OAKTREE | Insights

September
2024 Edition

The Roundup

Top Takeaways from Oaktree's Quarterly Letters

In September, the Federal Reserve cut interest rates for the first time in over four years. But even though debt costs are moderating, we still believe the corporate credit market is bifurcating. While the majority of companies will likely be able to comfortably refinance their debt in the coming year, a meaningful percentage may struggle. In the current installment of *The Roundup*,[1] Oaktree considers the risks and opportunities in various asset classes at a time when diligence – and attentiveness to documentation – is paramount.

Robert O'Leary
Co-CEO and Portfolio Manager, Global Opportunities

1.

Market Outlook: Split Personality

In *Performing Credit Quarterly 2Q2024: The Dual Economy*, we discussed the bifurcated consumer economy: the wealthy "haves" remain in a strong financial position while the "have-nots" are struggling. A similar dynamic can be seen in the credit markets. The rapid monetary policy tightening cycle that began in 2022 has created a clear distinction among borrowers. While the majority still have strong fundamentals, a subset has burned through their liquidity buffers, creating a large universe for opportunistic investors.

Since the Global Financial Crisis, there has been an unprecedented buildup of all forms of debt, particularly lower-rated credit. Outstanding leveraged loan, high yield bond, BBB-rated bond, and private credit debt has roughly quadrupled since 2007 to over $13 trillion today.[2] Thus, even if default rates remain low by historical standards due to the bifurcation among borrowers, the total amount of distressed credit will still likely be massive.

Beyond the sheer scale, one other major feature of the debt buildup in recent years was the drastic loosening of terms in credit documentation. Since 2020, issuance of covenant-lite loans (i.e., those lacking protective covenants) has exceeded $1.5 trillion.[3] As we note in *Value Opportunities: Navigating the Docs*, this has paved the way for a record volume of liability management exercises, in which a borrower restructures its existing debt outside of court. LMEs can help companies avoid formally defaulting, which often involves a long and expensive Chapter 11 bankruptcy process.

While the maturity wall in sub-investment grade debt has shrunk recently, it still remains imposing. And given that a meaningful number of issuers facing near-term maturities have weak fundamentals, we anticipate that LME activity will only increase in the coming year. In order to successfully navigate this environment, credit investors will require legal acumen and adequate resources to parse through extremely complex legal documents.

The current credit environment is uncharted territory for many investors – given the many uncommon events and trends that have shaped it – but what hasn't changed is the need to have size, expertise, and the ability to understand the docs.

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2.

Value Opportunities: Navigating the Docs

In the past two years, a major trend has emerged in credit markets: the increasing prevalence of liability management exercises (LMEs). An LME occurs when a borrower at risk of defaulting restructures its liabilities outside of court by directly negotiating with its creditors or by securing rescue capital from outside parties. As a result of the unprecedented number of LMEs this year, the volume of distressed exchanges so far in 2024 is already approaching the record high set during the Global Financial Crisis and is on track to well exceed that amount.[4] (See Figure 1.)

Overleveraged borrowers have been increasingly turning to LMEs to avoid the formal Chapter 11 bankruptcy process. They've been able to do so primarily because of (a) the proliferation of opportunistic lending funds in the last decade and (b) the ubiquity of covenant-lite debt in sub-investment grade credit issued in the years leading up to 2022, which has given borrowers more flexibility to avoid official defaults.

