Q2 2022 Leveraged Finance Market Overview

August, 2022

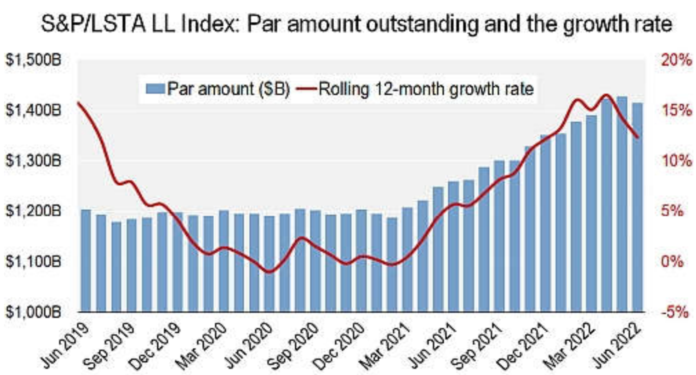
Q2 2022

Negative macroeconomic and geopolitical factors continued in Q2 2022, affecting the entirety of the leveraged loan market from issuance volume to pricing and demand. Rising interest rates, persistent inflation, geopolitical events, supply chain shortages, a bear market, and looming recession fears remain the main areas of concern affecting the health and sentiment of the leveraged loan market and the greater market at large.

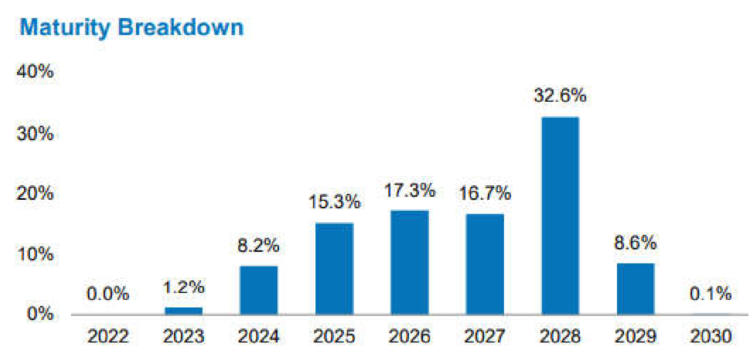
LOAN ISSUANCE SLOWS

The par value of leveraged loans outstanding declined by $1.41 billion, marking the end of a 16-month growth streak. Of note, record low interest rates and strong levels of balance sheet cash in 2021 created favorable credit conditions. As a result, the asset class in 2021 experienced a growth spurt, bringing in $464.5 billion in issuance. Since February, increasing rates and market instability has resulted in a decline of new issuance volume below the normal repayment cycle.

Q2 2022 institutional issuance totaled $56 billion, the lowest output since the onset of the COVID-19 pandemic in Q2 2020. Issuance in the first half of 2022 totaled about half of 2021's record breaking volume, yet still ahead of that of 2020. Nevertheless, record levels of bond issuance in 2020 and 2021 allowed companies to push out maturity walls – the point where debts are to be repaid or re-financed. As a result, maturing debt is set to peak in 2028. This indicates significant macro-level refinancing flexibility.

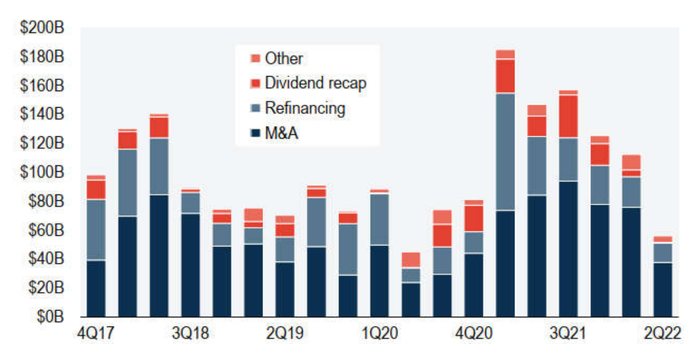


Data through June 30, 2022.
Sources: Leveraged Commentary & Data (LCD); S&P/LSTA Leveraged Loan Index



In line with previous quarters, M&A transactions represented the bulk of new issuance, accounting for 71% of total. The $36.6 billion issued for M&A transactions in 2Q 2022 is just above pandemic lows but only about half of Q1 M&A volume. Corporate and PE backed deals experienced 57% and 39% quarter-over-quarter drops, respectively. Refinancing dropped significantly as rates continued to rise and spreads widened.

