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LOAN & CLO REVIEW

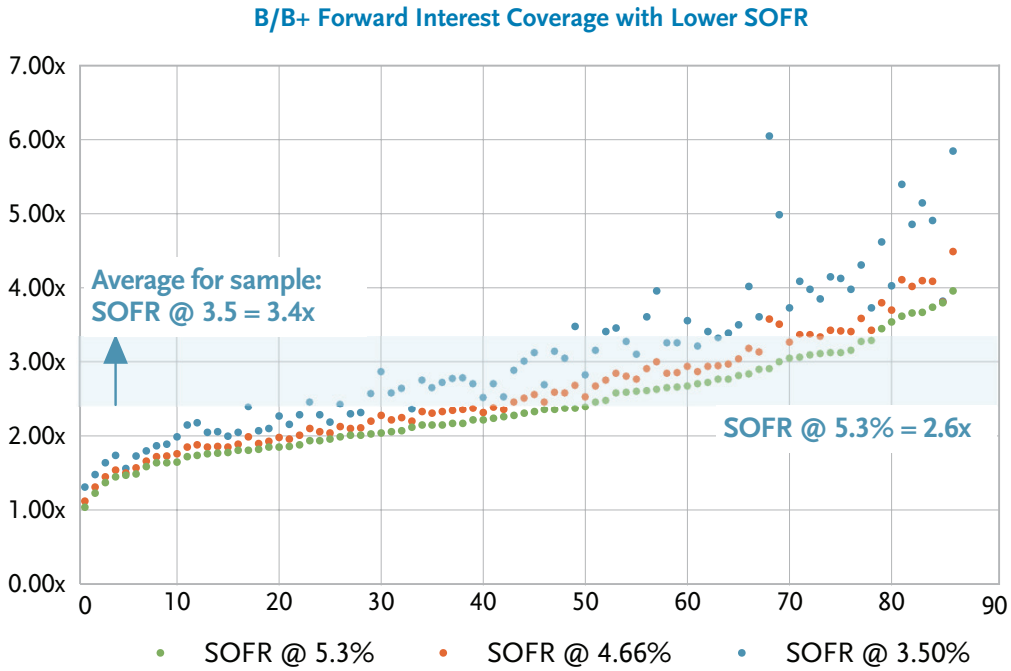
A Hint of Lower Rates Brings LBO Green Shoots

DREW SWEENEY & PALAK S. PATHAK, CFA | 17 OCTOBER 2024

Record leveraged loan issuance (nearly \$1 tn year to date) has masked a relatively uneventful year-to-date period for the leveraged loan market. On a price basis, market value returns are not far from flat compared to the beginning of the year with interest income constituting the vast majority of leveraged loan returns. The number of loans trading above par remained close to historical records in September and encouraged borrowers/arrangers to tap the market to slash borrowing costs. This tally has grown to almost \$500 bn (~50% of leveraged loan issuance year to date), which reduced Morningstar LSTA US Leveraged Loan Index spread by more than 10 basis points (bps) and dramatically increased spread duration in the loan market. While the magnitude of repricing has historically preceded periods of volatility, the potential technical pressure fails to capture the fundamental benefit from lower spreads and the secured overnight financing rates (SOFR). During the third quarter 1-month SOFR (the base rate used by more than two-thirds of borrowers) declined by -49 bps as market participants priced several interest rate cuts into the forward curve and the FOMC delivered its first interest rate cut since 2020. The move in the base rate together with repricing transactions can shave tens of millions of dollars from the cash interest expense of leveraged loan borrowers. Notably, most borrowers have already experienced or will experience a pronounced improvement in debt service coverage which is a key input into corporate family and facility ratings. In addition to reducing interest burdens for borrowers, more certainty over the forward path of rates helped to thaw the freeze in new deal activity during the third quarter. Lower financing costs, modest compression of enterprise value (EV) multiples (bid/ask), and private equity capital return requirements all contributed to the highest net new issuance (leveraged buyout (LBO), mergers and acquisitions (M&A), dividend and general corporate purposes, (GCP)) in the past 2.5 years during the third quarter.

