OAKTREE | Insights

State of the Credit Markets 2024

Top Ten Takeaways from Armen Panossian and Bob O'Leary

In December 2023, Oaktree's incoming co-CEOs Armen Panossian (Head of Performing Credit) and Bob O'Leary (Portfolio Manager, Global Opportunities) took part in a webcast for Oaktree clients that explored the state of performing and opportunistic credit markets and what we might expect to see moving forward. They argued that the current environment for credit investors is the most attractive since the Global Financial Crisis – based on the enormous size of today's markets as well as the elevated yields and reasonable investor protections being offered. Below are the top ten takeaways from the conversation.[1]

1. The size of the opportunistic credit universe has ballooned

Bob O'Leary: The most striking thing on the opportunistic credit side is the sheer enormity of the market right now. We think about the addressable market for opportunistic credit in four buckets: high yield bonds, BBB-rated bonds, leveraged loans, and private credit. The size of those four categories just prior to the financial crisis was about $3 trillion. Today, it stands at roughly $13 trillion, so that's a 4x increase – staggering growth in those categories.[2]

2. Skilled performing credit investors can potentially earn high yields while avoiding defaults

Armen Panossian: We're really excited about the current performing credit market. We recognize the risks. We recognize that we need to avoid defaults and losses, which are likely going to tick up in the broad market over the next couple of years. And we're monitoring the growing risk related to floating-rate borrowers that need debt or equity capital and are struggling to access it. We understand that this tail risk is certainly fattening.

However, in the context of the roughly 1,500 U.S. high yield bond and leveraged loan issuers, there are several hundred that are going to be just fine – even if defaults rise in the market broadly. So if you're a skilled credit picker who has managed capital through cycles, you may potentially be able to put together a portfolio of hundreds of broadly syndicated loans and high yield bonds that are going to perform quite well and generate an attractive yield.

3. Large-cap private credit opportunities expanded significantly in 2023

AP: In 2023, investment banks were stuck with about $40 billion of debt on their balance sheets that they had to clear at a discount.[3] As a result of these losses, banks didn't syndicate or originate very much debt in 2023, likely because their risk managers, their capital markets teams, and their leveraged finance desks were told to watch what they did with their balance sheets.

As a result, we saw a significant expansion in the large-cap end of private credit. Companies that have $100 million of EBITDA or more – or enterprise values of one billion dollars or more (and oftentimes six, seven, eight, or nine billion dollars) – were bought using private credit as the financing tool.

What we're finding in large-cap sponsored lending is that its pricing is wider than in traditional middle-market private credit deals. To put some numbers on it, we're seeing spreads for large-cap lending in the 550-650 basis point range.[4]

Spreads have been a little bit tighter in the last three or four months. But with base rates where they are, private credit firms can potentially earn 11.5% or 12.0% coupons while lending to multibillion-dollar businesses, in situations where a private equity sponsor is writing a multibillion dollar check, usually to the tune of about 60-70% of the total capital needed to buy the company.[5] That's a very attractive risk-adjusted return.

4. Looming maturities may create significant refinancing risk in leveraged credit markets

BOL: Maturities are going to start to ramp up over the next several years in a very meaningful fashion. You have over $800 billion of U.S. high yield bond and leveraged loan debt that is coming due in 2024, 2025, and 2026 – and roughly $1.4 trillion globally.[6]

All that debt needs to be refinanced in some way. Historically, the easiest way to do that has been by using the syndicated market. However, the syndicated market has become increasingly selective about which borrowers it will support. We can all look at credit spreads and say those are well within historical norms, but those credit spreads are available only to the best borrowers.

More and more, there are a lot of companies being left out that are looking for alternative solutions. Without those solutions, most of these companies will end up in a restructuring.

5. We're likely to see a diverse array of risks emerge in the coming years

AP: Clearly, the most acute area of risk right now is commercial real estate. That's because the maturity wall is already upon us and it's not going to abate for several years.

There's a need for capital, especially for office properties where there are vacancies, rental growth hasn't materialized, or the rate of borrowing has gone up materially over the last three years. This capital may or may not be readily available, and for certain types of office properties, it absolutely isn't available.

