GLOBAL CREDIT MARKETS: NAVIGATING RISK, INNOVATION, AND CAPITAL FLOW SHIFTS

Announcer 00:00

Please welcome the panel on "Global Credit Markets: Navigating Risk, Innovation, and Capital Flow Shifts," moderated by Sharon Chen, senior credit analyst, Bloomberg Intelligence.

Sharon Chen 00:26

Hi. Good afternoon everyone, and welcome to our panel discussion on global credit markets. A big thank you to the Milken Institute for inviting me back to moderate today's session, and also for getting together such an excellent panel of speakers. Let me start by quickly introducing them. Next to me, we have Matthew Boulanger, managing director and head of Europe at HPS Investment. Next, we have Avery Colcord, managing director AB CarVal Investors, and then Matt Michelini, partner head of Asia-Pacific at Apollo, and Tripp Smith, head of GA Credit, managing director, General Atlantic. Thanks for joining us now. Just to quickly set the scene, I think credit markets have stayed relatively resilient this year, and private credit continues to expand, even as the global economy faces some uncertainties from trade tensions. In September, we saw the Fed cut rates for the first time in the year, and it continues to face a balancing act between supporting growth and keeping inflation in check. In April, credit spreads spiked, but as of today, US corporate spreads at their tightest levels since the 1990s. So, with that backdrop, I'd like to kick off today's discussion by hearing your thoughts on the macro condition and also the outlook for spreads. So, Tripp, would you like to kick us off?

Tripp Smith 01:58

Sure. So being a credit guy, we always think the world's ending—so that's just part of being credit. I saw that next door there's like a crypto thing going on, which is much more interesting than credit. One of my LPS had asked me if I'd buy bitcoin from him, like, 20 months ago. He's an aggregator, he put on the platform. And I said—you know, are your other credit people buying Bitcoin? And they said yes. And I said, you should fire them, because credit people can't buy bitcoin. Now, you guys are—some of you are millennials, and you probably buy bitcoin. You can lend against it. You know, I think—and obviously the market—there's a lot of excess in the market now, spreads at all time heights, the high yield and leverage loan markets at all time heights and private credit is at all time heights. I think a lot of what's going on in private credit right now is kind of technical in nature, having to do with a lot of money coming into the market—and I think the advent of insurance money and to more of an extent, the retail money into the high yield mark to the private credit market has been the biggest event that's happened to that market in the last five years. That money, which is very valuable to the manager, from a stock performance perspective, needs to be deployed right away. A lot of the times you get that money in, it's not the best time to deploy, and it causes excess in the market. So I think we're kind of dealing with that for the first time, and you're seeing it in the market and the pricing and the deal flow.

Sharon Chen 03:33

Okay, sure, thanks for that. Matthieu, maybe you want to chime in and, you know, give us some sense on some what are the catalysts that we could see that could move spreads [inaudible].

Matthieu Boulanger 03:43

Sure, and maybe before I do that—I mean, I think from my perspective, and I agree with what Tripp just said—I think the two points I'd make in addition to this is—I think, right now, it's all about credit quality, right? So I think that the spread compression, we've seen it for the last few years. There's technicals, there's we are aware of it. I think you see that across every single asset class in credit, in direct lending or private credit, corporate, non-investment grade, you tend to see that as well. I think that when people start chasing the extra—the top of the capital structure, when people start chasing the extra 50 basis points, I think it comes with a lot of deterioration in credit when you do that. So, really, for us and others, I think the focus is making sure we find good businesses invest in them, take the spread compression. You see that kind of pretty much across everything you do. I think the second topic is—spread is one thing, but I think what investors are looking for, really, is for us to continue to generate that premium compared to the public market. So really trying to keep your eyes on that at all times. So for us, when we look at the kind of large gap, upper- mid-market, what we call core senior lending, trying to stay at account. It's been compressed, but it's like 200 basis points, 225, roughly, basis points, count premium. You move down to specialty direct lending, you add another account, 200 basis points, and then in junior capital trying to stay, you know, 4 to 6 percent wider than in terms of—premium compared to the high yield market. So I think really looking at spreads, but also like that kind of liquidity premium, I think is important so credit quality and the premium.

Sharon Chen 05:17

Matt, coming to you here, here in Asia, again, I cover Asian credits on the public side, and again, all time tight spreads, right? So what's the outlook for Asian credit, and how would you position your portfolio?

