

The Insight: Conversations – The Changing Face of Private Credit at Oaktree Conference 2024

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Hello and welcome to another special Oaktree Conference 2024 edition of *The Insight by Oaktree Capital*. I'm Anna Szymanski, Oaktree's Senior Financial Writer. And today you're going to hear all about the present and future of private credit in an excerpt from Oaktree's recent panel, *Thinking Big: The Changing Face of Private Credit*. This panel was hosted by Oaktree Co-CEO and Head of Performing Credit, Armen Panossian. He was joined by Raghav Khanna, Co-Portfolio Manager of Oaktree's Strategic Credit platform. Milwood Hobbs, Jr., Head of Sourcing and Origination. Christina Lee, Assistant Portfolio Manager of Oaktree's U.S. private debt platform. Nael Khatoun, Head of European Private Debt, and Loris Nazarian, Assistant Portfolio Manager across private assets. With that, I'll hand it over to Oaktree Co-CEO, Armen Panossian.

Armen Panossian

Today we're going to talk about private credit, and we've named this session *Thinking Big: The Changing Face of Private Credit*. And the reason that we called it that is because private credit has become a huge asset class. Now, as we look at just the U.S. liquid markets and loans and bonds that are below investment grade, the U.S. private debt markets now rival them. All of them are roughly \$1.2 or \$1.3 trillion now. Now, U.S. private debt was under \$250 billion prior to the Global Financial Crisis, so that's a 5x increase. Meanwhile, high yield bonds and levered loans have about doubled, a little bit more than doubled, since the Global Financial Crisis. We believe that U.S. private debt's going to nearly double again in the next five years, and that's really actually based on third-party Preqin data at an 11% CAGR. We are seeing a tremendous amount of growth, so I think that that \$2.3 trillion target is probably reasonable and might even be understated.

So the structure of today's conversation, we're going to talk about a few narratives that are prevalent in the private credit market today, and then the panel will discuss and debate those narratives as well. And at the end, we'll have a few rapid-fire questions as well as questions from the audience.

The first narrative is that there's too much capital chasing too few deals in private credit. The genesis for the narrative is that there's been all that growth in the assets under management in private credit, have we gotten to the point where it's saturated and there's just too much capital chasing too few deals? Maybe we could kick it off with the panel. Is there too much capital at this point chasing too few deals? Raghav, how would you contextualize this?

Raghav Khanna

The phrase, too much, is obviously subjective. I think there has been obviously a lot of fundraising growth, but it's not just the amount of capital formation in the asset class. I think we also have to look at the type of capital that's been raised. And there has been a significant shift, particularly over the last 24 months, where the fundraising model used to be institutional closed-end funds, where, from a manager perspective, it's pretty easy, or relatively easy, to manage the capital calls with the pipeline that you have. The deal pipeline.

What's shifted now is a lot of fundraising, especially those marginal dollars recently are in the retail channel where flows are raised on a monthly basis. And those dollars have to find a home on a monthly basis. So there can be periods of time where there is an excess of capital versus the pipeline of just general deals or quality deals in the market. I think we're going through that period right now where you are seeing a tightening of terms and pricing.

I think the good news is that, look, markets are generally pretty efficient. Over time, supply and demand balances out. We saw this as recently as 2022 where in the first half of the year where there was a lot of inflows into this channel, I think the folks on this stage here were holding their nose and saying, “Pricing and private credit doesn’t reflect the economic reality or the risks and doesn’t compare favorably to other parts of the sub-investment grade market.” And lo and behold, by I think it was June, July maybe, you started to see those flows slow down and outflows pick up. And by the second half of the year, the market was “balanced,” and pricing was in line with what we felt reflected the risks in the economy. So I think that will again happen. I’m confident it will happen in the next few months or quarters, and you will see a balance in the market.

Milwood Hobbs, Jr.