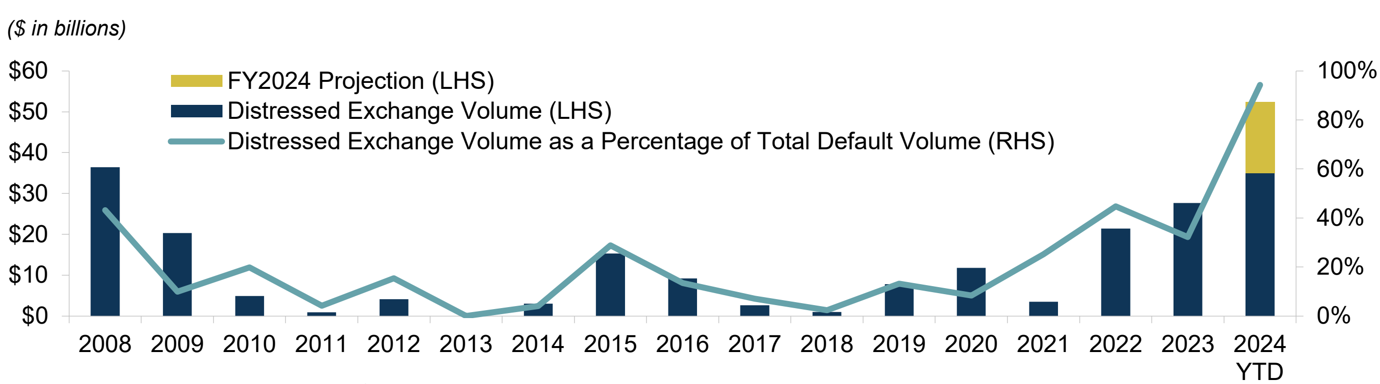
In a typical LME, the borrower raises new debt that is either senior to the existing debt or backed by collateral that had previously been pledged to the existing debt. LMEs are thus often to the detriment of unsuspecting existing lenders, who may find the collateral underpinning their debt to be less secure than initially thought. Complacent credit investors, who might not possess the legal acumen to parse through dense legal documents, are therefore at risk of experiencing meaningful losses.

Additionally, we've found that LMEs rarely solve the troubled borrower's fundamental problem: too much debt. Thus far in 2024, nearly 35% of defaults and LMEs involved companies that had previously defaulted or executed an LME.[5]

LMEs likely aren't going away any time soon. But there are ways to mitigate the risk of being on the wrong end of one. For instance, when underwriting prospective secondary-market debt investments, investors should seek to (a) build a large enough position in the debt tranche to effectively block an LME and/or (b) buy at a price that already reflects the risk of one of these exercises.

Even though the rise in LMEs has created risk – especially for inexperienced creditors – we also believe it has generated significant opportunities for investors with size, experience, and the skill to navigate today's often contentious waters.

Figure 1: The Volume of Distressed Exchanges Has Risen Significantly Since the GFC



Source: JP Morgan, as of August 31, 2024[6]

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3.

Mezzanine Finance: Bridging the Gap

Mezzanine financing – capital that sits between equity and senior debt – saw volumes drop during the protracted period of ultra-low interest rates following the Global Financial Crisis. But in today's new credit environment, where interest rates are expected to settle well above zero, we believe junior capital will play a crucial role in meeting financing requirements for middle-market, upper-middle-market, and large cap private equity-owned companies.

During the era of easy money, ultra-low interest rates led to a substantial rise in leveraged buyouts, which boosted purchase price multiples. In fact, leverage in these deals averaged 6x EBITDA between 2019-22.[7] Many of these companies saw their interest costs nearly double in recent years, which caused interest coverage ratios to decline. (See Figure 2.) This has created liquidity pressure and made senior debt more difficult to access.

