OAKTREE | Client-Only Insights

Opportunistic Credit

Finding Good Companies with Bad Balance Sheets

Current Market Opportunity

We believe opportunities in both distressed liquid credit and stressed/distressed private credit (e.g., rescue financings, debtor-in-possession loans, and exit financings) will grow in the coming years, due to the ongoing sea change in interest rates that has left many companies with increasingly unstable capital structures.

Key Points

- The supply of potential distressed credit has **more than quadrupled** in the last decade as companies around the globe have accumulated over $5.5 trillion in non-investment grade debt and more than $7.0 trillion in BBB-rated debt (the bottom rung of investment grade).[1]
- **If the annual default rates for leveraged loans and high yield bonds were to increase to their long-term averages for a three-year period, the resulting total would exceed the three-year default volume recorded during either the GFC or the dot-com crash in the early 2000s.[2]**
- Skilled opportunistic credit investors can potentially **earn strong returns in benign market environments while also generating outsized returns during downcycles.** By offering the possibility of an asymmetric risk/return profile, the strategy can play a critical role in a larger portfolio.
- Successful opportunistic credit investing requires **fixed income expertise, experience handling restructurings, and a deep understanding of credit cycles.** Additionally, if one wants to be a liquidity provider during dislocations, **discipline and patience** are needed during up-legs of the credit cycle.
- The origins of our Global Opportunities strategy date back to 1988, when the fund that laid the foundation for Oaktree's opportunistic credit platform was created.[3] **Oaktree was a pioneer in opportunistic credit investing and remains a widely recognized leader in this area. The strategy has a broad charter, a global footprint, and the flexibility to capitalize on market inefficiencies and cyclical downturns.**

What is traditional distressed debt investing?

Oaktree's approach to opportunistic credit is rooted in distressed debt investing, which has traditionally referred to purchasing the liabilities of companies that (a) appear unlikely to meet their financial obligations or (b) are already in bankruptcy.[4] The preferred target is a company that has an unsustainable debt load but also a strong underlying business, valuable assets, and the ability to generate cash. These overleveraged companies may struggle to service their debt – especially during economic downturns – and thus seek to reduce their liabilities by going through a restructuring, either inside or outside of bankruptcy court. In these proceedings, creditors will typically agree to exchange old debt for new instruments, including debt with modified terms, post-reorganization equity, and cash.

The primary appeal of distressed debt is simple: **Investors can potentially buy something for less than it's worth.** The most attractive bargains are usually found during down-legs of the credit cycle, when negativity is peaking and risk aversion has replaced risk tolerance.

Distressed debt typically trades below its full value for several reasons:

- **Holders of distressed debt are often highly motivated sellers,** as they frequently seek to dispose of these holdings for reasons other than fair value assessments. These reasons can include the need for liquidity, the inability to handle complex distressed situations, and concerns about further losses.
- Significant financial distress normally occurs when markets are beset by disarray and panic, meaning **security prices often reflect excessive pessimism.**
- **When the supply of distressed debt exceeds the amount of available capital, prices can decline precipitously.** Normally, few investors are both willing and able to take advantage of distressed debt opportunities because doing so successfully requires fixed-income expertise and restructuring skill as well as the ability to analyze complex assets. Additionally, investors seeking to be liquidity providers in a dislocation must be highly disciplined at all times and have a deep understanding of credit cycles.

What are the primary risks associated with distressed debt investing, and how can they be managed?

To invest in distressed debt, one must – by definition – be willing to invest in situations where things aren't going well. Investors in distressed, stressed, and other value-oriented debt opportunities typically take on significant credit risk that they must be capable of underwriting properly.

Other key sources of risk include:

- illiquidity;
- the corporate restructuring process;
- companies' potential lack of transparency about the extent of their problems; and
- regional differences, as stakeholder rights might be viewed differently across jurisdictions.

Such risks can't be eliminated, but they can be managed if investors adhere to a disciplined investment process and engage in meticulous credit analysis. Additionally, distressed debt investors can potentially mitigate risk by leading or taking an active role in restructurings, as doing so can enable them to have a meaningful impact on the outcome of the process.

