The Insight: Conversations – Off the Beaten Path with Matt Wilson, Christina Lee, and Jennifer Marques

Harry Whitelaw

Hello and welcome to the *Insight by Oaktree Capital*. I'm Harry Whitelaw, and today I'll be talking with a trio of Oaktree Investment leaders. We'll chat about what higher interest rates mean for private equity, why demand for junior capital solutions is growing, and address the impact of the supply/demand imbalance in asset-backed finance.

First up, we have Matt Wilson, co-portfolio manager in Oaktree's Special Situations group, which targets control-orientated equity and debt investments. Matt, great to have you join me today.

Matt Wilson

Thanks, Harry. It's good to be here.

Harry

Well, we can't do a finance podcast these days without talking about interest rates, so let's start right there. Higher rates are identified as a headwind to private equity portfolios, but Matt, the flip side is that elevated debt burdens may generate compelling buying opportunities.

Matt

Yeah, look, I think there's a significant opportunity created by the rate environment today. If you look at the cohort of LBOs that were done, frankly 2018 to the early part of 2022, if you're to go back and look at the models that they underwrote in those days, I think you would see a lot of them assume that the base rates would remain around zero for a very long time, and hence the multiples paid, and more importantly, the leverage employed to justify those multiples or allow those multiples to be paid was very high. And everyone's aware of what happened in '22 and '23 and where we sit today in that rate environment, but in a short version is those balance sheets have not de-levered because all the cash flow that was generated by those businesses that people thought was going to use to be paid down debt or make distributions to the equity instead went out the door as interest expense to the lenders.

And again, I think a lot of folks, if you look back to four or five quarters ago, at the beginning of 2024, would've been excited to think there'd be 150, 200 basis points of rate cuts by now. And we just haven't seen that level today. And the Fed seems to be on pause for the time being. So unless the economic environment gets worse in a material way, in which case there's a while other set of problems that the world's got to deal with, the Fed does not look like they're going to do a lot of movement this year, which creates a longer runway for these companies that need to survive that elevated balance sheet leverage. And for us, it's a very substantial opportunity either go in and provide capital solutions or even buy that debt in certain situations.

Harry

So we like to talk about good companies with bad balance sheets with the belief they're right for turnaround and value creation, but how do you know it's a fundamentally good company and not want in secular decline?

Matt

I think from our perspective, what is unique about this cycle versus the last 15 or 20 years is that the best companies went for the highest multiples at the top of the cycle, as you'd expect them to do. And the way you paid the highest multiples in 2018, '19, '20, '21 was to lever up as much as you could.

And those businesses had great cash flows and could support that level of debt, particularly with the 0% base interest rate. That said, when rates went up and most of that debt being floating rate debt, those balance sheets became very full in terms of leverage. And the cash flows, as I said earlier, went out to lenders not to the equity. And so there are a large number of really good companies that were bought in that time period at peak prices that we know are out there that are now have too much debt in their balance sheet.

The businesses are fine, maybe capital constrained because they don't have liquidity because that's going to pay down debt or going to pay off interest expense. But fundamentally good businesses and good industries that we focus on, and those are the kind of businesses we think are very unique that we get to see. Because I can tell you that did not exist from 2010 until probably 2024.

Harry

So in terms of addressing those opportunities, you have a pretty broad mandate. I think our audience probably are familiar with direct equity, distressed debt approaches. We're talking a lot more about structured equity these days. How does that fit in as a solution for these companies?

Matt

I mean, structured equity is one of my favorite things that we do. For us, we price these with both a fixed income component as well as equity participation. So a typical deal might look like something with a coupon between eight and 16%. We're very comfortable taking all of that in the form of PIC as opposed to cash pay interest. But we do it both ways. Typically, there's a couple of points of fees up front in the form of an OID or other kind of transaction fee. Typically, there's some minimum MoIC or call protection on these.

And then most importantly, there's usually a participation in the common equity either through a conversion feature or some kind of warrants that come along with the security. So from a risk point of view, we're structuring these things with significant downside protection, that margin of safety day one being the common equity sitting behind us with the priority and with a deep experience of structuring these solutions in a very bespoke manner and understanding how to get the contractual protections in these documents that give us the downside protection we require.

Even with the contracts, as I tell folks, we sit on the board of every one of these companies, we will not do this without board representation because we need to be in the room helping to make strong decisions on these companies and make sure they're doing the right things. And for us, that's part of the value creation as well. A lot of times when we do these deals and the sponsor or the owner gives up that piece of equity to us and the common is part of the conversion feature or warrants, they do so because they believe we're going to make it more valuable. And so we need to be in the room to help make strategic decisions to help do the right things with management teams and M&A and other things that are going to drive alpha in these investments.

