Episode 88

FireSide: Answering the burning questions around private debt—Part 1

Private debt is a rapidly expanding market that has become critical for the U.S. economy and an opportunity for investors. In part 1, we discuss the fundamentals of the market and trends driving its growth.

Lara Rhame: Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist, and today we're going to talk about a 1.6 trillion-dollar market. One that is rapidly evolving and is critical to our economy and to investors. It's private debt. I'm pleased to be joined by Robert Hoffman, a managing director and head of Credit Wealth Solutions.

Rob, it's a rare treat to have you in the office these days. You've been out on the road a ton, talking to investors and advisors. Welcome.

Rob Hoffman: Thank you very much. It's always great to be here.

Lara Rhame: Also in the studio is Andrew Korz, an executive director on the research team and you've recently co-authored an incredible paper on this topic. I'm going to give several commercials for it throughout this podcast today, but if you are interested in private debt, you will give it a read. Andrew, welcome.

Andrew Korz: Thank you, Lara. And they keep me cooped up in the office, much more so than Rob. So, they don't let me out much.

Lara Rhame: Rob is our face.

Rob Hoffman: I was there once. They set me free.

Lara Rhame: All right, Andrew, I'm going to pitch the first question to you because I know that there has been a lot of buzz around this space and this asset class, but take us through sort of the 101 initial, what is private debt?

Andrew Korz: Yeah, I think it's smart to start there because it has changed and shifted over time as the asset class has grown. So private debt, just to kind of set the baseline, is just the debt of a private company or a borrower that's extended by or held by a non-bank lender. That's kind of of the broadest definition.

People frequently use private debt and private credit interchangeably. Private credit is, again, the most commonly cited part of private debt, but it's, sort of directly originated loans to corporate borrowers specifically. So I think it's helpful to kind of frame out the private debt market, more broadly.

I think of it as two primary verticals. The first being private corporate credit. Private credit that includes things like direct lending, which is mostly, senior secured loans to, again, private corporate borrowers, mostly top of the capital structure. There's mezzanine debt, which is subordinated debt, preferred equity, and there's venture debt, which is basically direct lending to, early-stage venture companies.

And then there's the asset based finance or asset based credit side of the house, which includes things like real assets debt, commercial real estate debt, which is a 6 trillion-dollar market, infrastructure debt, and you have sort of your pure asset based finance, which is sort of a hodgepodge of different credit strategies within consumer asset based lending. Things like lending against, accounts receivable, inventory.

And then, contractual cash flows. Things like IP, music royalties, etc. So, you can think about this as the corporate credit side, extending credit to a corporate entity, with a broad claim on that firm's cash flows. And the asset-based side, which is lending against or purchasing diversified pools of financial or hard assets.

And then there's sort of the specialized strategies like distressed in special situations, which kind of sit on their own. Rob, I think, you know, is in the weeds on this stuff. I'd be curious, can you kind of walk us through what some of these loans look like? What are some of the terms? What types of borrowers are we talking about here?

Lara Rhame: Because it was a lot and I think we're going to dig into a lot of that, but like, tell us what's typical? What's the typical deal look like?

Rob Hoffman: Yeah. So the hard part about answering that question is that technically private credit and private debt spans so many asset classes and so many different types of lending that it's hard to pin one thing.

I think one of the things that Andrew said, like the difference between private debt and public debt. It's not so much that the company itself is a public or private company, but I think traditional public finance is companies would go to a bank and a bank would help arrange a financing, be it bonds, be it loans, whatever the form that it took.

But because that activity was done through the bank, that made it a public debt offering.

Lara Rhame: Right.

Rob Hoffman: Whereas private has really stepped in, and to a certain extent replaced the bank where you're dealing with a direct lender or a group of direct lenders acting together, filling the role that the bank sort of used to play.

