David Gaito

Episode 205: Direct Lending with Fidelity's David Gaito

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. Welcome back and thanks for joining us. Today's topic is direct lending, and we're joined by David Gaito, head of direct lending at Fidelity Investments. David, thanks for being on, man, this is going to be a good one, I can tell already. So, welcome.

David: Thank you Stewart, really happy to be here.

Stewart: So, before we get going very far, what town did you grow up in? What was your first job? Not the fancy one. And what makes insurance asset management so cool?

David: Well, I grew up in Pittsburgh, Pennsylvania.

Stewart: You're from Pittsburgh. Are you a Steelers fan?

David: I am. I'm not as avid a fan as I was when I was younger, but I love the Steelers, Penguins. A little less the Pirates, but I tend to still follow them. When you're traveling as much as I am and you have three younger kids, it's hard to stay abreast of sports. But I think there are very few Pittsburghers that would answer that question no, if they actually grew up there.

Stewart: Absolutely. Sorry, so I interrupted you. What was your first job?

David: My first job, well, I came from a pretty modest household, so I was probably in the fourth or fifth grade and told my mom I needed something, and she pretty quickly explained the difference between wants and needs, and guided me toward this is a want, and when you get wants you need to have a job. And so, my mom bought me a squeegee and a five-gallon bucket, and walked me down East Ohio Street in Pittsburgh, and said you're going to go on every business and see who needs their windows washed. And so, I was a window washer.

Stewart: Dude, that is inspiring. I don't know. I grew up similarly, and ours was grass cutting, but at a very early age. So, I feel you on that. All right, so what makes insurance asset management so cool?

David: Well, this is a really interesting part of the LP base, indirect lending, and it's probably one of the most sophisticated parts. And so, for me, I love working with really sharp people, I feel that they make me better, our teams better. And I don't think I've had one meeting with a prospective insurance LP that I've not walked away with learning something. And just seeing that is pretty exciting for me in this chair because this is new. My past life I wasn't fundraising, so this is a new and exciting part of my business, our business.

Stewart: I'm happy to hear you say that because I've beat that drum as hard as I possibly can. Insurance investment professionals are by far the most sophisticated institutional investors. It's not even close. It's not even close. And I'm so happy to hear you acknowledge that, coming from outside it. It's a family, this business, this industry, is like a big family kind of. And they don't let everybody in. And not everybody gets into the family. And I think that it is far too often that people think that insurance companies are unsophisticated because they just run these big core fixed income portfolios, and they're not very progressive. When you really get in and talk to somebody, it's real, there's some really sophisticated

folks out there running money. And so, talk a little bit about your background. You mentioned that this is new to you, and Fidelity's direct lending business is new as well. So, can you talk a little bit about your background and wrap in why Fidelity decided to build a direct lending business from the ground up versus buying an established platform? And why in 2021?

David: Absolutely. And I feel like, I was at a cousin to the insurance industry, in a large regional bank. So, I spent 22 years at PNC, a very strong, at the time, regional, now-national Bank. I had the great fortune of a very strong balance sheet, and an insatiable desire to deploy capital at a good risk return. So, I never had to raise money on the outside. I was responsible as an executive vice president and an executive responsible for about a 10 billion book of business, all middle market companies.

Stewart: Oh, very cool.

David: Yeah. I followed a guy by the name of Bill Cosas, a big mentor of mine, for about 20 years. And so, a Pittsburgh-based bank, started there, and moved to about five different geographies. It was a great experience, teaches you that when you're lending out deposits, what you're doing has consequences, if you grow up in the right environment. You're doing this with the savings of families, et cetera. So, really early on, the philosophy of credit is about downside protection, and not upside, given you don't have equity-like exposure typically. On the Fidelity front, it's a really interesting question, and there are a couple of reasons. We are and have been a scaled investor in the leveraged credit markets. So, we've got over $75 billion in high yield and leverage loan assets. And we were one of the first high yield funds in the late 70s, we were the first broadly syndicated loan fund in 2000.

