Bill Sacher & Fred Chung

Episode 225: Building Resilience – The Power of Private Credit in Insurance Portfolios

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. We've got a great podcast for you today and it's on a familiar topic from an unfamiliar angle. Today's topic is private credit portfolios and the topic is building resilience in private credit portfolios for insurance companies. And we're joined by two experts from Adams Street Partners. Bill Sacher, who's the partner and head of private credit at Adams Street Partners. Bill also is the chair of Adams Street's private credit investment committee and a member of the executive committee. Bill, welcome. Thanks for taking the time today.

Bill: Thank you. It's great to be here.

Stewart: And Fred Chung, partner and head of credit underwriting at Adams Street Partners. Fred also sits on the private credit investment committee. Fred, thanks for taking the time, it's great to have you on as well.

Fred: Thank you, Stewart, it's a pleasure as well.

Stewart: So before we get going too far, let's start them off the way we start them all. And I want to ask you both the first two questions, which is what's your hometown and what was your first job? Not the fancy one. Fred, I'll start with you, where'd you grow up?

Fred: Wow, tough question for me because I've been all over the place. I went to four elementary schools, a middle school and a high school in two different countries. I consider New Jersey my hometown, it's where I was born, so that would be my answer for where I'm from. But I've been all over the East Coast, and I actually went to high school in South Korea. In terms of my first job, my first job was cleaning hardcover books at my local library.

Stewart: Oh, wow.

Fred: I was armed with a bottle of Windex and some paper towels. Every Saturday and Sunday I had to go in there and wipe those books clean. Not much pay in that role, but it was a great service.

Stewart: That's awesome. All right. Bill, how about you, where'd you grow up and what was your first job?

Bill: So I am a pretty hardcore New Yorker, but like Fred, I moved around a bit. I spent a number of years in Brooklyn, Bronx, and then ultimately in Westchester County where I've resided to this day.

Stewart: Wow. And how about your first job?

Bill: My first job was not too much more glamorous than Fred's. I was a carriage boy at the local supermarket in my town. It was great exercise, helped build my biceps, but made me appreciate the benefits of being an executive in finance.

Stewart: That's so true, well, put. So that's a great way to lead in here. Adams Street is somewhat new to us, a Chicago icon for sure. Can you give us a little bit of background on Adams Street, and just how you got from being carriage boy to the senior executive position that you're in today?

Bill: So Adams Street is a longstanding private market investment manager with over a 50-year history. Chicago-based, originally, but now in every major market around the world. It has several core strategies, but largely driven by its private equity sponsor relationships that come out of our primary fund to fund business. For us on the private credit side it might very well be one of the best platforms for executing a private credit strategy, in that it provides us with a competitive advantage by being an actual partner in the funds that we're sourcing deal flow from. That is an advantage that is also very hard to replicate. And so this is giving us a significant edge, but it's also providing us with a relatively uncrowded niche in a market that has become increasingly more crowded and competitive. And the more crowded and competitive it gets, we think the more valuable this particular competitive advantage becomes.

Stewart: That's interesting and I think it's fair to say insurance companies have been major players in private credit. There is no doubt about the fact that the growth is slated to continue. In surveying our registrants for our upcoming symposium next week in Chicago, private credit and private structure were tied for the number one topic on a lot of people's minds. So I've thought that this marriage between private credit insurance companies makes so much sense because the ALM matchup works beautifully, they don't have a risk of running the bank and so forth. Can you talk a little bit about the asset class as a solution to the investment needs of insurers, and particularly compared to similarly traded public securities?

Bill: So let me take a first stab at that, Fred, please feel free to interject. Private credit does tend to reside in the safest part of the cap structure, is dollar one first lien senior debt, first in line for company cash flows. And so this combination of premium yields But at the same time being able to be in a relatively defensive position is an unusual combination of features in developed capital markets. And in our view is the primary appeal of private credit is that risk adjusted return. It also by being a relatively illiquid asset without public benchmarks, it also tends to be a relatively stable investment from a marked market standpoint, and does not get driven by the technical swings that can be fairly violent during periods of disruption in the public markets.

Stewart: So Fred, insurance companies spent 10 years wishing rates would go up, and then they went up 500 basis points in about an hour. And so it seems that that level of very low interest rates is behind us. Can you talk about the impact of the likely more-normalized rate environment that we seem to be in? And as part of your answer I think that just the impact on floating rate private credit, where the rates have reset higher and has the potential to create stress for those borrowers.

