Ashwin Krishnan & Jeff Levin

Episode 236: The Future of Private Credit with Ashwin Krishnan & Jeff Levin of Morgan Stanley

GUEST Q & A

Stewart: My name's Stewart Foley, I'll be your host. Welcome back and thanks for joining us. I apologize for my voice right now, but no worries, I'm hoping we can get through this podcast today. We've got a great topic for you, which is what does the future hold for private credit? And I think that's on a lot of people's minds, particularly insurance investors. And we're joined today by Ashwin Krishnan, Managing Director Co-Head of North American Private Credit, and Head of Opportunistic credit at Morgan Stanley Investment Management. Ashwin, thanks for being on. Thanks for taking the time.

Ashwin: Stewart. Great to be with you.

Stewart: And we're also joined by Jeff Levin, managing director, portfolio manager and head of direct Lending. Both of you gentlemen are with Morgan Stanley Asset Management. Jeff, thanks for coming on. Thanks for taking the time.

Jeff: No, we appreciate you having us today. Thank you.

Stewart: It's exciting. And we were just talking offline about the similarities of private credit to private equity 25 years ago, and I think that's really interesting take on things. But before we get going too far, I want to start off the way we always do, which is Ashwin, where did you grow up? What was your hometown and what was your first job? Not the fancy one. Let's start there and we're going to come to you next, Jeff.

Ashwin: Thanks Stewart. Yeah, I grew up in India. I moved to the States in 1999 to go to graduate school. I grew up in a city called Bangalore, which sort of thought of as the tech hub in India back then. My first job was actually selling large pieces of computer hardware for a company that doesn't exist anymore, but that was my first job out of college.

Stewart: Oh wow. That's cool. All right, Jeff, how about you?

Jeff: I grew up in Newton, Massachusetts, suburb of Boston. Went to school down in the southeast at Emory, moved up to New York in 2002. The first job I had besides babysitting for my younger brother and being a basketball or soccer referee, this is somewhat interesting, Citizens Bank was trying to poach customers from some of their competitors in Boston. And so they hired young guys to show up into Walmart stores and approach strangers and offer them $50 to open up a checking account.

Stewart: Wow.

Jeff: Yeah, and the pitch was if you wanted to, you could open up the account, take your money right out immediately and close. So I was probably 15 or 16 years old in high school approaching strangers in Walmart with that proposal. So I started in Walmart, but here we're now.

Stewart: Wow. That's one of the most interesting first jobs I've ever heard. That's so cool. So let's talk a little bit about your backgrounds in this space in private credit. It's always interesting to me and I think it's interesting to people who listen to our podcasts about how your career has progressed to this point. So Ashwin, talk to me a little bit about you come out of grad school, what have you been up to in private credit land since then?

Ashwin: Great question. Yeah, so I was doing some version of private credit here at Morgan Stanley from, call it 2006 to 2008. We were doing private credit and private equity on the firm's balance sheet. A lot of firms did private credit deals using the balance sheet back then and I was in a group that did that. I actually know Jeff from even before that, we've known each other for 20 years working at Morgan Stanley in tangential areas. And we both moved to the private credit business and started it as a matter of fact to manage third party LP money back in 2009.

Stewart: And Jeff, what about you? I mean that is a long way from approaching people at random at Walmart to running direct lending at Morgan Stanley Asset Management. So give me your background in a nutshell there?

Jeff: Yeah, so I started at Bank of America Securities and high yield capital markets. Came to Morgan Stanley, the capital market side within leverage finance in 2004, which as Ashwin noted, that's when he and I met. And then when the markets dislocated, Ashwin and a couple of others moved over to the investment management side and raised a middle market private credit fund largely focused around mezzanine debt. So that was my bridge into the asset class and we invested that fund really well. I went to Carlyle for seven years and then I rejoined the firm in early 2019. So as I joke with some of our LPs, Ashwin and I have been married since 2004, we had a seven-year breakup, but we've been back together for five and a half years now and we're happily married.

Stewart: That's perfect. I love that. So Jeff, right before we hit the record button, you were talking about how you viewed private credit and how it relates back to private equity many years ago. Can you talk a little bit about that to kick us off here and lay a foundation? Because I agree with your assessment as well, so I think it's a good place for us to start.

Jeff: Sure. So in short, rewinding 20 plus years ago, there were far more publicly traded companies than there are today. And that dynamic has largely been due to the fact that the private equity asset class has grown dramatically over the last couple of decades and performed really well and has proven the ability to be able to provide companies which large quantums of capital, growth capital, and recruit and retain really good management teams and employees. And so there's been less of a need for businesses to be publicly traded for access to capital.

