BLUE OWL

2024 Credit Outlook

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Introduction

At this time last year, we were cautious about what lay ahead for the economy and our borrowers. Inflation was stubbornly high, public markets were volatile and a soft landing seemed aspirational. This environment bore several risks, but, in our view, it also brought some unique opportunities. Dislocation in public credit markets meant that direct lenders financed the majority of the private equity-driven deal flow.[1] We also observed spreads at all-time highs for new deals with conservative leverage and strong credit quality. As existing portfolio companies continued to perform well despite higher interest burdens and direct lending fund returns across the industry followed suit, we believe the asset class received further validation of its staying power and durability.

Sitting here one year later, key indicators reflect a decidedly more positive economic backdrop. Inflation is waning, employment remains strong[2] and Fed policy appears more stable. That said, we remain vigilant of potential tail risks arising from higher borrowing costs and a potential retreat in economic growth. We also expect that substantial pent-up M&A demand should yield a more active deal environment. As such, we believe scaled capital providers that can speak for size, deliver a full suite of financing solutions, and remain consistently active in direct lending across the market cycle, are best-positioned to lead high-quality deals and deliver strong risk-adjusted returns.

In this piece, we present five themes that we think will characterize the direct lending market in 2024.

1. Direct lending continues to outperform other asset classes
2. Pent-up demand for M&A should yield a healthy deal environment this year
3. Borrowers should continue to perform well amidst an improving macroeconomic backdrop
4. The long-term opportunity for direct lending continues to grow
5. Managers differentiate with scale and strength of sponsor relationships

[1] Sources: Pitchbook, LCD. As of September 30, 2023.
[2] Source: U.S. Bureau of Labor Statistics as of December 2023

1 Direct lending continues to outperform other asset classes

The direct lending asset class is benefitting from an elevated interest rate environment and is currently generating record returns. In contrast to fixed income, the floating rate nature of loans increases their earnings power as rates increase. In 2023, direct lending returns rose +8.9%, as compared to –2.2% and +5.9% for traditional fixed income and high yield, respectively. Even as Fed policy is expected to ease this year, rates are likely to remain comfortably above their levels before the recent hiking cycle. Further, direct lending has historically outperformed competing markets during "flat-to-falling" interest rate cycles.[1]

Figure 1

Direct lending has continued to fare well amid a complex economic transition[1]

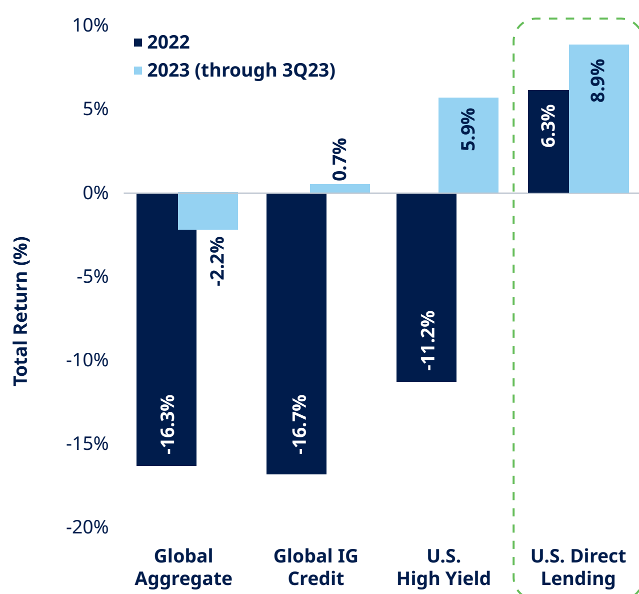
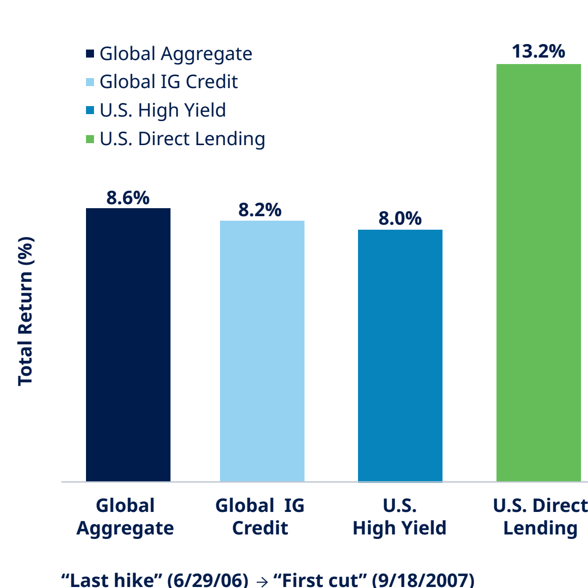


