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Private Market Talks:

Private Credit with Golub Capital's David Golub

June 21, 2024

In this episode, we are joined by David Golub, President of Golub Capital and one of the first movers in the private credit industry. Since its founding over 30 years ago, Golub Capital has made over $150 billion in loans and won over 40 industry awards. Today, the firm has over $70 billion of capital under management.

During our conversation, David discusses how he and his brother, Lawrence, started Golub Capital and the drivers of its consistent performance year-over-year. We discuss the current state of the leveraged loan market, including impact of the higher-for-longer interest rate environment, the resiliency of middle market companies, and the recent resurgence of the broadly syndicated loan market. We also explore key industry trends, including the potential for consolidation, the competitive advantage of scale, and the growing retail market for alternative assets. Finally, David reflects on the future of Golub capital.

Peter Antoszyk: Hello and welcome back to another episode of Private Market Talks, where we take a deep dive into the dynamic world of private markets with industry leaders. I'm your host, Peter Antoszyk. Today, we have a special guest: David Golub, the President of Golub Capital. Golub Capital is a leading private credit manager. Founded over 30 years ago, Golub Capital now has over $70 billion of capital under management. Since its inception, Golub has made over $150 billion in loans and won over 40 industry awards.

David is a member of the Stanford Graduate School of Business Advisory Council. He is a member of the Founders Council of the Michael J. Fox Foundation for Parkinson's Research, and he serves or has served on numerous other public and private boards. I am particularly pleased to welcome David to our podcast, as Golub Capital was our first client. One of my partners and I started the Private Credit Group at Proskauer over 20 years ago, and as one of the first movers in private credit, David brings a depth of experience and knowledge that few can match.

During this extended conversation, we look at the growth of Golub Capital, the state of the leveraged loan market, headwinds and tailwinds facing private lenders, and explore key emerging trends and opportunities facing private equity and private credit investors. So, tune in as we look at the state of the market for investors with David Golub.

As with all our episodes, you'll find a full transcript of this episode along with other helpful information at privatemarkets.com. And if you enjoy this episode, be sure to subscribe. And now my conversation with David Golub from Golub Capital.

David, good to see you.

David Golub: Great to see you, Peter.

Peter Antoszyk: Take me back to your background in the early days leading up to Golub Capital.

David Golub: I love talking about the Golub Capital origin story. So, I have to tell you the humorous version first — my father was a psychiatrist, and my mother went back to school, became a psychologist when my brother and I were young. When I've been asked in the past sometimes about, you know, when did it all start, I describe a conversation over the dinner table when my brother was 10 and I was seven and a half. And my parents were once again talking about dreams and feelings, and so, we decided we had to get even, and we started planning our middle market lending empire.

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I've actually told this story and had people believe it. It is not true. This is an apocryphal story. This is an apocryphal story. The truth is that both my brother and I went into private equity after business school, and we're working in different parts of the private equity landscape when in the late 1990s, right around 2000, we got together and started having some discussions about how the world of private equity, how the private equity ecosystem was fundamentally in need of a change.

It was, if you're familiar with Clay Christensen, a professor at Harvard Business School, and his writing about disruption. It was, in essence, a Clay Christensen moment of insight. And the insight was this; the insight was that private equity deals at that time were financed in a goofy way.

So, the typical way that private equity deals were financed then was you'd get a bank to lend you three and a half times EBITDA. Why three and a half? Because that's what the regulator said banks could do. And sometimes it wasn't even three and a half because there also had to be a certain amount of amortization that you needed to show you could do within the first four years of the deal's life. There were a whole set of, frankly, not completely sensible rules imposed by the regulators on how banks could finance LBO's. So, if you were private equity firm, you weren't satisfied with that degree of leverage. And so, you looked for a second tranche of leverage, a junior debt tranche underneath that senior debt tranche. And that junior debt tranche was typically provided by an insurance company. And the typical way it was done at the time was it was a mezzanine loan with penny warrants.

So, imagine you were a private equity sponsor and you carefully cobbled together this deal. You've got the seller at the finish line, you now have a senior lender and a junior lender, you've got a negotiated intercreditor agreement. That closing was a nightmare because you had to land three jets all at the same time. Worse, after you got through that, you didn't have your lenders on the same page as you. You wanted to grow your portfolio company. Typically, in order to grow, you wanted to have access to more capital. Maybe you wanted to do acquisitions, maybe you wanted to do a capital spending program.

Well, the senior lender wanted one thing; they wanted not to have to go back to investment committee because if you're a banker at that time, investment committee viewed you're coming back as meaning one thing and one thing only: there was bad news. And if you were talking to your junior lender, well, your junior lender wanted to get paid back. They wanted to be able to run with their free penny warrants because they were IRR focused and that meant their key priority was getting paid back their mezzanine loan.

So, the setup was not really attractive for the private equity sponsor. So we came in and said, “Hey, what if we created a financing firm that was dedicated to just one thing, to, to lending money to private equity backed companies? And what if instead of syndicating loans and having a multilayer capital structure, we raised capital in the form of a fund and we then provided that in the form of a single tranche loan,” what we then called one stops or unitranche loans. Those were — there was an unusual phrase at the time. Today it’s an everyday thing.

