

CALLODINE | CREDIT

Asset Based Lending

Quarterly Market Commentary: Q1 2025

Gene Martin
President &
CEO

Tyler Bak
Head of Business
Development

Steve Rainville
COO &
CFO

Nicole Solomon
VP of Business
Development

Market Commentary

We hope this letter finds our readers well. Market tone in Q1 2025 has stood in stark contrast to what were near-euphoric levels in Q4 2024. The first few months of this year have seen a return of market volatility and uncertainty not experienced since the onset of the COVID-19 pandemic in the first quarter of 2020. Concerns about the broader economy and around trade policy pushed markets lower. In addition to the sharp downdraft in equity markets in Q1, the undercurrent of stress in the credit markets caused spreads to widen dramatically resulting in reduced access to capital for many non-investment-grade companies both large and small.¹

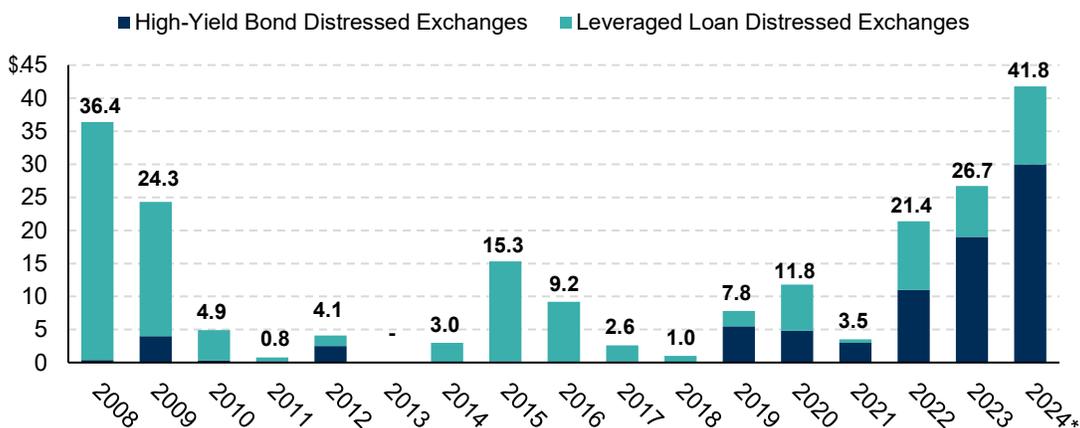
In addition to the above-noted market gyrations, the U.S. economy contracted at an annualized rate of 0.3% in the first quarter of 2025, marking the first negative GDP reading since 2022.² A surge in imports, driven by businesses getting ahead of impending tariffs, was a key contributor to this decline, weighing heavily on Q1 GDP and raising concerns that the economy may be closer to a recession than previously anticipated.²

Contrary to expectations of most in the market coming into 2025, the first quarter of 2025 did not see a rebound in dealmaking. Instead, activity has been squelched by growing concerns over tariffs, regulatory uncertainty, and heightened interest rate volatility.³ While M&A activity has yet to return to anticipated levels, deal volume could pick up in the second half of 2025 and into 2026 if we see some clarity/stability with respect to trade policy and the direction of interest rates.

Despite the elevated level of stress in the market, the percentage of companies that have defaulted or participated in distressed-debt exchanges remains relatively low—around 2% to 3% of all companies, according to Fitch Ratings (September 2024). However, J.P. Morgan has highlighted that, due to the rapid expansion of debt markets over the past decade, the dollar volume of distressed exchanges has reached record levels, as shown in the chart below.⁴

Distressed-Debt Exchange Volume (USD Billions)

FY 2008 - Q3 2024



Source: J.P. Morgan Investment Bank. Data as of September 30, 2024.

¹ Source: Reuters: [US Credit Spreads Continue To Widen, No New Bonds Announced \(April 7, 2025\)](#).

