Episode 104

FireSide: Is private credit a bubble?

Andrew Korz (00:00): That growth in private equity market has really catalyzed the growth in private credit. So, if you look at just today, the private equity space has about $2 trillion of dry powder to invest, right? So, what that tells me is generally these companies today are going to be about 50% equity, 50% debt. That's about $1.8 to $2 trillion of financing demand from private equity sponsors alone.

Lara Rhame (00:25): Welcome back to FireSide, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist, and today's episode of FireSide is going to focus on a question that hovers in the background or maybe the foreground of our conversations around private credit. Is private credit a bubble? To address this very critical question, I'm joined today by Andrew Korz, a Director on our Research team and an expert in all things private credit. Andrew, welcome.

Andrew Korz (00:55): Hi, Lara, how are you?

Lara Rhame (00:57): I'm great. I'm excited to tackle this head on. I think the other person that is joining us is the guy. We're lucky enough to have him in our home office in Philadelphia, but he is on the road all the time. He is in advisor offices, he's at conferences talking about this. Robert Hoffman, our Managing Director of Credit Wealth Solutions. Rob, welcome.

Rob Hoffman: Thank you. Always great to be here.

Lara Rhame: This is the dream team to break this apart. And Andrew, you and Alan on our Research team wrote a great paper, several months ago now, that breaks down this question, and I want to reiterate something because the overarching question, "is private credit a bubble," is important to address, but behind that, [there are] important questions regarding transparency of the asset class, the rapid flow of money into that asset class, the quality of borrowers in the asset class.

These are related questions that are important to address, and I think we value education above all. And so, I really encourage you, if you want data on this topic to really take 10, 15 minutes to read this paper. It's listed in the show notes. It is an incredible paper that's gotten a huge amount of traction and I think is a great companion to the discussion that we're going to have.

And so, with that said, I'm going to dive right in and make it easy and just hit Andrew with that question. Is private credit a bubble?

Andrew Korz (02:28): Well, I think I'll take that question and first I guess define what we look for when we think about a bubble and specifically a credit bubble.

So, I think in the simplest terms, what we look for is an increase in the amount of debt financing that's being thrown into the economy, and specifically private sector, right? Government debt sort of sits off on its own. When we think about a credit bubble, it's are we seeing increasing levels of private sector debt in the U.S. economy? And I think we have three pretty illustrative [examples] of credit bubbles over the past century or so: one being the Great Depression, the second being Japan during the 1980s and the 1990s, and the third being the most obvious one, the global financial crisis. So, during those periods you saw rapid increases in the levels of private sector debt to GDP. And at the same time, you saw rapid increases in prices of the assets that this debt was financing.

(03:24):So in the Great Depression, you saw it in stock prices. In the Japanese situation, you saw it in commercial property prices and then in the GFC, you saw it in home prices, you saw these asset prices really rising right alongside this increase in debt. And then once that debt financing stopped becoming available, the music stops asset prices plunge and you get this painful de-levering, which usually ends in a recession or a depression. So I think that's part of what folks are concerned about. You've seen this private credit asset class grow very quickly. Are there concerns of this type of situation occurring?

Lara Rhame (04:00): Current numbers around the growth?

Andrew Korz (04:02): Sure

Lara Rhame (04:02): That we've seen in this asset

Andrew Korz (04:04): Class, it's now about $1.8 trillion globally, roughly a trillion dollars in North America, which is meaningful. But when you think about US economy, that's what is it, $28 trillion nominal GDP, it's still relatively small and the market

Lara Rhame (04:18): Cap of the s and p 500

Andrew Korz (04:21): And the global private sector debt market is, it's hard to size precisely, but somewhere around $50 trillion. So still relatively a drop in the bucket here. So I think when we think about private credit and the types of borrowers that private credit is financing, generally it's corporate borrowers in the middle market, the upper middle market that are also served by the high yield bond market, the leveraged loan market, and banks. I think when we take those four types of borrowers together and we consider them as sort of one entity and call it leveraged finance, that grouping of lenders as a percentage of the overall economy has been really consistent over the past 5, 10, 12 years. Difference has just been where that money is allocated. It used to be that banks were the dominant player here, then we had the rise of the high yield bond market, then the leveraged loan market as banks started to syndicate off risk. And now it's been private credit at the expense of banks at the expense of the high yield bond market. So I think it's been less a question of more financing and more debt in the US economy and more really private credit taking share from these other types of

Lara Rhame (05:29): Lenders. I've heard you say that banks have moved from being in the storage business to the moving business. Yeah,

Andrew Korz (05:34): Absolutely. And private credit, it's really been a very direct sort of correlation between banks holding less and less commercial and industrial loans on their balance sheet and private credit sort of taking that business away.