Matthew Michelini 05:31

Sure, I agree with some of the things that Tripp said in terms of all the liquidity that's come into the market for credit. And it's interesting, when you look at most of flows, it's equities being sold to invest in credit. With rates being up, retirees want to lock in the yield—and so that has a demand for credit—and you know—so we ask ourselves all the time, what's going to reverse the trend? What's going to lead to spread widening? We do prepare for the worst. We're probably a little more optimistic the but what has to happen is liquidity flows have to change—and you think about all the money that's been printed, even since covid, and all the fiscal all the fiscal deficits that continue to run, and all the spending that governments are doing—all this money has to go somewhere. By and large, the US equity markets took it first—then it was the US credit markets. And so what reverses that flow? A couple of things that are large enough to do that—China reopening. You could see maybe a government, US government debt crisis. You could see a repricing of artificial intelligence (AI) risk in the equity markets. And you know, one of the things that I think what is interesting is, I think what you'll see over the next five to 10 years—and that's a long time away, is you are going to see a rotation from financial assets to hard assets. We talk a lot about, you know, the last capex spending spree from 2010 to 20 was a lot of sub investment grade companies, and that was measured in the trillions. But the now you have investment grade companies, they're going to need to spend tens and tens of trillions of dollars, infrastructure, digital infrastructure, green transition, defense, supply chain redo. And so you will see, you will see rotation from financial assets to hard assets, which should actually help spreads normalize—not go back to normal, but normalize a little bit. So for us, we're looking across the world at where liquidity flows can change, and what might catalyze that.

Sharon Chen 07:22

Avery, anything to add on your side?

Avery Colcord 07:24

Yeah. I mean, I think I'd echo everything, everything said. I would just add—I think, on the private credit side, which is where we're most active, a couple other factors I think are impacting the sort of, the amount of flow, amount of cash chasing deals is—you know, lately there's a lot more leverage offered to people in our industry. So people are employing more fund level leverage, more deal level leverage. And then I'd say the nature of private credit, which is mostly direct lending, or asset based finance—which I hope we'll talk about, it's you. You're you tend to, you believe you have a lot of diversification in your assets. And we believe we do, because we have, you know, hundreds or 1000s of loans to middle market companies, or, in the case of asset based finance, very diversified loan portfolios. And I think the managers have to be especially vigilant about that, because it gives you a sense of confidence in their diversification. But I think more inexperienced managers are going to fall into traps where by there's a lot of correlation among the assets, and I think some people could really get burnt with a false sense of diversification.

Tripp Smith 08:44

De-worse-ification.

Avery Colcord 08:47

Well said.

Sharon Chen 08:48

So it sounds like some structural things at play around liquidity, but also some caution is needed, right? So, I mean, you've talked a lot about private credit, and obviously there's a lot of interest in that. Let's start with Asia. So Matt, I know that Asia is still a heavily banked market, which is slightly different from our western counterparts. How do you see private credit developing here?

Matthew Michelini 09:16

Good question. So I'd say, on the demand side—there's actually a ton of demand for private capital building up in this region. You know—I am biased because I sit in Asia, so I'm going to acknowledge that bias. But if you think about historically, globalization and money flows—money flowing very quickly has resulted in zero diversification between Asia and the US. And you actually have, with increased regionalization, and now two big economic pulls, one centered around the US, one centered around China, what you're going to have is you're going to have real regionalization trends and macroeconomics. You see today, in the US there's inflation, China's exporting deflation again, and so you're going to have materially different cycles. And what you're going to see is around that region, or that big pull—there was a stat released the other day that regional trade will end up being 70 percent of all trade coming out of Asia, whereas 10 years ago, it was 20 percent. And as all of those is all that business footprint and those trade flows are changing. Private capital is actually helping to provide the catalyst to do that, or they get the capital to do that. Banks are still going to play a great role and so like—what we see on the banking side is that—banks are getting—banks are getting over concentrated, but there's not like one thing they're over concentrated in. They're either over concentrated by a risk type, a product type, a client type, a duration type, and so private capital is going to continue—like so I think more and more gaps will open up for what the banks aren't willing to step in and do. That doesn't mean debanking—that just means that more demand for capital, more demand for different types of capital. Banks have run into different concentration limits, and private capital will step in to really fill that void. I think one of the big ones we're seeing now is really on duration, and that's mostly an investment grade, but also a little bit in subinvestment grade, as well.

Avery Colcord 11:16

If I could step in. I think you're right, Matt. I think it's been a little bit frustrating to be an Asia private credit person, because I think our US and Europe colleagues have seen a lot more bank retrenchment happening much faster and really creating a lot of private credit opportunities. But, in Asia, even more markets where that are so heavily banked, I think we are seeing new platforms arise to fill certain needs. In some respects, FinTech was a little bit of a setback in the in the region, but I think there are now more, better, regulated platforms coming up with more serving borrower needs, much better than the banks can. So it's been a little bit nichey so far, but it does feel like it's growing.

