Q&A with David Golub

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Editor's note: Evercore Wealth Management supplements its core investment capabilities with carefully selected outside funds across the range of the firm's asset classes. Here we speak with David Golub, President of Golub Capital, which makes loans to middle market U.S. companies owned by private equity firms. Please note that the views of the external managers interviewed in *Independent Thinking* are their own and not necessarily those of Evercore Wealth Management.

Q: Please describe the middle market and Golub Capital's positioning within that market.

A: The middle market generally refers to companies that earn annual EBITDA of between $10 million and $100 million. Private equity sponsors typically buy middle market companies with a view toward growth – for example, expanding into new parts of the country, or rolling up smaller competitors. We provide debt financing to help sponsors acquire and grow their portfolio companies. We primarily make floating-rate first lien senior secured loans at conservative loan-to-value ratios, and we focus on minimizing defaults and credit losses.

Q: What do you see as the opportunities and risks for middle market private debt strategies in today's complex environment?

A: Our funds performed well in 2022, despite a bumpy investment environment, and we are cautiously optimistic we will be able to extend that strong performance into 2023. Yes, there are some widely recognized headwinds: Higher rates, inflation, tight labor markets, recent strains in the banking system and a slowing economy mean we are likely to see more credit stress in 2023. There are also tailwinds, arguably more powerful. The combination of higher base rates, wider spreads, lower leverage levels and tighter documentation terms means that the expected return on new loans has increased – and, at the same time, there's a greater margin of safety. Indeed, we believe we are in one of the best environments for making new loans that we've seen in our 28-year history.

Q: When credit spreads rise, as they did in 2022, on loans that are in the portfolio, how is the price of those loans impacted and how is that reflected in the overall portfolio's mark to market?

A: In general, when credit spreads rise in the market, the fair value of existing loans is marked down. Intuitively, the contractual interest rate of the existing loan is below the current market rate for an identical new loan, so a buyer of the existing loan in today's market would demand a discount to face value to make up the difference. This kind of fair value markdown is called an unrealized loss. The good news about unrealized losses is that they don't matter in the long run unless they become realized losses – in other words, if the loan isn't repaid in full. So we are laser-focused on avoiding realized losses. As long as we avoid realized credit losses, fair value markdowns should reverse over time as borrowers pay off, or as their credit attributes improve, or as credit spreads decline in the market.

Q: Do you believe that we will see a significant default cycle in this current economic environment? If so, what steps are you taking to limit defaults and maximize recoveries across the loan portfolio?

A: Last year and the coming period should, in our opinion, give lenders their most important "credit report card" since the financial crisis. Whether there's a recession on the horizon or just more muddling growth, we expect to see greater dispersion in the performance of middle market companies and, by extension, lenders to those companies.

So far, we are pleased with the way our borrowers have adapted to slowing growth and higher rates; the portfolio's performance ratings are strong, and nonaccruals and defaults remain very low. But given the potential for a hard landing, we are also taking extra steps to screen our borrowers for vulnerabilities. We have always believed that early detection of risks and early intervention to mitigate those risks are critical for limiting credit losses. We believe it takes scale and experience to do this well. We're not going to be 100% right – that's not a realistic goal. Our goal is to detect which of our borrowers are at higher risk and then to have early discussions with sponsors and management teams about how to make them more resilient.

Q: Are there any sectors that you think are particularly attractive in this environment? And are there any sectors that you have traditionally invested in that you are avoiding today?

A: Our lending strategy focuses on industries and subsectors that we believe are recession-resistant and where we believe we have deep expertise – industries like mission-critical enterprise software, and veterinary hospitals and specialty distribution. The sectors we think are particularly attractive today are not different from usual. One reason why this matters now is that we expect private equity firms in this uncertain environment to focus less on acquiring new platforms and more on growing their existing portfolio companies. We believe the implication is that there likely should be robust demand for add-on financing from companies in sectors we like where we're the incumbent lender. In terms of sectors we're avoiding, that hasn't changed much either. We tend to avoid industries that are tied to interest rates like home building or auto, or companies that are exposed to volatility in commodity prices or foreign exchange.

Q: A lot of capital has flowed into both private equity and private debt markets over the past decade, but over the last 12 months to 18 months, it appears that capital flows have slowed materially. How should investors think about the outlook for private debt?

A: While capital flows have slowed recently, the stock of private equity dry powder is remarkably high. Reports indicate it is approaching $2 trillion. As this dry powder is deployed, we expect the private equity ecosystem to double in size. This should lead to large increases in demand for private debt in an environment in which the amount of private *debt* dry powder is much lower than the amount of private *equity* dry powder. We think the current outlook suggests a sustained supply-demand imbalance that favors lenders.

Within the world of private debt, we see two dominant themes. The first theme is that the big and strong are getting bigger and stronger. This is because private equity firms don't want to have relationships with dozens of lenders – they want to have a core group of relationships with lenders that can do a lot of different things for them. For example, sponsors want to work with lenders that can finance their small deals as well as their large ones, offer a broad suite of creative solutions, bring subject-matter expertise to the table, and scale up as their portfolio companies grow. The second theme is that private debt solutions are gaining share from the broadly syndicated loan market. Growth among leading private lenders has enabled the private debt market to finance larger and larger transactions. And sponsors are finding that these private solutions can be very attractive for a whole range of deals that until recently would have been done in the broadly syndicated market – deals where there's a critical component like confidentiality, certainty of execution, or capacity to grow over time that the broadly syndicated market just isn't well suited to deliver. Both of these dominant themes play to the strengths of leading large-scale lenders.

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