THE PRIVATE CREDIT PLAYBOOK

William Kelly 00:00

Good morning, everybody. I just got the kind shout out. I'm Bill Kelly, the CEO of the CAIA Association. Certainly appreciate the partnership with the Milken Institute. Just to quickly set the table, we're going to talk about the private credit playbook, and to call this an asset class, I think you do at your own peril. It's about $2 trillion today, up 10 times from where it was at the GFC. And depending on who you talk to, probably approaching three to four trillion by 2030 so we're going to solve for all of that in the next 42 minutes and 31 seconds. But I'm going to start with some quick intros. Carmen, I'm going to start with you.

Carmen Alonso 00:32

Thank you, Will. I'm Carmen Alonso. I'm the CEO for Europe and Middle East for Patria Investments.

Mathew Douglass 00:38

Matt Douglass, CEO of PGIM, Private Capital, for 110 billion asset manager within PGIM, the asset management business of Prudential Financial in the US.

William Kelly 00:49

Thanks, Steve.

Stephen J. Ketchum 00:51

Before I introduce myself, is it too late to make this a Bitcoin panel? I think that's the only thing hotter— — than private credit. I think we just went above 100,000. I'm Steve Ketchum. I'm the Founder and CEO of Sound Point Capital, a $50 billion credit manager.

William Kelly 01:05

Thanks. Drew.

Drew McKnight 01:06

Drew McKnight, Co-CEO of Fortress Investment Group, $50 billion credit and real estate asset manager.

William Kelly 01:14

So Drew, I'm gonna stick with you for the moment, and you think about private credit, as I said, it's not an asset class anymore. And maybe start with some definitions, and maybe backcoming out of the GFC, this was sort of a sponsor based lending space, but it's gotten a lot more complicated. So maybe talk about how you're defining private credit.

Drew McKnight 01:31

Sure. And I think that definition is evolving and growing in real time. And I think as people try to define it, it gets harder and harder to define as we think about private credit, and we don't really delineate private or public. Public's a little more traded, but credit is credit. And so from our perspective, we look at everything from sponsored finance, non-sponsored finance, asset-based finance, we do litigation finance, intellectual property finance, so we really do all types of credit broadly, and that's part of what when I think people talk about the growth of credit, and when private credit started to emerge as a separate asset class post global financial crisis, one of the terms that folks talked about a lot was the shadow banking system. And I think one of the growth engines that we've seen even in the past, call it 12 or 18 months post Silicon Valley Bank, Signature Bank, First Republic is private credit expand even more broadly because of what it really is, is just providing credit in a world where traditionally, maybe banks and commercial banks and investment banks had been providing credit.

William Kelly 02:39

And maybe when it was winding up, it was direct lending, but if you think about private credit circuit 2030, what's going to be the dominant piece of it?

Drew McKnight 02:48

Again, I think all parts of that, I think the most, the largest part that's growing right now is really more in the asset-based finance space, consumer finance, and we're seeing that from an opportunity set right now— that's actually a bigger portion of our private credit book than traditional LBO and non-sponsor financing.

William Kelly 03:09

And we're going to come back to that again in some of the opportunities. But Matt, maybe on a similar theme, setting the table in terms of fund size. And I think these are pitchbook numbers that I saw, but back in the 2010s, half of the funds out there were less than a billion dollars, 80 percent of them are over a billion. A third of them are over 5 billion today, so the bigger players, maybe PGIM, are showing up in a very, very big way. Do you see the big getting bigger, and is it going to be—is that part of the future?

Mathew Douglass 03:36

Yeah, no. I mean, and it ties a little bit into Drew's question, a little bit. I mean, I think that there's obviously a couple massive trends. I'm sorry about this [moves microphone], is this coming through okay? Yeah, there's a couple massive trends that we all know about, both just, you know, banks jettisoning assets and being filled by the institutional world in terms of taking that stuff down. And then also the marriage of private equity and insurance and asset managers insurance. And, you know, I think, I think going back to the question about how— you know what is direct or what private credit, and how do you define it? I mean, to me, that's like saying, what's the food industry? There's so many massive pockets, and I think the size of the funds are really dictating— it's dictated by what element of private credit you're in as a hugely segmented market. But like large investment grade, for example, opportunities in ABF, those are going to be huge funds and tons of assets pooling there, but there's plenty of niches, esoteric credit, middle market stuff that happens that only so much capital can flow there, because the issuers can't issue enough of it. So I think you're going to continue to see just a mix of how those macro flows are going back and forth between those elements in the financial system. I think it'll splinter more and I think you'll see more focus on smaller funds, on more specific strategies, specific areas of the market that makes them relevant. And I think you're going to see large asset managers continue to get large as certain pools of capital that need billions, trillions to support it evolve over the coming years.

