DDJ CAPITAL MANAGEMENT, LLC
SPECIALISTS IN HIGH YIELD AND LEVERAGED CREDIT INVESTMENTS

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CIO's Perspective
2017 Leveraged Credit Review and 2018 Outlook

> Led by the lower-tier, leveraged credit markets produced another strong year of performance in 2017.

> With issuer fundamentals remaining healthy, external macro-risks loom as the biggest concern for returns in 2018.

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2017 High Yield Market Review

For 2017, high yield bonds produced a gain of 7.48% (as measured by the ICE BofA Merrill Lynch U.S. High Yield Bond Index ("HYBI")), representing the second consecutive year where the total return of the HYBI exceeded its start-of-the-year coupon. As reflected in Exhibit 1 below, strong gains during the first six months of the year largely drove high yield bond performance in 2017. Meanwhile, performance in the second half of the year lagged as optimism waned regarding the implementation of anticipated pro-growth policies in the U.S. Although tax reform eventually passed, the high yield market's response to such news was muted given its passage in late December. In addition, geopolitical risks relating to North Korea and Russia in particular added uncertainty and volatility throughout the year. Nonetheless, high yield bond spreads tightened in 2017. This tightening served to offset the effect that resulted from the multiple rate hikes adopted by the U.S. Federal Reserve during the same period.

At the same time, leveraged loans produced a gain of 4.25% for the year (as measured by the JP Morgan Leveraged Loan Index ("LLI")). Leveraged loans had a stronger second half of the year. This result was spurred by a decline in primary market activity and a rise in collateralized loan obligation ("CLO") origination. These two factors led to a strong bid for secondary issues during that time. Conversely, throughout the first half of the year, leveraged loan prices were capped by the asset classes' lack of call protection. According to Credit Suisse, approximately 62% of the leveraged loan market was priced above par at the start of 2017. That same figure was a mere 0.5% at the beginning of 2016. As a result, issuers took advantage of the friendly conditions in the primary market to adjust their balance sheets and lower their interest costs. All told, approximately 70% of the nearly $1 trillion of primary market activity for leveraged loans in 2017 was used for the repricing or refinancing of existing facilities.

Exhibit 1: Performance and Characteristics of High Yield Bonds and Leveraged Loans[1]

	Dec 31, 2016	1H 2017	Dec 31, 2017	Change v. 1H 2017
High Yield Bonds (HYBI)				
Total Return YTD	17.49%	4.91%	7.48%	2.45%
Yield to Worst (YTW)	6.17%	5.68%	5.84%	0.16%
Spread (OAS)	422 bps	377 bps	363 bps	-14 bps
Price	99.60	101.33	100.59	-0.74
Coupon	6.51%	6.46%	6.37%	-0.09%
Current Yield	6.54%	6.38%	6.33%	-0.05%
Average Rating	B1	B1	B1	Unch
Effective Duration	4.25	4.04	4.04	Unch
Default Rate (Par)	3.98%	2.02%	1.45%	-0.57%
Leveraged Loans (LLI)				
Total Return YTD	9.78%	1.85%	4.25%	2.37%
Yield (3-Year)	6.23%	6.02%	6.31%	0.29%
Spread (3-Year)	458 bps	430 bps	419 bps	-11 bps
Price	98.22	98.16	98.42	0.26
Default Rate (Par)	1.49%	1.42%	1.88%	0.46%

Source: ICE BofA Merrill Lynch and JP Morgan. Past performance is no guarantee of future results.
The ICE BofA Merrill Lynch U.S. High Yield Bond Index ("HYBI") and the JP Morgan Leveraged Loan Index ("LLI").

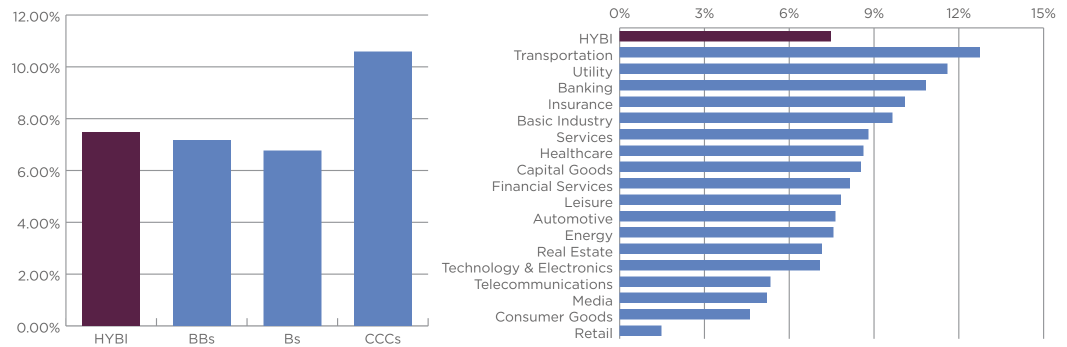
1. Default statistics for 2016 and 2017 include distressed exchanges. The index data referenced herein is the property of ICE Data Indices, LLC, its affiliates ("ICE Data") and/or its Third Party Suppliers and has been licensed for use by DDJ Capital Management, LLC. ICE Data and its Third Party Suppliers accept no liability in connection with its use. Please contact DDJ for a full copy of the Disclaimer.

