The Insight: Conversations – The Flip Side with Brook Hinchman and Matt Wilson

Harry Whitelaw

Hello, and welcome to The Insight by Oaktree Capital. I'm Harry Whitelaw. Now, the credit markets have been the subject of many headlines over recent months, some perhaps overly dramatic, but some also pointing to legitimate pockets of concern. Today, we'll flip the script and talk about the opportunities that could result from a less easy lending environment. With that aim in mind, joining today, we have two Oaktree leaders who operate in the complex end of the credit spectrum. Brook Hinchman, head of North America for Oaktree's Opportunistic Credit Strategy, and Matt Wilson, co-portfolio manager for our Special Situations Strategy. Great to have you both here today.

Brook Hinchman

It's a pleasure to be here with you, Harry.

Matt Wilson

Yeah, thanks, Harry. Good to be here.

Harry Whitelaw

Okay. Why don't we start off with a bit of economic backdrop starting with the interest rate picture. We have seen pretty big upward moves in treasury yields over the last few months. Fed cuts suddenly seem a little bit further away. Brook, what's going on here?

Brook Hinchman

I think this is a really important question as you think about investing today, and I would take us back to 2021. In 2021, we had been in an environment where you had over a decade of inflation running below 2%, below the Federal Reserve's inflation targets, and we ran into the period of supply chain dislocation as a result of COVID, and there was a view that inflation was transitory. And then, as we moved on, that transitory period has become more permanent. There's been tariffs, and then now, the Iran war, and we are heading into the sixth year where inflation has been in excess of the Fed's 2% targets. What we have seen is really a regime change in terms of inflation from a very low inflationary environment to a higher inflationary environment.

Matt Wilson

We live in a world today where, if you look at Brook's point about the stickiness of inflation and what we're seeing right now and add to that the fact that we've got oil prices over the last couple of months that have skyrocketed, they're back down around $90 today, but they've been as high as 110 at the WTI level and higher, it's a very tricky time in life where there's a lot of pressure to lower rates, to get growth stimulated, to get things going. At the same time, inflation's going the wrong direction, largely driven at this point by energy prices that are being driven by what's going on in the Middle East, and that's impacting everything from consumer businesses to industrial production, to other companies that have some kind of reliance upon the petroleum markets.

Harry Whitelaw

And explicitly at the borrower level, I always think there's a little bit of irony here, where the higher rates means the credit investor enjoys a better income. Look at high yield bonds right now, most of the 7% yield is coming from rates. But for the borrower, higher rates are not welcome, particularly for that subset of already struggling credits. If you're already an over-leveraged borrower, what does it mean for rates to not go down anytime in the near future?

Matt Wilson

We've been watching this, and this has been going on for a while. There's a point in time two years ago when rates were really peaking, maybe almost three years ago now when rates were peaking that we thought we would see a lot more distress in the debt markets. We thought we'd see a lot more of these companies that would default on their loans.

A lot of these companies restructured through liability management exercises where they kicked the can down the road and did out-of-court type of deals to give them more runway and took on more debt in a lot of cases to fund those higher cash obligations. But eventually, this will come home to roost at some point. If rates remain higher for longer, there are going to be a lot of companies that have to restructure their balance sheets. So again, from a credit investor's point of view, you got to be very mindful of where you sit in the cycle and where you sit in your current portfolio.

For a distressed investor's point of view, I think it's very interesting. I think there's an opportunity here if it stays higher for longer, that we're going to see the opportunity to purchase meaningful amounts of distressed debt and/or provide capital solutions that allow companies to de-lever through equity infusions that help de-lever those balance sheet on the more stress level rather than distress level.

Harry Whitelaw

So we have higher rates, good for credit yields, not great for your over-leveraged borrowers. Moving on to a topic where I'm very curious to get both your opinions. The US consumer, it's been a story of remarkable resilience, perhaps surprising resilience, over the last few years. Though now, it seems every data point entrenches the same idea and that's the K-shaped economy. Brook, how do you read into that dynamic?

