Episode 79

FireSide: Answering the burning questions around private debt—Part 2

We're back in the studio with Head of Private Credit Brian Gerson for more cool answers to your burning questions on this key asset class.

Lara Rhame (00:05):

Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist, and today is the next installment in a series in mid-April. We recorded answering the burning questions around private debt part one, and I got to say the response was overwhelmingly positive. We had an advisor actually call us and tell us it was the best 30 minutes on private credit that he had heard. So this is an asset class that is really important to investors and to the capital markets landscape and private credit has a lot of nuance and let's face it, it's getting a lot of headlines right now. So we really felt like it deserved a part two and we brought in an expert, really the expert. Brian Gerson. Brian, welcome.

Brian Gerson (00:52):

Thank you, Lara.

Lara Rhame (00:54):

Brian is our head of private credit here at FS Investments. He's the Co-President of FS KKR Advisor, which manages several BDCs managed by our firm and KKR, and he has over 25 years of experience in credit investing and corporate lending. Really 35 years on Wall Street, right? I mean, not to put an age on the both of us, but we've got some business cycles under our belt, let's say.

Brian Gerson (01:17):

We've seen a few, seen...

Lara Rhame (01:18):

A few, and I've had the pleasure of working with him for six years now.

Brian Gerson (01:22):

Yes, right about six.

Lara Rhame (01:24):

Also joining today, let's say cohosting is Andrew Korz, an Executive Director on the Investment Research team and my regular partner in podcasting. Andrew, thanks for joining today.

Andrew Korz (01:34):

Yeah, not quite as esteemed a bio, but I appreciate being here.

Lara Rhame (01:39):

So, Andrew and Brian wrote a great white paper on this asset class called "Awakening: The rise of private debt." It's in the show notes among other research and writing on this topic. I'm going to sort of pepper that in through today's discussion because you may hear something that we're touching on that we sort of gloss over. But again, so much nuance to this asset class. We would really love for you to dig deeper if you want to, and we feel like here at FS, we're a partner in education, so that really is reflected by a lot of phenomenal content that we put out on this. So I'm going to lob out the first question to Brian today because I want to use today…this continuing learning…and take off where the first podcast left off where we discussed the $3 trillion asset class and the growth of this asset class, why demand is strong, how it fits into investors' portfolios. But with you here, I want to dig deeper, like a day in the life of Brian Gerson. So maybe to start us off, you could tell us about your career, your career in credit markets, and really you've had a front seat to the growth that this has had over all that time. Yeah.

Brian Gerson (02:53):

Sure. Well thanks for the question, Lara. So I have been in the business for about 35 years. I spent the first 15 or so years in banking on the sell side where I sort of learned the ropes of leveraged finance financing buyouts for private equity sponsors doing restructurings M&A and general corporate finance work. This was a great experience for me. You really got to know a lot of these sponsors really well back… As a banker in the nineties, you're actually lending money, so you actually had a real credit view and you had to have a real credit view in how you looked at new loans for your clients because the bank was typically holding a big chunk of that loan and taking on the risk. And it was very important. What really changed in the early 2000s was the banking model, through regulation, went from becoming a principal lender to really an agent and selling risk.

(03:51):

So we like to say they went into the moving business versus the storage business, and that really changed a lot of the mindset of credit at the banks because it was not necessarily what's the best credit in the world that we want to hold. It's sort of: What can we sell? And I liked taking risk, I liked managing risk, and I kind of always had a desire to be a principal. So right around 2005 or so, I teamed up with a few folks and started a direct lender that eventually would become a BDC. We were seated by Magnetar Capital, which is a multi-strategy hedge fund out of Chicago. We built that business, took it public, called Solar Capital, had a good eight-plus-year run there, really interesting sort of the very early days of BDCs. BDCs have been around for a long time, but they began to become more popular in the early 2000s.

(04:47):

And back then there were really vehicles for junior lending and that changed over the years as the regulation for the BDCs changed, the size of the BDCs changed and they became more constructive around senior lending, but they were more risky ventures back then. After solar I left, I ran loan stores credit business for about three years, which was also a direct lending business, and then came to FS back in 2017 to oversee private credit in the BDC business here. And by that time the BDC market had really started to evolve and it's only accelerated over the last five years. And you've seen private credit enjoyed tremendous growth and we can talk about that—the BDC market capitalization, growing manyfold, but really a lot of that growth has been fueled by demand.

