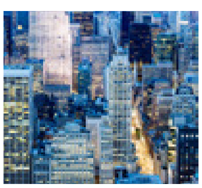
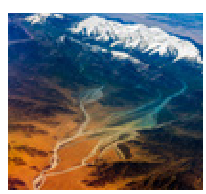
FitchRatings

November 2020 – Issue 9

Credit Journal

Leveraged Finance and CLOs





Welcome to **Credit Journal** – a curated compilation of Fitch Ratings' in-depth research and commentary. In this issue, we explore several angles of the leveraged finance and CLO market. We are committed to bringing transparency to the complex and evolving leveraged finance and distressed debt markets.

We hope this issue, as well as future ones, serve as reliable resources to help you make more informed investment decisions. We welcome comments for future issues, including suggestions for topical or credit-specific research.

For our latest insights, please visit **fitchratings.com**

Welcome

Nowhere is the depth and breadth of Fitch's expertise in corporate credit more evident than in our leveraged finance coverage.

In one of the most demanding global credit markets in history, the highest level of analytical skills are required to understand this sector's complex balance sheets, detailed and multi-layered corporate structures and complicated intercreditor relationships. Combining that understanding with the fundamentals of industry sector-based analysis from our dedicated corporate sector teams across 13 offices in the U.S. and Europe has made Fitch the most respected voice in leveraged finance ratings.

Each credit view combines bespoke borrower-level forecasts, a detailed analysis of current and projected capital structures and a well-researched view on enterprise values. Our recovery analysis reflects the same thorough evaluation of relative recoveries used by market practitioners daily, delivering an instrument-level opinion of unequalled transparency and credibility.

Backing this work is dedicated research and commentary from our specialist Leveraged Finance research teams in New York and London, looking at default rates, documentation trends, market evolution and more. Together with the unique insights of our colleagues at Covenant Review, LevFin Insights and Capital Structure, Fitch's view is an indispensable navigation aid through the most challenging zone of the corporate credit spectrum.

This Credit Journal will give you just a taste of the analytical resource Fitch offers to the leveraged finance markets. For more information, visit us online at *fitchratings.com/corporate-finance/leveraged-finance*.

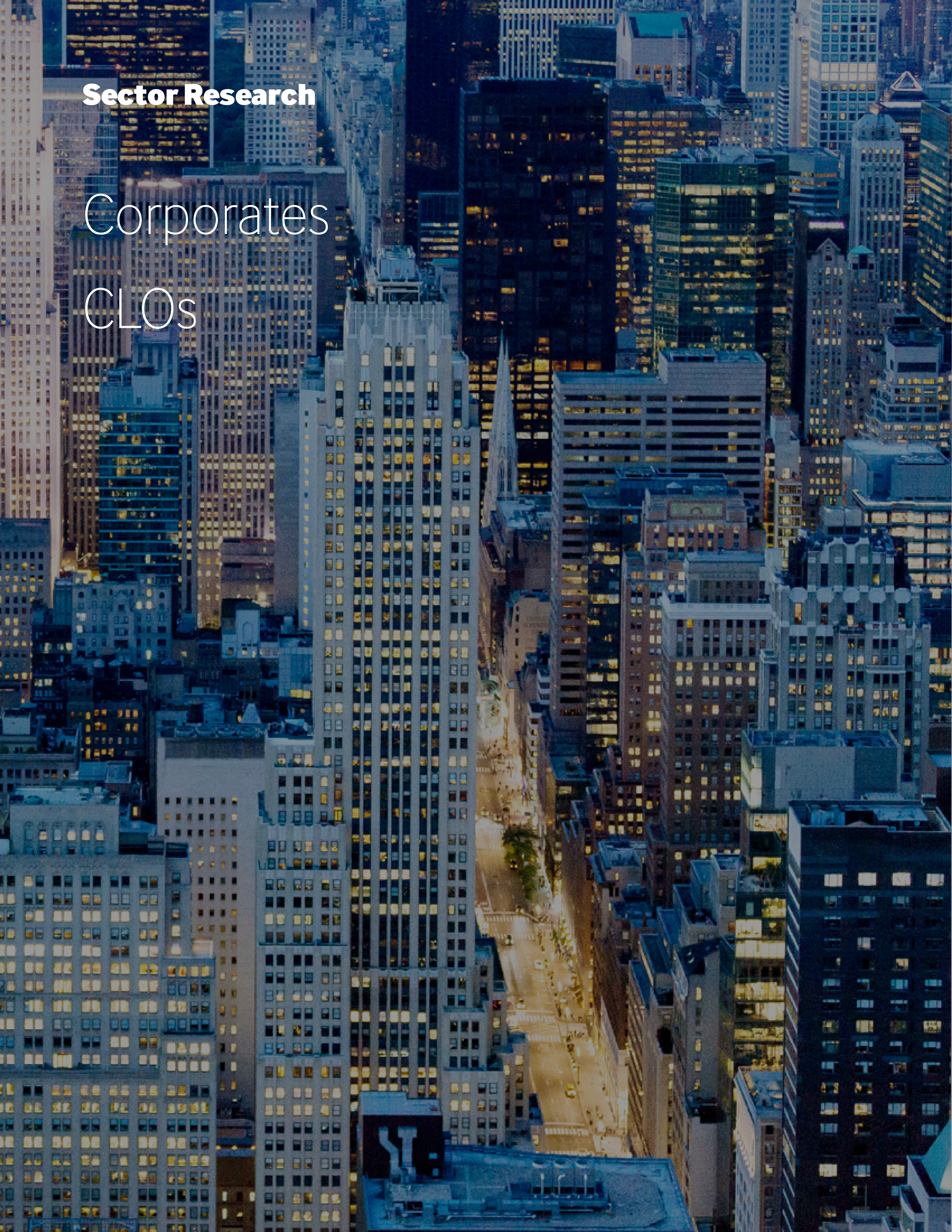
Enjoy your reading!

Richard Hunter
Global Head of Corporate Ratings

Sector Research

Corporates

CLOs



Corporates

Coronavirus Impact on U.S. Speculative-Grade Corporates

Fitch Ratings expects the coronavirus pandemic to put significant and long-lasting pressure on U.S. speculative-grade corporates; the eventual recovery will likely be uneven across and within sectors.

We believe that some recovery rates for defaulters during the crisis will be well below long-term average levels as an inverse relationship exists between default volume and recovery rates and there is significant uncertainty as to the length and severity of the downturn. The trajectory and timing of the rebound, along with the availability of corporate liquidity, will be driving factors of average loan and bond recovery rates during this stress period.

