CVC Credit Perspectives

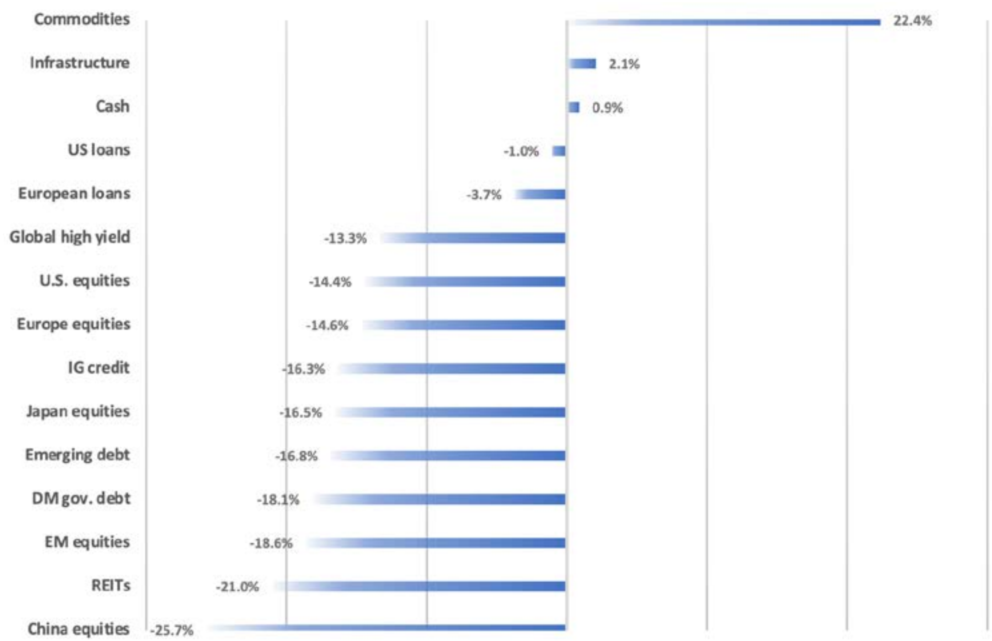
Attractive opportunities across global credit

January 2023

Market update

2022 was a tumultuous year for most asset classes. Investors were confronted with a confluence of risks and uncertainties – persistently high inflation, Russia's invasion of Ukraine, rising interest rates, cracks in major sovereign bonds and currencies, the energy situation in Europe, and global recession risk on the horizon. Higher rates have left investment grade and high yield bonds with double-digit declines this year.

Exhibit 1
2022 performance across asset classes

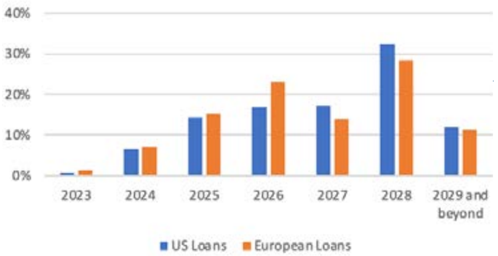


Data as of 31 December 2022. Indexes or prices used are: U.S. equities - MSCI USA Index, EM equities - MSCI Emerging Markets Index, Europe equities - MSCI Europe Index, Japan equities – MSCI Japan Index, China equities -– MSCI China Index, DM gov. debt – Bloomberg Barclays Global Treasury Index, Emerging debt – JP Morgan Emerging Market Bond Index (EMBI) Global Composite, High yield – Bloomberg Barclays Global High Yield Index, IG credit – Barclays Global Corporate Credit Index, US loans – Morningstar LSTA US Leveraged Loan Index, European Loans – Morningstar European Leveraged Loan Index, Commodities - Commodity Research Bureau (CRB) Index, Cash – Bloomberg Barclays U.S. Treasury Bill Index, REITs – S&P Global Real Estate Investment Trust (REIT) Index, Infrastructure – S&P Global Infrastructure Index.

Major central banks raised interest rates at the fastest pace and largest scale in at least two decades in 2022, as policy makers endeavored to contain surging inflation. In particular, the Fed's most aggressive monetary tightening campaign since the 1980s has brought the federal funds rate to a target range of between 4.25%-4.75% (from just above zero back in March), and we are starting to see price increases turn a corner. The CPI data released in December was better than expected (increased 0.1% in November), and the smallest 12-month increase since December 2021. While energy inflation will likely remain volatile due to the uncertainty around geopolitical flashpoints, food inflation has started to show signs of abating, and core goods have actually slipped into deflation. At the time of this writing, economists expect the Fed to raise its estimate for the so-called terminal rate. Similarly, the ECB has raised rates by a record 250 basis points since July 2022 to combat inflation, resulting in moderate price easing across some of the larger eurozone economies (attributed to a significant drop in energy prices).

