OAKTREE | Insights

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2025 Edition

The Roundup

Top Takeaways from Oaktree's Quarterly Letters

In the current installment of *The Roundup*,[1] Oaktree experts explore various investment risks and opportunities, including the heightened demand for mezzanine financing, potential entry points for special situations investors, the limited competition for unrated asset-backed finance investments, and the growing need for specialized life sciences lenders. Plus, we've included an excerpt from Howard Marks's 2024 year-end letter to clients.

Howard Marks
Co-Chairman

1.

Market Outlook: Unpredictability

Trends in investor psychology are impossible to predict, and no one should ever think they know what will happen in that regard. The pundits didn't expect much in terms of stock market returns in 2023 or 2024, and they got barnburners. Investors tend to turn more optimistic after a couple of good years, and that could happen here. But, while positive sentiment could support the markets for a while, every year of double-digit stock market returns increases the probability that gravity will prevail eventually. I certainly have no idea whether 2025 will be the year in which it does so.

As you know, the bottom line for me continues to be that non-investment grade credit currently represents a better risk/return deal than the S&P 500. Other markets and sectors may be lower-priced than the S&P, but the latter continues to be treated as a riskless default solution.

As 2025 begins, I think it's incumbent upon investors in the U.S. to take note of the following combination of factors:

- an extended economic recovery,
- the general predominance of optimism,
- above average equity valuations,
- below average risk premiums,
- a poorly functioning governmental/fiscal mechanism, and
- substantial geopolitical uncertainty.

I am far from ringing a general alarm bell, but investors who believe in adjusting their risk posture in response to prevailing conditions might choose at this point to somewhat emphasize defensiveness over aggressiveness. Increased allocations toward lending strategies and away from ownership strategies can play a significant part in this.

February 2025

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2.

Special Situations: Opportunities of Interest

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. This provides attractive entry points for investors, and the chance to create value by improving the financial and operational performance of these businesses.

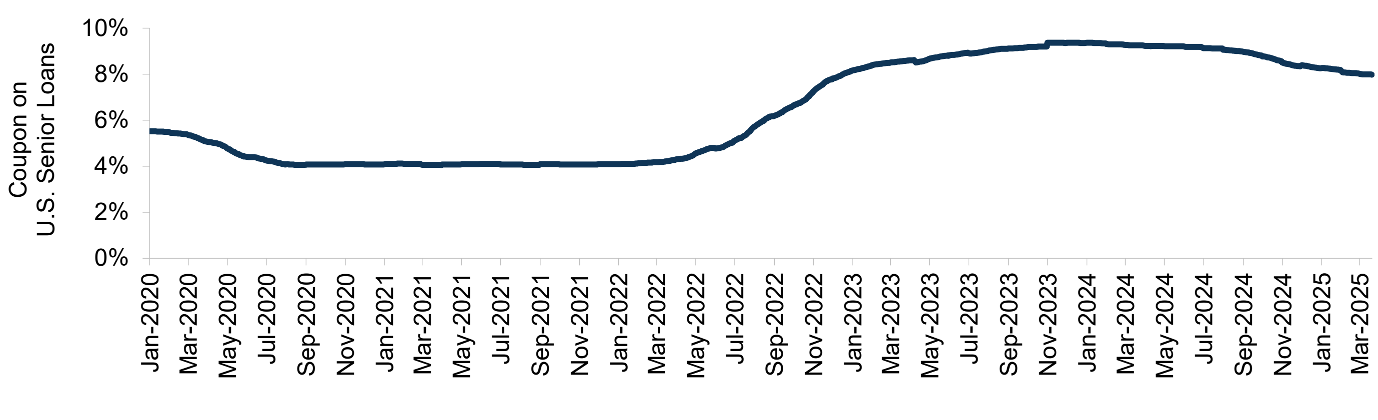
The coupon on senior loans has averaged close to 9% since 2023, up from less than 5% in 2020.[2] (See Figure 1.) This rise is explained by SOFR jumping from near zero to 4-5% during that period, an increase that floating-rate borrowers feel almost immediately in their coupon payments.[3] While the U.S. 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 2009-21.

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 paydown of existing debt and injection of fresh capital can help ensure cashflows 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

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3.

