



Episode 15

Leaders Series: Michael Forman and KKR's Dan Pietrzak talk BDCs

Bernadette Bridy (00:04):

Welcome back to FireSide, a podcast from FS Investments. This is Bernadette Bridy, Head of Marketing here at FS Investments. Today on FireSide, we're featuring a conversation with FS Investments CEO, Michael Forman, and KKR's, Dan Pietrzak. Dan is Co-President and Chief Investment Officer of FS KKR Capital Corp., as well as a partner at KKR and the Co-Head of Private Credit. Dan and Michael will be discussing the recent merger of FSK and FSKR, as well as market trends in the BDC space. We hope you enjoy today's conversation. Michael and Dan, thanks so much for joining us today and welcome to FireSide.

Michael Forman (00:40):

Thank you.

Dan Pietrzak (00:42):

Thank you, Bernadette.

Bernadette Bridy (00:43):

Michael, we're going to start with you. For those of us who are not familiar with the BDC industry, can you just provide a little bit of background on BDCs and the role they play in financing markets?

Michael Forman (00:53):

Sure. BDCs are a creature of statute. They were created by Congress back in the 1980s to foster the flow of capital to small and mid-sized businesses. And it was a fairly sleepy industry for a long time. In 2009, we launched the first non-traded BDC and really started generation of new BDCs, new non-traded BDCs, and today it's an asset class that probably has over a hundred billion dollars of assets under management. We're one of the largest players in the marketplace. We have a wonderful partnership with KKR and we invest in credit. We invest in private credit. We provide loans to middle market businesses to help them grow, to help them provide jobs, to help them satisfy their needs for capital, and it's a space that continues to grow and continues to be important in the formation of capital in the markets.

Bernadette Bridy (02:00):

And you talked a little bit, you mentioned the partnership with KKR. Can you describe that a little bit further when it started and just anything on that one?

Michael Forman (02:10):

Sure. We originally launched with a partnership with Blackstone. So we launched our first BDC then known as FSIC. The BDC franchise is now known as FS KKR, trading under the symbol FSK on the New York Stock Exchange. We entered our partnership with KKR and exited the partnership with Blackstone in 2018. So we've been doing this together for a little bit over three years.

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Michael Forman (02:40):

And it's just been a terrific partnership with the KKR folks.

Dan Pietrzak (02:44):

Yeah. And maybe Bernadette, just even add one additional point to what Michael said there, I mean, the partnership has formerly been three plus years, but we've had a lot of conversations obviously in advance of that, a lot of conversations for it starting. So it was probably almost approaching that four-year mark. It's been a really good partnership on both sides. I think we're two firms with very good cultures bringing very complimentary skills to bear, and we've been fortunate that we've done a lot over this time.

Michael Forman (03:16):

Yeah. And let me just pull that thread a little bit on the partnership and the culture. I think really what binds us together is our view on our investors and an unyielding commitment to putting our investors' interests first. So we think a lot less about how large we are or how much money we're going to raise or what our assets under management are, but rather the kind of performance we're delivering to our investors.

Bernadette Bridy (03:41):

That's great. Dan, I know that many members of our audience are familiar with KKR. I know that you alluded to the culture. Can you describe a little bit about the credit arm at KKR and what that entails?

Dan Pietrzak (03:57):

No happy to do that. I mean, I think you're right. I mean, KKR, 40 plus years in the investing business, really known out of the gate as a private equity firm, but when you do take a step back and we've been in the credit business since 2004, that credit business has grown to be north of \$150 billion of AUM. Inside that is \$58 billion of AUM, which is our private credit business, which the BDC is a very important part of that franchise. I think that AUM in credit we think is important, not to Michael's point. It's not about just because we like to manage the capital. I think credit has evolved into a place where size and scale matter. We want to have capital to control deals.