Figure 2

"Higher for longer" can lead to outperformance[2]



[1] **Past performance is not a guarantee of future results.** Index comparisons are for illustrative and informational purposes only. All investments involve risk of loss, including loss of principal invested. Indices listed do not represent benchmarks for the funds but allow for comparison of a fund's performance to an Index. There can be no assurance that historical trends will continue during the life of any fund. An investor cannot invest directly in an index. Index performance does not reflect fees and expenses. The indices presented represent investments that have material differences from an investment in a non-traded BDC, including those related to vehicle structure, investment objectives and restrictions, risks, fluctuation of principal, safety guarantees or insurance, fees and expenses, liquidity and tax treatment. Sources: Bloomberg, Cliffwater as of September 30, 2023 unless otherwise noted. Global Aggregate represented by the Bloomberg Global Aggregate Index, Global IG represented by the Bloomberg Global Aggregate Corporate Index, US High Yield represented by the ICE BofA US High Yield Index, U.S. Direct Lending represented by the Cliffwater Direct Lending Index.

[2] Sources: Bloomberg, Cliffwater for the period June 29, 2006 to September 18, 2007. Global Aggregate represented by the Bloomberg Global Aggregate Index, Global IG represented by the Bloomberg Global Aggregate Corporate Index, US High Yield represented by the ICE BofA US High Yield Index, U.S. Direct Lending represented by the Cliffwater Direct Lending Index.

While leveraged loan returns should also benefit from the higher rate environment, we believe direct lending is poised to outperform the syndicated loan market, particularly on a risk-adjusted basis. Less cyclical sector orientation, simpler capital structures, capital preservation features, private equity-style due diligence, in-house workout capabilities and higher equity cushions all facilitate lower default and loss rates relative to the syndicated loan market.

Figure 3

Direct lending offers structural enhancements

		Broadly syndicated loans	Direct lending
Illustrative Attributes	**Expected yield**	Mid-to-high single digit	High-single to low double digit
	Rate risk / duration	Floating rate / low	Floating rate / low
	Lender influence on debt structure	Low	High
	Liquidity	Medium to high	Limited or none
	Security	Senior Secured	Senior Secured
	Covenants	Generally covenant-lite	Typically maintenance-based or restrictive covenant-lite
	Workout process	Less control	More control
	Recovery rates[1]	**~40-60%**	**~75% or higher**
	Historical loss rates[1]	**~75bps**	**~30bps**

Blue Owl's Credit Platform has a historical annualized loss rate of **just ~6bps** on invested capital[2]

[1] Source: JPM Morgan Markets as of September 30, 2023.

[2] Average annual loss rate based on total annual net realized losses across all investments divided by the average aggregate quarterly cost of investments. The loss rate is based on the average loss rates in each year since inception from 2016 to 3Q23 . Loss rates by fund: OBDC (-0.17%), OBDC II (-0.12%), OBDC III (-0.08%), OCIC (-0.06%), OTF (-0.04%), OTF II (0.00%), OTIC (0.00%), OFLF (-0.01%), OLF (0.00%).

