ARC Ratings, S.A. affirms the final, public 'AAA(sf)' to 'BB-(sf)' ratings accorded to the credit protection provided by Red 2 Finance CLO 2018-1 Designated Activity Company, and revises the outlooks to stable from negative

London, 27 August 2020 - ARC Ratings, S.A. (ARC) affirms the final, public ratings of 'AAA(sf)' to 'BB-(sf)' accorded to the credit protection provided by Red 2 Finance CLO 2018-1 DAC via a Credit Protection Deed to Santander UK PLC ('Santander'), and revises the rating outlooks to stable from negative.

The above ratings relate to the credit risk the protection seller is exposed to on the Reference Registry.

Issuer	Class / Tranche	Attachment Point (31 July 2020)*	Rating Class	Rating	Outlook	Next Review Date
Red 2 Finance CLO 2018-1 DAC	Tranche A	43.89%	Synthetic CLO	AAA(sf)	Stable	27 August 2021
Red 2 Finance CLO 2018-1 DAC	Tranche B	34.74%	Synthetic CLO	AA(sf)	Stable	27 August 2021
Red 2 Finance CLO 2018-1 DAC	Tranche C	24.38%	Synthetic CLO	A+(sf)	Stable	27 August 2021
Red 2 Finance CLO 2018-1 DAC	Tranche D	19.50%	Synthetic CLO	BBB(sf)	Stable	27 August 2021
Red 2 Finance CLO 2018-1 DAC	Tranche E	12.92%	Synthetic CLO	BB+(sf)	Stable	27 August 2021
Red 2 Finance CLO 2018-1 DAC	Tranche F	7.31%	Synthetic CLO	BB-(sf)	Stable	27 August 2021

*ARC updated the tranche amortisation in the interim report given the portfolio's amortisation.

TRANSACTION OVERVIEW

The Oustanding Reference Portfolio Notional Amount is GBP 1.14bn as at 31 July 2020 and the transaction has a Scheduled Redemption Date of January 2025. The static portfolio is comprised of senior term loans and senior revolving credit facilities, which are secured against real estate in the UK, and were originated or acquired by Santander.

Preceeding this rating review, ARC placed all tranches on negative outlook following the outbreak of Covid-19; ARC identified this transaction as being particularly susceptible to the economic fallout from the pandemic. As such, this review focuses on the performance of the transaction, namely to distinguish whether there have been any changes to the quality of the underlying loans. ARC is in receipt of an updated Reference Registry reflecting the forbearance measures requested and received by the underlying obligors, which is incorporated into ARC's analysis. ARC notes that whilst a significant proportion originally requested forbearance, some have already resumed normal or increased repayments. Furthermore, only a very small proportion of these included interest payment forbearance and none of the measures included an extension of the original maturity date.

RATING RATIONALE

The rating action predominantly reflects the significant credit enhancement available to each tranche which reduces concerns regarding possible downgrades of the senior tranches in the medium term.

Key rating drivers include:

- Covid-19 and Internal Ratings: Following the outbreak of Covid-19 and the deterioration of the Commercial Real Estate ('CRE') market, as discussed in ARC's Press Release dated 01 June 2020, Santander have conducted a number of rating reviews of the underlying loans and as such for these loans, the updated Reference Registry does reflect their credit quality more accurately. However, ARC has applied additional stresses to ratings which have not been updated by Santander since April 2020, as the impact of the current CRE market and economic climate have not, in ARC's opinion, been reflected in these internal ratings. This has led to a decrease in the weighted average credit rating of the portfolio from 'BB+/BB' to 'BB/BB-'. Despite this, ARC drew a large degree of comfort from the portfolio's long weighted average seasoning of 48 months in addition to the amount of credit enhancement available for each rated tranche, which is sufficient to protect them against expected losses at their respective rating level. Therefore, Covid-19 is not a key driver for this rating action but ARC does note that the situation surrounding Covid-19 is constantly developing thus, ARC will continue to monitor the transaction and market developments through regular surveillance along with future reviews and will determine, where necessary, if any rating action is required. This is because a deterioration in the market is, in ARC's opinion, likely to have a combined impact of increasing arrears/defaults as well as causing a decrease in potential recoveries in an enforcement scenario.
- Tranche Amortisation: The portfolio's continued amortisation, and the absence of any losses, since the original ratings in October 2018 has resulted in the available amount of credit enhancement, as a percentage of the portfolio of loans, increasing for all of the rated (A-F) tranches. This is credit positive to the transaction as it means the current ratings have become less sensitive to market and economic variability (this is demonstrated by the transaction's ability to withstand ARC's additional stressed scenarios in light of Covid-19). Due to the aforementioned uncertainties relating to Covid-19 and the CRE market, combined with the proportion of the portfolio currently subject to forbearance measures, ARC has determined that, at this time, the tranches of this Credit Protection Deed should not be subject to further positive rating action.
- Cashflow Analysis: ARC's cashflow analysis determined that the rated tranches are able to withstand the respective level of defaults for each rating level under varying scenarios including front, stable and rear default vectors as well as front, stable and rear recovery vectors. In addition to the aforementioned scenarios, ARC also considered the impact of the forbearance measures on the rated tranches. Whilst the forbearance measures themselves did not impact the rated tranches, the possibility of forbearance escalating to increased arrears/defaults provided ARC with a sufficient degree of concern to not consider any further positive rating action at this time.

SENSITIVITY ANALYSIS

ARC has run sensitivity tests to determine to what extent the portfolio would need to deteriorate in order for ARC to take negative rating action. The table below shows the impact of increasing the weighted average default probability in conjunction with a decrease in the weighted average base recovery rate for each loan comprising the underlying portfolio on the ratings of the tranches.

Change in tranche ratings	Increase in the WA Default Probability (%)	Decrease in the WA Recovery Rate of the portfolio (%)
N/A - All tranches pass at current rating levels	10%	10%
Tranches A, D, E – No change Tranches B, C, F – Downgrade one notch	15%	15%
Tranches A, D, E – No change Tranches B, C, F – Downgrade one notch	20%	20%

KEY TIPPING POINTS

<u>Positive Turning Points</u>

- Recovery of the UK's economy and the CRE market.
- Decrease in the portfolio's probability of default, caused by an improvement in the internal ratings beyond ARC's modelled scenarios.

<u>Negative Turning Points</u>

- Increase in the portfolio's probability of default, caused by a decrease in the internal ratings beyond ARC's modelled scenarios.
- A further deterioriation of the CRE market, thus reducing collateral values and thus potential recoveries on defaulted loans.

RELATED CRITERIA

<u>Methodology</u>

ARC Ratings' Global Structured Finance Rating Criteria (September 2019)

ARC Ratings' Collateralised Loan Obligation (CLO) Criteria (February 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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