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Private Market Talks:

Thinking Different in Direct Lending with Hayfin's Tim Flynn

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On this episode of Private Market Talks, we're joined by Tim Flynn, Co-Founder and CEO of Hayfin, an alternative asset manager that has invested €35 billion of capital across more than 470 portfolio companies since its founding in 2009. Over the course of the conversation, we cover a wide range of topics, including the investment principles that have made Tim and his team so successful in private credit and leveraged finance.

Tim also describes what may be one of the most interesting career paths we've heard on Private Market Talks – from beekeeper to investor, and stops in between, and talks about the learnings from each experience that he still applies to this day. And of course, Tim discusses his view of the state of the private market and how it shapes Hayfin's nimble investment strategy. It's a great conversation and all happening on this episode of Private Market Talks!

Peter Antoszyk: Hello. We welcome you back to *Private Market Talks*. I'm your host, Peter Antoszyk. Today, I am speaking with Tim Flynn, co-founder and CEO of Hayfin Capital. I'm excited to speak with Tim because he's always been a forward thinker. He was an early mover in private credit, starting Hayfin in 2009 following the GFC.

Hayfin has since grown to be a leading UK-based alternative asset manager with over €30 billion in assets under management. It invests across various strategies, including direct lending, where it recently closed in excess of €6 billion in its Fund Four: special opportunities, tactical solutions, high yield credit and private equity solutions. Today, it has over 200 industry professionals worldwide. Since its inception, it has invested over €35 billion of capital across more than 470 portfolio companies, and it's not done growing.

Recently, it opened its newest office in Dubai to add to its twelve other locations, including those in the United States, Paris, Frankfurt and its headquarters in London. During my conversation with Tim, we cover a wide range of topics. Tim describes Hayfin's investment strategy and the principles that guide those investments. We then discuss the challenges faced by the broader ecosystem of private credit, and Tim shares his views of the future of private credit as an asset class. In this context, he also describes how Hayfin is positioning itself for the future. Finally, we wrap up with a few insights from Tim on what it takes to succeed as a professional in the private markets. As always, you can get a full transcript of this episode and other helpful information at privatemarkettalks.com. And now, my conversation with Tim Flynn, co-founder and CEO of Hayfin Capital.

Tim Flynn: Thank you, Peter. It's a pleasure to be here.

Peter Antoszyk: Before we get to Hayfin, we were talking before we started recording, and I learned that you were a lawyer by background. I'm kind of curious what your path was to getting a law degree.

Tim Flynn: Well, that's a bit of a story. I grew up a long, long way from Wall Street: geographically, culturally, economically. At one point, I was a banker. I was the nice guy that supervised the tellers at the local branch, but I actually started my career as a beekeeper, of all things.

I found myself graduating university with a lot of student debt and like a lot of graduates, I wasn't sure what to do next, but I knew I had to start repaying my student loans. I found out that if one worked for certain charities around the world, you could defer your student debt. I found a charity in Canada called CARE Canada that ran a beekeeping project in Nicaragua that was designed to help the people deal with the African bees that had taken over the country. They were advertising for a bilingual Spanish-English speaker who was graduating from university, so I took the job.

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I thought it was going to be an office job, a nice cushy office job. When I arrived, I found out that it was anything but that. I found myself in the fields, in 100-degree weather, 100 percent humidity, dressed in big boiler suits, lugging lots of equipment around, getting stung dozens of times a day.

Peter Antoszyk: You didn't see that as a future career?

Tim Flynn: Well, listen. That's what took me to law school is the answer. About a year on, I said to myself, "I need an office job," and I got myself from Nicaragua into law school, which is where I started my professional career, shall we say.

Peter Antoszyk: You ended up becoming an investment professional.

Tim Flynn: That's right. Well, I found out about the world of financial services when I was at university actually, and I applied to all kinds of banking programs. I don't think I even got an interview or responses to my letters, but one of my thoughts of going to law school was to use that training and try to figure out a way to go from practicing law into financial services, and that's what happened.

I worked at Sullivan and Cromwell for a little over a year. I did a deal with Goldman Sachs, and immediately after the deal closed, I begged the vice president for a job doing anything. just to give me a chance, and, thank God, they said yes. So, I was off to the races.

