BLUE OWL

Credit Outlook

JANUARY 2025

Introduction

2024 illustrated the difficulty of economic forecasting as well as the benefits of an all-weather asset class that is resilient amidst changing conditions.

Early in the year, a series of higher-than-expected inflation prints quickly tampered expectations for easing from the Federal Reserve, with some market participants questioning if any rate cuts would be seen by year-end. Therefore, borrowing costs remained elevated through much of the year. However, public credit markets did reopen after nearly two years of muted activity, allowing a significant number of borrowers to reprice existing capital structures at lower spread levels.

While a flurry of repricing and refinancing activities drove high transaction volumes, new deal issuance related to M&A continued to underperform expectations, likely driven by historically high borrowing costs and a mismatch in valuations between buyers and sellers. As we entered the final months of the year, inflation resumed its downward trend which, combined with modestly softened employment data, allowed the central bank to enact its first rate cut in September, followed shortly thereafter by additional rate cuts in November and December.

Against this backdrop, private credit portfolios performed well throughout the year. Within direct lending, elevated base rates remain supportive of all-in yields and fund returns. This has reinforced the outperformance of direct lending relative to traditional fixed income and public credit markets. The resilience that borrowers have consistently demonstrated, despite elevated interest rates, has been notable.

As we look to 2025, the trend of shifting economic narratives appears likely to continue against a backdrop of secular trends that may lead to new and expanding opportunities in private markets. In this piece, we will provide our outlook for 2025 while examining three key themes within private credit that may help orient investors as they seek to navigate the evolving marketplace.

What value creation looks like in a "higher for longer" environment alongside an expected increase in M&A

Our view

We believe 2025 could prove uniquely attractive for value creation within private credit, provided that managers are positioned correctly. Specifically, we believe scaled, pure play lenders with meaningful incumbency positions will be best positioned to benefit from an expected increase in M&A and therefore deal flow, allowing greater investment selectivity and, ultimately, better performance.

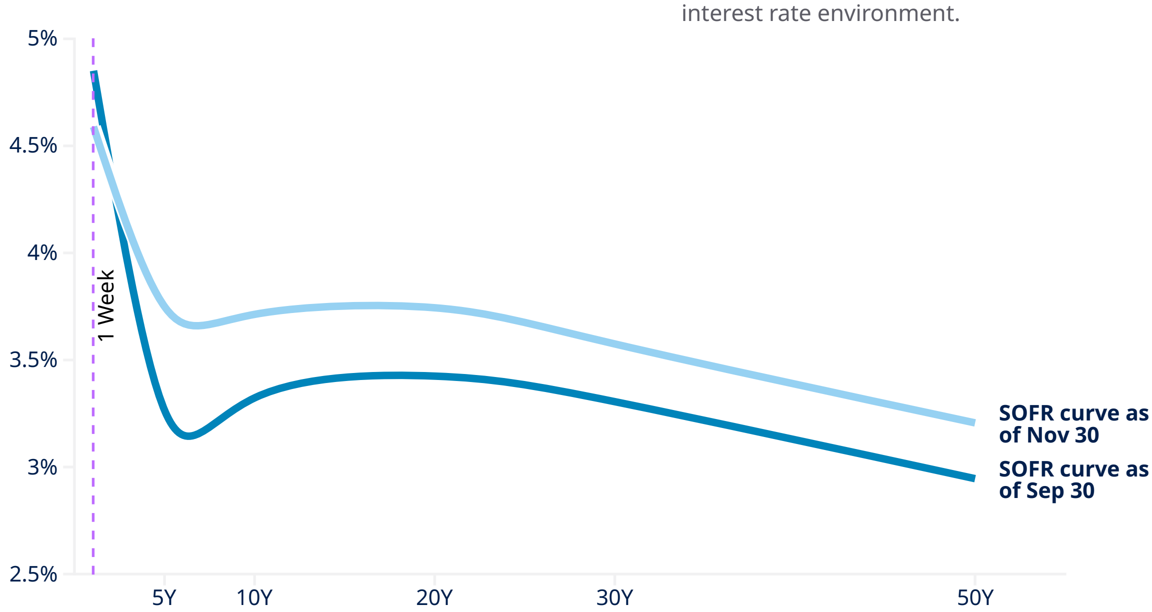
With interest rates easing and the incoming US administration expected to roll back regulations, private equity sponsors may look to take advantage of the more favorable dealmaking environment to execute consolidation strategies, make strategic acquisitions, and sell portfolio companies. We expect this environment to generate enhanced deal flow for direct lenders in comparison to recent years. In addition, with the long-term forward curve for interest rates projected to stay "higher for longer," we expect floating rate loans associated with direct lending to continue to deliver historically attractive (and elevated) returns.

