Kevin Marchetti

Episode 188: Leading indicators: The next five years in direct lending

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. I'm Stewart Foley, I'll be your host. Today's topic is the next five years in direct lending, and it's become increasingly clear that the next five years in direct lending won't be the same as the last. And today, we're talking with Kevin Marchetti of Man Varagon to see what he's seeing in markets and what he thinks that the three to five years is going to look like and so forth. So, without going too far there, Kevin, welcome back. You're a repeat guest and happy to have you.

Kevin: Very glad to be here. Thank you, Stewart. Appreciate it.

Stewart: So, you've gone through some of my shenanigans on personal questions, but here let's try this. What town did you grow up in? What was your high school mascot and what makes insurance asset management so cool?

Kevin: So those are great. Grew up in New Hartford, New York. So that is…

Stewart: I know where that is. I've been there.

Kevin: Okay. Well, then it is a huge metropolis that's about 25 miles away from Syracuse, which is the biggest city. My high school mascot was the Spartans, so we were the New Hartford Spartans where I did play sports. So, I was a big fan of the Spartan mascot.

Stewart: What were your sports?

Kevin: So, in high school I played, I was a three-sport athlete. I played football. I played baseball, and I played basketball.

Stewart: Nice. Wow, you're busy.

Kevin: And what makes insurance asset management so cool is I think it's an opportunity to work with very sophisticated firms. We have deep roots, which I'll get into in the insurance asset class, but you work with very, very smart people that have a great appreciation for an asset class that Man Varagon is very deeply entrenched with. And I love speaking with professionals from the industry and sharing our thoughts on the market and what we're seeing.

Stewart: That's really great. And I wanted to kind of get into the intro a little bit. One of the things you're going to talk about today is how you stress portfolios, which is I'm hearing from our CIO community saying, "Hey, can we get on a call to talk about what happens if?" But just as a reminder from your last podcast, if there's been a lot of water under the bridge over the last couple of months, there's been a transaction and so forth. So, can you give us the 50,000 feet on Man Varagon and what that looks like today?

Kevin: Absolutely. So, just as a quick refresher for the listeners. So, Man Varagon, we manage approximately $15 billion in assets and we continue to specialize in investing in senior secured financings in the form of first lien term loans and unitranche financings to performing private equity backed US middle market companies. At Man Varagon, we define the middle market as borrowers between $10 million and $75 million of annual EBITDA size. But we have a very good, specific focus and specialty in kind of the sub $50 million EBITDA size business. Our core investment strategy is focused on what we consider to be recession-resilient end markets such as critical business to business providers, healthcare, non-discretionary consumer staples within the packaging and food and beverage spaces, established software companies, and the aftermarket auto space. We avoid cyclical sectors, so we do not invest in retail restaurants, energy, or capital-intensive businesses.

Rolling forward since our inception 10 years ago, we've invested more than $27 billion across over at now 330 companies in the core middle market. We've closed transactions with nearly 140 private equity firms, and we are a lead lender over 90% of the time on our deals, which we're very proud of, and we'll talk about this a little bit later. We continue to drive in excess of 50% of our annual deployment out of our existing portfolio, which is a fantastic thing. And as I mentioned at the outset as we were chatting, we do have deep roots in the insurance asset management space. So, we were launched with some very large insurance backers, predominantly AIG and Aflac, who are very well-respected within the industry and they're key LPs of our business today. And Stewart, as you mentioned, it is a very exciting time for our platform since the last time we chatted. As you noted, in September of this year, Varagon completed its acquisition by Man Group and the platform was rebranded, Man Varagon.

It's a few things that's important to talk about here. I think first I want to emphasize to everybody, the entire team and the entire investment team remained with the platform. The investment decisioning process remains within the Man Varagon engine and the investment committee that has developed its 10-year track record will remain intact in making all investment decisioning. For those learning in, Man Group is a global active investment manager. They are a very well-respected brand that's powered by cutting-edge investment technology. They have a heritage that stretches back all the way to 1783. They are listed on the London Stock Exchange. Man Group manages an excess of $160 billion of assets today across alternatives along only private market approaches for its global client base. The Man Group transaction with Varagon is a significant milestone for our firm and will provide numerous benefits to our investors, employees, and our private equity partners.