And so, when you think about that, we're a known commodity in the leveraged credit markets, and almost any acquisition that we would've made would've been a bolt-on. And when you think about bolt-ons and acquisitions, generally, you're buying a culture. And our culture, and it's one that I've grown to really love, and have found a home not too dissimilar to what I left, is paramount to our success. And no matter what we would've done in an acquisition, it would've always been XYZ private credit shop within Fidelity. It would've never been Fidelity's private credit business, Fidelity's direct lending business.

And I think that's one of the reasons why we built it. And it's also one of the reasons why we've never made a material acquisition in the history of asset management. The culture side's important, and it permeates from us being a private company. We're one of the largest private companies in the world, and being a private company allows us to think differently. At its purest sense, I don't mean this to offend anybody that's made acquisitions, but acquisitions are shortcuts. They allow you to do something more quickly than it would otherwise take to build. And our philosophy is, it's better to build enduring brands internally than to buy something and hope that the culture fits. And thankfully the decision was made, and I'm the lucky recipient of that decision, and our team is.

Stewart: Wow, that's a great story. Compelling. So, most of the growth in the direct lending business has been attributed to banks withdrawing from this space. Given your background with a large bank, what do you think has driven the decline in share for banks, and what impairs banks in competing with direct lenders? And let me just, one little twist on this question. It seems to me that insurance companies from an ALM perspective are a much better fit for this kind of financing. It seems like a better fit. Have I got that right, or can you work that into your answer, please?

David: Yeah, I think you do have that right. And I think when I think about this business, a lot of the larger side of the market gets the news headlines, and you hear a lot about new, new, new. If you think about it in its purest sense, this business has been around for 30, 40 years, and insurance companies were at the forefront of it, with private placements, buying private placements for their book. Those are early direct lending deals. Commercial finance businesses like Heller, GE Capital, et cetera, have been around for decades. So, I think it is tailor-made for insurance companies in the ALM. Longer-term assets, if you build a portfolio up, have consistent patterns, a better risk-adjusted return if you can tolerate illiquidity, and I think that is tailor-made for an insurance balance sheet. The bank side is interesting. I'm an ardent believer that the regulations... And there's not one regulation that I think has caused this.

I think it's a culture of regulation, it's a culture of de-risking banks, and everything that has occurred in the past 10 to 15 years has pushed the end users of this product, largely private equity firms, to use direct lenders more and more. And it's interesting, 10, 15 years ago we had to convince someone at a bank because we were doing unitraunches before the term was popular. We were doing them, I can remember in 2002 and 2003, working with direct lenders that took the more yieldy piece, we'd take a little less risk, a little less yield. But we had to convince people to do that with direct lenders. The subtle

change that really happened post-GFC is that convincing held on, and a big shift away from banks to direct lenders occurred. And the banks can't really compete with the structures that are being offered, with lower amortization, and more flexibility that's out of a bank environment.

We've competed on some investments where we're 300 basis points more than a reasonable comparable solutional bank, and we're still getting selected. Because they want a partner that doesn't have the proverbial person in the back room, making decisions that they don't know, and impacting their investments. And when you think about why that is, most really good private equity firms know that they're not going to make their return off a quarter point, a looser document, necessarily, but they're going to make it on a partner, that when they have real challenges with that investment... Because this is a numbers game.

If you do enough investing, you are going to have challenges. And the most important thing in that private equity firm's mind is, they have a rational counterparty when those challenges hit. And I think what's happened over and over again is they don't have that in the banking market. And I put my money where my mouth is, and left a 22-year career, where I was treated really well, love the company, et cetera, but I just looked and saw a path that was going to continue to erode our business.

Stewart: That's really interesting. And I think really, I have a better understanding of it today than I ever have, after that, and I thank you for that.

David: Can I give you an example?

Stewart: Yeah.

David: Because here's an interesting example.

Stewart: Absolutely. Yeah, yeah, yeah.

David: And this occurs sometimes in insurance companies, right? You have a regulation, you're looking at tail risk, et cetera, and you design something that you have to comply with. And there's this repayment analysis that goes on in banking in the back rooms, and it can be arbitrary. Probably one of my best credits, in my view, in terms of downside protection. 100-plus-year-old business, Army Corps of Engineers uses this, it basically services the coastlines of America. And you can think of multiple reasons why this company will exist, not the least of which is the Army Corps of Engineers would support this business in some form or fashion. Not to mention it had billions of assets, billions of assets, that are almost impossible to replicate.

