OAKTREE | Insights

Oaktree Conference
2024

The Roundup

Top Takeaways from Oaktree Conference 2024

Oaktree recently held its biennial client conference featuring presentations from co-chairman Howard Marks, co-CEOs Robert O'Leary and Armen Panossian, and many other key Oaktree thought leaders. In a special edition of *The Roundup*,[1] we've highlighted various topics discussed at Oaktree Conference 2024, including the next frontier of private credit, dislocation in India's corporate debt markets, and the potentially once-in-a-generation opportunity in commercial real estate.

Howard Marks
Co-Chairman

1.

Market Outlook: The Definition of Insanity

Investors should understand that the investment environment and the starting point for investments have a huge impact on their success, and the shorter your time horizon, the truer this is. Albert Einstein famously said, "Insanity is doing the same thing over and over and expecting a different result." I think another version of insanity is doing the same thing in a different environment and expecting the same result. So, if the environment for business and investing is going to be thoroughly different in the coming five or ten years from what it was in the last fifteen to forty years – as I believe – it's folly to expect that the results will be the same as they were.

As I stated in *Sea Change* and the creatively titled follow-up, *Further Thoughts on Sea Change*, we went through an unusually long period of declining and ultra-low interest rates from 2009 to 2021. The result was the longest economic recovery in history, exceeding ten years, and the longest bull market in history, also exceeding ten years.[2] It was a great time for ownership of assets. It was a great time for borrowing money. And if you bought assets with borrowed money, you typically enjoyed a double bonanza.

But, in my view, that period is clearly over. As a result, I believe fixed income investing may be better positioned today in risk/return terms than equity investing. Liquid credit instruments currently offer yields in the high single digits,[3] and the yields on private credit are in the low double digits.[4] These yields are highly competitive with the excellent historical returns on equities. (The S&P 500 Index has an average annual return of roughly 10% for the last 100 years.[5]) These yields also exceed most investors' required returns and are considerably less uncertain than the returns on equity and other ownership strategies. In other words, they have a high probability of delivering what they promise.

I believe lenders and bargain hunters face much better prospects in this changed environment than they did in 2009-21. So how should investors respond? I think they should bear in mind a quote from the economist Paul Samuelson: "When events change, I change my mind. What do you do?"

Armen Panossian
Co-CEO and Head of Performing Credit

Brendan Beer
Portfolio Manager, Structured Credit

Loris Nazarian
Assistant Portfolio Manager, Private Assets

2.

Asset-Backed Finance: It Has Legs

In recent years, commercial banks have been reducing the size and scope of their asset financing activities, due to increased regulations, rising interest rates, quantitative tightening, and mounting risk aversion. As a result, alternative lenders now have the opportunity to gain market share in the core segment of the roughly $5 trillion[6] asset-backed finance market. This includes a wide variety of credit instruments backed by pools of assets, such as equipment leases, consumer loans, mortgages, and royalty agreements. Importantly, we believe this opportunity stems from a secular shift in the industry, not a cyclical change.

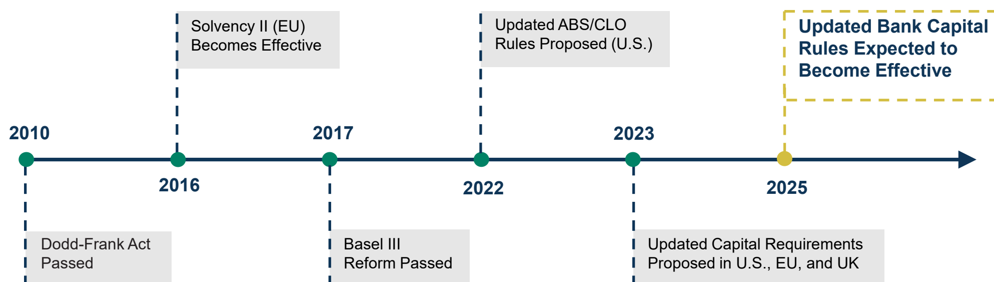
Banks and insurance companies have historically been the main providers of financing for two of the three key ABF segments: (1) investment grade (IG), the area with the lowest perceived risk and lowest historical returns, and (2) core, which has a higher risk profile but also private-credit-like return potential. (Banks have never had a large presence in the third segment, opportunistic, the more aggressive part of the ABF market.)

