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Private Market Talks:

Market on the Move with Bain Capital Credit's Mike Ewald

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As private credit lenders move up market, Mike Ewald, partner at Bain Capital Credit, joins the Private Market Talks podcast to discuss how big the market might get, when – and if – the syndicated market comes back, and what competition between banks and direct lenders might look like in the future. In the wide-ranging discussion, Mike also shares his thoughts on the shrinking denominator effect, rising interest rates and what he sees in the private equity industry as a credit investor.

Peter Antoszyk: Welcome to Private Market Talks. I'm your host, Peter Antoszyk. Today, I'm joined by Mike Ewald of Bain Capital Credit. Mike is a partner and Global Head of the Private Credit Group at Bain. He is also Portfolio Manager for Middle Market Credit and Senior Direct Lending Strategies. He is a Credit Committee member, as well as CEO of Bain Capital Specialty Finance, a registered BDC.

Bain Capital Credit is a leading global specialist and has over $40 billion in assets. They invest across the credit spectrum and in credit-related strategies, including leveraged loans, high-yield bonds, structured products, distressed securities and other products. Today, Mike talks to us about trends in the private credit and private equity markets, the denominator effect and more. Please download, listen and, if you enjoy it, tag and like it. Now, without further delay, my conversation with Mike Ewald from Bain Capital Credit.

Mike, welcome to Private Market Talks. I appreciate your being here with us today.

Mike Ewald: I'm happy to be here. Thanks for inviting me on the show.

Peter Antoszyk: So let's dive right in. I'd like to start with some news that was in the paper today…

Mike Ewald: Sure.

Peter Antoszyk: It was in The Financial Times that a deal was reported – I don't think it's closed yet, but it's been reported that Carlyle is acquiring 50% of Cotiviti, which is a healthcare analytics firm. And the acquisition is being financed by private credit lenders with a funding amount of about $5.5 billion.

Mike Ewald: Right.

Peter Antoszyk: That is...

Mike Ewald: Huge!

Peter Antoszyk: It's newsworthy; it's big.

Mike Ewald: It's huge.

Peter Antoszyk: What do you think that means for the industry?

Mike Ewald: It's interesting. There have been maybe a handful of multi-billion-dollar unitranches, I think, even going back to, I guess, Click Technologies, which I think was the first billion-dollar one. And everyone thought, "Geez, it can't get any bigger" and they do keep getting bigger.

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What's interesting, though, is that while they're not syndicated, they are still a club. So you've got probably two or three really large lenders in there. But then they're trying to fill out the rest of that tranche too. So we even got a call on that as well. As you know, our typical investment size is for companies with EBITDA of $25 to $75 million, so the facility size is 250, 100, or maybe 300 million. And we can certainly hold that ourselves, but we don't really have much business in the multi-billion-dollar unitranche space, which has certainly been very much on purpose as well. But look, I think until the syndicated market comes back alive, you will see more and more of these sorts of deals. However, I do think the syndicated market is going to come alive again at some point.

Peter Antoszyk: So in the interim, there's a huge opportunity for private credit. It's almost a greenfield for them, pending, as you said, the syndicated market coming back. But once it does, what do you think are the implications for the private credit industry?

Mike Ewald: I do think it comes back. It's certainly been hung up now. You've got banks with some hung deals. We all know, for example, the technology deals that are out there. At some point, though, that backlog is going to be cleared. One of the big buyers for credit like that is, of course, CLOs, broadly syndicated CLOs. And you haven't seen a lot of issuance in that space, certainly not throughout 2022 and certainly not in the second half of 2022. You've seen a couple of good deals this year. You've seen some middle-market CLOs even price this year. So that market could pick back up again. If it does, maybe towards the end of the year, there's some serious volume there and I think you'll see the investment banks come back out again with a number of syndicated options as well.

Peter Antoszyk: And when they do come back in, how will that impact the deals that are afoot? The competition between private credit and the syndicated market...

Mike Ewald: Yeah. It'll be tough, right? Because you do have a handful of players who have raised multi-, multi-, multi-billion-dollar private credit funds – in some cases specifically to go after this market segment. They have identified that as something that they want to go after because it has been an opportunity for the last 12-18 months.

If the syndicated market comes back, I think that competition is going to heat up more, and I think one of the knocks on that is that it's not even the upper middle market, right? It's kind of the syndicated loan substitute market, if you will.

Peter Antoszyk: Yes.

Mike Ewald: One of the knocks has been that you've got to compete with the syndicated market, which means more leverage, lower pricing, a lack of covenants – maybe a fake covenant, maybe a covenant enterprise value or something. And so, if the syndicated market comes back, as I suspect it will, you're going to start having some real pressure on terms, pricing, structure, et cetera, within that really large tier of unitranches.

Peter Antoszyk: Yeah, I want to come back to, sort of, the importance of some of those items, for instance, covenants and what not.

Mike Ewald: Sure.

Peter Antoszyk: What do you think the ceiling is for this?

Mike Ewald: Well, I would've said it was a billion, right. And then it was two; then it was three; then it was four; and now it's five. I do think at some point it does start getting unwieldy, though.

I don't know how many lenders are going to end up in that deal. Like I said, it's probably two or three people who are writing $500 million checks. And then you've got a lot of smaller guys. So at some point, it almost mimics the syndicated market. So what you might end up seeing is almost what you used to see with the investment banks, where they would actually hold some of the issues that they then syndicated. They definitely moved much more into the moving business than the storage business, kind of post-GFC really, and really shrank their trading balance sheets. So you could maybe see that it's almost like a parallel market—not really a syndicated market, but a parallel market that actually has some liquidity. At this point, there hasn't really been liquidity if you have six or seven holders. But if you end up with 15 holders in one of these, you could end up seeing some liquidity there.