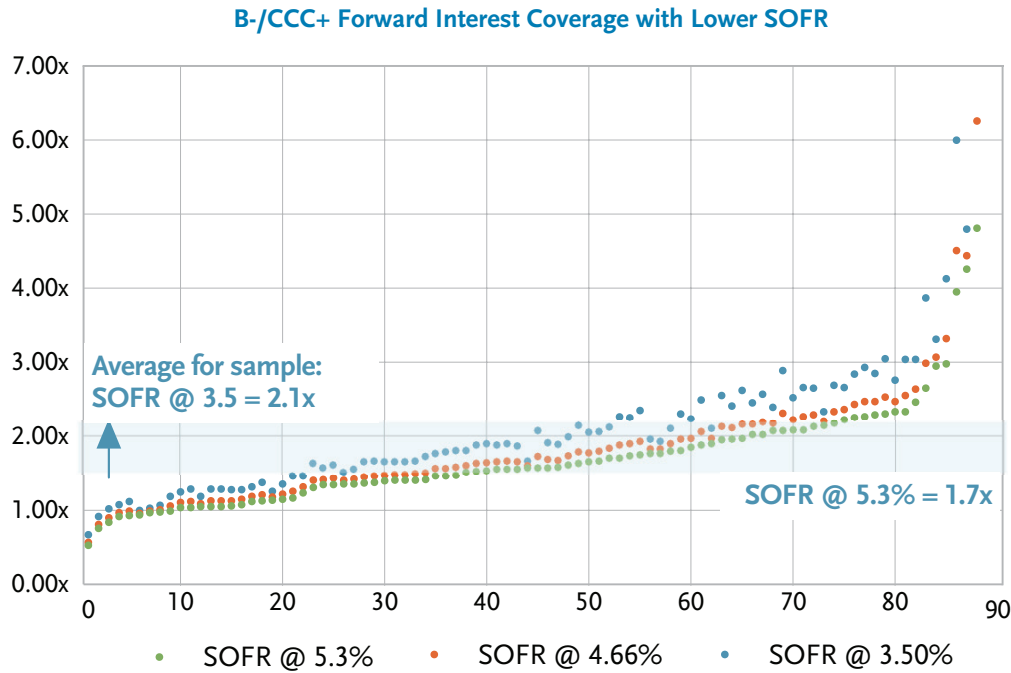
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The chart below illustrates the impact of lower SOFR rates on interest expense coverage for single B loans.



Source: TCW Loan Database, Bloomberg

The chart below highlights the impact of lower SOFR rates on interest expense coverage for split-rated single B/triple C loans.



Source: TCW Loan Database, Bloomberg

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The data for the two charts is from a sample size of over 250 loans and from TCW's proprietary database. We have two observations for you: 1. Companies with lower interest coverage ratios (ICR) tend to have higher spreads (for example SOFR+450 bps) versus companies with higher ICR have lower spreads (SOFR+200 bps). 2. Companies with higher EBITDA in comparison to interest (or companies with higher ICR) will have bigger absolute improvements in ICR based on lower rates.

The results are interesting but confound the importance of the change in ICR. Going from 3.0x to 4.0x interest coverage is far less impactful to a company's financial health/potential ratings trajectory than going from 1.0x to 1.5x.

Strong risk appetite and still-supportive equity arbitrage translated into ongoing CLO issuance during the third quarter. Stabilization of liabilities and a continuation of the repricing wave in leveraged loans resulted in renewed manager focus on resetting existing deals that had moved outside of reinvestment period. Many of these deals had already started to amortize, which rapidly deteriorates Internal Rates of Return (IRR) and encourages equity to call. Improvement in reset deal economics during the first half of the year has allowed managers to begin tackling the significant percentage of deals that had moved outside of reinvestment period. The higher reset volume provides additional benefits to the loan market given the restrictions on participating in Amend & Extend (A&E) leveraged loan transactions once out of reinvestment period. As deals are reset, it broadens the available buyer base for loans that need to be extended, which helps to facilitate more challenging refinancing transactions.

Despite record primary issuance and strong risk appetite, pockets of stress remain throughout the loan market. Liability management exercise (LME)/distressed exchanges continue to dominate restructuring activity but, in most cases, fail to adequately reduce debt and recapitalize the business following emergence. In the third quarter, Wheel Pros experienced one of the fastest bankruptcy filings following a distressed exchange (~12 months) and will likely not be the only example. These "zombie companies" with unsustainable capital structures and still-weak fundamental performance will inevitably lead to higher residual stress in the loan market absent a material reduction in base rates. Lower rates could either extend these "zombie lives" or help some avoid a Chapter 11 filing. This residual stress continues to weigh on CLO returns with the default rate (including distressed exchanges) well in excess of historical averages required to meet equity IRRs in the 12-15% range. It is easy for investors to underestimate the default rates as the traditional last 12-months (LTM) default rate is 1.28% as compared to the default rate with distressed exchanges of approximately 4 to 5%, depending on the source. Year to date, managers have had limited opportunity (i.e., episodic volatility) to improve the health of deals with performing, discounted names. In fact, given the compression of lower quality borrower prices to higher quality borrowers, we would think par building could include taking increased risk and will be very credit dependent. Higher risk single Bs and bond baskets have been more frequently utilized to support weighted average spreads and rebuild damaged overcollateralization cushions.

