September 2021

INVESTCORP

INVESTCORP CREDIT MANAGEMENT

# GLOBAL CREDIT HOUSE VIEW

A ROBUST PERFORMANCE WITH POSITIVE TRENDS FORECAST TO CONTINUE

Dear Investors and Friends,

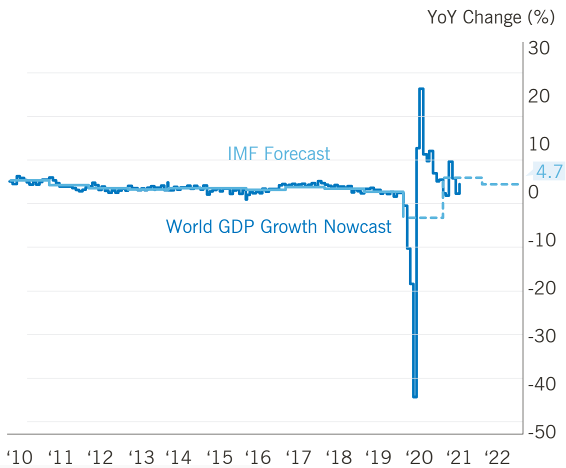
Welcome to the Investcorp Credit Management House View.  This quarterly note discusses the performance of both the US and European credit markets in the first half of 2021 and our expectations for performance for the remainder of H2 2021.

# 02

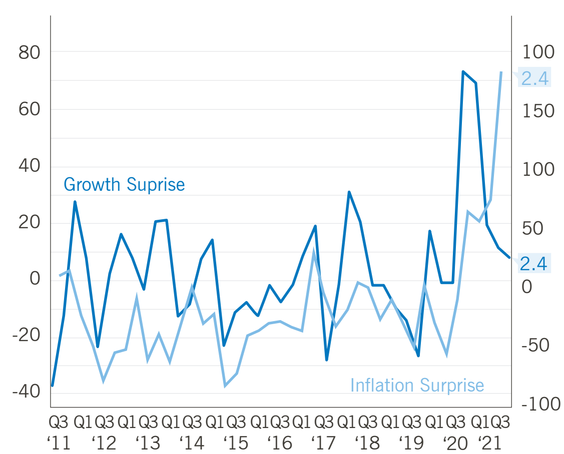
## MARKET OVERVIEW

Global growth remained strong in recent months, but elevated expectations were sometimes disappointed, particularly with regards to the speed of the US job market recovery. Non-Farm Payrolls were held back by a confluence of factors, including seasonal effects, availability of childcare or capacity issues. Still, leading indicators including consumer and corporate surveys suggest tailwinds from higher incomes and robust balance sheets are feeding through demand. The supply side is facing greater challenges however, as labour shortages and supply chain bottlenecks limit the scale of the production ramp up. Together with base effects, these dynamics play a role in the large upside surprises seen in US inflation data prints. With growth moderating, albeit from high levels, investors have more recently embraced the narrative that many of these drivers are temporary by nature.

### GLOBAL GROWTH NOWCAST & IMF FORECAST




### DEVELOPED COUNTRIES GROWTH & INFLATION SURPRISE




The macro-economic backdrop remains supportive with depth and breadth of momentum across sectors and geographies. But developed countries seem once again on the cusp of another wave of Covid-19 contaminations driven by relaxed social distancing measures and the greater contagiousness of the Delta variant. So far, immunization campaigns have been successful at reducing sharply hospitalization rates as current vaccines prove efficient in avoiding the worst cases of the disease. Still, greater virus circulation presents the risk of new variants emerging and requires that full populations be vaccinated, a potential concern as vaccination trends are losing momentum in the United States and the United Kingdom. This is a major risk to watch in the coming months as a lingering Covid-19 shock would seriously challenge the economic recovery and entrenched reflationary investor positioning. Each region is likely to adopt different strategies, driving greater dispersion in growth trajectories going forward.