Fred: And I think you actually alluded to the answer a little bit, Stewart, in your question. Rates being higher and spreads being somewhat sticky in private lending really results in an environment where from a return perspective, we're going to observe that higher nominal return for investors in private credit for the foreseeable future. We often say we're not in the business of predicting the future, but I think if you believe the Fed rates will stay higher for longer, and then we're certainly positioning our portfolio for that environment. So that's the good news, I do think investors will enjoy higher nominal returns for the medium term. I think what that comes with is is an ugly side, which is the stress or the size of the obligation for those underlying borrowers is higher. In that interest rates as observed by the companies that are borrowing have essentially doubled in the last few years, which again, more cash needs to be generated by these companies to service that debt.

And to the point Stewart you made that will put some strain on some companies that haven't been positioned appropriately, or haven't been capitalized appropriately to essentially account for that cushion. And so what that's going to lead to we think especially if that's combined with a soft economic environment, potentially an environment that could be recessionary. We're still seeing inflation in the market and potential underperformance of portfolio companies that have levered balance sheets high. And what that will mean for investors in private credit is a likely dispersion in returns for the managers that they're invested in.

And so fixed income is very unique in that there really is no upside to that return. The return is contractual, it's baked into the coupon, and so a manager can only underperform their return. So if you look at what the bottom and top quartile manager returns over the last decade, the band has been pretty tight and that's because it's been a relatively benign economic environment outside of maybe a brief window during COVID.

If you look in the GFC and potentially as we look forward into a potential recessionary environment if that is to fall upon us, you will see those returns widen. Because as companies take losses on their underlying loans, that is what's going to cause return dispersion. So we do think that as we look forward, we're an environment where underwriting really matters if you want to control for that loss experience.

And that if the economy doesn't maintain the resilience that we've seen over the last decade, that you are going to see the return dispersion on managers really widen out. So as we look at our investment tenants and the companies that we're focusing on, we are favoring companies that have strong secular outlooks. We tend to focus on sectors that are defensive, non-cyclical. And one of our core investment philosophies is to make sure we're investing in businesses that can perform in any type of economic environment, whether that's an expansionary environment or a contracting environment. So a long way of saying I do think what comes with high returns is often obviously a higher dollar interest rate, and we're going to see the effect of that going forward.

Bill: What effect that high interest rates are having is a little bit more of a rear-view mirror view. We came through a period with very low interest rates, the consequence of that among many was unusually high levels of leverage. Those companies in this higher rate environment are struggling to meet those fixed charges and service their debt. Going forward capital structures are incorporating already the higher interest rates. And those higher rates are serving to put a governor on leverage levels, and resulting in capital structures that are not only at yield levels that are at decade highs, but capital structures with leverage that are close to decade lows. The forward-looking view is actually quite attractive from that perspective.

Stewart: Can you talk a little bit, I've got in my notes here, some data points about your track record Can you expand on that s there something you could share with us about the credit performance that Adams Street Partners has experienced?

Bill: Yes. So there are several factors that contribute together to our low loss track record, and that is our ultimate goal - producing portfolios of money-good loans. We get there in part by having a disciplined underwriting approach that has been tested through multiple cycles. We go back over 20 years in terms of our track record. So we have some of that experience. The bottom line on our underwriting is that in the worst case scenario we have to believe that there'll be sufficient sustainable enterprise value to cover the debt in the underlying portfolio. If we're over that line, that to us is the difference between debt risk and equity risk and it's at the right line test. We also do go to market as a lead lender, and we enjoy a couple of intrinsic benefits that come out of that. One of which is an informational advantage where coming into the transactions at the very early stages, private equity sponsor doesn't even own the business yet, they're in the process of performing their own analysis, and we're being invited to work collaboratively together. Drawing on our respective resources to do real private side due diligence.

And during what's typically a two to three month period of time, we will get direct access to the management team, have multiple interactions. We'll have direct access to all the company files and records, we get all the third party reports, the quality of earnings, the industry studies, environmental studies. And we're ultimately making the investment decision based on our access to the raw data and our independent work. So for instance, we are not taking anybody's highly adjusted pro forma numbers. We're determining the underwritable EBITDA through that independent effort and access to the raw data.

The other element of the strategy is that we enjoy a significant benefit from operating the business on the Adams Street platform. We're one of the world's largest private equity fund to fund managers. We've been doing it for 50 years. We have in excess of $50 billion invested in literally hundreds of middle market private equity sponsors that are heavy users of private credit. And being an actual partner in the funds that you're sourcing deal flow from is a significant advantage.
So we have a disciplined investment process that's been tested through multiple cycles. We pick up an informational advantage by being the lead lender and coming into the deals early. But we also have better information to judge a deal that we feel strongly about doing, and seeing those deals that we want to pass on and avoid the mistakes.

