Commentary & Data (LCD); Morningstar European Leveraged Loan Index.

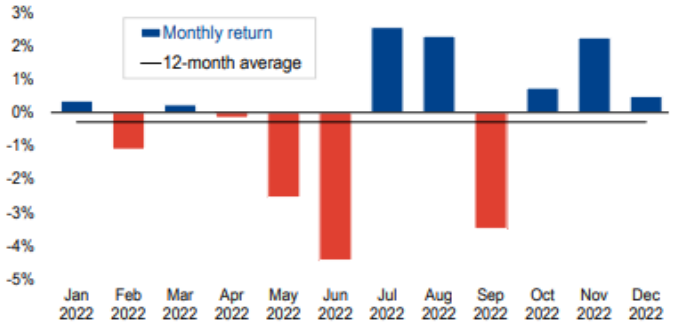
LOAN RETURNS LEAD MARKET

The leveraged loan asset class gained 2.74% in 4Q22 and returned negative 0.6% overall in 2022, far ahead of any other asset class for the year. Although each month in Q4 saw positive returns in the European Leverage Loan Index "ELLI", the index finished down 3.06% for the year. The ELLI reached a 2022 low return of -6.34% for the first nine months of 2022, with the Q4 improvement providing a much-needed uplift.

Returns by asset class	Dec 2022	Nov 2022	4Q	2022
Morningstar LSTA US LL Index	0.44%	1.24%	2.74%	-0.60%
Morningstar US High-Yield Bond	-0.71%	1.96%	4.07%	-11.09%
Morningstar US Corporate Bond	-0.34%	5.14%	3.72%	-15.71%
S&P 10-year Treasury Index	-1.49%	3.72%	0.24%	-16.47%
S&P 500	-5.76%	5.59%	7.56%	-18.11%

Data through Dec. 31, 2022.
Sources: Leveraged Commentary & Data (LCD); Morningstar; S&P Dow Jones Indices

Chart 14: Morningstar European LL Index monthly returns



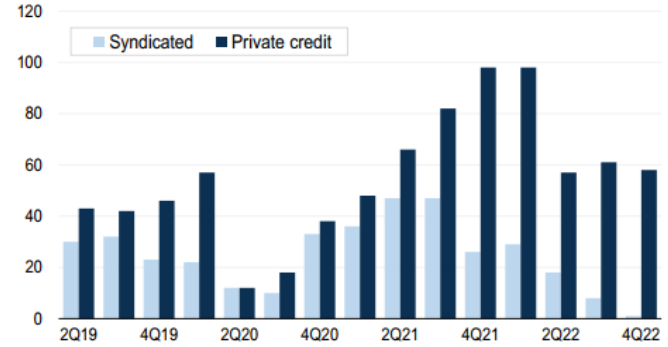
Data through Dec. 31, 2022.
Sources: Leveraged Commentary & Data (LCD); Morningstar European Leveraged Loan Index TR LCL.

PRIVATE CREDIT STEPS IN

Historically, banks were the go-to source of leverage for large LBO's and take-privates. 2021 represented a 14-year high of $146 billion in US loan volume backing LBO deals. For 2Q22 syndicated loan market volume dropped 82% year-over-year ("YoY") as underwriters generally declined to take underwriting risk in an illiquid market. To fill the void: nonbank direct lenders, who have amassed $155 billion in capital over the past two years, stepped in to become the new go-to debt financing source for LBO's.

This trend of private debt funding is expected to continue in early 2023 with banks re-entering later in the year after a period of offloading earlier unsold loans (~$42 billion) as liquidity returns to the market.

