VÄRDE

Värde Views: Phases of a Credit Cycle

A map of what's to come

April 08, 2020

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INTRODUCTION

Recently, George Hicks and Ilfryn Carstairs, Co-CEOs of Värde Partners, hosted a webcast for approximately 400 investors from around the globe to provide an update on the market environment and the state of Värde's business as well as a discussion on what investors should expect to see in the coming weeks and months as the credit cycle unfolds. Below are excerpts from the webcast.

MARKET ENVIRONMENT

George Hicks

In my more than 30 years in this business I have invested through many credit cycles. Some cycles have been in geographies, some in industries and then there are big systemic cycles like we saw in 1991, 2001 and 2008. Now we are clearly in one again, and at the start of a recession. None of these cycles have been the same, they evolve over multiple stages, and while some things are clear now, others will emerge over time. Clarity only comes with hindsight. For that reason, we rely on Värde's deep expertise in credit that we've developed over the past 26 years, and we rely on the strength of our global platform to enable us to pivot to the opportunities where we see the best relative value.

Ilfryn Carstairs

The impact of Covid-19 – and the speed of its disruption to society and markets – is unprecedented. It is clear that we are at the start of a major, connected credit cycle. In our view, we expect this will be as bad, or worse than, the Global Financial Crisis of 2008-09 (GFC).

The GFC, though, was about the fragility of the financial system at that point in time. This time, it is a physical disruption, a sudden stop, and there remains an open question on the depth of this event, which is driven by the open question around the duration of physical disruption.

Whole industries, and their value chains, are already in distress and we strongly believe we'll be dealing with the consequences of this period for many years. As we're still in the very earliest stages, though, the range of potential outcomes is incredibly wide.

We believe in many ways this is closer to an absolute black swan than what happened in the GFC based on the lack of time to adjust and the speed of escalation. This is important because it brings into focus downside scenarios that weren't considered even in the more draconian cases of prudent risk taking. It's difficult, for example, to ask an analyst who underwrote an investment in Italy why they didn't model a case where the country was shut down for several months. It goes beyond any downside case people were reasonably modeling.

> "It goes **beyond any downside case** people were reasonably modeling."

The start of this cycle is also much more significant than that of any previous recession, even a very deep one. The first order impact on over-levered credit is quite obvious, a quick impairment. It brings into play the deeper, second order of impact that can then cascade and create more systemic problems. Similar to what happened in the GFC, it creates a lot more impairment but also a lot more panic.

Panic feeds on itself, and panic has taken hold in markets in recent weeks. The consequences of this usually take a fair bit of time to manifest, and they're not easily fixed. That further informs our view that this is a very significant cycle.

We see dislocation in asset classes and even in the same capital structures – equity and credit telling very different things, for example. There is a big technical play that revolves around forced selling, a proper dislocation due to the unwinding of leverage positions. It's a broken market in places, and it's being exacerbated in part by ETFs, passive money and CLOs. The growing mismatch between assets and liabilities is playing a big role – and all as the intermediaries and banks are no longer acting as a significant cushion and are themselves dealing with physical disruption.

We've been asked quite a bit about the impact of stimulus. Our view is that monetary intervention has been critical in keeping even basic markets like treasuries functioning. Fiscal stimulus is coming thick and fast and it's warranted in our view. The level of urgency that policy makers have shown in heading off what could have been at least a temporary depression, and will at least be a deep recession, has been impressive in terms of the magnitude and speed at which it's come.

We note, though, that the stimulus has been targeted at survival and tilted to places that need it most – both consumers and basic market functioning. We think more will be needed and that focus on survival will really need to continue. Of course there will be some bailouts, but unfortunately for the world there will be huge impairments to deal with out of this, including in large amounts of credit previously and fairly considered safe. TARP stimulus came in early October 2008 and of course it was five months before the market bottomed, and the GFC opportunity ran for many years after.

We really don't think there is a silver bullet to avoid a large default cycle, it's more a question of how bad the impact is already and the paths from here. The paths will vary by industry and by country. Importantly, we believe the shape of the recovery will revolve around medical outcomes – whether a vaccine can be effectively developed and we get reliable testing to allow people to get back to work.