Sharon Chen 12:05

And Avery, what is the key opportunity that you're seeing in Asian private credit?

Avery Colcord 12:11

I'd say it would be financing these new platforms, new nonbank lending platforms, that are stepping into the spaces that the banks are finding too costly to do. So this could be things like sort of middle market construction lending. Now it's probably not going to be our fund doing the actual lending, but we'll work with the platforms to essentially come into forward flow arrangements, or financing arrangements with them. Whereby we would be essentially supporting these platforms grow their businesses, of stepping into niches where the banks are retreating.

Matthew Michelini 12:50

I would just add, I mean—what we find—I totally agree with that. And a lot of this is local, which makes it a little harder to source it, but you figure it out. For us, look, sponsor lending is certainly growing. It's a cyclical market, but it's growing. We do find a lot of demand for capex capital, especially cross-border. There's a lot of catalyst driven demand out of China—or, I'm sorry, out of Japan and Korea, given the corporate governance reforms, there's a lot of demand for consolidation capital coming out of Southeast Asia. In Australia, it's mostly asset-backed—all sorts of asset-backed consumer, asset-backed commercial asset backed. In India, it's a little bit given that the banks are flooded with liquidity right now. For India, it is more of a hybrid or senior equity risk profile that is interesting for us.

Sharon Chen 13:39

Tripp, coming over to you, then—what's the one opportunity that you're excited about in private credit?

Tripp Smith 13:48

Our fund. By far. You know, I've been doing this a long time, and I've really seen a pretty big change in the market over the last five years—and you know, the market's really bifurcated in private credit. When we first started doing—I think we did the first fund in private credit—certainly the first private BDC—and what we did then is everything that didn't kind of fit into the high yield market. And the high yield market was driven by retail inflows in and out, and it would shut down four months a year, and it'd be roaring for eight months a year and—because the money would pour in or pour out. And you know, whether it was size complexity, the market was shut down. You know, that's when we did private credit. And as we've rolled forward in the market, particularly with the advent of these retail strategies, all this money coming in, you know, a big part of the private credit market has turned into what I call, you know, the commodity private credit market. And that market is a capital markets driven market. It's an asset deployment market. It's, you know, it's what people need, it's what people want, but it's just a very different market that went old school private credit had been. And what we try to do is focus on things that don't kind of fit into the commodity private debt market and the high yield market, which is taking market share for each other. So it's anything complex, hard, smaller, because it can't deploy as much nonsponsored deals. And, you know, we're finding incredible value in doing that and generating good results, and in generating very good DPI—which I didn't know is very important, but I guess it is then, you know, other parts of the market—but it's a lot harder, so kind of getting paid for performance—but as opposed to kind of the deployment model. So which is good—I'm not going against it, but that's kind of what we've chosen to do. And it's, again, it's been, it's done well. I talked my own book there (sporadic laughter). I've never been able to figure age out. God bless you guys. Every time I've gone to a new firm, they've always said, "You guys should start credit in Asia. It's huge." And I'm like, well, the laws aren't great, and I just want to get my money back and the banks are aggressive. So I do think long term, Asia's just got to, you know, figure it out, and will be a great market. It's just—it's been hard to date. And, you know, these guys are trying to figure it out which is great—we can piggyback off and copy them for the next step.

Sharon Chen 16:19

And also, I mean, I've generalized it right by asking these gentlemen the question about Asia in general. There are so many different markets. Every market is different, so...

Tripp Smith 16:29

They're all hard.

Sharon Chen 16:32

Matthieu, last but not least, what? What are you finding attractive of the in the market?

Matthieu Boulanger 16:39

Yeah [inaudible]. I think some of the themes that all three as mentioned, we see as well. But like, I would say, in Europe, we continue to see, like, the big trend of banks kind of retreating—that's, you know, been going on for a while, but we tend to be slow in Europe. So you start to see that kind of accelerate in earnest—which is nice so, both in account—I would say, the plain vanilla direct lending. But, as Tripp said, also all the kind of specialty direct lending and junior capital, more opportunistic capital—we're pretty busy, and we continue to see a lot of tailwinds, frankly, globally—but in Europe specifically. And when I joined these guys, as well, as I think that the big themes right now in Europe, where we see a lot of opportunities tend to be asset-based finance and kind of private IG, private investment grade—where there's big market opportunity—and again, there's a lag with the US, but these are very active markets, and there's a lot to do there.

Sharon Chen 17:30

It's interesting that a couple of you have mentioned private IG, right? And that used to be my bread and butter when I was in MetLife. Why do these, you know, investment grade companies need to come to the private market and pay the premium?

