CVC

# CVC Credit Perspectives

## Attractive opportunities across global credit

Q2 2024

## Market update

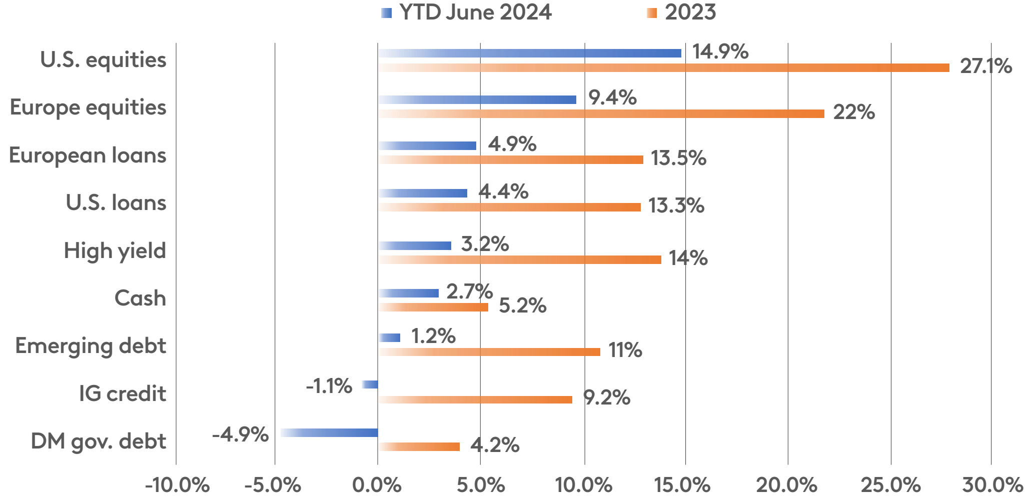
The first half of 2024 has seen the market successfully navigate the ongoing complex macroeconomic environment. As a result, the narrative surrounding a potential soft landing has persisted, although it is still not a foregone conclusion.

We observed towards the end of 2023 that the imminent rate cuts being priced in by the market may not happen, something which now has been proven correct. Whilst rates have been cut in the Eurozone, the Federal Reserve ("Fed") and the Bank of England ("BoE") are yet to do so. There is a possibility that the Fed maintains its current 5.25-5.50% range for the rest of the year, whilst it seeks more proof that inflation is moving sustainably towards its 2% annual target. The upcoming U.S. elections create more uncertainty around the path for inflation, but also around the leadership position at the Fed. Consequently, the range of outcomes for interest rates in the U.S. remains extremely broad.

In Europe and the UK, inflation has moved closer to central banks' long term targets, and we would expect gradual rate cuts over the remainder of 2024, although this is likely to be more an "easing off the brakes" as opposed to "stepping on the accelerator." Guidance from all three central banks has remained hawkish as inflation has remained sticky, suggesting the more dovish rate cutting programmes the market was expecting at the start of the year are unlikely to materialise, and instead we will remain in a period of "higher-for-longer" rates.

The macro-environment has remained robust, growth expectations in the U.S. have remained strong, and we are continuing to see more green shoots pointing towards a recovery in Europe. Equities continue to scale to new heights, although this has been uneven due to the disproportionate impact of technology. When we look at the equal weight S&P 500 the picture is less rosy as most of the U.S. earnings growth expectations are driven by a handful of tech companies benefitting from the AI boom, which has continued to push the index higher. Risks remain in the second half of the year, notably geopolitical, with elections having taken place in the UK and France already, and the United States preparing for the presidential election in November. There is also no visibility of any de-escalation of the conflicts in Ukraine or the Middle East. These elections and changes of government could have significant implications for fiscal spending, trade policy and international relations. Even so, the market is in a strong position and we are seeing signs of an uptick in activity in public and private credit markets.

### Exhibit 1
### Performance Across Asset Classes




YTD shows year to 30 June 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.

Europe bucked the central bank trend in June, cutting rates by a quarter of a percentage point to 3.75% – the first rate cut in Europe for nearly five years. Even so, Christine Lagarde has been quick to emphasise that the ECB may continue to hold rates at this level for some time as services inflation persists, driving sticky core inflation, and above headline CPI. The cut can nonetheless be regarded as a critical moment in Europe's fight with inflation, which was over 10% only two years ago.