THREE PHASES

While significant uncertainty on the duration and depth of this cycle remains, we know that the cycle will evolve over multiple stages, and with three key phases.

Phase 1

The first phase is the "processing period" and it starts with maximum uncertainty and some chaos. We are firmly in this phase now – specifically the chaos. Phase one can provide strong absolute returns with good downside protection, but that opportunity is quite short-lived relative to the length of the overall cycle. In this phase, investors can generally see high quality credit with liquidity at prices where one could benefit from what we view as irrational dislocations in the market.

In our view, **markets are dysfunctional, and prices in many places do not make sense**, creating hugely compelling potential opportunities."

As we would expect in this early stage of the cycle, we cannot overstate the shift in the opportunity set in recent weeks. In our view, markets are dysfunctional, and prices in many places do not make sense, creating hugely compelling potential opportunities.

Our experience through crises of the past has taught us that there is no time to waste to put money to work – in the right way – early on.

While the opportunity set may be enormous, we remain disciplined about where to focus our efforts and resources. What we do, and crucially what we don't do, are equally important aspects of investing right now. For example, we believe it is too early to underwrite long-term restructurings as there remains too much uncertainty and inadequate downside protection in this phase of the cycle.

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High quality names with downside protection

It might seem paradoxical, but the most dramatic mispricings have actually been in the most senior parts of the capital structure – and in high quality, investment grade names. These are often liquid blue chip companies with very large market caps, leaders in their sectors and, we believe, likely survivors of this cycle. The level of dislocation in markets also makes it possible to hedge downside risk relatively cheaply.

Ultimately, we are not preoccupied with trying to identify the bottom of the cycle while the backdrop is still highly uncertain. For now, there is an advantage to simply having cash on hand to transact with sellers who need liquidity.

As this more chaotic start winds down, phase one should then move to more deep value opportunities where finding clear survivors in more impacted parts of the economy becomes a real credit selection exercise. Some restructuring opportunities may begin to make sense.

Phase 2

Phase two begins when the range of outcomes narrows, markets return to more functioning levels, and liquidity comes back. Narrower outcomes better enable us to discern between potential winners and losers.

Now is when one would typically start to form stronger specializations around more impacted areas and sectors, and credit selection is critical as large restructurings happen. Less liquid opportunities should start to emerge. For example, in the GFC, opportunities centered around financials, distressed RMBS, and homebuilding lending platforms. As views on specific sectors become more clear and the market more fully processes, one can also expect to see opportunities emerge in the illiquid space, including more lending and those resulting from forced asset sales.

In recent weeks, certain markets have taken more time to reprice, and we expect these opportunities to evolve over the coming weeks and months as we head into phase two. While the structured credit market has seen some dislocation, it has yet to experience the same fundamental shift in pricing as the corporate market. It has pockets of very real default risk.

We expect to see more forced asset sales as we get deeper into the cycle, and rescue lending deals emerge. While those opportunities do exist today, in our view they are characterized by high levels of desperation and low quality collateral. We believe those in need of cash will ultimately come to terms with prevailing levels of price and risk, and eventually begin offering up more high quality assets.

The primary market will also have a role to play, with many firms facing a liquidity squeeze, and the quality of collateral will again be important.

Phase 3

The final phase is the aftermath. This can have a long tail that could last for anywhere from two to three years in developed markets and up to five to seven years in less developed markets. This opportunity set is generally much less liquid and can include nonperforming loans (NPLs), new money, and special situations lending. For example, countries like Spain and Italy were in crisis in 2009 but in our view NPL opportunities only really emerged in 2014 and beyond. Phase three in this cycle may yet be many years away.

PLATFORM AND PLAYBOOK

Strength of the business

George Hicks

We believe there is never a precise template for how any credit cycle of this magnitude plays out. We bring to bear our deep experience investing through many cycles to guide us on the best approach through each stage. We have always taken a rigorous approach to risk management, with a strong framework in place to review and assess deals.