Peter Antoszyk: I wonder though if there's a distinct advantage that the private credit market has that's maybe solidifying in this period; where they can provide the certainty of terms, the speed of execution, market flex, et cetera. So it might be harder when the syndicated market comes back for them.... for that market to be as competitive. I don't know if that makes any sense.

Mike Ewald: Yeah, but is that really true?

Peter Antoszyk: Yeah.

Mike Ewald: Because at some point, you are underwriting, right? You think you're pre-syndicating and making sure you have your club lined up. But if you're one of those big private credit lenders, I'm sure the syndicated banks all thought that they were fine and covered and not in any sort of trouble until they had their first hung deal. So you may well end up with a hung deal, and you're starting to see flex come into some of those bigger private credit deals as well. That speaks to the fact that there is some uncertainty around what the market-clearing terms are.

Peter Antoszyk: Oh, that's really interesting.

Mike Ewald: In fact, in this new deal, there is some PIK interest in there too, which is certainly new.

Peter Antoszyk: Yeah. It's interesting to hear you say that there's flex creeping in, because one of the features of private credit is that there isn't flex.

Mike Ewald: Right.

Peter Antoszyk: The historical feature of it as compared to the syndicated market gives it a competitive advantage over that market, which typically has one. For listeners, when we talk about flex, we're talking about flex in terms of pricing, where the pricing could adjust up or even down, depending on the market capacity.

Mike Ewald: Right.

Peter Antoszyk: Or, certain terms could flex. So it's moving; it could move a little bit depending on what the market appetite is.

Mike Ewald: Yeah, and I wouldn't say it's advertised as such. I think it's more a matter of, let's say, leading one of these deals. I may be buying it at a discount, right, so maybe it's $96. And I'm then selling to the market. Well, if it doesn't move at $98, I could then sell it at $97 or something. I could end up selling at $96. The nice thing if I sell at $98 is, of course, that I make a little bit of skim income. But I could give that up, right? So there is inherent flex that's built in there that's not quite as obvious as price talk in the traditional liquid or syndicated markets.

Peter Antoszyk: Got it, okay. So let me switch gears for a little bit.

Mike Ewald: Sure.

Peter Antoszyk: I mean, obviously, deals like the Cotiviti deal represent a huge deployment of capital and as we mentioned, there's quite a bit of fundraising going on. Oaktree announced it's raising a $10 billion fund. Ares announced in connection with the deal I just mentioned, they're going to go out in aggressive fundraising. Carlyle is out there. It seems insatiable, the appetite for private credit.

Mike Ewald: Mm-hmm.

Peter Antoszyk:– What do you think is driving that and do you think that's sustainable?

Mike Ewald: I think there are probably a couple things, right? One is that a lot of the players that you mentioned were publicly-traded players, right? So they are a little bit in the growth game. They've got EPS targets they've got to hit; they've got to show AUM growth, et cetera. So there tends to be this fund-size graduation, if you will, where they constantly get bigger and bigger.

Peter Antoszyk: And when you say AUM, you mean “assets under management”.

Mike Ewald: Correct, right, right. So you've got that, kind of, in the first place. Second place is that, again, you've had this 18-month period where there hasn't been a lot of syndicated issuance and so there's a market to be made, so they're kind of jumping into that market space. I think it does skew the headline numbers a little bit, though, because the dollars are large, but the actual number of funds that are looking to target that segment isn't necessarily as large. And so it masks, I think, that in the core middle market, which is where we play, again, companies with 25 to 75 million of EBITDA or even the lower middle market, 0 to 10, 15, or 25 million of EBITDA, there hasn't been as much fundraising there.

Peter Antoszyk: Got it. Why is that?

Mike Ewald: There's an issue broadly within the alternative asset management space, which is the denominator effect. So if you are an allocator for a large public pension plan, you have decided to allocate 20% to the stock market, 20% to liquid loans and let's say 60% to any sort of mix of alternative assets. Well, in the past, obviously over the past 12 to 18 months, you've seen those public markets trade off a bit. So now all of a sudden you find yourself over-allocating to alternative assets because the denominator has shrunk. And alternative assets, private assets by definition, for a variety of reasons, are not as volatile as public markets are.

So as a result, the next fund that comes up, whether it's re-up or something, you're not going to have as much appetite for that, because you can't. It'll throw your balance out of whack. And so, I think that's definitely impacting the alternative asset management business as a whole. Within that, though, I'd say there are probably two types of private credit investors: one that was an early adopter and has been investing in private credit for a while and tends to re-up with their existing relationships and maybe finds a new one every once in a while. There is still a cohort of – I'm thinking public pension plans, private pension plans, et cetera – who haven't allocated private credit yet and have a new allocation that is, maybe fixed income used to be 20%. Now they're breaking that up and saying, "Okay, maybe we'll make that 12% for illiquid fixed income, 4% for private credit and 4% for infrastructure, real estate, or something. They're becoming much more targeted in their allocation and so there is still some appetite. But if you go back a few years, nobody had any exposure to this asset class, so there's a lot more appetite without this denominator problem.