Harry

Let's pick up that business improvement concept. There's clearly some great entry points out there and buying well, as Howard Marks would tell us is crucial. But what about when you actually own the company? How do you ensure you are leaving it in a better state than when you picked it up?

Matt

Yeah, no doubt. Making money on the buy is something that's near and dear to our hearts as well. And buying right is something that's important because that's the one thing in an investment you can't change. What I would say is in an investment, you can change a lot of other things, and we can improve these companies and change them dramatically sometimes over our investment period.

We have a group on our team called the portfolio transformation team, PTT for short. They're part of our deal teams from day one of the underwrite. So they're in the diligence process. Part of what goes into our underwriting is what they think they can do with the business, how they can drive value and returns for us.

They'll sometimes act as interim management in a chief transformation officer role or a chief operating officer role to help drive value in there. But importantly, what they do is they are helping to implement tactically the strategic things we want to do in any business to create value. So when we underwrite a business, we look at what can we do in the gross margin? Can we take 200 basis points out of COGS? Can we take 100 basis points of cost out of OPEX? How do we do those things?

And once we identify those, they are then part of the team that goes in and actually executes that and they can leverage outside consultancies, but they're really working together hand in glove with our management teams to drive that type of value and help us deliver those type of returns. The other thing is it helps us provide downside protection. It is nice to have an early warning if something's not going to plan or to have someone in there if something's not exactly going the way we underwrote it to go.

Harry

So you want to improve the business partly so you can get great multiples. You can exit the business at a higher multiple than where you've entered. I've also seen people claiming that DPI a measure of distributions from a fund is the new IRR. I've even seen that written on baseball caps.

Matt

I have too. I've seen that cap.

Harry

We're not here to debate the merits of various performance metrics, as nobody would listen to us, but is it fair to say that distributing capital promptly is now really on the agenda in the industry?

Matt

Well, look, I think the industry is going through a very significant change in the sense that for the broader part of the 2010s, the momentum trade was always there. Funds were getting raised quickly. Money was given back quickly. There was a lot of M&A because rates were at zero and people could borrow and buy things cheaply.

Today, given where rates are, M&A has slowed down dramatically the last two years. I think everybody was hoping it would pick up this year, and so far has not. That has not been the case. So DPI is a real premium. The way this flywheel spun forever was that money would go into a fund and come out of a fund and go to the next fund. And when you haven't seen the return of capital in the last two or three years, it makes it much harder for LPs to make commitments. And so I think there is now a reward for sponsors that are giving back money will get money back first. But IRR doesn't go away. I mean, I think at the end of the day, the holy grail is to have both a good IRR and a good DPI.

I think what a lot of LPs are concerned about and rightly so, is that funds that have decent marks today, 20 plus percent IRR marks, but they have got 10 to 20% DPI. When the DPI finally comes in, it will not look anything like the marks. And I think that's a realistic fear given where things are marked today, and I think how long it will take for those marks to become realized in a lot of cases that IRR will not be in that same zip code as it is today when people come in. I think LPs are very skeptical of that.

Harry

So you mentioned that lack of deal activity, which links to the problem with distributions to LPs. What does that lack of M&A and LBO activity mean for you? It's not picked up definitely as we expected in 2025. Is that a headwind or is that a tailwind?

Matt

Well, look, I think mostly it's a tailwind in the sense that it gives our capital solutions opportunities real, real merit mean people are willing to sell pieces of businesses today and they'll do it in a structured form. And we are seeing that deal flow where sponsors are for the first time coming to us and seeing if we would invest into their businesses because they just have to get money back to LPs because it becomes existential to their business. They can't raise another fund until they give money back. And so they're doing things they would never naturally do, which is to sell a portion of a business or try to monetize something in part as opposed to whole.

Strategic buyers are very healthy and they've got a lot of cash on balance sheets, but it doesn't hurt to have a private equity bid. It certainly doesn't hurt to have a secondary buyer that has not existed for the last couple of years, and in significant ways that it had for the prior decade and a half where private equity was the high bid in a lot of cases. Right now, it is the fact that given where financing constraints sit, that private equity caps out on certain multiple levels, which makes a strategic buyer much more attractive given the fact they can pay a higher price and they have synergies and cost savings they can take out on the backside.

Harry

Thank you, Matt. That's some great insights.

