

Aqueduct European CLO 5-2019 DAC Name Change and ARC Ratings, S.A. downgrades the public, final rating accorded to the Senior Funding Facility for Aqueduct European CLO 5-2020 DAC to 'A+(sf)' from 'AA(sf)', with negative outlook

London, 10 June 2020 – Please be advised with immediate effect Aqueduct European CLO 5-2019 DAC has changed its name to Aqueduct European CLO 5-2020 DAC.

ARC Ratings has downgraded the final, medium-term public rating of 'AA(sf)' accorded to the Senior Funding Facility provided to Aqueduct European CLO 5-2020 DAC to 'A+(sf)' with negative outlook. The rating addresses the timely payment of interest and ultimate payment of principal on or before the Maturity Date.

<u>BORROWER</u>	<u>CLASS / TRANCHE</u>	<u>TRANCHE AMOUNT</u>	<u>RATING CLASS</u>	<u>RATING</u>	<u>OUTLOOK</u>	<u>NEXT REVIEW DATE</u>
Aqueduct European CLO 5-2020 DAC	Senior Facility	EUR 226.60m	CLO	'A+(sf)'	Negative	10 June 2021

TRANSACTION OVERVIEW

Aqueduct European CLO 5-2020 DAC (the 'Borrower') has been provided with a Senior Funding Facility (the 'Facility'), with a maturity date of 24 June 2021, to finance the acquisition of Collateral Obligations. As per the 29 May 2020 Interim Report, the Facility has an adjusted balance of EUR 134.99m, with an overall maximum limit EUR 226.60m, and is currently backed by an Aggregate Adjusted Collateral Balance of EUR 161.71m. The transaction is currently within its revolving period, ending 24 June 2020, and remains in the pre-pricing stage. At this stage of the transaction, the Facility benefits from a minimum of 20% fixed credit enhancement as well as excess spread. The Facility's Senior Funding Margin steps up after the Revolving Period, thus reducing the amount of excess spread.

The portfolio of collateral backing the transaction has a Weighted Average Rating of 'B/B-' and is composed primarily of Senior Secured Loans, Senior Secured Bonds and first lien loans, totalling 98.70% of the Aggregate Principal Amount of the Collateral Obligations; with the collateral obligations being primarily located in the UK (22.04%).

RATING RATIONALE

The rating downgrade reflects the decrease in the quality of the underlying collateral, the realised and potential impact of Covid-19, and the legal and financial structure of the transaction.

Key Rating Drivers include:

- Covid-19: in the context of current developments in the global market, ARC has examined each industry and jurisdiction the portfolio is exposed to and applied relevant stresses to account for the negative impact of

Covid-19. ARC's stresses have been determined by the severity of the impact of the virus on the different locations and industries. ARC notes that the most significant effects from the economic slowdown caused by the outbreak of Covid-19 is likely to fall on sectors that are most dependent on discretionary consumer spending, such as airlines, restaurants, hotels, oil and gas companies and leisure; thus leading to potentially irrecoverable asset deterioration in the portfolio. However, key products and services such as healthcare, communication and fresh food/beverage distribution are likely to be more resilient.

