CVC Credit Perspectives

Attractive opportunities across global credit

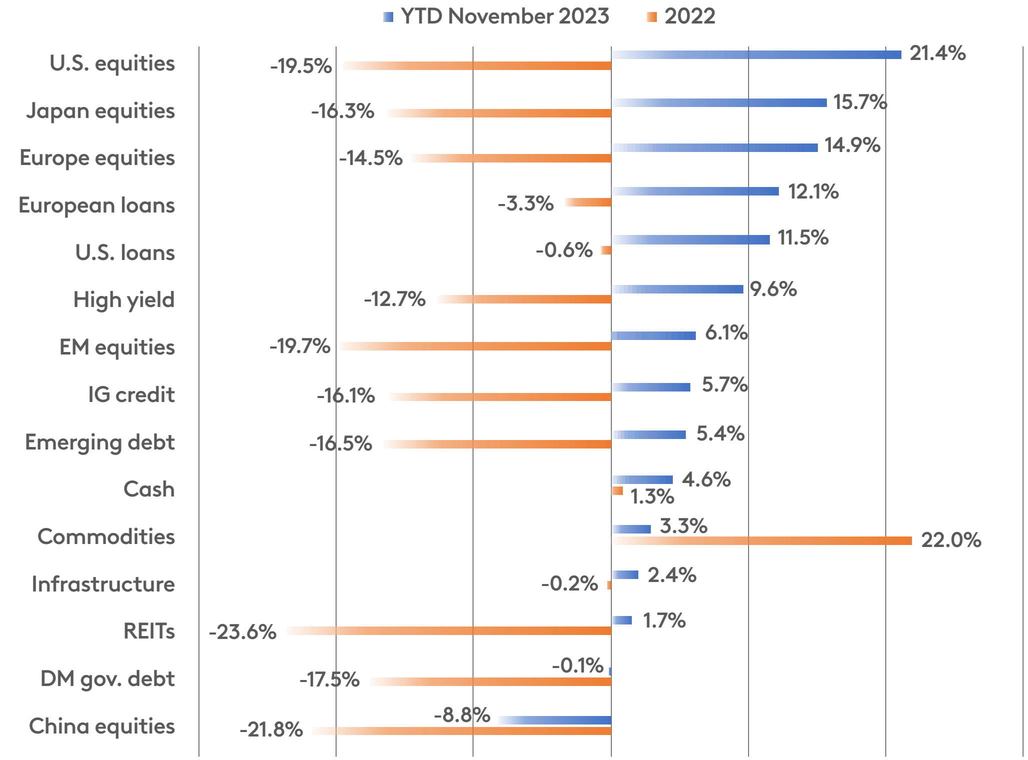
December 2023

Market update

2023 has seen a major improvement in market sentiment compared with 2022's annus horribilis. Even though the macro outlook remains uncertain, inflation has made big strides towards the 2% target that most central banks have set. This has led to more stability in markets and a drop in volatility. The jury is still out on whether central banks have managed to create a soft landing, or whether the delayed impact of rate hikes will lead to a recession in 2024. The consensus now is that inflation is sufficiently close to target to put any further rate hikes on hold for the time being. Instead, the debate has shifted to when and how quickly Central Banks will have to cut rates in 2024.

Despite several macro headwinds in 2023, U.S. equities have achieved double digit gains year-to-date, driven mainly by large cap technology stocks. Challenges such as the failure of several U.S. regional banks and Credit Suisse in Europe, the continuing war in Ukraine, the Israel/Gaza conflict and sluggish growth in China have all threatened to derail markets this year but performance has remained positive notwithstanding this. Similarly, these headwinds did not derail the leveraged loan markets, which were also one of the best performing asset classes in 2023, after having recorded fairly resilient returns in 2022 as it continues to benefit from its floating rate nature.

