

Michael Zorich

Episode 242: Uncovering Value in Investment Grade Credit



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. We've got a great podcast for you today and the topic is credit, but not just any credit, private credit, but not just any private credit. We're going to talk about investment grade (IG) private credit. We're joined by Michael Zorich, CFA, who is a managing director and head of IG Private Credit at Principal Asset Management. Michael, thanks for being on. Thanks for taking the time with me today.

Michael: My pleasure, Stewart. Thank you for having us on.

Stewart: I want to start this one off the way we always do. Principal has been with us for quite a while and this is the get to know you part of the program. Where did you grow up and what was your first job, not the fancy one?

Michael: Okay. I grew up in Pittsburgh, Pennsylvania, actually a suburb of Pittsburgh, Pennsylvania, just to the east of downtown. My first unofficial job was at a pet store by the name of Elmer's Aquarium. I was big into fish and reptiles as a kid, spent much of my time in Elmer's, knew all the pets and all the inventory. One day Elmer himself offered me a job when I was 16 years old and worked there for three years in high school. I ended up being in charge of the reptile aisle. There's a lot going on in the reptile aisle; there are feedings and healthcare, and a lot of ordering of reptiles around the United States, and that was my job. I think you'd be surprised at all the responsibilities of the reptile aisle.

Stewart: That is such a great story. That is a super cool story. I can completely picture that, right? That's just such a... What a great story, man. Thank you for that. Can you talk a little bit about the role that you play for the Principal Life General Account? But really it would be helpful if you can explain a little bit about how Principal Financial Group is structured and how the life insurance company and the asset management arm fit together and your background of how you've navigated Principal.

Michael: Sure. As background, Principal Life Insurance Company has been around for many years, many decades, and obviously as a life insurance company has significant assets under management that need to be managed.¹ Previously, that was managed internally by internal investment teams. At one point that platform grew large enough that it was spun out as a separate asset management platform. That platform is what's known today as Principal Asset Management. I'm in the Principal Asset Management platform. One of our largest clients is the life insurance company, Principal Life Insurance Company, and we're all housed under the PFG ticker, which is Principal Financial Group. Principal Asset Management, we have the life insurance company as one of our largest clients, but we have over a thousand third party clients that we also manage assets for now post the spin up.²

Stewart: Wow, that's cool. What can you tell me about the IG private credit market right now? What's been going on with the allocation there? It's an asset class that I'm personally hearing more about. Give me a baseline education here.

Michael: I think historically private placements have been around forever and there has been a large allocation to private credit, but it's increasing in the current market and that has a lot to do with what's going on with interest rates. The rate hike cycle that we've just gone through with the Fed and making those investments more competitive with what we were seeing creep into our space which were: direct lending has been a very exciting spot, and private credit, as well as asset backed investments, and now private placements.

Private placements are typically investment grade. When you're talking about direct lending and some of these other alternatives, they can be more risky or volatile—lower credit rating—but they offered higher yield. Some investors moved into those spaces. But now as the market becomes less certain, maybe conversations about: “Is there a recession coming?” “Is the job market slowing?” Investors are looking for: “How can I earn a reasonable risk adjusted yield in something that's a little less risky in the investment grade space?” With private credit, there's various reasons why private credit has a value proposition over public debt and that's what individuals are looking at right now.

Stewart: When you think about the benefits, one of the benefits that I often hear is covenants or protections. Can you talk a little bit about the structure and has that structure evolved over time? Has the structure in those IG privates evolved?

Michael: I would say let's talk about what that structure is. What we have is really the value proposition for private credit. There's basically four legs of that proposition. There's relative value to public debt, there's covenants that you just mentioned, there's better recoveries in distress situation, and then there's diversification. To break down the value proposition, to break down each one of them, the first relative value is relative value to comparable bonds. That's what's known as the spread between the public bond and comparable issuances of private market debt. That's really reflected in the coupon of those issuances or in the secondary market in the yield of public debt. There's typically a spread there that you're picking up, often referred to as the illiquidity premium. The private issuances are not illiquid, but they are less liquid than public bonds. There is an illiquidity premium that we pick up, which is a large portion of the value that we're tapping into by entering into the private debt market.

The second value proposition is covenants, as you mentioned. With investments in privates, we get covenants. Normally, you don't get covenants in public bonds. These covenants are typically financial covenants like limitations on debt, minimum interest coverage ratios. There's other control-related covenants where if there's a change of control or anti-subordination covenants, we get these in our deals and, again, we typically don't see those in the public bonds and they're meant to either support the credit worthiness of the issuer or to bring the investors back to the table with the issuer in the instance of financial distress. They have a lot of value.

The third leg of the value proposition is better recoveries. Related to those financial covenants we just mentioned, we can observe that recoveries in distressed private debt are higher than distressed public debt, which adds to return over the long-term on a portfolio. You get a better recovery related to those covenants as well in addition to the control.

