BLUE OWL

Navigating the credit markets

JANUARY 2025

Navigating the credit markets in high (and potentially choppy) waters

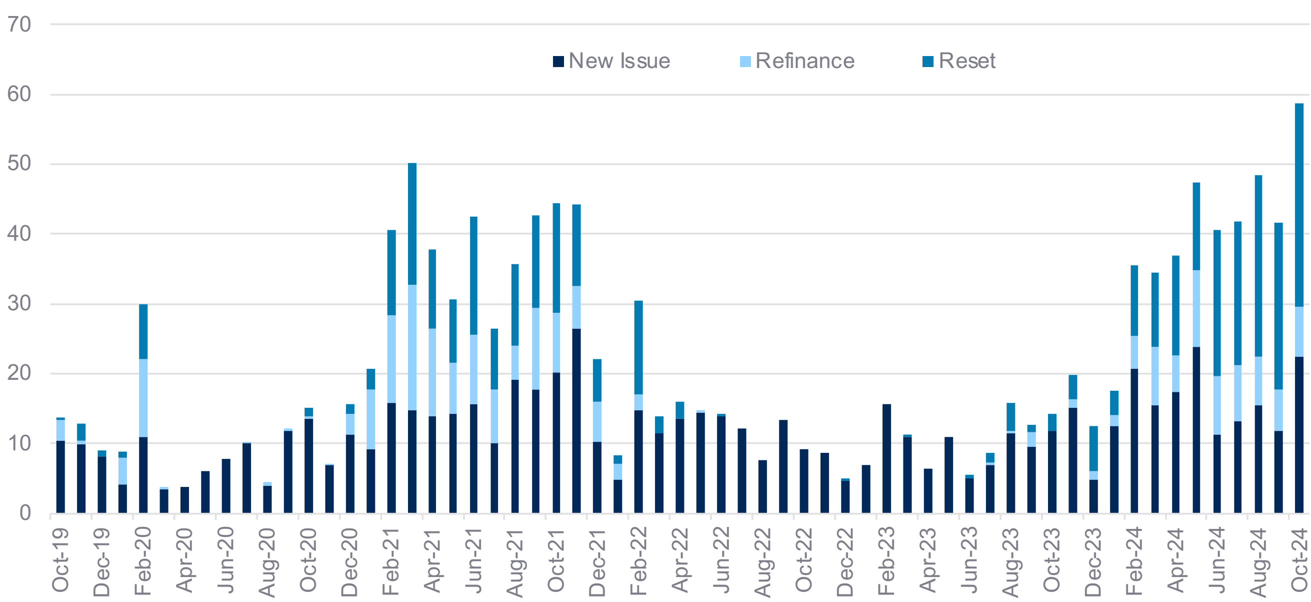
A sense of euphoria appeared to sweep the credit and equity markets after the decisive statement made by American voters on November 5th. We have found investors have embraced the prospect of a new administration as spreads tightened to near all-time lows and equity markets approached all-time highs.

Despite the markets' initial reactions, we believe the impact of a change in leadership on trade and fiscal policies has led to a significant move in interest rates and concerns around renewed inflationary pressures have once again appeared to push "higher for longer" rhetoric to the forefront of investors' minds.

At Blue Owl, we actively monitor the markets and individual companies for potential signs of weakness as we look to deploy capital and manage portfolios prudently in the face of the ever-evolving multi-variate equation that is investing. Interestingly, despite the recent market rally there are several factors in play that we believe should be in focus when evaluating investment opportunities in private credit. For one, competitive pressures in both the public and private credit markets have shifted the power dynamics back towards borrowers as reflected by the tightening of spreads we have witnessed over the past year. The broadly syndicated loan (BSL) markets have re-emerged as a viable option for borrowers and CLO issuance has once again picked up as evidenced by a record amount of issuance in 2024 ($164.4 billion through October).