Peter Antoszyk: Got it. Interesting. And then there's also the trend where private credit lenders are tapping into the retail investor, which opens up a whole new market.

Mike Ewald: Correct. Yeah, the most obvious structure there would be the BDC structure. And there's a variety of different flavors—

Peter Antoszyk: It's been around for a while.

Mike Ewald: It's certainly been around for a while. Look, I would say there have been almost like three different stages there. If you think late 1990s or early 2000s, it was almost more of a junior capital product back then, potentially a little bit more risky than it should've been for something that had a little bit of leverage and went into the GFC with some potential issues. Post-GFC, you saw much more of a focus on senior products. But the platforms themselves were generally single-product platforms. You had a BDC but not much else.

Peter Antoszyk: Right, right.

Mike Ewald: And then you've seen this kind of third stage, which is what I would argue, where you've seen a lot of alternative asset managers like ourselves, like the KKRs of the world, the Carlyles of the world, et cetera, who have now raised BDCs and are using them as part of a much broader platform of credit investing in general. But yeah, that is the main channel today for the retail folks to get access to this asset class. I do think there is room for this sort of product, like a BDC product, in a retirement account, for example. I'm not giving tax advice; I'm not a tax attorney so nobody goes out and buys BDCs based on my recommendation. But it's a very income-generating type of product, typically yielding in the 8–12% range. So if you're living in retirement, for example, it's a great tool; it's a great asset to have in order to help fund your lifestyle, right.

Peter Antoszyk: Yeah, that's the publicly traded BDC.

Mike Ewald: Correct.

Peter Antoszyk: Now you've just raised a non-publicly traded BDC. Is that right?

Mike Ewald: Yes.

Peter Antoszyk: And so just describe that and what the difference is.

Mike Ewald: Sure.

Peter Antoszyk: And why did you do that?

Mike Ewald: So when you think about a public BDC, I guess most of them started off as a private or a non-traded one and then IPO'd. And so then they became public. There are a few that kind of grew—Ares is actually a great example—through a number of acquisitions over the years and got to be very large that way. So that's certainly a way to grow, too. But in a steady-state environment, once you've IPO'd or completed a merger, for example, it's actually hard to grow that fund because of the way the dynamics of trying to grow an existing mutual fund effectively is really what it is. And so if you want to effectively refresh your capital, you almost have to go out and raise another one. In our instance, what we did was we raised another one that we decided to have non-public to provide sort of a respite from volatility, because we saw there was some stock price volatility.

Over time, there might be an investor class that prefers not to have that volatility. The detriment, of course, is that you don't have the liquidity either. You can build in some liquidity metrics like we did, where you can actually redeem some of your funds every quarter or some of your shares every quarter. So there is a way to actually exit.

Peter Antoszyk: Is that geared towards institutional investors, retail investors, or both? It doesn't...

Mike Ewald: Yeah, look, it's really both, even though our first one that we took public was a mix, not quite 50/50 but a mix of institutional investors as well as retail investors. Again, for retail investors, it's great. It's an income-generating asset. For institutional investors, there are certain types of institutional investors where there are tax issues as you well know...

Around 4,000 directly originated loans in the United States and a BDC as an equity share effectively blocks a lot of those tax issues. And so it ends up being a tax-friendly, if you will, way for particularly offshore investors—in some cases, nonprofits are onshore—to invest in this asset class.

Peter Antoszyk: Yeah, no, at some point I may do a podcast on the tax ramifications. I'm afraid I might lose listeners.

Mike Ewald: Right. I'll stop talking about the taxes.

Peter Antoszyk: Okay, fair enough, fair enough. Let's circle back to investing the capital.

Mike Ewald: Yes.

Peter Antoszyk: What are you seeing today in terms of deal flow, pipeline and quality of the deals? In particular, in the market that you serve, and it might help orient the listeners by giving some sense of the market that you focus on and then what you're seeing in that market.

Mike Ewald: Sure. So it's really in that core middle market—companies with 25 to 75 million in EBIDTA. I think somewhat differently than a lot of other folks, though; we are present and very active in the US and Europe, where we really focus more on Northern and Western Europe for various reasons. And then Australia, New Zealand actually we've got a pretty sizable franchise there as well. So the nice thing for us is that we can actually dynamically allocate across geographies based on what's interesting.

For example, in 2021, when the US market was very frothy, we proportionately invested more in Europe during that year than we have in past years. 2022 went the other way. Russia's invasion of the Ukraine made Europe a harder spot to invest in and so we shift a little more to the US. And Australia's always pretty steady. So we have that core middle market focus. We have geographic diversification, if you will. And then the other big one is probably from an industry perspective. As it turns out, we are fairly agnostic, partly because we've been doing this for 25 years and so we've just seen a lot over the years. Partly because we're obviously part of a much bigger organization, right?

So the private credit group that I run has about $10 billion in assets. If you think about the Bain Capital Credit and Special Situations platform, that's about $60 billion in assets. And so there's a lot of talent within that that we can then utilize on the diligence front, for example. So we have a $35 to $40 billion broadly syndicated loan business. That's set up by industry teams. So we're able to tap into different members of that team. They've never heard of our companies, right? Let's be clear. Our companies are way too small for that.

But they'll know a customer, they'll know a supplier, they'll know a competitor. They'll know the state of regulatory play. They'll know the acronyms and all the ins and outs of that industry. So as a result, when we're going out and talking to sponsors and companies, we're able to ask questions 11 through 20, not one through 10.

Peter Antoszyk: Got it.