Then finally, the fourth leg that some don't think about is the diversification. In the private market you can diversify because a lot of issuers in the private market don't issue in the public market. If you only have a public market portfolio, you don't hold those names. We could invest in a lot more names than what's seen in the public market. There's additional currencies, there's additional durations, additional geographies that we could tap into that are part of the private market. All those combine really to offer improved risk adjusted returns on a private portfolio, and also on a public bond portfolio that adds in a portion of private bonds, which is what we do with the life insurance company.

Stewart: If I'm a CIO or head of private credit, how much customization or how much tailoring can you do for me, if I'm a third party client of yours, how much tailoring can we get into a typical IG private credit portfolio?

Michael: We can be highly tailored. There's a lot of sectors within privates. We used to call it private placements since historically it was typically industrial issuers. Now, we have a lot of reissuers, real estate investment trusts (REITs), that make a meaningful position in our market. More recently, new issuers include really large global asset managers, alternative asset managers. We also see funds, investment funds that focus on business development companies (BDCs) and middle market lending, which actually is a great way to get exposure to middle market lending, which is typically below investment grade loans or assets.

But the way we structure them, our investments are investment grade, and that's a very large part of the U.S. economy. We've been able to tap into that. We have credit tenant loans (CTLs), ground leases. We're seeing growth in club deals, which are deals that are really issued to smaller group of larger investors like Principal is. We see those deals, so we can slice and dice where those sectors and the weightings of those sectors within portfolios, and that includes: infrastructure, the alternative asset managers we discussed, REITs, and industrials within the private credit sector.

Stewart: One of the things I've heard the term a lot of times, but I've never heard a crisp definition is what is a club deal? When people talk about club deals, what are they talking about?

Michael: Club deals are a really question of degree. In the private credit market, deals are limited to institutional investors already, and a club deal is a deal that is shown to even more limited number of investors in a certain deal. There's various reasons for this. Maybe they think they can do the whole deal with a limited number of investors, then typically that number would be somewhere around six or less. A deal that's done with six or less investors would be referred to as a club deal. Then the question is, are you shown club deals if you're trying to invest in this market? The institutions that are shown club deals are those that have been investing for a long time and investing in size. Principal typically sees a large number of club deals that we could put our clients into, whereas smaller investors and new investors aren't going to be seeing those deals, and those deals often offer outsized value. We're very happy to be seeing those deals and being involved in those club deals.

Stewart: You had mentioned this at the top of the show, but Principal has been doing this for a long time for their general account and then made the decision to go and manage third party assets as well. There has got to be some lessons you have learned over that time period that has defined your success in the private investment grade credit market. What do you think the keys to your success have been?

Michael: Right. Yeah, we have been investing for a very long time, and that's what the first one is: our long history in the sector. We have invested in private placements for 50 years.³ There's others that may have invested for 50 years, but you'd be hard-pressed to find another investor in private placements that's been doing it longer than Principal. Our heritage is in private credit. During that time, we have built an extensive network of relationships that bring investment opportunities to our pipeline, and that pipeline is crucial to success. That's the first thing I'd identify. We only invested in about one third of the deals that we're shown. A strong, robust pipeline of deals, it's imperative. We have that here at Principal given our history.

I'd say secondly is our team investment philosophy and approach. Again, building on our track record, we have an extensive and proven underwriting process that's core to what we do. We have very stable returns, very low default rates. I think currently it's less than 1% cumulatively over the past decade.⁴ Finally, we continue to evolve to the market where it's needed. As I mentioned, infrastructure has grown significantly as part of our market and this really demanded additional capacity and expertise. We recently added a new head for private infrastructure deals specifically and we'll be adding additional credit analysts for infrastructure in the near term. Continuing to evolve with the market as needed is the third leg of that success in the market.

Stewart: As you look out your window today, where do you think insurers can find good relative value? I think maybe even more importantly, what are you cautious on?

Michael: Well, for good relative value today, I'll go back to infrastructure. Just to put some numbers around it, for the past number of years, probably 25% of our annual deployment has been in infrastructure deals. Year-to-date in 2024, it's nearly 50% of our deployment because we're seeing a large number of deals driven by government spending on infrastructure driven by specializations in infrastructure like digital infrastructure, renewables, energy transition. There's just a lot of infrastructure out there and it's coming with outsized relative value.

Stewart: Is it fair to say that there is no end in sight for the opportunities in infrastructure right now? It seems like it is an opportunity that is here now, and it appears just from today that it's going to stay a good place to be looking for value going forward.

Michael: Yes. That's what we believe and that is supported by the resources that we've been putting into that area. I talked about evolving in the market where it's needed. There's always changes in the market. We don't always move resources like we're moving now, taking on a head specifically for our infrastructure investing, and adding several analysts with specializations in infrastructure beyond the seven that we already have with specializations in infrastructure. Yes, we see that as an ongoing opportunity. When you say what are the opportunities in private credit, what we look for, solid credit fundamentals matched with outsized relative value to public bonds. That's what we're finding in infrastructure. Infrastructure is making up a large portion of our overall relative value in the deployment that we're doing this year.