Growth remains uneven across the continent, but there are nascent signs of recovery. As inflation continues to fall, real wages will rise, and combined with easing interest rates, should result in a boost to consumer spending and an increase in business investment – both of which have stagnated over the first half of 2024. This consumer-led recovery is expected to drive economic activity, with EU GDP forecast to improve from 1.0% in 2024 to 1.6% in 2025.

Notwithstanding, structural headwinds remain for the economy, and both the UK and French elections this summer are driving geopolitical concerns around heightened populism and social polarisation. The recent European Parliamentary elections saw populist right-wing parties make strong gains, although their performance has possibly been exaggerated, as ultimately centrist parties maintained their grip on the chamber.

In the U.S., the economy has proven resilient in 2024, driven by strong consumer spending, and an extended period of high employment and strong real wage growth. At the beginning of the year many expected the Fed to engage in a series of rate cuts throughout 2024, but inflation has not fallen as quickly as expected. The current strength in employment and demand has somewhat underpinned the country's persistent inflation, with June's impressive jobs report the U.S. has now been at or below 4%

unemployment for the longest stretch in nearly fifty years. Even so, we did start to see some signs of softness creep into consumer strength towards the end of H1 and it is a trend we'll monitor closely.

In a year where globally more voters than ever in history will head to the polls, with Bloomberg estimating 41% of the world's population will be electing new governments over the course of the year, all eyes will be on the U.S. in November. The upcoming presidential election will affect the U.S. economy beyond 2024, and is a source of near-term uncertainty – the Democrats are now switching candidate only months away from polling day, and Trump continues to poll strongly in swing states. Regardless of who the Democrats confirm as their candidate they are highly likely to have starkly contrasting policies on spending, taxes, regulation and trade to Trump. Moreover, we could see some changes at the helm of the Fed post U.S. elections, which will introduce another level of unpredictability.

In summary, markets reported strong performance in the first half of 2024, and there appears to be reason for further optimism in the second half of the year. Growth expectations are being revised upwards, albeit marginally, and the public credit markets are once more open for business after low levels of activity in 2023. The central bank mantra of 'higher-for-longer' interest rates now appears to be accepted. M&A and IPO activity have seen an uptick from the exceptionally low levels we saw in 2022/23. We anticipate further growth in corporate activity in the second half of 2024, as investors have adapted to this "new normal" where ultra-low interest rates are gone for the foreseeable future. Risks remain, notably concerning how markets digest the elections in key economies such as the U.S., UK and France, which could spark policy changes, but we see reasons for optimism despite the potential for volatility.

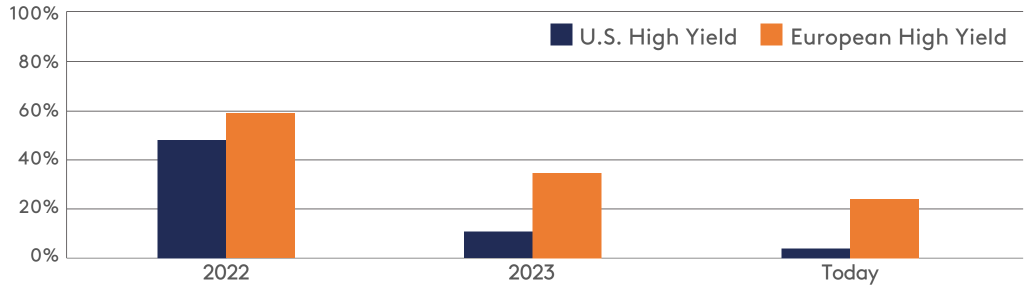
## Liquid Credit Markets

Spreads remain tight in comparison to historical averages as risk sentiment remains strong, despite a lack of rate cuts and sticky U.S. inflation. High yield returns remain positive YTD at 2.7% in the U.S., and 2.6% in Europe. Leveraged loans have also continued to post strong returns since the beginning of the year, with the Credit Suisse U.S. and European Leveraged Loan indices reporting 4.4% and 4.1% returns to date.[1]

Since the start of 2024, European high yield spreads have remained wider than the U.S., although both markets saw slight spread widening during the quarter, with European high yield widening by 6bps, and the U.S. by 17bps. Even so, both markets have tightened materially since the start of the year and the extent of this rally is even more considerable when comparing on a twelve-month basis, with Europe and the U.S. both tightening by ~60bps each.

