VÄRDE

Värde Views: A Cycle Revolving Around Financing Dependency

Credit Market Update

July 2023

Värde Views: A Cycle Revolving Around Financing Dependency

INTRODUCTION

Värde Co-CIOs Ilfryn Carstairs, Brad Bauer and Giuseppe Naglieri dissect the market's contradictory narratives around the unfolding credit cycle and surface the compelling investment opportunities revolving around the cycles' epicenter: financing dependency.

Please note that these views were authored at the end of Q2 2023 as part of our quarterly communication with investors and may have evolved since their publication.

The markets for many months now have been a place of several somewhat contradictory narratives; a picture that certainly continued to hold in the second quarter.

Equities remain relatively solid and seem to price at worst a mild recession, though averages have been heavily driven by the recent exuberance around tech and AI-related companies. Central bankers continue to raise rates in the face of a resilient economy and sticky inflation. Meanwhile bond markets price quick, significant rate cuts over the next 12-18 months, more suggestive of a major negative turn in the economy.

Credit market conditions reflect both views. Higher quality liquid credit spreads are around, or even inside, their non-recession average levels. CCC spreads by contrast are close to full recessionary levels. Even more starkly, many major parts of the private credit markets are in the throes of processing major stress in spread levels and the beginnings of default cycles.

Stepping back from this somewhat confusing picture one thing is abundantly clear: we are firmly in a credit cycle at this point. When we look back on 2023 in years to come, we think the only question will be: how big was the cycle?

THE CYCLE NOW

All cycles have epicenters, and the size of a cycle is determined largely by how far problems then spread from this center. The epicenter of this cycle revolves around financing dependency, and the prime example of that is the commercial real estate (CRE) market, particularly office assets and now spreading. CRE credit in the U.S. is a $5 trillion dollar market, larger in size than the combined high yield, leveraged loan and direct lending markets.

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It's valuable to remember that in 2015-16 we had a reasonably large credit cycle that emanated from stress in the energy sector – energy credit at that time was around a quarter of the then $700 billion U.S. high yield market. A drop in the bucket compared to the issues in CRE today.

That we are in the midst of a CRE cycle is now widely acknowledged. The center of that cycle is office CRE, and it is rapidly impacting even high-quality assets. From the same driver – financing dependency – we are seeing major stress in other markets too.

Cycles typically get worse because credit strain in major markets causes risk-taking to pull back more generally. Higher spreads and lower availability expand the orbit of credit that has issues. In most cycles we get

a countervailing force from policy that becomes more accommodative and offsets this negative loop to some degree. Instead, in this cycle, we have added headwinds from the continued tightening in policy. This is driving an even more significant pullback in credit availability than we would typically expect, and commensurately a somewhat boundless number of opportunities to provide credit into these gaps.

This deep gap in credit availability is the key plank of the compelling and actionable opportunity set in front of us, notably in the credit spreads paid by consumer and other small balance credit originators. Many parts of the structured products market and corporate credits are looking to roll over their debts in this new spread, base rate and low issuance environment. This opportunity is bolstered by increasing dispersion in the traded credit market and the beginnings of more motivated selling of credit assets by various market counterparties looking to raise liquidity. It's rare that we see this strong combination of all-in yield and downside protection in so many parts of the market.

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WHERE DO WE GO FROM HERE?

Clarity on the path of a cycle is always a difficult thing ex ante. The current, and we think necessary, policy stance creates something of a catch-22 as we wrote about earlier this year. If the general economy stays strong, policy is likely to tighten further or at least stay at these levels. A sharp change in policy would seem to require a real turn in this economic picture. Simplistically this catch-22 suggests two doors from here for credit.

Behind the first door, 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, 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. Thankfully the current environment is such that the investing pipeline allows for pricing both doors as well as most of the more severe potential outcomes behind them – a very different picture in credit compared to most asset classes.

The tug-of-war between financing conditions and the general economy implied by our catch-22 framework was again evidenced during the quarter. The weakness in cost and availability of credit remains profound outside of the most vanilla and high-grade credit markets, even in this relatively benign year overall for markets. U.S. high yield issuance continues to run at some of the lowest levels since the GFC and is only a little higher than this time last year.

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Leveraged loan issuance is down markedly and the price paid to access new leveraged loans or high yield capital is running generally 200-300bps above the spreads implied in the secondary market. The $713 billion CMBS market is seeing almost no primary issuance – only $19 billion for the year (down 80% YoY), which is almost unheard of.

At a more macro level, the regional banking crisis continues to tighten general credit conditions significantly. Despite the failure of another major institution in First Republic Bank, the systemic aspects of the crisis subsided to some degree during the second quarter. Banks themselves have retracted from providing credit, and in many cases are looking to raise liquidity by selling parts of their existing books, with several large transactions announced.

The math problem for credit is now translating into default activity, with leveraged loan and HY default rates jumping from their very suppressed levels back to historic averages, and likely to rise from here at least to the mid-single digits in our view.