Matt

Thank you.

Harry Whitelaw

Next we'll be looking at the rising demand for junior capital with Christina Lee, Co-Portfolio Manager for our U.S. private debt strategy. Christina is a specialist in mezzanine financing, the portion of the capital structure that sits between a company's equity and its senior debt.

Christina, great to have you join the podcast.

Christina Lee

Thank you, Harry.

Harry

Christina, we just left our prior conversation with Matt speaking about the potential for a return in LBO in M&A activity. The private equity industry is really the main customer for your financing. We've seen a slight uptick in deal activity this year, but perhaps not the boom we maybe anticipated back in 2024.

Christina

Absolutely. I think at the end of 2024, after it was announced that the next president would be President Trump, there was this high anticipation for an increase in M&A demand, because one, with this new administration, it was anticipated three things, reduce taxes, reduce regulations, and overall just a better deal-making environment. We saw equities rally, which helps boost purchase price multiples for sponsored back transactions.

However, we've seen this new administration have significant number of policies come out. For example, the big tariff announcement. That's creating a chill in M&A because there's so much uncertainty. Sponsors don't want to go out with a transaction or a potential transaction and not be able to sell their company, because that typically will reduce their purchase price multiple the next time they try to sell it. And so, we haven't really seen that big tick-up that everyone was anticipating at the end of 2024.

But it'll be interesting to see how the end of 2025 shakes out, because there is this push-pull demand dynamic happening where right now, M&A is on a chill because there's so many different policies going on. There's so much uncertainty. You're hearing stagflation, that word, more and more, but at the same time, sponsors need to make distributions to their limited partners. The limited partner's saying, "Where are my distributions? We need exits." And so, that should help with M&A, but this year is turning out quite a bit different than what people anticipated at the end of 2024.

Harry

Well, let's talk about what that small uptick could mean. Because there's so much of this PE dry powder, about 2.5 trillion, even a relatively small percentage uptick in LBO volume, that can mean a lot of absolute volume and potentially a lot of associated demand for the junior capital that you provide to sponsors.

Christina

Absolutely. There's still a significant amount of dry powder. If you were to take that 2.5 trillion of private equity dry powder, there's an estimated 2.26 trillion financing gap today. So, when M&A comes back, there will be an increased need for private debt, and where junior capital steps in is especially in this higher interest rate environment, because we're seeing companies that what we call grade A assets trade still for pretty high purchase price multiples.

However, where interest rates are today, it's really hard to do a financing with all senior floating rate cash paid debt. And sponsors are saying, "Oh, I can't put that much equity in because it hurts my returns. What am I going to do?" That's where junior capital and really mostly PIK options, pay in kind options, have really come into play, and we've seen an increased demand for those.

Harry

It always comes back to the sea change in interest rates, right? All roads lead to rates.

Christina

Yup.

Harry

Let's talk about the PIK point, though. These capital solutions, including pref, they're often structured with a pretty big PIK component. PIK seems to be a bit of a dirty word right now, but it's fair to say these financings, they're designed with PIK in mind. They're not a distressed loan that's been forced to switch from cash pay to PIK.

Christina

Exactly, so this is quite different, where it's not the company can't afford their pay their cash interest. It's more of, this is a really great company, a sponsor is buying it, for example, for 12 times purchase price multiple. Right now, when it comes to senior debt, maybe you can get five and a half times, so what does that mean? A sponsor has to put six and a half times of equity in. It's really hard to make the return. So, that's where you can put in a PIK instrument for, say, a turn, and think about all that equity cushion below you. You're not going into a distressed situation. You're going into a situation where it's a company that has high value, and you're going in to help bridge the funding gap for the private equity sponsor and reduce their capital needs.

Harry

We tend to talk about the new money deals, M&A LBOs, the most. That's probably more glamorous than refinancings, but with a few trillion of outstanding sub-investment grade bonds and loans, a lot of your capital might actually be used to deal with maturities rather than new deals.

Christina

Yeah. That is another use of proceeds that we are seeing a significant amount of demand for, especially in PIK. So, if you were to look back on when deals were done in a zero interest rate environment, the average leverage was about six times from 2018 to 2021. It is very difficult for a company to refinance right now, dollar for dollar, a six times deal, because cash flow is tight. This company may have grown single digits in profitability, but it hasn't grown fast enough, because interest costs have effectively doubled. SOFR has gone from zero to currently 430 basis points, and so what does that mean? Again, there's this funding gap where maybe you can get four and a half times of senior to help with the refinancing, but now you're looking for a turn and a half of that PIK instrument to help refinance out this capital structure.