Our strategy

The US Federal Reserve has begun an easing cycle, with three rate cuts made as of December 2024, but the central bank has indicated fewer cuts in 2025. Meanwhile, 2024's US election brings in a new administration that market participants anticipate will place a greater emphasis on economic growth. From a policy standpoint, this may lead to a rollback of regulations, potentially increasing M&A activity as companies are less constrained in executing consolidation strategies. Additionally, we may see more expansionary fiscal policies expressed through tax cuts and greater deficits. While such policies may spark higher growth, they may also be accompanied by higher inflation, and therefore a "higher for longer" interest rate environment.

A "higher for longer" expectation

SOFR forward curve pre and post-election



Source: Bloomberg. Curve ID S490 Corp which represents USD SOFR overnight index swaps.

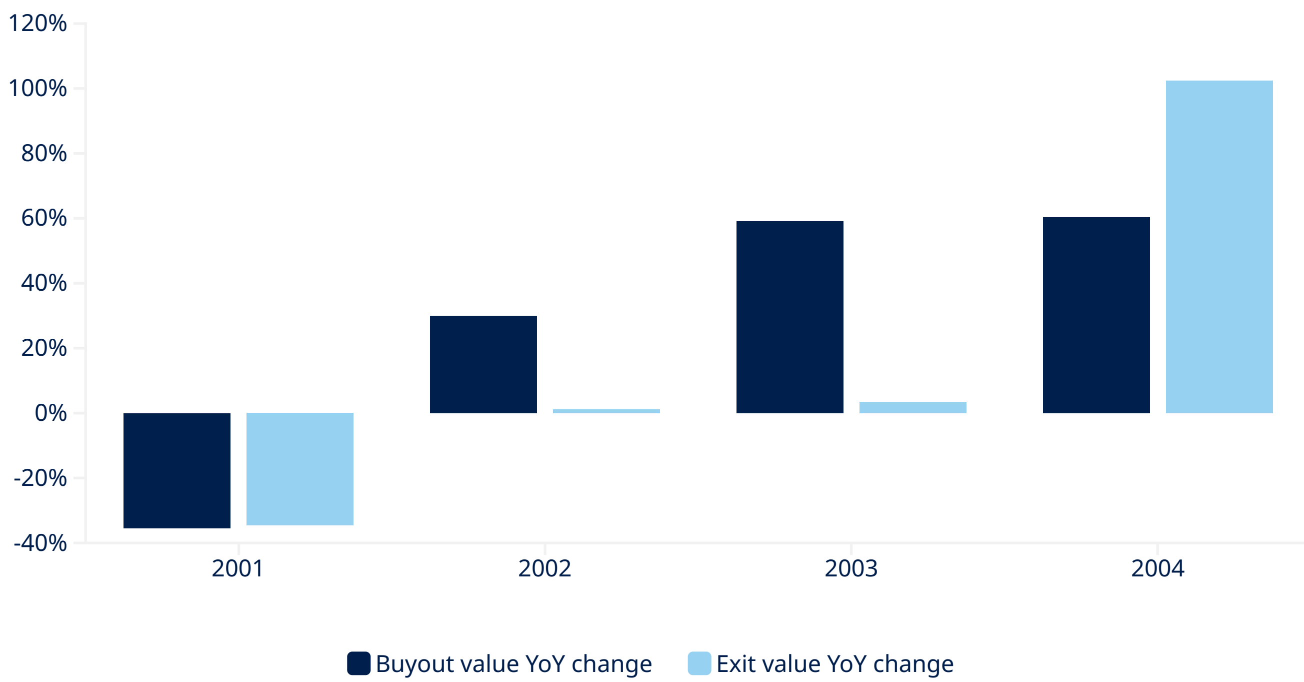
> The opportunity set in private markets is expanding, and managers with scale, established strategies, and incumbent relationships will take greater market share.