Stephen J. Ketchum 05:09

And I would just add one thing, and I completely agree with what Matt said. I do think, you know, from our standpoint, the element of showing a little bit of restraint in terms of size— because the algorithm of you know, if you have more opportunities than capital, there's a more higher likelihood that you generate alpha— I think the other phenomenon that we're seeing, I think all of us are seeing in the private credit space— is that a lot of our bigger investors, insurance companies and big sovereign wealth funds want to have the opportunity to do some co-invests. So you know, if you identify a deal that's 500 million and you put 100 million into your $2 billion fund, at least a lot of our investors like to see the opportunity to be able to invest directly into that loan.

William Kelly 05:56

And we're going to come back to some of these other trends we've seen certainly in the news this week, some big managers doing acquisitions, and then as the distribution play, some private market names that are not so well known in the retail space are marrying up around distribution too, but we can come back to that. So Carmen, another trend that I think we're starting to see more diversification is— it's been mostly a North American story in terms of fundraising and also investing. You spend a lot of time in the LATAM market. The world is bigger, it's coming from Boston you think the world begins and ends at the at the two oceans, but not so true. So maybe some of your thoughts about emerging markets, and what are you seeing outside in North America?

Carmen Alonso 06:35

Sure, and I think we are talking about the scope for growth in private credit. And you guys have talked about ends of the market, the large cap, the mid-market, different types of financings. But I think it's also important to focus on the different regions and some of these specific regional markets. So just to put the market into context, specifically in Latin America, the size of the overall credit market solutions is around 2 trillion, which is pretty much the size of the private credit market that we are talking about here in this panel. Half of it is with banks on the balance sheet, by those guys focused very much on plain vanilla type of financings, and importantly, on the blue chip, the bond market is around a billion, and that's corporate high yield and local currency. And the private credit market in LATAM based on [inaudible] numbers, is around 15 billion only. So that's kind of— could be the size of one of the large cap funds that we are talking about. And when you look at how that is made of—is basically, very much sort of local funds in one country, local currency. There are very few regional players. So it's a market that is not very well served. There's a market that is growing in terms of demand for these type of products, particularly when it comes to the more tailored solutions for mid-market companies. So it's clearly an opportunity where it's a good area to hunt. The returns, you know— it's the structures— because these companies have—are operating and this market is operating in a more volatile market, we are going to talk a lot later about interest rates, inflation, macro pressures and all of that— corporates and players are used to operate in those, sort of, volatile markets. So structures tend to be more conservative, the rate or the IRR that you tend to get there is, sort of, double digit figures. So the, sort of, risk-return proposition is quite interesting in a very underserved market. So it's a quite interesting proposition.

William Kelly 08:33

And the unique aspect—and you'd know this better than II was in Santiago and Bogota last year. And what I didn't realize they almost have an Australian super fund model, where, if I'm a retiree, instead of sticking it into a pedestrian 401K, with public market options that I don't find very attractive, you can turn it over to a super fund. So they're doing the due diligence, they're doing the buyers, so there might be a retail asset on the far end, but you really have an institutional makeup.

Carmen Alonso 08:59

Yes, we do. But that varies very much market by market. I think Chile is at the forefront of the institutional market development in Latin America. One of the interesting trends that we are seeing is the fact that the retail and the wealth management is also coming to maturity in the region. So we are seeing opportunities and distributing some of our funds to the wealth management in the region. So you not only have the institutional manager, but also coming in the region, the wealth demand for alternatives.

William Kelly 09:25

And Steve, there's a great setup from Carmen about wealth. And I think about the trends and disruptive trends. Democratization is alive and well, as it should be, to some degree, because I have my own 401K plan. As I said a moment ago, I don't like my options when the home of yield is now in the private markets. Capital formation is in private equity markets. So I think right now, as best I understand, the wealth is a small component of the private credit space, but growing very, very rapidly. So maybe some of your observations there.

