CIO MEMO

The Chopping Block

Chipping Away at the LME Opportunity

JUNE 2025

WHAT WE'RE THINKING ABOUT

Liability Management Exercises or "LMEs" have become a defining feature of the current credit cycle. While LMEs may feel like a new phenomenon given the extensive recent media headlines, industry white papers and a polished attorney rebranding, they are far from new. In fact, the tactic dates back over four decades to the early days of the junk bond market and Michael Milken at Drexel Burnham. Milken would use exchange offers as a means of restructuring struggling borrowers that Drexel had previously financed. Back then the activity was known as a "distressed exchange," but with a similar style to present-day LMEs, pitting creditors against each other to create more runway for overleveraged corporate borrowers.

For example, in mid-1986, Drexel successfully completed an exchange offer for MGM Studios, then owned by Kirk Kerkorian. Previously issued unsecured bonds used to finance Kerkorian's takeover were exchanged into longer-dated, senior bonds with lower interest rates (plus an equity kicker).

The exchange delayed formal default and the company subsequently sold assets to generate additional cash. A little over three years later, in early 1990, MGM filed Chapter 11. The "extend and pretend" model has been a mainstay of the leveraged finance markets since their inception.

While not new, the frequency and complexity has accelerated in the most recent iteration (beginning in late 2022) as capital structures set-up during the ultra-low-rate era, predominately leveraged buyouts, began to crack under the weight of higher financing costs. In this memo, we will attempt to share our own distinctive perspective of how this most recent version of distressed exchanges, rebranded as LMEs, is impacting the corporate credit markets and creating attractive investment opportunities for Axar.

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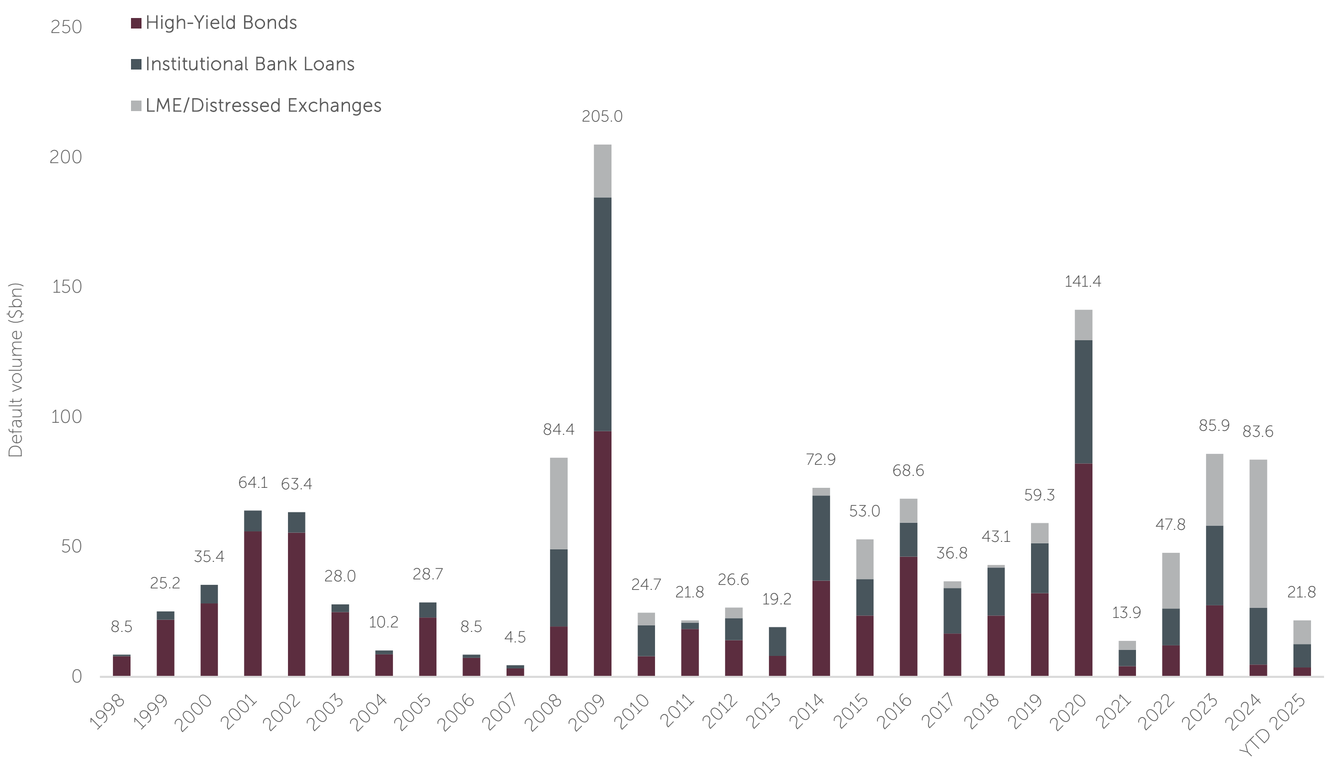
LME volume accounted for 68% of total default volume in 2024, an all-time high for the market and remained elevated at 42% in 2025 YTD through May. Below chart shows total default volume by type.