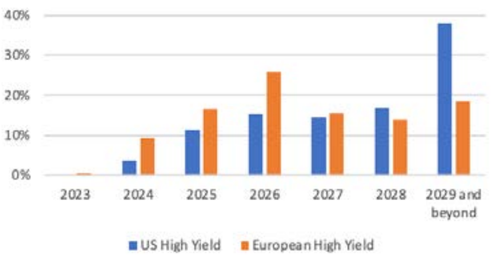
Borrowers and lenders in most regions are still trying to adjust to meaningfully higher interest rates and credit risk compared with a year ago. The record-high issuance volumes we saw in 2021 were driven by a combination of LBOs, refinancing activity given low interest rates, and pent-up issuance after the pause in 2020 caused by COVID. Issuance levels fell off sharply this year as higher interest rates have made M&A less attractive, and many companies in both the loan and HY markets have already refinanced and extended their maturities. Looking forward into 2023, we anticipate issuance to pick up, driven by a gradual return of LBOs by private equity investors, and to some degree refinancing activity (tilted towards Europe given the relatively higher percentage of total market coming due in the next two years).

Exhibit 2
Loan maturity wall
Approximately $370 billion in loan maturities through 2025



Sources: Leveraged Commentary & Data; Morningstar LSTA US Leveraged Loan Index; Morningstar European Leveraged Loan Index.

High yield maturity wall
Approximately $230 billion in high yield maturities through 2025



Sources: Credit Suisse High Yield Index; Credit Suisse Western European High Yield Index.

Performing Credit: Compelling opportunities across broadly syndicated loan and high yield markets

We believe the near-term default risk is fairly low in the U.S. and Europe, as companies have limited maturities in the next two years, reasonably good earnings and healthy liquidity. While default rates have started to rise, they've been doing so from record low levels and are currently well below their long-term historical averages. However, rising interest rates and slowing global growth will have an impact on free cash flow and interest coverage metrics, which will likely result in higher market-wide defaults in 2023. Our Performing Credit business enters 2023 with a defensively positioned portfolio that is more heavily invested in larger (EBITDA >$600mm) and highly rated issuers that should be more insulated from defaults, as those businesses often have several levers they can pull to de-lever and raise liquidity.

2023 US CLO issuance anticipated

$100b

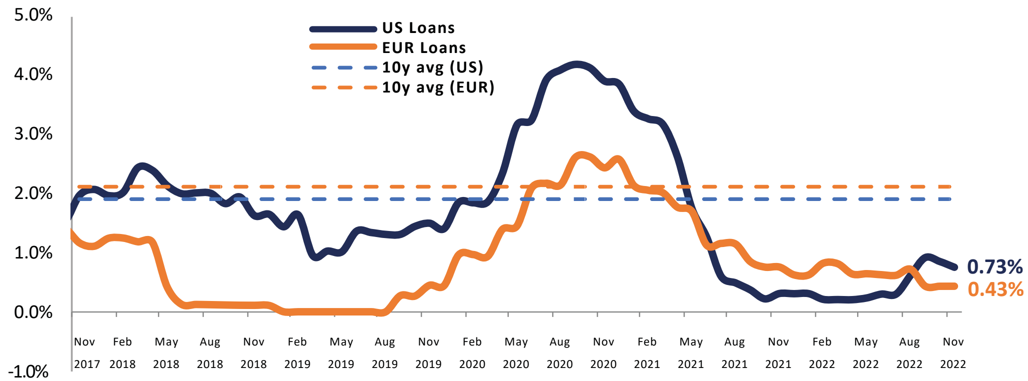
2023 European CLO issuance anticipated

€25b

Expanding loan markets in 2022

Europe	US
~3%	~6%

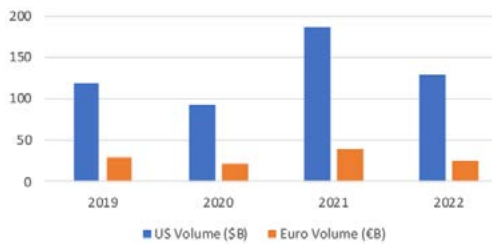
Exhibit 3
LTM default rates by amount



Sources: Leveraged Commentary & Data; Morningstar LSTA US Leveraged Loan Index; Morningstar European Leveraged Loan Index.

