

CADC: A CONVERSATION WITH THE PORTFOLIO MANAGER

A DYNAMIC RESPONSE TO MARKET DISLOCATIONS

Greg Margolies, Partner and Vice Chair of Ares, recently sat down with Lou Greco, Managing Director for CION Investments, for a discussion about the current market environment and where the risks and opportunities may be.

The economy remains solid, but with geopolitical uncertainty, sticky inflation and ongoing volatility, market dislocations may arise. A healthy portfolio with liquidity resources can be positioned to advantage of these opportunities.

The full conversation is below.

GREG MARGOLIES

When we think of the current market environment, the thing we really think about is volatility. We also think about having to discern between headlines and reality. Growth is slowing, but it is still fairly robust. Oil will have its set of issues, but for the most part the US economy continues to be strong and is outpacing global economies.

We're seeing good health in the US economy, notwithstanding all the macro changes and issues recently. The perspective on where rates are going has changed. The view is that, given what's going on in Iran and given sticky inflation, we're not going to see as many reductions. In some instances, globally, we may see some tightening, but we think it's going to be kind of flat and a lot less aggressive than what expectations were recently.

We think it's going to be status quo for the time being as the Fed digests what's happening in Iran, the impact to inflation and consumers, and watching the unemployment numbers that remain pretty strong, the expectation is there is not going to be any near term pressure to cut rates.

The S&P 500 has bounced around a lot and had some serious dips. However, we've continued to witness the markets rebounding, and both the equity markets and the debt markets have remained very resilient. There's a lot of liquidity out there, but again, the underlying performance of the companies that we are investing in continues to be quite strong. We'll that see some of that performance sometimes is related to fundamentals, and sometimes it is not.

Information technology, not surprisingly, has been probably the worst performer in terms of returns on loan spreads. We think that has to do with the "AI Armageddon" thought process and specifically what's happening with equity multiples for those software companies. There is, and should be, a differentiation from where equity multiples are versus where credit spreads are, especially when we look at the loan-to-values and how low they are in the credit markets. We see the loan market really slowing down this year. Gross issuance is lower, and most of it is in the form of refinancings and repricings, so new issuance is even lower than overall issuance.

Given all the uncertainty, volatility and headlines, we've seen a drop off in new issuance in syndicated loans, which is one reason why spreads have remained, relatively speaking, tight, notwithstanding all the macro issues. One of the reasons, in addition to lower new issue volume, is that we are seeing a very significant amount of new CLO origination.

In direct lending, it's interesting that spreads have stayed fairly consistent, bouncing in the mid-fives to low sixes, and then things started coming down into around 5% in the fourth quarter of 2025. Same thing with upfront fees, dropping from a point and a half down to a point. What we've seen in the last four months is the combination of spreads and upfronts, yields on new issue direct lending are up 50 to 75 basis points and are widening.

They're not gapping wider, but they are gradually moving out, and that is true on the traditional middle market and the upper end of the middle market. Where it's not true is on the lower end of the middle market where that competition remains pretty fierce and we've not seen a lot of widening there. If we're looking at a software company, we've seen another 50 basis points on top of that. Leverage has come down to around five times.

Everyone's been talking about software and AI risks. Our view is that no one should have been taken by surprise, as a lender, in either the liquid or the illiquid markets. This is a risk factor we have been looking at for years.

Does it change every year we look at it? You bet, because the technology speeds up, gets more effective and there are more capabilities, but in no uncertain terms, this risk has been there. This has been the main part of our due diligence from a technology perspective. We sensitized the portfolio and analyzed it just like we did in the GFC or the pandemic or during tariffs or high rates. We do the same thing for technology and AI risk, and we bucket things into low, medium, and high disruption.

AI is either additive, meaning low disruption, or potentially on death row, which is the high disruption. When we look at our current portfolio across all of our direct lending, about 99% of our book is in the low or middle disruption. Less than a handful are high disruption. This is basic diligence that we have been doing all along as the portfolio is built. We feel comfortable with our portfolio names in terms of what the potential disruption is.