Chart 51: Count of LBOs financed in BSL vs private credit markets



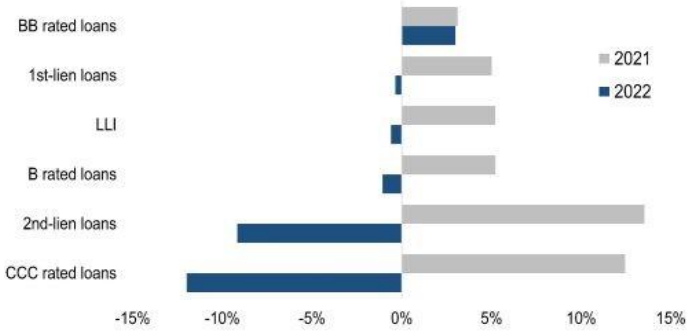
Data through Dec. 31, 2022.
Private credit count is based on transactions covered by LCD News
Sources: Leveraged Commentary & Data (LCD)

CONCERNS RISE OVER B-RATED ISSUES

Demand for single-B rated issues spiked 2021 as investors travelled down the credit spectrum in search for yield. The asset class makes up 63% of the leveraged loan index, the highest ever. While double-B loans (~25% of the index) were up 2.99% in 2022, single-B rated loans underperformed, down negative 1.07%. Demand for single-B rated loans fell off as the credit conditions tightened. Lenders are homing in on credit quality by imposing stricter lending standards as ratings downgrades continue to outnumber upgrades, reaching 2.8x by year end.

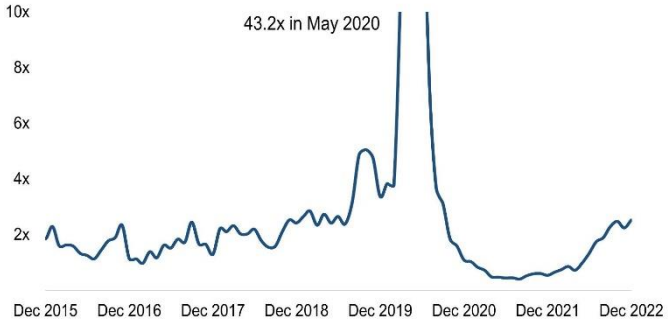
B-minus rated loans account for a record 25.3% of the index. Concerns raise over how many B-minus loans will cross over into the CCC+ threshold. The percentage of loans rated CCC grew from 5.5% to 6.6% in 2022; still behind the pandemic's peak of 10.9% in May 2020, but worth keeping an eye on especially when it comes to CLO portfolio fundamentals, whose underlying por

2022 vs 2021 loan returns



Data through Dec. 31, 2022.
Sources: Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index

US leveraged loans: Ratio of downgrades to upgrades



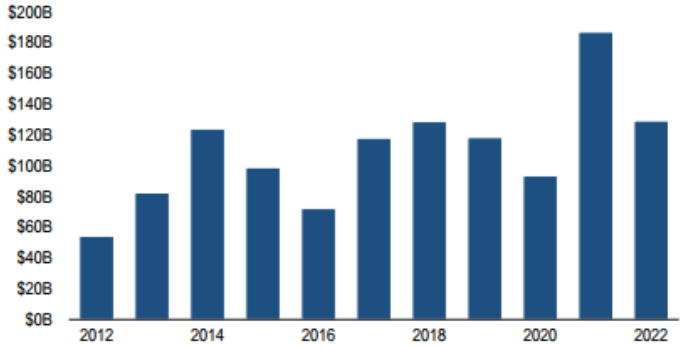
Data is rolling 3 months; data through Dec. 15, 2022.
Sources: Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index

CLO ISSUANCE REMAINS STRONG

CLO issuance fell further in the last three months of the year to $22.6 billion from $33.1 billion in 3Q22. Deals closed in the latter half of 2022 were subject to difficult market conditions; static deals became more prominent and those with reinvestment periods were shorter (3-4 years vs. 4-5 years normally). Despite slowing issuance, total CLO volume for 2022 reached $129.3 billion, down from a record $187 billion in 2021.

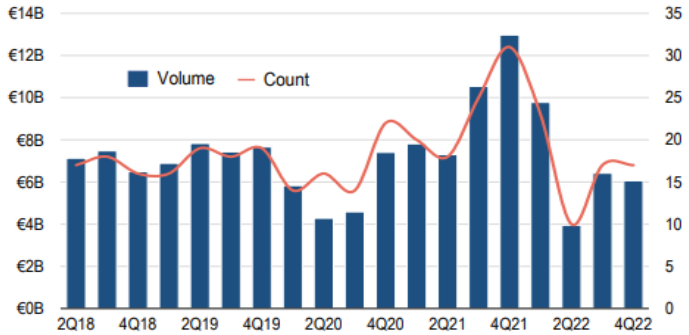
European CLO issuance dropped only slightly to €6.1 billion. Modifications including shorter structures, higher levels of credit enhancement, triple-A loan tranches, and unfunded single-B tranches helped get deals across the finish line. Just about all deals structured since March have been done so in the expectation of a refinancing within 18-months.

