CREDIT OUTLOOK: PRICING RISK IN A FRAGMENTED CREDIT CYCLE

Michael Milken

Well, good morning. Our goal here in the next short period of time is to tell you everything you need to know about credit and everything you read about that's wrong about credit, with five of the leading investors in this area. So Purnima, I'm going to start with you. You're in the middle. Despite global tensions and concerns about AI and software displacement, the spreads in liquid credit have really not widened a great deal this year. Why?

Purnima Puri

So I think there's a couple things. I think one is that earnings have been strong. They've been strong in the S&P. They've been strong in corporate credit. Revenues have been up 2 to 4 percent. EBITDA has been flat to up, and so therefore you haven't seen defaults, which generally leads to a widening. So that's point one. I think two is that the spread widening has been really isolated to software. And I guess I would expand that to software, IT services, professional services, but call it 18-ish percent of the index, which has widened about 200 basis points. But the rest of the index has actually hung in there. And in fact, over the last several weeks, the market as a whole, the loan market, with and without software, is both up. So it's been an isolated spread widening versus other cycles where you had energy or TMT pull the market out for different reasons. I think three is that because base rates continue to stay higher, yields are strong and people are looking for income, and this is an income market. It's not necessarily a convexity market, but an income market for solid risk. And the fourth thing I would say is that I do believe that the technicals are very, very strong. And the reason I say that is because I think that there's not a lot of places to go now if you actually want to diversify risk away from AI. So you've got the Mag Seven, which is 40 percent of the S&P, and you've got venture, and you have PE, which is somewhat dependent on tech and the IPO market. You've got investment grade, which is going to be 12 to 15 percent issuance is going to be IG. You have high yield, which is going to have 3 percent issuance of IG. So I do think when looking for ways to diversify a portfolio broadly to other industries where you can earn 7 to 9 percent, that's a pretty strong place to be.

Michael Milken

Well, we used to talk about the fact that actuarial assumptions for pension funds were often much higher than the ability to invest. But today's market, as Purnima just pointed out, you have ability actually to invest and get higher rates of return than the pension funds were dealing with this. And so I think it's a very important point. We just need to make sure we understand the availability of rates today in credit are significant for the investor. Well, Lee, you have a lot of pressure on you today, I know, from that standpoint. And so yes, let us know how recent issues in private credit are creating attractive opportunities for you. And the reason I told you, Lee, is we prepare us and the speakers 10,000 slides for the Global Conference. And the last couple years, Lee has won the best slide award by speakers. So that's why I wanted to let him know early what the pressure is.

Lee Kruter

Well, you know, Mike, given your excitement about my slides, I did show my slides to my wife this year, but she did not show me the enthusiasm that you do. So it is a lot of pressure. But so I think maybe just going to one slide, which we like, if you go to slide 19 maybe to start. Definitely there's been something unnatural in private credit, if we can go two slides forward to slide 19. When you look back the last 10 years, the difference between a top quartile manager and a bottom quartile manager in private credit has only been about 250 basis points. So there's been no dispersion. When you look at a typical or most other typical asset classes in credit, that's normally about 500 basis points. So you knew that there is going to be, obviously, it's been a decent cycle from an economic perspective, as Purnima was talking about, in the current environment, too. So there has to be more dispersion over different periods of time. So when we think about it, obviously there's been a lot of, I'd say, negative press about private credit, and a lot of this is very dependent similarly on what the economic cycle is. If you go back one slide, a lot of the numbers were reminding me of what we talked about with real estate back in 2020, where nobody's ever going to go to the mall again. We're all stuck inside. When you look back what the loans that were in special servicing in CMBS structures were back in 2020, it was around 11 percent, which is similar to what bad PIK is in private credit today. And ultimately, what happened over the last seven years is the annualized default rate in real estate was only about 1.5 percent. So there's always, I'd say, a lot of fear when you see things. But ultimately, to your point, Mike, and I think we're getting extremely excited about the opportunity today, is when there's fear like this, there's going to be more dispersion. There's going to be a lot of opportunities, particularly for, let's say, special situation lending, whether it's on refinancings, whether it's on returning capital to sponsors. So ultimately, while there should be some level of defaults, this fear of pulling capital out of the asset class should bring us some very good opportunities here in the very short term. Today, we're actually seeing those more on the asset backside, on the structured credit side. Ultimately, though, I'd say in the last six to eight weeks, we've started to get, I'd say, I wouldn't say our phone's ringing off the hook as it relates to private credit opportunities, but we're beginning to see this wave of things on the more opportunistic side as we go into the short term.

Michael Milken

So Gilles, thank you for joining us today, and you got a big job in charge of credit at Blackstone. So let's stay with software, where we started with Purnima. Software and its impact on broader markets, do you expect this to play out over a long period of time rather than a short period of time? How do you see this playing out?

