Dear Friend of AGL,

Our current and prospective investors ask us about bank loan market issues and trends, including credit quality, risk adjusted returns, covenants, timing and related matters.

We discussed many of these subjects with you in recent meetings. With Q3 2019 behind us and the seasonally active Q4 underway, we would like to take the opportunity to summarize AGL's current view on these subjects as follows:

<u>Credit Quality</u>

Contrary to the general press take on leveraged loans (past and present), especially Broadly Syndicated Loans, the businesses of most borrowers today compare favorably to that of past vintages. In most cases these are companies that survived the Great Recession, and many successfully focused on improving productivity in the challenging environment of limited ability to increase prices or pass through rising costs given intensified global competition. On the "business" side most companies are more "fit". This is definitely the case compared to the last cycle's cohort (2004-2007), when there was a speculative element to M&A and LBO investing, and especially so compared to the late '80s cycle that put leveraged M&A, including LBOs and Recapitalizations, on the map.

Of concern and appropriately so, is that leverage is at a high historical level as viewed through the lens of "top down" statistical aggregates. This vantage point can however obscure the great variation in leverage levels in this very large borrower population, including more moderate leverage levels of many borrowers. This includes those with higher enterprise values by virtue of recurring revenues, which can account for a higher proportion of the business mix of some companies today compared to more cyclical ones in the past. The US economy continues to evolve as well as grow. For example, the enterprise software services sector has been expanding 2-3X faster than GNP, and in many cases these borrowers justifiably have higher than average enterprise valuations. More significantly, many of these companies are highly disruptive to incumbent business models, firms and entire industries. We think this is a central credit quality concern, and one that is harder to identify and track than leverage. This is especially relevant in the context of investing in medium term loans, indeed in corporate debt of any type, including High Yield and Direct Lending, where the possible disruptive impact of "digital" and other changes may take time to become evident. In this regard it is worth noting that rating agency industry definitions in use are more than a decade old and can be less useful than before to assess industry level diversification.

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Also, of concern are the related recent phenomena of cash flow (EBITDA) addbacks which can understate leverage. Discerning net leverage is a key part of the investment analysis and due diligence process. The critical investment point with senior secured loans is the thickness of the "Value Cushion" of junior capital that underpins the collateral in the event of stress. Any assessment of this must not be based on marketed EBITDA but a prudent estimate of a "run rate" level. This and future projected cash flows are then downsized for negative scenario forecasting which is an essential part of the evaluation (which is enhanced for us by being a private side manager with access to material non-public information and direct conversations with management). Every investment we consider is evaluated on a case by case basis within the context of its industry, and with a specific focus on the relevancy of its business model and competitive position.

Another area of focus is the increasing number of "loan only" capital structures. This in part results from the recent period of rising interest rate expectations which then reversed early this year. This caused the new issue Broadly Syndicated Loan market to partially disintermediate the High Yield one but now the opposite is happening with strong High Yield issuance. Smaller borrowers in many cases have no access to junior debt, or if they, it is part of a "capital stack" where some investors participate in senior, junior and often also equity. The key point is not whether a borrower's indebtedness is all loan or not, but the extent of junior capital underneath it, which is the "Value Cushion" cited above. It is the level of senior leverage relative to a prudent estimate of enterprise value that matters most, and the degree of protection the collateral provides.

<u>Recent "Fallen Angels" and loan market price softness</u>

There have been a number, arguably small (1-2%) in an historical context, of negative borrower credit surprises resulting in big market price drops along with some ratings downgrades. This is a powerful reminder that credit risk comes in many forms starting with recession and industry risks, but paramount is idiosyncratic risk of each individual borrower. As useful as statistical averages and quantitative model-based methodologies are, it is specific borrower level analysis, both initially and on an ongoing basis, that matters most. Private side access is, needless to say, an advantage.

Loan prices have recently sold off moderately due to retail fund redemptions. This has not been due to recession concerns but the lower appeal of a floating rate product in the context of declining interest rates. Conversely in High Yield funds, prior outflows have reversed into inflows as investors seek to lock-in fixed rates (discussed further below). The loan price softness, including wider new issue spreads and bigger purchase price discounts, have made for more attractive investment opportunities at a given level of credit risk.