Stephen J. Ketchum 09:53

Yeah, it's a great question. The I mean, look, broadly speaking, the wealth management area, retail investors, are dramatically underinvested in alternatives, including hedge funds, private credit, private equity, et cetera. And when—there have been any number of white papers done, if you look at the math over the next few years, there's aspiration. There should be trillions of dollars coming into alts, including private credit from the wealth management channel. And now it's, as you said, it's really the democratization of alts for wealth management, but from a private credit standpoint, it's a relatively straightforward asset class. You can talk to the retail investors about what the expectations are about returns. They want current returns, and they want simplicity. So private credit sets up perfectly for that channel of distribution. And maybe I alluded to this without naming any names, but there is an ETF proposed with the SCC in the US, where it's—you can trade private credit intraday, which I think—if there's an asset class that lends itself to that it's probably more that than real estate or private equity, but I think it's giving the investor the mentality that these are trading mechanisms as opposed to investment vehicles. But if I think about the interval fund, which seems to be the wrapper du jour, I think private credit lends itself to that type of wrapper more so than private equity because of the cash flow. So do you see that the interval fund—is that the killer wrap, do you think, for wrapper? Yeah, I think there are two things. You're 100% right about the interval fund. And again, it's simple. The—there's an off-ramp for the—interval funds are set up to have an off-ramp for investors to actually get out if they want to. It's not—these are not daily traded, they're daily subscription, but there is an off-ramp. I think the other format which lends itself to which is—it has a similar off-ramp construct, are BDCs. One of the nice things about BDCs are typically—the way the paradigm works is there are institutional investors that come in as anchor investors, maybe the first billion dollars of a BDC, and then after that, the retailer wealth management channel gets to come in. The nice thing about that is they are quite literally investing side-by-side with sophisticated pension funds, endowments, and family offices.

Mathew Douglass 12:22

I mean, the whole issue there was retail having to get used to liquidity, right? That's the whole trick in managing that asset class and that flow of capital is there's gating, and there's—you could say you migrate to an ETF, is that just gonna have more volatility than a typical ETF might, and so kind of figuring out how to give—strike that balance of having mechanisms to provide liquidity with also an understanding in the retail world of, hey, I am taking a little bit of illiquidity risk, and how to—

William Kelly 12:29

[Inaudible]—the gating, too—and I'll come to you in once second—the gating, too, I think is an important point. I don't know if FT is here or not, but, but I think oftentimes the popular media gets it wrong—when it funds gate, it's to protect the investors that are staying, not trying to harm the investors who didn't understand the strategy in the first place. So if somebody wants to write that down, they can. Carmen, you had a point.

Carmen Alonso 13:11

Yeah, I just wanted to add a point. And it's that all these structures that we just discussed here are very US-focused. I think the European market is completely different. You have a number of different regulators with different regulatory framework that makes it significantly more difficult to have one vehicle that suits all of them. And so the development of the of the wrappers of the vehicles is been—is taking much longer in Europe. There is a lot of discussion about the European ELTIF or the LTAF. And so it's not as obvious and not easy, and therefore it's sort of, you know, it's a little bit more complex to be able to develop the wealth channel in Europe at scale.

William Kelly 13:51

Yeah, and it's $100 billion to transfer wealth, and I'm on the tail end of the Baby Boomer generation, so it is a massive wave hitting the beach. So it's—we're gonna figure it out. I think we have to—

Carmen Alonso 14:00

Yeah, we have to. Somebody was—I was looking at a podcast by EY over the weekend, and they were sort of—the person that was interviewed was mentioning that the wealth channel is approximately 435 trillion of dollars. So if you think about, sort of, the traditional allocation of 20% to alternatives, that is massive amount of money, in which part of it will be, obviously, to private capital, to private credit.

William Kelly 14:22

Yeah. And somewhat off topic, I heard the tail end of one of Michael's discussions as we were sitting in the speaker room, talking about the demographics in Africa. They're not so great in the US, and most of the homes, most of the equity, are owned by the Baby Boomer generation. So this transfer of wealth has implications as well, but we'll park that. So Drew, maybe talking about some of the risks in this space and you talked—I think you mentioned the shadow banking a moment ago. And this maturity wall was talked about quite regularly, but now I don't hear it so much anymore. So how should we be thinking about risks, or what tops your worry list?

