# Asset Based Lending

## Quarterly Market Commentary: Q2 2023


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# Market Commentary

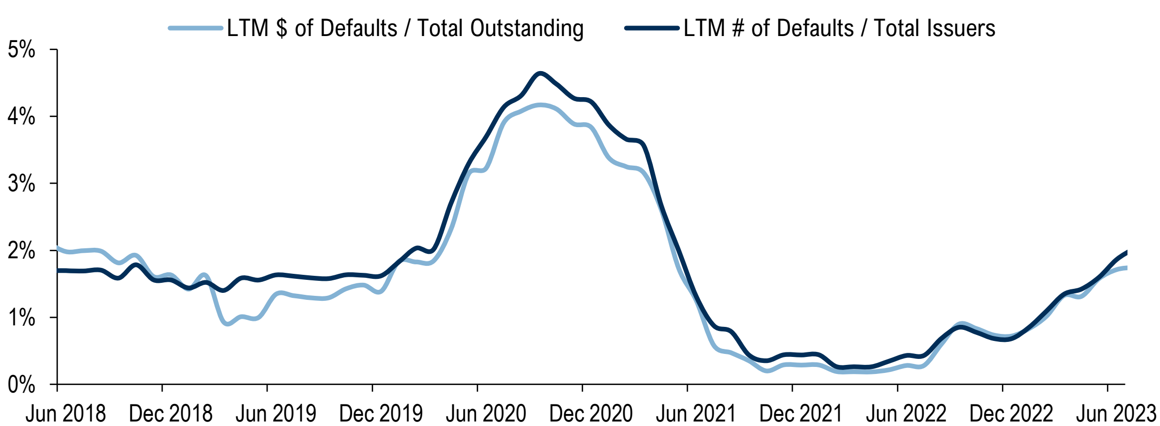
As we find ourselves just over the halfway mark for 2023, we continue to see this year as one that has been marked by a lack of market liquidity and broad credit availability. Many of the themes we touched upon in our Q1’23 letter remain. Banks continue to reduce credit availability in the wake of the regulatory fall-out from SVB, the high yield and broadly syndicated loan markets have been quiet, and borrowers are adjusting to a higher cost of capital across both industries and company size.

For the optimists among our readership, credit market volatility has moderated somewhat since our Q1’23 letter. Both equity and credit markets have been buoyed by more favorable economic data and the belief that we are at the end of the interest rate rise cycle. The “soft landing” that market participants have been rooting for despite seemingly long odds, may have actually been achieved.

For our skeptical readers, we would caution that credit fundamentals have deteriorated over the course of the last 12 to 18 months. Default rates have been on a steady climb upward since the beginning of 2022, as shown in the chart below. While not nearly at pandemic highs, the trend is worth watching, and we do not believe that there will be a reversal in the near term. On the contrary, we think that we are entering an environment where underwriting standards and portfolio management capabilities will be tested.

**Morningstar LSTA Leveraged Loan Index Default Rates**

June 2018 - June 2023

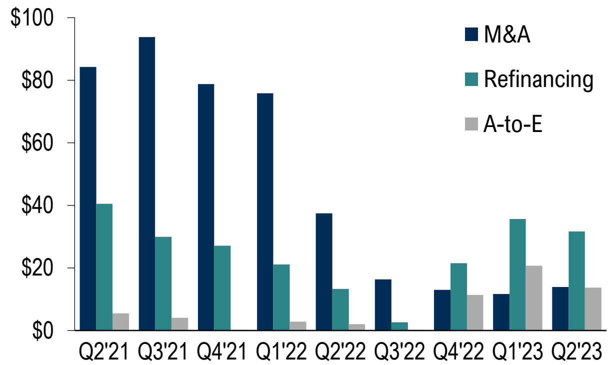



Source: PitchBook / Leveraged Commentary & Data (LCD), Callodine Research Team. Morningstar LSTA Leveraged Loan Inex Default Rates from 6/30/22 to 6/30/23.

As we’ve recently written, M&A activity remains low across the U.S. which quite naturally results in lower loan issuance volumes given a lack of financing needs. For the majority of transactions being executed in today’s market, companies are looking to refinance debt, shore up balance sheets and supplement liquidity. This is consistent with the uncertain economic outlook described above and explains why asset based liquidity solutions have become more prevalent, in our view.

**US Institional Loan Volume ($Bn)**

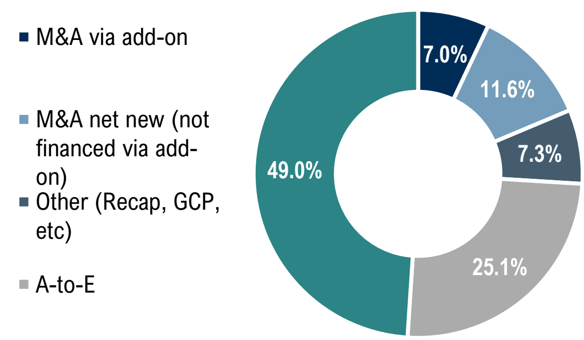
Q2 2021 - Q2 2023




Source: PitchBook / Leveraged Commentary & Data (LCD), Callodine Research Team. US institional loan volume from 6/30/21 to 6/30/23.

