Redefining Opportunistic Credit (Six Insights)

GOLUB CAPITAL

Contents

“Go Anywhere? Best Ideas?” Redefining Opportunistic Credit

There’s a saying, “If you’ve met one opportunistic credit fund… you’ve met one opportunistic credit fund.” The category lacks definition. In fact, it’s less a category than a concept (Preqin doesn’t even include “opportunistic” as one of the subgroups within private credit).

The fact is, most firms conceive of it as differently as they do their own businesses. Depending on which manager you speak to, “opportunistic” can mean:

- Whatever asset classes a private manager traffics in separately, now combined in a more flexible “go-anywhere” portfolio;
- A compilation of “best ideas” from the firm’s origination pipeline that do not fit in the firm’s other single-mandate funds; or
- Funds that are marketed only when extreme dislocation or distress occurs.

How can we better understand opportunistic credit, if not as an asset class per se, then at least as a more clearly defined investment strategy?

We consider three pillars in our definition.

1. Starting from the technical side, we note that credit opportunity emerges at the junction of high demand and low supply—a recurring phenomenon in the credit space.
2. Then, from a fundamental perspective, the pertinent variables include discounts and mispricings, which can range across the capital stack from senior debt to equity, with hybrid structures in between.
3. However, it’s neither technical factors nor valuation dynamics that fully capture the idea of opportunistic credit as we define it. The last (and key) pillar is the know-how, close rapport and alignment of incentives across longstanding participants in the credit markets.

In short, we believe opportunistic credit, done right, is less an asset class and more a business—a relationship business.

1. Scarcity Drives Opportunity

The level of supply or demand for credit is constantly in flux. There are many participants in the broad credit ecosystem who are periodically starved of liquidity and factors that, at different points in time, tend to constrain its availability or complicate its delivery. Three ingredients are often at work here.

Sources of Liquidity: Traditional sources of liquidity (banks, collateralized loan obligations [CLOs], mutual funds, exchange-traded funds [ETFs] and various private market funds) may periodically face limits on their ability to invest.

- Private funds may struggle to deploy capital when exits for their portfolio companies slow.
- Issuance of public debt securities in the broadly syndicated loan (BSL) or CLO markets may dry up in the face of macro uncertainty.
- Volatile flows from mutual funds and especially ETFs can reverse quickly, chasing liquidity from the markets.

These constantly evolving imbalances of supply and demand generate ongoing funding challenges (and opportunities).

Regulatory Constraints: Factors restraining access to debt are many and varied. Some can be regulatory in nature:

- **The Rise of Non-Bank Lending:** International bank regulators placed increasingly restrictive risk-based capital charges on commercial banks, penalizing them for holding lower-rated debt on their balance sheets. In response, middle market borrowers and their private equity (PE) sponsors were obliged to find alternative debt solutions among non-bank direct lending firms.
- **Insurer Demand for Private Credit:** National- or state-based insurance regulators have disallowed specific types of debt from inclusion in insurance general accounts, requiring feeder portfolios to be created, and then adjudicated by rating agencies, to allow for investment.

Scarcity drives opportunity. These regulatory impediments to the supply of debt capital continuously generate new avenues for liquidity and sometimes novel contributors of it.

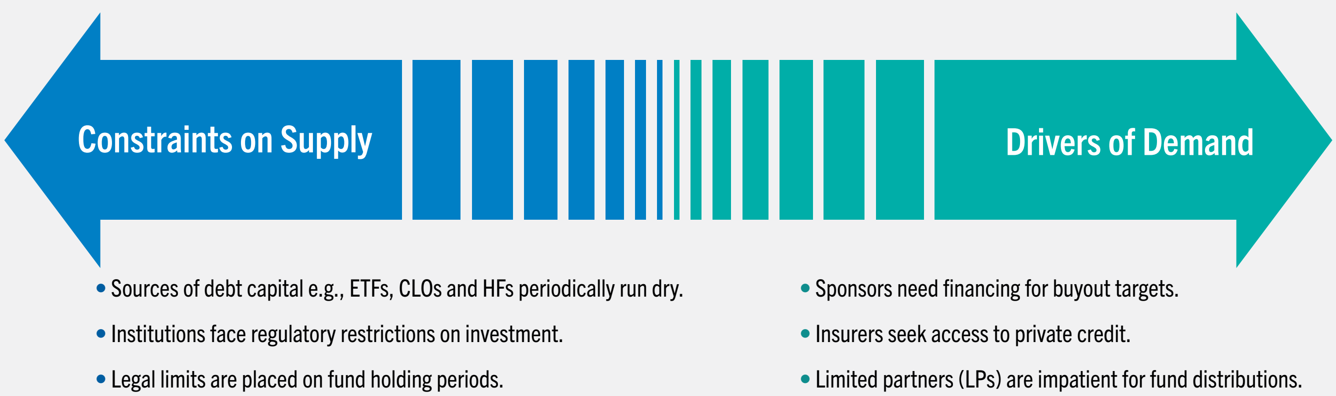
Fund Holding Periods: Other constraints on liquidity tie back to various legal strictures on the investment vehicles themselves.

