CALLODINE | CREDIT

Asset Based Lending

Quarterly Market Commentary: Q1 2024

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Market Commentary

We began the year optimistic that transaction activity would begin to pick up meaningfully in 2024 after a slow second half of 2023. It turns out that we have been half-right… loan volumes have increased substantially in Q1'24, however a significant portion of that volume is due to repricing and refinancing in what has become a more constructive capital markets environment.

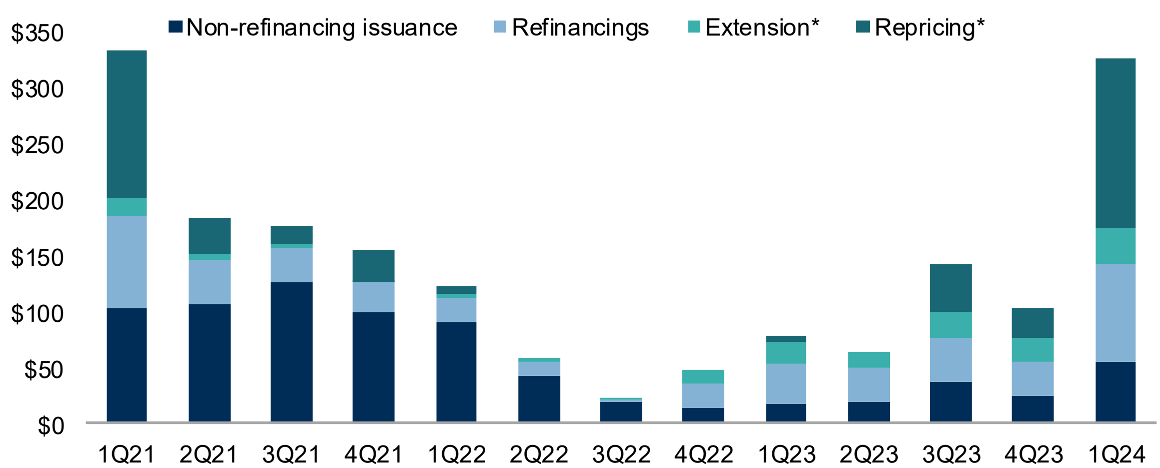
We think this trend is likely to continue, while we begin to see green shoots of M&A activity in certain sectors and from sponsors that have dry powder to deploy opportunistically. At Callodine, we remain constructive on the broader credit landscape, although we are cautious in the high yield and broadly syndicated loan ("BSL") markets, where we think that recovery rates will disappoint vs. historical averages.

Higher for Longer

Toward the end of Q1, we began to see a pickup in investment opportunities at Callodine. Most of these transactions are still largely focused on balance sheet management, which is consistent with trends in the broader market, as illustrated in the chart below.

US Institutional Loan Volume ($Bn)

Q1 2021 - Q1 2024



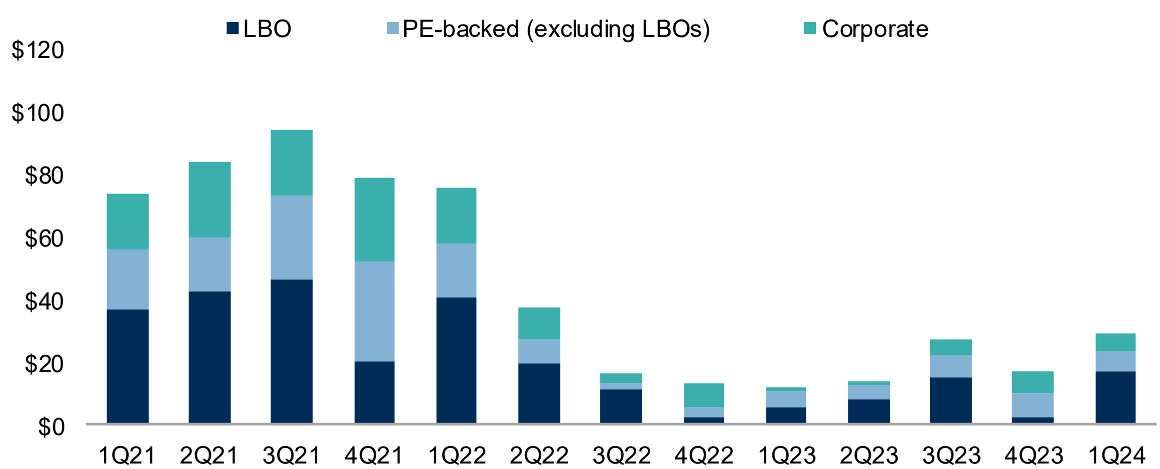
Source: PitchBook | LCD. Callodine Research Team.
Note: Data from 3/31/21 through 3/31/24. *Reflects repricings and extensions done via an amendment process only.