Chart 4: US institutional loan volume



Data through June 30, 2022.
Source: Leveraged Commentary & Data (LCD)

RETURNS CONTRACT ACROSS ALL ASSET CLASSES

The leveraged loan asset class lost 2.16% in June, bringing the quarterly total to -4.55%. Despite this sizable loss, leveraged loans outperformed all other asset classes on a YTD and LTM basis by at least 6.79% and 7.85%, respectively. Leveraged loans are historically known for performing well in times economic uncertainty.

Data through June 30, 2022.
Sources: Leveraged Commentary & Data (LCD); S&P/LSTA Leveraged Loan Index

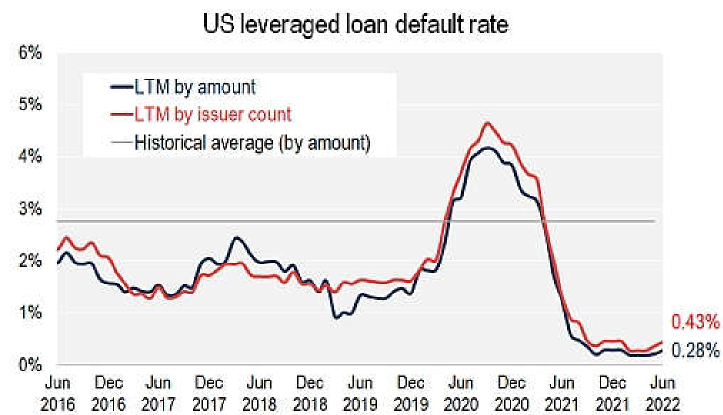
Returns by asset class

	Jun 2022	May 2022	2Q	YTD	LTM
S&P/LSTA Index	-2.16%	-2.56%	-4.45%	-4.55%	-2.78%
BAML HY Master (H0A0)	-6.81%	0.27%	-9.97%	-14.04%	-12.66%
10-year Treasury (GA10)	-0.86%	0.55%	-4.92%	-11.34%	-10.94%
S&P 500, including dividends (SPX)	-8.25%	0.18%	-16.10%	-19.96%	-10.62%
BAML High-Grade Corp (C0A0)	-2.35%	0.55%	-6.71%	-13.93%	-13.83%

Data through June 30, 2022.
Sources: Leveraged Commentary & Data (LCD); Bank of America Merrill Lynch

DEFAULT RATE REMAINS LOW

Issuer defaults increased slightly in Q2, mainly driven by the default of Revlon in June. The 12-month default rate increased from 0.19% to 0.28% in Q2, still near its 10-year low notwithstanding sharp macro volatility. As a lagging indicator, inflation and interest rate increases are likely to have some impact on the rate of issuer default. However, a market unsettled by geopolitical risk is relatively uncorrelated with distress or at heightened risk of default. Based on an LCD survey, the default rate is anticipated to increase to the 1.00%-1.50% within the next year. By historical standards, this is still a modest rate of default.

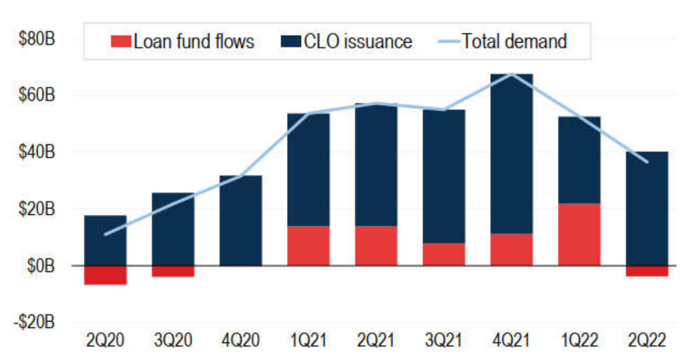


Data through June 30, 2022.
Sources: Leveraged Commentary & Data (LCD); S&P/LSTA Leveraged Loan Index

CLO ISSUANCE CARRIES LOAN DEMAND

Retail flows plunged in the quarter amid recession concerns, with outflows from loan mutual funds and ETF's totaling $5.55 billion. However, CLO issuance in the quarter totaled $40.2 billion, a 47% increase when compared to Q1 2022 but 16% below the FY 2021 quarterly average of $47 billion and 7% below the Q2 2021 quarterly total.