Drew McKnight 14:57

Sure, I think the maturity wall that we've talked about most recently is really focused on real estate and commercial real estate. And while it maybe hasn't manifested itself like folks were talking about two years ago, it hasn't gone away, it's just been extended. I would argue that the real estate reckoning is still going to come, and I think you obviously have to have a view on interest rates, but we personally think that—we don't think interest rates are going to go dramatically lower from here. And so I think that reckoning is going to come. And you're starting to see some buildings get handed back. And I think that's a healthy process. So I think that is still very much on the calm. I think risks in the broader corporate and LBO space—one of the risks is just the competitive dynamic. There is a lot of capital out there competing for deals. And so I think, from an all in return perspective, I think that is a risk. And so I think as investors, as LPs, they need to think about, what are their return expectations. That said, I do think the structures—I mean, you're lending on a first lien basis, you're at the top of the capital structure, and you are getting paid. And with base rates where they are generally, you're earning high single digits, low double digits on an unlevered basis. The other thing that I think, you know—probably the person that loves to talk most negatively about private credit is Jamie Dimon. And it used to be Bitcoin, and he stopped talking about Bitcoin negatively, and now he likes to talk about private credit. The one thing that I would say is, who would you rather invest with, you know—? Folks like this, you know, Steve's investing in every one of his funds personally. It's a closed-end fund where he's got maybe one-to-one leverage, match duration, and he's really investing alongside of that. Versus a commercial bank officer that's granting loans to folks. I personally think the credit formation within private credit is actually very responsible, and from a long-term perspective, actually provides more stability to the financial markets from an opportunity—you know, we run a lot of different opportunistic strategies and more distress strategies. It would be much better if there was more risk focused on people that didn't have assets and liabilities matched because that's where you create real opportunities. And for selling, generally within private credit, you know, I think you're going to have returns, maybe underperform or outperform in different environments, but generally, I think the credit is actually very responsibly structured and, frankly, probably taking away systemic risk.

William Kelly 15:20

Yeah, those points are well taken, I support. If I look at it from the other perspective, though, from the top of the mountain down, and look at sovereign debt. And it's interesting, being in this part of the world, there's sovereign wealth funds in the US, there's sovereign debt. And it continues to grow, no matter who you wanted to win this election, nobody had a plan to shrink that balance sheet, and we're now spending more on debt service than defense. So do you worry about the totality of debt? Well Elon—Elon and Vivek have a plan— Yeah, they're going to fix it—

Drew McKnight 18:05

To go after them. And I'm frankly, optimistic.

William Kelly 18:07

Actually, I don't know if they're the right two, but I think that plan is a pretty good one.

Stephen J. Ketchum 18:11

We know all the people who Elon's planning to get rid of, because he just—he tweets about it.

Drew McKnight 18:15

Exactly.

Mathew Douglass 18:16

And I also think, Bill, that—I mean that's always been there. It's just been a different place on bank balance sheets, and a lot of it now is going to be held by institutional investors. So—and I think, I think it's almost, it's almost better that this debt is being held in institutions, because we talk about a maturity wall, putting real estate aside, because I agree that's where it's normally talked about. The capital markets—there's so much private equity out there, there's so much—we're talking about the massive private credit market that's developing. There's so many pockets in there, it'll sort it out, and it'll come down to a company by company question, capital structure, what does a capital structure have to look like? And can you have pockets that fill it? Mezzanine capital, subordinated debt, great way to fill in a hole in the balance sheet between the equity and the senior debt, which is direct lending everyone talks about for over leveraged balance sheets, for example, maybe coming out of a period like that. So I think there's so much creativity also with investors that are suited for holding illiquid assets for a long period of time relative to banks, that I think it's—there's a better mechanism there for dealing with a maturity wall.

Stephen J. Ketchum 18:16

By name. And we're also getting paid—our investors are getting paid a much more interesting risk premium to invest in what we have. I just, I do want to pick up on something that Drew said, which I completely agree with. And there is—there's always talk about the private credit bubble, and Jamie Dimon loves to bash private credit. At the end of the day, we're just lenders, and I'm—a long, long time ago I was a banker, so I can say this, people that work for all of us are compensated, number one, they're all expected to have skin in the game, as Drew said. Number two, they're getting paid on the performance of the loans that they do. Bankers, commercial bankers, investment bankers, get paid based on fee generation. So that's a perverse incentive, right? And so—and then the second point he made, which I completely agree with, is 15 years ago, before the Great Financial Crisis, banks were levered at, you know, as much as 20 to 1, doing the same sort of loans that we're doing. The stuff we have is either unlevered or lightly levered. So systemic risk is, from my perspective, a non issue.

