Exchanges at Goldman Sachs

The Boom in Private Credit

Lotfi Karoui, Chief Credit Strategist and Head of the Credit Research Group, Goldman Sachs Research

James Reynolds, Global Co-Head, Private Credit, Goldman Sachs Asset Management

Allison Nathan, Host, Goldman Sachs Research

Recorded: June 21th, 2022

Allison Nathan: A boom in private credit is spreading quickly across the globe among a broader base of investors. But after its breakneck growth in recent years, is a correction in private credit on the horizon?

Lotfi Karoui: If you take one immediate headwind, which is the prospect of larger and more front-loaded hikes, we do see more vulnerabilities, potentially, on the private side relatively to the public side.

Allison Nathan: I'm Allison Nathan and this is Exchanges at Goldman Sachs.

[MUSIC INTRO]

Allison Nathan: To help us understand the evolution and the outlook for the world of private credit and more, I'm sitting down with James Reynolds, global co-head of private credit within Goldman Sachs Asset Management, and Lotfi Karoui, chief credit strategist and head of the credit research group in Goldman Sachs Research. James, Lotfi, welcome to the program.

Lotfi Karoui: Thank you for having us.

Allison Nathan: James, let's start by just talking about what we mean by private credit and this term we keep hearing about related to it, which is direct lending.

James Reynolds: Well, let's start with direct lending, which is basically the fact that you originate a loan or an investment, a debt investment, without the need for an intermediary. I would say if you go back 20 - 30 years ago, typically when a corporate borrower wanted to raise financing, it would go to their banks. And then the banks at that time would club a number of banks together and then offer the financing. This eventually rolled towards underwriting and syndicating to the markets.

And what direct lending has done in the last 10 to 15 years is really putting the borrower directly in discussion with the eventual holder of the debts. Right? And so, it's this ability to originate directly, to negotiate the terms of that financing directly with the borrower. The terms. The documentation. And the way that basically the debt is going to function for the duration, which is typically seven or eight years. So, it's that ability to directly lend without an intermediary to a borrower.

Allison Nathan: Why would a company choose to go that route rather than go to a bank?

James Reynolds: There are multiple benefits to this. First of all, the banks are not the eventual holders of the debts. They need themselves to syndicate it in the markets. And so, there's a big question mark around what would be the state of the market at the time of syndication? And it typically happens two to three months after the banks have unwritten the financing.

And so, for the borrower, whilst they have their financing unwritten by the banks, they don't know the price of the debt. That's a big risk that they're taking, in particular

when there is volatility and the markets can be shaky, the price of your debt might be a lot higher than what you had expected. So, that's point number one. If you're dealing directly with the eventual holder of the debts, then you can negotiate with the price of that debt is going to be. There is no uncertainty particularly linked to the market volatility.

Second is when you're dealing directly with the eventual holder of that debt, your financing can be very bespoke. It's very flexible in nature. It can really suit the needs of the borrower when it comes to its cashflows, when it comes to its effects. A lot of these companies may need an acquisition facility to grow, something that you can negotiate up front. There is no rating required.

If you go to the markets, the management teams will have to go and seek a rating with the rating agencies. Here, there's no rating required. And so, the management team can spend their time elsewhere. The process is very confidential. It can be also very conducive to speedy execution and very nimble.

And then what I would say is for a borrower, for its management team, for its owner, knowing and trusting

who owns your debt is very important. And we've really experienced this in particular during the midst of the lockdown and during COVID where we had to sit down with some management teams to figure out a way to give them a bit of breathing room given what was going on with the global lockdown. And something that would be very difficult to achieve if you had hundreds of lenders that you meet maybe once a year.

Allison Nathan: And so, have you seen that borrower base change then over time?

James Reynolds: Absolutely. So, the borrowers are larger. They're very high quality. We've seen unitranche or privately placed financing up to 3 - 4 billion dollars. And that's becoming, you know, a recurring theme, both in the US, but also now increasingly in Europe. And so, we've seen companies that would have no problem raising debt in the public markets, deciding and choosing on purpose a direct lending solution for all the benefits that I mentioned earlier.