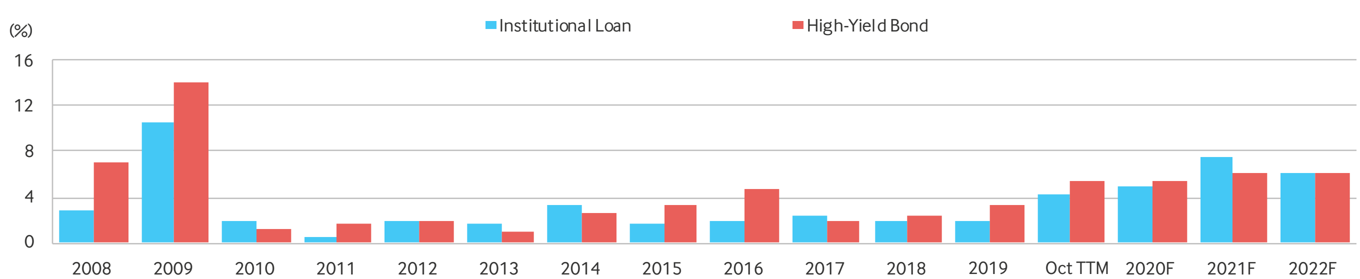
Our analysis of issuers rated 'B+' and below between March 17 and April 24 found that two-thirds experienced no 'RR' changes at any place in the capital structure. 86% of first-lien RRs were unchanged, even with the presence of many energy debt instruments and retail asset-backed loans. The remaining 14% were cut by one or two categories, and were primarily 1L-only capital structures. First-lien recoveries have trended lower in recent years as a result of increased reliance on loan-only capital structures and favorable borrowing conditions. This trend has continued since February but did not meaningfully accelerate as a result of the pandemic.

Flexibility in debt documentation has allowed some issuers to access the capital markets for rescue financing. The impact on ratings has varied. While the additional liquidity is necessary, on its own the financing may not indicate rating stability across all speculative-grade borrowers. In some cases, it may be helpful in extending the runway to default in the long run, but in the near-term, ratings may be negatively impacted. Fitch has taken downgrade actions in line with rating sensitivities where the additional debt is expected to result in sustained deterioration of the issuer's credit profile.

Pandemic to Keep U.S. Loan, HY Default Rates Elevated Through 2022

The depth and uncertain duration of the coronavirus pandemic will result in a multiyear period of elevated U.S. institutional term loan and high-yield (HY) bond defaults that could lead to higher than normal defaults through 2022. Our three-year 2020–2022 cumulative U.S. default rate forecasts for term loan (LL) and HY bonds are 17%-20% and 15%-18%, respectively. This forecast compares with the three-year cumulative default rate of 15% for LL and 22% for HY bonds from 2008 to 2010 occurring as a result of the Great Recession.

U.S. Historical Institutional Leveraged Loan and High-Yield Bond Default Rates



F – Forecast. Note: The years 2021 and 2022 represent the midpoint values related to the 2021 U.S. Institutional Loan Default Forecast Range of 7%–8%, 2021 U.S. High-Yield Default Forecast Range of 5%–6% and 2022 U.S. Leveraged Loan and High-Yield Default Forecast Range of 5%–7%.
Source: Fitch Ratings.

Sector Research

TTM LL and HY bond default rates stood at 4.3% and 5.5%, respectively, as of October 2020. We expect the 2020 LL and HY default rate to finish around 5% and 5.5%, respectively, equating to more than $70 billion of volume for both segments.

In addition, we lowered our 2021 forecasts to 7%-8%, from 8%-9% for LL and to 5%-6, from 7%-8% for HY bonds, partially due to government stimulus and the extension of debt maturities mitigating near-term default risk. We project total volume of defaults to exceed $100 billion for LL, surpassing the record $78 billion in 2009, and to remain around $70 billion for HY bonds in 2021.

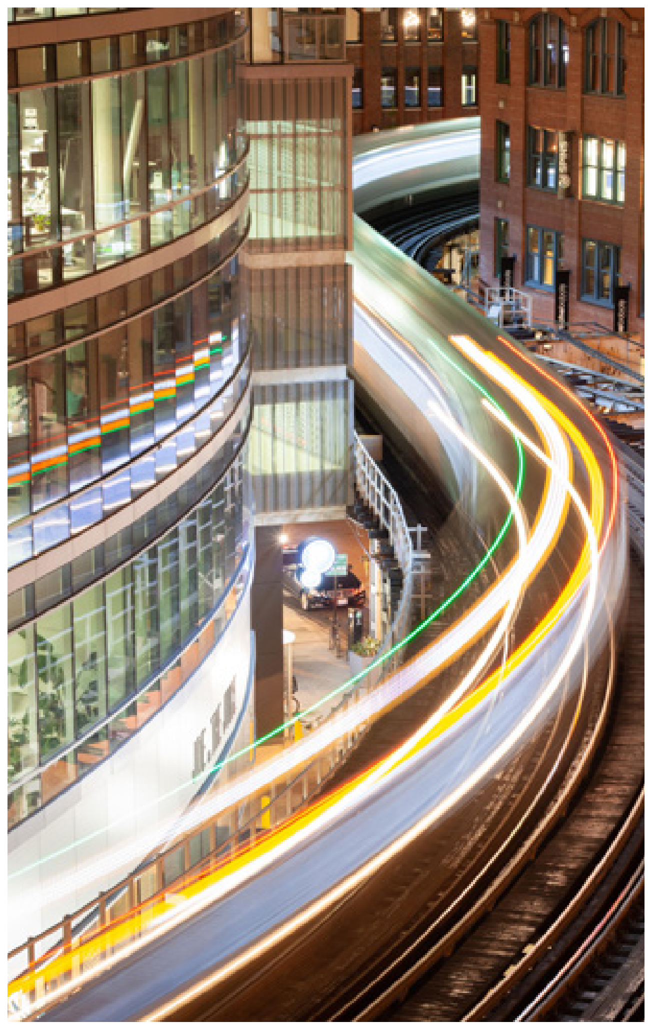
Some sectors continue to face more risk than others due to the pandemic. The combined 2021 LL/HY default rates are expected to be most acute in the leisure and entertainment industries, at more than 40%, and at approximately 20% or higher for retail and energy.