It's also important to note that investing in distressed companies may – perhaps paradoxically – sometimes be less risky than investing in high-performing companies. That's because distressed debt investors focus on issuers that are out of favor. (It's nonsensical to say, "This is a distressed company that everyone is optimistic about.") **By targeting distressed companies, an investor can typically avoid buying assets at prices that reflect excessive investor optimism – an objective that we believe is key to achieving superior investment results over the long term.**

How did traditional distressed debt investing evolve into the broader category of opportunistic credit investing?

The evolution of this investment style has been a gradual process. In the late 1980s, Oaktree's principals and other investors who focused on distressed assets primarily targeted high yield bonds in North America, where a dependable rule of law protected creditor rights. The opportunity set eventually expanded to include bank debt, mortgages, and private credit.

In the decade following the Global Financial Crisis, experienced distressed debt investors like Oaktree began to find opportunities in an even wider array of categories, such as rescue loans, non-performing bank loan portfolios, real-estate-related debt, specialty-finance platforms, and structured credit, among others. Investors who had previously focused on distressed opportunities increasingly began to explore situations that were complex but not classically distressed, especially those in illiquid markets or niche industries in which companies' access to capital was limited.

Importantly, we found that private distressed/stressed investments can, like traditional distressed opportunities, provide both significant upside potential and strong downside protection. Additionally, we've observed that in these situations, investors with roots in distressed debt – and thus decades of experience structuring deals – often have an edge versus competitors with backgrounds in non-distressed leveraged finance.

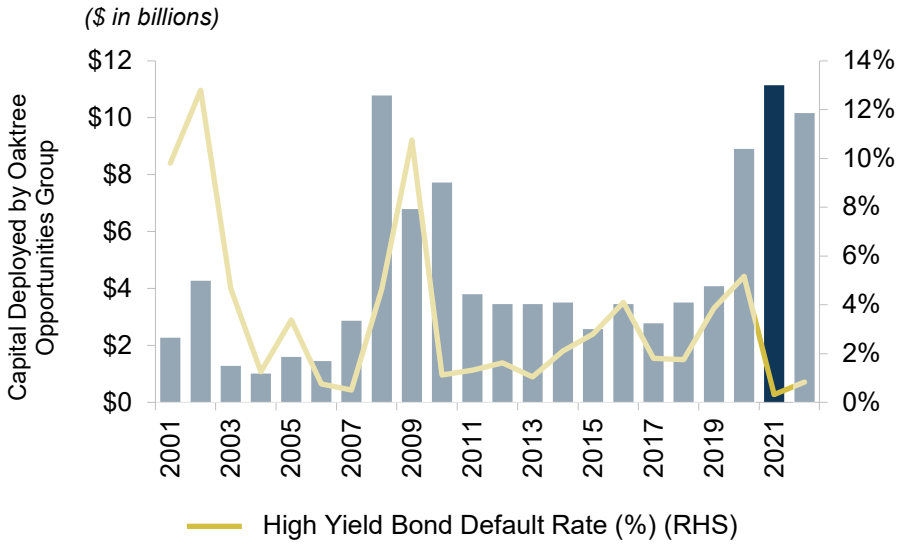
As the opportunistic credit toolkit expanded, so did the geographic footprint for a select set of investors, including Oaktree. Our investment universe first widened to include Western Europe, where opportunities proliferated following the onset of the eurozone crisis, and then continued to expand as international debt markets grew and many countries modernized their bankruptcy laws. In recent years, Oaktree has begun to explore opportunities in Asia, with a focus on China and India. For example, we recently opened an office in Mumbai to take advantage of the increasing opportunity set in this region.

What is the biggest change opportunistic credit investing has undergone in recent years?