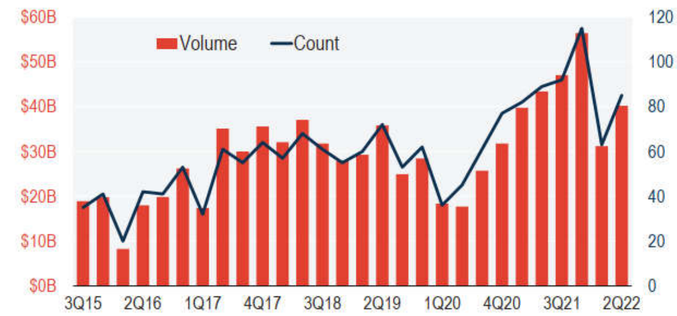
Chart 2: US leveraged loan market – measurable investor demand



Data through June 30, 2022.
Fund flows data includes monthly reporters.
Sources: Leveraged Commentary & Data (LCD); Lipper

Despite higher than anticipated issuance relative to Q1, Deutsche Bank and Barclays revised their original FY2022 forecasts downward to ~$90-$135 billion from ~$110-$150 billion, respectively as market conditions worsen. CLO's remain the largest investor in leveraged loans.

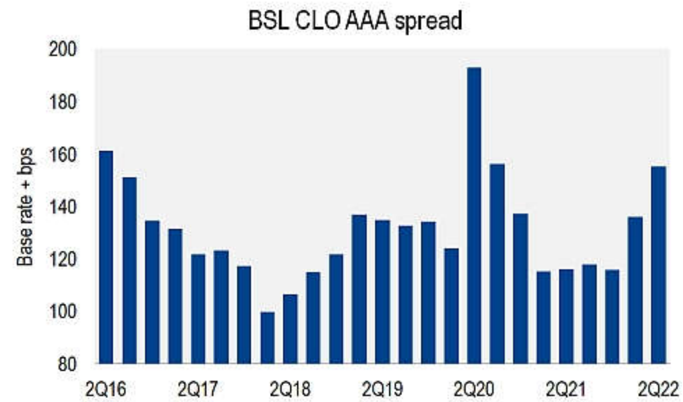
CLO issuance increases despite obstacles...



Data through June 30, 2022.
Source: Leveraged Commentary & Data (LCD)

AAA SPREADS ON THE RISE

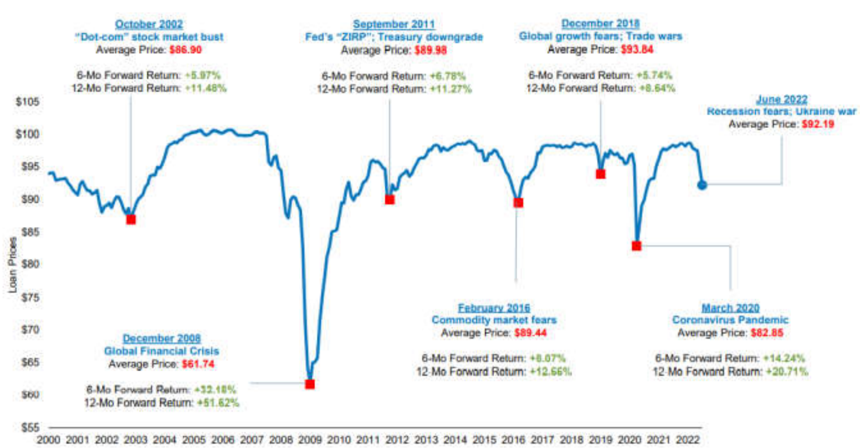
AAA spreads are on an upward trend to compensate for the evolving quality of underlying portfolios and turbulent market conditions. Average AAA spreads increased from 136 bps in Q1 to 155 bps in Q2. Above average volume of "print-and-sprint" deals took place during June. These issuances are characterized by short dated or static reinvestment terms, with proceeds targeted for purchasing discounted loans in the secondary. The asset class remains attractive due its tranched structures and portfolio diversification of senior secured loans. Investors have historically been attracted the floating rate aspect of CLO's and their resilience in economic downturns. Looking forward; measurable investor demand is likely to keep issuance afloat.