Lara Rhame (05:46): Hoff, you're having these conversations every day. Is this still a question that is top of mind that you get asked a lot?

Rob Hoffman (05:53): Yeah, I mean, it is a very popular question. I think one of the things that really spurs it, the way that I hear it framed the most in talking with financial advisors is their phones are ringing off the hook from new sponsors or private credit funds, or everyone's trying to come to them to sell the next private credit fund or the existing private credit fund in. That just raises a level of concern, and I think that's a fair concern. But to Andrew's point, just because something is popular doesn't mean it's a bubble. Just because spreads have tightened as money has flowed there does not mean that it's a bubble, and it doesn't mean that it's not still a good investment. And I think private credit has continued to generate very strong returns for investors. And for that reason it continues to attract capital and you continue to see businesses investing in private credit solutions and companies wanting private credit. So that's not to say that it's perfect or that people can't be making mistakes, but it's hard to see bubble in the classic sense of bubble right now in looking at the data,

Lara Rhame (07:01): The fact that these advisors are getting these calls so often, is there an access story there? Is that part of the reason why they're getting more of these sort of calls from a wider variety of strategies? Because I think we're starting to see that access improve for a wider variety of investors.

Rob Hoffman (07:21): Oh, absolutely. I mean, private credit, it's been an asset class. It's been around for a while here at fs. We really,

Lara Rhame (07:31): And I think that's important to recognize this isn't actually a new asset class, correct? Yeah.

Rob Hoffman (07:35): But at fs, we have a history of bringing some private credit solutions that date back almost 15 years at this point. And you started to see the market grow in its adoption. The fund structures changed, new platforms started to add these offerings. I think to a certain extent, if you go back 15 years ago, we were almost a first mover, not just in providing access for retail, but moving into private credit before a lot of institutional investors have even made their allocations into private credit. And so as you look back over the past 15 years, broader adoption by individual investors, better fund structures, the market evolves, its attracted institutional capital. All of that has come together to create what seems like a boom in private credit. But to Andrew's point, a lot of it is shifting from other markets towards private credit and away from other markets. And to your point, Lara, it's absolutely access. Now we have all these different ways to be able to invest in it versus a more limited subset. That doesn't mean it's a bubble.

Lara Rhame (08:43): Right. Okay. So I think against that backdrop, if we've hopefully convinced listeners that it's not a bubble in the classic sense based on leverage and really sort of a systemic threat to the economy, I want to also acknowledge the fact that maybe people are saying bubbles sort of casually when really they're thinking of other concerns that are lingering in the back of their mind. Andrew, one of the things I love about the paper is that you sort of give the overall is it a bubble yes or no answer? And then you break down just three pages, three questions, three answers, really clean, look at some of the top concerns. And so I think concern number one, has private credit raised too much money too quickly, talk about a little bit over the last seven years we've really seen the asset class I think grow significantly. Why is that? There are reasons behind it, and I think those are really important to understand against the backdrop of this question.

Andrew Korz (09:45): Yeah, absolutely. And I don't have the exact figures here, but again, it's about $1.8 trillion globally. I think it's increased by three or four times over the past decade. So certainly significant rise in the size and the importance of the market, and specifically the importance of the market to the private equity space. A lot of private credit deals are being done to finance buyouts done by private equity firms. I think it's important to put the growth in private credit in context with the growth in private equity, right? Sure. And we've written a lot about the growth in private equity, the growth in sort of companies staying private for longer, referring to stay private rather than go public for areas, different reasons. So that's different parts of private credit as well. But we're I think talking mostly about sponsored deals here. So there's only about 500 billion globally of private credit dry powder, right?