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# US AND EUROPEAN CREDIT MARKETS

## US MARKET

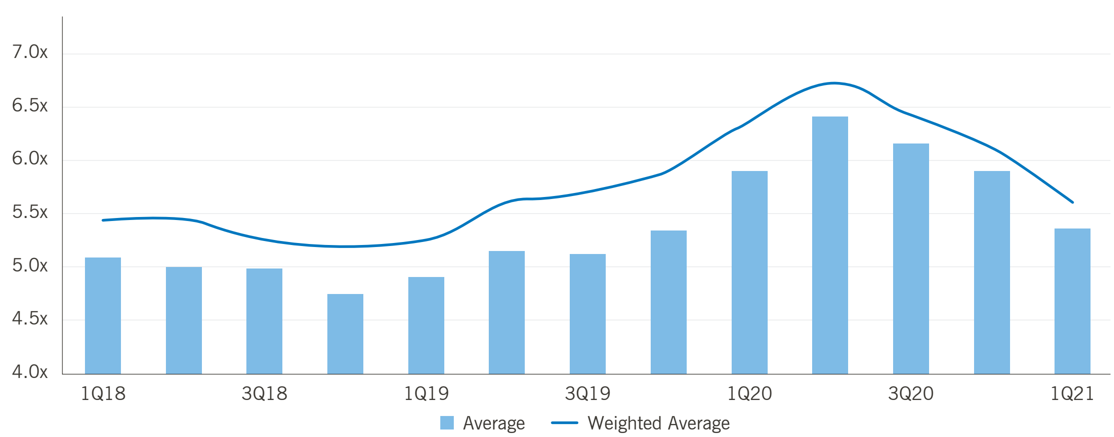
**Key Themes:**

- Continued global economic recovery
- Favorable credit fundamentals
- Loans continue to be well-positioned

We expect the environment for credit to remain favorable in H2 2021. The global economy is continuing its post-pandemic recovery, central banks remain accommodative, capital markets are accessible to borrowers and credit fundamentals are improving. These factors drove strong H1 returns for HY and leveraged loans of 3.89% and 3.48%[1], respectively which we expect to extend into H2. Demand for leveraged loans, given their low duration and floating rate nature, should benefit from continued concerns about rising rates that drove strong returns in H1 2021 .

Credit fundamentals continue to improve as a sharp post-pandemic economic recovery has accelerated into Q3 2021. Revenue and EBITDA are increasing, leverage is declining (from a spike of 6.41x in 2Q 2020 down to 5.36x as of 1Q 2021[2]), default activity is low and we expect these improving trends to accelerate as we approach the anniversary of the weakest quarters during the pandemic. Borrowers have taken advantage of favorable capital markets conditions to improve liquidity and extend maturities. The current 1.25% trailing twelve-month default rate is significantly down from a peak of 4.17% in September and the current distress ratio of 1.02% is at the lowest level since November 2014[3]. Default rates are expected to remain below average for the remainder of 2021 and 2022 with most strategists calling for 1.0%-2.0% through 2021.

FIGURE 1: **AVERAGE LEVERAGE OF OUTSTANDING US LEVERAGED LOANS**[4]




Data through March 31, 2021.
Source: LCD, an offering of S&P Global Market Intelligence

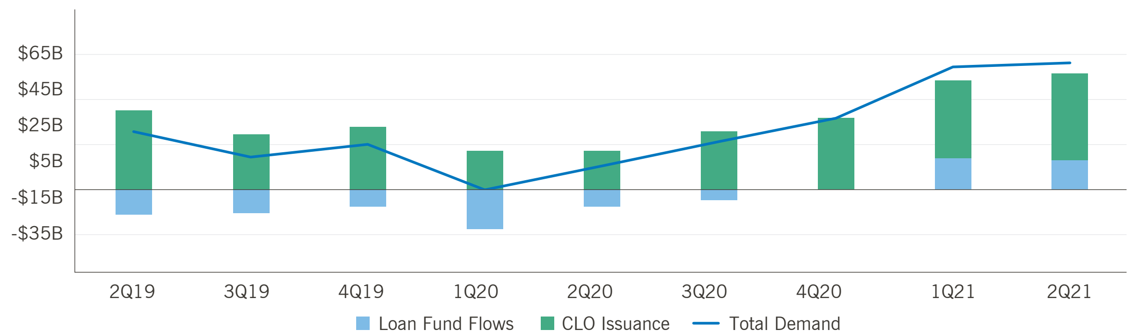
[1] Source: Credit Suisse High Yield Index, Credit Suisse Leveraged Loan Index, June 30, 2021.
[2] Source: S&P/LSTA Leveraged Loan Index, March 31, 2021.
[3] Source: S&P LCD News, July 1, 2021.
[4] Source: S&P LCD, March 31, 2021.