> "We bring to bear our **deep experience investing through many cycles** to guide us on the best approach through each stage."

We have ample resources with more than 100 investment professionals around the globe, including CIOs in the US, UK and Singapore.

We have always been big believers in investing in our business, building the right infrastructure and having back-up plans to deal with any crisis. While no one could have anticipated the events of recent weeks, we benefit from our experience working seamlessly across time zones and our ability to stay connected to address the operational challenges in this new environment.

With more than 300 people working across three offices in the US, five in Asia and five in Europe, all our business functions in-house, and trading operations in each region, we were well prepared to adapt and respond to ensure there was no disruption to our operations.

Responding in the right way

Ilfryn Carstairs

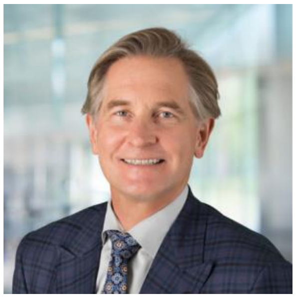
We are also committed to responding to this global crisis in the right way – carefully looking after our people, being good and responsible counterparties, and giving back to our local communities.

With a strong, established culture, we have fostered a significant sense of community in the firm over many years. In recent times, we've had to adapt to make sure we keep that sense of community alive while we all work from home. We are learning as we go on this to some extent, but we are trying to put an emphasis on mental health and wellness and on keeping connections while we are physically apart. This includes heavy use of video meetings as well as social gatherings like virtual lunches and such.

We've also had a terrific philanthropic response targeted at our local communities and actively finding ways for our employees to volunteer remotely as well.

This is a very sobering period for us. We feel very fortunate that we have a platform with the strength, resilience and expertise to work on behalf of our investors in these times.

About the Authors



George G. Hicks

Co-Founder and Co-Chief Executive Officer

George Hicks is a Co-Founder and Co-Chief Executive Officer. He is a member of the firm's Investment Committee. Based in Minneapolis, George cofounded the firm in 1993.

As a founder, George was an original architect of the firm's investment thesis and philosophy and has helped guide the application of those principles to an ever-changing, growing and dynamic investing environment. He has presided over the growth of the firm, overseeing its transition from a start-up to a global enterprise with the infrastructure required to support offices around the globe and a diverse investor base. George played a central role in developing the mandates and raising the capital for Värde's funds. He has served as a lead creditor in a number of corporate restructurings and has served on the boards of a number of the portfolio companies owned by the Värde funds.

Prior to founding Värde, George served as senior vice president of Cargill Financial, the financial services subsidiary of Cargill, where he helped build and manage the company's worldwide merchant banking department. A lawyer by training, George also served as counsel in the Cargill legal department.

George graduated from Gustavus Adolphus College, Minnesota with a B.A. in Economics and History, and received his J.D. from the University of Minnesota Law School.

Ilfryn Carstairs

Partner, Co-Chief Executive Officer and Chief Investment Officer

Ilfryn Carstairs is a Partner, Co-Chief Executive Officer and Chief Investment Officer. Based in Singapore, he chairs the firm's Investment Committee and leads the global 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 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 assumed his current role as Chief Investment Officer and Co-Chief Executive Officer in 2020.

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

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

About Värde Partners

Värde Partners is a leading global alternative investment firm with roots in credit and distressed. Founded in 1993, the firm has invested more than $68 billion since inception and manages over $14 billion on behalf of a global investor base. The firm's investments span corporate and traded credit, real estate and mortgages, private equity and direct lending. Värde employs more than 300 professionals across 13 offices worldwide. For more information, please visit www.varde.com.

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Regional Headquarters

London

2 St James's Market
London SW1Y 4AH
United Kingdom
+44 (0)20-7808-3370

Minneapolis

901 Marquette Avenue South
Suite 3300
Minneapolis, MN 55402
United States
+1 952-893-1554

New York

510 Madison Avenue
12th Floor
New York, NY 10022
United States
+1 212-321-3780

Singapore

6 Battery Road, #21-01
Singapore 049909
Singapore
+65 6579-0800