CIFC Asset Management

CIFC Portfolio Intelligence

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Fundamentals

We have been taking stock of macro indicators, off-cycle earnings reports and other read-throughs ahead of the 2Q24 earnings season. What we see makes us more cautious on the margin about US growth – particularly the consumer – and we are managing our portfolios accordingly.

The most striking macro indicator to us in recent weeks was the Services ISM report on July 3, which came in at 48.8 versus Bloomberg consensus of 52.7, putting it at the lowest level in recent memory outside of COVID and the GFC. Employment and new orders contracted for the first time since May 2020. The soft signal on employment was corroborated by the latest continuing jobless claims, which climbed to their highest level since November 2021; the JOLTs report, which included negative revisions and underlying details; and, of course, July 5's muted unemployment report.

Generally speaking, pressure on the consumer has already manifested itself in a shift away from discretionary goods and durables in favor of consumables in recent quarters. Nike noted pressure from the "value consumer"; Walgreens, H&M and L'Oréal were similarly cautious. More recently, Helen of Troy missed Bloomberg consensus estimates significantly, citing factors including lower replenishment orders from customers and softer consumer demand, and noted that challenges became more pronounced at the end of the quarter. Within consumer staples, there has been a shift to value, including private label. Some results indicate that after a solid run of price increases, consumer staples may be losing pricing power: General Mills said it is spending more on coupons, and Mondelez is seeing trade down[1].

In our opinion, the picture on manufacturing is less clear. In 1Q24 earnings calls, a number of industrial companies in the loan market cut revenue guidance but forecast flattish revenues in 2024 nonetheless, with price offsetting some of the anticipated volume decline. HVAC manufacturers predicted that while 2Q24 would be down, the sector is troughing and destocking is largely over. The June manufacturing ISM of 48.5 was modestly below Bloomberg consensus, but the new orders component jumped strongly.

Technicals

Views from CIFC's trading desk

Loans

- The Morningstar LSTA US Leveraged Loan Index has returned 4.35% year to date.
- Loan market technicals remained firm through 1H24, driven by:
  - "Higher for longer mantra", coupled with limited true new issue loan supply
  - Continuous CLO creation (+$101.4bn year to date) and steady retail inflows (+$6.6bn year to date)
- While new issue primary volumes were robust, much of the activity skewed toward repricing / refinancing.
  - Thus far approximately $332bn (~21% of the market) has repriced, resulting in a reduction of 54bps.
  - This trend is expected to continue as ~47% of the market still trades >100.
  - Spread compression remains a key theme.

1. Reflective of CIFC's opinion and assumptions; subject to change without notice.

There are pluses and minuses elsewhere in the economy[1]:

- Healthcare continues to be underpinned by admissions growth: 1Q24 actual results were +3.8%, and recent survey data indicates +3.4% for 2Q24. These compare positively to long-term averages of +1-2%.
- Expectations for 2024 technology spending have increased, propelled by networking and storage. Semiconductors are doing well overall, although operators are wary of potential escalation in trade tensions. Software spend remains healthy, led by security.
- The sharp decline in lumber prices in recent months is consistent with cautious commentaries about residential and multifamily investment and repair / remodel spending in mid-2024.
- Despite comparisons to strong "revenge" spending, the travel industry has grown well in 2024 so far, punctuated by record-setting Fourth of July results. Year-to-date domestic airline traffic is up 8%, and global travel sites daily visits are now 31 million versus 28 million pre COVID. However, spending has been driven by those with larger discretionary budgets; lower-income consumers are reportedly pulling back.

We will share our findings as the 2Q24 cycle unfolds. Please contact us with any questions.

Technicals

Views from CIFC's trading desk

HY bonds

The US High Yield index finished the first half of 2024 on a constructive tone, gaining 94bps in June. In our view, risk assets were buoyed by somewhat softer economic data, providing investors optimism for rate cuts later in the year. Yield decompression was a key theme throughout the month of June as the market looked to reduce idiosyncratic credit risk and move into quality duration names. High quality long duration risk outperformed the rest of high yield by over 40bps for the second consecutive month2. We expect this trend to continue and prefer to take rate risk over cyclical and CCC credit risk.

Cash levels across the street remain relatively robust and supportive of both primary and secondary high yield risk. New HY issuance came in at $17.9bn in June, slightly below the June average of $24.4bn (since 2010). Year-to-date new issue ended June at $165.5bn, in line with the 10-year average. The primary market is still available to most issuers and has allowed many companies to term out near-term maturities at attractive yields.

