

# The Insight: Conversations – Vigilance with Brook Hinchman, Christina Lee, and Matt Pendo

## Harry Whitelaw

Hello and welcome to *The Insight by Oaktree Capital*. In this episode, we'll be exploring recent headlines relating to the private credit industry. The asset class remains coveted by income seeking investors offering attractive yields and low volatility, but the quality of underwriting has recently been under scrutiny. Here today to help separate fact from fiction, we have Brook Hinchman, Co-Head of North America for the Opportunistic Credit group, Christina Lee, Co-Portfolio Manager for Oaktree's U.S. Private Debt strategy, and Matt Pendo, Head of Corporate Development and Capital Solutions and President of Oaktree's BDCs. Great to have you all here today.

## Brook Hinchman

Good to be here with you.

## Christina Lee

Thanks for having me.

## Matt Pendo

Thanks as well.

## Harry Whitelaw

Well, we've commented quite a bit on this podcast about the bifurcated nature of the credit markets, whereby most the market is performing just fine, but we have a notable tale of unloved names. This is easy to measure in the liquid markets where we can instantly see spread levels across rating bands, industry sectors and such like, but things aren't so clear in private credit, and that's both a source of valuable stability and perhaps fuel for concerns about lurking credit problems, also now termed cockroaches. Our main question, are these concerns justified and what can private credit managers do to navigate the current market environment? Christina, perhaps we start with you just providing a broad overview of the health of the direct lending market.

## Christina

Yeah, I call it the great cockroach wars. I think that has been a big debate in the headlines and the question is, are there more? I would say this. When you're doing sub-investment grade lending, you are inherently taking risk. And so there will be defaults, there will be bankruptcies, and there has been a string of high profile bankruptcies that have happened recently, but we find them to be rather idiosyncratic than a systemic issue across direct lending. We are seeing cracks or pressures in certain segments or vintages.

For example, the vintages where you had direct lending activity occur when the interest rates are zero. Some of these companies haven't performed that well or haven't grown enough to cover their fixed charges. But would I say that across the industries you're seeing an immense amount of pressure? No, you're not. You may see a slight increase in defaults, but I wouldn't say that the cockroaches are going to come out and play in full force in direct lending.

## Harry

Makes sense. What about taking a look at the sectoral side? Brook, software is a very significant part of the private credit market and the broadly syndicated market for that matter as well. How are you viewing the disruptive impact of AI in that area?

## Brook

Yeah, that's an excellent question. I would say that AI has been a huge accelerator in the ability to bring new enterprise software solutions to market for agentic venture capital backed businesses, and that is reducing the barriers to entry for legacy enterprise software companies. There's also a crowding out effect in legacy enterprise software where the new incremental dollars that companies are spending are more likely to be on AI as opposed to spending on their legacy enterprise software systems.

The impact to date has largely been a slowing of the growth of legacy enterprise software, but as we move forward in time, we see AI having a bigger and bigger impact on enterprise software, and we see an increased divergence within enterprise software between the haves and the have nots. And the have nots, we see accelerating, the declines and lowering retention rates for those companies. And we expect that to create credit issues in enterprise software going forward.

## Harry

Christina, when underwriting new software deals, and this is a sector that's hard to avoid entirely in your world, what are you looking for in terms of getting you comfortable with lending money to these companies?

## Christina

Yeah, I think that's something that comes up often and software tends to be one of the largest industries in direct lending, and is one of the few industries where there's actual M&A deal flow over the last few years. I think when we evaluate software, we look for a few things. I think one is how embedded in the business is it? For example, what we call ERP, enterprise resource planning. And those are really hard to take out, they're so embedded in the business.

Or two, it's a software offering that, again, is mission-critical. I remember someone was telling me, "What if they take away Bloomberg terminals because of AI?" Okay, could be a certain use case for that, but think about how many users there are, how scaled that platform is and how many people do you have to retrain on whatever software comes up new? There's that element that we also look for. I wouldn't say that we have 100% guardrails or guidelines of this is yes or no because we're bottoms up investors, which is very true with Oaktree.

## Harry

And we've just finished earning seasons. How has that looked across the sectors, Christina, for your companies?

## Christina

I mean, overall, it's been relatively resilient, but there have been pockets of softness. One area that used to be a darling of direct lending is physician practice management companies. They used to get very high leverage in a low interest rate environment. People said healthcare spending, it's stable, it's not cyclical. But what you've seen is these businesses were over-levered, partially because they were overvalued.