Chart 16: US CLO issuance – annual



Data through Dec. 31, 2022.
Source: Leveraged Commentary & Data (LCD)

Chart 25: European quarterly CLO new-issue volume and count



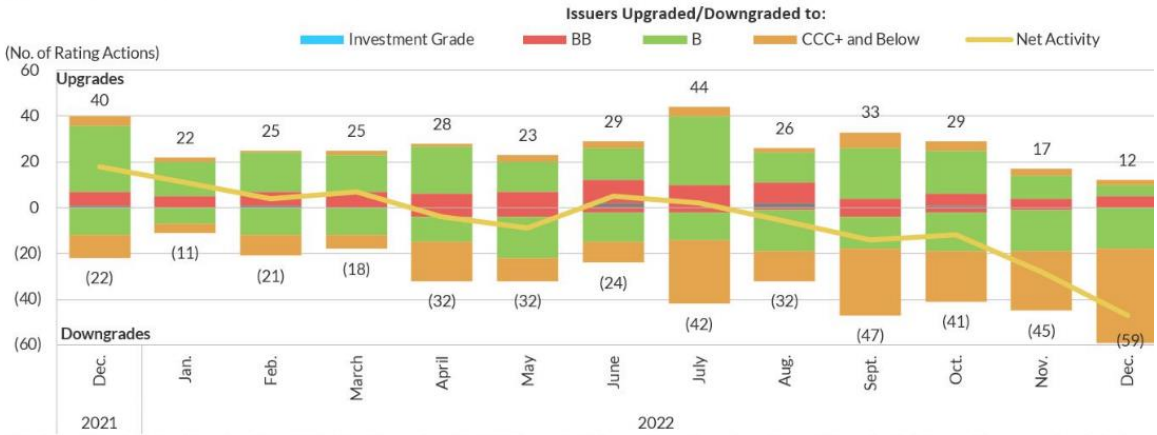
Data through Dec. 31, 2022.
Source: Leveraged Commentary & Data (LCD)

CLO COLLATERAL MATTERS

Historically, institutional investors have been attracted to the floating rate aspect of CLOs and their resilience in economic downturns. CLO portfolios make up the bulk of the demand for leveraged loans. Unsurprisingly, CLO portfolios snatched up the wave of single-B rated debt issues in 2021. The current concentration of single-B rated debt in CLO portfolios is estimated to be ~30%.

CLO portfolios are subject to a variety of concentration tests to maintain credit quality. The rating agencies focus on maximum concentration of triple-C rated loans, overcollateralization & interest coverage ratios and the Fitch minimum weighted average ratings factor. Bank of America estimates downgrades could push average CCC holdings in CLO portfolios into the 8-10% range which is beyond the typical 7.5% limit.

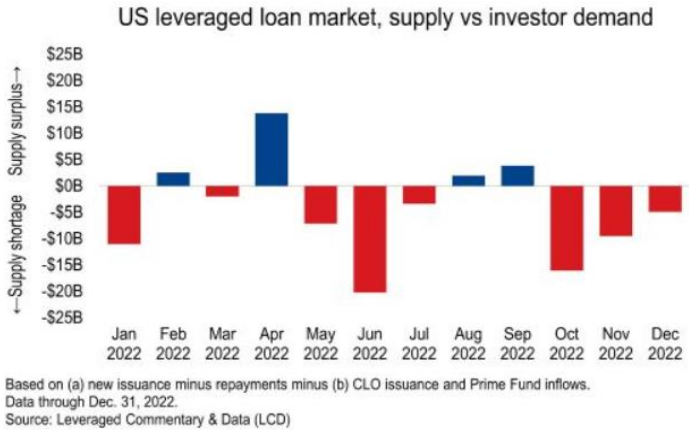
TTM Rating Activity in Fitch-Rated CLO Portfolios
(by IDR Equivalency Rating Post-Action)



IDR – Issuer Default Rating. Note: As of Dec. 2022. Out of approximately 1,500 issuers in Fitch-rated broadly syndicated loan CLOs under Fitch's surveillance at each point in time. See CLO and Corporate Rating Criteria for IDR Equivalency methodology. Non-rated credits, rating changes due to expirations or withdrawals excluded.
Source: Fitch Ratings.