And what do I mean by that? I think first and foremost, it'll provide us with a greater origination and negotiation capabilities due to the combined breadth and depth of both firm's relationships on a global basis. I think secondly, it's going to provide us with an enhanced ability to source execute attractive opportunities for our investor base, deliver even more flexible financing solutions to our borrowers across multiple cycles. And then I think when you look at the combination of Varagon's direct lending engine, and you combine that with Man's global salesforce that includes over 250 professionals, it's going to allow us to accelerate and grow our platform that we would not have been able to do on a standalone basis. So, it's very exciting for us, we couldn't be more happy to be partnering with Man and the name has a nice ring Man Varagon and that's what they do with their investment engines that they have across their platform.

Stewart: That's fantastic. That's a great background. That's really super helpful. A lot has happened since we last spoke. What I hear from private credit folks is, "Hey, it's got a floating rate coupon." The challenge is that rates are significantly higher and borrowers are paying significantly higher rates. Inflation has been kind of stubborn. I'm hearing higher for longer, As a little bit of a mantra, can you talk a little bit about the notable changes over the last seven or eight months and how you think that's impacting the direct lending market in particular?

Kevin: You hit it, Stewart, right. The US macro environment in the last eight months has continued to be driven by Fed policy overall uncertain economic environment, and probably most recently some additional geopolitical unrest. As we all know, Fed's been trying to fight inflation with rate hikes, which has driven the 10-year treasury up, I think about 150 basis points since we last caught up in early April. And at that point in time, it was up over 150 basis points from when I spoke with you in 2022. And as you noted, specific to the market segment where Man Varagon operates, which again senior secure private equity backed middle market companies, 100% of our portfolio is in fact floating rate, right? So, with the reference rate for our underlying loans now eclipsing about 540 basis points in many cases three months so for today is right around 540 basis points.

That compares to about four 60 bips when we talked in April. So, you've had almost 100 basis point increase since the last time we caught up. So, absolutely we've seen borrowing costs and then associated questions from our investors about stress within the middle market increasing significantly. Given that dynamic, we spend a significant amount of our time continuously stress testing and analyzing our portfolio and benchmarking our portfolio against what we'll get into, but some of the leading and lagging indicators within our asset class. But I think most importantly, it's continuing your deep credit focus while you're evaluating all your decision deals. It is very, very interesting though for sure.

And I think look kind of an extension from this Stewart, but it's relevant is as we've spoke about in the past, the current market dynamics, higher rates for longer choppy demand on the inflationary side, we believe this is reinforcing that our investment in portfolio construction strategy is performing exactly as we had hoped. Namely, given the fact that we do focus on those more recession-resilient industries and the borrowers that are within our portfolio as a result. But I think additionally, given we are a lead lender in our deals, over 90% of the transactions we are an admin agent or the joint lead arranger. It allows us to have very good controls on the credit terms and documentation terms and be actively monitoring all these credits.

And as an example of our deal, Stewart, we have at least one financial maintenance covenant that's governing the credits that we finance, and we have more lender-friendly reporting on those assets than you typically seen in the BSL world. So, it's really allowed us to have our hands on the controls during this period of time when cash flows have been compressed because of rates and various inflationary challenges have impacted folks on the top line and the margin line.

Stewart: Yeah. It's interesting. We had somebody on talking about fixed coverage ratios and a third of their companies that they monitor it was under one. And so, when you look at your strategy in this environment, how has it held up in terms of some of the things that I think folks look at like interest coverage ratios, and you mentioned one of the covenants. Give me some color on how things are going with this in the macro that we're in.

Kevin: Yeah. There's a whole host of items that we're laser focused on, but I think pull up for a second, Stewart, obviously, we're very proud the track record performance we've had over the last decade, but as you noted right at the outset, we don't think that's going to be the same case the next three to five years. But the majority of the last decade was free money environment. Everything was growing up into the right and there really was no differentiation with respect to defaults losses during that period of time. So, when you think about the market, right? And you think about the outlook for the next three to five years, we do fundamentally believe that our approach at Man Varagon will continue to provide durable and consistent returns to investors. But in addition to interest coverage, fixed charge coverage ratio sensitivities that we discussed a few minutes ago, we're laser focused on a few other, what we call leading indicators, which I'll lay out for you.

And we believe those are the most important data points that provide insight to identify early signs of credit deterioration within your portfolio. And I think part of the benefits of operating in the core middle market where we do, you have to have the ability to actually have real-time data to analyze those, right? So, granular analysis and those trends is very, very important. When you think of the Man Varagon portfolio, 70% to 75% of all of my underlying borrowers do report monthly financials to us. So, we have very good insight into real-time performance of those companies. And through September, as a result of that, about 90% of borrowers in the portfolio are still growing revenue year over year. And about 70% are still growing both revenue and EBITDA. So, we fundamentally believe that that's proof points that the inherent credit selection, durability of those companies is holding up. That's part of it.

