SPECIAL EDITION: SURVIVING AND THRIVING IN AN ERA OF 'LOWER FOR LONGER'
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**FOREWORD**

Oaktree recently hosted a panel of investment professionals to discuss investing in a prolonged low-interest rate environment. Rajath Shourie, Co-Portfolio Manager of our Distressed Debt investment strategy, moderated the discussion and was joined by Bill Casperson (Co-Portfolio Manager, U.S. Private Debt), Josh Connor (Co-Portfolio Manager, Infrastructure Investing), Pedro Urquidi (Co-Portfolio Manager, Distressed Debt and Head of Distressed Debt Europe), Matt Wilson (Co-Portfolio Manager, Special Situations), Francoise Giacalone (Managing Director, U.S. High Yield Bonds), and Nael Khatoun (Managing Director, European Principal and European Private Debt). What follows is based on that conversation.

**Rajath Shourie:** Pedro, let me pose the first question to you. What do you think are the major effects of today’s low-interest rate environment on the investing landscape in Europe?

**Pedro Urquidi:** From my perspective, there are three major consequences. First, the low-rate environment has clearly pushed valuation multiples to cyclically high levels. This phenomenon is present not only in corporate bonds, but also in infrastructure and other asset classes. And while it’s most prominent in the public markets, it has also spread to the private markets. Second, there has been increased use of leverage, both direct and indirect, in an attempt to push single-digit returns into double-digit territory. The use of leverage now is much greater than what was observed leading up to the last financial crisis. Finally, sustained low rates have caused many public-market investors to shift their attention, and their allocations in turn, to private markets, where higher yields are more prevalent. Along with other phenomena, this has created a significant market for direct lending in Europe. In fact, Europe went from having almost no private market for direct lending before the credit crisis, to having outstanding loan value that is now estimated to be $75 billion to $100 billion.

**Rajath Shourie:** And Nael, what effects have you seen from a private equity perspective in Europe?

**Nael Khatoun:** The low-rate environment and corresponding investor search for yield – which in turn have driven up pricing for many assets – make it a really attractive time to exit investments, particularly those with strong fundamentals. The issue, however, is that most of these exits have materialized via highly competitive auctions, resulting in valuations that are reliant on excessive leverage. The average enterprise-value-to-EBITDA purchase multiple in Europe now exceeds nine and a half times, including over five times debt-to-EBITDA. In addition, the behavior of some private equity sponsors creates cause for concern. In their eagerness to own an asset that’s being auctioned off, some sponsors have conducted limited due diligence before submitting a bid. For instance, we recently sold a portfolio company where the bidder entered into a binding purchase agreement in less than 48 hours in order to pre-empt the auction.

**Rajath Shourie:** There’s certainly yin and yang in that, right? It is fabulous if you’re a seller, but if you’re a buyer, maybe not so much. Bill, how has the low-rate environment affected middle market lending in the U.S.?

**Bill Casperson:** The effect has been quite significant. The higher returns offered by middle-market and direct loans have attracted a host of non-bank lenders to the table, particularly as U.S. banks have exited the middle market, largely for regulatory reasons. While these non-traditional lenders have been very successful in fundraising to finance middle-market LBOs, they’ve also created a very “crowded” marketplace dynamic.

**Rajath Shourie:** And how do you all think the impact of a low-interest rate environment has affected the investor base in your markets? Have any increased risks arisen as a result?

**Francoise Giacalone:** Low prospective returns over the last few years on high yield bonds have pushed investors to expand their scope by looking at other asset classes. This often means that investors are taking on more risk in an effort to increase returns. One way credit investors have done this is by moving down the credit-quality spectrum. In some cases, investors who typically sought only investment-grade assets are now fully utilizing – and in some cases expanding – their allowable high yield bond allocation.
Bill Casperson: In the middle markets, investors have been pivoting between sponsor-led and non-sponsored deals. As a result, we are seeing some elevation of risk as participants do this in an attempt to benefit from a yield difference between the two. However, lending to non-sponsored companies generally means you’re dealing directly with a company’s management team, so if there’s a bump in the road and that team is hesitant to make material changes or terminate key executives, as a lender you may be more limited in your ability to force change in order to improve the credit standing of the business. That’s sometimes easier when you’re working alongside a sponsor or as part of a syndicate of lenders. Investors should be wary of new or less-experienced investment managers who suddenly pivot toward non-sponsor backed deals, because while yields may be more generous, these transactions generally entail greater risk.