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A useful point about loan and all asset market price changes is these reflect the changing balance of supply and demand. Fundamentals are often the driver as in the case in the "fallen angel" examples just cited. Price changes can be sentiment, or even panic driven, as in 2008, when the loan index was just above 60. This implied, conceptually, that 100% of all loans in the index would default and recover 60 cents on the $, *or,* that 40% of all loans would default and recover zero (in these examples the assumption is that 60 is not an average, but the price of all loans in the index). It can also be purely technically driven at times, such as an investment category being "full" (e.g. loans rated B-/B3 in a given industry), or by 2nd order effects, such as the exit of many retail investors from floating rate products as described above.

<u>Availability of Loans and Depth of the Asset Class</u>
There is a sufficient quantity of appropriate loans available in both the primary and secondary markets (we look to the latter mainly for mis-pricing opportunities relative to our analytical assessment of risk adjusted fair value). A key point to emphasize is that statistics are a necessary framework but can be misleading from the standpoint of specific investing (there are over 1000 borrowers in the Broadly Syndicated Loan asset class that exceeds $1.3 trillion). This breadth of investment opportunity in terms of industry sub-sectors, but especially the sheer number of individual borrowers, presents significant opportunity.

We are pleased to report that current new issue loan quality is also good overall, and returns (spreads plus purchase price discount), as noted above, are at much better risk adjusted levels than we have seen for most of the last decade (including 50 + bps wider than last year, except for the December selloff and rapid snapback). Recently the primary market has an increasing number of "story" financings, meaning new investments, which, if LBOs, are not PE sponsor to sponsor transactions (i.e. borrowers that are known to the market), but de novo leveraged borrowers. These loans require more intensive underwriting and market price discovery, and generally have meaningful additional return premiums. For many years now the new issue Broadly Syndicated Loan market has been mostly re-financings of existing loans, plus private equity sponsor to sponsor portfolio company transactions, so no net new supply. The addition of "new' borrowers is a welcome development which we hope continues. Low interest rates and PE dry powder should help.

In summary, many of Broadly Syndicated Loans generated thus far in this economic expansion, on a case by case basis, present better credit attributes than those in prior ones.

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Covenants
Another subject discussed frequently is Cov-Lite (covenant light, which is typically defined as no financial maintenance covenants, in institutional B loans). We are unhappy with this longstanding issuer and owner driven but investor unfriendly trend. The narrative in the press and elsewhere however is misleading. Decades ago, only banks provided senior secured loans to borrowers constituting the B loan universe. Then financial covenants had teeth in the sense that a breach resulted in a forced deleveraging action to improve credit quality (e.g. selling assets). Today most B loans are held by crossover High Yield investors, who are from a financial maintenance covenant free world. They traded maintenance covenants as a credit improvement tool for repricing triggers. The result has been borrowers paying more in interest expense, and it is certainly logical (if not also appropriate) to get higher return for increased risk. But this is not the same as a catalyst to reduce risk as originally intended. Ironically this reflects loan-bond convergence but with an unintended consequence. High Yield bonds of course have no repricing triggers and now B loans don't either. Importantly two key differences between the two remain. The latter are of course senior and secured plus are private contracts not securities. Importantly it should be noted there is no correlation between presence or lack of a repricing trigger, or more significantly, that of a financial maintenance covenant, to default probability ("DP") or loss given default ("LGD"). DP and LGD are primarily a function of lower than expected resilience of a borrower's business *and/or* excess leverage.

As discussed in the Credit Quality section, the amount of total leverage, and that of the "Value Cushion", relative to a prudent estimation of total enterprise value, is key. While the presence or lack of covenants have no predictive value, excessive leverage is a good indicator of DP, as is the size of the Value Cushion for LGD, and its inverse, future recovery value. These metrics and values and form the framework we use to evaluate risk adjusted returns and prices for both new issue and secondary loan candidates, and especially the latter where mispriced loans are frequently available.

It should be emphasized that loans to smaller and certainly weaker borrowers, at the time of a loan's issuance, do have covenants. As a generalization, borrowers that have "capital markets" access, be it to Broadly Syndicated Loans and/or High Yield, are now in a converged loan-bond world. Middle Market and Direct Lending are discussed below.