Performance – Loans

In the third quarter, the Credit Suisse Leveraged Loan Index (CS LLI) and the Morningstar LSTA US Leveraged Loan Index (LSTA LLI) posted returns that were +2.08% and +2.04%, respectively, accelerating from last quarter's returns of +1.86% and +1.90% and building on strong gains throughout the year.

In the third quarter, the Morningstar LSTA US Leveraged Loan 100 Index (L100), which includes the largest, most liquid borrowers, performed +1.89%, which is below the broader LSTA LLI. Managers used larger, liquid capital structures, trading at or near par, to fund the growing new issue calendar, which weighed on prices throughout the quarter. Retail fund flows, particularly ETFs, moderated slightly in the third quarter as several rate cuts were priced into the forward curve and retail investors became more cautious on floating rate product. Lower quality (Split B and CCC) generally outperformed during the quarter showing continued manager appetite for performing, discounted names although this cohort remains highly bifurcated depending on LME risk, credit agreement quality, and lender groups. This is evident in CCC's return composition during the quarter, which showed market value declines offset by strong interest income. The vast majority of the split B and CCC loans without imminent risk of a transaction (i.e., bankruptcy, liquidity, distressed exchange) remained well bid into the third quarter (i.e., performing CCCs traded in the 96-97 context). LME's have dominated headlines and continue to be a source of material value leakage for lenders excluded from groups. However, outside of idiosyncratic refinancings with larger anchor orders, the market has thus far failed to show coordinated pushback when it comes to negotiating key terms of credit agreements for new issue. Against this backdrop, alternative sources of financing (private credit, hedge funds, etc.) have rushed to bridge gaps left by creditor-on-creditor violence. Private credit has reemerged as one of the go-to refinancing sources for highly levered, CCC loans that would otherwise require significant equity checks from sponsors to

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complete refinancings in the broadly syndicated loan (BSL) market. This dynamic has underpinned strong demand for short dated, performing CCCs with some trading as high as 98-99 in anticipation of potential refinancing transactions. Even with the private credit stress relief valve, it has become increasingly common for borrowers to delay refinancing for as long as possible to achieve more opportunistic pricing or rates. The aforementioned factors explain instances of higher earnings/news related volatility that have appeared in an otherwise well-bid market. Third quarter earnings together with any election-related volatility will test the market appetite for higher risk credits and inevitably increase dispersion by industry, rating, and other factors. The highest and lowest quality cohort (Split BBB and Distressed) significantly underperformed other ratings cohorts over the LTM period with returns of +8.22% and -11.25%, respectively. Notably, the distressed category's LTM returns improved significantly compared to prior quarters as opportunistic buyers consolidated exposure and more lender friendly exchanges received continued support following transactions.

Total Return by Rating

By Rating	Q3 2024	Q2 2024	LTM
CS LLI Returns	2.08%	6.61%	9.65%
Split BBB	1.78%	5.65%	8.22%
BB	1.91%	5.88%	8.74%
Split BB	1.96%	6.17%	9.32%
B	2.03%	6.82%	10.08%
Split B	2.74%	4.66%	6.77%
CCC/Split CCC	2.61%	11.59%	14.19%
Distressed (CC, C and Default)	2.18%	-13.17%	-11.25%

Source: Credit Suisse Leveraged Loan Index

Sector Performance

Fundamental variability accelerated during the third quarter, adding to growing dispersion in the second quarter and closely following a year (2023) of more homogenous returns across sectors. The dispersion between the worst performing and best performing sectors expanded to +368 bps for the second quarter (compared to +225 bps in the second quarter). In Q2 of 2024, the top performing sectors were media/telecom (+439 bps), utility (+232 bps), and service (+222 bps) while the worst performing sectors were transportation (+29 bps), food/tobacco (+72 bps), and aerospace (+123 bps). For the LTM period, utility, healthcare, and food and drug led all sectors with total returns of +10.99%, +10.96%, and +10.94%, respectively, while transportation, food/tobacco, and information technology were the worst performing sectors with returns of +7.67%, +7.7%, and +8.43%, respectively. Telecommunications has been topical throughout the year given idiosyncratic stress in large capital structures followed by sector-wide strength in the third quarter given elevated M&A multiples paid by major providers. Utilities has also been topical as there has been a clear and developing thesis surrounding the need for power. This has been driven by fleet electrification, data center power needs and an aging infrastructure. It has been further reinforced by the recent Pennsylvania-New Jersey-Maryland (PJM) rate auction. Variability in fundamental performance across sectors appears set to continue as inflation moderates unevenly, consumers curb discretionary spending, and destocking pressures persist.

