PRIVATE CREDIT UPDATE

Entering 2022 on the Heels of a Strong Year

Many segments of private credit posted strong activity in 2021: Private placement annual volume, for example, reached a ten-year high. We see the potential for 2022 to follow suit. However, macro developments and geopolitical risks certainly bear monitoring, as they have the potential to alter financial conditions. Asset selectivity with a focus on strong covenant & deal documentation can help investors mitigate risk.

Macro Picture

In late February 2022, Russia launched a full-scale invasion of Ukraine, with many nations responding with broad, coordinated sanctions. While the ultimate outcome was uncertain as of March 8th, the global economy was already feeling the impact through continued supply chain disruptions, rising commodity prices and significant price pressure to risk assets. On the other hand, the war could slow the pace of monetary policy tightening and spur new government spending and investment in some areas.

Middle Market Direct Lending

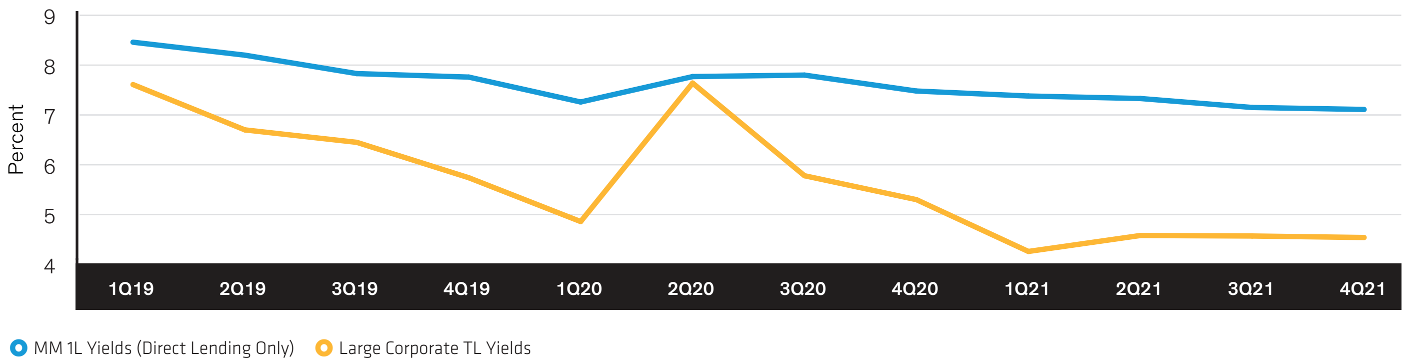
Through early 2022, sponsor M&A activity remained high in the private direct lending market. The execution of jumbo (greater than $1 billion) unitranche financings has contributed to the elevated activity; direct lenders are rapidly disintermediating investment banks and taking share from the broadly syndicated loan market.

These larger unitranche financings expand opportunities for scaled direct lenders, though these deals include many features of the broadly syndicated loans they're looking to displace—such as weaker documentation and covenants. We'll continue focusing on serving the needs of core middle-market financial sponsors while also leveraging our scale to execute up-market on a highly selective basis.

New issue yields in the fourth quarter were a touch lower; however, the illiquidity premium in direct lending remains above the historical average. Yields for middle market direct lending transactions averaged 7.1%, slightly lower quarter over quarter and about 35 basis points (b.p.) lower year over year. For large corporate loans, 4.5% new issue yields were also down quarter over quarter and down 76 b.p. year over year. Direct lending's illiquidity premium expanded during 2021, averaging 280 b.p. The 260 b.p. fourth-quarter yield was well above the long-term average of 195 b.p. since 2013. A critical point: we don't believe investors are taking on more credit risk to capture this extra yield.

NEW ISSUE MMDL 1L VS. CORPORATE TERM LOAN YIELDS

Illiquidity Premium of 260 b.p. Well Above Long-Term Average of 195 b.p.



As of December 31, 2021 | **Source**: Refinitiv LPC

Direct lending volume in the sponsored middle market reached an all-time quarterly high for the second consecutive quarter, capping a record year at $131 billion—easily topping the prior record of $103 billion from 2018. Sponsor-related activity increased for both direct lending and syndicated solutions, though not at the same pace as direct lending continued to gain share in 2021.

The ratio of direct lending to syndicated volume reached an all-time quarterly record of 3.3× in 4Q21. Sponsor M&A activity was up 94% year over year in 2021, driving robust sponsor-related financing volume. This higher activity benefits our platform—which lends primarily to sponsor-backed companies—by allowing the team to be even more selective in its asset selection. Robust deal activity has carried into 1Q22, breaking the seasonal trend of muted volumes early in a given year.

