Q1 2023 Leveraged Loan Market Overview

The Market Recovery Continues

May 4, 2023

Q1 2023

THE MARKET RECOVERY CONTINUES

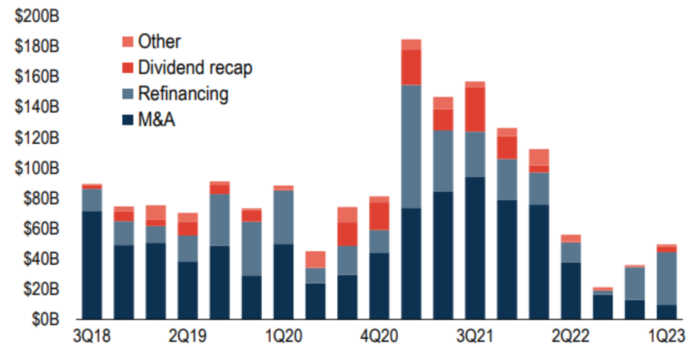
The leveraged loan market, as measured by secondary trading levels, showed an upswing in the fourth quarter of 2022. This trend continued through January, but temporarily reversed in March with the collapse of SVB and Signature Bank. By the end of the quarter, however, secondary prices had fully recovered but remain well discounted to par.

While we have not seen a return to a normal underwriting environment, leveraged loan and CLO issuance levels increased quarter over quarter from 4Q22, spreads narrowed, and increasing amend-and-extend ("A&E") activity allowed many borrowers to address their nearing maturity walls.

SUPPLY: LOAN ISSUANCE EVOLVES

US institutional loan issuance volume in 1Q23 reached $49.5 billion, an improvement from the $35.8 billion issued in 4Q22 but the slowest start of a year in seven years. Issuance volume peaked in February as the market accelerated before temporarily halting with the emergence of the regional banking crisis. 1Q23 nevertheless ended a six-period streak of declining loan issuance.

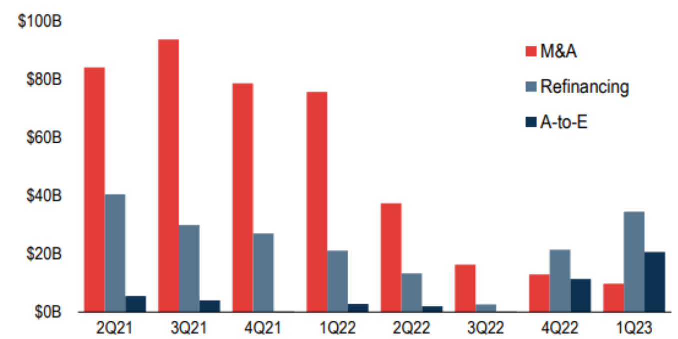
Chart 4: US institutional loan volume



Data through March 31, 2023
Source: PitchBook | LCD

Institutional activity for the quarter was dominated by refinancing and A&E activity (A&E is not included in total issuance levels) as borrowers addressed loans maturing in 2024 and 2025. A&E activity for the quarter reached $20.7 billion, the highest output since 1Q12. Refinancings accounted for 70% of total institutional loan issuance. M&A followed far behind representing 20% of issuance, declining to $9.8 billion, its lowest quarterly output since 2010. For reference, M&A made up 69% of loan issuance volume in 1Q22 when market conditions were vastly better. With costs of debt remaining high, M&A issuance was expected to remain low.

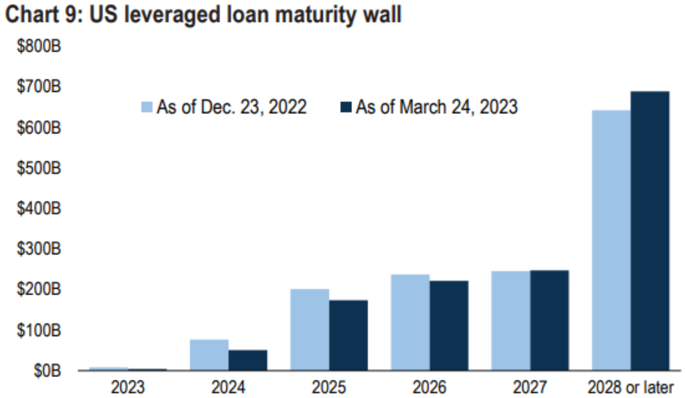
Chart 8: US institutional loan volume



Data through March 31, 2023
Source: PitchBook | LCD

Double-B and single-B rated issuers alike made up the majority of refinancings in 4Q22 and 1Q23. The combination of refinancing and A&E activity reduced the 2024 and 2025 US loan maturity wall by $25.7 billion and $27.7, respectively.

