CVC

CVC Credit Perspectives

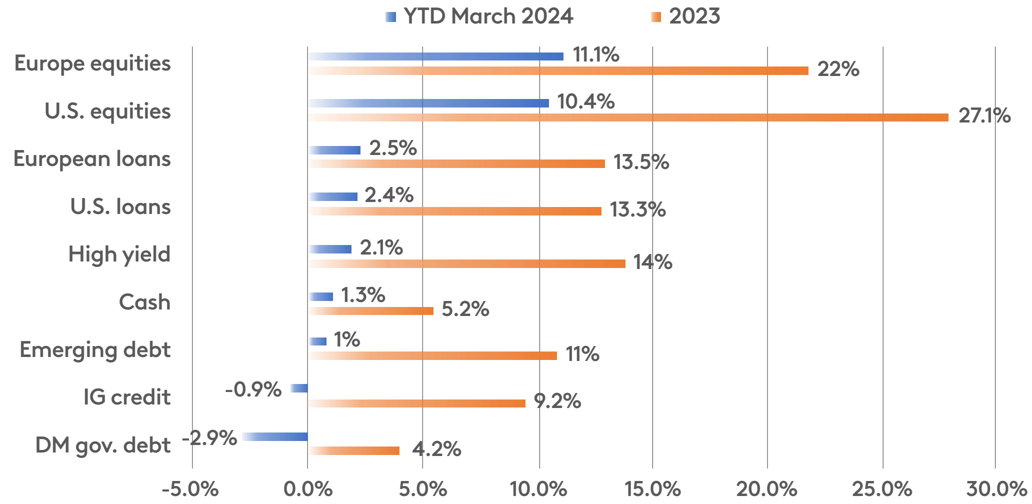
Attractive opportunities across global credit

Q1 2024

Market update

The start of the year has seen the market pick up from where it left off in December, shrugging off macro and geopolitical concerns to stage an impressive equity rally as investors remain confident central banks will cut rates this year. Technology in particular has turbocharged this rally as excitement continues to build surrounding the potential transformative impacts of AI which has led to the Magnificent 7 leading from the front as the S&P 500 reached all-time highs at the start of the year. Taking a step back, there are still several macro questions lingering from the end of the year that are yet to be resolved, namely if/when central banks will begin to cut rates after a series of rapid hikes in 2023. After the late rally in rates towards the end of 2023, investors have pared back expectations as to how aggressively central banks will cut rates this year, and as a result sovereign bonds have experienced modest negative returns since the start of the year due to the repricing of duration. Even so, the consensus remains that the Federal Reserve ("Fed"), European Central Bank ("ECB") and Bank of England ("BoE") are likely to cut rates later this year, although there is less clarity with regards to the pace of these cuts.

Exhibit 1
Performance Across Asset Classes



YTD shows year to 31 March 2024. Indexes or prices used are: U.S. equities - MSCI USA Index, European equities - MSCI EU 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, US loans – Morningstar LSTA US Leveraged Loan Index, European Loans – Morningstar European Leveraged Loan Index, Cash - Bloomberg U.S. Treasury Bellwethers: 3 Month Index.

Uncertainty continues to shroud Europe as inflation remains sticky, particularly with regards to wages and domestic inflation which has meant any talk of rate cuts before June has dissipated, with all eyes now on the progress made ahead of the June ECB meeting. The expectation remains for the ECB to begin cutting rates in June, and the market is now pricing approximately a percentage point of ECB easing in 2024, although we note this timeline could be pushed back if the central bank determines insufficient progress has been made in reaching their 2% medium-term goal. Economic growth remains muted, although there have been green shoots in recent months, with consumer spending edging higher, fixed investment increasing and the European PMI surprising to the upside in February as Services PMI started to reverse its recent contraction. Growth across geographies continues to vary – the UK has dipped into recession, German growth continues to lag as well while France recovers more strongly. Data releases over the next few months will continue to be scrutinised intensely as the market tries to gauge the timing and pace of rate cuts in Europe, with June being the earliest are likely to see a loosening of monetary policy.