- Asset Quality: The weighted average credit rating of the portfolio is 'B/B-'. Assets with these ratings are, in ARC's opinion, more sensitive to economic shocks and thus are a higher risk/carry a higher risk weighting. ARC notes there has been a number of rating downgrades within the portfolio, with further downgrades expected in the short-term. This is demonstrated by the increase in the percentage of CCC rated assets from 0.5% on 2 March 2020 to 8.34%, as at the 29 May 2020 (as per the 29 May 2020 Interim Report). In addition, the amendment executed 13 March 2020 increases the weighted average rating factor to 35 from 34, with the limit already being exceeded as at 29 May 2020 at 36.50. ARC considers the increase in the weighted average rating factor to be credit negative. ARC anticipates further deterioration in the credit quality of the portfolio as these assets experience increased economic stress and subsequent deterioration in credit quality as the economic impacts of Covid-19 become more apparent. The impact of this deterioration is compounded by the absence of any obligation to immediately improve the quality of the portfolio, with the only obligation being to maintain or improve the weighted average rating factor through any collateral purchase or sale.
- Industry distribution: The portfolio is diversified across multiple industries, with the largest concentration in healthcare (29.15%, this encompassing medical device manufacturing, sample testing, and care providers), high tech industries (11.61%, encompassing software development companies), business services (7.16%, this encompassing office and business supplies, such as water coolers) and retail (9.22%, this encompassing those dependent on discretionary consumer spending). Whilst ARC takes some comfort from the level of industry diversification, industries that are seen as resilient in the face of the outbreak (e.g. healthcare and pharmaceuticals) may still be susceptible to breakdowns in related supply chain industries such as transportation and distribution (particularly cross-border supply chains) and, nevertheless, have low ratings in the 'B' range, making them sensitive to the wider macro-economic situation. Furthermore, ARC considers the exposure to the 'at-risk' industries to outweigh the benefits from defensive sectors.
- Geographical distribution: The assets are concentrated in four geographical regions: UK (22.04%), France (18.48%), Germany (16.32%) and US (15.90%). Under normal market conditions, ARC would draw comfort from the aforementioned geographic diversification levels however, whilst the governments of these countries have implemented fiscal and/or monetary policies to bolster their respective economies, the negative effects of Covid-19 are being felt globally with an annualised decrease in Q1 2020 GDP's across the four economies ranging from 2.0% in the UK (Office of National Statistics) to 5.0% in the US (Bureau of Economic Analysis). While these economies are expected to recover quicker than developing economies, the potential prolonged nature of a global economic recession due to Covid-19, coupled with potential negative impacts from Brexit, for the UK in particular, will hamper recovery expectations.
- ARC's cashflow model assessed the timely payment of interest and ultimate repayment of principal of the Facility by the maturity date of 24 June 2021. ARC's cashflow analysis assumed that the assets with the lowest rating

defaulted first, up to the level determined in ARC’s default model, in order to put the greatest pressure on excess spread and thus available credit enhancement. ARC also ran front and back loaded default vectors to ensure the timely payment of interest and ultimate repayment of principal. The structural enhancements present were sufficient for the transaction to pass at an ‘A+(sf)’ rating.

SENSITIVITY ANALYSIS

ARC has run sensitivity tests to determine to what extent the performance of the portfolio would need to deteriorate in order for the rating to be downgraded. The table below shows the increase in the weighted average default probability for the underlying assets that would trigger a rating downgrade.

	Increase in the Weighted Average Default Probability of:
1 Notch Downgrade	4.00%
2 Notch Downgrade	8.50%

KEY TIPPING POINTS	
<p><u>Positive Turning Points</u></p> <ul style="list-style-type: none"> Given current market circumstances, ARC deems upward rating movement unlikely. 	<p><u>Negative Turning Points</u></p> <ul style="list-style-type: none"> Further deterioration in the credit quality of the portfolio, as evidenced by an increase in the weighted average rating factor (36.50 as at 29 May 2020). Increased allocation to consumer discretionary sectors suffering from reduced rating quality of the underlying assets. Decrease in the portfolio Weighted Average Recovery rate (from current rate of 65.3% as at 29 May 2020), caused by a decrease in the expected recoveries of the individual assets.

RELATED CRITERIA AND RESEARCH

Methodologies

ARC Ratings` Global Structured Finance Criteria (September 2019)

ARC Ratings` Collateralised Loan Obligation (CLO) Criteria (February 2020)

Data

Aqueduct European CLO 5-2020 DAC Interim Report as of 02/03/2020, 16/04/2020 and 29/05/2020

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This Review Report should be read together with initial Rating Report and with the subsequent Review reports.

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