While banks continue to operate in the IG segment, they've been exiting core ABF because of substantial changes occurring in the lending environment, including tightening banking regulations. This trend is epitomized by the Basel III endgame, a massive regulatory overhaul that will have a substantial impact on the global banking industry. These types of regulatory changes can make ABF lending less attractive to banks by raising the associated capital charges. (See Figure 1.)

Seperately, we believe public shareholders may be encouraging banks to deemphasize activities like core ABF lending. First, core ABF has become a harder space for banks to manage risk in recent years, as it has become increasingly complex. Second, elevated interest rates have caused bank shareholders to demand a higher return on equity. The typical way for banks to boost ROE is by adding leverage, but stricter bank regulations make doing so challenging. Thus, banks may turn to the second-best option: shifting away from lending in favor of fee-generating activities.

The massive changes we're seeing in credit markets today are reminiscent of the seismic shifts that occurred following the Global Financial Crisis, when tightening regulations made many lending activities less attractive to banks and thus opened the door for the rapid growth of private credit. This is why we believe core ABF isn't a short-term opportunity, but rather the next frontier of private credit.

Figure 1: Timeline of the Major Regulatory Developments Impacting Traditional Lenders



Note: Solvency II is a regulatory framework impacting the EU insurance and reinsurance industries

Pedro Urquidi
Portfolio Manager and Head of Opportunistic Credit ex-North America

Gaurav Parasrampuria
Head of Asia, Global Opportunities

3.

Global Opportunistic Credit: Mind the Gap

India represents a massive opportunity for private debt investors today, as the growth of the nation's credit markets hasn't kept pace with the country's dramatic economic expansion. Over the past two decades, India's economy has grown by 13% annually, and, as a result, it is now the world's fifth-largest economy, having jumped six places in ten years.[7] One would expect growth in India's credit markets to have outpaced its GDP growth – as is typical with developing nations – but this hasn't been the case.

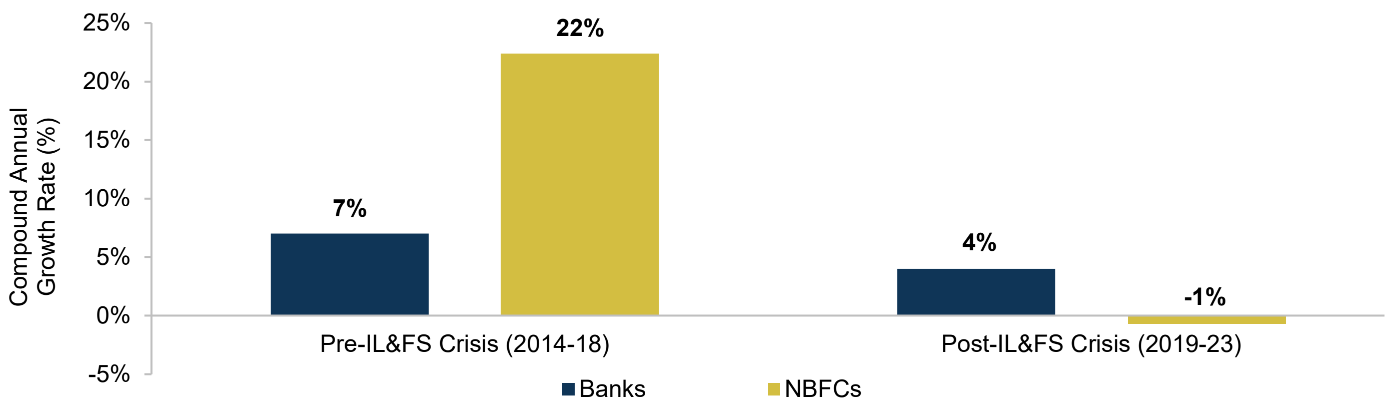
Instead, India continues to have underpenetrated and underdeveloped credit markets. Before the Global Financial Crisis, banks provided roughly three-quarters of the debt financing for India's corporate market.[8] However, there was a meaningful shift following the GFC due to regulatory changes and increased risk aversion among banks. As traditional bank lending declined, non-bank financial corporations (NBFCs) became the go-to providers of alternative credit in India: their market share increased from 13% in 2008 to 20% in 2018.[9]

