VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Alternatives Quarterly Views

Edition Q2 2024

Our quarterly insights into Alternative investments

Professional investors only

Overview

Introduction

Welcome to the fifth edition of our *Alternatives Quarterly Views* from Van Lanschot Kempen, a leading independent European wealth manager with almost 300 years' experience. We couple long-standing relationships with a talent for staying one step ahead. We preserve and create wealth for our clients and for society, in a sustainable way.

We believe that Alternative investments can play a key role in long-term investment plans, with potentially better risk-adjusted performance than traditional investments, improved portfolio diversification, and the possibility to embed sustainability. This publication shares our perspectives on alternative investing trends and opportunities, across Private Real Assets, Private Equity and Private Credit. We hope that you enjoy reading this publication and welcome any feedback.

Market review Q4 2023

During Q4 2023 traditional asset classes delivered very strong performance, with Global Equities up 11.0% and Global government bonds up 5.8%*. Consequently, the widely used 60/40 balanced portfolio gained 8.9% during Q4. The yield on 10-year German government bonds fell from 2.8% to 2.0%, while the yield on 10-year US Treasury government bonds fell from 4.6% to 3.9%.

Alternative investments also performed well, delivering strong total returns in Q4 as spreads tightened and credit default rates remained relatively low. Corporate distressed debt performed strongly (+4.3%), followed by Structured credit (+3.2%) and Corporate direct lending (+3.0%). Private Equity returned +1.5% during Q4. Real assets saw strong bifurcation between categories during Q4, with Private Infra performing strongly (+10.0%, on a marked-to-market basis), Private Farmland delivered +2.3%, while Core Private Real Estate continued to reprice (-2.1%).

Macro-economic outlook 2024

The US economy remains robust, but we believe that the markets' 'no landing' scenario is optimistic as consumers' purchasing power is squeezed by sticky inflation and somewhat softer labor markets. In the Eurozone, broad leading indicators and hard data continue to point to further contraction, but there are some green shoots, particularly in peripheral Europe. Given the robustness of the US economy and inflation trends, Fed policy rate cuts are being pushed further into the future. Given the weaker economic outlook in Europe, the ECB is likely to deliver several rate cuts over the course of 2024. Meanwhile geopolitical tail risks continue to build, from Ukraine to the Middle East to the South Chinese Sea. As macro-economic uncertainty seems to fade somewhat and public markets have performed well, this could drive a stabilization in valuation expectations and discount rate assumptions, and subsequently improve transaction activity. Meanwhile, strong market performance has also eased the denominator effect.

* Global Equities: MSCI ACWI Net Total return USD index; Global government bonds: ICE BofA Global government bond index (W0G1, USD hedged). Alternatives' indices are typically released with a one-quarter time lag due to their less liquid nature. Please see important disclaimers and disclosures at the end of this document. Past performance does not guarantee future returns; your capital is at risk.

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Private Real Estate (Core)

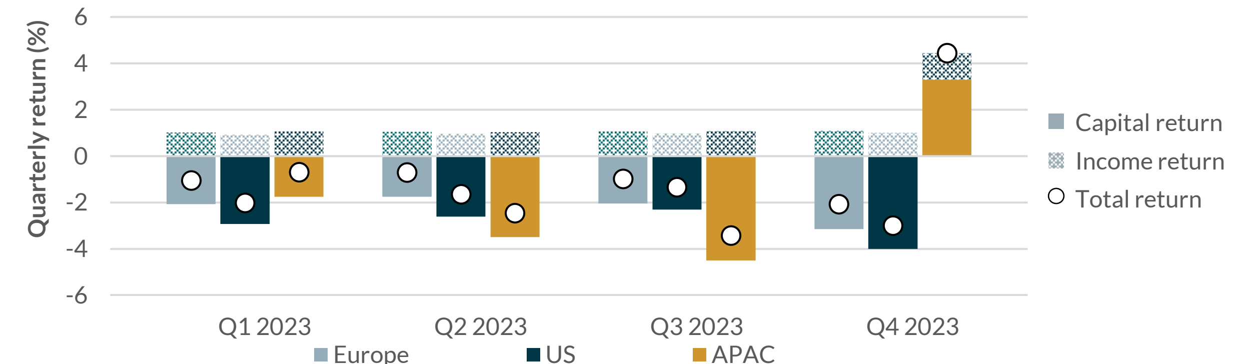
Performance Q4-'23: Another quarter of negative returns across regions

Despite easing inflationary pressure and interest rates falling during Q4, Global Core Private Real Estate ('PRE') posted again negative quarterly total returns. This isn't overly surprising however, as backward-looking appraisals, rising loan delinquency rates and ongoing redemption requests continue to put pressure on capital values. 2023 has been a very challenging year for Global Core PRE.

US Core PRE saw a total return of -3.0% over the fourth quarter, while European Core PRE returned -2.1%. Asia-Pacific Core PRE performance delivered +4.4% (-1.2% in local currency). In the US and Europe, downward repricing of the Office sector again served as the main performance detractor.

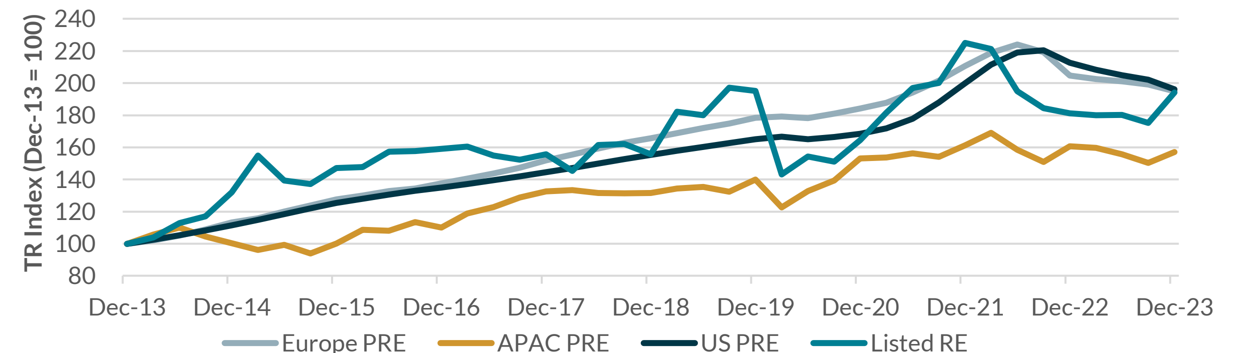
Over the long term, Global Core PRE and Global Listed Real Estate have performed in line. We recommend evaluating performance for this asset class over a long-term time horizon as private valuations tend to lag public markets and instruments tend to be less liquid.

1. Performance Private real estate



Source: MSCI Real Assets, Van Lanschot Kempen (Dec. 2023).

2. Performance Private real estate versus Listed real estate



Source: MSCI Real Assets, FTSE EPRA, Factset, Van Lanschot Kempen (Dec. 2023).

* US PRE: MSCI U.S. Quarterly Property index (Unfrozen), European PRE: MSCI Europe Quarterly Property Index (Unfrozen), APAC PRE: MSCI Global Quarterly Property index (Unfrozen) Asia-Pacific. Global Listed Real Estate: FTSE EPRA NAREIT Developed index. Performance is shown gross of fees, in local currency. See also Index definitions. Past performance does not guarantee future returns; your capital is at risk.

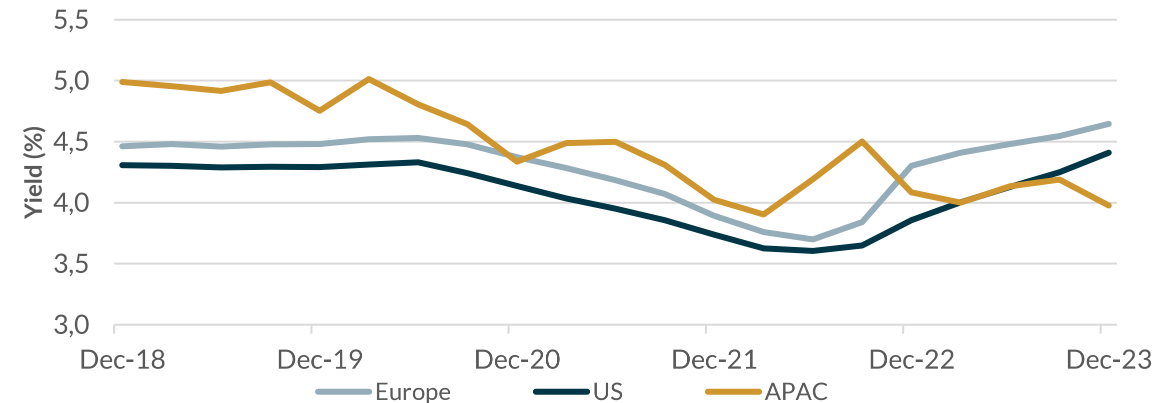
Private Real Estate (Core)

Current metrics: NOI yields stable around 4.5%, Cap rate spreads still tight

In terms of valuations, Net Operating Income (‘NOI’) yields in Core PRE, a proxy for gross income returns, average between 4-5%, with small increases in the US (+0.2%) and Europe (+0.1%) and a small decrease in APAC (-0.2% in USD terms).

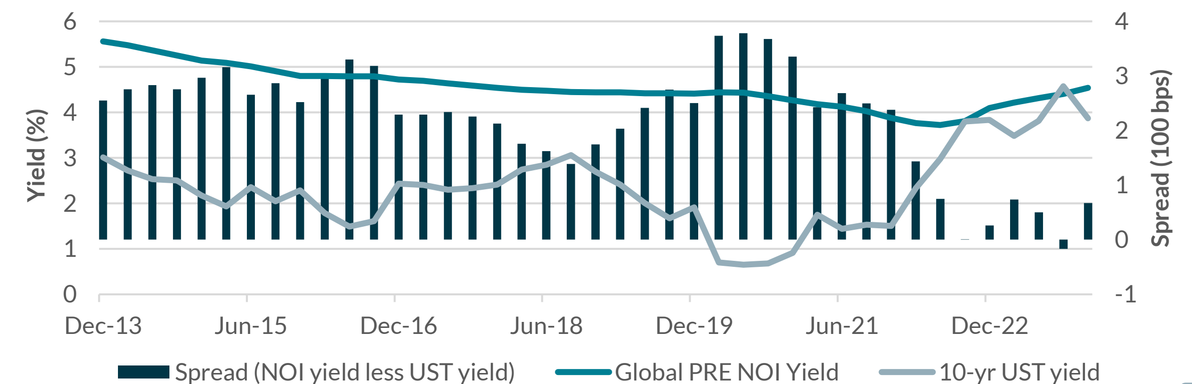
Another important valuation indicator for Core PRE is the capitalization rate (‘Cap rate’) spread, which measures the excess spread investors receive over ‘risk free’ government bonds. Cap rate spreads are currently 100 to 150bps too tight versus their long-term average. If government bond yields were to stabilize around current levels, we believe that cap rates will need to increase (e.g., NOI to increase and/or valuations to decrease) by at least 100bps. to lure investors into Core PRE again.

3. Valuations - NOI Yields stable around 4.5%



Source: MSCI Real Assets, FTSE EPRA, Van Lanschot Kempen (Dec. 2023).