Stewart: Fred, so Bill mentioned the term ‘lead lender’. I've spent a long time running money, but I've not spent any time as a private credit investor. And there's also this idea, this term ‘club participant’. So can you unpack for us what does it mean to be the lead lender? Why does it matter? And do you typically serve as the lead lender, or are you often a club participant? There's people who are new to this industry that don't know much about it, and if you can unpack some of those terms it would be really helpful too.

Fred: Yes, Stewart, happy to. So being a lead lender, so to answer one part of your question upfront, we at Adams Street, we're a lead lender in 90% of the transactions that we're in. And so we prefer that lead position for a number of reasons,

which I'll go through. One obvious benefit of being lead although in our minds maybe not the most important, is that there is an economic benefit. Lead lenders tend to get higher upfront fees in certain situations, we get other administrative fees in serving in that role.

But the power of being the lead lender really comes largely on the due diligence side. In a traditional M&A auction that process will run anywhere from two to four months. As a company is prepped for sale, put through the auction process and ultimately sold to a financial buyer, it's only the lead lender that engages with that private equity buyer at the start of that process.

So if you think about situations that we're typically engaged in, we are getting contacted directly by the buyer of that business to work alongside them over a two to three month period, and underwrite that business on a full private side basis. It's only lead lenders that do get that access. So when the initial management meeting occurs, we are usually there in a seat observing that company firsthand when there are factory tours, when you're commissioning market work, accounting work, legal work. It's usually the lead lender that is driving that process on behalf of the credit facility, and therefore having that access of information to really do a full underwrite of that underlying opportunity. You, Stewart, mentioned being a club participant; being a club participant is a lender that comes in very much at the back end of that process. So it's not uncommon for us to be a lead lender, fully underwrite that loan, negotiate that loan directly and bilaterally with that private equity sponsor.

And really in the last two or three weeks of the process, ask a number of smaller club lenders to come in and be a part of our deal. One of the reasons which it's already implied in what I said we don't typically engage as a club participant is, one, we don't like underwriting someone else. We insist on doing that underwriting directly, and making sure everything about that company, and all the investment process sticks to the tenants that we've established for our loss avoidance philosophy.

We like having influence over the deal terms, whether those are covenants, whether those are baskets, whether those are other legal requirements that are part of the company's obligation for the lender. We like negotiating those directly, again, that's the role of the lead lender. And then finally during the life of the loan post-closing, it is the lead lender that has the influence and the relationship to be the first point of contact throughout the loan.

And so if that borrower needs an amendment or has a future financing need, again, that ask is typically coming through the lead lender. And so all to say there are large benefits of course of being the lead lender. The reason we have been successful in positioning that way in the market really goes back to what Bill said, which is that we have these decade-long relationships with those private equity sponsors. And private equity sponsors want to work with institutions they know because the lead lender they're working with is obviously a critical component of their success. And so utilizing that relationship we get that role 90% of the time, and it's one of the differentiating factors of being part of our private credit program.

Stewart: And one of the things I think, Bill, that you touched on this a little bit, but it really gets down to deal flow. You have these relationships with people who you've known for a long time, they know you, they know what you're looking for, you know what they've got. You've found them to be trustworthy partners, the information they provide you is accurate and true and so forth. Can you talk about how that creates the deal flow that results in the track record that you're talking about?

Bill: So first, we are an actual partner. The private equity sponsor has a deep, longstanding institutional relationship with the firm that in many instances goes back decades. And so there's an instant level of trust and partnership that is critical to their selection of a lead lender. Despite all the very sophisticated things that we think we all do, at the end of the day it's really a people business and the selection is based on longstanding experience and trust.

We earn that instantly by virtue of how long we've been doing this. We also do it though in scale there are literally hundreds, as I mentioned, of middle market private equity sponsors that comprise our portfolios, and they represent a significant portion of the overall deal flow activity. And so we have a very large opportunity set that we're fishing out of. And so the combination of those features puts us in a position to enjoy what is a material portion of the overall deal flow, and to be instantly perceived as a value-add partner that makes us a strong candidate to lead those deals.

Stewart: Thank you. And it's interesting, I think it's truer now than ever that the structure of an investment plays a significant role in whether or not... it impacts the attractiveness to an insurance company from the perspective of return on adjusted capital, if you will, or return on risk-based capital. And so as a result allocating capital efficiently is very important to these folks. Can you talk a little bit about some of the ways that Adams Street's private credit strategy can help insurers in this regard?

