EXPERT Q&A

A different kind of discipline

The strength of the current market represents both a challenge and an opportunity for direct lenders, says Alexis Maged, head of credit at Owl Rock, a division of Blue Owl Capital

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Q How has the experience of the pandemic over the past 18 months impacted your approach to underwriting, due diligence and risk management?

Heading into the pandemic, Owl Rock had displayed strong portfolio performance since inception while focusing on downside protection and portfolio diversification across non-cyclical sectors. Owl Rock was well-positioned after building a diversified direct lending portfolio of upper middle market companies with an average EBITDA of $100 million.

At the onset of covid in March last year, while we were confident in our portfolio, we quickly implemented significant adjustments to our portfolio and credit process in response to the new environment. We were in the middle of an investment committee meeting on 11 March 2020 when we received news that someone in the building tested positive. The firm initiated its work-from-home protocols and requested that everyone leave immediately. We were all expecting to return in a few weeks' time, only to be out for over a year.

At the onset of the pandemic, we were well-positioned to benefit from our large, senior underwriting team. Our approach to scaling the firm was always based on hiring in anticipation of size. As a result, we had highly experienced, senior underwriters on the team and immediately embedded those individuals within each of our portfolio companies alongside industry-focused subject matter experts.

At the same time, we 'heat-mapped' our credits based on issues arising or those we felt were likely to surface. This elevated our focus on consistent, open dialogue with borrowers and sponsors for real-time updates. Early on, that heat map displayed some of the most impacted borrowers and, in turn, allowed us to focus our efforts on these positions.

We already had a well-established quarterly portfolio watchlist process and we began to hold those meetings weekly so that the investment committee could effectively track what needed management's attention quickly and where we needed to focus our resources in the near term.

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Q How was dealflow affected by the pandemic?

As a growing firm, we had an abundance of capital and strong relationships, and we made it clear to sponsors and portfolio companies that we were open for business. We had access to dealflow throughout the pandemic and figured out ways to execute without the ability to meet management face to face or visit facilities. In fact, we had close to $6 billion in origination activity in Q3 and Q4 2020 alone.

We benefited from expert networks and requested virtual tours of sites via video link, and management teams, sponsors and bankers were incredibly helpful with and receptive to that. We certainly didn't lower the bar on due diligence, and if we couldn't get comfortable with something, we didn't pursue that opportunity.

Just in the last few weeks we have reverted to doing things as we were doing them pre-pandemic, but it has taken the best part of 15 months.

Q What lessons have you learned during the market disruption?

A key lesson learned for us, and something that we have since incorporated into our diligence memos, is understanding the vintage of the private equity fund where a portfolio company was held. As a relative newcomer, most of our portfolio was from newer vintage funds, but we had taken for granted the aggregate assets under management of large sponsors and assumed they had significant cash available.

In fact, during the pandemic, the market witnessed situations where private equity funds had little to no liquidity in a legacy fund to support that fund's portfolio companies. The reality is that covid was so sudden that in almost all cases the issues were not covenant issues but rather liquidity issues.

One of our portfolio holdings was a dental services business which saw 90 percent of orders dry up overnight when dental offices closed. If private equity funds did not have the liquidity set aside to support these situations, the gap needed to be filled by the lenders. Now, we look more closely at the available dry powder in the fund backing our investment.

Secondly, we entered the pandemic with a focus on the upper middle market, looking at companies with an average EBITDA of $100 million. We believed those businesses to have greater ability to withstand shocks and more flexibility to cut costs, sell off assets, absorb pricing pressures and so on. We firmly believed they had multiple levers with which to protect themselves, and that hypothesis was certainly proven true during the pandemic.

We don't have a lot of small company exposure, unlike other direct lenders, and we have also sought out to have low volatility, staying away from cyclicals, concentration risk, commodities and the like. Much of our portfolio is in food and beverages, business services, technology and software, and logistics and distribution. These sectors generally held up well, and some outperformed.

Finally, we have generally been more conservative on physician practice management companies, which are essentially roll-ups of businesses involving medical practitioners of some kind. Those transactions are structured a bit differently because of state regulations related to the involvement of healthcare professionals, and that has caused us anxiety. That proved prescient. Many of those businesses struggled during covid and the lenders did not have access to the same rights and remedies as they would have had with other credits.

