INVESTCORP CREDIT MANAGEMENT

GLOBAL CREDIT HOUSE VIEW

Dear Investors and Friends,

Welcome to the inaugural Investcorp Credit Management House View. This quarterly note discusses the events over the past quarter and based on our insight into both the US and European credit markets and offers our views as to the market dynamics we expect to see in Q1 2021.

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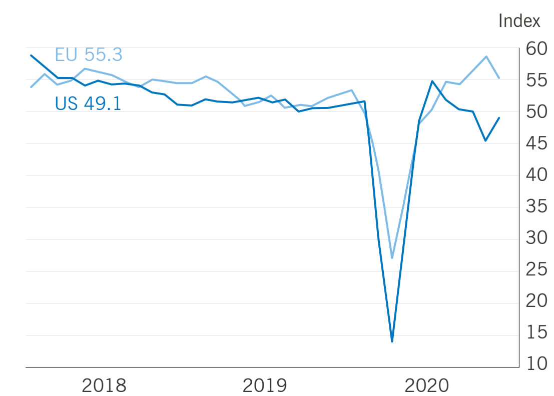
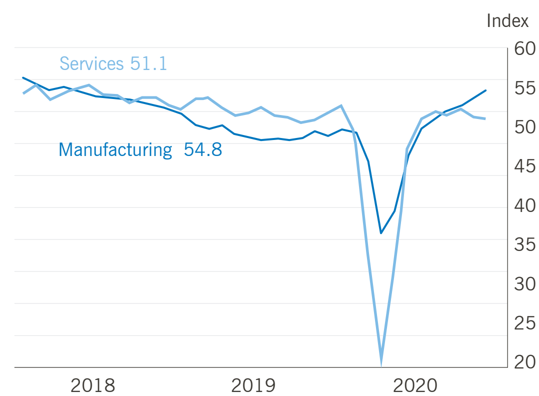
GLOBAL OVERVIEW

Global economic momentum slowed during the fourth quarter. A faster rise in Covid-19 contaminations, particularly in Europe, forced many governments to impose again stringent social distancing measures. Thankfully, economic leading indicators suggest that the impact has been more limited than during the initial lock-down. Businesses and consumers have adapted, improving the resilience of the economic system. For instance, temporary unemployment in the United States has shrunk from a high of 17.5m in April to 2.8m in November. Permanent job loss has increased significantly but economic scarring looks milder than what could have been expected a few months ago. Also, China has managed to remain immune to the virus second wave and its economy continues to benefit from a sharp loosening of credit conditions such as the one we observed in 2013 and 2016. This impulse has been a major driver in boosting manufacturing activity globally.

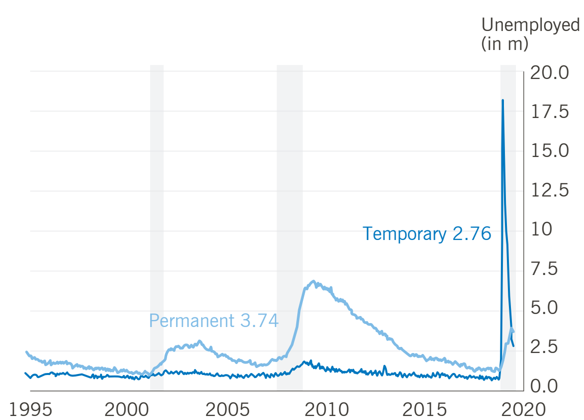
COMPOSITE PMI INDICES[1]



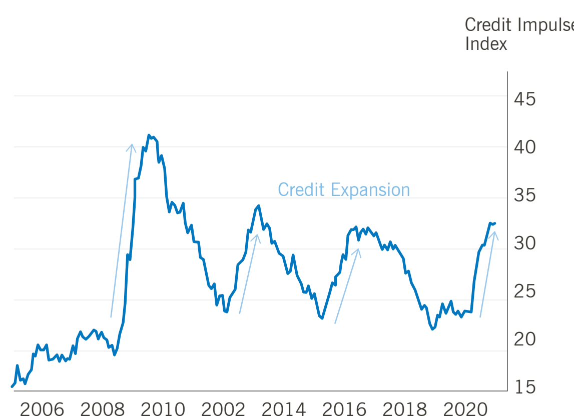
DEVELOPED COUNTRIES PMI INDICES BY SECTOR[2]



