Citi Research

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The Speculative Grade Beat: Rating Agencies - What AI Disruption?

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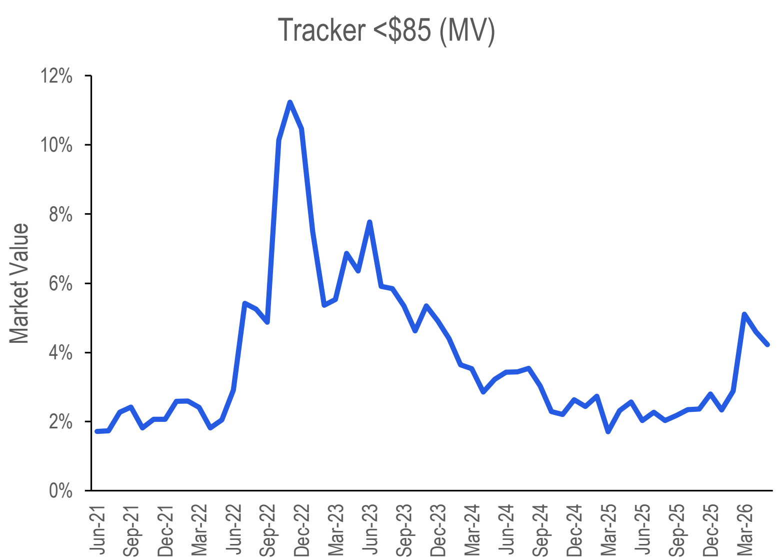
See Appendix A-1 for Analyst Certification, Important Disclosures and Research Analyst Affiliations

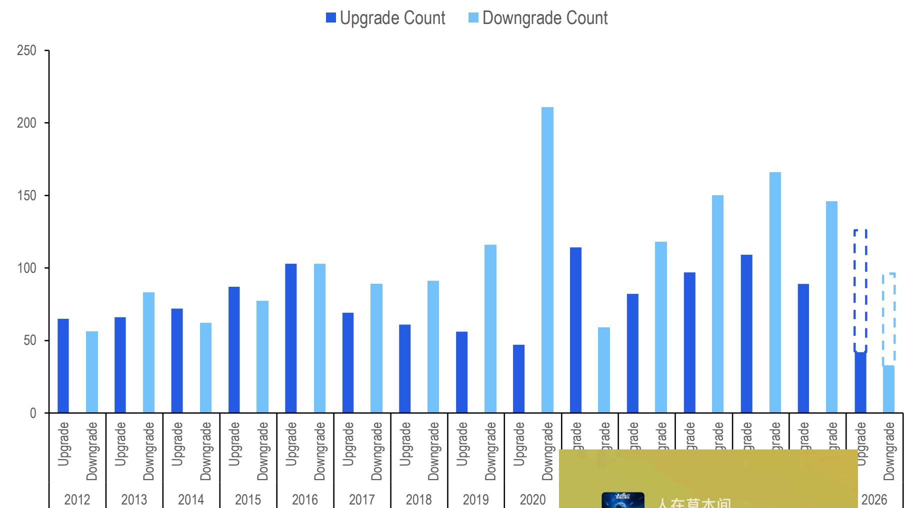
Rating Agencies: What AI Disruption?

The divergence between rating agency action and market pricing is striking as the downgrade/upgrade ratio reaches its best level in years while the amount of distressed loans remains elevated. If the next eight months follow a similar trend, upgrades could have their best year since the Tracker’s inception.