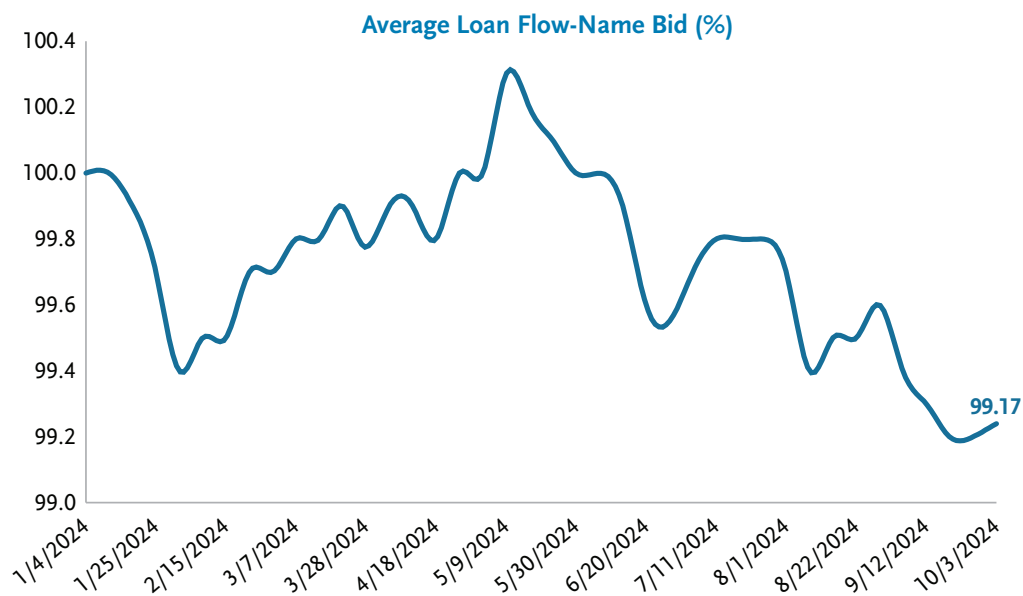
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Industry Returns

Sector	Q3 2024	Q2 2024	LTM
AEROSPACE	1.23%	6.02%	9.19%
CHEMICALS	2.08%	8.12%	10.68%
CONSUMER DURABLES	2.21%	7.59%	9.87%
CONSUMER NON-DURABLES	1.90%	7.11%	10.61%
ENERGY	2.04%	7.57%	10.29%
FINANCIAL	2.02%	6.65%	10.14%
FOOD AND DRUG	2.20%	8.23%	10.94%
FOOD/TOBACCO	0.72%	4.86%	7.70%
FOREST PROD/CONTAINERS	1.80%	6.93%	10.65%
GAMING/LEISURE	2.04%	7.38%	10.33%
HEALTHCARE	2.06%	7.90%	10.96%
HOUSING	1.77%	6.23%	9.54%
INFORMATION TECHNOLOGY	1.70%	5.49%	8.43%
MANUFACTURING	2.06%	7.07%	9.96%
MEDIA/TELECOMMUNICATIONS	4.39%	6.45%	9.74%
METALS/MINERALS	1.66%	5.79%	8.76%
RETAIL	1.73%	7.72%	10.13%
SERVICE	2.22%	6.22%	9.28%
TRANSPORTATION	0.29%	5.03%	7.67%
UTILITY	2.32%	7.93%	10.99%

Source: Credit Suisse Leveraged Loan Index

The average bid of the S&P LCD (Leveraged Commentary & Data) flow-name composite was down -38 bps from 99.55 on June 30 to 99.17 on September 30. The technical backdrop of CLO ramping activity and redeployment of repayments continued to provide support for loan prices during the quarter. However, managers funded the rapidly growing new issue calendar with weaker relative value loans at or above par, which weighed on the larger, liquid names in the index. The new supply was welcomed by investors following the first half of the year which was dominated by repricing/refinancing and resulted in significant supply/demand imbalances. The prospect of lower interest rates, moderating enterprise value (EV) multiples, and private equity return-of-capital requirements all contributed to a loosening in capital markets conditions. This has continued and accelerated into the fourth quarter which will likely put additional pressure on the largest liquid names in the index as manager cash balances move into deeply negative territory.