Coronavirus Takes Aim at Valuations in U.S. Bankruptcy

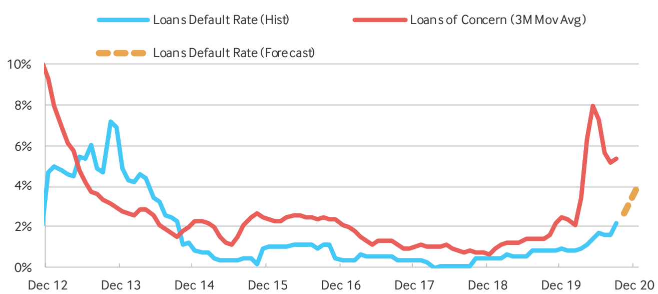
Recent occurrences of bankruptcy liquidations, as well as procedural difficulties in executing certain liquidating sales, demonstrate the degree of value erosion caused by the onset of the coronavirus. Specifically, bankruptcy liquidations in the retail, entertainment and restaurant sectors have faced unprecedented challenges due to the coronavirus lockdown and the impact on recoveries may be material.

Often, distressed borrowers who file for bankruptcy seek to maximize their value by demonstrating that the going concern value of the company is higher than an alternative liquidation value. If the going concern value of the company is so low that recovery would be maximized via liquidation, operations would be shuttered and an asset liquidation process is pursued. However, issues that may delay a swift and efficient liquidation of assets may further erode value and reduce recoveries.

The effect of the coronavirus lockdown (and the broader economic decline) on retail and restaurant operations has led several distressed companies to either abandon plans for a going concern restructuring or to seek liquidation. However, besides merely triggering liquidations, the negative impact of the lockdown on liquidating procedures (including the inability of retail debtors to properly conduct going-out-of-business sales) may further reduce liquidation values and impair secured lender recoveries. Unsecured creditors such as landlords may also be affected by bankruptcy court rulings allowing bankrupt companies subject to the lockdown to suspend rent payments for a period of time while in bankruptcy.

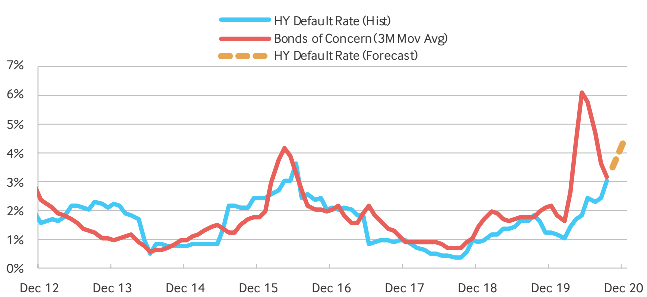


European Loans of Concern vs Default Rate



Source: Fitch Ratings

European Bonds of Concern vs Default Rate



Source: Fitch Ratings

European At-Risk Leveraged Credit

Trailing 12 months default rates for Fitch Ratings' European corporate HY bonds and loans rose to 3% and 2.2%, respectively, in September 2020. Fitch maintains its forecasts for European default rates in 2020 at 4.5% for bonds and 3.8% for loans as concerns about a second wave of the coronavirus pandemic extend social-distancing and travel restrictions on issuers in vulnerable transport and leisure-related sectors.

We reviewed approximately 90% of our EMEA HY bond and loan portfolio by the end of September. Fitch initiated expedited reviews in March 2020, prioritizing issuers with near-term maturities and low rating headroom entering the crisis, and within sectors highly exposed to the direct economic impact of social distancing and travel restrictions.

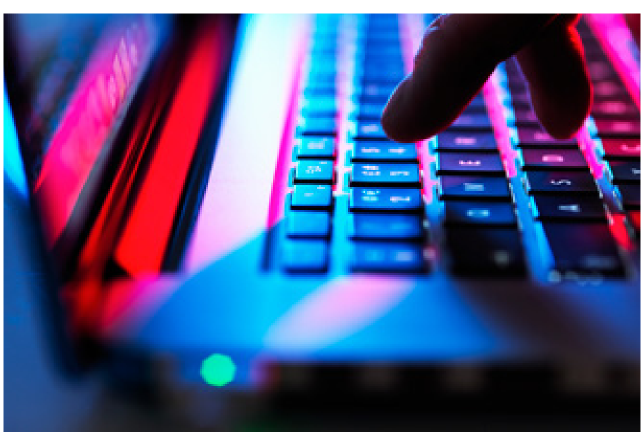
Downward rating migration has resulted in 45% of entities in the European leveraged portfolio having ratings and Credit Opinions of 'B-' or 'b-*' and below. The share of those with Negative Outlooks or in the 'CCC' category (the "at-risk" credits) declined to 26.2% in September. We expect the at-risk portion of credits to continue to stabilize or decline in 4Q20 as the worst of the crisis passes. Proactive liability management on stressed credits, including asset sales, equity raisings and debt-for-equity swaps, will lead to positive rating actions, while defaulted credits and distressed debt exchanges should improve credit profiles.

The length of our Concern Lists declined for the four consecutive months ending September, down to 2.7% of the bond market and 5.1% of loans, since peaking from March to May. The declines reflect fewer rating actions, improved secondary-market conditions (which also supported refinancings) and defaults. We expect default rates to continue rising into 2021 as issuers in sectors affected by the extension and re-introduction of social distancing protocols and travel restrictions engage creditors for balance-sheet relief and additional liquidity.

Coronavirus Impact on the U.S. TMT Sector

Fitch views technology as having medium exposure to the effects of coronavirus pandemic relative to other corporate sectors due to weaker expected demand as supply chain challenges have largely eased. However, end-market mix and exposure, as well as financial flexibility, will determine the ultimate impact on operating and credit profiles within the sector. Technology issuers with exposure to small and medium-sized businesses. as well as to the automotive, transportation, consumer and industrial end-markets, will struggle to regain operating and revenue growth momentum.

U.S. media companies are facing broadly negative effects on near-term operating profiles as a result of the coronavirus pandemic, with varying implications across advertising, television and out-of-home entertainment. Companies with heavy exposure to out-of-home entertainment, including theme parks, filmed entertainment and movie theaters, will be most affected in the near term.



Fitch believes the telecom sector will be more resilient in a downturn than other sectors, with the potential for modest declines in revenue (assuming the economy turns in 2H20). In the near term, residential customers should be relatively resilient, but under increasing pressure over time as unemployment rises. These supportive factors are balanced against potential lower revenues from business customers.

Recovery Analysis for Recurring Revenue Software Companies

Recent transactions in the software and data analytics segment indicate a growing level of investments with private equity firms in early stage companies with yet-to-be-proven business models. These deals have historically attracted venture capital investments. At the time of acquisition, some companies were near breakeven or still incurring negative EBITDA.

Venture debt-funded tech companies that are privately rated or assigned an Issuer Default Credit Opinion by Fitch tend to be evaluated in the 'CCC' range. Many of these companies may have a strong market position in growing industries and material revenue growth. However, their credit profiles are pressured by a lack of meaningful EBITDA generation, weak or negative margins, and negative FCF. These companies tend to be aggressively levered, typically due to significant spend on operating expenditures and on growth to reach critical mass when profits can be realized.