So, private credit, direct lending is certainly one of the areas that is most common in one of the largest sectors within private debt. So, what does a typical private loan look like? It looks a lot like the public floating rate loan market has historically looked like. It's just that instead of having a syndicate of a hundred different borrowers, you maybe have one or three or 10.

And so, to that extent, it's a senior secured floating rate loan. You're secured by all the assets of the company, typically five-to-seven-year maturity dates. They are very common, floating rates. So they're based on SOFR, and it's SOFR plus a spread. Typically, it depends on the timeframe and the range, but 200 to 400 basis points over public markets.

So, if today, spreads in public markets are 300 to 400, private credit spreads may be, 450 to 650.

Lara Rhame: So really attractive overall yield.

Rob Hoffman: Yeah. I mean, I think the long-term average is 200 to 250 basis points of yield premium over the public comparable. And then that sets aside all of the unique bespoke opportunities within private credit.

When you get into Mez and special situations and really complex deals where you can get, pay in kind or pick coupons and really high yield and debt with equity kickers and all sorts of other stuff. But the regular loan is typically a senior secured floating rate loan, five to seven year maturity, SOFR plus, 450 to 650, that type of borrowing.

Lara Rhame: All right. So I think, something that we really need to dig into is: why this market has grown so much right now? Because I want to talk about the structure and really sort of why as an investor, this is so attractive and clearly the yield is going to be a big piece of that.

But Andrew, take me through some of the backdrop. What has caused this market to just really go from being something that , felt very niche and only, the most wealthy or pension funds were interested in to something that now we're really seeing interest in from such a wide variety of investors?

Andrew Korz: Yeah, and I think the reasons for this growth have...

Lara Rhame: And borrowers. It's not just investors, you know, that's so important to understand.

Andrew Korz: Yeah. And I think, you know, as sort of a disclaimer, a lot of these topics will apply to the private debt market broadly, but we're kind of specifically talking about regular way, direct lending, private credit here.

I think that market has grown pretty tremendously over the past, call it five to 10 years. Assets under management globally, 500 billion dollars in 2015. To your point, 1. 6 trillion-

+dollars today. That sounds like a big number. The private sector debt market globally is, at the floor at least 50 trillion dollars.

So still kind of a drop in the bucket in terms of the overall global private sector debt market, but you know, growing pretty quickly. And I think there's sort of two sides of this story. On one side is sort of factors that have impacted the ability for traditional lenders to lend and the clearest example of that is the banks.

The risk taking capacity for the banks has kind of been slowly eroded away over the decades. Banks have consolidated, Dodd Frank was probably the biggest sort of earthquake here. In 2010.

Lara Rhame: This has been like this secular retracement of the banking footprint.

Andrew Korz: Yes. And today the average bank holds only 50 percent of its assets in actual loans versus two thirds around 1990.

So, the industry has changed, Basel end-game is still kind of hovering out there. So we could see some more of this. And as you've talked about a lot, Lara, the impacts of an inverted yield curve on the banking industry. You know, the volatility we've seen in public markets, Rob brought up sort of the traditional syndicated loan and high yield bond markets.

These markets got really volatile during 2022 and part of 2023. And I think what you saw was private lenders step-in to where public markets were maybe not willing or able to provide credit to a lot of these companies. Private lenders could take sort of this longer term view on the credit worthiness of that company, and we're able to kind of, put capital to work.

So I think those are, and that'll sort of ebb and flow over time, but I think those are kind of the broad, lending factors that have contributed to the growth here. And then there's the capital demand factors, right? The borrowers. and I think the growth of private markets here is a really important point.

Companies just want to stay private longer, to your point, right? They don't want to have to deal with going public and dealing with a bunch of shareholders and getting credit ratings and, all of these disclosure issues that are onerous in terms of time and cost.

Lara Rhame: Especially if you're a smaller company.

Andrew Korz: Exactly, yeah.

Lara Rhame: I mean, if you're Apple or Google, it's no problem, but if you're a middle market company. That's a big ask. You want to work with somebody more personally.