Gilles Dellaert

I think it will take some time. I think, as Lee said, you're in this moment right now where uncertainty is really high because it's really hard to figure out what this all means for individual companies and the sector writ large. And I think whenever that happens, the first move in spreads is a lot wider because people haven't quite figured it out. I think the retail mall point is a good example. I think it happened with retailers. People said retailers are going to be dead when Amazon got fully going. And some retailers died, and some, like Walmart and TJ Maxx and others, are a lot bigger today than they've ever been. And so there's always going to be winners and losers. I think in software in particular, look, AI disruption is real. It's going to kill, I think, a large number of analytical layer companies that were focused on single cells and things like that. But I think deeply embedded software that large corporations that are regulated and other things like that, that have sensitive information flowing through their systems from a workflow perspective, that is going to take a lot longer, I think, than people with the AI bull factor lens might lead you to believe. And so what is happening right now is that multiples in the equity market aren't waiting for that moment, and they're not waiting for that cycle to play out. They've obviously rerated materially from 20 times to 10 times or lower in certain scenarios. And so I think it's largely going to be an equity pain point first. It will flow through to the debt markets because I think some loans were made that will have a hard time, that will have to get restructured. Some companies will have to pivot. But some of those companies, I think, will use AI as a tool to change their business model, and they'll be able to do that. I think the larger companies with large sponsors that have the wherewithal to do that will succeed. Others will not. So I think as it always goes, there's going to be winners and losers. It's going to take a fair bit of time. I think the implementation cycle, if I were to bet on this, will be a little slower than people are believing right now. But while this is all happening, to Lee's point, I think it provides a fair bit of opportunity because it's not just happening in software. I think it's broader impact on credit writ large is starting to lead to, I think, spreads being more attractive for the first time in a long time.

Michael Milken

As the largest private equity firm, how do you integrate your credit business with your equity business?

Gilles Dellaert

So look, I think it's one of our major advantages, I think, as a credit underwriter. I think about it in three steps. One is when we underwrite a loan deal, we fully leverage the half of the firm and the intelligence we have on the equity side. Two, we have a large portfolio operations team that implements process improvement, AI development, things like that in our private equity businesses. Those people are quite relevant in terms of having first ground intel on what's happening today. And then three, when a situation goes bad and we have to take control of a company, we're exceptionally well-positioned to leverage that playbook and that expertise firm-wide and bring it into the credit side of the equation. We have a CIO office within credit that has 120 people. A big chunk of that is people that are focused on workouts and asset management, and they get to leverage the private equity side of the business as well as our portfolio ops team. So I think it gives us quite a unique scale advantage or benefit to be able to lean into that.

Michael Milken

So Victor, I always used to say it's easy to make an investment. It's harder to build a company. And you have uniquely positioned your firm, in a sense, by staffing it, et cetera, and focused here on helping the skills to improve and operationally transform companies. Tell us how that's worked out. Maybe give us even an example or two.

Victor Khosla

We find that companies which get troubled, assets which get troubled, it's not like you're just buying something as a paper investment. And you say, "Hey, I bought it cheap, I'm going to sell it higher." What we have found is, if you're going to take control of a company through a debt restructuring, good management teams leave a couple of years even before the company gets into trouble. And if you're going to go fix this and get the true upside which exists with these businesses, you go out, you strengthen the management team, you rebuild a business plan, you often invest more capital in it. Today, on average, our companies have more employees than when we kind of took over. So for us, the way we do credit, and Mike, the way we do credit is not just, "Hey, we're going to do a good buy." The way we do credit is we are going to fix it, improve it. And the upside, my gosh, private equity generally has bought good businesses. They've bought good businesses which have just gotten really levered up. But to create that good business again requires those kind of skills.

Michael Milken

So I mentioned to a few of you over the years, there was a book written, came out around the year 2000 called *Good to Great*. And a lot of the principles there are applicable. They picked 11 companies, of which three have failed. So long term, there were challenges. But what they really talked about was getting the right people in a company first in order to grow your company. And how do you get the right people, Victor, in a company?

Victor Khosla

So, an example. We took over what we think is a really good business called Hornblower. Hornblower has the Niagara Falls Ferry concession 20 years ago, Statue of Liberty, Alcatraz. And we said, these are essentially monopolistic businesses with long-term concessions. The company ran into trouble because they extended out. They wanted to try and build a business overnight cruising on the American rivers. Didn't work. Lost $400 million in it. And as a result of it, the company ended up in a restructuring. For somebody like us, first, it was to kind of jettison that huge money-losing business in a restructuring, in a bankruptcy process. But then it was really, we have a new chairperson, we have a new CEO, we have a new CFO. We've hired some really great people who are really good at government regulatory affairs, so they have the right relationships with the regulators. And this business, when we bought it, we thought it was $88 million in cash flow EBITDA. We thought we could make it $140 million business. By the way, think about that, 80 to 140. Why? I'll give you—some things are very simple. The Niagara Falls Ferry, we own the Canadian side of the concession, not the American side. American sides charge 30 bucks. Canadian side charge 20 bucks. Well, guess what? We went to the Canadian regulator, we said, "Guys, you get a piece of the upside. Let's go 30." And we went 30 in months. The cost structure itself had gotten bloated. We're working through it much harder. In Niagara Falls, if you go on the ferry now, there's a fast pass line, so you can get in front of the boat, right? But do you see what it takes to go from 80 to 140? And look, if we succeed, and we believe we are now, a year into this, we believe we are. It's extraordinary what a payday that is for somebody like us.