The structure of loans to early-stage high-growth software and data analytic companies reflects this lack of earnings history and minimal or negative EBITDA. Credit agreements documenting the transactions are replacing adjusted EBITDA-based metrics and financial

covenants with others based on recurring revenue metrics. EBITDA-based metrics use some measure of a company's profitability or financial health. However, since recurring revenue is pre-expense, metrics based on recurring revenue are not tied to the profitability or financial performance of the company. Increasing revenues do not equate to increasing profitability, as expenses may outpace revenue growth and margins may deteriorate. A company may have reduced its ability to service debt, yet this would not be accounted for within a recurring revenue-based metric.

Fitch expects the financial performance of debt-funded growth-stage companies to be negatively affected by the coronavirus crisis, primarily due to the sector-specific exposure of the individual companies to end-market customers. Exposure to businesses heavily affected by physical distancing will result in greater negative effects.

U.S. Gaming: Half a Year into the Pandemic, Las Vegas Has a Problem; Regional Gaming Picking Up Slack

A reacceleration of infections related to the coronavirus pandemic is not likely to result in the widespread re-closure of U.S. casinos, which showed resilience during the summer spike in infections. Our Negative sector outlook suggests that downside credit risk remains but strong liquidity will help operators navigate a volatile recovery toward pre-coronavirus norms.

The Las Vegas Strip will experience the slowest recovery relative to other major gaming markets and segments globally, given its greater reliance on inbound visitation, air capacity (nearly 50% of visitation comes by air), and conventions. Air capacity is still about 60% of normalized levels and visitation is even lower.

While gaming declines are less severe, about two-thirds of the Strip's revenues are non-gaming and will require a rebound in tourism and conventions. Recent easing of group restrictions is a positive but Fitch does not envision a material increase in convention attendance or broader air capacity until a health solution is present.

Regional casinos have rebounded since re-openings started in May 2020. Operators reported significant margin expansions after the re-openings due to lower promotional and amenity expenses. However, Fitch expects margins to normalize as the recovery progresses. New Jersey and Pennsylvania online gaming revenues remain elevated subsequent to re-openings, suggesting some land-based gaming may have permanently migrated to online.

Following the debt issuances of 1H20, the sector is sitting on an abundance of liquidity to navigate the recovery. Operators termed out defensive revolver draws with mostly unsecured notes while also pushing out maturities to 2022 and beyond. De-levering capacity will be stronger for regional operators and suppliers; global operators will see a slower path to being FCF positive due to prolonged weakness in destination markets. Most issuers have some rating cushion on the downside given Fitch's focus on 2022/2023 leverage metrics.

Sector Research

CLOs

Fitch Provided Thoughts on Coronavirus Impact on U.S. CLOs

In a What Investors Want to Know report, Fitch Ratings answers commonly asked questions on the impact to U.S. CLOs from business and market disruption due to the coronavirus pandemic. Fitch is continually assessing CLO notes based on our current views of how the pandemic and related mitigation measures are affecting leveraged loans and CLO portfolios.

Factors that most impact ratings on CLO notes include downgrades to issuers of U.S. leveraged loans held by CLOs, recoveries on loans that default and correlation between the portfolio assets. As such, Fitch initially applied a stress scenario in March to all CLO portfolios globally to capture anticipated rating changes to leverage loan issuer ratings and flag notes vulnerable to such actions. Fitch applied a one-notch downgrade (with a 'CCC-' floor) to all assets from issuers in eight industries identified as being most exposed to negative performance resulting from business disruptions related to the coronavirus. A multiplier of 0.85 to recovery rates on these companies' loans was also incorporated. Outside these industries, a one-notch rating adjustment (with a 'CCC-' floor) was also made to all companies' ratings that were on a Negative Outlook. New rating analyses as well as a review of every CLO under Fitch's surveillance was tested under these stresses.

As corporate rating reviews have been undertaken, Fitch has moved away from industry-related notching to issuer-specific notching. Ratings to issuers with loans that are on a Negative Outlook are taken down one rating level (with a 'CCC-' floor), without any additional recovery stress. Ratings on Rating Watch Negative are already notched down, as per criteria.

Reports issued when ratings are assigned and reviewed (if a new rating, outlook, or watch assignment is made) will explain the sensitivities run on the respective portfolios.

Fitch provides resources to investors to monitor CLO metrics. These include Tracker files that summarize a deal's key features, the original rating hurdles and current portfolio metrics. There are also regular reports such as the U.S. Leverage Finance and CLO Weekly newsletter, *U.S. CLO Index* and *U.S. Middle Market CLO Snapshot*.

Static CLOs May Face More Rating Volatility Than Revolving CLOs

CLOs with static portfolios will have more rating volatility on their notes when compared to those issued by CLOs with revolving portfolios. This is due to the absence of a stress portfolio in Fitch's analysis of static CLOs that create buffers against rating thresholds. Ratings assigned are robust and loss hurdles are comparable across CLO types. This volatility can be anticipated by comparing the default cushions for notes from static CLOs, which would be lower, with those for notes from revolving CLOs, available per deal on Fitch's website.

The default cushions published for each class of notes indicate the level of additional defaults the portfolio can absorb given the assumed recovery rate for the stress level before a CLO note may be downgraded, if all other key rating drivers remain equal. Investment grade rated notes are expected to be repaid in full despite some volatility. Adjustments to the ratings are to ensure that ratings are comparable across products in terms of default probability.

The market has recently shown greater interest for issuance of static CLOs where the portfolio is identified and purchased prior to or at the closing date of the CLO. This portfolio approach offers note investors a clear view into the underlying collateral that will be available to support repayment of their notes.

Fitch's uses the same methodology for assigning ratings to CLO notes of static portfolios and maintaining ratings on notes issued from CLOs with revolving portfolios. Additionally, Fitch will continue to publish the break-even default rate, recovery assumptions and default cushions for each class relative to the hurdle levels for the CLO note ratings assigned. This allows investors to consider the level of portfolio deterioration that each note could withstand prior to a rating revision.

CLO Manager Survey Illuminates Resources at Platforms

Experience and workload at CLO platforms are among the features that Fitch details in its survey compiled from responses of CLO managers that participated in Fitch's CLO Asset Management Handbook. There were 121 firms represented.

U.S. and European CLO portfolio management (PM) teams have nearly 25 and 23 years of experience on average, respectively. The largest average range of experience for PMs within U.S. CLO teams was 20 to 25 years (52% or 59 of 113 managers reporting). Only 21 or 19% reported having teams with less than 20 years' average experience, with the lowest being 14 years. A greater proportion of European platforms (35% or 15 of the 43 managers reporting) had PM teams averaging less than 20 years.