Andrew Korz: Absolutely. And you know, every company has their own unique reasons, but this is a trend we've been seeing for decades.

And I think it's only accelerating from here. The other thing is, these borrowers are growing. There's a survey out there of middle market companies. Two thirds of these companies expect to take on new debt to grow in the next year. That's the highest we've seen in 15 years.

And the final thing would just be the refinancing need. We've talked a lot on this podcast about the commercial real estate refinancing wave that's coming. It's true a bit to a lesser extent in corporate debt, but it's still there. There's going to be a lot of capital that's going to be needed for refinancing this debt going forward. And that's just another source of demand here.

Lara Rhame: Rob, why is that attractive to investors? I mean, again, we just talked about the yield. What are investors getting out of this? And how do they fit into this new growth of this market?

Rob Hoffman: Yeah, I think it's interesting. If you go back to, say, the syndicated loan market in the very first loan funds, which were called the prime rate funds. And they came out in the nineties and at that time they were actually structured as interval funds, quarterly liquidity funds, and there was some broad adoption, but what ended up happening in the debt markets, like a lot of things is that as the growth in mutual funds and ETFs and indexing.

There was a broad adoption of moving all of those to daily liquid structures. And for a long time, when we think about the typical retail investor was really this demand for something that's daily liquid, but what we have started to see over the course of the past 15 to 20 years is that there's is broader and broader acceptance by investors of being willing to own an asset that's not necessarily daily liquid.

And I think you've seen that interest from investors move down from, you know, the big institutional investors into the ultra-high net worth investors that are used to doing things like drawdown funds. And now it's moved into what we sort of term the mass affluent, as you have seen broader and broader adoption of more limited liquidity type investment vehicles.

And then over the past five years, that's only exploded even more as it's become broader and you've seen more and more platforms that have adopted these types of strategies. And so what that's enabled, I think, is when you look at a lot of private debt, the nature of a loan or a debt, whatever it is, only being owned by a small handful of lenders.

Inherently, that asset is not particularly liquid, and it's not really appropriate to hold in a mutual fund, for instance, that requires daily liquidity. And so I think as investors have started to understand the yield premium that's available in private debt market, some of the investment benefits that can bring to a portfolio through diversification and low correlation, the multitude of private strategies that are out there combined with a broader acceptance that I don't need to have a hundred percent of my portfolio liquid a hundred percent of the time.

It's grown this pool. And then frankly, as returns have been pretty good, it's this sort of self-fulfilling prophecy that people started to do it. They liked the returns. It grew a little bit. Some new platforms started to offer these types of products. More people bought them. Returns generally stayed pretty good and it's grown and grown and grown.

And it's moved from almost an institutional market. It's still an institutional market, but you've added the retail component, which when you look at assets held in IRAs and other places. It's hundreds of billions to, trillions of dollars that are there, that has allowed this market to grow so significantly over time.

Lara Rhame: It's something I've heard you educate people on for years now. That you need to have a match of the structure with the investment. And there's a reason why there is this limited liquidity and this structure because these aren't deals you can just trade in and out of by any stretch of the imagination.

That's what makes them more profitable and more attractive and to everybody who's involved in them.

Rob Hoffman: Everyone likes to talk about the Yale endowment and David Swensen and, they moved out of traditional assets and 30, 40, 50, 60, 70 percent allocations to alternatives.

And I think now it's just more and more common to see financial advisors talking to end investors saying, look, can we get five, 10, 20, 30 percent allocations to alternatives and the benefits that that can bring to portfolios and private debt has been a big beneficiary of that trend. But I think underlying all of it is it's there because the returns have worked and a lot of these strategies have worked really well for investors and that has created continued demand.

Lara Rhame: For sure. I mean, Andrew in the paper, you give an example of a portfolio with 15 percent allocation. So I just think it's really helpful to have these real world examples, you know, especially with everything that's going on today in the 60/40.