Exhibit 1
Performance Across Asset Classes



YTD shows year to 30 November 2023. Indexes or prices used are: U.S. equities - MSCI USA Index, EM equities - MSCI Emerging Markets Index, European equities - MSCI Europe Index, Japan equities - MSCI Japan Index, China equities - MSCI China Index, DM gov. debt - Bloomberg Global Treasury Index, Emerging debt - JPMorgan Emerging Market Bond Index (EMBI) Global Composite, High yield - Bloomberg Global High Yield Index, IG credit - Bloomberg Global Credit - Corporate Index, U.S. loans – Morningstar LSTA US Leveraged Loan Index, European Loans – Morningstar European Leveraged Loan Index, Commodities - Commodity Research Bureau (CRB) Index, Cash - Bloomberg U.S. Treasury Bellwethers: 3 Month Index, REITs - S&P Global Real Estate Investment Trust (REIT) Index, Infrastructure - S&P Global Infrastructure Index.

The outlook for Europe remains mixed. So far corporate fundamentals have remained relatively resilient, even though we have seen more earnings weakness creep in towards the backend of 2023 as consumers begin to tighten their belts in light of excess post-pandemic savings dwindling. Europe is also better prepared for winter than 2022 after the supply shock caused by the war in Ukraine but gas supply constraints could still become an issue if the continent experiences harsh weather conditions. Persistent inflation has resulted in the ECB following other developed economies in adopting an aggressive approach to monetary policy with ten consecutive rate hikes in just over a year, increasing the deposit facility from -0.5% to 4.0%. This approach appears to be working as inflation has consistently trended downwards, with the latest print coming in at 2.4%, the lowest level in nearly two years, albeit still above the ECB's 2% medium-term goal. Thus, although we may have reached the end of the hiking cycle, rate cuts are unlikely in the near term as Lagarde reiterated the central bank was in a long race to control inflation.

The tale of 2023 for the U.S. has been one of resilience despite the challenging macro backdrop. The U.S. economy continues to rumble on despite the Federal Funds rate target range now rising to 5.25%-5.50% and inflation continues to trend downwards, although remains well-above pre-pandemic levels. The consumer has continued to spend despite rising prices, the labor market remains tight and household savings remain in excess after being accumulated during the pandemic. Even so, previous suggestions that rates could be cut in late-2023 have dissipated on account of the Federal Reserve's (Fed) higher for longer mantra as they look to definitively tackle inflation, despite the potential growth implications. This has reverberated across markets, for example, the U.S. 10-year treasury yield hit its highest level since 2007 in October on account of this uncertainty as investors contend with the possibility that rates may need to climb higher yet in order stabilize the economy. Even so, the recent decision to hold rates in November has given some return to more positive sentiment in U.S. equities.

Accordingly, market sentiment remains split as to whether a soft landing is still possible, if there is a monetary policy lag effect from these rapid rate hikes it has yet to be seen. History isn't on Chairman Powell's side, tightening cycles of 400bps have rarely escaped recession and the long-term effects of such rapid monetary tightening remain unknown, particularly in more vulnerable sectors such as Commercial Real Estate (CRE). Other headwinds also remain - the U.S. was stripped of its AAA rating by Fitch in August, multiple actors now threaten international stability, Congress and the White House continue to teeter on the edge of government shutdowns and another divisive presidential election looms in the distance.

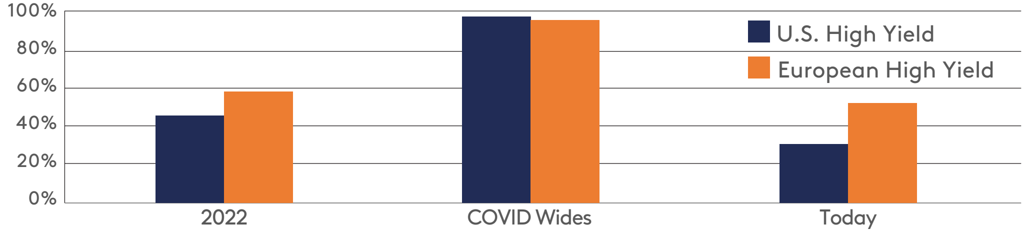
Turnover in the White House in particular could complicate matters for markets in a year when the U.K., EU and Russia also head to the polls, although some results are more clearcut than others at this stage. Whilst the story of 2023 may have been one of resilience, uncertainty mars 2024.