Markets quickly priced in this new paradigm, as we can see from the upward shift in the SOFR forward curve immediately before and following the election. Notably, base rates are still expected to fall over the near term, which would bring relief to borrowers, but long-term expectations for rates have shifted up by approximately 50 basis points, which would benefit returns in direct lending.

In addition to easing debt burdens for borrowers, lower base rates would reduce financing costs for private equity sponsors, potentially resulting in increased M&A activity. Indeed, there is historical precedent for this dynamic, as shown below by the growth in private equity buyout and exit transaction volumes following interest rate cuts in 2001. Importantly, over 80% of leveraged buyouts executed in 2024 were financed by private credit[i], indicating that a resurgence in dealmaking could be expected to largely benefit direct lending, given its status as the preferred financing solution for M&A transactions. And further, this feeds into our thesis that the opportunity set in private markets is expanding, and managers with scale, established strategies, and incumbent relationships will take greater market share, as we explain below.

Rates down, M&A up

PE buyout & exit activity following rate cuts



Source: Pitchbook 3Q24 US PE Breakdown. Note: For the period 2001-2004. The first rate cut occurred on January 3, 2001.

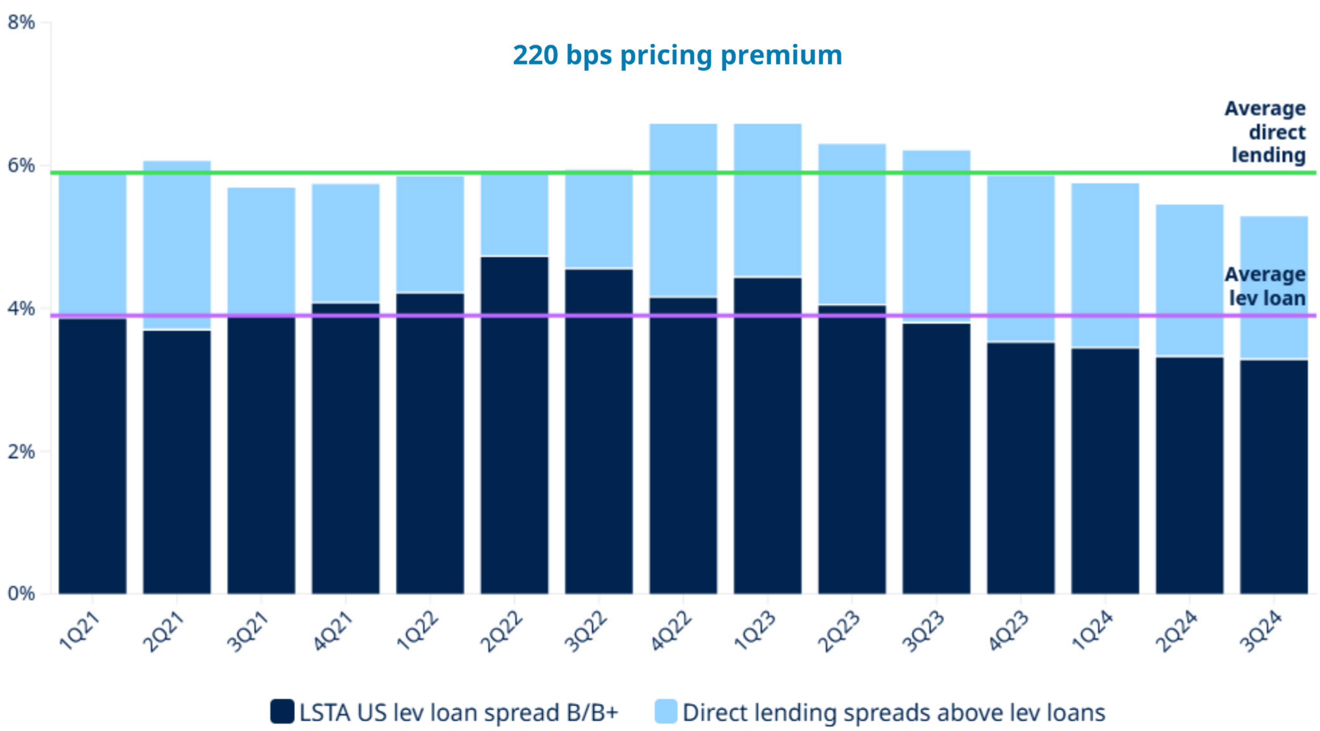
The opportunity set in private capital markets is rapidly expanding

