Grady Frank

Episode 245: Market dynamics, opportunities and creative solutions in private credit

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com Podcast. My name's Stewart Foley, I'll be your host. Hey, welcome back and thanks for joining us. Today's topic is private credit. And we're really talking about the upper end, the larger borrowers, today. And we're joined by Grady Frank, who's a partner and head of private credit origination at Golden Tree Asset Management. Grady, thanks for taking the time. Thanks for being on, man. We appreciate it.

Grady: Thanks a lot for having me, Stewart. Looking forward to it.

Stewart: Me too. So you're professor for a day, but I want to start this off the way we always do, which is where did you grow up and what was your first job? Not the fancy one.

Grady: Yeah, no, I probably have a little bit of a different personal background. I actually grew up in northern Alabama with my family there and then went on to college at Virginia and Washington and Lee University, and then spent a few years in Charlotte before I moved up to New York City for 16 years.

And my first job definitely had nothing to do with finance. My family has a farm in north Alabama and my first job was being bossed around by my grandmother, cutting the hedges and cutting the grass and doing odd jobs. Which, surprisingly, she could keep me very, very busy from 8:00 in the morning to 5:00 PM. But that was my first job. I think she paid me about $7 an hour. But that's where I cut my teeth on hard work, I guess you could say.

Stewart: That sounds hauntingly familiar. So for those who are where Golden Tree's not necessarily a household name, can you talk a little bit about... Just give me the 50,000 foot view before we get going into the specifics about how you approach private credit?

Grady: Yeah, sure. So Golden Tree, we're a large firm. We've managed $55 billion of assets. I think we take an approach of, we're entirely focused on credit. We're not a firm that does private equity or runs a long short equity book. All of our business lines are very focused around credit. But we approach credit from multiple angles. And I think one of the defining characteristics of our firm is, we like to be opportunistic across asset classes in credit, but also geographically. We have a robust team in the US, of course, but also in Europe. And so most of our investing is in the US and developed countries in Europe.

We do have an emerging markets business as well. Because the opportunities across credit, the way we think about it, it's not always the same, but it's always changing. And if you're going to generate alpha for your investors, it's important that you have beachheads in certain asset classes where you can react quickly. I think that for us, we started 25 years ago founded by Steve Tananbaum, who's still our CIO and managing partner, the distress business was something that we started early. We run a hedge fund now that's $11 billion that invests really across all the different asset classes that we invest across. And we think about that as sort of our best ideas fund, and that's how most people know us. And now we're just continuing to expand the footprint, which I'm really excited about. And private credit.

And we've also made inroads in the real estate credit market to expand there, and continue to take small incremental moves to increase our base. But we always do that very methodically. And we continue to believe that there's a lot of really interesting opportunities that we see, but we also know that there's some that we may not see but we need to react to quickly, and that's part of the way we built our model to be opportunistic like that.

Stewart: That's terrific. So when we were talking before this podcast, you had mentioned that your average EBITDA is something on the order of $300 million, which is certainly on the larger end. Can you talk a little bit about how Golden Tree approaches private credit?

Grady: I think Golden Tree has never been, really, a middle market lender. And as we expanded our private credit platform, we weren't going to try to do anything different than what we've done for 25 years. And so what we really define our business around is really being a solution provider to larger issuers. We generally focus on companies with at least $75 million of EBITDA. I'd say in the last three years, the opportunity set has been particularly attractive in private credit, which has allowed us to generate really attractive returns by lending to larger companies. There were periods of time in '22 and '23 where depth of market was really the solution that needed to be solved for, and those larger transactions needed to price wider with more attractive terms. That's changed a bit now as the market has recovered and spreads have tightened.

And so we've pivoted away from some of those larger, what we'll call ‘straight down the fairway’ types of deals, and focus more on solutions, where there's so many borrowers now feeling the pressure of higher rates and the M&A market has been somewhat anemic. And so borrowers are having to look at maturities that are continuing to get closer and closer and figure out ways to perhaps reduce the cash paid debt that they might have to get those maturities solved for.