In light of these uncertainties, we continue to favor investment strategies with high and predictable income generation.

Performing Credit Markets

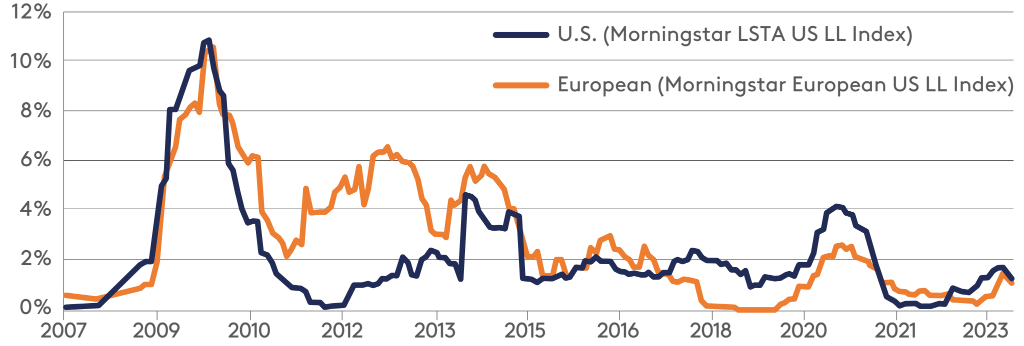
Leveraged credit has enjoyed a bounce back in performance in 2023 relative to last year's modest sell-off, with U.S. and European high yield posting 9.7% and 9.4% returns, and U.S. and European leveraged loans enjoying even stronger returns of 11.5% and 12.1% respectively YTD[1], on account of their floating rate nature. The high running yield on the asset class, through a combination of high base rates and wide credit spreads, means investors gain meaningful protection from macro volatility. For instance, in recent months rates have sold off amid rising uncertainty surrounding the U.S. macro outlook and the Fed's positioning whilst defaults have continued to trend upwards. Nonetheless, performance has improved markedly vs. 2022, illustrated by U.S. and European high yield loan spreads which have tightened by 102bps and 83bps YTD respectively and are now trading at median historical levels on account of robust fundamentals and a supportive technical environment. In particular, the lower-rated segments of both markets, namely CCC's, have enjoyed particularly strong performance due to investors dipping down in quality to pick up extra yield and in high yield's case, their lower duration profile compared to higher rated credits.

Exhibit 2
U.S. and European High Yield Spreads Percentiles Relative to Historical Levels



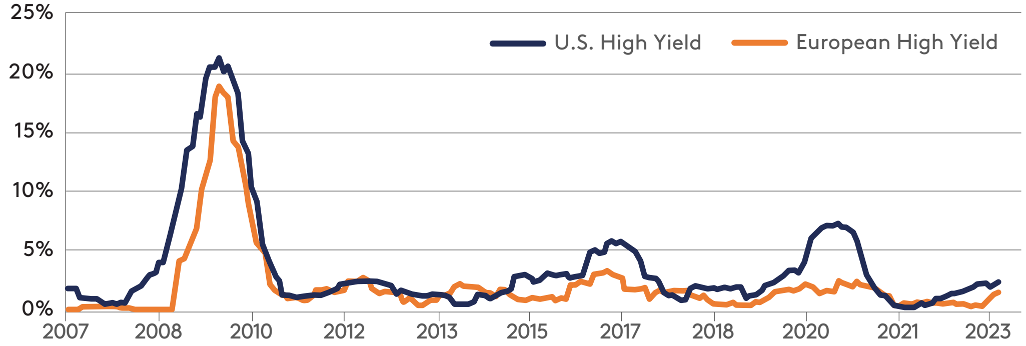
Data through 31 October 2023. Source: Credit Suisse. Percentiles ranked vs. monthly spread data starting 01/31/2000. 2022 represents 31 December 2022, COVID Wides represents 03/31/2020 and today represents 10/31/2023.