Supplementing this, 55% (59) of U.S. managers said their credit analyst teams had an average of 10 to 14 years of experience and 6% (six) reported analyst teams with over 20 years of experience. Only 14% (15) reported having teams averaging less than 10 years of experience. Overall, the U.S. team average was 14.7 years and the European team average was 10.5 years.

Most CLO managers said their staff handled 30–50 names per analyst (65%). Some noted heavier workloads, with 9% of platform respondents indicating their analysts covered over 50 names. Roughly 10% reported 20 credits or less. European platforms reported a significantly higher concentration in the 20–30 credits per analyst category than U.S. firms, at 45% versus 16%, indicating smaller average caseloads.

Sector Research

Fitch invites all active issuers of U.S. BSL, U.S. MML and European CLOs to participate in the annual survey and to be included in our CLO Asset Manager Handbook published every year.

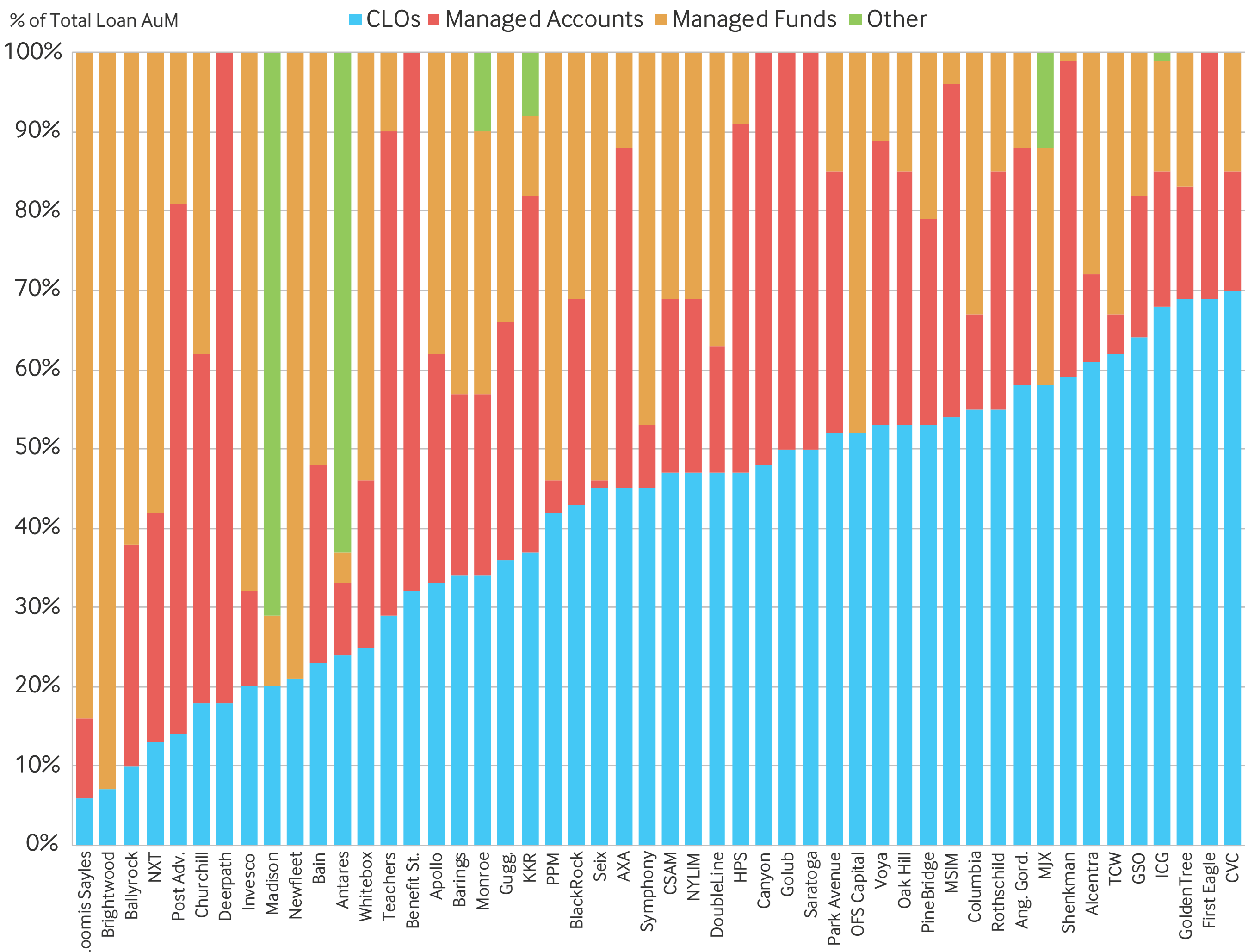
CLO Managers Show Diversity in Their Assets Under Management

A large proportion of collateralized loan obligation (CLO) issuers manage loans outside of CLOs, highlighting the fact that many issuers are not solely dependent on CLO management fees. Diverse loan platforms can strengthen managers' ability to weather slower periods of CLO issuance.

Multi-channel managers have the advantage of other sources of assets under management (AUM) from separately managed accounts, retail/private funds or other products with more active investor interest during volatile credit cycles, such as opportunistic funds and distressed credit. When markets slow, firms with diverse

CLO Manager Loan Product Diversification

Firms With >30% Non-CLO Product Offerings



Source: CLO Asset Manager Handbook

business models and established investment platforms are often well positioned to maintain consistent analytical staff levels through loan product reallocation/ AUM retention.

Higher investment staff levels are typically associated with lower credits-per-analyst ratios and, in turn, with more attention paid to individual loan assets, which can support higher returns over time.

Responding managers from Fitch Ratings' annual CLO Manager Handbook survey reported loan AUM in the following categories: CLOs, managed accounts, managed funds, or "other" products. Of the 114 firms providing this data, 87, or 76%, reported managing some portion of loan assets outside of CLOs, with responses ranging from less than 1% to 94%. Of these firms, 54, or 47%, reported having at least 30% non-CLO loan AUM.

No specific structure or investment mandate dominates this group of 54. It is more or less representative of the overall Handbook list, including large institutional affiliates, private equity firms, alternative credit specialists, insurance arms and broadly syndicated loan boutiques.

Payment Frequency Mismatch Widens in European CLOs

European CLOs have been witnessing a rapid increase in semi-annual interest obligations from quarterly payments that has widened the payment frequency mismatch between underlying loans and rated quarterly-paying European CLO notes. The share of semi-annual obligations among many Fitch-rated CLOs jumped to around 50% of the portfolio balance in July 2020 from less than 20% in December 2019.

