The Takeaway with Troy Gayeski: Are private credit markets too good to be true?

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[00:00:21] Harrison Beck: This is "The Takeaway with Troy Gayeski," a podcast from FS Investments. We sit down with Chief Market Strategist Troy Gayeski to get the key insights from his latest strategy note. I'm Harrison Beck, FS Investments content strategist. I'll take Troy through today's top questions so that you can get the takeaway.

So, Troy, your new strategy note, it's called, "Are private credit markets too good to be true—Or just factually true?" It's a detailed, deep dive on private credit markets. It's full of some amazing charts and some really actionable resources for answering tough client questions on private credit.

In this strategy note, you write that the opportunity set for private credit is still rich, and you take us through this two-part structure for answering investment questions, a top-down approach, and a bottom-up analysis. That's how we're going to have our conversation about this today. Tell us about this structure for understanding this question.

[00:01:42] Troy Gayeski: I think for every investment strategy, we, along with other market participants, are trying to come up with the best strategies, the best investment opportunities, with the best risk-adjusted returns, and it's very important to look at it from a top-down lens, right. A, to make sure you're not missing anything, right. Because that's really where things can go pear-shaped. Where, for instance, going into the Global Financial Crisis, if you're unaware of the impending danger of the housing market, real problem. You just got completely obliterated. There are some really great investors, I won't name them, that were big in banks and just had no idea what was going on. And so it really destroyed their careers. Similar to if you're unaware of just the power of money supply growth driving assets higher.

So we're always trying to look at whether it's broader markets or individual strategies or individual trade theses. What is the top-down macro data telling us? Is there more risk, less risk? Should we be more concerned about this, less concerned about it? And so that's always a staple of how we attack any opportunity. And then the bottom-up, it's very important to triangulate top-down theory with bottom-up data, regardless of whether it's a stock, a credit position, private or public. In this case, looking at market pricing. In fact, when we go through this discussion with investors, here's what the top-down theory is telling us. But by the way, if you always ask me who's winning the supply for credit or the demand for credit, the best way to answer that is look at current market pricing.

Because I could tell you all the top-down theory in the world, but if spreads were 200 over and we were about to have a recession and the Fed was going to cut to one percent, it's a different situation. So, I think triangulating those two is important for any investment strategy. Unfortunately, both the top-down and the bottom-up in this case continue to argue for a robust opportunity for private credit—whether it's commercial real estate lending, whether it's asset-based lending or asset-based finance, or whether it's middle market, upper middle market, cash-flow based loans to corporate, typically private corporate entities.

[00:03:52] Harrison Beck: Well, let's get into it. Let's take a look at the...

[00:03:55] Troy Gayeski: Sweet.

[00:03:56] Harrison Beck: Let's start with top-down theory. So, first of all, there's this trend you speak to of the consolidation/disintermediation of banks from lending. How is this trend creating potential opportunity for private credit investors?

[00:04:11] Troy Gayeski: So, we often talk about secular trends, but within secular trends, there are cycles. And one of the most profound secular trends as it applies to private credit has been this consolidation of the U.S. banking system. And so, depending on your time horizon, we have roughly 71% fewer banks, I believe, than early nineties.

And that bank consolidation wave has helped explain or drive the fact that commercial and industrial lending is roughly less than half of bank balance sheet assets versus when we had vastly more banks out there. And so this is certainly a mega trend of consolidation. And then again, within that mega trend, you have certain periods of time where banks are less willing to lend, more willing to lend. Obviously, the Global Financial Crisis, much less willing to lend; eurozone crisis, similar. You had a boom in bank lending coming out of the pandemic because banks had tons of tier one capital. Had ridiculous levels of total reserves or excess liquidity. And we're basically told by the regulators, SEC, FDIC, Treasury, get money out the door. That's your job. And I'm not even talking about the PPP program, which was a separate stimulus measure. And then you hit environments...we started to enter Q1 of last year, and actually even earlier, if you take interest rates into account of banks really, cutting back on lending. So, bank consolidation has been an important reason why the opportunity for private credit has emerged.