# 04

Despite record low yields for bonds and loans, we expect continued strong performance for leveraged credit. On a relative value basis, loans yields look attractive compared to high yield bonds. Yields for the HY bond index (4.37%) are only 21bps above that of loan issuers (4.16%), compared to a 92bps gap for the cross issuer base since 2010[5].

From a technical perspective, demand for loans remains robust. CLO issuance ended at a record $79bn[6] in H1 and is projected to reach $140bn for the full year[7] which would surpass the full year record of $129bn in 2018. Inflows into loan retail mutual funds and ETFs have been averaging over $750mm per week YTD[8] as investors, worried about rates, continue to favor the floating rate nature of loans.

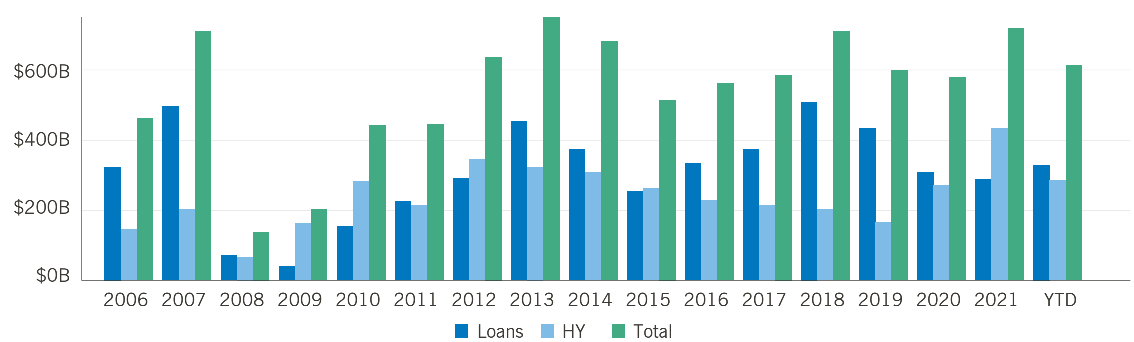
## FIGURE 2: US LEVERAGED LOAN MARKET DEMAND[9]




Data through June 29, 2021.
Sources: LCD, an offering of S&P Global Market Intelligence; Lipper

On the supply side, given extremely low yields, 2021 has seen a record pace of leveraged credit issuance ($330bn in leveraged loans and $286bn in HY bonds[10]). The total market size outstanding surpassed $3 trillion at the end of 1H 2021[11]. We expect this to continue into H2 as many strategists have now revised their initial 2021 full year issuance projections to be as high as $600bn+ in loans and $500bn+ in HY bonds.

## FIGURE 3: US LEVERAGED LOAN AND HYB ISSUANCE[12]




Data through June 30, 2021.
Source: LCD, an offering of S&P Global Market Intelligence

[5] Source: JP Morgan, High-Yield and Leveraged Loan Morning Intelligence, July 16, 2021.
[6] Source: S&P LCD, June 29, 2021
[7] Source: JP Morgan, 2021 Mid-Year High-Yield Bond and Leveraged Loan Outlook, June 28, 2021
[8] Source: JP Morgan, High-Yield and Leveraged Loan Morning Intelligence, July 16, 2021
[9] Source: S&P LCD; Lipper, June 29, 2021
[10] Source: S&P LCD, June 29, 2021
[11] Source: S&P/LCD News, July 15, 2021
[12] Source: S&P LCD, June 30, 2021