Andrew Korz (05:39):

Yeah. So Brian, dovetailing off of you sort of walking us through your career, I think it's fair to say you've had a leading hand at originating billions, tens of billions of dollars over the years. I don't think we have an exact number, but approximately a lot of money partnered with lots of different sponsors lent to various companies in a wide variety of industries. So this may be a challenging question to sort of distill into one answer, but can you give us a sense of what the most important factors, metrics, considerations are for you when you're sort of diligencing a potential loan, a potential borrower? Can you kind of walk us through from when you sort first get the idea, come to your desk to sort of going through that process, what are some of the things that you look for that makes a good credit? What are some of the things that are clear red flags that would make you throw it on the trash sheet? Walk us through kind of that process for you.

Brian Gerson (06:35):

Great question. Look, I would start by just taking a step back, maybe going 10,000 feet. When you think about credit selection, it's different than many other investment processes because what we are really trying to do is avoid losers, not necessarily pick winners because a winner for us is just getting our principal and coupon back. We can't make a multiple of our money, but we can have principal impairment. So good credits, they tend to be boring, they tend to be predictable, they tend to have relatively straightforward business models, simple accounting things that are very understandable and straightforward. When you go about looking at a credit, you kind of start with the industry that it's in. Is it a growing industry? Is it a shrinking industry? Are there exogenous factors that are creating secular growth or secular decline? What's its competitive position? If that's all reasonable, you start moving forward and looking at the company.

(07:35):

Different lenders tend to focus on different parts of the overall middle market. Historically, the upper middle market we think has attracted just better companies because they tend to be larger, they tend to have deeper management teams, they tend to have more diversified business models and frankly just more leverage to pull if something goes wrong. And you also typically have large sponsors with large equity tech checks backing them, but at the end of the day, you are underwriting the business in a very fundamental way. These processes typically take six to eight weeks. You look at all of the P&I drivers both on the revenue line and the cost line. You look at competitors in the industry, you bring in third-party consultants to the extent necessary to look at the market, to look at the accounting, to look at the legal structure, any liabilities, both off balance sheet, on balance sheet, you want to get good checks on the management team. You clearly want to understand the investment thesis of the sponsor. Is it a business that's going to be acquisitive? Is it a business that's going to be run for cash? And then fundamentally, we really focus, you have to focus on cash flow because that's how companies deleverage and get refinanced. So you typically have to model out lots of different scenarios. Again, figure out what the drivers of the P&I are, stress them and be comfortable that in downside scenarios, the company can still cover its fixed charges and can pay its interest.

Andrew Korz (09:10):

No, that makes sense. And I want to kind of zero in on that last point you made, companies being able to cover their fixed charges and the obviously incredible regime shift we've had in the past couple of years in terms of interest rates. You go back to 2021, it wasn't that long ago where for the entirety of that year, the 10-year was sitting below 2% for the most part, below one point a percent Fed funds was at zero. There was lots of capital coming into the space, lots of capital being deployed by lenders. Can you walk us through the difference in terms of what it was like to underwrite loans in say late 2020/2021 versus maybe 2023/2024, and sort of how the knowledge of we are now in a higher interest rate environment. I know that these companies are going to have to be able to cover 10, 11, 12% interest expense versus 2021. And those lenders who were putting money to work then who maybe obviously didn't have the knowledge that interest rates would go up 500 basis points in a year.