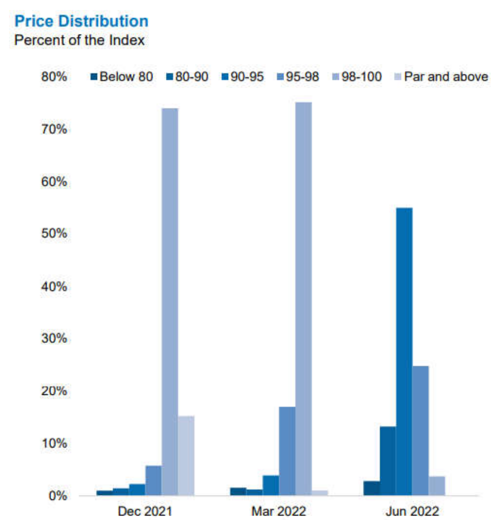


Data through June 21, 2022.
Source: Leveraged Commentary & Data (LCD)

SECONDARY MARKET PLUNGE

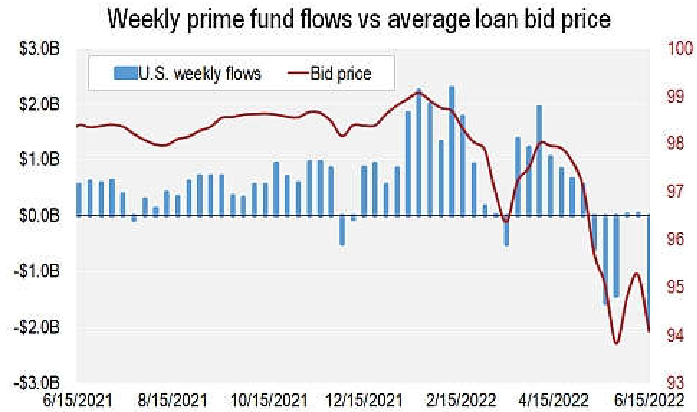
Broad selloffs in other risk markets driven by volatile market conditions, rising rates, and stagflation concerns pushed the weighted average secondary loan bid to 92.19 by quarter end; far below January's peak of 99.08 and the quarter's high in April of 97.48. All-in spreads increased to SOFR +627, the highest in 10 years.





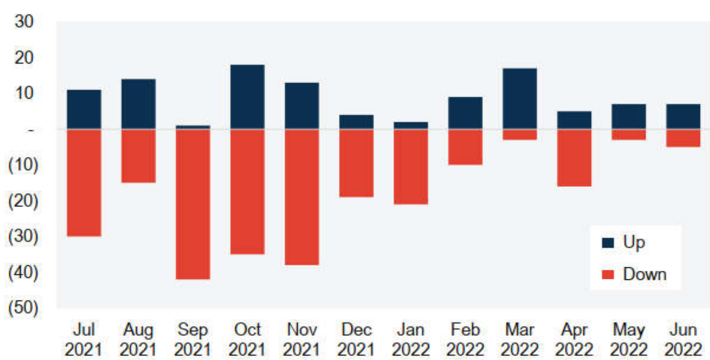
PRICING FLEXES UP AS SPREADS WIDEN

Price flex in Q2 followed suit as many deals were either forced to the sidelines or completed at large discounts. Investors are demanding higher new issue pricing to correlate with the secondary market decline. For a moment in April, downward price flexes outpaced upward flex by a ratio of 3.2:1. The situation promptly flipped with the selloff that occurred in May. Flexes shifted in favor of investors 7:3 upward to downward and June ended with a ratio of 7:5.