05

## US MARKET OUTLOOK

**Expect periods of volatility as global risks to the “reflation trade” emerge and central bank policy remains in focus.**

The market’s focus on reflation and rates risks we shared in our last update have subsided. As the reopening has accelerated, there have been clear increases in wages, material costs and commodity prices. Investors, however, seem to have embraced the view that inflation is transitory as evidenced by the strong recent rally in Treasury yields which have now declined from the March highs of 1.7% to 1.3%. Additionally, risks to global growth prospects have emerged as the Delta variant and uneven global vaccination rollouts have led to an uptick in infections which threaten growth particularly in emerging economies where vaccination rates are low.

We continue to expect strong US economic growth to sustain into 2022 albeit at more modest levels than the torrid, immediate post-COVID growth rates currently underway. We agree with consensus that the Fed will likely begin tapering its asset purchases late this year and is likely to begin raising rates in the first half of 2023, if not somewhat sooner. We expect leveraged credit, and loans in particular, to continue to perform well in this environment.

In terms of our current industry positioning and concerns in the US market, we think the Delta variant concerns could delay some of the full potential of the reopening, but we don’t think it derails the recovery. In particular, we are less concerned about Delta in geographies with high degrees of vaccination penetration. We are cognizant of the pressures that wage, material and other input cost inflation could put on earnings. However, given robust economic demand, most of our borrowers have been able to offset these pressures with price increases and expect some of these structural pressures to ease later in the year. We are more cautious on sectors and individual credits with “reversion risk” and have reduced exposure in areas where we are unsure of the sustainability of the COVID led demand bump.

**We continue to drive value and outperformance through a “front footed” active trading and portfolio management approach focused on protecting principal while also finding opportunities for capturing total return and convexity.**

# 06

## EUROPEAN MARKET

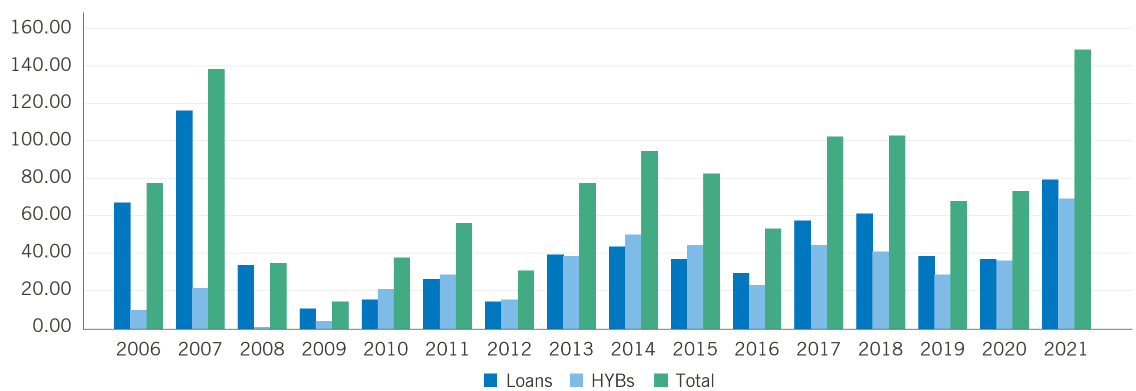
**Key Themes:**

- High levels of Primary Issuance
- Supply / Demand balance returning with positive implications for pricing
- Expected levels of default continue to reduce

Looking back on H1 2021, the most striking evidence of the recovery in European credit markets is the sheer volume of new issuance and, probably even more impressive is, the ability of the European market to absorb this level of issuance.

Total new issuance levels across the European leveraged loan and high yield markets set record levels in H1 2021, as the market was flooded with deals either from Private Equity deploying its dry powder in new transactions after a relatively barren COVID hit 2020, issuers accessing more liquidity to drive COVID recovery plays or Private Equity Sponsors refinancing those deals which were transacted at premium pricing in 2020.