Look, I think at Oaktree, since I do sourcing, I’ll talk about that. Out of a hundred deals, we’re going to do three or four. Our job is to avoid losses. So really, when you think about private credit and how much capital there is, I think what we try to do is be disciplined around are we pricing capital or are we pricing risk? And I think in today’s market, what you’re seeing is that debate. And what happens is, in this market, everyone, the movie’s good, everyone thinks they knows the ending and so everyone is investing. In 2020, what you saw is, the movie was bad and everybody froze. I think we were probably one of the few firms that actually deployed a significant amount of dollars in a dislocation.

There are moments where the market dislocates, we saw it in Q1 of ‘23. Our expectation is we should see it again because the reality, and I’ll say this, and if you don’t want to hear it, close your ears. Since 2019, the majority of capital structures that were put in place were put in place with 0% base rates. So there is a view presumably that most of those capital structures are over-levered because rates have moved 500 basis points. And so what we’re trying to do is manage for when does the market actually price in that excess leverage on the balance sheets of companies?

Armen

Milwood, do you think that private credit managers will step in and provide solutions to those or is it just going to be disaster?

Milwood

The sort of textbook answer would be, well, if you liked it today at par, you should love it at 80. The reality, what happens is, people wonder if it’s going to go to 60, and so everyone freezes. I think what we do is say, “We liked it at 98. We should love it at 80. We should marry it at 60.” What we try to do in those moments of dislocation is actually take advantage of the fact that if today risk was eight percent and price at six because everyone wants to do it, in that kind of market, the eight is ten because of the volatility of markets, and you can get a twelve or thirteen because no one wants to do it. So opportunistic credit doesn’t have to mean that it’s distressed or over-levered. It could just be a moment where there’s just no one investing.

Christina Lee

But I also think that there’s private credit solutions for some of those deals that were done in 2019. For example, if you did a deal in 2019 at six times leverage, your interest expense has effectively doubled. It’s really hard for a borrower to cover their cash interest. Where we’ve seen more interest and demand is on junior debt, to help reduce the cash burden for a business. And we’re seeing more opportunities there, and that’s a private credit solution for those capital structures.

Nael Khatoun

And I would add that the challenge with these kind of market narratives for Europe is, they really failed to capture the nuances between the different jurisdictions. So if you think about the UK or Germany where private credit has taken maybe 60% of the market, then perhaps some of these comments would be good reflection, or fair reflection, of the market. But look at Spain. Now, Spain today is still 90% bank-led. There’s only been 10% private credit penetration. So in that market, these kind of statements would be purely inaccurate.

Armen

So I guess in a way to summarize this point is, if private credit were purely first lien-sponsored direct lending in new LBOs, if that was purely the narrow definition of private credit, perhaps in short intervals, because of what Raghav was saying, especially with retail fund flows as well as some institutional, it would appear that at least for now there is too much capital chasing too few deals. But as you think about it, as you step back and think about the broader landscape of private credit, things like rescue lending, junior lending, European non-sponsored lending, there are areas that are less efficient, more bespoke, you have to work harder to find the deals, you have to work harder to structure the deals, and avoid landmines. But also, as we look at the maturity schedule over the next two or three years in both private credit and public credit, the need for that type of capital-solution-oriented private credit is going to only grow.

Over the long run, I think even the first lien-sponsor lending, new LBO market needs more capital than there actually is to date. If you look at the amount of dry powder out there in global private equity firms, it's in the trillions. And if you were to assume that for every dollar of private equity dry powder, there needs to be \$1.30 of debt available in the markets, there's a nearly \$3 trillion funding gap that the public and private markets need to fill. The dry powder in the private credit markets about \$400 billion. So it's considerable, but it's nowhere near the trillions that exist in private equity. So over the long run, or the medium to long run, there's still room for growth of private credit to deploy at reasonable prospective returns.