Michael Milken

So Victor, I have to tell you, I've taken the ferry. Okay? I've taken your ferry. It's great. It's easier to go from the Canadian side than the US side. I've taken the one around the Statue of Liberty. And I'm sad to tell you, I was an investor in the private equity firm that you bought the company from.

Victor Khosla

They're still our partners. They own 25 percent of it.

Michael Milken

So Tony, it was more than 20 years ago that I had tried to figure out who could manage our family money, and I was so impressed by the research team that you had assembled, and I felt it was at least as good or the best research team in credit, and I think I had become your largest individual client at that time, 20 some odd years ago. Today, you've been on the forefront of deploying technology and AI, in your weekly meetings and for all your analysts today. Talk a little bit about, has AI made your investment process at Eldridge and Security Benefit better? How has it affected, how have your employees adjusted to this?

Tony Minella

Thanks, Mike. So first, I think when AI came out last year, we really began implementing it. We sold a lot of software exposure. It's not because we could identify a specific risk where we exactly knew how we were going to implement that technology or the impact of it. But it was game-changing. It was clear it was game-changing. Earlier this year, in January, we really were able to get Anthropic's attention. We were able to get an enterprise version of Claude. We had a small group of users that were able to implement it. I was one of those. And then we just pushed it out to the entire organization. Right now, in our holding company and our asset management business, we have about 440 people; 397 of those people are monthly active users. Of those 397, 70 percent are daily active users. We've spent only $133,000 in compute from mid-February, when we rolled it out, to April 30. And if you go to the next slide, I think you need to lead from the front. And the mean and median dispersion here is pretty big because we've got a power user who's an analyst on our team based in Dallas that spent, in March, $4,300, in April, $3,400, building new tools to help ingest information and help us make investment decisions and process more and make better judgments, really, for our capital base. The AI lead, who leads a team of about 12 people that have a combination of technology and consulting experience. And so I think you need to have people embedded in the organization that really drive and force change throughout, is the number two guy there. And I'm below the top 25 percent. I think I'm 86th in the organization right now, and I'm trying to move that up. But $172 of spend in April. And we have a daily morning call. We have consistent investment committees. We pull it up. All our workflows are in Slack. Every time that an analyst brings up an investment or reports on an investment that comes through in Slack they have a Claude project that they attach. I can click on, or anyone in the organization can click on that Claude project. All the source material is inside of that Claude project, so I can ping it and ask it questions. This is workflow that 10 years ago we would've had over email. Now we can do it and leverage technology and make everyone's job a lot more interesting. But we're in the fortunate position. We don't have a different private equity firm and a private credit firm. We have one central intelligence research function of about 60 people, plus another 15 or so in Mumbai. So we can, one, work around the clock and two, give those people tools to really improve their lives and grow. We're not trying to reduce our costs. Clearly, it's not that expensive. It's not that expensive to implement tech. Now, Anthropic might change the pricing on us, and our team has assured me that all of the tools that we've built in Anthropic system could be easily ported over to another large language model. So it's really the intelligence that you're building at the orchestration layer that leverages a number of models that right now we've chosen to go with Claude.

Michael Milken

So Tony, compare and contrast. Today is May 5, 2026. And your weekly investment meetings, let's say they occur on Wednesdays, which would be May 6, 2026. How much different would they look today than they did one year ago?

Tony Minella

So if you go to the third slide that I had. People talk about private credit. Purmina talked about liquid credit and had a slide that showed that the bigger the business was, the more sustainable the EBITDA was and the more it was growing. We just look at income, and we look at income across a number of different ways that we can deploy it. So I think a risk-free rate in this environment is just around 5 percent, and that's AAA CLO liabilities. They've never defaulted your 60 cents on the dollar against a portfolio of senior secured credit. The problem with those bigger companies is the banks that have distributed broadly syndicated loans have distributed them with no intent to hold anything, and they compete with other banks to get fees to distribute those securities. And they use the law firms that the private equity firms that are borrowing from them ask them to use. And so there's holes in that documentation. So today, a CLO is managed with a lot more diversity than it was 20 years ago, which is the way to mitigate that risk. But when those companies get distressed, and Victor's got a tougher job right now in taking over companies, the credit documentation has holes in it. And you need to get big in that credit documentation, and so you can elevate yourself in the recovery. The recoveries are going down in broadly syndicated credit. And then that's a result of the documentation, not necessarily inherent weakness in the business. And then when you look from the AAA CLO liability, which despite that risk, I don't think you're ever going to lose money in a AAA CLO liability. We go out to asset-based credit and that pushes about 10 percent. And our strategy there is encumbering essential use equipment. That's private credit. It's hard to originate. We've done about $20 billion of it and have had about 2 percent annual defaults and 102 cent on the dollar recovery. Because the bet there, that is, even if you have a broadly syndicated loan that is financed out there in the marketplace that's trading at 50 cents and Victor gets in there and accumulates a big position in it, we own the equipment that you actually need to reorganize around. And push comes to shove in 120 days after bankruptcy, you're going to accept that lease. We've seen it time and time again. And that capital that's around that asset is going to reorganize in a way that that business continues to live and it doesn't liquidate.