As previously mentioned, the supply of leveraged loans and high yield bonds has been very limited in 2022. Global issuance totaled only $406 billion through September 30, a roughly 70% decline year-over-year (source: Moody's) as the rising cost of capital has limited M&A and PE deployment, while floating-rate refinancing transactions became uneconomical. Despite lower global primary activity, lower prepayment rates have resulted in both the U.S. and European loan markets expanding in size by approximately 6% in the U.S. and roughly 3% in Europe through December 12, 2022 (source: Morningstar). While demand for loans has been mixed as outflows from retail has been more than offset from the continued CLO issuance, the bifurcation between higher quality loans and lower quality loans has become evident in trading levels as investors have favored higher quality, more defensive names in the current economic environment while shying away from lower single B and CCC rated facilities. We currently anticipate CLO creation in 2023 to be lower than 2022 given the macroeconomic environment, but still anticipate to see near $100B of U.S. new issuance and €25b in European new issuance.

Exhibit 4
Annual CLO Activity



Source: Leveraged Commentary & Data (LCD); Wells Fargo Securities Structured Finance Research. As of December 30, 2022.

In 2023, increased volatility driven by slowing growth, weakening credit metrics, rating agency downgrades and defaults are to be expected across the market. Private markets will not be impervious to the ongoing slowdown (more on that in the next section). While near-term default risk remains subdued, the risk over the medium term is increasing as the market continues to discover a true terminal rate. Borrowers, especially ones that don't have market scale or diversified supply-chains and/or a diversified customer base, may struggle to pass along cost inflation, which will ultimately hurt their bottom lines and credit metrics. For loans in particular, base rates have risen significantly, thereby further exposing borrowers who did not hedge their interest rate risk. Furthermore, the persistence of inflation risks prolonging central bank hawkishness and delaying a pivot may potentially lead to a deeper credit crunch. After the massive repricing in yields and spreads across loans, bonds and CLO debt tranches, the asset classes look quite attractive despite the aforementioned risks, which we believe are largely priced into the market. That being said, credit selectivity remains paramount given the bifurcation in markets, especially as investors move into single B rated credit.

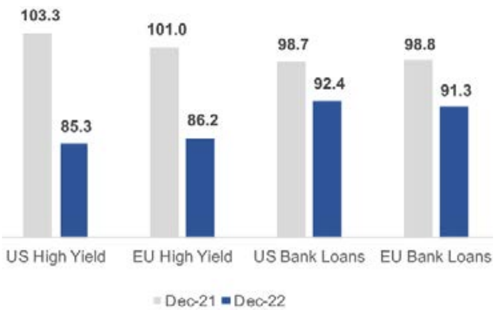
Loans look more attractive on a spread basis, while high yield appears to offer better value on a cash price basis. With a lower cash price and better convexity to the upside, some investors are positioned for a rally in high yield. We saw a similar setup in July when U.S. high yield rallied 6% in a month in anticipation of a Fed pivot, only for the market to give back all its gains in August and September as inflation data continued to come in higher than expected and Fed officials made it clear they were not about to pause yet.

Going forward, inflation data and central banks' response to the data will continue to drive the relative value between loans and high yield and we continue to believe there will be volatility until a market-accepted terminal rate is established.

Exhibit 5
Attractive carry and convexity

Average Yield Levels

Average Cash Prices



Sources: Indexes used are: US High Yield – Credit Suisse High Yield Index, EU High Yield – Credit Suisse Western European High Yield Index, US Bank Loans – Morningstar LSTA US Leveraged Loan Index, EU Bank Loans – Morningstar European Leveraged Loan Index, Commodities

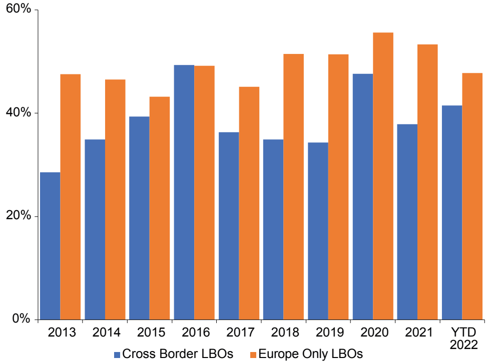
Private credit

Given the ongoing volatility across liquid public markets, the traditional financing market has been restricted in its ability to execute, and has resulted in broadening the opportunity set for private credit managers. Private debt has gone from providing 2% of capital borrowed by leveraged companies in 2012 to over 20% in 2022[1]. After years of a borrower-friendly market with spreads tightening, leverage increasing and loan covenants loosening, the tables have turned in favor of lenders. We anticipate this trend to continue in 2023 as borrowers of all sizes find it more challenging to secure financing. We are also likely to see more clubbed unitranche lending, particularly in the large-cap space where larger managers can step in to fill the gaps left by a still challenged public markets backdrop. Likewise, the lower/core mid-market will continue to drive the growth in private debt funds as traditional banks tighten further on terms.