Brian Gerson (10:11):

Well, I'd address that in a couple of different ways. Clearly, rates have moved significantly over the last three years, two-and-a-half years. And what that's done more than anything is reduce the amount of cash flow after interest to pay down debt. So a lot of these companies haven't delivered as much as planned. What that does is it creates a little bit of less room for error. So we've seen decent growth in EBITDA over the last two years across middle market companies, typically mid- to even high-single-digit EBITDA growth. So you've had some EBITDA growth to offset rising rates, but today you have the benefit of, and by the way, when we underwrite those deals back in '20, '21, '22, of course you're using the forward curve when you model these things out. And of course you're sensitizing rates. But this was a very quick move in rates, and I'm not sure many people, if any, anticipated it. So today what you're seeing is just less levered businesses because rates are what they are today. So higher equity contributions to offset lower leverage. And frankly, what we're seeing is very attractive businesses to finance because even though M&A volume is down—really because sellers still have high expectations on price—they're selling their best quality companies. So we're seeing really great companies to finance. We'd like to see more, but again, the quality is very good.

Andrew Korz (11:53):

And this, I think Lara, is where it gets into why vintage matters, right? You go back to the 2020/2021 vintage, there isn't anything inherently wrong with the assets, these companies. Yeah, no, nothing inherently wrong. But again, putting money in the ground in '20, '23, '24, you have this understanding of the hire-for-longer environment. You have a better understanding of what these companies can cover in terms of debt service. And ultimately, like Brian said, you're seeing higher equity contributions, maybe some more conservative underwriting. So I think that's an important point to make. I...

Lara Rhame (12:24):

Think so too because against the backdrop of this really extraordinarily aggressive rate hike cycle, there has been concern that somehow demand for this asset class would dry up. And that's absolutely not what we've seen. And so to your point, I think it's important to recognize that a strong economy really is the foundation of this asset class and has enabled companies to still effectively function even in this higher rate environment.

Brian Gerson (12:54):

Yeah, absolutely. Right. I go back to a point you touched on and something I mentioned before, which is sponsors really like the product. It's a great risk mitigation tool for them. Private credit has always come at a premium to public credit, and it's always had tighter terms. This isn't a new case, and sponsors have continued to adopt this product. So why are they paying more for something that's more onerous? Well, because it delivers value. There are a couple things that sponsors think about. Number one, when a sponsor signs up a purchase agreement to buy a company and they sign financing papers with us, they're terms and price certain. They absolutely know what their coupon is, they know what all their covenants are. There's no syndication process, there's no flex, there's no ratings process and they're done. So it's a very convenient, convenient process for them.

(13:57):

Number two, private credit can provide what's called delay draw term loans. And what these are basically are term loans that are unfunded, that can be drawn down over time to fund acquisitions and their guardrails on those. They have to be within certain leverage parameters, et cetera. But what that does for the company is it not only gives them funds certain for this acquisition, but also for all future acquisitions or for many future acquisitions. And if you do a syndicated loan and you have an acquisition target, you have to hope that the market's there when your acquisition is there.

Lara Rhame (14:39):

A highly volatile market, by the way, highly volatile market? Not recently, but again, looking in history historically, one of the more volatile.

Andrew Korz (14:46):

Markets, these are exactly the points that we outlined in the white paper as well. I mean the certainty of execution, pricing certainty, the ability to get a deal done quickly if you need to do so.

Brian Gerson (14:56):

And probably the most important thing is that the sponsor knows who their lender is.

(15:03):

And what that allows for is a very constructive relationship and good times and bad. So if they have an acquisition target that may not fit the delay draw term basket, they go back to their private lenders who have capital to invest in every market who readily finance that acquisition. And if they need an amendment, they're talking to one, two, maybe three players to get that done. And that's very different than trying to go out to the market and deal with a hundred CLO buyers or hedge funds or what have you. And that can be incredibly value-destructive. So this is a really cheap insurance policy in many ways for these sponsors.

Lara Rhame (15:51):

Something that a lot of people don't appreciate. This asset class has continually grown. It's not a flash in the pan. It's been around for some time. And something that I think is underappreciated is the fact that there are really important reasons on the demand and on the supply side why this asset class has grown. And I think your experience speaks to the fact that it's not new. It's been around for a really long time. Yeah.