Historically, the size of this strategy's investing universe was closely correlated with default rates in developed markets, but this has changed as traditional distressed debt investing has evolved into the broader category of opportunistic credit investing. Companies are obviously likely to struggle to service or refinance their debt – and thus liable to see their debt trade at distressed levels – when markets are weakening, major economies are slowing or contracting, and the majority of investors are becoming risk averse. **However, in recent years, Oaktree's universe of attractive opportunities has widened even when developed market default rates have remained below their long-term averages.**

Consider the Covid-19 crisis. In 2020, default rates for U.S. high yield bonds and leveraged loans rose above pre-pandemic levels, but they never approached the double-digits heights seen in prior crises, and by 2021, they were at their lowest levels since 2007.[5] **However, during 2021, Oaktree's Opportunities group deployed an average of almost $3 billion per quarter in investments with extremely attractive risk/return profiles.** (See Figure 1.) These opportunities were mostly in sectors that were highly exposed to the pandemic, such as retail, travel & leisure, real estate, and energy. The Opportunities group was able to act quickly as attractive opportunities arose because of our extensive experience, industry expertise, global networks, and access to large amounts of capital.

Figure 1: Opportunity Set Is No Longer Limited by Default Rates



Source: JP Morgan for default rates; Oaktree deployment data as of December 2022

What is Oaktree's approach to opportunistic investing?

Oaktree's flagship Global Opportunities strategy has a **broad charter, a global footprint, and the flexibility to capitalize on market inefficiencies and cyclical downturns.** Oaktree can invest in financial instruments, companies, and hard assets in the U.S. and around the world. We look for companies that are fundamentally sound but overleveraged: in other words, "good companies with bad balance sheets."

We believe the Global Opportunities strategy can play a critical role in a larger portfolio. **That's because it has the potential (a) to outperform many other credit strategies when market conditions remain stable – and to do so without the use of composite-strategy-level leverage – and (b) to earn even higher returns when conditions worsen.** In other words, we can potentially generate asymmetry in our performance, something our co-chairman Howard Marks has referred to as, "the essence of investment excellence and a standard against which investors should be measured."

Oaktree's opportunistic credit platform has evolved and expanded significantly over the last few decades. Thus, in 2021, we officially changed the strategy's name from "Distressed Opportunities" to "Global Opportunities" to better represent the breadth of our mandate. Our team now has seventy-three members, including dedicated investment professionals, restructuring experts, and traders, spread over six offices and three continents.

The Opportunities group's seven key investment categories are detailed below:

- **Distressed liquid credit:** Purchasing the debt of companies that appear unlikely to meet their contractual obligations or those already in bankruptcy.
- **Rescue financings:** Providing financing to distressed borrowers seeking to avoid entering into default and/or a formal bankruptcy process.
- **Debtor-in-Possession financings:** Participating in court-sanctioned financings that enable borrowers to continue operating during bankruptcy proceedings.
- **Exit financings:** Providing capital that companies need to exit the bankruptcy process.
- **Loan portfolios:** Purchasing portfolios of performing and/or non-performing loans with a diverse set of borrowers and assets.
- **Platforms:** Partnering with experienced management teams to establish platforms in industries experiencing dislocation and/or reduced access to capital.
- **Opportunistic capital solutions:** Providing borrowers with creative, customized solutions in highly complex situations where speed and certainty-of-execution are critical.

Although the Global Opportunities group has the flexibility to purchase a variety of instruments, our focus has long been on distressed liquid credit. Generally, these investments are either paid off at par plus accrued interest, or the debt is converted into some combination of new debt, cash, and equity through a restructuring. When investing in these types of instruments, Oaktree seeks to secure both downside protection (by buying claims on assets at bargain prices) and upside potential (by helping companies restore their financial viability, usually through a restructuring).

The Global Opportunities strategy often seeks to lead or take a very active role in restructurings. We believe doing so gives us the best opportunity to ensure that the outcome will be beneficial for the credit classes to which we belong. In instances where we emerge as meaningful equity owners following a bankruptcy, we strive to turn around the business by taking various actions, including appointing new board members and management teams.

In order to limit our susceptibility to economic fluctuations and other risks specific to opportunistic credit investing, we always take measures focused on preserving capital. We generally seek to hold the senior secured debt of quality companies that have tangible underlying assets, dependable cash flows, and durable business franchises. Additionally, we build portfolios that are diversified across industries and companies, and we usually keep individual positions below 10% of a portfolio (and never have positions representing more than 15%).

