

2H 2024 Private Credit Outlook

J.P. Morgan Alternative Credit Solutions

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Private credit has been a strong contributor to portfolio returns, directly benefiting from higher interest rates whilst being less volatile (due to illiquidity) than public credit markets. It has been one of the fastest growing asset classes in recent years, with c. \$250bn¹ raised each year from 2020-2023, across very different market environments.

Will high rates persist? In the first half of the year, investors who thought there would be multiple rate cuts in the U.S and Europe were proven wrong. Inflation has remained stubbornly above the 2% target in both the U.S and Europe while wage and labor data has been resilient. We do expect moderate declines in interest rates in the back half of the year, which will reduce defaults and improve loan performance. However in the absence of visible stress in the economy, the pace of rates cuts may feel more like a stroll than a gallop. In a changing rate environment, private credit is attractive because private credit managers can negotiate terms such as rate floors and call protection. This adaptability is valuable when navigating the complex dynamics between short-term rate adjustments, long-term rate expectations, and the broader economic outlook.

Today, **we see better value in private credit than in high yield bonds and leveraged loans.** Since the regional bank crisis in mid-2023, banks have continued to adopt a risk-off approach to many types of lending. The combination of elevated rates and credit spreads has resulted in historically strong returns for the sector. In contrast, spreads in non-investment grade U.S and European bonds and loans are at historical lows and have continued to tighten over 1H 2024; and default rates have gone up².

In private markets, there continues to be some concern that valuations have not fully adjusted (downwards), especially in areas that are very sensitive to interest rates and growth. In our view, when asset values are uncertain investors may want to seek a margin of safety which can be achieved by generally **moving up in the capital structure into credit. Moreover, private credit today can offer equity-like base case returns, and investors are “paid to wait”.**

In anticipation of a higher for longer rate environment, we continue to emphasize exposure to performing strategies with a “floating rate” component. Corporate lending is broadly attractive, as are a number of specialty sectors where funding remains constrained. Additionally, we believe that private credit secondaries offer diversified access to the private credit universe, with the benefits of portfolio transparency and discounted entry points.

Private credit is a permanent allocation in many institutional multi-asset portfolios. We expect flows to remain strong however **investor outcomes will be driven by strategy and manager due diligence, as well as portfolio construction.** We are focused on building resilient and diversified portfolios for investors. Over 1H2024, we have had 100+ meetings with private credit managers investing across different strategies and geographies. We have also reviewed 30+ secondary transactions representing over \$25bn of NAV over the last 12 months.

Sources: ¹Guide to Alternatives, Data are based on availability as of May 31, 2024, J.P. Morgan Asset Management, ²FitchRatings, 30 April 2024. For discussion and illustrative purposes only. Information shown above is based upon market conditions at the time of the analysis and is subject to change. Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Information as of June 30, 2024.

Strategy Heatmap

The strategy heatmap is integral to our portfolio construction process. It guides our portfolio allocations and represents our conviction in different strategies over the year.

				Headwind	Tailwind
Commercial Real Estate					
Traditional lenders pulling back while demand for debt is high as maturities hit. Good asset / bad balance sheet issues in multifamily and industrial. Busted development deals may require rescue finance	1 st Lien Bridge				
	1 st Lien Construction				
	New Money / Rescue Finance				
	Note Sales				
Residential Real Estate					
Mortgage credit continues to perform very well although new origination looks less attractive in our view. MSRs likely have negatively convex profiles at this stage. European NPL volume still muted.	Performing / Non-QM				
	Re-performing Loans				
	MSR				
	NPL Sales				
Consumer					
Opportunities as non-bank lenders face stress in challenging funding environment. Charge-offs generally still low outside of the 2021/22 non-prime cohort.	Unsecured Consumer				
	Charge-offs & Restructurings				
Corporate					
General environment for corporate lending remains attractive from a yield, leverage and documentation perspective. Capital solution / rescue finance opportunities are arising among highly levered borrowers. Too early for classic distressed debt strategies.	"Hard Money" / Asset Backed				
	Senior Direct Lending				
	Reg Cap / Risk Sharing				
	New Money / Rescue Finance				
	Distressed Debt				
Esoteric/Other					
In particular, secondaries, LP and GP led, represent an attractive way to enhance return and build in downside protection.	Aircraft Lending / Leasing				
	Alternative Energy				
	Healthcare				
	Secondaries				

Source: J.P. Morgan Alternative Asset Management. For discussion and illustrative purposes only. Information shown above is based upon market conditions at the time of the analysis and is subject to change. Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Information as of June 30, 2024 unless otherwise stated. Investments involve risks, not all investments are suitable for all investors. Investments are not similar or comparable to deposits.