Mike Ewald: So we tend to be pretty open-minded from an industry perspective. Generally speaking, we do focus more on sponsor deals and private equity sponsor-backed companies within our senior direct lending strategy. So it's about 80% of our assets. And then we have a junior capital strategy too, which is actually our original business. And that’s maybe 60% private equity sponsor-focused, with 40% being a little more bespoke. So it is a pretty wide swath of types of deals that we can do.

Peter Antoszyk: And within that industry, what are you seeing in terms of deal flow and quality of the deals at this point?

Mike Ewald: Yeah. Industry-specific-wise, I would say consumer is tough right now. I think the base case for just about any deal right now is a recession case. And I think that's probably even more impacted on the consumer, so...

Peter Antoszyk: The recession always seems to be six months away, though.

Mike Ewald: Well, it does, and it's funny because I would've said a month or two ago that there are some signs that maybe we can actually avoid it completely. And then Powell came out today and said, "Well, geez, I think interest rates might go even higher than we were expecting. So you're right; it is one of those where bad news always seems to be around the corner. Every time you think there's good news, it turns out to be bad news right behind it. So having said that, we're debt investors, right. So we want to be conservative. So we're always going to assume there's some doom and gloom out there, but certainly right now.

So consumers are tough. Industrial is a little bit tough right now, too. So we're really focused on business services to a large degree. We do continue to have a pretty active high-tech space—software as a service, et cetera. I think high tech in general has been painted with a bad brush of late, based on what's happened in some of the public markets. But if you actually parse it out, it's really a lot of B2C issues that are out there, Meta laying off 10,000 people, Google laying off 10,000 people, for example. It's not really impacting true enterprise software-type businesses as much, right. And on the business services side, if you make things better, cheaper, easier, faster and more efficient for a company to operate, you're always going to be in vogue, right. So we like those businesses a lot. One that we've soured on—I wouldn't say soured on—but one that we're not as excited about anymore—and which people tend to view as a very defensive industry—is health care.

Peter Antoszyk: Interesting. So in terms of the deals you are seeing and the deals you are doing, what's the leverage that you're providing on those deals compared to what you provided, say, a year ago? How are you thinking about that?

Mike Ewald: It's interesting, right, because as much as—

Peter Antoszyk: And if I can, just...

Mike Ewald: Yeah?

Peter Antoszyk: Really, this is really for our listeners. When you're structuring a deal, one of the key things you're thinking about, in addition to interest coverage, I'm sure, is the ratio of debt to EBITDA...

Mike Ewald: Right.

Peter Antoszyk: As we think about leverage, and in the past, say in the go-go years of '21 and '22, it was creeping up to seven, maybe even a little higher.

Mike Ewald: Yeah.

Peter Antoszyk: Seven times EBITDA in terms of the debt to EBITDA ratio.

Mike Ewald: You mentioned two statistics that are important, but I would dive a little deeper. The leverage one for example, in our minds it really, and I'm sure you meant it this way too, really depends on the industry.

Peter Antoszyk: Of course.

Mike Ewald: Right, you've got a recurring software business. You've got really great retention. Sure, you can use it six or seven times. You've got a tier-three auto supplier who is at the other end of that supply chain and gets beat up by everybody along the way, maybe two or three times, right.

Peter Antoszyk: But maybe it's relative.

Mike Ewald: Yeah, so I was going to say...

Peter Antoszyk: Maybe it's relative to what was being done before the leverage was...

Mike Ewald: Yes. So we've gone more from loan to value in terms of how we look at things, right? And so if we're talking about a first lien debt, we'd love to be at 30%, but it's probably closer to 40%, maybe all the way to 50%. If we're doing a junior capital piece, it's probably going to detach around 60% loan to value. That is stage –

Peter Antoszyk: That being a function of EBITDA though, right.

Mike Ewald: Well, it's a function of enterprise value. I mean, it is a function of EBITDA, sure, right. But how much is the company being sold for, right? And that was going to go to my other point, which was you look at the public markets, they've traded off a fair amount.

Peter Antoszyk: Sure.

Mike Ewald: The private markets haven't traded off as much as the public markets have.

Peter Antoszyk: Is that, are you saying that they haven't traded off because they haven't been valued, or because the actual trades, the actual sales...

Mike Ewald: Yeah, the actual sales. It hasn’t come down as much. So if you think about multiples for a typical middle-market company, maybe they were up at 11, 12, for a variety of industries. The public markets will tell you that should be off 20%, so it should be eight or nine times. They're probably still hanging in at, like, ten times now.

Peter Antoszyk: Interesting.

Mike Ewald: If you think about that and then you think okay, you're somewhere in the four- to six-turn range there, from a leverage perspective. Having said that, the interest coverage ratio is the tricky one, right.

Peter Antoszyk: Yeah.

Mike Ewald: Because even 12 months ago, I mean, I think 13 months ago, the base rates were zero, right, or single-digit basis points. And we're talking 450, 500 and Powell says it's going to go up even higher.

Peter Antoszyk: Right.

Mike Ewald: Right, so that alone is a huge increase in the interest burden. But then spreads have widened out a little bit as well. So a first lien deal that maybe was 550 pushing 525, over the risk-free rate SOFR in this stance, it's probably 650 to 700 now. So all of a sudden—

Peter Antoszyk: Yielding to about 11%...