Smaller Borrowers not eligible for bank financing
Direct Lending, while senior and secured, plus being "covenanted", are loans primarily to smaller borrowers that present more credit risk for many reasons, including less diversified business profiles and fewer competitive strengths. These also often have the complexity and possible conflict of the equity participating in higher levels of the capital structure as noted.

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This is mostly a new asset class untested as yet by a recession. While covenants are typically present, as noted, it is the overall leverage and thickness of the "Value Cushion" that protects against loss, not loan contract terms.

While in the past (2005-2006) we considered bank-originated large middle market loans to be attractive from a relative value standpoint, we no longer think this is the case. We see middle market and direct lending to be "crowded" with little or no premiums for heightened credit risk, due to smaller borrower size, or illiquidity.

<u>Timing</u>

We think timing is especially good to invest in the Broadly Syndicated Loan based strategies, both for its own compelling attributes, and the fact that for many other investments, expectations are for lower forward-looking returns. With respect to Broadly Syndicated Loans, the long period of compressed "all-in" spreads (including purchase price discounts) may be behind us. Many market participants and investors we talk are contemplating possible asset class allocation adjustments in the context of higher levels of uncertainty, including from low interest rates, changing globalization and the prospects for the global economy. As such, senior secured Broadly Syndicated Loans are an excellent defensive asset class where return levels are holding, and may be poised for higher risk adjusted ones (same risk profile but higher return). We believe Broadly Syndicated Loans offer significant relative value in addition to other benefits.

Meanwhile using leverage on a structured credit basis continues to be favorable, including availability of long-term leverage without any market value triggers, together with long reinvestment periods. Attractive fund offerings are available, either lightly, fully levered or unlevered, that can generate attractive risk adjusted returns, while providing downside protection. It should be noted that the best-known investment of this type, CLOs, are a proven product due to performance in the 2006-2014/17 timeframe, which included the Financial Crisis and Great Recession (the so-called 1.0 vintage). A leading example of this are the "1.0" CLOs that I and some of my colleagues were directly responsible for creating and managing.

<u>Relative Value in the Debt Space</u>

It is interesting that Broadly Syndicated Loans and High Yield bonds currently have approximately the same average returns on an all-in yield basis. This is despite the fact the former are senior and secured, while the latter are junior in a borrower capital structure, and do not have priority of payment. Based on the "voting with your feet" measure of investor sentiment, it is clear, in the context of the prevailing expectation of lower interest rates (which for loans, would reduce all-in yields as the LIBOR rate component is floating), that investors are