**US Institional Loan Volume by Transation Type**

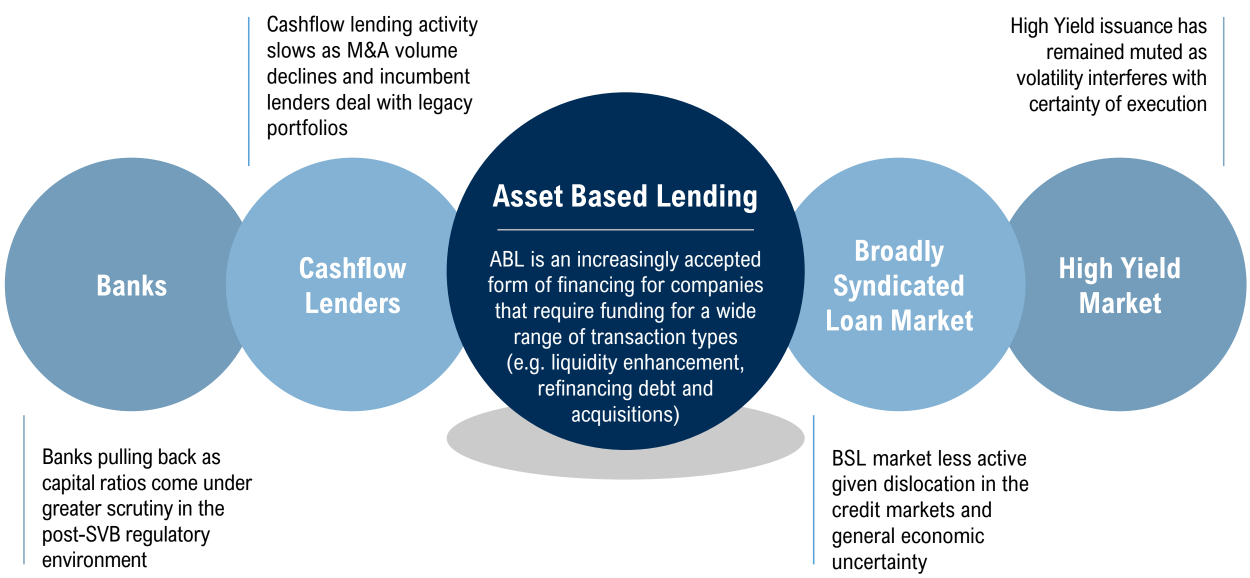
January 2023 - June 2023




Source: PitchBook / Leveraged Commentary & Data (LCD), Callodine Research Team. US institional loan volume by transaction type from 1/1/23 to 6/30/23.

To put it more directly, credit investor malaise has had a significant impact on capital availability for both middle market and larger, non-investment grade borrowers thus far in 2023. As we look at the competitive landscape for credit providers, we see broad retrenchment across channels. Banks have been steadily tightening lending standards for over a year, as we discussed in our Q1'23 letter. This trend is only accelerating, from our perspective, with the collapse of SVB, Signature Bank and First Republic. We firmly believe regional banks will sharply reduce lending in the face of uncertain economic conditions, as well as a more challenging regulatory environment, and have observed this trend in real-time on a number of transactions.

We have also heard from both borrowers and certain sponsors that there is less capital available from traditional enterprise value or cash flow lenders due to fear of recession/economic slowdown that we believe will further drive more borrowers to seek out ABL credit solutions.




Source: Callodine Research Team. Exhibit is intended to be strictly illustrative in nature and reflects Callodine's subjective, proprietary views of the current market landscape.

The result of all of this? Credit and structures have continued to shift in favor of lenders that are both willing and able to provide financing solutions with structures that work for both borrowers and lenders. Specifically, as it relates to the ABL market, we have observed a diverse and growing opportunity set that has been defined by:

1) An uptick in middle market companies seeking capital,
2) Larger, more sophisticated companies having to access the ABL market for liquidity, and
3) Borrowers previously served by regional banks that are now turning toward alternative lenders like Callodine.

We have witnessed an overall improvement in the competitive landscape for ABL private credit as a number of our competitors appear to be retrenching. From a deal perspective, closing fees and spreads have stabilized after a material shift to the benefit of lenders. At Callodine, we believe private credit managers should be focused on extending call protection to create incremental convexity and a durability to their return profiles.

We continue to believe that the current environment for ABL credit presents the most attractive opportunities we have seen in over 10 years, and we expect the back half of 2023 to be quite active for lenders that have both dry powder and an ability to work with borrowers to create liquidity solutions.

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