And the response was interesting, Peter. The initial response from sponsors was, “Why would I want to do that?” And it took quite a long time for us to persuade middle market sponsors to try this one stop approach from a fund instead of the syndicated bank deal and junior debt from an insurance company. What happened is folks tried it and they liked it. And so we developed this group of sponsors who became core customers, repeat customers of Golub capital. And how our one stop approach began to gain share versus the more traditional, bifurcated capital structure syndication model. And within, you know, roughly 10 years, we started to see a very significant shift in the market toward our approach.

Peter Antoszyk: Can you describe the size of the deals at that time? Because I think it’s relevant to how the industry has grown, which we’ll get to later on.

David Golub: Oh gosh, it’s funny you ask about that. So I have a credenza behind my desk in my office and have some toys, some deal mementos that relate to that. One of the deal mementos is a bottle of wine that was given with gold engraving commemorating the first meaningful financing that Golub capital did, and it was from 2003, if I remember correctly. It was from Wachovia legacy. But you know, this was before Wachovia and Wells Fargo combined. And it commemorates $150 million financing. And you know, I remember thinking at the time that was a huge deal. Of course, today we make $150 million loans most days.

So, the size of the transactions that we were working with at that time were meaningfully smaller than the ones that we're involved with now. It was, you know, typically a $20 million, $30 million-sized loan. As we've grown we've been able to offer financing solutions, including one stops, to larger and larger sized companies. And today, you know, typical transaction ranges in EBITDA size from 20 million to well over 100 million. The financing can range from that. We haven't stopped doing those $30 million deals, but they can range from $30 million up to several billion.

Peter Antoszyk: So, when you think about the changes over the last 30 years since you've been in this seat, what have been the major inflection points that have driven your growth from a few billion early on to over $70 billion today?

David Golub: I'd identify four key — not even sure the right word is inflection points — but four key factors, I'll call them, that have been behind our growth and the industry's growth. The first of those factors is the growth of the PE ecosystem. In 1987, when I graduated from business school, there were, I don't know, a dozen PE firms globally. If you raised a billion dollar fund, you were a mega fund. Some of those firms still exist — KKR, Warburg Pincus. Some of them don't. You don't hear much about Wesray these days. There's been a lot of change. But today, if you look at the PE ecosystem, there are thousands of firms. It's the dry powder that's available to the private equity ecosystem that is estimated today at north of a trillion dollars. It's a gargantuan marketplace. So we have, in some respects, the private credit industry at Golub capital. We have drafted behind the growth of the PE ecosystem.

The second factor is, we used to compete much more with banks. And over the course of the last 30 years — through at least three, arguably four regulatory cycles — banks have been constrained from competing in our marketplace other than as arrangers and syndicators. People think this is a new phenomenon. It's not a new phenomenon. It started in the early 1990s in the wake of the savings and loan crisis, when banks were told be very careful about doing what were then called HLTs, highly-leveraged transactions. It continued in the early 2000s, in the wake of the telecom bubble and the internet bubble bursting where banks again were told by regulators that the problem that they should really be focused on is leveraged lending. And then it really took hold after the financial crisis in the wake of Dodd-Frank, when all of the bank regulators got together and delivered what they colloquially referred to as guidance, which really meant they dictated what banks could do and couldn't do. So, a second key factor is what you might expect to be the traditional source of financing for private equity backed companies. Bank financing has really been very limited.

The third key factor that's been particularly important to Golub Capital and our success has been bad management by some of our competitors. You know, if you go back in time, there were a number of players who were much bigger than us in the early 2000s. And one of the key factors, if you look at the history of the industry, is that there's a pattern of players growing too fast and making mistakes, either on the credit side, making bad loans, or on the financing side, relying too much on short term loans to finance their long term illiquid book of borrowers. Both of those have played out in ways at different times over the course of the last couple of decades that have taken competitors out of the picture.

And then I'd add a fourth factor, and I say this with total sincerity: luck. Like, we've been extraordinarily lucky. If you asked me in 2003, you know, how big is Golub Capital going to be in 2023, I would have been off by decimal places, you know? I had no appreciation for the size and scale of the opportunity that's developed over the course of the last couple of decades. And we've absolutely made some good decisions. I'm very proud of a lot of those good decisions, but also very cognizant that we have been very lucky.

Peter Antoszyk: How do you think about organic growth versus growth by acquisition?

David Golub: So, I want to take your question in a slightly different direction first, because it's an important premise to answering your question. Many people in the alternative space, they talk about a good asset class where they talk about a good time to invest. We've never thought about our business that way. We've thought about our business as a business. We want it to be good every day. We want to be focused on nurturing a set of competitive advantages so that we can produce premium returns consistently. And, you know, this is a typical way people think about businesses. If you're talking to an equity analyst about, you know, why is Nvidia a good business? They the first thing they talk about is Nvidia's competitive advantages. They wouldn't talk about how great semiconductor chips as an industry is. They wouldn't talk about why this is such a great time. No, they talk about Nvidia's competitive advantages. So I'm a bit puzzled honestly about why alternative investors, both GPs and LPs, spend so much time talking about whether something is a good kind of asset or whether it's a good time. I think what they should be focused on is, do they have an opportunity to invest in a really good business?