US UNEMPLOYMENT[3]



CHINA CREDIT IMPULSE[4]



1 Composite PMI: Investcorp, Macrobond, Markit
2 Developed Countries PMI: Investcorp, Macrobond, Markit
3 US Unemployment: Investcorp, Macrobond
4 China Credit Impulse: Investcorp, Macrobond, Bloomberg

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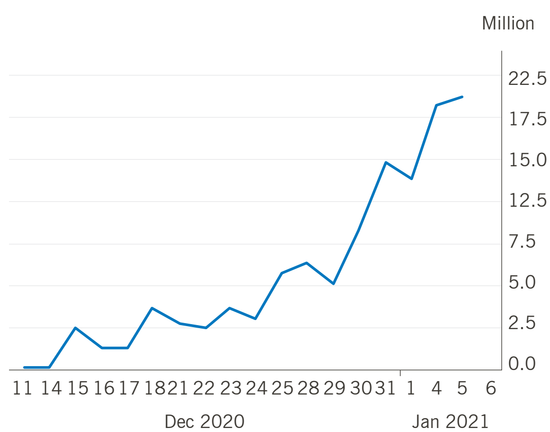
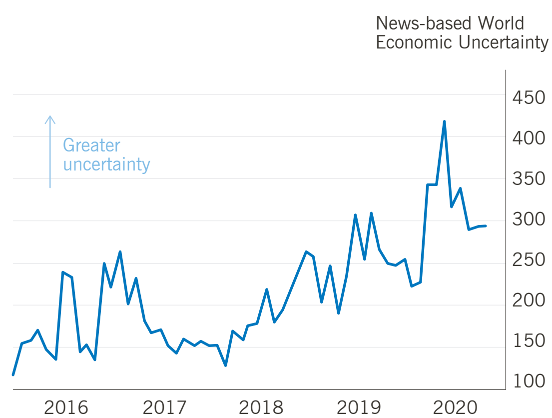
Uncertainty abated across two major fronts in recent months. First, Democrats and Republicans agreed on an extension of the CARES Act relief measures with a package worth $900 billion. Continued fiscal support will help mitigate the adverse effects of new lockdown measures on confidence. The Democratic win in the January Georgia run-off Senate races suggests larger fiscal support is likely coming in the United States, with Democrats having been vocal advocates of more aggressive spending. The reconciliation process for the 2020 and 2021 budget will offer an opportunity to direct more funds to consumers, state and local authorities as well as address policy initiatives including infrastructure spending. Secondly, the years-long Brexit process culminated in a last-minute deal allowing continued market access for goods across the Channel while the outlook for services remains somewhat uncertain, dependent on future assessments of regulatory divergences between the UK and the EU. Thirdly, the outlook for the healthcare situation has also brightened with several pharmaceutical companies announcing positive vaccines efficacy results in recent weeks. Vaccine distribution may come too late to avert a difficult winter, but this allows economic agents to look through to a better future.

COVID-19 GLOBAL IMMUNIZATION CAMPAIGN[5]



WORLD ECONOMIC POLICY UNCERTAINTY[6]



Lower uncertainty and continued policy support have allowed financial conditions to stay loose. This bodes well for the near-term, allowing troubled businesses to stay afloat and avoiding catastrophic feedback loops through credit channels. It is still early to assess whether the crisis and its management will have detrimental longer-term consequences on productivity and potential growth. But, as we look forward to the next twelve months, the global economy is likely to recover from the shock – delivering faster growth than in recent memory.