(10:36):

So it's about a fourth of the total amount of private equity, investible capital available. Now, private credit's not going to get all those deals. It's going to wax and wane, but it's been between 70 and 80% of LBOs are going private credit recently. So you've got a real tailwind in terms of private equity, dry powder and demand for private credit. The other thing I would say is if there was too much capital coming into this space and chasing too few deals, I think you would see that in underwriting standards getting really lax, right? Certainly we've seen credit spreads come in, but we've seen that in public markets too. That's not something that we wouldn't expect given what's happening in high yield bond and loan markets. If you look at the equity contributions like PE companies are putting in 50% plus equity contributions into these deals. That's way more than it was occurring two, three years ago. So we haven't seen a deterioration in underwriting standards. To me, that's what I would look for in terms of is there too much money chasing too few deals really?

Rob Hoffman (11:34): Yeah, no, I think that's spot on. If high yield spreads at the end of 22, we're at about 500 basis points. And if you look at over the course of the average for the second quarter was probably 3 50, 3 25 to three 50. We in one of our calls yesterday, talked about the deal volume that we had done in private credit over the second quarter where we deployed one and a quarter, one and a half billion dollars at an average spread of SOFR five 50. So about 200 basis points wide to public markets. Now, where were things at the end of 22 on private credit, maybe more SOFR 600 to six 50, but just like you've seen tightening in the public markets, you've seen tightening in the private markets and the average spread of private over public today is I think very similar to the long-term average of 200 basis points or so. And so again, I think strength in the market does not mean that it's a bubble. The economy has been strong, the stock market was at all time highs. People are in a mood of taking risk and the markets reflect that that's going on, but that's how markets function. Supply and demand doesn't have to be a bubble.

Lara Rhame (12:44): Yeah, yeah. Well, and I think Andrew, you've also brought up the point that activity has ebbed somewhat. I mean, we have seen in the wake of the fed rate hike cycle, we've seen m and a activity slow. These are healthy signs.

Andrew Korz (12:57): I mean, rates went up 500 basis points. It got much more challenging to get deals done in private markets. I don't think that's a little bit any secret

Rob Hoffman (13:04): Here. It's more expensive, I forget.

Andrew Korz (13:06): So I've heard, I mean to your point, the space raised a lot of money in private credit in 2021 and the first part of 2022, and then deal activity kind of moderated and we're still kind of trying to get back to a more normal MA environment, but we've seen private credit fundraising kind of slow to meet that. So I think that's the sign of a healthy market when participants are watching the environment and sort of calibrating their capital deployment to sort of match that. So to me, again, that's representative of a market that's healthier than it is a bubble.

Lara Rhame (13:41): So I think that's the second concern I want to address today. Two of three is that the concern that valuations don't reflect reality. I think this is a concern that may stem from the fact that data on this space is hard to come by. I think, Andrew, you've made the comment before that today you can look at the high yield market and get every single metric that you could ever want and leverage loans as well. And this space is more challenging to find those numbers. And here again, our paper has a lot of metrics on this, a lot of data, not all of it, but what there is available we have. And so it's a good place to really find those charts and that data on this. But I want to start, Hoff, I'm going to flip it to you because I think you make the important point that a lot of protections are built into these deals.

Rob Hoffman (14:37): Yeah, I mean, I think especially in the market where I'm out talking with financial advisors and a lot of the products that they have available to them, most of these are SEC registered investment vehicles. They all have market valuation requirements. If we're doing offerings where we're selling shares at a certain price, the SEC requires us to go through valuations on a regular basis to make sure that the price of the shares that we're offering reflect the value of the fund. And so many of the sponsors are private credit vehicles, have third party independent valuation firms that are doing these valuations on a monthly or quarterly or annual basis. And I think that does provide a lot of protection for people that are looking to buy these offerings that the price that they're paying for share should be somewhat reflective of the underlying true value of these assets. Now they are private assets. They don't trade in the market the way a syndicated bank loan or a high yield bond trades with numerous broker dealers making markets and quotes, or it's not like a stock price that you can just look at and see what the market is willing to pay for it. And

Lara Rhame (15:48): That's the illiquidity premium, right?

Rob Hoffman (15:50): And it also results in variations in valuations. So it is true that on certain deals, if you start to run into issues, you may see some valuation firms start to take down that mark faster than other valuations, and it can lead to different firms that have different marks on the same position. That does happen, and I do think it's important for investors to understand if you're investing into a fund, what is the valuation policy? How frequently do they do it? Those are really good questions to ask. But in general, there are a lot of protections around valuations as it relates to private credit, especially for the vehicles that most investors are rushing towards today in the marketplace.

