

CALLODINE | CREDIT

Asset Based Lending

Quarterly Market Commentary: Q2 2024

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Market Commentary

We hope this letter finds you and your families well as we hit the dog days of summer. 2024 has, thus far, proven to be a year of contrasts. The US economy remains vibrant with healthy growth and a growing acceptance among many market participants that the Fed may have actually pulled off a “soft landing” after a sharp cycle of interest rate hikes. In concert, equity markets have (until recent bouts of volatility) risen steadily, and credit spreads have tightened meaningfully since the beginning of 2024.

Conversely, while private equity firms have substantial dry powder in this seemingly “Goldilocks” economy, that firepower has been stymied by high interest rates and high valuations.¹ Moreover, we are seeing some flashing warning signs in consumer credit, commercial bankruptcies, and the non-investment grade credit space, where debt service coverage ratios are the weakest since 2007 (cue the Darth Vader music!).¹ Finally, let’s not forget that this is a presidential election year that has already proven to be unpredictable and volatile. The backdrop of the election will add another element of uncertainty to both the U.S. economy and global capital markets.

That said, we believe the back half of the year will be more active as companies look to shore up balance sheets, address their maturity profiles, and improve overall liquidity as insurance against some of the economic headwinds mentioned above.

Below we provide more detail on some of the factors that we believe will provide momentum for the asset based lending segment of private credit for the remainder of 2024 and into early next year.

Dearth of Acquisition Activity – *Dude Where’s My M&A?*

In the first half of 2024, most of the activity in the broadly syndicated loan (BSL) market was related to refinancing or repricing existing loans. In Q2, 87% of BSL activity was related to these two categories, with dividend recapitalizations and mergers and acquisitions (M&A) activity making up the remaining 13%. This marks a low not seen since the global financial crisis.¹ We have witnessed a similar and more acute dynamic in the asset based lending (ABL) markets, as acquisition-related financings have been few and far between. Anecdotally, the majority of transactions we are seeing in the ABL market continue to be for refinancings, balance sheet management, and liquidity enhancement.

Despite these modest levels of transaction volume, there are signs pointing towards a potential increase in M&A activity in the coming quarters. Recent conversations with our sponsors indicate

¹ Source: Pitchbook LCD Q2 2024 US Credit Markets Quarterly Wrap.

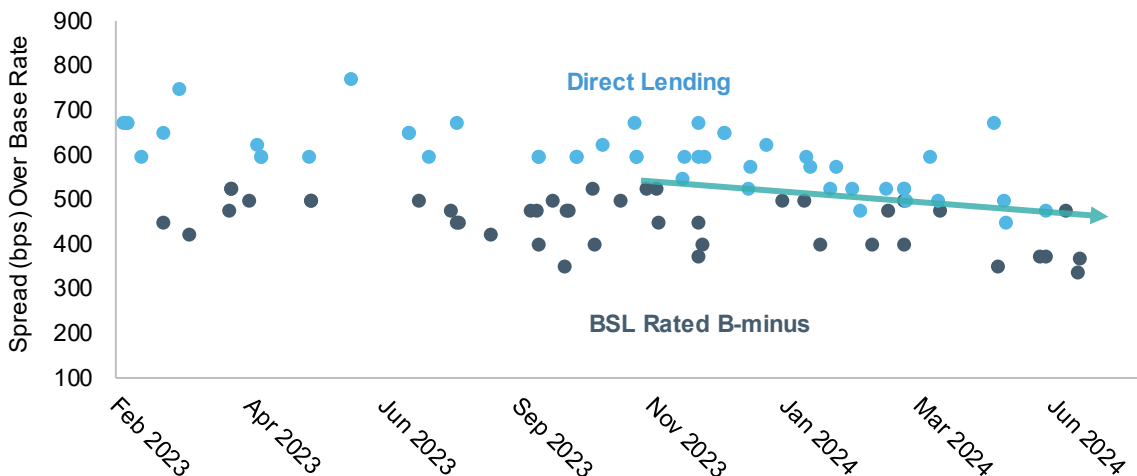
a rise in the number of non-disclosure agreements (NDAs) signed and a significant amount of dry powder, suggesting that M&A activity could soon pick up. Still, we have yet to see a meaningful uptick in new financing transactions.

Spread Compression

With M&A activity subdued and investor appetite for risk increasing, loan supply is running behind investor demand, leading to compressed credit spreads. In the first few months of the year, the syndicated loan market reopened for lower-rated borrowers to refinance and reduce their cost of capital.¹ While that trend has continued, in Q2 we saw private credit providers start to fight back and get creative to avoid losing deals. As a result, new issue spreads between BSL and direct lending for acquisition related deals have started to converge (as shown in the exhibit below). However, this impacted direct lending primarily within the large corporate and upper middle market segments that would compete most directly with the BSL market.