Brook Hinchman

We absolutely see a K-shaped economy and you see it in all the data. It's been well-reported that consumers are experiencing a big K-shaped economy and that higher income consumers that are exposed to assets and investments that have performed very well and their incomes are rising are doing very well.

And then, the lower portion of consumers are getting squeezed by higher food inflation, energy inflation that they are disproportionately exposed to and they are having minimal gains from the investments that are performing so well. What I would say that we are seeing is that there's also a K-shaped economy for companies. There's a small collection of companies that are capturing a greater and greater share of the profit dollars of the US and global economy, and what we're seeing is that there is a big bifurcation in terms of the haves and have-nots of companies' performance.

Matt Wilson

If you look at real wage growth, if you look at the nominal wage growth for high income earners, it's been 6% year over year. It's north of inflation, which means your real wages are growing. Contrast that with lower income consumers to one-and-a-half percent growth. So that's actually not keeping up with the pace of inflation. Their real income is shrinking, and you see that dispersion in the actual spending patterns.

While consumer spending looks good overall, it's largely being driven by the top of the pyramid. Those with the most amount of wealth are still spending money and spending a lot of it, but those at the bottom are really struggling.

And then look, you layer in the recent spike in gas prices. If you look at what the total card spend for lower income consumers is, it's about 8% of their income goes to pay for gas. Contrast that with a higher income earner, it's half that. You think about someone going to work every day and having to fill their car up to do it, it becomes a real tax on that person's income, particularly at the lower level.

That is a share of the wallet they cannot spend on discretionary items. But again, it's been buttressed by the fact that you've had a very strong equity market that's kept people wealthier at the top and you've had real income growth for higher-income earners. Those two factors alone have driven the consumer spending in the economy far more than the offset from those at the bottom.

Harry Whitelaw

So moving on to the credit markets, looking first at the liquid sub-investment grade markets. The median spread for high yield bonds and senior loans presents a fairly unremarkable picture, but as I think Howard would tell us, you should never trust averages. Right now behind the index-level spread, we really see massive dispersion between that bulk of haves and the tail of have-nots, right?

Brook Hinchman

The median high yield bond and leveraged loan issuer is trading at very tight spreads, tighter than the average. But when you look below the hood, that really obfuscates the amount of dispersion that there is in securities prices. And so what we see is the dollar amount of debt that is trading below $90 price and above 15% yield-to-maturity is over 200 billion of debt across over 250 issuers currently, which is actually a very large amount. And it's really concentrated in the 2021 and 2022 LBOs and debt deals that were done in that period of time.

And with the average maturity of six years for leveraged loans and high yield bonds, that debt really starts to come due in '27 and '28. And so what we see is that the opportunity set for that vintage of deals, we're about to go into the maturity cycle. And we think to Matt's point that there's been a lot of kicking of the can as a result of LMEs and PIK and you've really kind of stretched as much as possible to delay the inevitable. But once you get to these hard maturities, we see that there is going to be a lot of opportunities that come out of that maturity profile.

Harry Whitelaw

So moving on to the direct lending market, data is a bit harder to navigate here, but we've definitely seen a ton of headlines already in 2026. Now I don't think we believe the asset class is fundamentally flawed. In fact, the concept of privately negotiated senior loans to PE-backed companies makes a lot of sense, but what pockets of potential weakness are you monitoring in that area right now?

Brook Hinchman

What I would say is that the direct lending market is experiencing three issues that are all coming to head at the same time. The first is that about a quarter of the direct lending market has an asset liability mismatch where these interval funds and private BDCs have quarterly redemption features on what is fundamentally an illiquid asset class. The second issue is that you've got a vintage issue where the 2021 and 2022 LBOs were fundamentally over-levered. These LBOs were done assuming that interest rates were going to be zero into perpetuity.

And so the math was just you could put a lot of leverage on a business when interest rates are zero. And so you had peak EBITDA and you had peak leverage. Then the third issue is enterprise software. It was the sector that had the most exposure and it's the sector that had the highest level of leverage.