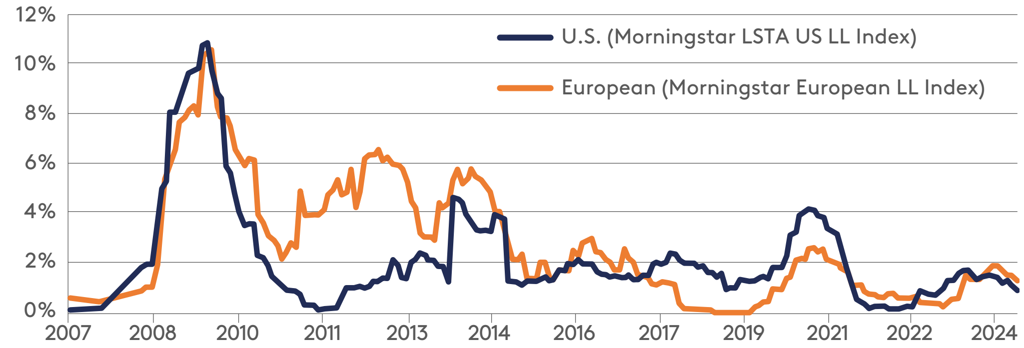
Both U.S. and European high yield continue to trade close to 25-year historical tights on a spread level, as illustrated in Exhibit 2. Spreads in the loan market are more attractive than in the HY market, particularly in Europe. Even so, all-in yields continue to look attractive both in the U.S. and in Europe compared to historic levels for both loans and HY bonds, resulting in inflows into leveraged credit as an asset class. These inflows, in combination with low financing requirements due to persistent low M&A volumes, has resulted in a technical rally in spreads. The outperformance of the lower-rated segments of the market has also persisted, with CCCs continuing to outperform the higher-rated segments – earnings have in general been stronger than expected which means companies with higher leverage tend to generate better returns for investors.

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



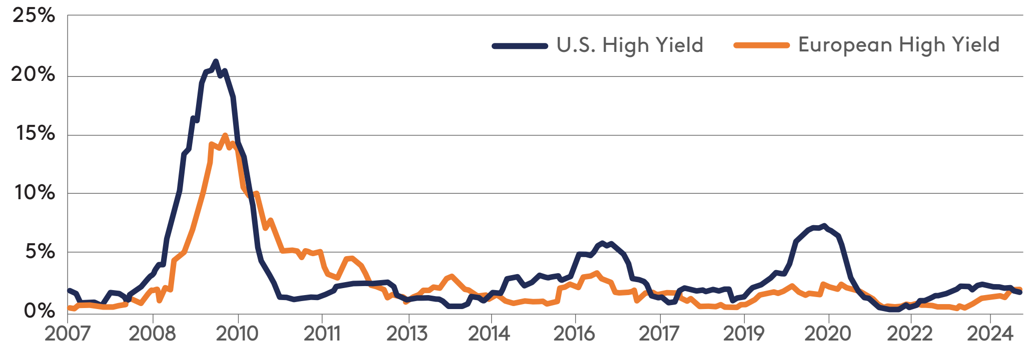

Data through 30 June 2024. Source: Credit Suisse. Percentiles ranked vs. monthly spread to worst data starting 01/31/2000. 2022 represents 30 December 2022, 2023 represents 29 December 2023 and 'Today' represents 30 June 2024.

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




Data through 30 June 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 30 June 2024. Source: Bank of America Global Research.