Corporate Direct Lending

Given today's base rates and spreads, direct lenders broadly make 11 to 12% gross unlevered returns on senior secured credit which is a very strong risk adjusted return.

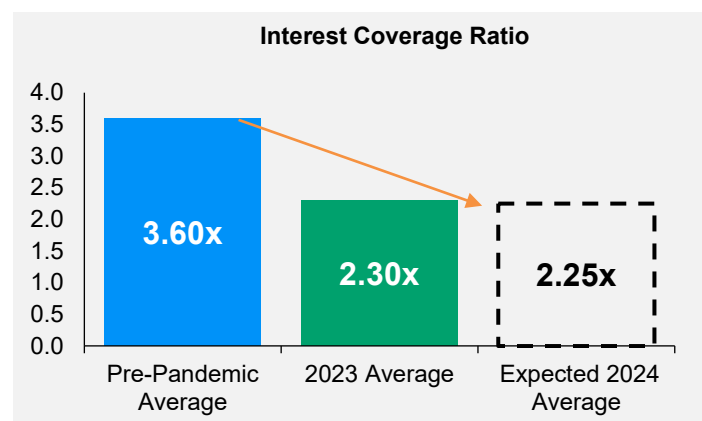
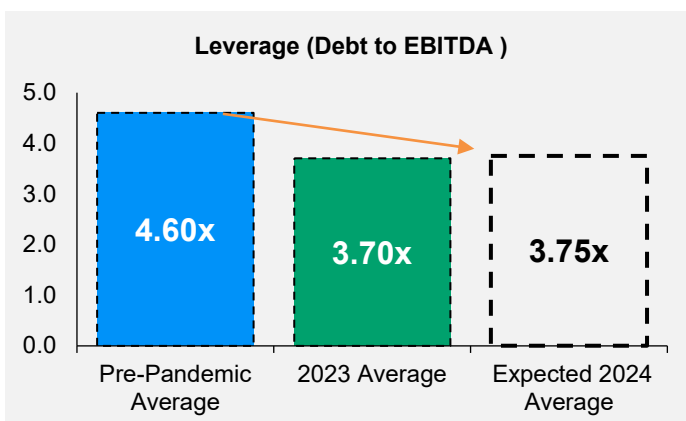
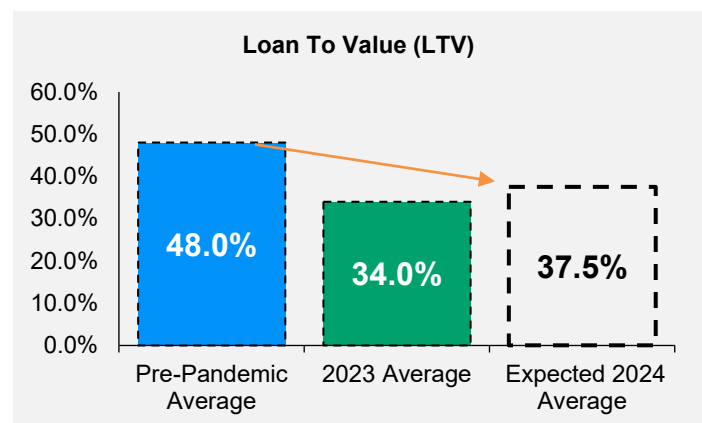
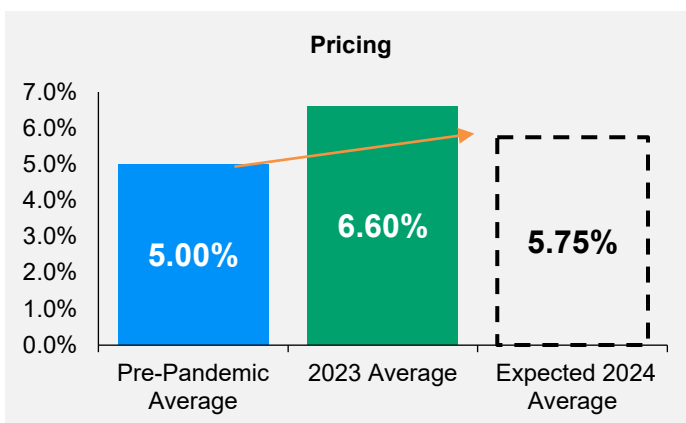
While direct lending is more competitive than other areas of the private credit universe, the risk reward characteristics of middle market first lien senior secured direct lending to sponsor-backed companies in the U.S and Europe, is attractive. That said, it is important to make a distinction between the core/lower mid-market and the upper mid-market as the competitive dynamics and thus pricing and lender protections, differ widely.