4. Cap rate spreads are tight relative to their long-term history



Source: MSCI Real Assets, Capital Economics, Van Lanschot Kempen (Dec. 2023).

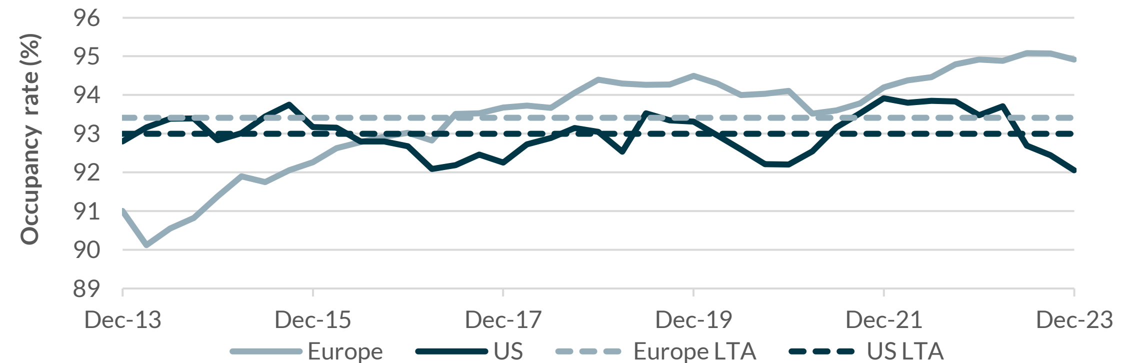
Private Real Estate (Core)

Outlook (6-12 months): Expect to find a bottom in the second half of 2024

Fundamentals in developed real estate markets remain strong as several sectors benefit from high occupancy rates amidst strong demand and low supply. While European occupancy rates remain well above their 10-year long-term average, US occupancy rates are soft in a historical context. This is mainly caused by Office sector occupancy rates declining to 82% as of year end (source: MSCI Real Assets).

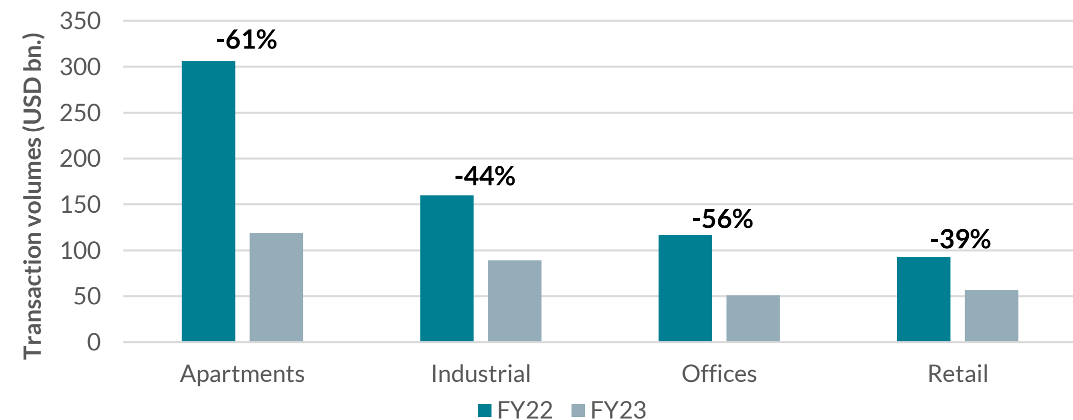
Amidst strong fundamentals, property prices that have corrected, and support from somewhat lower interest rates towards year-end, real estate could become interesting again. The mild rise in transaction volumes in Q4 across the EU and APAC might lead to some price stabilization, although transaction volumes have a seasonal peak in Q4. Price expectation gap analysis indicates that properties may need to fall another 5-15% across regions before transaction activity might normalize (source: MSCI Real Assets). As Core PRE provides little excess spread over 'risk free'' government bonds, we maintain our cautious stance on Core PRE.

5. Occupancy rates strong in Europe, softer in US



Source: MSCI Real Assets, FTSE EPRA, Van Lanschot Kempen (Dec. 2023).

6. Transaction volumes dropped sharply across US sectors in 2023



Source: MSCI Real Assets, Capital Economics, Van Lanschot Kempen (Dec. 2023).

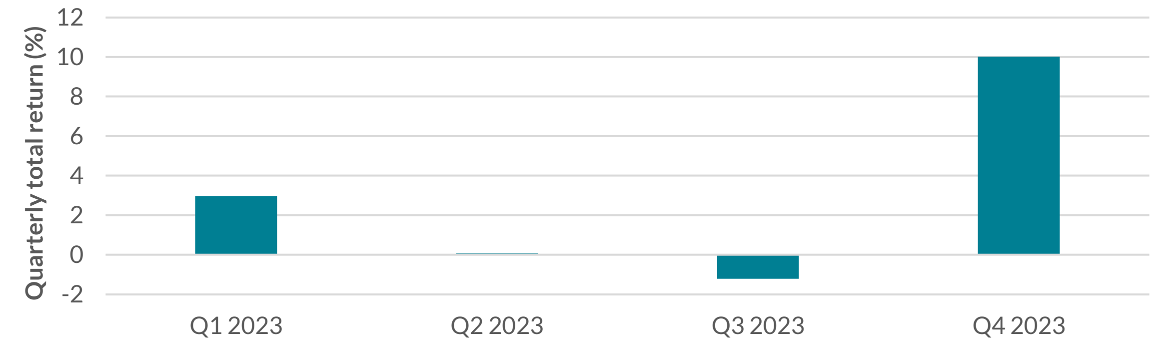
Private Infrastructure (Core/Core+)

Performance Q4-'23: Strong rebound in the fourth quarter

Despite a challenging 2023, Private Infra equity delivered a positive total return, evidencing the asset class's ability to "pass-through" higher inflation and its resilience to a higher interest rate environment. Private Infra equity returned 10.0% over the fourth quarter of 2023, compared to 11.1% for Global Listed Infra equity. This performance was in line with global developed equity markets during Q4. We recommend evaluating performance for this asset class over a long-term time horizon as private valuations tend to lag public markets and instruments tend to be less liquid. During Q4, the Transportation sector was the largest contributor to returns.

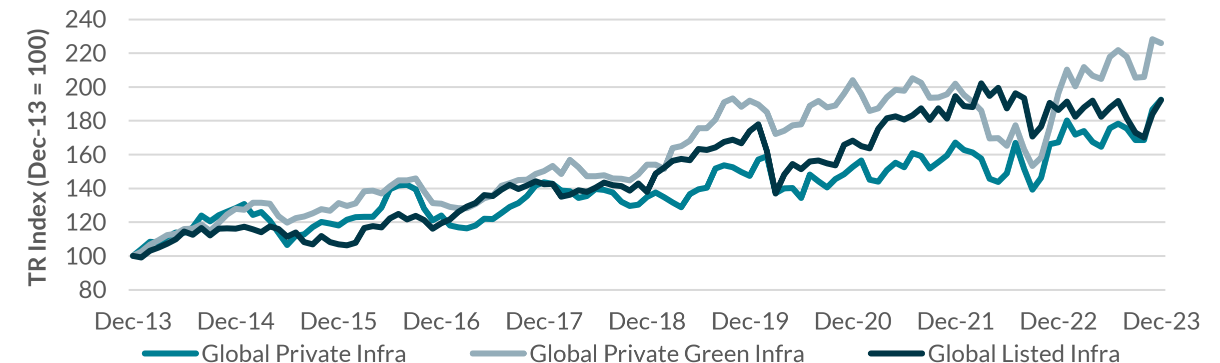
Over the long term, while Private Infra equity and Listed Infra equity have performed in line, while Private Green Infra equity, currently mainly consisting of contracted wind power generation projects across Europe, has strongly outperformed both.

7. Performance Private infra equity



Source: Scientific Infra and Private Assets Pte Ltd., FTSE, Van Lanschot Kempen (Dec. 2023).

8. Performance Infrastructure (private versus listed)



Source: Scientific Infra and Private Assets Pte Ltd, FTSE, Van Lanschot Kempen (Dec. 2023).

* Global Private Infra (equity): EDHEC Infra300 index, Global Private Green Infra (equity): EDHEC InfraGreen index, Global Listed Infrastructure (equity): FTSE Global Core Infrastructure 50/50 index. Performance is shown gross of fees, in local currency. See also Index definitions. Past performance does not guarantee future returns; your capital is at risk.

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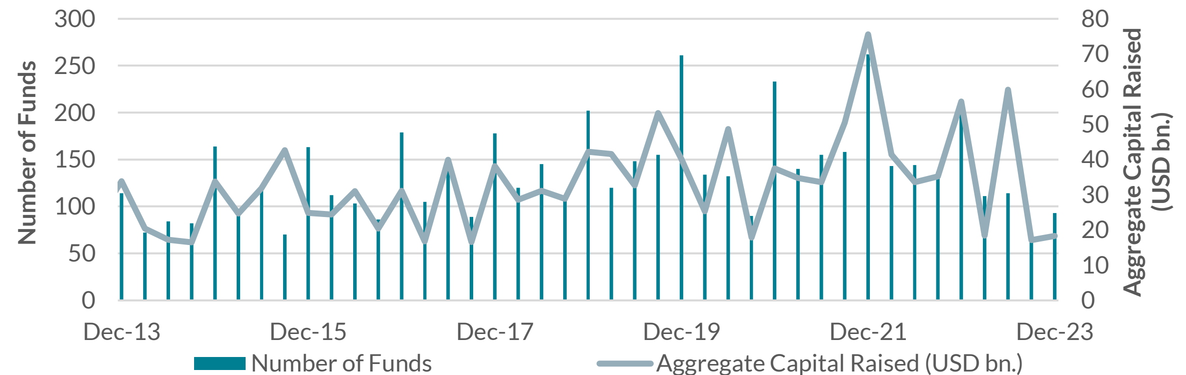
Private Infrastructure (Core/Core+)

Current metrics: Fundraising low, deal activity skewed to Renewables

Private Infra equity fundraising was challenging in 2023, coming in around 90bn. USD, a drop of 40-50% versus 2022 and mostly driven by a strong pick-up in Q4 2023 (around 69bn. USD). The slowdown in fundraising in 2023 was largely due to macro-economic uncertainty, a wedge in asset valuations between buyers and sellers, and the denominator effect.