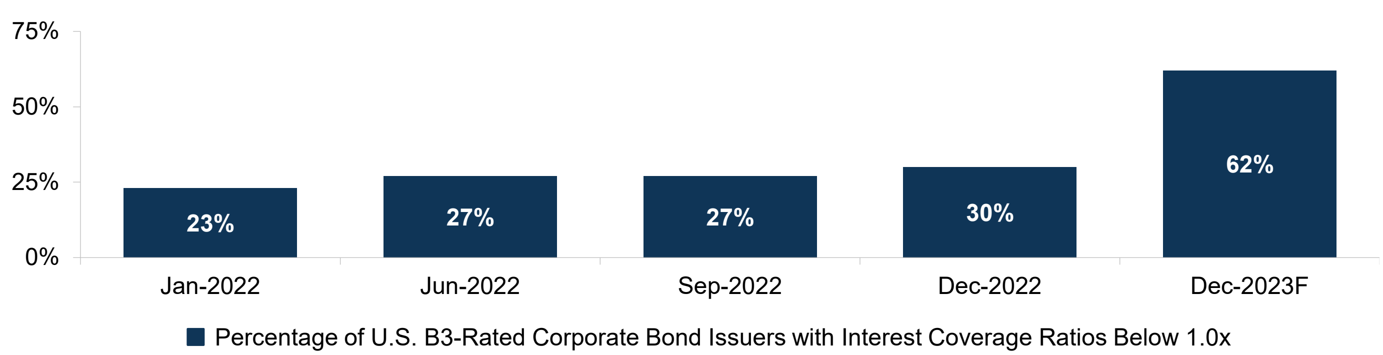
Junior capital has also become a favorable option for sponsors completing LBOs. It can enable sponsors to limit the amount of cash equity they have to commit at a time when the average LBO purchase price multiple is above 10.5x EBITDA[8] and senior debt is still prohibitively expensive. So even though junior capital is pricier than senior debt, it's still cheaper than other forms of financing and thus can enhance returns on equity.

Meanwhile, U.S. corporate borrowers are facing a meaningful maturity wall. Roughly $1.9 trillion of below-investment grade debt is set to mature between 2024 and 2028.[9] Companies are therefore increasingly seeking junior capital solutions to fill the funding gap.

The economy appears to be at a pivot point now that the Federal Reserve has begun to cut interest rates. But this may make mezzanine debt even more attractive. First, the fixed-rate nature of most junior capital instruments offers mezzanine investors the chance to lock in today's high yields. And, importantly, the added flexibility that mezzanine capital provides relative to senior debt will likely ensure sustained demand from both borrowers and sponsors, regardless of the interest rate cuts expected to occur in the next year.

In other words, investors in mezzanine financing today have the potential opportunity to take advantage of a set of circumstances that doesn't come around too often.

Figure 2: Interest Coverage Ratios Are Under Pressure



Source: Moody's Investors Service, as of December 31, 2023[10]

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4.

Opportunistic Real Estate: Demographic Dividend

The rapidly aging population and accompanying rise in healthcare spending has created an attractive opportunity to invest in medical outpatient buildings (MOBs), including primary and specialty care units, surgery centers, outpatient clinics, emergency departments, and other medical facilities.

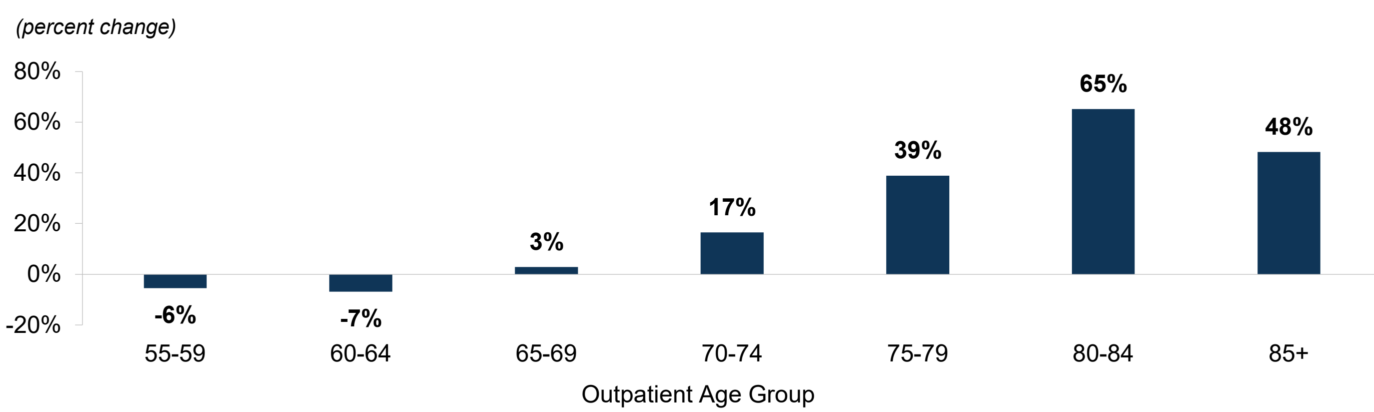
The U.S. population is aging at an unprecedented rate: the median age has risen from 30 to 39 over the past four decades.[11] By 2050, the population of Americans aged 65 and over is projected to increase by nearly 50%[12] to include nearly one in four Americans. This demographic shift is likely to increase already-high national healthcare expenditures: the annual figure is expected to hit nearly $7.8 trillion by 2032.[13]