So, by thinking this way, we've built up over the course of decades, a set of, I think, really quite large competitive advantages that lie at the core of why we've been able to produce the returns we've been able to produce, why we don't have a single bad fund, we don't have a single bad vintage. This is not all luck; it's too many years for it to be all luck. I think what lies behind it is a real focus on repeat customer relationships with key sponsors, making sure that we can be a compelling strategic partner by having a wide breadth of different kinds of opportunities that we can finance for them by being super reliable, by focusing on building internal expertise so that we can add value to the deals that we get involved in and we can get up to speed quickly, by having lots of capital so that when sponsors want incremental capital, we have it, it's there for us to be able to give them. It's about working with the same investors over and over again, not over promising, not signing up for giant commitments that we don't call down. Like, these may sound like basic ideas but, like in our —

Peter Antoszyk: It's blocking and tackling, you know, in some ways there's a good credit investor.

David Golub: Being a good partner. Just, you know, just being a really good partner, putting ourselves consistently in the shoes of our partners and making sure we're doing what we would want if we were on the other side of the table. Those lie at the core of how we think about our business.

So now let's go back to your question, you asked about acquisitions. Acquisitions are hard. Acquisitions are sometimes not necessary. If you can grow as quickly as you want to grow without doing acquisitions, probably a better path than doing acquisitions. If you want to do acquisitions, you've got to be very careful to make sure that there's cultural compatibility, that there is consistency in leadership style. So I'm not saying acquisitions are bad.

Peter Antoszyk: They can also accelerate your growth.

David Golub: Exactly. I'm not saying acquisitions are bad, I am saying that if you look at our industry there's a mixed track record.

Peter Antoszyk: Is there a Golub-type deal? Is there a profile of a type of deal that you would say, yep, that fits within our box?

David Golub: So, funny story. So we're coming out of the financial crisis and we've performed very well through the financial crisis. You know, our underlying borrowers performed very well. We had debt facilities in place that were not market-to-market that had long term to them. So, we didn't have financing issues. Many in our industry did. And there was this conference and my brother was speaking at this conference. And someone asked him in the Q&A session, "So Lawrence, how did you guys do it? How did Golub Capital come out of the crisis, you know, doing so well?" And my brother has a very deadpan sense of humor, said deadpan, "Well, we make loans to borrowers who pay us back." And there was this silence for a period because, at first, people didn't realize that it was joke and then few people started laughing and it got some momentum.

The truth is, it's a joke and it's not a joke. It was absolutely intended at the time to be a joke, but it's not a joke in the sense that we worked very hard in our approach to looking at deals, to making sure that we're investing in good companies, resilient companies, companies where it's unlikely that things are going to go wrong. And if they do go wrong, we look for companies where, even if some things go wrong, there's going to be a strategic buyer out there who's going to want to own that company at a price high enough so we're not going to lose money. We call that a second way out. So a typical Golub capital deal could be across a wide array of different industries. But it's going to share this common characteristic that it's going to be hard to kill. They're companies where their customers need them, and as a consequence of that, there's a market for the company even if it gets beaten up.

Peter Antoszyk: So when you look across your portfolio, how many corporate borrowers do you have?

David Golub: Within our direct lending portfolio today we have a little under 400 different borrowers.

Peter Antoszyk: And do you skew your business one way or the other in terms of structures?

David Golub: I don't know what you mean by that.

Peter Antoszyk: Well, what I mean is, do you skew it more towards senior, junior? How is your portfolio weighted in terms of structures?

David Golub: So from a structure standpoint, we've long been big fans of first lean, often first lean in a one stop form, but big fans of first lean. We do some junior debt, so it's not *verboten*, but we're very careful about the junior debt positions that we take. I'd say our *dish dujour*, but what's the *spécialité de maison*, is one stops. If you look at our portfolio, it's probably eighty percent one stops.

Peter Antoszyk: So, I'd like to turn to get your thoughts on the current market. How do you think about investing in the current market? Is it a good time to be a credit investor?

David Golub: So, I'm going to start by answering the first of those two questions. I think about it humbly and I want to elaborate on what I mean by that. If you go back to April of 2020, the heart of the COVID crisis. What'd everybody think at that time? Everybody thought we're in for some deep doodoo. We're going to have a serious recession. And, of course, we didn't. We had a post-pandemic boom. And then there was a widespread view that, yeah, we might get a little bit of inflation, but it's going to be transitory. And again, wrong. We got the worst inflation that we've seen in this country since the 1970s. When that inflation was running rampant, there was a very widespread view, a very big consensus that it was going to be around for a long time. Wrong again. It was very policy responsive. As soon as the Feds stepped in and started raising rates, you know, within months inflation started going down. Within a year it was much lower than people thought it would be. Last year, at the beginning of 2023, there was an extremely widespread view that we were going to see a recession, and that drumbeat got really, really loud around the time of the regional bank crises, the Silicon Valley Bank, Signature Bank, First Republic, in March of, of 2023. Guess what? Wrong again. We had a pretty good growth year.