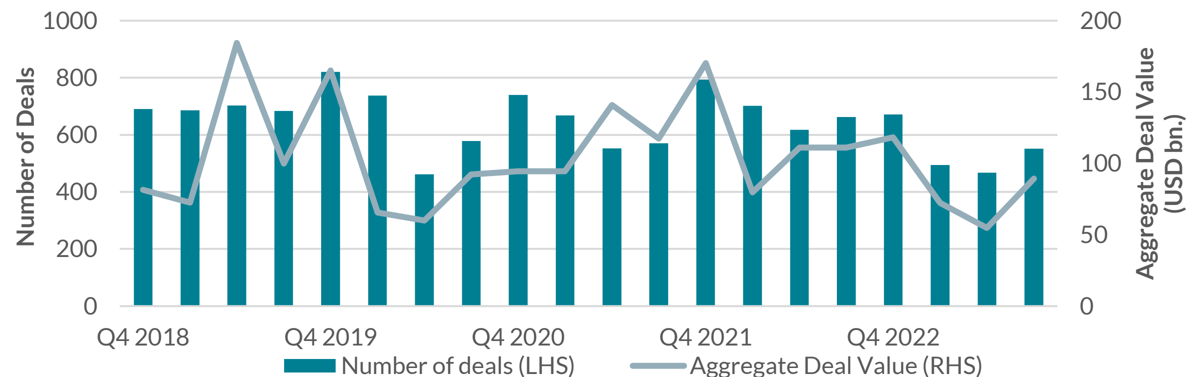
Deal activity also saw a slowdown in 2023 due to the rise in interest rates (higher cost of financing deals). Renewables (e.g., solar and wind farms) and Digital infrastructure (e.g., data centers) took a relatively large share in overall deal-making in 2023 (source: Infralogic). Global renewables capacity increased by 50% over 2023 and governments' increased attention to develop renewable energy projects has created several investment opportunities.

9. Fundraising Private Infra has slowed considerably in 2023



Source: Preqin, Van Lanschot Kempen (Dec. 2023).

10. Deal activity Private Infra also relatively low versus previous years



Source: Preqin, Van Lanschot Kempen (Dec. 2023).

Private Infrastructure (Core/Core+)

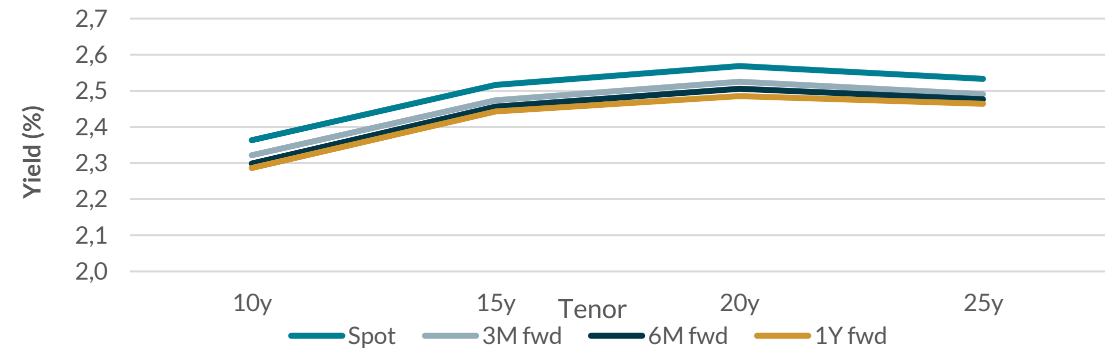
Outlook (6-12 months): Rates may stabilize while valuations are attractive

For 2024 we see an improved outlook for Private Infra equity. We expect to see fundraising and deal activity to pick up over the year as interest rates start to come down somewhat and the denominator effect diminishes after a strong public market rally. The asset class benefits from a strong pass-through mechanism, in case inflation would remain structurally higher. Furthermore, valuations in Private Infra equity look compelling (EV/EBITDA around decade lows, at 10.5x) and seem to price in a higher interest rate environment (source: Scientific Infra).

Infrastructure also benefits from several structural tailwinds, such as a global need for infrastructure investment over the next decade (e.g., supported by the European Green Deal). At a sector level, we retain our view that long-term, structural themes such as the energy transition and increased adoption of new technology such as AI and machine learning will act as tailwinds for Renewables and Digital infrastructure.

Overall, we remain moderately positive on the asset class.

11. Forward markets see interest rates slightly lower in a year's time



Source: Refinitiv, Van Lanschot Kempen (4 Apr. 2024) Forward curve for German government bonds, same trend applies for US Treasury government bonds.

12. Valuations Private infra are close to decade lows

Source: Scientific Infra and Private Assets Pte Ltd, Van Lanschot Kempen (Dec 2023).

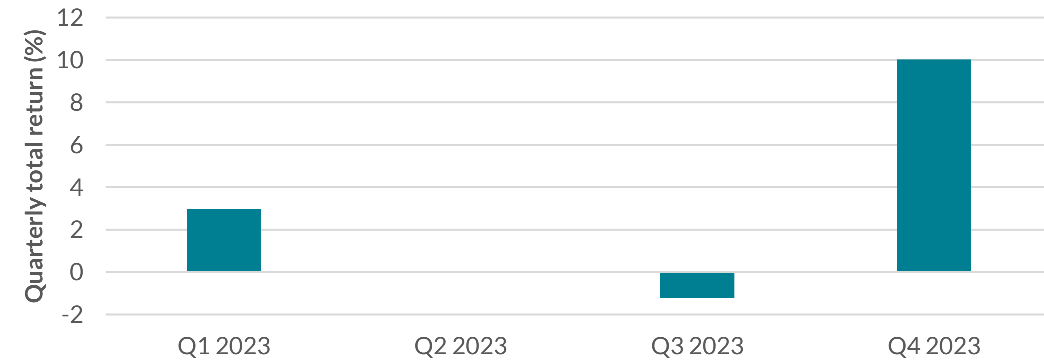
Private Farmland

Performance Q4-’23: Strong performance, driven by seasonal income

Private Farmland (equity) returned +2.3% over the fourth quarter of 2023, which resulted in a total return of +5.0% over 2023 for this asset class. Q4 performance was mainly driven by seasonally strong income returns, with a significant proportion of crops’ income marked in the fourth quarter. Over the past years, Farmland values have risen as inflation rose and competition for high-quality cropland intensified amidst limited supply of new arable land and food scarcity.

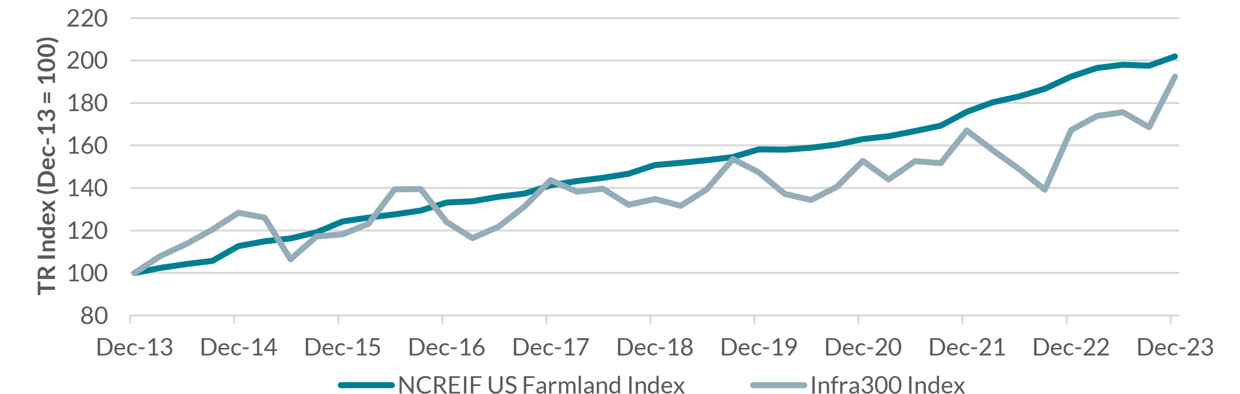
Private Farmland has historically delivered stable returns with low volatility. On a relative basis, Private Farmland has marginally outperformed Private Infrastructure over the last decade, with significantly lower volatility. It is worth keeping in mind though that infrastructure investments tend to operate with greater leverage, which has an impact on overall returns. We recommend evaluating performance for this asset class over a long-term time horizon as private valuations tend to lag public markets and instruments tend to be less liquid.

13. Performance Private farmland



Source: NCREIF, Van Lanschot Kempen (Dec. 2023).

14. Performance Private Farmland (relative to Private Infra)



Source: NCREIF, FTSE, Van Lanschot Kempen (Dec. 2023).

* US Private Farmland (equity): NCREIF Farmland Property index, Performance is shown gross of fees, in USD. Past performance does not guarantee future returns; your capital is at risk.

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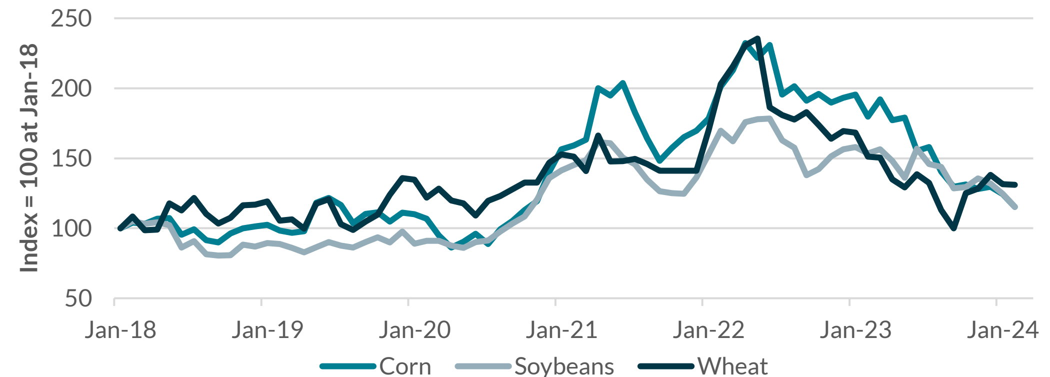
Private Farmland

Current metrics: Food prices continue to decrease, due to excess supply

Food prices have continued to fall at the start of 2024, which is partially attributable to greater than expected market supply. Exports from Ukraine, one of the world's largest grain exporters, have experienced a notable uptick in recent months, reaching record levels of export volumes in February. This is despite the ongoing conflict in Ukraine. The U.S. Department of Agriculture has raised Ukraine's 2023-24 estimated corn and wheat exports for a second and fifth straight consecutive month, respectively. This, combined with increased Russian exports, has resulted in a significant surplus of grain exports from the Black Sea region versus market expectations.

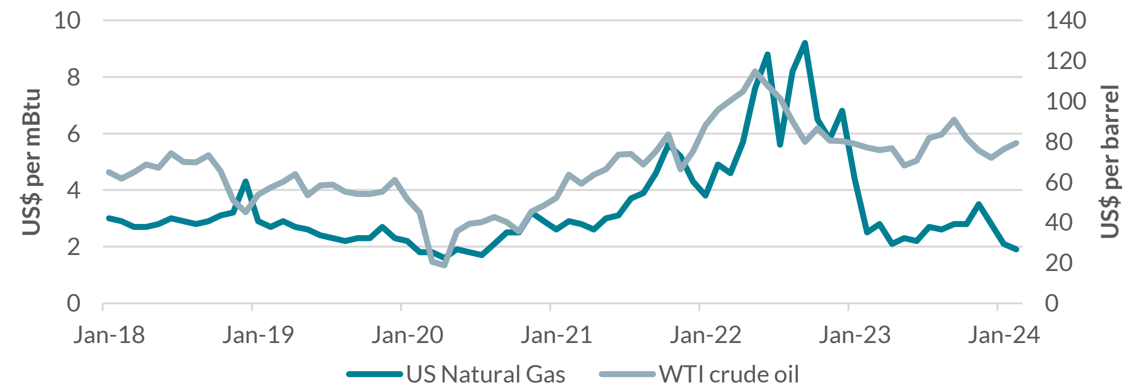
However, the impact of falling food/crop prices on farmers' profitability has been partially mitigated by lower energy costs. The price of natural gas, which is a key input to produce fertiliser, has continued to trend downwards at the start of 2024. Fuel costs have also moderated in recent months, despite the ongoing tensions in the Middle East and OPEC decisions to limit supply.