Q What do you see as the priorities when it comes to creating downside protection going forward?

Our approach to risk management is to focus on segments of the market where we feel comfortable, conduct extensive underwriting, diligence, and structure,

Q Which parts of the market still present challenges, and why?

The strength of the current market is a challenge to any kind of lender because it leads to increased competition, spread compression and degradation of terms from what we would otherwise expect to receive. That takes discipline. There's also a huge velocity of deals coming to market, so you have to be able to efficiently sort through which opportunities are right for you. We have a large team and we need everybody firing on all cylinders, which also requires internal management to make sure that everyone is focused where we want them to be focused.

document and portfolio management each investment thoughtfully. We are incredibly selective – we only close on 5 percent of the deals we review in line with our historical average. We have intentionally set up a fully scaled origination machine that generates considerable dealflow, allowing us to be highly selective.

We have a very disciplined approach and believe that an investment should not represent more than 2 percent of a fund's exposure. In reality, unexpected issues for a portfolio company will occur, therefore we avoid outsized exposures or "tall trees". We also focus on larger companies and stable credits. We believe smaller companies, regardless of how well structured the credit documentation may be, don't have the same flexibility to navigate themselves out of operating or capital structure issues.

We spend an inordinate amount of time on documentation and other protections in our deals – we negotiate all our own documents, and our deal teams are exceptionally well trained in that respect. Where we draw the line is on things that can impair us if something goes wrong, so limiting the ability of assets to move out of the borrower group, for IP leakage, and so on.

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Q Where do you currently see the most exciting private lending opportunities?

The reality is that over the past year we have done some marquee transactions and sponsors took a lot of comfort in partnering with us on significant investment opportunities. Many large sponsors had never done a deal with a direct lender before, and the flexibility of our capital made us a very attractive counterpart. We can maintain confidentiality, speak for size and execute bespoke transactions very efficiently.

It was an exciting growth period for us, in terms of both deploying capital and demonstrating our capabilities to the upper middle market and large-cap sponsors. The market is now seeing larger unitranche deals than we have in the past, due to the availability of capital from direct lenders and willingness of large sponsors to transact.

In April, we led the US's largest ever unitranche loan, a $2.3 billion financing in support of Thoma Bravo's acquisition of Calypso Technology. We like large companies because we think they are better credits, so that's an exciting opportunity for us; it allows us to be more consequential on deals.

The other area where we have really distinguished ourselves is in technology lending, where we have relationships up and down the spectrum and have extremely flexible capital to deploy from venture capital to growth equity and into much larger tech LBO credits. That's an area of growth and where we believe we are in a pre-eminent position to build our franchise.

Q Finally, can you tell us about the creation of Blue Owl Capital this year, through the combination of Owl Rock and Dyal, and explain how you are positioning the business to respond to market demand?

Blue Owl was formed by the strategic combination of Dyal and Owl Rock. The firm's breadth of offerings and permanent capital base enables us to offer a differentiated, holistic platform of capital solutions to participants throughout the private market ecosystem, including alternative asset managers and private middle market corporations. Blue Owl has over $62 billion in assets under management and more than 250 professionals.

Blue Owl's complementary platforms allow for enhanced origination opportunities and access to unique, proprietary dealflow and, in turn, provide institutional and private wealth clients access to compelling and differentiated opportunities.

We have come into the market to be a lender of first choice and the combination of Owl Rock and Dyal creates a significant force in this market. We have established Blue Owl to allow us to provide one-stop-shopping for all financing services and capital services that an alternative manager needs.

We have extensive alternative asset manager relationships, which allow us to quickly and efficiently source potential GP and fund level investment opportunities. Since inception, on a combined basis, we have generated fund level dealflow from over 570 sponsors and completed 60 equity and debt GP level transactions.

We believe our deep relationships position us to receive the 'first call' from alternative asset managers, which in turn allow us to be highly selective in deciding which investments to pursue. We also believe the depth and breadth of our relationships are predicated on several, differentiating features of our platform and that alternative asset managers value our team's experience and deep focus both within products and across a broad spectrum of capital solutions. ■

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