Distressed Loans Growing



Upgrades Outpacing Downgrades

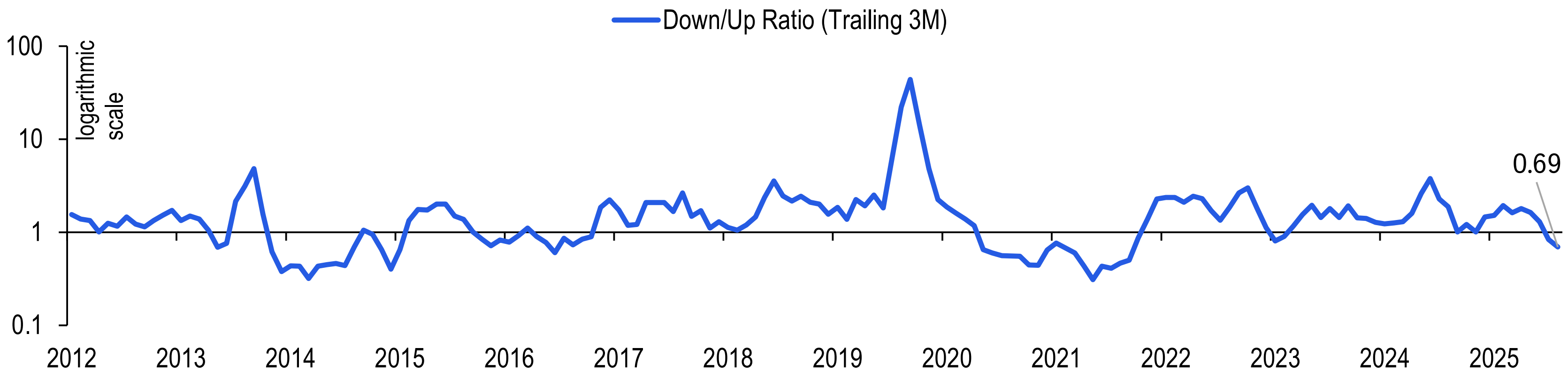


Source: Citi Research, Citi Leveraged Loan Tracker

Best Downgrade/Upgrade Ratio in Years

The downgrade/upgrade ratio touched 0.69 at April month-end, its lowest level in four years. We examine the drivers by quality and sector, as well as the numerator and denominator of the ratio.

Down/Up Ratio Reaches 4Y Low

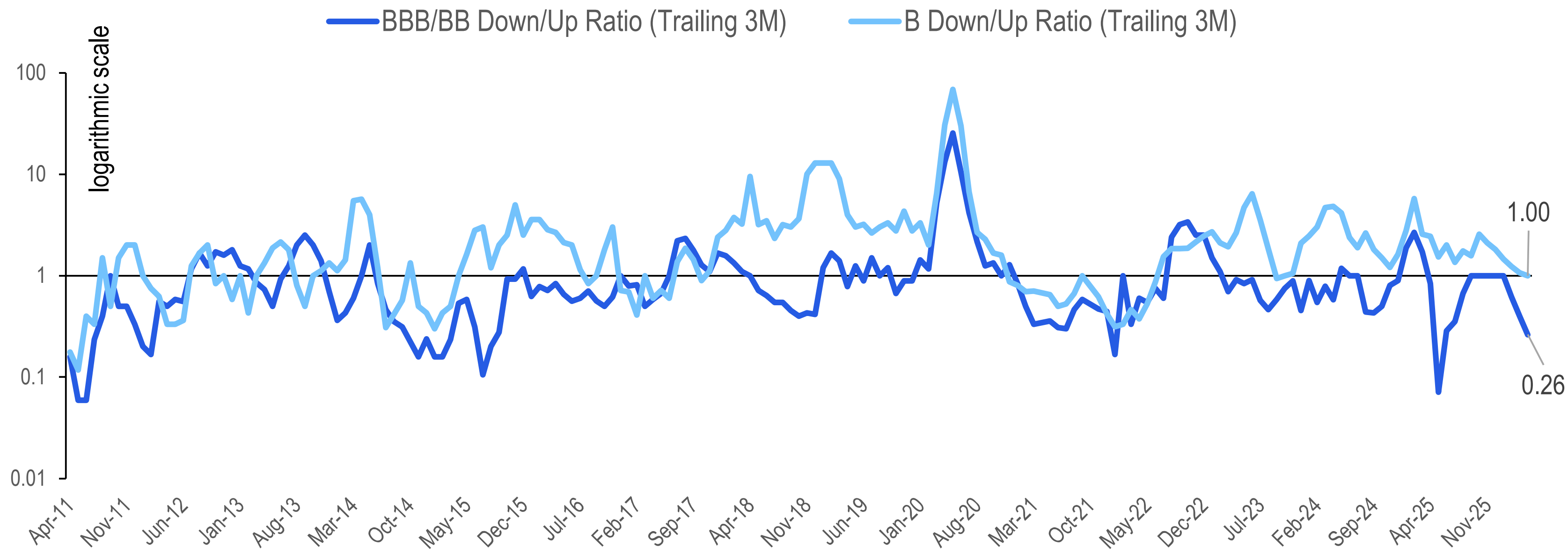


Source: Citi Research, Citi Leveraged Loan Tracker

Quality Lens

The BBB/BB downgrade/upgrade ratio is historically low, sitting at the 9th percentile at month-end. The B downgrade/upgrade is also low, but not quite as significant, at the 27th percentile. The large number of upgrades are the driving both ratios down. Additionally, downgrades are low relative to history for BBB/BB, and more middling for single-B.