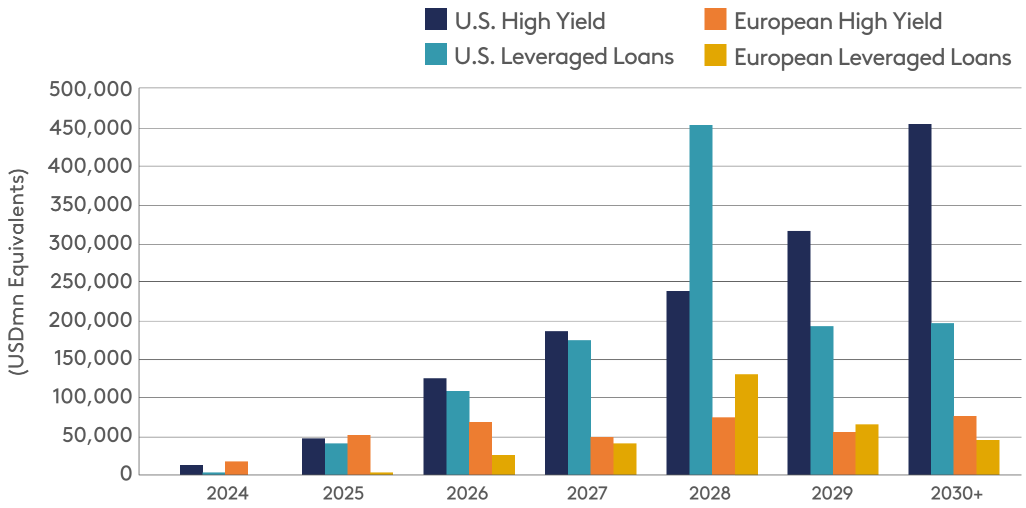
1 As of 30 June 2024. U.S. High Yield represented by the Credit Suisse High Yield Index (USD Hedged). European High Yield represented by the Credit Suisse Western European High Yield index (EUR Hedged). U.S. Leveraged Loans represented by the Credit Suisse Leveraged Loan Index (USD Hedged). European Leveraged Loans represented by the Credit Suisse Western European Leveraged Loan Index (EUR Hedged).

Consistent with the macro theme, fundamentals remain robust despite 'higher-for-longer' rates and we have not seen a surge in defaults. Default rates in the U.S. appear to be gradually ticking downwards in both high yield and leveraged loans, reporting 1.9% and 0.9% default rates respectively last month. European default rates also remain relatively stable, with the high yield market marginally ticking up to 2.1% and leveraged loans remaining stable at 1.3%. It's worth noting that the leveraged loan default rate statistics exclude distressed exchanges, which rating agencies include in their statistics. Distressed exchanges don't necessarily lead to a loss of capital for lenders and hence we exclude these from our data. Finally, over half of the U.S. and European high yield markets are still benefitting from very low coupons on their debt stack, the average cost of debt for high yield issuers is still well below the average yield on the high yield index both in the U.S. and in Europe, which could imply there is more pain ahead for high yield issuers when refinancing.

The expected spike in defaults as a result of higher interest rates taking their toll on borrowers is yet to occur. Defaults have stayed close to historical averages as the market continues to be resilient in the face of tight financial conditions and sticky inflation. Taking a closer look at the fundamentals, interest coverage ratios for high yield issuers remain at the low end of historic averages (source: Goldman Sachs), and whilst the ratio of interest expense to total debt for median high yield firms remains below historic averages. This should rise as more issuers refinance at higher base rates.

Leveraged loans have seen a gradual deterioration in credit quality, with downgrades outpacing upgrades, although this has not led to a surge in defaults. We expect there will be marginal credit deterioration in the second half of the year as issuers continue to feel tight financial conditions, especially for high yield issuers where the higher cost of financing still needs to flow through cash flow statements. However, we remain optimistic that this will not result in a significant rise in downgrades/defaults as coverage ratios remain robust and leverage manageable.

**Exhibit 5**
**Maturity Wall for Loans and HY**




Source: Bank of America, 30 June 2024

Issuance was strong in the second quarter of the year, both in the high yield and leveraged loans markets, as capital markets have truly re-opened after a quiet 2023. In the first half of 2024 there has been over $160bn of new issues in the U.S high yield market, already over 90% of the total for the whole of 2023. This has primarily been driven by the need to address looming 2026 and 2027 maturities which are steadily declining as primary market access continues to improve. Loan issuance has also been strong, with the U.S. and European markets issuing over $280bn and €50bn of loans to date, market access has continued to improve and thus there has been a wave of refinancing. We are also beginning to see a gradual uptick in M&A related activity as confidence grows within the market, although refinancings and repricing amendments continue to dominate as borrowers take advantage of spread compression. Similarly, CLO issuance has been strong year-to-date, with $105bn and €26bn of issuance so far, close to double the volume of 2023's issuance at this stage.