Harry

From your perspective as a provider of financing, how do you approach the new LBO versus the refinancing of maybe a company that's a bit better known, it's had bonds loans out for a while, but that '26 maturity might be looking a bit tough all of a sudden?

Christina

Yeah. I would say for us in LBO we tend to like better, because there's fresh capital coming in. Also, there's a new first lien lender coming in. For refinancings, we tend to have a higher bar, and that's because where we don't want to walk into is one where lenders are fatigued, or for example, a sponsor may not support that business going forward with fresh capital or additional capital.

And then second, what we also are curious about is, these are outstanding deals. Is this still an important deal for the sponsor? Where does it sit in their fund? Do they need to make this work? These are all questions that we ask ourselves about a refinancing, and that's why it's a higher bar, because usually with a new deal, there's a lot of optimism. You're like, "This business is worth 10 times plus. Everyone's super excited." For refinancing, sometimes it's because the existing lenders don't want to extend maturity. Then you ask yourself, "Are we missing something?"

Harry

So, mezz is generally a fairly small part of the capital structure. It's inherently more niche than mainstream direct lending. How's the lender competition in your world different to senior direct lending?

Christina

It is very niche, and with niche comes, it's less competitive. For example, if we were looking to do a junior capital deal, we were typically competing against maybe one other provider, maybe at most two. But when you look at competing on the unitranche side, which we do, you are looking at competing against a handful of other providers, and that's why I think mezz tends to be less competitive, so what does that mean? One, the pricing here is pretty sticky, the structuring can be more bespoke, and that's how you're really generating that alpha.

Harry

So, I guess the reward can be great. The competition can be low. The flip side is you need to have a really, really robust focus on risk and downside protection here.

Christina

Absolutely, because you are sitting in the more junior side of the capital structure, and so you need to be highly selective in what credits you're going to, and which sponsors you're doing business with, but that's only half the story. The other half of the story is, when things go wrong, and inevitably something will go wrong in a portfolio, what do you do when things go wrong? Do you have a playbook? And I think one of the things I always say is, look at a track record. How long is that track record? How long does that span? Because we just haven't been in a market environment in the last 10 years where there's really been a prolonged dislocation.

Harry

Awesome. Exciting opportunities, a need for risk control. We'll leave it there. But Christina, I'm sure we'll have you on again to chat about all things private debt.

Christina

Thanks, Harry.

Harry Whitelaw

And now for our final conversation, I'm delighted to welcome Jennifer Marques, head of strategy and structuring for our asset-backed finance strategy.

Jen, great to have you join the podcast.

Jennifer Marques

Thanks for having me, Harry.

Harry

So Jen, asset-backed finance is perhaps less broadly understood than the likes of direct lending or corporate bonds. And that in itself may bring some advantages, but it does mean you need to explain exactly what it is at the start of each discussion.

Jennifer

Well, we're always happy to help people understand. So yes, to take a step back, asset-backed finance is in essence the business of lending to lenders. Every time a bank or a specialty lender issues a mortgage or an auto loan, rights equipment lease, they are originating an asset. Now, if origination is the business of extending credit or making a loan, then asset-backed finance is the business of funding those loans, or where the money comes from.

Now, fueling the breadth of the global economy through these financing structures has been a mainstay of bank lending activity for years. So what's new today is not so much the asset class, but rather the changing role of banks. At Oaktree, specifically in our asset-backed finance strategy, we're looking at lending against or owning pools of contractual cash-flowing assets, so loans, leases, mortgages, receivables, broadly diversified across sectors. Everything from digital infrastructure, fiber to the home, for example, to transportation, for example, aviation leasing. We like to talk about financing Main Street rather than Wall Street.

Harry

That's a helpful explanation, just what we needed. And a good reminder, this isn't a new asset class. It has been led, as you said, by banks, both regional and international, for decades. But in a manner a little bit similar to corporate lending after the financial crisis, banks are tilting away from this asset class.

Jennifer

That's right. We've talked before about the retrenchment we've seen in the past two years from banks in asset-backed finance, reminding us of the retrenchment we saw from banks in corporate direct lending over a decade ago. Banks in response to various different headwinds are significantly reducing their lending business in these areas, which are generally capital intensive and not fee or deposit generative for them. And that's giving rise to a really interesting opportunity for private alternative lenders such as Oaktree to step in and fill the financing void.

