Proskauer

Talking Trends with Blue Owl

August 5, 2024

In Women in Private Credit: Talking Trends, we delve into the world of private credit through the lens of eminent women in the field — from professionals at the forefront of industry leadership to our own lawyers. Together, we navigate the trends and topics influencing private credit against the backdrop of today's ever-evolving geopolitical landscape.

In our latest edition, Proskauer private credit partner Jessica Shearer and associate Hyun Seung (Sarah) Suh speak with Blue Owl managing director Nicole Drapkin and vice president Erica Wilson regarding the evolution and resilience of private credit, as well as current and future opportunities for the asset class.

Market Evolution. How have you seen the private credit market evolve since Blue Owl came onto the scene in 2016?

Blue Owl: When Owl Rock (the predecessor to Blue Owl's Credit platform) was founded in 2016, there were only a handful of pure play private credit lenders and they primarily focused on the core of the middle market in the U.S. Today, private credit is a much larger percentage of the overall U.S. Leveraged Finance market and is poised for further growth.

While there are many factors driving this growth, one key element is the demand from institutional and private wealth investors. We've seen more capital flow into the space as investors increasingly view private credit as a core strategic allocation in their portfolios. Additionally, the advent of the non-traded BDC product has allowed private wealth investors to access the asset class at a level we had not seen before. At Blue Owl, we have over $20bn of assets in our non-traded funds today and expect to see that trend continue.

As direct lenders have scaled and become more institutional in quality, sponsors and borrowers have also become more comfortable utilizing direct lenders. This has driven increased deal flow into this part of the market, taking increased share from the broadly syndicated landscape. Direct lenders can not only speak for size and provide certainty of execution, but they can also offer a range of solutions across the capital structure. Further, as direct lending platforms have grown, they have been able to finance increasingly larger transactions. A few years ago, the $1+B unitranche was a focus for the market, but we routinely see (and often lead) $3-5+bn financings. This has significantly increased the opportunity set for direct lenders and is further driving the share shift from public to private markets.

Proskauer: On the legal side, the same trends — with sponsors and borrowers becoming more comfortable utilizing direct lenders, and direct lenders becoming more comfortable playing in the upper middle market — have played out through the legal documentation. Concepts that were foreign to the direct market in 2016 have come down from the broadly syndicated market into direct lending deals, but in doing so, they have evolved to reflect the strengths (and sensitivities) of direct lenders who are making loans with the intention to hold them over the life of a credit facility and work with their borrowers as active partners during such period.

New Opportunities. Where are you seeing private credit lenders find opportunities as “higher for longer” continues through 2024? Do you expect that to change as we head into the second half of the year?

Blue Owl: Focusing on the market backdrop for a minute: deal flow continues to remain muted as it has since the beginning of 2023. While we continue to believe there is substantial pent-up desire for private equity firms to return capital to LPs by exiting companies and that increased clarity on the rate environment could drive more M&A activity, that has not yet meaningfully materialized. We are starting to see the backlog continually build (public to privates, add-on acquisitions, sponsor to sponsor sales), which will hopefully translate into higher deal volume during the back half of the year and alleviate some of the spread pressure we have seen.

We also believe the "higher for longer" environment will create more opportunistic financing transactions for companies that are decent performers but have unsustainable balance sheets. These may take the form of more traditional liability management exercises or other more creative solutions with an aim of reducing leverage and/or interest expense.

> "A few years ago, the $1+B unitranche was a focus for the market, but we routinely see (and often lead) $3-5+bn financings. This has significantly increased the opportunity set for direct lenders and is further driving the share shift from public to private markets."

Nicole Drapkin and Erica Wilson, Blue Owl

Proskauer: There has also been a new (or in some cases, renewed) interest in different types of financing structures. While traditional OpCo financings are, and will remain, the primary focus for many private credit lenders, we have worked with a number of private credit lenders to explore financing opportunities at different attachment points within a capital structure, such as NAV facilities and other fund level financing solutions. These structures have provided additional opportunities to deploy capital while the overall M&A activity remains depressed.

Blue Owl: You are exactly right. One of the defining features of Blue Owl is that we invest across the private markets ecosystem, providing liquidity solutions to companies and sponsors during their lifecycle. This includes not only credit but also real estate, GP stakes investing and alternative asset classes. As the number of players in the private credit industry has expanded (including many newer entrants chasing yield during 2022 and 2023), the ability to differentiate your offerings and provide creative solutions has become even more valuable. Scale is one of those key differentiators as larger platforms tend to have multiple advantages in M&A processes, including higher quality teams with in-depth and sector-specialized market knowledge.

Junior Capital. We have spent the last several years living in the age of the unitranche. Do you see an increased market for junior capital?