We believe the catalyst for such an increase in activity at the end of Q1 and into Q2 is linked to the realization by companies and their CFOs that interest rates are not going down any time soon. In 2023 and continuing into this year, there has been a prevailing sentiment among companies that they would postpone financing, anticipating a decline in rates, however as we like to say at Callodine… *hope is not a strategy*.

As it can be inferred from the exhibit below, M&A activity remains muted thus far in 2024, as use of proceeds remains predominantly balance sheet focused (maturity extensions, refinancings, liquidity enhancements).

US Institutional Loan Volume Backing M&A ($Bn)

Q1 2021 - Q1 2024



Source: PitchBook | LCD. Callodine Research Team.
Note: Data from 3/31/21 through 3/31/24.

Our view is that M&A activity will remain suppressed for some time, as both valuations and interest rates remain high, despite the fact that private equity firms have been accumulating a substantial pile of "dry powder". That said, while the bulk of investment opportunities we are currently evaluating relate to balance sheet management, we are also reviewing several M&A situations as well. This is anecdotal, but hopefully a sign of more to come.

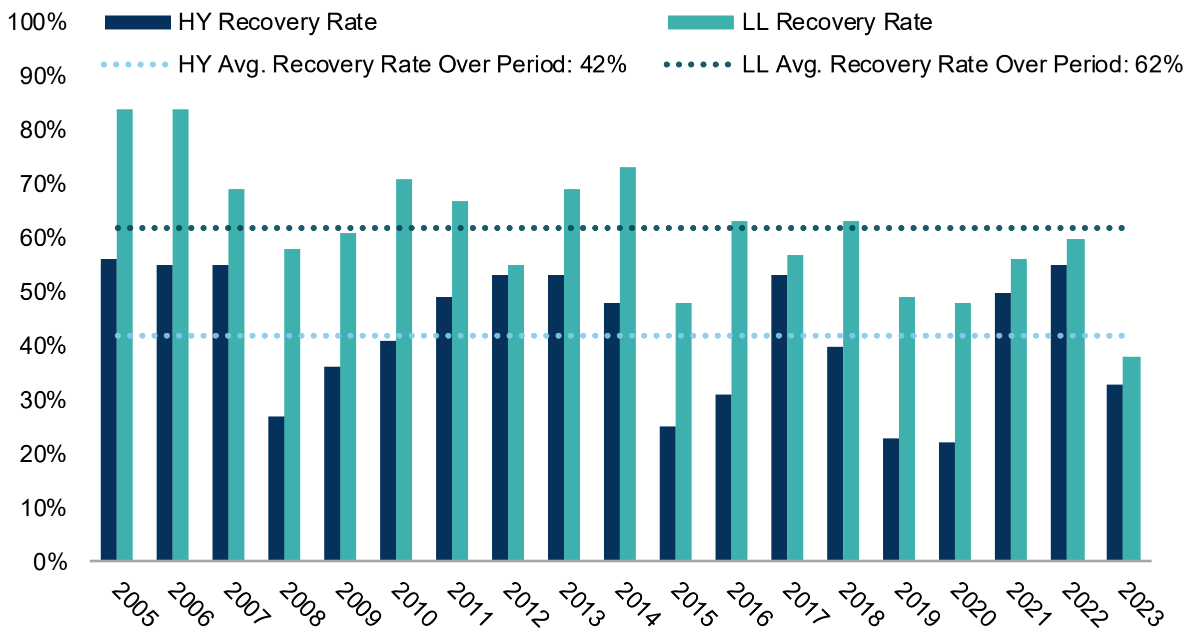
Not All Loans are Created Equal

One of the themes that we have been discussing at great length with investors is that not all loans are created equal, and our belief that secured loans with strict covenant packages are likely going to fare better in a default scenario than traditional leveraged loans.