And we do benchmark that to a private database in the US that includes over 4,000 middle market companies. And it does tell a very, very good story. But what's more important to us right now is we're closely tracking a few things. So, we'll rip apart on a quarterly basis and benchmark ourselves to the public BDCs in this database, but we're looking at percentage of financial maintenance covenant defaults in your portfolios. We're looking at the percentage of non-accruals in portfolios. We're looking at the percentage of investments that are marked at 85% or below of par. We're looking at... This is an interesting one that I don't think people are really focused in on yet, but we're looking at the percentage of portfolios that include pick components of interest because in the core middle market you're not originating loans with pick. So, in our mind when you're looking at this, it's showing amendments that have had to been done to improve cashflow positions for those companies. So you're showing some stress cracks there.

And the other thing we're looking at is risk rating migration. So, in some of the public filings you can find risk ratings of fours and fives, and we're looking at how those are migrating over time. And I have a team on my portfolio side that will literally look at these statistics on a quarterly basis and benchmark our performance to those leading indicators. And we think that that's what you should be really focused on over the next, at least the next 12 to 18 months because you are starting to see signs of stress across portfolios and credit decisioning and credit selection, we fundamentally will think we'll rule a day for the next three to five years.

Stewart: So, as an example, so leading and lagging indicators, right? But a leading indicator for you is if the amount of PIK interest in the portfolio as an early warning sign to say for those that may not. So, PIK stands for Payment-in-Kind, right?

Kevin: Yup.

Stewart: PIK, Payment-in-Kind, which means that you're basically rolling that interest into the loan to be paid later. And the idea is that you're going to reduce the cashflow stress on the company that is experiencing that stress predominantly through higher interest rates, right? Not necessarily that there's something wrong with their business at all, it's just there's a change in the capital markets that they're dealing with. And so, to your point, loans aren't issued in PIK, PIKing start usually, right? So that requires a modification and you can see that modification come through and that's what you're focused on.

Kevin: That is exactly right. I mean, the playbook that started in COVID when you're thinking about amendments of some type of impacts, the cash flows right now, as you just said, Stewart, rising rates have been the leading impact to cash flows. If capital structures and companies have too much leverage to service that cashflow debt, you're doing amendments where you're taking a portion of that and converting it to PIK and accruing it as exactly like you said, that to us is an indicator that you have cashflow challenges and those underlying borrowers, right? And there's amendments that are being done. And we're very pleased to see how our portfolio is versus the peers that we benchmark. But that is an absolute key indicator for us right now.

Stewart: Is there anything that you look at that you think is lagging?

Kevin: Yeah. I mean, lagging for us is... Look defaults, losses are lagging, right? And when you think of that's going to catch up over time, but we think covenants can be a leading indicator in the fact that it's a leading indicator in terms of financial performance deterioration. But the actual percentage of defaults is obviously a lagging indicator. Defaults are a lagging indicator. Our financial reporting while helpful to have current, it's a lagging 12 months, right? It's information that's happened. So, we really think you need to be zoned in on some of those migrations within a portfolio on a real-time, quarterly basis to really capture the inherent risk, whether it's PIK or percentage of non-accruals. Things of that sort where you have companies that are converting to some type of stress. They're in front of some type of restructuring or some type of workout situation. But I think for us, Stewart, what's very important is, and you mentioned this, stress testing the portfolio from an interest coverage perspective, real time is important and there's a nuance with that.

What we do, and I think it's the appropriate way to look at things, is when we stress test our portfolio on an interest basis on a monthly and quarterly basis, this is just how we simulate it. We take the benchmark rate. So, today, we'll use 5.5% as the SOFR benchmark rate and we'll stress test our portfolio on a pro forma basis. So, we're fully loading the next 12 months of interest expense on those underlying companies looking forward, right? Not assuming rates go down where many of our peers will look at an LTM basis and it doesn't really capture the full rate increases over that period of time. So, we'll simulate our stress testing looking forward and then we'll stress earnings off the portfolio as well.