Andrew Korz: I think that's a really good point. We talked about the illiquidity of the asset class and sort of the yield premium.

And I think those two things are very much connected. You think about why borrowers want this, right? It's the execution certainty. It's the ability to get deals done. A syndicated loan process can take, correct me if I'm wrong, Rob, but two to three months. And you're sort of, as a borrower, uncertain whether that's going to price or where it's going to price over time.

Private lenders can do it quickly and they can give you certainty because they do have that sort of longer term view. There's flexibility on deal structure and on deal terms that private lenders can offer that, a bank, for example, in a syndication is sort of targeting at the median investor who's going to come in and buy that loan.

And then of just knowing your lender, right? Relationships are important. If there's an issue with the borrower, the ability to negotiate, to do repeat business, all of these things I think are benefits to borrowers and are uniquely suited for private debt because it is a liquid, because it's sort of lend and hold.

And, you think about borrowers being willing to sort of pay up that extra two, two and a half percent in interest costs. It's because they can get these benefits that are unique to private credit because it is an illiquid asset class. So I think that illiquidity premium we talk about in private markets is available because it is illiquid and that allows it to offer these unique benefits.

Lara Rhame: Yeah. And we talked about the fact that the yield that you're often getting is more than you could get through public markets. Why would a borrower want to, I mean, that means a borrower is paying more for this. Why would they want to?

Rob Hoffman: Yeah, well, I think it's one of the biggest changes that we've seen in private credit markets over the past 10 to 15 years to now.

Which is before it was all about size of company and the amount of money that you were borrowing and we'd use a figure like 50 million dollars of EBITDA or as a rough proxy for cash flow and if your company generated more than 50 million dollars of EBITDA you were typically borrowing enough that you could go to a bank and gain access to the syndicated or public debt markets which was generally cheaper. But if you were smaller than 50, as a function of Dodd Frank and post financial crisis, now the banks weren't there to do those types of deals.

Your deal wasn't going to be liquid enough for the market that demanded liquidity and those borrowers had to go to private lenders. But what has really changed, I think, as we've seen this growing adoption of private credit. Is that that range has expanded so that you could now target companies with 50 to 150 million dollars of EBITDA and still have a very large pool of companies that are also seeking private debt solutions for a lot of the things that Andrew mentioned from speed of execution, the ability to do some bespoke structuring terms.

And in many cases, just the preference of dealing with a small group of borrowers or a single borrower instead of a bank cohort of a hundred different lenders that they arranged because typically as a borrower, if something goes wrong, if you need to get an amendment to your debt agreement, you may have to go out and get a 51 percent vote of your lenders, which if you have 100 or 150 different lenders, that may not be easy.

Lara Rhame: Or even three publicly traded banks, they're going to have different priorities.

Rob Hoffman: Or, God forbid you start to run into problems and have to deal with restructuring type issues. And then you get a bunch of really aggressive lenders that step in and they buy half your deal. And their goal is to put you into bankruptcy and take your company.

Versus if you can build a relationship with a single private lender or just a few private lenders, you have a better idea for how they're going to act and what they're going to do. And that's why I think you've seen a lot of private equity firms that even have the option to do public debt.

Saying, well, you know, in this instance, I'd rather do private debt or some private equity investors that have basically said, we don't really want to do the public markets at all anymore. Private debt is so big and we're able to do multi hundred million dollars of deals through private credit. We'd rather just deal with private lenders.

We understand it may cost a little bit more, but we think that's a better place to be as a private equity firm that owns these companies. Versus going to the public.

Andrew Korz: Yeah. And just to kind of put a final point on that route, we've seen a lot of volatility in again, public markets over the past couple of years.

And there's been times where they've been open. There's been times that they've been closed. And you think about if you're a borrower, like building a relationship with these private credit firms is really important. Because right now you may be able to go out and get a syndicated loan to finance your leverage buyout or whatever it is.