This is further accelerating, by the way, at times of dislocation when the main competitor, the banks, are also

retrenching. And really, we saw that, I would say, at the GFC time 15 years ago when the banks started retrenching back in '08/'09/'10. It really opened the gates for direct lenders to go and step into the shoes of the banks. And we're seeing it a little bit right now with the volatility that is hitting the markets.

And there has been a fundamental change, by the way. If you look at 20 years ago, the banks were very much on a take and hold basis. And then they started moving from take and hold to underwriting and placing the debt with market participants. And as the syndication becomes more tricky at volatile times, then suddenly it leaves the way for others like direct lenders to step in.

And so, now you've got the confluence of both sides. On the LP sides, i.e., the investors. On the borrowers' side. And things are accelerating, actually, to the point where you can say that private credit has become a very large asset class today. And to some extent it's become a lender of first choice as opposed to a lender of at least resort. That's been one of the most meaningful changes that, certainly, I've witnessed in the last 15 years.

Allison Nathan: And you've also seen the type of investor then evolving, correct? So, this used to be just the realm of sophisticated institutional investors. But you've now seen other types of investors getting involved.

James Reynolds: Absolutely. I think private credit has been demystified. And again, if you look at one or two decades ago, very few players, typically sophisticated LPs, pension funds, sovereign wealth funds. Insurance companies started getting into private credit. By the way, some of these LPs are also direct, setting up their own direct teams.

And I would say with now 10 to 15 years of track records of the asset class, having gone through, in particular, some of the cycles that we've seen, including COVID recently, and the outperformance and the lower volatility of these asset classes, somewhat the superior returns given the origination that is attached to direct lending, you're now seeing different types of vehicles targeting retail investments around the world to get them access to private credit. And that is fueling the growth of this particular asset class. Which, in turn, is allowing those investing platforms to go and target even larger companies,

potentially. And truly compete with the banks.

Allison Nathan: So, Lotfi, let me bring you into the conversation. Given all this growth, you know, how do we size the market for private credit right now? And how does that compare in size to the public credit markets?

Lotfi Karoui: So, in terms of size, we're talking about 1.2 trillion dollars globally. So, that includes a variety of segments. Direct lending is about 40 percent of it. And then you have other segments like infrastructure, distressed, special situations, et cetera.

Now, 1.2 trillion, essentially, makes private credit a scalable and investable asset class that is comparable in size to other well-established markets like the high yield bond market, for example, which is worth around 1.6 trillion. Or the broadly syndicated leverage loan market, which is also worth around 1.4 trillion dollars.

So, over the years, there's no question that asset allocators, particularly on the fixed income side, now have come to the conclusion that private debt is a slice that they need to have in their portfolios.

Allison Nathan: And from an investor perspective, what does private credit in your portfolio do to it? Why do investors want to own it, Lotfi?

Lotfi Karoui: Yeah. I mean, the popular narrative has been investors go to private debt markets because they're looking for some kind of a yield pick up. We've always had a more nuanced view. I think the yield pickup is something that you can perfectly achieve by deploying leverage, for example, in some macro products and credit like CDX high yield, for example.

What you can do, however, by deploying leverage into macro indices is get the risk adjusted returns that private credit gives you. And I think that's really the value proposition of the asset class for multi asset investors.

If you look at the risk adjusted performance of direct lending, for example, and compare that to high yield bonds and broadly syndicated leveraged loans, what you see is that direct lending outperformed, pretty much, since 2010. And so, the ability to generate higher sharp ratios is, in my view, the number one appeal for multi asset investors.

Now, of course, that ability to generate higher risk adjusted returns has a price. And that price is illiquidity. Unlike public bonds or broadly syndicated leveraged loans, private debt is illiquid, almost by design. But as James alluded to earlier, that illiquidity is hardly an issue given the investor base in private debt markets. In fact, when you look at the ownership structure of private debt markets, what you see is two thirds of it is dominated by investors that are traditionally net liquidity providers as opposed to net liquidity consumers. And so, that includes insurance companies, pension plans, sovereign wealth funds, foundations, family offices.