Andrew Korz (16:32): And I would just add two things. I think number one, private assets should be less volatile than public markets. There is an inherent illiquidity to private investments, and I think most people would agree that's where the potential return premium comes from. But folks who hold liquid investments want that liquidity. The problem is in times of stress, that liquidity and getting out of that investment can cost money.

Lara Rhame (16:58): I should say we're recording this on August 8th, 2024 after two weeks of epic volatil

Andrew Korz (17:06): Pop above 50 in times like this. And we've seen during Covid, the bid-ask spread on the leveraged loan market was over 300 basis points. So that has nothing to do with the inherent value of the security, it's just how much it cost you to get out of that security. So I think that's number one. And number two, we have about, I would say three probably good examples of down periods for private credit over the past 15 to 20 years, GFC, the 20 15 16 energy sort of bust and the covid period. And if we look at the valuations across the private credit market during those periods, the amount that loans in the aggregate were marked down ahead of the credit losses. The amount they were marked down was about double what the actual realized credit losses were for the market overall.

Lara Rhame (17:55): That's interesting because I know that when you're a lender, when you're a credit guy, you're just worried about avoiding losses. That's the goal. And I think it speaks to how cautious, Andrew Korz (18:06): And to be clear, there's a lot of dispersion there between managers. The nice thing about public markets is it sort of engenders this nice standardization. You see a quote on the screen on the Bloomberg, that's it. You kind of know what the price is with private markets, you really have to dig in and see who's the manager here, how are they doing credit selection, what's their valuation policy? All these things are really, really important when you're entering into private markets. Yes. So I think it's less about is this a bubble and more about what's my process for vetting these managers and making sure I'm getting top tier investors?

Lara Rhame (18:37): What are the best practices, right? Yep. Okay. Last concern that I want to address is the concern that somehow private credit borrowers are less credit worthy or that the credit is lower quality. And this is something that I think again comes from the idea because it's changed so much. 25 years ago, if you were a good company and you had really great growth prospects, you'd go to the bank and you'd get a loan or you'd go to public markets and you'd issue a bond. And I think there's the idea that today the borrowers somehow feel like they would be rejected or that those options aren't open to them and they're forced to go to the private credit space because this sort of avenue is closed to them because of their somehow weaker quality. And that I think is one of the most important pieces of this because I was even surprised to learn there's a reason why borrowers would spend 200 basis points more for a private credit deal. And I think that is one of the most important pieces of this. So Hof, take

Rob Hoffman (19:44): Us through that. I mean, I think that's right. If there's a question, is private credit providing capital to companies that otherwise no one else would be willing to do it? Right? I

Andrew Korz (19:55): Think that's the operative question here.

Rob Hoffman (19:58): And I think the answer to that is very clearly no. These are companies that over the past 30 or 40 years have all been financed in the market, whether it was a bank providing them the financing and holding it on their balance sheet, whether you have the birth of the high yield bond market and the syndicated loan market. Like companies were accessing capital in different ways. And today, private credit solutions for a lot of companies is an option. They could go to the public markets and get a syndicated deal, or they may prefer to stay and have a private deal because of some of the flexibility that it offers them. But what it's not doing is saying, here's something that nobody else wants and we're going to take an exorbitant amount of risk to hope that we hit a home run and it pays off. That's not what the private credit market is. And so I think from that standpoint, it really reflects the shifting of preferences, the growth in the market, what that attracts a certain type of company to say, well before private credit wasn't even an option to me, now private credit is an option. Let me see what it offers. And I think that's a lot of what the market is. It's not

Lara Rhame (21:06): When we did our podcast with Brian Gerson, I think he really went through, and I think there's also a link to that in the show notes. It's a deeper dive into his process, but he talks a lot about the reasons and the discussions that he's having with borrowers and the reasons why they opt for private credit versus a public option.