Victor Khosla

And you thought I was the tough guy.

Michael Milken

Okay, so HPS today is effectively not that independent entrepreneurial company you joined a number of years ago, and you're part of one of the world's largest money managers today. How have you been able to keep your culture after the transaction?

Purnima Puri

I think that we've been able to keep our culture because of a few reasons. One is that the core leadership team is the same core leadership team that's been there since 2007, so almost 20 years ago. And we run our business in a very similar way. Now the business has grown and expanded a lot, so we've had to make changes on the margin, of course. But the processes are the same. The investment committees are broadly intact and the same. They've expanded somewhat. The research process has gotten better, I would say, actually, with BlackRock in many ways, in that we have access to a broader sourcing funnel, which is super important in the private credit world. And in some instances have access to more information that we might not have otherwise had access to. And that's been quite good. But the people that are leading these businesses and implementing our research processes are the same people that were doing it before. I think where we continue to enhance our processes are on a risk basis. There's a lot more data to look at now, a lot of more systems to integrate. That's been helpful. But broadly speaking, I would say the leadership team has been the same as it's been.

Michael Milken

All right, Lee. So your firm is specialized in identifying increased returns at lower risk than the market thought. Where are you going to take us today? Where are you thinking today are the great opportunities?

Lee Kruter

You make it sound so easy, Mike. No, if we go to, I think it's my last slide, and Steve Tananbaum, who's staring at me right now in the first row, he was complaining. I complain if we go to slide 21. Apologize. Right now, really on the asset backside, I'd say purely in, there's many different names for it. It's either risk transfer or other capital allocation strategies for banks specifically. This is probably the area as a team where we've spent the most time building, and we've been the busiest by far over the course of the last, I'd say, four to five months specifically. And both Steve and myself, I think we've both been relatively surprised, and this is not what we define. I think most people when they think about risk transfer, it's exclusively taking corporate assets off of banks and taking a first loss on those corporate assets. It's a relatively diversified pool of underlying asset types, and what we try to do is we stress these assets to think about what multiples of financial crisis-type defaults would you need to have a first dollar of loss. So on average, and what we show here on the slide, typically, it's anywhere between three to five times financial crisis type defaults where you have that first loss, getting returns in the mid-teens. So we think about our master fund today, which is our largest strategy. We've had our highest structured credit exposure as we've probably had in the last 20 years, since the financial crisis itself. And then the other area which we continue to find more things to do as we've been building out over time is typically, and we talked about this for the last several years as well. So two, wherever banks are running away from, that's usually where there's good opportunities on the lending side. So in the real estate space, particularly in new construction real estate, that's an area that we continue to find very good opportunities. It's diversified both Europe and the US across many different asset types. But normally today, banks which were historically lending to zero to 50 or zero to 70 percent loan to cost, they're capping out at that 30 to 40 percent loan to cost level. So there's ability for us on the mezzanine level to come in with great sponsorship behind you. If it's condo assets, condos that have been pre-sold virtually 100 percent at this point in time, so you're not taking much risk on that, you're just taking construction risk, and similarly able to slot in there at that sort of mid-teens type of level. I'd say our issue when you look at everything on this slide today, I define them, and in the context of the world today, they're very much high RR, low MOIC type of opportunities. So typically our average hold period in these is about a year and a half. So I always define my life, as I have the last few years, as I'm like a hamster on a hamster wheel. So the second we put these positions on, they're already repaying, or we see them repaying in a very short period of time. So as a point of reference today, and we think for at least in the next few months until we see some more of, say, stressed opportunities both on the private credit side and the liquid market side, this is by far where we're spending the most time, or at least myself, is the most time with our team specifically.

Tony Minella

How do you guys think about multiple of default? What does that mean?

