

## Market Reflections & Outlook

### Continued Opportunity for Yield

Last year saw a notable shift in the capital markets and interest rate landscape as inflation fears, higher interest rates, and geopolitical conflict weighed on economic confidence and M&A volume. Despite these factors driving negative returns in major publicly traded classes, the Cliffwater Direct Lending index posted a gain in 2022, once again demonstrating the resilience of the asset class. Select segments of the lower middle market (“LMM”), the focus segment of Capital Dynamics Private Credit (“CDPC”), delivered further relative outperformance. Contrary to the first half of 2022, the shift towards more conservative investor sentiments and outlooks in the second half of 2022 drove the pricing and credit protection pendulums back in lenders' favor, reversing a longer-term trend where borrowers held the upper hand.

Regarding pricing, aggressive Fed rate hikes combined with wider spreads and deeper original issue discounts (“OIDs”) gave rise to middle market loans yielding 10% or more becoming market standard. Alongside this, less cooperative capital markets coupled with greater lender discipline resulted in more conservatively levered new LBOs with tighter documentation, including, for example, a greater focus on financial maintenance covenants. These factors, including lower loan-to-values (“LTVs”), higher sponsor equity contributions, magnified yields and enhanced investor protections, were generally more pronounced in the LMM relative to the core and upper-middle markets, offering investors focused on the LMM further relative risk-adjusted return advantages. For example, average middle market unitranche spreads widened by approximately 20 basis points over the year, while LMM spreads widened by 50 basis points. Over the same period, average leverage for middle market unitranche loans remained above 5x, while LMM loan leverage retreated to 4x or below<sup>1</sup>.

**Our Views:** The Capital Dynamics Private Credit team remained active in 2022 and sought to take advantage of the improving market dynamics. The team closed 11 deals during the year, accelerating deployment in the latter half of the year as the aforementioned enhanced risk adjusted return advantages started to matriculate in the pipeline. Moving into 2023, we expect favorable market conditions in the LMM to persist, and the team remains focused on prudently deploying dry powder into new LBO opportunities, while continuing to support our sponsors and portfolio companies by financing accretive add-on transactions. Dislocation in broadly syndicated markets, coupled with a general pull back and greater discipline among direct lenders, sets the stage for enduring market tailwinds that include an expanding opportunity set and a greater ability for market participants to control both structure and pricing. Leveraging the relationship networks of our colleagues in Capital Dynamics' Primaries and Co-Investment businesses, the CDPC team has constructed a diverse pipeline of actionable loan investments, many of which are shown on a proprietary basis and outside of traditional auction processes, providing for a healthy deployment cadence while remaining selective in our investment decisions and diversified in our portfolio construction.

(1) Per KBRA DLD 2023

### About Capital Dynamics Private Credit

Capital Dynamics has been investing in middle and lower middle market private assets for over 30 years. The Private Credit group within Capital Dynamics provides tailored, one-stop financing solutions to private equity-backed lower middle market companies, focusing on financings that support leveraged buyouts, acquisitions, business expansions, re-financings, and short-to-medium term liquidity needs. Capital Dynamics Private Credit offers directly originated, senior secured loans, including first lien, unitranche, and second lien, as well as other flexible capital solutions.

Comprised of over ten investment and platform professionals based in New York, London, and Zug, Capital Dynamics Private Credit draws upon its vast experience investing across the capital structure and in a wide array of industries to deliver flexible, value-added solutions customized to fit the unique needs of each borrower.

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