The U.S. economy continues to report robust economic data, although inflation remains persistent with CPI prints surprising to the upside so far this year. As a result, US Treasuries have modestly sold off as the market reprices rate expectations. In December futures were aggressive in pricing c.145bps of cuts for 2024 which has subsequently been dialled back in light of recent data releases. It is now unlikely the U.S. will cut rates in June, and will lag behind Europe as central banks begin to cut rates later this year. Corporate profit margins remain resilient and this trend is likely to continue as we begin to see lower input and labour costs, whilst continued investment in artificial intelligence may also improve margins further, particularly in the technology sector. As the Republican primaries draw to a close, attention is also shifting towards the upcoming US Presidential Election in November, which will see a rematch of the 2020 contestants, President Biden and former president, Donald Trump. The market reaction to the general election will be intriguing.

Thus, whilst markets have repriced rate expectations for the year in both the U.S. and Europe, there still remains optimism that we will see the first rate cuts of the cycle in June, providing the data supports this trend. Growth remains stronger in the U.S. than Europe, whilst equity markets continue to charge forward and scale new heights as investors become increasingly confident that soft landings are in sight. Even so, headwinds remain, particularly if inflation data remains sticky and central banks reiterate their higher-for-longer mantras from last year. Geopolitical uncertainties also remain; near-term resolutions for the conflicts in the Middle East and Europe appear highly unlikely, whilst the largest election year in history is also kicking off around the globe which could bring further complications. As we stated in our last quarterly update, uncertainty mars 2024, but we see reasons for optimism despite the potential for volatility.

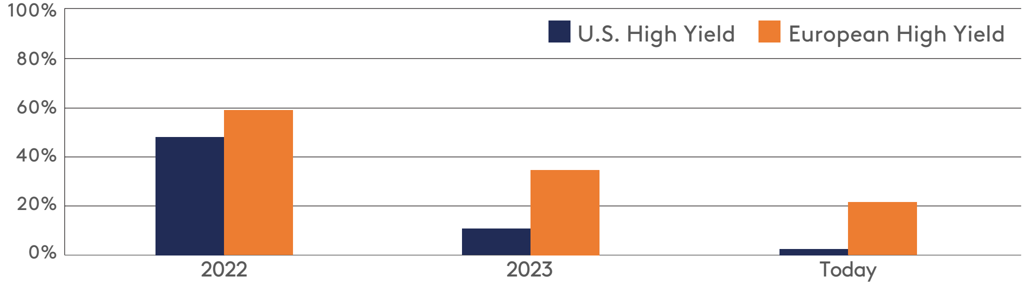
Performing Credit Markets

Leveraged credit has seen spreads tighten further to historic top quartile tights as risk sentiment has continued to improve despite renewed concerns on inflation. High yield returns remain positive 1.7% and 1.2% in the U.S. and Europe YTD, despite the sharp repricing of rates since the start of the year.

Leveraged loans have reported marginally stronger performance figures so far this year with the Credit Suisse U.S. and European Leveraged Loan indices reporting 2.5% and 2% returns to date[1]. High yield spreads have continued to tighten, with U.S. and European high yield spreads tightening by 42bps and 38bps YTD respectively, and are now trading close to historic tights since 2000, as illustrated in Figure 2. This improvement in market sentiment has been more pronounced in the lower-rated segments of the market, namely CCC's, which have continued to outperform the higher-rated areas of market as investors continue to dip down in quality to pick up extra yield.

Fundamentals continue to remain resilient despite tightening financial conditions although there has been a decline in cash balances as debt servicing costs continue to increase which has impacted metrics such as net leverage and interest coverage. The gradual uptick in defaults that was seen in 2023 has continued and hovers around historic averages for the loan and high yield market as expected. Defaults remain slightly more muted in the leveraged loan market, with the U.S. and Europe reporting 1.1% and 1.6% of defaults respectively, in contrast to their high yield market equivalents which stand at 2.2% and 1.4%. The balance sheets of lower quality business have felt the impact of noticeably higher input costs which have squeezed margins, although we still do not expect defaults to rise significantly higher than their current levels. One notable theme has been the increase in distressed exchanges over the last twelve months as a proportion of defaults, as businesses seek to avoid bankruptcy with out-of-court settlements instead. As expected, we have also seen a gradual decline in the quality of the high yield market, with downgrades outpacing upgrades, in contrast to the positive upgrade-to-downgrade ratio experienced in 2023 (source: J.P. Morgan), as margins tighten due to the impact of higher-for-longer rates. Even so, there have been $9.1bn of rising stars leave the U.S. high yield index in contrast to $5.2bn of fallen angels joining it. The leveraged loan market has also seen negative ratings actions, with downgrades outpacing upgrades for nearly two years, the upgrade/downgrade ratio now hovers around 0.5:1 (source: J.P. Morgan). Consequently, we maintain our view that whilst economic conditions remain tight, downgrades and defaults will continue to moderately rise in both markets, particularly for highly levered borrowers and/or those in cyclical industries, although we do not foresee this rising to levels seen during previous recessionary periods.