For this type of investors, liquidity is not really a need. If anything, like said, they tend to be liquidity providers on the public side. And so, it's well suited for an investor base that doesn't need liquidity on a daily basis. And if it has the ability to provide superior sharp ratios relative to high yield bonds or broadly syndicated leveraged loans.

Allison Nathan: But we're now entering this somewhat treacherous macro environment. We have rising rates. Very high inflation. The Fed is tightening sharply. There is a lot

of concern about recession risk. So, how would you expect private credit to behave in this type of macro environment?

Lotfi Karoui: So, there's the investors' view and then there's the borrowers' view. On the investor side, I think the biggest challenge right now is that public portfolios will have experienced such a sharp decline year to date that it's going to be a little bit difficult to allocate more into illiquid private markets.

What I mean here is that if you simply took a traditional 60/40 portfolio: 60 percent equities, 40 percent bonds, that portfolio is actually off to its worst start since the mid '70s, which is the inception of the Bloomberg Ag Index. And so, you can instead look at a global portfolio in terms of two slices. One is very liquid, tilted to the public side. And the other one is illiquid, tilted to the private side. Right now, the public slice of that portfolio looks a lot cheaper relative to the private one.

And so, two things could happen. One, a little bit of caps down on the private side in terms of valuation. Or two, a little bit of a slow down in terms of inflows until, basically, the two sort of reconnect.

Structurally, however, I do think we've got the case, it's still very strong, partly because that ability to generate better charts relative to public markets is still there. It hasn't gone away.

From the perspective of the borrower, you're ability right. I think we're entering a period that is unprecedented, at least by the standards of the great moderation, i.e., the last three decades. But if you take one immediate headwind, which is the prospect of larger and more front-loaded hikes, we do see more vulnerabilities, potentially, on the private side relatively to the public side, particularly if you look at the high-yield bond market.

The reason is directly lenders lend in floating rate terms. And so, if you think about it, what's going to happen over the next two to three quarters is an immediate shift in the cost of funding for these borrowers, and not all of them will have the ability to withstand that.

On the public side, if you look at the bond market, however, well, number one, bonds are fixed rate. And then number two, there's the average maturity has extended

quite, quite materially over the last two to three years. And so, there's definitely some differential between the two markets in terms of the ability to withstand an aggressive hiking cycle with larger and more front-loaded hikes.

Beyond that, I do think that there are a number of offsets on the private side that are important to keep in mind. But obviously, oftentimes private equity sponsors are solo lenders. And so, they do have the ability to provide more liquidity at times of financial distress for the borrowers. We saw that playing out very vividly during the COVID shock. But in the two to three months that followed the COVID crisis, actually, high-yield bonds issued by sponsored companies sharply outperformed their peers issued by non-sponsored companies. Which is the exact opposite of what happened during the global financial crisis. And the reason for that is the market's perception that the ability to have access to a funding backstop provided by a private equity firm was views as an asset as opposed to a liability. And so, that does provide and offset to the prospect of higher rates here.

Allison Nathan: James, from your seat, what are you seeing in terms of how rising costs are affecting

underwriting standards, investment opportunities, and the broad investment landscape?

James Reynolds: It's a difficult question to answer because it's not that one size fits all, right? And that's where, really, credit selection applies. Finding those borrowers who can support slowing growth, who can support rising rates. One of the fundamental questions that we ask ourselves as we [UNINTEL] assets is really around the pricing power of these assets and their ability to pass it through to their customers. Linked to this is also their cash flow generation power given rising rates. We've pivoted towards those sectors and those companies that have those attributes.

And so, if you look at the sectors in which we tend to gravitate, a lot of healthcare. A lot of the healthcare services. A lot of software. In Europe, in particular, we have a lot of exposure to ERP software companies that would sell their products to SMEs with really a deep moat around their business model, very low churn, and an ability to pass through pricing, but also to grow volumes through, maybe, new product launches. We like investing in essential services, business services. And we have quite a

few of these companies in our portfolio globally that have the ability, frankly, to grow with their customers. But also pass through any inflationary pressure they're seeing.