Lee Kruter

So as I mentioned, what we typically go to is we think about what is the worst default under any one underlying asset class. So if you think about, obviously you mentioned CLOs, when you think about what was defaults of underlying loans during the financial crisis. So call it approximately 13 percent. To your point, obviously, that had a much higher recovery rate at that point in time. We take a much lower recovery rate today, probably agreeing in that 50 percent plus or minus sort of recovery rate. And then for something like, I think you highlighted before, something like AAA CLO. So something like AAA CLO, you need today probably around 60 percent defaults for one to two years in a row or two-plus years in a row before you have a consistent default. So that's how we look at all these different asset classes is what's been peak defaults, what's changed, and then what multiple of those peak defaults do you need to have that dollar of loss? So if you go to my first slide, slide 17, and we talk about systemic issues in the market, obviously a lot of people talk about private credit. Banks and the ABLs that banks have lent into the private credit world, obviously there's a lot of fear and worry about them. We've actually viewed them basically like AA CLOs. So when we think about the systemic risk, we just don't see it from a bank perspective on the private credit side. So similarly, when you look at for a typical private credit or BDC ABL, you would need 55 percent defaults for two years in a row in order to break that ABL that the bank has. So that's why we've just not been worried about that. So we do this similar sort of analysis when we think about how do we think about sort of each of the underlying asset classes as well too. But to your note as well, you need asset classes, and fortunately we've tried to find things where there's a long history of underwriting. That's why we're able to miss some of the—whether it's the Tricolor or the MFSs of the world, where there's new underwriters or new people in the securitization market. This is an area where you really need to trust the underwriting capacity of either the bank or others that you're working with specifically.

Michael Milken

So insurance has changed dramatically. It's been a large part of everyone's life. We have insurance companies that have been around for more than 200 years. And in the late '70s, early '80s, you had a few new entrants. First Exec was one. But the traditional insurance companies that you had seen, Prudential, Metropolitan, et cetera, had pretty much stayed as they were for 200 years. Gilles, what does the insurance business—it looks to me you can go out and buy a 30-year US government bond at 4.9 or 5 percent. And you're lucky enough, if you live in California, you can pay 52 percent of that out in tax. Or we could call you up, or we could call Tony up, and we could get an annuity that compounds tax-free for a long period of time. And so it appears today that there's almost an infinite amount of demand for annuities when people understand if you're not taxed, what happens in compounding versus if you're taxed. How do you build portfolios today to take part? How large is insurance for you at BlackRock today?

Gilles Dellaert

So insurance for us is around $285 billion.

Michael Milken

And what would it have been 10 years ago?

Gilles Dellaert

Less than 10.

Michael Milken

Okay.

Gilles Dellaert

So it's grown a lot, and I think there's a bit of a misconception in all the headlines that the same private credit noise that exists around direct lending is applicable or relevant to insurance companies. Insurance companies don't really do direct lending. Right? It's not capital efficient. The vast majority of what they do or what we do for them is investment-grade rated private debt. Why are they buying it? Two simple reasons, right? Purnima said it, liquid credit spreads in IG, high yield, EM, whatever market you want to cover, are running at all-time tights. You're not getting compensated for duration risk in the senior unsecured market. And so people have pivoted towards an adoption of more private credit strategies. Now, insurance companies have always done this. Right? They've been buyers of commercial mortgage loans for a two private placements. The finance companies that manufactured a lot of the ABS assets that have been talked about used to be owned by insurance companies, so they're familiar with it. I think that what's happened in the last few years that's accelerated the growth and the adoption is when you had newer entrants like Apollo, Athene, my old firm, Goldman Sachs, and Global Atlantic, and a number of others, and Tony and Todd at Eldridge. They showed that if you had appetite for less liquid assets and you could underwrite credit risk well, you could capture a really significant excess premium on the asset side and that would make you more competitive and capture market share on the annuity side. Ten years ago, none of these firms were in the top 10, 15 sellers of annuities. Today, every single top 10, top 15 name in the US annuity market either is one of these firms or has partnered with firms like us to get access. It's become table stakes to compete. If you don't have access to these strategies, you're not relevant. You can't capture the share of growth that you're talking about. They're generally speaking, very low-risk strategies, and I think the confluence of that thematic happening at the same time as what we've seen on the back of banks de-risking in some of these assets, and now I think the emergence of digital infrastructure, the massive amount of CapEx that is needed there, that private market capital pocket is very conducive to financing a lot of these longer duration projects. And so I think what we've done is we've brought insurance companies, and by the way, it's spread from insurance companies to pension funds, sovereign wealth funds, who also have a lot of liquid fixed income and are realizing, hey, if I can capture 100, 200 basis points of excess spread, that's a lot of risk-adjusted excess yield when base spreads in liquid markets are 50, 75, 100 basis points. That's why it's happening, and if you bring them closer to it and set up safe strategies across real assets, that's very appealing. That's not just happening in the corporate space. Corporate space is a very tiny fraction of it. The vast majority of it is asset-backed, residential real estate-backed, digital infrastructure, power, energy, all those markets are enormous. And you're attracting more and more flows into the private channel.

Michael Milken

So if we go back in time 20 years, 30 years, 40 years, and you had all these pension funds in industrial operating companies, were they in an industrial company or were they a finance company? At the extreme, GE, a 1 percent change in their actual assumption of their pension fund wiped out all their earnings. And so as you've mentioned, many of them, AT&T and others, are trying to get out of the money management business by selling their pension funds today. How do you see that market?

