VÄRDE

Värde Views: Credit Market Update

Evolving and emerging investment opportunities

July 2024

Värde Views: Credit Market Update – Q2 2024

INTRODUCTION

Värde Co-CIOs Brad Bauer, Ilfryn Carstairs, and Giuseppe Naglieri share their views on the state of credit markets coming into the second half of 2024 and discuss the evolution and emergence of investment opportunities across Värde's platform.

Please note that these views were authored at the end of Q2 2024 as part of our quarterly communication with investors and may have evolved since their publication.

MARKET OUTLOOK

The second quarter of the year saw little change in major markets as a whole, though, behind this relatively calm facade, there were some significant pockets of volatility and several developments that we believe should take on much more importance as the year progresses.

By mid-quarter, the market had effectively priced out all the expected rate cuts for 2024 and commentary was even starting to contemplate whether rate hikes may be back on the table. Alongside this, the Fed finally acknowledged that strong asset markets, economic resilience, and sticky inflation call for a more cautious policy stance – and moved its own expectation for rate cuts from three to one for 2024. Despite this hawkish shift, we would guess that the rhetoric will shift back to more cuts if the data gives any window in which to follow through on that agenda.

Confusion around the direction of monetary policy remains a key theme of the year, and we are at the point where there is no single answer across the globe. The debate around policy rates looks to be a key driver of the markets in the second half of the year.

Politics was a key story of the quarter, and political developments across the globe will have a significant influence on the remainder of the year. Indeed, the stage was set for an even more interesting second half, with strong reminders of the fragility of the current status quo as well as the generally unusual and unpredictable political environment in which we live.

Back to the economy, at the margin, we saw a few more amber lights to monitor compared to the very robust results of the first quarter. Most notably, the U.S. unemployment rate ticked back up and we saw the first signs of weakness in data such as jobless claims. Alongside this, there were some additional signs of softness from the U.S. consumer in terms of both spending and delinquency data. No doubt these are amber and not yet red lights. There have been other such signals from the U.S. economy over the past 18 months that turned out to be false alarms. However, they certainly warrant watching as the year progresses, particularly against a global backdrop that continues to rebuild momentum but is hardly a driver of growth in and of itself.

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Few of these concerns appear priced into general markets – spreads are tight, levels are high, and volatility is low. Perhaps the market's view – like ours – is that monetary policy now has enough room to move more quickly to head off any slowdown, alongside the continued strong impact of U.S. deficit spending on the general economy. That may all prove to be true, but it creates a market environment where there is not much room for error, in our view.

Excerpt from July 2023 Värde Views: "Behind the first door ("Door A"), higher for longer rates and tight policy create a math problem even for reasonably solid credit that cannot pass through the step-change higher cost of borrowing. Behind the second door ("Door B"), weaker earnings, but potentially looser policy and somewhat lower rates, reduce some of the math problems but increase the earnings-related stress. Clearly there are a range of paths once a door is open, but behind either door one would want to be highly respectful of downside protection and accurately assessing the ability for specific borrowers or assets to navigate what the cycle may throw at them."

For credit markets, as we wrote in our 2024 Market Outlook and Opportunities, the economy is behind "Door A" until it isn't, and it is still with higher rates and a strong economy, leaving haves and have-nots in credit. Door A continues to drive stress and distress in both large rate-sensitive credit markets such as commercial real estate and in many idiosyncratic situations where companies or asset structures cannot sustain their balance sheets.

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General risk/reward in credit has become more challenging throughout 2024 as the credit market also prices very little risk from the complex backdrop behind Door A with average spreads at or near post-GFC tights – let alone any risk from Door B, a shift to a weaker economic scenario. A major force driving this in both public and private credit markets has been strong issuance, with a general reach for yield and deployment certainly a feature of the year and a key distinction from 2023.

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OPPORTUNITY SET

Consistent with our views on the broader market and economic backdrop, our views on the nearer-term opportunity set took a step toward the more cautious and patient end of the spectrum as we entered the third quarter. Tighter pricing of risk, driven partly by general optimism and partly by an extended period of muted transaction activity, has left a smaller margin for error that should be acknowledged and accounted for in risk decisions. While the opportunity set has certainly moderated to some degree in 2024, there continues to be a strong foundation to our pipeline, and we expect it to grow over the balance of the year.

We see gradual signs of increased transaction activity and demand for capital, which will ultimately have a chilling effect on the pricing and terms on which the market is willing to transact. This can be observed in new issue activity in debt capital markets and early signs of thawing in commercial real estate through data points such as the growth in broker price opinions during Q2. Corporate M&A, on the other hand, remains slow and highly discerning buyers show no signs of becoming unnecessarily aggressive.

Below we detail some of the most attractive themes we see across our platform.

PRIVATE MARKETS

Commercial Real Estate: The CRE market is in the midst of a longer-term process of revaluation, recapitalization and, in some sectors, a more fundamental reconsideration of existing supply amid structural changes to demand.