Today, parts of the upper mid-market are under pressure from the broadly syndicated loan (BSL) market, which has re-opened after a quiet 2023. Reduced recession worries and pent-up demand saw strong BSL and CLO issuance in the first half of the year.

As of May 2024, c.\$14bn of direct lending was refinanced in the BSL markets, generating savings of up to 300bps³. As a result of greater competition on the larger end of the market, direct lenders are seeing narrower spreads and some are forecasting c.500bps of spreads by the end of 2024.

While spread tightening has been felt across the sector, core mid-market lenders still expect to generate a 50-150bp premium over the upper mid-market segment. From what we have observed in this segment, underwriting conditions remain relatively stringent with below 5x leverage at close (i.e. Debt to EBITDA) and below 50% LTV, on average.

2019 to 2024 (Expected) Trends In US Core Mid-Market Direct Lending Metrics



Source: J.P. Morgan Asset Management based on discussions with underlying Managers

Source: ³ Pitchbook, May 31, 2024; J.P Morgan Alternative Asset Management. For discussion and illustrative purposes only. Information shown above is based upon market conditions at the time of the analysis and is subject to change. Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Information as of June 30, 2024 unless otherwise stated. Investments involve risks, not all investments are suitable for all investors. Investments are not similar or comparable to deposits.

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(Corporate Direct Lending – continued from prior page) Turning to corporate health, we do not see indications of fundamental and systemic weakness across companies. Direct lending managers tend to focus on service-oriented sectors such as business services, industrials, healthcare services and technology, where corporate borrowers have largely been able to gradually pass through higher costs to customers and maintain profit margins. According to the Proskauer Private Credit Default Index for senior secured and uni-tranche loans, Q1 2024 default rates came in at 1.84%, up slightly from the 1.41% in Q3 2023 but lower than the 2.15% from a year ago⁴.

While default rates remain low, we have seen elevated loan amendment and modification activity in the last year, driven by the rise in base rates. By our estimates, roughly 10-15% of all private loans have had an amendment of some kind. In these cases, lenders have generally shown some flexibility towards borrowers, usually in exchange for de-leveraging actions from sponsors. That said, it would not be surprising to see non-accrual rates and default rates move up from current below-average levels, thus our focus remains on managers who underwrite in a disciplined manner.

In 1H 2024, there were only 21,000 M&A deals globally which was 30% below the same period last year⁵. However, private equity funds are facing a lot of pressure to transact and we expect the opportunity set for direct lenders to increase substantially in 2H.

Private Credit Secondaries

The continued growth in Private Credit should be positive for secondaries deal flow. As with private equity, we expect to see a 2-3% turnover in portfolios via the secondary markets, driven by LPs' liquidity needs as well as active portfolio management considerations.

We estimate that total deal flow across private credit secondaries in 2024 will exceed \$30bn, compared to total dedicated capital of \$10bn, leading to a significant supply / demand imbalance and hence, a compelling opportunity for investors.

Compared to just 6 months ago, the economic outlook today is stronger, meaning that private credit secondaries pricing should modestly tighten. However, this adjustment is more than compensated for by the expected improvement in performance of the underlying assets. As pricing tightens, we expect to see a material increase in deal flow as bid-ask spreads become more palatable for sellers. As a consequence, we should end up seeing more deal flow on the senior end of the capital structure.

