NASHVILLE NOTES

Illiquidity as an asset class

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I think it was May 2007. I had made a presentation about the market to KeyCorp management when the then-CFO, Jeff Weeden, looked at the National City tower in downtown Cleveland and said, "marked-to-model now, mark-to-market eventually." He was referring to bubbling issues surrounding mortgage assets that would broaden to involve most risk assets a year later.

The financial crisis of 2008 entailed multiple subplots, but at its core it was about rapid credit growth centered in residential finance, with too much debt financing that morphed into a liquidity crisis and forced asset sales to unwind leverage. The saga playing out over private business development company (BDC) funds managed by Blue Owl Capital Inc. rhymes a bit with what began to transpire in 2007.

I do not think the Blue Owl situation is a canary in the coal mine that signifies something worse to come in of itself, though a daisy chain of blow-ups in the leverage credit markets — London-based Market Financial Solutions Ltd. is the latest — could precipitate a withdraw of capital that roils markets.

Private credit has experienced rapid growth for over a decade and rapid credit growth often leads to problems, but the issue at Blue Owl reflects investors who want liquidity now when the underlying assets are illiquid and the funds that own the assets are not publicly traded.

> ***Investors accept illiquidity in private business development companies to obtain higher returns. It turns out that some have had regrets.***

Illiquid assets held by a fund whose limited partner interests are not publicly traded is a feature, not a bug. Investing in illiquid assets has grown so much in the past several decades for a variety of structural reasons that illiquidity itself can be considered an asset class. Investors accept illiquidity to obtain higher returns.

It turns out that some of the investors in private BDCs managed by Blue Owl had regrets about their decision, which probably were magnified when privately held Blue Owl Capital Corporation II (BOCC II) entered into a since-terminated agreement to merge with publicly traded Blue Owl Capital Corp. last November. The exchange ratio was to be based upon each entity's net asset value (NAV), but the publicly traded BDC traded at a roughly 20% discount to NAV.

If BOCC II's shares were marked at a similar discount to NAV, then the exchange ratio would have been OK, but that was not the case. The shares apparently were marked at NAV, and the fund would redeem up to 5% of assets each quarter at NAV. I suspect the board had a lively discussion of the

exchange ratio issue before approving the agreement, and the shareholders would have too prior to voting, had the agreement not been terminated a couple of weeks later.

That said, there are two issues to consider: widespread mismarking of private assets, both credit and equity; and potentially a lot of bad private credit that eventually may result in high losses for limited partners and general partners alike.

Suspicion among investors that there has been a lot of bad lending resulted in publicly traded BDCs beginning to trade notably below NAV last fall after the blow ups at First Brands Group LLC and Tricolor Holdings LLC were digested. Likewise, private credit managers have seen their shares under pressure as investors assess the potential for investment write-downs and lower asset management fees.

> ***Eventually the market will prevail, whether it remains "depressed" versus current marks or rebounds toward net asset value marks.***

As Jeff Weeden said, eventually the market will prevail, whether it remains "depressed" versus current marks or rebounds toward NAV marks. Private credit investments either will pay off at par (usually via a refinancing or recapitalization of the private equity-backed company) or the loan will be restructured or default, resulting in less than par being realized.

The same is true for private equity. Eventually, equity investments have to be sold from finite-life funds, though the rise of general partner-led continuation funds for both private equity and private credit extend the holding period runway for general and limited partners who elect to roll over into the continuation vehicle.

And for Blue Owl private credit investors, liquidity is available, but at a price after considering liquidity that will be generated from $1.4 billion of loan sales. Saba Capital and Cox Capital, who specialize in illiquid funds, are offering liquidity to BOCC II investors at a discount to NAV at 20% to 35%.

We will never know how much of the discount reflects a haircut for mismarked loans (Blue Owl would argue none, especially after the loan portfolio sale transacted close to par) versus the inherent illiquidity of the equity interests to be tendered.

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