FIGURE 4: **EUROPEAN LEVERAGED LOAN AND HYB ISSUANCE**[13]

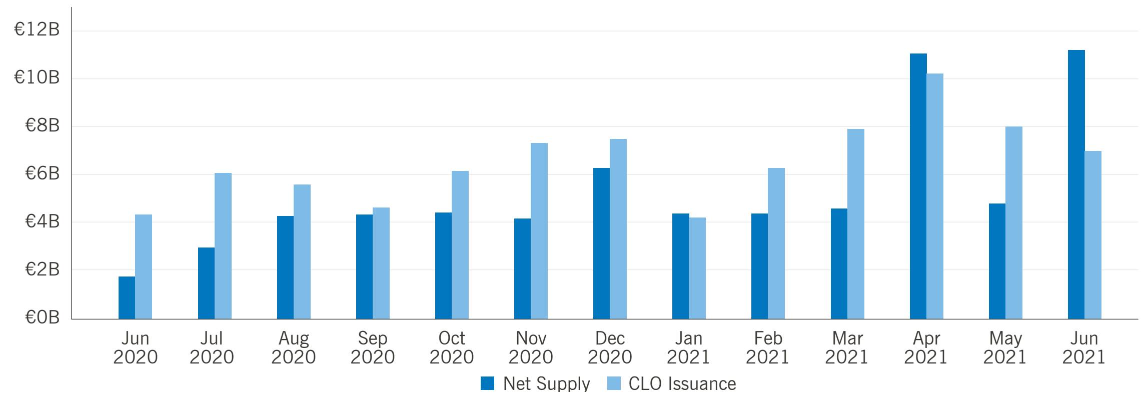



To put this in context, the total issuance across loans and high yield of €151.5 billion in H1 2021 was €11 billion or 8% above the previous record year in 2007. High yield issuance set an outright record at €70.6 billion in H1 2021 and loan issuance of €80.9 billion, although behind the record H1 2007 issuance of €118.4 billion, looks set to potentially rival the full year tally for issuance in 2007 of €165.5 billion.

Despite this significant level of issuance, the leveraged loan market continues to absorb the supply as newly issued CLOs scheduled loan repayments alongside and kent the demand for assets high. In fact, Europe saw a supply deficit for most of H1 2021 providing a strong technical tailwind resulting in tightening credit spreads.

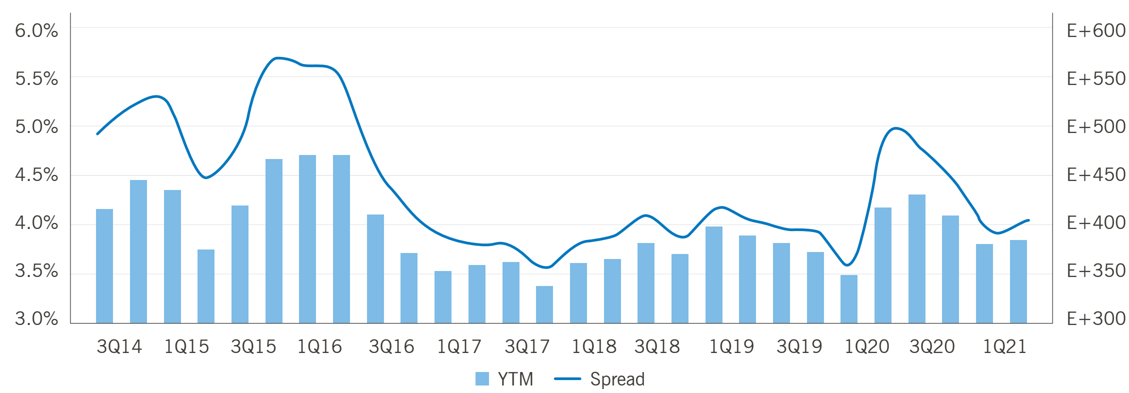
[13] Source: S&P/LCD News, July 2021

FIGURE 5: **INSTITUTIONAL MARKET NET SUPPLY VS. CLO ISSUANCE (ROLLING 3M)**[14]




As a result, issuers generally benefitted from favorable pricing, with tightening spreads through most of H1 2021. This in turn fueled an increase in opportunistic dividend recap and refinancing activity by Sponsors. The secondary market bid also held up well again reflecting the high levels of demand seen for senior secured loan assets.