What we continue to look for as we build out the portfolio is whether we can continue to get a real yield premium, either by spread or by upfront fees, by investing in self-originated illiquid assets with some complexity that we can get paid for. By being able to structure our own deals, we can get structural protections and covenants. It's one of the benefits of direct origination, but it's also creates the ability to build a bespoke portfolio and be selective. That selectivity, coupled with investing in senior secured credits in defensive industries, allows us to be able to dynamically allocate the portfolio to take advantage of market disruptions.

The market doesn't disrupt all at the same time in the same sectors, in the same sub-asset categories, and we have to be able to stay enabled for that. The portfolio today is highly diversified, with more than 950 names, and the average position size is less than 50 basis points.

We are diversified by name, industry, geography, and asset category. The portfolio is more than 80% private, self-originated loans. We talked about being able to build a bespoke portfolio heavy on the diligence with structural protections and covenants, and the outcome of that is that we are 92% floating rate because we're about 90% senior and secured loans, in industries that we believe are defensive and can go through a cycle.

This portfolio today continues to have EBITDA growth in the low double digits. That's up from the fourth quarter of last year, which is up from the quarter before that. We've had very strong, accelerating EBITDA growth for the last two years. We even have strong, high single digit revenue growth showing that we have real organic growth, not just margin expansion and by cost cutting. Interest coverages are up. Loan to values have stayed more-or-less flat. Leverage is ticking down in the portfolio. Interest coverage is improving not just because the risk-free rate is coming down, but also because our companies are organically growing and paying down debt.

For the last eight quarters, our non-accrual rates have been more-or-less flat, and in the last quarter, it actually ticked down. We are not seeing an increase in non-accruals and defaults in our portfolio. Our watch list has bounced around as a percentage, but it's been within a range for the last two years. In the first quarter, it has ticked up just a little bit, but it stayed within that range. Furthermore, we are not seeing a thematic issue in either the non-accruals or the watch list. The names are idiosyncratic, i.e. it's a company that made a bad acquisition and is having trouble integrating it. It's a company that just fired its CEO because they were underperforming. What we're not seeing is a theme by industry. We're not seeing software technology dominate the list, or in terms of new names coming in.

We're seeing real health in the portfolio. It's a wonderful opportunity for us as markets start to dislocate, to not have to worry about the health of the underlying portfolio but rather be on the offense instead of having to protect a troubled portfolio. Our PIK rate as a percentage of the portfolio has been fairly constant the last couple of quarters. PIK is payment-in-kind. Instead of getting cash, we're getting more securities in lieu of cash. PIK could be there for one of two reasons: Either we structured it upfront or something is going wrong and the company can't afford to pay cash.

Ninety-three percent of our PIK was structured upfront on purpose. It could be a preferred or a second lien that we've structured as a PIK, but we're getting equity-like returns for it. Again, the overall health of the portfolio remains strong. Returns in the portfolio have historically bounced around year to year. We can't really look at any one year because there can be an exogenous factor in one year that if rates are coming down quickly, the fixed rate portfolio could do better, not because of spread, just because of the risk-free rate.

What do we look at in this investment environment? What are we worried about? Where are the opportunities?

Deal flow in direct lending had slowed down due to the war in Iran, and before that because of all the software news. We're now beginning to see more deal flow come out. Not a lot of software names, not surprisingly, for the first time we've been approached by new software names that are in the really early stages, we're seeing aerospace defense deals, we're seeing healthcare services deals, business services, general manufacturing. We went into this disrupted market with lots of liquidity, whether being under levered on the credit facility on purpose, having excess liquid assets on purpose, so we're very well positioned for what's going on in the market. Spreads have widened, but they've not gapped out.

We nibble here and there on things that have gotten wider, but it's not like it's a screaming, "Oh my gosh, these are pandemic-like prices." We're hoping that we'll see more disruption because we're well-positioned to take advantage of that. We love being a lender when everyone else is scared and running for the hills, or more importantly, when their portfolios are in such pain, it gives us the opportunity to refinance them or sometimes even buy their portfolios. This type of disruption historically has been when the portfolio has flourished.