Andrew Korz (16:20):

I also think, I mean the common trope within private credit I feel like, and its growth has been banks have been regulated more heavily. They have a lot more guardrails on the risk they can take. Private credit has come in and kind of filled the gap, but for some of these companies, it's the only game in town. Right. And I think what we've tried to talk about here is the idea that no, actually private credit is a solutions provider. It provides a lot of benefits to these private equity sponsors. To your point, some flexibility that they wouldn't otherwise get from other parts of the market. I'm curious, have you seen that change over time as the market has matured, as these lenders have gotten larger, have you seen a change in how borrowers view private credit from sort of the companies that couldn't get capital otherwise to sort of now more and more actually acknowledging the benefits of private credit? Has that been a development over...

Brian Gerson (17:14):

Your career? Absolutely. Yeah. We have sponsors that routinely make acquisitions with multibillion-dollar financing packages that will only go private credit. They could absolutely go syndicated, but for all the reasons we talked about, they just prefer private credit execution. And we're just seeing this more and more and more. It's interesting. People have said, gee, haven't you had a big chunk of your portfolio get refinanced? Have you seen a lot of refinancings in private credit by the syndicated markets? And at least our experience has been no. We've seen sponsors come in and want some price concessions because the market's tightened up a bit, but we haven't really seen sponsors come in and say, hey, we're going to get a credit facility syndicated by JP Morgan and see you. They like the product. Yeah.

Lara Rhame (18:08):

Brian, I think one of the questions that comes up a lot, we get it, but it's also in the popular press, is the fact that so many investment dollars have flown into this space, almost $1.7 trillion now that there's somehow too much competition to put this money to work rationally or appropriately allocating risk. Speak to the competition that you're seeing day by day in your deal flow.

Brian Gerson (18:34):

Sure. Well, look, I think I've told you before, having been in these markets for a long time, I can't remember a time when Wall Street hasn't been competitive.

Lara Rhame (18:43):

This is something that I always tell people too, as the folks in the room that have maybe seen a lot more business cycles than Andrew has.

Andrew Korz (18:51):

It's like companies like raising prices. It's like companies didn't just want to start raising prices overnight. You know...

Lara Rhame (18:57):

What I mean? There's always been competition, always been, everybody's a rational actor. There's always been competition. Yeah.

Brian Gerson (19:03):

Look, and I would tell you that the market has continued to absorb this capital. And that goes back to the demand side. It goes back to the fact that there's, call it a trillion-and-a-half of dry powder and private equity land.

(19:21):

And if you said, gee, your average LBO is financed to five times, let's be conservative, let's say four times, that's six trillion in financing demand, which is greater than the size of the entire high yield leveraged loan and private credit market combined. And I do think the size of the capital raised in private credit has caused the size of the private credit market to expand, because three, four years ago, $500 million financing was a big financing. Now we routinely see two, three, four billion financings, and those couldn't have been done without the growth in private credit. Now, look, in any market, there are ebbs and flows. There are markets that are more issuer constructive, and then there are markets that are more lender constructive, and you have to know that and recognize that. And when things become a little frothy, that's when you have to just have your guard up a little bit more and recognize that it's a long game. I always like to say that if deployment is your problem today, you don't want to solve today's problem and deployment by creating tomorrow's credit problem.

Lara Rhame (20:44):

Yeah, that's great. I love that.

Brian Gerson (20:46):

So I do think lenders need to take a balanced approach to this. I think if a lender feels like they have capital burning a hole in their pocket, maybe it'll be compelled to be a little bit more aggressive. But we've seen this market grow and continue to grow, and I don't know what's going to stop it.

Lara Rhame (21:07):

Let me take us out of the trajectory of the asset class for a second. I'm interested in asking about the deals that you're making and what you're seeing from the end users or the companies that you're lending into, economists in the room. How do these companies look right now against the backdrop of broader growth in the U.S. economy? Are there industries that you see that you favor in this sector? Are there certain industries that are coming under pressure, some that are flourishing? Just thinking about inflation being a huge problem for companies, you have...I feel like an insight into these middle market firms that to me are the real engine powering the economy forward, and yet all we get the data on every day is like Apple and Amazon, and the reality is they're 200,000 middle market companies. What do you see from the companies that you're interacting with regularly?

Brian Gerson (22:04):

What we're still seeing is decent growth. Call it, like I said, mid- to high-single-digit EBITDA growth.