So those are some of the opportunities that we've been psyched about over the past few years. And so I think we continue to believe the larger market, where is the fastest growing area of private credit, and where we see, particularly with this move from public markets to private, has the most runway to go from here. So we're excited that this private credit market has moved into our sweet spot, as you'd say.

Stewart: That's super helpful. When I think about things, and you could say spreads have tightened and markets have loosened. What type of opportunities is Golden Tree identifying in this market? And I think for a lot of our listeners, equally important is: what are you cautious on?

Grady: Yeah, that's a great question. It's certainly been a market environment that changed a lot. Again, 2021 is the period of time where we consider the peak of valuations. IPO market was incredibly hot. Sponsors were having to pay very high multiples to compete with that market as a corollary. They had to get every drop of debt that they could to make the math work on some of those transactions. And then we saw that valuation changed drastically in the first quarter of '22. Which the market is still kind of on a recovery path from.

And then we saw rates gap out, which put some pressure on, further pressure on, those businesses. So there was a really nice opportunity set there in '22 and '23 and parts of '24 to be a credit investor, but now it's gotten a lot tighter. Because we haven't seen M&A come back anywhere near the levels of '21. And we may not in the immediate term. But now's a period of time where it's a great time to have a platform like ours where you're not just playing the plain vanilla deal.

Because just doing deals where sponsors are putting in 60% equity checks of performing companies is a nice business, but it's also a commoditized business right now. And so as a result, with the broadly syndicated market tightening, it's very attractive. Private credit has had to tighten as well. Where we've been pivoting towards is more of the companies that, we'll call them complicated refinancings. Companies that are probably a bit too levered. There's going to be some new equity coming into that transaction, perhaps some non-cash paid debt.

The other situations are great companies, where one of the solutions that sponsors need in this new market is that we've all heard the drum beat of not enough capital being returned to private equity LPs. And with an IPO market that is slow to recover, M&A markets are slow to recover, those have all been headwinds for private equity to return capital. And so we've stepped into some really nice companies and offered dividend recaps to those businesses, where we feel like there's plenty of balance sheet capacity to return capital. And that's been very well received.

It has to be the right company, obviously. But those are some great opportunities where private equity is willing to pay and receptive to those because one of their... We all have to satisfy our LPs and make sure we're doing the right thing by them. And when the M&A market has been this quiet for a couple of years, returning some capital via dividends can be a nice way to improve returns and also give back capital.

Stewart: It's something that I'm not familiar with, the dividend recap transaction. Can you just unpack that a little bit for our audience, just that we can get a little bit more clarity on how that sort of thing works?

Grady: Sure. So if you just take an example of a company with a $100 million of EBITDA that would have been bought in 2021, and that company was bought for 10 times EBITDA. And so they paid 10 times, and it was levered, let's say, 6 times. So it was a 40% equity check. And that business, despite high rates and some of the volatility in the market, has performed really well and now leverages at 3 times. And so you have a company that had a 40% equity check, 6 times leverage, because of the performance of the business, coming to 2024 with a three times levered company and valuation, if the business has done that well, it's probably the same. And so you have seven turns of equity value underneath, but for that type of a business, let's say it now has $120 or $130 million of EBITDA, for that type of business, to go public, it's pretty challenging. You're just too small, for the most part.

And the M&A environment, there continues to be this bid-ask spread between sellers and buyers. And so you're sitting there with a company, if you're a private equity sponsor, you bought the company 3 years ago. Typically, the whole period, 4 to 6 years for these types of sponsors. So you're waiting for the M&A market to kick on, you're waiting for the IPO market to kick on. Rates may drop in the future, that feels like a tailwind evaluations. But in the meantime, if you have a 3 times levered company, a balance sheet capacity, and so if you believe that you can still operate that business very attractively and you may be willing to take three times leverage up to 4.5. And if you're a lender to that company and you were comfortable at 6 times and you've seen the business deliver, and probably deliver better than expected performance, you're likely comfortable with that.