Matt Wilson

And the highest valuations.

Brook Hinchman

And the highest valuations. And that came at a period of time where there was a fundamental change in the competitive landscape where Anthropic released Claude Code about six months ago and it has continued to get better and better. And so what you've seen is a situation where the primary barrier to entry for enterprise software was the ability to, one, develop code and then two, to switch your data and switch your processes and systems from one enterprise software to another.

Those barriers to entry has come down meaningfully and it's resulting in a wide dispersion between the winners and the losers for a category of business models that historically had been very stable, very sticky and very steady. So to your point, Harry, we don't think that direct lending as a asset class is broken, but what we see is that the current subset of deals are overexposed to one challenged industry and overexposed to one bad vintage.

Matt Wilson

To Brook's point, the major pockets of distress are isolated around one particular sector and a couple of years of vintages. I do think though that there are things in that market you need to watch closely.

And one of the things we watch is the amount of PIK interest, what we call bad PIK, that we see in the marketplace. And I define bad PIK as the following, a loan that you make upfront where you say the coupon is 10% and 8% is cash and 2% is PIK, that's good PIK. You agreed upfront on what proportion was PIK and you agree that's how it was going to work.

Bad PIK is when you have a loan that was 10% cash and now you can't pay the cash. And so you go back to your lenders and ask if you can pay 7% in PIK and 3% in cash while you get your house in order. I think it speaks broadly to the elation that was in the market or the exuberance that was in the market at the time of these loans. The supply and demand balance of capital got put out of whack. The supply of capital accelerated.

And when that happens, managers either don't do deals, which is hard to do in the business, particularly when you're getting flows every month, or they began to do things at higher levels and tighter spreads. And so all that coming together, I think that the direct lending market will have opportunities for folks like us with that restructuring and distressed experience to take advantage of in the coming years.

Harry Whitelaw

So my question before we come a bit further onto the capital solutions element, Matt, are you seeing much in the way of secondary activity in the direct lending market, whether that's LPs, GPs trying to offload loans? I think this is quite an opaque area, but something people are definitely very, very curious about.

Matt Wilson

Yeah. What you do not have in the direct lending market because it just hasn't evolved to that point yet is a true exchange like you have on the trading desk and the broadly syndicated markets.

What you see right now are portfolio trades. Folks will sell a portfolio with presumably some really good assets and presumably some not so good assets and that portfolio gets priced in the aggregate.

You don't have, as far as I've seen in the market, any one-off trading that is systematic where there's an exchange, you can go in and try to find X, Y, Z name. And obviously the information opacity is part of the problem there. Folks don't have the same data. There's no data rooms like they have in the syndicated markets for secondary players to look at.

Brook Hinchman

To Matt's point, we are seeing opportunities in direct lending portfolios that because of the asset liability mismatch and because of redemptions by investors to meet that liquidity, we are beginning to see portfolios trade. And so we have started to see that portfolios opportunities in the direct lending space and expect that to continue to accelerate.

Harry Whitelaw

So as we think about a backdrop that's a little bit tougher given the rate environment, given we have this subset of weaker credits, I want to get your takes on potential solutions for struggling credits. Brook, maybe take us through the cycle of a credit that will struggle to refinance via the usual channels, by the BSL market, direct lending. Maybe it's 24 months out from maturity. It seems it's not going to be easy to just re-tap those markets. What could happen next? What could a potential solution look like?

Brook Hinchman

Yeah, I would say solutions generally fall into one of two buckets and there's opportunities for managers to invest that have specialized skillsets in both of the two vectors.

The first vector is the equity owner, whether it's a sponsor, family office, public company, whatever, believes in the business and has capital to help recapitalize the business. And then with the deleveraging from the equity investors, you can provide either a first lien unitranche solution or a middle layer of the capital that is a hybrid solution combined with a first lien. That's the first path, and we're seeing a lot of deals fall into that vector.