Our view

We believe we are in the early stages of a significant change in the way not just institutions, but individuals, will choose to invest when it comes to deciding between public and private markets. In the fixed income markets in particular, the majority of what exists in the public markets is now becoming available in the private markets as well, including leverage/financing, ratings, and daily pricing. Initially this has been focused on the investment grade areas of the market, but we believe this blurring of the lines between the public and private credit markets will continue to expand, and ultimately investors will focus on how much additional return they may achieve in the private markets versus the public markets. Since the inception of our strategy at Blue Owl, we have witnessed a consistent yield premium relative to the public markets, and we believe that premium will continue to persist.

The private credit advantage

Private credit yield premium vs. the BSL market



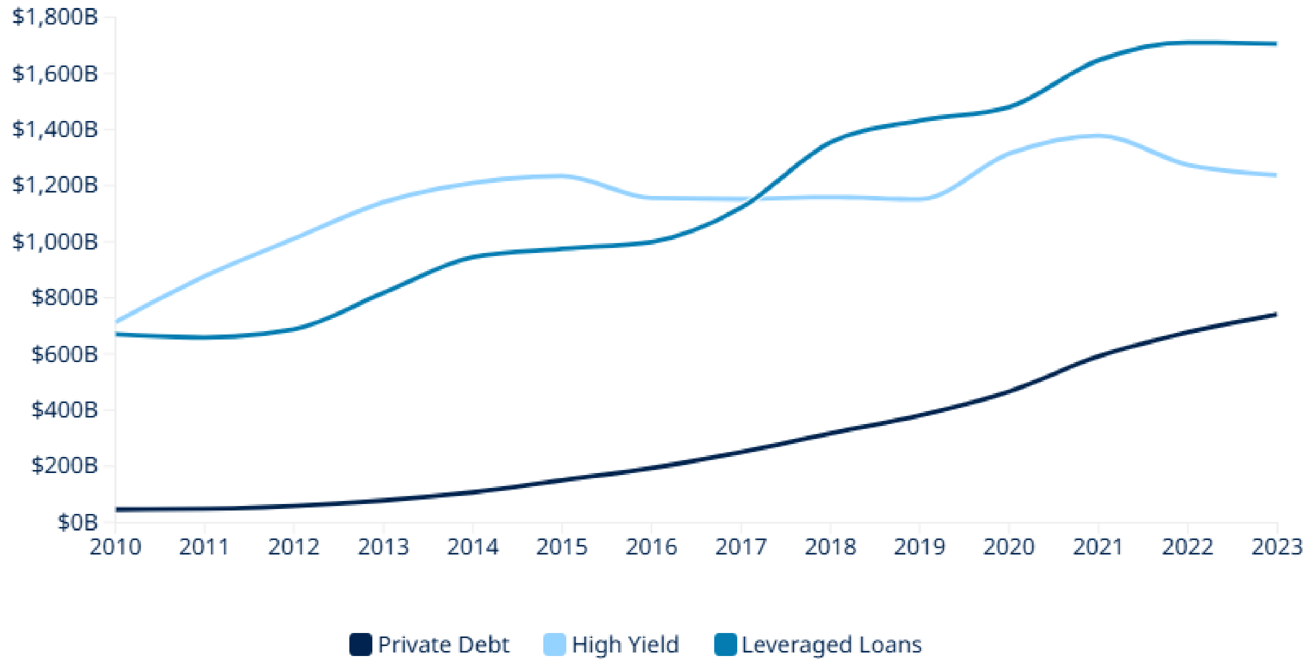
Source: KBRA DLD and Pitchbook LCD

Our strategy

Following the 2007-2008 Global Financial Crisis, more restrictive regulations prompted banks to reorganize their balance sheets away from illiquid assets with higher capital requirements, including corporate loans. This retrenchment in bank lending allowed direct lending to fill the void, especially in the lower and core middle markets. Meanwhile, the growth of direct lending in recent years and its expansion into the upper middle market has been driven by increasing demand from larger borrowers and private equity sponsors seeking more flexible financing solutions — including multi-currency tranches, delayed draw and revolving credit