TALKING POINTS

David Golub, president of Golub Capital, says he is very proud of the way his firm has risen to the challenge of covid-19

Covid and private debt: The lessons learned

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Q This year has put all investment managers and strategies to the test. How do you think Golub Capital fared?
2020 isn't over yet – but right now I would tell you I am very proud of how Golub Capital has handled this year's challenges. Golub Capital has performed well both for sponsors and for our investors, despite the challenges of covid.

When covid began, we launched a three-part strategy. First, we gathered information about the virus and pandemics, how long this might last and the likely policy responses. The second phase was to identify our hardest hit borrowers and put in place game plans to help them address their issues. The third phase was to scour the entire portfolio and develop game plans for every borrower. We are now well into phase three, so we have a good sense of where the problems are and aren't. The good news is that, for the vast majority of our portfolio, it is business as usual. Over 80 percent of the portfolio is in areas like business-to-business software that have continued to perform well and grow despite covid. We don't have exposure to the hardest-hit sectors like airlines, hospitality, gaming, energy or commercial real estate. We do have some exposure to sectors like retail, restaurants, health clinics and fitness clubs. Taken together, these represent less than 20 percent of our portfolio, and that 20 percent has gotten an outsized portion of our attention these last six months.

What we have found to date is that our borrowers have generally performed much better than expected – and especially those in the covid-impacted sectors.

Q What is your view on the outlook for private debt managers?

I'm optimistic about our niche in sponsor finance. The sponsor finance business is driven by private equity, and we think it's likely that private equity will continue to grow rapidly. Consider that private equity has its largest reserve of dry powder in history—over $1.5 trillion according to data from Preqin. In terms of buying power, even on a conservative 1.5:1 ratio, that is over $3.75 trillion. By contrast, the whole of the current syndicated loan market has approximately $1 trillion outstanding. Looking three or four years ahead, we think it is very likely that private equity will continue to grow, and this will create more opportunities for the leading sponsor finance players.

Q To what do you attribute the better-than-expected results?

I think there are three key factors that underlie the better-than-expected results. First is good underwriting. We have always sought to lend to resilient companies in resilient industries backed by strong private equity firms. Many of our borrowers have done well through covid because of their inherent resilience. But even where we lent to consumer-facing businesses that were hard hit, they have generally done well – because we backed powerful franchises with passionate customers.

For example, one of our companies is a boutique sneaker retailer that shut down during the lockdown but saw lines out the door when it reopened and has had double-digit positive same store sales during this covid period. Another example is a bakery concept called Nothing Bundt Cakes. Their customers have stayed very loyal to the company's version of 'comfort food'. Same store sales growth has been double-digit since May.

Second, I have been really impressed by how quickly and ably our management teams have adapted to covid by cutting costs and pivoting to new ways of reaching customers. Ironically, this may have been an unexpected dividend of the financial crisis: I think one of the learnings from the financial crisis was the need to react with speed to a changed environment. I also think it's a testament to our sponsors and their skill at building and backing strong managers.

Finally, sponsors have stepped up. When covid began we were concerned there would be so many problems in so many areas that sponsors would not know where to focus. That hasn't happened. Our sponsors have been very engaged. They have provided their companies with great advice and counsel; in some cases they have parachuted in operating personnel, and in many other cases, sponsors have provided equity infusions.

Of course, it hasn't all been smooth sailing. We have done over 300 amendments across our portfolio. Sponsors didn't always get everything they wanted. We have needed to balance our desire to be a good partner for our sponsors with our desire to be a good partner for our investors. I think so far we have done a good job of establishing that balance.

Q What has been the feedback from investors?

Our investors have told us they are pleased with both our returns and our transparency. We don't sugar-coat. When we had lousy results in Q1, we explained why, we explained what we were focused on and we explained what we expected for the rest of the year. Most of our investors have been with us through multiple cycles, and they know that what matters most in the end is realised credit losses, not short-term market volatility. So, we focus a lot on helping our investors understand the difference between unrealised losses (which will reverse over time) and realised losses (which won't). The story of Q2 and Q3 has largely centred around reversals of unrealised losses.

I think our team has done a great job of helping our investors understand what to expect from Golub Capital,

including our approach to underwriting and portfolio construction. This is immensely helpful during periods of turbulence because it gives us a frame and a common language. Covid is preventing us from visiting with our investors in person the way we are used to doing, but despite this, we have been very successful in raising additional capital. We've raised over $5 billion of incremental firepower so far this year.

Q What lessons have you learned from navigating covid so far?

If you had told me in January that we were going to have to shift to an all-virtual working environment over the course of a weekend in March, I would have said that was unlikely to go well. In fact, it went exceptionally well. We complete approximately 300,000 cash transfers and send out tens of thousands of investor reports in a typical year. The fact that we were able to continue with loan operations, treasury functions and investor reporting without missing a beat is a testament to our team and the careful business continuity planning we had in place.

The investment function has also worked exceptionally well during this period. Thank goodness for MS Teams and Zoom. With these tools, we have been able to sustain the spirited discussions that are core to our decision-making process.

We have also made some mistakes. In the early days of the pandemic, we were too tough on some of our borrowers/sponsors. For example, several of our borrowers in the eye-care space and in veterinary services were seeking additional capital to accelerate their growth through acquisitions. We supported them, but in hindsight we were too cautious.

We have also learned an important lesson about risk: there is a collinearity of risk around businesses that involve people congregating in close proximity. This is not a factor risk we previously considered in investment decisions. We should have, and we will in the future.

I think we are already better than we were pre-covid, and we are on a flight path to continue to get better still.

"Covid is playing to the strengths of the largest, most successful private debt managers, reinforcing competitive advantages based on relationships and incumbencies"

Q What trends are you observing in deal activity as we move towards the end of the year?

In Q3 we started to see a pick-up in deal activity, especially in areas not highly impacted by the pandemic like software and veterinary services. Now, we are seeing a broader revival in M&A. We are not back to pre-covid levels, but we are definitely seeing a more robust level of activity. After periods of depressed M&A, you tend to have periods of high activity. I expect dealflow in 2021 to be strong.

There are also some interesting trends in how deals are being financed. In important ways, covid is playing to the strengths of the largest, most successful private debt managers, reinforcing competitive advantages based on relationships and incumbencies. Because it's hard to form deep bonds over Zoom, there is a natural tendency for sponsors to want to work with people they already know well. For us, that's a boon, because we have always done a lot with repeat customers. More than 80 percent of our originations each year going back nearly a decade have been with a core group of 200 sponsors we have done deals with before.

Incumbencies are a similar story. Pre-covid, the existing lender (that's what I mean by an incumbency) tends to be in pole position when the company needs a bit more capital, or if the company is sold to another sponsor. In a covid environment, that's even more true because it is harder to do due diligence. Again, that accentuates the competitive advantages of the larger, established private debt players.

Q What about loan sizes?

In 2019 we started to see the emergence of what we call 'mega one-stops', which are unitranche loan facilities north of $500 million. Golub Capital has done more of these than all our competition combined, leading 17 mega one-stops done in the last two years. In 2020, we are seeing the trend towards mega one-stops continuing. I think the reason is simple: middle market sponsors have long known that one-stops are highly reliable, highly scalable solutions well-suited for buy-and-build strategies.

Now that they can be executed in size, one-stops are gaining share in larger transactions. We recently expanded two unitranches, bringing each to over $2 billion. ■