So where do I take from the site? One thing I take from this is that our collective prediction capabilities are pretty bad right now. I don't think they're always this bad. I think they're unusually bad in this period. If we think about ourselves, our brains as being an AI model, we must have been trained on the wrong data because we're coming almost too consistently to the wrong conclusion about where things are heading. If you tried to make random calls over the last four years, you'd probably do better than the consensus has done. So this makes me humble about our capability and my capability of predicting where we're going to go from here.

Having said that, I'll give you a take. My take is that the economy's been much stronger and more resilient than folks have expected for this entire period, and that we're likely going to see some continuation of that trend. If you look at the Golub Capital middle market report, which we published quarterly — which talks about how our portfolio is doing growth in EBITDA — growth in revenues year over year, the story there is very consistent. The story is one of continued, strong performance. Private equity-backed companies are adapting well to this higher interest rate environment.

Having said that, there's also a tail. And we see that tail in the high yield market, we see that tail in the broadly syndicated market. We've got a little bit of that tail in our portfolio. Happily, it's little, but the tail is a group of companies that are not adapting so well to the higher interest rate environment. And there's some kind of common threads amongst those companies. One of the common threads is the synergies, the adjustments that were thought to be reasonable at the time the deals were done; they haven't come through.

A second pattern is that the companies have had trouble raising prices. They've had increases in costs associated with inflation, but they've had challenges sustaining margins. They haven't had pricing power. A third problem: some of them were just structured with too much leverage. They weren't structured in a way that anticipated the increase in interest rates that we've seen. And there's just not enough room for error in their capital structures. And then there's always the special stories. You know, there's always the idiosyncratic story of this company lost a big customer, this company had an unexpected regulatory change. This company had, you know, bad management turmoil. I think, Peter, over the course of the next year or two years we're going to see an increase in the number of companies that go into payment default, that need to go through some kind of restructuring, even as I think we're likely to see a continuation of the pattern of overall relatively good economic performance across the macro-economy.

Peter Antoszyk: I would like to get your view on the second question I had, which was, is this a good time to be a credit investor in this environment?

David Golub: I don't think we ought to spend a lot of intellectual bandwidth trying to think through timing questions as investors. I think as investors we all think about, is the firm that I'm giving capital to, does that firm have competitive advantages? Does that have a business? Does that have a way of producing premium returns over time? I think that's the much better question to ask than saying, "Hey, well it's, you know, August of 2018, I should get out." Again, I just go to the data. If you look at our funds' performance over time, there's really not a meaningful difference in performance between GCP six and GCP 12 and GCP 14. They've all performed well.

So, I don’t know whether it’s a good time or a bad time to invest in long duration traditional fixed income. I don’t spend a lot of time thinking about the future direction of interest rates. I spend a lot of time thinking about, what can we do to sustain and what can we do to nurture and grow our competitive advantages?

Peter Antoszyk: Meanwhile, money has continued to flow into the private credit industry, generally. In fact, it was just — I think it was just announced. Goldman just closed their largest private credit fund. I think it was $21 billion. Banks are looking to form partnerships or acquire private credit platforms. Are there secular shifts that are favoring growth of private credit?

David Golub: A couple of thoughts in response to your question. One is, I’m not sure what private credit means anymore as a phrase. Like, it used to be when we were talking about private credit that we meant middle market direct lending. But clearly, we don’t just mean middle market direct lending anymore. There’s all kinds of other niches within private credit. There’s infrastructure, there’s real estate, there’s taking assets off of bank balance sheets in various ways, including synthetic risk transfer deals. There’s asset based. So, if one uses a broad definition of private credit, then there are enormous tailwinds. Because increasingly, banks are being forced to realize that they’re not the natural repository for every kind of loan asset in the world, and that in fact, in many cases, they’re better off specializing. They’re better off using origination and distribution models instead of origination to hold models. So, all of that is creating opportunity in the private credit ecosystem. In addition to that we continue to see growth in the private equity ecosystem. Now, we’re in a bit of a deal lull right now. We haven’t talked about this so much, we probably should.

Peter Antoszyk: We will come back to that.

David Golub: But we’ve been in this, relatively speaking, deal lull in the period since, say, mid-2022. But I don’t think that changes the big picture, which is that, you know, over the course of the last 25 years and I would argue, for sure over the course of the next 10, the PE ecosystem is going to continue to grow. I think it’s going to grow a lot and that as well will create opportunities for traditional sponsor finance.

Peter Antoszyk: So given those tailwinds that you’ve just described, where do you see opportunities for growth at Golub Capital?