Multiple Speakers 17:46

Maybe I'll start. Oh, well, I don't know what the [inaudible]

Matthew Michelini 17:50

This is why we're so optimistic. We're just, we're just little bit—

Tripp Smith 17:54

IG shop player. We're not taking any credit risk. We're just an IG shop. So companies, well, there's two there's two factors. So you have two big factors. One is around asset backed and you know, in the banks, as our CEO likes to say, Dodd-Frank, worked like the banks are de risked. All the risky stuff has been put off their books. All the non risky stuff has been taken off their books, except for a handful of asset classes, and that origination now sits within private markets, and the private markets are capitalizing a 40 trillion plus market that most of which is asset backed. In Europe, there's at least a trend for by governments and regulators to accept the need for asset backed capital to finance all the things that Europe has to finance over the next five years, five to 10 years— this is because the banks are full up. The governments are running fiscal deficits,—and they're going to need private capital to actually come in and provide some of that capital. On the pure corporate side, it really is what we talk about, this "Global Industrial Renaissance"—and they need large they need large scale, tailored capital to match the underlying project cash flows, or M&A cash flows of a business plan that they're that they are undertaking. And if you think about how you normally capitalize that—you normally capitalize that with equity, or you capitalize with that with debt—but because the cash flows aren't coming in until the project actually comes about or the acquisition has been integrated. You'd rather just match the cash flows and not have it, not have it ding your debt capacity, and not have to explain a complicated story to the equity markets—Because in both those markets, as we like to say, like those markets, have mostly become flow driven, not like a bunch of analysts that used to work in the 1980s and 90s, really digging apart a company and providing the bulk of that capital. So when there's any level of story or complexity or size or matching cash flows better, or tailoring the cash flow to a business plan that isn't just short duration and cheap—10 year and bullet maturity or equity—private capital is stepping in in a major way. And when you think about the big, major industrial trends around again, AI, infrastructure, defense—that's mostly investment grade, companies are going to do those projects.

Sharon Chen 20:12

Okay, thanks. We've talked a lot about the different opportunities, but one thing we haven't touched upon is AI—and there's been so much excitement. And, you know, the equity markets keep hitting record levels because of this whole AI excitement, and we're seeing massive investments in digital infrastructure. Matthieu, I understand HPS has a portfolio here. How are you capitalizing on this opportunity?

Matthieu Boulanger 20:39

Yeah, sure. I mean, to your point. I mean, the numbers are staggering, right? So whether it's public capital or private capital, we think, you know, the private credit has an important role to play here. So we have been active in that space. I think that when you look at digital infrastructure, everybody thinks you're in data centers—I mean, that's one of them. There's more to it. I mean, one interesting statistics I was reading the other day is like—you look at the digital account economy, in general, you look at warehouses, distribution centers in the US, I think the average age for these warehouses and distribution center is like 43 years old, and 80 percent of them are not automated at all. Right, so when you look at this, and you're a digital player today, you look at that whether you're building a distribution center or data center—you want something that's come built on spec for you lik. So yes, we're very active kind of financing data centers, etc, but we're also reactive in a little more niche strategies, like things like triple net lease right, where you work with a counterparty to go and customize a facility for their purposes, etc. So I think there's a lot of different ways to play that. But yes, it's a huge space, and one where I said, like, you're gonna need a lot of capital—so private credit is a place to play.

Sharon Chen 21:49

Avery, I think we discussed a bit about data centers in the prep call. So do you want to chime in here?

Avery Colcord 21:55

Yeah, I mean, I agree with Matthieu. It's enormous, and there are a lot of different ways to play on the data center specifically, I think the types of projects that we are likely to want to finance—it sort of calls for a different sort of capital than we're normally managing. Our normal investor base would be people who are looking for sort of medium term, relatively high returns. And I think for the for the data center we're going to we're going to we're really going to have to look toward more sort of special managed accounts, largely, funded by insurance capital.

Sharon Chen 22:30

Coming back to you, Matt, and think Tripp might have brought in Evergreen funds earlier. So that's another key theme, at least, you know, in terms of the press reports, we see it a lot, and I know that Apollo has launched a few Evergreen funds to tap retail money. How quickly do you think the source of fund can scale? And also, how does the fund structure mitigate some of the duration mismatches, like some concerns there that we've heard about?