Stewart: That's great. Anything that you're avoiding or anything that you're cautious on?

Michael: Yeah, I think that there's going to be continued volatility in the real estate space. What we see in our market is typically in the form of REITs and those REITs, the Real Estate Investment Trust can be focused on different areas. Some are focused on industrial real estate, they're less problematic. Some of them, called the ODCE Fund Index⁵, are spread

out across various sectors inside real estate, and so may be more heavily weighted towards office, maybe more heavily weighted towards retail. Those deals continue to come to the market, but we have less appetite for those REITs, particularly in sectors that we remain cautious on.

Stewart: That's super helpful. I've gotten a great education today. I really appreciate you being on. I've got a couple of fun ones before you're out the door, if you'll put up with me. The first one is what would you tell a 21-year-old Michael Zorich, given what you know right now, there's a lot of folks who don't know that insurance asset management exists, a lot of folks that don't know what the opportunity set is. If you could catch yourself walking down the stairs after college graduation with that diploma in your hand, a big smile and a mortarboard on your head, what would you tell yourself?

Michael: Well, there's a couple of things. First of all, I always emphasize to the young folks that ask me for advice, get a strong background in accounting, because we spend a lot of time in accounting and building financial models. No matter what you majored in, finance, corporate finance, it's going to come back to your capabilities and understanding of accounting. Secondly is that modeling with Excel in the models, the new entrants, the new hires that we have, their capabilities to build models and use programming inside of software like Excel to build these extensive models that model out thirty-year infrastructure projects that have a lot of moving parts is a new quant capability that I think wasn't as in demand as it is right now. I didn't have that type of modeling capability when I started in the business, didn't need it, but it's certainly something that if they don't have it, we're sending them for training for their modeling capabilities in Excel and additional quantitative capabilities that you don't normally, I guess, think of when you think about a credit analyst.

Stewart: It's like investment finishing school. It's like you need more than they're teaching at most universities. It needs to be a little bit more, well, not a little bit more, a fair amount, more advanced. You're able to find that training commercially if they don't have it out of college.

Michael: That's right. There's training specifically for model building for credit analysts, both in investment grade private credit, as well as the high yield private credit that we also do, which is at the direct lending side. If they don't have it, we can send them out for it, but I will say that more and more of the applicants that we talk to are coming in with that capability. They understand they need to build that out, and it might be extracurricular to their university education, but they have found avenues to build out that expertise and they come to us with it.

Stewart: Yeah, thank you. My last question is a fun one, and if you could have a lunch with yourself and three guests, doesn't have to be three, you can have up to three, alive or dead, who would they be?

Michael: The three would be Steve Jobs, Warren Buffett, and Elon Musk.

Stewart: Wow. That would be quite a lunch.

Michael: That would be a lunch.

Stewart: That would be quite a lunch. Buffett, it's funny, I worked for a company owned by Buffett and I had the opportunity to be around him for a couple of two hour presentations. He's just a fascinating individual, but he figured out, right now there's a big trade on with private equity (PE) owning insurance companies and it's a big trend. What he did in 1960, I think he did it in 1964, was he bought half of the Governmental Employees Insurance Company, which is now Geico. He understood float and that insurance companies are cashflow positive and can be used as an engine for investment the year I was born. It's astonishing just the success that he's had with a relatively simple formula. In Jobs, Jobs is a guy that you never knew you needed an iPhone until he put one in front of you and then you can't live without it. Right? Musk is the same. That would be quite a lunch. I think that's really, really a cool select set of folks there.

Michael: I would expect in that lunch I would be on 2% talking mode and 98% listening mode.

Stewart: Yeah, exactly. Exactly. I've learned a bunch today, Michael, thanks for being on. I really appreciate it. I know our audience does, too.

Michael: My pleasure. Thank you for having us and I really appreciate you taking the time.

Stewart: My pleasure. We've been joined today by Michael Zorich, CFA Managing Director and Head of Investment Grade Private Credit at Principal Asset Management. Thanks for listening. If you have ideas for a podcast, please shoot me a note. It's Stewart@Insuranceaum.com. Please rate us, like us, and review us on Apple Podcasts, Spotify, Google Play, wherever you listen to your favorite shows. My name's Stewart Foley. We'll see you next time on the Insurance AUM.com podcast.

1 Founded in 1879. As of 6/30/2024 Principal Financial Group assets under management were \$695 billion.

2 Number of clients as of 6/30/2024 was 1,381.

3 Experience includes investment management activities of predecessor firms beginning with the investment department of Principal Life Insurance Company.

4 As of 12/31/2023.

5 The NFI-ODCE, short for NCREIF Index - Open End Diversified Core Equity, is an index of investment returns of 38 open-end commingled funds pursuing a core investment strategy on both a historical and current basis. The NFI-ODCE Index is capitalization-weighted and is reported gross of fees.

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