And, if we hadn't had bank consolidation, if we hadn't had regulatory reform coming out of the Global Financial Crisis, if in the case of commercial real estate...basically banks completely gave up on transitional lending, which is really what alternative lenders focus on, the opportunity for private credit would be much more muted.

What would end up happening is if capital were raised, you would end up with far lower return opportunities, which would in turn be self-correcting. Returns would be stinky and people would wonder: What the heck do I need this for? I'm not investing. Maybe I'll buy JP Morgan stock or buy the stock of a bank. But fortunately that's not the world we live in. And we're in this universe and these are the facts as they've played out over the last 30, 40 years.

[00:06:24] Harrison Beck: Well, there's another trend that has increased the demand for private credit, and that's more companies going private and staying private. What is this trend, and how has this trend impacted private credit markets?

[00:06:36] Troy Gayeski: So this is another one of those mega trends, where you've had just tremendous growth, really kicked off by Sarbanes-Oxley reform, which was, when there are crises in this case, it was the dot-com bubble implosion. Sometimes there's regulatory overreach and, I'm not saying it was regulatory overreach, but it really disincentivized companies to stay public.

'Cause the reporting requirements were so much more rigorous and the motivation for CEOs and investors to have to go through those hoops and focus on quarter to quarter. It helps explain a lot of that, but you've had this tremendous boom in companies remaining private. Approximately 40% more and approximately 38% less, I want to say, that are public now.

And so that is a mega trend. And then as that trend has occurred, you've seen this buildup in both private equity capital. 'Cause if you can make good returns in private equity, and companies want to stay private for longer, there's a nice symbiosis there. And one of the things people forget about is that typically every dollar of private credit or equity that's invested, there needs to be a dollar of private credit. And so they're naturally grown together. And, again, if you look at the vast trove of private equity capital that has already been raised, that has not been put to work, it's about 1. 8 trillion, globally; about half of that's in the U.S. And typically half of the credit dollars for private transactions these days come from private credit. So, you have 1.8 trillion; cut that in half to 900 billion. That's just the demand for private credit we're going to see from capital that has already been raised in private equity. Even though private equity inflows have slowed, they're still very large in scale.

From our perspective, going forward, this mega trend will continue. It means that, when you see these numbers of a billion raised here, five billion there, when you're an advisor or institutional consultant and you've just been pitched six private credit funds, I understand how it makes you nervous. But you have to step back a little bit and think about it holistically, and the fact that the demand equation is going to be with us for quite some time.

[00:08:42] Harrison Beck: So do you think it's true these advisors are seeing just numbers that look really large, and they're saying, well, that must just mean too much has already been done here? I should look elsewhere.

[00:08:54] Troy Gayeski: Well, yeah, for about six months, there's been a lot of private credit launches. There've been some press articles that have been less flattering of the strategy. And again, the motivation for the press is, is it a good one. Let's shed transparency on a less transparent market.

And in our opinion, sunlight's the best disinfectant, right. So the more transparency, the better, but you know, if those articles are skewed negatively, for whatever reason, that combined with the launches combined with, again, a billion dollars here, five billion dollars there, twenty billion dollars in the case of one large wealth management firm. Those are big numbers.

And for those of us that grew up, or were born in the '60s or the '70s or the '80s, sometimes you forget just how vast the U.S. economy is and how much it's grown in a short period of time. We had a little over a $5 trillion, I think it was 5.6 trillion roughly in 1990. It's now 28.6 trillion in size, 1.8 trillion of that's been added in a 15-month period. If you look at how much bank lending growth has taken place over that time, it's been much, much lower than you would have expected.

The vast scale of bank lending, B; the vast scale of the private credit opportunity, C; and the fact that there's been this very meaningful shortfall over a relatively short period of time in banks' willingness and ability to lend, the number is roughly 450 billion. That's a big number, right. That's how much more credit creation you would have expected from banks in terms of loans and leases over the last 15 months based on where nominal GDP has grown. If you keep that bank loan and lease ratio to nominal GDP right at 0.45, which is typically where we've been in the post-consolidation period of banks, in the '90s.