Peter Antoszyk: And then you ultimately became a partner there.

Tim Flynn: That's right. I spent a little over a decade at Goldman. I started in the mergers department. Then I found myself staffed a little bit into the role of what I think was, from memory, Goldman's first high-yield bond deal in Europe. Literally no one else at the bank at the time wanted to work on it. They viewed it as commercial banking, beneath their IPO and M&A practice, but I immediately fell in love.

I remember the business as working on countless pitch books. The number 10 person on the team, writing materials that no one seemed to read or care about, and I found myself staffed on this deal. It was a tiny, grubby little business. It sold cigarettes in nightclubs and operated a chain of small little convenient shops that primarily sold tobacco, lottery tickets and alcohol. They had like $10, $15 million of EBITDA, but it was super real to me in a way that the big deals weren't. It was a real business, real cash flows. I loved that it required me to be a jack-of-all-trades because literally, I was the banker, salesman, trader, syndicator, risk manager, roadshow coordinator and relationship manager, and I immediately fell in love as soon as it closed.

I asked if I could move to fixed income and be part of this new trend in the nineties in Europe – and certainly for Goldman – of leverage finance.

Peter Antoszyk: And then, how long did you do that for?

Tim Flynn: I stayed there for about a decade. It suited me to a tee a bunch of different levels. One, the legal training – which is such a valuable basis in this business. Secondly, it was very entrepreneurial. The business didn't exist, and I really enjoyed the creativity, the thoughtfulness and the lack of playbooks and rulebooks to help design the business. I never anticipated the tailwind of growth of the leverage finance markets, even in those years. And then again, when I left to start Hayfin on a thesis and an idea, the tailwind growth of what we now call private credit has been far beyond certainly my wildest imagination at the time.

Peter Antoszyk: Take me back to 2009 when you start thinking about an alternative to doing Hayfin at Goldman. What was the investment thesis?

Tim Flynn: Well, let's go back. If you let me paint the picture the following way – if you think about these markets before 2008 – there really was no institutional non-investment grade market. You had a small, very small, high-yield market. You had a tiny syndicated loan market that was really just syndicating into CLOs, and that was it. Everything else was driven by banks, from vanilla credit through distressed, driven by banks, held on balance sheet. I think it was in 2007 that I was aware that Basel 2 would be adopted (Gen1 in 2008). It's pretty simple math when you look at risk weighting and when you think about Bank ROE and try to understand where middle market loans or non-investment grade loans would have to reprice to make the math work for banks. I began to think perhaps that spread would attract institutions. I spent a lot of time looking at the U.S. There wasn't the scale of private credit firms that there are today. There were a few, but you had the big non-bank lenders: GE Capital, for example. And I began to think that, plus what I started to see in the CMBS market and the AAA spreads blowing out – it was a very simple idea – that the combination of those two factors could create a window to build what we hoped would be the homegrown European market champion and what we now call private credit.

But I thought about it as leveraged finance, and I thought about it developing into an institutional business rather than a bank-dominated business. So that was the thesis. In hindsight, when I think about the risks that we took and how lucky we've been to be successful, I certainly underestimated the risks. I certainly overestimated my skills as a CEO and business builder, but what we got right is this tailwind created by that combination of factors and, of course, the crisis happened while I was on garden leave, which made capital formation certainly harder. But what a great entry point in terms of building a track record, to give us the credibility to flush out the products and really build our business.

Peter Antoszyk: At the time when you founded it, what types of deals, investments did you focus on?

Tim Flynn: We started at the pointy end of credit: stress and distressed. The way that we thought about the products suite is, imagine a private equity firm. What are all the financing needs? Bank debt; middle market could be in a direct lending fund or larger cap on high-yield syndicated loans, business; all forms of junior debt, preferred, convertible, preferred into minority equity for GP-led secondary transactions. That's how we thought about the product suite.

We also thought about the product suite as one that needed to be equally fluent in financing growth and financing stress and distress. And we started, as I said, at the pointy end of credit. I think it was not until 2011 or 2012 that we made our first direct lending loan. We started our high-yield syndicated loan CLO platform a few years after that, and I think it was seven, eight years ago we started the private equity solutions business.

Peter Antoszyk: When you think about investments and you're trying to decide between investments today, whether or not to make one, what key principles guide your investment decisions?