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



Data through 31 March 2024. Source: Credit Suisse. Percentiles ranked vs. monthly spread to worst data starting 01/31/2000. 2022 represents 30 December 2022, 2023 represents 29 December 2023 and 'Today' represents 28 March 2024.

Furthermore, technical factors remain constructive within credit which have continued to support spreads as we suggested at the end of the year. Fund flows have indicated positive investor sentiment with small net inflows so far this year as investors continue to see value in leveraged finance despite tightening spreads. Issuance has also been strong in the U.S. high yield market, totalling over $86bn YTD which is already half of total issuance in 2023, and ~80% of 2022's volume. This has been due to issuers seeking to address the impending maturity wall for 2026 and 2027 maturities, taking advantage of improving primary market access and the market pricing in rate cuts which have yet to be realised. Such is the improvement in conditions that the number of new issues from recently stressed credits has doubled in the recent months compared to the issuance after the U.S. regional banking crisis last year (source: Bank of America). By contrast, the European high yield market continues to lag which has been a consistent theme since mid-2022 although we still expect issuance to increase as the year progresses. Similarly, the leveraged loan market has also seen strong issuance since the turn of the year, with the U.S. and European markets issuing approximately $150bn and €30n of loans to date, as market access improves and we begin to see an increase in M&A activity as corporate management teams grow in confidence that a soft landing is possible and rates will begin to be cut later this year. This trend is also evident in the CLO market, particularly in the U.S. which has enjoyed strong new issue pace with $51bn already being priced this year. Europe has also enjoyed robust issuance with €11bn to date, and recent leveraged loan issuance is struggling to keep pace with the CLO market as borrowers take advantage of tight spreads.

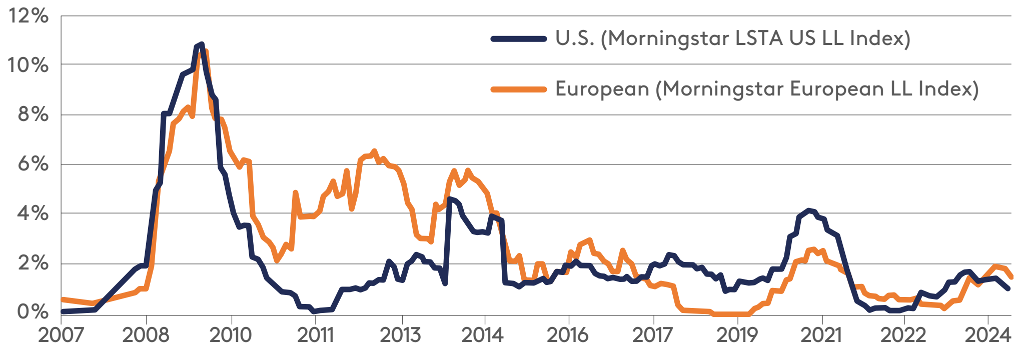
1 As of 31 March 2024. U.S. High Yield represented by the Credit Suisse High Yield Index (USD Hedged). European High Yield represented by the Credit Suisse Western European High Yield index (EUR Hedged). U.S. Leveraged Loans represented by the Credit Suisse Leveraged Loan Index (USD Hedged). European Leveraged Loans represented by the Credit Suisse Western European Leveraged Loan Index (EUR Hedged).

Thus, we maintain our view that 2024 will continue to be mixed from a technical and fundamental viewpoint although there remains attractive opportunities in the market. Net supply has increased as expected since the start of the year, and we see this trend continuing as M&A activity picks up and issuers begin to address the maturity wall, particularly in the high yield market. Spreads have continued to compress on account of improving risk sentiment and despite an increase in net supply which typically is not a supportive technical factor. Even in a downside scenario where a soft landing is not achieved, we do not expect to see spreads widen to historic recessionary levels due to our expectation that defaults will remain at 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.