We maintain our view that 2024 will continue to be a strong year for credit investors from a technical and fundamental viewpoint, whilst attractive opportunities remain through active portfolio management. The increase in net supply was a trend we flagged last quarter, and this has continued as M&A and refinancing activity continues to pick up. Similarly, default rates remain similar to Q1 and whilst there has been a gradual deterioration in quality, it has remained manageable and in-line with expectations. The reality of higher rates for the medium term could pose awkward challenges for some of the most levered issuers, but we don't expect to see defaults rise to historic recessionary levels due to the strong starting position many issuers found themselves in coming out of COVID. The tightening in spreads since the beginning of the year has been marked, but we would not expect significant gains beyond current ranges, as spreads are now close to historic tights.

During the first half of 2024, we have continued to prefer floating rate loans over high yield. This has proven the correct strategy as loans have outperformed high yield both in the U.S. and in Europe. Notably, loans have benefitted from higher carry due to their floating rate nature in this current investment environment as central banks have continued to be reluctant to cut rates. As we have seen more pressure on credit spreads in the U.S. than in Europe, we have increased our exposure to Europe in our flagship Global Yield fund from 34.2% as at 31 December 2023 to 40.9% as at 30 June 2024. This has resulted in a pick-up of an additional 0.25-0.75% in spread for similar credit risk. Moreover, with early signs of green shoots in the European economy we believe that earnings should remain resilient, whilst cyclicals are also showing signs of recovery. Even so, there are still considerable geopolitical risks ahead of us and on the back of the French elections, we have proactively reduced some French exposure in the portfolio as there is currently no meaningful risk premium associated with French loan issuers. Looking slightly further ahead, we also have upcoming elections in the U.S., which could lead to further market volatility if the vote is split roughly 50/50 without a clear winner. Again, this would favour higher exposure to Europe. However, we remain nimble and are flexible to reposition portfolios quickly where necessary.

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.

# Private Credit Markets

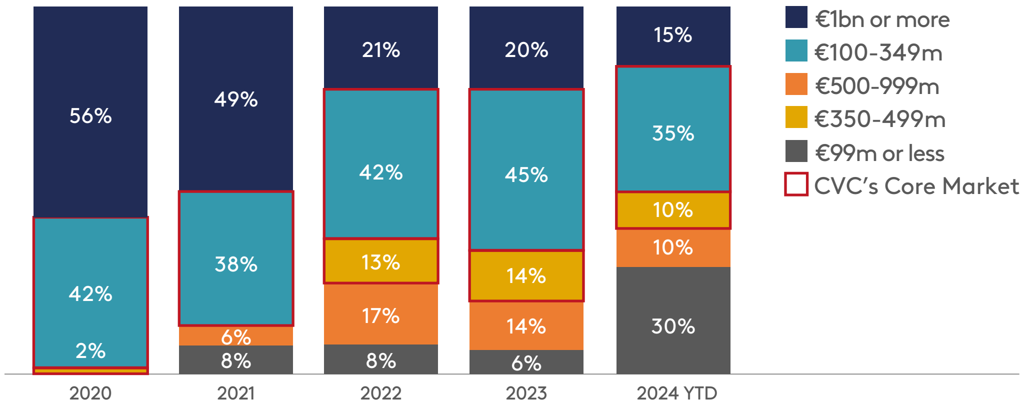
The private credit market has shifted over first half of the year, and despite the ongoing theme of limited M&A activity, the broadly syndicated market ("BSL") has seen a surge in activity relative to 2023, which has seen a reduction in issuance volumes in the private credit space. Despite this, we believe the market continues to offer a compelling opportunity, given the flexibility and execution certainty the asset class provides borrowers vs. public markets, particularly those mid-market issuers who cannot access public markets as readily as large cap issuers.

Activity in the first half of the year has predominantly been driven by issuers looking to refinance, with refinancing volumes at their highest levels since 2020, and double the amount completed in H1 2023 (source: S&P LCD). The reopening of the BSL market has resulted in some borrowers turning to the liquid credit markets for refinancing solutions, as we flagged last quarter, which has led to spread compression, which we would expect to moderate in time. A number of the issuers in the BSL market were larger borrowers who obtained financing in the private markets in 2023, in the absence of bank underwriting. Indeed, a handful of these names were among the opportunistic transactions in larger borrowers executed by CVC Credit European Direct Lending Fund III, which have been, or will be, exited in the coming months, and have delivered excellent returns for the fund, in line with our expectations for those investments. This shift in market opportunity means that there are fewer large cap issuers tapping the private credit market than we saw in 2023, and rather we are seeing a return to more normalised conditions.