Lara Rhame (22:11):

These are the answers that make me happy.

Brian Gerson (22:13):

Quarter out. Again, we tend to focus more on the upper middle market where companies have pricing power, which I think has helped maintain margins through sort of the inflationary cycle. I think some of the things that we're very wary of today is wage inflation is just continued to bite companies, and if they don't have pricing power, they they're really being squeezed on margins, so you have to watch out for that. I think that certain sectors in health care, especially tied to Medicare reimbursement, are tough right now because of the reimbursement environment. But we're still seeing lots of great industries to invest in, whether it's insurance brokerage, still seeing great software businesses, we tend to look at cash flowing software businesses. We aren't really constructive around that annual recurring revenue construct, which is financing businesses based on a multiple of revenue, not cash flow, but we really like what we're seeing in software business services is still pretty strong. We've really reduced our consumer exposure, very wary about that. We can't quite figure out what's going on with inventory levels at retailers.

Lara Rhame (23:32):

Yeah, tell me about a brother . I'm trying to try to forecasting GDP swinging around like crazy.

Brian Gerson (23:38):

It's very hard for suppliers because everyone's talking about destocking and they've been talking about destocking for 18 months. So I think those types of things are tough to stay away from. But again, I think the deal flow that we're seeing just tend[s] to be very good companies right now because of what can demand the higher multiple.

Lara Rhame (23:59):

That's great. Okay. Brian, this is the easiest question, easiest and hardest question. Is private credit a bubble?

Brian Gerson (24:06):

No.

Lara Rhame (24:08):

Alright, let's draw that out a little bit. Let's back up and go home. Yeah. I'm going to tease up another resource in the show notes. Another phenomenal paper that not only answers this question about private credit being a bubble, but goes through some of the key concerns investors have. I think that single question that I just shot straight at you is one that is driving me to a high level of frustration because I hear it all the time and I'm really just trying to push back against it because private credit today fits really no criteria for being a bubble. It's an asset class that's grown a lot for very good reason. What are you seeing? Give us a more thoughtful answer than mine.

Brian Gerson (24:56):

Well, look, as I said before, I think in any market, some lenders can be more aggressive and some can be more conservative. That's what makes a market. That's why everyone has a 3% conversion rate in their deal funnel because that's what makes a market for all the reasons why we talked about it. I think the demand is real. Could there be an increase in defaults because rates stay higher for longer maybe. But does that going to impact your ultimate recovery if you're investing in the right business because you have a period of time where the company needs some relief on its fixed charges? Look, I'd make the bet that a lot of these companies that may have too high a fixed charge coverage, you can recapitalize and they'll be fine. It's just a sick balance sheet. It's not a sick company.

Lara Rhame (25:45):

And I think something you've talked about a lot is that any bubble in history has relied on leverage, and that's something that really differentiates private credit.

Brian Gerson (25:56):

That's where I'm going next. So I think people worry about a bubble not because of the bubble per se, but because of the consequences of the bubble and the consequences of the bubble are a crash in asset prices and what causes the crash in asset prices for selling and what causes for selling leverage. You saw that back in the great financial crisis, multitudes over.

Lara Rhame (26:21):

Sure.

Brian Gerson (26:22):

Private credit has very conservative financing. If you look at BDCs, for example, under the Investment Company Act, BDCs cannot be levied more than two times equity in practice. Most BDCs keep their leverage between 1 and 1 1/4 times equity. Their leverage...are not, it's not short-term facilities. Typically, it's a mixture of, for the larger BDCs, long-term unsecured bonds that don't really have covenants other than maintaining your investment company act tests. And then you have revolvers with banks that are typically relationship banks, and those revolvers are four or five years, and BDCs routinely extend them. You compare that to a bank, banks are 10 plus times levered. Sure. They rely on deposits, which can get pulled overnight.

Lara Rhame (27:23):

That is one of the most critical differences I think, between this space and banks that people don't appreciate. There's a reason for the structure for BDCs and it not being overnight liquidity. Banks do have to manage that very different.