We had a three times loan, that was fully secure, and we had unsecured debt behind us. We had to rate that loan substandard, which is a watchless credit. It's a performing company. Because the business couldn't repay the sub debt. Well, you probably know this, in a stress situation, the sub debt becomes equity, and it's a big buffer for the senior secured lender. But the regulations don't allow you to look at that way, they make you do suboptimal things to comply with the regulations. I think that's one of the biggest challenges on the regulatory front, is you're trying to comply with the regulations versus making good investments, making good loans.

Stewart: Do you guys have a rated note feeder?

David: Fidelity is a friend to the insurance industry, on the credit side and we also distribute certain annuity products, in a meaningful way, across the country. And so, the insurance market was one we looked at early when we were trying to raise institutional capital. It's been an educational process, it's probably one of the hardest things that we've done in terms of facility structuring. But it's been great because it's allowing firms to invest in tranches that they want to invest in, in meaningful ways, and allowing us to access capital with investors that we think highly of. And as I said before, we think some of the sharper investors that we're working with. So, yes.

Stewart: Yeah, I'll be the first to tell you that I don't think this is an easy crowd, at all. And for the reasons that you stated, I think they're some of the best investors in the world. There's no doubt about it. That's really interesting. I don't really want to get off this topic, but I've got another one to bring up. What does scale mean in direct lending, and does it matter?

David: Scale is something that is really hard to put your finger on. And I can tell you from my experience of moving to Fidelity, that can be very powerful. I think it's often overhyped. And quite frankly, that latter comment is probably a reason Jeff Scott, one of my partners, Therese Icuss, one of my other partners, and I, when we joined Fidelity in '21, we underestimated the power of scale. Because you hear scale, and it's a really... It's a big business, it's disparate, et cetera, and you don't see the power of it. But I think scale is going to increasingly become important in direct lending. And the reason is that when you think of the constituents, your employees, equity investors, debt investors, customers and sponsors, they all care about scale. They all care about scale. Think about equity investors, they want to know what you can do for them just beyond direct lending.

Do you have other products and services that they can partner with you on? They want a bigger relationship, not just a one-off here or there. Debt investors, we saw this firsthand, it was pretty extraordinary. [15:27] And it's not because of David, Jeff and Therese, it's because we're part of Fidelity, and those debt investors looked at Fidelity as a whole. And that's a meaningful advantage, and really powerful in the marketplace. The one interesting thing that I've found is on the sponsor side, the customer side. They really want more than just a direct lender, they want to know what else you can do for them.

And when you think about an impact to a firm, if you have a big liquid team on the broadly syndicated loan side, a big high yield team, and we have the added benefit of being one of the larger IPO buyers in the world, that is exponential impact to those firms, when they access those markets, if you could put that into motion. And so, that's been the eye-opening thing to us, let alone the shared resources that you could have. The analyst teams, that you can have as specialists. And I think you're going to see that more and more in the larger providers, that are very thoughtful on how to use their scale.

Stewart: That's really interesting, so thank you for that. So, there seems to be a pattern of direct lender scaling and then shifting market focus. Why do you think that is?

David: I think the simple answer is many of the larger direct lenders have had fairly prolific fundraising. And the reality is, if you think about a billion dollar unitranche, if you're able to win that, and close that, that's a lot easier to do than to do five $200 million financings, or 10 $100 million financings. We think that's a bit of a mistake. The core and lower mid-market, we believe, are areas that you can consistently generate alpha. There are a lot more of those investments, there are a lot more firms that buy those companies. They value the partner immensely. There's not a real market for those to go to, because the bank market, as we talked about earlier, just isn't as robust. Whereas, the larger end of the market, it competes with the broadly syndicated side.

These are also borrowers on the lower-end core, that are very loyal to the lender, and you can follow them as they grow and as they change owners, which we think is impactful. The upper end of the mid-market competes largely with the broadly syndicated loan market. And while our industry has eroded the broadly syndicated loan market a bit, we don't think it's gone away. There's a real need for that marketplace, that provides very competitive financing, the lowest cost financing you can get of that company of size, generally. And quite frankly, the loosest. That allows companies to operate in largely a covenant-light environment.