The primacy of risk control is the first tenet of Oaktree's investment philosophy and a central pillar of our approach to opportunistic investing. We always act as long-term investors, not short-term traders, standing by Oaktree's long-held conviction: "If we avoid the losers, the winners will take care of themselves."

Current Market Opportunity

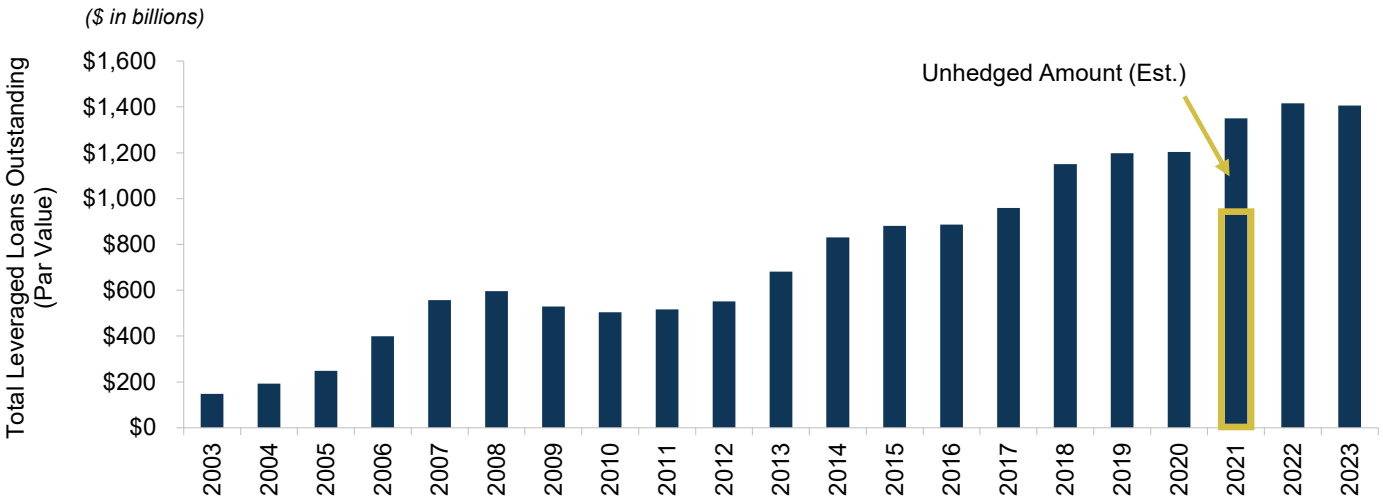
The opportunistic credit universe – which is already expansive – may become even more so in the coming years, due to the dramatic increase in interest rates that has left many companies with unsustainable capital structures. In short, we believe the "easy money" policies of recent decades, which came to an abrupt halt in 2022, have provided the kindling for a **significant opportunity in traditional distressed liquid credit and distressed/stressed private credit.**

We've begun to see a clear pattern emerge among companies struggling to navigate this sea change in financial markets:

(1) Companies borrowed too much low-quality, floating-rate debt: The volume of leveraged loans and private credit outstanding ballooned by 2.7x and 5.7x, respectively, during the period of ultra-low interest rates that followed the GFC.[6] The majority of this growth was concentrated in the more speculative ends of these markets, meaning the credit quality of both the U.S. leveraged loan and U.S. private credit markets has declined substantially since the GFC.[7] Loans with credit ratings of B or below represented 30% of speculative-grade debt outstanding (i.e., debt rated BB+ and below) in 2000, but this percentage rose to 60% by year-end 2022.[8] And almost two-thirds of leveraged loans outstanding as of June 30, 2023 were rated B or below.[9] While the private credit market isn't rated by agencies, we suspect its credit quality has diminished similarly.

(2) Companies failed to hedge their floating-rate exposure: Both leveraged loans and private credit typically have floating coupons tied to reference rates. We estimate that roughly two-thirds of U.S. leveraged loan volume was unhedged as of YE2021. (See Figure 2.) Three-month SOFR (the most common reference rate used today) has increased by more than five percentage points since then, meaning many of these borrowers are now facing dramatically higher interest costs.