15. Agricultural crop prices



Source: Factset, Capital Economics, Van Lanschot Kempen (Dec. 2023).

16. Energy prices have been trending down in recent years



Source: Factset, Capital Economics, Van Lanschot Kempen (Dec. 2023).

Private Farmland

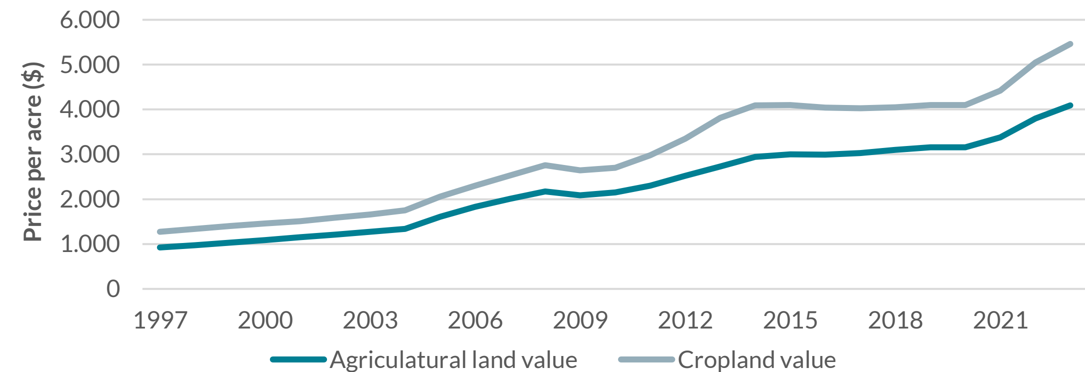
Outlook (6-12 months): Retain positive view, some uncertainty short-term

Market expectations of policy rate cuts in the second half of 2024 will support farmland prices, help to reduce financing costs (interest expenses) and improve liquidity. However, short-term climate-related headwinds remain.

Whilst the 2023-24 El Niño weather pattern is estimated to have peaked in December 2023, uncertainty remains surrounding the La Niña weather pattern, which could cause further extreme weather in the second half of 2024 and impact wheat and corn production in the US, as well as soybean and corn production in South America.

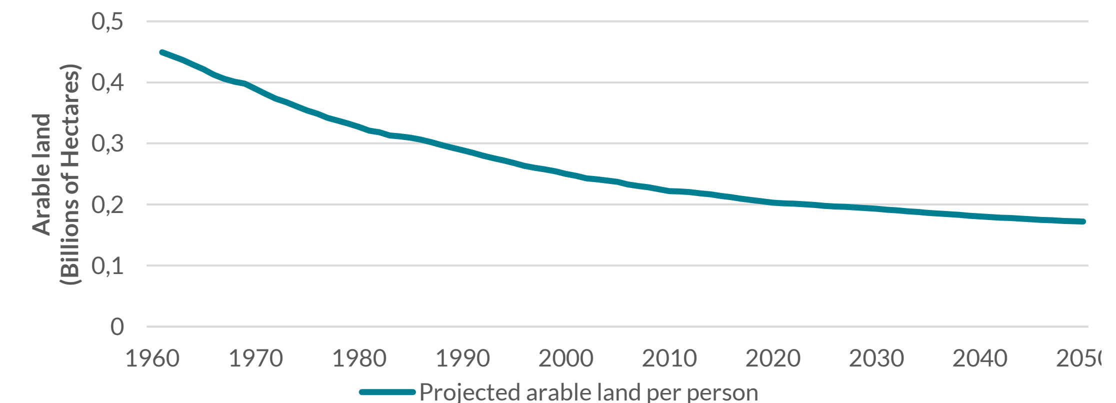
Agricultural land and cropland values have continued to sharply increase in recent years, helped by positive longer-term secular trends for the asset class. The impact of an increasing global population (need for food) and urbanisation (reducing total arable land) will continue to put upward pressure on farmland values. We remain moderately positive on the asset class.

17. US land and cropland values have risen sharply in recent years



Source: USDA, The World Bank, Van Lanschot Kempen.

18. Global arable land per person projected to continue decreasing



Source: FOA, The World Bank, Van Lanschot Kempen.

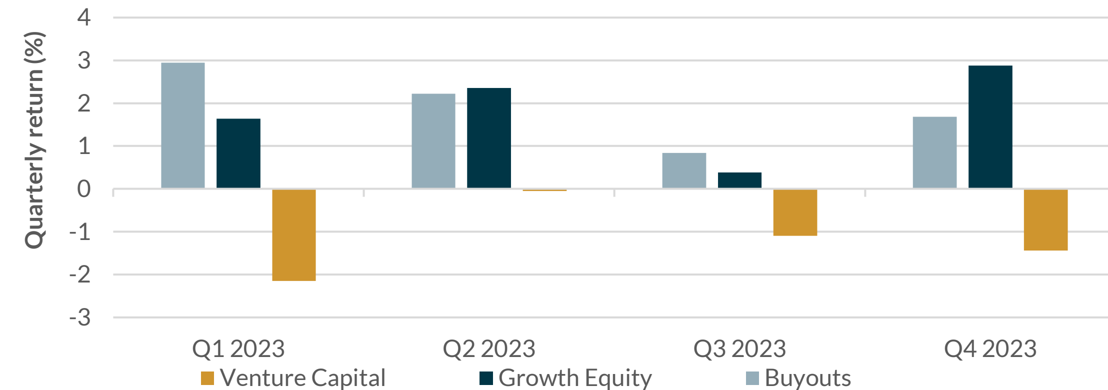
Private Equity

Performance Q4-’23: Growth equity outperforms Buyouts and Venture

Private equity (‘PE’) delivered positive Q4-’23 returns (+1.5%): Growth Equity (+2.9%) was the strongest performing sector, followed by Buyouts (+1.7%) and Venture capital (-1.4%). PE firms face considerable headwinds from the uncertain macro-economic environment, an asset valuation wedge between buyers and sellers due to a fast rise in interest rates, and end investors (‘LPs’) demanding liquidity in a (still) dormant exit environment.

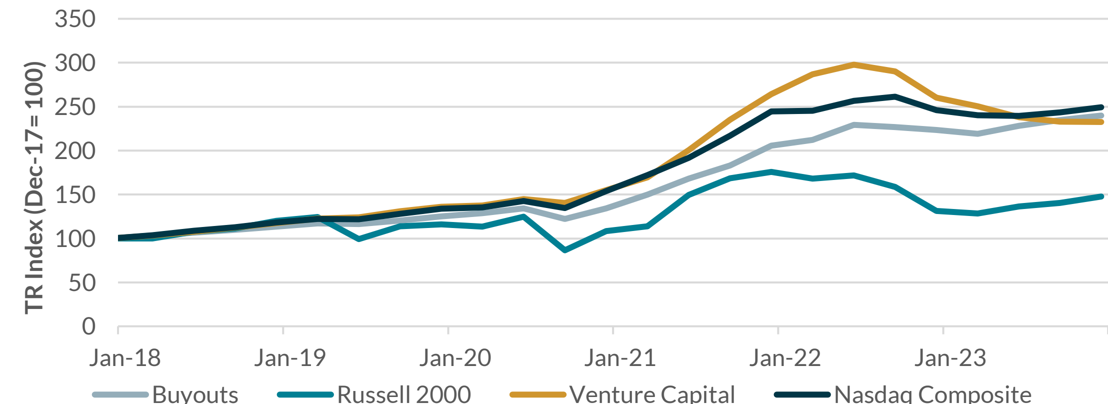
Despite its relatively weaker performance versus public markets in 2023, Buyouts have strongly outperformed their listed equity comps (US small caps, Russell 2000 index) over the past five years. Performance for Venture capital was close to the Nasdaq Composite (US growth stocks). We recommend to evaluate Private Equity performance on a long-term horizon as valuations tend to lag public markets and instruments are less liquid.

19. Performance Private equity



Source: Preqin, Van Lanschot Kempen (Dec. 2023)..

20. Performance Private Equity versus Listed Equity



Source: Preqin, Van Lanschot Kempen (Dec. 2023).

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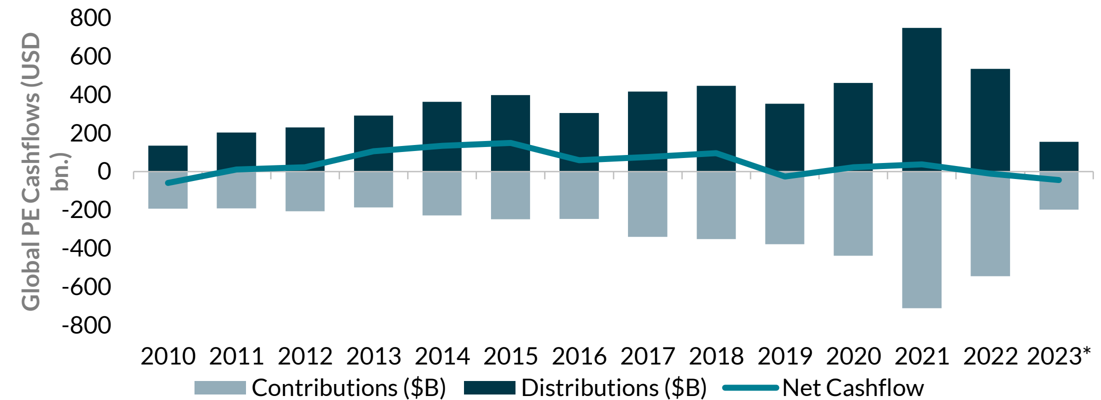
Private Equity

Current metrics: Negative net cashflow, buoyant secondary market

During the past quarters, PE managers held out to achieve better exit valuations, which led to a significant decline in deal- and exit activity. Private equity's ratio of (number of) exits relative to investments has continued to fall to multi-year lows (0.36x for US, 0.41x for EU). Also in value terms, exit activity sits near decade lows.