Tim Flynn: Well, I would identify two. Let me start with the investment strategies themselves. I think one of the key insights that we had when we were starting to put the business together is that in Europe, we use the same words that you use in the U.S. to describe these products and businesses, but the market is fundamentally different. The key difference is that it's very, very shallow and inefficient. There are all of these markets and niches compared to the U.S. I learned at Goldman that if you respect the inefficiency of the market, then it's an easier place to make net return in a portfolio compared to the U.S. It's also an easier place if you don't respect the inefficiencies to make a worse net return.

We learned that we have to run extremely broad mandates compared to what we would do in the U.S. We have to think about each of the funds in our fund complexes as a risk-return equation. Take direct lending, for example. If we were in the U.S., we might run a very focused, cash flow only, sponsor-only business. In Europe, we don't really have that luxury, in my opinion, because markets can go in and out-of-favor very, very quickly compared to the U.S.

The other principle is a true north that I think has served us really well, which is understanding that we're in a commodity business. It's just money. We can add a bit of value around origination. We can add a bit of value around underwriting. We can add more value around successfully managing bankruptcies, or restructurings or adding value and portfolio companies, in terms of helping improve operations. But it's a commodity business; it's just money. And if you think about any commodity business, first of all, they are cyclical. Let's not forget that. We could be lulled into thinking they're not. These are cyclical businesses. And like any commodity, one has to be very alive to supply and demand.

And the attachment point, where are you attaching? And it's not driven by our fancy suits or our fancy educations. It's really driven just by technical factors. One of the things in Europe that's really different to the U.S. is small changes in absolute terms of supply of credit versus demand for credit. Small changes in absolute terms lead to very big changes in risk-return in Europe compared to the U.S., which is more like an aircraft carrier. So, one of the most important things that we try to do with these broad mandates – and we can't predict the future, we're not perfect stock pickers – but it's fairly easy to observe, particularly if you're running a broad mandate, supply, demand and entry points. We try to be very alive, very thoughtful around the technical. That is our entry point: setting deployment targets for a quarter, developing a shopping list in terms of which areas and broad mandates are in our favor. What's against us? Let's focus on the parts of our mandate where technicals are more in our favor and benefit from a better entry point in terms of risk-return.

Peter Antoszyk: I'm curious, given how dynamic and volatile that environment is, how, internally, do you manage that? How do you assess those on a week-to-week, month-to-month, quarter-to-quarter basis?

Tim Flynn: Well, the first thing is: if you're narrowly focused, it's very hard to observe changes in risk-return. You can always justify the next deal with reference to the deal you just did. When you're running a strategy where you're looking at, not just different geographies, but risk-return for financing real estate or shipping or some other healthcare pharma businesses or other asset-backed businesses, it's much easier to compare it – to be able to understand when one of your areas is poorly priced because of something technical because it's by reference to something we're doing in another part of the business.

So, we start with the advantage of having lots of data points coming in. That helps us understand relative risk-return and the way that we actually manage it is, before we start, we take our most commoditized business (which is our direct lending business in the private credit group), and we start each quarter with a deployment target. We understand what our neutral rate of deployment is for whatever fund complex, and we set a deployment target for the quarter with reference to that. So, if we set a really low deployment target because we think the market is generally pretty expensive; it's a pretty small window to get through. We have to be really selective, but the concept is since we can't time markets, it's best available. So, within that deployment target, select the best risk-return we can, and we'll set a shopping list in terms of which areas of our mandate are in focus. The risk-return metrics, for example, might be blended leverage, spread, OID, attitude towards covenants, structures, et cetera, and then we originate according as best we can to that shopping list.

Peter Antoszyk: Got it. And so, when you look out at the market today, where do you see the opportunities?

Tim Flynn: Well, let's look at last year for a second. Let's focus on the direct lending business, which is, I think, the easiest place to make the point. Last year was a classic European year. If we think about 2022, in general, where we operated with very modest deployment targets and a very limited risk appetite, we had a relatively slow deployment year as a result. As we moved into Q1 2023, the technicals shifted about as rapidly as I've seen in the market in a long time in favor of the lender, and demand for credit was low. Given the M&A volumes, there were a lot of refinancings. We had the Scandi banks largely step out for a period of time, which sucked a lot of supply into that market. We saw some of the most attractive risk-return we've seen in the most vanilla part of our direct lending mandate: Tier 1 sponsors, cash flow loans,, and we set a deployment target that was relatively ambitious for the first quarter. We had an exclusive focus on the sponsored, cash flow business, upper mid-market.