And one of the trends that we've all been seeing within the private credit ecosystem over the last many years is more capital coming into the private credit market given how well private credit has performed now for such a long time through multiple cycles, through COVID and so on, so forth. And so as the private credit asset class has grown and managers like ourselves and our competitors have taken on more money, have been able to move up market when appropriate and provide big businesses with large loans and provide them with growth capital the same way private equity did. And I think what it's done for us as investors is giving us more optionality in terms of where to deploy capital and when. So widening out the origination funnel, allowing us to be really in turn more selective. And we'll play way up market, we'll play down market and in between. So it's bought us more optionality, like I said, and I believe that trend will continue to be the case.

Stewart: There seems to be absolutely no end in sight. I mean, and not only that, but the ALM, the way the ALM sets up, insurers are natural lenders in private credit just because of the nature of their liability. So whether it's a P&C player who's in the curve or somebody who's riding life in annuity blocks way out the curve, there's plenty of options for these guys and there's not a risk of a run on the bank. I mean, I can tell you personally as an owner of a small business, banks do not want to lend to me, particularly businesses that are growing at a significant clip. They want to look at my tax returns from 2023 and I'm like, well, we've grown significantly and they're just not a viable option. So we're looking at the private markets as well.

But I want to get back on topic here because one of you is the head of Opportunistic Credit and the other one is the head of Direct Lending and you kind of are able to marry this on one platform. I don't know if this is Ashwin or Jeff, can you talk a little bit about two strategies together as one platform?

Ashwin: Sure. Let me give it a stab. And when we define opportunistic credit, it means different things to different people. The way we think about it is really serving as a capital solutions provider to private North American issuers today. And so that means being able to invest across the balance sheet in junior debt, in senior debt, and in some cases even in forms of hybrid capital, debt and equity combined, to show up with a solution. And so the industrial logic of having direct lending, which is a first lien focused private equity focused strategy and capital solutions next to each other is that the strategy is are highly complimentary and very synergistic with little to no overlap. So we're creating a really interesting opportunity funnel because we have teams that execute against two strategies and really we're in a position to provide a capital solution to any private issuer in North America between the strategies that we manage.

Stewart: And is there a particular point across the capital structure that you think is attractive today versus the others, or do you just not look at it that way?

Ashwin: No, that's a great question. I think the era of zero or close to zero interest rates that we had beginning in 2009 and running up to 2021, that's over, that's in the rearview mirror. And with the benefit of hindsight, it's probably an easy observation to say that back then the equity in many ways was being subsidized by a very low cost of debt. With rates where they are today and where they're forecast to be, even if we do have rate cuts, that trend will reverse, has reversed and is in the process of staying at a higher for longer base rate. And so we think that that results in all parts of the credit spectrum reversing the subsidization that occurred and actually becoming exceptionally attractive, especially if you compare it to a last 10-year basis just driven by base rates alone. And then you can go into places in the capital structure at a moment in time, which may have better relative value versus others, but generically speaking, the whole asset class is rerated in a very meaningful way and the returns are tangible because it's cash income in your pocket.

Stewart: A question that comes to my mind, and I think it's a question that comes to the mind of other CIOs, is that there are a variety of folks who have entered the private credit space, many of them have been there for a long time, some are newer, right? And some have been in private credit for a long time, but just not in insurance. So talk to me a little bit about how Morgan Stanley Investment Management is different? Or are you different than other players in the space?

Jeff: Sure. Ashwin, take a stab and then obviously supplement as needed. No, it's a good question, Stewart and one that we hear frequently from investors given the number of private credit managers in the market, both in the US and in Europe. I think when you take a step back, and when we look at the marketplace, many of the managers look pretty darn similar and most managers are fishing in a relatively similar pond, have similar size headcount, similar types of investment parameters and so on, so forth. And so I think the market's been pretty benign for a long time in terms of defaults and credit losses so the vast majority of private credit managers have performed well for investors, which is great.

I think the way that we think we're quite a bit different is we have a team of about 75 people in the US, upwards of 20 people in Europe. And so our headcount is very similar with the other market-leading private credit managers. And we have a very strong origination platform and diligence platform within our private credit business within Morgan Stanley Investment Management. But at its core, the primary difference is that our business is the primary private credit investing business within not just Morgan Stanley Investment Management, but all of Morgan Stanley. And so we get access, we think, to a lot more deal flow than our competitors do because we have, frankly, many, many more feet on the street interfacing daily with users of private credit, which is as it relates to direct lending, that's private equity firms. As it relates to opportunistic credit, it's a combination of non-sponsored businesses and private equity backed.

And so we have hundreds of bankers daily are interfacing with users of private credit, which means we think there's a lot more deal flow coming in through the four walls of the firm, which means we can be more selective as we deploy capital. So that'd be the first point.