Matthew Michelini 22:59

Right. Look, the source of funds is is scaling, and it's going to continue to scale pretty significantly. I mean, one of the major trends driving all of our businesses is the opening up of privates—private assets for individual savers. And, you know, one of the reasons why this has become available to individual savers is because private assets are not just risky assets anymore, private equity, venture capital, hedge fund. You know, the first one that was a little bit more institutionalized was real estate. Now it's private credit, as the headlines define it, which is effectively sponsored lending, or corporate, leveraged corporate lending. And increasingly you're starting to see investment grade private credit made it more available to the individual saver. So these funds and strategies are absolutely going to continue to scale. You know, to your question on how do you manage the liability mismatch? Look, there's no—Ithere's going to be some headlines about this, no doubt. And, in fact, we actually lived through this in the 80s and 90s, where a lot of these private funds, the way people ended up getting liquidity was you ended up having to list the vehicle, and it traded massively below nav. You're going to see some of that, and you're going to see some bad underwriting. And there's going to be some talk about, oh, there's a liquidity mismatch, but it was actually just bad underwriting. In general, we've seen the path paved a little bit with the real estate funds, because I would argue that the real estate funds are less liquid than leverage lending and the gates actually worked. If you were a responsible manager, and the underwriting actually worked, and the underwriting was solid, the gates worked. People are making money, and flows are coming back into those vehicles in private credit—I think you'll end up seeing the same thing, like you'll end up seeing a couple of big, couple of managers who end up having to put up the gates for whatever reason, underwriting reasons, market reasons, performance reasons, and the gates should work, or the gates will work from an ALM perspective, you know. But then you go back, go into the investment grade market, which is a totally different market because the leverage lending market, there isn't really a ton of liquidity in those loans. I mean, you could move them, but you're going to take a pretty large hit, or it's going to take some period of time. In private investment grade, the markets are being made because it's mostly a ratings driven market. You know, we started by launching a market making business, Goldman then followed, JPMorgan then followed, other banks will follow, and so you'll see the private investment grade market, given its size and and it's driven by ratings, be much more liquid, and that's what's allowing private investment grade to be put into ETFs in the US, which can be made daily liquid even on the private assets.

Matthieu Boulanger 25:33

I wanted to add something maybe to what Matt just said. Like, you know, if you think about it, these products are too Matt's point like—I think they're great products for private individuals, right? So kind of private credit product is very suitable from that perspective. I think that, if you think about it's a yield product, right? So why do people allocate to that? It's basically to get yield, but they're going to stay invested in it because of performance. So when you go back to, like, the one degree, kind of deeper, like I think what needs to happen is, when people entrust you with your with their capital, you need to have a GP that's got a big origination platform because what you want is manage your inflows make sure you stay true to your mandate. Your mandate is to invest in private credit. Often it's going to be at the top of the capital structure, senior, secure direct lending, to play it safe. And when you start to see people taking too much money too quickly, you start to have the risk of seeing that kind of mandate drift right over time and people taking more risk. So you've seen people invest in junior capital, or people put too much money in, like liquid credits. So I think it's a combination of having a big mousetrap on the origination side, make sure you see as many deals you can. Try to stay disciplined on the investment process that you've put in place, and also be somewhat disciplined on your inflows, right? Like you need to be transparent to your end user, which is kind of like a private savers that, okay, sometimes I need to reduce my inflows if the market is having a hiccup, or if the opportunity is not the right one, and trying to really manage that all the time. It's a lot of work, but I think it needs to come and be done.

Tripp Smith 27:09

The private credit for retail individuals, is going to grow dramatically. And I really admire what some of these firms have done in their fundraising apparatus, in the private markets. You know, there's funds raising a billion dollars a month from retail—full fees with leverage. It's incredible what they've been able to do. The issue with the product right now is when you get the money in, you have to invest it right away to maintain your dividend. And usually when you get the most money is when the market's the frothiest. And if you look at it right now, there's a ton of money coming in. We're at all time heights, and there's not a lot of deals going on, because the public to private, the PE to PE business is dead—because there's no realization. So we're caught in this trap right now that we as an industry have to figure out—because if you have a gun to your head to invest and the market's not there, you're going to do bad things. You're not you don't have the same incentives as your LP. So that's something I think we're going to have to all try to figure out—what's the best way of tapping that retail market. Because right now, you know, it doesn't feel great all the time based how it's currently structured.

Sharon Chen 28:20

So Tripp. Actually, this is a good segue into my next topic, which is, you know, given the fund flows that we're seeing into private in private credit—the amount of interest new fund launches from an investment behavior perspective—and I think Matthieu, you touched on it as well. Are you seeing more aggressive competition? How are, you know, liquidity premium holding up—any risk taking behavior?