Gilles Dellaert

I think the pension market, I think, has evolved in two ways, right? Some people, to your point, have sold their pension plans. UK market in particular has a big PRT or pension risk transfer market develop around it. Same thing has happened in the US. The same types of players we just talked about have capitalized those. And then secondly, if you're not selling your plan, but to your earlier comment, if you're fully funded or your funding status in today's investing environment allows you to capture the fixed income portion of the funding assumption at 7 or 8 percent, you're clearing the hurdle rate. And so you've seen, I think, a shift out of equity or equity-like strategies into a variety of private credit strategies that allow you to make those returns. So I think either pension plans internally through their CIO functions or their OCIO function have adapted increased allocations towards these strategies, or they've gotten access to it by selling the pension plan to somebody who has access to it. Both end up in the same place, but that's been a good thing for that system.

Michael Milken

So, Victor, we recognize there's a lot of private equity positions out there today that have the wrong capital structure today for their business. And there are a few of the largest private equity firms that used to spend their time trying to turn around their problem situations. And what they concluded is they would generate a higher rate of return if they took their best people and put them on their best situations for growth and didn't invest as much time and energy of their talent on their problem situations. It seems to me you are a natural partner for them. Have you had any success in going out to the owners of tens of thousands of companies today? If you talk to heads of private equity over decades, and you ask them what was their biggest mistake, they will tell you they didn't change management fast enough. So why are you not knocking on the door?

Victor Khosla

We're knocking. We're just not having a good reception. Because look, when people make these investments with a 10-year view as to what they can do with them, and even when they get into trouble, I think what you see happen today, Mike, is there are these things called A&Es, amend and extend, and there's a more pernicious one, LMEs, liability management exercise. So what we find most private equity firms doing today is, you got a problem? The documents are written very loosely. Let me see if I can get a 30-cent haircut on my debt, and then let me see if I can manage them. But to the point you're making, 75, 80 percent of LMEs fail three years later. But people, I just find these are smart people, they're determined people, and they will keep trying to make a go of it.

Michael Milken

So well, I think I'm going to suggest to a few of them that I'm investing that they get your phone number from that.

Lee Kruter

Well, but I think to that point, Mike, as Purnima started with, we've been in a benign economic environment at this point. So to Victor's point, it's kind of a free option for these guys just to, as we say, kick the can down the road for a little bit of time. But we haven't seen—you've seen already some private equity sponsors walk away from businesses that, to your point, Mike, there are probably businesses that cannot change or are going in the wrong direction at this point, which my guess is, I think Victor and us, we share the same thing, that those are the hardest businesses if you see them directionally going down or the hardest ones to change. So we're still at the point where a lot of the sponsors, simplistically, without a lot of cost, as I think Victor was highlighting, could keep the option alive in an okay economic environment. I think that starts to hit the wall in the next two years, whether we're talking about software or other businesses. But the economy's actually helped out or kept this cycle elongated at this point in time for people.

Victor Khosla

Now, [inaudible], I do think the pressures, I know I don't find the world has been so benign the last two years. High-yield default rates, according to Moody's, are 6 percent a year. So underneath this calm is this churning and burning, which has been going on for two years. You add software to it, you add an oil shock, and we know what a long, extended oil shock can do to the economy. I think our view would be these 6 percent default rates you've seen over the last couple of years, they continue for the next two, three, four years. So the pressures you are seeing, and Mike, perhaps that changes attitudes. But today at least, the attitudes are pretty hardened, best as we can tell.

Michael Milken

So let's jump to another area. Claude today, Tony, that you've deployed. You can ask it, "Please read this loan document, and I'm thinking of investing. What are the loopholes in it? How could you take advantage of the creditors?" On one side of the coin, it could give you a full report. On the other side of the coin, as a company, you could ask the same question. "Where do I need to loosen these to give myself more flexibility?" Is that a question you're asking?

Tony Minella

Yeah. So we're buying a business right now. Before we made any comments on the stock purchase agreement, we put all the documents inside of a Claude project. Before we spent a dollar with any of the lawyers, we interacted with it with our internal legal team and our internal deal team, and then we came up with a very succinct list to go deliver to the law firm. I think every business model is going to have to change in the face of AI, and you need to just get in the middle of it and embrace it. And I've said, and some of my colleagues are probably sick of hearing me say this, but I think ignoring AI and not being in the middle of it is tantamount to not downloading Netscape in 1995. "Oh, forget about that internet thing. I don't want to learn about it." And so the power that's there, that's in the palm of your hand, that's on the desktop, that you have access to, is game-changing. And this new Mythos product that was after an argument with the government, was released in a clandestine way and then allowed to be used by 50 of the top organizations within the United States. Who knows what that has the power to be able to do? But I've heard speculation that it can penetrate the most sophisticated technology systems in the matter of minutes. And so if it can do that, and if it gets into the wrong hands, the challenges that it could bring to our society, to some of those not-sophisticated infrastructure that we have here, like water or some of our power, I think is potentially super threatening. So it's something that we need to take seriously, and we need to deploy it, and you need to learn about it. You can't be afraid, because it's not going away. And maybe the government gets involved and there's some type of a separation between the models and software companies and orchestration layer that I've talked about. But I think that orchestration layer is what a Salesforce might end up evolving into because they need to deliver tools at scale to users to be able to leverage the models. So it'll be an interesting 12 to 24 months, but it'll come pretty quickly. And if you remember last year at this conference, all we were talking about was tariffs. And so it's a much different world if you roll forward 12 months from where we were last year.