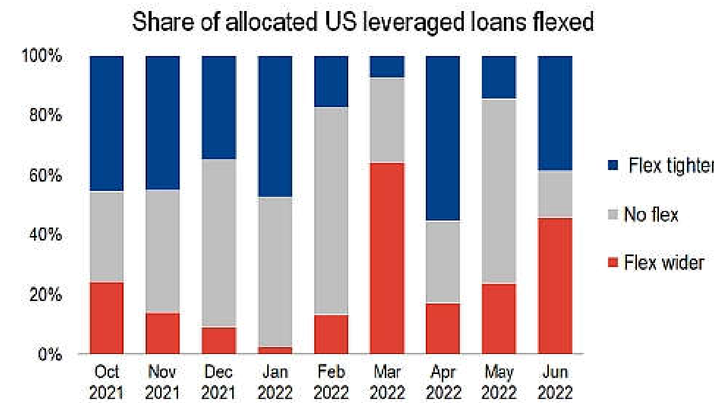


Data through June 15, 2022.
Sources: Leveraged Commentary & Data (LCD); Lipper FMI

Chart 5: Count of upward to downward flexes



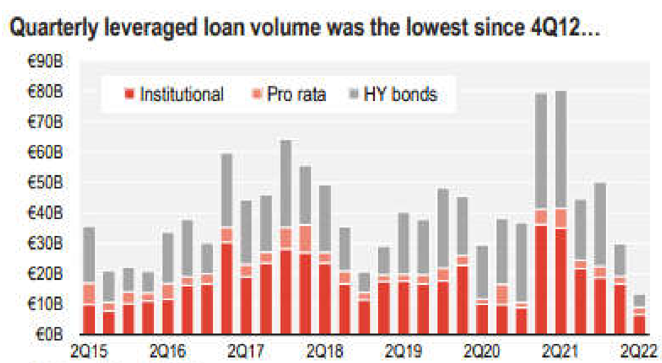
Data through June 30, 2022.
Source: Leveraged Commentary & Data (LCD)



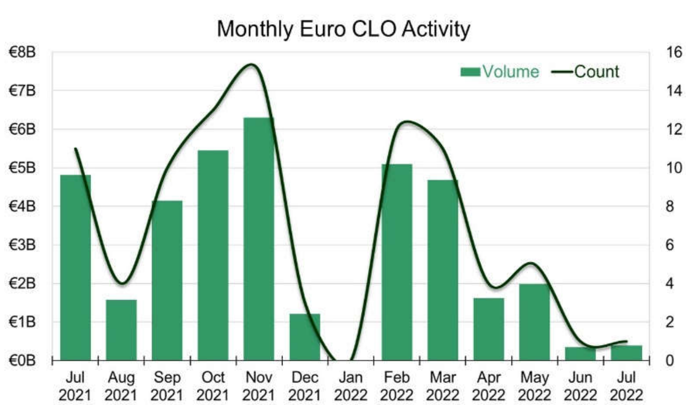
Data through June 30, 2022.
Source: Leveraged Commentary & Data (LCD)

EUROPE DIPS

Supply and demand for European leveraged loans dipped in the first half of 2022. Institutional loan issuance reached just €28.1 billion, compared to €71.2 billion in the same 2021 period. Q2 issuance volume reached just €9 billion, compared to €19.1 billion in Q1 and €41.5 billion in the same period last year.



Data through June 30, 2022.
Source: Leveraged Commentary & Data (LCD)

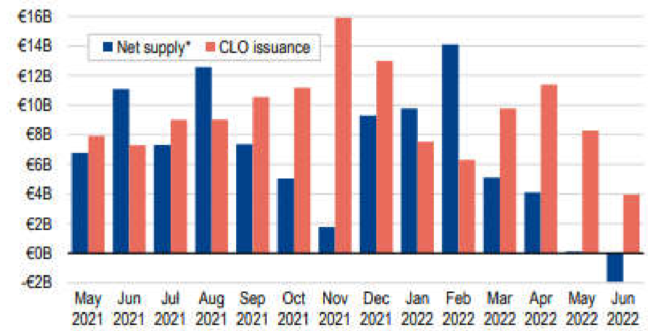


Source: Leveraged Commentary & Data (LCD)

