OAKTREE INSIGHTS

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SPECIAL EDITION: INVESTING IN CREDIT TODAY

OAKTREE

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INVESTING IN CREDIT TODAY

FOREWORD

Oaktree recently hosted an investment professional discussion on credit investing in today's markets. John Frank, Oaktree's Vice Chairman, moderated the discussion and was joined by Raj Makam (Co-Portfolio Manager, Middle-Market Finance) and Justin Bickle (former Managing Director, European Principal and European Private Debt, and current CEO of Glenveagh Properties, a European Principal portfolio investment). What follows is based on that conversation.

John Frank: Justin and Raj, you focus on middle-market lending in Europe and the U.S. respectively. Is this a good time to be providing private loans, particularly as there has been a lot of capital directed at private lending opportunities? If so, where are the opportunities?

Justin Bickle: We believe this is a good time to be lending to the middle-market segment that we target, comprising European companies with enterprise values of €500 million and below. Industry research estimates that there is a €2 trillion gap between demand and supply, meaning there is significantly more demand for financing than there is capital available to meet it. We think the best opportunities are in the non-sponsor-led middle-market segment because there are fewer lenders in this segment, which means there is less competition and we can potentially charge more for our capital. In addition, sourcing non-sponsor-led deals requires an investment team with a broader reach, as well as the tenacity and structuring expertise to source and execute these deals, which further limits our competition.

Raj Makam: I think the U.S. is another good place to be investing, because right now it's possible to earn unlevered yields of approximately 6.5% on private loans. This compares favorably to seven-year Treasury yields around 2.15%. Despite this favorable lending environment, it's important to be aware of the pace of U.S. middle-market lending activity and where we are in the economic and credit cycles. We are in the midst of the third-longest economic expansion in the U.S. since World War II. There has been a meaningful amount of money raised for direct lending and private debt strategies, but overall company performance is sluggish and deal flow is down. Given this potential imbalance of supply relative to demand, while we feel the environment in the U.S. is conducive to Oaktree's style of investing in credit, we have to be extremely discriminating and selective. This is the time to be defensive, because you don't know when the cycle will turn against us.

John Frank: What would you say are the main differences between the private debt markets in the U.S. and Europe?

Justin Bickle: My sense is that the U.S. market is more liquid and commoditized than the European direct lending market, but Raj is best placed to comment given his experience there. I will say that because we target the non-sponsor-led segment, each transaction we look at requires more work on the front end in order to identify interesting opportunities across Europe and devise an individualized structuring solution for each. In contrast to the U.S., which has a unified legal regime, you need "feet on the ground" in the various jurisdictions and more than just credit under-writing expertise. Our private debt strategy would not otherwise be feasible except that it is undertaken by the European Principal Group, which has approximately 50 investment professionals, including senior advisors and a team of in-house lawyers already focused on private equity transactions in the same jurisdictions in which we lend.

Raj Makam: I think lending in connection with financial sponsor-backed deals in Europe is probably a little less relationship-driven compared to deal-making in the U.S., where lender-sponsor relationships are quite important and symbiotic. Sponsors drive deal flow for private debt funds and, in turn, managers of debt funds are usually incentivized to participate in the next deal so that sponsors will continue to approach them with financing opportunities. At the same time, sponsors want to be able to obtain financing from these lenders on a regular basis. As a result, both lenders and sponsors are motivated to make sure each loan performs as anticipated and to work together when issues arise.

John Frank: Raj, can you tell us a little more about your team's relationships with sponsors?

Raj Makam: Our relationships are primarily with middle-market sponsors whose funds range in size from $250 million to $2 billion of committed capital. Over 75% of our loans since inception have been to sponsors to whom we've provided financing for multiple deals. Considering that our track record spans 16 years and over 80% of our investments are in junior debt, we believe it's quite an achievement that so much of our business is with repeat sponsors. We have found ourselves in difficult situations in which we were at odds with the sponsors to whom we lent, but because of our constructive, responsible approach and the long-term nature of our relationships, both sides were motivated to work together toward resolutions. We feel it's a testament to our franchise and willingness to work through tensions to resolve issues that we have maintained strong sponsor relationships, which has resulted in strong deal flow for us.

John Frank: How do you mitigate risk and structure transactions to protect the downside?

Justin Bickle: As a team with both a private equity background and credit underwriting capabilities, we work on a credit-by-credit basis, undertaking private-equity-style diligence on the companies and assets to whom or against which we lend. If we decide to proceed with a transaction, our next step is to decide how to structure a loan that will satisfy our risk criteria. We create bespoke structures that protect our downside and, in a worst-case scenario, enable us to take control of the underlying asset. This is not a "loan-to-own" strategy, but if something goes wrong, we will exercise our share and asset pledges. Also, when structuring our loans, we avoid jurisdictions where there is less certainty that we could exercise these pledges. Typically, our investments are structured as senior debt plus some upside consisting of equity or warrants. We like first-lien interests and uni-tranche loans, and we will accept a combination of cash and PIK coupons. Because we are not the source of the cheapest capital, one of our big concerns is that our borrower will prepay our loan, so we typically include prepayment penalties in our loan documentation.