For the second consecutive year, CCC rated high yield bonds were the top performing ratings group within the broader high yield market.

Rating and Sector Performance

For the second consecutive year, CCC rated high yield bonds were the top performing ratings group within the broader high yield market. At year end, approximately 46% of CCC rated bonds within the HYBI fell within the Telecommunications, Transportation and Healthcare sectors, which produced very strong gains on a relative basis during the year. Within the broader HYBI, in 2017, Transportation was the top performing sector, while the Retail sector was the biggest laggard as it continued to suffer from the "Amazonification" of the industry. Though much of the positive performance in the HYBI can be attributed to the first half of the year, the Energy sector in particular posted a strong second half largely related to a rise in oil prices, as it earned almost all of its full year return during such six-month period.

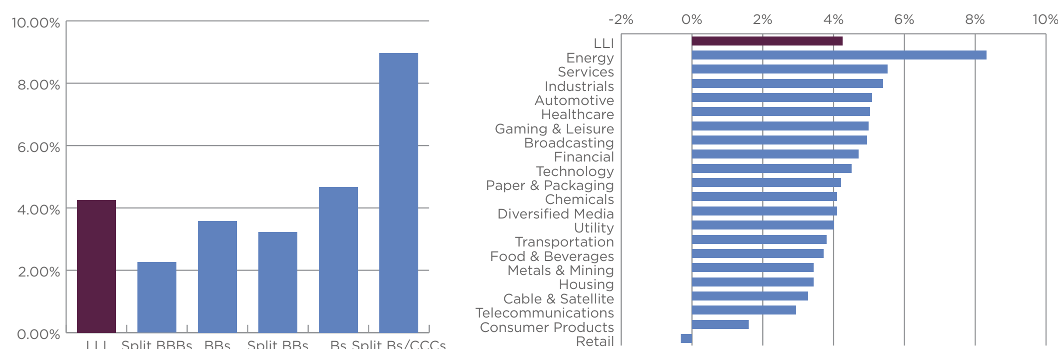
Exhibit 2: HYBI Rating and Sector Performance: Full Year 2017



Source: ICE BofA Merrill Lynch; The ICE BofA Merrill Lynch U.S. High Yield Bond Index ("HYBI"). Past performance is no guarantee of future results.

With respect to leveraged loans, performance among Split B/CCC rated loans more than doubled that of their higher quality peers. Furthermore, loans by companies within the Energy and Retail sectors were the top and bottom performers, respectively. In addition, second lien loans posted impressive gains for the year, outperforming their first lien peers. For context, approximately 80% of first lien loans were priced $99 or above to start the year compared with 47% of second lien loans. During the course of the year, second lien loans experienced more meaningful price appreciation than their first lien counterparts. Specifically, according to Credit Suisse data, the average price for second lien loans in the LLI increased by more than 7.5% during the year compared with price returns for first lien loans that were essentially flat on average.

Exhibit 3: LLI Rating and Sector Performance: Full Year 2017



Source: JP Morgan; The JP Morgan Leveraged Loan Index ("LLI"). Past performance is no guarantee of future results.

2018 Outlook

Over the long term, historically high yield performance has been driven almost exclusively by coupon income. On the other hand, overall market performance in the short term is influenced primarily by the ebb and flow of market technicals. Given the length of this current credit cycle, one would expect that the high yield market is moving ever closer to an inflection point. That said, given the current dynamics, the market appears to be creeping along to that point rather than steaming full speed ahead.

