Special Situations: Opportunities of Interest[1]

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Higher interest rates may support a target-rich opportunity set for special situations investors. Increased interest expenses negatively impact the balance sheets of otherwise healthy companies, creating "good company, bad balance sheet" opportunities. We believe this provides attractive entry points for investors, and the chance to create value by improving the financial and operational performance of these businesses.

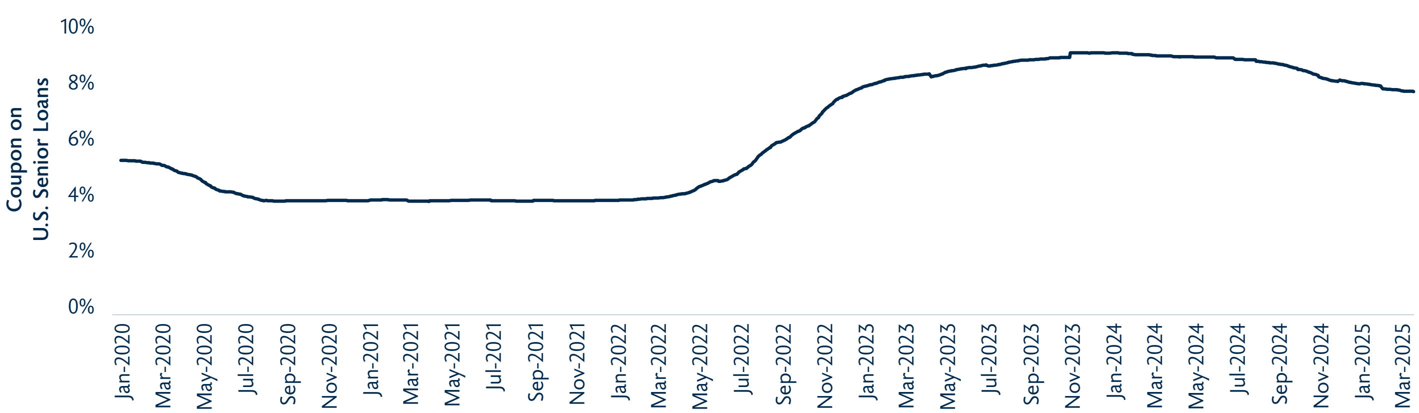
The coupon on senior loans has averaged close to 9% since 2023, up from less than 5% in 2020.[2] (See **Figure 1**.) This rise is explained by the Secured Overnight Financing Rate (SOFR) jumping from near zero to 4-5% during that period, an increase that floating-rate borrowers feel almost immediately in their coupon payments.[3] While the U.S. Federal Reserve has made cuts to the fed funds rate, Treasury yields and SOFR remain stubbornly elevated, and we expect rates to remain above the lows of 2009-2021.

The bulk of issuers may weather this debt burden, but with a record $3 trillion of sub-investment-grade public credit and an estimated $1.5 trillion of private debt outstanding, only a moderate distress rate is needed to create a significant volume of dislocation.[4] Alongside direct equity and distressed debt investments, structured equity solutions may help companies with cash flow and debt repayment issues. Through structured equity, which blends aspects of debt and equity, managers can seek to control downside risk while still incorporating equity upside.

Against this backdrop, accessing bargains is the first step for special-situations investors but business improvement is the next. Financial improvement, such as the pay-down of existing debt and injection of fresh capital can help ensure cash flows are used for business enhancement rather than interest payments. Operational improvements may include optimizing supply chains, enhancing corporate governance, and expanding into new markets.

Ultimately, elevated rates can provide the opportunity to purchase companies with weakened balance sheets at a discount. However, this environment also mandates asset owners to improve businesses—not just achieve good entry prices: with higher rates, true value creation is required rather than a reliance on multiple expansion through cheap leverage.

Figure 1: Interest Expenses Have Dramatically Increased



Source: Credit Suisse Leveraged Loan Index.

ENDNOTES

[1] Source: ***The Roundup***: Top Takeaways from Oaktree's Quarterly Letters—December 2024 Edition. The content is derived from or inspired by ideas in 4Q2024 letters or other materials sent to clients in 1Q2025; the text has been edited for space, updated, and expanded upon where appropriate.

[2] Credit Suisse Leveraged Loan Index.

[3] Federal Reserve Bank of New York.

[4] PitchBook.

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