But the next deal you do, the public markets may not be quite as open and you want to have those relationships ready so that you can go to them and say, “Hey, I have this deal. I want to get done. It's indicated by the low market's tough right now. Can I come to you for this capital?”

And so I think more and more these partnerships between private equity and private credit firms are becoming really important.

Lara Rhame: I just want to also raise something that you've told me many times, which is that. It's not an either or for our financial markets. Private markets are not going to erase or take the place of public markets.

Like we need both. Or banks, yeah. I think what I see is a much more diversified capital landscape, which is only a positive for markets, and for borrowers and for our economy, frankly. I'm an economist. That's where I always take it. But you know.

Andrew Korz: And it's a good thing.

I mean, we saw that in 22 and 23. Again, the public markets were challenging. Private credit came in and did a lot of deals. This year, public markets got a little more benign and there was a little bit more competition. So I think it kind of smooths out the ups and downs of the credit cycle, which hopefully can help smooth out the ups and downs of the economic cycle too.

Rob Hoffman: Yeah. Well, and look, something that you mentioned, Lara, typically, especially the larger companies get, if they are private, they are often owned by private equity firms. Private equity firms aren't dummies. They know what they can do. They know what options are available to them.

And you're seeing this growing and growing preference in many cases to be able to access private credit. They know, should they go public, should they go private, where is the best opportunity for them to raise money. And it's not that private credit is there as a lender of last resort only to the worst companies that don't have any options.

In many cases now, it's very successful, very well run, great growing companies where the owners of those firms have said, look, we think this private credit solution is better for us. At this point in time versus the options of going to a bank and getting a syndicated or public deal in the markets.

Lara Rhame: So not to paint too rosy a picture.

I think, you know, you're on the road again. Lucky to have you here. I think you're going straight from here to the airport. When you are talking with investors. I know that one of the big questions you get is what could go wrong? Is this a bubble? That's a broader question. Is this a bubble is almost a more like philosophical question, but a lot of money's come into this space.

And I think recognizing that any investment carries risks, like talk us through that piece of the conversation and how you think about it.

Rob Hoffman: Yeah. I mean, I think at the end of the day for a credit investor, whether you're public or private. It all comes down to credit risk, your ability to properly underwrite a deal, to properly structure the terms that protect you in that investment, and your long term ability to analyze that company and its growth trajectory and cashflow abilities.

That risk profile of private credit is no different than the risk profile on public credit. One of the differences is that you don't have the same degree of liquidity. So if you're in a public deal and the company reports really bad numbers and the loan trades down. You probably still have the option of selling out of it. You may not like the price that you're getting, but you can still sell it.

Whereas in private credit, if you go down that path, your most likely buyer is someone that already owns it. But in a private deal where there's a lot less owners, there's a lot less potential buyers. And so certainly one of the risks, I think investing with a partner who's active in private credit, you want to know that they have a big, robust team, are they skilled in dealing with restructurings and workouts and complex legal issues, and negotiating legal credit agreements and all these types of things, because that very much can come into play as a private credit investor and manager, whereas in the public markets, you say, "Well, I can just sell it and get out of it and not have to worry about that stuff."

But at the end of the day, I don't think we see it as being a bubble. As I said, it's not just a lender of last resort. It's not like private credit is just flocking to the worst part of the market that's willing to accept private credit. There's a lot of great deals out there because a lot of firms want private credit solutions.

Lara Rhame: Yeah. I mean, I think bubble implies a rational pricing, right? And I know Andrew, you're planning on writing about this very soon. What have you seen?

Andrew Korz: It's a legitimate question. Anytime you get a bunch of money that's coming into a space, I think it's logical for folks to ask that, especially when you're dealing with credit markets.

Lara Rhame: I once heard a manager say that they're actually frustrated that private credit feels like a hot market because it's been around for a very long time now.