Improvement Across Quality, More Dramatically for Higher



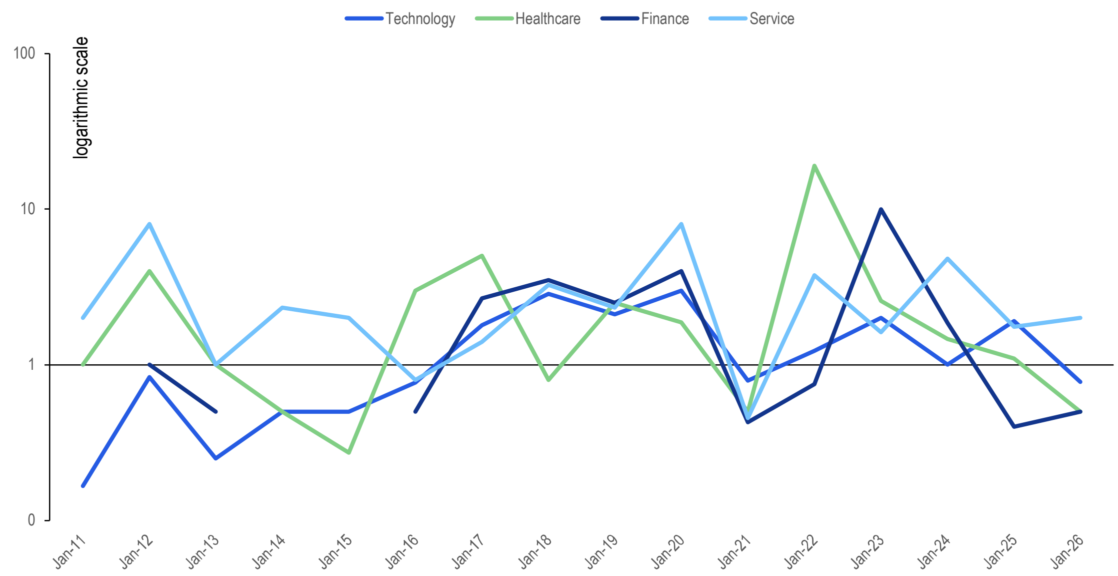
Source: Citi Research, Citi Leveraged Loan Tracker

Sectoral Lens

Further encouragement comes from strength that is present across the largest four sectors – technology, service, finance and healthcare – which comprise 52% of the Tracker by market value. For all four sectors, the ratio either remained stable or declined from 2022-23 peak. They represent very different business models, additional proof that credit improvement is broad based.