In terms of positioning, we continue to be cautious on fixed rate high yield given the rally we have seen over the last few months and have materially reduced exposure to the asset class, both in Europe and the U.S. We have increased exposure to European loans at the margin as a result of favourable valuations compared to U.S. loans. Whilst the European macroeconomic outlook is not as strong as the U.S., we do not believe earnings will decline materially. Even some of the more cyclical European credits appear to be showing green shoots of recovery, or at least are seeing signs of stabilisation. In terms of ratings exposure, BBs are starting to look expensive, in particular in the U.S., after a recent repricing wave. There is still downside risk to B- rated companies if they were to get downgraded to CCC area. Hence, we prefer to be overweight B+ and B names and underweight B-, with some selective CCC exposure in names we have strong conviction in.

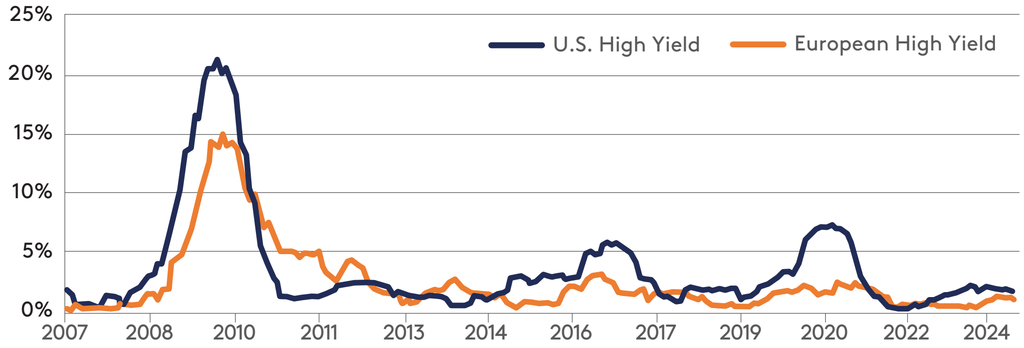
The mixed market outlook reiterates the importance of active management and effective credit selection to navigate volatile markets, allowing managers to successfully capitalize on dislocation, rather than fall into the trap of complacency or indiscriminately chasing yields.

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



Data through 31 March 2024. 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 31 March 2024. Source: Bank of America Global Research

Private Credit Markets

In late 2023, the economic data indicating calming inflation led to improved sentiment across both equity and credit markets. Indeed the broadly syndicated loan (BSL) market showed signs of re-opening, and that trend accelerated in the first three months of 2024. The combination of limited new mergers and acquisitions (M&A) and deal supply created an opportunity for existing leveraged debt issuers to reprice their debt facilities.

A wave of repricing has occurred across the US and European broadly syndicated markets. Some of the larger private credit issuers have, where possible, also taken the opportunity to refinance their private credit facilities by returning to the publicly rated credit markets. In fact, the volume of private credit facilities refinanced in the public loan market in the US and Europe reached a total of circa $10.5 billion and €4.2 billion, respectively, so far this year (source: PitchBook LCD, through March 14, 2024). Consequently, private credit has seen some spread compression in certain new deals and refinancings.

Exhibit 5
Private credit facilities refinanced in the BSL market in Europe

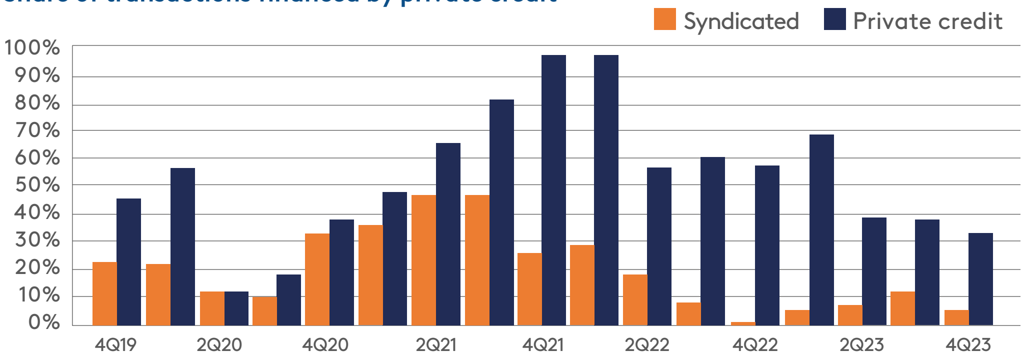
YTD 2024 first-lien loans that refinance direct lending loans

Company	PE Sponsor	Borrower Rating	Debt being refinanced
Planet	Advent	B-/B3	€254m unitranche
Ingenico	Apollo	B+/B2	€1.05bn term loan placed with PIMCO
April Insurance	KKR	B/B2	€800m unitranche
Deutsche Fachpflege	Advent	B/B3	~€300m unitranche
Group.one	Cinven	B/B2	~€340m club loan
Ivirma	KKR	B/B2/B+	€820m loan placed with direct lenders
P&I Personal & Informatik	HG Capital	B/B3	€300m private loan
Normec	Astorg	TBD	Private credit debt

Source: PitchBook | LCD. Data through March 14, 2024.

