CALLODINE | COMMERCIAL FINANCE

Quarterly Market Commentary

Q1 2023

Asset Based Lending

Market Commentary

We hope our Q1'23 quarterly commentary finds you well, despite the recent market volatility and uncertain economic climate. In our Q4'22 commentary, we made the observation that "credit markets, while showing some signs of healing, remain challenged, and commercial banks continue to be very cautious in their approach to lending." With the collapse of SVB and the sale of First Republic to JP Morgan, you can underline and bold the second clause in that sentence. Commercial banks, and specifically smaller regional banks, have completely retrenched after the events of late March – continuing an overall pullback by the banks that we believe began in earnest in Q2 2022. While potentially problematic for the broader economy and general credit availability, we believe this is a boon for Asset Based Lending and other forms of creative liquidity solutions for barrowers.

To begin the year, credit markets were buoyed by the appearance of strength in the high yield and leveraged loan market. Both markets saw notable spread compression and an uptick in new issue volume as fears of a deep recession seemingly began to abate. By February, the initial credit market exuberance had begun to wane, as the economic reality of rising interest rates and a yield curve that signaled a looming recession resulted in pessimism, credit concerns and widening spreads. This represents a continuation of the trend from the beginning of 2022, with CCC spreads over 450 basis points ("bps") wider since January 2022, and Single-B spreads over 380 bps wider.

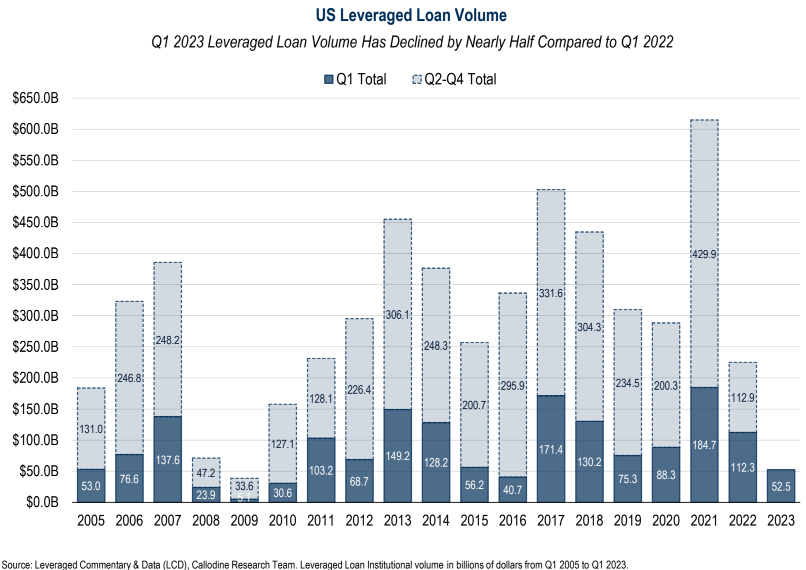
Source: Ice Data Indices, LLC, ICE BofA CCC & Lower US High Yield Index Option-Adjusted Spread [BAMLH0A3HYC], retrieved from FRED, Federal Reserve Bank of St. Louis, Callodine Research Team. Data from 1/1/22 to 3/31/23.

Source: Ice Data Indices, LLC, ICE BofA Single-B US High Yield Index Effective Yield [BAMLH0A2HYBEY], retrieved from FRED, Federal Reserve Bank of St. Louis, Callodine Research Team. Data from 1/1/22 to 3/31/23.

Similar to what we saw for a good portion of 2022, credit market volatility and the above spread widening have had a significant impact on capital availability for both middle market and larger, non-investment grade borrowers thus far in 2023. We have seen a sharp drop-off in new issue volume of late and expect this trend to continue for the next 12-24 months, as the broadly syndicated loan and high yield markets remain quite challenged and largely unavailable at reasonable levels for many issuers (particularly those in the middle market). Another factor that has played into lower issuance volume is a lack of acquisition activity. Looking at the broader M&A landscape we would contend that high equity valuation multiples coupled with credit market volatility have muted the number of transactions taking place. As many of our readers are well aware, M&A activity is fuel to the fire of the leveraged finance markets, and without it, the new issuance market dries up quickly.