Rajath Shourie: In a time when rates are low, what are your thoughts on managers taking a more creative and flexible approach to their core mandate in search of returns?

Matt Wilson: How you define creativity and flexibility makes all the difference here. Within Oaktree’s Special Situations Group, our investment strategy calls for us to “pivot” our investment focus in sanguine times like today by making direct investments in companies, rather than attempting to buy distressed debt in the open marketplace or pursuing “distress-for-control” investments, which we do when markets experience dislocation. In other words, flexibility is a core element of our investment approach. That said, it can be a sign of significant danger when you see a manager go outside its wheelhouse. For example, while we may make a direct or structured equity investment in a private company, we would not pursue a leveraged buyout, because it does not align with our emphasis on managing downside risk.

Francoise Giacalone: I agree this is about how you define creativity. There’s often a fine line between looking beyond the obvious and being overly clever. We certainly strive to look past what’s plainly evident to identify or create good investment opportunities. Of course, the most flexible bond mandates have the ability to be more broadly creative than the more tightly defined ones. That said, similar to other markets, we’re dealing with low interest rates, high valuations, and high leverage. Our job is to dig beyond the headlines to understand a company’s underlying business in order to determine if its cash flows will be able to support its debt incurrence – and especially the particular paper we own in its capital structure – if times get tough.

Pedro Urquidi: Our Distressed Debt strategy has a highly flexible charter, allowing us to be creative as we adapt to whatever the market brings us – whether we’re in the down-leg of the credit cycle or not. In overall benign times, we look for idiosyncratic or sector- and company-specific distress, whereas in a downturn, we avail ourselves of systemic distress opportunities and largely concentrate our buying in the public debt markets. What doesn’t change irrespective of the environment we’re in, however, is our emphasis on working with the right partners and counterparties, and ensuring appropriate resourcing to underwrite, manage and exit investments successfully.

Josh Connor: Flexibility has been a huge topic within the infrastructure arena, beginning with how infrastructure is actually defined, either narrowly or broadly. Our team focuses on midstream energy and power generation in the energy sector and on airports, ports, freight rail, and other transportation infrastructure assets in the transportation sector. It’s tempting to stretch the definition of infrastructure in order to be able to deploy capital more readily and easily. While we understand the temptation, we believe it’s critical to stick to investments that fit the mandate for which our clients have hired us. This means sometimes we have to exercise patience, remaining disciplined while we wait for appropriate opportunities. And while we have flexibility in the way we structure a particular investment, we always evaluate the same criteria before buying an asset – things like barriers to entry, business cyclicality, seasonality, regulatory and political dynamics, and so on. We’ve seen a surprising amount of wiggle room in what some of our competitors consider an infrastructure investment or mandate. An example would be aircraft leasing, which we think is too much of a stretch.

Rajath Shourie: Many investors are now wondering what sensible, attractive investment opportunities exist today. Can each of you describe where you see such opportunities in your respective areas?

Nael Khatoun: I would categorize the opportunity set into two themes, covering both European private equity and European direct lending. The first and most interesting to me in terms of sheer size – and also the most obvious – is the opportunity available to investors focused on smaller transactions. For instance, in Europe today there is a significant difference between the average EV-to-EBITDA entry multiple
for transactions over €250 million and for businesses valued between €25 million and €100 million. That difference is something we regularly seek to exploit by acquiring single assets and aggregating them into a larger portfolio or platform that can potentially command a much higher valuation multiple at exit. You see the same in the European direct lending market, where large companies can get easy access to liquidity, while small and medium-sized enterprises have limited access to European Central Bank funding and, thus, may be priced inefficiently. As a result, we seek to generate higher returns by targeting the small and medium-sized enterprise markets where access to financing is far scarcer, enabling us to charge higher interest rates on our loans. The second thematic opportunity, we find, is in making direct loans to companies outside of a competitive process. We do not participate in sponsor-driven direct lending, which is much more of an “auction” market. As a result, in our non-sponsor deals, we’re able to charge a 400 basis point premium with higher capital structure priority. Many European direct lending funds today are taking on subordinated debt risk in an effort to achieve the same yield as they might have several years ago when the market was in its infancy. Focusing on less-competitive situations enables us to get our desired yield and be at the right place in the capital structure to maximize recovery in the event of a default or restructuring.