William Kelly 20:21

So, Carmen, and then we'll come down to—

Carmen Alonso 20:22

Yeah, and I think it's interesting, actually, we've seen that dynamic capital markets and private debt already in the last few years. During the period of 2022, 2023, the broadly syndicated loans market was very muted, and then the private credits stepped in and helped with a bunch of refinancings, and so that pushed the whole, sort of, risk of the maturity wall to the side. And then in 2024 the banks are back, refinancing, reprisings again. And interestingly enough, they are refinancing a handful, particularly in Europe, a handful of private credit banks, private credit transactions. So we see how the funds move back and forth, removing the pressure from the maturity wall. And what's been very interesting is our asset class, you know—we have been there throughout, so we have not dried up. We have not—our activity hasn't muted, we've been pretty active throughout. So I think this is an opportunity for us to step in and refinance situations when needed, and I don't think that we are about to have—face a liquidity crisis because of an maturity wall.

William Kelly 21:25

Yeah, one thought we'll go to Drew. So we're going to talk about BSL in a second, but the point Steve made—if you think about the patient capital of a private fund versus a bank who's got a maturity mismatch, and Silicon Valley Bank, there was nothing wrong with the balance sheet. They just couldn't sell them when interest rates went up 300 to 400 basis points in a matter of months and it was a hold to maturity problem. So there's—I think that mismatch for the banks is an issue.

Drew McKnight 21:52

One thing that I was going to say, that I do think worries us, and I think is probably underappreciated and maybe even being ignored by the rating agencies, is in the BSL space with liability management exercises. I think within the private credit space, when we have a document, covenants or no covenants, generally, the document is the same document, and the rules of debt or creditor enforcement are the same for sound point as they are for fortress. I think one of the things within the BSL space is these liability management exercises, where if you have more than 50% of the debt, a group of lenders can go in and do something with the sponsor, move assets, drop assets, put new money in that primes other lenders, and lenders who entered into an agreement thinking they were pari-passu all of a sudden, find out they aren't pari-passu. And I think the recoveries are going to be—or have been very, very different. And I think these transactions are only getting more aggressive. I think if you think about one of the systemic—one of the powers of the credit markets right now is the CLO engine, and I think it works really well, it allows different folks to invest in different parts of the capital structure. But CLOs have—obviously their models are driven based on returns, and they're driven by the CLOs all work the same for everyone. And the reality is recoveries are very different in these scenarios. And I think, you know, first lien CLOs don't really work if recoveries are 20 cents across a whole portfolio. And that's—I think it's a real systemic risk. And so I would like to see the rating agencies get a little more aggressive in how they rate things based on documents, because right now, they largely ignore that. And I think, I do think that's a real systemic risk, because if the CLO engine turns off, then the broadly syndicated loan market essentially shuts down.

William Kelly 23:45

So Matt, what's your view on BSL? Will the banks come back? And I see even now, big firms like Apollo are going into the BSL space. So what are the banks—

Mathew Douglass 23:53

Look, I think—and that was where you first saw a lot of this private credit trend happen, right? It was direct lending, up market, as a BSL and high-yield replacement. And now there's been so much flow into that space and direct lending supported, that I think you have a new equal—you have an equilibrium that's basically being established, I think, between the BSL, the high yield, and now the direct lending, upper market. That's kind of natural, as the private and public sides of credit kind of converge. So I think, you know—and you can see, BSL is back this year, high, yields back right? And spreads are kind of converging. So I think we're going to settle into as private credit continues to merge with public credit, you're going to see it settle out in the kind of market dynamics that have an equilibrium. But I think, to build on Drew's point, and there's lot of talk about this—and where can you go in, let's say, the direct lending market, and get—maybe not have the LME activity that leads to pretty binary kind of outcomes, which is not a credit way to think—but getting down into the middle market, even sponsorless—a lot of discussion about sponsorless financing—getting to credits that are tougher to get to, you get better protections, you get pricing premiums, and really generate a little bit more alpha in the sector. And I think there's a lot of focus there and how—and I think it will continue to be. I think it comes down to, you know, can you find that type of credit and how—because that's harder stuff to get at—where you can kind of drive for investors better terms, better pricing and that sort of thing, and have the downside protections that you're kind of expecting credit.