- Mutual funds and hedge funds (HFs) represent sizable sources of ready capital but may be prohibited from engaging in certain areas of the market or may face periodic redemption obligations.
- These funds may brush up against their own internal limits on acquiring certain types of less-liquid debt exposure or face caps around how much (and how long) they can hold it.

All of these factors can influence the amount, availability and price of debt capital at any point in time.

Exhibit 1

Crimped Liquidity and Funding Challenges



Source: Golub Capital; for illustrative purposes only.

2. Before Distress Comes

There's Always a (Liquidity) Mismatch Happening Somewhere

Investors often assume a connection between distress and opportunity. However, this should not imply that opportunistic funds, as a rule, require market-wide dislocation to succeed.

A credit-centric understanding of the opportunistic category should not be limited to a specific point in the business cycle where periods of extreme distress may arise. While such moments may create especially attractive opportunities for credit managers, they tend to be rare and hard to time and often pass quickly.

To be truly opportunistic, by our definition, a credit manager should be continuously alert and able to identify a variety of occasions and types of investment—most of them well short of true distress. The opportunistic credit manager draws from the full toolkit of debt investing to deliver a solution most pertinent to the need at hand. The solution could be situated anywhere from senior debt at the top of the capital stack to structured or common equity at the bottom. Also, because the number and sorts of participants in the broader credit universe continue to evolve and expand, the range and scale of opportunities will only grow and develop over time.

Here are some examples, all of them short of true distress:

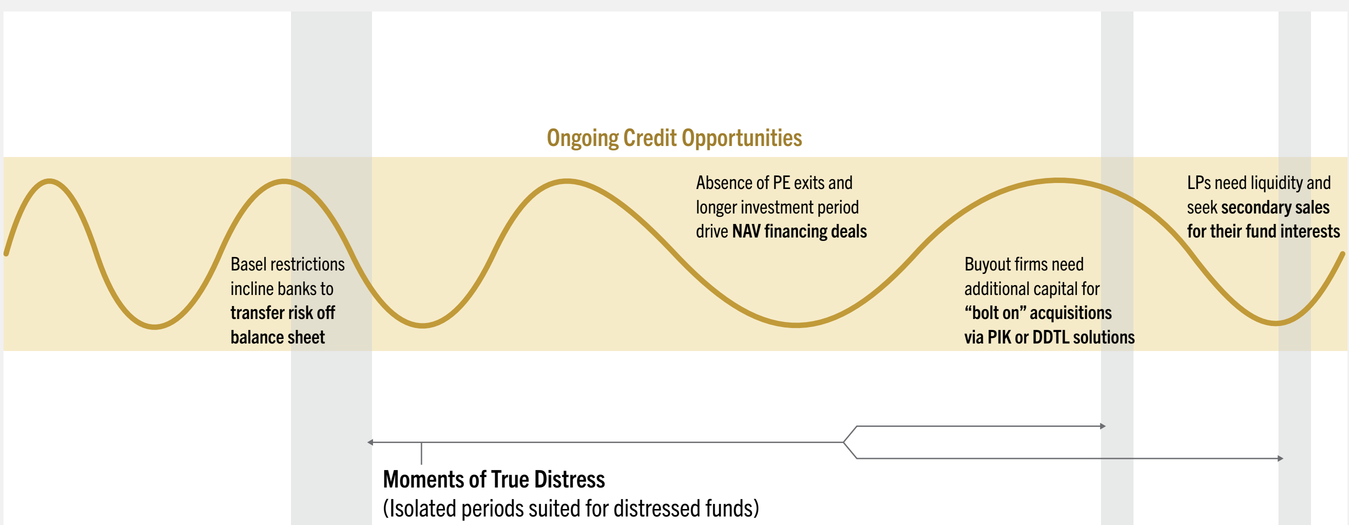
1. **Fund Finance (NAV Financing):** During a period of low exit activity, when both the M&A and initial public offering markets were relatively inactive, PE funds saw investors grow uneasy with anemic distributions. NAV financings sourced from opportunistic lenders give fund general partners (GPs) a novel form of debt capital, allowing a kind of private fund overtime—a chance for fund GPs to extend their investment period, put more capital to work in their best deals and deliver interim liquidity back to their LP investors.
2. **Junior Capital Solutions:** The latest generation of PE GPs can no longer count on organic company transformation to drive the desired level of multiple expansion in their deals. Today, most pursue a buy-and-build approach instead, where buyout funds require substantial add-on capital to bolt on smaller competitors to their portfolio companies. They can do this through delayed draw term loans (DDTLs), recapitalizations or junior capital solutions—all provided by opportunistic lenders to enhance or replace the borrower's original capital structure.
3. **Synthetic Risk Transfer (SRT):** Banks face their own regulatory constraints on liquidity, sometimes exacerbated by idiosyncratic market conditions. Given the often painful risk-based capital charges for holding certain types of debt on their balance sheets, many have sought SRT solutions from opportunistic lenders to lighten those exposures. These transactions help banks manage their balance sheet in a cost-effective way, freeing up capital to pursue other opportunities.