As we roll forward in time, different pockets of risk – or different dimensions of risk – may develop. We're probably at the beginning of a cyclical downturn, so we don't believe it's a good time to go heavy into cyclicals or interest-rate-sensitive asset classes, like, for example, homebuilding and building products.

Another area where we see risk increasing is among floating-rate borrowers broadly, specifically those that took on debt in 2018-21 when base rates were zero and the cost of borrowing was 5-7%. The costs for those same borrowers are now more like 11-13%.[7]

Generally speaking, when these companies took on this debt, the sponsors and borrowers assumed that they would see synergies or increased growth and cash flows. Most of this hasn't materialized. Some businesses have grown, but they typically haven't grown to the level that they or their owners thought they would.

Therefore, in addition to seeing a meaningful escalation in their cost of borrowing, these floating-rate borrowers have also been negatively impacted by the economy and therefore haven't been able to grow into their capital structures.

6. Credit investors should be prepared for more aggressive liability management exercises

BOL: From my perspective, in opportunistic credit, what you're going to see over the next three years is an unprecedented wave of liability management driven by the really poor debt documents that were written over the last five years. That is a big risk that I don't think the market fully appreciates.

Those structures are perfectly positioned for predatory sponsor action, more commonly known as "creditor-on-creditor violence." If you're in those structures and you're not aware of what's going to happen, you're likely going to have a rude awakening.

We've seen this trend emerge to a very limited degree in 2023. But it's likely going to tick up in 2024, precisely because maturities are going to start to ramp up, and borrowers aren't going to have the ability to address them through the syndicated market. Sponsors who are backed into a corner are likely going to try everything at their disposal to save their equity. The easiest way to do that is to pit creditors against each other and to advantage a certain set of those creditors to create liquidity for the company.

This is not like the distressed market we saw in 2007, where you could go out and buy a loan and expect to get the same treatment that you would in a normal bankruptcy or restructuring process. These sponsors will act. There are few sponsors who are going to be above aggressive liability management, so you should be ready for that.

7. We believe we could continue to see volatility around Treasury auctions

AP: We saw a nice rally in duration during late 2023. The 10-year Treasury yield hit a high of about 5% in mid-October. It then fell back down to closer to 4% in less than six weeks. But this rally may not be repeated.

Moving forward, we believe we're going to test the domestic market for treasuries. I would pay close attention to Treasury auctions. How do they go? How well do they clear? How do new Treasurys get placed, and who is buying those Treasurys? The foreign buyers of Treasurys, which were the largest owners in prior years, may be tapped out.

Given the quantum of debt the U.S holds and the budget deficit that is upon us, it's hard to imagine a scenario where the dollar value of Treasurys that need to be rolled every quarter or every month would actually decline. Thus, we're somewhat concerned about where the 10-year Treasury yield goes from here, given supply and demand imbalances.

8. We expect to see opportunities increase in loan portfolio sales and risk transfer transactions

BOL: Some really poorly underwritten debt was issued over the five years leading up to 2022. A lot of it found its way into the banking sector. A lot of those banks, including both regional and large banks, are sitting with big embedded losses on their balance sheets. These losses might not have to be recognized immediately, but the people running the risk books for those banks probably feel pretty uncomfortable. They'll likely look to shed that risk.

They can shed it directly through loan portfolio sales. After the financial crisis, Oaktree's Opportunities group bought roughly 60 different pools of non-performing loans involving over $2 billion of equity capital deployment.[8] We may not see an opportunity of that size this time around, but there will be pools for sale out there.

A more elegant way to reduce risk is risk transfer. We're seeing an increase in the number of banks interested in talking to us about risk transfer involving high-quality assets that are simply mispriced – they were just purchased in an era that doesn't exist right now. We're very excited about this growing opportunity.

9. We believe the competitive dynamics in rescue lending will benefit creditors

BOL: Rescue lending refers to a consensual loan between the borrower and the lender and is therefore viewed as a valuable capital solution by the owners of those businesses, including private equity firms.