Second point I'd make is the due diligence advantages we have are also significant. So leveraging the firm's research capabilities, both equity and fixed income, bankers that have been covering various industry sectors for 30 or 40 years, they're clients that are C-suite executives that we get access to. And even though the business that Ashwin and I oversee is predominantly in the US, we have a business in Europe as well, but the US business, a lot of these companies have global presence. And so Morgan Stanley's global presence and insights into local markets is critical.

The last point that I'll make is when we're competing on a deal with other private credit managers, we can offer them more than just the private credit solution because we can welcome them into the Morgan Stanley suite of services. So for example, they can get access to our M&A franchise, industry banking coverage, they can get access to capital markets advice from us. So there's a lot more that we can do for a company, whether it's private equity backed or not, than just be a lender. And we think that that in turn becomes a tiebreaker when a private equity owner or management team is trying to figure out who they're going to use as their primary financing source. They're going to get more from us than just the loan. So the ROE, so to speak, of them choosing us is higher than it is than if they go with one of several of the managers
Stewart: As an entrepreneur, that answer makes a lot of sense to me and I can understand the advantages there. Just to clarify, you said that you're actively engaged in both sponsored and non-sponsored deals. Is that right?

Ashwin: That's right, yes.

Stewart: And so just to pick up on your earlier point, Ashwin, about, I mean the title of the podcast is The Future of Private Credit. So there's been a lot of discussion about, hey, rates have gone up 500 basis points since '21 and gee, that's going to cause some rate reset stress. But the point was made on a couple of podcasts to go that it is going to serve to as a governor of leverage ratios going forward. Would you agree with that? And if so, can you just expand on it a little bit?

Ashwin: Yeah, absolutely. When rates go up, there's only a finite amount of debt capital that you can put on a company's balance sheet in a prudential fashion. So if you go back to 2021 where rates were still zero and up to 2022 when rates started to go up, we've gone from 0% to 5% at the fastest clip in history. And so what you found is companies private equity backed unsponsored are readjusting to a much higher cost of capital, no different from other aspects of inflation. And therefore when they think about the next capital raise or financing need that they have, the lens is now through that higher cost of capital that they need to manage. So if back in 2021 and beyond the appropriate leverage ratio, and I'll use EBITDA as the metric to show, if the appropriate leverage ratio was 5.5 times debt to EBITDA at its max, that's probably a lot lower now somewhere in the fourish times debt to EBITDA because there's only so much debt service that a company can make without having any cushion to breath.

So that's a good thing because from our perspective, from the investor perspective, we're actually achieving a higher rate of return with a company taking on lower quantums of debt on their balance sheet. Now over time when rates normalize it, we get to a happy medium I think, but that's been the primary effect of this increased rate on companies and how they think about capitalization.

Stewart: And can you talk a little bit about why it matters to lend across the middle market? I think that it's sometimes opaque to investors, how people define middle market, what really we're talking about there. So Jeff, if you would, could you just go ahead and get into the idea of the types of companies that you're lending to and what does that entail across the middle market?

Jeff: Yeah, sure. So as you noted earlier, we have these two businesses, the direct lending business and the opportunistic credit business. The objective of both of them though is effectively the same, which is to generate the best risk adjusted returns that we can within the targeted strategies. And so the ability to have really flexible money and go up and down the size spectrum is critically important. Invest across industry sectors is critically important. As it relates to the direct lending business, that business is really designed to generate a very stable NAV and dividend yield for our investors. So we focus within that business away from the deeply cyclicals. So we don't invest in businesses in the restaurant space, retail space, energy space.

So for example, one of the sectors that we like best, the software given the predictable recurring nature of the revenues in those cash flows and so critically important to the operating systems of their customers, whether those companies, their customers are doing really well or somewhat struggling, they need that software to exist. So very hard to rip and replace. And so that's what we're looking for. We're looking for really resilient companies that generate a lot of free cash flow and are led by really strong management teams that understand how to weather downturns.

But the ability, there are some of our competitors are exclusively focused in the lower end of the middle market or the very large cap space. I personally think that that strategy is somewhat flawed, this is an investing business. And so there are points in time like last year when going way up market and financing very large companies was a no-brainer from an investment standpoint because the syndicated loan market was effectively closed. There are certain other environments when there's more value down market. And so having that ability is I think critically important as an investor. And I'll turn it over to Ashwin cover the opportunistic side.

Ashwin: Yeah, that was a great overview. And then if you just talk about the depth of the market, the US middle market is either the fourth or sixth-largest economy depending on how you count it. So it is huge, the opportunity set continues to increase in size. And what's interesting is that at the end of the day, we are providing a bilateral solution to a counterparty that we're going to have a multi-year relationship with. And we view that as a partnership even though we're providing capital to a company for a specific use case and our partnership is governed by a loan agreement. But that's just what the contractual limits of the agreement, right? Over and above that, we are working with these companies on a regular basis and really coming to them with proactive views on strategy, where they should grow, how they can enhance their capital structure or business strategy.