New-Issue Spread of Acquisition-Related Deals, PE-Backed Companies

January 2023 - June 2024



Source: PitchBook | LCD. Callodine Research Team.
Data through June 30, 2024 • Direct lending data is based on LCD News coverage.

We believe the ABL market has seen about 100bps of spread compression since the end of last year, based on the transactions we have participated in and seen executed in the space. We have seen some lenders defensively cutting rates for portfolio companies in order to not lose existing credits (and correspondingly, AUM).

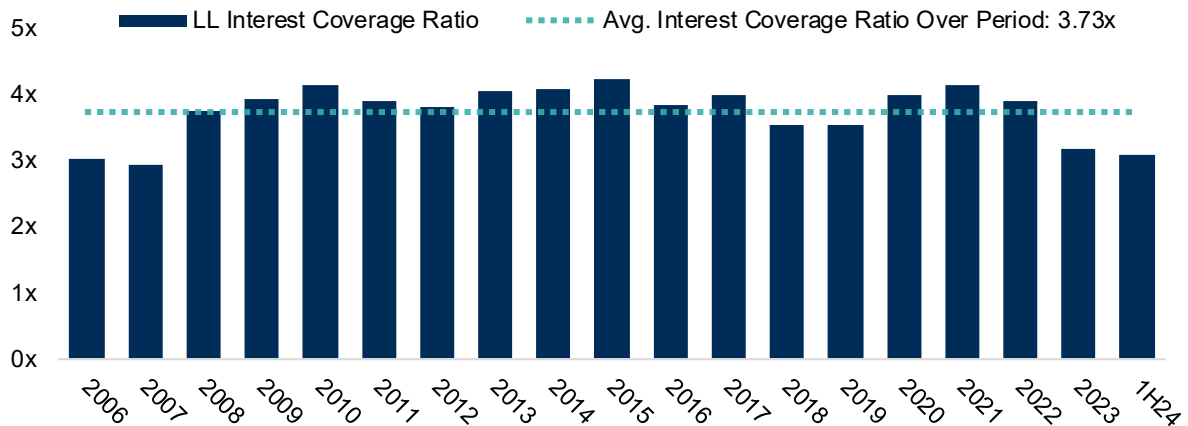
¹ Source: Pitchbook LCD Q2 2024 US Credit Markets Quarterly Wrap.

Credit Pickers Market

While new-issue spreads retreated to multi-year lows, the elevated base rate continues to put pressure on interest coverage. As shown in the chart below, interest coverage ratios of leveraged loans had an average EBITDA/interest ratio of 3.1x at issuance, which is the lowest reading since 2007.

Interest Coverage Ratio of Leveraged Loans

January 2006 - June 2024



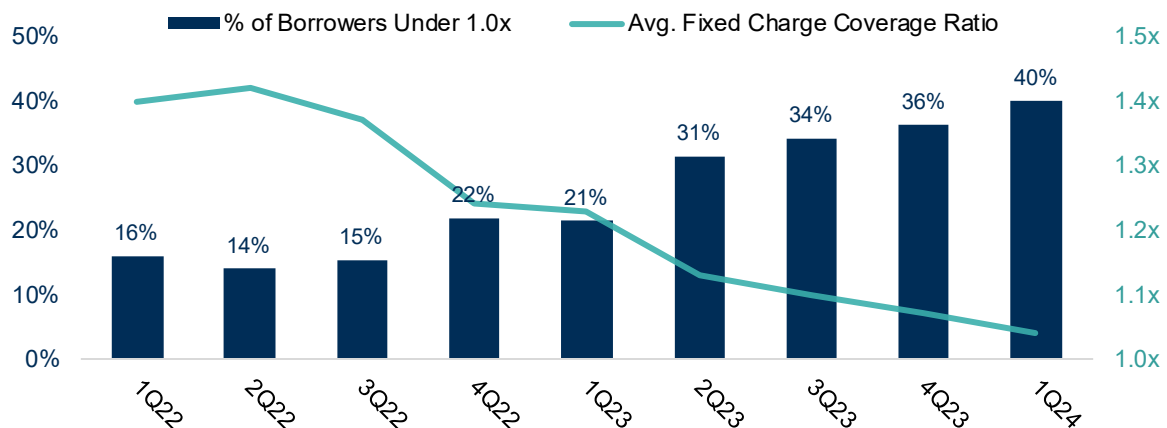
Source: PitchBook | LCD. Callodine Research Team.

Note: Data through 6/30/24. Reflects pro forma interest coverage in the new -issue leveraged loan market.

We've seen a similar trend within private credit. The percentage of private credit borrowers with fixed charge coverage ratios below 1x has risen from 16% two years ago to 40% this year according to Lincoln's data (see exhibit below).

Percent of Private Credit Borrowers With Fixed Charge Coverage Ratios Under 1x

Q1 2022 - Q1 2024



Source: Lincoln International.