DEMAND FOR LOANS NOW EXCEEDS SUPPLY

Declining new issuance, coupled with still strong CLO creation, has resulted in a supply/demand imbalance, with demand for loans now exceeding supply. Notwithstanding this imbalance, secondary loan spreads remained at historically low levels during much of the year due to uncertainty. Record high CLO issuance costs in an uncertain market have pushed CLOs to demand wider pricing.



CLO'S IN 2023

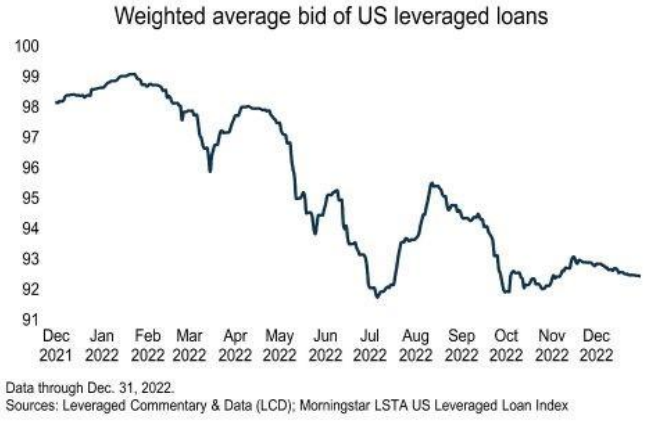
Banks' US CLO issuance forecasts for 2023 are lower YoY. Consensus points to a difficult 1Q23 with demand picking up in 2Q23 as inflation retreats. Key concerns going into 2023 include increasing recession risk and weakening loan fundamentals. Credit Suisse, Deutsche Bank, Bank of America and Morgan Stanley project slightly lower than average full-year issuance volume ~$80-100 billion, while J.P. Morgan and Barclays project more normal volume of ~$115-125 billion. Much of the activity is expected to be via refinancings; by the end of 2023, 90% of current CLO's will move beyond their non-call dates, creating the potential for $63 billion in refinancings and resets. Increased CLO default activity is also anticipated in 2023.

AAA SPREADS CONTINUE TO RISE

Average AAA spreads increased further to 226.5 bps over SOFR as a function of maintaining demand. Capital requirements may be raised for major financial institutions resulting in many investors pulling away from the asset class despite sound credit quality and historically low default rates. Some analysts speculate rates to continue to rise as others believe they've reached their peak. Bank of America shares "AAA's had one of the highest total returns this year for floating-rate asset classes that would mitigate price volatility incurred in other fixed-rate assets."

SECONDARY STABILIZATION

The secondary market experienced fewer volatile movements in the last quarter of 2022. Prices oscillated in the low-to-mid 90's in the second half of the year, finishing at 92.44, five points below year open at 98.64 and slightly ahead of Q3 close of 91.92. The low point of this year of 91.75 was reached in July. Europe experienced similar pricing trends through the year, closing the year on a more stable mark which may set the stage for increased primary supply.



NEW ISSUE SPREADS NARROW BUT YIELDS CLIMB

Spreads in 4Q22 continued to narrow, with a slight uptick in December 2022. The average new issue spread for B/B+ rated borrowers dropped from its 510 bps peak in July to 457 bps by year end. However, many of the loans issued in Q4 were actually underwritten several months earlier, making trend conclusions difficult. The main indicator of pricing trends is in the yield of new loans because underwriters use original issue discount to supplement pricing. In order to compete with secondary yields, underwriters were forced to offer large original issue discounts,

Chart 23: New-issue spread and YTM of B/B+ loan borrowers

Data through Dec. 31, 2022.
Source: Leveraged Commentary & Data (LCD)