² Source: CNBC: [U.S. Economy Shrank 0.3% In The First Quarter As Trump Policy Uncertainty Weighed On Businesses \(April 30, 2025\)](#).

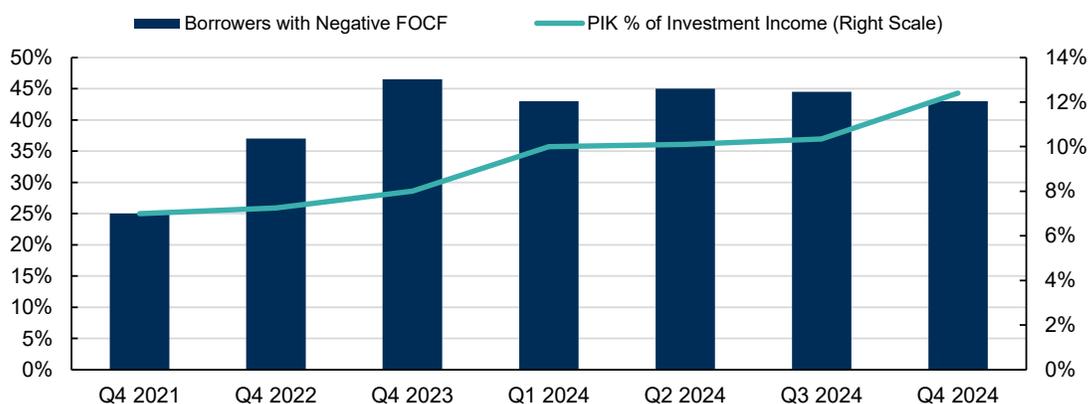
³ Source: Pitchbook LCD Q1 2025 US Private Credit and Middle Market Quarterly Wrap.

⁴ Source: J.P. Morgan Private Bank: [Alternative Investments In 2025: Our Top Five Themes To Watch](#).

While the current environment may present challenges for companies with larger debt loads and limited access to capital, it also has created opportunities for specialized private credit firms like Callodine. As we have seen before, market volatility forces many companies to seek alternative capital providers (e.g. asset-based lending) to fulfill their financing needs. The current market environment is one of the best we have seen since the immediate aftermath of the COVID-19 pandemic. The key drivers are as follows:

1. **Broader Market Conditions Remain Challenged.** We expect some of the prevailing market conditions to persist throughout 2025, driven by ongoing volatility and elevated costs of capital. According to S&P Global, 188 large U.S. companies filed for bankruptcy in Q1 alone, marking the highest quarterly number in 15 years. Companies with weaker balance sheets are especially vulnerable as they face refinancing in a significantly more unfavorable interest rate environment, alongside growing macroeconomic headwinds compared to when they previously issued.
2. **Consumers are Also Feeling the Strain.** LegalShield data reveals that personal bankruptcy inquiries in Q1 surged to their highest level since early 2020. Record debt levels, rising delinquencies, persistent financial stress, and inflationary pressures linked to tariff uncertainty suggest a significant risk of a surge in bankruptcy filings this summer.⁵
3. **Continued Pressure on Free Cash Flow Generation.** Against this backdrop, concerns around earnings pressures and cash flow challenges are rising, particularly in certain industries or among borrowers facing specific risks. Notably, even before the tariff impacts, nearly half of direct lending borrowers were operating with negative free cash flow, extending their reliance on payment-in-kind (PIK) structures and amend-and-extend restructurings (see chart below).⁶

Share of Direct Lending Borrowers with Negative Free Operating Cash Flows and Share of PIK Income in Select Traded BDC's



Sources: Bloomberg Finance L.P.; S&P Global Ratings; and IMF Staff Calculations.

⁵ Source: [Q1 Bankruptcy Inquiries Reaching Pandemic Levels Is 'Warning Sign' Amid Tariff Concerns: LegalShield](#).

⁶ Source: IMF Global Financial Stability Report, April 2025: Enhancing Resilience amid Uncertainty.