Dan Pietrzak (04:47):

Yeah. But it's also having scale on the human capital side. We've spent a great amount of time over the last half decade, what I call, institutionalizing our business, building out the origination footprint, building out the structuring and execution, hiring as far as almost desk lawyers on the team to deal with the structuring of transactions, having portfolio management, even workout people available in case something does go wrong, really bringing this to an absolute best in class lending operation and thinking about that how do we institutionalize this to make this better, to perform best for our investors? So while the KKR is known as that private equity firm, in some ways probably still known for that today, 150 billion plus of credit assets, almost 60 billion of private credit assets, really one of the largest players in the space today.

Michael Forman (05:42):

Yeah. And an observation on the private equity background, so credit has continued to evolve and lenders are providing a little bit more guidance to the portfolio company, sometimes taking equity, and those deep roots in private equity have been really, really helpful. So if we hit a road bump, we've got a great firm that has lots of experience in the private equity space that can help that company manage through that road bump. If we take a piece of equity in that company, KKR understands how to monetize that equity. So we look at that as being a real

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value add in partner with probably the leading brand and leading manager in the large buyout space.

Bernadette Bridy (06:28):

Sorry [inaudible 00:06:31].

Dan Pietrzak (06:30):

I think Michael's point is a good one because the... I think that gives us definitely an edge within in our mind. Even with obviously dedicated people waking up every day, the culture of this firm is one where we use the resources of the whole firm to succeed and generate these outcomes. We're trying to find that edge and we think that's important and the nature of this firm and the culture that Henry and George have built over the last 40 plus years really allows us to do that.

Bernadette Bridy (07:01):

So I was going to ask both of you, it very much seems like a partnership when both of you speak. Have you ever disagreed over something?

Michael Forman (07:11):

First of all, I would say it's been a terrific partnerships and partnerships can be complicated. At FS we're really in the partnership business and understand partnerships and we couldn't be happier for the partner we've chosen here in the way the group is working. There is no question that from time to time, we'll have differences of views, and certainly in the crisis, you had lots of important issues that needed to be made. And then we had a lot of important decisions to make as we look to merge, as Dan said, six non-traded BDCs into one publicly traded BDC. And there's lots of different views and lots of strong personalities and we went back and forth.

Michael Forman (7:58):

What I found was there was never any finger pointing, never any blame if there were issues, and we all got together after some tension that you normally have in good decision-making, got to a decision and supported that decision. So I think in some respects, having lived through those first very difficult months of the pandemic and having gone through the very complicated mergers, we've been time tested and the partnership has not only thrived, but I think has gotten better as a result.

Dan Pietrzak (8:30):

I would agree with that. I mean, we walked into this with a very clear objective of this being a true 50, 50 partnership. We are a firm, we do what we say we're going to do. I think the culture of FS Investments that Michael has built is the same. I do think Bernadette you have a very experienced management team around the table. I think that management team has gotten itself comfortable to the point of maximum transparency. Maybe in some forms that could be viewed as disagreeing. I think we've had good healthy debates. I find that's the best way to get to the right result here, and I'm actually very proud of how the management team has clicked. I think we enjoy being in each other's company even outside of this. There might be a little bit of disagreement. I think Michael needs to give me a couple more strokes on the golf course because he's beat me in the last couple times, but we'll save that for the rest of the summer.

Bernadette Bridy (9:32):

I hear you. I think Michael needs to give a lot of people some extra strokes on the golf course. You've both mentioned a little bit about the merger. FS KKR Capital Corp. just recently completed the merger of two public BDCs, FSK and FSKR. What do you see as the significance of the transaction?

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Michael Forman (10:02):

Dan, you want to start with that?

Dan Pietrzak (10:04):

Yeah, I'll start. I mean, I think there's a couple of things. I mean, one, I think the market does like simplicity, right? We've worked very hard to bring this down to this one entity. Even when we had FSK and FSKR, you had two publicly traded entities, but they were doing the same investing strategy. While it saves us a little bit of work because we only have to do one public call versus two, I think that's the smaller part of it. Just the simplicity of the message. The lack of the conversations. But I think it clearly solidifies us in one of these market leading positions in the industry. I think we want to be a thought leader and I think where we're sitting here today, I think we feel quite good about how we're positioned.