And so those are the kind of situations we look at for dividend recaps where businesses that performed really well, the balance sheet can support it. The other side, what's not happening, is businesses that were 6 times levered that went to 7, and people trying to architect some way to put another turn and a half on top, those aren't at least the kind that we're doing at Golden Tree. I don't think the market's really doing those types of deals. So it's a way to reward businesses that are struggling to find ways to monetize in the public or M&A markets, they can monetize through the credit markets.

Stewart: That's super helpful. So I really do learn a lot on these podcasts. That is super helpful. So let's talk about fund sizes. Fund sizes continue to grow, some approaching $40 billion plus. What are the implications on the asset class, from your perspective?

Grady: Yeah, look, I mean, it's stunning, the amount of capital that's been raised in private credit. I've been in the leveraged finance markets now for 24 years, and it really wasn't that long ago where the largest deal you could do in private credit was maybe $300 million. That was probably like 2014, 2013. It just wasn't that deep. And that was always the issue with private credit, was that if you really needed to raise a billion dollars or more, then you needed to do it through the public channels. It was the same thing with the IPO market. If you had a company with $400 million of EBITDA and you wanted to sell that business, you needed to sell that business to the public market because there wasn't private equity groups that could write those kinds of checks.

Now there's plenty of private equity firms that can write multi-billion dollar equity checks on a standalone basis. And now we're seeing $2, $3, $4, $5 billion transactions in private credit. So the depth of the market has changed drastically. But we're continuing to expand that breadth and depth by these larger funds. I think when you just look at the technicals today in private assets, not just private credit but include private equity, we have close to $3 trillion of dry powder in private equity hands, and a similar number around private credit. So there is a lot of dry powder there waiting for M&A and other financing opportunities to shift from the public markets into private, and I really think they will.

But some of the challenges with that, from an investor standpoint is, boy, you got to feed the beast. You've just raised a $25 billion fund. You need to do deals. You need to do big deals. And the reality is today there's just not that many of them. Now we've talked before, we think that's coming. But in the immediate term it's pretty light on the M&A side. So I think from a Golden Tree perspective, we've always been very careful about sizing of funds that we raise. We never want to be in a position where we have to chase the market. And we've been very disciplined about how we've raised funds throughout our lifetime as a firm. And I think we will continue to do that.

And I think the other thing is many of these companies are public companies. And if you look at the motivations of public equity, investors are very focused on scale, very focused on FRE, which is the major metric by which public alternative asset managers are valued. And so there's certainly a driver behind a lot of the public asset managers to raise capital and do bigger and bigger funds. And scale is really the goal. And I think for us, we remain focused on returns. Making sure that we can deliver a really great experience for our investors while also creating and adding value for our partners on the private equity side and management teams that we're doing financings for.

So we're not a public company. We're owned by the partners at Golden Tree, so we're most focused on growing and scaling very carefully and having smaller funds. Our private credit fund today is a billion four, we're about 80% deployed right now. So we are not feeling pressure in this tighter spread, lower deal environment to go chase the market. And I think we're feeling fortunate that we didn't raise a bigger fund because we were able to be very selective and our returns have reflected that.

Stewart: So I've got a view that I'd like you to validate or refute. Which is, larger issuers are increasingly using both public and private markets for financing alternatives. Just real quick, do you agree with that?

Grady: Yeah.

Stewart: Okay.

Grady: It comes and goes. It's like, how much they use either one of those markets ebbs and flows.

Stewart: And so I guess the question is, is this a structural change to the asset class and what does this mean for current private credit managers?

Grady: I would say you'd have to say there's been a structural change just given the depth of market that has evolved in the past 8 years or so. But, on the other hand, it's not a new thing that the public credit markets and the private credit markets can work hand in hand. Because there's certain things, the public market is a rated market, everything needs to go through the rating agencies. That can create complexity, that can restrict access to capital for borrowers when things need to be more bespoke. Private credit, it's an easier path for an issuer, and to construct those types of financings outside of the public domain.