At this point in prior credit cycles, we have generally observed animal spirits take hold, as the fear of "missing out" has driven investors to pile into risky assets. However, we are not seeing this pattern unfold in the current high yield market. For context, according to data from JP Morgan, high yield mutual funds have suffered outflows in four of the last five years totaling approximately $53 billion. This activity followed $89 billion of aggregate inflows for the four years prior. In my opinion, these more recent outflows do not support the idea that investors are worried about "missing out" on the next high yield rally. What we have seen throughout this cycle are examples of events that historically would have marked an inflection point (e.g., the oil price decline in 2014 or the unexpected Brexit vote in 2016) instead only resulting in relatively minor market corrections. It is my belief that such a point has failed to materialize in part as result of cautious money previously on the sidelines acting to stabilize the high yield market after such corrections. However, if animal spirits do take hold, we could experience a rush of flows into the high yield market. Such action would result in a larger pool of investors in the high yield market in all likelihood with less information or understanding as to the underlying well-being of each individual credit. When the market eventually corrects, the initial exuberance of these investors may quickly reverse itself in response to negative headlines, irrespective of whether or not such a reaction would be rational. In such circumstances, their coordinated "rush for the exit" would be further destabilizing to the market.

Fundamentals of high yield issuers are relatively healthy…

In my opinion, superior credit selection is the key to successfully investing and generating outperformance in the high yield market. With respect to each investment opportunity, one

I do not recall a time in which it has been easier for private equity firms to access capital.

must understand the fundamental health of the issuer's business together with the risks to that business and its industry. Broadly speaking, fundamentals for high yield issuers are presently stable and in some cases improving. Leverage is close to cycle highs, though interest coverage remains firm. In addition, once the effects from financially pressured Energy sector companies are removed from the evaluation, the fundamentals of the remaining high yield sectors are surprisingly healthy. Furthermore, capital markets are not providing CCC rated issuers with indiscriminate access to new debt financing. In the past, such action has generally marked a meaningful relaxation of lending standards and has typically signaled that the end of the credit cycle is near. Another plus is market participants punishing firms for poor quarterly performance, which gives me some comfort that investors are still paying attention to company financials. These items are all positives and suggest that poor issuer fundamentals will not be the catalyst for a sudden turn in the cycle anytime soon.

...yet macro risks to the high yield market have heightened

I do not recall a time in which it has been easier for private equity firms to access capital. An important dynamic contributing to this result has been the proliferation of direct lending funds. According to Preqin, as of June 2016, assets under management for direct lending funds was $153 billion.[2] With respect to these assets, 88% was held by funds with vintage years between 2011-2016.[3] Private Equity ("PE") firms oftentimes use such direct lending funds to receive certainty of pricing compared to what a PE firm could expect in the price discovery process of a broadly syndicated loan or bond. Equally important, engaging a direct lending fund can provide a PE firm with greater confidence with respect to both timing and certainty of closing. However, deals involving direct lending funds will typically have more leverage relative to what would be otherwise permitted by a more traditional bank lender. To ensure that their committed capital gets deployed, these funds may relax their underwriting standards, which would heighten the risk associated with a default and other potential downside scenarios for such investors.

Furthermore, in the event of a correction the high yield market might experience exaggerated price declines. In many ways, one may view the high yield market as a more liquid alternative to direct lending. Stated another way, although the issuers of the debt may have similar business characteristics (e.g., size, industry, ratings, etc.) the very nature of a publicly registered high yield bond makes it more liquid than a private direct loan. Therefore, in such instances, as investors look to raise capital from relatively liquid positions, high yield bond prices may suffer.

The occurrence of an unforeseen geopolitical event that disrupts markets presents an added concern. In particular, the present U.S. presidential administration's unorthodox approach to foreign policy with respect to long-time allies and foes alike represents a significant departure from the norm. Up to this point, the market has seemed content to shrug-off these tactics as their impact on the economy has been limited. However, any international crisis could result in a rapid acceleration by market participants in a risk-off mentality, which could jolt the high yield market, among others, resulting in a period of losses.

One word to describe today's high yield market: Bifurcated.

It is worthwhile to observe that today's high yield market is bifurcated among BB rated and CCC rated credits. As of December 31, 2017, the BB rated segment of the HYBI had an OAS of 218 bps while the CCC rated segment had an OAS of 841 bps.[4] The difference between the

[2] Preqin is a leading provider of data for alternative assets classes including private debt.