So it's much more than just capital into the business. It's a pretty deep intertwined relationship with these companies. And we find that to be much more effective in the middle market because you're typically 1, 2, 3 or four lenders in a club in this situation where you're interfacing on a regular basis with senior management, private equity ownership, whatnot, right? In the upper end of the market, you could buy a loan or a bond, but you're one amongst hundreds and may not have that same access once you do the deal or even in the lead up to your due diligence process, which is why I think being in the middle market makes a lot of sense for us and fits well with what we do well.

Stewart: I think any discussion of any asset class today for insurance companies, and you guys have been working with insurance companies for a long time, right now, it seems that the structure of the investment has a lot of importance beyond just the asset class. So I'd like to just, could you touch on your capabilities to provide capital efficient solutions to insurers who are really looking for return on statutory capital, if you will. And it does matter what the capital charges are on these vehicles. So what can you share with us along those lines?

Jeff: So this is true across other types of investors as well in terms of flexibility and creativity and thoughtfulness. As it relates to the insurance space, so not surprisingly, Morgan Stanley across the institution, so within MSIM and more broadly, has very, very deep knowledge of everything you just articulated in terms of efficiency of capital, optimizing risk return and capital charge and so forth. And so we leverage not just the dedicated resources within MSIM, many of those people have been in the insurance markets for 30 plus years, but also the rest of the firm within the fixed income division as well as the investment bank. And there are dedicated groups geographically, so in the US as well as Europe, that specialize in exactly what you just said.

Stewart: As we say here, if you know one insurance company, you know one insurance company. The solutions, it's one of the reasons I think that the investment side of the house tends to collaborate as effectively as they do because the right solution for insurance company A, B and C can be different and really depends on a multitude of factors, which all of those that you're addressing right here.

And I've learned a tremendous amount today and I really want to say thank you and thank you for bearing with me with my goofy voice. Would you mind wrapping us up with a couple of takeaways, maybe one from each of you, what you want our audience to take away from today's podcast? I'll start with you, Ashwin.

Ashwin: Yeah, thanks Stewart, and I hope your voice gets better soon.

Stewart: Thanks.

Ashwin: Take away is it's an asset class that's gone from niche to mainstream to continue to expand across the globe, and especially in the US. And we're excited with our position because we're growing with the market in many, many ways. Stewart: That's great. How about you, Jeff? I do have a fun one for you guys out the door because I know Ashwin's got to run, but I got a quick one for you on the way out the door, but let's get your takeaway first.

Jeff: All right, Stewart, I'll try and be quick. I think one of the mistakes that certain investors make, and this is as it relates to the direct lending, first lien, senior secured, 40% loan-to-value, lower risk of the market where our direct lending business resides, I think some investors try and time the market a little bit too perfectly. And my advice to investors is that the direct lending asset class is one that is really not all that vintage year dependent. Spreads don't move around all that much. Senior leverage profiles don't move around all that much either. And so if you look over the years, there's not much variability in terms of the returns across vintages. So my advice would be get invested into the space with a manager's capabilities, match it with their objectives, and don't try and time it perfectly. And we've been doing this for a long time and getting in and enjoying the strong dividend that we're able to pay out to investors really in all markets good and bad. So that's a takeaway for me, Stewart.

Stewart: That's fantastic. So here's the fun one. We can have a table of lunch at lunch with four people. It's you two and then you each get to invite one person, alive or dead. Who do you want to join you at lunch? And maybe we can make it three people and you guys could agree on one. Because as you mentioned, you've been together since '04, so you probably know each other's backgrounds, et cetera. So Ashwin, who are we having for lunch today?

Ashwin: I would say Marlon Brando.

Stewart: Wow. We've never had that answer. Well done. All right, Marlon Brando, that was quick. Jeff, how about you?

Jeff: So I'll give two, one of which won't be that interesting to Ashwin, but it's interesting to me. So the first that I think he would enjoy as well, I think you got to give Martin Luther King a seat at that table.

Stewart: Absolutely.

Jeff: I think he gets the first slot. And then I was going to say my only grandparent that I never met was my maternal grandfather, so I would have him at the table. But as I said, that's for me, not Ashwin.

Stewart: Can we agree on MLK?

Ashwin: We can agree on MLK for sure, yes.

Stewart: There you go. I've had a great time on this podcast, I've learned a lot and I appreciate it. The title of the podcast is What's The Future Hold for Private Credit? And we've been joined today by Ashwin Krishnan, Managing Director, Co-Head of North American Private Credit and Head of Opportunistic Credit, and Morgan Stanley Investment Management, and Jeff Levin, Managing Director, Portfolio Manager and Head of Direct Lending, also at Morgan Stanley, investment Management. Gentlemen, thanks for taking the time. Thanks for coming on today.

Ashwin: Thanks Stewart.

Jeff: Thank you.

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