2 Pent-up demand for M&A should yield a healthy deal environment this year

Light investment and exit activity over the last twelve months have generated substantial pent-up demand for M&A.[1] This should create a more active deal environment this year as the rate outlook stabilizes and markets return to normalcy. In addition, private equity firms have ample dry powder to deploy and will be motivated to return capital to investors after a period of limited distributions. We anticipate an increase in sponsor-to-sponsor LBOs and refinancings, which were quiet in 2023 but have begun to come back. We also expect a continued steady flow of take-privates, corporate carveouts and tack-on acquisitions for existing portfolio companies.

Large platforms that have a long direct lending track record may also benefit from incumbency positions, in which they provide incremental capital to existing borrowers, as portfolio companies trade hands or make transformative acquisitions. Last year, over 40% of our new deals were made with existing partners, and we expect this percentage to grow over time.

Figure 4

M&A volumes likely to pick-up after an 18-month slowdown

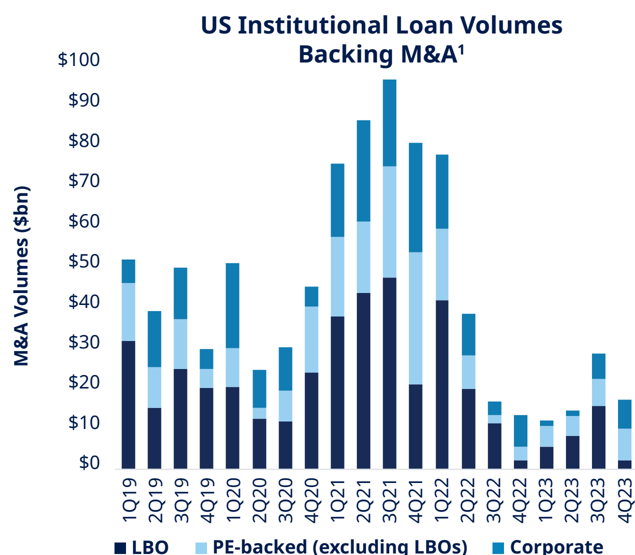
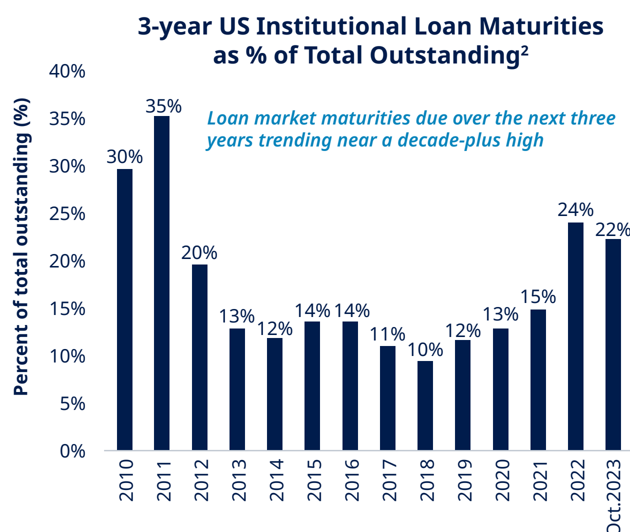


Figure 5

Elevated upcoming loan market maturities could fuel near-term refinancing needs



Spreads on new deals have tightened from highs at the beginning of 2023. This has come alongside the further reopening of public credit markets and an influx of capital into direct lending.[1] However, we expect absolute returns will remain compelling as benchmark rates remain high. Many new deals are also coming at lower leverage and loan-to-values than in prior years, resulting in improved risk-adjusted return profiles.

Finally, we expect repayments will increase alongside ramping deal activity. This should increase direct lending fund returns as loans are repaid at par and, in certain instances, call protection premia are collected.

[1] Sources: Pitchbook, LCD. As of September 30, 2023.
[2] Sources: JP Morgan. As of October 31, 2023. 2024 High Yield & Bank Loan Market Outlook.