[3] The 2017 Preqin Global Private Debt Report

[4] "OAS" is an acronym for option adjusted spread; "bps" is short for basis points.

two spreads was 623 bps. For context, in December 2006, a point in the previous credit cycle that resembles today's market, those same statistics were 194 bps and 528 bps, respectively, which resulted in a difference of 334 bps. Furthermore, in June 2014, just before the commodity price declines, such spreads were 249 bps and 639 bps, respectively, for a difference of 390 bps. Historically, as the high yield market has approached the end of a credit cycle, the various credit ratings tiers have tended to exhibit a tighter relationship among their respective spread levels as compared to where they stand as of this writing. Specifically, over the past 20 years, the difference between CCC and BB spreads[5] at the end of the credit cycle tends to be in the top decile of all spread observations. In other words, the difference in spreads between CCC and BB rated credits is wider than one would expect at this point in the cycle. For context, as of December 31, 2017, the difference in spreads between the two ratings groups, 623 bps, was just inside of the 20 years median of 645 bps. This observation suggests that either BB rated bonds are overbought or CCC rated credits have room to tighten relative to their higher quality peers.

Exhibit 4: 2017 Option Adjusted Spread Compression

	HYBI	HYBI BB	HYBI B	HYBI CCC
December 31, 2016	422 bps	271 bps	410 bps	971 bps
2017 Change	-59 bps	-53 bps	-41 bps	-130 bps
Change as a % of December 31, 2016	-14%	-20%	-10%	-13%

Source: ICE BofA Merrill Lynch
"2017 Change" and "Change as a % of December 31, 2016" are calculated as the change from December 31, 2016 to December 31, 2017.

As set forth in Exhibit 4 above, spreads of BB rated bonds tightened approximately 53 bps in 2017, which represents more spread compression, on a percentage basis, than either B or CCC rated bonds during such period. I believe that this tightening reflects a risk-off attitude by high yield market participants that increasingly focused on higher rated investments within the high yield universe.

In addition, I also believe that continued accommodative monetary policy in Europe also contributed to BB spread compression. For context, as of December 31, 2017, the total amount of negative yielding debt globally stood at $8 trillion, a substantial portion of which is European issued. It appears that as investors have searched for yield, they have dipped down the credit quality scale, the effects of which can be observed in the European high yield market. According to data from BofA Merrill Lynch, the ICE BofAML Euro High Yield Index had a yield to worst of 2.49% as of December 31, 2017. Such yield was only 0.09% above the yield on the 10 year U.S. Treasury as of the same date, and was 3.35% lower than the yield on the HYBI. This difference makes an investment in U.S. high yield particularly attractive to European investors, even after accounting for the costs of currency hedging against the U.S. dollar. Furthermore, the European high yield market is roughly a quarter of the size of the U.S. high yield market and approximately 75% of it is BB rated. As such, given the relative size of the European high yield market and its ratings characteristics, it seems likely that European high yield investors have expanded their opportunity set into a familiar arena within the upper tier of the U.S. high yield market. As a result, such European investment has potentially influenced the tightening of spread levels of BB rated bonds in particular.

Furthermore, the new tax law in the U.S. may further contribute to the bifurcation amongst BB and CCC rated bonds, as such legislation appears to provide more incentives to higher rated

[5] Over the past 20 years, the top decile of CCC-BB spreads observed was less than or equal to 415 bps.

In my opinion, the expected coupon income for the HYBI at the beginning of the year is a reasonable starting estimate for a target return in 2018.

high yield issuers. For example, CCC rated issuers tend to be highly-levered and accordingly are more likely to be harmed by the cap on interest expense deductibility set forth in the new legislation as compared with BB rated issuers with lower interest costs. In addition, unprofitable CCC rated issuers will not receive the benefits associated with a lower corporate tax rate, which will be enjoyed by higher rated companies that will now owe a significantly lower amount of taxes on their net income. For these reasons, the new tax regime provides a greater economic incentive for issuers of CCC rated credits to de-lever, which would ultimately serve as a credit positive. However, overall, we anticipate that the new tax code will have a neutral to slightly negative effect on the high yield market, though on balance higher quality issuers are poised to receive more benefits than their lower rated peers. That said, the intricacies of the new rules need to be assessed on a case-by-case basis, and it is still too early to know how the actions that each company takes in response to these changes will affect the high yield market.

Furthermore, as the Federal Reserve continues to normalize monetary policy, BB rated bonds and their already very tight spreads have limited room to absorb further rate increases. Alternatively, CCC rated credits could produce gains through spread tightening assuming such interest rate hikes coincide with continued economic growth, which should enable CCC rated issuers to remain financially healthy and avoid credit defaults. Finally, companies in the Energy sector comprise approximately 18% of all CCC rated issuers, a higher percentage than the BB/B rated segment. Therefore, increasing oil prices could provide a boost to performance for CCC credits over and above any enhancement provided to the broader high yield market.