Mezzanine Finance: Junior Capital in Demand

Demand for mezzanine financing has broadened as borrowers of varying sizes have been drawn to the flexibility junior capital can provide, including PIK options, wider covenants, and no amortization. By creating a capital structure with an optimal combination of senior and junior capital, borrowers can lower their overall cost of capital and thus enhance their equity returns. Multiple factors may expand the opportunity set for providers of junior capital in the next phase of the market cycle, including:

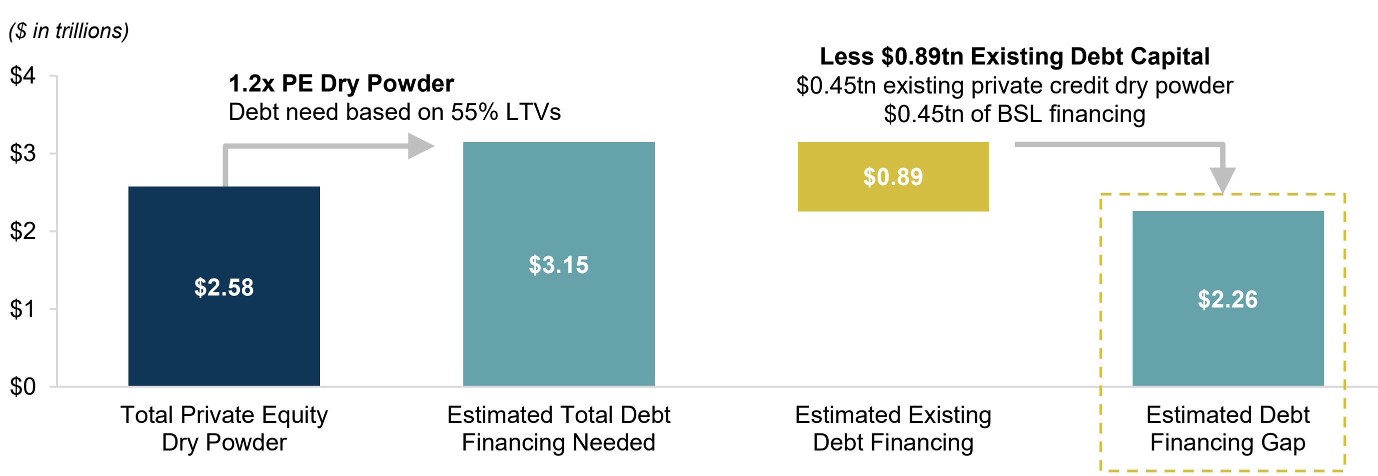
1. **An unprecedented volume of private equity dry powder, with more than $2.5 trillion of available capital.**[5] Merger and acquisition as well as leveraged buyout opportunity (LBO) activity has remained limited, but any rise from the lows of 2023-24 would require significant debt financing: assuming an average 55% loan-to-value means deploying this dry powder will require over $3 trillion of debt.[6] (See Figure 2.)

2. **A decrease in the amount of senior leverage a sponsor can obtain in an LBO.** While purchase price multiples have remained elevated, senior debt multiples available in financing transactions have declined, creating a meaningful funding gap for private equity buyers.[7] As a result, sponsors are increasingly turning to junior capital to bridge the gap and reduce the need for expensive cash equity.

3. **A need for issuers to address their looming debt maturities, with almost $1 trillion of high yield bonds and leveraged loans set to mature before 2030.**[8] Many of these companies are now experiencing liquidity pressure as interest costs have increased, and senior leverage available in financing transactions has declined as a result.[9] Thus, sponsors are seeking to use junior capital to help refinance capital structures.

Taken together, we believe these factors may lead to a surge in demand for junior capital, and an opportunity for experienced providers of mezzanine financing. Credit selection is pivotal when being a junior lender: investors can access high, mostly fixed-rate, yields but must remain hyper-focused on avoiding defaults.

Figure 2: The Funding Gap for LBO Financing Is Significant



Source: Preqin, as of December 31, 2024

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4.

Asset-Backed Finance: Unrated Opportunity

We've talked a lot about how banks are reorienting their lending efforts – particularly in asset-backed financing – due to factors such as tougher capital requirements and the unreliability of customer deposits. But what about insurers, historically institutions keen on high cash-flowing credit investments? U.S. insurers hold over $8 trillion in investible capital and are significant buyers of credit assets, with over 60% of their investments in the form of bonds.[10]

However, attaining credit ratings can be challenging for certain segments of asset-backed finance (ABF). This isn't necessarily due to weak collateral quality, but instead unique structures that don't fit the rigid approach of large rating agencies. Thus, the rated segment of the market omits many robust asset pools for which attaining an investment grade rating simply isn't practical. Non-risk-based reasons that may render a particular capital requirement unsuitable for an investment grade rating include:

- **Short tenor** (e.g., a warehouse facility used prior to the borrower accessing the public asset-backed security (ABS) market): Rating agencies require a special purpose vehicle's debt to have a maturity at least as long as the underlying assets in the SPV, making it challenging to rate short-term warehouse facilities.

- **Variable funding** (e.g., revolvers, delayed drawn term loans, and lines of credit: all of which are common in asset-based lending): These are difficult for insurers who prefer to write liabilities (i.e., policies, annuities) and match them with assets of a set duration, such as term financing.

- **Early-stage platforms:** Originators with smaller, less developed platforms and with asset pools that are not yet fully ramped or with less performance history are typically not yet fully "banked" and unable to access public ABS markets or achieve a rating for their debt.