We tend to shy away from companies that are exposed to commodity prices. And that would be probably more on the manufacturing side. We don't have a lot of exposure to these sectors. And no question that we'll start seeing also rising defaults here from borrowers that are enabled to grow out of their capital structure, bearing in mind in particular the rising rates. And I think you're going to start seeing really differentiated performance as we go through a more challenging cycle.

Allison Nathan: So, what are you seeing in terms of investment opportunities?

James Reynolds: We're seeing a lot of investment opportunities. And I think there are several reasons for that. Number one is if you look at the dry powered in private equity, it's about three times what it was about 15 years ago. And so, there's a lot of money here waiting to be invested by private equity firms. And they, themselves, are buying larger companies. So, that's one factor that is

underlying some of the tailwinds around private credit.

Number two is we're seeing the banks retrench in these environments of high volatility. And why is that? Because they're less confident about their ability to go and syndicate in the markets given the volatility and given the fact that the market participants are also taking a very conservative view in this environment. And that's on a senior side, also on the junior side.

And on the structured credit side, I think we're also starting to see companies who've raised capital in the past, financing in the past, and are in the need of kind of restricting their balance sheets. And here, an ability for us to step in and provide a solution to give, maybe, those companies a bit more breathing room, maybe longer maturities so that they can go through this current cycle. And so, whether it's on the senior or on the junior side, or on the more optimistic side, private credit, at a whole, I think, is seeing, probably, an increased level of opportunity. And it is certainly validated by our credit plan.

Allison Nathan: All right. Lotfi, you just recently published a piece of research talking about the pace of

fund raising in the sector and the outlook. So, what are you expecting to see from here?

Lotfi Karoui: Continued maturation of the asset class, I would say. So, first of all, keep in mind that of the 1.2 trillion of AUM, there's a little less than third that is just dry powder, so, capital available for future investment. In the near term, I do think that public markets have reset from a valuation standpoint to levels that are starting to look attractive, particularly from a high-yield standpoint. If I take the high-yield bond market as an example, the average yield was around 3.75 percent in June of 2021. Today, it's at 8.5 percent. And so, there are some competing alternatives out there on the public side that will likely slow things down a little bit in the near term.

But structurally, in the medium to long term, the case is quite strong, in my view, on the investor side. I think you'll see continued growth of the asset class. And more importantly, more breadth too and more depth instead of financing. One of the fascinating developments to the last couple of months has been these large LBO transactions that have been entirely funded on the private side. That's a paradigm sift. We're used to thinking of private markets as

sort of niche markets for small issuers. But I think private markets have also demonstrated their ability to commit and allow investors to deploy capital in these multi billion type of transactions.

And so, definitely more depth, which is good, I think, for the reputation of the market. And I think it will continue to stimulate demand over time.

Allison Nathan: Another differentiating factor that hasn't come up in our conversation yet is just the fact that private lending is relatively lightly regulated, relative to public markets. So, are there protections in place to protect borrowers and investors in this space? Or is there risk there?

Lotfi Karoui: Actually, the protections are stronger, if anything, then public markets. Whether it's governance structures, due diligence, the standards are typically higher on the private side than they are on the public side. So, that shouldn't be a concern in my view.

The concern that you hear all the time is a sort of parallel between private debt markets and shadow banking or

shadow lending. We disagree with that characterization. One, if you about the two primary ingredients that led to the global financial crisis, leverage and then mismatches in balance sheets to the mismatches between assets and liabilities, those are not here today.

Direct lending involves very little leverage. There is a little bit of leverage, but nothing that comes remotely close to the levels that we had in pre-global financial crisis. The way a direct lending fund works is quite straightforward. Capital is locked in for a period of time. And it's basically lent to borrowers over the same period. And so, there's little mismatch between the assets and the liabilities. That mismatch was one of the primary drivers of the large deleveraging shock that followed the global financial crisis.

And so, we disagree with the view that from a systemic risk standpoint, private debt markets and direct lending in particular would exacerbate the severity of any macro shock.