These factors support our focus on senior lending at conservative LTVs to account for ongoing fundamental risks as well as selective capital solutions at higher LTVs with quality sponsors in sectors, assets and markets where the risk/reward is justified. In terms of areas of greatest focus today, we err toward assets and markets where we believe rents and occupancy can maintain pace with inflation while also benefitting from structural protections to maintain net operating income through some combination of market undersupply and contractual lease terms.

Housing: The U.S. housing market continues to operate at reasonably healthy levels with builder margins running at or above mid-cycle levels. Builder and developer discipline has also been notable in the face of what has been a robust market in recent years, apart from a short period of recalibration to higher rates in later 2022 and part of 2023. We continue to focus our pipeline on homebuilding credit secured by lot inventory. This segment of the U.S. housing market has high barriers to entry as larger builders, both public and private, seek to consolidate financing relationships with investors who have history in the market and bring extensive industry knowledge to the table, alongside the capital necessary to support the builder's strategic objectives.

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Asset-Based Credit: As the ABS markets have improved, the broader market continues to normalize toward what we view as a healthy, steady state. Terms and pricing have, on the margin, been impacted but risk has also adjusted in a similar fashion. So, when taken together, we still see attractive opportunities in the market with investors being appropriately compensated for risk. Competition in our target segments and general supply/demand dynamics are better balanced, leading to a more stable pricing of risk as compared to what we see in other areas of private credit. We maintain a bias toward commercial credit given more uncertainties in the consumer space.

We also see opportunities in secondary market activity coming out of regulated sellers such as banks and credit unions. Significant risk transfer (SRT) is one area of the market that has garnered material and growing attention in the U.S. As the SRT investor base has expanded, we have observed spread tightening leading us to become more selective, focusing on asset classes that are not as well understood by market participants.

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Asia Pacific Private Credit: Asia Pacific continues to deliver attractive and growing markets where sustained demand for credit will benefit those who have built and maintained a true commitment to the region. Importantly, we maintain discipline in both pricing and structures as individual situations can be dynamic, but we see activity and pricing holding at attractive levels in the current environment.

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India presents a significant lending opportunity with real asset collateral owned by borrower groups that are both well-capitalized and well-known to us. Our pipeline in India has expanded in part due to increased volatility around elections and a need for capital that is not being fulfilled by the banking sector due to growth and regulation.

In Australia, we are also beginning to see local bank capital starting to pull back as higher interest rates start to affect both consumer demand and property loans. Our focus is on lending in situations geared toward longer-term infrastructure or commodity-related businesses in Australia where capital access for borrowers is retrenching.

TRADED MARKETS

Maturity Wall Refinancings: We firmly believe the higher for longer rates environment will provide our platform with a highly attractive and durable opportunity in traded credit. Recent market developments during the quarter have reinforced our conviction that we will see increased dispersion, with clear winners and losers already emerging.

2025 and 2026 will be pivotal years in credit markets as many companies are forced to refinance a significant portion of their debt ahead of an impending maturity wall. In advance of these maturities, we saw several of the healthier companies begin to address their capital structures during the quarter through a combination of traditional market access, private debt involvement, and highly structured amend and extend exercises typically involving sponsor equity contributions.

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Each one of these scenarios presents opportunities for us to leverage our structuring experience and deep knowledge of credit across both public and private markets to invest capital nimbly and strategically at what we believe to be attractive expected returns. On the other hand, we also saw prominent examples of companies and sponsors engaging in highly aggressive transactions of various forms to extend their equity optionality, a practice already well established in the U.S. but one that came to Europe in earnest over the quarter. This means that the downside for being wrong on earnings or approach has increased, reinforcing our cautious attitude towards less solid companies and sponsors.

Looking ahead, we maintain our preference to invest when we can form a differentiated view in the top part of the capital structure of healthier companies with strong sponsors where we can play an active role in the refinancing if traditional sources of financing are unavailable.

Global Financials: During the quarter, banks continued to demonstrate strong fundamental performance which, alongside a conducive market, catalyzed further spread compression in the sector. While we still maintain our positive view on global financials and believe they remain cheap relative to the market, we have continued to reduce exposure as the gap to fair value has narrowed across most of the space and we find more attractive relative value elsewhere.

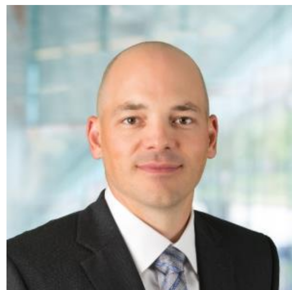
We believe credit dispersion will increase throughout 2024 as the market worries about asset quality in certain corners of the market, such as CRE or leveraged loans. We have continued to find idiosyncratic opportunities, particularly in countries such as the U.K. and Germany, where fundamentals remain more mixed. We are also keeping a close eye on the potential return of systemic risk in Europe linked to the French and U.K. elections. While it's not our base case, it could be a potential source of significant incremental opportunity across this space.