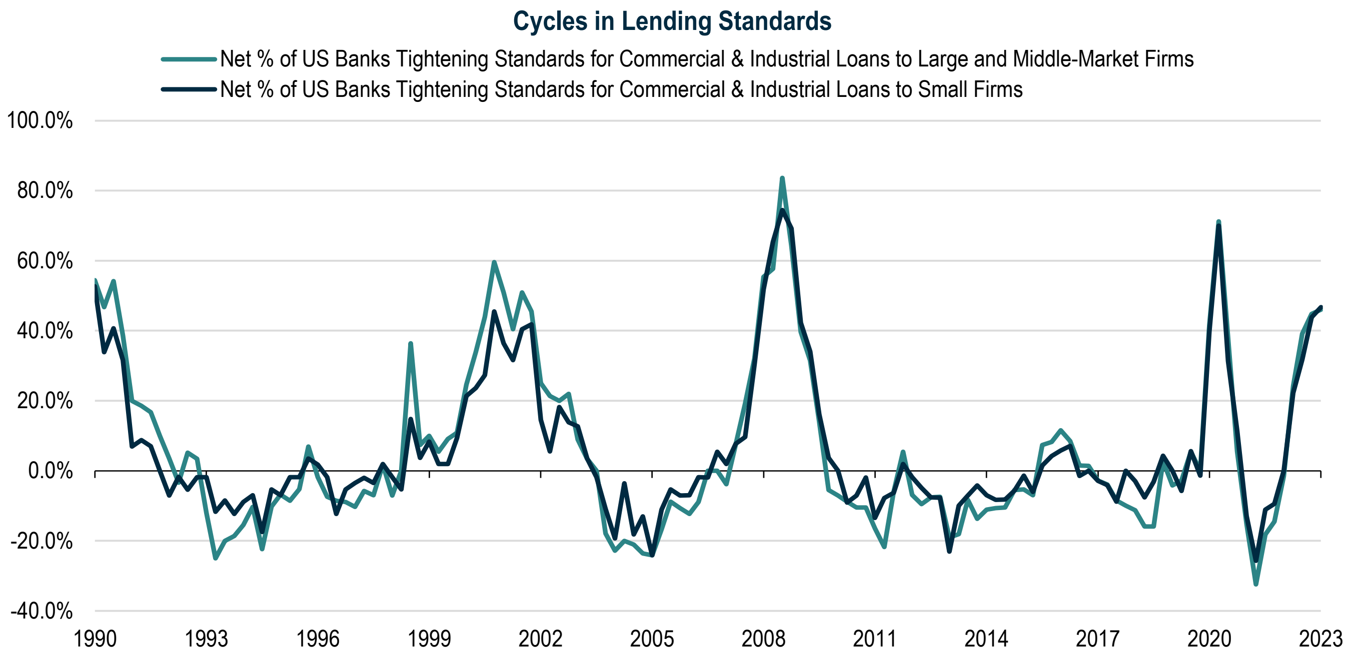
Looking at the exhibit to the right, we can see that leveraged loan volume has fallen precipitously over the last two years, and Q1 2023 represents the slowest start to the year for new issuance since 2016 (and prior to that, all the way back to 2010). Unsurprisingly, this fact pattern has led a host of borrowers across industries to search for alternative sourcing of financing.

Unfortunately for many borrowers, in addition to the pullback in the broader capital markets, banks have been steadily tightening lending standards for over a year. This trend is certainly expected to accelerate with the collapse of SVB, Signature Bank and First Republic.



Source: Leveraged Commentary & Data (LCD), Callodine Research Team. Leveraged Loan Institutional volume in billions of dollars from Q1 2005 to Q1 2023.

We firmly believe regional banks will sharply reduce lending in the face of uncertain economic conditions and are seeing it play out in real-time. In the exhibit below, you can see the sharp tightening of lending standards, which resembles the initial onset of the COVID-19 pandemic, and almost as sharp of a reaction as what we saw during the Global Financial Crisis.



Source: Board of Governors of the Federal Reserve System's Senior Loan Officer Opinion Survey on Bank Lending Practices, Callodine Research Team. Net Percentage of Domestic Banks Tightening Standards for Commercial and Industrial Loans to Large and Middle-Market Firms [DRTSCILM] and Net Percentage of Domestic Banks Tightening Standards for Commercial and Industrial Loans to Small Firms [DRTSCIS] retrieved from FRED. Data from 3/31/90 to 3/31/23.

Here at Callodine, our senior investment professionals have seen this cycle play out many times. For banks that are looking to reduce exposure, the common progression is:

1) Eliminate lending capacity for new borrowers/clients,

2) Sharply curtail incremental credit availability for existing clients, and

3) In some cases, “manage” existing clients out of their lending books by not renewing existing facilities.

We are firmly in the camp that we will continue to see banks pursue all three courses of action to reduce exposure and shore up capital bases. Our view is that this has and will continue to result in a dramatic increase in the number of borrowers turning to the ABL market for alternative sources of liquidity.

To address activity within the ABL market, specifically, we have already started to see a pick-up in transaction activity. As alluded to previously, use of proceeds for new deals dominated by balance sheet management (refinancings, liquidity enhancements and shoring up cash balances) rather than M&A. There have been select situations where we have seen interesting M&A financings, but we view those transactions as the exception in the current environment.

From a sector perspective, consumers have proven to be surprisingly resilient. The implication for the ABL market has been less activity/opportunities in the consumer and retail industry segments, but more deals in the industrial segments, however, consumers at the weaker end of the credit score spectrum bear close watching, and we expect that consumer and retail transaction could increase materially if we see further weakening of the broader economy.

In summary, notwithstanding broader macroeconomic concerns, we continue to believe that the current investing climate is as attractive as we have seen for Asset Based Lending and are eagerly optimistic about the opportunity set in front of us. We believe that less capital available from both banks, as well as traditional enterprise value or cash flow lenders, due to fear of recession and/ or economic slowdown, will further drive more borrowers to seek out ABL credit solutions.

In terms of how we expect this to manifest itself in practical terms, the opportunity set within Asset Based Lending will further diversify by both size and type of borrower. We believe larger, more sophisticated companies will look to the ABL market for liquidity and creative structures to allow them to continue running their businesses without interruption. Similarly, we believe the traditional middle market opportunity set will also see a substantial uptick in activity. We are also of the view that credit quality and structures, already very lender favorable, will continue to improve. Closing fees and prepayment fees have seen a notable increase as well, resulting in stronger cash yields and what we refer to at Callodine as “underwriting Alpha.”

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