FIGURE 6: **AVERAGE YTM AT ISSUE FOR SINGLE-B EURO-DENOMINATED TLBS**[15]




From a credit risk perspective, the original predictions of high single digit default rates for loans in Europe has not materialized. The combination of easily available liquidity from governments and/or capital markets, plus Private Equity support, aided by the fact that the European market is now largely covenant-lite has meant that defaults, despite the clear COVID related underperformance of some credits, have been almost non-existent. H1 2021 saw the default rate for European leveraged loans continue to decrease, ending the half year at 1.13% having started the year at 2.57%. To put this in full context, the European default rate is now only just above the level of 0.97% recorded in February 2020 immediately before the COVID crisis.

[15] Source: S&P LCD, July 2021

This all fed into positive returns for European leveraged loans and high yield bonds in H1 2021. European leveraged loans generated a return of 2.91%, with the average price of the index finishing the half year at 98.74% (versus 97.35% at the end of December 2020). Returns were driven by higher risk assets, as the low default rates and COVID recovery plays enticed more risk taking across the market, with CCC loans returning +10.73% in H1 2021 while Single-B's gained +2.50% and BB loans returned +1.29%[16].

Perhaps unsurprisingly in this context, the outperforming sector was the one probably most impacted by COVID risks, Gaming and Leisure which returned +7.04% followed by Consumer Durables (+5.20%) and Consumer Non-Durables (+5.16%). Metals/Minerals (+1.56%), Media/Telecommunications (+1.64%) and Food/Tobacco (+1.61%), were the relative underperformers through the half-year[17].

European High Yield bonds were similarly positive, generating a return of +3.26%, with the average price of the index finishing June 2021 at 100.91% (versus 98.58% at the end of December 2020)[18].

## EUROPEAN MARKET OUTLOOK

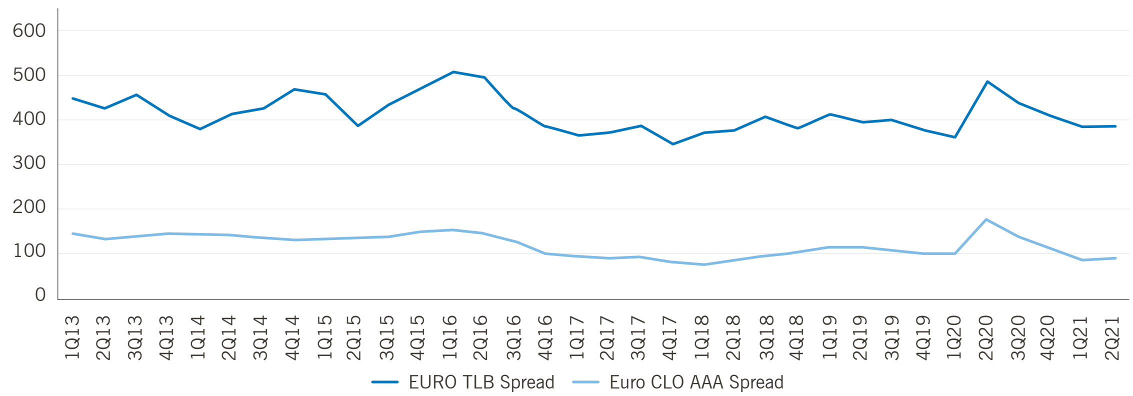
As we look forward into H2 2021, European credit markets seem set for a positive second half driven by ultra-low default levels and increasing credit spreads as the supply/demand imbalance seen over H1 2021 corrects.