The second vertical is situations where there is no new equity. And one of the big changes in the market over the last two decades has been the elimination of covenants and the widening of what companies are able to do with their existing debt documents. And so even if there isn't new equity to come into businesses, because a lot of these documents that are first lien in name, they're really like Swiss cheese. And so what we can do is come into these capital structures and fill in the holes in the Swiss cheese. Through liens baskets, through unencumbered assets, through investments baskets, et cetera, we can make super senior loans to these companies at low LTVs in what are complex structures but are very well downside protected.

Matt Wilson

I think the evolution of the LME market has really changed the game here. So to Brook's point, you can do something super senior in the capital structure, which protects that new money, but probably is detrimental to the ultimate equity and even the first lien secure debt that existed prior to that super senior coming in. But I think that in any of these cases, if you're going to buy into the existing debt, you've got to be very, very mindful of what these documents say and don't say.

So as a secondary debt investor, when we're coming into a situation that we think is interesting and we're buying the debt at a substantial discount, we're always focused on getting to size. If you're the biggest creditor, you can typically help dictate the terms in conjunction with that borrower that are beneficial to you as the new investor. And whether that be adding new debt and rolling up your existing debt into that new facility on a senior basis or a super-senior basis, or whether it means you do an up-tier exchange where you're putting your money ahead of other creditors, or you're facilitating a drop-down asset where you take an asset out of the borrower group, put it into an unrestricted sub, and then put your old debt or some new money into that to give you yourself a very advantaged position, that only comes with scale.

Brook Hinchman

I would just add to what Matt said that the value of size has never been higher than what it is today. And the reason for that is that there was historically the expectation that large creditors and small creditors would have the same recovery, same instrument regardless of their size. That has fundamentally changed because of the nature of credit documents that no longer prohibit non-pro rata exchanges in non-pro rata treatment.

So in a recent study by a large investment bank where they looked at $60 billion of debt across 21 different LMEs between 2022 and 2025, the average LME had a 13-and-a-half-point benefit to the in-group ad hoc members that were on the SteerCo versus the out-of-group members. So that's almost $8 billion of transfer of value from small minority creditors to large creditors. So that really drives the difference between winning and losing increasingly. And so it's critical, to Matt's point, that you have to be big and you have to be active in these structures.

Harry Whitelaw

And Matt, sticking to the solutions idea, I wanted to ask you about structured equity. I'm aware this is an interesting flexible capital solution, but one that probably isn't that well understood. How can structured equity be utilized?

Matt Wilson

The simple way to explain this is it is a priority position in the capital structure. So on a loan-to-value basis, there is a margin of safety day one on this. And we have a full spectrum. On the healthy side of things, we have a lot of family and founder owned businesses that just do not want to borrow money. They don't want to go to direct lender despite the fact they could borrow money at far cheaper rates than we provide because they don't want to be in a borrower-lender relationship where that lender's going to expect cash every quarter and they have to pay it or else they lose their company.

Harry Whitelaw

They want to be a partner, you mean?

Matt Wilson

They want a partner. They need a partner in a lot of cases. Some of these are, they're all healthy companies where they want to do M&A. They want to do a transaction to diversify their estate in the case of a family business. The next generation may not want to run the company, so they want to take some chips off the table. They may want to build a new plant. They may want to buy an old shareholder out. There's all different needs for the capital.

In those situations, private equity, pure private equity would love to own that business, but that borrower or that seller at that point is not a seller. They don't want to go to private equity and sell 80 to 100% of their business. What they want is capital to come in with some benefit of partnership that we bring, and we bring a lot of partnership to the table. We're very hands-on in these situations. We bring our operations team that come in and help build these companies better. And so they get benefit and what we get is a priority position in the capital structure that protects our downside. So we've got a much safer security.

