WINTER 2024 EDITION

PRESENT VALUE

Alternative Credit Newsletter

Welcome to the Winter 2024 edition of "Present Value," your premier source for the latest developments and insight within the ever-evolving world of private credit. In this issue, we discuss the Canadian auto lending market and the launch of our mutual fund trust. For a primer on the asset class, please refer to our White Paper.

Slow and Steady Wins the Race: The Launch of our Mutual Fund Trust

We are pleased to announce the mutual fund trust version of our Chesswood Canadian Asset-Backed Credit Fund (CABCF). The fund offers quarterly distributions, monthly purchases and redemptions, tax-free registered account eligibility and will be available for purchase beginning this month.

Central banks lifted interest rates at a historically rapid pace in 2023, which aided many private credit funds exposed to variable-rate loans. In the figure below, we track the Collateralized Loan Obligation (CLO), or leveraged loan portfolio (typically benchmarked to SOFR), over the past 10 years compared to the past 12 months.

Many comparables to private credit are similar in performance to structured credit. In fact, the floating rate debt products (i.e., CLOs) that have generated exceptional performance over the past 12 months typically perform similarly to high yield through cycles with potential for heightened volatility.

At the end of an economic cycle, the decline in interest rates is often met with a rising risk premium (typically known as credit spread widening) for credit to compensate for the potential of rising defaults. The CLO index performance has tracked this dynamic closely.

The leveraged loan and private credit markets have grown significantly in size since the Global Financial Crisis, but the percentage of lower-quality debt in these markets has also increased.

According to alternative investment giant Oaktree, *"loans with credit ratings of B or below represented almost 75% of U.S. leveraged loans at the end of 3Q2023, compared to roughly 35% in 2000. Additionally, our market observations indicate that private debt experienced a similar deterioration in quality in the decades leading up to the recent interest rate spike."*

As we look ahead, we believe our private credit solution offers greater risk-adjusted returns amid a backdrop of stable to lower interest rates.

Our private credit fund (CABCF) marks to market losses as incurred and benefits from decades of loss history through many market cycles. We expect our secured fixed-rate leases and loans to outperform other private credit strategies, particularly floating-rate debt, as rates fall either this year or next. This results from lower credit losses and greater funding spreads upon reinvestment, as the yield curve normalizes to where short-term rates are lower than longer-term rates.

In addition, we highlight the following features of our fund:

1. We are dealing with individual obligors and individual pieces of equipment, along with standardized legally enforceable contracts (average size of $50,000) with a clear and immediate path to monetizing collateral in the event of default. We are not at risk of being "primed" within the capital structure. The collateral (leases and loans) is held at the fund level.

2. We do not allow loan modification, such as Payment-in-Kind, ensuring that our tail risk is minimized. This contrasts to strategies often employed in other private credit strategies (i.e., direct lending or mortgage pools). We take limited refinancing risk, as the leases/loans are amortized to $0 at maturity with little to no residual value.

3. With decades of lending experience (Chesswood started in 1982), our historical performance data provide reasonable predictive ability on losses over a cycle and is invaluable when constructing a pool of leases and loans to generate a targeted return.

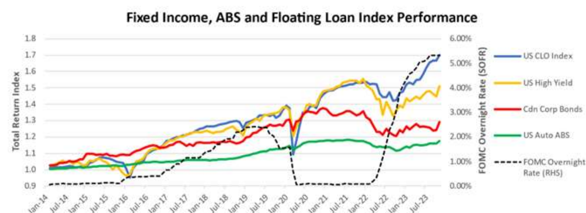
4. Our fund has a significant liquidity advantage over many alternative types of private credit. The leases and loans in our fund are fully amortizing, thereby generating natural liquidity of 2% per month over a 48-month term. Furthermore, we have deep relationships in Canadian and U.S. securitization markets and have been active ABS issuers in the U.S. for many years. Private and public securitization markets are another way in which our fund can access liquidity.

5. Asset-Backed Private Credit has the lowest correlation to a range of relevant asset classes, and Small-Ticket lending to an even greater extent.