5 Covid-19 Immunization: Investcorp, Macrobond, Our world in data
6 Policy Uncertainty: Investcorp, Macrobond

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GLOBAL CREDIT MARKET

US MARKET – Q4 2020

In the US, markets have been “risk-on” across all asset classes since the Pfizer vaccine news on Nov 9. US equities have reached record levels, commodities led by oil and copper have hit recent highs and treasury yields have widened. In credit, high yield spreads tightened over 140 bps over the final two months of the year with yields recently sitting at an all-time low of 4.57%[7]. U.S. High Yield returned 5.48%[7] in 2020. Leveraged loans returned 2.78%[8] in 2020, an exceptional recovery from the negative 19.76% YTD[8] returns we saw at the March nadir. The strong rally in November produced a remarkable 2.13%[8] monthly return followed by continued strength in December, which returned 1.30%[8]. There has been a clear rotation into cyclical and COVID-19 -recovery names across equities, high yield and leverage loans. Discounted, higher beta and higher COVID-19-related loans led the Q4 rally. CCC loans outperformed in November, returning 6.12%[9], while Single-B’s gained +1.86%[9] and BB loans returned +1.63%[9]. In December, similar trend continued as CCC returned +2.39%[9], while Single-B’s gained +1.37%[9] and BB loans returned +1.14%[9]. The US loan market ended the year with 80.97% of the loan index trading above 98c/$ which is similar to pre-Covid levels.[9]

Both credit fundamentals and loan market technicals remain strong as we enter 2021. The market technical continues to be supported by strong CLO formation, an increasing pace of prepayments, a restrained supply of new issue loans expected over the next several weeks and expectations for continued Fed support and fiscal stimulus from the new administration.

Credit fundamentals have been buoyed by the extremely encouraging vaccine efficacy and expectations for wide availability by summer 2021. We now have clarity on the US elections, Q3 earnings have been in-line and many borrowers have taken advantage of accommodative capital markets to shore up liquidity runway to reach 2022.

2021 US MARKET OUTLOOK

Looking towards 2021, we expect improving credit fundamentals and declining default rates as the economy recovers from the pandemic to result in credit spreads tightening further. We expect loan issuance to increase from depressed levels in 2020 driven by a significant recovery in M&A and LBO activity. Demand for loans will be driven by strong anticipated recovery in CLO issuance to over $100B and by high yield crossover buyers drawn to relatively attractive loan yields and the rate protection afforded by floating rate loans. We continue to see opportunities in “Covid-recovery” sectors as vaccine distribution allows normalization beginning in Q2/Q3. However, understanding which credits will normalize from more transitory effects of the virus and which sectors will likely face permanent changes to their business models (e.g., airlines, cruise lines, theatres) will be critical.

[7] Credit Suisse High Yield Index
[8] Credit Suisse US Leveraged Loan Index
[9] JP Morgan Leveraged Loan Index

While we are encouraged by the improving macro outlook and credit fundamentals entering 2021, we remain mindful of the various challenges and unknowns which could emerge and lead to periods of volatility. Namely, we are monitoring progress around stimulus funding to support the consumer and offset the effects of the persistently high unemployment. We also acknowledge the upcoming "dark winter" threat as infections and deaths rise and stay at home orders increase in Q1 which would curtail Q1 GDP. Finally, there could be volatility brought on by a "taper tantrum" type correction as the massive stimulus, accommodation and central bank asset purchases begins to reverse as the economy improves.

We continue to find investment opportunities where we see higher margin of safety and where we have conviction in the business quality, liquidity and post-pandemic recovery prospects. We anticipate being able to outperform by focusing on disciplined credit selection and opportunities where we've identified steeper rates of post-Covid recovery both across and within industries that offer attractive risk-adjusted spread and catalysts to drive total return.