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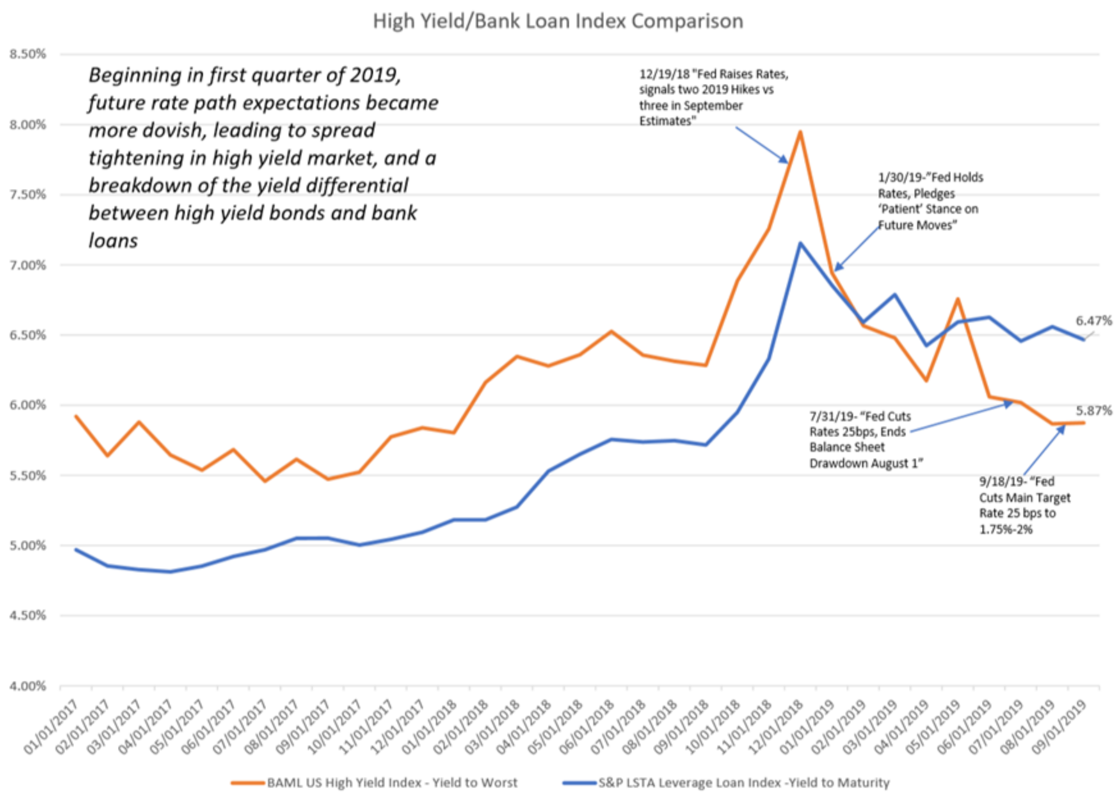
focused on yield, not the downcycle protection that Broadly Syndicated Loans offer. As the same investors dominate both asset classes, this may indicate confidence on their part that the Fed will maintain a dovish posture to keep the expansion going. In any event Broadly Syndicated Loans are clearly attractive relative value. The graph below compares Bank Loan and High Yield indexes.



Source of quoted headlines: Bloomberg

<u>Suitability</u>

A final point about Broadly Syndicated Loans is that they are a "full cycle" and "all weather" asset class. Banks structure these loans to fit a borrower's credit profile, and specifically the ability to fully repay the loan from operating cash flow, and to do so in all circumstances, including in the event of borrower specific problems and/or recessions. In the event a severe credit deterioration occurs, the backstop to repayment is the collateral, which is typically all assets / the full valuation of the borrower. While loan managers can take advantage of Broadly Syndicated Loan secondary market liquidity as a risk management tool, in addition to projected recovery value, the originating banks focus on repayment, not a sale, and in the worst case, exercising the 1st Lien senior secured rights. To take full advantage of these “full cycle” and “all weather” attributes, investors, and the managers working for them, should have a long-term framework. Broadly Syndicated Loan cash flows, and the enterprise valuation underpinning the Value Cushion (aka collateral protection), line up with long term performance, not short-term price fluctuations. For long term investors, especially in a fund structures with so-called CLO technology (long-term leverage with no market value trigger), price volatility is an opportunity, not liability (due to ability to invest in discounted assets).

A key question is the suitability of the different loan-based products for different types of investors and their objectives. For example, are retail loan funds, which feature immediate liquidity, appropriate for “main street” investors? In the case of Broadly Syndicated Loan based products, sophisticated long-term investors are the best fit. They are well suited to benefit from the cash flows of the underlying loans that drive returns, and underlying Value Cushion protection that supports a loan’s fundamental valuation. Price / NAV products arguably have a speculative element, as these rely on future price changes.

In summary, products based on the cash flows of the underlying Broadly Syndicated Loans provide both stability and consistency of returns, whereas price-based ones are subject to unknown future price changes.

<u>The Bigger Picture</u>
There are other subjects that warrant comment, especially the possible causes of US GNP deceleration or recession, the specter of financial instability (a possible recession catalyst) and changing investor expectations. Other topics include what benchmarks may or may not be appropriate to measure performance, including volatility in a mark-to-market context, and what are the relative benefits and trade-offs between absolute (cash based) or total (price driven) return strategies, including accounting/reporting treatment. We have views on these and other matters which we would be pleased to share, and more importantly, to learn your views.

Hopefully this commentary is helpful, and we are of course ready to provide more information.

Separately my colleagues and I look forward to our continuing discussions.

Best, Peter Gleysteen

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