David Golub: It probably won't surprise you, as I've talked about our focus on competitive advantages, to hear that we're looking to do more of the same. Our main strategy is more of the same. And maybe in some businesses you'd say, "Oh, that's too boring. That's not ambitious enough." I think in our business it's plenty ambitious, because our underlying market in the PE ecosystem is likely growing by 15, 20 percent a year over the coming period. So we've got enormous growth potential without having to go into areas that we don't know or understand.

At the same time, we are also looking at adjacencies. So I'll give you an example. Back 10 years ago, we started doing some transactions in Europe. We'd have U.S.-based private equity firms that would ask us, "So, can you help us with financing with such and such company that's based in the UK?" And we'd staff the deal from the U.S., but we'd work with this sponsor that we knew in the industry that we knew and provide the financing. In 2019, we decided this is dumb. We should open an office in London and really look to position ourselves to be able to provide better service to our private equity sponsors in respect of European deals.

And in the period since, we've grown that office, we've added originators, we've added underwriters and, you know, we now have a $13.5 billion dollar European direct lending business. You know, I think there's very significant opportunity to continue to grow that part of our business. But that's an example of how we think about growth. It's taking adjacency where we've got some starting momentum with clients who want to work with us, industry that we know well, people that we know well and let's build from that.

Peter Antoszyk: Are there verticals that you're looking at that you're not currently in?

David Golub: So, we're always looking for adjacent industries opportunities. I'm not sure I'd call them verticals. I'm a little skeptical on ABL. So, ABL's interesting. We've looked at ABL a number of times over the course of the last 15 years, and —

Peter Antoszyk: And, and for our listeners, when we say ABL, we mean asset-based lending.

David Golub: Asset based lending, yes. Thank you. Tendency toward jargon. The reason I'm a little skeptical about the opportunity in private credit in asset-based lending is that I think it's an area that banks do really well. And I think it lends itself to the bank business model, so —

Peter Antoszyk: It’s certainly heavier lift than doing a term loan.

David Golub: It’s not only heavier lifted origination, it’s heavier lift on an ongoing basis to service. So I tend to find more attractive niches where we can go in and we can offer a better experience to our customer. And I’m not sure in asset-based lending that private credit players have figured out how to make it better.

Peter Antoszyk: So, some market analysts see potential headwinds. We’ve talked about tailwinds for private credit, some analysts see potential headwinds that may potentially impact private credit and the CLO market. Where do you see potential headwinds in the foreseeable future and how do you risk assess them?

David Golub: So, they’re always headwinds, okay? Let’s start with that. John Gray was quoted widely last year talking about the Golden Age of private credit. I cringed every time I heard the phrase because I think the truth is, in every moment there are headwinds and tailwinds. Today, if you look at the headwinds, there are several significant ones. One of the key headwinds is spread compression. In the period since the beginning of this year, across all credit markets — but inclusive of private credit markets, inclusive of our niche and sponsor finance — we’ve seen a significant narrowing of credit spreads in the broadly syndicated market. If you look at the data, overall spread compression in Q1 was in excess of 50 basis points. On new transactions that are, you know, in the B2, B3 range, I think it was more like 75 basis points. In the middle market we’re insulated but we’re not immune from credit spread compression. So, one headwind we’ve got right now is that we’re able to charge less in terms of a risk premium for the loans that we’re making.

A second headwind that we're facing is there aren't as many new deals as I'd like to see, and we touched on this a few minutes ago. Since the summer of 2022, there's been a bit of a disconnect between buyers and sellers in private markets. It's understandable. We saw a big increase in interest rates. We saw public equity markets go down significantly. It's understandable that sellers would want to still get the price that they could get in February of '22, and buyers wanted a different price. It surprises me a little, Peter, how long it's taken to reach a new equilibrium, because things are still slow. They're not as slow as they were in the first three quarters of 2023. They started getting more robust in the fourth quarter of last year, in Q1 of this year, but we're not normal. We're not at a pace of deal activity that I would have expected if you had asked me to make a prediction a year ago. I think a big factor impacting that is uncertainty. We've got two wars, we've got very polarized politics, we've got an election coming up. I think in the intermediate term we're going to see buyers and sellers kind of recalibrate and get back to a place where there's a meeting of the minds, but I'm not sure it's going to happen in the next month or two. It may take 'til after the election, it may take till the early part of next year before we see M&A come back the way that I think we, and a lot of other people, would probably — you and in your business — would all like to see.

Peter Antoszyk: So you mentioned that there's been spread compression, the BSL market, the syndication market has opened up a bit recently. Why would an issuer choose a private credit solution if they could access a less expensive capital market solution?

David Golub: So, that's a great question and let's just parse it a little bit further. So, if you think about companies by EBITDA size, you know, when you're below somewhere between 75 and 100 million dollars of EBITDA it's hard to access liquid credit markets. You're just not big enough. But if you're bigger than that, then you have choices. One of your choices is the broadly syndicated loan market, one of them is the high yield market and one of them is the private credit market. And if you're a private equity backed company for sure you're thinking about all of those. These firms have very sophisticated capital partners teams that look at the different choices and the pros and cons of the different choices.