Figure 2: Most of the U.S. Leveraged Loan Market Was Unhedged Before the Interest Rate Spike



Source: Market size from Pitchbook LCD; percentage of hedged loans based on Oaktree estimate; both as of June 30, 2023

(3) Companies made overly aggressive EBITDA[10] adjustments: Much of the aforementioned debt was issued based on optimistic EBITDA assumptions (e.g., growth, synergies, cost cuts, etc.) that haven't materialized. In fact, LBO adjustments as a percentage of EBITDA rose by 75% in the 14 years through 2Q2023 to hit 14%.[11] As a result, many of these loans are much more highly leveraged than they appear on paper.

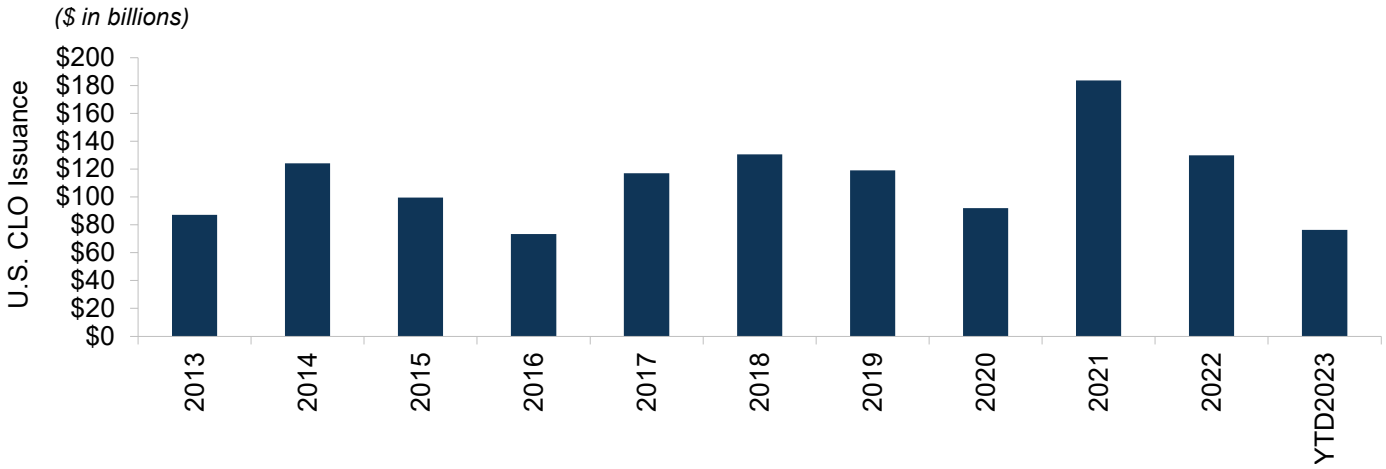
(4) Companies now have razor-thin coverage ratios: Many companies in our universe have fixed-charge coverage ratios below or only slightly above one (i.e., the companies are at risk of, or already lack, sufficient cash to make their interest and debt amortizations payments). For example, private credit loans tracked by Lincoln International had an average FCCR of just above one as of 1Q2023, and 45% had an FCCR below one.[12]

As a result of this trend, we're likely to see rising distress among borrowers, especially once they feel the full effect of the most recent interest rate increases. In July 2023, the credit rating agency Moody's analyzed the impact that an increase in this rate to 5.25%-5.50% would have on interest coverage ratios[13] of more than 300 corporate issuers in the U.S. and Canada with credit ratings of B3 (the equivalent of B-). Moody's projected that, in this scenario, the interest coverage ratios of 62% of these companies would fall below one by the end of 2024.[14] Again, this means many companies won't be generating sufficient earnings to cover their interest expense.