These may seem like unrelated transaction types. However, many of these actions and actors are intertwined—each influenced by the others' need for and access to liquidity. And most of them occur in normal market conditions well short of deep distress.

Exhibit 2

Distinct from Deep Distress

Periods of extreme distress are not required for opportunistic credit managers to address a diverse array of liquidity needs



Source: Golub Capital; for illustrative purposes only.

3. Aligned and Incentivized

The opportunistic credit manager most suited to identifying and addressing the liquidity challenges we've outlined sits at the center of a diverse community of participants. These include private fund GPs, their middle market portfolio companies, the direct lenders that supply them capital, the LPs that invest in their funds, the banks that supply fund leverage and help syndicate their public BSLs and the agents and other trading relationships in both the BSL and CLO markets. All of them, at various points in time, could be either in need of debt capital or the providers of it, or both, simultaneously.

However, it's not enough just to be known. The successful opportunistic credit manager should have longstanding relationships with most of these actors across the debt continuum. They have deep ties running decades long with a fundamental understanding of their respective businesses and what works for each. Often, investment edge does not come from algorithms calculating the most probable next tick of a security's price but from personal relationships and industry understanding. Two examples of this are:

- **The Power of Incumbencies:** Consider a direct lending manager who provides initial debt capital to a GP-sponsored core middle market company with earnings before interest, taxes, depreciation and amortization (EBITDA) of $40 million. Over time, the company grows to $250 million in EBITDA and now seeks additional debt, but this time management issues it in the public syndicated loan market. Because the direct lending manager has strong incumbent relationships with the original company, its management team and its sponsors, they will possess a distinct information edge. That manager is far more likely to understand and more accurately calibrate any discounts or mispricing on that newly public BSL debt than outside peers, particularly if it trades in stressed ranges. If the manager knows that the price discount is disproportionate to the impact of any fleeting credit dislocation, they can invest with greater confidence.
- **From CLO to BSL to RNF:** Take the debt manager with know-how and scale in CLOs—someone expert in looking through and unpacking the vulnerabilities in such a portfolio of credit assets. They might see in advance when a particular credit would likely be sold by a CLO manager due to stressed pricing or a lapsed rating. This, in turn, could provide early warning of a potential opportunity for the BSL team to purchase the credit in the open market. Alternatively, the CLO group could give them the upper hand in more accurately assessing credit risk in novel types of rated note feeders (RNFs) that other investors find opaque and difficult to accurately price.

The intersecting threads of information across this ecosystem of creditors and debtors create a rich network of opportunity for an attentive and connected credit manager.