Understanding Risk Adjusted Credit Returns Through Cycles

- Floating rate debt products (ie CLOs) that have generated exceptional performance over the past 12 months, typically perform similarly to unsecured high yield through cycles with potential for heightened volatility

	US Auto ABS (Prime) TRI		Cdn Corp Bond TRI		US High Yield TRI		Palmer Square CLO TRI*	
	10yr	Last 12 Mo	10yr	Last 12 Mo	10yr	Last 12 Mo	10yr	Last 12 Mo
Annualized Return	1.63%	4.82%	2.54%	3.91%	4.27%	8.69%	5.50%	15.89%
Annualized Volatility	1.60%	1.66%	4.44%	5.46%	7.42%	5.58%	9.13%	4.18%
Excess Return (to RFR)	0.45%	0.07%	1.25%	-0.70%	3.09%	3.93%	4.29%	11.14%
Sharpe Ratio	0.3x	0.0x	0.3x	-0.1x	0.4x	0.7x	0.3x	2.7x
Max Month	1.22%	1.01%	4.60%	2.90%	5.90%	3.81%	2.93%	3.00%
Min Month	-2.31%	-0.46%	-5.28%	-1.62%	-11.46%	-1.29%	-20.56%	-0.75%
Maximum Drawdown	-5.48%		-12.39%		-14.74%		-21.39%	



* Representative of Gross Returns for a Collateralized Loan Obligation (CLO) Portfolio (Floating Rate to SOFR)
Source: Bloomberg, Chesswood Capital Management. See disclaimer.

Chesswood Capital Management WAYPOINT 10

The Opportunity in Canadian Auto Lending

"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." Warren Buffett

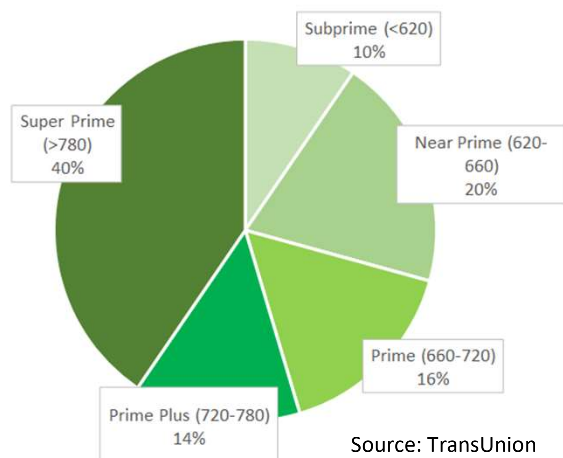
Comprising approximately 40% of its diversified mix, our CABCF holds near-prime and non-prime auto loans.

These are sourced through our wholly owned subsidiary Rifco, which has been in the auto lending business for over 22 years. Headquartered in Red Deer, Alberta, Rifco works with over a thousand individual dealers, and evaluated $6 billion in applications last year, underwriting approximately $150 million of loans. The yields vary based on credit quality, but range between 12% and 30%, with an average loan size of $32,000. We believe that the turbulence encountered by the Canadian auto lending industry over the past twelve months has provided an opportunity for strong risk-adjusted returns in the coming years, benefiting unitholders of the fund.

How the Market Breaks Down

We estimate the Canadian prime and super-prime market segments comprise 70% of total auto loans outstanding in 2023, versus 66% in the United States, and given those percentages, the large Canadian banks tend to focus on these segments of the auto lending market. Moreover, the auto lending book is not a large part of their broader credit portfolios, and there have been exits from the sector. In September 2023, BMO elected to shut down its indirect retail auto finance business. The bank stated, “By winding down the indirect retail auto finance business, we have the ability to focus our resources on areas where we believe our competitive positioning is strongest.” BMO’s indirect auto lending book was less than 3% of total credit outstanding at the bank.

Canadian Consumer Loans by Credit Quality

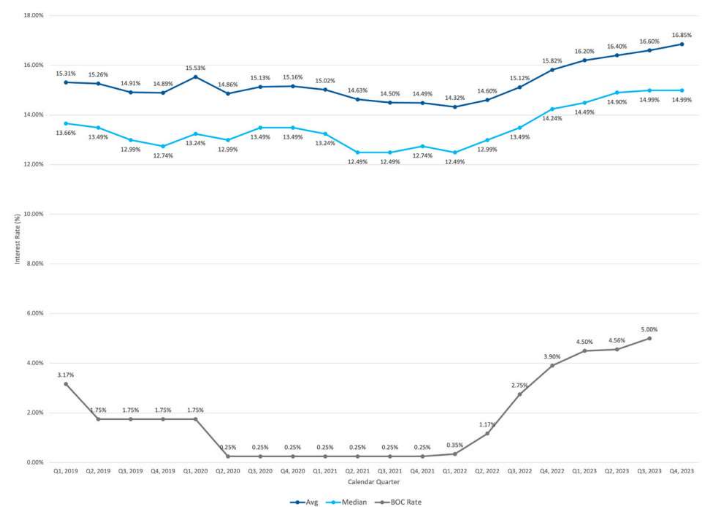


Source: TransUnion

A Growing Non-Prime Segment in Canada

The non-prime and near-prime auto market in Canada has expanded materially over the past two years, which is attributable to a number of factors, but likely the most influential is the well-known overarching issue of affordability in the current interest rate environment. More consumers are falling out of the prime bucket due to a myriad of factors. The average non-prime rate for used auto lending in the fourth quarter of 2023 was almost 17%, according to Dealertrack (and 8% for prime credits).