(5) Companies have debt maturing in the next few years that will likely need to be refinanced at significantly higher interest rates: Most of the borrowers we've been describing have maturities that will need to be addressed in 2024, 2025, or 2026. Currently, the average yield-to-maturity of loans rated B is near 9.8%, compared to 5.3% at YE2021,[15] while the average yield-to-maturity of unitranche private credit loans is near 12.5%, compared to 7.2% at YE2021.[16] If interest rates remain elevated – which we think is likely – many issuers are apt to struggle to refinance their massive debt loads. While 2026 may seem far away, markets usually start to analyze and react (via yield spread changes) to an issuer's ability to address maturities 18 to 24 months before the maturity date. Thus, it likely won't be long before we see concerns about medium-term refinancings creep into market prices.

(6) Companies have fewer financing options, especially given declining demand from CLOs: Collateralized Loan Obligations are the major buyers of leveraged loans, holding more than two-thirds of the outstanding U.S. loan market.[17] But the creation of CLOs has slowed significantly in 2023, with gross issuance in 2Q2023 representing the lowest quarterly volume since 2Q2020.[18] (See Figure 3.) This is largely due to the shrinking CLO arbitrage and money-center banks' reduced appetite for AAA-rated CLO tranches. Additionally, 40% of CLOs are set to exit their reinvestment periods before YE2023, which means many CLOs will likely have limited ability to participate in new financings and refinancings or pursue "amend and extend" modifications of their existing holdings.[19] Meanwhile, retail investors are also reducing their exposure to the asset class: Loan retail funds have recorded over $18.0 billion in net outflows in the first eight months of 2023.[20]