Chart 9: US leveraged loan maturity wall

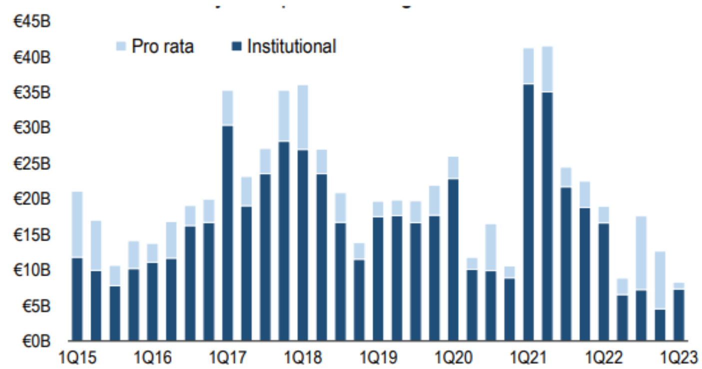


Source: Morningstar LSTA US Leveraged Loan Index; PitchBook | LCD

ISSUANCE: EUROPE

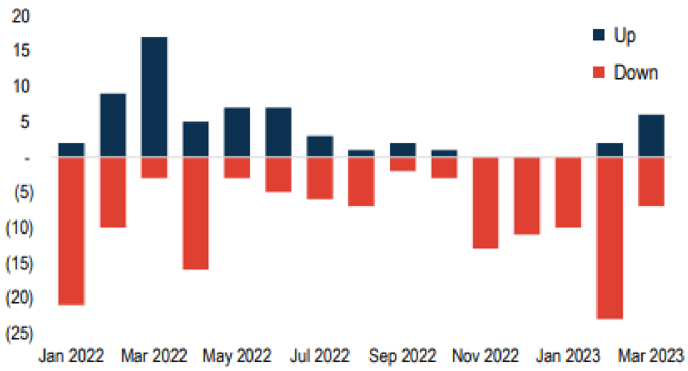
Leveraged loan issuance in Europe mirrored that of the US. 1Q23 institutional issuance was €7.3 billion, ahead of 4Q22 but behind that of 1Q22. After coming off a slow 2022, issuance was higher than expected, backed by strong technical support earlier in the quarter before stalling with the regional banking crisis and the emergence of the news regarding Credit Suisse in March. The majority of issuance in 2023 was to fund bolt-on acquisitions, refinancings and some modest recap activity.

Chart 2: Quarterly European leveraged loan volume



Data through March 31, 2023
Source: PitchBook | LCD

Chart 6: Count of upward to downward flexes



Data through March 31, 2023
Source: PitchBook | LCD

PRICING CONTINUED TO FLEX IN FAVOR OF ISSUERS

Deals continued to flex in favor of issuers in the first part of 1Q23, an indication that market conditions were improving. In total, 13 of the 25 refinancing deals that flexed down in the quarter were for single-B issues. As the quarter progressed, however, the banking crisis temporarily drove secondary pricing lower, which resulted in deals being flexed up to clear market.

LOAN RETURNS NO LONGER LEAD MARKET

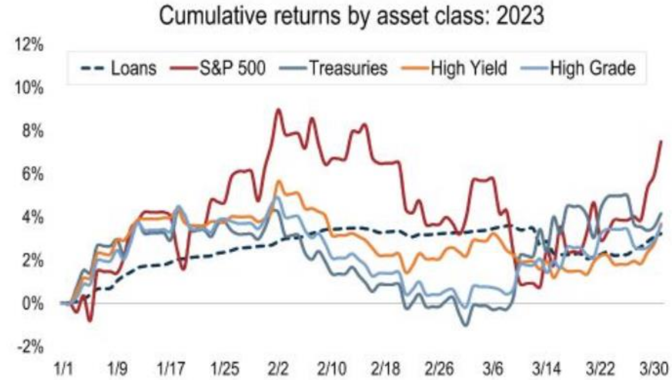
1Q23 was a strong quarter for all asset classes. The leveraged loan asset class gained 3.23% in 1Q23, ahead of the 2.74% gained in 4Q22 (which was the highest return for any asset class in the quarter). Although positive and greater than the 4Q22; this quarter's leveraged loan return was modest in comparison to the other asset classes. Leveraged loan returns are arguably resilient and not overly reactive to positive or negative movements in global market environments. This notion is supported by its 2.54% LTM return, far ahead the return of any other asset class.