Andrew Korz: Well, our firm knows that perfectly.

Lara Rhame: Yeah, exactly, as we know. We want it to be sort of set it and forget it. You know, it's a good investment that harvests a lot of return over time.

Andrew Korz: I think, to Rob's point, if private credit were just sort of doing deals for companies that nobody else wanted to lend to, I think that would show up in more leverage in the system, right? Companies are getting leverage that they wouldn't otherwise have gotten. And I think if you look at this current expansion, this is the perfect case study here.

So, you've got this period where private credit again, over the past four or five years is growing at a 22 percent annualized clip, just a tremendous growth in the asset class. But if you look at this economic expansion, it's not driven by increases in debt. Especially on the corporate side.

It's driven by strong income, higher asset prices, and really good productivity growth. So, you have this period where private credit is really growing. And then you look at the actual broader corporate credit pie. It's not growing at all. It's actually lower today as a percent of nominal GDP than it was in 2019.

So, I think this idea that the growth in private credit is driving leverage levels up, and that's going to be some issue, some systemic issue when we have a downturn. It just doesn't show up in the data right now. And I think, again, this is the perfect case study for it.

Lara Rhame: Awesome. All right. So, what I've heard is not only reasons for an increase in supply, reasons for an increase in demand.

And, you know, this is a market that is heterogeneous. It's backed by a lot of different types of assets. And I think what your paper does, awakening the rise of private credit really gives a long view of these changes and the evolution of the depth and complexity that this market is going through. That's a great way to phrase it. As it's become mature, I think going forward, we've talked a lot about the problems right now facing investors who are, really riding off of the momentum of a good economy but are facing an equity market.

Today is April 17th. The market's up 5.5 percent year to date but price to earnings ratios are 20%. Bloomberg AG is actually down 3. 5 percent year to date because we've seen fixed income interest rates continuing to rise. And then the correlation of the 60/40 has just hit a 25 year high.

So, when I talk about the positive outlook for the economy. Investors are facing a lot of challenges. Rob, I'll pitch it to you for the last question. Why now for private debt? Why should investors consider this today?

Rob Hoffman: Yeah, I mean, I think you mentioned the Bloomberg AG. I think as I was looking yesterday, I don't know how it updated today, but the five year annualized return was exactly zero.

Lara Rhame: Yeah, that's a great point.

Rob Hoffman: The five year annualized returns for private credit are eight to 10 percent plus. I mean, it's done really well. And as we think about. "Well, isn't this a really risky asset class?" It's like, your risk of traditional fixed income was pretty bad over the past five years too.

But no one's saying that needs more regulation. So, I think overall private credit, it's been a great solution for investors. It tends to generate pretty high income, eight, 10 percent plus at times. The returns have been fairly steady. One of the large indexes for regular way, direct lending has only had one year of a negative return, and that was 08 and it was down five, 6%, it was not that bad, bounced back pretty quickly.

Certainly, you get the diversification of dealing with private marks on assets. I do think it's important for investors to look at valuations and how those valuations are being done. But at the end of the day, I think the market has generally worked and it's provided good returns and it's added good diversification and it generates high income, which is always in demand.

And I think you put that collectively together and that's why it has grown as a important part of individuals portfolios and a nice part of portfolio diversification alongside 60/40 allocations. And it's just worked.

Lara Rhame: Yeah.

Rob Hoffman: And that's not to say it won't experience periods of volatility. That doesn't mean it's not working.

Every market goes up and down and private credit will go up and down like everything else. But I think over the long turn if it can generate these nice attributes and generate a return premium, it'll continue to do what it's supposed to do.

Lara Rhame: I feel like we've just scratched the surface today. I feel like we should call this a part one and do a deeper dive in a couple of weeks.

What do you, what do you think?

Andrew Korz: I say let's do it.

Lara Rhame: Alright. Thank you so much for today.

Andrew Korz: Thanks Lara. Thanks. Take care.