Figure 1

Trailing 5-year US CLO Issuance (bn)[1]



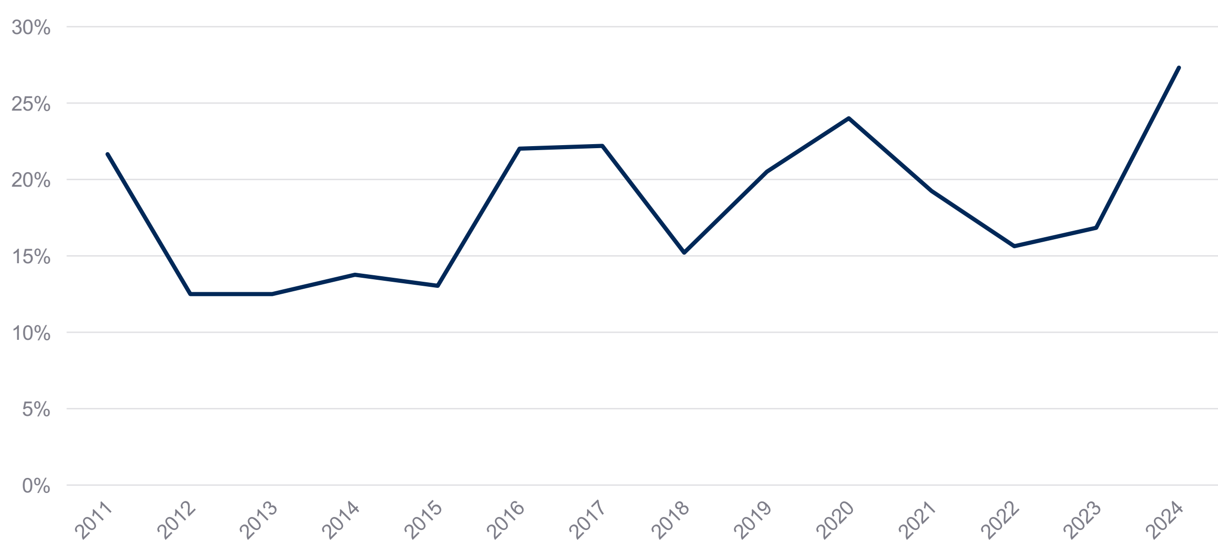
Despite this pick up in competition, private credit has continued to solidify its role as a critical source of financing for middle market companies. In fact, direct lending originations totaled $97 billion during the third quarter, a record high since the beginning of the KBRA data series in 2021. Notably, through the third quarter of 2024 Blue Owl has originated approximately $40 billion in loans, and approximately 50% of the new fundings across our platform were to existing borrowers, highlighting an increasingly important source of deal flow that accrues to Blue Owl as a function of our increasing scale and long-standing relationships with companies and financial sponsors. In other words, incumbency and the strong relationships we have built over the past 8+ years are paramount in sourcing and prudently deploying capital in the current environment.

Another area of focus for Blue Owl is credit documentation. According to S&P Global, since the mid-2000's the percentage of covenant lite loans has increased from approximately 25% to over 90% today. We have found one notable impact of this growth in covenant lite issuance is that "liability management exercises" (LME's) have become more commonplace as companies utilize the flexibility afforded them by weak credit agreements to their advantage (and to the potential disadvantage of certain creditor classes). For lenders, the importance of documentation and control has become paramount in seeking to protect their interests - these are areas where we believe Blue Owl has a distinct competitive edge due to the scale of our platform and the fact that we are the lead agent on over 65% of the deals we participate in.

On the interest rate front, the Fed's fight against inflationary pressures over the past several years triggered the largest tightening cycle in over four decades. As a result, we have observed higher base rates putting pressure on borrowers, especially those with floating-rate debt or those with a more pressing need to refinance near-term maturities. While private credit managers have likely benefitted from higher rates due to the floating rate nature of these loans, the potential for more defaults in a higher-for-longer rate environment could test the resilience of private credit portfolios. From a credit fundamentals perspective, across Blue Owl's portfolios our borrowers generally remain in strong positions, delivering consistent revenue and EBITDA growth alongside stable-to-improving coverage ratios. The vast majority of our portfolio companies have also managed to retain and improve their EBITDA margins by moderating their input costs and by being proactive about cost management measures. Importantly, interest coverage ratios and liquidity levels remained adequate after the Fed rate hikes in 2022-2023, and we believe coverage ratios should gradually improve from current levels. In the select instances when borrowers have encountered meaningful stress, our credit documents have functioned as intended and have protected our investments.