Blue Owl: As a firm, we typically target about 5-15% of our investments in high-quality second lien opportunities. We have always had a high bar for our second lien investments, focusing on businesses with scale, diversity and strong credit/cash flow metrics. The average enterprise value of these second lien borrowers is roughly double that of our first lien positions. These borrowers typically have performed very well and add attractive spread to the portfolio. One notable theme that we have observed the past few quarters is a refinancing of many of our second lien loans, with roughly 40% of our existing second lien positions repaid during the first quarter of 2024 alone. As these are high performing businesses with organic deleveraging, it is natural they would be refinanced in this spread environment, but we have found it difficult to replace them given the overall rate backdrop.

As we mentioned earlier, many companies are also suffering from OpCo balance sheets that remain unsustainable in this rate environment. Given the amount of private capital on the sidelines (especially amongst equity funds) we have also seen a rise in PIK preferreds, with a use of proceeds to help pay down debt and reduce the ongoing interest burden at a borrower. While we have seen at influx of opportunities with this profile, we have found relative value difficult to reconcile given deep attachment points.

Proskauer: In addition to PIK preferred and other holdco solutions along the lines of what Nicole and Erica described, we have seen an increasing number of borrowers continue to seek unitranche solutions to these pressures but with super-priority revolvers and other first out/last out structures. These arrangements, which may be documented within the credit agreement itself or pursuant to an agreement among lenders, offer the simplicity of a single credit agreement from the borrower’s perspective and additional rate flexibility on a blended basis, while offering a more attractive attachment point for private credit lenders than a traditional second lien or PIK preferred financing.

Resiliency of Private Credit. We have continued to see the resilience of private credit over this period of elevated rates. What are some of the characteristics of private credit that you have found most valuable

during this period?

Blue Owl: There are several aspects of the private credit process which we believe contribute to both better credit selection and more optimally structured transactions. For starters, at Blue Owl, we serve as the administrative agent or lead lender on the majority of our loans. This affords us advantageous access to diligence during the underwriting process, as well as control over the upfront negotiation of credit documentation and any amendment or workout situation. We also aim to diligence almost every transaction that goes through the US leveraged finance markets (both syndicated and direct), although our approval rate remains incredibly low. Evaluation of these transactions, regardless of whether they end-up as investments, provides us with a deeper diligence understanding across sectors as well as a better competitive lens into what is getting done in the market away from us.

To hit on some portfolio specifics, on average, we continue to see steady top- and bottom-line growth on both a quarter over quarter and year over year basis. Our borrowers were well positioned coming into the past few years, having successfully navigated higher interest rates by growing revenues and profitability, adjusting cost structures and managing cash flow and working capital where needed. We believe our companies are faring well by design, as we have intentionally invested in large, high-quality businesses and recession resistant sectors, often backed by operationally sophisticated, private equity sponsors who have large cash equity investments in these businesses. Despite the higher for longer rate environment, we haven't seen any material pickup in stress across the across the portfolio. We continue to have a small number of borrowers on our watch list, but this subset has remained relatively static over the last few quarters.

Proskauer: The default rate for senior-secured and unitranche loans in our Private Credit Default Index was 2.71% for Q2, which is much lower than the default rate for broadly syndicated loans. One strength of private credit has been the formal and informal communication channels that are frequently a feature of the private credit market. As Nicole and Erica noted, private credit lenders are able to build relationships with private equity sponsors and management teams through their role as administrative agent for the credit facility. Additionally, many credit agreements include enhanced reporting rights which allow private credit lenders to receive financial updates more frequently and anticipate trends as they develop and start planning for solutions in advance of when an actual default may occur.

Women in Private Credit. The community of women in private credit continues to grow. What advice would you give to women looking to take the next step in their careers?

Blue Owl: Network! While credit selection and appropriate structuring will distinguish managers and drive returns, private credit is still a relationship-driven business. Meeting management teams, financial sponsors, service providers, lawyers and peers are integral to forging new relationships and sourcing better investments. Today we are fortunate that there are many sophisticated women’s groups that have evolved as the industry has gotten larger that help facilitate these connections.

Proskauer: Step out of your comfort zone. For a lot of people, that is probably synonymous with networking — and I completely agree with Nicole and Erica on that one — but there are more ways than ever to put yourself out there whether it’s contributing to an article, participating on a panel or seizing an opportunity to take a deep dive into a new area of the market. There are so many great opportunities to get involved in the private credit community, and in particular, the women in private credit community.

For more than 20 years, the Private Credit Group at Proskauer has been intrinsically involved in the evolution of the industry, working on pioneering structures and products. Our technical strength, combined with our expansive experience, makes us the Firm of choice for first-in-kind transactions. Acting as strategic partners to our clients across industries and jurisdictions, our team of lawyers has expertise in U.S. and Europe-centric transactions, as well as North American and European cross-border transactions.

Proskauer Women in Private Credit offers a knowledge sharing and peer network platform for females active in the private credit market. **Click here to register your interest in receiving future updates**.

Related Professionals

- **Jessica G. Shearer**
  Partner
- **Hyun Seung (Sarah) Suh**
  Associate