facilities, and payment-in-kind flexibility — which public credit markets are unable to accommodate. Indeed, we can see that the size of the private credit market has grown to approximately 20% of the leveraged finance market, which includes high yield bonds and leveraged loans, and we expect its growth to continue in the years ahead.

Private debt's rise

Global corporate credit market sizes



Source: Preqin, Credit Suisse, Pitchbook LCD, Bloomberg, StepStone Group. As of June 2024. Refers to United States and Europe combined.

As we look to alternative credit, and specifically asset-based finance, we see a similar, albeit more nascent, theme: Banks are increasingly retrenching from holding asset-based portfolios given a mismatch in duration between these assets and their deposits, leading to potential risks absent an effective hedging strategy. Additionally, recent regulations have provided an additional tailwind to the theme, as banks now take a significant capital charge on asset-based holdings while being required to mark these assets at a discount. This has led many banks to seek to sell their asset-based portfolios to more appropriate long-term investors, creating a growing opportunity for managers. Notably, the estimated addressable market within asset-based finance is believed to be nearly $11 trillion, with private markets currently accounting for only approximately 4% of that, highlighting the high potential for growth. We believe that private market penetration of alternative credit will likely double to 8% over the next five years while the overall market continues to expand.

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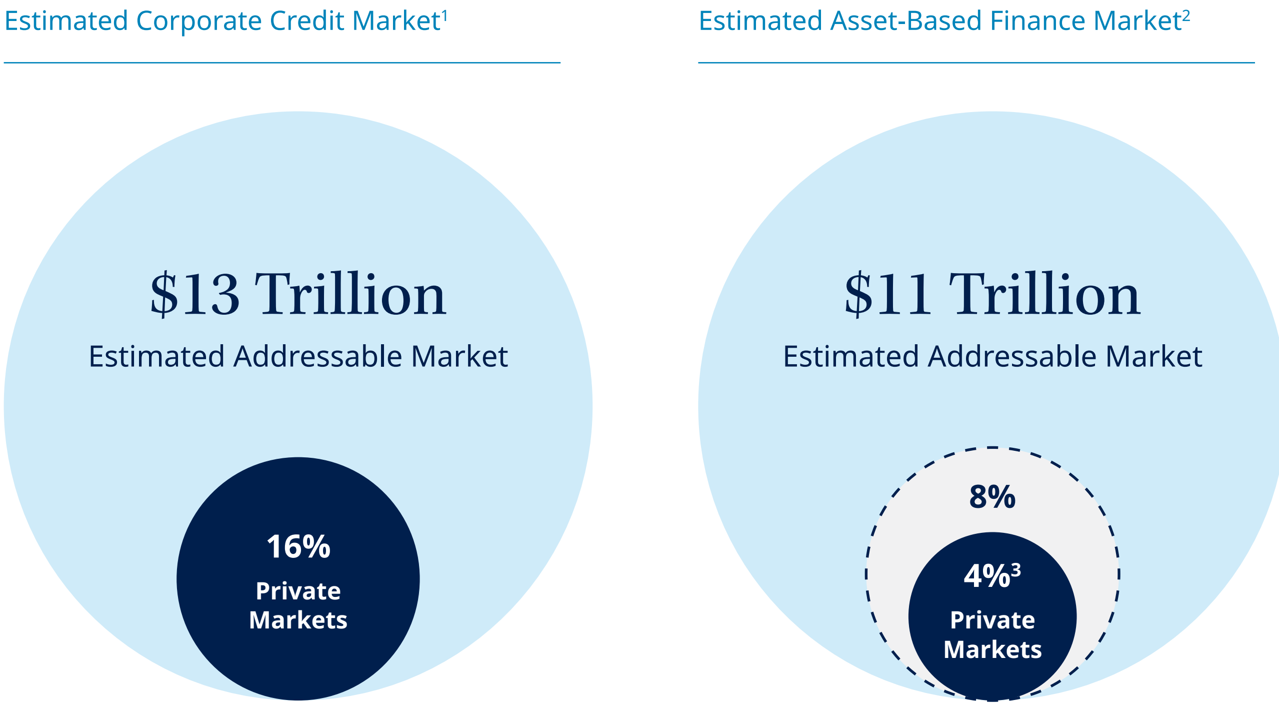
Credit market size