Figure 2

Annual Total Return Differential: Median vs. Bottom Decile BDC[4]



We believe competitive pressures and elevated interest rates have contributed to a significant increase in performance dispersion in private credit managers this year. In fact, per the chart from Goldman Sachs above, using the total return differential between the median and the bottom-decile business development company (BDC) as a proxy, dispersion in 2024 has reached its highest level since 2011.

Even amidst this dispersion, our portfolios have continued to perform well. Our credit platform at large returned 3.3% in the third quarter, and 15.2% over the last twelve months. Weighted average Loan To Values (LTVs) remain below 40% across the platform. Lastly, our direct lending annual loss rate has averaged 10 basis points since inception, meaningfully better than market averages.

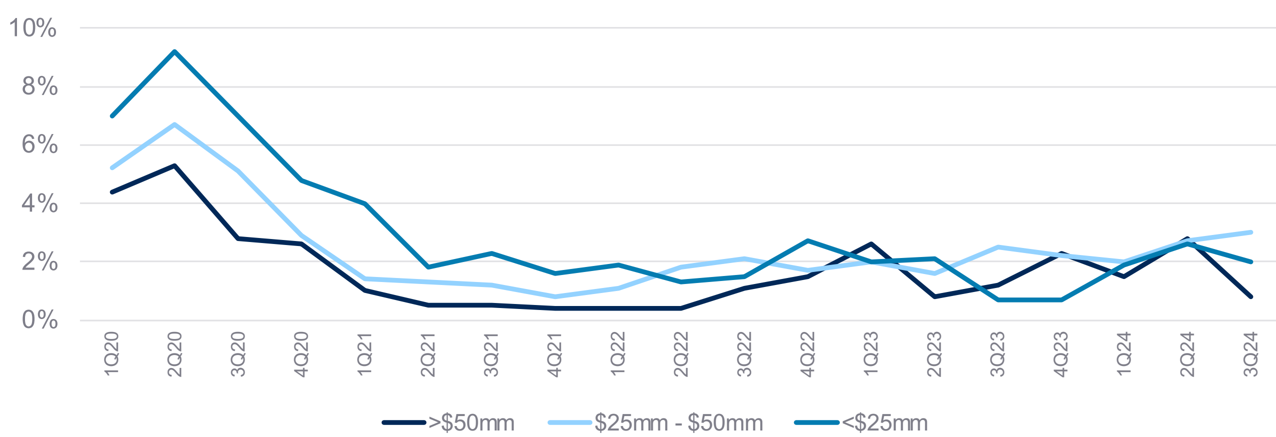
We believe a significant factor in our strong performance has been our focus on companies in the upper middle market (typically $100mm+ in EBITDA). This is a core tenet of our investment philosophy for two primary reasons: First, we believe larger companies tend to be more durable across the market cycle—this facilitates our goal of constructing a conservative portfolio aimed to generate attractive risk returns for our investors.

Second, we believe the upper middle market enjoys favorable competitive dynamics compared to the core or lower middle markets. While there are many lenders that can make commitments in the range of $100 – $250 million, there are far fewer that can speak for significantly larger deals. This in turn helps support discipline on pricing and documentation terms within the upper middle market.

Notably, this thesis also plays itself out in the data. According to Proskauer's direct lending database, through the third quarter of 2024 companies with greater than $50 million of EBITDA have seen a long-term default rate of approximately 1.7%, notably lower than the long-term average of approximately 3.0% for borrowers with an EBITDA of less than $25 million and 2.5% for companies with $25 to $50 million of EBITDA. This performance differential has been even more stark in times of market stress, such as COVID in 2020 (see chart below).

Figure 3

Default Rate by EBITDA[5]



As always in private credit, the key will be striking the right balance between risk and reward. Navigating around these swells in the unpredictable sea of the market will require careful due diligence and a disciplined approach to underwriting and portfolio management.

Sources

1. DataSource: Pitchbook LCD.
2. KBRA, Q3 2024
3. S&P Global, "Covenant lite deals exceed 90% of leveraged loan issuance setting new high", October 2021
4. Data Source: Pitchbook LCD, Goldman Sachs Global Investment Research.
5. Data Source: Proskauer, Q3 2024 Default Report.

Important information

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