And then two, they had margin compression. Why? There was wage inflations for doctors and nurses, and they're relatively pricing elastic. Insurers pay them, they can't really raise pricing. And so that's one area of the market that we've seen a lot of softness and frankly, reticence in terms of new deal flow.

## Harry

The other area that seems to get no love at the moment, and maybe this is a little bit more liquid, high yield and loans, is the chemical sector. That seems potentially the most unloved sector. Brook, how are you viewing that one at the moment?

## Brook

Yeah, we are really seeing the K-shaped economy manifest itself in credit. And I would agree with Christina's point that the average credit is doing well, and we are seeing EBITDA rise and interest expense come down as the Fed is cutting rates, but we're seeing more and more divergence within credit. And the declining portion of the K, chemicals, building products, and paper and packaging, I would say are the three sectors that we are seeing the most weakness.

In terms of demand profile, we are seeing housing and home goods have a big reversion to the mean after having a significant boom during the Covid period where everyone was spending more on goods, spending more time in their home and underspending on services. And we're seeing that unwind in combination with a housing cycle that is driven by higher interest rates.

Building products and home products are one of the largest end markets for chemicals, so we're seeing weakness on the demand side. And then even more importantly, we're seeing a very significant increase in supply, especially out of China, but also out of the broader Asian region. And that combination of increased supply meeting weak demand has had a dramatic impact, particularly on commodity chemicals.

So we have seen that sector have significant weakness, both on the public credit side, as well as the private credit side. And we think that there will be opportunities in chemicals, paper and packaging, and building products. We think that there's going to be a real restructuring cycle in all three of these sectors, and we think that there will be opportunities that come out of that.

### Harry

So I think our consensus is earnings and health, mostly good, some clear sectoral headwinds, and simply the fact that some of these loans were put in place in a very different rate environment, and that obviously leading to pressure as rates goes up. As we look more at the cockroach point, and I think here we mean credits that go from apparently fine to very obviously not fine in a very, very quick timeframe. Christina, do you think these are numerous or are they isolated?

### Christina

I think these are isolated incidents, and frankly, these incidents happen every year. I think it's just been more in the headlines with the recent news, but when a restructuring happens, things change for a company quite dramatically. And this has been historical precedent. And so, I think part of it is there were three or four cases that came out in short order, but I don't see that as really systemic across direct lending.

### Brook

Although I would agree with Christina that I don't think it rises to the level of being systemic, I do think that there has been a meaningful increase in the number of frauds this year that have been exposed. And I don't think that we are done, and I think there are a number out there. And I think that it is a result of too much capital chasing too few deals without the level of diligence, quality documentation, and there are collateral perfection issues, particularly in the asset-backed finance market that are important to get right.

### Harry

What are you viewing as the clear red flags in light of these recent issues?

### Christina

Yeah, I agree with Brook. I think the issues for the most part of you think about what themes can you get from some of these recent headlines is it's bad underwriting. And I think it is a sign of the frothiness of the market. I mean, if you think about direct lending, we've been in a muted M&A environment for 18, 24 months. And so there's just been a supply demand imbalance where there has been more direct lending dry powder versus deal flow.

For us, I think when we think through how do you avoid those situations, it's going back to the basics, doing detailed due diligence, doing bottoms up analysis, asking questions, as Brook said, is your collateral perfected? We call those kind of 101 credit underwriting. And I think a lot of times you are seeing lenders really not do some of those basics or get to an underwrites very, very quickly, which can lead to some of these issues.

### Harry

Brook, could you expand on the qualitative underwriting that you think should go hand in hand with the more model-driven side?

## Brook

I think that the qualitative angle is as important, if not, more important than the quantitative. The quantitative underwriting has become more and more commoditized. And so the real value add is everything that you can bring from proprietary data sources, from your network of diligence with operating advisors, with deep and thorough background checks, with differentiated documentation, with real covenants that have teeth to old school, actually visiting the operations of a business can result in a lot of diligence findings.

It's kind of like a picture is worth a thousand words. Well, being in person, meeting with management directly, being on site is something that you can't get on a Zoom call and that ability to have rigorous and thorough underwriting practices is something that I think differentiates high quality managers that are able to weed out the tails of losses in the credit spectrum.

## Harry

That makes sense. So I want to now move on to the structural side, particularly looking at BDCs or business development companies, a prominent way to gain private credit exposure. So we've seen some of the perhaps more extreme headlines suggesting private credit could present a systemic risk to the financial system. Matt, you are our right guy to opine on this, not just being president of our BDCs, but also former CIO of the U.S. Treasury's Troubled Asset Relief Program. How do you view the suggestion of systemic risk from private credit?