Stephen J. Ketchum 25:22

Yeah, it is interesting. It's a little bit perverse, right? Because, you know, we like to say size is the enemy of performance, right? So in private credit, we do think, you know, being—showing restraint around size of funds provides the opportunity to generate alpha. We're—we tend to focus on the core middle market, and we're generating spreads 150 or 200 basis points wide of the the mega direct lenders who are now competing with banks for loan deals in the broadly syndicated market because of the factors that Drew mentioned—you probably are better off being a larger CLO manager, because you end up being with the haves instead of the have-nots. And the differential, if there is an LME or some sort of impairment, the differential could be as much as 30 or 40 points in terms of recovery if you're in the priming group, as opposed to the group that gets primed, so.

William Kelly 26:20

So Carmen follow up on that. And then maybe, if, in terms of what tops your wall of worry, maybe it is the LATAM emerging markets.

Carmen Alonso 26:28

I just—I was just going to follow up on a point that Matt was discussing just now, and it's, how do you access that mid market, those credits that perhaps give you the opportunity to generate alpha and really differentiate yourself? I think you need to be local, particularly when it comes to Europe and Latin America, right? They are kind of a mosaic of different countries, of different cultures, different languages, and therefore you need to have local teams on the ground that understand the different dynamics in each country, the different sort of legal frameworks, regulatory frameworks, etc. And that gives you access to develop the relationships with the key players in the market. I think if you want to stay true to the market, fund size is important, but local approach is definitely key. In order to access and to be able to select the right credit.

Mathew Douglass 27:15

You don't want to be the dumb foreign money.

Carmen Alonso 27:18

We always said, you know, that if the transaction gets to London for a mid-market in Italy, it's probably because it's been declined by all the local players.

Mathew Douglass 27:26

Well, I think you know what's going on.

Stephen J. Ketchum 27:28

Yeah, I think—look, I've been in the credit markets for 35 years. Whenever I see an increase in PIK—and it's a three-letter word, not a four-letter word—I start to get concerned. We've never done a PIK deal. I guess it's always dangerous to never say never. But to me, that's a phenomenon that isn't great, and which is why we stay away from it. But it's so—it's a, you know, it's, it's a warning light.

Carmen Alonso 27:28

Yeah, exactly.

William Kelly 27:28

So I want to get off the wall of worry, but before we do that, I want to leave some time for opportunities. But Steve, you mentioned BDCs before, and maybe one of the challenges in the private markets is they're private, so it's hard to get data, hard get behind valuations, defaults, etc. So maybe the best proxy we have to data is the BDCs. And I think if these numbers are actually right, about 4% of the interest income was picked about 5 years ago. It's now 9%, so it's doubled. So still, 9% is still the minority. But does this—does this PIK movement concern you in a market where we have greater transparency than maybe other parts of it? Yeah, so flashing yellow. They— Yeah, fair point. So, I wanted to—we've got about 10 minutes left. I want to get off the wall of worry and maybe just start with you—

Carmen Alonso 28:38

I just want to add a comment on that. I mean, this asset class has been phenomenal, resilient over the last three, four years. We've gone through a pandemic, wars, increasing inflation and spike in interest rates, and despite the fact of all of that, the portfolios remain quite resilient, the default rates, loss rates, remain quite, sort of, flat, but PIK has increased. I mean, we—the beauty of our asset class is that we are patient capital, we talked about it, we have a bilateral relationship, and we have access of information, that information from management teams and sponsors with part we partner with that gives us the ability to adjust the structures, to give the companies, sometimes the breathing space that they need. And so PIKs have increased, not necessarily because we are structuring new transactions which are more risky with PIK, but because we've had to give that breathing space to companies. And that takes me to a point that somewhat, sort of, does worry me, or I think is worth keeping in mind, it's that a lot of the legacy transactions that we have where is structure, pre-pandemic, and perhaps the leverage levels were slightly higher than, you know, would be acceptable today, the companies may have still facing the pressure of sort of digesting this increase in interest rates, and therefore they—when they come to refinancing, will they have the ability to refinance that amount of money, the leverage might be too high, the loan-to-value might be too high. Value is a point that we have not talked to in this panel in private equity portfolios, but that's something I think we need to keep an eye on, not just the wall the refinancing wall out there, but importantly, whether the existing refinancing will be able to do so in current market conditions.

Mathew Douglass 30:26

Creditors. We're creditors.

William Kelly 30:28

All of you are in the alpha business. That's the name of the game. And when I think about inefficiencies and disruption, starts to smell like alpha. So Drew maybe the total addressable market is huge, so there's still going to be upside growth. But where are you seeing opportunities, and what makes you excited about the market we're in, and what's your hunting ground?