<u>Real Estate & Structured Products</u>: In real estate and structured products, market sentiment generally improved during the quarter with increased optimism around lower rates and a moderate pick up in transaction activity. For example, we saw three back-to-back CRE CLO issuances placing the BBB- in the market, which is notable given we have seen limited interest for BBB credit over the last 12 months. In any case, given the structural gap in availability of credit and the large leverage build-up of the sector in an era of zero rates, we believe this theme will continue to be an area of significant opportunity for us in the years to come. We continue to find opportunities to finance REITs that are overleveraged and struggling to address their upcoming maturities. However, we remain selective in our approach and prefer sectors with strong fundamentals and underlying demand trends.

CONCLUSION

There has certainly been enough dispersion and idiosyncratic opportunities in credit to drive both solid deployment and returns for our platform this year, but we enter the second half more cautious of the general state of the credit market. The risk/reward from providing origination solutions in asset-backed and more complex private credit remains the most compelling opportunity set we see and is the focus of our pipeline going into the second half of the year.

About the Authors



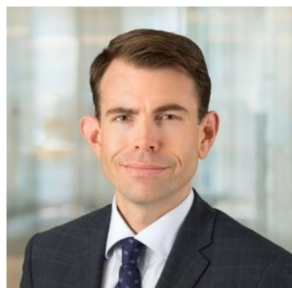
Brad Bauer
Partner, Co-Chief Executive Officer and Co-Chief Investment Officer

Brad Bauer is a Partner, Co-Chief Executive Officer and Co-Chief Investment Officer. Based in New York, he co-chairs the firm's Investment Committee and leads the firm's global business and investment strategy.

Brad joined the firm in 2007 and was named Partner in 2013. He has held a variety of both business and investing leadership roles working out of the firm's U.S. and U.K. offices. From beginning his career at Värde on the Corporate and Traded Credit team to later leading the firm's private credit strategies, Brad's extensive investing experience spans numerous industries in public and private markets. Brad has served in a CIO role since 2019 and was named Co-CEO in 2023.

Prior to joining Värde, Brad held senior investing and portfolio management roles focused on distressed debt and credit trading at both Deephaven Capital Management and Ameriprise Financial, Inc. Prior to Ameriprise, he worked for U.S. Bancorp Piper Jaffray in the Middle-Market Mergers and Acquisitions group.

Brad received a B.S. in Finance from Iowa State University, where he also competed on the varsity golf team. He earned his Chartered Financial Analyst (CFA) designation.



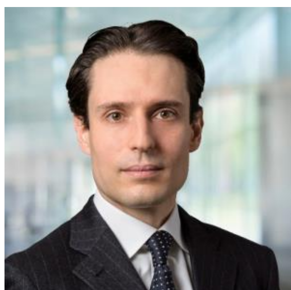
Ilfryn Carstairs
Partner, Co-Chief Executive Officer and Co-Chief Investment Officer

Ilfryn Carstairs is a Partner, Co-Chief Executive Officer and Co-Chief Investment Officer. Based in Singapore, he co-chairs the firm's Investment Committee and leads the firm's global business and investment strategy.

Ilfryn joined the firm in 2006 in London, where he played a key role in building Värde's team and business in the European region. Through his career with the firm he has invested across a wide spectrum of financial assets ranging from corporate restructurings and liquidations to more actively traded opportunities. Ilfryn was named Partner in 2011 and served as Co-Head of Corporate and Traded Credit managing Värde's liquid investing activities globally before being named Co-CIO in 2017 along with his move to Singapore. He was named Co-CEO in 2020.

Before joining Värde, Ilfryn worked for Deutsche Bank London in the Financial Sponsors Group, and Pacific Equity Partners, an Australian leveraged buyout firm.

Ilfryn received a B.C. with First Class Honours from the University of Queensland, Australia and an M.B.A. from INSEAD, France.



Giuseppe Naglieri
Partner and Co-Chief Investment Officer

Giuseppe Naglieri is a Partner and Co-Chief Investment Officer. He oversees public markets investing activity and is a member of the firm's Investment Committee. Based in London, he joined the firm in 2009 and was named Partner in 2016.

Prior to joining Värde, Giuseppe worked for Goldman Sachs as an Associate in Fundamental Strategies. Prior to Goldman Sachs, he worked at JP Morgan in Investment Banking, focusing on telecom, media and technology.

Giuseppe graduated from Bocconi University with a B.A. in Business and Finance.

About Värde Partners

Värde Partners is a leading global alternative investment firm specializing in credit and credit-related assets. Founded in 1993, the firm has invested more than $100 billion across the credit quality and liquidity spectrum in both public and private markets. Värde currently manages over $13 billion in assets with teams in North America, Europe, and Asia Pacific focused on Corporate & Traded Credit, Real Estate, and Financial Services & Diversified Private Credit. For more information, please visit www.varde.com.

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Offices

New York

520 Madison Avenue
34th Floor
New York, NY 10022
United States

Minneapolis

901 Marquette Avenue
South, Suite 3300
Minneapolis, MN 55402
United States

London

2 St James's Market
London SW1Y 4AH
United Kingdom

Singapore

88 Market Street, #23-04
Singapore 048948
Singapore

Mumbai

#77, 3 North Avenue,
Maker Maxity
Bandra Kurla Complex
Mumbai 400051
India