Dan Pietrzak (10:50):

You can't be ever rest on your laurels in credit, but I think we've liked what we've seen. Size and scale matters. We have the ability to access the liabilities or access the market for the liability side of our balance sheet. I think it's a simplification story, but I think it's also a more positioned quite well today, but Michael should add to that.

Michael Forman (11:12):

Yeah, I agree with that. I've never felt better about the franchise, frankly. And it's been a little bit of a choppy ride to get to where we've gotten. I agree with Dan that size and scale matters. Those of us who follow the market know it's a tight and competitive market and the team has done a terrific job and I think we'll continue to build upon that and continue to build upon the success that we've had together.

Bernadette Bridy (11:41):

So Dan, can you provide some more detail on the underwriting performance of KKR credit?

Dan Pietrzak (11:49):

Yeah. No, I'm happy to. I mean, maybe to dive in specifically what I'm talking about as it relates to the BDCs and I think as a management team, have been very focused in providing good transparency to the market.

Dan Pietrzak (12:07):

Credit is one of those businesses where you need to be right 99 times out of a hundred. We have spent a lot of time ensuring our origination funnel is big as possible. People like to talk about their hit rate on deals. I think our hit rate on deals is 2% versus the deals we screened. I think the honest truth is I'm not sure it matters if it's 2, 3, 4, 5. I think the point of the story is can you make sure that you're seeing enough deals as possible so you can be selective as possible?

Dan Pietrzak (12:39):

We're not spending our time figuring out how to stretch on risks to get paid an additional 50 basis points or a hundred basis points. We're spending our time where we can make a good loan, get paid fairly for that, and get our money back. So I think we've been quite pleased with what we've seen and like I said, I do think the platform set up, i.e. that size and scale point coupled with your origination footprint is actually one of the biggest risks mitigants that exists today. Because if you can be selective, no one deal really matters if we do it. We want to be a good lender, we want to be a good partner, but we're not going to stretch on risk and I think the numbers have shown that over the last, not just three years of this, but even for the years prior on the KKR credit platform.

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Bernadette Bridy (13:30):

So to just change tacks a little bit, both of you have referenced the pandemic and I just don't think we can have a conversation with managers of credit without asking about the pandemic's impact. Can you talk us through what 2020 was like for FS and KKR and how you were able to navigate that?

Michael Forman (13:48):

Sure. Obviously the pandemic was somewhat unforeseen. We had spent a lot of time stress testing the portfolio. And I remember many meetings prior to that, we have a quarterly joint venture operating committee led by Dan and from his team, Brian Gerson, who has private credit here at FS, and which includes some of my senior colleagues and some of Dan's senior colleagues. So I felt like we were prepared as we could be going in. We always talk about the liability side of the balance sheet. What is our debt look like? Because that's where you can get hurt in credit. It's not only the asset side, which are the loans, but you're a borrowing as well to, to fund the acquisition of assets. But nevertheless, it was difficult. And the first couple months, March and April were really, really difficult in the credit markets. I think we made some really smart decisions. We did borrow a little bit more money to make sure we had liquidity.

Michael Forman (14:54):

And then on top of that, we listed FSKR, which was the other BDC, which has now been merged into FSK. So there was a lot of work to do. There was a lot of time that we all spent together. We got to know each other very, very well I'd say in the second quarter of 2020, and what was really, really gratifying looking back at it was I don't ever remember a sideways remark, there was no finger pointing, there was no blame. There was no real complaining. I think people looked at it very realistically. It's two really good firms that have great resources. We listed FSKR, got the merger done into FSK, and while I wouldn't want to go through a pandemic again, I think in some respects, we've been battle tested and we passed all the tests.