Mike Ewald: 12%, right, whereas that deal used to be 6 or 7%. So companies can't afford as much leverage anymore, which is one of the reasons why you saw Cotiviti come out with a PIK component too, a pay-in-kind. So they're actually not paying some of their interest in cash because they just can't afford it. Because you can't put as much down on the companies and the purchase price multiples haven't fallen as much, the math makes it tough for a private equity sponsor to actually get excited about buying a company. As a result, M&As have definitely come down. So that's really what's driving that, in addition to the recession being the base case. Private equity sponsors, by definition of being equity investors, are always going to be thinking up and to the right, whereas we're always thinking flat and slightly down.

Peter Antoszyk: Yeah, that raises a couple implications for the private equity industry, and I know you're on the credit side.

Mike Ewald: Sure.

Peter Antoszyk: But I'm sure you think about it from the private equity side, which is twofold. One is, if the valuations are stable or coming down a little bit, what does that mean for their ability to turn their portfolio? If they can't turn it, then that of course suppresses M&A activity and two, what does it mean for the bid spread?

Mike Ewald: Yeah, two things. One is yes; definitely, you have seen the whole period increase. Typically, for a senior debt deal, I would say pre-COVID, we would see a whole period of two, two-and-a-half years.

We're being refinanced, the sponsor is selling the copy, making some huge acquisition and refinancing the capital structure. Now it's north of three times. And the hold period of those private equity firms has definitely increased as well, to the point where we're actually starting to have conversations with sponsors about reaching maturity. Right. The maturity of these deals is typically five to seven years. You never—I mean, you know this—like we never end up getting anywhere near maturity.

Peter Antoszyk: Right. Right, right.

Mike Ewald: It's almost a theoretical thing in the future, right. But it's happening now, which has not happened in the past. Now the related issue is sponsors saying, "All right, well, I've got to hold onto this; I don't want to sell it now or I can't sell it now. But let me think ahead a year or two. How can I make this more attractive? Guess what? I'll do a bunch of add-ons. So we are actually seeing a fair amount of deal flow. You mentioned and asked about deal flow earlier. More of our deal flow has shifted to adding onto existing positions as companies grow. But also interestingly enough, we're getting a lot more calls now from sponsors we haven't talked to in a while who are trying to grow, but their existing lender group is tapped out. So they need to bring a new lender in, which means...

Peter Antoszyk: It's a nice opportunity.

Mike Ewald: It's great; it has all sorts of implications for the existing structure and facility and everything else. The deal count is actually holding stubbornly steady, even in the face of a true M&A market coming down, because there's this add-on and the dollars are just smaller.

Peter Antoszyk: So the add-on activity though, couple things: one is the add-ons, loan to value; what you are willing to lend is lower.

Mike Ewald: Yes.

Peter Antoszyk: So that's going to require them to invest more equity. But the other piece is in the existing loans, where there are provisions, as you know, called MFNs.

Mike Ewald: Correct.

Peter Antoszyk: And those are the most favored nation terms, which require that if new financing comes in at a higher rate...

Mike Ewald: Yeah.

Peter Antoszyk: Depending on the terms, the existing debt is ratcheted up a notch...

Mike Ewald: Correct.

Peter Antoszyk: So what impact does that have?

Mike Ewald: Yeah, there are some ways around that. So look, the first thing is that if you, as a private equity sponsor, have owned a company for a few years, theoretically it should have de-leveraged over time, because you should be hitting your plan and leverage should be coming down. So to answer the first part of your question, there should be room to re-lever.

Peter Antoszyk: Got it.

Mike Ewald: And maybe not even without putting equity in. So you might actually get away with a debt-funded acquisition, right, depending on what

Peter Antoszyk: Before the go, go days of 2021, '22...

Mike Ewald: Yeah.

Peter Antoszyk: There was no re-levering. It was just that the values were going up.

Mike Ewald: Correct.

Peter Antoszyk: And so they just layered on more debt.

Mike Ewald: Yeah, that was even easier, right, yeah.

Peter Antoszyk: That was, yes.

Mike Ewald: Yeah.

Peter Antoszyk: And now we're in a new world.

Mike Ewald: Right.

Peter Antoszyk: And what you're saying is they're going to have to show some de-levering in order to tap into those baskets.

Mike Ewald: Or they have to put some equity in as well, right.

Peter Antoszyk: Yes.

Mike Ewald: And then, on your MFN question around pricing, there are some creative ways around that, and the one we tend to use most is the original issue discount, or OID. If the deal currently is SOFR 575, but today's market would tell you it should be 650, you have to somehow get the economics right. There are some limits to the MFN structure. So maybe you can increase it by 25 basis points or 50 basis points without triggering that. But then there are still some additional economics that you need to make up for.

So one of the ways you can do that is to say, "Well, the maturity is three years away, so if we amortize some sort of return level that we need to recoup over three years, if we buy this debt at 96 or if we buy it at 95 or 94, we can make up some of those economics. So that has tended to be how we've gotten around it. From a cover price perspective, the price hasn't changed much, the pricing hasn't changed much, or not at all. But we're still making sure we're finding ways to get compensated for the higher risk levels that we see out there.

Peter Antoszyk: Got it, got it, interesting. So one of the things you mentioned earlier was that in your deals, as compared to most of the upper-market syndication-style deals, you have financial maintenance covenants.

Mike Ewald: Right.

Peter Antoszyk: And can you explain two things? One is what they are, and two is why you think they're so important.

Mike Ewald: Let me start with the second one. Having been in this business now for 25 years, there are a lot of cycles we've lived through.