As illustrated in the chart below, loan recovery rates dropped below 50% in 2023, which is the lowest rate of recovery in the sample size dating back to 2005. This is not altogether surprising as we have seen creditor protections continue to deteriorate in the BSL market.

Leveraged Loans & High Yield Bonds Historical Recovery Rates

January 2005 - December 2023



Source: JP Morgan Markets Research via Cliffwater's 2023 Q4 Report on US Direct Lending. Callodine Research Team.
Note: Data from 1/1/05 through 12/31/23.

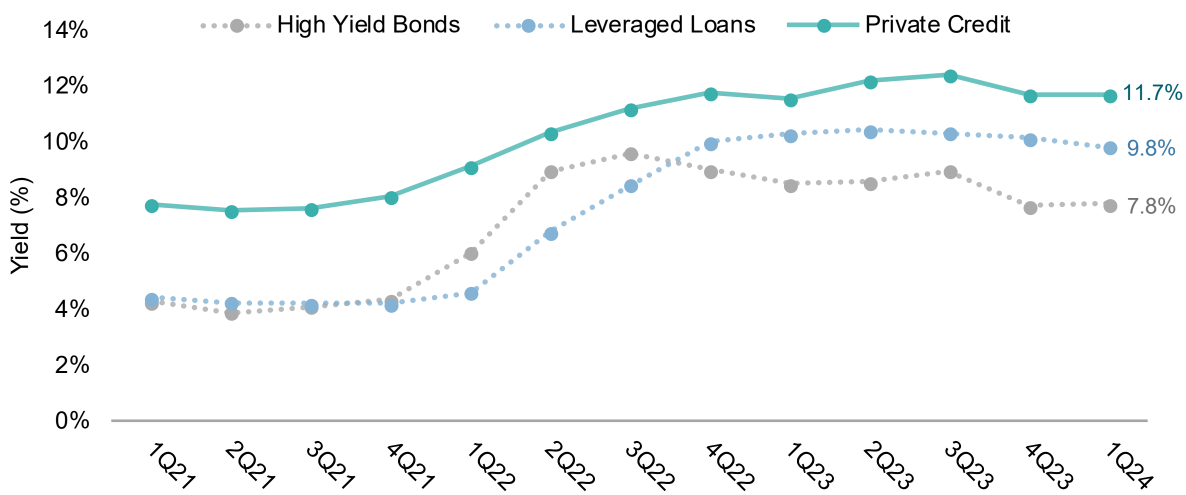
High yield bonds typically reside at the bottom of the debt stack, and are poised to endure the full impact of prolonged periods of elevated interest rates exhibited in today's market environment. As shown above, high yield bonds have fared even worse than leveraged loans, with recovery rates nearly reverting to Covid-19 pandemic levels. This is a trend worth watching if and when the economy starts to soften and borrower fundamentals weaken.

Private Credit Spreads Hold Strong

Looking at yields across different segments of the credit markets, we see that private credit yields have remained stubbornly high despite the compression in spreads across the leveraged loan and high yield markets. We believe the sustained elevation in private credit yields can largely be attributed to disciplined pricing practices and restricted access to capital markets, coupled with reduced bank credit availability. We have also seen this trend persist within the ABL credit markets, where spreads have shown limited compression. Our view is that companies accessing ABL credit tend to be a bit more "storied" and often lack access to, or have limited access to, the broader capital markets.

Recent Private Credit Deals Yield About 190+ BPS Above Public Markets

Q1 2021 - Q1 2024



Source: PitchBook | LCD. BofA Global Research - HY Strategy Chartbook. Houlihan Lokey. Callodine Research Team.
Note: Private Credit Yields are represented by Houlihan Lokey's Private Performing Credit Index. Data from 3/31/21 through 3/31/24.

As noted in our last few quarterly letters, our viewpoint remains unchanged in that banks continue to take a conservative posture towards lending, especially to those companies with a "story," as lenders like to say. We believe this trend will continue not just for the remainder of 2024, but into 2025 and beyond as banks reassess how they price and manage risk. We are excited about the opportunities ahead of us heading into the summer months.

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