So, what are some of the reasons why private credit wins in a market like we're in today, different from nine months ago when maybe the choice is in the liquid credit markets weren't there, weren't attractive? But today, when they have a choice, why would they pick private credit? Well, they might want the confidentiality. You don't have to post your information out there to the world. Your competitors don't get to see your margins, your competitors don't get to see and hear about where you're planning to take your business. You might want a reliable and quick solution. You might want something that's easy to expand. You might prefer to get a structure that includes a pick component or AD — I'm sorry, I'm using acronyms again. You might want to choose a solution that includes an ability to pay in kind to preserve cash.

Peter Antoszyk: Instead of paying interest you're paying in kind, which is basically adding interest to the principal balance.

David Golub: Correct, thank you. Or you might want to include in your solution an ability to put in place some delayed draw term loans to give you firepower to do acquisitions. These are attributes that are more commonly found in private credit solutions than in the broadly syndicated market. But I think your question's really important to think through in the following sense. We've just come through a period when the competition from liquid credit markets was weak in the second half of '22 and '23. The competition from liquid credit markets, sometimes there wasn't any at all, and if it was there it was limited. Now we're in a period where it's strong. Liquid credit markets, I talked about this last month at this LSTA conference as the Empire Strikes Back, liquid credit markets are back.

And I think that is a wakeup call to some in the industry who thought that would never be the case, who thought that the broadly syndicated loan market was forever dead. I was not in that camp. I've been saying for a long time, you know, there's some technical dynamics that have led the broadly syndicated loan market and the CLO market that drives it to be dormant for a period of time, but that we've seen this before. It thaws and goes back into action. So, we're seeing that now, and I think there's a bit of a rivalry between the liquid credit market and the private credit market in respect of larger deals. Have you got rivalries? It's healthy. I don't think that's a bad thing, but I do think it makes the large market private credit business less of a good business than the middle market private credit business.

Peter Antoszyk: So, I'd like to pivot back to our discussion a little bit where you touched upon it, the impact of the higher for longer rates and the sticky inflation on your portfolio companies, and you described how they have actually performed pretty well.

David Golub: Can I just push back on your characterization?

Peter Antoszyk: Sure. Okay.

David Golub: So, rates, they're about where rates have been most of the last two decades. Inflation, you know, I don't know what —

Peter Antoszyk: Not, but not in the last several years. Yes, you're going back decades, but you know, when you think of vintages of private equity funds and their thesis of going in in the 2019, 2020, '21, '22, it was a different world than it is today.

David Golub: One hundred percent. The point I'm driving at is, what's the anomaly?

Peter Antoszyk: And then the leverage that they were there.

David Golub: Is the anomaly the ultra-low rates that we saw for a period of time, particularly post-COVID, or is the anomaly where we're at right now? I would argue that the ultra-low rate period was the anomaly.

Peter Antoszyk: Completely agree, completely agree. However, the balance sheet structures are different now than they were 10 years ago or 20 years ago. That my only point is the leverage profile of the company is different. Therefore, the impact of higher rates and stick inflation could be more significant than it was when they were less levered.

David Golub: Okay, so —

Peter Antoszyk: Would that be a fair observation?

David Golub: I think we're going to have to agree to disagree.

Peter Antoszyk: Okay. [Laughter]

David Golub: Let me describe my perspective on this. I don't think inflation has been sticky. I think inflation has been policy responsive and I think it continues to go down. It will continue to go down in a restrictive monetary environment. We're in a restrictive monetary environment by any definition of restrictiveness that you can pick if you're a Fed watcher. Would we all wish that inflation, you know, continue to go down to two percent quickly? Yeah, I guess we could all wish that, but it shouldn't be that surprising to us that the last point, point and a half is harder than the earlier part.

The second point I'd make — I don't know your view, I would suspect that it's hard — that we wouldn't find a lot of takers saying that inflation is going to be sustained at a rate lower than two, two and a half percent over the course of the next decade. So we think inflation is going to be in that two, two and a half percent neighborhood in a good case scenario. And we think that in order to keep it there, we're going to have to have real interest rates. That means we probably are going to need to have four percent rates.

Peter Antoszyk: Three and a half to five percent somewhere in that range right?

David Golub: So, people talk about sticky high rates. They're not that high relative to where they, I think, need to be in that stable environment. Maybe they're, you know, 50 to 100 basis points high. So, with that in mind, if you kind of got my view that where we're at is closer to normal than where we were, that the anomalous period was the period of ultra-low rates, then we've got an adjustment. You're right, because there were a lot of balance sheets constructed during this ultra-low rate period that anticipated a continuation of the ultra-low rate period. But this isn't a revolution, this is everybody's thinking's got to go back to where their thinking was pre this anomalous period. And my take is that that's happening, the adjustment's taking place right before our eyes. In most cases it's going just fine. But there's a tail and the tail's going to have to be dealt with. It's a gargantuan tail in real estate land. In our world, it's a small tail. Still important, it's still going to lead to significant dispersion of performance among different debt managers, still going to lead to a lot of business for your restructuring partners. But it's a tail, it's not the dog.