All Sectors See Credit Improvement

Annual Down/Up Ratio

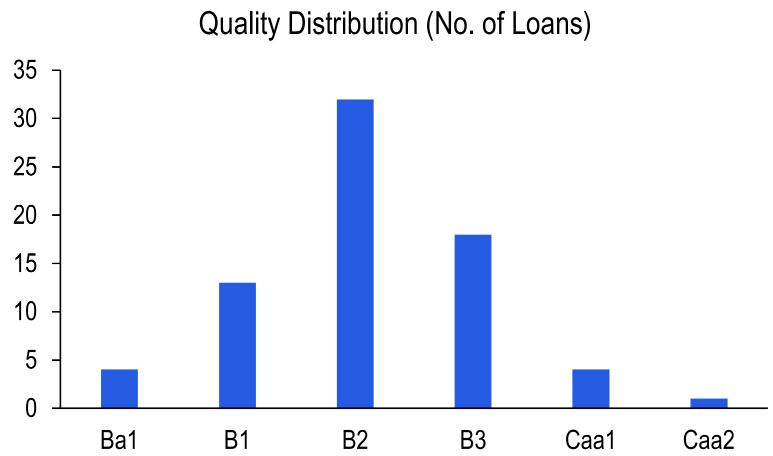


Source: Citi Research, Citi Leveraged Loan Tracker

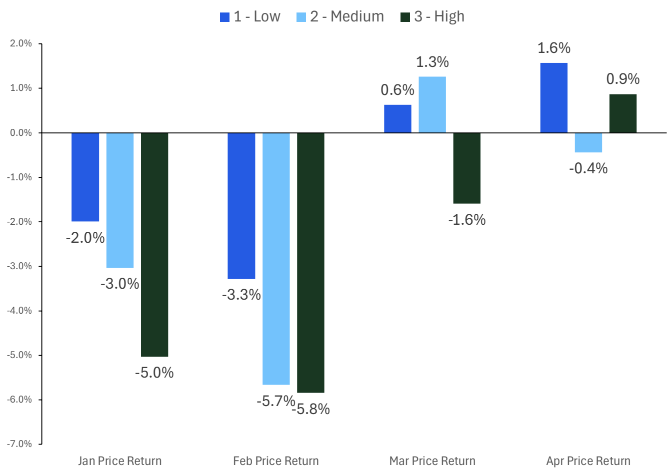
Market Valuation: AI Risk Emerges as a Return Differentiator in B1 and B2 Software Loans

The 75 software loans in our Tracker span the full range of speculative-grade credit ratings, with the vast majority concentrated in the B rating tier. We had previously found for software loans that January-end price level and our proprietary AI Risk Score had considerable explanatory power for performance.

Rating Distribution in Software Loans



Monthly Performance by AI Risk Score

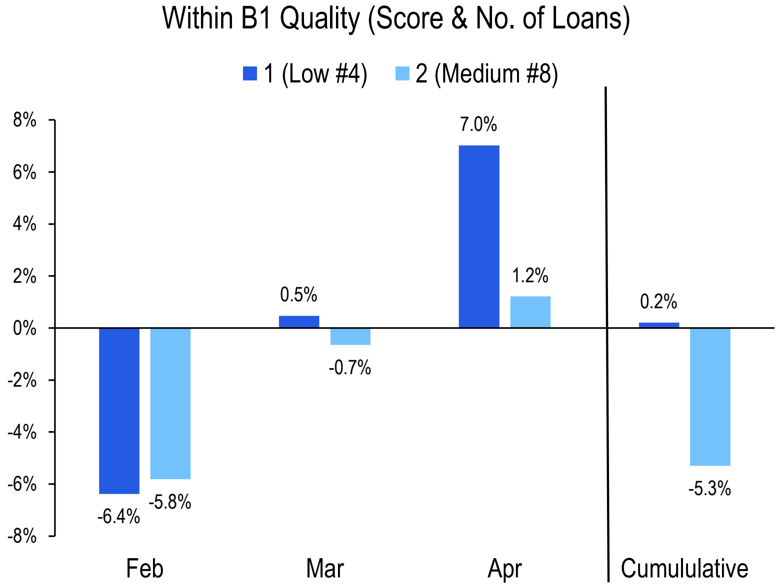


Source: Citi Research, Citi Leveraged Loan Tracker

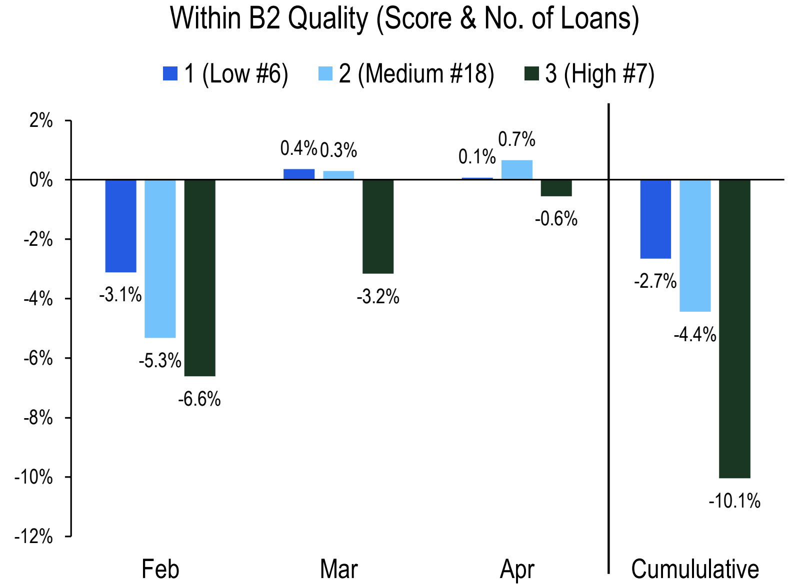
AI Risk Score Serves as Clear Differentiator

In this update, we find that AI Risk Score has emerged as the clearest differentiator in the portfolio, specifically in the B1/B2 cohorts. These loans are leveraged enough for AI disruption to be financially material, liquid enough for the market to reprice it, and not so distressed that idiosyncratic factors overwhelm the valuation.