Brian Gerson (27:39):

You could have mismatches between your assets and liabilities and banks, which we saw in the last year or so. BDCs tend to have primarily floating rate assets and floating rate liabilities, so they're matched. Yeah. So I think it's just a very different risk management proposition. Obviously, you have to be a good credit manager and you don't want to experience losses, but you're never going to, there just isn't a circumstance where BDCs are going to be four sellers. Yeah.

Lara Rhame (28:12):

This is something that you and Andrew wrote about in your paper.

Andrew Korz (28:18):

Yeah. One thing we wrote about in the private credit bubble piece, we walked through three of the famous credit bubbles, the Great Depression, the Japanese real estate bubble in the eighties and nineties, and then obviously the Global Financial Crisis, the housing crisis. In each of those cases, you see what is classic credit bubble behavior where you have credit getting overextended rising asset prices that are sort of beginning more lending, and you end up seeing what is sort of a broad increase in private sector debt to GDP over a decade, 12, 15 years. And then to your point, you get to a point where asset prices stop going up, everything starts de-levering, and there's sort of this crash, and one stat that I put out there is private credit has grown by eight or 900 billion in the past five years. The U.S. private sector debt to GDP DP ratio hasn't gone up at all. Right? So what that tells me is this is a market composition shift, right? This is private credit taking share in this market in what is a growing market because it's just a better mousetrap for a lot of these companies. This is not a market size issue where there's too much credit being extended to companies who wouldn't have otherwise gotten it. That's how I read that data.

Lara Rhame (29:24):

Yeah, that's a really good way to phrase it. Yeah. I think you've talked a lot about the most important piece of doing your job well is risk management. I know, again, I feel like out of central casting for a credit guy, because that's what...

Andrew Korz (29:44):

They're saying, you can be an old credit investor or you can be a bold credit investor, but you can't be both, right? Correct.

Lara Rhame (29:51):

I think those best practices and maintaining that discipline is the cornerstone of what has made you so successful over the years through these business cycles, through a lot of really tough markets. Can you talk to us about what that really means day to day and how important that is to your practice?

Brian Gerson (30:11):

Yeah. I mean, you got to hate losing money, but look, we like to say that anybody can make a loan, just give away the price and give away the terms. The hard part is getting paid back, and that's where pricing and terms matter, too. But having a very rigorous risk management process where you're monitoring monthly, quarterly performance, where you're in dialogue with the bars and the sponsors, where you're proactively reaching out if you see a problem or an opportunity.

(30:49):

Where you have really well-institutionalized practices around how you underwrite, how you risk manage, how you portfolio manage, where you have real portfolio construction targets, and think about the risk you're putting on, not just in isolation, but in the context of your whole portfolio. And then being willing to fight for your money and not being afraid to do so when you have to, and having the resources necessary to prevail because again, your upside is capped and you have to aggressively manage your downside. Got it. So if you take care of the losses in credit and limit them, the return takes care of itself through the coupon.

Lara Rhame (31:39):

Yeah. Brian, I know that we were so lucky to get you today. Everything you just described, your work, you have your team. You are so busy, and you do so much. So thanks for taking the time to come down from New York to be in the home office with us here in Philadelphia. We really appreciate it, and I feel like we need to have a class, like a master class from Brian and credit. I've already written quotes down that we should just put on the website.

Andrew Korz (32:05):

You…just thank you for doing an episode. Now you want to do a class. That's right.

Lara Rhame (32:09):

That's how I bring people in. You do one podcast and before you're signed up for a longer series.

Brian Gerson (32:14):

Oh, this was a lot of fun, guys. Yeah, thanks, Brian. Happy to do it.

Lara Rhame (32:17):

Anytime. I think final reminder to everybody that we have a lot of resources, papers that Brian's written, papers that Andrew has written, our first podcast, the part one, two. This is a great introduction to these deeper concepts that we're taking you through, and I know we're going to keep this conversation going. So again, thanks for making this fun and approachable and understandable. My pleasure. Thanks guys. This episode is recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was produced by the Investment Research team; edited and engineered by Aaron Sherman, video produced by Melissa Vendetti and copied provided by Harrison Beck. Special thanks to show coordinators Ellie Zhang and Lara Coleman. Thanks for listening.