Stewart: Okay. So, David, there seems to be two groups battling in the direct lending space. There's a group that looks like they prefer larger borrowers, and a group that is staying focused in the lower mid-market. Why do you think that's the case? Can you talk us through it?

David: I think it piggybacks on what we just talked about, in terms of investors scaling. And quite frankly, also have groups that say sponsored versus non-sponsored, right? These to me, are a bit of buzzwords, designed to get investors to think a certain way. At the core of the group that your listeners are trying to learn about, I think they really have to understand who that firm is. Why they're successful. Why are they focused on that area? Is it just to deploy more and more amounts of capital, or is it that they believe it's a good investment opportunity? We like the lower end core because we think you can generally get alpha there. More covenants, more spread, et cetera. We don't buy the argument that larger is better, because we think if you look at credit on a spectrum, larger companies on one end, smaller on another, you're going to have a diversified pool of assets.

So, in theory, you should be able to diversify your risk out of either side of the spectrum. Larger companies have good aspects, they are larger, they might have durable competitive advantages that you can lend against. They also might not, there are a lot of large companies that I wouldn't lend to. Why? Because they generally all have looser structures, limited covenants, even if they have a covenant, it's loose. And you're getting a lower spread. And so, you've got to take that into

context of what your risk return is. Are you the type of firm that gets the first call on an investment? The last look? The right to say no? That last thing's really important to us. The ability to say no to a sponsor, and we are a sponsor-focused group today, Stewart. We do believe that sponsor-backed businesses in the lower core are where you can generate alpha, and limit your downside. When I was at the bank, we did both sponsored and non-sponsored, and quite frankly, most owner-entrepreneurs and family businesses didn't understand lean priority the way I'd like them to. They viewed their equities-

Stewart: Easy, this is getting awful close to home.

David: Well, look, we're in the risk business, and when you're earning a small spread, in the best case, over SOFR, you've got to limit your downside. And so, that's where we do it. They're very good owner-operated businesses and family-owned businesses, and they could be great businesses to lend against. We just, we like the sponsored section, and segment in the lower-end core. But practically speaking, to answer your question, if you're with the right manager, you can get a good risk return from that manager in I think each of these segments, and you just got to dig through why that is with that firm. And that's the hardest part for your listeners, is actually digging through that firm, and believing that they've got a right to win in the marketplace.

Stewart: So, middle market direct lending today is around a trillion dollars in AUM. And so, for the last 10 years there's been a modest manager dispersion across middle market direct lending. What is driving that, and how should investors be thinking about this and the road ahead in terms of manager selection? It's a wordy question, but I think that you understand the point here.

David: Yes. So, there has been largely limited dispersion. I would argue the oil and gas crisis from '14 to '16 had some dispersion. There are firms that are no longer around that invested heavily in those segments. There are other firms I think that asterisk that performance, and have shut down businesses since. But when you think about the pandemic, it was a short-lived test, it wasn't a full-blown period of distress. And it was very stressful, I had a big book of customers, and the stress was real. But the liquidity that came into the system, what effectively occurred is your really weak borrowers, which, if you have a portfolio of any size, you'll always have weaker borrowers. They may not be on the cusp of default, but you'll always have a weaker pool. The challenge with private non-traded markets is you can't trade out of those loans, you have to manage through those loans with the companies and owners.

Those are the ones that felt the most impact. Almost everybody else in your portfolio felt a shock for a month or two, and then liquidity came into the system, and largely gave direct lenders an easier path to recovery than they might've otherwise had. The period we're in now is going to be really interesting, '21 was a very aggressive market, with leverage levels well in excess of 5, and many times in excess of 6. And it's just math. The current rate environment doesn't work with that level of leverage, that's why leverage has come down so much recently, and you see better capital structures, and you hear things about the current environment of investing in direct lending. So, I suspect '24 is going to be an interesting year, and a pivotal year for our marketplace. And I think you are going to see some potential dispersion if rates remain high for an extended period of time.

Stewart: So, this has been a very interesting discussion, I have learned a lot. If you could give me, what are a couple of takeaways that you would want our audience to remember from this podcast? And then, I got a fun question for you. Not that direct lending is not fun, man, but just, there's a fun one coming. Just to give something to look forward to, because otherwise people, they stop listening to these things, I've been told.