Allison Nathan: Let me just ask because, I mean, we always look at past crises and the cause of a past crises just never seems to be the cause of the next crises. And

there does seem to be some concern. So, is there any pocket of concern at this point? Where are these concerns about systemic risk coming from? And is there any pocket of the market that does concern you?

James Reynolds: I think there are a couple things in my mind. One is, will this asset class produce the same returns in this cycle as it has in previous cycles? So, that's one concern. And again, I don't think this is a systemic risk concern.

I think as private credit is being increasingly sold to retail investors, there's no doubt there is going to be more disclosure required, more transparency around the portfolio construction, around how much due diligence is coming into these investments, around kind of the GP, their teams and so on. No doubt there's going to be more disclosure here. And hence, the regulatory is probably going to take a closer look at direct lending.

Lotfi Karoui: The other concern that you hear all the time is that large losses on direct lending portfolios would eventually lead to a contraction of credit available to borrowers. And then you enter some kind of a vicious circle

where credit contracts and then the pressure on growth gets exacerbated.

I think there are two big offsets to that, in my view. One, you have to put the numbers in context a little bit. But direct lending, if you count dry powder, is worth probably around half a trillion dollars. That is still very small relative to the broader credit complex. I mean, keep in mind that the investment grade bond market, for example, is worth around 6.5 trillion. The high-yield bond market is worth another trillion and a half. 1.6 trillion almost. And then the broadly syndicated leverage loan market is worth 1.4 trillion. And so, in the grand scheme of things, the size of direct lending is still reasonably small, even if you have large losses in the system.

Two, the risk of leveraged losses, which is eventually what fuels a systemic crisis, and that was the key ingredient in 2008. It's not so much the size of subprime mortgages, it's really the leverage that was deployed behind them. Leverage is very low this time around. It's nothing remotely close to the 15, 20, or sometimes 30X leveraged structures that we had back in 2006 and 2007.

But as far as the narrative goes, it's usually the risk of large losses in direct lending portfolios leading to a contraction of credit. And therefore, exacerbating the severity of an economic downturn.

James Reynolds: And I would say, maybe to add to this, look, if you look at the asset allocators: large pension funds, retirement plans, insurance companies, if they were not themselves diversified and heavily exposed to, let's say a particular asset class, maybe direct lending or particular GP, then subsequently at their level and for their member's level, this could pose a risk.

I think when we go through their asset allocation, it's surprising that, actually, for some of them, this is the first time they allocated to private credit. Right? So, we're still at the early phase of the growth, I think, of this asset class. It's really taken off 15 years ago, as we've said. But that would be another reason that, maybe, the regulator may have some concerns. It's how diversified are those pension funds across asset class, public and privates, and asset class equity, infrastructure, real estate, credit, and so on.

But certainly, when we speak to CIOs, we're not concerned

about how diversified or not diversified they are. They're very diversified. Even if private credit is typically a very small fraction of their own portfolios.

Allison Nathan: Okay, great. Lotfi, James, this has been a really interesting conversation. Thanks so much for joining us.

Lotfi Karoui: Thank you.

James Reynolds: Thank you.

Allison Nathan: Thanks for joining us this Wednesday, June 21st, 2022, for another episode of Exchanges at Goldman Sachs. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to like, share, and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

This transcript should not be copied, distributed, published, or reproduced, in whole or in part, or disclosed by any recipient to any other person. The information contained in this transcript does not constitute a recommendation from any Goldman Sachs entity to the recipient. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this transcript and any liability therefor (including in respect of direct, indirect, or consequential loss or damage) are expressly disclaimed. The views expressed in this transcript are not necessarily those of Goldman Sachs, and Goldman Sachs is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this transcript. In addition, the receipt of this transcript by any recipient is not to be taken as constituting the giving of investment advice by Goldman Sachs to that recipient, nor to constitute such person a client of any Goldman Sachs entity. This transcript is provided in conjunction with the associated video/audio content for convenience. The content of this transcript may differ from the associated video/audio, please consult the original content as the definitive source. Goldman Sachs is not responsible for any errors in the transcript.