US Commercial Real Estate Debt

Investors continue to keep a close eye on travel statistics as a way to gauge demand in certain sectors. US air travel, for instance, continued its rebound with Transportation Safety Administration throughput increasing for the third straight quarter in 4Q21. While 2021 throughput trailed pre-COVID-19 figures, the gap is tightening, with throughput up 124% year over year. The DJIA Hotel Index ended 2021 up 31.5%, a remarkable rebound from 2020 supported by a strong $44.5 billion in investment activity. During the last quarter of 2021, US hotel investment volume also experienced significant growth: single asset deal volume increased 162% compared to the same period on sales of $28.0 billion last year.

Transaction volume of US commercial real estate sales surpassed pre-COVID levels in FY2021, setting a record high of $808.7 billion that handily outpaced analysts' projections of $600 billion. Multifamily (42%) and industrial (21%) dominated activity. Multifamily investment volume reached a high of $335.3 billion, up 128% year over year and 74% from 2019. Support was strong throughout the year, with average rents up by 13.4% and vacancy rates falling to 2.5%, a record low. Industrial set a record transaction volume in 2021, with asset prices up more than 80% from their pre-global financial crisis (GFC) peak.

Data centers took center stage through 2020 and 2021, remaining a major player in nontraditional real estate assets. Market capitalization rates fell to a historical low in the first half of 2021—analysts expect this trend to continue amid strong competition. Sustainability is a priority for all new construction; investors are placing more importance on clean-energy sources and alternative cooling solutions.

Distressed transaction volume was unexpectedly muted in 2021, as real estate proved resilient to COVID-19 and macroeconomic volatility. At the onset of the pandemic, managers believed that the downturn would be comparable to that surrounding the GFC; they raised billions in capital to revisit distressed investment strategies that proved successful after that downturn. However, the US government's swift action ensured a continued flow of capital into debt markets.

European Commercial Real Estate Debt

Investors in the European commercial real estate market remain optimistic, and 2021 wrapped up with investment volumes up across almost every sector. The strong session confirms the resilience of both the European economy and real estate markets.

Total volume was up 25% year over year. Residential and multi-family were two of the main drivers, with a +42% year over year change on a trailing twelve-month basis. Industrials, hotels and office space saw strong increases during the year. Looking to 2022, we expect capital for investment in Europe to grow based on this strong performance, especially as international investors return to market.

Debt activity across Europe, historically concentrated in larger markets like the UK, has become more geographically diverse recently, with some secondary markets in the eurozone, such as the Nordics, receiving more attention. Banks remain the primary debt source in Europe, but alternative capital is slowly gaining market share, as regulations continue to tighten and banks' risk appetite decelerates.

One theme that we've seen emerge is the uncertainty of future office use in Europe creating a positive force for the multi-family market, as pandemic lockdowns demonstrated the ability of people to work from home. Investors have shifted their focus and capital in response.

Within the prime-office sector, steady demand for both debt and equity investments has produced firm transaction volume. Loan-to-value ratios were mostly flat quarter over quarter, with certain sub-markets like Paris seeing moderate increases—hovering around 60%.

Residential real estate set a historical investing record in the third quarter of 2021, as 24.7€ billion of capital flooded into the market. Purpose Built Student Accommodation (PBSA) has yet to experience pricing tailwinds, with higher margins in multiple European markets suggesting less liquidity. We're seeing a cautious tone from investors as they evaluate PBSA opportunities.

Private Placements

The private placement market enjoyed another strong year of issuance, continuing a decade of steady issuance growth. Full-year issuance was up 5% versus 2020 at just under $80 billion, with the fourth quarter one of the busiest.

An interesting theme in 2021 was a pickup in the short end of the curve, driven partially by the composition of industries that have been active in the market—namely financial institutions. Financials have historically accounted for a relatively low percentage of issuance versus public-debt markets, and are generally much shorter tenor issuers. Because most private placement buyers are life insurers with much longer liability-duration profiles than, say five years, we think those that can allocate a percentage of their portfolio to this shorter-maturity bucket should do so.