However, in September 2018, there was a shock to India's credit market, as IL&FS, one of the dominant NBFCs, defaulted on its debt and went into bankruptcy. Following this default, NBFCs found it extremely difficult to fund themselves. Thus, they altered their strategy, reducing their exposure to corporate credit and focusing more on retail lending, just as Indian banks were prioritizing the same area. As a result, many Indian corporates have faced limited financing options in recent years, even as their demand for capital has continued to grow. (See Figure 2.)

This funding gap has created a tremendous opportunity for private creditors operating in India. We estimate that the current addressable universe for private credit in India is over $300 billion.[10] And competition to provide corporate credit is limited, given the retrenchment among banks and NBFCs, so private debt investors with capital to deploy and expertise in the country have the opportunity to lend at elevated prospective yields, while securing creditor-friendly terms.

We believe that India is well positioned to continue its rapid economic expansion, due to many supportive economic and geopolitical trends. Thus, we anticipate that this gap won't go away any time soon.

Figure 2: Indian Corporate Credit Growth Before and After the IL&FS Crisis



Source: Reserve Bank of India, Morgan Stanley, Jefferies

Nael Khatoun
Portfolio Manager,
European Private Debt

4.

European Private Credit: Come Together

European banks and the region's private lenders are often depicted as rivals for deal flow. While European private credit firms have gained market share in recent years, we believe the future of this relationship will be defined more by partnership than competition.

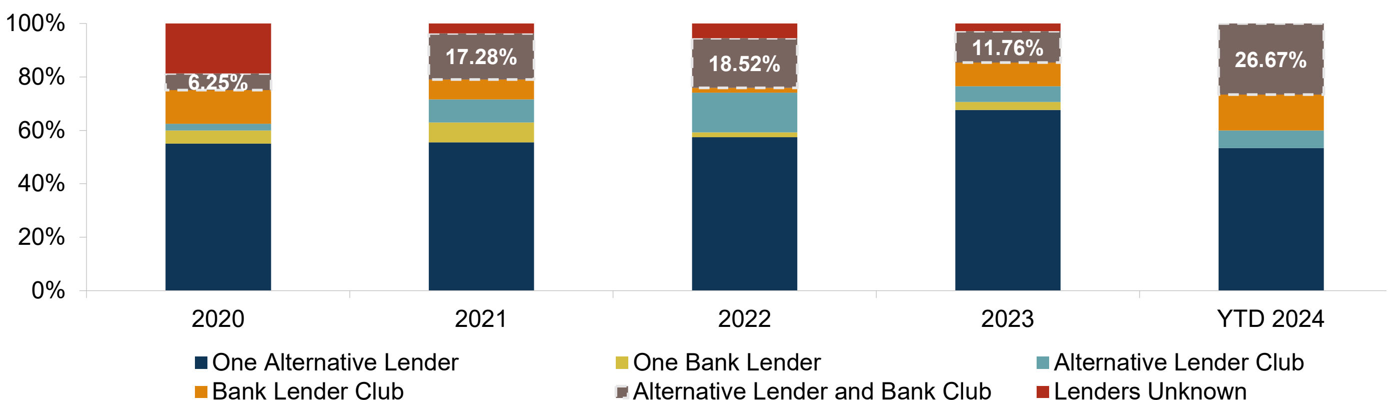
We've seen significant changes in European credit markets in recent years. First, European banks – which have historically controlled the vast majority of corporate financing in the region – significantly reduced their lending activities in 2023, as many faced bruised balance sheets and uncertainty about the trajectory for interest rates. While the volume of leveraged buyouts and M&A transactions decreased in 2023, given the spike in financing costs, European corporates continued to face a funding gap.

