PE Hub

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PUBLISHED: 25 September, 2024

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Oaktree finds market for special situations investing 'incredible'

Oaktree's SSF III has deployed nearly 55% of its nearly $3bn total raised, with investments in companies such as NexGen and TriMark

Oaktree Special Situations is continuing its pursuit of mid-market businesses that have defensible business plans and strong long-term prospects.

In late 2023, Oaktree Special Situations closed its third fund at $3 billion, beating a $2.5 billion target. So far, out of that fund, the firm has deployed a little bit more than half of the $3 billion. It has made deals for companies such as Malibu, California-based specialty finance firm NexGen Financial, Lewisville, Texas-based food-service equipment company TriMark and Mesquite Gaming, the owner of the Casablanca Resort Spa and Virgin River Hotel and Casino in Mesquite, Nevada.

To learn more about Oaktree's outlook on dealmaking, PE Hub reached out to Matthew Wilson and Jordon Kruse, managing directors and co-portfolio managers of Oaktree's Special Situations Group, about how much of the fund has been deployed, what trends the firm is seeing in PE dealmaking and their outlook on deals going into 2025.

Jordon Kruse, Matt Wilson, Oaktree Special Situations Group

Q After closing its third fund late last year, where is Oaktree Special Situations right now?

Wilson: The market environment for special situations investing has been incredible for the past two years. While people often think of special situations as a stressed or distressed strategy, we regularly partner with sponsors and founders to invest in very healthy, growing businesses. This all-weather nature allows us to deploy capital in any part of the economic cycle. Our latest fund, SSF (Special Situations Fund) III, has already deployed nearly 55 percent out of its nearly $3 billion complex, which is faster than our usual pace of deployment.

Kruse: We're also seeing the most "good company, bad balance sheet" opportunities since the early 2000s. This trend is largely due to the adverse effects of rising interest rates on highly-levered capital structures of otherwise healthy, growing companies. Even with the Fed's recent cut, we anticipate rates will remain elevated, and with over $3 trillion of non-investment grade debt outstanding, we expect this environment to persist for some time.

Q What types of investments have you made out of the fund? What types of targets are you looking for going forward in size and sector?

Wilson: The hallmark of our strategy is the flexibility to invest in both debt and equity, which allows us to capitalize on attractive risk-reward opportunities in any given market environment. In SSF III, we've deployed over half of the fund in structured equity investments, which are customized solutions that have debt-like attributes, offering priority over common equity and a fixed-income return, along with equity upside through warrants or a conversion feature. About a quarter of the fund is invested in traditional private equity, and the remaining balance is in distressed debt, where we buy secondary debt in anticipation that a restructuring would result in our ownership of the business.

Kruse: In terms of check size, we typically invest somewhere between $100 million and $300 million per deal. We look to invest in mid-market businesses that have defensible business plans and strong long-term prospects, where our active ownership can drive growth and performance improvements. While we are industry-agnostic, most of our investments are in our areas of expertise, including the consumer, industrials, business services and financial services sectors.

Q What's your strategy and approach when it comes to investing in mid-market companies experiencing stress or temporary dislocation?

Wilson: I'd say the beauty of our strategy is that we can invest in both healthy, growing businesses, as well as those experiencing some kind of stress or distress. Our approach to both situations is the same – we create value through earnings growth and multiple improvement. We buy into businesses at a discount to prevailing market multiples because the company is facing a "special situation," we help drive revenue and earnings growth, and then, by the time we exit, the business is stronger and healthier, which allows us to generate a market or premium multiple for the asset.

Kruse: Some of the reasons why a healthy business would seek our type of capital is to gain access to our team of operational experts to help grow the business, because they are facing unique circumstances, or they are misunderstood by traditional capital markets. Sponsors and founders also like the trade we offer with a partial fixed-income investment that minimizes the dilution to their existing equity investment.

Q What opportunities and challenges do you face with investing in companies experiencing high stress?

Wilson: Businesses that are especially stressed can have significant capital structure and operational issues that need to be addressed. Capital structure issues are fixed upfront through a restructuring that deleverages the company's balance sheet and injects fresh capital to drive growth and turnaround efforts. Many of these businesses suffer from exhausted management teams who have been focused on making interest payments versus growing the business, which usually leads to chronically under-managed and under-invested companies. You never know with 100 percent certainty what problems the business had, but therein lies the opportunity.

Kruse: Operationally, we run a playbook that addresses any specific issues that caused the business's underperformance and transforms the company's operations. These initiatives can include divesting unprofitable business segments, exiting or restructuring unfavorable customer and supplier contracts, uncovering deficiencies in inventory management and unlocking significant working capital.

In many cases, while we understand the root causes of performance issues, we find additional opportunities only after we've had a chance to really look under the hood. In these stressed situations, we mitigate the risk of these unidentified problems by investing at discounted valuations. We always expect the unexpected and take comfort in the fact that our team has proven time and time again that we can turn these businesses around and drive value.

Q Are there any general trends that you see in private equity dealmaking now?

Wilson: Dealflow for most of the private equity industry has been depressed for the past 18 months given the interest rate environment and lower leverage available for leveraged buyouts, which has compressed purchase multiples and led to a divergence in seller and buyer expectations in the market. With the recent rate cuts, I think we'll see a significant pick up in sponsor-based activity over the next five or six quarters.

Kruse: We've seen quite a few opportunities for partial monetization transactions though, in which sponsors are keen to return capital to their LPs to begin the fundraising process for their next vehicles. Our expectation is that those transactions will pivot to full sales as rates continue to come down and sponsors can achieve better valuations for the entire asset. That said, even with the Fed acting to lower rates, we don't expect a return a zero-interest rate environment. A number of highly levered, private equity-owned business still won't be able to address cashflow and maturity issues, and so we expect to continue to see a fulsome set of structured equity rescue financing opportunities.

Q What sectors are attractive for you right now?

Wilson: As we mentioned, we really are opportunistic and pretty industry-agnostic. Generally, we are finding investment opportunities across sectors in businesses who raised debt pre-2022 and are facing liquidity issues, unsustainable capital structures, or are unable to refinance, as well as sponsors with healthy businesses that need at least a partial monetization for some of their portfolio companies in order to return capital to their fund LPs.

Kruse: Since we can offer a flexible capital solution that allows founders and owners to monetize a portion of their investment today at what they view is a favorable valuation with the ability to retain some upside in the business, we're seeing a lot of opportunity. We also provide these owners with access to our team of operations and M&A experts to help drive growth. In exchange, we take more downside protection, often through a fixed coupon, structural seniority, liquidation preference and minimum return provisions.

Q What's your outlook on deals for the rest of 2024 as we head into 2025?

Wilson: If we have in fact found ourselves in a soft landing, we expect M&A dealflow to pick up meaningfully now that the Fed is expected to cut interest rates materially by the end of 2025. The underpinning of any valuation is the amount of debt that you can use to finance an acquisition, so we can expect there has been a backlog of businesses that have been waiting out this recent trough.

Kruse: A less likely but possible scenario is a recession in the next 12-15 months. If this happens, rates could drop closer to 0 percent, but of course, many businesses will struggle if the economy contracts. In terms of how that affects our strategy, we are indifferent. There is $1.5 trillion of high-yield debt and leveraged loans that mature in the next four or five years, and even with a modest reduction in rates, many businesses will need to address their funding gap. Should we enter a recession, we will continue executing our strategy and capitalizing on significant distressed debt buying and accretive M&A opportunities. ■