TOTAL DEFAULT VOLUME BY TYPE



Source: JP Morgan; Pitchbook Data, Inc., Bloomberg Finance L.P.; S&P/IHSMarkit As of May 2025

Many middle market companies acquired between 2020 and 2022, primarily financed with floating rate leveraged loans, now have debt structures that are no longer sustainable due to base rates going from near zero to over 4%, increasing the average debt service costs by an estimated 75-100%. As equity owners grapple with these higher interest costs and resulting refinancing challenges, LMEs have emerged as the bridge between over-levered status quo and the eventual reckoning that will be required to deleverage the company. Today, Axar's pipeline is dominated by post-LME opportunities and companies that are likely to pursue an LME. These exchanges are actually enhancing the investment opportunity for Axar – they are creating a new batch of senior secured debt, tighter documents, higher coupons and more access to fulcrum-security investing.

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KEY FACTS AND OBSERVATIONS

A New Middle Market Reality

The middle market has transitioned out of the benign credit environment that defined the previous decade. Between 2020 and 2022, sponsors leaned heavily on floating-rate structures, aggressive leverage, and covenant-lite terms to support record leveraged buyout activity. The subsequent rise in rates has exposed the fragility of those deals. Many capital structures simply don't work at 8% to 12% interest rates, especially when paired with inflationary margin compression and some weakening of macroeconomic trends.

LMEs have become the tool of choice for sponsors and incumbent lenders attempting to avoid full-blown restructurings. In many cases, these maneuvers involve layered financings, up-tiering of existing debt and/or drop-down strategies that shift collateral value away from certain existing holders and into the hands of a subset of lenders that become the new-money participants.

Why LMEs Often Make Things Worse

Conceptually, LMEs are designed to buy time. In practice, they frequently add complexity and increase leverage – both absolute leverage levels and debt service costs – to an already over-levered situation. The activity is highly lucrative for the attorneys and financial advisors constantly pitching the practice to their private equity clients. For the Sponsors, who rarely provide additional capital in these transactions, it's an obvious decision to buy more time versus walking away from the investment.

However, for incumbent creditors, the rationale to support these transactions is more nuanced: less a strategic choice and more a coercive response to weak creditor protections. Bound by loose documentation and facing the credible threat of third-party capital and asset stripping, they are often forced to participate — exchanging at a discount, capping potential upside if things do work out, and allowing Sponsors to preserve their equity option. But this alignment comes at a cost to the company and to those same lenders: continued financial stress from excess leverage and resulting in lower recovery rates down the road.