Now there have been times even higher, like the pre-Global Financial Crisis, like during the PPP period. By the way, right before banks started to fail, there have been times we've been lower, like in the aftermath of the Global Financial Crisis. It looks like we're trending lower right now. But these are big numbers, and I think that's one of the principal challenges for us again. Every strategy is just trying to articulate and educate on…if you see a billion here, 5 billion there. When we were all younger people back in the nineties or even the 2000s, those are big numbers. But now they're relative drops in the bucket compared to this opportunity set.

[00:11:25] Harrison Beck: Well, going back to banks, how have those recent bank failures impacted bank loan growth? And what does that mean for private credit investors?

[00:11:34] Troy Gayeski: So, like I said before, the banks were really on this lending binge starting late 2020, '21, and even through Q1 of '22, where they had tremendous levels of tier one capital, well above 50% more than pre-Global Financial Crisis over 4 trillion in total reserves; but also, because they're capitalist institutions and the economy is growing, to lend, and lend aggressively.

And then you start to see underwriting standards tighten in '22, even as far back as '21, in '22 is mainly driven by much higher interest rates and the uncertainty that caused financial condition tightening. But then in '23, when banks started to fail, you saw underwriting standards tighten even further. And you saw this massive deposit flight out of the U.S. banking system. And, basically what was going on is you had about 1.2 trillion of deposits fleeing regional community banks, about 400 billion of that going to too big to fail banks. So that created an environment where you not only were constrained in what you could lend, but also, you had to be concerned about your current assets because as deposits flee, and you're seeing very well-publicized failures of very, very large banking institutions, you're clearly going to be even more risk averse.

So, basically bank lending is grown at a very small pace. It stagnated and actually contracted for several [00:13:00] quarters in '23. It started to pick up more recently. But back to this concept of big numbers, there's been roughly 380 billion of, or 350 billion of loan and lease growth from the time right prior to the bank starting to fail.

So we cut that off at 331, from '23 to today, versus an expected loan and lease growth of about $800 billion, again, based on that 1.8 trillion of nominal GDP growth. And so when you think of that shortfall, and this is a classic example of trying to come up with thoughtful top-down ways to understand the opportunity because I've never seen this done anyplace else.

The shortfall is about $453 billion, very, very big number. And clearly, as the bankbook losses have come down, underwriting standards are still tightening, relative to the prior quarter, which is kind of shocking, actually, because they've been tightening for quarters now. Eventually, banks will get more comfortable. And so you will see loan and lease growth pick back up, we think. But this actually brings me to another topic in conversations with advisors. I'm always very quick to point out to people that we don't expect the opportunity for bank sourcing assets directly from banks to last forever.

We don't expect the opportunity to do bankruptcy, probability, eviction, reduction, dip, asset-based loans forever. Because over time, the banking system will cure itself. We'll get back to more normal loan environment and they won't be rebalancing away from asset classes like commercial real estate or asset-based loans, and providing us with the opportunity. Furthermore, one would expect the companies that have come into this dramatic tightening period where the Fed hiked so aggressively, and just didn't plan for that. Eventually, they'll grow EBITDA enough that they won't need help from private credit folks like us to extend credit, in most cases, receivables. So, no opportunity lasts forever. The opportunity for private credit we think is evergreen, but those are two really unique niches within there that we guide people to say, hey, this is awesome. We're leaning into it now. It's not going to last forever.

I'm not saying banks are going to go back to the lending that they did pre-Global Financial Crisis; it's a whole new world. However, within private credit, we think there are some really unique niches now that were clearly created by bank stress, that were clearly created by the Fed hiking at the fastest pace in over a generation that when I think of three, five years from now, either won't be there or won't be as target rich as they are now.

So you always got to strike while the iron's hot with the acknowledgement that yes, this is a secular opportunity. I wasn't suggesting that. I was just suggesting that some of the niche opportunities that we're monetizing today, aren't going to last till 2050.