Pedro Urquidi: The distressed debt opportunity set in Europe has been largely tied to the sale of non-core assets by European banks, to the tune of about $100 billion annually. For the past several years we’ve been investing heavily in these non-core assets, mostly in the form of non-performing loan, or NPL, portfolios. As European banks continue to unload a significant amount of these assets each year, the market to buy NPLs has become extremely competitive, and this activity has now compressed returns for potential buyers. As a result, we’ve been making fewer acquisitions of NPL pools. That said, the areas that appear less competitive, and where we are finding more attractive and interesting opportunities and therefore are making more investments, are in single-loan acquisitions and stretch-senior recapitalization deals. Stretch-senior recapitalization lending is where we might lend capital to a borrower so they can buy back their loan from a bank, for example. In these cases, the borrower can often negotiate a much better discount than we ever could because of their relationship with the lender. Our Distressed Debt strategy is also finding interesting investment opportunities in Asia. These markets are currently more dislocated and generally more disparate than European markets. We haven’t been highly active in Asia yet, but we are optimistic that, over time, we’ll be able to do more in this region with less competition than in other parts of the world. In Asia we’re also working on recapitalization lending with real estate developers, where there are very-high-quality assets and an opportunity to potentially earn what we consider very attractive returns. Finally, together with Oaktree’s Emerging Markets Debt group, our Distressed Debt team has been able to invest capital at deep discounts in select EM credits thanks to episodic dislocation. The corporate high yield bond market within the emerging markets has grown from $191 billion before the global financial crisis to about $820 billion today, and the EM loan market has doubled from $1 trillion to $2 trillion. We see many evolving opportunities in the emerging markets as a result. Of course the key requirement is highly specialized EM expertise.

Rajath Shourie: Francoise, what do you think of the opportunity set today in performing credit, and what has been your approach to investing in such in the current environment?

Francoise Giacalone: For high yield bonds, the opportunity set is typically most robust in the new issue market. In strong markets, like this one, the amount of issuance is very high – this year alone it’s expected to be around $290 billion. The high yield bond market as a whole is quite large – over $1.5 trillion. Generally our maturities are up to ten years, but due to the callable nature of the bonds within three to four years, there is a continuous flow of issuance for refinancing. We also actively monitor the secondary market, where previously issued bonds are trading. Oftentimes we initially pass on new issues because we don’t see the desired alignment between risk and potential reward; although we may have liked the risk, we often required a higher prospective reward. By actively monitoring the secondary market, we may encounter the same credit we liked at issue but with improved economics if the price has declined.

Rajath Shourie: Bill, how would you characterize the opportunity set in the middle market?

"Investors are taking on more risk in an effort to increase returns. One way credit investors have done this is by moving down the credit-quality spectrum."

Francoise Giacalone, Managing Director, U.S. High Yield Bonds
Bill Casperson: I’d say that the opportunity set is very good for us. We see a large number of deals a year – about 300 to 400. Most of those deals are by invitation only from private equity firms with whom we have established relationships over many years. Selecting the 15 to 20 transactions that we’ll invest in from the initial 300 to 400 deals available is a challenge, but our approach is to be highly selective and patient.

Rajath Shourie: Josh, how does your team view the opportunity set on the transportation side?

Josh Connor: The United States was once a global leader in infrastructure, but today we have fallen far behind many other nations. Ironically, the U.S. spends $350 billion a year on transportation infrastructure, yet one doesn’t need a survey to show that such spending has done little to improve or even to maintain our infrastructure assets. In the last few years, great emphasis has been placed on improving the safety of infrastructure, especially with respect to roads, bridges and airports. And while at one time governments were able to issue debt repeatedly to fund infrastructure financing needs, they’ve been unable to keep pace as asset quality has declined precipitously. This has created a great need for alternative financing and, in turn, a great opportunity for infrastructure investors like Oaktree.