So to give you a sense, one scenario we run is we'll take our base rate sensitivities and sensitize those from 5.5% up to 6.5% and then we'll also take earnings across our portfolio. And while we think it's defensible and the lagging financial indicators are holding up well, we'll stress test earnings by 25%-30% as well. And we're looking at that consistently on a monthly basis to see if we can identify any cracks. And one other aspect that we do from a simulation perspective, which I think is very important, is it's great to look at that looking forward and looking at the company's LTM earnings. But, what my team will also do is we'll do that same analysis, but we'll annualize the last three months of financial performance of those underlying companies to determine if there's any cracks that we're seeing recently to try to stay ahead of any potential step functions down in the near term. So I think it's a very dynamic process, but running multiple sensitivities and simulations I think will allow you to hopefully stay ahead of any issues before they pop up.

Stewart: That's really helpful. And that prospective interest modeling is something that I've heard elsewhere in trying to get ahead of financial stress, right? And planning accordingly. Can you elaborate a bit more on some of the qualitative aspects of the current environment like deal flow with M&A down significantly in recent months? How are you dealing with that? What do you see coming in? I believe you work exclusively with sponsored deals. Have you seen any difference in deal flow there versus non-sponsored deals?

Kevin: Yeah. That is outside of stress testing in interest coverage. It's funny, Stewart, that's the next question, right? What are you seeing on the deal side in deployment? And it has been a challenging market, right? Given the gap out in rates, as you know, M&A activity within the middle market has been down 40% to 50% quarter over quarter in '23 versus '22. And it really came to a screeching halt I would say in Q3 of 2022 when rates really started to kick off. The good thing from Man Varagon on our platform is we still have been able to continue to deploy dollars for our investors in very attractive deals.

So the key question is how? Right? How have you been able to do this? So, given the market has been challenging on the deal front it does go back to exactly what you just said, and it's a very important aspect.

Our model is backed on solely financing private equity backed companies. So, we don't do any non-private equity backed deals, any kind of entrepreneurial owned non-institutional backed deals. And we think that by completely focusing your strategy on private equity sponsor backed deals, does provide some inherent benefits and some fundamental benefits for our investors on deployment in that instance, so we discussed the strong activity in the middle market within private equity that they support their portfolio companies, right? So, since inception we've deployed on an annual basis, 50% to 60% of our annual invest comes out of our portfolio. We have 170 borrowers in our portfolio that are performing, right? The sponsors that own those businesses are fundamentally looking to grow those execute on M&A, especially in this environment when new deals are down. And that has continued to be the story in 2023. And it's attractive new deployment in quality core companies at more attractive rates and upfront fees given where we are in the cycle.

And I think as we talked about credit terms in this environment as well, I'm not just saying we're deploying in attractive assets given the gap out in rates and given some of the tightening and credit structures. We've been able to invest in very, very attractive companies at lower leverage attachment points, higher spreads, right? Higher benchmark rates, and a little bit more attractive fees upfront. And I also think we've been able to... on new deals that we've seen while down, we've been able to negotiate better structures upfront with respect to tighter financial maintenance covenant levels, right? Tighter documentation aspects around your definition of EBIDTA, tighter protections around your negative covenants. What I mean by that, so it's aspects that protect your incurrence debt limits for the company post-close, or collateral, or cash leakage out of your system. And we've been able to do that. But I think fundamentally behind that, it is the fact that we're investing in performing businesses backed by private equity firms at the time of origination.

So, in times of down M&A on the new platform side, you have this installed base of portfolio companies that those private equity firms want to continue to grow and invest dollars in. And we've seen that I think though more recently, which will be interesting to folks, and I'd say with probably within the last month or two, I think there is more conviction now around where rates may be going, right? I think 12 months ago people didn't know where we could be going, how high. And I'm not saying rates are coming down. But what I am saying is I think there's more conviction around higher for longer, probably in a very tight range of where we'll see those spreads be. And as a result of that, we've seen some bankers start new processes because I think sponsors are now looking at the fact that they've got better conviction.

And even if enterprise multiples compress a turn or two, you can still have a nice return. They've invested heavily in these companies over the last 12 to 18 months and grown EBIDTA, right? So, multiple compression is offset by EBITDA growth inherently. And I think you're seeing some lenders and then the last month tighten spread slightly, maybe 50 basis points, fees coming in maybe 50 basis points, an encouraging sign that people do want new deal M&A to come back. But I think the key though, Stewart, is investing in private equity backed companies that are performing, allows you to have that nice installed base during periods of new origination volume being down.

Stewart: I think you're exactly right. And I know that your compliance folks may not allow you to say this, but I can. I can't imagine that we're up another 400 basis points in short rates, right? I mean, from here, I'm just sort of from a sense check perspective. I'm personally agreeing with you, this is not a Man Varagon statement. And so, see if you can confirm this with me that there are enough quality deals that you don't need to reach. Is that a fair assessment?