[00:15:55] Harrison Beck: Well, it just speaks to the fact that whatever manager you partner with needs to be somebody who's agile enough to understand when a trend like that is happening and understand exactly what you're saying, the trend is also going to have limits.

[00:16:07] Troy Gayeski: That's right, and back to this concept, there are secular trends and then there's cycles within that secular trend. Bank consolidation, secular trend…but there are cycles where there's more and less. Bank underwriting standards have gotten secularly tighter, but there are cycles within that. Private credit and private equity have grown, dramatically, but there are cycles within that secular trend as well.

[00:16:32] Harrison Beck: At the beginning of this episode, we talked about how you split the strategy note into two sections, the top-down approach and the bottom-up approach. Let's transition to the bottom-up pricing of private credit within corporate and commercial real estate loans. What's happening here specifically with spreads and leverage?

[00:16:51] Troy Gayeski: So this is really interesting, and this gets back to this whole concept of triangulation. And so there's a lot to unpack here, but a great starting point for looking at spreads, pricing, loan-to-value ratios, debt-to-EBITDA and corporate loans. January 2022 is a pretty good time to start. It was really before markets started to adjust to a dramatic Fed tightening cycle. It was before markets started to adjust to a higher risk of recession than we'd seen certainly in late '20 and '21 and early '22. And so, we started basically there.

With a very low base rate of secured overnight financing rate (SOFR), at the time, I believe it was still LIBOR, it was certainly LIBOR in '21, and we were in the process of transitioning to SOFR. So as a floating rate private lender, your starting base rate was basically zero. And then, you had spreads that were roughly, and I want to quote this accurately. So I'm going to double-check. I should have this memorized, but I want to triple-check because this is going out to the public. So, you had spreads at 5.50 to 5.75 over, then you had a small amount of fees. And so basically your three-year yield was roughly 6.5%–7%. Obviously, much better than risk free, much better than investment grade bonds or what you'd see in munis.

But the flip side is that you also had higher risk at that point, particularly in late 2021/early 2022 because you had the highest LTVs and the highest debt-to-EBITDA ratios, partially because banks were lending like crazy and lending very, very aggressively. That was kind of a counter-trend rally in bank lending. So you had LTVs in the 50 to 60 range. You had debt-to-EBITDA roughly 5.5 to 6 times. So on a risk/reward, not that great. And then as we went through this tightening cycle and the strategy breaks it up, different timing because as spreads were widening, the base rate wasn't quite at its max and then spreads started to tighten, really from the summer of '23 after base rates have maxed out.

But you think where we are today, you're basically at SOFR 533, 529, but let's call risk-free five-and-a-quarter, five-and-a-half. Fees are basically the same, spreads are actually tighter today than they were back in January '22, but you can think of that as a concession for private lenders to their corporate borrowers, because of how much higher the base rate is. And LTVs very, very importantly are materially lower in that 40%–50% range. And debt-to-EBITDA is more like, let's call it four-and-a-half to five. So, I often say, when you can get more total return, think roughly, I don't know, 4.5% more income, let's call it wide range, 4.25 to 4.75% more income. You could do it with significantly lower risk in terms of LTVs and debt-to-EBITDA.

You've gotten a free look at a pandemic, at an inflation surge, at a rate shock. Those opportunities don't come around that often. So, both the macro environment, these secular top-down trends, and bottom-up pricing are telling you that you're in one of those unusual periods where you can earn meaningfully more return, through income, with much lower risk. And that's a rare combination. Now, we're also the first to admit that spreads are tighter today than they were at the wides from October '22 to June, July of '23.

Okay, great. I wish we could lend at risk-free plus 10% at 10 LTVs. Just because spreads are tighter today than they were at the wides does not mean the opportunity is not still great. And when you compare it to high yield bonds, for instance, high yield bond spreads are about 300 basis points tighter, so private credit moves with a lag to public markets. There isn't as much beta or amplitude in the move. So, when high yield blew up by 300, private credit blew up by about 150, 175. When private high yields come back in… private credit…spreads come back in as well.