And along the way, there will be periods of dislocation and need for more complex capital solutions. So we are excited about private credit. While we loved the dislocation in the markets in late '22 and early '23, that gave us spreads that were 125 to 150 basis points more than what we're earning today, we have recognized that the tightening of private credit spreads in the market over the last 15 months is roughly equivalent to the spread tightening that we've seen in the public markets as well, both in high yield and in loans. So it's not like one has tightened more than the other. I think generally speaking, there's just a lot more liquidity and desire for credit products given high base rates and given some of that stimulus money that came out during COVID, it has now made its way into the hands of savers. And those savers are really attracted to 8 to 12% prospective returns in liquid and illiquid performing credit these days.

Raghav

Just on that, I think that's an important point, Armen, which is true, private credit has tightened by about a hundred basis points, but because all of liquid credit has also tightened by a hundred, if not by more, you are still earning that illiquidity premium. Going back to, again, the first half of '22, when we were taking a pause, a big pause, as an institution on private credit, the reason was liquid credit was selling off, private credit wasn't. Now, I get that private credit is a slower moving market, but you were getting a negative illiquidity premium, which didn't make sense of course. But from a relative value perspective, today you are still earning, I think, low double digits for first liens, which is very attractive.

Armen

And I think on an absolute basis. I agree with Raghav's point about relative value, but on an absolute basis, given the high cost of borrowing, mainly because of base rates, new LBOs, when they're done, they usually have a greater than 50% equity check. The deals that we're looking at these days are 60 to 70% equity checks, which needs to be the case for the LBO math to work. So to get paid something like 10 to 12% coupon for first lien debt, and this includes large cap lending where the businesses are worth many billions of dollars and you have a private equity firm writing a multiple billion dollar equity check at 60% of the capital stack, it's pretty good absolute return too or prospective risk adjusted return, just given that backdrop.

Raghav

I think the last thing I would just say, and Milwood should chime in on this, is lower LTV, more equity, all of that is true, higher absolute returns, but it feels like the quality of businesses that are being transacted is much higher.

Milwood

Yeah, much higher. And I think asset selection is paramount today. You're seeing larger businesses, larger equity checks, lower leverage. So despite the market feeling like there's a lot of capital chasing it, it should be noted, as Raghav mentioned, that these are what we think are better assets and should perform better through a cycle, larger companies.

Christina

And I also think that there is a supply demand imbalance. M&A activity was down 60% last year, but what we're hearing from our sponsors is their LPs are pressuring them to exit, to return capital, and that should drive M&A volume. And just looking at that chart of the \$3 trillion, about 25% of that is four years or older. And that means that sponsors want to invest that capital before the investment period ends, which again should further drive M&A.

Armen

So the second narrative we want to discuss is the banks, that bank lending is back and competing against direct lending. In 2020 to 2021, private credit accounted for 44% of transaction volumes, whereas in 2023, it was 69%. So as you think about, will that share normalize back to the prior levels? Why don't we kick it off? Who wants to talk about the banks?

Milwood

I'll talk about the banks. So look, the reality of it is in what you're showing there on 2022 is that there was \$78 billion of hung LBO risk in 2022. And I think banks are in the moving business. We're in the storage business, and if you can't clear the pipe, which they couldn't in 2022, they shut down. So that market share movement is the pure shutdown of banks at the end of '22. Today, both markets are pretty open, and I think for us to see private credit continue to grow, we need the banks to be functioning partners. The banks will come in and out of the market. So there'll be moments where you feel like the banks are gaining share or losing share, but over time, I would expect both markets to be balanced in terms of opportunities. The one area of banks that we haven't talked about is the regional banks.

And the regional banks are actually our largest competitor. They used to be our largest competitor in middle market loans. They've got two big assets, commercial real estate and they call it CNI, which is middle market loans. What you're seeing there is they are not lending today because what they figured out with SVB and First Republic is that deposits are actually not that sticky. And what they can't do is they can't actually sell assets at a loss because that will create a capital hole, which creates a runoff on the bank, which the government will have to solve again. So what they're doing is to shrink their portfolios naturally, they're just not lending. So that's actually exacerbating the capital need within small and medium-sized companies and regions which also leads to what's driving part of the asset-backed finance trend.