The LME transactions leave the company with more debt and still facing significant challenges including:

- Talent risk: Difficulty retaining, recruiting and incentivizing top-tier management talent in the face of worthless common equity
- Capital Starvation: Limited cash flow to invest in capex, R&D and other critical defenses against competitive intrusion (moats become harder and harder to defend)
- Governance misalignment: "Out of the money" equity holders are highly incentivized to swing for the fences when making important business decisions
- Operational distraction: Management teams encumbered by litigation and adversarial creditor dynamics

Given the above, why do creditors engage in and often seek out LME-related activity?

This is a classic case of short-term versus long-term incentives. In the short-term, being on the right side of an LME transaction, can result in a move-up in the trading prices of the distressed incumbent debt securities. Many creditors, especially CLO managers, cannot see past the opportunity to improve their position in the short term and get a resulting "pop" from completing the LME, which typically involves moving their debt ahead of other creditors (e.g. participating in an up-tier exchange).

However, over the long term, we expect the majority of these companies will still end up in Chapter 11 or another form of restructuring as a result of the extended time required to truly fix the problems (noted above). For a middle-market corporation, being distressed for several years is very different from enduring five or more years under the weight of an overleveraged balance sheet.

As a result of the wide-ranging use of LME transactions, we are in a prolonged, slow-bleed type of default cycle, a company-by-company grind, that will play out over many years.

What We're Seeing in Real Time

The post-LME securities left behind, often illiquid and dislocated, can still be valuable if approached with the right precision, but investors must be wary. Time is not a friend of the overleveraged corporation. Much of our current pipeline reflects the LME aftermath. In navigating this terrain, we are:

- Tracking issuer-level behavior to understand sponsor intentions and transaction design
- Assessing embedded complexity, including legal, structural, and documentation nuances
- Positioning ahead of inflection points, before and after LMEs occur
- Seeking the hallmark Axar investment: a business with a durable competitive advantage in a structurally sound and growing industry

While the media may portray LMEs as technical footnotes, we view them as structural catalysts. Unfortunately, many of these companies will not survive intact. But for specialists with the ability to navigate opacity and pricing inefficiencies, the opportunity can be highly attractive. Importantly, many of these credits have embedded dynamics that limit who can participate:

- Lender DQ lists limit competition prevent certain buyers from engaging
- Structural opacity keeps many secondary buyers away
- Legal uncertainty around LME documentation creates an entry barrier

We believe these structural developments in the corporate credit markets create an opportunity to generate asymmetrical returns through nimble security selection and active involvement.

The increased capital structure complexity and limited competition translates to a growing opportunity set for investment firms like Axar.

KEY TAKEAWAYS

- **LMEs are a defining feature of the current credit cycle, especially in the middle market.** While not new, they are now more frequent, more complex, and often more damaging to legacy lenders and companies.
- **They create opportunity through complexity, opacity, and structural nuance.** The result is a group of mispriced securities that we are uniquely positioned to evaluate and pursue.
- **We do not need a recession or a crisis to find compelling investments.** This is not a crisis-driven opportunity set, it's a structural unwind of mispriced (too cheap) leverage that will unfold company by company, deal by deal, over many years. The recalibration is already underway, one company at a time. LMEs are surfacing opportunities and this is a "grind," not a "crash." It's a structural theme that we expect to remain relevant for years given the extended timeframes created by these activities.
- **Our investment edge lies in anticipating and navigating these dynamics.** That means sourcing, tracking, assessing and understanding capital structure evolution, engaging before and after LMEs occur, and maintaining readiness regardless of macro headlines.

CONCLUSION

LMEs will prove to be a destroyer of long-term corporate success for many companies that engage in them. However, the practice is doing some heavy lifting for us by surfacing stressed credits, shaking loose secondary market opportunities and setting up cleaner entry points for post-LME investments.

While widely discussed, they remain underappreciated as a long-cycle structural driver for middle market distressed investing. We expect this theme to persist for a while, providing years of opportunity for disciplined, specialized investors like Axar.

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