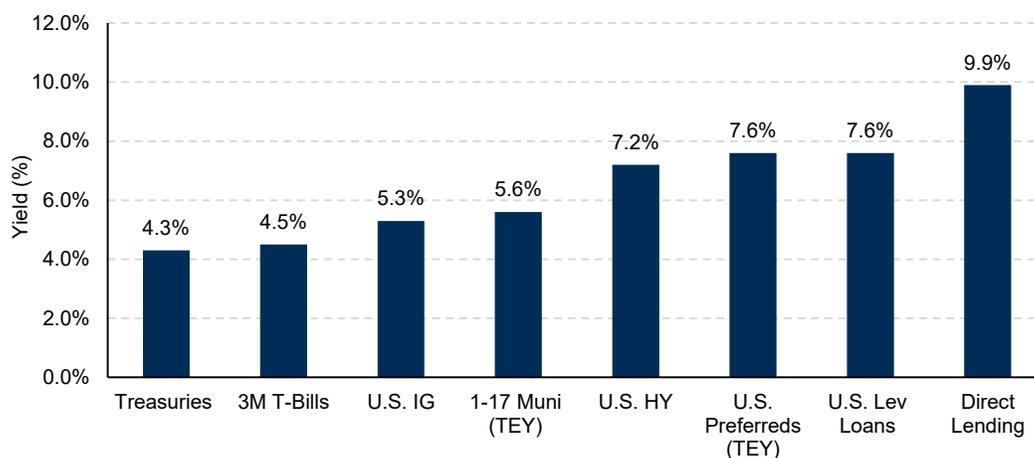
Furthermore, private equity firms have increasingly turned to PIK notes to help portfolio companies manage rising borrowing costs, which have weighed on valuations and increased future debt burdens.³ These instruments allow interest payments to be deferred, providing short-term cash flow relief as interest payments instead accrue to a higher principal balance.

Yet within this challenging environment lies opportunity. We believe the current market volatility will push companies facing financial obligations they can't meet through traditional syndicated markets to seek alternative solutions—an opportunity where specialized private lenders can step in and provide flexible capital solutions.

Looking ahead, despite some yield compression over the past year, spreads came off their multi-year lows and began to increase offering compelling yields, especially when compared to more liquid credit and high yield alternatives (see chart below).

Compelling Yield Opportunities in Direct Lending

Yield Comparison by Security Type (%)



Source: Bloomberg Finance L.P., data as of November 8, 2024, Callodine Research Team

Asset-based lending focuses on structuring deals with both strong asset coverage and yields, ultimately targeting consistent and financially sound loans.

We anticipate a meaningful pickup in origination activity over the next six to twelve months, as we believe higher quality borrowers across a range of industries and company sizes will increasingly turn to private credit for tailored financing solutions. In an increasingly uncertain macroeconomic climate, maintaining underwriting discipline will be critical for lenders to preserve credit protections and manage risk.

³ Source: Pitchbook LCD Q1 2025 US Private Credit and Middle Market Quarterly Wrap.

Disclosure

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by Callodine Commercial Finance, LLC (“Callodine”), an affiliate of Callodine Credit Management, LLC, to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information’s accuracy or completeness, nor should the attached information serve as the basis of any investment decision.

Past performance is not a guarantee of future results.

The views expressed reflect the current views as of the date hereof and neither the author nor Callodine undertakes to advise you of any changes in the views expressed herein. It should not be assumed that the author or Callodine will make investment recommendations in the future that are consistent with the views expressed herein, or use any or all of the techniques or methods of analysis described herein in managing client accounts.

This analysis is for illustrative purposes only. This material is intended for informational purposes only and should not be construed as legal or tax advice, nor is it intended to replace the advice of a qualified attorney or tax advisor. The recipient should conduct his or her own analysis and consult with professional advisors prior to making any investment decisions.

All projections contained herein represent our current beliefs and should not be construed as recommendations or a guarantee of future results.