Blue Owl believes there is significant growth potential for the private market segment within the $11 trillion asset-based finance market.

Past performance is not a guarantee of future results. There can be no assurance that historical trends will continue. The estimated addressable Asset-Based Financial markets discussed above have been amalgamated from various sources including, but not limited to:

1. Morgan Stanley Into the Great Unknown November 19, 2023, Preqin Private Debt 2022 data, Interval Fund Tracker Most Recent Quarter Data 2023, S&P Global Credit Trends Report October 2, 2023.
2. Federal Reserve Z.1 Financial Accounts of the United States Q3 2023, FRB NY Quarterly Report on Household Debt and Credit November 2023, SIFMA statistics Q3 2023, Secured Finance Foundation 2023 Secured Finance Market Sizing and Impact Study, 2022 Equipment Leasing & Finance Industry Horizon Report, CFPB Fact Sheet March 30, 2023, Preqin Private Debt 2022 data, S&P Global Credit Trends Report October 2, 2023, Ginnie Mae Global Markets Analysis Report December 2023, Interval Fund Tracker Most Recent Quarter Data 2023, MSI research Q4 2023.
3. With Intelligence, Private Debt Investor, Preqin, NAIC, Morgan Stanley Into the Great Unknown November 19, 2023, Private Equity International: Sizing the NAV finance market December 1, 2023, company websites, MSI research Q4 2023.