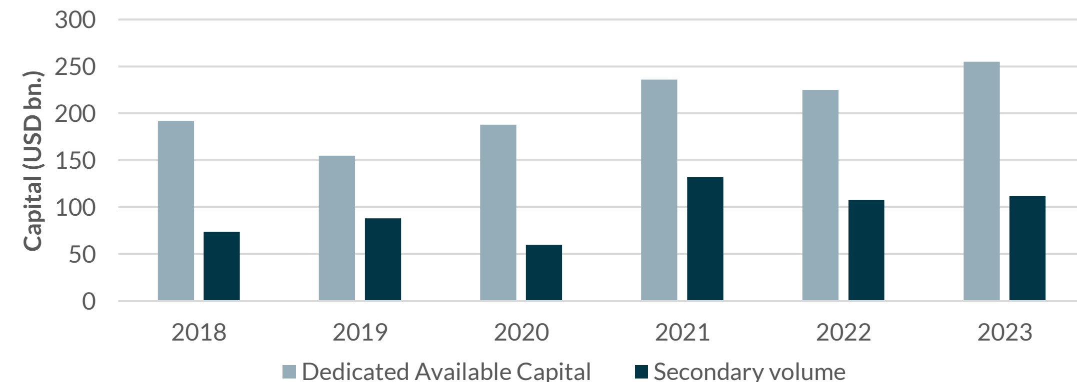
For fully invested funds, longer holding periods have led to lower cashflow distributions to LPs. As some LPs needed liquidity to fund previously made capital commitments and/or rebalance their portfolio, some PE managers were under pressure to 'engineer' exits, such as through the secondary market. This created compelling investment opportunities in the secondary market, which recorded its second-highest transaction volume in history (112 USD bn.) in 2023, with average pricing for LP portfolios around 85% of NAV (source: Jefferies). Future fundraising will also depend on PE managers being able to return cash to LPs.

21. Global PE Cashflow distributions to LPs still net negative



Source: Pitchbook, Van Lanschot Kempen (Dec. 2023).

22. Global PE Secondary market is buoyant



Source: Preqin, Jefferies, Van Lanschot Kempen (Dec. 2023).

Private Equity

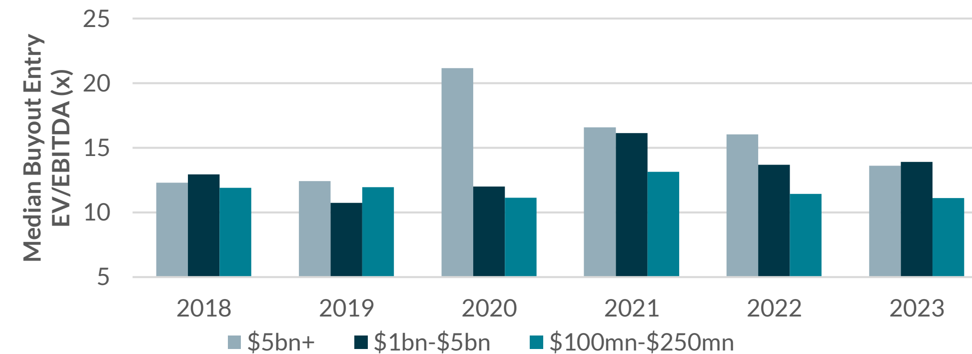
Outlook (6-12 months): 2024 likely a better year, if exit activity recovers

We believe that 2024 will be a better year for private equity as better visibility on economic growth and some moderation in policy rates may support a pick-up in exit activity. There are already some tentative signs of a recovery in the PE market:

- The valuation gap between buyers and sellers seems to have narrowed as public markets have performed and valuation multiples have softened to more compelling levels (e.g., EV/EBITDA to ~ 11,1x for smaller deals);
- Leverage continues to decline, as managers focus on optimizing operational performance rather than financial leverage. Average debt contribution has fallen to ~44%;
- M&A and IPO market activity is slowly picking up again, broadening the number of exit opportunities.

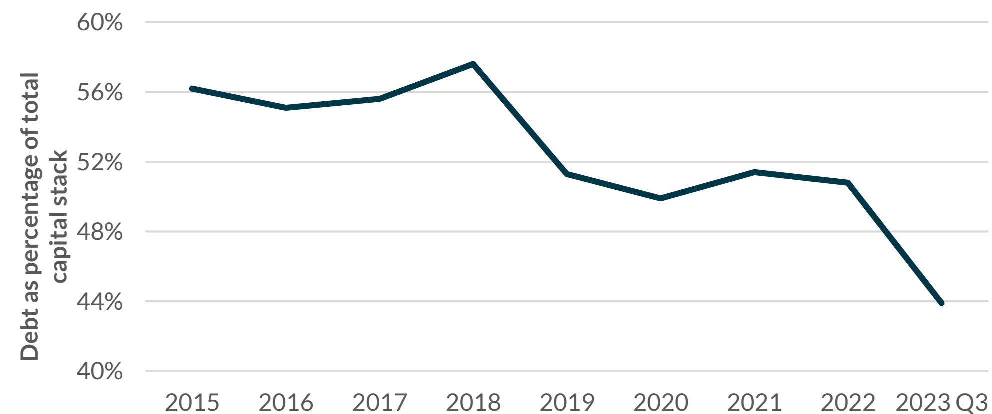
While we remain cautious on Private Equity (particularly on large buyout funds), we note that there might be compelling opportunities in smaller PE deals given lower entry multiples and greater operational value creation potential.

23. Valuations stable, smaller deals trade at more compelling multiples



Source: Pitchbook, Van Lanschot Kempen (Dec. 2023).

24. Deal leverage has continued to decline as debt became expensive



Source: Pitchbook, Van Lanschot Kempen (Dec. 2023).

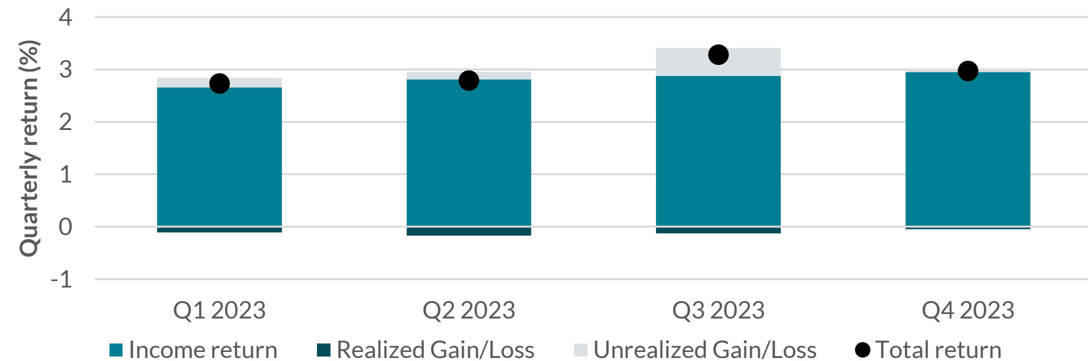
Corporate Direct Lending

Performance Q4-’23: High stable income, outperforming Leveraged Loans

US (senior secured, sponsor-led, middle market) Corporate direct lending returned +3.0% over the fourth quarter of 2023*. Total return was fully attributable to its coupon return (+3.0%). Asset classes with floating rate coupons (e.g., Corporate direct lending, Leveraged loans) currently deliver relatively high income, thanks to elevated policy rates. Benefits of Corporate direct lending are for instance that direct lenders can provide more flexibility to underwrite and assist different types of borrowers and can in turn negotiate relatively stronger covenant protections, potentially securing higher recovery rates than with syndicated Leveraged loans.

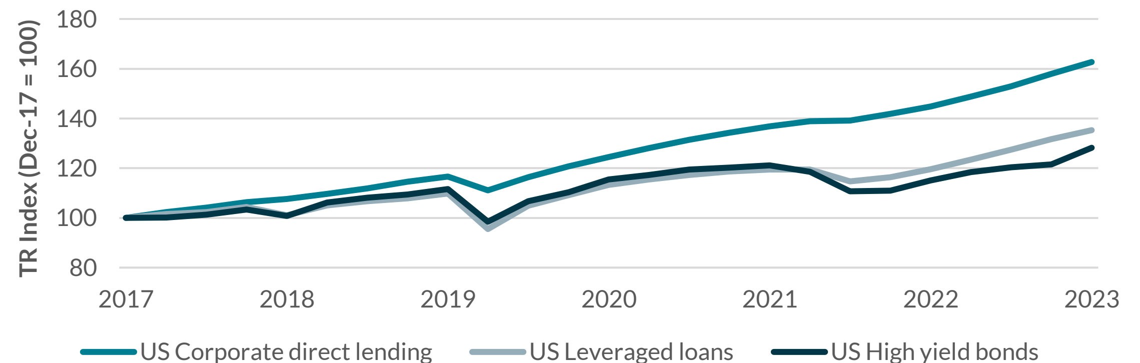
During Q4-’23, US Corporate direct lending (+3.0%) underperformed US High yield corporate bonds (+7.1%) and performed in line with US Leveraged loans (+2.8%). However, on a longer horizon US Corporate direct lending has outperformed both other categories.

25. Performance Corporate direct lending



Source: Cliffwater, Van Lanschot Kempen (Dec. 2023).

26. Performance versus High yield bonds and Leveraged loans



Source: Cliffwater, ICE BofA, JP Morgan, Van Lanschot Kempen (Dec 2023).

* Corporate Direct Lending: Cliffwater CDLI-S Index, US High Yield: ICE BofA US High Yield Master II Index (H0A0), US Leveraged loans: JP Morgan Leveraged Loan index. Returns in USD. See also Index definitions. Past performance does not guarantee future returns; your capital is at risk.

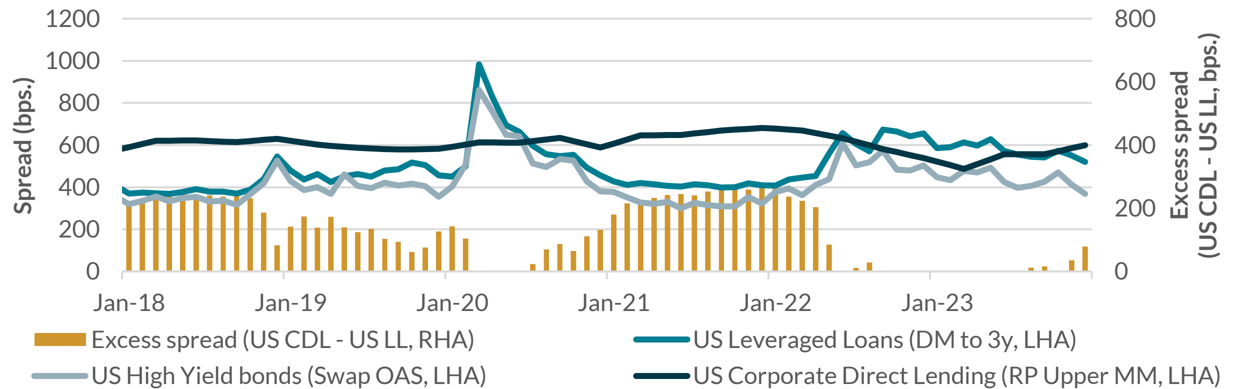
Corporate Direct Lending

Current metrics: Spreads and default rates around long-term average

Yields on US Corporate direct lending remain high, around 11.7% (unlevered), thanks to high policy rates. However, spreads (~600bps.) are close to their long-term average and only slightly wider than US Leveraged loans (521bps.), as competition between private lenders to deploy capital has increased. US High yield bonds screen as relatively tight (363bps.), despite their higher credit quality.