Exhibit 3

Incumbencies and Partnerships

Opportunistic managers occupy the center of the credit ecosystem

Source: Golub Capital; for illustrative purposes only.

4. A "Tweener" Opportunity

In many ways, the space we're identifying for an opportunistic credit strategy sits in between the more traditional and constrained domains of large-scale PE and senior-oriented direct lending. Opportunistic deals may approach the boundaries of these entrenched mandates but will tend to focus instead on the broad continuum of opportunities that live between them. The domain includes transactions that the larger strategies do not (and sometimes cannot) pursue, up and down the capital stack.

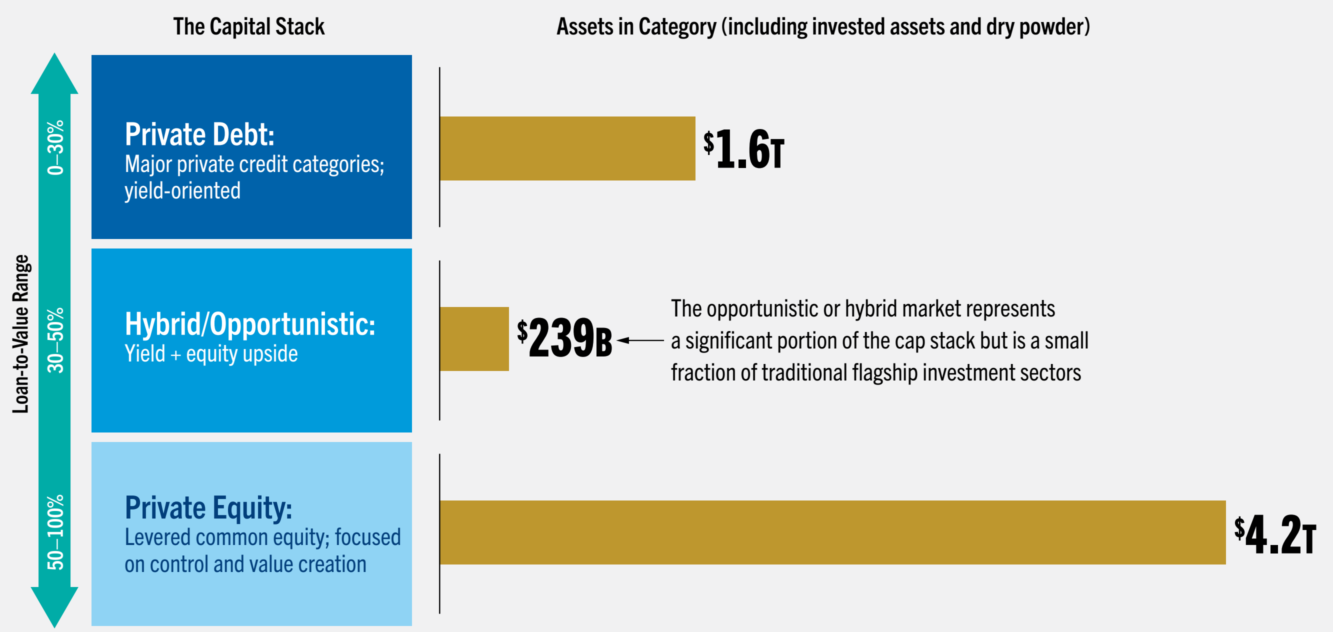
While many institutional investors have been allocating to PE for decades, and some have made room for direct lending over the last 5–10 years, very few have a dedicated opportunistic bucket. This is partly why the size of this opportunistic category is more modest, in terms of invested assets, relative to the larger pure play approaches. This familiar cohort of large, traditional investment managers tends to focus more exclusively on control equity (in the case of PE) and traditional senior-oriented debt (in the case of direct lending).

In addition, the underlying characteristics of the deals in this new middle space are likewise a blend, combining contractual yield and equity upside, taking the best from both worlds to secure a more balanced or hybrid outcome.

These investment characteristics will tend to dictate both the types of managers best suited to exploiting this space and the expertise required of them; it suggests that the typical attributes advertised by many established private managers may not be the most apt. Scale may be less important in execution than agility; check size may matter less than flexibility; innovation and structuring expertise may outweigh brand name.