EUROPEAN MARKET – Q4 2020

Similar to the US, European markets have been significantly "risk-on" following the November vaccine news which has been further intensified by a relative lack of primary issuance across sub-investment grade credit markets. European Leveraged loans returned +3.54% in the quarter ended 31 December 2020, with November seeing a +2.66% monthly return, driven by higher beta CCC-rated assets, most of which are high COVID impacted names, which returned 11.75% in the month. European high yield returned an even stronger +5.36% in the quarter, including +4.08% in the month of November alone, with spread reducing by 123bps in that month. The European high yield market ended the year with average yields at 3.79%, below the 3.95% level seen at the end of January 2020 before the crisis.[10]

Looking at European leveraged loans in detail, the market currently has significant technical tailwinds driven by a pronounced structural supply deficit, led by subdued primary issuance and continued new CLO issuance, which has been a market feature since September 2020. Primary loan issuance in the quarter was €8.8 billion while for the 2 months ended November 2020 (the latest data available at the time of going to print) new CLO issuance was €5.8 billion and loan repayments €3.5 billion. In addition, recent M&A and IPO activity has led to a pipeline of known repayments from large issuers in the market in early 2021, including Nets (~€2.5 billion of issuance) and Paysafe (€1.25 billion).[11]

As a result of these technicals, European leveraged loans, as measured by the Credit Suisse Western European Leveraged Loan Index, posted a +6.42% return in H2 2020 which has resulted in full year 2020 return of 2.38%, an exceptional result in the context of the -14.03% year-to-date return position for the market back in March 2020. As a result, despite the March volatility, European loans have extended their unbroken track record of positive annual returns to 9 years.[12]

[10] Credit Suisse Western European Leveraged Loan Index and Credit Suisse Western European High Yield Index as at 31 December 2020
[11] S&P/LCD News Euro Loans and Technical data 31 December 2020
[12] Credit Suisse Western European Leveraged Loan Index as at 31 December 2020

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EUROPEAN MARKET OUTLOOK

Looking forward to Q1 2021, underlying European market fundamentals remain potentially problematic. The COVID-19 pandemic has created one of the most significant global recessions in history with the longer term impacts likely to be felt in 2021. although the roll-out of vaccines is clearly positive news, the second (or third wave) of infections is currently resulting in renewed lockdown measures across Europe and it is unlikely that Europe-wide vaccination programs will be fully effective until the summer of 2021 at the earliest. As such, we believe it that European default rates will remain relatively elevated through 2021 given the long-term impact of the COVID-19 crisis on corporate balance sheets. Furthermore, the over reliance of European markets on Central Bank stimulus is significant medium-term risks as this stimulus is reduced or removed especially given the market was already heavily propelled by ECB stimulus even prior to the COVID-19 crisis. Against this, the Brexit deal has removed one short term potential driver of additional market volatility.

Positively, we expect a pick-up in new loan issuance in Q1 2021 given recent and expected M&A activity and near-term maturities on some issuers in the market. However, we expect that this will be largely absorbed by the significant repayments expected in H1 2021 (as mentioned above) and continued CLO issuance. As a result, we expect to see continued pressure on new issue margins albeit, as is usual with the European market, there will be a floor driven by the CLO market especially given the current need to optimize CLO equity returns.

Given the above dynamics, we continue to conservatively position our European portfolios alongside, where sensible, taking advantage of short-term trading opportunities provided by the positive vaccine news. On the positive side, we expect that as new primary transactions pick up in Q1 2021 we will be provided with opportunities to rotate portfolios to increase yields.

SUMMARY

The unprecedented global market conditions experienced during 2020 have demonstrated the resilience of the large cap leverage loan market, whilst highlighting the need for disciplined and active portfolio management. Default rates although elevated have to date been largely confined to those sectors most exposed to COVID-19 and potential economic impact cushioned by the various forms of state intervention.

As we look forward to 2021 we are cautiously optimistic. The US and European markets are both experiencing technical features associated with the current supply/demand imbalance. In both markets we expect his to gradually unwind during Q1 2021 as M&A activity increases and investors assume a more risk-on approach, with some of the “hot money” invested into the more defensive leveraged loan credits being redeployed.

There will likely be greater volatility across the asset class than typically experienced as markets remain skittish with regard to COVID-19 news. This may well create opportunities to rebalance portfolios and for active managers to capture added value.

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