Dan Pietrzak (15:50):

Yeah. Yeah. I mean, let's hope that was a once in a lifetime event. I think to Michael's point, we went into it well-prepared but went into it well-prepared thinking about the learnings of the financial crisis. We have always had very good processes here as it relates to portfolio review. I mean, we literally review the whole portfolio quarterly over the course of a week or a quarter. So I think prep going in was pretty good. I think the one tough thing is no underwriting case was a global pandemic. I mean, you had companies who were very good who went from, pick a number, \$60 million of EBITDA to zero overnight. So I think you had to deal with issues. I think the team came together tremendously.

Dan Pietrzak (16:41):

The regular way investment professionals on the KKR credit side really took it to a next level. As the management team of the BDC, we literally had a daily call at 3:00 PM every day for the better part of 13, 14 weeks just to make sure we were... And because things were moving and obviously stimulus monies came in. I think that the couple of things that were probably interesting is companies who were, let's call it, wounded or underperforming going into COVID, it had a really bad impact that maybe they had a difficult time recovering from. We did see some of that in the portfolio. A lot of the companies, again, we like to back that up brand of the middle market, a lot of those companies that were even directly COVID impacted, we saw sponsors or owners stepping up and supporting those businesses. We wanted to be a constructive lender. We had a very clear view to the market that this was nobody's fault. This was not bad management, this was not an ERP implementation issue. This was not whatever it might be.

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Dan Pietrzak (17:50):

So we were a good partner. If people wanted to make any material changes to their loan documents, we did ask them to put in more equity dollars to de-risk us. We think that was a fair and constructive ask. I think the large market participants came together in a very productive way. All the heads of NCIOs, the BDCs were talking, "How do we help here? How do we do this?" I think that was important. We had a place of defense and we played a little bit of offense as well. There's definitely a few situations where they were very good investment opportunities. There was a couple of situations where we had to invest dollars in the companies that were struggling.

Dan Pietrzak (18:36):

I'm pretty happy to never go through one of those again, but I think, we were all sitting in fairly large risk seats when the financial crisis happened. So there was a playbook to go there. You just had to adapt for the situations that were in front of you.

Bernadette Bridy (18:55):

So does your underwriting case change? On a go forward basis, are you going to add global pandemic into that?

Dan Pietrzak (19:03):

Yeah. We're not going to add global pandemic. I think it is in everybody's mind though. Especially where we sit today, I mean, we have conversations about other variants, you have conversations... I mean, there are industries who've actually benefited from COVID pretty meaningfully. I mean, I think half the people I know seem to have bought a dog during COVID. You look at any veterinary business or pet food business, they've made more money in the last 12 months than they did any years prior. So there's probably some sustainability questions and my sense is COVID just probably accelerated a lot of things that were going to happen anyway. Retail was challenged going into COVID. I think it just probably took out some of those weaker retail players, made others who were able to get to the other side probably a little bit stronger. So I would say, Bernadette, it's changed probably the downside cases, but we're not going to have the global pandemic case.

Bernadette Bridy (20:09):

I hear you. You started this a little bit, but I'd be curious to hear from both of you about what the private credit markets look like today, and the current investing landscape.

Michael Forman (20:22):

I'll start, but Dan should definitely engage in this. It's a very difficult market. It's a very tight market and I think you see that across all asset classes right now. There's certainly a lot of liquidity in the markets. There's a reflection of asset classes going on right now and that is certainly impacted the credit market, which is all the more reason to be careful. We're seeing some players make the same mistakes that they've made in the past, reaching for risk, under pricing deals. We just have to keep our discipline and we've done that thus far. Dan mentioned before, we have a lot of available capital. We're not sitting on the sidelines, but we're being really, really judicious because this is a very tight market and sometimes in these tight markets, people do unnatural things and we're seeing some of that and we're not going to participate in that.

Dan Pietrzak (21:22):

Yeah, I think all that's fair. I think we have a quite positive view about both corporates, consumers, housing, just the general macro tail wind for the next two plus years are quite, I

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think, strong. Wall Street's always a competitive place. That's nothing new. That said, I think the markets have probably taken it to a new level, which does make it hard to invest dollars. I think that goes back to that origination footprint, that goes back to our ability to be selective. I think the one thing that is interesting as it relates to the market is if you asked me 10 years ago, maybe 12 years ago, was private credit a long-term business or a trade? You might've gotten into more of the trade conversation, would post financial crisis things have comeback differently?