And so today with tight spread environments, the broadly syndicated market looks really, really attractive. And I think we're seeing a lot more people run in that direction, which makes perfect sense. But if you wound it back to '22 and '23, the percentage of LBOs that were financed through the private credit market were close to 100%. Which also wasn't sustainable. And I think it's a good thing for private credit that look, when markets get a little choppy and deals get really attractive to finance, then private credit takes share. When the market gets really white-hot and spreads tighten, then that's a better fit for the broadly syndicated market. I like the market where we do the best when things get really cheap. But look, I think there's areas where both markets can coexist, and look, I think taking a bigger step back, this is a really good thing for the economy. It's a really good thing.

Stewart: Absolutely.

Grady: That there is deep pools of capital, with longer dated fund structures, that allow them to be more patient. I think we're going to see a lot more predictability and returns in credit. I think there'll be borrowers that, even when we go through periods of time like '22 where the bottom drops out of the market, that there's deep pools of capital that will step in to provide financing. And in all the periods of time, you go back to the great financial crisis, when the market really bottomed out there was no M&A to do. Everything was a public market financing vehicle of any scale. And so M&A just died.

And a lot of companies, default rates went sky high because companies couldn't create these kind of more creative, bespoke solutions to help them get to the other side. And that's a lot of what we're focused in on right now is good companies going through a little bit of trouble, because obviously rates have spiked and they might have been levered to a zero rate environment, but they're good businesses that deserve a second chance, or deserve an ability to get to the other side of whatever struggles that they're dealing with. We haven't even mentioned COVID. Many companies still smarting from the wounds of that experience that are also perfectly fine businesses.

But I think private credit, part of what's such a benefit to the overall system is their ability, with longer dated capital, they could be a little more patient to step into those situations and help those companies get to the other side. It's going to save jobs, it's going to help good companies stay in business. So I think it's a very good thing for the system. Which was part of the reason, I think from a regulatory standpoint, there's a lot of reasons to like private credit and it's fit in the economy.

Stewart: I really think that's a very good point. Banks are not lending. We struggle to get financing. Bank financing is brutal. And private credit in the insurance industry is funding a lot of economic growth, which is good for everybody. And as long as the underwriting's solid. Which brings me to my next point. Which is my view here is that private credit has not experienced a meaningful cycle yet.

And we had someone on that was talking about... Who focused on the distressed market. And they said, "This will be the greatest crop of distressed debt ever because the issue has to do with base rates having gone up, not necessarily the problems with the business itself." Which is similar to the point that you just made. But with base rates elevated now for a couple of years and growth moderating, what do you expect from a default rate perspective in private credit? And what do you think is going to characterize the winners and losers in the next cycle?

Grady: Yeah, look, there's definitely some risk around this in private credit. Because if you look back at the vintages, I think vintage matters a lot. And I also think we haven't really seen this play out quite yet. I do feel like private credit has certainly cleared a few early hurdles in terms of portfolio performance. Because look, we're in 2024, things changed a lot in '22, rates have gone way up. Default rates are still pretty low. I think company performance, economic performance, has been certainly better than feared. And so whereas I think there were a lot of people that might have, at the beginning of '22 when things changed so drastically, a lot of people might have forecasted that by the end of '24 we're going to see a lot of private credit deals facing super big challenges. But that really hasn't been the case as a general view.

However, I still think that hasn't quite fully played its way out. We had very heady conditions, very borrower-friendly conditions in 2017, 2018, 2019, and then really 2020, 2021. As I mentioned before, what private credit can do is help companies kick the can down the road. Or effectively do refinancings that help borrowers kick the can down the road. That's all great, as long as that business is still relevant. But you can't kick the can down the road on a business and succeed on a business that is just obsoleted from a technology standpoint or has just lost the thread with their customers. And so I think we will see that play out over the next 2 to 5 years. And I do think there's going to be more situations from that era, particularly the '18 to '21 era, that are going to be problems for private equity and private credit.