Let's go to Q4, where the technicals shifted the other way, again, about as rapidly as I've seen where the supply-demand technical meant that, in terms of risk and documentation and return, it became much more of a borrower's market. Again, our LPs would see a much lower deployment target, much less deployment and hopefully, still reasonable, but much, much less attractive than it would have been in Q1. As we move through '23, and sitting here in this quarter, it's still a relatively tight lending market, you know, in the cash flow side of the business, and there's an increasing focus on parts of our non-sponsored business, parts of our asset financing business and into maybe private equity firms. It could be perceived as Tier 1 or Tier 2 or Tier 3 private equity firms.

Peter Antoszyk: You spend a lot of time now traveling and speaking with investors and fellow GPs. What are those conversations are like in the broader ecosystem of private credit?

Tim Flynn: Well, the immediate answer is what I think about the LP community. There is a far more focused mindset on workout capability, on trying to understand where are we in the cycle, and does my manager have adequate workout capability. I would say that is the number one theme in the LP community.

At our Investor Day, actually, we took a poll. I can't remember the big list of possible factors, but "workout capability" was certainly far and away the winner, and I think that is an appropriate focus. Our view is that we are in a good old-fashioned corporate-earnings-driven recession in Europe. I don't care what the public markets are saying. You could see it in the figures, and I remember about 15 months ago or so, at our 2022 annual Investor Day in Q3, we encouraged our investors to begin preparing, like we were preparing, for what could be a moderate to severe recession, and a consequent spike in defaults.

So, if you cast your mind back 15 months ago and kind of think about the world, we had just come off an incredible level of stimulus on the back of COVID, not just from the central banks, but the extraordinary level of fiscal stimulus to plug the hole created by the COVID lockdowns. That was obviously just beginning to unwind, starting to reverse and has continued to reverse in a pretty dramatic way. Of course, in Europe, we had an inflationary shock on the back of Ukraine that hit us much more directly than it would have in the U.S. And so, as we were thinking about all of that in Q3 of 2022, and even though we didn't have a crystal ball, it made sense to us that it would be wise to prepare for what could be a period of elevated defaults. And as we move through 2023, what we began to observe in the figures, in our portfolio and other situations where we had data, particularly price volume data, we began to see in Q1 '23 some of the impact hit earnings from inflation.

Think about healthcare services business, for example, in the UK, trying to recruit staff, professional staff –some very big wage increases – or think about businesses with vastly different energy costs and limited ability to pass them through. So, we began to see that in Q1 '23, in terms of margin pressure and as we moved into Q2 and even more so in Q3, we began to see something quite different, which is just old-fashioned slowdowns starting to hit the top line of a lot of businesses. And what we began to see – we knew prior to that from businesses where we had commercially sensitive information around price volume – and we could see already before that, both price and volume going the wrong way, and all that began to hit the numbers in Q3 of 2023.

If you’re a German business, for example, selling into any kind of CapEx decision or a French business – there’s been some very, very soft top line as we move. Looking forward, we don’t have a crystal ball. We’ve observed our watchlist go from a cyclical low 12 months ago in Q4 2022 which is something that is more in line with what we would expect. Where we go from here is hard to really judge. What’s the depth and magnitude of the slowdown? There’s a big rate bet in the market. Maybe that plays out, maybe it doesn’t, but there’s certainly a lot of pressure in front of us as we move through 2024.

Peter Antoszyk: Certainly, at least in the U.S., the default rate numbers as reported by S&P, and frankly by our own index, are still very modest in historical terms. What would you say the default rate is in Europe, and does the default rate reflect what you’re describing as stress in the portfolio?

Tim Flynn: I can’t speak to the market. I just don’t have the data points. Obviously, I can look at the indices or what public markets are telling us, but you’ve got to keep in mind that these kinds of moves, just taking the right move, take a long time to cycle through earnings. It takes a long time for earnings to cycle through to covenants, and ultimately result in default. And I think it’s fairly easy to go back and look at historical periods and think about a 24 to 36-month period as just one thing. But these things take time. Just go back and think after the financial crisis, with rates going to zero, how long did that take to really cycle through to valuations? And then into earnings? It takes time.