Everyone remembers COVID, even though it was actually, ultimately, fairly short-lived, right. It was like a six-month crazy period, and then we kind of grew out of it. The GFC, or global financial crisis, was obviously a longer one, although the number of people, as you know, who are in our business who remember that and lived through it and had to deal with it is dwindling. But there was the dot-com bubble of 2000/2001. There was a media bubble in the, there's actually been a few media bubbles. There was the oil and gas issue in 2015.

So there have been a whole bunch of different cycles, however big and small, over the past 25 years. And there's been one thing that's been consistent as we've looked at the market. It's been extremely important to have financial covenants. They are goal posts for us in terms of ensuring that the performance of these companies is within some bounds of what expectations are, because that's what we're lending into. You don't see them much in the syndicated market anymore, but the theory is that if you don't like the performance, you can trade out of the security. Again, these loans are not liquid. We've talked about some of the big unitranches; maybe some liquidity gets introduced. But the ones we're in, we're typically one of one, two, or three lenders.

Peter Antoszyk: Right.

Mike Ewald: In fact, in three-quarters of our deals, we are the majority lender, meaning we own at least 50% of the tranche. For us, having that goalpost or that trigger point that says, "All right, performance is actually 30% off of plan, let's have a conversation, doesn't mean we want to take control of the company from the owner or from the sponsor, or whatever the case may be, but is it a temporary blip? Did you make an acquisition or spend a lot of money on something that kind of flew through your income statement and you're going to get some benefit from it later? Okay, you know what? We'll let that slide; no big deal; a 25-basis-point amendment fee. Has there been a longer-term trend of your sales just drying up or some cost-bar issue going out of control? Well, you guys have got to put some more money in, or we have to be compensated more, or both. And so having that trigger really compensates us for the lack of liquidity in these names. Oh, sorry, and I should add, Peter, that I think that the latest stat is that 91% of our senior direct lending deals actually have covenants in them, so you're right. We absolutely insist on them.

Peter Antoszyk: Yeah, and that's as compared to—I think the number has almost flipped.

Mike Ewald: Yes, for the syndicated market.

Peter Antoszyk: Flipped for the syndicated market.

Mike Ewald: Yes, 100%.

Peter Antoszyk: And the covenant, I think, is typically a leverage governor.

Mike Ewald: Yes.

Peter Antoszyk: Is that right?

Mike Ewald: There used to be a whole package of maximum capex, fixed charge, leverage.

Peter Antoszyk: Now you're going back, way back.

Mike Ewald: Yeah, back when I started this business, yeah. So those are the days, I tell you what. So now it's generally just leverage if you only have one. But we're seeing some bespoke ones. In a SaaS business, for example, you might see renewal rates that need to stay at a certain level to ensure that, especially if the EBITDA is very low or even negative, you want to make sure that the top line is actually still stable so you can catch that sooner. But it's interesting too, because, if you do the math, yeah, it's nice to have more covenants for sure. But you can work the math, and we used to do this, right? We used to have these tables of, "Well, let's set these covenants here and that covenant there and that covenant, and try to have one trigger before the other. But everyone's kind of in on the joke and they all end up triggering at the same time. So whether you have three or one, you can generally make sure that you're somewhat protected.

Peter Antoszyk: We could do several podcasts on financial maintenance covenants.

Mike Ewald: Yes.

Peter Antoszyk: In terms of how they are calculated and the terms, et cetera. But I think we'll leave it there; they're important, however, they're drafted.

Mike Ewald: Yes.

Peter Antoszyk: What other terms might be moving more in favor of the lender that you're seeing?

Mike Ewald: Yeah.

Peter Antoszyk: Because there was this period, I'd say in the last ten years, where the terms had been moving in favor of the sponsor borrower. But there has been some shift back in favor of the lenders. I'm curious as to what you're seeing.

Mike Ewald: Yeah. Well, there are a few that I can think of. One is restricted payment baskets, right? So to what extent can the company pay the sponsor management fees or give tax distributions if it's an LLC structure? Do something where value is leaking out of the company, not to the benefit of the debt holders. So I think those baskets have been tightened.

I think the other one that we've been pushing a fair amount on is to what extent you can re-lever the business as it's supposed to de-lever, as we talked about. And it used to be that you could lever right back up to closing leverage and basically stay fully levered the entire time. Now maybe it's half a turn less than that or a full turn less than that. So there are a bunch of ways that you can tweak things and tighten up language. And your point is that the EBITDA definition for some of these is not a gap-defined term.

Mike Ewald: The EBITDA definition, in some of these credit agreements, is like three-pages long.

Peter Antoszyk: At least.

Mike Ewald: So you can absolutely tighten that up. I think the most egregious EBITDA add-back we ever saw was that we could add back any cost savings the CFO thinks can reasonably be achieved within the next 36 months.

Peter Antoszyk: Yes.

Mike Ewald: And that was a rolling thing, so every quarter, it’s like, "Oh, I think there's a whole bunch of savings we can get in months 33 to 36 from now, which is crazy.

Peter Antoszyk: And why that's important is because the calculation of leverage isn't just determining the financial covenant. It is impacting the ability of the company to incur additional debt, the ability to make, as you said, restricted payments, dividends and the like. So it flows throughout the document. And so the ability to increase that...

Mike Ewald: Manipulate that.

Peter Antoszyk: I didn't...

Mike Ewald: Okay.

Peter Antoszyk: "Increase."