As we have progressed through Q1 we can see that the improved sentiment is generating new deal opportunity with both add-on M&A and an increasing volume of sell-side processes. The combination of this together with the expectation that rates may remain elevated through the year and settle at more regular levels, has continued to deliver strong deal flow into our private credit platform at compelling risk-adjusted yields. In recent times, private credit financing at both the senior and junior level has proven to be a very credible and efficient alternative to bank underwritten solutions and has been strategically adopted across the middle and larger cap sponsor markets. Moreover, the capacity to provide acquisition and capex add-on financing with consistency and speed continues to offer broader optionality to private equity sponsors as they grow their portfolio companies. We believe this adoption will continue and as such, the addressable market for European (and US) private credit has expanded, with a wider set of borrowers utilizing the product as a reliable and transparent corporate financing solution. Indeed, we believe many clients now consider private credit products as a strategic allocation in their alternatives portfolio. In a recent Moody's report, it was noted that the European and UK corporate private credit market have been growing at an average rate of 21 percent per annum over the past decade. This compares with a 14 percent average annual growth rate in the US[2]. Regulatory changes will also open the door for retail investors to access the private credit market, further expanding the pool of available funds.

Exhibit 6
Share of transactions financed by private credit



Source: PitchBook | LCD. Data as of December 31, 2023.

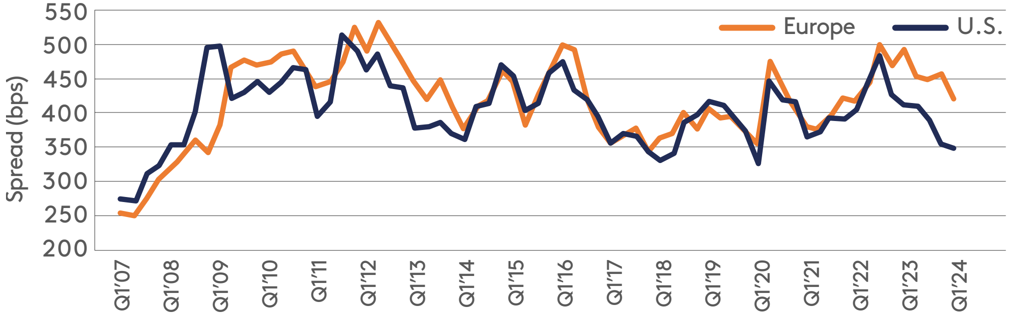
Recent improvements in the functioning of the broader debt capital markets are positive for financial sponsors, and by default private credit. We expect that the opening of the BSL and bond markets will spur new broad based M&A activity in both the larger cap and middle markets segments. In turn, we would expect renewed deal supply will bring a new equilibrium pricing level for credit markets across both rated and private markets. We would anticipate that this will also temper the level of repricing activity we have seen recently. In the larger cap space we would expect this will lead to a wide variety of junior capital opportunities. In the mid-market space we expect direct lending will continue to prevail as BSL and bond investors continue to focus on the liquidity afforded in the senior component of larger, more liquid deals. As such, we would expect that there will be deals that are going to be more appropriate for direct lenders than syndicated markets and vice versa.

2 Alternative Credit Investor: "Moody's predicts ongoing boom in European private credit".

Why is the deal flow likely?

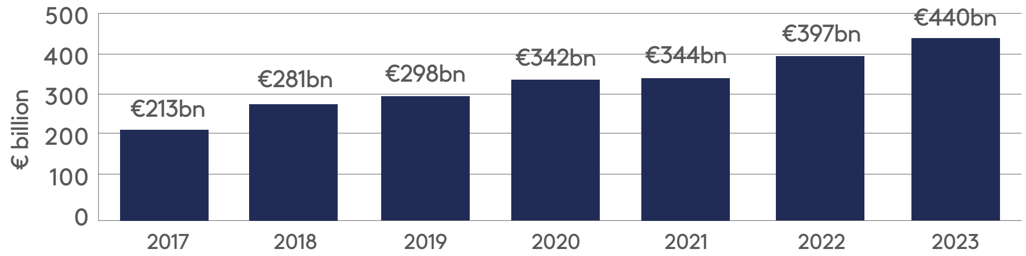
Firstly, private equity sponsors continue to sit on a record amount of dry powder globally (Exhibit 8). With a record 26% of global buyout dry powder now four years old[3], general partners are under growing pressure to do deals. The shift of global central banks and stabilization in the macro backdrop will likely create positive tailwinds for financial sponsors looking to deploy capital, setting the stage for a pickup in M&A activity, and hence funding needs. Secondly, it is estimated that there are over $3 trillion in value of PE owed businesses given realizations have been muted in recent years by macro events and market dislocation. This backdrop should give rise to increased exit activity.