Nael

And I think just to pick up on Milwood's point, the scope for both banks and private credit firms to coexist in Europe is far greater because Europe has traditionally been much more reliant on bank debt than the U.S. If we think about this year, have banks gained market share? Yes, of course they have, but it's not unusual to see these ups and downs in market share. So they're 20% of the market today. They were 10% last year, but that's still some way below the 40% they enjoyed between 2020 and 2022.

So my view, I actually think you'll see more dual track processes going forward. I think you'll see the banks continue to gain a little bit of market share. And if you take it one step further, one of the interesting things we've seen this year in Europe is that in 27% of all capital structures we've seen both a private credit firm and a bank in the same structure. Now that's pretty unique and that to me says there's plenty of room for both.

Armen

Are they coming in pari-passu or is one junior to the other?

Nael

Typically, one's junior to the other. Typically, the senior banks tend to prefer the RCFs and the undrawns and the private credit sits junior to them.

Armen

What about partnerships between banks and private credit? Does that make sense? We've seen some of those headlines in the U.S. Somebody want to tackle that? Does that make sense? Does it not make sense?

Nael

I'm happy to jump in from a European perspective. One of the challenges I guess for banks in Europe is typically, when you think about the big four banks, for example, in the UK, they capture 25 million tickets each. So they're forced to sit in a syndicate, which means that when push comes to shove and they want to fight for what's important to them, which is services, they have to compete against the other members of the syndicate. In my view, the combination of the services a bank can offer and the capital firepower that a private credit firm can provide provides a really interesting one-stop-shop solution. It basically marries the speed of execution with the other benefits you could get in the syndicated process.

Armen

Loris, you're a recent addition from a bank. What do you think?

Loris Nazarian

Yeah, well, banks are under tremendous pressure with their capital and how they're going to function. And one key consideration when thinking about bank's involvement in the lending market is you are a chief risk officer of one of those banks and you are looking at the amount of balance sheet you have at disposal. And to Milwood's point, you're in the moving business and you need to use that defined balance sheet multiple times, rinse, repeat as much as you can to really generate the fees that's associated with the underwriting of those loans. So the health of how fast you can move that business is very key because you can't be a bank and just sit on that risk for too long. You're taking the risk also of writing down those exposures you have on your balance sheet. You don't want to do that. You don't want to communicate to your investor in a quarterly earnings that you had to do that.

So there's a lot of scrutiny on actually the CLO market who is about 70 to 80% of the broadly syndicated loan market. And every time that someone in global capital markets is underwriting a deal, you have a phone call to the CLO, this is "how are the warehouses going, how is the CLO market going?" So in today's market, the first five months of the year, we were at \$70 billion of CLO issuance versus \$45 billion last year in the same period of time. The market is going well. So banks are asked to put on risk because they have more certainty that they will be able to have those loans absorbed by the market. In downturn scenarios or period of volatility, they'll be obviously more reticent in putting on risk. And that's what we saw in 2020, 2021.

Armen

So that's I think a good way to summarize the banks and private credit tension and relationship, which is the banks are regulated. The banks have some short-term considerations and uses of capital against which they have to earn a certain return. They are also subject to the markets. And whether that CLO market is functioning well means a lot to them. If the bid for CLO tranches weakens, then that kind of has a negative effect on the bank's certainty of placing new loans into the market.

And therefore, I think at this point, private equity firms and other owners of businesses have realized that banks are an important counterparty, but they're not there at all times under all market conditions. So having options matters a lot. Therefore, what we see in private credit is a private equity firm for a large deal maybe one time will go with the private credit market. The next time, if the bank market's open, they'll go with that. Sometimes they dual track between the two to see which one of them makes a little bit more sense. But I think that the private equity firms have realized it is important to have a functioning private credit market and a healthy public credit market as well, and they will support both.