Source: PitchBook | LCD

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Performance – CLOs

Despite a short blip in early August, CLO performance remained steady in the third quarter. CLOs returned +1.78% over the quarter, down from +3.35% in Q2 and +3.66% in Q1. YTD, CLOs are returning +6.36%, outperforming investment grade (IG) credit (+5.23%) and underperforming high yield (HY) credit (+8%), and loans (+6.54%).

Secondary CLO 2.0 Total Returns

	September 2024	YTD
CLO Total	0.68%	6.36%
AAA	0.59%	5.39%
AA	0.65%	6.38%
A	0.69%	7.28%
BBB	0.97%	9.03%
BB	1.55%	14.24%
B	2.05%	26.55%
IG Credit	1.71%	5.23%
HY Credit	1.62%	8.00%
Leveraged Loans	0.71%	6.54%

Source: JP Morgan CLOIE Index, Bloomberg, Morningstar

Secondary CLO spreads tightened across the stack with the exception of AAAs which widened slightly by 2-5 bps as accounts sold AAAs to rotate into wider-spread new issue. Additionally, as refi and reset volume picked up over the quarter, the premium on secondary AAA bonds became less attractive as more and more bonds were pricing to a negative discount margin (DM)-to-worst scenario. As a result, AAA spreads widened a few bps over the quarter with dollar prices softening 5-10 cents. The rest of the stack held in well with BBBs and BBs tightening over 25 bps as the bid for risk improved. With the Fed kickstarting its rate cutting cycle with a 50 bp cut in September, lower rated loans rallied, improving BB and BBB market value overcollateralizations (MVOCs) and giving investors more comfort on portfolio tail risk exposures.

CLO equity continued to perform well as net asset values (NAVs) remained stable and quarterly equity payments, although squeezed slightly lower by loan spread compression, were a robust 4%, or 16% annualized. Reset activity also helped equity returns with par flush payments distributed for 2022 deals that built par as loans sold off in 2022/2023 and then rebounded in 2024.

Trading activity also remained stable with \$10.2 bn in bids wanted in competition (BWIC) volume versus \$10.6 bn in the second quarter. Overall trading per TRACE decreased to \$40 bn versus \$50 bn last quarter. Trading was dominated by IG with customers net buying \$2.2 bn. Notably, CLO IG trading totaled \$4 bn during the first week of August volatility as investors sold AAAs to raise cash and/or meet outflows. During that period, CLO ETFs saw their first outflow of \$250 mm (2% of total CLO ETF AUM) but then quickly turned back around to garner a stunning \$3+ bn in inflows over the quarter.

Secondary CLO 2.0 Spreads

	September 2024	QoQ Change (bps)
AAA	105-135	2
AA	155-185	-2
A	180-225	-5
BBB	275-375	-10
BB	525-725	-25
B	800+	-25

Source: TCW

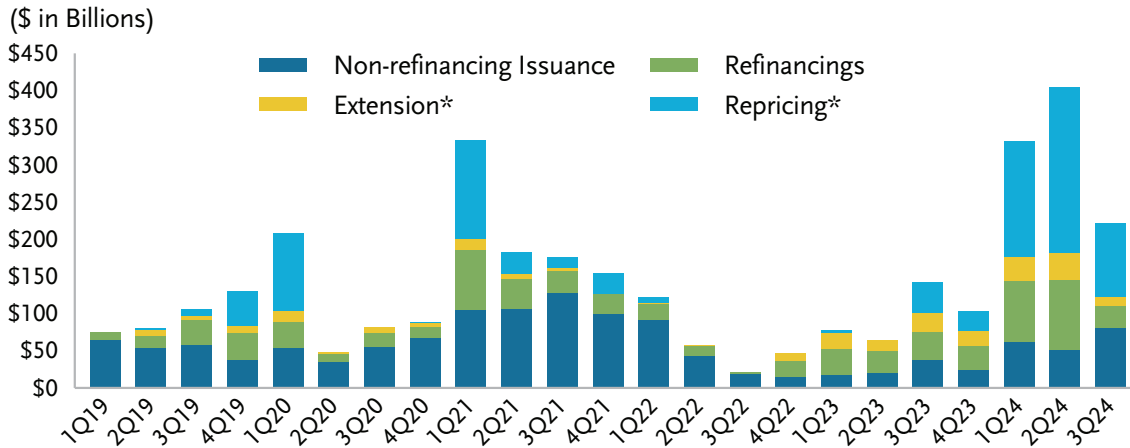
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Technical Conditions – Loans

Leveraged loan funds reported outflows of \$4.65 bn in the third quarter of 2024 as several cuts were priced into the forward curve and investors became more cautious on floating rate product. Two months of consecutive outflows brought the total number of outflows over the last 24 months to 14 as prospects for a soft landing contended with elevated default rates (adjusted for distressed exchanges). Retail investors continued to receive historically high all-in yields and significant incremental compensation above pari-passu fixed rate notes. The steepness of the forward curve and expectations for a more aggressive cutting cycle have challenged the optically wide loan market as investors shift favor to bonds to capture rate-related price appreciation. However, even with full realization of the curve, bank loans continue to demonstrate strong relative value compared to fixed rate counterparts which are predominately unsecured.