Tripp Smith 28:46

Yeah, yeah. You know, I kind of laugh when people have this obsession with spreads, you know, like, oh my god, the high—you know, the private credit markets reprice from 500 over to 425—you know, like, who cares? I mean, it doesn't matter. It's not gonna change anyone's life. What happens, though, is the compromises on structure and credit will kill you, and that's the big problem. And if you can't get your money back—it's all about getting your money back. And you do some software deal at 12 times because someone paid 17, and you get a 10 Cent recovery—you can't make that up in credit because you there's not enough upside in these deals. Private equity, you can argue there is, right. You can have a five times deal, and that makes up for a lot of sins. And private credit, if we get one and a half times, we're like, you know, that's great, great performance. So that's kind of what worries me there. It's not as much to spread stuff, but you know, this forced deployment and having to compromise on credit quality and structure.

Sharon Chen 29:40

Is that what you're seeing in the market right now? Like, have you had to pass more deals?

Tripp Smith 29:43

Yeah, there's, there's more of that. I have a friend that's in one of these funds, and he said—you know, these lawyers, you know, these lawyers cost a lot of money, right? It's incredible what they charge. And he said—We should just get, you know, the documents aren't worth anything. We should just have the LBO from just sign an IOU and a napkin, because. It's the same thing. And that's kind of what, somewhat, what goes on right now. So you'd save, like, a half a million bucks in legal fees. So, you know, that's it's something we really do need to focus on as an industry. And I think we will. There's a lot of really smart people out there, and there's been a lot of money raised, and so we'll have to play that out and see, you know, kind of where it ends up.

Avery Colcord 30:20

I mean, I would echo Tripp's cautionary comments, because I think you know—part of the reason why credit, private credit, has grown so fast is because borrowers have become more sophisticated about shopping for their different options. And some of those borrowers are good borrowers who are going to repay, but you know, there is bound to be, you know, borrowers whose business plans didn't work out and they were just really aggressive, and the competition among the private credit funds to deploy is is intense, so there's going to be mistakes made.

Matthew Michelini 30:58

I would add one thing—

Tripp Smith 30:59

Seeing you and I'm glad I'm in investment grade.

Matthew Michelini 31:03

I know. Thank God, I don't have these challenges (all laughing). I was just gonna play devil's advocate, because I agree with everything that's said, and I think most everybody in the room does. The offset that we grapple with, especially when we talk to investors that come into these semi-liquid vehicles, is like—okay, where's that money coming from? They're selling 30 times PES and P to derisk and try and get a 10 percent yield—and okay, the downside is assuming that you've picked the beta—a manager that will deliver you beta of that market. Okay, what do you think default rates go to? Let's just say 10 percent in private credit? Fifteen percent, 50 percent recovery. Okay, that's half a year to a full year of coupon. Then you get your money back in the in the vehicle, and compare that to buying like, 10 stocks at 30 times PE, where, like, you don't really know the return on any of the capital that they're spending. Now, if this was coming from their bank account, from a portfolio allocation perspective, you'd be having a much different conversation about risking up and whether now is the time to risk up into private credit. So I do think that there's— from an individual retail investor, that is one big offset. The second offset, which I think you're seeing more of these types of models, which is the manager incentives for these semi-liquid vehicles are terrible. I mean, it is. They're great fees. You have gates. You can unilaterally change the gates. You've seen that happen, and you get paid on PIK.

Tripp Smith 32:28

And get to mark your own portfolio.

Matthew Michelini 32:30

You mark your own portfolio, you get paid on PIK. It's like, it's a home run for the GP, like for us, like we would love that, but our model is we actually buy every single thing on our own balance sheet that goes into these funds. So which is why we need the cash yield. We need the downside protection. It's backing insurance like ultimately backing an obligation that we've made to policy holders and a promise that we've made to regulators, and stress tests we show regulators and public. So I think you're going to see more. I think you're going to see GPS being forced to put up a little bit more capital to be able to preserve what many of them have today that don't have that same alignment.

Sharon Chen 33:05

I mean, you brought up PIK and default risk, and I really don't want to harp on risk, but we are a credit panel, so we have to touch on that. Maybe, Matthieu, do you want to kick us off on where you see default rates going? Where do you see the most risk?

Matthieu Boulanger 33:24

Yeah, I mean, like, I don't know a crystal ball. I think, like my view, and our view in general is, like, I'm not sure default rates are good, necessarily a good indicator anymore, and the reason for that—you've seen a lot of liability management exercises over the last few years—so you feel like these default rates are probably artificially low. I do believe that a better indicator is going to be over time people look at recovery rates, right, and that joins everything, as we said today, frankly. Well, so this is like the quantitative side of things, where investors are going to look at default rates in your portfolio and how many covenant breaches you have, or many good PIKs, bad PIKs you have, and all that stuff. But there's also recovery, right? And the ability, I think there's not that many people who take action early when there's issues in their portfolio, and you see that over long, long periods of time, like, you know, if people have been doing it for a long period of time, they've taken action early and the recovery rates are high—people are going to recognize and reward that, hopefully. And that's definitely our, our belief. I think that the debate around like PIK, like, good PIK, bad PIK, is kind of obvious. We've seen that for way too long, frankly, from where we sit, where people have been PIKing coupon in the middle of the transaction right after a couple of years, because the company is not performing telling their LPs, everything's marked at par, and don't worry about it—Nothing to see. I think that again, when, when the tide goes down, like we'll see who's left, and hopefully people will reward that. So difficult to predict, but I'm not sure it's necessarily a good indicator. I would probably focus on recoveries