Financial covenants in middle market direct lending

In our opinion, one of the defining characteristics of middle market direct lending is the strong protections provided by loan documentation in this segment of the market. As the originators of primary issuance, middle market direct lenders like LBC, CIFC's direct lending division, negotiate bespoke terms and conditions tailored to the specific risks of each borrower. Overall middle market credit agreement protections include limitations on incurring additional debt, restrictions on distributing cash or transferring assets, and, importantly, financial maintenance covenants. Financial maintenance covenants are ongoing tests to monitor borrowers' financial performance, debt levels, and ability to service debt.

The two most common financial covenants are typically defined as[2]:

- **Total Net Leverage: (Total Debt – Cash (Subject to Caps)) / Adjusted LTM EBITDA**
- **Fixed Charge Coverage Ratio ("FCCR"): (Adjusted LTM EBITDA – Capital Expenditures – Cash Taxes) / (Debt Principal Payments + Interest Payments)**

In special cases other specific covenants may be applied. For example, lenders might apply a limitation on capital expenditures for a company with significant capital outlays in the forecast. In middle market direct lending structures, covenants typically feature[2]:

- Measurement on a quarterly basis using compliance certificates provided by the borrower
- Calculations tested against minimum / maximum threshold levels that are established in the credit agreement for every quarter through the life of the loan
- Target cushions of 30-35% EBITDA decline before a covenant is tripped
- Leverage levels stepping down over time to align with forecasts and encourage deleveraging
- Rights and remedies for the lender in the case of covenant default, triggering a negotiation with equity owners (e.g. the private equity sponsor)

Michael Hertz, Managing Director and Head of US Direct Lending Underwriting

Mr. Hertz is responsible for managing LBC's research and underwriting function and serves as a member of the Investment Committee. His previous roles include responsibility for sourcing, structuring and negotiating new direct lending investments in the New England region and co-managing the research and underwriting team. He has over 17 years of experience in middle market M&A and leveraged lending transactions across a wide range of industries. He holds a Bachelor of Science, Finance from the University of Delaware's Alfred Lerner College of Business and Economics.