Raghav

Just to maybe add to that though, you kind of have to define what is the bank market. There is the market which we're most familiar with, which is a bank underwrites a loan for syndication into CLOs and that market, I feel like their share will go up and down depending on how much confidence they have in CLO formation and just general public market

sentiment. The other way in which banks compete with us is not the syndication market, it's the buy and hold market where they are actually originating loans, oftentimes syndicating those loans to other regional banks. But generally, those loans are being placed on balance sheet. Now to Milwood's point and Loris's point, because the cost of capital is going up and regulatory costs are going up, that is the place where I feel like long-term, structurally, those regional banks in particular, the smaller banks, will be shrinking their balance sheets. And I think that market share will be picked up by private credit.

Armen

Well, that's a good segue into our next narrative, which is asset-backed finance. Asset-backed finance is nothing new. But there is a narrative here around investors looking at asset-backed finance as a new area of investing. And so the narrative is, is asset-backed finance a transitory opportunity? We'll talk a lot about the underpinnings, but maybe Loris, if you could tell us what is the definition of asset-backed finance?

Loris

Well, the way that we describe asset-backed finance at Oaktree is basically a set of pools of contractual assets with highly predictable cash flows. And it can be pools of loans, leases, receivables, royalties, mortgages. Historically, the way that Oaktree has invested in asset-backed finance is opportunistically, but more recently across different areas of lending, including consumer, real estate, specialty finance, we've seen a number of traditional players in these lending areas who've completely withdrawn from this opportunity set.

So there is multiple ways of investing in ABF now. There was the opportunistic way, there's the investment-grade way where you are senior in capital structure and it's rated investment-grade, but there's a new set of opportunity that is more attuned to a below-investment-grade private credit in this area that's becoming less crowded and very attractive, creates a little bit of diversification as well, away from corporate credit risk or real estate risk because you're investing in a product that's going to pay interest and principle during the life of the investment. It's going to be quite self-liquidating effectively, and you're taking less risk to refinance or relying less on the value of company or real estate at the end of that investment because you're getting that principle over time.

Armen

So Loris, you mentioned that some large players are stepping back from the market. So I guess the question is the private asset-backed finance opportunity, short-term in that these people that are exiting the market, will they be back? Why are we at a place where we do see a durable opportunity?

Loris

One thing to look at is really something that's been cooking for the past 14 years with the implementation of regulations to banking and insurance capital. And especially banks now with the updated capital requirements as well as Basel III reform Endgame, we are seeing a number of banks, regional banks and larger banks, that are the traditional lenders in those areas to completely withdraw from those traditional areas of lending. And that creates really an opportunity for investment managers like ourselves and institutional capital to step in. This is not something in our view that is transitional. I think it's something that will be durable very similar to corporate credit direct lending post-Great Financial Crisis back in 2010.

Armen

What's interesting about asset-backed finance, I think before this regulatory shift with Basel III in Europe and Basel Endgame discussions globally, the market was bifurcating. I think Loris, he talked about it. There was the opportunistic side where you put first-loss capital into an originator, you own a piece of that business, sort of an equity play. You got to really know the collateral well and it's higher risk, higher return.

And then there was the investment-grade part where there were structured securities, good for insurance assets, but there wasn't much of a below-investment-grade category because the banks were providing lines of credit that would sort of absorb all the way down into that what would be below investment-grade other than in probably the more cuspy parts of asset-backed finance, the sub-asset classes within asset-backed finance that had some sort of hair on them, some high-loss

or high-expected loss, consumer finance or just other asset types that maybe were a little bit off the center of the fairway that a bank wouldn't want to finance quite as deep, for example.

So I think from a below-investment-grade alternative credit manager's perspective, the attraction to asset-backed finance is the expansion of particular opportunity where you now have a below-investment-grade opportunity set in a very broad range of underlying collateral, in music royalties and life sciences and equipment finance, shipping aircraft, et cetera. Whereas historically, that below-investment-grade part where you could get a low-teens return usually meant you self-selected to a higher-risk sub-asset class.