3 Borrowers should continue to perform well amidst an improving macroeconomic backdrop

Borrowers have been resilient amidst an inflationary and rising rate backdrop. While this is partly driven by continued strength of the economy at large, we feel it is also supported by our focus on scaled, high-quality borrowers. Indeed, average EBITDA across our direct lending platform is over $200 million.[1] We believe such businesses are better positioned than traditional middle market companies by virtue of their diversification, strategic significance in their industries, greater operating leverage, and ability to withstand unforeseen cost pressures.

Our portfolio is also skewed toward durable end markets such as software, healthcare and food & beverage. Across most sectors in which we invest, we have observed low-to-mid single digit quarterly revenue and earnings growth. Margins have improved in recent months as inflation wanes, price increases are realized and companies proactively cut costs. We expect borrowers to demonstrate continued resilience this year.

Blue Owl is well-positioned in the current environment

Disciplined investment strategy and credit underwriting process

Highly Selective	%Senior-Secured	%Sponsor-Backed	% of deals Blue Owl is a Lead
~5%[2] closed	~90%[3]	~90%[3]	~85%+[2] of closed deals
Portfolio Company EBITDA	**Portfolio Company EV**	**Portfolio Company LTV**	**Annual Loss Rate Since Inception**
~$218M[1]	~$4.5B[1]	~40%[3]	6 bps[4]

Even in a sustained elevated-rate environment, we anticipate the vast majority of borrowers will maintain more than adequate cash cushions. While a small number could experience liquidity pressures, we believe we are largely insulated by ~60% average equity cushions beneath our debt and private equity firms' demonstrated ability and willingness to support their investments with additional capital when needed. Finally, we expect that any modest increase in losses will be more than offset by the earnings accretion of our funds from higher benchmark rates.

[1] As of September 30, 2023. Borrower financials are derived from the most recently available portfolio company financial statements, have not been independently verified by Blue Owl, and may reflect a normalized or adjusted amount Accordingly, Blue Owl makes no representation or warranty in respect of this information.
[2] As of September 30, 2023. Excludes add-ons, syndicated transactions, equity only deals, and transactions for existing borrowers
[3] As of September 30, 2023 based on Fair Value.
[4] Average annual loss rate based on total annual net realized losses across all investments divided by the average aggregate quarterly cost of investments. The loss rate is based on the average loss rates in each year since inception from 2016 to 3Q23. Loss rates by fund: OBDC (-0.17%), OBDC II (-0.12%), OBDC III (-0.08%), OCIC (-0.06%), OTF (-0.04%), OTF II (0.00%), OTIC (0.00%), OFLF (-0.01%), OLF (0.00%).

4 The long-term opportunity for direct lending continues to grow

We believe the direct lending asset class is still in the early innings of growth. Today, it represents only approximately 20-25% of the leveraged finance market with potential to grow to 35%+ over the next several years.[1] This growth is driven by both 'supply' and 'demand' factors. Direct lending presents an attractive value proposition for end investors and users of capital, both of which should continue to support the upward momentum of the asset class.

From a 'supply' perspective, we believe direct lending is more commonly becoming a strategic, rather than tactical, portfolio allocation. It seeks to deliver consistent yield that is not correlated to public markets. At the same time, 'demand' has increased as we have observed companies becoming more comfortable choosing private financing over public markets execution. In our view, sponsors appreciate the predictability, flexibility, privacy and partnership approach of private loans. Not only can direct lenders speak for large size on deals, but they can also offer a full range of solutions across the capital stack.

Direct lending was an outsized beneficiary of market volatility in 2023. With public credit markets effectively closed, direct lenders financed 86% of leveraged buyouts last year.[2] Even as public credit markets return, we believe this share shift toward direct lending will likely continue.

