Alternative Credit: 4Q22 Review

Credit assets rebounded in the fourth quarter as improving inflation data sparked hopes that the end of the Federal Reserve's rate-hike cycle was near.

The broadly syndicated loan market, as reflected by the Credit Suisse Leveraged Loan Index, delivered a total return of 2.33% in the quarter and -1.06% for full-year 2022, compared with the Bloomberg US Corporate High Yield Index's performance of 4.2% and -11.2%, respectively.[1] Leveraged loan market fundamentals have remained relatively resilient in the face of input cost pressures, a higher cost of capital and slowing economic activity. Loan defaults by volume—a backward-looking indicator—pulled back in the fourth quarter and currently remains well below historical norms. Meanwhile, market technicals were fairly favorable during 2022, as the supply of and demand for loans declined to keep the market in relative balance.

Current economic trends suggest issuance is likely to remain muted in 2023. The slowing economy should weigh on the enterprise value of companies while their cost of capital remains elevated, resulting in lower leverage ratios on new deals. Given the heightened uncertainty in the market, we continue to be thoughtful about loan structuring; notably, asset-based lending (ABL) structures may represent an opportunity to put capital to work for an attractive risk-adjusted return over the long term.

KEY TAKEAWAYS

- Credit assets rebounded in the fourth quarter as improving inflation data sparked hopes that the end of the Fed's rate-hike cycle may be near.
- While leveraged loan market fundamentals have remained relatively resilient in the face of input cost pressures, a higher cost of capital and slowing economic activity, a rising distress ratio suggests trouble may lie ahead. Market technicals continued to be fairly favorable, as a decline in both the supply of and demand for loans kept the market in relative balance.
- All-in yields for direct lending have seen a meaningful increase, driven by higher reference rates and larger original issue discounts.
- Given the heightened uncertainty in the market, we continue to be thoughtful about loan structuring. In such an environment, asset-based lending structures may represent a particularly attractive opportunity to put capital to work.

1. Source: Bloomberg; data as of December 31, 2022.

Market Fundamentals Hanging on

Markets in the fourth quarter embraced the idea that easing inflation and slowing economic growth would enable the Fed to conclude its tightening cycle at some point in the first half of 2023. Indeed, the 50 basis point hike announced in December was a deceleration from the 75 basis point pace that characterized the four hikes since June, and the 4.25–4.50% range at which the fed funds rate ended 2022 was well within shouting distance of the Fed's current terminal rate forecast of around 5.1%. While Fed Chair Powell has taken pains to convey his intention to keep rates higher for longer, markets appeared not to be buying the rhetoric. Pricing in the futures markets suggests that while the fed funds rate may reach 5% or so in 2023, policy will at some point before the end of the year pivot toward rate cuts as economic growth continues to wane.[2]

Leveraged loan market fundamentals have remained relatively resilient in the face of input cost pressures, a higher cost of capital and slowing economic activity. A lot of this is likely due to borrower behavior in the cheap-money period following the outbreak of Covid-19. The vast majority refinanced debt at low rates, and some likely employed derivatives techniques like hedges and swaps to mitigate the impact of rising rates and extend the maturity of their debt loads. The maturity walls for this year and next are quite manageable as a result, and a variety of credit metrics remain well supported. For example, weighted average leverage is back to pre-pandemic levels and interest coverage remains ample. This number can shift quickly and dramatically as rates rise, however, and there can be significant differentiation across industries and among individual borrowers. Those with pricing power and the ability to pass along higher costs onto their customers should be better positioned to defend EBITDA levels and margins, as will companies with reasonable inventory levels.

> Market fundamentals have remained relatively resilient, but a rising distress ratio suggests trouble may lie ahead.