Given the current inflationary challenges and rate environment, it is key to continue emphasis on structuring new deals to minimum levels of debt service and interest coverage under a recessionary downside case that will be stressed to simulate margin pressure, lower demand and rising rates. The main result of this is new sizeable LBOs tend to be some of the most resilient businesses but yet require higher levels of equity and patient junior capital. Credit spreads are also wider and this naturally reduces senior and total leverage, improving attachment points for junior debt. In less sizeable transactions, direct lending solutions can be applied. We have clearly seen this come through in our third vintage flagship direct lending vehicle, which currently reports an LTV of just 38%. As such, the all-in yield per unit of leverage is much more attractive today compared with a year ago.

1 Pitchbook article: "Private Credit 2023 Outlook: More market share, higher yield. But more defaults, too", December 21, 2022.

Exhibit 6
Equity contributions



Source: PitchBook Data, Inc. – LCD's Quarterly European Leveraged Lending Review: 4Q22

While the U.S. currently benefits from higher base rates than Europe, we believe the credit spreads available in the European market, as well as the relative strength of the dollar give rise to an interesting investment opportunity in the European private credit space. Across Europe, banks have increasingly turned to a distribution rather than hold model, which produces opportunities across each of the local markets in which CVC operates. Local presence, knowledge, understanding and relationships drive incremental origination and investment opportunity. Moreover, unlike the U.S. market, where there has been significant banking consolidation over the last three decades, the European market has remained more fragmented. In Europe, low double digit returns are now available for direct privately negotiated senior secured loans, whilst the private junior capital is yielding mid-teens returns, in each case for high quality resilient issuers, many of whom would otherwise have accessed broadly syndicated or high yield markets. These types of returns with strong sponsors, conservative structures and documentation provide a historically compelling risk-adjusted return.

What we have seen in the last two economic downturns is that lending to private-equity backed companies can provide additional protections for private credit lenders. This is because PE sponsors have access to additional resources, both operational and financial, to support businesses in a downcycle.

When there is a recession and difficult economic times, that is typically a good opportunity for private credit. The best vintages tend to come out of adversity so long as you have dry powder, a focused pipeline and a disciplined investment approach. There are many companies with looming maturities that may have a more difficult time refinancing given higher funding costs, which may translate into yet more opportunities for CVC Credit to help provide solutions. Our aim is always to partner with top-quality sponsors, management teams and successful businesses, with stable revenue streams and strong cashflow generation. Our investment philosophy is driven by a fundamental bottoms up analysis of each investment opportunity where we draw from the vast experience of the broader CVC network. Our focus is on defensive end markets such as, healthcare, pharma, infrastructure, or business/financial services, with borrowers that have strong market shares, pricing power and provide a clear need to its end market.

With a higher cost of capital, we anticipate new deal activity will focus on strong businesses that operate in the most resilient segments while some existing issuers will tap private markets to make bolt on acquisitions, with others focusing on maturities and liquidity as we move into 2023. Through our extensive network of sponsor relationships and deal interactions, we continue to see both new deal and incremental growth financing opportunities within our portfolios. In December 2022 alone, CVC's Private Credit team completed seven transactions for a total of €700mm.

In our view, agile, innovative private credit lenders with experienced teams will be best positioned to navigate choppy markets, and ultimately be most competitive in taking advantage of new opportunities.

Conclusion

There will be clear winners and losers from a country, industry, quality, and individual capital structure perspective as the market tries to revert from the volatile economic swings we have seen since COVID. In our view, this reinforces the need for an investment process rooted in diligent underwriting and creative approach to capital solutions, in order to drive outperformance. We believe that volatility will lead to attractive entry points for long-term buyers who are focused on fundamentals and able to wait for liquidity. Our ability to be patient and flexible in our deployment across strategies positions us well to pursue opportunities in the current market environment.