Figure 3: CLO Creation Has Declined Meaningfully in 2023

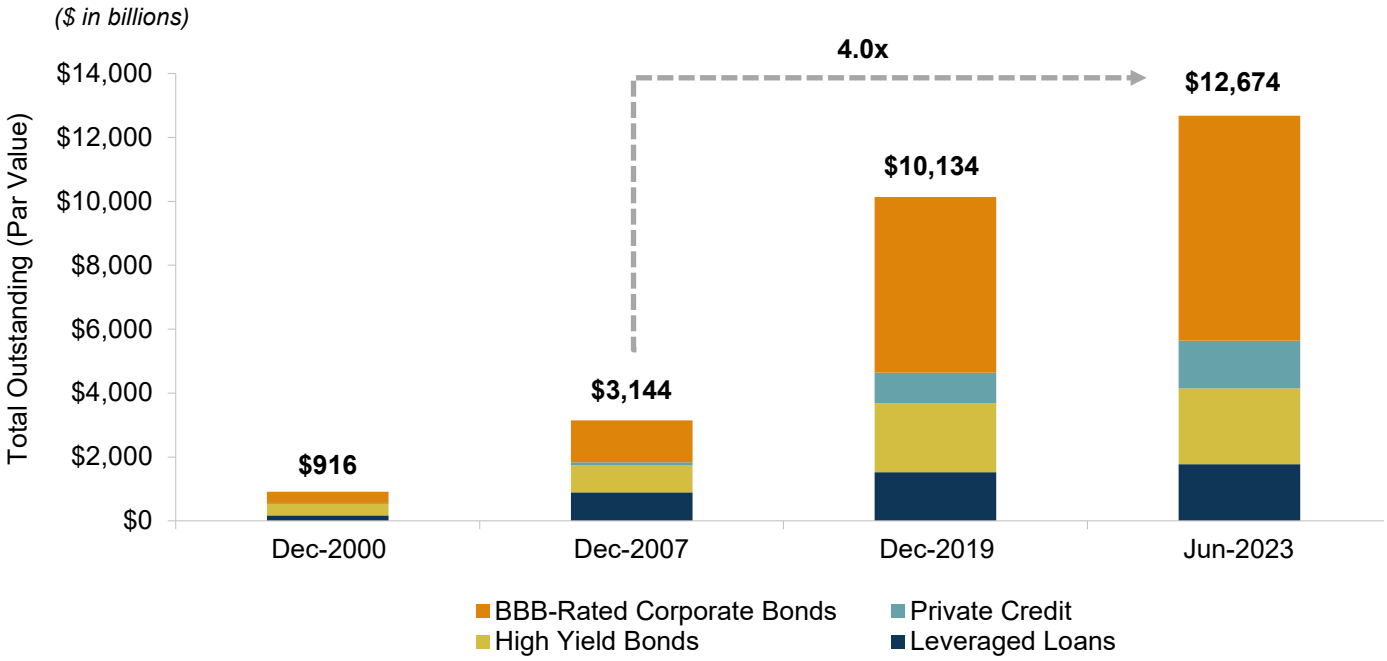


Source: JP Morgan, Pitchbook LCD, gross issuance as of August 31, 2023

The financing landscape in 2023 has proven to be especially challenging for the most highly leveraged borrowers. While total leveraged loan issuance (excl. refinancings) has decreased by 70% in 2023, the decline has been even more dramatic among the lowest-rated borrowers, with only a handful of CCC-rated loans made in 2023 this year.[21] At the same time, downgrades of leveraged loans outpaced upgrades for 16 consecutive months through August 2023.[22] If this trend persists, more borrowers may find themselves with credit ratings that make refinancings extremely challenging – if not impossible.

As a result of the above, **defaults and distressed exchanges have increased in 2023 compared to the levels in recent years, and we anticipate that this trend will continue – even if there isn't a recession in the next year. That's because the universe of potential distressed debt has quadrupled since the GFC.**[23] (See Figure 4.) As of June 2023, companies around the globe had accumulated over $5.5 trillion in non-investment grade debt and more than $7.0 trillion in BBB-rated debt (the bottom rung of investment grade). If the annual default rates for leveraged loans and high yield bonds were to increase to their long-term averages (i.e., to their normal averages, not their recessionary averages) for a three-year period, the resulting total would exceed the three-year default volume recorded during either the GFC or the dot-com crash in the early 2000s.[24] Consider that default/distressed exchange volume in the first half of 2023 already exceeds the total annual volumes in 2021 and 2022.[25] Moreover, if you annualize the default volume in 1H2023, it translates to the third-highest annual default volume on record.[26] And, remember, this growth has occurred during a period of fairly healthy economic activity.

Figure 4: The Global Universe of Potential Distressed Credit Has Ballooned



Source: Bloomberg, Credit Suisse, ICE BofA, Preqin, Cliffwater as of June 30, 2023. Private Credit data from Preqin as of December 2022.

To be clear, we're not outlining a doomsday scenario. Current economic trends are too complex – and often contradictory – to support such a call. However, what we can say with certainty is that **(a) we've already seen a meaningful increase in the supply of distressed credit in 2023 and (b) multiple trends indicate that we could see an uptick during the coming years.**



Bruce Karsh

Co-Chairman and Chief Investment Officer

Mr. Karsh is Oaktree's Co-Chairman and one of the firm's co-founders. He also is Chief Investment Officer and serves as portfolio manager for Oaktree's Global Opportunities, Value Opportunities and Global Credit strategies. Prior to co-founding Oaktree, Mr. Karsh was a managing director of TCW Asset Management Company, and the portfolio manager of the Special Credits Funds from 1988 until 1995. Prior to joining TCW, Mr. Karsh worked as Assistant to the Chairman of SunAmerica, Inc. Prior to that, he was an attorney with the law firm of O'Melveny & Myers. Before working at O'Melveny & Myers, Mr. Karsh clerked for the Honorable Anthony M. Kennedy, then of the U.S. Court of Appeals for the Ninth Circuit and retired Associate Justice of the U.S. Supreme Court. Mr. Karsh holds an A.B. degree in economics summa cum laude from Duke University, where he was elected to Phi Beta Kappa. He went on to earn a J.D. from the University of Virginia School of Law, where he served as Notes Editor of the Virginia Law Review and was a member of the Order of the Coif. Mr. Karsh serves on the boards of a number of privately held companies. He is a member of the investment committee of the Broad Foundations. Mr. Karsh is Trustee Emeritus of Duke University, having served as Trustee from 2003 to 2015, and as Chairman of the Board of DUMAC, LLC, the entity that managed Duke's endowment, from 2005 to 2014.