Loan defaults by volume—a backward-looking indicator—pulled back in the fourth quarter and currently remains well below historical norms. This may belie trouble ahead, however, as the distress ratio—a forward-looking indicator that reflects loans trading for less than 80 cents on the dollar—ended the year at 7.4%, up from 5.8% at the end of the third quarter.[3] Ratings agencies, meanwhile, appear to be taking a rather pessimistic view of credit performance going forward; credit actions turned negative midyear, and downgrades outpaced upgrades by nearly three to one by year-end.[4] Lower ratings curb the demand for loans, particularly among the collateralized loan obligations (CLOs) that serve as their primary buyer, as the CLO structure is highly sensitive to the regulatory limitations of their investor base (insurance companies, banks and asset managers). All told, a bias toward downgrades typically results in greater price volatility, fewer new issuance and refinancing challenges.

Supply and Demand both Waned, Keeping Market Balance Intact

Market technicals were fairly favorable during 2022, as the supply of and demand for loans declined to keep the market in relative balance. US new-loan issuance fell by 68% in 2022, reaching lows not seen since the early 2010s.[5] After a robust start to the year, volume declined sharply and the swoon culminated in a third quarter that was the lowest for issuance since 2009 before more supportive conditions in the fourth quarter prompted a small rebound. Refinancing activity also was off sharply in 2022, thanks to high interest rates and a shaky secondary market. Similar to the new-issue market, however, refinancing volumes improved in the fourth quarter as did "amend and extend" activity. Despite weak activity overall in 2022, the volume of loans coming due in 2023 is minimal as strong refinancing in previous years has pushed out the loan maturity wall.

It's worth noting that for companies already facing liquidity challenges, we've started to see the reemergence of "lender-on-lender violence" in which a group of lenders—typically with the support of the borrower's financial sponsor—provide a new financing structure at terms beneficial to themselves and detrimental to others in the same priority class. One example of this is "uptiering"—lenders extend an incremental financing package to a

2. Source: Bloomberg; data as of February 10, 2023.
3. Source: PitchBook, Leveraged Commentary & Data (LCD); data as of December 31, 2022.
4. Source: PitchBook, Leveraged Commentary & Data (LCD); data as of December 31, 2022.
5. Source: PitchBook, Leveraged Commentary & Data (LCD); data as of December 31, 2022.

borrower on a super-priority basis and subordinate existing debt in the process. Such lender opportunism, which can have a significant impact on loan pricing, has been facilitated by the prevalence of covenant-lite loans and the reduction of barriers that may have prevented such activity.

Demand for loans—historically has been driven by a combination of CLO formation and retail funds, with the former typically the much larger contributor—also has declined. With yields across traditional fixed income asset classes much higher than they began the year, institutional buyers have multiple high-quality alternatives to CLO investment, many of which entail considerably less complexity, in our view. In addition, CLO demand from foreign institutions—notably the large Japanese financial institutions that are large buyers of AAA CLOs—has been further hampered by steadily rising dollar-hedging costs. Despite these headwinds, CLO formation appeared to be running at a pretty consistent rate in 2022, even if levels are considerably below 2021. In contrast, mutual fund flows were consistently negative in 2022, and full-year outflows in loan funds totaled $11.4 billion.[6]

The challenges facing public fixed income markets took time to trickle into the middle market direct lending space. This lag is not unusual, in our experience, as a largely nonexistent secondary market for these facilities and their directly originated nature has tended to somewhat insulate them from fluctuations in the public markets. At this point, however, we view the direct lending and broadly syndicated loan markets as being comparably valued. All-in yields for direct lending, in particular, have seen a meaningful increase, driven by higher reference rates and larger original issue discounts (OIDs). An OID represents the difference between a loan's par value and the price at which it is issued; such discounts improve the economics of a deal from the lender's perspective and suggest that credit rationing may be underway.

Most of the direct lending deals we have seen of late are add-on transactions, and even there the fairway is narrow. Risk-sensitive lenders appear to be focused on the most pristine opportunities—facilities with lower loan-to-value ratios extended to noncyclical businesses—and generally are wary of businesses dependent on healthy consumer-demand dynamics and discretionary-spending trends.