This chasm has increasingly been filled by the expanding European private credit industry. In fact, private credit's share of the European LBO market was roughly ten percentage points higher at the end of 2023 compared to the level two years ago.[11] While banks' lending activity has risen in recent months, it remains depressed by historical standards. For example, even though the percentage of the European LBO market financed by broadly syndicated loans is now more than double the 10% low reported in 2023, this is still well below the roughly 40% average seen between 2020 and 2022.[12]

But what is even more notable is the shift in the composition of corporate financings. Almost 30% of European LBOs completed in the year to date have featured debt financing from both banks and private credit firms – a level of cooperation eclipsing anything we've seen in the past.[13] (See Figure 3.) While this trend has many drivers, we believe one key reason why traditional lenders have sought to partner with private debt firms is tightening regulations, which are encouraging banks to reduce their risk exposure.

Such partnerships have much to recommend them. Borrowers gain greater certainty of execution and quicker deal timelines. And these arrangements also reduce deal complexity by providing sponsors and management teams with a one-stop solution for senior debt financing. Consequently, we believe this shift toward collaboration will only accelerate in the coming years.

Figure 3: The Increase in the Percentage of European LBOs Financed by an Alternative Lender and a Bank Club



Source: Pitchbook LCD, as of March 18, 2024

John Brady
Portfolio Manager and Global Head of Real Estate

5.

Opportunistic Real Estate: The Time Is Now

We believe we could be on the precipice of one of the most significant real estate distressed investment cycles of the last 40 years. Many traditional lenders, particularly U.S. community and regional banks, are currently facing substantial balance sheet challenges, due to their exposure to commercial real estate, much of which has declined in value significantly since 2020. Consequently, these traditional lenders are now less willing and able to lend just as the real estate market is facing an imposing maturity wall. (See Figure 4.) This is creating a significant opportunity for providers of alternative real estate financing.

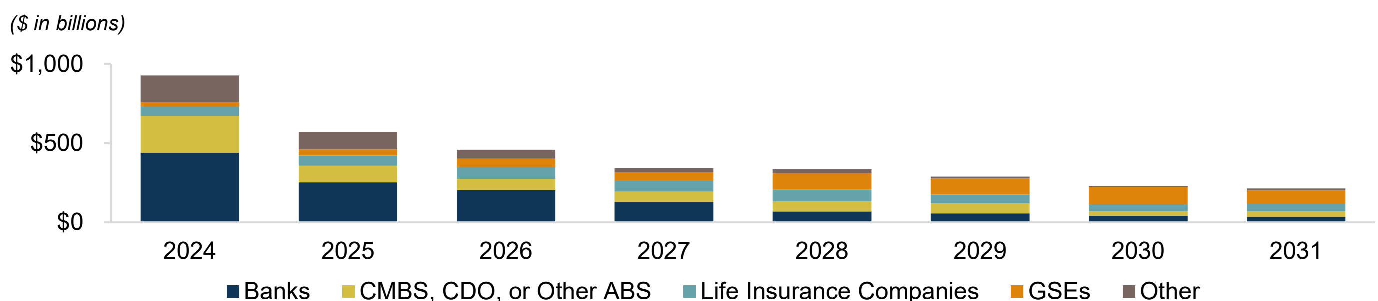
Consider the magnitude of the value destruction we've seen in U.S. commercial real estate. Valuations in the office sector have declined by 56%, on average, from their previous peak, while values in the multifamily and industrial sectors are down by 33% and 26%, respectively.[14] CRE exposure is concentrated among banks with under $250 billion in assets, particularly the roughly 4,600 banks with under $50 billion in assets. While the latter represent only around one-quarter of all U.S. banking assets, they hold over half of the CRE assets in the system.[15]

