AEGON Asset Management

Commentary

Second Quarter 2023

PRIVATE & ESOTERIC ABS

Second quarter review – banks step back, direct lenders step in

Broadly syndicated ABS issuance remained robust against a backdrop of fears around credit contraction. Second quarter volumes for ABS issuance exceeded $68 billion, up from $60 billion in the first quarter. Spreads in public ABS markets remained range bound to slightly tighter, contrasting against wider spreads across the capital structure in broadly syndicated CLOs. Fundamentals are slowly creeping into the narrative for both traditional ABS and CLOs. Delinquencies for consumer assets are drifting higher alongside declining free cash flow for bank loan issuers. Currently these are manageable, but markets are still searching for clarity on the duration of Fed rate hikes and evidence of a soft landing.

In the second quarter two trends converged, resulting in a tangible opportunity in private ABS:

1. Turmoil in the regional banking system has prompted lenders to tighten standards around corporate lending.
2. Elevated levels of private equity (PE) investments by firms large and small continue to fuel demand for private credit and more specifically, direct lending.

To the first point, as banks step back from corporate lending, non-bank lenders (private credit firms via funds, rated notes or Business Development Companies) are stepping in to fill the void. Aegon AM has observed an increase of inbound activity from banks looking to reduce exposure as well as from non-bank lenders structuring middle market CLOs as an alternative financing source. Funding costs have increased as result of this dislocation, presenting an attractive opportunity for allocation.

To the second point, today, middle-market, corporate loan originators enjoy the benefit of underwriting to companies under higher base rates and companies' specific business challenges. To further strengthen the deals for investors, lenders also work directly with presiding PE sponsors when business plans face challenges, relying on the sponsors to inject capital if necessary.

Where does private ABS come in? These trends have synthesized into structured finance opportunities at the senior-secured part of the capital stack. *Why?* The wider spread levels in the direct lending space present an opportunity to structure additional credit enhancements (subordination, overcollateralization, excess spread, etc.) and help provide originators both flexibility and surety of execution in deploying capital. While private, direct lending is subject to the same macro risks seen in the public high yield and leverage finance markets (default, industry and interest rate risks), several mitigating factors help make it an attractive investment for insurance companies when in a structured ABS format, including:

1. Economic alignment with PE sponsors through their large equity commitment.
2. Stronger, privately negotiated credit agreements versus broadly syndicated markets.
3. Low leverage levels provide increased financial flexibility to help withstand shocks.
4. Bilateral agreements, which allow for closer lending and restructuring relationships.

Third quarter expectations – private structuring continues to fill the void

Markets are functioning well despite the economic uncertainties. As such, we maintain conviction that premiums available in private and esoteric ABS continue to present a very attractive opportunity over traditional corporate bonds as credit spreads continue to discount these uncertainties. This quarter's deal spotlight (sidebar) highlights a synergy between direct lending and structured finance. Generally, we expect the importance of private structured finance solutions in filling the void of traditional bank lending to continue through the third quarter and the remainder of 2023.

Deal spotlight

Sector: Direct Lending CLO

Status: Closed 2nd quarter 2023

Tranche Narrowly syndicated 4a2	
Tranche size	$352.9 million
Rating	AAA
Average Life	4.7 years
Spread to SOFR	327 bps (inclusive of spread and upfront OID fees)

Direct Lending CLO is a delayed-draw middle market cash flow collateralized loan obligation (CLO) being issued in the 4a2 market. This transaction will acquire a diverse pool of directly originated, senior-secured loans to private equity sponsored, middle-market companies. The originator is the direct lending arm of a prominent global financial group with exclusive access to the pipeline of loans generated by the firm's investment banking activities and M&A relationships.

The deal includes a 4-year reinvestment period where the originator/manager can use principal proceeds from the portfolio to originate new loans.

Following the reinvestment period, the notes pay down sequentially. The CLO benefits from robust credit enhancement as well as collateral quality and concentration tests which place guardrails across the portfolio, preventing deterioration and extension risk. This transaction requires certain expertise to assess the origination and management capabilities of the issuer as well as thorough understanding of the risks and nuances of CLO transaction language and mechanics.

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Adtrax: 5047615.4
Exp date: 11/30/2023