Exhibit 3
U.S. & European Leveraged Loan Last 12-Month Default Rate: Principal Amount



Data through 30 September 2023. Source: Pitchbook|LCD; Morningstar LSTA US Leveraged Loan Index; Morningstar European Leveraged Loan Index

Exhibit 4
U.S. & European High Yield Last 12-Month Par-Weighted Default Rate



Data through 30 September, 2023. Source: Bank of America Global Research

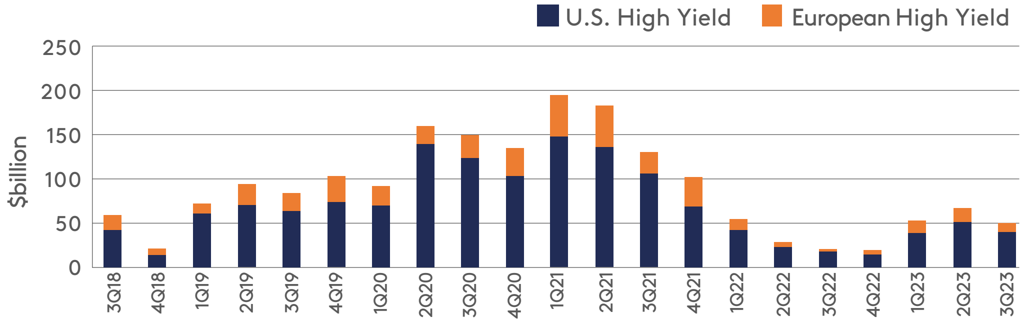
1 As of 30 November 2023. U.S. high yield represented by the Credit Suisse High Yield Index (USD Hedged). European high yield represented by the Credit Suisse Western European High Yield index (EUR Hedged). U.S. leveraged loans represented by the Credit Suisse Leveraged Loan Index (USD Hedged). European leveraged loans represented by the Credit Suisse Western European Leveraged Loan Index (EUR Hedged).

Fundamentals continue to remain resilient despite tightening financial conditions although there has been a decline in cash balances as funding costs continue to increase which has impacted metrics such as net leverage and interest coverage. Although the default environment remains benign relative to historical levels there has been an uptick in both the U.S. and European markets as the impact of higher interest rates becomes more apparent. For instance, the 12-month trailing, par-weighted U.S. high yield default rate increased to 2.4% in November, whilst the European high yield default rate came in at 1.4%, both notably higher than twelve months ago (source: Bank of America Global Research). Leveraged loans have also seen an uptick in defaults although remain more muted than the high yield market, with the U.S. and European markets reporting 12-month trailing default rates of 1.48% and 1.42% respectively (source: Pitchbook data). Whilst defaults remain lower in the loan market we expect this to gradually reverse due to the universe being lower rated in nature and the floating rate structure of these instruments meaning the impact of rising rates will be felt more quickly. The high yield market has also continued to trend upwards in quality, with $112bn of rising stars leaving the U.S. index in comparison to $16bn of fallen angels joining it. Even so, our view is this trend is likely to falter as economic conditions continue to tighten and we expect downgrades and defaults to continue to rise in both markets, particularly for highly levered borrowers and/or those in cyclical industries.