Peter Antoszyk: So, speaking of restructuring, have you seen a dispersion in the default rates of issuers of the of the upper middle market companies? And when I'm talking about upper middle market companies, I'm talking about those companies that have cove light, BSL type loans — whether they're BSL or BSL style loans — provided by private credit lenders and middle market companies, which tend to have covenants and tighter documents.

David Golub: So, it's funny you should ask, because I've been talking about this a lot recently with, with our investors. There are a number of our competitors who focus on large market deals. Who in their pitch decks have these charts that compare the quote default rate of large borrowers versus middle market borrowers and they make the argument, "Look, see the default rate for these large borrowers is way lower than the default rate for the middle market borrowers." Many of them cite Proskauer's debt report. And it's balderdash. It's balderdash because they're comparing apples and oranges. They're — you have to read the books.

Peter Antoszyk: Which, you know, we're very clear. So, we'll come back to that.

David Golub: You guys are very clear about this. It's some of my competitors who are using the data, I think, in a misleading way. What they're doing is they're saying, "Look at the default rate for large companies who don't have many covenants." Mostly that default rate is measuring payment default and they're comparing it to default rates for middle market borrowers where they're including financial covenant default rates. Because those middle market borrowers have financial covenants. So, in essence, what they're showing is that loans that have covenants have more frequent defaults than loans that don't have covenants. It's kind of goofy. It's not really the headline that they're portraying the data proves. Our experience is that as a lender, it's good to have covenants. It gives you an earlier seat at the table. It gives you an ability to work with sponsors before problems are really severe and you can very often figure out good solutions.

Large companies that are good credits, they don't have covenants. That's been true for more than a decade now, and worse, they have loose document terms. And we've seen a variety of different lender liability management transactions that aim to take advantage of those loose document terms. So there are a whole bunch of pretty significant disadvantages of large market loans. You can get refined by the liquid market any day. You don't have good covenant protections; you don't have in general good documentation terms. You can be subject to liability management transactions. I much prefer our business, which is focused on middle market borrowers that don't have those issues. But, you know, we have a number of competitors who for the last couple of years have pounded their chest and talked about how great lending to large companies is.

Peter Antoszyk: I'd like to turn to deal activity. Now, you touched upon it briefly. You noted that it has been muted to date. Maybe there's been a little bit of a pickup. Can you expand upon that? What do you see as the activity today, and where do you think it's going?

David Golub: So, let's go back in time. So in June of '22, we'd seen a big increase in interest rates. We'd seen a swoon in public equity prices and this gap developed between what buyers thought businesses were worth and what sellers thought businesses were worth. And that gap has driven the relatively slow M&A market of the last almost two years. Usually when this happens, in my experience over the last few decades, it takes six months to a year for there to be a recalibration. And what we're seeing this time that's interesting is we're almost two years in and the gap's still there. Is it better? It's better. In Q3 of 2023, in Q1 of 2024, we saw a higher level of M&A activity than we'd seen in the prior period. We're continuing to see some improvement in Q2 '24. I think we'll continue to see that improvement through the rest of the year, but we're not at normal. And I think the key to getting to normal is going to be reducing some of the sources of uncertainty. There's ample financing available right now. The problem is not an absence of financing. The problem is that buyers want to base their price on an EBITDA path that just looks lower than the EBITDA path that the sellers want.

Peter Antoszyk: Do you think we need a recession to reset buyer and seller expectations?

David Golub: No, I think without a recession we'll see a recalibration happen. It will just maybe develop in a different way. It may take a bit longer. I think the recalibration happens by the early part of next year, regardless of recession. I think the driver of it is motivation. Let me explain what I mean by that. There are a lot of private equity firms with investment periods on their private equity funds and they're running out of time. They need to be deploying capital at a more rapid pace than they've been deploying the capital or they're literally going to run out of their investment period without spending their capital. We also have a set of private equity firms who want to go back and raise a new fund, and they've been told by their investors, "Hey, we love you, but you've got to send us back some money before we can commit to your new fund." So, we got motivated buyers and motivated sellers just in the private equity community. On top of that, you've got family-owned businesses where we have a couple of years' worth of pent-up selling demand. So I think there's a lot of reason for optimism about M&A getting better. I just think it's a question of time. How much time is that going to take?

Peter Antoszyk: What are the implications of that pressure that that you've just described on the private equity funds to transact, whether it's on the sell side or the buy side? What are the implications for private equity funds under those types of pressures that you've just described in terms of their performance?

David Golub: So people have been predicting the fall of private equity returns for two decades. I mean, literally you can go back and look at consultant reports and see year, after year, after year: oh, this vintage is going to be, but this vintage is not going to be as good. The truth is that, if you go back and look at the data, while there's some differences from vintage to vintage and private equity, private equities outperformed by a significant margin and —

Peter Antoszyk: Outperformed relative to what index?