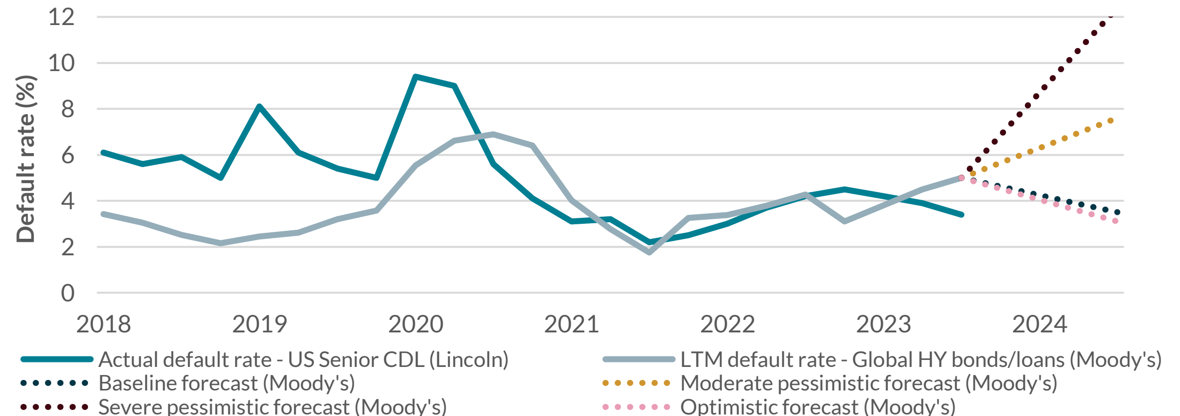
The default rate environment is expected to remain benign, although we still expect some deterioration due the lagged effects of restrictive monetary policy. For US Corporate direct lending the actual default rate fell to 3.4% per year-end. Direct lenders may have stronger covenants, but (unlike Leveraged loans) also assume greater latitude in determining if restructurings count towards the default rate. Besides, direct lenders have offered borrowers the option to switch to PIK interest (paying interest in additional debt instead of cash) and have been willing to provide equity infusions, to stave off defaults, for now.

27. Valuations - Corporate direct lending spread a bit wider in Q4



Source: Cliffwater, ICE BofA, JP Morgan, Van Lanschot Kempen (Dec. 2023).

28. Speculative-grade corporate default rates – actual and forecasts*



Source: Moody's Investor Services, Lincoln, Van Lanschot Kempen (Dec. 2023).

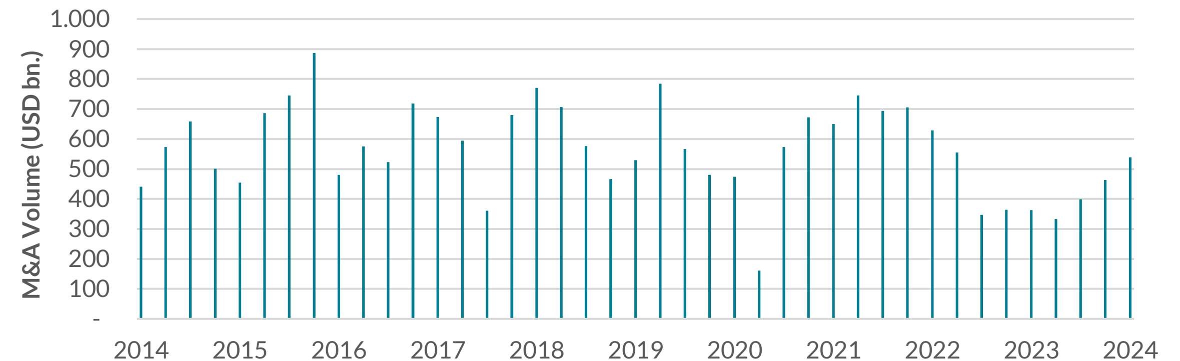
Corporate Direct Lending

Outlook (6-12 months): Strong competition for a growing opportunity set

With an estimated 200 USD bn. in dry powder waiting to be invested (source: Preqin) amidst tighter public market spreads, we expect that the excess spread versus leveraged loans will remain under pressure. While the elevated yield is a strong tailwind for future total returns, the peak in policy rates is likely behind us and thus we expect that the appeal of floating rate coupons will dissipate.

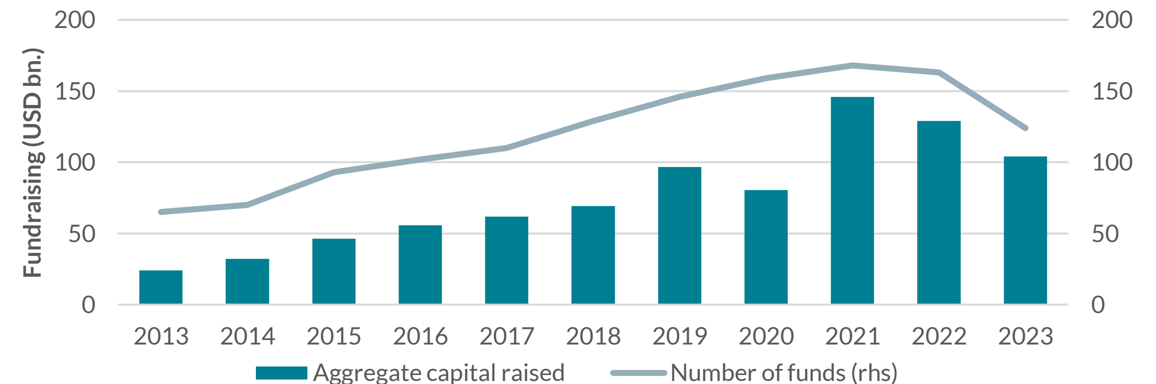
Better visibility on the macro environment and a rebirth of M&A activity could help to expand the opportunity set in the next quarters. Further European bank disintermediation will underpin Corporate direct lending growth in the long term. Modest Eurozone growth expectations and elevated policy rates imply that overall credit quality for speculative-grade borrowers could decline somewhat during 2024, but we do not expect default rates to spike. With spreads near their long-term average and only slightly above leveraged loans, we maintain our Neutral view on this asset class.

29. M&A activity is picking up again



Source: Factset, Van Lanschot Kempen (Dec. 2023).

30. Fundraising for US Corporate direct lending still elevated



Source: Preqin, Van Lanschot Kempen (Dec. 2023).

* Corporate Direct Lending: Lincoln Senior Debt index, 12 month Global speculative-grade corporate default rate (including distressed exchanges) and forecast: Moody's Investor Services.

Structured Credit

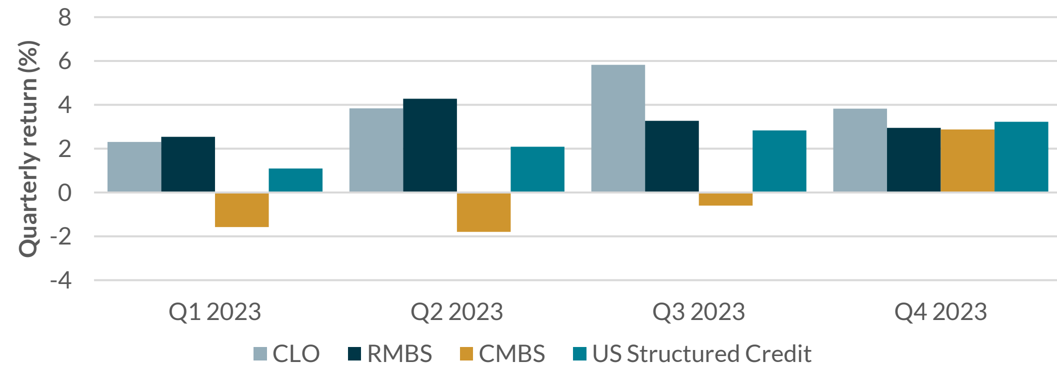
Performance Q4-'23: Positive return across sectors, including CMBS

Structured credit (US private sector, mezzanine) performed strongly (+3.2%) over the fourth quarter, partially driven by the first positive quarterly performance in CMBS (+2.9%) in 2 years' time. US BBB CLOs were the best performing sector in 2023 with a total return of 18.9%*.

CMBS spreads widened until end October due to fears over refinancing risk and credit losses in commercial real estate (Offices in particular) after 10-year Treasury yields approached 5%. That trend reversed when the Fed guided on Nov 1st for more aggressive easing; 10-year Treasury yields fell to 3.8% and the likelihood of a US 'soft landing' increased. This led to more calm in the CMBS market again.

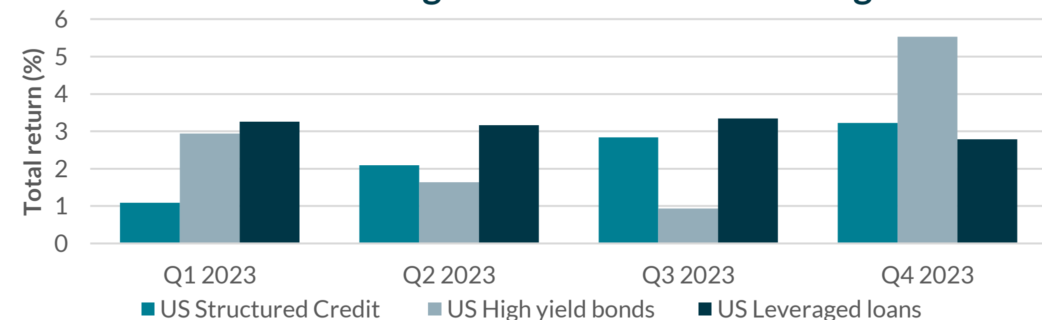
On a relative basis, Structured credit performed better over Q4-'23 than US Leveraged loans (+2.8%) while underperforming US High Yield corporate bonds* (+5.5%).

31. Performance Structured credit



Source: JP Morgan, ICE BofA, Citi, Van Lanschot Kempen (Dec. 2023).

32. Performance versus High Yield bonds and Leveraged loans



Source: JP Morgan, ICE BofA, Citi, Van Lanschot Kempen (Dec. 2023).

* Structured Credit: focus on BBB rated, thus an equally weighted proxy of JP Morgan CLOIE BBB index (US BBB CLOs), ICE BofA US BBB CMBS index (CB40) and Citi US non-agency RMBS CRT M2 securities (US BB RMBS). US High Yield: ICE BofA US HY Constrained (0-5 Y)(BB-B) index (H4CD), US Leveraged loans: JP Morgan Leveraged Loan index. CLOs are Collateralized Loan Obligations, RMBS are Residential Mortgage-backed Securities and CMBS are Commercial Mortgage-backed Securities. See also Index definitions. Past performance does not guarantee future returns; your capital is at risk.