That's partly because U.S. residents over the age of 65 visit the doctor three times more frequently than the general population, on average, with chronic conditions cited as the primary reason for 56% of the former group's outpatient medical visits in total.[14] It is estimated that 230 million Americans, or nearly 70% of the projected total population,[15] could be living with one or more chronic conditions by 2030.[16] During the same period, the volume of outpatients aged 80-84 is expected to increase by over 65% from the level seen in 2021.[17] (See Figure 3.)

While rapid growth in the U.S. elderly population is boosting demand for outpatient medical services, the supply of MOBs isn't increasing at the same pace. The average occupancy rate at MOBs across the U.S. currently sits at 93%.[18] This figure is expected to move higher in the coming years because development of new MOBs has been limited since 2021 and construction starts for this property type still remain well below pre-pandemic levels.[19]

In short, real estate investors have a rare opportunity to benefit from this secular demographic trend while playing a key role in addressing the supply/demand imbalance in the MOB market.

Figure 3: Outpatient Volume Among the Elderly Population Is Projected to Grow Meaningfully from 2021-31



Source: JLL Research, Advisory Board, as of April 2024

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5.

Emerging Markets Equities: Shareholders Rising

Several Asian countries are following Japan's lead in recognizing the benefits of improving corporate governance.

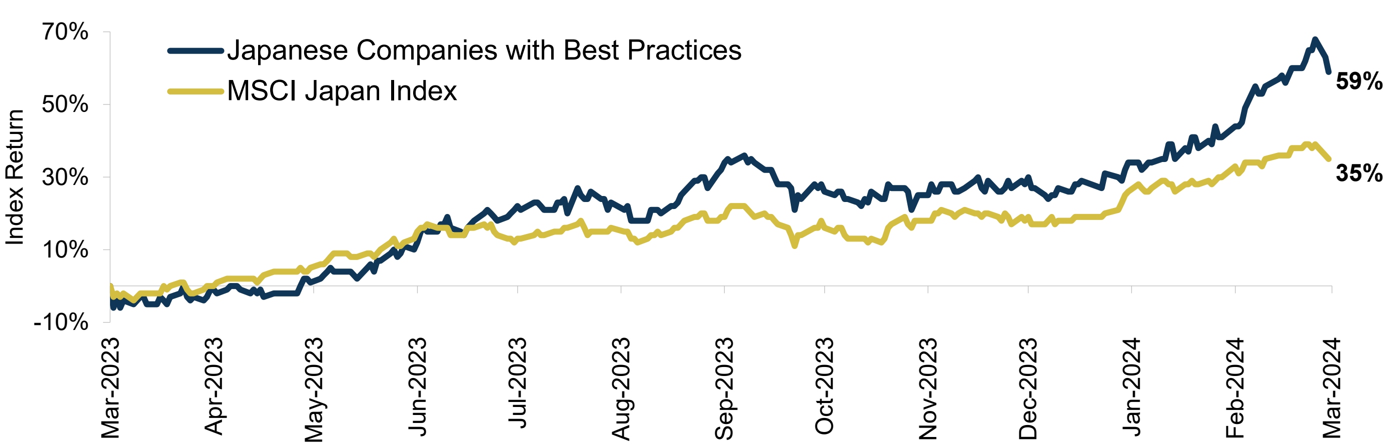
In early 2023, Japan introduced its stock exchange reform program, which sought to enhance corporate valuations by addressing the country's historically widespread capital mismanagement. Since the announcement, Japanese businesses that have adopted the program's best practices have meaningfully outperformed the MSCI Japan Index. (See Figure 4.) Subsequently, we've seen similar efforts in many Asian countries, especially China and Korea, where the governments are now pushing for greater focus on shareholder returns and enhanced transparency in corporate governance.