Bill: Well, as a starting position private credit has a lot of attractive features as we were discussing the premium yields, the relatively lower risk profile, but private credit is generally below investment grade in terms of the issuers involved. Below-investment grade investments for insurance companies are limited and the capital charges against them tend to be relatively high. We have a variety of ways that we've approached that for insurance companies that involved getting ratings on actual underlying issuers that have tended to be high in their ultimate ratings.

We have rated funds, we have rated sleeves that contribute as a feeder to our funds, and we use CLO structured technology to take tools of senior loans that are rated below investment grade and create to over-collateralization investment grade tranches, debt that represents the vast majority of the underlying investment. In some instances, insurance companies want the full exposure and take a vertical strip from top to bottom, and in other instances the various tranches including the equity can be sold to third parties that are better suited to hold that asset.

Stewart: That's fantastic. I really appreciate the education today on private credit and building resiliency into these portfolios. I've got a couple of fun ones for you out the door, if you'll indulge me. The first one is the question is really about providing advice to people who are earlier in their careers. And so I'm going to ask what would you tell your 21-year-old self or your 25-year-old self today, or advice you would give somebody who's early in their career that you think would be helpful to them as they move forward here? I'll start with you, Fred.

Fred: That's a good one. I got some advice early in my career and it's really stuck with me, and it's actually led me to this seat working with Bill and with Adams Street. But that's in some ways to not over-engineer your own career. Opportunities will emerge that are maybe unexpected, maybe not exactly according to the plan you had written out for yourself. And to be able to pivot and pursue interesting opportunities will often lead you to success, and sometimes you don't know where that's going to be coming from. So to not overthink or over-engineer your own path, and make the right decisions at the right point in time. So that would be one. I think the second one I think is really critical is to no matter what you're doing, to make sure you're surrounding yourself with smart people because you're always certainly learning. And if you can maximize that learning by being in a group of people that are hopefully smarter than you, it's just going to help you improve your own outlook. I've certainly stuck to that philosophy and it's really served me well.

Stewart: That's fantastic. How about you Bill, what's advice you'd give your 21-year-old self?

Bill: I would say something along similar lines. But despite most 21-year-olds' supreme confidence about what they think they want to do, at that stage most people really don't know what they don't know at that point. And so I would strongly advise people entering any career to expose yourself to as much as you can and be open to opportunities.

And I'll even use myself as a direct example. When I was in business school I was committed to wanting to go into venture capital. I ended up for a variety of reasons taking a job at Bear Stearns doing mezzanine debt. Mezzanine debt is the precursor to the private credit market as we know it today. I've been riding that wave for over 30 years and it was an area that I was completely unfamiliar with, and had I not taken that step it literally would've changed the course of my life.

Stewart: That's fantastic. So I got the last fun one for you is we got a table at lunch, we can invite three people to a table at lunch alive or dead. So how about one from each of you and one you got to agree on. So you can have anybody you want. I'll start with you this time Bill, who would you most like to have lunch with alive or dead? You're a dedicated New Yorker, there's got to be-

Bill: It's a hard choice, but I think I'm going to answer the question with two choices, even though I'm supposed to pick one. Either Teddy Roosevelt or Chuck Yeager.

Stewart: Wow, there you go. We've had Teddy Roosevelt before, but never Chuck Yeager. How about you, Fred?

Fred: Yeah, give me a second. I was going to say John Lennon as one.

Stewart: There you go.

Fred: For sure.

Stewart: That'd be a neat table right there. Teddy Roosevelt, Chuck Yeager, John Lennon, you guys, I'd love to come to this if I can make it.

Fred: I just wanted to add something a little different into the mix, so I'll go with John Lennon. I'm just a huge Beatles fan. I love a lot of what he did with his music, of course, in his life.

Stewart: It's absolutely cool. That's a great choice. I've learned so much today. Guys I really appreciate it. We've been joined today by Bill Sacher, who is a partner and head of private credit at Adams Street Partners. And Fred Chung, who's a partner and head of credit underwriting at Adams Street Partners. Gentlemen, thanks for being on today. I've really learned a lot and so did our audience. So thanks so much.

Bill: Thank you for having us.

Fred: Thanks Stewart.

Stewart: My pleasure and thanks for listening. If you have ideas for podcasts, please shoot me a note at stewart@insuranceaum.com. Please rate us like us and review us on Apple, Podcasts, Spotify, Google Play, Amazon, or wherever you're to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast. Look forward to seeing you next time.