So, I don’t think it should surprise anyone that when it’s unwinding the other way, it takes time. You’ve been around a long time as well. You know, these kind of old-fashioned corporate earnings-driven recessions is a longer period of time than some sort of financial shock. So, no, we have not seen a default spike. We have seen an uptick in our watchlist, which, if you like, is the waiting room. How all this plays out is a very dangerous thing to predict with any certainty. I don’t know; we don’t know. What I can tell you is that, as you would expect, we’re hyper-prepared for this: not just to manage defaults, but one of the counterintuitive things for a lot of people is, actually, that it’s in these moments where the technicals are most in the vanilla lender’s favor so any good manager, and there are a lot of good managers in the market, will be doing the same thing I suspect that we’re doing, which is making sure we’re adequately resourced and overprepared for a spike in defaults. It takes a lot of time, but it’s also important to be really prepared and to be over-invested on the front foot in terms of origination because if that is the environment I suspect, if history holds, this will prove to be a fairly extraordinary vintage, even for vanilla lending.

Peter Antoszyk: So, private credit as an asset class has exploded over the last 20 years, and some have described it today as the golden age of private credit. From your perspective, what are your thoughts on the future of private credit as an asset class?

Tim Flynn: Let’s break it down. My thoughts on the future of non-investment grade lending as an asset class are very bullish. This is a financing tool that’s been around now for a very long time, and I think it’s deeply embedded, certainly in terms of how most Western countries operate in trade and finance themselves. So, my thoughts on non-investment grade lending, the non-investment grade product suite; there’s no reason to be anything other than fairly bullish in terms of how the market evolves.

By private credit, I think you're referring to this phenomenon that we've had where so much of this lending is done in institutional hands, intermediated by firms like Hayfin, as opposed to bank balance sheets. And I think you're probably making a distinction between the traded credit markets, but it's all the same thing, and it's nuanced. Hayfin and all the European managers have been the beneficiary of a regulatory tailwind. That's the whole basis on which we set up the firm. We have a regulatory overlay that has the effect of driving aspects of the leveraged finance business out of bank balance sheets and into institutional hands, and there's certainly no sign of that abating at the moment. In fact, you could make the case on the back of Silicon Valley Bank and Credit Suisse and some other things a risk of a reversal is lower than it was prior to that.

Europe has an even more interesting growth position compared to the U.S. when you think about the differences in the two markets. Maybe private credit as a concept didn't exist in a significant way before the financial crisis, but we had all the non-bank lenders and that's, in fact, who we really thought about when we started Hayfin – the GE Capitals and Heller Financials of the world. So, the market had begun to institutionalize I think really not long after the savings and loan crisis for us old guys, and Europe started 15 years later in 2008, 2009. And, if you look at the risk assets that continue to be on bank balance sheets rather than institutional hands, and if you look at how the market has developed over the past 15 years, it could be faster or slower in certain geographies or certain periods of time. But there's a very pronounced trend that generally, and at a high level, we would expect that to continue. It provides a higher growth rate in Europe than the U.S. as the European economies catch up to the kind of funding model that exists in the U.S.

So, all of that is very positive. I say it's nuanced because my experience as an investor and as a businessperson is that when there are very, very big growth tailwinds, the industry should be thoughtful about a few things: corners can be cut and things can grow faster on the front end than they should, given the middle and back end of these businesses. So, I think there are some good reasons to be cautious. I also think things to be mindful of, certainly we try to be mindful of, are let's imagine a big default cycle, be thoughtful around political risk.