Competitive dynamics are always a question of supply of capital versus demand for it. Right now – and I think for the foreseeable future – demand will outstrip supply in rescue lending. Demand for capital from sponsors is strong. And, importantly, we haven't yet seen the teeth of the maturity wall that's going to ramp up starting in 2024.

CFOs typically begin seeking refinancing solutions at least a year in advance of maturities. As we flip the calendar to 2024, a lot of people are going to start looking at 2025 maturities and are going to be trying to find ways to address them. Thus, we expect to see a big uptick in the demand for rescue capital, especially once CFOs start to focus on 2026 maturities.

Supply of capital is very constrained right now. Many of the LPs that would typically provide capital to the sector are currently restrained by legacy portfolio issues and the fact that they're not getting the distributions they anticipated. So we except the supply of capital in this area to remain very constrained, creating attractive competitive dynamics for us.

10. Accessing premier opportunities in this environment will likely require a distinctive skillset

AP: We think well over half of the opportunistic credit investments that Oaktree will make over the next two years will be large rescue financings in which speed, size, and certainty of execution are key. Therefore, we expect to be in a good position to dictate pricing and legal terms.

On the performing credit side, we believe we're well situated to be a very important counterparty for private equity firms and other business owners in both good times and bad times – and especially in bad times. When we're in a downcycle, most performing credit investment managers aren't in a position to support a business. The average manager doesn't have the ability to offer capital solutions with the size, speed, and depth that we're able to.

We believe that Oaktree's reputation, history, capabilities in the market – both on the performing and on the opportunistic side – are advantages we have that others don't. We look to leverage that in our sourcing every day.

About the Authors

Armen Panossian

Head of Performing Credit and Portfolio Manager

Mr. Panossian is a managing director and Oaktree's Head of Performing Credit, where his responsibilities include oversight of the firm's liquid and private credit strategies. He also serves as a portfolio manager within Oaktree's Global Private Debt and Global Credit strategies. Mr. Panossian joined Oaktree's Global Opportunities group in 2007. In January 2014, he joined the U.S. Senior Loan team to assume co-portfolio management responsibilities and lead the development of Oaktree's CLO business. He became head of all performing credit in 2019. Mr. Panossian joined Oaktree from Pequot Capital Management, where he worked on their distressed debt strategy. Mr. Panossian holds a B.A. degree in economics with honors and distinction from Stanford University, where he was elected to Phi Beta Kappa; an M.S. degree in health services research from Stanford Medical School; a J.D. degree from Harvard Law School; and an M.B.A. from Harvard Business School. Mr. Panossian serves on the Advisory Board of the Stanford Institute for Economic Policy Research. He is a member of the State Bar of California.

Bob O'Leary

Managing Director and Portfolio Manager

Mr. O'Leary is a portfolio manager for Oaktree's Global Opportunities strategy, leading the group's investment activities in North America. In this capacity, he contributes to the analysis, portfolio construction and management of both the Global Opportunities and Value Opportunities strategies. Prior to joining Oaktree in 2002, he worked at McKinsey & Company, where he was a consultant, and Orion Partners, a private equity firm, where he focused on investments in private companies. Mr. O'Leary graduated magna cum laude from Pomona College with a B.A. degree in economics, and he received his M.B.A. from Harvard Business School.

Endnotes

1. Quotes have been edited for readability, clarity, and compliance considerations and updated where applicable.
2. Bloomberg, Credit Suisse, ICE BofA, Preqin, Cliffwater, as of November 30, 2023; For middle-market direct lending data: Preqin, as of June 2022.
3. Deutsche Bank, Credit Suisse, Bloomberg, Moody's, as of January 27, 2023. Includes committed LBO financings by banks that are $1 billion or more in total debt amount that have been partially or fully syndicated.
4. Based on Oaktree observations in the market, as of November 30, 2023.
5. Based on Oaktree observations in the market, as of November 30, 2023.
6. JP Morgan, as of November 30, 2023.
7. Based on Oaktree observations in the market, as of November 30, 2023.
8. Based on Oaktree records.

Notes and Disclaimers