Post the last financial crisis, CLOs have been managing a mismatch between payment frequencies of underlying loans and rated notes through a frequency switch event (FSE) and the maintenance of an interest smoothing amount (ISA). Until now, FSE and ISA had been a dormant clause in CLO documentations. However, the recent rising trend of semi-annual obligations presents a possibility of CLOs switching to semi-annual or maintaining an ISA.

FSE is a mechanism to switch the payment frequency of the rated notes to semi-annual and the base rate for floating-rate notes to six-month EURIBOR. FSE will trigger if a considerable percentage of obligations switch their payment period to less frequent than quarterly in the same due period. Such obligations are called frequency switch obligations (FSO). In most transactions, the threshold percentage for FSOs is set at 20% of the aggregate collateral balance, along with an additional condition of the adjusted senior interest coverage ratio (ICR) being less than a certain percentage, which ranges between 100% and 120%.

So far, no Fitch-rated European CLOs has triggered an FSE, which indicates either that the FSO threshold is not being breached or that significant headroom remains on the adjusted senior ICR. Given a recent spike in the proportion of such obligations in the portfolio, we would expect managers to mitigate the widening payment frequency mismatch by setting aside some reserves as ISA in the next few months. Fitch does not see this recent increase of semi-annual obligations as increasing credit risk given that the FSE and ISA mechanism is already in CLO documentations.

European CLO Note Ratings Resilient

European CLO ratings have been fairly resilient since the beginning of the coronavirus pandemic and downgrades have been limited to a few tranches rated 'BBBsf' or below.

Fitch placed around 260 tranches, mainly rated in the 'BBBsf' and below rating categories, on Rating Watch Negative (RWN) between April and June 2020. Since then, the agency has resolved approximatively 80%, most of which were affirmed with a Negative Outlook. The Negative Outlooks on these tranches reflect the risk of medium-term credit deterioration due to the economic fallout from the pandemic.

Forty-one tranches have been downgraded by a single notch, primarily at the non-investment grade level, though four 'BBBsf' tranches were downgraded to 'BBB–sf'. The bulk, 34 'BBsf', were downgraded to 'BB–sf', and three 'Bsf' were downgraded to 'B–sf'. The downgrades reflect the deterioration of the portfolios resulting from the negative rating migration of the underlying assets.

The average credit quality of the portfolio backing European CLOs has been stabilizing. The Fitch weighted average rating factor (WARF) remains just below 35 while the average 'CCC' exposure remains just below

7%. The net portfolio gain/loss was negative for the sixth consecutive month and decreased to -0.4% in October from -0.3% at end-September 2020.

U.S., Europe CLOs See Improved Market Conditions in Q3

Market conditions for U.S. and European CLO primary issuance improved during the third quarter of 2020, with issuance, average 'AAAsf' spread levels, reinvestment periods (RP) and weighted average life (WAL) tests for transactions that priced during the quarter stabilizing or normalizing. Year-on-year comparisons still show caution, however.

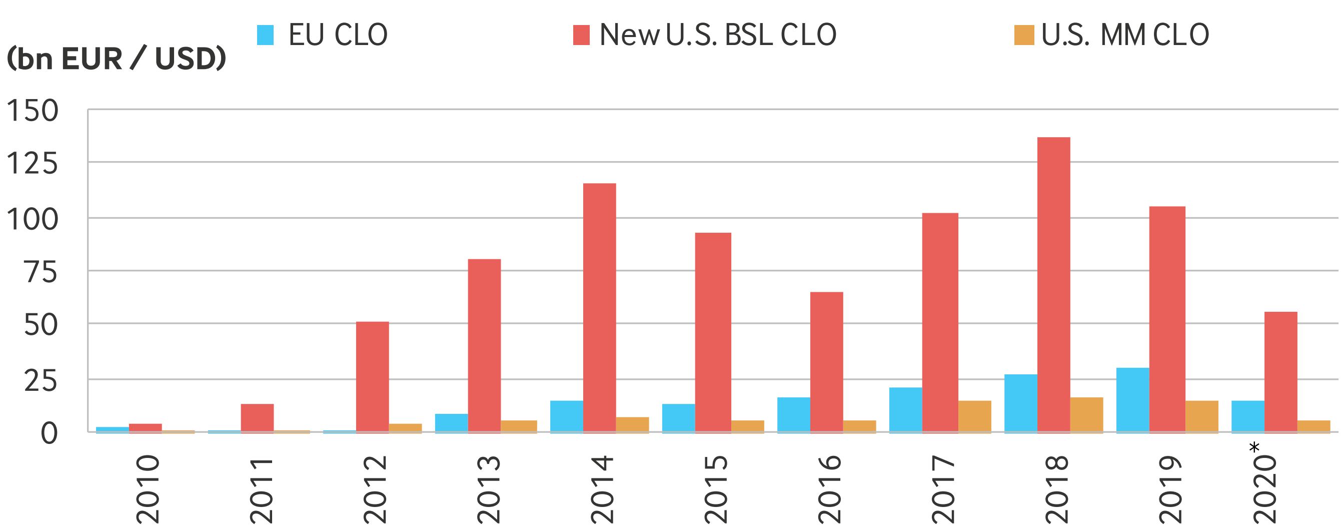
Issuance for U.S. broadly syndicated loan (BSL), middle market (MM) and European (EU) CLOs all were higher in Q3 than other quarters this year. All average RP lengthened, with the U.S. BSL CLOs maintaining the longest RP compared to the other types, as usual. Typical U.S. CLOs that priced in Q3 averaged 3.2 years, while EU CLOs averaged 2.7 years and U.S. MM were 2.4 years. This comes as senior-most spreads tightened for all categories to 158 bps for U.S. CLOs, 136 bps for EU and 223 bps for MM. Each were much higher than levels logged at the end of 2019 (136 bps, 93 bps and 17 8bps, respectively).

The WAL test for newly pricing CLOs in 3Q averaged in the 7 to 8 year context, increasing by around 6 months compared to 2Q deals.

Credit quality in CLO portfolios showed signs of stabilizing in 3Q, with various metrics showing improvement. Average overcollateralization (OC) cushions built-up in U.S. BSL CLOs and EU CLOs, though MM CLOs continue to thin, but from a higher base versus the other types of CLOs. The average weighted average spread (WAS) improved for U.S. BSL and MM CLOs in 3Q20, while remaining stable for EU CLOs. It averaged 3.7% for U.S. BSL CLOs, 3.8% for EU CLOs and 5.7% for MM CLOs. WAS is being supported by new underlying loans with higher spreads and also by LIBOR floors.

