CALLODINE | CREDIT

Asset Based Lending

Quarterly Market Commentary: Q4 2023

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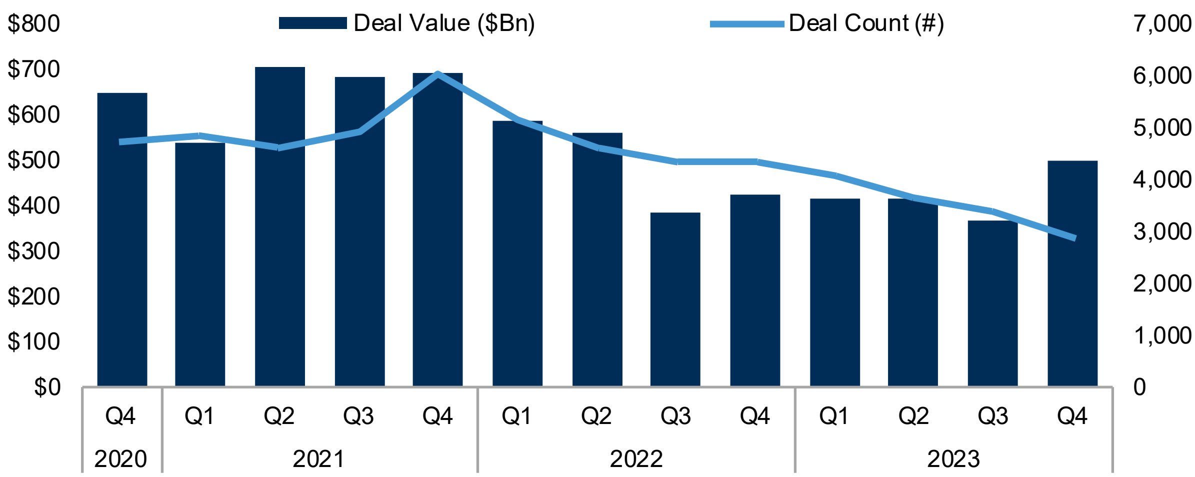
Market Commentary

The fourth quarter of 2023 was a continuation of many of the themes that we witnessed and wrote about throughout the year. The M&A market remained challenged given the chasm between valuation expectations and the availability and cost of financing, as evidenced by the continued and steady decline in number of closed transactions dating back to the end of 2021 (as shown in the exhibit below). Overall deal quality for new opportunities reviewed remained challenging, as we saw higher quality borrowers continue to "kick the can down the road" wherever possible, hoping for better markets on the horizon. At Callodine, we saw considerable deal flow in the fourth quarter, almost all of which we decided to pass on given the quality of the underlying credits and available collateral. While frustrating, we believe it was important to preserve our capital for what we believe will be a far more active year in 2024.

US M&A Activity

Q4 2020 - Q4 2023



Source: PitchBook's 2023 Annual Global M&A Report. Callodine Research Team.
Note: US M&A Activity is represented by North American-focused M&A activity by quarter from from 9/30/20 through 12/31/23.

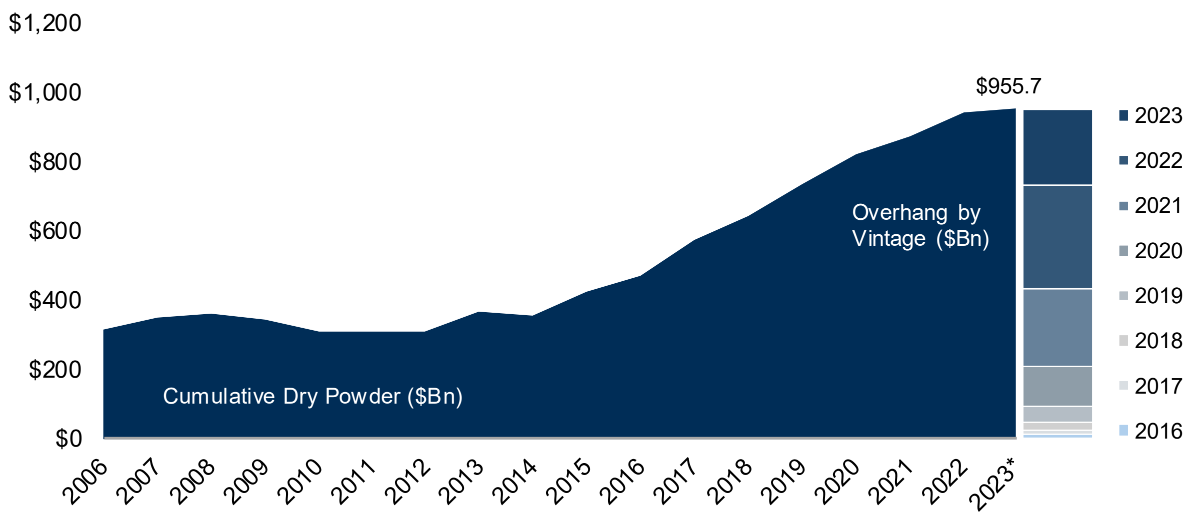
We believe that there are several key themes that will drive an uptick in transaction volume over the next 12 to 24 months, specifically for borrowers that will be in the market for alternative sources of bank financing. To that end, several key themes that we see playing out in 2024 include the following:

I. Private Equity Dry Powder Being Put to Use

We have been through enough market cycles to know that the M&A market won't stay quiet forever. As capital markets stabilize, valuation spreads narrow and dry powder continues to burn a hole in the pocket of PE sponsors, acquisition activity will resume and the need for debt financing will return in force. Looking at the exhibit below, we can see the wall of capital patiently waiting to be put to use. It's important to note that not all of this capital is 2022 or 2023 vintage, meaning that a significant portion of this capital is likely approaching the end of its investment period. As a result, we expect the trend line in the 'US M&A Activity' chart shown on the previous page to reverse course in relatively short order.

US Private Equity Cumulative Dry Powder

January 2006 - March 2023



Source: PitchBook's 2023 Annual US PE Breakdown Report. Callodine Research Team.
Note: US PE Cumulative Dry Powder by vintange from 1/1/06 through 3/31/2023. "*" reflects 2023 is not a full year.

In addition to the capital available for deployment, sponsors are also under pressure from their Limited Partners to show realizations and return capital in the form of distributions. We believe that these two motivating factors, taken in tandem and combined with a more conducive interest rate environment, should result in increased M&A activity.

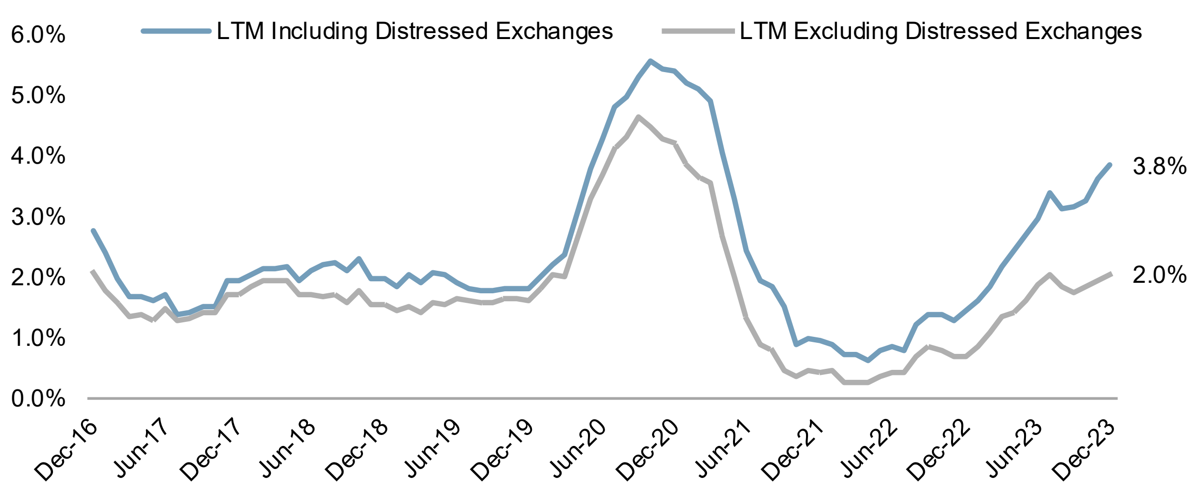
II. A Marked Increase in Restructuring Activity

One of the themes that we began to observe toward the end of 2023 was an uptick in restructuring activity. While our observations were anecdotal, we can look to the fourth quarter earnings of several prominent investment banks known for their advisory practices to see the "tale of the tape." To borrow an excerpt from a report by Bloomberg columnist, Irene García Pérez:

> *Houlihan Lokey reported $128.6 million in revenues for its financial restructuring practice alone in the last quarter of 2023, 30.1% more vs same period a year before. For all advisory activities, revenue was $511.13m, up 12%.*
>
> *Meanwhile, PJT Partners reported $290.6 million for its advisory practice (that includes all advisory activities) for the same period, 26% more than the previous year, "due to an increase in restructuring revenues, which was partially offset by decreases in strategic advisory and private capital solutions revenues".*
>
> *Lazard reported $477 million in financial advisory (again, all advisory activities included here) in the quarter ended Dec. 31, 18% more than the previous year, and implied restructuring and liability management practices were behind part of that growth.*
>
> — *Irene García Pérez. LinkedIn, February 2024.*

In the loan market, you can see this activity taking place in the form of distressed exchanges and other capital markets machinations that are providing relief to stressed borrowers. This doesn't always manifest itself in a higher default rate, but peeling back the onion we can clearly see a notable increase in the number of companies seeking relief from their current lending group.

US Loan Default Rate (Issuer Count)
December 2016 - December 2023



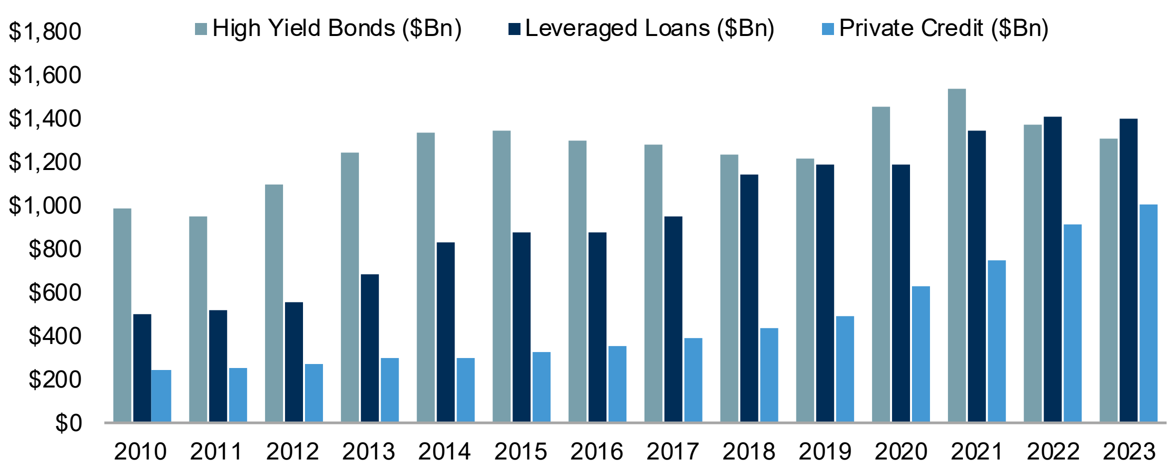
Source: PitchBook | LCD's Dual Track Default Rate via the Morningstart LSTA US Leveraged Loan Index. Callodine Research Team.
Note: Data from 12/31/16 through 12/31/23.

An increase in restructurings combined with an uptick in defaults should result in banks increasing loan loss reserves, further exacerbating a prevalent post-SVB them of commercial banks pulling back on new lending and managing certain clients out of their portfolios. Which leads us to theme #3…

III. The Private Credit Market Continuing to Take Market Share

This is a drum we've been beating for some time, and while not the most controversial "take", it's a critically important trend to our business. Private credit solutions have continued to take market share within the debt capital markets, particularly when compared with the regional banks. Even looking at the High Yield and Broadly Syndicated Loan market, borrowers are increasingly looking to the private credit market to meet their financing needs.

US Credit Market Sizes (Outstanding Debt)
January 2010 - December 2023



Source: BofA Global Research (ICE). Preqin's Global Private Debt Report 2024. Callodine Research Team.
Note: High Yield Bonds and Leveraged Loans are represented by Developed Market (DM) USD issues. Private Credit is represented North America-focused private debt assets under management. Data from 1/1/10 through 12/31/23.

We believe the rationale behind this phenomenon lies in the fact that private credit providers have the capability to offer tailored solutions that more precisely cater to the needs of their clients. When executed properly, private credit managers have the ability to fit transaction structures to client needs in a way that syndicated markets can't given their lack of flexibility. We think this is and will continue to be a structural advantage for the asset class moving forward.

Callodine continues to be disciplined and focused on high quality investment opportunities in the face of an uncertain macroenvironment. Fortunately, we are now starting to see higher quality borrowers return to our market, as well as green shoots within the broader M&A landscape. We are of the view that through a combination of increased acquisition activity and balance sheet refinancings for creditworthy borrowers, we will see a spike in activity at the end of Q1 and throughout the remainder of the year.

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