But just because you're no longer at the wides in price does not mean the opportunity isn't rich. I always go back and I say this a lot. When you think about where we were September of '21, before the Fed admitted that inflation was transitory, I think most of us that had a clue were aware at the time, but it took them until November '21 to admit that. A lot of what's transpired gets back to that too good to be true concept. Like it's, oh my goodness, the Fed is hyped by 525 basis points and we haven't had a recession. Oh my goodness, not only are you earning 4.5% more income with lower risk.

You have two discrete opportunities in private credit that you wouldn't have dreamed of back then, sourcing assets directly from bank balance sheets—which for every student in market history—we thought was well behind us. And then second, being able to provide these short-term financing vehicles for companies like Weber or Bausch. That opportunity had never existed before. And so, sometimes you have to pinch yourself and say, not only is this not too good to be true, it's factually true. And, when you have an opportunity to make more income total return and take materially less risk, you have to seize it. Don't let headlines that may be skewed by viewpoints or the fact that the fifth private credit firm came into your office and said, hey, we've got this great strategy. Don't let that distract you from this wonderful opportunity to kind of seize the day.

[00:22:47] Harrison Beck: Well, usually this is the point at which I kind of wink and nudge toward the title of the show and ask you to give us the takeaway from the strategy note. And since we've talked through so much great data today, let me be more specific with my final question. We've heard your top-down analysis. We've heard your bottom-up analysis. What can we conclude from all this data about the opportunity set for private credit?

[00:23:09] Troy Gayeski: Yeah, I think the number one conclusion I'd say to people is, remember, this is a secular trend. It's been with us for quite some time. You've had materially better outcomes as an investor in private credit than most other assets. Both the macro environment from an economy and Fed policy standpoint have been very accommodative. We've gotten the added benefit of banks being more risk averse. We've had the added benefit of whole new areas opening up that groups with that capability can take advantage of. So if you're looking for strategies, that can solve for low risk and high single-digit low-teen return, it's really hard to figure out how you beat a clean vintage private credit strategy that can focus on asset-based loans, source loans directly from bank balance sheets. It's a wonderful time for private credit. And that's why I've said for quite some time, the time for private credit is now.

[00:24:06] Harrison Beck: The time for private credit is now. Well, before we close out this episode, tell us what's coming up. What will your next strategy note be about?

[00:24:15] Troy Gayeski: Yeah. So I'm always trying to figure out ways to evolve from the last strategy note. Again, we want to stick with the major theme this year of putting cash to work because many institutions, mega QPs, family offices, the average investors have way more cash, whether it's in T-bills or money markets or preferred savings accounts than they ever had historically. So we've tried to stick to that major theme, but we gave folks a lot to digest in terms of top-down, bottom-up pricing. And I think the next strategy note, I'm going to get more specific on actual tangible examples, give a lot more color on the bankruptcy probability reduction, dip ABLs, for instance, sourcing loans, whether they're commercial real estate or whether there are other types of asset-based loans directly from bank balance sheets.

I haven't talked about private equity in a little while, and there's just so much wonderful stuff going on in the secondary market or now in the co-invest opportunity. I was thinking of maybe combining them, but probably for brevity, I'll stick and close out private credit, and then I'll segue to the following strategy note to highlight people…all the really cool stuff we're seeing in middle market private equity, in particular. And you can't understate this enough, how much richer that opportunity is relative to make a cap buyout where it's a much more challenging environment.

[00:25:35] Harrison Beck: Well, we'll look forward to seeing that when it comes out. For now, check out Troy's current strategy note, "Are Private Credit Markets Too Good to be True or Just Factually True?" You can find it on our Insights page at fsinvestments.com/insights. This note is full of amazingly actionable data, succinct arguments, speaking of brevity, and great charts for informing client or prospect discussions around the opportunity in private markets. Thanks for a great conversation, Troy.

[00:26:05] Troy Gayeski: Great to see you, as always, Harrison, enjoy the rest of your summer.

[00:26:09] Harrison Beck: Thanks so much, you too.