Pricing has been largely bifurcated across senior secured funds and more junior oriented funds. For the latter, pricing has not materially moved over the last few months (low-80s), while at the higher end of the capital structure we have seen deals price much closer to NAV. In our view, sourcing, due diligence and pricing matter more than ever to investor outcomes.

Source: ⁴Proskauer, 23 April 2024. ⁵PWC, Global M&A Industry Trends, June 25, 2024. ⁶S&P Global, 28th May 2024; JP Morgan Alternative Asset Management. For discussion and illustrative purposes only. Information shown above is based upon market conditions at the time of the analysis and is subject to change. Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Information as of June 30, 2024 unless otherwise stated. Investments involve risks, not all investments are suitable for all investors. Investments are not similar or comparable to deposits.

Corporate Distressed Debt

While the corporate default rate has picked up over the course of 2024, traditional corporate distressed debt opportunities remain limited. That said, a relatively new opportunity set has emerged to provide high yielding, well-structured capital solutions and rescue finance to certain over-leveraged borrowers.

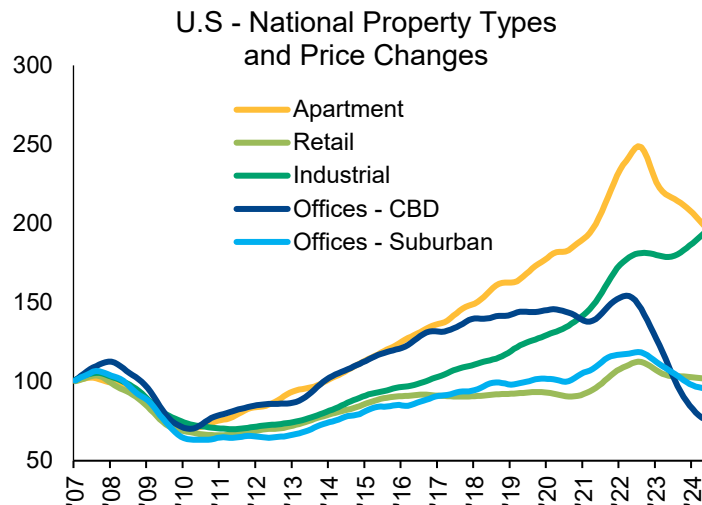
At the smaller end of the market, the bank lending pull back in both the US and Europe has meant increased stress among non-sponsored lower middle market companies. Much of this debt has been amended and extended to avoid defaults and extend runways. Some of these companies remain in a delicate position today, vulnerable to further economic weakening or supply side shocks.

Commercial Real Estate

The commercial real estate (CRE) lending market remains relatively dislocated in both the US and Europe. Over the next two to three years as loans mature and interest rate caps start to roll off, property owners will have to deal with these issues, which should in turn lead to attractive opportunities. Today, there are very selectively, interesting opportunities in the construction completion space, i.e., short term bridge financing in mezzanine debt or preferred equity.

Over the course of 2024 CRE credit spreads have come in. However, 10-year rates remain elevated and the high cost of financing has dampened transaction activity. In US REITs, implied cap rates are c. 8%⁶, and are now higher than implied cap rates in private markets. As transaction activity picks up, private market cap rates will ultimately have to move by a similar amount as seen in public markets.

By segment, US multifamily and industrial are both working through significant supply increases over the last few years. After years of difficulties, brick and mortar retail fundamentals have stabilized, supply remains limited and credit issues with tenants are fewer.



Source: MSCI, RCA CPPI™ US, Commercial property price indexes

(Commercial Real Estate – continued from prior page) As for the U.S. office property sector, the outlook can be divided by quartile. Top quartile properties remain in good shape with still healthy rents and tenancy levels. Bottom quartile office properties are in most cases obsolete but removal of these properties from the market will take several years. Middle quartile office properties will ultimately benefit from the overall lower supply.

In Europe, the big picture is similar in many respects and European banks have largely pulled back lending. Private lenders today are focused on assets with strong fundamental performance such as residential and resi-adjacent (multifamily, student housing, care homes, self-storage); hospitality and industrial.

Residential Real Estate

Residential real estate fundamentals look reasonably strong given the overall health of the consumer and significant home equity gains for existing homeowners. In the U.S., we agree with our investment bank colleagues that supply/demand remains supportive of positive home price growth.