Exhibit 4

Mind the Gap: A Rich "In Between" Space



Source: Preqin, as of 12/31/24; Hybrid/Opportunistic category includes Hybrid, Hybrid Funds of Funds, Blended-Opportunistic, and Junior/Subordinated Debt categories, per Preqin's classification. Golub Capital Analysis.

5. Crossing the Stack

The essential expertise of the opportunistic credit manager we're defining is the ability to identify, source, calibrate and execute credit opportunities across the capital structure. Deep ties to the participants, an understanding of their markets and the ability to credibly and creatively work a deal are indispensable virtues.

That means having deep proficiency and long history in all forms of debt, from senior loans down to mezzanine and from junior debt to structured equity solutions. It also means having close knowledge of the lender–borrower ecosystem and skill in discerning structural needs, imbalances and other opportunities across the different slices of a company's capital structure.

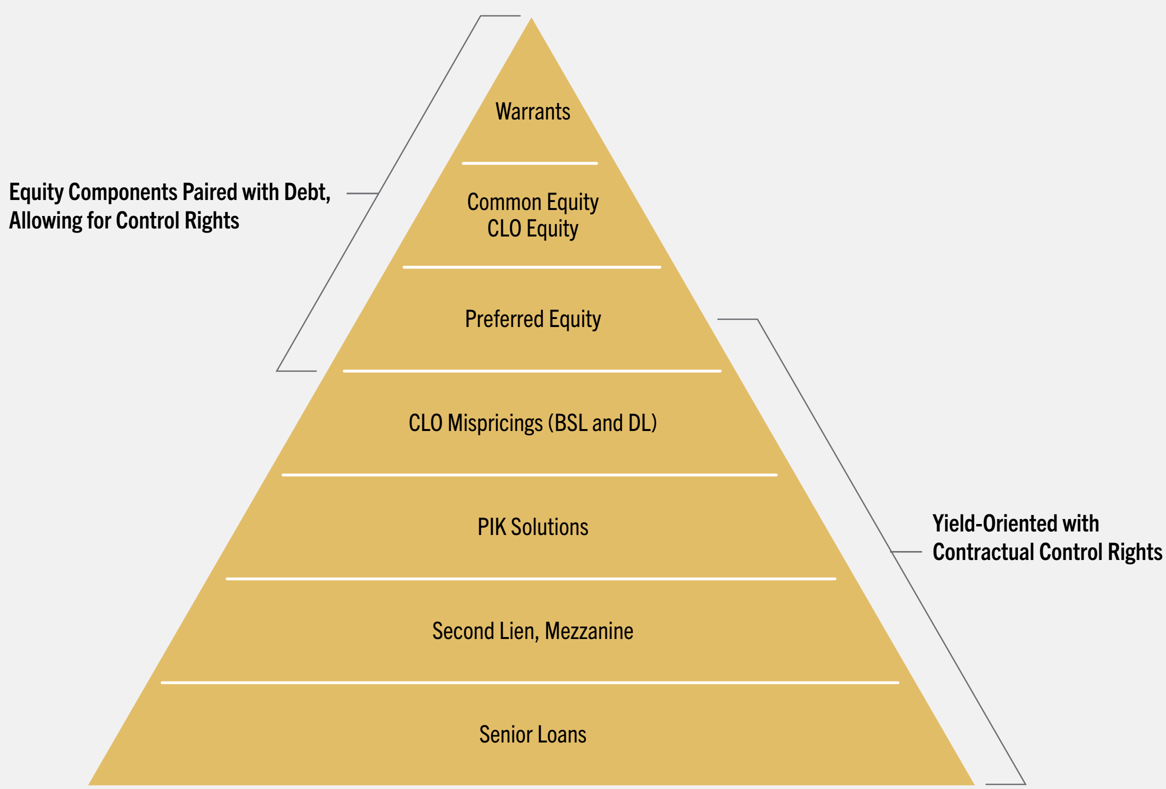
An opportunistic credit manager should have:

- A keen sense for traded markets in public syndicated loans along with the aptitude to identify and capitalize on perceived mispricings in first lien, second lien, hung syndications or other types of stressed debt securities.
- Recognized expertise in BSL or middle market CLOs with an ability to buy in scale—and the patience to hold—enables preferential origination. A competing hedge fund manager with a higher velocity of trading (and thus shorter hold periods) would be less able to harvest the illiquidity premium on less-liquid credits.
- The facility to secure risk-managed exposure for equity upside through warrants and common shares, carefully paired with debt to allow for potential control rights.