Andrew Korz (21:26): No, absolutely. And I think we've gone through that. It's the ability to get deals done quickly. If you're a private equity sponsor, you have a company, you want to get a deal done fast and you want certainty of execution, you want pricing certainty, private credit's going to give you that a lot better than the public markets might. It's the ability to come to the table if something goes wrong and try to negotiate out of that. All of those things, a lot of borrowers are worth 150 to 250 basis points. And Rob, I love what you had to say because it does kind of bring us full circle back to the original question and sort of our macro discussion. If private lenders were lending to companies in a 2 trillion market that just didn't exist before, and companies that wouldn't have gotten financing, that would show up as higher and higher debt levels in the private sector. And we just haven't seen that at all. So it really is this, if you've got these different buckets in the leveraged finance market, it's just putting a little more water in this bucket and a little less water in this bucket. And you've talked about this a lot. As the private credit market has institutionalized, it's increasingly gone up market. It's increasingly first lien, whereas before it might've been more mezzanine stuff. So the market has evolved, but by and large, I think all these deals were getting done. It's just which types of lenders we're doing

Lara Rhame (22:42): Them. And I think if we zoom out even further, we can look at the very strong revenue generation that is within the middle market even compares very favorably to what you get from s and p 500 company revenue generation. So these are companies that are smaller, they've got more growth trajectory ahead of them, a lot of them are very stable. I think that is critical to appreciate that you're talking about a really large pool of borrowers, 200,000 middle market companies and get to weigh in as the macro economist that with an economy that looks like it's doing well and growing at a healthy pace, albeit probably a little bit less frothy than it was over the past year and a half, looks on target to grow around 2% for this year. That is certainly of strong backdrop for these companies. And there's a really, I think, rich pool to draw from and these companies need financing.

(23:42):

Alright, so as we conclude this, I think maybe one of the key takeaways is the worry about a bubble really implies this systemic risk to our entire financial system. So, I really want to try to put everyone at ease that it's not living in private credit. There isn't a boogeyman here that's going to affect all of the financial system. And I think more importantly, digging down into these concerns, which I think are valid and we need to address, is something that reflects a fact that we need to really, as financial advisors, think about the growth, income and diversification that our clients want, and focus in on that.

Andrew Korz (24:31): Yeah, absolutely. And I think ultimately this is an investment with credit risk. I think to your point, I love what you said. I mean, this isn't necessarily something we need to look for a deeper concern in from a systemic standpoint. It's more so just evaluating on its merits as an investment. We think right now it offers really attractive income and sort of reasonable credit risk for that income level, but it is a credit market. If we have more concerns about the U.S. economy, there could be defaults and losses in this market.

Lara Rhame (25:09): Absolutely. But I do think the more meaningful discussion is evaluating it as an investment option, not necessarily this larger bubble risk.

Rob Hoffman (25:10): Yeah, I fully agree with that. There will be winners and losers. There will be defaults again that come to market, and there will be private credit funds that have more defaults than other private credit funds. It just goes into the process of evaluating what manager do you want to partner with and what are their best practices and how do they value their assets and are they stretching for deals or are they sticking to their investment guidelines? All of those are very valid concerns and valid questions to ask. But to me that's like every other investment option we're faced with in the marketplace. And that goes hand in hand with how we pick investments and build portfolios.

Andrew Korz (25:46): And I would be just one more thing. I would be a little bit wary of reading articles in the news media. Thank you.

(25:56): The reason being, as you mentioned earlier, it's challenging to come by really good data in this market. So, what ends up sucking up the air is sort of a deal here that's done with ridiculous terms that shouldn't have been done, a quote from a manager over here and it catches on wildfire, and everybody starts quoting it, and it becomes sort of the market narrative of the day. And it's really important to sort of try to aggregate as much data on this market as you can and make educated decisions based on that. But I think what ends up getting picked up in the news media isn't necessarily reflective of broadly what's happening in this market, which

Lara Rhame (26:31): [This] Is the best advertisement possible for your own paper, which does have an aggregated, thoughtful look, and really pulls the data in and gives that education on these issues and really what you can expect and what you're looking at. So please give it a read.

Thank you everyone. Thanks, you two. Appreciate it. Hoff, great to see you here in Philadelphia.

Rob Hoffman: Hey, great to be here. Thanks, Lara. This episode was 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 Venditti and copy provided by Harrison Beck. Special thanks to show coordinators Ellie Zhang and Lara Coleman. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.

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