The competitive advantage afforded by scale is only now being amplified

Our view

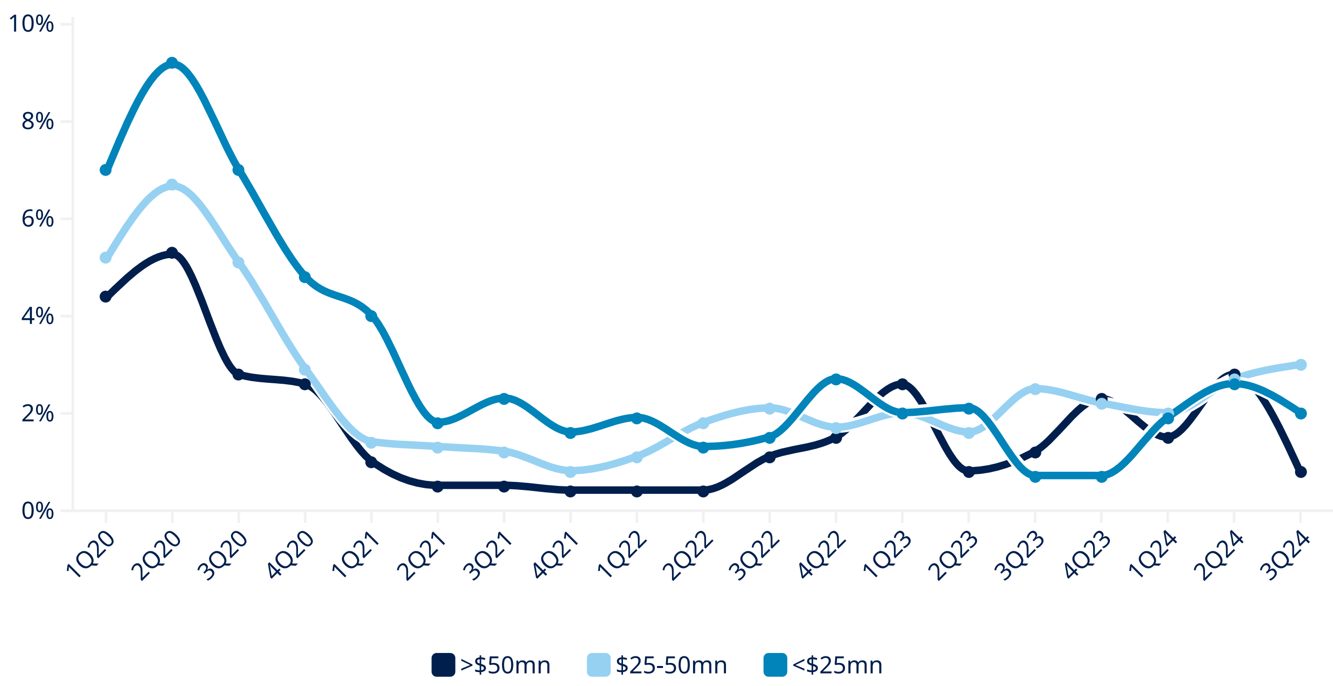
We believe a significant factor in our strong performance in direct lending has been our focus on companies in the upper middle market (typically $100 million or more in EBITDA). This is a core tenet of our investment philosophy for two primary reasons: First, we believe larger companies tend to be more 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).