Returns by asset class

	Mar 2023	Feb 2023	1Q 2023	LTM
Morningstar LSTA US LL Index	-0.03%	0.58%	3.23%	2.54%
Morningstar US High-Yield Bond	1.08%	-1.30%	3.68%	-3.44%
Morningstar US Corporate Bond	2.95%	-3.14%	3.61%	-5.20%
S&P 10-year Treasury Index	3.87%	-3.10%	4.16%	-6.81%
S&P 500	3.67%	-2.44%	7.50%	-7.73%

Data through March 31, 2023
Sources: PitchBook | LCD; Morningstar; S&P Dow Jones Indices

Cumulative returns by asset class: 2023



Data through March 31, 2023
Sources: PitchBook | LCD; Morningstar LSTA US LL Index; Morningstar US HY Bd TR USD; Morningstar US Corp Bd TR USD; S&P Dow Jones Indices

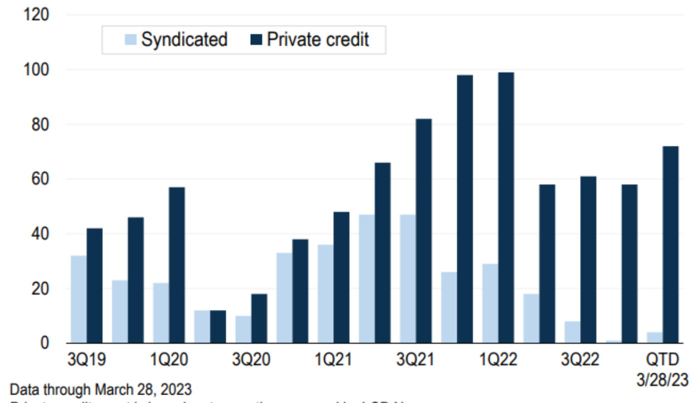
PRIVATE CREDIT CONTINUES TO TAKE MARKET SHARE

Historically, banks were the go-to source of leverage for large LBO's and take-privates. Banks typically underwrite to distribute. As a result, they often refrain from leveraged finance activity in times of economic uncertainty due to enhanced underwriting risk. Private credit funds typically buy and hold loans and are therefore not subject to underwriting risk constraints. As banks retreat, private credit steps in, making it a reliable source of financing. Not surprisingly, private credit made up the majority of deal financing in 2022 and 1Q23 on both sides of the Atlantic.

This trend of private debt funding is expected to continue. Investors at Blackstone described this as the "golden moment" for private credit, stating they are seeing the greatest demand today given the higher interest rates and wider spreads. Blackstones' returns for private credit were 3.4% in 1Q23 and 9.1% LTM.

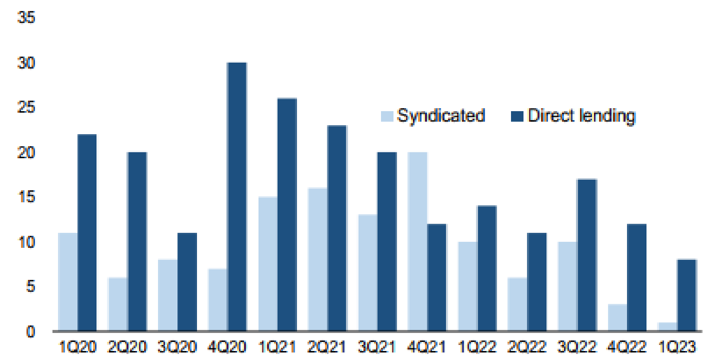
Banks are expected to re-enter later in the year after a period of offloading earlier unsold loans as liquidity returns to the market. According to LCD, banks won't stand by quietly. Some banks, such as JPMorgan, have their own direct lending platforms. News emerged in Q1 2023 that JPMorgan would invest least $10 billion to its direct lending platform.