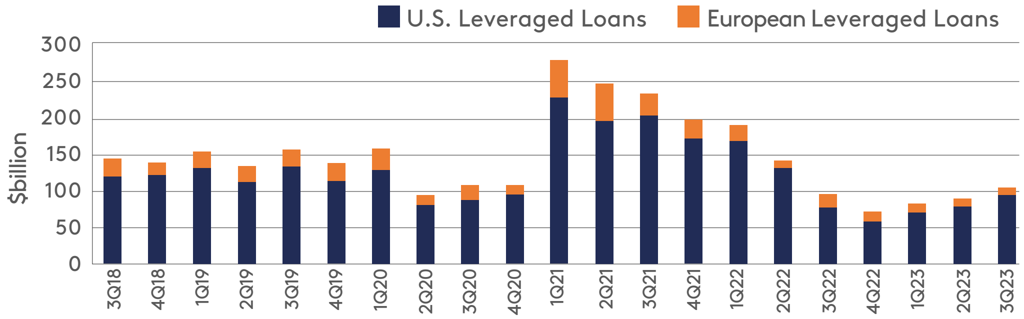
Default rates have moved up in line with our expectations, but are nowhere near the levels some of the more bearish strategists were forecasting a year ago. There are a number of reasons for this. The higher funding costs for borrowers has been offset by relatively resilient earnings, a theme we expect to continue in 2024. For example, when we look at the S&P 500, consensus is pricing in nearly 7% earnings-per-share growth for the next 12 months (source: Bloomberg), indicating that earnings should continue to remain resilient despite higher costs. Similarly, in Europe, consensus for the SXXE is 1.6% earnings growth, below the U.S. but resilient nonetheless. There is also a view that the average quality of issuers is better than in previous economic cycles. For example, the average EBITDA on the U.S. HY market was $200m in the GFC, while it is now $1bn. Larger companies tend to be more resilient in a difficult macro environment which also supports the thesis as to why we haven't seen a dramatic upturn in default rates. The quality of the market has also been supported by several companies selling non-core assets to de-gear their balance sheets in anticipation of higher funding costs and ensure strong liquidity. Finally, default rates are also lower than many feared 12 months ago due to private equity managers sitting on a record amount of dry powder which has resulted in several sponsors injecting more equity into businesses they own where required rather than letting them fail.

Furthermore, technical factors have also continued to support spreads in both the high yield and leveraged loan markets as issuance has remained weak compared to historical averages, although has improved on 2022 levels which were some of the lowest on record. Companies continue to be torn by the dilemma of a pending maturity wall and higher funding costs which has stunted issuance and failed to address the pending maturity wall. Although we have seen over $170bn of high yield bond issuance in 2023 year-to-date, already surpassing 2022's total of $126bn, it remains on the low-side. This, coupled with the $112bn of rising stars leaving the U.S. high yield universe has continued to support spreads, which are currently tighter than historical averages despite the challenging macro outlook. Leveraged loans have also seen muted issuance with $280bn being priced YTD 2023, as mergers and acquisitions (M&A) remain limited which has resulted in refinancing continuing to dictate supply in the market. The CLO market has seen $140bn of new issuance this year, down slightly from $154bn at this stage last year, which should provide a technical tailwind for high yield and bank loans and continue to maintain a floor on price levels.