Funded Loan Interest Rates – NonPrime



Source: Dealertrack

Monthly Canadian Auto Loan Bookings by NonPrime Lenders

Source: Dealertrack

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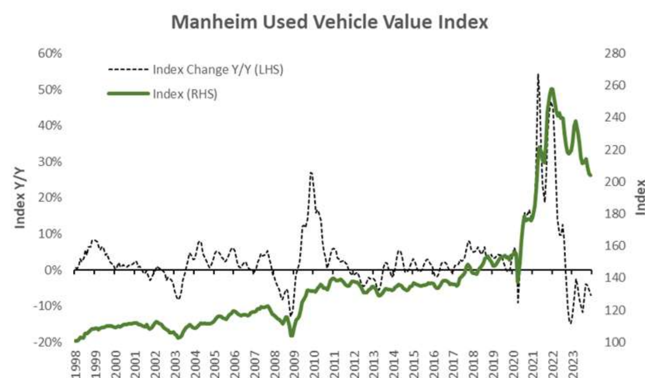
It Hasn't Been Easy for Lenders

There have been publicized reports about certain lenders struggling in the marketplace, causing a pullback in originations as they face elevated losses and a more challenging environment with regards to raising capital.

Why?

Coming out of Covid, with consumers flush with governmental support payments and relatively low rates, optimism within the sector was abundant. Due to constrained supply of new auto production and steady demand, prices surged to unprecedented levels within the new and used market in Canada and the U.S. Online auto marketplaces surfaced and offered attractive prices to consumers for used vehicles, creating more competition for used cars and keeping prices at premium levels. Essentially, loans at very low rates were extended to consumers for cars at very elevated prices. The good times didn't last…



Source: Cox Automotive

As inflation reared its ugly head, an unprecedented increase in rates started to impact affordability, credit availability and used car prices. According to AutoTrader, from 2019 to 2023, the average monthly car payment for a used vehicle in Canada rose by 37%, from $474 to $651, owing to higher interest rates and sale prices.

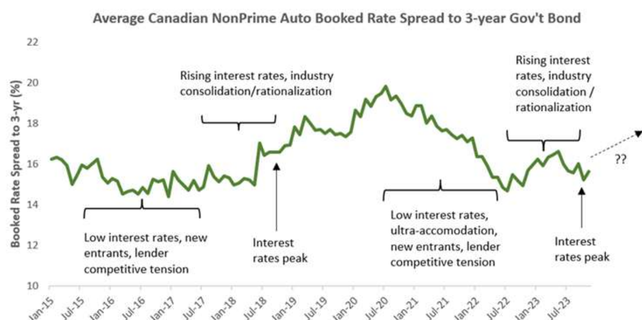
Used car prices peaked in December 2021, and have subsequently fallen by nearly 21%, impacting collateral value for 2021 and 2022 lending vintages. By March 2023, a high profile online auto firm, Canada Drives, had filed for creditor protection after stating, "The rising costs of holding inventory…has made this specific business model no longer viable." On November 15, 2023, Canadian non-prime auto lender Axis Auto Finance reported auto loan originations of $11.2 million, down from $44.5 million in the year ago quarter, "as credit and underwriting parameters were further tightened."

Hindsight is 20/20, but Credit was Mispriced in 2021-2022

It is easy to look back now and come to the conclusion that credit was, in our opinion, mispriced in the euphoric period of 2021-2022. Factors like home ownership, which historically has been a positive attribute to credit performance on account of likelihood of more stable incomes and availability of home equity, have now potentially shifted to negative attributes as variable mortgage rate pressure has shifted parts of this segment to a much more challenged subset of borrowers on account of sharp rises in mortgage payments. For those that do not own homes, rent inflation has also been punitive for most Canadians. This has likely been influential on previously prime borrowers experiencing deterioration in their credit profiles into a near or non-prime rating. In the institutional fixed income markets, this is akin to what is known as 'fallen angel' risk, where an investment-grade rated credit is downgraded to non-investment grade (junk bond) status because of deterioration in its credit profile. Regardless of asset class, what has been a common theme for lenders broadly is 2022 turned out to be undoubtably one of the worst years to underwrite credit in many years on account of higher defaults relative to the margin (and interest rate) at which

credit was initially priced, which is common to credit cycles that we've seen play out in the past.