Count of LBOs financed in BSL vs private credit markets



Data through March 28, 2023
Private credit count is based on transactions covered by LCD News
Sources: PitchBook | LCD

European count of LBOs financed via BSL vs. direct lending markets

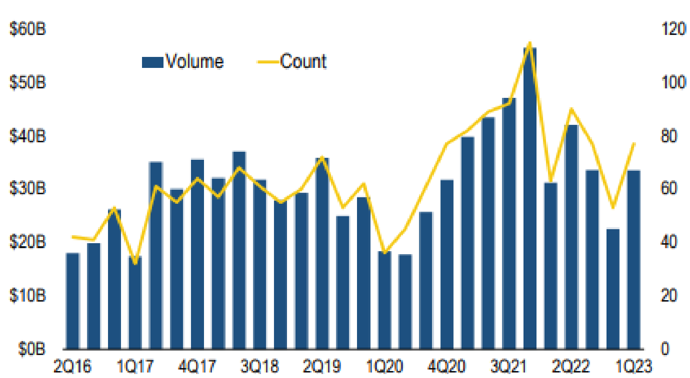


Data through March 10, 2023. BSL refers to broadly syndicated loan market. Direct-lending count based on deals covered by LCD News.
Source: PitchBook | LCD

CLO ISSUANCE REMAINS STRONG

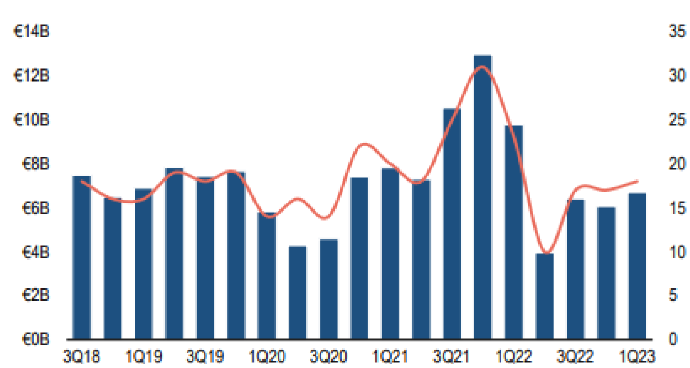
1Q23 US and European CLO issuance was higher than expected in light of historically wide spreads, limited loan supply, smaller investor base and an asset downgrade wave. This quarter's total US CLO issuance of $33.6 billion is far ahead the $22.6 billion issued in 4Q22 and just slightly ahead the $33 billion issued in 1Q22. European CLO issuance increased from €6.1 billion in 4Q22 to €6.7 billion in 1Q23. February was a record breaking month for both regions, printing the highest monthy volume of deals since 4Q21 for US and 1Q22 for Europe. Looking forward, investors question whether this pace will continue into 2Q23.

Chart 14: US CLO issuance – quarterly



Data through March 31, 2023
Source: PitchBook | LCD

Chart 28: European quarterly CLO new-issue volume and count

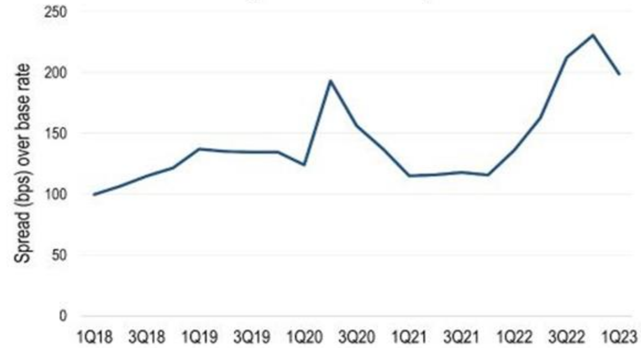


Data through March 31, 2023
Source: PitchBook | LCD

AAA SPREADS BEGIN TO RETREAT

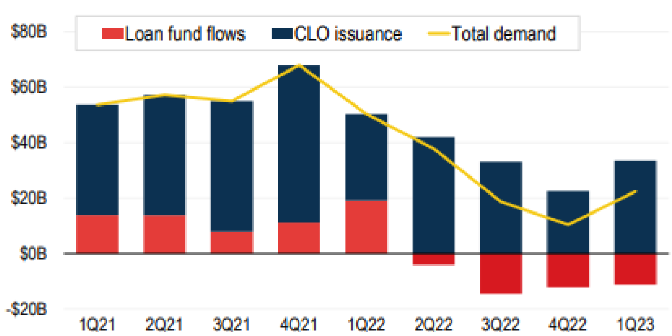
Average CLO AAA spreads began to retreat in 1Q23 contributing to the asset class' higher than expected issuance. This retreat, however, may be short lived as secondary AAA spreads widened with the regional banking crisis at the end of the quarter.