CMBS, reflective of the CRE market broadly, remains under pressure – the de minimis new issuance as we noted above is causing that market to shrink after 8 years of growth. CMBS delinquency rates are rising and loans in special servicing are increasing as are loan modifications; unsurprisingly, office is the driving factor for now. CRE borrowers face major headwinds from rising interest rates, declining valuations, and challenging fundamentals in some places as well as a tough refinancing market.

Nevertheless, the general economy remained more robust than we would have expected so far, outside of the most financially levered sectors – though cracks are appearing in this picture to some degree in Europe, and more significantly in China. Can all this sustain in the face of tighter for longer monetary policy? We are skeptical, though the picture is nuanced, and we think it highly unlikely to be one of a generalized global hard landing.

Geopolitics remains an ever-present influence on the backdrop and global policy rates continue to play out their part in the first door narrative, with all major central banks raising rates further during the second quarter. It is important though that as the inflation picture at least continues to gradually moderate there is a reasonable buffer now built to react more decisively for (most) central banks if a sharper economic downturn begins. A key driver of the inflation moderation has been weakness in commodities – themselves signaling a harder landing and an upside risk to inflation from here if the economy remains strong.

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OPPORTUNITY SET

As financing dependency signals the epicenter of this unfolding credit cycle, it also serves as a common theme across major parts of the opportunity set that we find most actionable today.

PRIVATE MARKET OPPORTUNITIES

Overall, we are strongly of the view that performing credit offers some of the best relative value in today's market, and we remain focused on opportunities where we can directly originate into sectors with clear and persistent capital gaps. Pricing and/or risk has remained attractive and somewhat agnostic to the ups and downs of the broader markets, and in many cases, the market offers attractive returns in risk profiles resilient to a wide variety of economic outcomes.

Below we detail several thematic motivators with reference to the most impacted asset classes or sectors:

Borrowers addressing forthcoming maturities or proactively raising liquidity: For the last 12 months, borrowers have often sought to delay the inevitable as maturities approach in hopes of timing a better market. This has led to select transactions where borrowers simply cannot afford to wait any longer. More recently an opportunity has emerged for us to take a proactive approach as borrowers bite the proverbial bullet by

accepting a higher cost of credit now well in advance of hard deadlines as a bridge to what is hoped to be more favorable market conditions.

This driver of opportunity touches most every geography for both corporate borrowers and commercial real estate asset owners. For the former, we have seen some creative and some highly aggressive transactions in the market, and in certain geographies, we've begun to see asset owners, both corporate and sponsor, forced to sell assets cheap and/or in off-market transactions to meet upcoming maturities.

Bank and non-bank lenders managing capital, liquidity and exposure limits: Lenders seeking to raise liquidity in a visibly motivated manner applies across both primary and secondary transactions. In primary markets, issuers of credit are accepting costly and constraining terms only imposed on them when capital supply is scarce, the need for liquidity is high and alternative choices are sub-optimal. In secondary markets, we have seen both banks and non-bank lenders actively selling assets, mostly in portfolio form, to free up capital and/or to generate liquidity.

Non-bank lenders expressly dependent on the warehouse-to-securitization model have limited ability to slow origination activity without doing long-term damage to their franchise or balance sheet. This push-pull manifests in opportunities to structure transactions, particularly in consumer and commercial asset-based private credit, with both attractive pricing and strong downside protection in what we view as a lender's market.

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On the other side, banks of all sizes are tightening up to manage capital, liquidity, and overall exposures. An example of this is banks entering significant risk transfer (SRT) transactions to reduce risk-weighted assets as well as conducting outright asset sales. The assets most actively for sale in today's market include commercial real estate loans, fund finance (namely subscription lines), housing-related loans, and consumer credit. We expect this theme will likely persist for some time as U.S. regulators begin to take a harder stance on bank capital requirements.

Housing market fundamentally under-supplied against a higher rates backdrop: As time has passed with the impact of higher base rates, homebuilders have continued to sell through homes at a strong pace. Secondary market transactions have slowed dramatically as homeowners struggle to justify the trade into a much more costly mortgage, yet demand appears largely unabated. New home sales as a percentage of overall activity stands at historically high levels today after a period of decline following the Covid housing boom.

Through this, homebuilders have been proactive and prudent on inventory, so much so that they are being forced back into the market to transact, but only in the most de-risked pockets of communities with visible demand and known building margins. While not entirely evident how the macro environment will continue to unfold, we are seeing several shorter duration land banking and related opportunities that screen very attractive in the homebuilding sector.

Early makings of fundamental distress presenting: Inevitably, there have been and will continue to be borrowers unable to achieve their capital needs in the current market backdrop, especially in the face of potential further macro stress on the horizon. In our view, those at the most elevated risk of default include the weakest borrowers, the most challenged assets and over-levered situations. While we maintain an exceptionally high bar to selectively pursue pure distress as an investment opportunity at this time, the growing stress in the market as well as looming threats on the horizon have pushed some competitive capital into distressed opportunities on the margin. Although distressed broadly does not offer the strongest relative

value today in our view, especially in comparison to performing credit, we expect it to become more compelling with time and a larger portion of our private market pipeline.

