KEYNOTE INTERVIEW

Cycle-proof values

Private credit managers should focus on the timeless values that will serve them well despite broader market uncertainty, according to David Golub, president of Golub Capital

Private credit managers are, by nature, conservative. When the upside is clearly defined, they will devote their energies to managing the downside, which always involves considering the future. But when the future is hard to predict, how should managers go about that?

David Golub, president of Golub Capital, believes the answer is operating with timeless values that will serve and protect the bottom line regardless of the market's overall climate. Those values include discipline, humility and nurturing and maintaining long-term relationships.

Golub should know. His firm is celebrating its 30th anniversary this year and boasts an enviable track record. So, *Private Debt Investor* sat down with Golub to get his take on the current market, how sticking with those core values helped build the business and how they continue to serve Golub Capital, in the good times and in more challenging conditions.

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Q What is your take on current market conditions and some of the themes you see playing out in the market today?

If we look at market conditions today, I'd highlight a couple of themes. One is that, in the period since covid-19 began, the consensus has been consistently wrong. Consensus was wrong in thinking that covid would lead to a bad recession. It was wrong in assuming that all the stimulus spending would lead to transitory inflation. It was wrong that inflation was going to be sticky and stubborn after interest rates went up. It was wrong in 2023 when, once again, many expected a recession. So, we're in a period where we have to be careful about making predictions and admit the limitations of our capacity to draw conclusions from patterns.

The second theme is that M&A volume has been depressed since the summer of 2022. In the wake of rising interest rates, deal volume fell dramatically. This was partly because public equity valuations fell, and sellers didn't want to settle for new, lower prices. Additionally, financing was challenging for a period. Since the fourth quarter of 2023, that's no longer the case. The investment-grade market, the high-yield market, the broadly syndicated loan market, and the direct-lending market are all wide open.

The consensus expectation has been that, with financing healthy again, deal activity would rebound. That's been the prediction for the last five quarters, but it hasn't come to fruition. My sense is that we're going to have to wait until 2025, perhaps even the middle of next year, to see a meaningful rebound in deal volume.

Deal activity will benefit from interest rates being on a downward trajectory, increased clarity on policy once the US election is decided, and the potential for higher taxes when the Trump tax cuts expire in 2025. A pattern we've seen in our business over many years is that sellers are typically motivated to get transactions completed before tax hikes happen.

Q What are you seeing in your own backyard of private credit?

We have seen a particularly rapid growth of private credit over the course of the last five years. Private credit has not only grown with the private equity ecosystem, it has also taken a significant amount of share from the broadly syndicated loan market. I don't think either market is going away, but we are seeing a movement toward a new equilibrium between the broadly syndicated market and the private credit market.

Q What does that new balance look like? 70/30? 50/50?

It's important to offer some historical context here. In the early days of the private equity ecosystem, there was no private credit. Deals were 100 percent financed by banks, often coupled with a junior class of debt provided by an insurance company or a mezzanine lender. In the early 1990s, we saw the first of ultimately three waves of regulatory action that put increasing constraints and disincentives on banks to the point where direct bank lending to sponsor-backed companies is now very small.

Today, there are effectively two markets. For middle market private equity-backed companies, the market is dominated by direct lenders. For larger companies, there's a mix. Starting in 2019, companies requiring $500 million or more in debt, which historically would go exclusively to the broadly syndicated market, started to go to private credit. That shift was a function of several private credit players, including us, developing the scale to offer solutions of that size.

What I think everybody's been surprised by is the pace of growth in the large market private credit niche, which is where the broadly syndicated market has lost a significant amount of share. Today, we see sponsors choosing between a broadly syndicated solution and a private credit solution for large market deals, depending on what works best for a particular situation. And we see sponsors move from one solution to the other in the same obligor. I think this will be a long-term trend for large market deals. We focus on the core

Q Golub Capital is celebrating its 30th anniversary, so there's plenty of muscle memory for addressing all kinds of cycles. From your perspective, what's the key to longevity in direct lending?

There are two core beliefs that have guided Golub Capital since we got started in 1994. The first, which may sound obvious, is that investing is hard. There are very few investment geniuses. Investing is just like any other business – to produce consistent premium returns, you have to build and sustain a strong set of competitive advantages.

The second core belief is that relationships matter. Good businesses have strong enduring relationships with their customers. Their customers want to work with them, and they want to work with their customers. There's a path to an alignment of incentives where each group is actually looking out for the other. This is a very different mentality from the modern Wall Street world of counterparties.

I think these two principles have been foundational to our ability to deliver 30 years of results for our clients, partners and employees.

middle market, where this dynamic is less common and private credit is still the dominant choice.

Q What do you credit for your long-term competitive advantages?

We identified a niche, which was to be the best at providing financing solutions to middle market companies backed by private equity firms. Perhaps most importantly, we've stuck to that niche. It can be very tempting when you're successful at one thing to think you can be successful at a dozen other things too. We've intentionally stayed focused, and that has allowed us to develop several competitive advantages in our niche of sponsor finance.

One key advantage is that we believe we are very good at assessing credit risk, as evidenced by our historical default rate versus the broadly syndicated loan index. In general, we're lending to smaller companies, and getting paid more in spread than investors in broadly syndicated loans. So, we should have a higher default rate than the BSL market. But for over 20 years now, we have had a default rate that's less than half that of the leveraged loan index. We are good at figuring out whether companies are resilient enough and have the right characteristics to avoid getting into trouble.

As I mentioned earlier, relationships matter. We designed Golub Capital to be a compelling strategic partner to private equity firms. Sponsors want a partner that can provide a range of financing solutions for companies large and small, has the scale to grow with borrowers, can provide industry expertise and add value during diligence, and has a steady hand when the seas get choppy. By doing all of these things over time, we have cultivated strong, long-term relationships with sponsors. About 90 percent of our deal flow each year is from the same core group of about 200 firms.

Incumbencies are another source of competitive advantage. We are lead lender to about 350 companies. When those companies need new capital, the incumbent lender is often the most logical provider of that capital. We already know the company, we know the CFO, we've already underwritten the credit, whereas a new lender would be starting from scratch.

"We've built our competitive advantage by picking our niche and staying faithful to it"

Q Given predictions are often wrong and we are navigating an era of perhaps heightened uncertainty, how are you building resiliency into the portfolio?

Resiliency is crucial to producing consistent premium returns over different market cycles and economic climates. We build resiliency in a number of ways. First, we're making floating rate senior secured loans. It's good to be floating rate in an era when interest rates are hard to predict – you're not taking interest rate risk. It's also good to be senior secured, at the top of the capital stack – a lot can go wrong without seriously jeopardising your position.

We also invest in what we believe are resilient businesses. We focus on industry leaders that have pricing power and revenues that are reasonably predictable. Think of a mission critical business-to-business software company with a subscription model. It really doesn't matter whether we're in a recession or not. The company needs to keep paying for that software.

Focusing on sponsor-backed businesses also facilitates resilience. Sponsors we work with have deep operational expertise, which means they can create value by improving the businesses they own and helping companies navigate through bumps in the road. We are also constantly monitoring the portfolio to detect potential problems early so that we can engage with sponsors to help avert them.

In short, we are always building a portfolio that can thrive in any market, even in those we couldn't predict. ■