Exhibit 7
Avg. New-Issue Institutional Spreads: Europe & U.S.



Source: PitchBook | LCD.

Exhibit 8
Private Equity dry powder in Europe



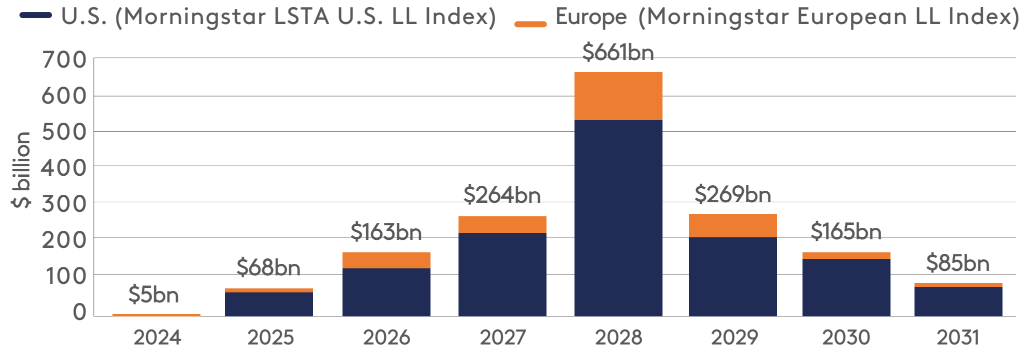
Source: Preqin as at 31 December 2023.

2023 saw €66bn and €52bn of near-term maturities (issues maturing between 2024-2026) being addressed in the high yield and leveraged loan markets, respectively[4]. Although companies have made progress tackling the amount of debt due in 2024, pressures remain as the maturity wall is a multi-year issue, and we believe there are going to be a lot of companies looking to refinance.

3 Bain & Company, Global Private Equity Report 2024.
4 Goldman Sachs, EMEA Leveraged Finance 2023 Review

Exhibit 9

Global Leveraged Loan Outstandings Maturity Profile



Source: Pitchbook | LCD. "LCD Global Report – US/Europe" Q1 2024. Data through 31 March 2024.

Since April 2023, CVC Credit has completed ten transactions in its junior capital strategy alone. In terms of opportunities we are seeing across Europe and the US today, private junior capital is yielding mid-teens returns. Issuers are increasingly looking towards Holdco Payment-in-kind facilities (PIK) or preferred equity, as well as unitranche facilities with flexible features to maximize senior secured cash pay leverage and reduce their overall cost of capital.

Junior capital is an increasingly attractive opportunity set due for strong businesses utilizing these products for solutions in light of maximizing cash flow for deleveraging and the need to bridge valuation gaps as rates settle. Our view is that private junior capital solutions will continue to be increasingly active as the larger scale M&A cycle accelerates.

Within our European direct lending business, we have similarly seen healthy deployment with 20 transactions completed in 2023, deploying over €2.2bn of capital during this period. All-in yields are currently in the 9-11% range for Euro based senior secured first lien deals. 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 38% and achieving a c.11% yield. Since the new year, we have closed two further transactions in the first quarter of 2024, as sponsor-backed businesses continue to turn to CVC Credit for financing solutions. We believe these types of returns with strong sponsors, conservative structures and documentation provide a historically compelling risk-adjusted return.

As the market settles into the current interest rate environment with inflation pressuring margins, we continue to monitor all assets closely through our portfolio management function, with a keen focus on interest coverage ratios and liquidity across the portfolio, as well as frequent interactions with management teams and sponsors. 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. As ever, we remain disciplined in our credit selection. We deploy into defensive companies in non-cyclical sectors, backed by reputable sponsors, which ultimately creates a diversified portfolio able to withstand challenging market conditions.