2. Based on LBC's internal definitions and observations on market conventions, which may change without notice.

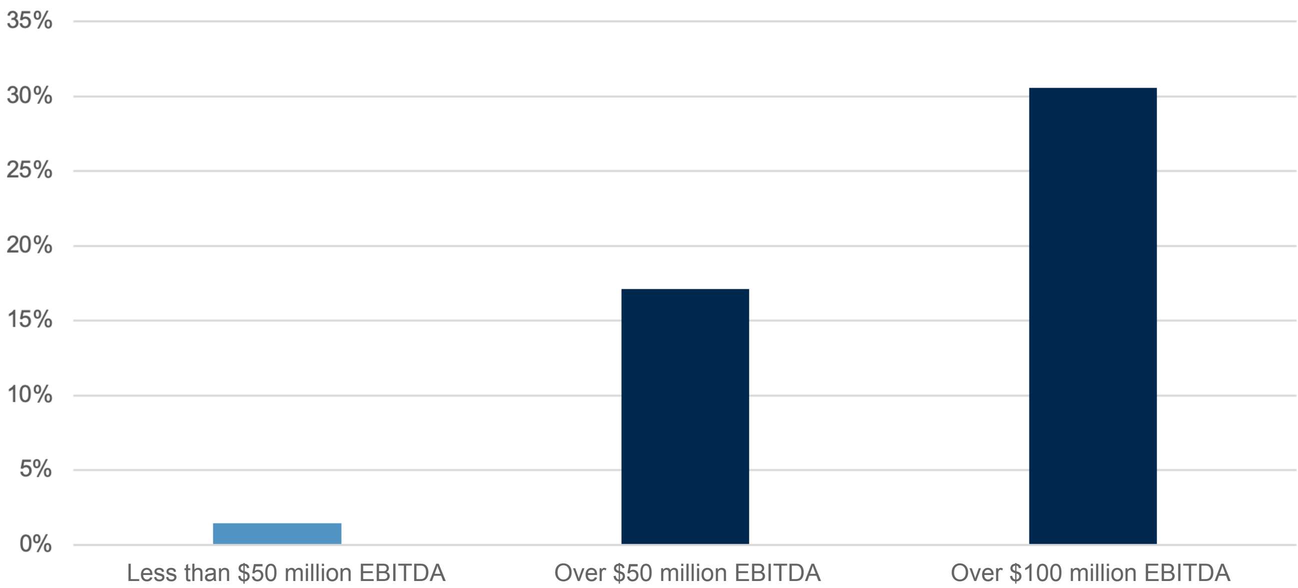
Broadly syndicated loans

Having financial covenants is the market standard for loans to middle market borrowers. In the upper market, however, loans with no financial maintenance covenants ("cov-lite" loans) are more prevalent[2]. For broadly syndicated loans ("BSL"), cov-lite issuance has represented over 90% of volume since 2022 and cov-lite share has increased over time[3]. Although financial maintenance covenants are rare, BSLs typically have meaningful secondary trading activity. BSL lenders may be able to sell their positions to secure a recovery if they anticipate deteriorating borrower performance. This dynamic allows for early risk management and the ability to take action without financial covenants in place. This liquidity typically does not exist for direct lending loans, making credit agreement protections more critical.

Direct lending

In the upper end of the direct lending market, cov-lite issuance is less prevalent than in BSL but still meaningful. This is likely because these lenders often compete directly with BSL alternatives (not a competitive factor in the middle market). Lenders are also competing for a more limited supply of deals with a narrower universe of sponsors than the middle market. As shown in the chart below, for middle market direct lending loans with borrowers less than $50 million of EBITDA, cov-lite issuance in the past five years has been negligible (<2% of loans). However, for borrowers with more than $50 million and $100 million of EBITDA, this increases to 17% and 31%, respectively. Further, for upper

Percentage of cov-lite direct lending loans[4]



3. Source: PitchBook LCD LoanStats Weekly as of June 20, 2024.
4. Source: Data per LSEG Loan Connector, based on direct lending deal count from Q2 2019 – Q1 2024.

market direct lending loans that are not cov-lite, it is typical for there to be fewer covenants and for those covenants to be set at looser thresholds with wider cushions (i.e. less protection). EBITDA definitions in upper market documents are also typically more borrower-friendly, with greater allowances for add-backs and pro-forma adjustments that may mask true declines in cash flow and limit the efficacy of covenants. Upper market direct lending loans lack the covenant protections of middle market loans while simultaneously lacking the liquidity of BSL. As such, in an economic downturn, upper market direct lenders may face a situation where borrower performance is deteriorating but their ability to act is limited.

Meaningful covenant protections in illiquid loans are particularly important during times of uncertainty or when facing a potential slowdown in economic conditions. Without financial covenants, lenders may need to wait until a payment default occurs to exercise their rights under the credit agreement. At that stage, performance has likely declined further to the point that cash flows are limited or negative, borrower liquidity has been expended, and enterprise value has eroded.

In contrast, middle market financial covenants are designed to trip much earlier, allowing lenders to take steps to enhance their recovery. This may include requiring sponsors to infuse more equity to bolster liquidity or potentially working towards a sale of the company while enterprise value is still sufficient to fully repay outstanding debt.

"Meaningful covenant protections in illiquid loans are particularly important during times of uncertainty or when facing a potential slowdown in economic conditions."