Exhibit 5
High Yield & Leveraged Loan Issuance: Quarterly

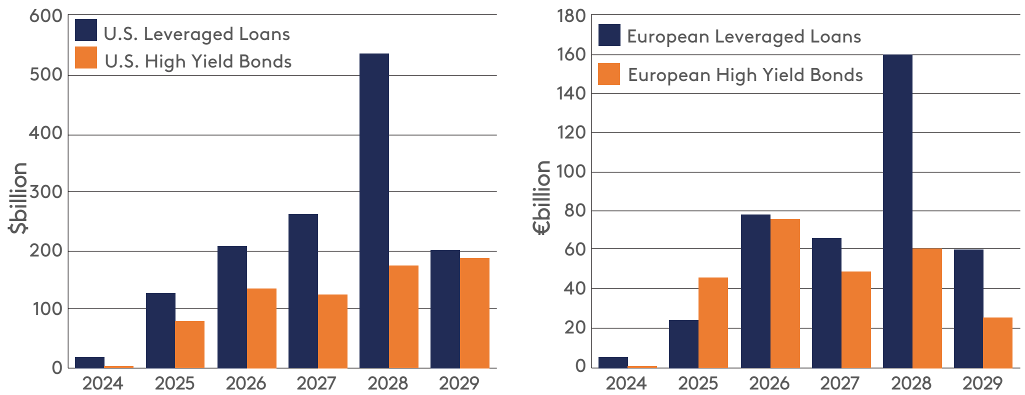


Data through 30 September 2023. Source: Pitchbook|LCD



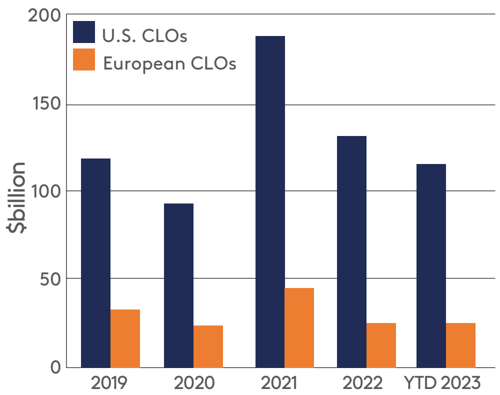
Data through 30 September 2023. Source: Pitchbook|LCD

Exhibit 6
High Yield & Leveraged Loan Maturity Wall



As of October 31 2023. Source: Credit Suisse Leveraged Loan Index, Credit Suisse High Yield Index, Credit Suisse Western European Leveraged Loan Index and Credit Suisse Western European High Yield Index.

Exhibit 7
U.S. & European CLO Broadly Syndicated Loan Annual New Issuance



Data through 30 November 2023. Source: Pitchbook|LCD

After a challenging first half of the year, CLO new issuance has picked up significantly in recent months as managers have looked to take advantage of tightening liability spreads. Despite the increased supply, AAA and AA secondary spreads ended in November back down near Q1 levels while A-BB spreads are at or near the tights of the year as CLOs continue to see strong demand given high all-in yields. We are seeing more interest in CLOs across the cap structure. Although CLO debt demand from U.S. banks is still weak due to both the macro and regulatory environment, we have seen an increase in large Asian and European financial institutions participating in the market. Top-tier managers are still able to bring new deals to market successfully, and our platform continues to benefit from captive equity, as well as a loyal following of CLO debt investors. This enables us to be opportunistic and nimble, ultimately accessing the market on attractive terms.

As we enter 2024 the market outlook is more mixed from both a technical and fundamental viewpoint. Net supply is likely to increase as M&A activity is expected to bounce back from the very low levels we've seen over the last two years. In the leveraged loan market, the impact of the maturity wall is fairly limited as a lot of issuers extended their maturities already. These issuers have already felt most of the impact of higher base rates. This is not the case for high yield issuers though, where the maturity wall is more of a concern as issuers have been postponing refinancings given they benefited from low legacy coupons. We expect more refinancing activity in the high yield market in 2024 and this could create very attractive opportunities to add high yield exposure to multi-strategy portfolios. During times of volatility, active management with a steadfast approach to credit selection remains critical for managers to capitalize on dislocation, rather than fall into the trap of complacency or indiscriminately chasing yields.

In terms of valuations, absent any major macro shocks or unexpected geopolitical developments, we believe high yield spreads should remain range-bound within the 400-500bps range moving forward, tighter than historical peaks in recessionary environments. Historically, high yield spreads have peaked at ~800-1000bps in a recession, whereas this cycle spreads have currently peaked at just under 600bps in the U.S. and ~650bps in Europe. Not only have spreads been tighter on account of the technical factors discussed previously, they have also been supported by the higher quality of the index vs. previous recessions. Issuers have also benefitted from clear foresight in the run up to higher interest expenses which has allowed firms time to prepare for these headwinds.

Moreover, we do not expect to see spreads widen to historic recessionary levels due to our expectation that defaults will rise to long-term averages but not trend higher like previous recessions. This is partially due to the quality of the index as well as the lack of maintenance covenants which would have typically triggered a wave of defaults early in the cycle. Instead, the default cycle is likely to be spread

over a number of years, rather than a high concentration of defaults in the early stages of the credit cycle. Finally, the entrance of Private Credit into the leveraged finance market has also supported valuations as private credit managers became a marginal buyer in 2022 when ETFs or funds with daily liquidity had outflows. This resulted in strong inflows into the market which most likely prevented spreads peaking wider. Absent any geopolitical shocks, these structural differences in the high yield market should now result in spreads remaining range-bound at a lower level than experienced during previous credit cycles.