What's the relevance of insurers not being significant buyers of unrated ABF? Like bank retrenchment, it contributes to the favorable supply/demand dynamic for alternative investors that can provide more flexible financing. Importantly, this may provide a source of additional spread that isn't a result of simply taking more credit risk, but instead a result of reduced competition for deals. To navigate this area – which may not have the comfort of a third-party rating, managers need significant structuring acumen and broad experience in asset-backed finance.

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5.

Life Sciences Income: The Biotech Funding Paradox

Biotech firms currently face a quandary: amid a surge of innovation, drug developers are facing a severe lack of funding. This financing paradox unfolds against a backdrop of inherent sector volatility, amplified by turbulent macroeconomic shifts. For astute investors, however, this tension creates fertile ground for specialized financing opportunities.

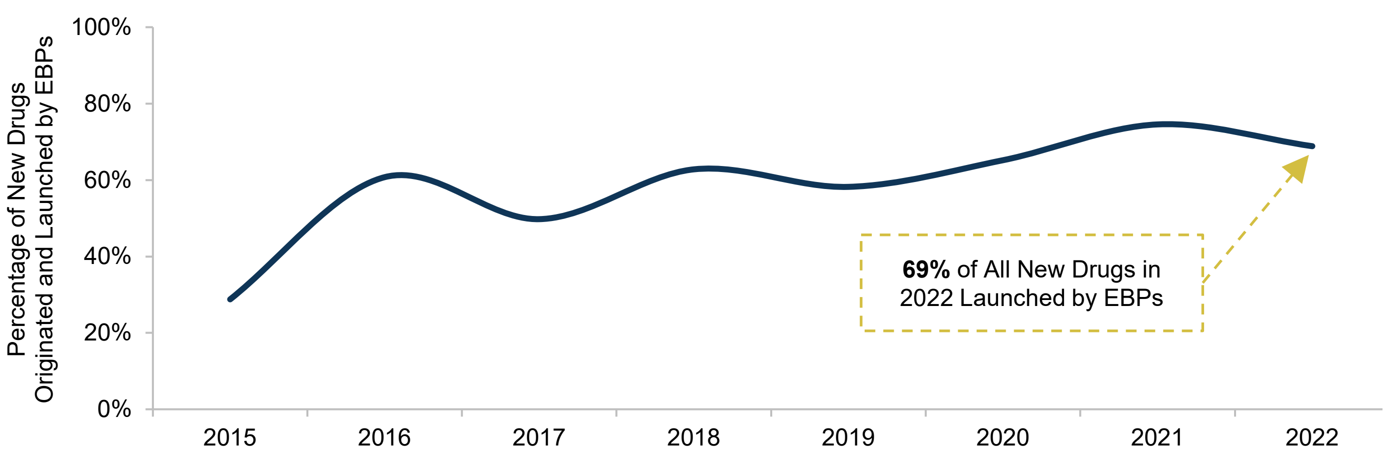
A confluence of revolutionary biotechnologies is reshaping the medical landscape. We've seen meaningful advances in the likes of mRNA technology, as well as in artificial intelligence and diagnostic tools. This technological progress may help in addressing some of the most challenging medical needs. Notably, a substantial portion of this innovation is being driven by emerging biopharma companies, which are responsible for nearly 70% of all new drug launches. (See Figure 3.)

Despite the rise in demand for biotechnology products, traditional financing channels are only offering limited support to emerging biopharmas. Raising equity capital has become challenging for biotech companies, with IPOs particularly hard to execute. Meanwhile, banks are reluctant to engage deeply with the biotech sector as they typically lack the expertise to understand this nuanced market.

This lack of financing supply means a growing cohort of standalone biotech companies are innovation-rich and capital-poor. Thus, there is an acute need for specialized lenders, who understand the life sciences ecosystem and can offer tailored financial solutions that address the specific requirements of companies developing essential therapies. This may include providing the flexible financing to commercialize promising therapies and build critical manufacturing facilities.

As such, it's crucial for investors to take a prudent, credit-driven approach to this complex sector. This involves having a core focus on capital preservation, providing a secure investment profile with which to access an industry characterized by high development risk and fluctuating market conditions.

Figure 3: Emerging Biopharmas (EBPs) Are Driving Innovation



Source: IQVIA Institute, as of January 2023

Endnotes

1. 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.
5. Preqin, as of December 31, 2024
6. Preqin, as of December 31, 2024. Assumes 45% equity contribution in LBOs, which was the average for 4Q2024 U.S. buyouts. The share of LBO capital financed in the direct lending market has varied over the last several years but has seemingly settled around 50%.
7. LSEG LPC 4Q 2024 U.S. Sponsored Middle Market Private Deals Analysis.
8. JP Morgan, as of November 11, 2024.
9. LSEG LPC 4Q 2024 U.S. Sponsored Middle Market Private Deals Analysis.
10. NAIC Capital Markets Bureau, as of December 2023.

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