Tripp Smith 34:55

If you know, the industry PIKs everything instead of, you know, seizing everything, because they don't have covenants. So, you know, there's no defaults, really—unless it's really, really bad. And you can kind of look at the amount of PIK in these, BDC, for instance, and that's a good indication of how bad the portfolio is. And I think you're going to see some really bad recoveries. The other thing the industry's done is we've gone all in on asset like businesses, and that became very in vogue. You know, I'm sure you guys have all heard, you know, it's all software and healthcare services, because they're high free cash flow. They're growing at 20 percent but you know, again, our market as a credit investor is to get our money back. And if you do make a mistake, if you do it with old economy company that has assets, you generally get a much better recovery than some of these newer economy, non asset businesses, which I think we're going to see some very, very bad recoveries, because those industries can change so rapidly. What AI is going to do to software? I don't know, but it's going to change it. And it's somewhat of a binary risk for a credit investor, where you know, again, your upsides capped and your downsides pretty bad. So it'll be interesting to see how all that plays out as well. But I couldn't agree more with what you said the default. People that obsess on default, it's, there's, it's not a great indicator what's going to happen. And PIKing generally doesn't work out well for the LP—either the sponsor ignores it and collects management fees, or they have to go for it to get back in the money. Neither of those are really good outcomes for a creditor versus trying to get at the asset right away, but it's difficult.

Matthew Michelini 36:39

The interesting thing about PIK, real quick, just to add on to that, is when it's really a vintage issue. It's the 2020 and 2021 funds that have like, 20 percent plus PIK, because at that point in time, you didn't have the rate increase and you didn't have inflation. So they underwrote a totally different environment for these businesses and totally different cash flow coverage for these businesses. And so we'll actually know, in some senses, the answer on this, on PIK in the next two to two years, because a lot of that stuff's coming up for refinancing, and we'll see if they can refinance. So it's it. There is overexposure in the older vintages versus some of the newer vintages that underwrote higher inflation and higher rates

Tripp Smith 37:19

And phony, but we could talk about phony, but that's a good one.

Sharon Chen 37:23

It sounds like all the headlines around PIK might be more concentrated in certain types of funds.

Matthew Michelini 37:28

There's a lot of concentration in some of the older ones. Yeah.

Sharon Chen 37:31

And going back to your point about default rates not being a very good indicator anymore, recovery rates is much further along, right? Like it's kind of the end game in the credit world. How do we monitor, you know, the state of the market prior to that?

Matthieu Boulanger 37:49

Yeah, I mean, look, it's that's why I think when—I mean—all of us, I think around the table should have been doing this for a long time. So I think people can look at these long periods of time, right? So whether it's in the past life, or whether it's in your current kind of firm, I think we have kind of long track records and long portfolios. I mean, on our side, we've been at it for 17 years, right? So you people can look back 17 years and look at the recoveries, frankly, across cycles and a few cycles. And I think that, you know, that's why I said, like, you know, you can't really just look at the headlines anymore. You need to kind of go during the diligence phase, kind of one layer deeper on, almost like a line by line, and try to understand what happened and what's going on with that credit. So I think it's just—I think having been in this market for a long time is is an advantage to all of us here. And yeah, I think, I think that that need to be recognized over time. But to your point, it's not easy and it's not straightforward, right? It's not a short analysis,

Sharon Chen 38:44

Yeah, because, I mean, I spoke to someone, they were like, it makes sense that spreads are so tight, default rate is near zero, right?

Matthieu Boulanger 38:51

That's the issue.

Sharon Chen 38:53

Avery. do you want to chime in on what you think you know could be like in terms of APAC anyway—where the list the risks lie within this region?

Avery Colcord 39:05

Well, I guess I think I talk a little bit more toward the asset based finance world. There's been a big focus for us, and I think we spend a lot of time looking at the consumer. So aside from the corporate cycles, which I agree with everything you guys have said. I think on the consumer cycle, there's also, you know, lots of, lots of signs to beware. If certain segments where you see increasing debt at the consumer levels—you have in the US—you have, you know, lower income, wage growth has been very slow. And you know, inflation is always sort of a threat that could occur and perhaps reverse the interest rate cycle. So, you know, all of those could lead to lots more defaults, higher default rates in. The underlying portfolios for asset based finance. So something you've got to be very careful of.