David: I doubt that. You're a great host, so I'm sure your listeners love the podcast, and I've listened to some of the previous ones, so I'm going to become an avid listener. So, thank you for doing this. A couple of takeaways. Look, first, I hinted at this in a brief comment, a lot of the news and media is focused on the upper end of the mid-market. And how it fluctuates in and out, et cetera. So, don't always take some of the big media sources as gospel, really dig in and talk to your prospective managers and your existing managers about what they're seeing in the marketplace. I'm a believer that direct lenders can provide an enduring risk-adjusted return above what you can get in the liquid markets, if you're with the right manager. And I think that's the second point. There have been a lot of new managers to come into the marketplace, and add competitive pressures.

Whether you're with a manager you've been with for a decade, or looking at a new manager, I think you really have to get to know that manager. Make sure they, if it's an existing manager, you've evolved with that manager. What's their right to win in the marketplace? Because I think the past five years, the business has changed a good bit. And the businesses that haven't evolved, they're going to have challenges in the future. And the top of the class is going to execute really well on

who they are as a brand. And I think that's one of the more important things. And then lastly, I would certainly keep tabs, how the portfolio is doing. Because the counterbalance to the media is a proliferation of "Everything's fine". And I think that, by and large portfolios have performed well relative to expectations, but we're not out of the woods yet. We've got to get through '24 in a likely higher SOFR regime many had hoped to do that. And if it stays high for longer, I think you are going to see some manager dispersion.

Stewart: Terrific, thanks for that. And as you may have known, we have a couple of fun questions out the door. And they go like this. What's the best piece of advice you've ever gotten in business? And two is, who would you most like to have lunch with, alive or dead? Now, I should say that you have the option of answering either or both, but after talking with you for a minute, I think you're going to take both. So, go right ahead.

David: Well, Stewart, thank you for having me today, I'll try to overachieve and give you three answers. How's that?

Stewart: Holy smokes. Look out. Future guests don't stand a chance.

David: The best of piece of advice is actually easy. One of my mentors early on said, people pay you back. I don't care how strong of a collateral package you have, how much cash flow the business have, the people on the other side of the transaction are the ones that make sure that we get all our money back, plus interest. And I can tell you that over my nearly 25 years, that is true in spades. The people on the other side of the table, that I've worked with at times, have helped me get out of investments that they had no opportunity to make money on. Those are the things that you learn in this business, sometimes the hard way. And I learned that early, and I saw it in action early. Alive, or dead? So, I'll start with my father. My father passed away when I was in my twenties, and it would be great to have lunch with him, to see where my family is and our family is today. That'd be a lunch that I couldn't pass up.

Stewart: I got to think he'd be proud of you, man. Really.

David: Yeah, I know he would be. And it's more of, he was a really hardworking person, that did not have a lot of success in life, and so, it'd be fun to give him a glimpse of what he helped accomplish.

Stewart: It's not dissimilar to, my grandfather's the same. And my buddy that used to work at PNC, who you may know, Mike Kaminsky, his dad was a hardworking guy, from Pittsburgh, dyed in the wool, and... Yeah. Guys like your dad, that's solid folks.

David: On the positive front, and I'm going to try to do this, I'd love to have lunch with Peter Lynch. And I didn't read a lot growing up, for better or for worse, but as you get more educated, you learn that reading's actually a very good thing, and it's fun. And Peter Lynch wrote the first business books I read, and I've loosely followed them in investing. Even in businesses. It's simple things, don't get overly complicated, invest in businesses you understand. And so, he's still involved with Fidelity, and I've just been in the weeds trying to build this business with our team, and the infrastructure, but at some point soon I'm going to shoot him an email, and say, I'd love to grab lunch with you.

Stewart: Wow, that's cool. Well, Peter, if you're listening, make a little room in the calendar.

David: That's right.

Stewart: Good stuff. Listen, I really enjoyed having you on, I really did. It was great to get to know you, and thanks for a great education.

David: Thank you, Stewart. This was a lot of fun. My first podcast, so you always remember your first, and it's been great.

Stewart: So true. David Gaito, head of direct lending at Fidelity Investments. Thanks for listening, my name's Stewart Foley, I'm your host, and this is the InsuranceAUM.com podcast.

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