What are we worried about? What keeps us up at night? I am worried about inflation. I'm worried about how long the war in Iran goes on and how long oil stays at 100 bucks a barrel or higher and how that impacts the consumer. I am worried about how the economy is getting along with the rest of the globe, whether via tariffs or being at odds with NATO and elsewhere and the impact to trade relationships and how that will impact the consumer at home. Those are my long-term worries, but the core underlying economy in the US is quite strong and our portfolio companies are operating well, and our origination capabilities have us squarely in a position to take advantage of things when they go bump in the night, and we're even beginning to see some of the banks getting a little heavy with commitments that we're having some conversations around being able to take assets off their books at attractive levels.

These are the types of conversations that don't happen when the markets are humming along nicely but are exactly what we look forward to in these types of markets.

LOU GRECO

What excites you about the current credit environment?

GREG MARGOLIES

There are going to be problems in the market and deals that are going to go sideways. We're going to see weakness elsewhere, and it's going to be exacerbated in the press. That is going to drive opportunity for us. We have liquidity, not only in this fund, but across our platform, to be able to take advantage of companies that are in need of liquidity, and the existing lender can't handle it.

We love the idea of a healthy underlying economy, but broken investors, if that makes sense. It creates opportunities to make good investments with healthy spreads in a positive economic environment. We are looking forward to and have begun to see some of those opportunities, whether it be from other investors or from the banks. What we are most excited about today is leveraging our liquidity, our history, and our origination capabilities to take advantage of what's going to start happening out there.

LOU GRECO

We've constructed this fund with a sleeve of liquid credit, whether that's for operational purposes or relative value opportunities. What is that target? How large is it today? And the second part of that question is these new opportunities that we find attractive, how are we thinking about liquidity and participating in these deals in real time across your pipeline?

GREG MARGOLIES

We continue to maintain a healthy amount of liquid assets, syndicated loans, high yield bonds, CLOs, and mezzanine debt that remain well bid and quite liquid so we can rotate utilizing some of those assets to buy self-originated assets at deep discounts or wider spreads. We continue to see parts of our portfolio turnover and get refinanced, so we can get liquidity that way. We've got a credit facility that's currently underdrawn. All of those things are meant to be there as a balance for either turbulent times or investment opportunities. It's going to be in alternative credit, special situations and in US direct lending, but we're waiting, we're being very selective in terms of what we're investing in today.

We are continuing to be very conservatively positioned both from liquid assets, our excess credit facility, and cash flows coming off the portfolio in terms of refinancings, so that we feel super comfortable that we can handle both redemptions and investment opportunities.

LOU GRECO

Could we elaborate on software and what does our allocation look like in this sector?

GREG MARGOLIES

That 20% is a mix of software and services which are not necessarily all software, so the number is lower. If we look at the areas that we are heavy or in technology or software related, it is in things like human resources, ERP, software systems that can't be replaced by AI. They can be augmented, made better, but we're not going to rip out ERP or a human resource system and try to have it get done by AI. The companies that we are investing in are not seeing a decrease in EBITDA or revenue, and they're not seeing a decrease in expected spend going forward.

As I said, we have less than a handful of names that we think are exposed, and we're going to have to work our way through those, but across the whole portfolio, less than five names. This portfolio alone has 950 names in it. We don't have a large exposure either by number of companies or the dollar amount associated with said companies. We will continue to look at software companies. They are getting priced to get about 50 basis points wider than the rest of the market if they can get done. If we can find high quality companies that we think are insulated from the AI risk but rather can get made better by adopting some AI capabilities in-house and we're getting it much cheaper than the market, those are the types of things we're supposed to go toward, not run away from.

We've done a deep dive, and we continue to do a deep dive on our names. We're actively calling customers, we're actively calling competitors, we're hiring third party consultants to help us dig through. We are re-diligencing every single one of these names, and we're not going to stop. We continue to do that. It's what we always do with our portfolio, but we really do not feel we're at risk in that part of the book at all.

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