Tripp Smith 40:06

You look at Tricolor and First Brands. I mean, those are late stage bad situations. And I was talking to someone yesterday, and they're like, you know, it just feels familiar. You know, you get the late stage kind of dicey recoveries and situations that go fast, really badly, which has happened before. And then the largest LBO of all time gets announced right afterwards, which is like United Airlines. So it's interesting times. We'll see how it plays out.

Sharon Chen 40:36

So I noticed we have less than five minutes, and I realize we're the last panel before cocktails, I believe. So this question, I guess, if we can limit it to about 30 seconds per person, and coming, coming back to AI, we talked about, you know, investing in opportunity earlier, but now in terms of, you know, how it could shift credit investing, and in terms of your credit processes as well. Can you talk us through how you're incorporating AI? Tripp, do you want to start?

Tripp Smith 41:11

Well, AI is obviously from a process standpoint and diligence, it's a great tool. I'm fortunate enough to be part of General Atlantic, which obviously has a great perspective on AI, and there's actually a voting member on the Growth Capitals Investment Committee—which is some person that's an AI person. We haven't cut and got to that in credit, but it's something we're going to look at. I think there's parts our business is more episodic and more hands on. But I think there's parts of the business, like CLOs that probably would be better off in AI. And back to the AI credits—I worry a lot about the AI credits. I think, if you know, still being part of that AI culture at GA but when you look at it from a credit lens, and a lot of these data center deals—you're like, oh, you know—like there's twice as much EBITDA, there's twice much capex as EBITDA for the next five years—like, what's going to happen?

So it's going to be interesting how that plays out, right? It kind of reminds me a little of the CLEC fiber issues that we had with the internet when you look at the credits—so interesting times.

Matthew Michelini 42:17

For us, aside from all the baseline ChatGPT, productivity enhancements, etc. We're asking really two questions in credit. The first is, how do we take our junior, mid level, senior credit investors and free up their day such that they are spending 85 percent of their day asking questions and not reading things, summarizing things, but they're actually engaging with a real Q&A—like really thinking about investment, investment thesis testing. So that's kind of big challenge, one for us, big challenge. Two that we have is we have 35 years of investment history. We touch all these borrowers across all these countries, and we have all these different teams who we want to keep and retain at Apollo for 20, 30,40 years. But the reality is, how do you being in the judgment business—How do you institutionalize judgment? And so we're spending a lot of time thinking about how we better institutionalize judgment with AI and which will better empower our people to make better decisions, because they'll have the 35 years of track record, they'll have a perspective from the equity lens, the US, the credit lens, the US lens, the APAC lens, to make better decisions.

Tripp Smith 43:27

What you can do with data is amazing. It's crazy aggregating, and all that.

Avery Colcord 43:32

I mean, I would say, like, I It's hard to, you know, it's hard to underestimate the effect it's gonna have on our business. And certainly, you know, in our shop, we saw, we see, you know, lots of lots of new tools arrived, and I've never seen quite as much collaboration about brainstorming about how we use these tools. And everybody is sort of asking each other questions and saying and demonstrating new ways they're using it—that are somewhat surprising. But to Tripp's point, I would say, I also I get the sense that we're not paying a lot for these tools. So I sort of wonder, it's great, but I sort of wonder about the business models.

Matthew Michelini 44:13

You didn't pay a lot for Netflix at first either.

Avery Colcord 44:16

Fair enough. Fair enough.

Matthieu Boulanger 44:18

Firstly, I'd say maybe next time you should do the cocktail before the credit panel. I think it'd be better. In terms of what we do on our side, it's a little bit of a mix of everything you've heard, right? I mean, I think there's the operational side, or operating side where, like, you know—how the fund functions or the firm functions. I think on the investment side, it's all about kind of same thing we've had, like, you know, 17 years of data. You start kind of look at what could be done with this, and how can we learn from the past, whether it's sectors, countries, structures, etc. There's also a lot of what Matt said about freeing up people's time. When you think about legal documentation, stuff like this, synthesizing kind of info, memos, etc, there's a lot to be done there. So which, right? You can't really; it's more about, I would say, optimizing people's time.

Sharon Chen 45:03

I think what Matt said is correct. We're getting addicted to AI and then they'll start charging us more. Thank you very much for an engaging discussion. Thanks for joining us, and please join me in giving our speakers a big round of applause.

Audience 45:42

[Applause]