With banks reclaiming market share via the larger European corporate borrowers, there have been fewer opportunities within larger-cap borrowers during H1-24, resulting in origination largely recentring around middle and upper-middle market borrowers. This is the core focus of CVC's direct lending strategy, and one which we believe continues to offer attractive risk-adjusted returns. We still expect a portion of opportunities with larger borrowers to remain, as structurally private credit has proven to be an efficient and reliable source of financing, but the market has certainly recentred this year. We believe that for patient, credit focused managers, there are still opportunities to source compelling transactions offering attractive risk-adjusted returns.

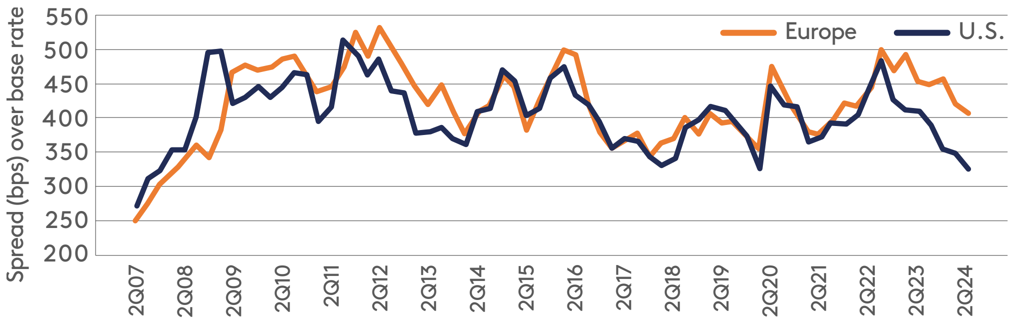
M&A activity is also returning gradually, with LCD reporting a 19% growth in LBO activity YoY, and whilst it has not been the primary source of deals this year, we expect this will gradually change as private equity sponsors begin to exit current investments and deploy dry powder. As a result of these factors – the resurgence of broadly syndicated loans and limited M&A – there has been increased competition for opportunities in the private market, which has in turn put downward pressure on pricing.

**Exhibit 6**
**Deal size diversification of European direct lending deals, by count**




Source: Pitchbook | LCD. Data through 30 June 2024. Analysis based on transactions covered by LCD News; share calculated based on deals where size information is disclosed.

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

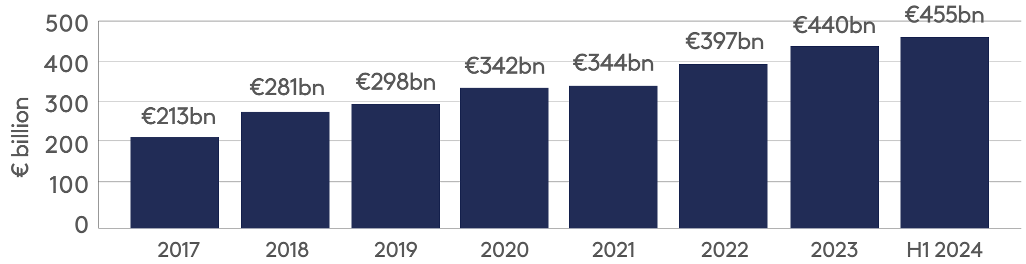



Source: PitchBook | LCD. Data through 30 June 2024.

Despite this, the flexibility private credit provides remains compelling from a borrower perspective, particularly as we enter a more active M&A market, with demand for creative financing solutions that are otherwise unavailable in public markets. For instance, we continue to see strong demand for junior capital solutions such as PIK, preferred equity and unitranche facilities, enabling borrowers to maximise cash flow for deleveraging, and bridge valuation gaps as rates settle. This will likely increase further as the M&A cycle accelerates, with purchase multiples for high-quality assets remaining elevated, and banks remaining steadfast in only providing c.5.0x leverage. This has resulted in an attractive market opportunity for lenders, and since April 2023, CVC has completed eleven transactions as part of its junior capital strategy with exposure across Europe and the U.S., with assets yielding mid-teens returns. We believe this trend will continue as private equity sponsors continue to find themselves under pressure to return capital to investors, and in turn, start deploying the record levels of dry powder they have accumulated in recent years.