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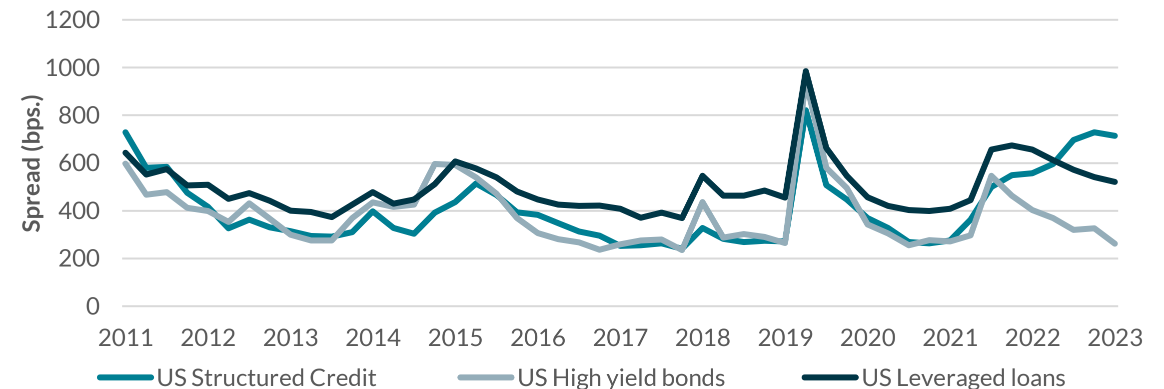
Structured Credit

Current metrics: Spreads flattish, bifurcation between sectors still high

During the fourth quarter, US High Yield corporate bonds* and US leveraged loan spreads tightened to 262 bps. and 521 bps. (respectively). A continued strong demand for yield and the increased likelihood of a 'soft landing', meant that high yield spreads tightened towards historically low levels. Structured credit spreads tightened to 714 bps. Bifurcation between Structured credit sectors remains high: spreads on US BBB CLOs and US BB Non-agency RMBS tightened to 409 bps. and 384 bps. respectively, while US BBB CMBS spreads widened further, to 1349 bps.

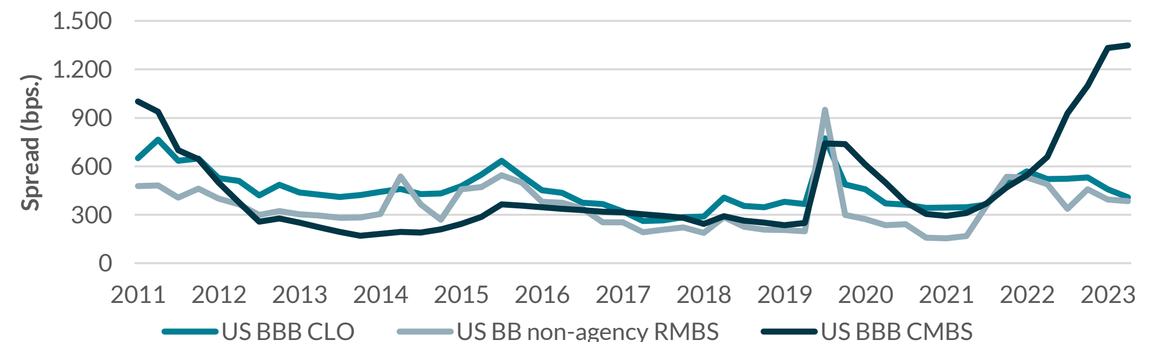
Fundamentals in US RMBS remain relatively strong: negative net supply of homes has driven a continued rise in housing prices (e.g., S&P CoreLogic Case-Shiller 20-City composite index up ~5% year-on-year). Many home-owners are 'locked into' their mortgage as the effective US mortgage rate rose further, to 3.8% at year-end. This may also explain the continued strong credit performance on residential mortgage loans, with late delinquency rates around 0.8%.

33. Valuations – spreads wider than similar-rated corporate exposure..



Source: JP Morgan, ICE BofA, Citi, Van Lanschot Kempen (Dec. 2023).

34. ...but these elevated spreads are mainly driven by stress in US CMBS



Source: : JP Morgan, ICE BofA, Citi, Van Lanschot Kempen (Dec. 2023).

* Structured Credit: equally weighted proxy of JP Morgan CLOIE BBB index (US BBB CLOs), ICE BofA US BBB CMBS index (CB40) and Citi US non-agency RMBS CRT M2 securities (US BB RMBS). US High Yield: ICE BofA US HY Constrained (0-5 Y)(BB-B) index (H4CD), US Leveraged loans: JP Morgan Leveraged Loan index. See also Index definitions.

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Structured Credit

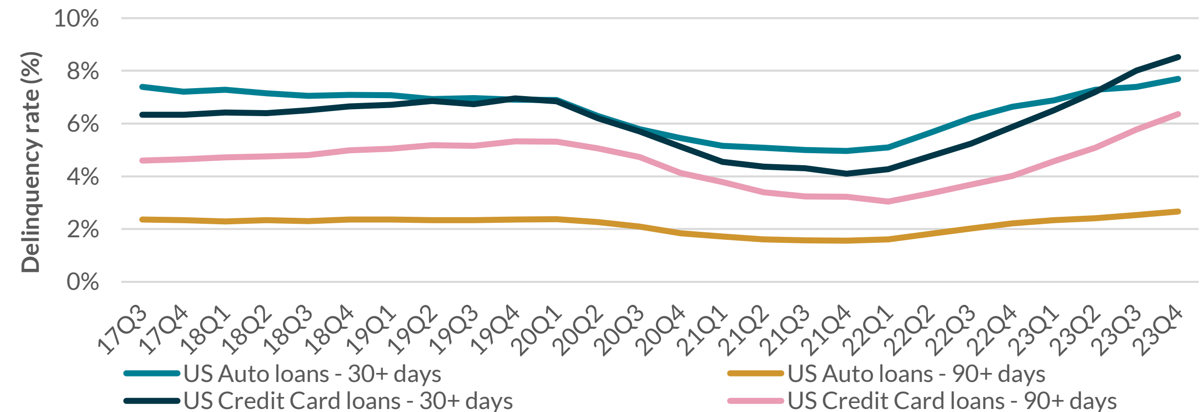
Outlook (6-12 months): Some segments require close monitoring

Fundamentals in US CLOs remain in line, as underlying leverage loan performance remains strong and liability spreads have tightened. Credit default rates in leveraged loans remain close to their long-term average of 3.0%.

In US Consumer ABS, higher credit risk segments such as auto loans to subprime borrowers and unsecured consumer loans (e.g., credit cards) continue to face deteriorating credit performance as consumer finances are under pressure from still elevated inflation. However, structural protection within the ABS structures has so far helped to offset weaker loan credit performance.

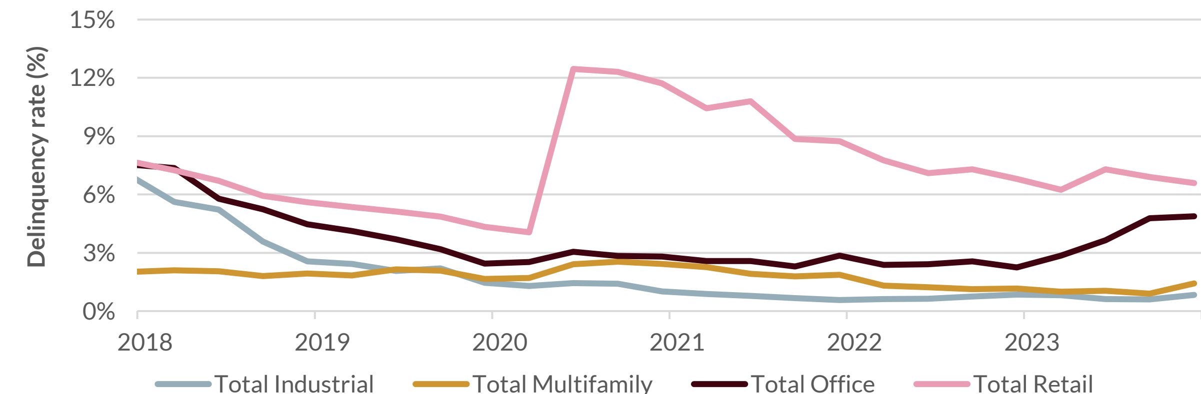
As spreads in most US Structured Credit sectors have tightened back to their long-term averages and CMBS trades wide due its weaker fundamentals, we have changed our view on the asset class back to Neutral.

35. US Credit card and Auto loans' delinquencies continue to rise



Source: US NY Fed, Van Lanschot Kempen (Dec. 2023).

36. US CMBS delinquency rates rose mainly in the Office sector



Source: JP Morgan, Van Lanschot Kempen (Dec. 2023).

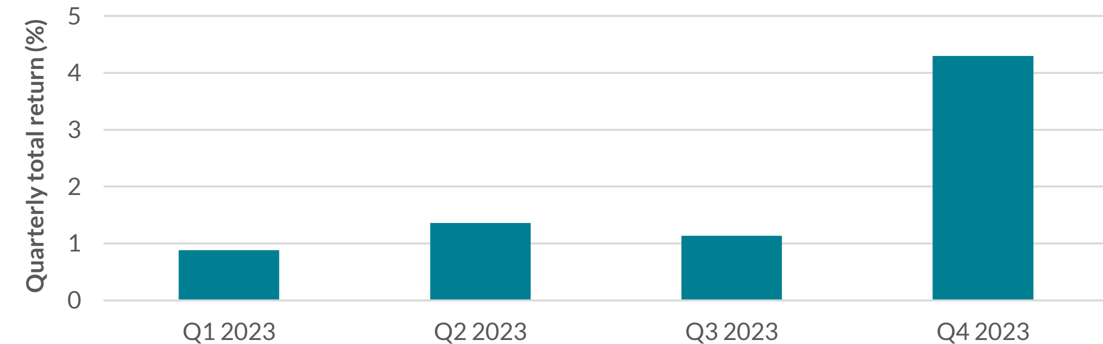
Corporate Distressed Debt

Performance Q4-'23: Strong absolute return after three mild quarters

Corporate distressed debt performed strongly over the fourth quarter of 2023, returning +4.3% (2023: +7.9%), helped by strong public market performance*. On a relative basis, Corporate distressed debt outperformed US Leveraged loans (+2.8%) in Q4 and underperformed US High yield corporate bonds (+7.1%).

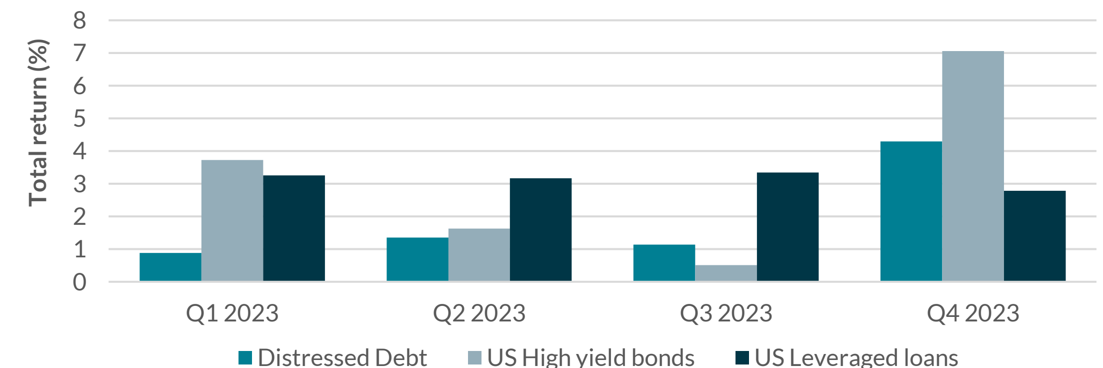
While market consensus early on in 2023 was for a (shallow) recession, the US economy was quite resilient over the last quarters thanks to strong consumer spending and continued fiscal stimulus from the US government. This led to a strong rally in equity and credit markets and a less appealing distressed opportunity set. Major sectors in the distressed opportunity set are Healthcare, Media and Telecoms. Covid-19 has accelerated many secular themes in Healthcare, leading to winners and losers much faster than most investors were expecting.