Raj Makam: We are very selective and turn down 80-90% of the deals we see. It is extremely important for us to pick the right partner, so that if things go wrong, no one panics; instead, we take our time and work together on a solution. An important part of our diligence involves stress-testing every factor to see whether a company will still be able to repay our loan after accounting for all fixed charges, interest payments and capital expenditures. Managing unpredictability is key, and we look to maximize our chances of fully recovering all of our capital and interest. With regard to structuring our loans, the majority of our investments are junior debt, which we structure to ensure as much downside protection as possible. Our loans have a combination of cash and PIK coupons, initial commitment fees, and some call premiums.

John Frank: Raj, Justin mentioned uni-tranche loans – what are these, and how do they affect what you do?

Raj Makam: A uni-tranche structure places both tranches of debt – junior and senior – in one instrument. Usually, we don't believe this is a great choice for companies because pricing tends to be more expensive. Also, if things go well, the company can't pay off the more expensive portion of the debt, whereas they can if their debt is structured as first-lien and mezzanine tranches. Uni-tranche structures are typically used in situations where time is of the essence. For example, in an M&A situation, a uni-tranche provider can help get the deal done more quickly. We find uni-tranche deals a little more complicated for our investment strategy, because if you want to hold a diversified portfolio, issuance has to be sizeable. Right now, we estimate that 10-15% of the market is in uni-tranche debt, but I don't foresee a scenario in which uni-tranche loans will be as much as 30% of the market.

John Frank: Speaking of the market, can you discuss your industry sector preferences?

Justin Bickle: We like manufacturing and tend to stay away from pharmaceuticals and other sectors with a heavy research and development component. A large number of our investments have been referred to us by our other portfolio companies, which means we tend to stick to sectors in which we've invested before.

Raj Makam: We are industry-agnostic, but we like stable companies with slow, careful growth. It's easier to point to the sectors that are not a focus for us. For example, we tend to stay away from industries whose growth is the result of some short-term trend, because it's difficult to incorporate this into our analysis.

BIOGRAPHIES

JOHN FRANK

Vice Chairman

Mr. Frank is Oaktree's Vice Chairman and works closely with Howard Marks, Bruce Karsh and Jay Wintrob in managing the firm. Mr. Frank joined in 2001 as General Counsel and was named Oaktree's Managing Principal in early 2006, a position which he held for about nine years. As Managing Principal, Mr. Frank was the firm's principal executive officer and responsible for all aspects of the firm's management. Prior to joining Oaktree, Mr. Frank was a partner of the Los Angeles law firm of Munger, Tolles & Olson LLP where he managed a number of notable merger and acquisition transactions. While at that firm, he served as primary outside counsel to public- and privately-held corporations and as special counsel to various boards of directors and special board committees. Prior to joining Munger Tolles in 1984, Mr. Frank served as a law clerk to the Honorable Frank M. Coffin of the United States Court of Appeals for the First Circuit. Prior to attending law school, Mr. Frank served as a Legislative Assistant to the Honorable Robert F. Drinan, Member of Congress. Mr. Frank holds a B.A. degree with honors in history from Wesleyan University and a J.D. magna cum laude from the University of Michigan Law School, where he was Managing Editor of the Michigan Law Review and a member of the Order of the Coif. He is a member of the State Bar of California and, while in private practice, was listed in Woodward & White's Best Lawyers in America. Mr. Frank is a member of the Board of Directors of Chevron Corporation and a Trustee of Wesleyan University, Polytechnic School, Good Samaritan Hospital of Los Angeles, and the XPRIZE Foundation.

RAJ MAKAM

Co-Portfolio Manager, Middle-Market Finance

Mr. Makam joined Oaktree in 2001 and currently serves as co-portfolio manager for the Middle-Market Finance Group. His primary responsibilities include origination, underwriting and execution. Prior to joining Oaktree, Mr. Makam worked at Banc of America Securities LLC (previously NationsBanc Montgomery Securities LLC) for four years in their Leveraged Finance/High Yield Group. During that period he specialized in bridge finance, with responsibility for deal origination, market analysis, structuring, due diligence and legal documentation. Prior to joining Banc of America Securities in 1997, he worked for five years as a senior software engineer at Montage Group Ltd. and Dantec Electronics Inc. Mr. Makam received a B.S. degree with distinction in engineering from the Bangalore Institute of Technology, India. He then went on to receive an M.S. degree in engineering from the University of Akron, Ohio and an M.B.A. in finance from Yale University.

JUSTIN BICKLE

Former Managing Director, Oaktree Capital Management (UK) LLP and Current CEO of Glenveagh Properties PLC

Mr. Bickle is a former Managing Director of Oaktree Capital Management, where he was part of the London-based European Principal Group from 2005 to 2017. He left the firm in November 2017 to become CEO of Glenveagh Properties PLC, a European Principal portfolio company that subsequently listed on the Dublin and London Stock Exchanges. Mr. Bickle joined Oaktree in 2005 from the London office of the U.S. law firm of Cadwalader, Wickersham & Taft LLP, where he was a Partner in the Financial Restructuring department and advised on many of the first debt restructurings in Europe. Mr. Bickle graduated from the University of Exeter with a law degree in 1992 and qualified as a solicitor in England and Wales in 1995. Outside of Oaktree, Mr. Bickle is the Chairman of the English National Ballet and an Executive Fellow of Finance at the London Business School.