Robert O'Leary

Managing Director and Portfolio Manager, Global Opportunities

Mr. O'Leary is a portfolio manager for Oaktree's Global Opportunities strategy, leading the group's investment activities in North America. In this capacity, he contributes to the analysis, portfolio construction and management of both the Global Opportunities and Value Opportunities strategies. Prior to joining Oaktree in 2002, he worked at McKinsey & Company, where he was a consultant, and Orion Partners, a private equity firm, where he focused on investments in private companies. Mr. O'Leary graduated magna cum laude from Pomona College with a B.A. degree in economics, and he received his M.B.A. from Harvard Business School.



Pedro Urquidi

Managing Director and Porfolio Manager, Global Opportunities

Mr. Urquidi is a portfolio manager for Oaktree's Global Opportunities strategy for which he leads all of the group's investment activities outside of North America. Mr. Urquidi joined the firm's London office in 2005 and subsequently built, led and managed the European and Asian Opportunities teams from there before relocating to Hong Kong in 2019 to also help develop the firm's investment activities in the region. During his tenure at Oaktree, he has also served on various boards including Eolia Renovables and TI Automotive. Prior to joining Oaktree in 2005, Mr. Urquidi spent ten years at Morgan Stanley & Co., where from 2001 to 2004 he built, led and managed Morgan Stanley's European Special Situations Group in London as well as served as overall risk manager for the firm's European high yield, bank debt and distressed debt businesses. Between 1994 and 2001, he worked in New York and Hong Kong as a trader in Morgan Stanley's Global High Yield group, including roles as Head of Emerging Market Corporate Trading and senior high yield trader. Mr. Urquidi graduated with an A.B. degree in economics from Princeton University and an M.B.A. in finance from Columbia Business School.

Endnotes

1. Bloomberg, Credit Suisse, ICE BofA, Preqin, Cliffwater, as of March 31, 2023; for middle-market direct lending data: Preqin, as of June 2022.
2. JP Morgan and Oaktree analysis.
3. In 2021, the names of Oaktree's Distressed Debt platform and Distressed Opportunities strategy were changed to Opportunistic Credit and Global Opportunities, respectively.
4. When we say "bankruptcy," we're referring to the U.S. process as well as equivalent foreign processes.
5. JP Morgan.
6. Preqin and Pitchbook LCD.
7. As of June 30, 2023. The credit quality of the leveraged loan market is determined by the rising percentage of lower-rated debt, as measured by S&P Global Ratings. While the private credit market isn't rated by agencies, our observations suggest that credit quality in the private market has diminished similarly.
8. S&P Global Ratings Credit Research & Insights, S&P Global Market Intelligence's CreditPro.
9. PitchBook LCD.
10. Earnings before interest, tax, depreciation, and amortization.
11. PitchBook LCD.
12. Lincoln International: Lincoln Valuation & Opinions Group Proprietary Database; size-weighted. Fixed Charge Coverage Ratio defined as = (LTM EBITDA – Taxes – Capex) / LTM Interest Expense + (1% * Total Debt). All assumptions assume a reference rate of 5.5%.
13. Interest Coverage ration defined as (EBITDA – capex)/ LTM interest expense.
14. Moody's Investors Services, as of July 27, 2023. Data as of December 31, 2022.
15. Credit Suisse, as of August 31, 2023.
16. DLD May Monthly Insights & Outlook Data through May 31, 2023.
17. Credit Suisse, as of August 31, 2023.
18. PitchBook LCD, as of June 30, 2023.
19. Kanerai, Intex, MarkIt, and Barclays Research through June 30, 2023; "amend and extend" refers to amendments in syndicated loan agreements that extend the maturity dates.
20. JP Morgan, as of August 31, 2023.
21. JP Morgan, as of September 15.
22. JP Morgan, as of July 31, 2023.
23. Bloomberg Barclays, Credit Suisse, ICE BofA, Preqin, as of June 30, 2023. For Middle Market / Direct Loans data from Preqin as of December 2022.
24. JP Morgan and Oaktree analysis.
25. JP Morgan.
26. JP Morgan and Oaktree analysis.

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