Below is an illustration of how non-prime auto spreads to benchmark rates in Canada responded to the last interest rate cycle. Following the economic slowdown in China in 2015, central banks globally responded with exceptionally low interest rates to fight deflation which allowed lenders to borrow cheap money and realize wide margins to non-prime customers.



Source: Dealertrack, Industry Reports

Specific to non-prime auto in Canada, the global auto lending giant Banco Santander acquired Carfinco in 2015, along with additional new entrants that increased competition and reduced spreads (shown as interest rate of customer less yield on a three-year government benchmark bond). As interest rates began to rise in 2017 and 2018, compressed margins were met with rising defaults, which led to consolidation of smaller fragmented players and easing competitive tension amongst lenders, transitioning to a regime of expanding margins for lenders.

This was akin to the ultra-accommodative environment post Covid, which triggered a similar cycle of expanded lending capacity and growing fragmentation. Less disciplined underwriting ultimately came to a head in 2022-2023 when rising credit losses intersected with compressed margins and many funders ran out of capacity to continue to lend.

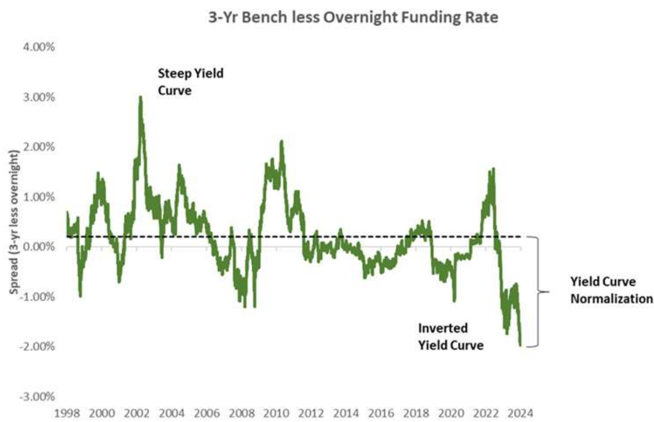
Turbulence Today, Clear Skies in the Future?

We expect several factors may contribute to widening margins and attractive returns within the non-prime auto segment over the next several years:

1. As demonstrated in previously experienced credit cycles, we've experienced rationalization amongst Canadian auto lenders, which we expect may transition to a regime of expanding NIM (net interest margin) within non-prime auto.

2. We have tracked non-prime auto loans over historical cycles and believe delinquencies may be peaking and credit written today at wider spreads should deliver attractive returns over the cycle. Over the past several months, elevated losses have compressed margins for credit originated in 2021 and 2022 (high losses in a lower-pricing environment). In this part of the cycle, margins would enter a troughing phase as a portfolio of higher-priced loans may transition to easing financial conditions, which has a lagging effect on relieving credit losses and expanding margins through the portfolio.

3. Normalization of the steep yield curve inversion will transition to expanding spreads of yields within our portfolios relative to overnight funding rates (i.e., interest earned on cash). Our credits are typically priced against the 3-year bond rate (~3.5% in mid-January 2024) relative to the current overnight rate of 5.0%, which is where floating rate private credit products and earnings on cash (or GICs) is benchmarked. With the widespread belief that interest rates will begin to decline in 2024, yield curve normalization would suggest larger declines are to be expected in the overnight rate relative to the 3-year bond yield against which our credit is priced. Relative to historical levels, normalization equates to the potential for 150-200bps of expanding excess yield.



Source: Bloomberg

Conclusion

We believe near-prime and non-prime auto credit underwritten properly at current yields incorporates elevated risk and funding levels and should deliver solid returns over the cycle.

The lack of funding capacity and the withdrawal of certain market players in Canada has created a more appealing competitive dynamic, which should benefit the Chesswood Canadian Asset-Backed Credit Fund and its unitholders in the years ahead.

For more information on private credit and our funds, please visit: www.waypointinvestmentpartners.com or contact Michael Lindblad (mlindblad@waypointinvestmentpartners.com) or Chris Nunes (cnunes@waypointinvestmentpartners.com).

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