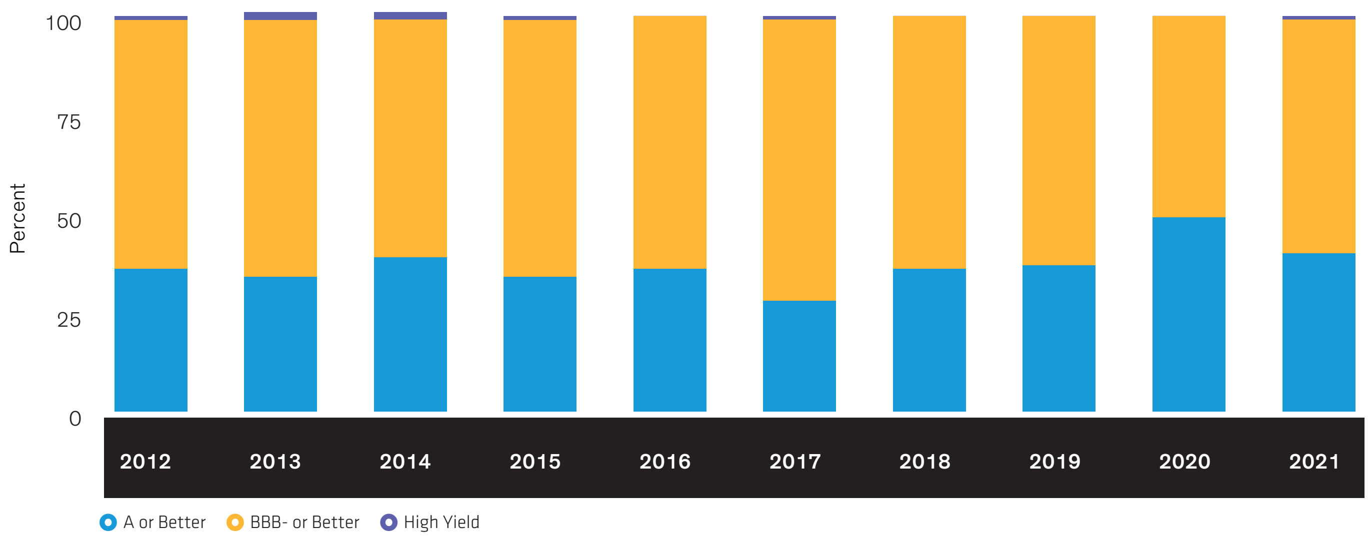
The short end of the curve has been relatively attractive, since traditional demand is in the 7–10 year cohort and even longer. However, we continue to emphasize that the composition of financial issuers in the private placement market differs from the public market. Banks rarely issue in the private market; typical financial issuers include asset managers, business-development companies and funds. We think these types of financial issuers offer an attractive way to diversify financial exposures within investment-grade portfolios.

Investor demand remained robust throughout 2021, contributing to lower spreads, especially among the more traditional industrial and utility issues that have been coming to market. That said, we're still seeing at least a 15 b.p. spread pickup over public corporates in those standard issues. But we think it's noteworthy that the dispersion of spreads in the market is wide, creating value in certain pockets including uniquely structured transactions and infrastructure deals.

Despite the strong demand—with most deals multiple times oversubscribed—we haven't seen weakness in the covenant packages connected to deals, which we've historically avoided. In our view, investors' unwillingness to accept weaker packages and documentation—which can be a differentiator when looking at private assets as a whole—is a sign of the market's long-term health.

The credit quality landscape began returning to historical norms in 2021. BBB-rated issuance ended a touch under 60% of the total, in contrast to 2020's tilt toward higher-quality investment-grade issuers coming to market—driven by the uptick in financial issuers, which typically carry AA or A ratings. Some high-yield issuance also returned, as investors' appetite for lower-quality investment-grade and below investment-grade issuance is becoming more prevalent. As we look forward to 2022, we expect this trend to continue, and we wouldn't be surprised by an uptick in high-yield issuance. However, this would still be only a fraction of total overall issuance.

CREDIT QUALITY OF PRIVATE PLACEMENT NEW ISSUANCE



For illustrative purposes only.

New deals by dollar amount. Numbers may not total 100% due to rounding.

As of December 31, 2021

Source: Bank of America

US firms once again were the majority of the market in 2021, but not to the same degree as in 2020. In other geographies, government support to local companies in 2020 made it unnecessary to seek financing in other venues, such as the private placement market. But as the need for that support waned, foreign companies' reliance on US private debt markets rebounded. Europe's and Australia's shares of global issuance each grew by 3% year over year, while US issuance dropped from 71% to 66%.

Despite this decline, US corporations' share of the market is still above pre-COVID trends. As we think about 2022, one theme we'll keep our eye on with respect to country issuance is emerging markets. Corporate issuance from entities domiciled in emerging markets was very slim during the pandemic, and it's an area that we think could grow in the medium term.

All signs point to another year of strong volume in 2022, with three sectors likely to remain active issuers: infrastructure, real estate investment trusts and financials. With no signs of strong investor demand abating in the near-term, it won't be surprising if spreads compress. Still, the private placement market offers investors value over public investment-grade portfolios via issuer and sector diversification, along with added risk mitigation from strong covenants and packages.

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