To determine the extent of the potential risk, we conducted an analysis of all federally insured U.S. banks in this sub-$50 billion cohort. The FDIC[16] defines "at-risk" banks as those whose equity-to-asset ratio is below 6%. At-risk banks are subject to increased regulatory oversight and operating limitations and therefore usually face severe liquidity challenges. Even if we assume that U.S. CRE values have only fallen by 20% from their recent peaks, the number of U.S. banks at risk and the collective assets they hold would exceed what we saw during the Global Financial Crisis.[17]

While CRE values have plummeted across many asset types in recent years, we don't believe that fundamentals have eroded nearly as much in most sectors, with the notable exception of office. Consequently, real estate investors may have the opportunity to lend at depressed valuations while financing properties with strong fundamentals. But doing so will only translate into superior returns if investors have the ability to properly assess risk and structure investments with strong downside protections, a task that has become increasingly challenging given the dramatic secular changes impacting the real estate market.

Today, we think few asset classes are as unloved as commercial real estate and thus we believe there are few better places to find exceptional bargains.

Figure 4: The Imposing Maturity Wall in U.S. Commercial Real Estate



Source: Mortgage Bankers Association, The Federal Deposit Insurance Corporation, Federal Financial Institutions Examination Council, SNL Financial and Oaktree Capital Management Analysts, as of December 31, 2023[19]

Jordon Kruse
Co-Portfolio Manager,
Special Situations

Matt Wilson
Co-Portfolio Manager,
Special Situations

6.

Special Situations: Plot Twist

Companies that took on too much debt through leveraged buyouts in 2020-21 are increasingly struggling in a higher interest rate environment. While this is a familiar market story, it includes some novel elements that are creating an especially attractive environment for special situations investors.

In the beginning of the last credit cycle, when investors were still smarting from the fallout of the Global Financial Crisis, risk tolerance was extremely low, and few borrowers could obtain leverage greater than six times EBITDA.[19] However, as the cycle progressed, memories of the carnage from 2008-09 began to fade and risk-taking increased. As a result, purchase multiples for LBOs rose by nearly 50%.[20]

By the end of 2021, upwards of 80% of LBOs were using more than six turns of leverage, and almost 60% of LBOs had leverage exceeding seven times EBITDA.[21] (See Figure 5.) However, these massive debt loads appeared sustainable because the cash required to service them was fairly limited in a world where money was essentially free, i.e., when the base rate was near zero.[22]

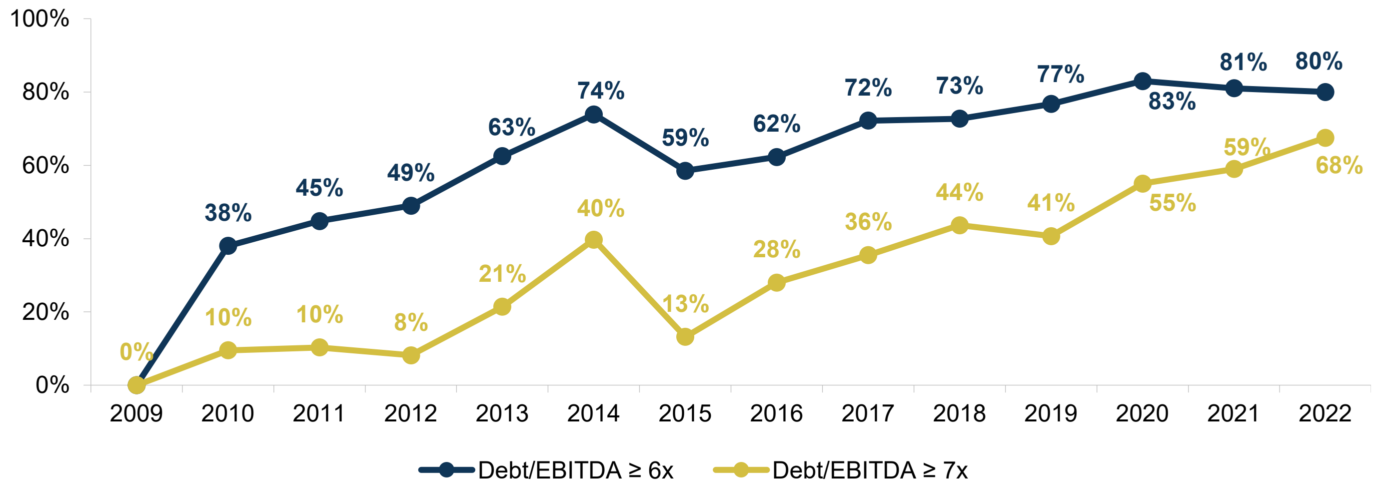
Of course, these calculations changed dramatically after the Federal Reserve began to raise interest rates in 2022 to combat the spike in inflation. Suddenly, pesky credit statistics – things like the fixed charge coverage ratio and EBITDA-to-interest ratio – didn't look quite as good for a large swath of companies.[23]