Rajath Shourie: Matt, you’ve been deploying capital over the last few years despite a dearth of distress. How would you characterize the current opportunity set in special situations and private equity investing within the U.S.?

Matt Wilson: The backbone of our strategy is a focus on distress that is idiosyncratic or situational. An example of this would be acquiring a company, or providing a capital solution to a company, that has found itself in trouble as a result of overpaying for an acquisition and assuming more debt than it could reasonably service. It’s a classic “good company, bad balance sheet” type of opportunity that can occur irrespective of systemic or cyclical distress. In general, in a benign economic environment our strategy seeks to find investment opportunities that arise from something going wrong at the company- or at the micro-levels, rather than at the macro-level. Mismanagement isn’t cyclical! Over the last 18 months, the bulk of our capital has been deployed in what we call “structured equity” deals. This is, effectively, rescue financing, or financing that can’t be obtained in the traditional capital markets. We like structured equity investments because they allow us to establish a priority position in the capital structure, often with an attractive interest coupon; yield enhancement through an original issue discount; call protection; significant warrant coverage or convertibility into the company’s equity; plus governance rights. These types of transactions require great creativity and proprietary relationships to identify, but they are our investment of choice in the type of market we’ve seen over the last several years. When the cycle finally turns, I suspect we’ll continue to do structured equity deals, but a decline in public debt markets will inevitably create even more opportunities for capital deployment in distress-for-control-type situations. We look forward to that time, but we’re staying plenty busy in the meantime.

Rajath Shourie: I think most of us agree with you, Matt. A distressed cycle, however far away, is likely to create incremental opportunities for Oaktree. But in the interim we’ll continue to seek value and deploy capital consistent with our investment philosophy.

“Mismanagement isn’t cyclical!”
– Matt Wilson, Co-Portfolio Manager, Special Situations

Sources
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BIographies

Rajath ShouriE
Managing Director and Co-Portfolio Manager, Distressed Debt
Mr. Shourie is a managing director and co-portfolio manager within Oaktree’s Distressed Debt group. He contributes to the analysis, portfolio construction and management of the Distressed Opportunities and Value Opportunities strategies. Since joining Oaktree in 2002, Mr. Shourie has spent his time investing in distressed debt. He has invested in the airline/aircraft industry for a number of years, and led the firm’s investments in financial institutions during the global financial crisis. Mr. Shourie has worked with a number of Oaktree’s portfolio companies, and currently serves on the board of Taylor Morrison (NYSE: TMHC). He has been active on a number of creditors’ committees, including the steering committee in the restructuring of CIT Group. Prior to joining Oaktree, he was an associate in the Principal Investment area at Goldman, Sachs & Co., and a management consultant at McKinsey & Co. Mr. Shourie earned a B.A. in economics from Harvard College, where he was elected to Phi Beta Kappa. He then went on to receive an M.B.A. from Harvard Business School, where he was a Baker Scholar.

BiLL CAsPErSON
Managing Director and Co-Portfolio Manager, U.S. Private Debt
Mr. Casperson joined Oaktree in 2001 and currently serves as co-portfolio manager for the Middle-Market Finance Group. His primary responsibilities include origination, underwriting and execution. Prior to joining Oaktree, Mr. Casperson worked in the Leveraged Finance and Global Syndicated Finance Groups at J.P. Morgan Chase where he was responsible for leading high yield deal teams in all phases of due diligence and “one-stop” financings including senior credit facilities, high yield bonds and bridge loans. Prior to that, Mr. Casperson was a member of Chase Manhattan’s Financial Sponsor Group, where he was responsible for managing relationships with a variety of buyout funds. From 1989 to 1998, Mr. Casperson worked at NationsBank N.A., most recently as a principal in the High Yield Finance Group. Prior to NationsBank, he was an auditor at Touche Ross & Co. Mr. Casperson holds a B.A. degree in accounting from Rutgers University and an M.B.A. from The University of Michigan School of Business Administration with a concentration in finance.