Note: Fixed Charge Coverage Ratio = LTM EBITDA - Taxes - Capex / LTM Interest Expense + (1% * Total Debt).

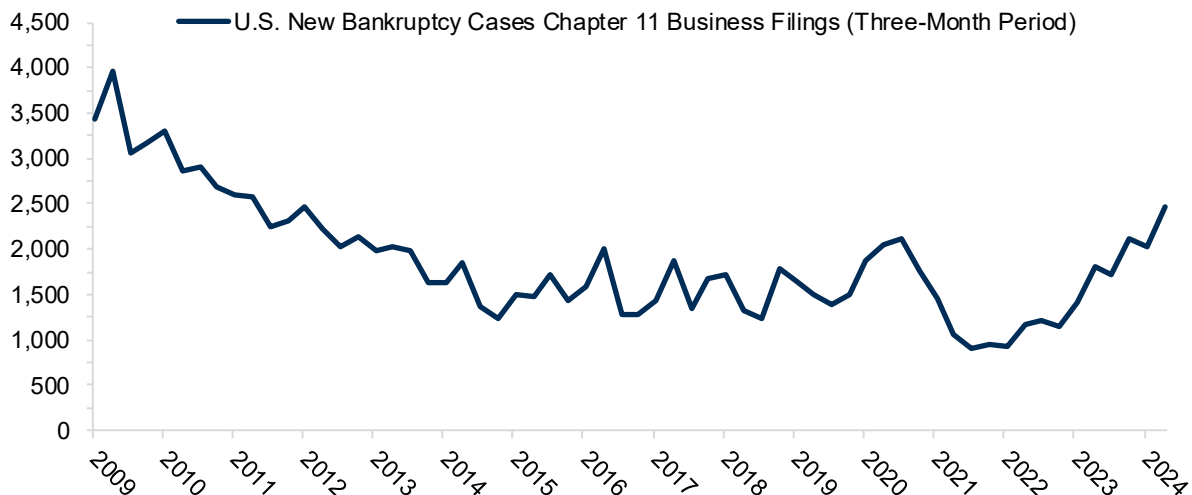
This suggests that a significant portion of borrowers are living on the edge of payment defaults, a situation that we believe warrants close monitoring and could result in the need for more flexible capital solutions.

The prolonged period of higher for longer interest rates has forced companies to get creative to avoid defaults. We've seen this through elevated payment-in-kind (PIK) interest, increasing amend-and-extend activities, and covenant holidays.

With that said, one can only “kick the can down the road” for so long. Private credit defaults have risen for the third consecutive quarter to 2.7%, albeit remaining below the overall default rate for BSL at 4.3%, per Fitch Ratings.² While the sirens are not flashing yet, it's worth noting that there were 346 bankruptcies in the first half of the year, marking the highest figure in 13 years.³ June alone witnessed 75 bankruptcies, with consumer discretionary having the most of any sector.³ In the below exhibit, you can see that in the US, Chapter 11 cases have increased and the number of weaker companies not making their debt payments is rising as they struggle to balance assets with their liabilities due to rapid rate hikes.

Chapter 11 Filings Reaches Highest Level in More Than a Decade

Q1 2009 - Q2 2024



Source: Administrative Office of US Courts (as of 6/30/24).

History tells us that should this trend continue, banks and credit providers for smaller, weaker-rated credits will pull back – creating an opportunity for highly skilled, asset based lending teams like Callodine to fill the gap and provide capital that others may be unwilling or unable to provide.

² Source: [Private Credit Defaults Rise to 2.71% According to Latest Proskauer Index \(July 22, 2024\)](#).

³ Source: [US corporate bankruptcies in June reach highest monthly level since early 2020 \(July 8, 2024\)](#).

We believe that the market is in the early innings of this trend and that the underwriting skills and restructuring capabilities of credit investors are about to be tested. In times of growing stress, we are of the view that asset selection will prove to be more successful than strategies focused on asset gathering.

Over the past year, we've reviewed and declined several transactions that later resulted in restructurings, workouts, or bankruptcies. Lenders in these situations have suffered losses or are expected to. Despite the temptation to stretch capital deployment, we believe the current environment is not conducive to lenient underwriting standards. Higher interest rates, weakening coverage ratios, and intensified competition leading to looser lending terms reinforce our cautious stance.

On the transaction pacing front, new deals are taking longer to execute as companies continue to “fence sit” and hope for a more favorable interest rate environment that may result from any near-term cuts by the Federal Reserve. At Callodine, we don't believe that hope is a reliable strategy and believe that inaction from corporate CFOs and Treasurers will result in significant opportunity for solutions-oriented credit providers. We look forward to keeping you apprised of our activity in the second half of the year and remain available for one-on-one conversations about the market.

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