In the past, companies with unsustainable capital structures, rising borrowing costs, and upcoming maturities would typically have defaulted and restructured. However, today, private equity sponsors are often seeking to avoid this outcome by playing the long game and taking on new partners in hopes of salvaging some of their original equity value.

As a result, over the last year, we've seen a surge in opportunities to provide rescue financings to good companies with bad balance sheets – i.e., companies with strong underlying fundamentals despite short-term liquidity issues. Firms with the size, expertise, and experience to efficiently provide these structured solutions have the potential to earn attractive returns while securing strong downside protections.

Importantly, we expect this opportunity to persist even if interest rates have already peaked in this cycle. Our base case assumption is that the Fed will cut rates by 25-50 basis points in total through the end of 2024. If this proves to be correct, then we expect the large pool of overleveraged LBOs to continue providing a steady stream of opportunities to special situations investors. If our expectations prove to be too dovish, then that stream could easily turn into a flood.

Figure 5: The Dramatic Increase in the Leverage Used to Finance LBOs from 2009-22



Source: LSEG LPC's Leveraged Loan Monthly as of December 2023; Data for Large Corporate LBOs, which represents companies greater than or equal to $50 million of EBITDA at the time of the transaction

Endnotes

1. The content is derived from or inspired by ideas presented at Oaktree Conference 2024; the text has been edited for space, updated, and expanded upon where appropriate.
2. “Bull market” refers to the performance of the S&P 500 Index.
3. “Liquid credit” refers to high yield bonds and leveraged loans; ICE BofA US High Yield Constrained Index, Credit Suisse Leveraged Loan Index, as of May 31, 2024.
4. Based on Oaktree observations in the market, as of May 31, 2024.
5. Bloomberg, as of May 31, 2024.
6. Based on estimates from internal analysis and industry peers, as of December 31, 2024.
7. World Bank, as of 2022.
8. Reserve Bank of India.
9. Reserve Bank of India.
10. Based on Oaktree’s calculations, as of April 30, 2024.
11. By deal count; Pitchbook LCD.
12. Pitchbook LCD, as of 1Q2024.
13. By deal count; Pitchbook LCD.
14. Green Street Commercial Property Price Index, as of March 31, 2024.
15. The Federal Deposit Insurance Corporation, Federal Financial Institutions Examination Council, SNL Financial, and Oaktree Capital Management Analysts; as of April 24, 2024.
16. Ibid.
17. The Federal Deposit Insurance Corporation.
18. Based on Oaktree analysis, as of May 31, 2024.
19. The “Other” category is made up of commercial/multifamily mortgage investor groups, including mortgage-related real estate investment trusts (REITs), debt funds, credit companies, pension funds, and warehouse facilities.
20. Earnings before interest, tax, depreciation, and amortization.
21. LSEG LPC’s Leveraged Loan Monthly as of December 2023; Data for Large Corporate LBOs, which represents companies with at least $50 million of EBITDA at the time of the transaction.
22. Ibid.
23. The fed funds rate, LIBOR, and SOFR were all near zero over much of this period.
24. Based on Oaktree observations in the market.

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