JosH COnNOR
Managing Director and Co-Portfolio Manager, Infrastructure Investing
Mr. Connor is a managing director and co-portfolio manager of Oaktree’s Infrastructure Investing strategy, specializing in the transportation sector. He joined Oaktree in 2017 after having served as a strategic advisor to the firm’s Infrastructure Investing team since September 2015. For over 20 years, Mr. Connor has been an investor, key strategic advisor, lender, and an investment banker to many transportation companies around the world. Prior to joining Oaktree, he founded Connor Capital SB, an investment firm that focuses on equity investments in transportation companies. Prior to forming his own firm, Mr. Connor was a managing director and the co-head of the Industrials Banking Group at Barclays, a member of the Barclays Investment Banking Operating Committee, and Global Head of Transportation Banking, which became a top-three global franchise under his leadership. He joined Barclays in 2011 from Morgan Stanley, where he spent 15 years and was the global co-head of the Morgan Stanley Transportation & Infrastructure Group, a member of the Morgan Stanley Investment Banking Management Committee, and on the Board of Trustees for the Morgan Stanley Foundation (Finance/Investment Committee). He currently serves on the boards of directors of Frontier Airlines and Copa Holdings (NYSE: CPA). Mr. Connor received a B.A. degree in economics from Williams College.
BIOGRAPHIES (CONTINUED)

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**Co-Portfolio Manager, Distressed Debt and Head of Distressed Debt Europe**  
Mr. Urquidi is a co-portfolio manager within Oaktree's Distressed Debt group and head of its investment teams in Europe and Asia. He contributes to the analysis, portfolio construction and management of the Distressed Opportunities and Value Opportunities strategies. Prior to joining Oaktree in 2005, Mr. Urquidi spent ten years at Morgan Stanley & Co., where from 2001 to 2004 he worked in London as head of Morgan Stanley’s European Special Situations Group as well 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 the 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.

MATT WILSON  
**Managing Director and Co-Portfolio Manager, Special Situations**  
Mr. Wilson is a managing director and co-portfolio manager of the Special Situations Group. He is responsible for management of the strategy and all of its investing activities. Prior to joining Oaktree in 2007, Mr. Wilson worked at H.I.G. Capital, LLC, where he was a founding member of Bayside Capital, Inc., a firm focused on special situations and credit-oriented investments. Previously, he worked at J.H. Whitney & Co., in its middle market buyout group. Mr. Wilson began his career in the Investment Banking division at Merrill Lynch & Co. He currently serves as Chairman of the Board of Directors of Agro Merchants and Boardriders, and on the board of Glam Squad. Mr. Wilson previously served on the boards of AdvancePierre Foods, Billabong International, Diamond Foods and the Bridge Direct. He is also the previous Chairman of the Board of Trustees and currently serves on the Board of Directors of The Children's Bureau of Los Angeles. Additionally, Mr. Wilson serves on the Board of Trustees of The Chadwick School. He earned a B.A. degree with distinction in economics and history from the University of Virginia and an M.B.A. from the Harvard Business School.

FRANCOISE GIACALONE  
**Managing Director, U.S. High Yield Bonds**  
Ms. Giacalone joined Oaktree in 2005 from Lord, Abbett & Co. LLC, where she served as a senior securities analyst for High Yield Bonds and Convertibles Securities. Before that, she spent over three years as a vice president and senior analyst in the Fixed Income Research department of J.P. Morgan Investment Management Inc. Prior thereto, Ms. Giacalone worked at Muzinich & Co. as an analyst and assistant portfolio manager, and spent eight years at Credit Lyonnais Securities (USA), Inc., serving most recently as Director of High Yield Research. Ms. Giacalone holds a B.S. degree in biology from University of California, Los Angeles and an M.B.A. with a specialization in finance from California State University, Long Beach. She is a CFA charterholder.

NAEL KHATOUN  
**Managing Director, European Principal and European Private Debt**  
Mr. Khatoun joined Oaktree in 2005 after spending three years as a transaction executive at Terra Firma Capital Partners Ltd. Prior thereto, Mr. Khatoun spent three years in the Investment Banking division of Goldman Sachs International. Mr. Khatoun received a B.A. degree with honors in philosophy, politics and economics from Oxford University. He is fluent in French and Arabic.
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