In both non-qualified mortgages and repurchasing loans, credit continues to perform very well. While delinquencies and foreclosures have picked up slightly, losses remain very low given strong home price appreciation over the past several years. That said, post securitization returns do not look particularly attractive.

In contrast, returns in second lien loans and home equity lines of credit (HELOC) look attractive on a levered and unlevered basis. Given the trillions of dollars of untapped equity in the US housing market, we see the opportunity to originate attractive second lien loans and HELOCs to higher quality borrowers.

There are pockets of opportunities in areas such as low dollar price “scratch and dent” agency mortgages – these are loans that have been “kicked out of” agency pools, typically due to minor defects. Given the low credit risk associated with these loans, buyers of scratch and dent loans can work to bring these back in compliance with agency guidelines and re-securitize the loans.

Consumer

Loans to consumers and small and midsize businesses generally offer attractive yields, especially as banks continue to retrench from this segment. Lending platforms typically rely on short-term credit lines from banks to fund the loans they originate, securitize the loans and sell them to the market. The washout of financing from banks to consumer lenders has given private capital providers the ability to dictate terms and build in considerable downside protection.

Returns from this segment ultimately rely on the strength of the consumer. In the U.S., employment and labor data, consumer leverage ratios and household debt service payments remain healthy, though the pickup in delinquencies among lower FICO borrowers points to the need for caution.

In Europe, there has been a decent recovery in consumer confidence, modest wage growth and declining headline inflation. At the end of June, Fitch upgraded European Consumer.

ABS asset performance to “Neutral” on the back of the stronger than expected consumer and an improved macro-economic backdrop.

Nonetheless, we continue to see a migration towards higher quality consumers; also private credit consumer lenders in both the US and Europe are extending credit with an economic slowdown in mind.

Clean Energy

Asset backed financing in the clean energy sector is experiencing a multi-year tailwind due to structural and regulatory changes. While existing investments have come under pressure because of higher rates, the shakeout of competition has made new money lending attractive.

We see interesting opportunities in the construction space to provide short-term financing of 6 to 36 months to projects that have already achieved “ready to build” stage, whether in sponsor/sponsorless deals. This financing typically serves as a bridge and is meant to be replaced with bank financing that is cheaper and longer term.

At the moment, loan margins appear better in Europe than in the U.S. given the dearth of equity capital; our approach tends to be more selective in the US.

Looking to the future, the opportunity in both the US and Europe are compelling for areas like battery storage assets alongside wind and solar assets. We expect that there will be many opportunities to develop or lend against these assets.

Healthcare

In Healthcare, the post-pandemic “over exuberance” for life science companies came to an abrupt end in 2021. Equity capital has been either very costly or very hard to get. Existing borrowers have had to be much more pro-active, in order to refinance and / or plug holes in their balance sheets.

Turning to new origination, the lack of capital in the market has allowed lenders to be very selective and to move up in borrower quality. Lenders today are focused on borrowers that have a clear pathway to cash flow profitability in one to two years, i.e. are fully funded and will not require external raises to get to cash flow profitability.

Aviation

In aviation, following the pandemic and more recent sharp rise in interest rates, banks have pulled back and capital markets activity has slowed. A lot of capital has been taken out of the system in the aviation space and that presents an opportunity, particularly for private lenders.

Meanwhile, the aviation space today is fairly healthy. Demand for air travel is back and aircraft valuations remain well supported given undersupply in the market. With that backdrop, we feel comfortable taking selective asset backed risk provided with strong protection from the collateral value.

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Conclusion

Over the last 18 months, private credit investors have benefited from a combination of high spreads, high rates and a resilient economy. Over 2H 2024, we expect to see some fluidity in spreads depending on the competitive dynamics and the quality of the borrower /asset. Interest rates should moderate slightly which will be a welcome relief for many private credit borrowers and help to mitigate defaults. Finally, with the economy softening, we do expect non-accrual rates and default rates to normalize from current below-average levels.

With banks continuing to retrench from many areas of lending, there are ample opportunities for investors to deploy capital into private credit. However, it is important to be selective and to build a diversified portfolio that can weather a range of economic conditions.

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