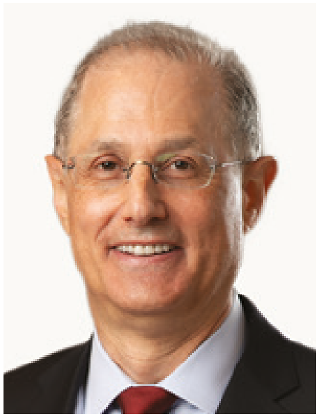
EXPERT Q&A

The largest firms have key advantages heading into the next decade, says Golub Capital's David Golub



Scale matters for private debt

SPONSOR

GOLUB CAPITAL

The rapid growth in private debt over the past decade has seen the emergence of a small number of 'mega-firms' that can now claim to have taken their place as key players in the global financial system.

David Golub, president of Golub Capital, explains why he expects this trend to continue. He also gives his perspective on why a 'real credit report card' for private credit managers is likely around the corner.

Q Golub Capital has been around for nearly 30 years. What are the biggest changes you've seen in the private credit market?

I see three giant changes. First has been the sheer growth of the private equity ecosystem. I will give you an example: private equity assets under management[1] have grown from $988 billion in 2013 to nearly $3 trillion at the end of 2022. Today, private equity dry powder is at a record high of $1.9 trillion. That's more than triple the amount of dry powder that was available for private equity funds to invest 10 years ago, according to Preqin.

Second is the role of banks. Thirty years ago, private equity deals were financed primarily by banks. Banks still play an important role in underwriting and distributing broadly syndicated loans, but they now play a much smaller role in actually holding loans to private-equity-backed companies.

And third is the degree to which the broadly syndicated loan market has ceded share to private credit. This started in the 2000s in the middle market, but now we see large-scale private credit players, including Golub Capital, able to finance multi-billion-dollar transactions.

Q How has the growth in the industry impacted performance for investors?

The industry's growth has been surprisingly good for investors. In many investing businesses, being bigger makes you mediocre. If you are a long-only equity manager and you have to reach for your 131st best idea, that idea is probably not as good as your 9th best idea. The dynamics in private credit have been different, in my opinion. Scale in our industry has been – and continues to be – a source of real, sustainable competitive advantage.

Let me give you some examples. The first is relationships. If you are one of several lenders that a sponsor likes to work with, and you have demonstrated reliability and partnership over time, you will get more opportunities from that sponsor – more first looks, more last looks, more proprietary looks. That's a big advantage.

Larger firms also benefit from the advantages of incumbencies. About half of our originations over the past decade have been loans to existing borrowers. When you are the primary lender to a borrower, you have informational advantages when it comes to evaluating a new loan. You already know the credit, the company and management team. You already have a negotiated document. This makes for an efficient process for sponsors and enables you to make more informed decisions, which is good for investors.

A third competitive advantage is expertise. If you have a very large platform, you are going to have a very large underwriting team. We organise our underwriting team by industry, and we have developed sector and sub-sector specialisations. Our ability to have people who really understand industry sub-sectors enables us to evaluate new transactions more effectively and more quickly. This adds value to the due diligence process.

Finally, there's a limit to how many lender relationships a capital markets team at a sponsor can focus on. They are very likely to focus on firms that can do a lot of different things for them – firms that have a wide geographic scope, a wide scope in terms of industries, a wide scope in terms of dollar size of transactions. So being a large-scale player helps you stay on that priority list of strategically compelling lender partners because of the breadth and depth of your capabilities.

As leading private credit players have developed scale and competitive advantages, they have been able to sustain strong performance for investors.

Q Will that limit the scope for new players to come into this space over the next 10 years?

To a degree, but I suspect there will always be some new players. I think the much bigger story has been – and will continue to be – the growth of the leading players. Our capital under management has gone from about $7 billion to over $60 billion over the last 10 years – and we are not alone in achieving that kind of growth. The more meaningful trend over the last decade has not been about new entrants – it has been about the growth of market-leading, large-scale players. And I think these players are so well-positioned strategically that they will continue to grow in the next decade, too.