Kevin: I think it's an absolutely fair assessment. I think that there is enough deployment volume within our existing portfolio as well as new deals that come in from our best quality relationships within the private equity side that maintaining discipline within our sectors and our credit selection process allows us to deploy as much as we would like to in the current environment.

Stewart: You know, I did a podcast the other day about bank dislocation, and again, I don't see that going away. I mean, I think that the ALM matchup is better between insurance companies and the companies who are needing this financing, and it just seems like a secular shift in the way that businesses are getting financed. I could see how partnerships with banks could work out, but it seems like this structure in the way that you're doing things is here to stay.

Kevin: Stewart, I think you're right. And I think what's fascinating is you obviously have two aspects that have been competing on the private... I'd say private side versus the banks. You have some of the very large direct lenders that are competing to displace the BSL, the legacy BSL world, right? The mega unit tranches. And then earlier this year, obviously, you had the regional banking crisis, right? And I think that is going to drive incremental volume to the core private side in the middle market, right? 'Cause deals that used to be financed by some of the regional banks are now going to need that financing within the kind of private debt community that's focused on kind of the smaller core middle market. I think it's there to stay. There's been talent shifts and it's a relationship game, especially when you're working with private equity companies. I agree with you.

Stewart: Absolutely. So, what three takeaways would you want our listeners to take away from today's discussion?

Kevin: I think first we believe defensive and durable investing strategies will be the absolute differentiator in the next three to five years. Credit decisioning will finally help drive alpha between managers, right? With lower losses and lower defaults. I think second, sourcing relationships with PE firms, private equity firms, coupled with that credit selection is going to make the inherent difference. Because in order to be a very selective credit decisioning team and stay true to your discipline, you have to have a very large opportunity set in order to maintain that level of selectivity. And I think Varagon's partnership now with Man Group is going to position us to be even a more compelling overall strategic partner to many of the private equity firms that we work with, so that's going to help. And lastly, the third takeaway I'd leave you with is as an insurance investor today, investing in middle market loans, I think you should be focused on those key indicators and KPIs that we discussed in our discussion today.

We believe those are the primary data points that are going to identify initial points of weakness and portfolio performance, and folks should be asking their managers about those indicators and how they're seeing them within those portfolios. But many managers in our space were capable of offsetting gross credit losses over the past 10 years with equity gains, and we do not believe that's going to be a valuable strategy in the next three to five years. So, credit selection staying on top of many of the things that we talked about today, Stewart, those are the three things that I think people should take away and really be laser focused on for the current market dynamics we're facing today.

Stewart: I've really learned a bunch today and I really appreciate it. I really have, just a great discussion and thank you so much. I've got some optionality for you on the way out the door. We have two questions you can take, either or both. A lot of people take both. No pressure. So, number one is what's the best piece of advice you've ever gotten or given? And number two is who would you most like to have lunch with alive or dead?

Kevin: Best piece of advice that I've ever gotten or given. So, I started my career in asset-based lending in Charlotte, North Carolina for the CIT group. And I worked for a very senior individual there that had been at the time, 40 years in the industry. And first credit committee I ever went to was a junior analyst on the team on the writing deals. And he looked at me and he said, somebody talked too much and the deal got turned down. He looked at me and he said, "Whizzbang." They used to call me Whizzbang. "Sometimes you need to know when to speak up and sometimes you need to know when to shut up." So that was something that stuck with me because sometimes when there's gaps and times, you should just be quiet and let people think. So that's always something that stuck with me because in conversations I think you should not be afraid of the pause and the gaps in discussion. So that was something that always stuck with me.

Stewart: That's phenomenal advice, but how in the hell did you get the name Whizzbang?

Kevin: I'm not quite sure because... Yeah. I still don't know, but that's probably the second most interesting thing about me. So, I'm going to stick with it, Stewart.

Stewart: I like it.

Kevin: And you know, look, I think someone that I'd love to have lunch with if I ever could, and I'm a huge sports fan. I'm a big guy on teamwork and trying to get the best out of a group. Some of the parts is better than any individual. In my generation, the greatest athlete I've ever seen do that is Michael Jordan. I've read his books, and I would love to just have lunch with that guy and just understand his perspectives on taking a group of people and getting the best out of them to be a champion or be the best you can be as a group or business.

Stewart: Those are both great answers. Thanks for being on Kevin, I really appreciate it.

Kevin: Glad to be here, Stewart. Thank you.

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