Mike Ewald: My words, not yours.

Peter Antoszyk: Your words, not mine.

Mike Ewald: Yeah.

Peter Antoszyk: It is very significant.

Mike Ewald: Yes, and there are even some deals, of course, where the interest rate itself, the spread itself, is dictated based on the leverage, right.

Peter Antoszyk: Based on the pricing grid,

Mike Ewald: Exactly. So if you're massaging that number, let's say massaging instead of manipulating, then that can certainly come through there as well.

Peter Antoszyk: Yeah, we talked a bunch about deployment and terms. But as you mentioned, Chairman Powell just testified today that the rate at which interest rate increases have to, may have to be accelerated, and really looking to control inflation, which of course may have a recessionary knock-on effect.

Mike Ewald: Sure.

Peter Antoszyk: That's what everyone expects. I guess from my perspective, I'm curious how that impacts your portfolio management, you're thinking about how your portfolio companies are going...

Mike Ewald: Yeah.

Peter Antoszyk: To be able to deal with the continuing increases in interest. It's an additional debt burden and a cash flow burden on them. So I'm just generally curious as to your thinking about that.

Mike Ewald: Yeah, well look, certainly with this latest announcement, I think we're going to have to go back and do some more math. But what we did do, maybe the end of the third quarter last year, as rates were continually increasing and the forecast was for more, was we just took our entire portfolio of 250-some odd borrowers and said, "Okay, if base rates SOFR, and at the time I want to say it was probably around 350 or 400 basis points, but talk was it was going to maybe peak at five here in the first quarter sometime, if SOFR went to 500 basis points today, and again this is back in September, and it stayed there for eight quarters, what happens to And I think that's the kind of scenario modeling you should be doing.

Peter Antoszyk: Yeah, you're stress-testing.

Mike Ewald: Yeah, exactly. And you should be doing it on a regular basis to try to weed out some of those potential problem children ahead of time. The worst thing you can do is get a call from the sponsor saying his company is running out of money next week. Can you put some money in?

Peter Antoszyk: Right.

Mike Ewald: So you want to make sure you are way ahead of that. And I think we were pleasantly surprised that our companies actually held up pretty well. There were certainly a few, probably more than a handful, but maybe up to a dozen or so out of that 250 where there'll definitely be a shortfall, but it's probably going to be four, five, or six quarters out. So I think the question in our minds now, based on the latest announcement here, is: Is that a short-term issue? Is he going to keep them elevated for a while? What's going to happen there? So it's certainly something that we're going to reevaluate internally against all new news at this point. But hearkening back a little bit to COVID, where companies were shut down for three or six months and had zero cash flow, and leverage covenant levels, for example, were completely out of whack, all we really cared about was liquidity. So we had a number of amendments that we went through then. And it was a matter of how we were going to preserve liquidity such that the company could fight to live another day, basically. It could be, I mean, it depends on the situation, right.

Typically a sponsor has to chip in a little bit, but could we PIK some of our interest, for example? Sure, that is a tool that is available to us. But we view PIKing as reinvesting in the company. So we have to want to do that. So I mean, I think there are ways to deal with it. I think the question is going to be how high and low for how long, ultimately.

Peter Antoszyk: The way I think about COVID is that it was like a heart attack. It happened…

Mike Ewald: Yes.

Peter Antoszyk: It happened quickly. The recovery was pretty quick for a whole host of reasons. That's not this.

Mike Ewald: Yeah, I might get in trouble for saying this, but I was pleasantly surprised at how private equity sponsors generally performed during COVID. And the reason I say that is because if you think back to the GFC again, it was the proverbial frog boiling in a pot of water. You didn't notice anything until all of a sudden, you were really in deep water, in a deep situation, at the deep end of the pool there.

So with COVID, it was so instant that everyone really jumped on it and had a playbook ready of, "Okay, let's delay some capex, let's go through a RIF, if we need to. Where else can we save on some liquidity? Because liquidity is king in situations like that. And there was a concern initially that a lot of other lenders shared with us as well: that every company is going to be a problem, and sponsors are going to pick and choose which ones they're going to support, and “geez, I really hope I'm going with the right one.” But they actually blocked and tackled very well; they worked really well with the management teams, and they got that done, partly because it was some of that shock therapy.

You need the defibrillator. It wasn't like a slow burn from that standpoint. So I'm hopeful that folks have that playbook ready. Problem is, they may have exhausted a lot of those things. And we're starting to see, and I'm sure you're starting to see this on the legal front too, requests for amendments creeping up. It's one of those classics, where back in the second and third quarters of 2020, it was 25% of the portfolio. It was like, hey, we might need something, but it ends up being less than that. But now it's one or two companies.

All of a sudden, it's three or four, and you're like, okay, just a little trickle is becoming a bit of a stream here. And right now, there's a lot of bluster, a lot of hey, we're the private equity sponsor, the owner, whoever it is, we'll take care of this, no problem. I don't know how much of that is bluster versus, oh, gee, is this the beginning of the flood? And/or how much do we have left in the tank to actually cut costs, cut capex, or do whatever.

Peter Antoszyk: Right. I think, from a company's perspective, I've found the middle market to be very resilient during this period.

Mike Ewald: Yes.

Peter Antoszyk: But it must be incredibly stressful right now to be a CEO or CFO...

Mike Ewald: Yes.

Peter Antoszyk: Of one of these middle-market companies. As you keep marching down, you're able to pass on some price increases, you're able to absorb some of the...