Korea's equity market has traditionally been undervalued because of its weakness in these areas. Thus, regulators recently introduced the corporate "Value Up" program, which includes measures and policies designed to improve capital management, shareholder returns, and stock valuations. In turn, three key sectors where corporate governance is particularly imperative – banks, autos, and insurance – have all outperformed the MSCI Korea Index by over 15% thus far in 2024.[20] We believe Korea is on the road to becoming classified as a developed country and we expect to see a gradual rerating over the next few years.

Similarly, several large Chinese companies have been taking a proactive approach to improving shareholder returns in 2024, even as China's equity market has continued to struggle broadly due to concerns about the country's growth outlook. This is especially true of state-owned enterprises. For example, the Industrial & Commercial Bank of China recently reported strong performance, largely because it introduced plans to pay its first ever interim dividend this year.[21]

We anticipate that the companies implementing reform programs throughout Asia will see their valuation multiples rise over time, even if slowing global growth weighs on broad market performance in the short term. And, importantly, if these programs continue to elicit a positive response from investors, then EM countries in other regions are also likely to put greater emphasis on improving shareholder returns moving forward.

Figure 4: Japanese Companies Adopting "Value Up" Best Practices Have Outperformed the Market



Source: JP Morgan, as of March 12, 2024

Endnotes

1. The content is derived from or inspired by ideas in 2Q2024 letters or other materials sent to clients in 3Q2024; the text has been edited for space, updated, and expanded upon where appropriate.
2. Credit Suisse, ICE BofA, Preqin, Cliffwater, as of September 2024; For middle-market direct lending data: Preqin, as of June 2022.
3. Pitchbook.
4. JP Morgan as of August 31, 2024.
5. JP Morgan as of August 31, 2024.
6. FY2024 Projection assumes average monthly rate of distressed exchanges YTD2024 for the four remaining months of the year. The distressed exchange volume for 2H2024 is the same as 1H2024.
7. LSEG LPC's Leveraged Loan Monthly, as of December 2023. Reflects leverage ratios for large corporate LBOs, which represents companies greater than or equal to $50 million of EBITDA at the time of the transaction.
8. LSEG LPC's 2Q24 US Sponsored Middle Market Private Deals Analysis. Reflects yearly average purchase price multiples of middle market LBOs financed by all senior debt.
9. Moody's Investors Service, as of October 1, 2023
10. Interest coverage as defined by EBITDA less capex/interest.
11. U.S. Census Bureau, 2023 National Population Projections.
12. U.S. Census Bureau, *America Is Getting Older*, as of June 22, 2023. U.S. Census Bureau, 1980 Census of Population, Volume 1, Characteristics of the Population (PC80-1).
13. Centers for Medicare & Medicaid Services, National Health Expenditure (NHE) Fact Sheet, as of June 12, 2024.
14. National Center for Health Statistics, *Characteristics of Office-Based Physician Visits by Age*, as of April 2023.
15. U.S. Census Bureau, as of February 2020.
16. Milken Institute, *An Unhealthy America: The Economic Burden of Chronic Disease*, October 2007.
17. JLL Research and Advisory Board, as of April 2024.
18. JLL Research and Revista (Top 100 Markets, MOBs over 7,500 sq. ft.), as of June 2024.
19. Ibid.
20. JP Morgan, as of July 9, 2024.
21. Industrial and Commercial Bank of China.

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