Primary issuance remained near historically high levels in the third quarter bringing the year-to-date issuance to nearly ~\$1 tn, which includes more than ~50% repricing, ~30% refinancing, and the remainder non-refinancing (LBO, M&A, dividend, and GCP). The current pace will represent the busiest year on record for gross issuance although the first half of the year was dominated by repricing/refinancing resulting in relatively limited net new supply. Strong market conditions in the third quarter, lower prospective interest rates, and modest enterprise value multiple compression encouraged borrowers/arrangers to tap the market to fund dividends, M&A, and LBOs. This dynamic resulted in the highest level of non-refinancing new issue loan volume in the past 2.5 years.

U.S. Institutional Loan Activity

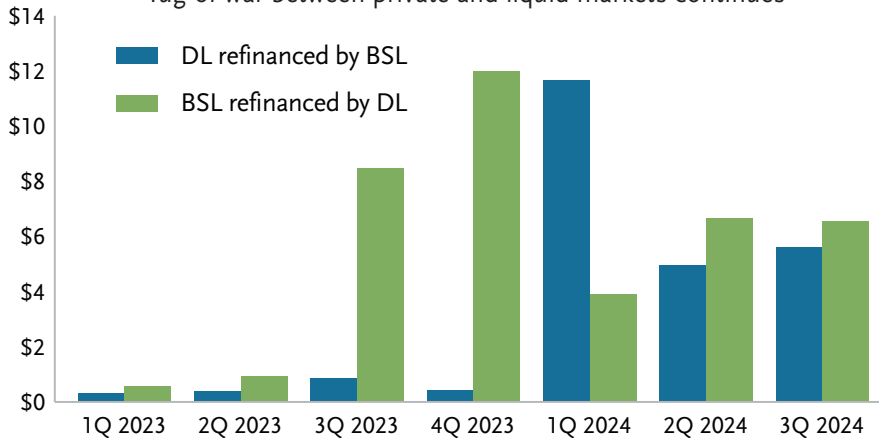


Source: PitchBook | LCD • Data through September 30, 2024

*Reflects repricings and extensions done via an amendment process only

Syndicated Loans and Direct Lending Takeouts (\$ Bn)

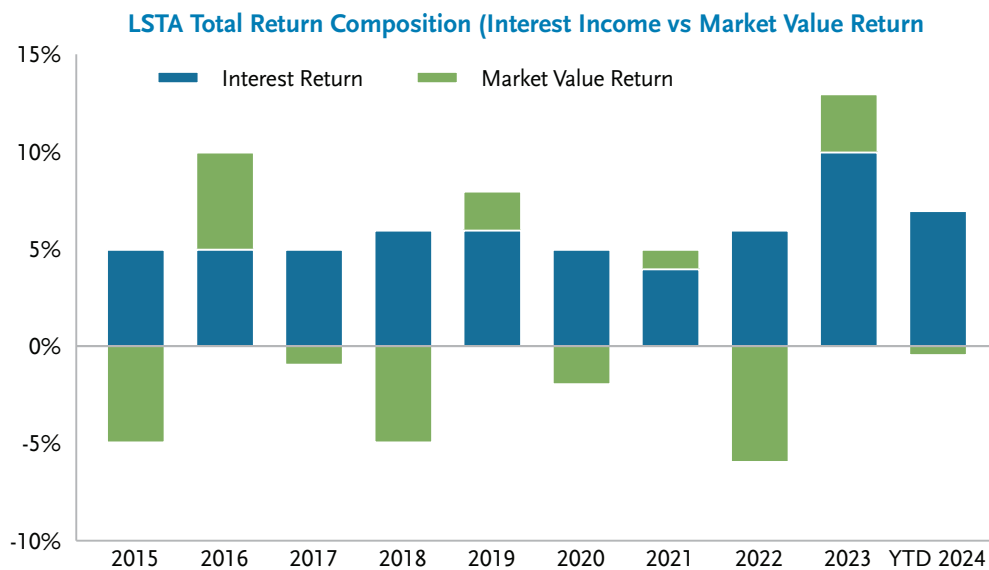
Tug-of-war between private and liquid markets continues