## Matt

Thanks, Harry. Great question. And I do think my time in DC gives me kind of a unique perspective. I do think the regulatory bodies have achieved their objective of taking this systematic risk out of the banks. And the banks are participants in the private credit market, they lend to BDCs. So BDCs borrow from the banks. They tend to be levered around one times, the publicly traded ones maybe slightly above one. So to begin with, they're not very levered.

Second of all, and this is a development that's really taken place over the last five years, for the most part, the BDCs are investment grade rated and they have access to the institutional investment grade unsecured bond market. And so about half of the capital of the BDCs comes from this unsecured market and it's unsecured as opposed to the bank lending, which is secured by the assets.

So about 50% of the capital is below the banks. There's one times the equity below the banks, but then even on the debt side, about half of that comes from outside the bank community. So I think it really provides protection to the banks and really, really allows the banks to be partners and part of this of the BDC ecosystem, but not systemically at risk.

## Harry

So what would need to happen in the BDCs for the banks to lose money on the financing lines they've extended to BDCs? A lot, presumably, go wrong?

## Matt

So there would have to be a dramatic increase in non-accruals. And then loss, there would be increase in defaults, increase in non-accruals, increase in defaults, and then an increase in what we call loss given default. So their collateral would have to be basically decimated. And the probability of that happen is quite, quite low. Again, for the reasons when there's not that much leverage to begin with, so there's equity below you, and then there's unsecured debt below the banks as well. So there's two levels of protection to the bank providers.

## Harry

So to suggest this change has reduced risk to banks, I suppose you'd have to say lending to the BDCs is safer than making the loans to the companies and the BDCs as banks originally would've. Is that right?

## Matt

Well, I'd say there's that. A lot of the private credit loans were loans 10, 20 years ago the banks made. And besides the cost of capital and everything else, I think just the efficiency of a bank saying, "We're just going to make one loan to the BDC and then we'll let the BDC make 10 loans to the private credit providers." And that's a more efficient model for them because they're making one loan to, for the most part, a large asset manager, BDC operator that is investment grade rated.

So the loan they're making themselves is investment grade rated, so it is better capital treatment for them. And then just kind of the cost and the books and records monitoring of just that loan is materially less and the cost of underwriting than the 10 to 50 additional loans that the BDC itself makes. So I think the whole business model has evolved to one that is just better for the banks. It's better for the borrowers and it's better for our institutional retail investors who invest in the BDCs because they get access to private credit that's professionally managed.

## Harry

So the other big topic of headlines in private credit is marks, questions around the valuations ascribed to private positions. Maybe you can take us inside that process. There's suggestions, there's discrepancies between managers, but how robust is that process?

## Matt

So the process is very robust. It's not a complete science, so you will see divergence. But for the most part, the BDC managers will rely on third party firms to value a vast majority of their assets. There's four or five firms that they use and they're like, for instance, we'll use three or four across our BDC, so not just one firm. So we'll be able to see and have experience with different valuation firms. And that's done every quarter or every month, depending on the BDC. The BDCs also have independent boards of directors. Those boards of directors approve the valuations, approve the filing of the 10Qs and the 10Ks. The other things in the BDCs, they're public registrants. So they file a 10Q and a 10K that lists every investment. They're called SOI, schedule of investment. So you can see every loan that's been made, so it's very transparent.

Where you tend to see the biggest discrepancy will be if there's some uncertainty going on with the company, they may be doing a restructuring, they may be doing a kind of critical financing. And so when you come to valuation, you'll have a range of outcomes that will span, the company has sold so there's a repayment at par plus accrued, or there's a restructuring where it's something different. And when you're evaluating those situations, you have probability to weigh each of the outcomes, but then once the outcome is achieved, that's the outcome, so it's not probably weighted. So that's why you will see some kind of divergence in particularly in those situations, which are not that common, quite frankly.

## Harry

And there's also quite a bit of press about the fact that public BDCs themselves are trading at a discount, particularly in compared to the private BDCs. How should we read into this dynamic?

## Matt

So the publicly traded BDCs, they trade on exchange, so they trade every day. The perpetual BDCs have monthly subscriptions. So investors will come in monthly at NAV. There's a monthly NAV that's calculated, and they're allowed to redeem quarterly at NAV. The other difference is the public traded BDCs are older. So they've been investing for 10 plus years. Where the perpetuals have really started in the last two to four years. So they didn't do a lot of investing in the 2020 and 2021 vintages, which were the vintages when interest rates were zero.