U.S. BSL and European CLOs saw declines in their average 'CCC' exposure (including +/-) and default exposure quarter-on-quarter. The rates were the highest in U.S. MM CLOs and increased on the prior quarter.

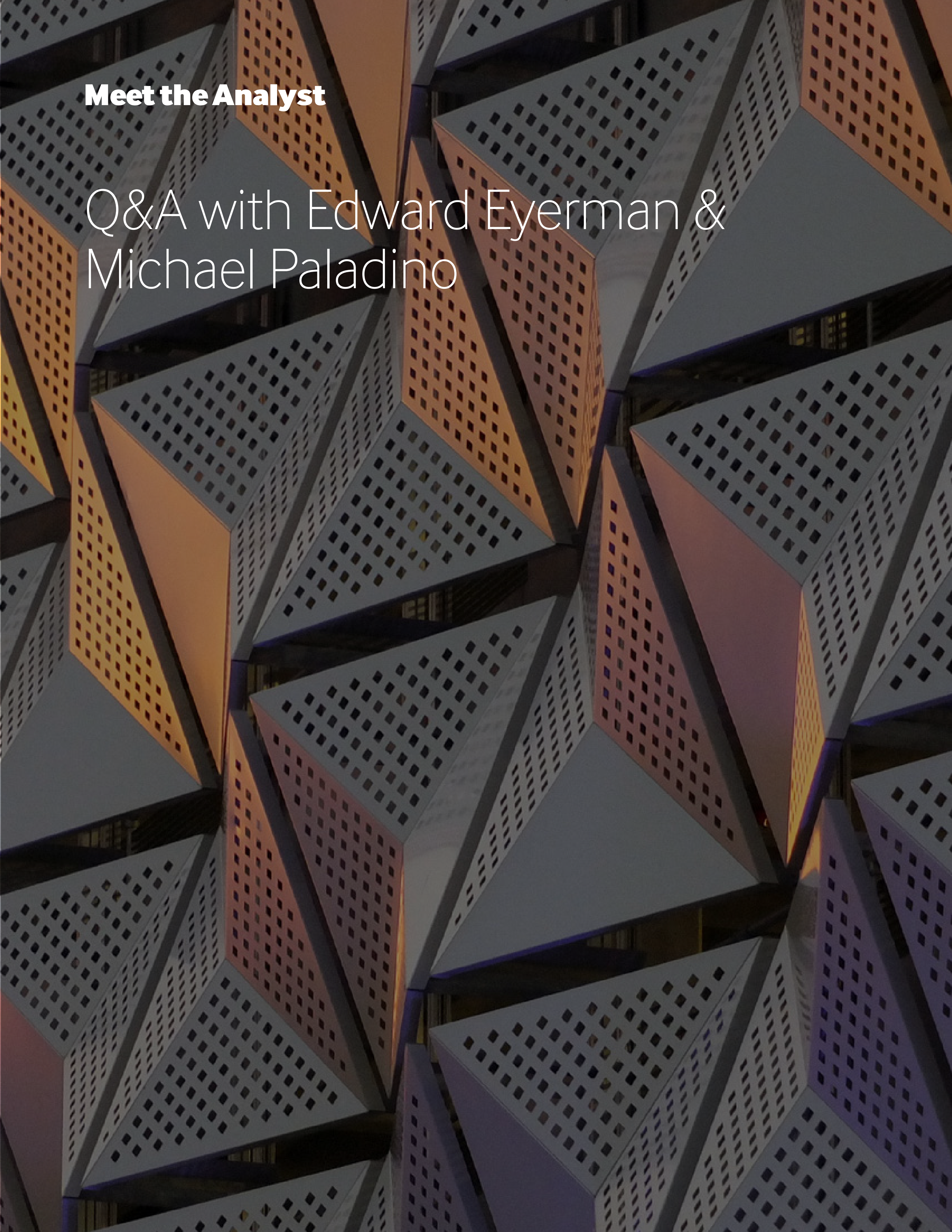
New CLO Issuance



Data for EU new issue CLOs only, US data for new issue and reissue CLOs
Source: Fitch Ratings, public domain
*As of October 2020

Meet the Analyst

Q&A with Edward Eyerman & Michael Paladino



Edward Eyerman
Managing Director
Head of European
Leveraged Finance

Michael Paladino
Managing Director
Head of U.S.
Leveraged Finance

Edward Eyerman & Michael Paladino

Q. At a high level, how have credits been impacted by the current environment?

Edward Eyerman:

A. The pandemic interrupted business operations and raised immediate funding needs across large segments of our EMEA high yield bond and loan portfolios. A few exceptions relate to issuers in telecommunications, healthcare and food retail, where the pandemic accelerated business activity. In addition to the near-term lockdown impact, medium-term revenue, operating profit and corresponding credit metric assumptions for 2020 and 2021 required adjustment, leading to over 100 downgrades and a further 50 issuers with current ratings placed on Outlook Negative.

Michael Paladino:

A. As the pandemic worsened in the U.S. and the financial markets began reflecting the reality of the severe economic impact ahead of us at the time, we started to see corporate behavior that we would expect in a crisis. Liquidity in the market shut down, issuance halted, and companies drew revolvers, hoarded cash, cut costs and furloughed workers.

We reviewed nearly 700 leveraged credits with the greatest risk among issuers within industries directly impacted by shutdowns and smaller companies. More than a third of the entities in our leveraged portfolio entered the crisis with low rating headroom, and many were in high exposure industries. Favorable credit markets over the last few years contributed to significant growth at the lower end of the loan market. As a result, 2/3 of the portfolio was entering the crisis in the B category or lower with the largest cohort at B– encompassing many of our private monitored ratings, which are largely middle market companies. This indicated particular risk in the middle market/direct lending portion of our portfolio, given the high demand and search for yield we've seen in this segment of the loan market over the last few years.

Q. What are the risks and opportunities that you see in the coming months?

Edward Eyerman:

A. Continued social distancing protocols and travel restrictions may lead to more material delay in recoveries with a corresponding rise in unsustainable debt burdens, especially for travel and leisure issuers. Monetary and fiscal policy support may accelerate recovery and lead to a more rapid return to pre-pandemic leverage levels.

Michael Paladino:

A. Positively, the initial pandemic-related shutdown in the U.S. capital markets was relatively brief in comparison to the Global Financial Crisis, which impacted financial institutions to a greater degree. Additionally, government support programs injected needed liquidity that helped weaker companies, enabling some to meet near-term financial needs as business activity was being impacted.