> *"What do sponsors want from private credit providers? They want reliable, compelling and distinctive solutions"*

Q How will the private credit industry fair now that we are in a period of macro-economic volatility?

To answer that question, we need to look at whether private credit is doing a good job for its key stakeholders – sponsors and investors.

What do sponsors want from private credit providers? They want reliable, compelling and distinctive solutions. In the last 10 years, we have seen the growth of one-stop financings, of delayed draw term loans, of multicurrency facilities, of add-on transactions, as well as growth in the size and scale of private credit-led financings. In other words, I think private credit has delivered.

Private equity sponsors would likely say that they are in favour of the continued growth of the private credit industry, and that they like working

Q One of the other interesting trends is that some banks are looking vulnerable. What does that mean for private credit?

The last few months have demonstrated again that there is a certain structural fragility to banks. In particular, the small and regional banks in the United States are showing signs of weakness. These banks have two disadvantages relative to larger banks: their cost of funds is higher, and their cost of operations is higher. They have attempted to address these disadvantages by taking more risk. We have seen this show up already in interest rate risk at several of the failed banks. I think we will see this higher risk also show up in some banks in their loan books, notably in commercial real estate. That suggests to me that we are likely to see more failures, and ultimately I suspect that the pace of bank consolidation will accelerate. A decade from now, I expect we are going to have a lot fewer than 4,500 banks in the US.

Overall, I expect the private credit industry to continue to expand. I think we are going to see increased globalisation of the industry, increased market share in new areas like commercial real estate, and continued dominance of large players with sustainable competitive advantages.

"About half of our originations over the past decade have been loans to existing borrowers"

with private credit more than they like working with the broadly syndicated bank loan market.

Naturally, the growth in private credit will also hinge on whether managers provide attractive risk-adjusted returns to their investors. The good news is that over the course of the last decade, the track record of the industry has been strong.

Last year was a terrible year for most asset classes – fixed income was down about 13 percent[2], according to the Bloomberg US Aggregate Index, and US equities in the S&P 500 Index were down about 18 percent[3], but private credit performed well, with mid to high single-digit returns[4] for private credit funds, according to Cliffwater Direct Lending Index data.

Will the industry be able to continue to deliver strong results for investors? I think the key will be controlling credit losses. We have gone the last 10 years without a traditional recession. At some point, we will inevitably have a credit downturn that will test the mettle of private credit managers. When that happens, some players will perform better than others, but I think the industry as a whole will perform pretty well. I'm cautiously optimistic that the next decade is going to be one of continued growth for the private credit industry, driven by its ability to do a good job for its two key stakeholder groups.

Q Do firms in the market have the experience to navigate higher interest rates and higher inflation?

Higher interest rates and slower economic growth are going to provide a test for the industry. We are going to see a more challenging environment, and with that, we are going to see more dispersion in results. There are going to be companies and industries that struggle to adapt to the new economic realities of higher rates, muddling growth and inflationary pressure. We are going to see more difference in performance between good managers and not-so-good managers. That is already happening, but the differences will get more pronounced over the next couple of years. I think this is a good thing. It has been a while since we've had a real credit report card in our industry. ■

1 Source: Preqin. Represents assets under management for North America-focused private equity firms.
2 Fixed income is represented by the Bloomberg US Aggregate Index. The Bloomberg US Aggregate Index represents securities that are SEC registered, taxable and dollar denominated. The index covers the US investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.
3 US Equities are represented by the S&P 500® Index. The S&P 500® Index includes 500 leading large-cap US equities and captures approximately 80 percent of investable market capitalization.
4 Source: Cliffwater Direct Lending Index. The Cliffwater Direct Lending Index seeks to measure the unlevered, gross of fees performance of US middle market corporate loans, as represented by the underlying assets of Business Development Companies ("BDCs"), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements. The CDLI is an asset-weighted index of over 11,000 directly originated middle market loans totalling $262 billion, as of December 31, 2022. The CDLI is asset-weighted by reported fair value.