Michael Milken

And Tony, the amount of money that each individual is spending using AI tools is relatively low when I look at what you've given us before, somewhere between a couple thousand to maybe $4,000. Do you see that as the future? That you're—

Tony Minella

I don't know. I think we just made the decision that we couldn't just delegate this to our IT team and to working groups and to small teams. We just needed to embrace it across the organization. And so I joke around that we in college used to chug beers. We got to chug Claude. That's got to be your mentality. Because you got to get in there and you got to—

Lee Kruter

It's a weird visual, by the way.

Tony Minella

It's a real—Yeah. Well, that's what we're doing. And I'm proud that I'm above the mean. And I want to stay there, although I don't think it's going to be possible. But it allows me to be deep enough into the technology to be able to interact and challenge the team on what the capability set is. And so there's a lot of other power users out there that are dramatically transforming how we do work. And we're not doing less work, we're doing more work. We're making better decisions, and we're being better capital allocators as a result of leveraging the tools. You've told me a bunch of times, right? That you've been disintermediated three times in your life. And so AI is the third time you've been disintermediated. The first time was the calculator. When you could calculate bond yields in your head and trade bonds quicker than your counterparty. And so, technology is a force that's ripping through all markets right now, and you can't ignore it.

Michael Milken

Tony, if you told everyone in your investment department that they wouldn't be with you in a year if they weren't on Claude, how many would you lose?

Tony Minella

None. I mean, I've already told them that.

Gilles Dellaert

By the way, I agree with Tony on that. I think this is not something you can outsource to a working group. I think if you want to have people truly adopt it and lean into it, you've got to do it from the top. You've got to show it. You've got to share what's working, what's not. Every week, we share what we learned from it for everybody to see. I do it. Our teams do it. We have two of our youngest people in the whole business that are in charge of driving implementation and the learnings from it. You just can't retread the kind of typical approach of let's roll this out and whatever else. This requires something different, and people need to behave differently to really lean into it and adopt it. It's not easy, but it's incredibly powerful. And the biggest thing we've gotten from it is people enjoy their jobs more. I think if you look at more junior people in the organization, that rub sometimes while we're doing all these presentations, all the modeling, sending it all around. They're having more fun doing what they're doing with these tools at their disposal. And that's a big win.

Tony Minella

When you set up a project, the chat, you can share the project with everyone in the organization, and then your chat with the content is private. And so the level of conversation that you could have with your colleagues, having interacted with the tech—

Gilles Dellaert

—Much deeper—

Tony Minella

—Is much deeper, right? And so base level questions like, "Who's the sponsor? What does this business do? What are the competitive threat?" I mean, those are gone. Those are table stakes. And now you're having a much more substantive discussion about what the risk is associated with this business and whether or not you want it as a part of your portfolio.

Michael Milken

Purnima, let's talk about some misconceptions we want to put to bed. Number one, how diversified, if I come to HBS for credit on a diversified portfolio, how many different credits are in that portfolio? How wide is that?

Purnima Puri

That would depend on products, right? So we've got the liquid business, you got the ABF business, private investment grade, junior capital solutions, direct lending, et cetera. So I'll do some sort of averages here across the board. But I would say on a liquid side, your average position size will be 25 to 50 basis points in this environment where we don't think there's a lot of great opportunity. I think that's going to change, by the way. On our direct lending side, Mike Patterson who runs that business, he will preach diversification for that business as a pretty protective measure; 1 percent is kind of the top exposure in that book in the direct lending business. And there's lots of dispersion across industries as well. And then on our junior capital business, anywhere from 2 to 3 percent position sizes, so it ranges. And then obviously on CLOs, everyone sort of 25 to 50 basis points across the various CLOs. I think the thing that I would comment on here is our business as a whole, which I think is important, someone made the dispersion comment. I don't know who was making it. Maybe it was you, you, everybody. Is that in our business, we are very, very focused on bigger businesses. So if you look at the state of the world, in our private credit business, 60, 65 percent of companies with over $100 million of EBITDA are private businesses. And our business generates—we tend to lean towards larger companies. I think the average EBITDA is, depending on the business, $250 to $300 million. So we're really focused on that. And there's a huge, huge dispersion underneath the surface. It was Victor who was talking about it. The dispersion underneath the surface, because if you look at businesses sub $25 million in EBITDA, those are double-digit default rates right now. They're approaching 15 percent. If you look at businesses on the private credit business that are over $100 million of EBITDA, those are in the 1 to 2 percent range. So the dispersion is massive that's going on underneath the surface. And I think we've seen that in industries as well. We talk a lot about software and dispersion there. Other industries which are hanging in there. We haven't really talked about how a prolonged war and prolonged inflation could feed through to various industries and feed through gas and fertilizer, helium, and all sorts of things. So that supply chain disruption could also take a long time to kind of come back. So, our view is that bigger companies way better than smaller companies, in terms of where we're sort of focused. Diversification is your friend across all these things, certainly right now. And we do think that there might be some pretty significant opportunities as there's been this whole retail pullback on private credit. By the way, institutions are leaning in, which is also really interesting in terms of that dynamic. But that pullback could lead to a lot of opportunities because generally speaking, people still need to be financed and that could give a big opportunity to various folks on this panel.