AI Risk Score Functions as a Differentiator in B1 Quality



…And In B2 Quality as Well



Source: Citi Research, Citi Leveraged Loan Tracker

Reasons for Importance for B1/B2

Key Rationale Behind the Impact of AI Risk Score to B1/B2 loans

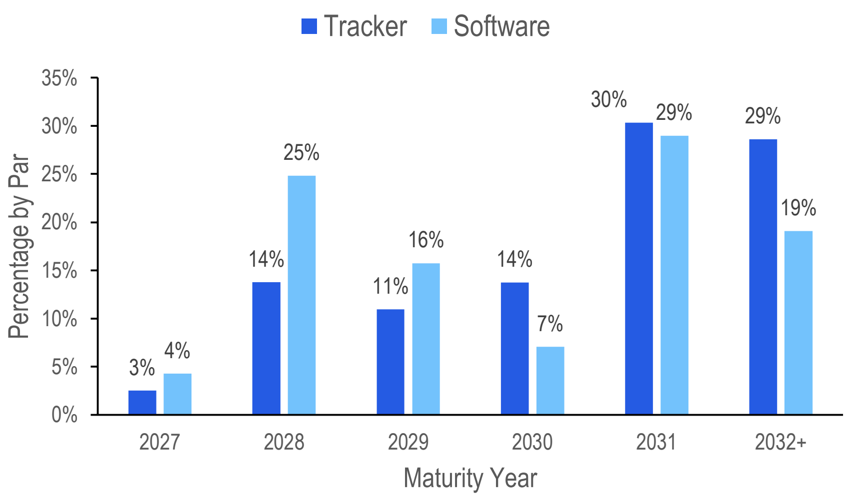
Reason	Rationale
1. Price Level	Structural business risks visible but not yet fully priced.
2. Leverage Increases Sensitivity	Typically 5-8x leveraged LBOs. High leverage amplifies AI disruption risk into a credit event.
3. Business Model Vulnerability	Credible threat of customer retention or slower contract renewal growth can raise doubts on the future cash flow sufficiency and affect valuation.
4. Liquid (CLO Core)	B1/B2 loans sit at the heart of CLO portfolios and are frequently repriced

Source: Citi Research

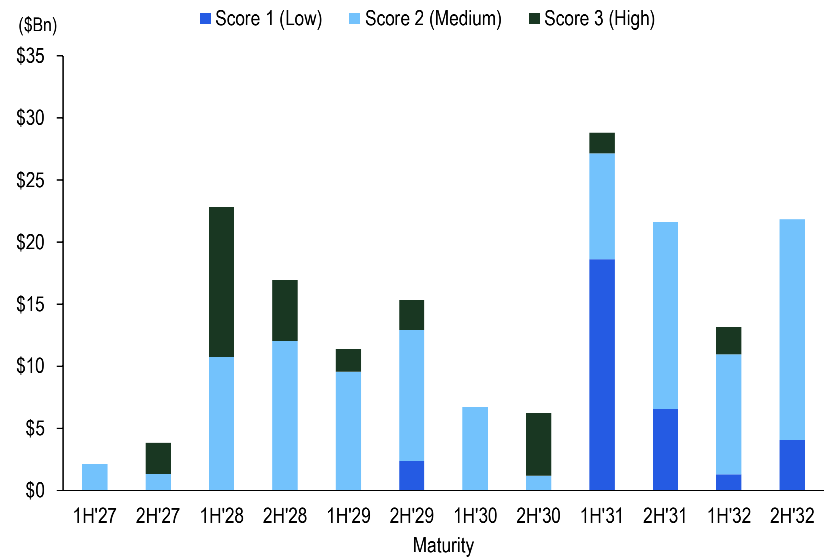
Beyond Valuation: Active Risk Management

We have previously noted that software loans carry a shorter maturity runway relative to the broader leveraged loan universe. Applying the AI Risk Score framework to the software maturity wall reveals a concerning concentration: near-term maturities are disproportionately weighted toward medium and high AI Risk issuers (Scores 2 and 3). This near-term maturity concentration warrants active portfolio risk management.

Software in General Has Shorter Maturity Runway



Applying AI Risk Score Reveals Another Near-Term



Source: Citi Research, Citi Leveraged Loan Tracker

Q & A