And therefore their credit performance is better than the publicly traded ones, at least at this point. And so I think that's what you're seeing a difference in the discount to NAV. Both BDCs, if you look at the dividend yields on a NAV basis, are roughly equivalent. And then if you take the trading discount for the public traded ones and kind of adjust for some of the non-accruals, if you do the math, you kind of get in a pretty efficient market. They're both kind of the same, risk adjusted. So I think that's what you're seeing. And just a publicly traded vehicle will be more volatile that will react to headline news about cockroaches and rate moves and other things.

So you'll see that volatility in the short run that will kind of dissipate over the long run. But I think that's kind of how I think about the current discount today in some of the publicly traded BDCs versus perpetuals that are a NAV based vehicle.

### Harry

That makes a lot of sense. Thank you very much, Matt. So Christina, I want to come back to you as we look ahead. What do you consider the right approach to private credit going forward?

### Christina

Yeah, it's been a really interesting run for private credit. This industry has expanded dramatically over the last 10 years. I think going forward, I know Brook had also talked about pockets of volatility, pressures, cracks, where you're going to see differentiation is where managers have had due diligence and underwriting rigor, and that also have experience dealing with turnarounds, restructurings, or when times are bad.

There's few and far between those types of managers, I would say, as being part of Oaktree and having a 20-plus year track record through a recession, as well as the scale and scope. Having access to Brook's team, for example, we speak to Brook's team about what's the latest and greatest technologies that they're seeing in LMEs. That helps. And I think that's what's going to really differentiate managers in the go-forward.

### Harry

That's great. Brook, we spoke about most private credit universe being performing, but maybe even a small relative percent becoming stressed is quite a big absolute amount. How does your team think about accessing that opportunity?

### Brook

Yeah, that's an excellent question. To your point, the market for private credit has grown dramatically. It's on the trillions of dollars. So even if you take a small percentage of that that are currently non-performing, it's still a very large dollar opportunity. And we have been tackling that in three different ways. That first opportunity set is sourcing loan portfolios in the non-performing and semi-performing space.

The second opportunity that we're seeing, which is actually even larger than the first category, is rescue financings and providing capital directly to the borrowers that need refinancing. As the cohort of companies that have either challenged EBITDA or have a capital structure that was built for the 0% interest rate environment of the pre '23 LBOs, as those companies are facing maturities from debt put in place when interest rates were 0%, as that debt comes due, there's opportunities for us to step into the capital structures on a super senior basis.

And then the third area where we've seen opportunities that has been limited to date, but we expect to accelerate, is credit secondaries. We think credit secondaries on an opportunistic basis, particularly as the LP community has experienced a very significant increase in their allocation to private credit, we think that there will be situations where they will look for liquidity in the private credit space and that there will be opportunities for Oaktree to participate in that.

### Harry

Sounds very interesting. Christina, why don't we touch on the supply side as our final point? So we've been probably a little bit disappointed by M&A volumes over the last year, but there is a tremendous amount of dry powder out there. There's also a lot of capex needs, both across Europe, the U.S., infrastructure build-out, AI, data centers, defense. What do you expect the role of private capital to be in the years ahead?

### Christina

Yeah, I think the past two years have been really marked by what I've called that supply-demand imbalance. I think if you were to ask folks at the beginning of 2025, end of 2024, that 2025 was supposed to be a banner year. Obviously, with the volatility and some of the new administration's policies, it created a lot of uncertainty and M&A was paused. But you have some driving forces that should make M&A demand pick up.

First and foremost being distributions, a lot of private equity firms, LPs are asking, “Where’s our money? We need distributions.” Without them being able to provide those distributions back to the limited partners, it really inhibits their ability to fundraise. So what you’re seeing and what we’re hearing in the market is a lot of portfolio companies starting to engage investment bankers to launch for 2026, which should help the supply-demand imbalance going forward between deal flow has been low, a lot of private credit dry powder. So we’re optimistic for 2026.

I think this is still a great asset class. You’re still getting better relative value versus liquid markets. There is still kind of demand for the product, and I think the demand will grow as deployment gets better through flow. So this is an asset class that I think is here to stay and can still be really attractive for limited partners. But for limited partners, they should really diligence their GPs. Who are the ones that have, again, that due diligence rigor, who has a longstanding track record, and who knows how to manage situations when things get tough?

## Harry

Great. Well, we’ll wrap up there. Hopefully that’s provided some clarity on the many private credit headlines out there. Thanks to Brook, Christina, and Matt for joining today, and thank you all for listening in. Look out for future episodes wherever you get your podcast or via the Oaktree public website. We hope you all enjoy a restful holiday period, and we’ll be back in the new year with more episodes.