On the more stressed businesses, I won't say distressed businesses, because distressed businesses, it's much harder to do this. But on a stressed situation where you say you're six-and-a-half times levered today and you can refinance that first three turns of the balance sheet and you need someone to pay down that three-to-three-and-a-half turns that's behind it, in certain situations where we think there's a reasonable margin of safety, the company's worth 11, 12 times, and we can get in at a 50, 55% type LTV with a good sponsor that we trust and we know that will accept our help and will accept our shared governance of the company, we're finding those are good situations to participate because it helps us in the context of putting money into situations where you've got a partnership arrangement, you've got low leverage in front of you, and they need something to help them solve a maturity and refinancing issue, for example.

The last piece is DPI. There's been very little money given back in private equity over the last three or four years and LPs are well aware of this. And so you've got a dynamic now where sponsors are desperate for DPI, and the first time in my career, they're willing to come to folks like us and our cost of capital to take dividends out. And in certain situations, we will consider those deals where we can put something in that's well-structured, that is very senior in the capital structure with very little risk in front of it. And the trade for that sponsor is they're able to get money back to their clients and allow them to potentially raise another fund.

Harry Whitelaw

Okay, very interesting. So considering these more complex transactions versus vanilla direct lending, so Brook, maybe a rescue loan versus a standard middle-of-the-fairway direct loan, what kind of spread premium are we looking at here?

Brook Hinchman

Yeah, absolutely. So in terms of the average deals, what we're seeing is that they're anywhere between a 300-basis-point and a 1000-basis-point premium to the direct lending market. And so these are very significant spreads and they are achieved with a mixture of upfront OID with the base spread and then oftentimes some sort of equity kicker conversion feature. And so that's a significant premium to what you're seeing in the direct lending market. There's a lot of direct lenders out there that can do plain vanilla deals, but there's very few investors particularly in size that can do these structured solutions for companies. And so there is a big premium as a result of it. And we think that that premium is really more alpha than beta.

Harry Whitelaw

So Oaktree is a credit shop first and foremost, but ownership is a natural feature of opportunistic lending, whether intentional or inadvertent, deliberate, pre-planned, whatever. Matt, can you talk us through what can be done as an owner to try and improve the prospects of a struggling or just neglected company?

Matt Wilson

For us, it's not about financial engineering. It's about number one, making money on the buy. So it's structuring these deals right, making the entry multiples distress-for-control situation three or four times EBITDA for a company that may have traded at 12 or 13 times. If you can buy these things at 60, 70, 80% discounts on the multiple to where they were created at a time in their lifecycle where their earnings are depressed, so you're getting not only a multiple arbitrage buying something well below its target multiple, but also at a point in time where something's gone wrong that we believe is fixable, you're getting that benefit of earnings growth on the backside too. Now, the earnings growth piece is the harder piece to achieve. You need to have the know how to do that. We have a stable of executives in our core industries, dozens of them that we can parachute in to sit on our boards, to run our companies, to act as CEOs or general managers.

And we include our operating team from the inception of the underwrite of an investment all the way through the exit. There's no handoff in our business because we fundamentally believe that to create that equity value, you have to have accountability and ownership of the deal team. And so when we underwrite a new investment, whether it be a debt purchase or a structured capital solution or even just a straight buyout of a company, the integrated approach of our portfolio transformation team is that professional is underwriting what they believe they can do with the business, whether it be cost outs or revenue growth, whatever it may be to achieve that profitability and cashflow growth. And it's the evaluation of the management team, it's the talent gaps that we need to fill in. It's all of those things and we leverage that team very aggressively from the first day of underwriting all the way through the final exit.

It's a playbook of probably 15 different activities we can do from optimizing supply chain to revenue cycle management to resourcing your business in Asia to consolidation of plants. We've got a playbook for everything. Most of our companies don't need more than one or two of these, but we've got the playbook that we've done over and over again. It's a really integrated operational approach to how we invest because we believe that to create the alpha, you have to have that operational bent.

Harry Whitelaw

Well that's a great place to end. Maybe we are no longer in an easy credit environment, but that doesn't just present risks: it presents opportunities as well. Thanks to Brook and Matt for joining us today and thank you all for listening in. Look out for future episodes wherever you get your podcast or via the Oaktree public website.