Larger companies, smaller default rates

Credit default rate by EDITDA



Source: Proskauer Q3 2024 Default Report

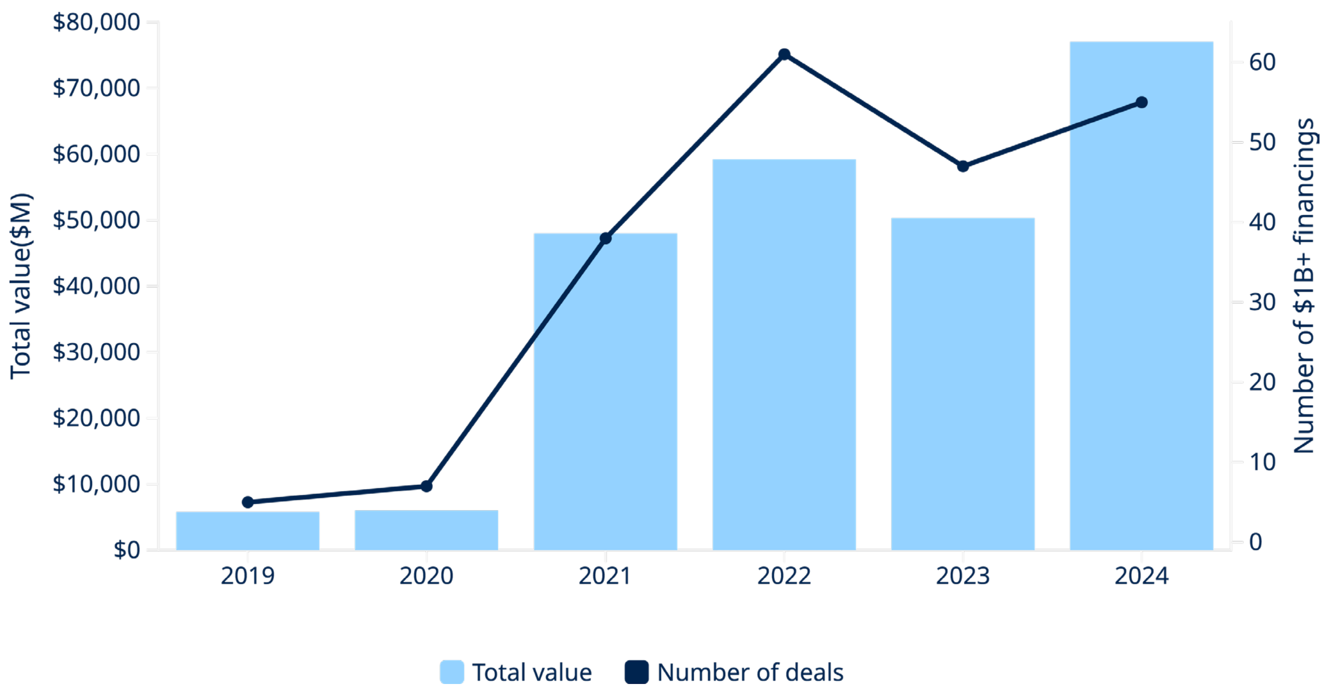
Our strategy

As mentioned above, direct lending has grown significantly in recent years as borrowers and sponsors of increasing sophistication and size seek flexible private capital solutions. Indeed, a direct lending deal of $1 billion or more was relatively uncommon as recently as 2020, but such financings have become commonplace as ever larger borrowers tap private credit markets. This trend of rising deal sizes has increased the relevance of scaled, pure-play lenders. Such lenders, who can write checks of at least $400 million (and often over $1 billion) are able to lead even the largest deals and serve as the fulcrum in structuring and document negotiations while ensuring execution. Since there are only a handful of lenders who can compete at the upper end of the market, we believe this segment of the middle market enjoys favorable competitive dynamics. Smaller lenders, however, typically face greater competition for deals given the growth of capital providers in the core and lower middle markets, potentially leading to adverse selection as well as pricing and credit documentation pressure.

Similar to our expectation that the direct lending market will continue to grow in absolute terms, we believe there is the potential for more frequent and increasingly larger deals, which will likely further benefit scaled lenders.

Bigger deals, and more of them

History of $1 billion+ direct lending transactions



Source: KBRA

Within asset-based finance, we expect scale to play a meaningful role as the asset class matures. We believe banks and non-bank lenders seeking to sell asset-based portfolios will look to establish long-term partnerships with scaled managers who are able to consistently speak for size, following a trend similar to what we have observed within direct lending. Additionally, large platforms are often able to negotiate and secure lower cost financing, which allows scaled players to bid more competitively while selecting investments from a potentially broader universe of opportunities. Finally, we have observed that banks and non-banks alike prioritize relationships with scaled investment managers that have a range of costs of capital available to serve needs for capital across secured warehouse financing, forward flow purchase programs, opportunistic portfolio sales, and growth capital solutions.

Conclusion

We believe long-term market dynamics will continue to favor private credit in 2025 and beyond.

As a scaled, well-established platform, we believe Blue Owl can be a key beneficiary of the continued growth of private credit. We believe we are set up to succeed given our deep origination capabilities, strong sector specialized underwriting expertise, in-house portfolio management, and workout and fund financing capabilities. Because we can anchor large private transactions and are strategically well positioned, we believe we can receive better access to deal flow and can be highly selective on credit selection and deal terms. Above all, we believe Blue Owl will continue to deliver attractive risk-adjusted returns to our investors, by virtue of our broad origination footprint, prudent asset selection, conservative structuring, and focus on capital preservation.

Author

Craig Packer
Co-President and Head of the Credit platform

Endnotes

i. Pitchbook LCD Private Credit & Middle Market Quarterly Wrap 4Q24

Important information

Unless otherwise indicated, the information referenced herein is as of December 31, 2024.

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