However, leveraged markets face notable headwinds in the coming months. There is the potential for a second wave of lockdowns, particularly as businesses re-open

Meet the Analyst

and outdoor options become more limited in winter months. A vaccine may take longer than expected to develop while the ultimate distribution and consumer willingness to take a vaccine adds to uncertainty as to when markets feel that we are truly beyond pandemic-related risks. Lastly, leveraged markets face near-term risks related to the completion of government support programs and uncertainty regarding subsequent support, as well as the potential for a prolonged disputed U.S. presidential election.

Q. What is the longer-term outlook?

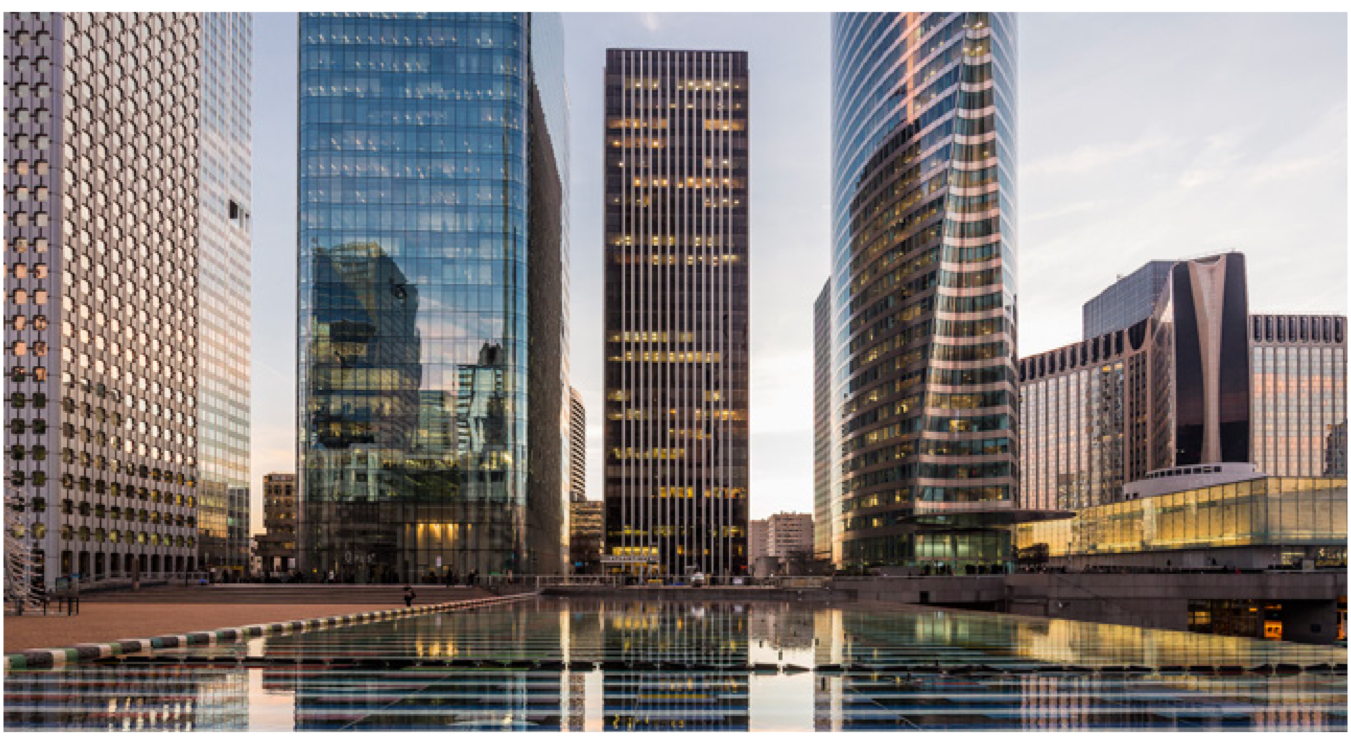
Edward Eyerman:

Many credits entered the crisis with high leverage as attractive coupons and loose terms led issuers to pursue debt-funded acquisition strategies or extract dividend payments via debt-funded re-capitalizations. The business interruption and increased funding needs from the pandemic raised leverage further such that debt maturities in 2023 and beyond may represent a substantial maturity wall.

Many issuers will require capital market conditions to remain as accommodative or even more accommodative than they are today. Policy stimulus may result in a stronger operating profit and de-leveraging outlook, though they may also imply that price pressures and benchmark interest rates may rise from current historical lows.

Michael Paladino:

A. We expect U.S. default rates to be elevated through 2022 largely as a result of the pandemic. We now expect 2020 default rates of 5% for leveraged loans and 5.5% for high-yield bonds, roughly 200 basis points higher than our pre-pandemic forecasts of 3% and 3.5%, respectively. Longer-term, we forecast the cumulative three-year U.S. default rates for 2020-2022 to approach 17-20% for leveraged loans and 15-18% for high-yield bonds. This compares with the cumulative three-year default rate of 15% for LL and 22% for HY bonds from 2008 to 2010 occurring as a result of the GFC.



Company News

Fitch Solutions Launches New Fitch Ratings ESG Relevance Scores Data Product

Fitch Solutions has launched a new product, Fitch Ratings ESG Relevance Scores Data, which allows market participants to transparently and easily analyse credit risk as it relates to environmental, social and governance factors for Fitch-rated entities.

Fitch Ratings ESG Relevance Scores Data provides ESG relevance scores for the majority of Fitch Ratings' publicly rated entities and transactions across corporates, banks, non-bank financial institutions, insurance, public finance (international and US municipal), global infrastructure and structured finance (ABS, CMBS and RMBS).

The Fitch Ratings ESG Relevance Scores Data builds on Fitch Group's commitment to a growing ESG franchise.

For more information see *https://www.fitchsolutions.com/products/fitch-ratings-esg-relevance-scores-data.*

CREDIT-RELEVANT ESG SCALE - DEFINITIONS

How relevant are E, S and G issues to ther overall credit rating?

5	Highly relevant; a key transaction or program rating driver that has a significant impact on an individual basis.
4	Relevant to transaction or program ratings; not a key rating driver but has an impact on the ratings in combination with other factors.
3	Minimally relevant to ratings; either very low impact or actively mitigated in a way that results in no impact on the transaction or program ratings.
2	Irrelevant to the transaction or program ratings; irrelevant to the sector.
1	Irrelevant to the transaction or program ratings; irrelevant to the sector.

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Company News

Fitch Bohua Receives Approval to Rate China Onshore Issuers and Bonds

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Business Contacts

Aymeric Poizot, CFA, CAIA
Global Head of
Investor Development
+33 1 44 29 92 76
aymeric.poizot@fitchratings.com

Jill Zelter
Global Head of Corporates
and Structured Credit
+1 212 908 0774
jill.zelter@fitchratings.com

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