Moreover, despite concerns over credit deterioration, the fundamentals of the private credit market remain robust. Lincoln reported annual EBITDA and revenue growth rates in Q1'24 of 5.6% and 6.6% for private corporates within private credit portfolios, comparing favourably to the S&P 500 which reported a 5.4% YoY EBITDA growth rate and 4% YoY revenue growth rate over the same period. There have been some cracks in a limited number of managers' portfolios, where interest coverage ratios have come under pressure due to the impact of higher-for-longer rates,

**Exhibit 8**
**Private Equity dry powder in Europe**




Source: Preqin as at 30 June 2024.

but these are exceptions rather than the rule. CVC's European Direct Lending platform continues to perform well, deploying €1.9bn in the last twelve months with a weighted average loan-to-value of 35%, achieving an attractive yields of c.10%. Interest coverage ratios across all vintages remains strong, and leverage manageable given robust fundamental performance.

Looking forward, whilst we have seen increased activity in the BSL market, private credit remains attractive and structurally will remain an important source of financing for borrowers, due to the reliability and efficiency of the market. Bank of America estimates that whilst there has been a trend towards the BSL market in recent months, the growing adoption of private credit will not abate, estimating it accounts for 20% of the leverage finance market today, and long-term will increase to 30%. The demand from investors to gain exposure to the asset class continues to grow, illustrated by a recent Moody's survey of large insurers which showed 80% of respondents were planning to increase their holdings in private credit. The survey also revealed insurers are not strongly differentiating between public and private credit in determining their investment strategies, shifting their portfolios to less liquid holdings with similar risk profiles for greater returns. Investors no longer view private credit as necessarily translating into higher risk than liquid strategies, but instead offering a different profile to bonds and loans. In Europe, we see private credit continuing to grow in adoption due to the less sophisticated and mature nature of capital markets on the continent vs. North America, which means companies who require financing, particularly in the middle market, CVC's main area of focus, require support from private lenders who can provide flexible solutions.

From a CVC Capital Markets perspective, private credit remains an attractive financing option for its buyout activities and continues to be an active consideration in the execution of transactions. Structurally we believe the private credit opportunity remains compelling as many borrowers will continue to utilise this market for financing solutions.

Furthermore, we believe the European direct lending market is particularly attractive due to the fragmented nature of the market in comparison to North America. This provides greater opportunities for managers with local a presence and local expertise. The diverse nature of the European market creates vastly different market dynamics across each jurisdiction. Be it industry drivers, regulatory considerations, language, culture, access to finance, market counterparties all make it a more difficult and complex market to navigate. It is truly clear that without a local network of experienced investment professionals, it is extremely difficult to source, diligence and price risk successfully in private credit. This underlines the significance and uniqueness of the CVC Network, which allows CVC Private Credit to be integrated into the network and utilise the firm's market intelligence and deep knowledge of each region to source attractive opportunities, as well as support the due diligence process, delivering better investment decisions and portfolio diversification.

Following on from the success of CVC's institutional offerings within European Private Credit, CVC has recently launched its first semi-liquid vehicle, CVC-CRED, offering private wealth access to the CVC Network and its European direct lending platform. CVC-CRED is an open-ended vehicle, providing investors flexibility to access the strategy through monthly subscriptions and quarterly redemptions whilst distributing income through quarterly distributions. Investors benefit from the choice of EUR and USD share classes, on both an accumulating and distributing basis. We expect these vehicles to become increasingly prominent in the market, providing investors access to an attractive asset class previously only available to large-scale institutions, as well as providing additional capital for lenders to deploy in a growing market.

In conclusion, the private credit market opportunity remains attractive. We believe that the European market in particular is exciting due to the structural tailwinds expanding adoption and with that the market opportunity where returns remain attractive. In the near-term risks remain and we anticipate a bifurcation in manager performance as some portfolios become strained by inflationary pressures and higher-for-longer rates. These dynamics reinforce the need for an effective sourcing channel, a robust due diligence process, disciplined credit selection and vigilant portfolio management. Our portfolios remain rooted in defensive, non-cyclical sectors, backed by reputable sponsors, and diversified by geography and industry, to be able to withstand challenging market conditions.