Risk-sensitive direct lenders appear to be focused on the most pristine opportunities—facilities with lower loan-to-value ratios extended to noncyclical businesses.

Looking for Opportunities in an Uncertain Market

Given the slowly deteriorating environment for leveraged credit, we aggressively went up in quality in the second half of 2022 and de-levered on the margins, which should help mitigate downside risk in the event the macroeconomic backdrop continues to soften and position us to seek out potential opportunities as they emerge. We also have continued to be thoughtful about loan structuring. While some direct lenders have followed the broadly syndicated loan industry down the path of "covenant-lite" loans, we strive to incorporate at least one financial covenant and/or liquidity test in all of our directly originated loans, whether cash flow-based or asset-based. For cash flow-based loans, this typically is a leverage covenant, sometimes accompanied by a fixed charge covenant. Over the past several months, we've witnessed the value added by these contractual provisions, as a tripped covenant has allowed us to renegotiate a loan's pricing and structure in a way that improved our economics.

Current economic trends suggest issuance is likely to remain muted in 2023. The slowing economy should weigh on the enterprise value of companies while their cost of capital remains elevated, resulting in lower leverage ratios on new deals. As long as the environment remains somewhat unstable, it's difficult to see an impetus for a significant rebound in transaction volume. Given the heightened uncertainty in the market, we expect asset-based lending (ABL) structures may represent an opportunity to put capital to work for an attractive risk-adjusted return over the long term. Traditional middle market financing solutions like broadly syndicated loans and direct lending are underwritten based on an assessment of the borrower's cash flows. ABL facilities, in contrast, are secured by specific assets of the borrower—such as inventory, accounts receivable, real estate, machinery and equipment, and intellectual property—and thus provide a specific source of collateral the lender may tap should the need arise.

6. Source: Pitchbook; data as of December 12, 2022.

The opinions expressed are not necessarily those of the firm. **These materials are provided for informational purposes only.** These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation to buy, hold or sell, or the solicitation or an offer to buy or sell any fund or security.

Past performance is not indicative of future results.

Asset-backed loans (ABLs) are loans or lines of credit collateralized by a pool of assets, such as mortgages, credit-card receivables, auto loans and student loans.

Broadly syndicated loans (BSLs) are loans extended by a group of financial institutions (a loan syndicate) to a single borrower. Syndicates often include both banks and nonbank financial institutions, such as collateralized loan obligation structures, insurance companies, pension funds or mutual funds.

Collateralized loan obligations (CLOs) are financial instruments collateralized by a pool of corporate loans.

Bloomberg US Corporate High Yield Bond Index measures the performance of the US dollar-dominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk are excluded.

A **credit rating**, as represented by credit quality breakdown, is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other bonds. AAA ratings denote the lowest expectation of default risk. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.

Credit Suisse Leveraged Loan Index measures the performance of the investable universe of the USD-denominated leveraged loan market. The index inception is January 1992. The index frequency is daily, weekly and monthly.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

One cannot invest directly in an index. Indices do not incur management fees or other operating expenses.

Risk Disclosures

All investments involve the risk of loss of principal.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest, which may cause the strategy to make more speculative, higher risk investments than would be the case in absence of such arrangements; and
- Below-investment-grade loans, which may default and adversely affect returns.

FEF Distributors, LLC (Member SIPC) distributes certain First Eagle products; it does not provide services to investors. As such, when FEF Distributors, LLC presents a strategy or product to an investor, FEF Distributors, LLC does not determine whether the investment is in the best interests of, or is suitable for, the investor. Investors should exercise their own judgment and/or consult with a financial professional prior to investing in any First Eagle strategy or product.

First Eagle Investments is the brand name for First Eagle Investment Management, LLC and its subsidiary investment advisers. First Eagle Alternative Credit is the brand name for those subsidiary investment advisers engaged in the alternative credit business.

© 2023 First Eagle Investment Management, LLC. All rights reserved.

M-TL-ACT-ACR224-P-LT