Mike Ewald: Labor issues or anything else.

Peter Antoszyk: Labor issues and other costs and costs of capital, et cetera. But boy, the hits keep coming, don't they?

Mike Ewald: Yeah, yeah. Yes, they do.

Peter Antoszyk: So we were talking about this in preparation for this, and I was curious because I hadn't really seen many statistics on this, but when those deals do go into default, what do the recoveries look like for these senior secured loans?

Mike Ewald: Yeah.

Peter Antoszyk: How did that compare to, let's say, the syndicated telecast?

Mike Ewald: Syndicated market, yeah. Well, I think that's another good reason to have covenants, quite frankly, because you can catch problems earlier. Right, the reason you end up going into default in some of these syndicated deals is cause of payment default. So things are pretty bad before you stop paying your bills.

If you have a covenant issue in a middle market deal—a traditional covenant—you can catch things earlier. I'm not faulting them for this, but the natural reaction if a company is declining in performance for an owner, be it a private equity sponsor or otherwise, is going to be to swing for the fences. That might not be the right answer from the perspective of a lender, of course, because you can strike out a lot if you're coming out of your shoes swinging. So, almost by definition, the recovery rate is going to be lower for syndicated deals because more value has been effectively eroded before anyone else can step in.

So I don't know about markets; I want to say it's around 60 or so for first-lien deals, and you may know this better than I do, but I think it's somewhere in that kind of range. We're in the 80s. And so we've actually done pretty well there. So if you look at our 25-year history on the senior side, our annual loss rate, so that's effectively your default rate multiplied by your recovery rate, it's about three basis points on an annualized basis; it's about three basis points a year. On the junior side, it's under 30 basis points a year. Obviously, you're taking more risk there; you kind of expect that.

Peter Antoszyk: Right. Right, right, right.

Mike Ewald: So when you think in the context of again today, senior deals are 12% yields, but historically they've been more in the 8- to 10%-yield range, if you lose three basis points to credit, that's actually pretty good.

From a junior capital perspective, we're generally in the 12 to 14% range. You're probably willing to give up 30 basis points in order to get that kind of return.

Peter Antoszyk: Got it. Interesting. So we've talked about a number of trends that are going on even as they've been coming out in the news as we're speaking. I'm curious: are there any other major trends that you observe going on in the private credit industry?

Mike Ewald: Well, look, I mean, I certainly think it's become more professionalized and more established. Again, one of the ways you can see that is that LPs now have actual allocations to private credit. What happened five or ten years ago was, geez, I don't know where to put this product. It's illiquid, so I have to put it in my private equity bucket, but it's not obviously returning what a private equity deal is, right? So it's not competing very well with private equity. And I can't put it in my fixed income bucket because it's not liquid, right? But now everyone has actually gotten, or almost everyone at this point has gotten, an allocation to private credit, so...

Peter Antoszyk: Yeah. I'll tell you a funny story. When we first started this private credit group at Proskauer, we went to our fund formation colleagues and said, hey, you might want to introduce our private credit clients to LPs because they're raising capital. And they're like private credit—what is that? They didn't even know how it would fit in an allocation...

Mike Ewald: Yes, yeah.

Peter Antoszyk: Within the pension funds, you know?

Mike Ewald: Right, right. It's been an uphill battle. And to all the new private credit providers out there, you're welcome for that.

Peter Antoszyk: Yes, exactly.

Mike Ewald: I was on the tip of the spear for that one. But the tough thing too is that private credit just means different things, and middle market just means different things to different people.

So you almost have to explain yourself now, because private credit could include infrastructure; it could include real estate. It's not just your corporate debt or bilateral deals anymore.

Peter Antoszyk: Right, right. This has been great; thank you. I just have two more questions. When you look back five years from now, what developments will surprise most people in the private credit industry? Not things that you can see. Things that you could imagine could occur that would surprise you.

Mike Ewald: I think the degree to which the retail market participates; we've talked about B2Cs, and there is some retail participation, but I think that's dwarfed by these institutional funds of $5, $10 and $15 billion. A lot of the B2C companies, from a market-cap perspective, are around $1 billion. There are a couple exceptions, obviously, right? But the scale is nowhere near what I think it can grow to over time.

Peter Antoszyk: They sound small now.

Mike Ewald: They do, seriously. So we have a lot of growth ahead of us, right. So I think that's one point.

I think the other one that's interesting, is that some of these bigger private credit funds that are again trying to displace the syndicated market may have nowhere to go or may have less opportunity, because A, there aren't that many big companies like that, right, for the amount of capital that's been raised, and B, I do think the syndicated market comes back at some point. My question mark in all this is: What happens to the high-yield market?

Peter Antoszyk: Oh, interesting.

Mike Ewald: Does that get displaced? So is there all this capital that's looking for a private deal, and you end up with a three-handle, billion-dollar subordinated second lien, which is effectively some sort of junior strategy, right? Because you've definitely seen the senior market being competitive at the private credit level with the syndicated market, but you haven't seen the junior market play there yet. So private high-yield offerings – is that going to drive away the public high-yield bond market?

Peter Antoszyk: Interesting.

Mike Ewald: I don’t know, but that's something I could see happening in five years with this capital and with this development.

Peter Antoszyk: Thanks for sharing that, and thanks for sharing your insight in the private credit market, I appreciate it.

Mike Ewald: Of course. Thanks for the invitation.

Peter Antoszyk: All right.

Mike Ewald: See you soon.

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