TRADED MARKET OPPORTUNITIES

There are similar themes in traded markets where liquidity is in shorter supply for harder credits or more nuanced parts of the market, yet plentiful for the highest quality and largest businesses as lenders race to deploy capital in size at these higher base rate levels. Our experience in various markets allows us to be selective and avoid the most competitive situations.

Global Financials: In the wake of the U.S. regional bank disruption earlier this year, the market for financials credit offers as dislocated and compelling relative value as we have seen it in years (early to mid-2020 aside). The space today offers a near-perfect setup in our view: the rare combination of deep value opportunities in a market of significant scale where we have both significant expertise developed over many years and a differentiated view of the sector and individual credits within it.

A good portion of bank credits have recovered as the market has normalized and stabilized post the volatility of Q1, yet we observe significant pockets of value remain in parts of the market that we think are still underfollowed or misunderstood. We are still finding good trading opportunities in the capital structures of a number of larger banks in several countries across Europe. The U.S. also offers some pockets of value in bank credit. While much of the market trades too tight to be of interest, some capital structures of banks outside the largest global institutions have lagged the market's recovery and appear to offer good value.

Dislocated First Lien: We are finding much to do in senior credits of mid-size "higher quality at high yield" corporates in the U.S. and Europe, which oftentimes offer double-digit yields with the lower risk profile, and potentially advantaged negotiating position, offered by seniority within the capital structure and security over businesses and assets. Capital gaps have exacerbated in our view, as outflows from non-IG strategies and a more cautious approach from traditional market participants leave the space less competitive.

Complementing our efforts to source paper in secondary markets at deep discounts to par, we are increasingly focused on driving new-money financings to provide liquidity-constrained businesses with fresh capital or timely refinancings. With the market turning its focus to the significant volumes of credit maturing in 2024 and 2025, corporates that can clear this hurdle efficiently in quiet refinancings with only a few lenders send a positive signal to the market. This event itself can also be the catalyst to crystallize value more quickly in discounted credits. These opportunities have come about in several forms, and we seek to help structure closely syndicated club deals or reverse inquire bilaterally.

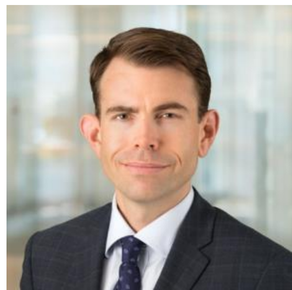
Real Estate & Structured Products: This burgeoning segment has continued to rapidly expand as stress is becomes more evident across the market and financing dependency exposes the sector's vulnerabilities. Real estate remains front-and-center as property-level issues (e.g., inflation, labor shortages, sluggish leasing in office and otherwise) combine with challenging capital structures and capital markets dynamics. This stress is evident in the persistent price-to-book discounts of listed REITs and the wider spreads on offer in real estate structured products.

Beyond real estate, we observe the impact of tightening credit conditions on other structured products sectors and see it improving the value to be had selectively in corporate CLOs and consumer ABS.

CONCLUSION

While large parts of the market trade as though a soft landing has been achieved and a recession averted, many other segments of credit markets are pricing in a darker outlook and, within this, highly attractive risk/reward can be created from better quality credits and assets. It is premature to declare a soft-landing scenario as we are clearly contending with a very levered system with sustained higher costs of borrowing. However, the capital gaps resulting from this environment present a compelling opportunity set for those who can step in as providers of financing.

About the Authors



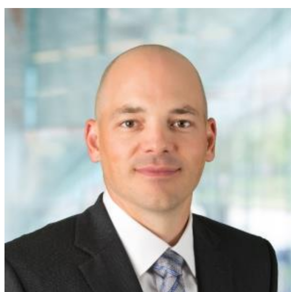
Ilfryn Carstairs
Partner, Chief Executive Officer and Co-Chief Investment Officer

Ilfryn Carstairs is a Partner, Chief Executive Officer and Co-Chief Investment Officer. Based in Singapore, he 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-Chief Investment Officer in 2017 along with his move to Singapore. He was named Co-Chief Executive Officer in 2020 before becoming Chief Executive Officer in 2022.

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.



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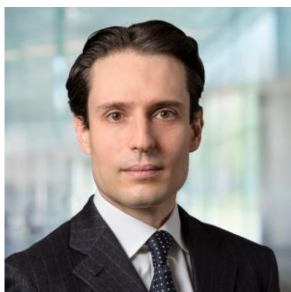
Brad Bauer is a Partner and Co-Chief Investment Officer. He oversees private markets investing activity and is a member of the firm's Investment Committee. Based in London, he joined the firm in Minneapolis in 2007, was named Partner in 2013, and has led the firm's London office since 2019.

Brad has held numerous leadership positions throughout his time at Värde, including oversight of all non-investing functions. Prior to that, he was involved in managing the firm's Corporate and Traded Credit team. Brad's experience spans an array of industries and spectrum of credit markets.

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.



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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 through multiple credit cycles, building on its roots in special situations and distressed to invest more than $95 billion across the credit quality and liquidity spectrum in both public and private markets. Värde currently manages over $12 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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