Average US CLO AAA spread



Data through March 24, 2023. Excludes middle-market CLOs.
Source: PitchBook | LCD

Chart 2: US leveraged loan market – measurable investor demand



Data through March 31, 2023. Fund flows data includes monthly reporters.
Sources: PitchBook | LCD; Morningstar Direct

LOAN SHORTAGE CONTINUES

Large loan fund outflows occurred over the recent quarters as a result of uncertainty in the market. Investors pulled $1.94 billion from US loan funds the week of March 22 following the SVB news. However, relatively robust CLO issuance more than offset mutual fund outflows. This, combined with declining new issuance, resulted in a supply/demand imbalance for the quarter, with demand exceeding supply. Year-to-date 2023 total measurable demand exceeded supply by $32.4 million.

SECONDARY PRICING RETRACE GAINS

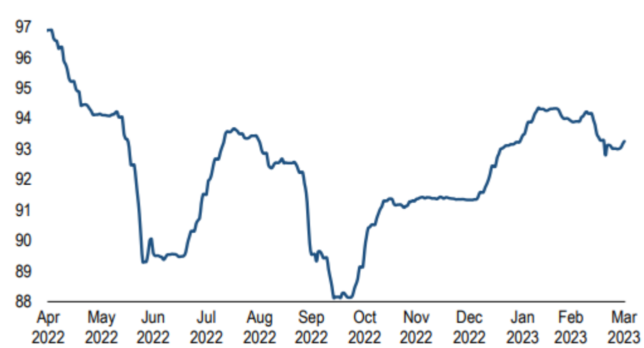
Prices in the US secondary rallied in early 2023, reaching a peak of 94.71 on February 9 as investors looked to put cash to work. Prices fell 0.76% on March 13 representing the second largest single-day decline since April 2020 as news on the regional bank failures dominated headlines. This followed a 0.17% decline on March 10, and two days later, on March 15, the index fell a further 0.54%. Market conditions settled later in the quarter as the failure of SVB and Signature Bank appeared to be well contained. Come quarter end prices began to re-coup the gains made earlier in the quarter, finishing at 93.38.

Similarly, Europe's secondary rallied in Q1, reaching a 94.36 peak on February 9. The region experienced a less drastic impact from the regional bank failures only dipping slightly below 93 in mid-March and finishing at 93.17 by month end as conditions stabilized.

Chart 20: Weighted average bid of US leveraged loans

Data through March 31, 2023
Sources: PitchBook | LCD; Morningstar LSTA US Leveraged Loan Index

Chart 32: Weighted average bid of European loans



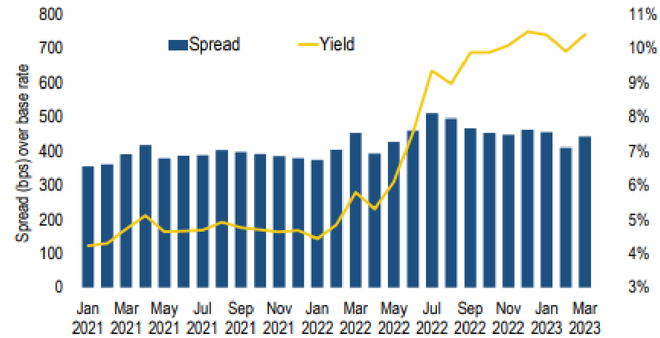
Data through March 31, 2023
Sources: PitchBook | LCD; Morningstar European Leveraged Loan Index

NEW ISSUE SPREADS NARROW BUT YIELDS CLIMB

Spreads in 1Q23 continued to narrow in the first half of the quarter before widening slightly in March. The average new issue spread for B/B+ rated borrowers declined to a 10-month low of 410bps in February before widening to 463 bps by the end of March. In both the US and Europe, yields took a slight retreat in February before finishing where they began the quarter.

Notwithstanding these broad trends and current secondary pricing, some recent financing transactions have been completed at lower original issue discounts (in the range of 150 bps) and with more normalized credit spreads. ARC considers this to be a strong indication of generally improving market conditions.