During 2023, we generally favored floating rate loans over fixed rate high yield, and loans generally outperformed high yield. Looking into 2024, we expect a slow rotation from loans into high yield as we can lock in some of these higher coupons for longer. In particular, the new issue market in the HY space should offer some attractive opportunities.

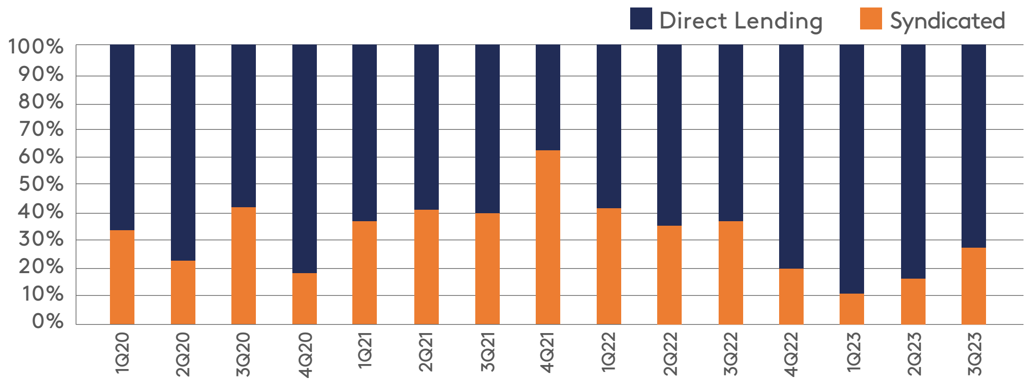
Private Credit Markets

Heading into the end of 2023, private credit is benefiting from higher base rates, attractive spreads, and M&A levels showing meaningful signs of resurgence. In Q3, we saw a number of mid-market deals completed and refinancing activity resume. With bank risk tolerance still subdued, save for the low-levered credits in acceptable industries, we continue to see sole lenders and clubs of direct lenders dominate even the largest deals. We have seen the direct lending market in Europe gradually become mainstream and more desirable as a source of financing. The private debt asset class has provided solutions for sponsors and borrowers who are seeking long-term partnerships, and for investors who are seeking attractive and consistent risk-adjusted returns. As a result, we expect the opportunity for larger transactions to be executed in this space to experience higher adoption as sponsors now have a choice.

The liquid market has been volatile in the last 18 months, offering an opportunity for private credit to capture market share. At our Credit AGM in early October, Adil Seetal from CVC's Capital Markets Team commented – "In the case of CVC Capital, private credit has gone from less than 10% of our financings five years ago to 75%+ in the last two years. There will be an equilibrium reached at some point." While the syndicated market continues to claw its way back, for issuers it is not as stable or predictable an option as it was a few years ago. Instead, we are observing banks are more willing to participate alongside private credit funds to underwrite large deals in the current environment. This widespread adoption of private credit solutions is illustrated by the growth of the market size, expanding from $875 billion in 2020 to approximately $1.4 trillion[1] at the start of 2023 and is expected to increase further to $2.3 trillion by 2027[2]. The reliability of the market has improved with scale and wider adoption has presented attractive opportunities in the senior direct lending space as a result.