Exhibit 5

Seeking Opportunities Up and Down the Capital Stack

From first- and second-lien loans to preferred equity and warrants



Source: Golub Capital; for illustrative purposes only.

6. A Completion Strategy

It's no surprise, from the contours we've laid out for this type of hybrid approach, that the return and risk profile of opportunistic credit is itself a carefully weighted blend of debt and equity: predictable, contractual income yield alongside structured equity upside. The returns fall in between the traditional direct lending and buyout categories, with a dominant component being robust cash yield with a high degree of consistency and substantial margin of safety.

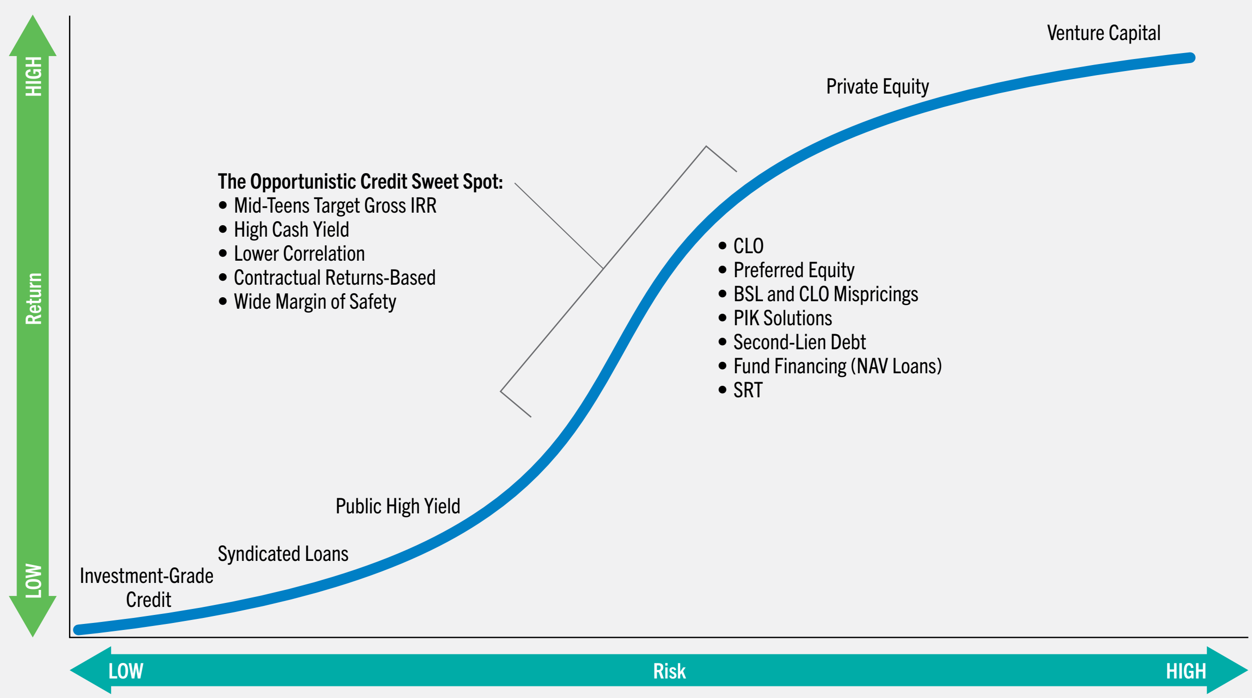
Due to the varied mix of underlying strategies—from traditional senior-only direct lending to preferred and CLO equity—the investment characteristics tend to be diversified across an array of deal types (with low correlation between them). And given the counter-cyclical returns of some opportunistic investments, these exposures will include elements that may help diversify a client's other private market exposures.

Taken together, these factors make opportunistic credit, as we define it, a completion strategy for a client's comprehensive private market allocation. It helps fill the exposure gaps lying between traditional and less flexible PE on one hand and direct lending on the other. In this light, it could be construed as a natural adjunct to an investor's PE allocation, delivering PE-like returns but with credit-like downside protection.