Michael Milken

So let's try to put another misconception to bed. Obviously, we've seen a lot of discussion about private credit in the media. A lot of it fueled by people that work for major banks in our country. But they have a liability structure that's very short, one or two years. So people who want money need people that can have long-term investments, not short-term investments. So what percent of HPS's assets are potentially redeemable out of your assets today?

Purnima Puri

So our—

Michael Milken

—So we're talking now retail who read the newspaper, and they think it's time to get out—

Purnima Puri

—So two things. One is, our business, to factually answer, our business as a whole has about 15 percent of our assets are retail. Okay, in private credit as a whole, roughly $400 billion are in retail hands on a denominator of $1.7 to $2 billion. So call it 20 to 25 percent. I do want to say, I think we were talking about this, high yield is 30 percent retail, okay? So I think there's a lot of focus on this. The redemptions are limited.

Michael Milken

I just want to make sure, this is really important. Who owns HYG? Ultimately, retail is a much larger holder than they are in private credit.

Purnima Puri

Yeah, massive. And the numbers are 30 to 35 percent for high yield. And as we said, the numbers in private credit, this is an asset class that's grown tremendously, is sort of 23 percent, call it. HPS, as I mentioned, our retail base is about 15 percent in terms of those people that can make redemptions. The BDCs are structured. There's been a lot of fact and fiction on this. The BDCs are structured to have 5 percent redemptions per quarter. We have delivered those 5 percent. Everyone talks about outflows, no one talks about inflows, by the way. So that is also happening. And most of these BDCs are, certainly I can talk to HPS's BDCs, we have a 4.9-year average maturity.

Michael Milken

Okay, so let me come back. Twenty-some odd percent, and you can redeem 5 percent a quarter, so 1 percent of your assets could be redeemed a quarter total, and your—

Purnima Puri

Fifteen percent.

Michael Milken

—institutional investors are buyers. So there's a great opportunity here, and I just want to stress here, we could figure out why they've attacked this market, but it's hard to compete when you have one-to-two-year liabilities versus people that have long-term. All right, Victor. I was sitting here a few years ago, and buildings in downtown LA were selling for 600 to 700 a square foot. We talked about it. They borrowed 300 to 400 a square foot. Now, if you're up to it, you can buy them for 100 to 150 a square foot. You have a significant focus on real estate assets. Are you a buyer here of those buildings?

Victor Khosla

We are, with a very narrow focus. So, we bought a building in Los Angeles through the debt. It is not in downtown LA. It's in the Silicon Alley of Los Angeles. It sold for $500 million in 2014. And through the debt, we bought it for about $200 million, $200 a square foot. And we bought it, and this is an area which is 90 percent occupied today. You can't get the right property, and we bought the nicest building in this. We bought a building which was a shopping mall in Ireland, the best mall arguably in Ireland, which was sold for a billion euros in 2015. Through the debt, we bought it for about 500 million euros. And it was sold for a billion euros, and it's got 50, five zero million in NOI today before we go to work on it or a 10 percent cap rate. Yeah. What's happening in real estate today? Yes, there are these amendments, but these are trophy properties. These are not some silly little $30 million property in a suburban area, right? And that sort of stuff, but thoughtfully, selectively, it's there to be done.

Michael Milken

And you're negotiating with the creditors, not with the equity holders on these buildings, right?

Victor Khosla

We are. Well, you always end up negotiating with the equity holder, right? But when you buy the debt, like in this deal in Ireland, there was 500 million of senior debt, 250 of junior debt. We bought the junior debt for 5 million euros, and then the banks actually lent us money as part of our purchase to be able to make it work, right? But when you own the mezzanine debt, there's not much of a negotiation afterwards.

Michael Milken

All right. Well, we've had a good tour de force of credit from five of the leaders in this area in the world. They've given you different approaches. We've attempted to deal with misinformation that has existed to give you a clear opportunity here. And I just want to underline another point that Gilles and Tony, there is a revolution in the life insurance annuity business here that had been pretty stable for more than 200 years. And today, 280 billion at Blackstone and 70 or 80 billion at Security Benefit and Eldridge, 250 to 300 billion at Apollo. And so the traditional firms and names you've heard for decades and have been around for centuries are being converted in order to compete in this insurance business today. But the key is, do you have the expertise on the investment side to be able to take market share here? Thank you for joining us. I want to thank our panelists today.

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