Source: PitchBook | LCD • Data through September 30, 2024

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CLO issuance increased compared to the same period last year but was down sequentially from the second quarter as attention shifts from new CLO issuance to resetting deals out of the reinvestment period. Entering the year there were ~40% of deals out of reinvestment period and actively amortizing balances with loan repayments but that number has dropped to ~20% currently. The increasingly open capital markets backdrop and tightening liability prices have encouraged managers to tap the market in order to reset deals. Despite a shift toward resets, new issue remains relatively robust and has been supported by elevated equity distributions in the first half of the year. However, the repricing wave that began early in the year has grown to one of the broadest and most impactful in the history of the loan market, encompassing more than 30% of the loan market and shaving 10+ bps from the index spread. In order to defend equity distributions over the next 12 months, issuers have targeted higher spread loans (CCCs and second liens) in order to hit the weighted average spread target for existing and prospective equity investors. This strategy has run into natural barriers as many managers carry CCC exposures within 200 bps of the indenture-specified cap and liability investors become increasingly concerned about the lowest quality cohort of the market. Against this backdrop, LTM loan returns decelerated to 9.59% compared to 13.05% last year. In 2023, loans posted their first double digit full year return since 2010; however, price appreciation continues to moderate and even fall in places throughout 2024. In the first three quarters of the year, the total return was dominated by interest income (constituting >100%), which helped to offset modest market value losses across ratings cohorts.



Source: PitchBook | LCD; Morningstar LSTA US LL Index • Data through September 30, 2024

Technical Conditions – CLO Primary

CLO primary volumes increased 5% quarter over quarter with \$54 bn pricing across 88 deals (78 BSL/10 middle market). YTD issuance now stands at \$101 bn, 25% higher year over year. Although issuance remains active, the real action was in refi/reset volume. As AAA spreads continued to tighten and more deals exited their non call periods, an astonishing 200 deals refi-ed or reset during the quarter. YTD, over 450 deals have refi-ed or reset. To put this in perspective, YTD 2023 a mere 23 deals were refi-ed or reset. 2024 refi/reset volume is now surpassing 2021’s record year of refinancings with 425 deals reset/refi-ed in the first nine months of 2021.

Primary spreads tightened over the quarter with tier 1 BSL AAA spreads 4 bps tighter, ending the quarter at SOFR + 136 bps. The rest of the stack was 5-10 bps tighter except for BBs which were 75 bps tighter, ending the month at SOFR + 525 bps. Adjusting for the LIBOR/SOFR basis, BB spreads are close to approaching their post-crisis tight. Not only has the credit curve compressed but private credit/middle market CLO spreads also tightened with AAAs ending the quarter at SOFR + 160 bps, offering only a 24 bp pick up from BSL AAAs vs a long-term average of 45 bps.

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CLO New Issuance

	Q3 2024	YTD 2024	YTD 2023	% Change
New Issue (\$bn)	\$54.20	\$101.40	\$81.00	25%
Refi (#)	51	155	8	
Reset (#)	147	296	15	

Source: TCW

Tier 1 New Issue Spreads (5nc2)

	September 2024 (bps)	QqQ Change (bps)	YTD Change (bps)
AAA	136	-4	-89
AA	170	0	-140
A	190	-10	-195
BBB	300	-5	-265
BB	525	-75	-425

Source: TCW

Fundamentals – Loans

Lagging 12-Month Default Rates

Actual	July 2024	August 2024	September 2024	3ME 9/28/2024	3ME 10/3/2024
By Number	1.45%	1.28%	1.26%	1.26%	1.18%
By Principal Amount	0.92%	0.78%	0.80%	0.80%	0.71%
Shadow Default Rate					
By Number	0.09%	0.09%	0.08%	0.08%	0.08%
By Principal Amount	0.07%	0.07%	0.07%	0.07%	0.07%

*Shadow default rate includes potential defaults, including those companies that have engaged bankruptcy advisors, performing loans with SD or D corporate rating and those paying default interest.