Chart 7: New-issue spread and yield-to-maturity of B/B+ loan borrowers



Data through March 31, 2023
Source: PitchBook | LCD

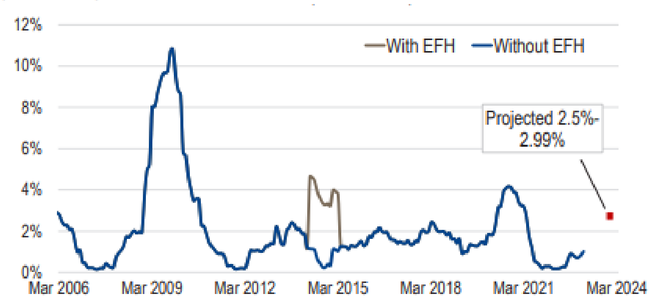
DEFAULT RATE CONTINUES TO RISE

The US leveraged loan default rate increased to 1.32% in 1Q23 from 0.79% in 4Q22 after the ratio of downgrades to upgrades peaked in February at 3.32x. 79% of loans downgraded were among lower-rated issuers with the most common reasons being weak liquidity, uncertain refinancing prospects and underperformance. Industries currently most at risk include consumer products, media & entertainment, and retail & restaurants.

Additional rate hikes in 2023 are anticipated to put B and B- issues under greater pressure with focus turning to cashflow generation, coverage ratios. and liquidity. Based on the most recent LCD survey, the median expectation for the 12-month trailing loan default rate one year from now has been revised up from 2.0-2.5% to 2.5-3.0%. ARC continues to expect default rates to reach 3% by year-end.

The default rate in Europe increased minimally from 0.42% in 4Q22 to 0.44% in 1Q23.

Chart 27: What do you think the US loan default rate will be 12 months (3/31/2024) from now?

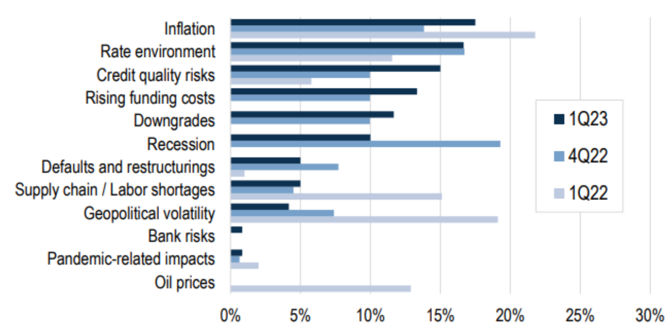


Data as of March 22, 2023
Chart shows historical and projected default rates by dollar amount. EFH = Energy Futures Holdings.
Sources: PitchBook | LCD; Morningstar LSTA US Leveraged Loan Index

LOOKING FORWARD

LCD's most recent survey indicates that 80% of loan market practitioners anticipate worsening market conditions, this is up from 70% at 2022 year-end. Inflation, the rate environment, and credit quality risks lead the list of concerns. The majority of respondents believe inflation will remain in excess of the Feds target of less than 2%, likely between 3% and 5% one year from now. Greater frequency of credit events is expected alongside rough market conditions as the number of B- borrowers has increased over the past two years. 69% of the $54.5 billion of loans maturing by 2024 are rated B- or lower or are unrated.

Chart 30: Which of the following will most likely impact the performance of credit portfolios in the next six months?



Data as of March 22, 2023
Source: PitchBook | LCD

ARC believes this survey was conducted during the regional banking crisis and was likely influenced by that news. Increasing secondary pricing suggests market sentiment is improving. Even as respondents expect volatility to worsen, the majority of respondents believe the worst is behind us.

Broad secondary trading indices have improved considerably over the last few quarters are now approaching a level where normal underwriting activity becomes viable. The overall trend towards lower all-in yield in the loan and CLO markets are positive signs for 2Q23. A few recently completed loans priced at an original issue discount of 150-200 bps and with credit spreads in the high 300 range demonstrates that underwriting activity is once again becoming feasible.

ARC therefore expects M&A activity to begin improving during the second quarter as banks seek underwriting revenue and sponsors seek to put money to work. While macro events, such as the regional banking crisis, could easily disrupt this trend again, ARC is optimistic that market conditions will continue to normalize.

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