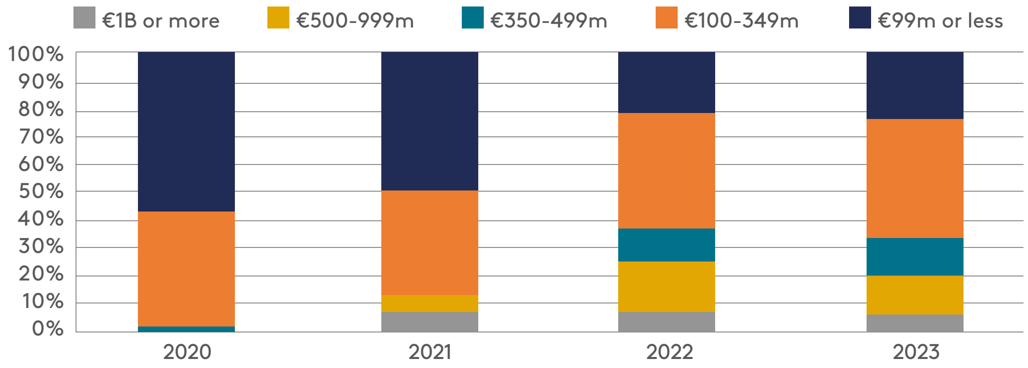
Over time, it will become clear that specific types of deals will be better suited for each product. For example, completing large Sterling deals has always been complicated in the liquid market and private credit may offer a better solution. Other likely examples where private credit may be the preferred approach include: i) public-to-private transactions (P2Ps) with significant uncertainty or long closes; ii) M&A stories which require regular "taps" of the capital structure (doing this in the public market is labor intensive for borrowers e.g. with rating agencies); iii) certain bespoke situations where it is preferable to work with a small group of lenders. The syndicated market will always have significant market share with large sponsors, but there will definitely be more balance in the future.

Exhibit 8
Share of European LBOs financed via BSL vs. direct lending markets



Data through 30 September 2023. Source: Pitchbook|LCD BSL refers to broadly syndicated loan market; direct-lending count based on deals covered by LCD News.

Exhibit 9
Deal size diversification of European direct lending deals



Data through 30 September 2023. Source: Pitchbook|LCD. Analysis based on transactions covered by LCD News; share calculated based on deals where size information is disclosed.

Lastly, over the past couple of years, the private credit community has spent a lot of time getting to know and doing deals with the large sponsors. These relationships will be important for future deal flow. In fact, 38% of our deal activity since the inception of CVC Credit's European Direct Lending Portfolio have been repeat transactions and the result of an existing relationship with either the management team or sponsor. This is particularly notable not just in terms of deal flow, but also because it does not require any sacrifice in quality to do so. These are typically accretive add-on acquisitions for companies that we have underwritten and invested in for years. This has benefitted us in the slower M&A environment in the first half of 2023.

In the second half of 2023, M&A volumes have started to come back. The market is dealing with higher rates which are likely to persist for some time, and wider bid-asks between buyer and seller expectations. Our sponsor partners have not been standing still though – highest quality assets have still been trading, sponsors have continued to need capital for tuck-in acquisitions, and new opportunities have opened up to us such as P2Ps as well as PIK solutions that can solve for stretched cash interest coverage ratios or bridge-like financing to manage a near-term maturity wall or to a more receptive IPO market. As a result, CVC's Private Credit team have been in high demand, and since April 2023, have completed eight transactions in our junior capital strategy alone. In terms of opportunities we are seeing across Europe and the U.S. today, private junior capital is yielding mid-teens type returns. Issuers are increasingly looking towards Holdco PIK or preferred equity alongside unitranche to maximize leverage and reduce their interest cost burden, as it remains cheaper than equity. Thus, junior capital is an increasingly attractive opportunity set due to strong businesses utilizing these products for solutions in light of constrained cash flows and the need to bridge valuation gaps as rates settle.

Within our European direct lending business, we have similarly seen healthy deployment with eighteen transactions completed in 2023, deploying over €1.7bn of capital during this period. All-in yields are currently in the 10-12% range for senior deals with lower leverage and first-lien risk, our most recent investments have been no exception to this trend, with us entering these deals at a weighted average loan-to-value (LTV) of 36% and achieving a c.11% yield. We believe these types of returns with strong sponsors, conservative structures and documentation provide a historically compelling risk-adjusted return.

Even so, the caveat of higher returns for private debt is rising default expectations, which we expect to increase in light of borrowers bearing higher interest costs, which in turn puts pressure on margins and profitability. This will primarily impact more cyclical industries and highly levered businesses. As a result, we expect there will be a bifurcation in manager performance, reinforcing our belief for the need of an investment process rooted in diligent underwriting and ongoing portfolio monitoring, in order to drive outperformance.

Sources

[1] Bloomberg. As of January 2023

[2] Preqin. As of January 2023