Harry

Well, let's talk about another type of institution that can be a big lender, insurers. They have an awful lot of investable capital, very sophisticated, but not all of ABF necessarily fit their specific requirements.

Jennifer

Yes, that's right. Insurers absolutely have been a big player in this market and will continue to have an important role to play providing capital in asset-backed finance. But crucially, insurers or managers investing behalf of large insurance-affiliated balance sheets will often require an investment grade rating for their investments, which is just not possible for vast swathes of the ABF market. And we believe that's a non-risk-based reason for depressed competition in the unrateable area of the asset-backed finance market.

And it's precisely in this unrated area, where the banks have just left and insurance capital can't go, that we're seeing the most attractive pricing, and ultimately the ability to really be in the driving seat in obtaining robust creditor protections in what is currently a very uncrowded area with significant capital need. And that doesn't mean there's not a lot to do in the investment grade space. There is, and it's a huge part of the addressable market in asset-backed finance, but we're just seeing that to be more crowded and with tighter spreads.

Harry

Well, unrated is an interesting concept. Immediately, I think you hear unrated and you think badly rated, but we're not actually talking about that. We're not talking about assets that tried to get a rating but were of inadequate quality. We more mean they're of a structure not suitable for what can be quite a rigid assessment delivered by large credit rating agencies.

Jennifer

Yes, that's a really important point and a common misconception, actually, that the reason a particular investment is not suitable for an investment grade rating must be because it's riskier, a lower quality pool of assets, for example. And whilst that can occasionally be correct, more commonly it's the structural features of the borrower's financing need that precludes a rating.

Remember, in asset-backed finance, we'll typically partner with an originator. The originator is the one writing the underlying loans or leases, and they'll contribute those assets, those loans or leases into a bankruptcy remote SPV, which we'll lend to or own or otherwise take control of as part of our financing structure. Now, there might be a variety of non-risk-based reasons why our financing to that SPV might not be suitable for an investment grade rating. Perhaps our investment is shorter tenor, such as with a warehouse financing. Our investment that we make might be a two-year facility, but the underlying assets in the vehicle could have a longer duration.

A rating agency will typically require that the assets be able to term out during the financing period, and so will not be able to rate that investment. Or perhaps the nature of the borrower's financing need is regular variable funding, a revolving or delayed draw financing designed to finance regular originations of auto loans to consumers, for example. Again, troubling for rating agencies that like to match the financing with insured assets of a set duration.

Now, neither of these factors say anything about the underlying risk profile of the sector in question or the asset pool necessarily. And we find that borrowers are willing to pay a premium for more flexible capital when it's required, and that premium might be 200, 250 basis points wider than comparable public ABS in the same sector. So that spread premium, in our view, can be seen as an overpayment for comparable credit risk, a payment for that flexibility in our financing.

Harry

Well, that supply/demand dynamic definitely seems to favor the alternative lender, but we should be very upfront. This is not a asset class where you can be casual in your underwriting.

Jennifer

That is correct. It's crucial. We've been investing in asset-backed finance and traded structured credit for over two decades at Oaktree. And our 20 years of investing experience both on the performing and opportunistic side enables us to consider relative value across the ABF market and be able to structure downside protections. We're fortunate to have both deep sector expertise in the underlying industries that we're financing and understanding of how the collateral and how the originations businesses themselves work, but also crucially the necessary structuring acumen to navigate this complex asset class.

Things like including a dynamic borrowing base in our facility that can dial down our go-forward exposure in the event of performance concerns. Or strict collateral eligibility criteria might control the assets the originator can include in our facility. Or performance triggers, which can redirect cash from the assets to pay down our investment if breached.

All of these features, things like cash reserve accounts, excess spread, that are inherent within asset-backed finance can all help protect against downside risk. But away from structural protection, there is no better protection in our view than having the institutional insight to avoid the wrong deals, the wrong collateral, the wrong originators altogether.

And the advantage of Oaktree's scale and our breadth of experience in asset-backed finance isn't just the investments we make on behalf of our clients, but also the deals we know better than to pursue. We think that discipline is especially important in unrated ABF, and the great thing is that the supply and demand dynamics and the fact that the addressable asset-backed finance market is just huge, in the trillions, means that we can be very selective in picking what we believe to be the best deals.

Harry

That's a great place to end. Thank you, Jen. So, asset-backed finance, interesting market opportunity, but certainly one requiring astute navigation.

So there we have it. Thanks to Matt, Christina, and Jen for their contributions today. And thanks to you for joining us for this episode. Look out for future content wherever you get your podcasts or via the Oaktree public website.