Exhibit 6

Completing the Private Market Allocation

Opportunistic credit returns deliver a mix of contractual-based yield with equity upside



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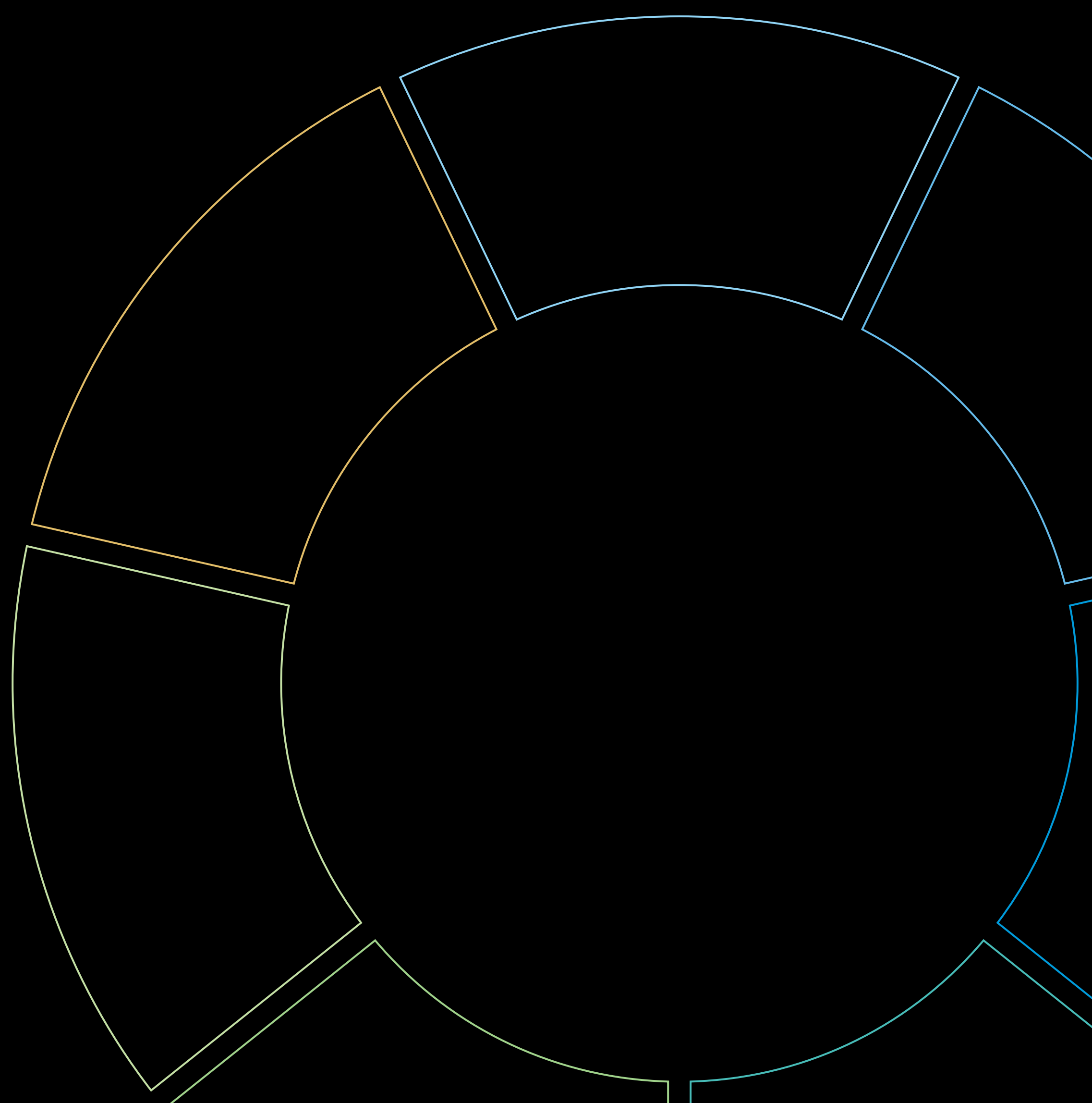

The opportunistic fund category lacks definition and breeds confusion; we try to provide clarity by taking a credit-first view: Opportunistic credit sits at the center of a distinct universe of credit participants facing constantly shifting liquidity requirements and demand for debt capital. The breadth of this approach and its hybrid risk and return profile (with elements of both debt and equity) may help diversify and complete a comprehensive private market allocation.

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