Drew McKnight 30:47

Yeah, I think the area I mentioned earlier that we've been most active over the past years—what we call forward flow, some folks call it asset-based finance, consumer finance—and that's been, you know—we've followed this space for a long time. We hadn't—we'd really been financing other counterparties in that space because we weren't competitive to actually acquire the loans, again, on the back of Silicon Valley Bank, Signature Bank last year, and frankly, the deposit flight we saw and the questioning of the fractional banking system in the US at a time when their duration of their of their real estate portfolios had all extended, you saw banks pull back meaningfully, starting in kind of third quarter, fourth quarter of last year. And so that's the area we've been most active, and you know, you're earning, you know, high single digits to low to mid double digits, unlevered. And it's—you can finance it, it's high cash flowing—I think one of the things when people talk about private credit and is there a bubble, it's that you think about the character of the returns. And when we say we're going to earn you 12% or 15%, that means we're actually getting cash every single year. And I think one of the problems we've had in the in institutional market is private equity, and the under performance ,and the lack of liquidity. And I think that's because the character of those returns were really backend weighted. And so from our perspective, we're really excited about asset-based finance. I think then—then when you go into more niches, I think, you know—two areas that we've got big businesses, is in the litigation finance business and in the intellectual property business, both of which are much more idiosyncratic. They're obviously not dependent on interest rates or equity markets or capital markets, and so we like that, just in the idiosyncratic and totally uncorrelated return. And it's something that we think is really differentiated. So we like that just as it informs our view around what we're seeing also within the performing credit markets.

Stephen J. Ketchum 32:42

And I think—just to add to that—I think the good news is that over the past few years, beta in private credit hasn't been awful. I mean, it has not been awful, it's been good. Obviously, we all want to work to generate alpha for our clients. And again, going back to the theme that we talked about, it's easier to generate alpha when you have a smaller fund and you're focused on smaller deals. So as I said, in our in our regular way, middle market lending business, we generate a couple 100 basis points, higher returns, but we've got—the market loves asset-based financing. We've got a specially financed fund that is more consumer-focused, which is very, very interesting. So there's—so as Drew said earlier, private credit is much more broadly defined than it might have been five or six years ago.

William Kelly 33:29

And Steve, it might have been on the prep call. I think it was you. I brought up opportunity, maybe special sits or distressed, but I think it was you that had maybe a different view on that?

Stephen J. Ketchum 33:38

Yeah. Well, I guess my point was, distress looks very different today than it did 30 years ago. 30 years ago, a typical distressed investor like Elliot would look at a capital structure, they'd say: this is a good company with a bad capital structure, we think the loan will be reinstated at par, we think the fulcrum is the senior unsecured bond, we're going to buy it at 30 cents on the dollar, exchange it for equity, and make multiples of our return. If our math is right, today the fulcrum tends to be the loan, and as as we talked about earlier, there are the haves and have-nots. And so if you are not already in the capital structure, if you don't already own the broadly syndicated loan, it's very difficult to get in the group. So the distressed business has changed dramatically, and it's more of a timing business. There were some interesting, you know, distressed bond opportunities and loan opportunities on the back of COVID. But the opportunity—it was defined by five or six weeks. If you weren't in in those five or six weeks, the opportunity went away. I don't think there's anyone in our business that has any sort of pools of distressed capital that look back and say, you know, we did enough. There's just—it's the timing, it's all about timing. And timing, in most cases, is ephemeral.

Mathew Douglass 35:02

The central banks haven't allowed it to exist. The last 15 years—capital area, flooding the markets of liquidity has eliminated that market, practically. But we find, I think, interesting areas going forward. Again, really trying to differentiate from an alpha standpoint, because it has been fantastic beta. And I think markets will dictate that that gets kind of bid down. I think, you know, mid-market—you guys got to go find things that are tougher to get, to get access, to have relationships in order to access totally great, Carmen. And there's just more durable value there for investors, but it's a little bit more of a grind-it-out model, and having to have feet on the ground and local sourcing. The other element too, and I mentioned earlier—I do think this is an interesting time for mezzanine, especially if you think senior all-in cost of financing with those rates or spreads are going to come down, because they can't stay at these levels forever, I wish they could. You know, mezzanine offers a fixed rate, it offers equity upside, it offers call protection, non-call for two years, maybe even the third or fourth year of protection. There's a way, by moving a little bit down the capital structure at a soft landing time, if you believe in the soft landing, to get that extra return and maintain those yields, even with some equity upside—you still have the second bite at the apple, protection of being in a sub debt position, still being a lender, even if you have your one-off situations that could get troubled. So we think that's a pretty interesting space to be right now.