David Golub: Relative to public equities. It's outperformed significantly and if you are smart enough to be able to manage your portfolio of private equity managers to exclude bottom quartile managers, it's outperformed by a lot. I think the prospects for private equity outperformance prospectively remain, remain very good. And the reason I think that is, is because the other two forms of ownership of businesses are so bad.

So think about the value proposition of being a public company 20 years ago. If you were public company CEO or CFO the promise was your stock was going to be liquid, you were going to be covered by some really smart research analysts who are going to help you get the word out on what you're doing and why you're doing it. You're going to be able to issue new shares if you wanted to, an attractive valuation. Well, guess what? Unless you're a multibillion-dollar company today, you have none of that. You're trading volume is low. You can't really move shares. Your valuation is not exciting. The research analysts have been defunded by the consequences of Sarbanes-Oxley and Dodd-Frank. So the value proposition of being a public company today, unless you're multibillion dollar scale, is just not there.

If you're a family-owned business, that's great if you're the founder, but imagine a business that's two generations from the founder. Now you've got a couple of kids each generation. You've got eight people trying to figure out who should be the CEO, what should be the strategic direction of the company, who should work in the company and who shouldn't. What distribution policy should we have? Gosh, that's hard. That sounds like a recipe for some bad Thanksgivings.

So, private equity is not an unflawed model. There are flaws with the private equity model, but gosh, having alignment around success of the business, having professionals focused on buying great companies and figuring out what they need to get even better. It's proved to be a very durable and successful model and I think will continue to.

Peter Antoszyk: So you've been around the block a few times, and I'd like to get your views on what you see as emerging trends in private credit or even private equity since the two industries are so synergistic. What would you describe as some of the not so obvious emerging trends?

David Golub: Both industries are maturing, Peter, and with maturation you tend to see some similar threads across a wide variety of different industries. I think you'll see these threads in private credit and private equity. One of the threads is growth in scale. So the leaders in both industries have gotten much bigger than I think many of us would have predicted five years ago. I'm going to go out there with a prediction. I think they're still small compared to where we're going to see scale go over the course of the next 10 years. International: I think you're going to go from having players who are focused on one market to players who are global. I think you're going to see more overlap between private credit players and private equity players. Not to say that we won't continue to see some boutique players who are only one strategy, but we're probably going to see the growth of some multi-strategy large players.

On the investor side, likewise, I think there's some maturation trends that, that are predictable. One of them is that large investors are becoming more sophisticated. And we're demanding. And with that, it drives some of the scale issues on the manager side because it's hard for small firms to manage some of those demands. But you're going to see more large, sophisticated investors driving co-investment, driving arrangements with managers that look more like strategic partnerships than they do like old fashioned GPLP relationships.

At the same time, we're going to see the continued development, I think, of a profoundly large retail market for alternative assets. It's already started. This is not something that's brand new, but if you look at penetration of alternative products and in particular private credit and private equity in the portfolios of wealthy individuals, wealthy families around the globe, we're still at the very early end of that trend.

Peter Antoszyk: Do you expect to see a consolidation in the industry on the private credit side?

David Golub: So, if by consolidation you mean that the big get bigger, the big develop a larger market share of the whole, I'd say not only do I expect that, it's already happening. It's already happened to a significant degree. The large players in private credit in the last five years have gotten much, much larger and I think for good reason. I think they're big advantage is to scale.

Peter Antoszyk: So this has been a great conversation and I very much appreciate you joining us on *Private Market Talks*. I just have a couple of questions to wrap up. The first is, looking back over the past 30 years — this being the 30th anniversary of Golub Capital — in the amazing success that you and your brother have enjoyed building one of the leading private credit platforms from ground zero in an industry that we talked about earlier — that pretty much didn't even exist 30 years ago — what would you be most proud of?

David Golub: The thing that by far I'm most proud of Peter, is the people and the culture that we've built at Golub Capital. It's an astonishing group. And just every day I go in and it doesn't go away. I kind of have to pinch myself about the fact that I have the opportunity to work with the team that we've got.

Peter Antoszyk: If our successors were sitting here 30 years from now, what do you hope that they will be saying about Golub Capital?

David Golub: Since the beginning, we've focused on a culture around two words: gold standard. And what we mean by gold standard is that we treat all of our partners the way we would want to be treated if we were on the other side of the table. It's about win-win. It's about nurturing long term, mutually advantageous relationships. My hope is that we're able to sustain that. I think if you look at the history of Wall Street, Wall Street used to be like that. It's not anymore. And my strong hope and prediction is that we will be able to sustain that.

Peter Antoszyk: Thank you very much. I think we'll leave it there and thank you for joining us on *Private Market Talks*.

David Golub: Thank you, Peter. It's been a lot of fun and I have to say, huge kudos to you and your colleagues at Proskauer for being great partners of Golub Capital for many, many years.

Peter Antoszyk: Thank you. And thank you listeners for listening to this episode of *Private Market Talks*. If you enjoyed this episode, please be sure to subscribe.

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