But on the other side, I think we feel incredibly good about the opportunity sets that we saw in '22, '23 and '24, where we've really seen, because of rates, leverage went way down, valuations of companies went down, and we saw deal structures improve. Bigger equity checks, wider spreads. And now we're moving into a period of time where rates should be coming down, which will be a tailwind to some of those borrowers. And so I really think it's about vintage. I would definitely have concerns over the pre-'22 vintage.

And I don't know what the default rates are going to be. Some of my friends in restructuring have told me that liability management is going to be the new restructuring. And part of that is due to this deep pool of private credit and the ability to do bespoke deals, is that we aren't just going to see a flame-out bankruptcy. Because I think the other dynamic is that we've seen many times that the only people that make money in a bankruptcy are lawyers. And a lot of value gets destroyed for lenders and holders in bankruptcy. So if you can figure out a solution preemptively outside of court, you can preserve a lot of value, a lot of management time and effort.

And with pools of capital like private credit and other more bespoke types of capital, you can get those types of deals done. And so I think that will elongate the default cycle. And so this will play out over two to 10 years. You mentioned something which is discipline of credit underwriting, which cannot be overemphasized in credit. Credit is a great business as long as you don't have meaningful defaults. And the minute you start sacrificing your underwriting discipline, you can really suffer.

And so I think it's one of the things that we preach in our firm, is just we have a process and we don't deviate. And it's part of what I see of... There's a natural pull to lean in when you have to manage such large pools of capital and you have constituents that want that capital to double and triple and get bigger. It's a pressure on underwriting standards. It just is. And so I think that will be the challenge for private credit, particularly larger in the market, is people that have grown tremendous scale, can they maintain discipline through the cycle?

Stewart: That's super helpful. You mentioned M&A being low, and with a lot of PE dry powder. Do you expect M&A activity to rise? And if it doesn't, is there enough to do in private credit?

Grady: Look, I think M&A will undoubtedly rise. Myself and everybody else in this market's been saying that for a year. And it's been slow to come back. And so this bid-ask on buyers and sellers has been pretty stubborn. But it's got to wilt at some point, and I think we'll see more activity. But look, if it doesn't, it's going to be interesting for people that manage enormous pools of capital, because M&A is the primary driver of activity that those firms are banking on.

But again, I think for us, I think some of the firms that... I really think about it as a sweet spot where we manage 55 billion in capital, we're not small. But we have funds, where again, we'll be focused on being disciplined on size. But if there's no M&A to do, we'd feel really confident in our ability to put that capital to work. And the more complex refinancing and solution-driven things. If you had 20 billion in capital, you can't fill the coffers on just creative solutions.

And by the way, you got to have a track record in those types of deals, which we definitely do. Across our fund structures, which I think has been proven out by top quartile returns over 20-plus years. So I think there's a real mode around that business, the more complex refinancing business. And it's not deep enough for people that manage very, very large funds to feed themselves off those types of transactions. So there really needs to be an M&A market. But I think there will be. And I really remain bullish on the private equity industry as just a better solution for many companies. And I know that probably the ability to exit and the returns that will be generated by maybe the '19, '20, '21 vintage, there's some concerns about that.

But I think longer term, the ability to provide and add value in the private context with some really, really intelligent folks that have incredible resources is going to continue to be a place where institutional and retail investors find value in the private equity world. And as a corollary, the private credit market will be dragged on alongside it for many of the same reasons. I think we'll generate great returns for investors as well. So I'm not worried about the direction of the private markets, and quite excited about it.

Stewart: That's awesome. I have gotten it. You've been a phenomenal professor for the day. I really appreciate that. I've got a couple of fun ones for you on the way out the door, if you'll entertain me.

Grady: Sure.

Stewart: The first one goes, you went to Washington and Lee, and you're not alone in that. There's another senior person in this business that also went to Washington and Lee. So I want to take you back to when you graduated. What advice would you give a 21-year-old Grady Frank, given what you know today?