Source: LCD, an offering of S&P Global Market Intelligence

There were three defaults in the third quarter of 2024 bringing the LTM default tally to 19, a significant decrease from the full year default rate of 34 that occurred in 2023 and a sequential decline from the LTM default tally in the second quarter of 22. Chemicals, healthcare, and retail led all sectors each with three defaults followed by telecom and services/leasing with two. There were no other sectors with more than two defaults over the LTM period. The default rate of the LSTA LLI by issuer count declined to 1.26% while the par outstanding default rate decreased to 0.80%, which was the lowest LTM figure since December of 2022. Distressed exchange activity continues to be elevated (4.20% LTM), which is the highest rate since March of 2021 during the pandemic and compositionally represents the highest percentage of total default activity on record (~85%). Borrowers continue to favor distressed exchanges to formal bankruptcy proceedings in order to save valuable cash on restructuring fees and negotiate a better outcome for equity partners. In many distressed exchange transactions, debt is cut by a smaller percentage (anywhere between 10% and 30%) and oftentimes occurs in a non-pro-rata manner with incremental liquidity. The mechanics of distressed exchanges fail to adequately reduce debt and right-size the capital structure when compared to formal restructurings. This can leave “zombie companies” with elevated leverage, still-weak fundamentals, and high risk of filing for bankruptcy post-exchange. In fact, the third quarter witnessed one of the fastest distressed exchanges to bankruptcy filings in history (~12 months).

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Fundamentals – CLOs

CLO fundamentals improved over the month as managers sold CCCs into the rally and while also resetting their deals. The median CCC exposure in reinvesting deals was 5% at the end of September with Junior Overcollateralized cushions at a healthy 4.7%. Tail risk continued to improve with the percentage of loans below \$80 at 3% for reinvesting deals and BB MVOCs up 50 bps to 106.5%. As mentioned above, we expect CLO fundamentals to continue to improve sans a recession as interest burdens on loan issuers ease with SOFR on a downward trajectory.

Loan Valuation

Since 1992, the average 3-year DM for the CS LLI is 472 bps. The 3-year DM finished the quarter at 498 bps which was -26 bps tighter than the second quarter. The DM spread differential between double Bs and single Bs is now 178 bps which is -17 bps tighter than the same period last year and slightly tighter than the historical differential since inception. Outside of deeply distressed credits, market dispersion has evaporated for performing single B and double B credits. The highest risk cohort of the market (CCCs) has retained relatively elevated levels of dispersion given weak credit agreements, aggressive sponsor behavior, and lender-on-lender violence. Additionally, Idiosyncratic/earnings-related news continues to create isolated pockets of dislocation and incremental trading activity within lower quality.

3-Year Discount Margin Differential Between BBs and Bs

Average Since Inception	191.8 bps
September 2023	194.3 bps
September 2024	177.3 bps

Source: Credit Suisse Leveraged Loan Index

CS LLI Snapshot

YTD Total Return	6.54%
Average Price	95.61
Spread	373 bp
Coupon	8.81%
Current Yield	9.23%
Yield (3-year life)	8.24%
Discount Margin (3-year life)	498 bp

	Spread	DM (3-Year Life)
Split BBB	221 bps	225 bps
BB	267 bps	277 bps
Split BB	354 bps	422 bps
B	393 bps	455 bps
Split B	441 bps	1,083 bps
CCC/Split CCC	521 bps	1,262 bps
Distressed (CC, C and Default)	538 bps	3,240 bps

Source: Credit Suisse Leveraged Loan Index

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Summary and Looking Forward

The first half of the year saw one of the heaviest repricing and refinancing volumes on record as borrowers capitalized on strong market sentiment to slash borrowing costs and push out maturities. The overwhelmingly supportive technical backdrop in the beginning of the year carried forward into the third quarter. This dynamic, along with lower prospective interest rates, compressing bid/ask on enterprise value multiples, and PE capital return requirements, have encouraged borrowers/arrangers to tap the market with new money transactions (LBO, M&A, dividend, and GCP). As a result, the third quarter saw surging net new issuance, breaking a 2.5-year lull driven by elevated financing rates and helping to alleviate the undersupplied state of the market. Demand for new money deals remained robust, allowing borrowers to flex pricing tighter from initial talk and omit key lender protections. Higher priced, liquid loans were used by managers to fund the growing new issue calendar and contributed to the shift in bank loan returns to interest income rather than market value gains.

Looking forward, managers will remain focused on limiting higher risk exposure (CCCs) while also fighting to offset the ongoing repricing impact on weighted average spread and corresponding equity IRRs. After a strong start to the year for equity distributions, payments will likely moderate into the back half of the year amidst still-elevated distressed exchange activity and lower spreads due to repricing. While liabilities have tightened significantly since the beginning of the year, they appear to have reached a point of exhaustion (AAAs stabilizing in the +133-140 range) without a corresponding slowdown in repricing activity. The fundamental credit quality of these deals has started to deteriorate which has provided managers a source of higher spread paper below par but typically precedes periods of higher volatility in the market. This episodic volatility, previously commonplace in any given year, has failed to appear during 2024 amid the supply/demand imbalances and overwhelming technical support. These periods have become critical for managers to improve deal economics, rebuild overcollateralization cushions damaged by defaults/LMEs, and keep repricing activity in check. ■

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