William Kelly 36:30

Carmen, where's your optimism now?

Carmen Alonso 36:32

Very quickly, because I'm conscious of the time. For us mid-market, think it's where the opportunity is. There's still quite a lot of growth left in there. I think the market is, at the moment, is bifurcated, with the larger funds getting bigger and having to buy the market to be able to deploy capital rapidly. So I think the mid-market is somewhat less well-served. And so that's one, being regional player, as I said before, mid-market for us comes with boots on the ground and having the expertise in those local markets. And importantly, one of the things that we are doing in order to be able to attract unique opportunities, identify the good ones, is sector expertise. I think we are trying to focus on sectors that are benefiting from secular trends. And that could be whether it's healthcare, is either agribusiness, particularly in a region where we operate, which is Latin America, logistics, transportations, and last but not least, on energy transition and renewables. So trying to have those verticals, that expertise with regional boots on the grounds, put us in a very good place to be able to generate alpha.

William Kelly 37:37

Excellent, well, I'm not sure what 3 minutes and 16 seconds divided by 4 is, but quick, closing observations. Drew, I'll start with you.

Drew McKnight 37:44

Yeah, Steve touched on this. But I think, you know, I think the wealth channel within private credit is still very early. And I think, you know—I think about wealth, and you think about private, you know, private wealth. And I think, about my mom and people talk about, "is it appropriate?" And I look at—my when I first look at my mom's portfolio—and she had this 60/40 allocation, and I was like—nearly jumped out the window, because I'm like, Mom, what do you like—? The fact that someone put her into that, and she owned 40% fixed in income versus she can own either private credit or a publicly traded BDC and earn double what she was earning, or at least 150% of what she was earning on that fixed income portfolio. I do think it's still very early days. If you think 3% to 5% of high net worth is allocated to alternatives, but you then think about that versus institutions where David Swensen, you know, 30 years ago, started doing this, and you look at the performance and the out-performance. So I do think that is still very early days.

William Kelly 38:41

And hopefully you're not charging your mom 2 and 20. Steve?

Stephen J. Ketchum 38:44

Yeah, I would say, you know—the one thing that we talk about, you know, private credit is in this existential fight with the banks. I think the reality is, we're—this market is grown dramatic in the past few years. If you look at the math today, there's two and a half trillion dollars of committed but undrawn private equity powder. There's not one private equity manager who is going to give back their share of that two and a half trillion. And if you assume, let's make a conservative assumption, let's say three turns of leverage on that two- and-a-half trillion, which is quite low. So that's seven-and-a-half trillion dollars of capital that's needed in the leverage markets. The banks will get part of that—will—private credit managers will get part of that, but that's seven-and-a-half trillion dollars of new required capital in the next 5 to 10 years. So the addressable market is massive, and there's plenty of room for everybody.

William Kelly 39:41

Good point, Matt.

Mathew Douglass 39:42

I'll tie back into the first question to Drew, in terms of thinking about allocators and decision-making. People keep saying private credit. I've been in it for 30 years as well. There's lots of pockets. There's lots of differentiation. Oddly enough, even as more people come in there and the [inaudible] flying there, you know, there—it only allows for, I think, even more differentiation. And so really getting in and understanding, you know, there's gonna be lots of room to play for all sorts of managers, and understanding, you know, your needs and how a given asset manager can, kind of, accommodate them and has a specialization. I think it's going to be incumbent on allocators to have to really dig into that more to understand those elements of differentiation.

William Kelly 39:47

Thanks, Matt. Carmen, final word.

Carmen Alonso 40:31

It's hard to say anything else that my colleagues have just said in the last couple of minutes, but I think, you know, it's an asset class that has proven itself. It's growing. The opportunity is fantastic, its resilient, but there are still many pockets, to [Matt's] point, where we can still create a lot of value, differentiate ourselves, and contribute to the diversification and the growth of the of the portfolios of our investors. So it's here to stay. Looking forward to it.

William Kelly 41:00

Excellent. Excellent discussion. Please join me in thanking the panel.

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