There’s a lot of talk in the papers from time to time about shadow banking, and the systemic risks that are in the industry and mark-to-market and all the rest of it. The systemic risks on the private credit side, compared to a bank balance sheet, are certainly different in terms of the funding models and maturity mismatches and the rest. But what I would say is in an environment with a big default rate, where investors are losing money, where asset owners might be facing foreclosure, my experience as a human in this world is a lot of political pressure comes on the back of that. A lot of scrutiny and bad press can come on the back of that. And my experience is also, when you have very fast growth rates, I think the vast majority, certainly all the firms, fellow GPs that I know, are highly, highly professional and very well run. But when the tide goes out, it‘s not uncommon to see incidences of bad behavior or corners cut. So, my outlook over the long term, I back the asset class, and I back most managers’ ability to recover principle and the default cycle, so long as they have an adequate workout capability. So, over the medium-long term, my view remains very bullish, but I certainly think it’s worth thinking about and being thoughtful around some of the political risks and some of the scenarios that we could face as an industry as we move through the next few years.

Peter Antoszyk: So, as you think about the next five or 10 years, how do you think about the future of Hayfin in that environment?

Tim Flynn: Well, one of the things I love about financial services as probably a frustrated creative is just how creative it is or can be. Markets are so dynamic, and the world is so complex and ever-changing. Markets are generally pretty efficient at competing over time, excess risk-return out. So, the one thing I know for sure is the business that we have today compared to the business that we might have in 10 years’ time is likely to be very different.

I think one of the core values or attributes of the Hayfin group of professionals is a dedication to trying to be very thoughtful students of markets, understanding how we might have made excess return or adequate return yesterday but trying to look to tomorrow and to opportunities and segments and how conditions evolve to build the business and the product suite that fits a portfolio need, based on the market of tomorrow. So, I can’t tell you because I don’t know.

What I can tell you is what I love about this job and this business is exactly that phenomenon. You know, our business today and our business tomorrow is going to be different, and how fun is it to be part of that and try to use our brains and our intuition and our analysis to try to adapt as conditions adapt.

Peter Antoszyk: This has been a great conversation. I appreciate it. I just have a couple of final questions. When you look at hiring a young professional, what do you look for in that individual when you're hiring?

Tim Flynn: Well, I'll answer the question in two ways. First of all, persistence is an undervalued but incredibly important trait in any professional services firm. One of the things that is really important when we're looking at hiring young people is evidence of persistence. There's a core value within Hayfin around adaptability and trying to be athletic. If we look at almost all of our investment professionals because our mandates are broad and, and our focus moves, the more athletic they are, the more types of things they can do: a vanilla loan today, managing a complicated restructuring tomorrow. It's very, very important. Ours is a no superstar culture where we value the midfield general, who makes everyone else 10 percent better, over the superstar striker. And so, for a person to thrive at Hayfin, they genuinely need to be low ego and put the team and clients and firm ahead of themselves and operate with humility.

The second way I'd answer the question is back to this world being complex and dynamic. If you think about one of the core functions of any investment professional, it is to predict the future trajectory of earnings, and earnings are driven by a very diverse, complicated geography or world. One of the things that I feel like we've learned over time is the more our team resembles the world around us, the better investment decisions we make. From a nationality perspective in Europe, it's pretty easy, you know. There's some French businesses that are very difficult to understand from an American or English perspective. Diversity can be a core value and is an important value, but actually, as an investment firm, it's essential. I remember learning that very early in my career at Goldman when the French team brought a business forward, a business that made frozen food or prepackaged frozen dinners that was sold at enormous prices and enormous gross margins, and I remember thinking about TV dinners as a kid that you buy for nothing and eat in front of the TV. I just thought, "This is the stupidest business model I think I've ever seen." Then I remember being completely blown away to realize that actually, in the French market, that was an absolutely fantastic business. That's when I said to myself, "We need some French people on our team."

Peter Antoszyk: So, I know you're an avid listener of podcasts. What is a guilty pleasure podcast that you enjoy?

Tim Flynn: I am really enjoying Marc Maron's *WTF* podcast. What I love about his podcast is he can engage with all kinds of different people: stand-up comics, all people from very different backgrounds, and get them to talk about things. I remember listening to his podcast with Barack Obama years ago, and he got Obama to talk about aspects of his childhood growing up and his life that I'd never heard before. I'm on a long flight to Tokyo tomorrow, this was before I came here. I already preloaded a bunch of Marc Maron *WTF* podcasts to keep me company on the flight.

Peter Antoszyk: Tim, thank you so much for being on *Private Market Talks*. I appreciate it.

Tim Flynn: You're welcome, Peter. I've enjoyed our conversation and thank you for having me.

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