Grady: I remember coming out of college and the only thing that I was sure of is that I didn't know what I wanted to do. And all I wanted to do was learn, really, in a direction that I thought would help provide me opportunities. And so, look, the advice that I would have given myself is pretty much the advice that I followed, which is go the path that gives you the best optionality and do your absolute best.

And I worked at Goldman Sachs for 15 years and counseled a lot of junior analysts, and I used to always tell them that even sometimes if they were struggling with the hours and the time put in, and maybe even they wanted to do something else, I would say, look, the most selfish thing that you can do for yourself is to do a really good job. Be the best teammate that you can be. You're surrounded by a group of people in the Wall Street finance arena that are almost all going to be successful by definition. And your job is to have all these people walk away from having worked with you with a positive impression. Not just of your work product, but most of all about you as a person, as a teammate, as someone they trust.

And so jump on any opportunity to help somebody. Think long-term about your career and your brand. And relationships matter more than maybe anything that you'll build in your career. And also, the relationships are not about impressing your MD, it's more about your peers. Because those are the people that you may work with and find opportunities with and benefit from their counsel over a 30-year career. And so maintain a long-term view, be resilient and do your absolute best and try to create... This is what I tell my kids. Try to create a mentality and a commitment to excellence in everything that you do. It's just a habit. And I tell my son, you can't turn that off and turn it on. You can't just go lollygag through practice in basketball and then expect to be a star in the game. You have to be committed to it, in everything that you do. And if you do that, boy, you're going to do just fine.

But I still think that the path through investment banking is an incredible place to learn. And so I've given a lot of people advice to follow that path. And it's not easy, but it's just a great place to expand your horizons and treat it as a privilege and don't take these things for granted, especially as a young person. I didn't appreciate it at the time, just how important it was. And thankfully, I think I did a reasonable enough job accomplishing those things that, 25 years later, I've got a lot of friends in the business, a lot of these people that are ex-colleagues of mine I work with almost every day outside the firm. And those relationships are very differentiating in success for people 25 years later. So you're building the framework for it early on and it's worth the hard work.

Stewart: I love it. Great advice. So here's the fun question. The one on the way out the door. You can have lunch, a table of four, you're one of them. You can have up to three guests, alive or dead. Who would you most like to have lunch with?

Grady: My goodness. I am a huge Hamilton fan. I think I would love to have lunch with Alexander Hamilton and hear about our country and how it was founded and just to understand or some of the things that we think we understand. Was it true? And then maybe give him a little bit of an update about how far things have come. Yeah, I think he would be right up there. Boy.

Stewart: It doesn't have to be three. You can just have one.

Grady: I think Nick Saban is one of my personal heroes.

Stewart: Oh, there you go.

Grady: I'm a huge Alabama football fan. I really like Nick because a lot of the things that I said about commitment and success and motivating young people, I've listened to him for 20 years. And the way he talks about it and what's all... It basically gets down to there's no substitute for hard work and discipline. And trying to get everybody on the same page to believe that, and then you can create something really special. I think about that as with my team and trying to be a leader at Golden Tree, and set the right example for my kids. I just think he's a phenomenal leader. And I'd love to just learn from him and have him as a mentor. If I could get him to pick up my calls, that'd be great.

Stewart: Great. That'd be a heck of a good lunch table. Nick Saban and Alexander Hamilton and Grady Frank. That's fantastic. I've learned a lot today. I really appreciate you being on, and thanks for taking the time.

Grady: Thanks a lot for having me. This is ton of fun, Stewart.

Stewart: That's awesome. We've been joined today by Grady Frank, partner and head of private credit origination at Golden Tree Asset Management. Thanks for listening. If you have ideas for podcasts, which I never get an email from anybody, but just in case it's Stewart@insuranceAUM.com. Please rate us, like us and review us on Apple Podcast, Spotify or wherever you listen to your favorite shows. My name's Stewart Foley. We'll see you next time on the Insuranceaum.com Podcast.