Figure 6

The loan market size has decreased for the first time in a decade[2]

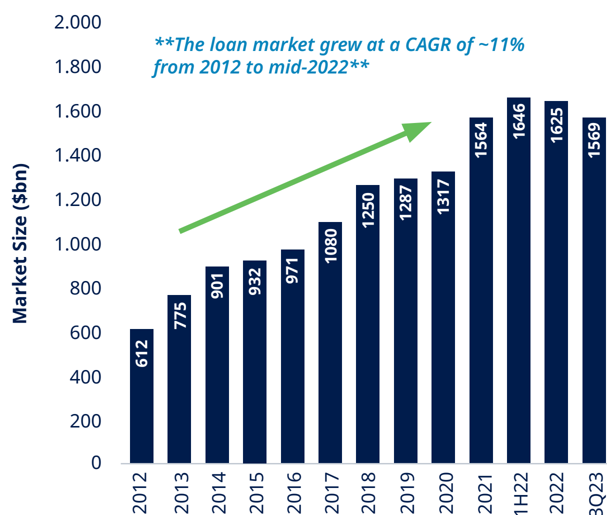
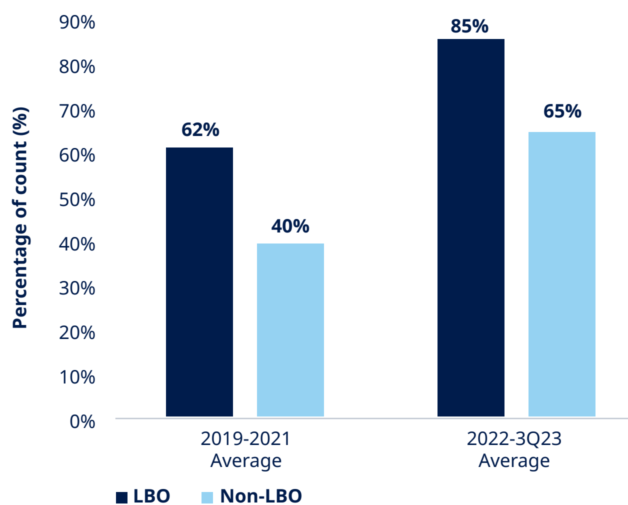


Figure 7

Percentage of total LBOs and non-LBOs financed in private credit markets[1]



[1] Sources: Pitchbook, LCD. As of September 30, 2023.
[2] Sources: JP Morgan. As of October 31, 2023. 2024 High Yield & Bank Loan Market Outlook.

5 Managers differentiate with scale and strength of sponsor relationships

We believe scaled direct lenders are better positioned to succeed than sub-scale capital providers by virtue of their deep origination capabilities, strong sector-specialized underwriting expertise, in-house portfolio management, and workout and fund financing capabilities. Because they can write large checks and are strategically relevant to their counterparties, bigger managers typically receive better access to deal flow and can be highly selective on credit selection and deal terms. While there have been many new entrants to the space in recent years, several of which have traditional private equity, distressed or public markets heritage, we believe scaled pure-play providers that focus on direct lending across the market cycle and employ a partnership-based approach will likely continue to be a 'first call' on deals. In an asset class in which the best possible outcome is to recoup full principal and interest payments, top-tier manager returns are driven by capital preservation and low loss rates – not stretching for higher asset-level yields on riskier deals.

Conclusion

Looking ahead to 2024, we believe the new deal opportunity set should remain attractive, existing portfolio companies should perform well, and direct lending funds should continue to generate strong returns. We have heard many laud this time as the "golden age" of private credit, while others are cautious about how the asset class will fare. We hold a more nuanced perspective. While today's market is attractive, and we expect it to remain so for the near-term, we do not believe one can, or should, perfectly time the market. A long-term allocation to direct lending should provide a compelling risk-adjusted return to investors across the cycle regardless of short-term vagaries in the market. Further, we believe the asset class has thus far proven resilient across many economic environments and should continue to do so.

As direct lending market share grows, lenders will be able to finance increasingly larger businesses and, as a result, the quality of direct lending portfolios should continue to improve. Even still, differentiation across managers should become increasingly apparent and scaled, well-established platforms should outperform over time. We are confident Blue Owl is poised to deliver solid risk-adjusted returns to our stakeholders due to our broad origination footprint, prudent asset selection, conservative structuring and focus on capital preservation.

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Important information

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