37. Performance Distressed debt



Source: HFR, Van Lanschot Kempen (Dec. 2023).

38. Relative performance versus High Yield bonds and Leveraged loans



Source: HFR, ICE BofA, JP Morgan, Van Lanschot Kempen (Dec. 2023).

* Distressed Debt: HFRI Event Driven: Distressed/Restructuring Index, US High Yield: ICE BofA US High Yield Master II Index (H0A0), US Leveraged loans: JP Morgan Leveraged Loan index. See also Index definitions. Past performance does not guarantee future returns; your capital is at risk.

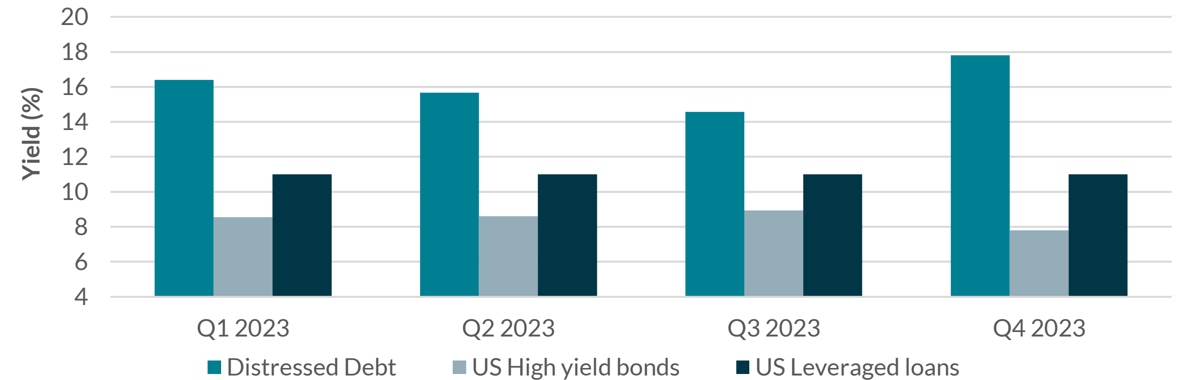
Corporate Distressed Debt

Current metrics: Excess yield remains high, defaults may rise further

Per the end of the fourth quarter, the yield on the Corporate distressed debt opportunity set (~18%) is still significantly higher than yields on US High yield bonds (~8%) and US Leveraged loans (~11%). Yields on Corporate distressed debt are higher to compensate for its typically higher credit default, illiquidity and litigation risk.

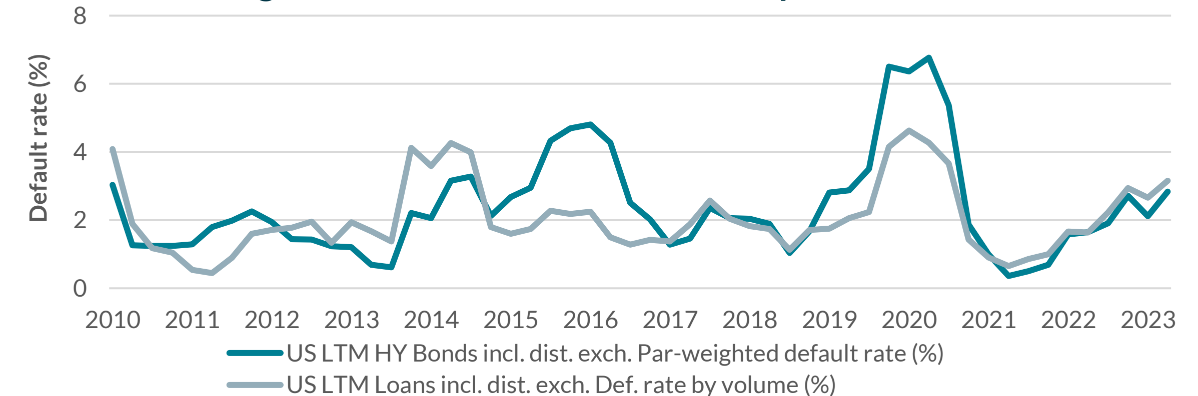
With base rates still materially higher than 24 months ago, the cost of capital has almost doubled for many companies; this has resulted in default rates (including distressed exchanges) trending higher for US High yield bonds and US Leveraged loans, ending the year at 2.8% and 3.2% respectively (versus 1.7% at the end of 2022). There is no reason to expect a spike in default rates though. Another trend has been the surge in distressed exchanges as most low-rated loan issuers are backed by Private equity, who favor distressed exchanges to preserve more equity.

39. Excess yields on Distressed debt opportunity set remains significant



Source: ICE BofA, JP Morgan, Van Lanschot Kempen (Dec. 2023).

40. As financing cost are elevated, defaults may rise further



Source: JP Morgan, Van Lanschot Kempen (Dec. 2023).

Corporate Distressed Debt

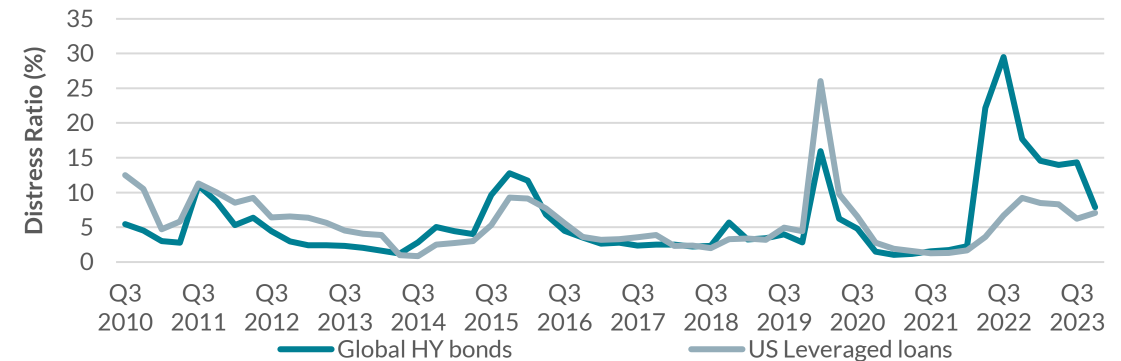
Outlook (6-12 months): Plenty good companies with bad balance sheets

With US GDP growth expected to slow in 2024, companies financed with high leverage (at previously low cost) will continue to face elevated borrowing costs. This should bring opportunities to refinance and/or restructure good companies with bad balance sheets.

The Distressed debt ratio, an indicator that has anticipated several default peaks in the past, declined considerably over the last quarters. The jury is out if this is a sign of market complacency: in 2007, distress ratios were also very low while at the onset of the GFC. In US Leveraged loans, there are still two credit rating downgrades for every upgrade (even worse for lowest-rated loan borrowers) and there is an impending maturity wall starting in 2025. Actual default rates are close to their long-term average.

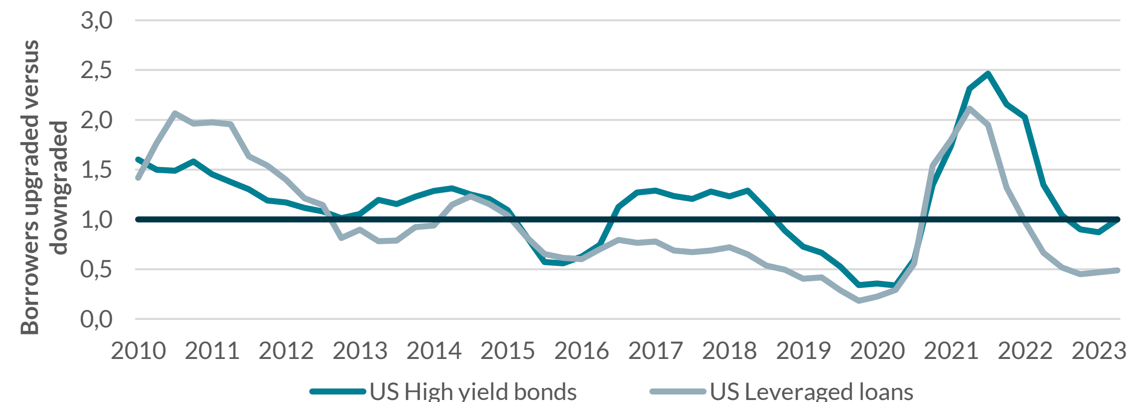
We expect the opportunity set to remain attractive and thus remain moderately positive on the asset class.

41. Distressed debt ratio has declined considerably during last quarters



Source: ICE BofA, JP Morgan, Van Lanschot Kempen (Dec. 2023).

42. Stabilization of upgrade-to-downgrade ratios



Source: Source: JP Morgan, Van Lanschot Kempen (Dec. 2023).

*Distress Ratio: market-value weighted proxy based on (percentage) HY bonds in ICE BofA Global High Yield index (HW00) trading below 80 cash price, US Leveraged loans in JP Morgan Leveraged Loan index trading below 80 cash price, All including distressed exchanges.

Index definitions

Private Real Estate
The MSCI Quarterly Property indices are value-weighted and measure the unlevered, net of fee, total return of private directly-held property investments by region, with a Core risk profile. Total market cap of selected indices is roughly USD 430bn. for US, USD 300bn. for Europe and USD 87bn.

Private Infrastructure
The EDHEC Infra300 equity index is equally-weighted and represents the marked-to-market (net of fees, local currency) total return of 300 unlisted private infrastructure equity investments (globally, with a market cap of $304bn.). The EDHEC InfraGreen equity index has 104 constituents and market cap of $13bn., representing infrastructure assets in the solar and wind sectors.

Private Farmland
The NCREIF Farmland index is a value-weighted index, representing the unlevered (net of fees) performance of a large pool of individual income-producing US-based agricultural properties ($16bn. total market cap), acquired in the private market for investment purposes only, as held by US pension funds.

Private Equity
The Preqin Private equity quarterly index is a value-weighted index, using fund-level cash flow transactions and net asset values for over 4000 closed-end private equity funds collectively worth more than $7.7 trillion.

Corporate Direct Lending
The Cliffwater Senior Direct Lending Index (CDLI-S) seeks to measure the unlevered, gross of fee performance of directly originated U.S. (senior secured) middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements. Market cap of the index is currently around $100bn. We see US as representative for global exposure as it covers roughly 65% of the global market.

Structured Credit
For (mezzanine) Structured Credit an equal-weighted mix of 3 sector indices (gross returns) has been used. The JP Morgan Collateralized Loan Obligation BBB index (CLOIE) is a value-weighted index of USD-denominated BBB CLOs. The ICE BofA US BBB CMBS index (CB40) is a value-weighted index of USD-denominated BBB CMBS. Citi provides US non-agency RMBS Credit Risk Transfer M2 (typically BB rated) data. We see the US as representative for global exposure as it covers roughly 70% of the global Structured Credit market (per Dec-2021).

Distressed Debt
The HFRI Event-Driven Distressed Restructuring index is an AuM-weighted index of funds that focus on investing predominantly in debt instruments issued by companies (globally), trading at a significant discount due to (formal, or market perception of) near-term bankruptcy proceedings. Returns are reported net of all fees.

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