Summary

In my opinion, the expected coupon income for the HYBI at the beginning of the year is a reasonable starting estimate for a target return in 2018. However, there are several factors that could result in an outcome that falls short of that initial guess. As it stands for 2018, in light of the risks outlined in this paper, a sub-coupon return for the overall market seems more probable than not. However, from our stand-point, fundamental analysis of each new investment opportunity coupled with ongoing monitoring of each of the credits held in our client portfolios is far more important to our success as a high yield investment manager than the yearly ups and downs of the market as a whole. With that idea in mind, our approach to 2018 will be like any other year. We will endeavor to source attractive-yielding credits issued by companies that can weather a market correction and ultimately pay back their fixed income obligations upon their maturity. From a portfolio management perspective, discipline in the face of any temporary mark-to-market losses will remain crucial, especially in the event of a widespread market disruption or a potential inflection point in the current credit cycle. For skilled investors, such situations invariably create buying opportunities as market inefficiencies become more pronounced. Ultimately, as we move towards an inflection point in this credit cycle, we must stay focused on achieving attractive long-term results for our clients, while remaining poised to take advantage of any opportunities presented by short-term market movements.

Appendix

Amazonification: In this instance, as it relates to the Retail sector, DDJ is using the term "Amazonification" to refer to the transition from brick and mortar to on-line shopping and its subsequent impact on the Retail sector.

BPS: Stands for basis points. A basis point is one one-hundredth of one percent (0.0001).

Callable: A callable debt instrument (e.g., bond or loan) is one that can be redeemed by the issuer of such instrument prior to its maturity

Call Protection: is a protective provision of a callable security prohibiting the issuer from calling back the security for a period early in its life.

Coupon: The stated interest rate paid on a bond. Coupon payments for high yield bonds are typically made semi-annually.

High Yield Bond: A high yield bond is a debt security issued by a corporate entity where the debt has lower than investment grade ratings. It is a major component – along with leveraged loans – of the leveraged credit market.

Investment Grade: investment grade are those securities rated Baa3/BBB-/BBB- or above by Moody's, S&P, and/or Fitch, respectively.

LBO: A leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition.

Negative Covenant: A negative covenant is a clause in a bond indenture or loan credit agreement that prohibits the borrower from an activity. For example, a negative covenant may restrict the payment of dividends or the issuance of new debt.

Second-lien Loans: Second-lien loans have a junior (second in priority) claim, following senior debt, on the collateral of an issuer in the event of a default.

Spread: The yield of a bond minus the yield of the government bond that matches the maturity (or appropriate call date) of the bond.

10 yr. Treasury: Treasury yield is the return on investment, expressed as a percentage, on the U.S. government's debt obligations. Looked at another way, the Treasury yield is the interest rate that the U.S. government pays to borrow money for different lengths of time, in this case, 10 years.

Yield: The yield is the income return on an investment, such as the interest or dividends received from holding a particular security.

Yield to Worst: Yield to Worst ("YTW") is the lower of the yield to call or yield to maturity.

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Past performance is no guarantee of future returns.

Investing involves risk, including potential loss of principal.

The ICE BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Please note that one cannot invest in the index.

The ICE BofA Merrill Lynch Euro High Yield Index tracks the performance of Euro denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Please note that one cannot invest in the index.

The J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of USD institutional leveraged loans, including US and international borrowers. Please note that one cannot invest in the index.

Moody's Investors Service and Standard and Poor's Financial Services use a different nomenclature for their ratings system. For example, the Moody's equivalent to a S&P rating of CCC+ is Caa1. For information on the rating agencies' methodology go to: https://www.moodys.com or www.standardandpoors.com.

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ABOUT DDJ CAPITAL MANAGEMENT

DDJ Capital Management's goal is to consistently produce attractive long-term investment returns, while minimizing downside risk for our investors, which include:

- Corporate pension accounts and public retirement plans
- Endowments and foundations
- Insurance companies
- Other institutional clients

The underpinning of DDJ — a disciplined investment philosophy, coupled with a commitment to exhaustive credit research — has remained constant since our founding in 1996. Our highly skilled team is steadfast and focused on executing our strategy to identify strong risk-adjusted investment opportunities in the leveraged credit markets.

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