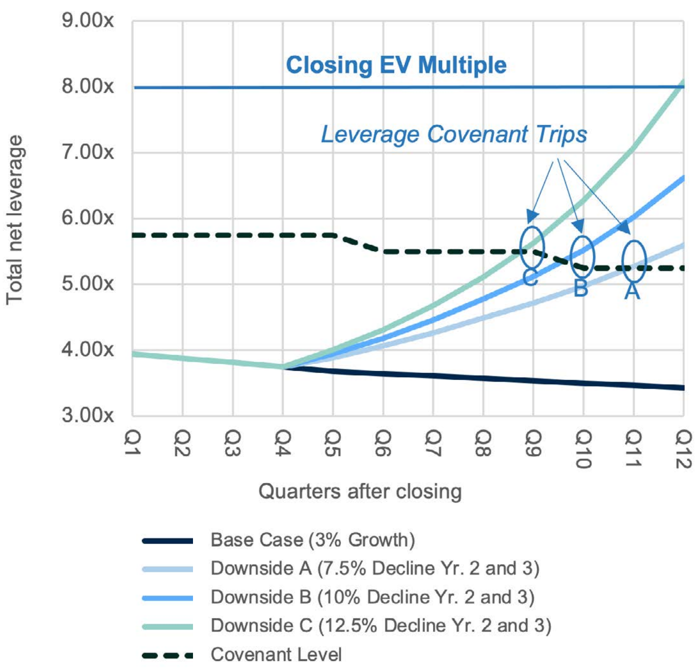
Simulating covenant protection

The financial model output on the next page shows a generic middle market borrower's leverage forecast and a set of illustrative leverage covenants for a loan closed at 4.0x EBITDA. This illustration also overlays scenarios for varying rates of revenue decline after the first year to simulate a cycle of demand softening. Under these scenarios, several quarters after declines begin in Q5, covenants will trip. For example, in Downside Scenario B (10% decline per annum), covenants would trip in Q10 at approximately 5.5x leverage (versus a covenant of 5.25x).

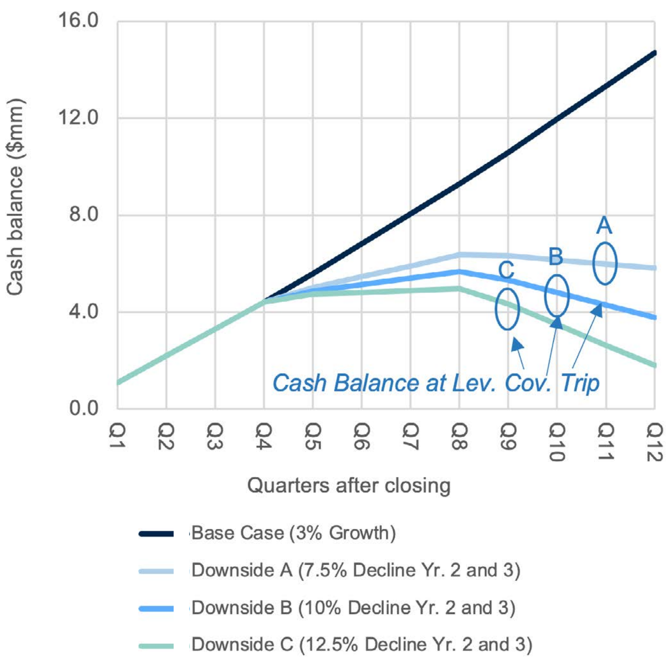
Assuming the business was originally worth 8.0x EBITDA (50% LTV), the loan should still be fully covered by the enterprise value with meaningful cushion. Even with a discount to that multiple, a full recovery could potentially be achieved through a sale of the company as a going concern. The covenant default would theoretically allow more time to facilitate such a sale. We expect there also would be significant cash remaining on the balance sheet at the time of the covenant trip, providing liquidity for debt service and company operations during the workout process. In this same scenario with no covenant or looser covenants, more time would expire, leverage would continue to increase, and liquidity would decline before the lender had any ability to take action. Waiting for a payment default could meaningfully impair recovery.

This analysis demonstrates how financial covenants can be a powerful tool that allows middle market lenders to have greater control when it is most needed. This aligns with a consistent theme we observe in middle market direct lending – while borrowers are smaller, we believe loans are not necessarily riskier when factoring in the enhanced structural protections (e.g. lower leverage, better covenants) that may mitigate losses. It also highlights the importance of manager experience with structuring loans and navigating portfolios through various cycles and economic environments.

Borrower leverage sensitivities versus covenant[5]



Remaining liquidity at covenant trips[5]



5. Output from illustrative financial model built by LBC for a generic borrower and senior loan structure. Key base case assumptions: SOFR at 5.3%, cash netting for leverage capped at $5 million, $0 starting cash balance, $20 million closing EBITDA, 4.0x leverage at closing, 1.0% amortization, cash interest SOFR + 600bps, 3% revenue growth per annum with flat margins, costs 75% variable / 25% fixed, flat working capital, capex 2% of revenues, 30% tax rate. In downside cases, SG&A and capex remain the same as base case and working capital flexes with revenue based on flat working capital days.

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The Cliffwater Direct Lending Index, or CDLI, is an asset-weighted index of ~14,000 directly originated middle market loans.

The Morningstar LSTA Leveraged Loan Index is a market value weighted index designed to measure the performance of the U S leveraged loan market based upon market weightings, spreads and interest payments. The index is reviewed weekly to reflect pay downs and ensure that the index maintains its characteristics The index returns are calculated daily as described in Morningstar.

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, 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.

The S&P 500 is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States.