Dan Pietrzak (22:23):

I think we've actually gotten to the point now where we talked to corporates, they are just viewing it as another financing option. They can access the syndicated loan market, they can access the high yield bond market, they can come to folks like us on the private credit side, and we're providing them a solution. Maybe it's a one-stop shop for someone like us who can write a larger deal. You're providing them certainty of execution. Quite frankly, they're going to pay more for it, but sometimes that speed or that certainty or that partnership is more valuable to them, especially if they're in businesses that maybe they're going to do a couple of ad-ons or roll-ups and they need that partner. So I think we've found ourselves just as a regular rate generally accepted financing product, which is great. And then the one thing which is probably offsetting certain points, the number of deals that we see in our pipeline has never been more active.

Dan Pietrzak (23:26):

Now, I think that's a little bit of a combination because we've built out our origination team meaningfully, we've obviously got a good capital footprint, but three quarters of our business is financing sponsors. So other private equity firms who are buying companies. The amount of capital raise for middle market PE is up multiples of the amount of money that's been raised inside BDCs or other private credits or the footprints. So just the necessity of the product is there. You put all that together, you got a good macro, you got a competitive market, you go back to that size and scale point matter. I think we feel quite good about the risk that we're able to deploy. I think we're a little bit worried about spread compression, Things like inflation are on our mind.

Michael Forman (24:14):

Yeah. And let me just pick up on that one point for our listeners. It is really, really important to note a couple things. What Dan said about rising interest rates, none of us really can predict that. There's a case that says we're in a long-term deflationary environment because of technology and developments and things are going to get less expensive and less expensive and that's frankly what we've seen over the last decade or two. On the other hand, there's certainly a case to be made that money is really easy.

Michael Forman (24:50):

If Biden continues to get his policies through Congress, our debt will grow and does that create a rising interest rate environment and inflation?

Bernadette Bridy (25:00):

So lastly, I would like to hear from both of you about what you feel the future holds for the BDC market. Just both the market and also for your product specifically. I know I'm asking you to pull out your crystal ball a little bit, but curious to just see your outlook.

Michael Forman (25:17):

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Well, we were one of the pioneers in the BDC space having launched the first non-traded BDC and then there were a succession of non-traded BDCs that followed us. I think you'll continue to see growth in the BDC space. I think, again, as Dan said, this is a real asset class. It's a great way to deliver credit exposure to clients.

Dan Pietrzak (25:43):

Yeah, I share that because I think you'll still see some real growth in this private credit and direct lending markets. I think that's positive. And I think to Michael's point, we were one of the two largest in the industry, but you look at a bunch of the other players, there are institutional names attached to them as well on the advisor side. So in addition to us, you have others that are publicly traded names who are tied to this business, which I think lends a real amount of credibility. I think there was a bunch of smaller scale players when this thing started historically.

Dan Pietrzak (26:23):

So now these are tied to some of the biggest names in the investment advisory space. I think that's helpful. I think that'll fuel that growth even further, and then I think it's becoming a little bit more interesting beyond just that regular way retail investor. The institutional folks who might buy banks or other fincos are starting to see that there can be value here, so the investor base. So all that lines up pretty well for growth if you're thinking that crystal ball. The underlying assets should grow, the entities themselves are more professionally managed, for lack of a better word, and I think the investor interests will continue to expand.

Bernadette Bridy (27:04):

Well, I think this has been just a great conversation. We really appreciate both of you taking the time. I hope both of you have a great summer and hopefully get to speak to you again.

Michael Forman (27:15):

Thank you, Bernadette. Thank you, Dan. Good seeing you.

Dan Pietrzak (27:16):

Thank you all. Bye.

Speaker 4 (27:25):

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