The European leveraged loan market has started to show the first signs that the weight of primary issuance seen to date, and expected going forward, is starting to cause some indigestion. New issuance loan spreads increased in June 2021, as a combination of the strong forward primary pipeline, with new issuance showing no signs of abating in the near term, reduced repayments and slowdown in demand for CLO AAA assets in Europe has shifted the supply/demand balance. This correction has gained momentum as we have moved through July.

Given the relative reliance on CLOs in the European market, which represent over 50% of primary issue demand in the market[19], this last point is especially important as European loans tend to generate very strong underlying new issue spreads in the periods where primary issuance is high and the new CLO issuance market is more difficult. Although CLO AAA spreads averaged 86 bps in Q1 2021 the expectation is that spreads will increase to 100bps+ in Q3 2021 given the relative level of supply and demand in the new issuance CLO market.

[16] Credit Suisse Western European Leveraged Loan Index, June 30, 2021
[17] Credit Suisse Western European Leveraged Loan Index, June 30, 2021. Food and Drug excluded from sectoral analysis due to the sector not posting returns for the full period
[18] Credit Suisse Western European High Yield Bond Index, June 30, 2021
[19] S&P LCD, July 2021

FIGURE 7: **EUROPEAN LEVERAGED LOAN NEW ISSUE SPREADS VERSUS NEW ISSUE CLO AAA SPREADS**[20]




The dynamic seen in June 2021 has continued into July, resulting in both spreads on new issue widening and some softness in the secondary market, especially in low rating/lower spread names, and we expect it to continue through Q3 2021 and potentially into Q4 2021 if, as we expect, new issuance is maintained at current levels.

Positively, the overall size and liquidity of the European leveraged loans market has benefitted from the new issuance we have seen. The market (per the Credit Suisse Western European Leveraged Loan Index) now comprises 520 issuers with a face value of €340 billion compared to 507 issuers and a face value of €310 billion at the end of December 2019. We expect that the size of the market will continue to grow over 2021, providing more opportunity to diversify risk and actively manage portfolios.

From a credit risk perspective, it is hard to see at the current time the driver for an increase in default rates in the near term, despite the fears of a Delta variant driven third (or fourth) wave of COVID cases in Europe. We expect that defaults will occur in the market but likely in 2022 and beyond as issuers deal with either the removal of government basked liquidity or the overall strain on their balance sheets from COVID. However, even these defaults we believe will be sporadic and it is more likely that the more overly levered credits across the European market will see their maturities extended so that they can eventually grow out of their current structures given that a default is unlikely to be the best option for issuers or investors.

Clearly, risks do still exist in the market. In the short-term inflation is a potential issue across all issuers in credit markets both in terms of long-term wage inflation as employment normalises and in the time lag between increases in input prices and the ability of issuers to pass that on to customers. However, we expect these impacts to feed through our portfolio companies over 2021 and to be broadly offset by the increase in performance as the COVID recovery continues. Longer term, we are still wary of the impact of the eventual removal of central bank stimulus from European markets.

[20] Source: S&P/LCD News, June 30, 2021

Overall though we expect H2 2021 to provide strong investment opportunities for our Funds. Given our strong market position we are well placed to continue to benefit from the strong, well-priced primary issuance we have seen recently and to use this to rotate portfolios to increase yields.

## SUMMARY

The persistent demand from investors for senior secured credit stands as evidence as to the resilience of the product and the robust structures of the funds in which they are held. The asset class has to date weathered the COVID crisis; concerns over the covenant-lite nature of much of the debt supporting the larger-cap transactions has been offset by the flexibility afforded by Private Equity Sponsors, which have quickly supported their investments without the threat of an impending bank driven restructuring.

As we look forward through H2, we expect to see improved economics as the supply of new transactions not only recovers from the COVID lows but also benefits from the catch-up as Private Equity processes the inevitable backlog created through 2020.

With many market pundits now predicting record levels of issuance for both US and Europe we look forward to a very busy 2021.