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High Yield Bonds

Securities in the lower rated categories and comparable non-rated securities are subject to greater risk of loss of principal and interest than higher rated and comparable non-rated securities and are generally considered to be predominantly speculative with respect to the issuer's capacity to pay interest and repay principal. They are also generally considered to be subject to greater risk than securities with higher ratings or comparable non-rated securities in the case of deterioration of general economic conditions. Because investors generally perceive that there are greater risks associated with the lower rated and comparable non-rated securities, the yields and prices of such securities may be more volatile than those for higher rated and comparable non-rated securities. The market for lower rated and comparable non-rated securities is thinner, often less liquid, and less active than that for higher rated or comparable non-rated securities, which can adversely affect the prices at which these securities can be sold and may even make it impractical to sell such securities.

Bank Loans and Participations

Bank loans and participations involve the risk of invalidation as a fraudulent conveyance, lender liability claims, environmental liabilities with respect to collateral and limitations on the holder's ability to directly enforce its rights with respect to participations.

Nature of Bankruptcy Proceedings

Investing in companies involved in bankruptcy proceedings presents significant risks, foremost of which are the lack of control over certain events, the bankruptcy filing itself may have an adverse impact on the company, the duration of the proceedings are difficult to predict and may be further impacted by delays, the costs inherent in the process are frequently high, creditors can lose their priority and ranking in a variety of circumstances and representation on a creditors committee may subject the creditor to various trading and confidentiality restrictions.

Foreign Investments

Investments in securities or obligations of foreign entities involve certain special risks, including social, political or economic instability; the possibility of unfavorable foreign governmental actions; price fluctuations and market volatility; differences in auditing and financial reporting; adverse taxes; and different laws and customs. These factors may increase the likelihood of potential losses being incurred in connection with such investments. Further, because such investments in foreign entities are likely to be denominated in multiple currencies, the fluctuation in currency exchange rates may have an adverse impact on performance.

Convertible Securities

Many convertible securities are not rated investment grade. Securities in the lower-rated and non-rated categories are subject to greater risk of loss of principal and interest than higher-rated securities and are generally considered to be predominantly speculative with respect to the issuer's capacity to pay interest and repay principal. They are also generally considered to be subject to greater risk than securities with higher ratings in the case of deterioration of general economic conditions. Because investors generally perceive that there are greater risks associated with lower-rated and non-rated securities, the yields and prices of such securities may be more volatile than those for higher-rated securities. The market for lower-rated and non-rated securities is thinner, often less liquid, and less active than that for higher-rated securities, which can adversely affect the prices at which these securities can be sold and may even make it impractical to sell such securities. The limited liquidity of the market may also adversely affect the ability to arrive at a fair value for certain lower-rated and non-rated securities at certain times and could make it difficult to sell certain securities.

Stressed Credits

Any deterioration of underlying market fundamentals could negatively impact the performance of investments in stressed companies. Changes in general economic conditions, tax rates, operating expenses, interest rates and the availability of debt financing may also adversely affect the performance of such investments. For these or other reasons, investments in stressed companies may become "non-performing" after their acquisition, and during an economic downturn or recession, stressed investments are more likely to go into default than securities of other issuers not experiencing financial stress. Securities of stressed companies are also often less liquid and more volatile than securities of companies not experiencing financial difficulties, often involving a higher degree of credit and market risk.

Real Estate Investments

The value of real estate-related securities can fluctuate for various reasons. Real estate values can be seriously affected by interest rate fluctuations, bank liquidity, the availability of financing, and by regulatory or governmentally imposed factors such as a zoning change, an increase in property taxes, the imposition of height or density limitations, the requirement that buildings be accessible to disabled persons, the requirement for environmental impact studies, the potential costs of remediation of environmental contamination or damage and the imposition of special fines to reduce traffic congestion or to provide for housing. Income from income-producing real estate may be adversely affected by general economic conditions, local conditions such as oversupply or reduction in demand for space in the area, competition from other available properties, and the owner provision of adequate maintenance and coverage by adequate insurance. Furthermore, certain investments in mortgages, real estate or non-publicly traded securities and private debt instruments have a limited number of potential purchasers and sellers. This factor may have the effect of limiting the availability of these investments for purchase and may also limit the ability to sell such investments at their fair market value in response to changes in the economy or the financial markets.

Illiquid Investments

Certain strategies will involve the use of illiquid securities or securities which are restricted as to their transferability. Such restrictions may limit the ability to sell such securities at their fair market value.

Leverage

Certain strategies may engage in activities that involve the use of leverage. While leverage presents opportunities for increasing the strategy's total return, it may increase losses as well. Accordingly, any event that adversely affects the value of an investment would be magnified to the extent leverage is used.

Investments in companies whose capital structures have significant leverage are inherently more sensitive than others to declines in revenues and to increases in expenses and interest rates, posing a greater possibility of bankruptcy or default.