FY 2022 CLO issuance forecasts for the European market were also revised down to €80 billion from €100 billion as institutional loan issuance plummeted. Q2 2022 European CLO issuance totaled €13.7 billion from 33 deals compared to €14.7 billion from 37 deals for the same period in 2021. June marked the first time since mid-February that YTD issuance CLO volume fell behind that of last year. Of note, sources state there are CLO deals to be done but investors are willing to wait

In line with the US market, loan market conditions deteriorated further in Q2 2022. The S&P European Leveraged Loan Index (ELLI) decreased to 89.3 in Q2 from 97.3 in Q1. Notwithstanding this significant secondary market drop, new issue yield has held up well, widening by only about 25 bps from E+475bps in Q1 2022 to ~E+500bps in Q2 2022.

Chart 12: Institutional market net supply vs. CLO issuance (rolling 3M)



*New issues tracked by the Index minus repayments Data through June 30, 2022.

Sources: Leveraged Commentary & Data (LCD); S&P European Leveraged Loan Index.

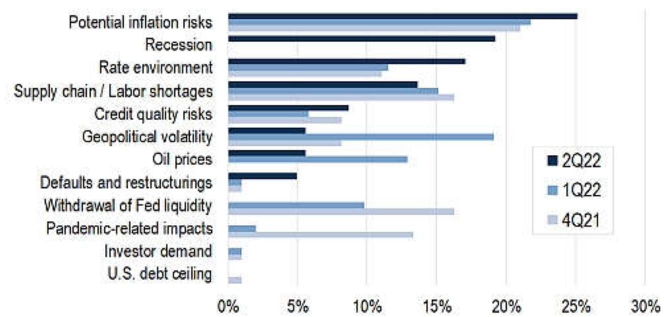
LOOKING FORWARD

Previous surveys conducted by LCD pointed to a majority of respondents anticipating a market correction near the end of 2022 or in early to mid-2023. Inflation, recession and the interest rate environment lead the list of concerns while market observers generally expect the 12-month rolling default rate to remain low. Concerns regarding the pandemic related and investor demand have fallen off in 2022.

For the near term, ARC expects active issuance but at muted levels compared to the past two years given the shift in market conditions.

ARC expects default rates, which are currently very low, to remain at favorable levels through 2022 and well into 2023. While ARC expects default rates to increase somewhat in the second half of 2023, ARC expects the current historically favorable default environment to continue. Chris Holman, managing partner at TwentyFour asset management states in a research note: "It is evident that corporates appear to have done the heavy lifting over the past couple of years, strengthening their balance sheets, extending their maturity profiles and building up their liquidity…with limited refinancing risk currently in the market, we think this will continue to be a supportive facet to why default rates should remain below the historical average." ARC very much agrees with this assessment.

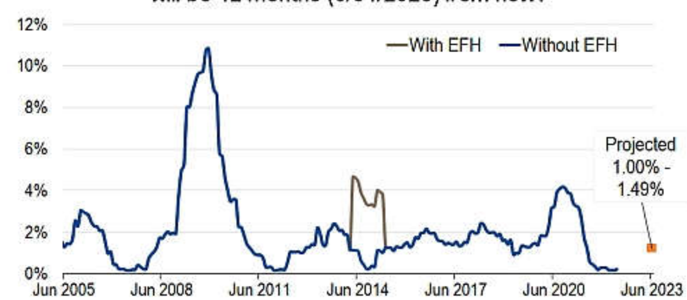
Which of the following will most likely impact the performance of credit portfolios in the next six months?



Data as of June 27, 2022.

Source: Leveraged Commentary & Data (LCD)

What do you think the US loan default rate will be 12 months (6/31/2023) from now?



Data as of June 27, 2022.

Chart shows historical and projected default rates. EFH = Energy Futures Holdings.

Sources: Leveraged Commentary & Data (LCD); S&P/LSTA Leveraged Loan Index

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