DEFAULT RATE ON THE RISE

The US leveraged loan default rate decreased slightly to 0.72% in 4Q22 from 0.85% in 3Q22. The record low of 0.26% occurred in April of 2022. Rating downgrades outpacing upgrades. Based on an LCD survey, the default rate is anticipated to increase to 2.0%-2.5% by the end of 2023. Rating agencies and some underwriters, however, have a more pessimistic view. Moody's default rates reaching 5% by the end of 2023, Barclays is forecasting 5-6%, and Morgan Stanly expects 2.5-3%. S&P calculated that $56 billion of defaults would need to occur to reach the 2020 high of 4.17%, whereas $145 billion of defaults would be required to reach the all-time high of 10.81% in 2009. Some practitioners note many defaults may have been flushed out by the default spike at the peak of the pandemic. ARC gives credence to this view, and expects defaults to peak at around 3% by year-end.

Chart 24: What do you think the US loan default rate will be 12 months (12/31/2023) from now?

Data as of Dec. 9, 2022.
Chart shows historical and projected default rates by dollar amount. EFH = Energy Futures Holdings.
Sources: Leveraged Commentary & Data (LCD); Morningstar LSTA US Leveraged Loan Index

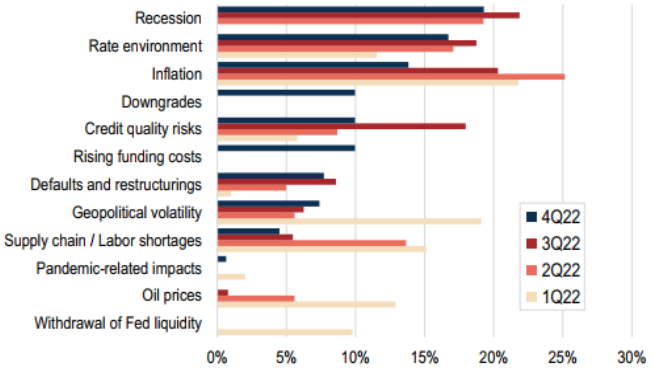
2023 OUTLOOK

LCD's most recent survey indicates that 70% of loan market practitioners anticipate worsening market conditions. Recession, the interest rate environment, and inflation lead the list of concerns for credit portfolios, while downgrades and credit quality risks tie for fourth. Issuers that took advantage of credit markets in 2021 and 2022 pushed out debt maturities at favorable rates and are likely to maintain debt service payments, in other cases, increased interest costs for leveraged borrowers may become an issue and contribute to downgrades and defaults.

Overall, the leveraged loan market is expecting a slow start to 2023 as headwinds and uncertainty linger. Recession is deemed almost inevitable by 2Q23.

ARC expects direct lenders will continue to take share from large banks as the originate-to-hold business model of direct lenders remains viable in a market where banks' originate-to-distribute approach entails excessive placement risk. Banks and private equity alike are in no rush to push forward with M&A transactions until seller valuations deflate to meet the economic backdrop.

Chart 29: Which of the following will most likely impact the performance of credit portfolios in the next six months?



Data as of Dec. 9, 2022.
Source: Leveraged Commentary & Data (LCD)

Amend-and-extend ("A&E") activity, which was popular in the wake of the 2008-9 recession, is expected to increase. A&E is preferred when the market is short on cash. Currently, liquidity is tight, but companies are still performing and able to service their debt. A&E is not factored into S&P volume totals.

In Europe concerns are focused on borrowers' ability to service debt. Refinancing and dealing with maturities will be the main issuance driver and the default rate is expected to rise to 2.75% by the end of 2023.

Consistent with participants' expectations and rating agency's revised forecasts, ARC believes default rates will rise. However, ARC expects default rates to remain at a moderate 2.5-3.0% level as lack of near-term maturities and extensive use of covenant-light loans significantly mitigant recessionary impacts. ARC also expects supply chain issues to be largely resolved during the first half of 2023, which will ease pressure on some sectors. While ARC believes interest rates will remain elevated though 2023, it anticipates only modest increases, leading to a loan market rebound by the end of H1 as Fed rate increases decelerate.

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