Milwood

On asset finance, what's great is that the asset you're actually financing is directly attributable to revenue. So whatever that asset is, it generates revenue or return and what you can do in asset-back is lend against the expected value of that asset. And historically, banks didn't really price the risk of that asset. I think today the reason why we're able to get better prospective returns is one, the banks are moving away from it, and two, you can actually more appropriately price the risk or the opportunity cost of that asset actually generating revenue.

Nael

And I think global strategy in this domain are really interesting because if I think of Europe, Europe tends to lag the U.S. by five years or more generally speaking. And in this particular instance, Europe is far behind in terms of size and penetration of the markets. The flip side of that is the asset-back lending market in Europe is forecast to double between now and 2027, taking it to a trillion dollars and that's pretty exciting. So it's rare that you see these pockets where these type of asset classes provide that type of growth potentially in a short period of time.

Armen

Great, thank you. I think we'll go to some rapid-fire questions and then open it up for the audience. In terms of the rapid-fire question, I got three. Which of these three drivers will have the biggest impact on private credit market over the next few years? Interest rates, regulation, or retail participation in the markets? Why don't we start with Nael?

Nael

Interest rates.

Raghav

Interest rates.

Christina

Retail participation.

Loris

Retail inflow.

Milwood

What? Interest rates. Interest rates.

Armen

Okay, so let's talk about the retail. Why do you both focus on retail versus interest rates?

Christina

I think there's still a significant amount of penetration and what you've seen for certain managers who are really beholden to retail investors and retail inflows, it directly impacts that supply-demand imbalance that we're seeing and the behavior that we're seeing right now.

We're seeing those asset managers where majority of their funding is coming from retail and their significant inflows, they have significant pressure to deploy as soon as those dollars come in. And that drives sometimes what I call more questionable behavior, questionable pricing. As Milwood said, you're not pricing that risk.

Armen

Yeah, look, I would agree with retail as the answer. The reason is I think interest rates, they're high, I don't think that that impacts the market. I think that just generates continued great income. But I think retail, the democratization of the asset class has resulted in changes in behavior month to month that are dangerous.

And by the way, sometimes they go the opposite direction. In early 2022 and into mid 2022, we saw meaningful gross outflows out of those retail vehicles that caused those investment managers that are predominantly focused on retail as their AUM for private credit to just completely exit the market for a period of time. And so they went from writing \$500 million checks to zero very, very quickly and that really expanded the opportunity set. I think if we do see changes in private credit, it's going to be probably because the retail vehicle becomes either more popular or frankly it goes through some of its own testing and volatility.

Raghav

I thought it was interesting no one picked regulation because presumably the question was regulation of private credit, which we all hear a lot, but the regulatory burden on banks is a real thing. Even without that, one of the trends we've noticed, interestingly, this is the magic of bank accounting in the U.S. at least, which is if you made a mortgage when rates were zero at 2% interest rate, now base rates are 5% and the mortgage should be at 7%, you don't have to market below par. You can still market at par.

So now if you have to raise capital, and this filters through to everything we're talking about, corporate lending banks losing share, asset-based finance banks losing share, they have three options. Option one is go raise equity capital, obviously not cheap. Option two is sell that mortgage, which you are marking at par at 80 cents, which is where it belongs now. You take a 20-point drop in your equity and then of course you have to go replace it, raise equity. Third option is don't do anything and retrench, which is kind of what we're seeing right now.

Armen

What were you going to say when I cut you off?

Milwood

So I was going to say, look, I'm going to use an analogy called rain. If it rains every day, but you don't necessarily need a umbrella, at some point the ground gets soft and you experienced this in LA, mudslides, sinkholes. And I think the issue with interest rates being higher longer is that you're creating what could be catastrophe in the ground.

Armen

These were supposed to be rapid fire. I apologize. This was anything but rapid fire.

The next one is, in one or two words, what is the most concerning area in private credit? Milwood, why don't you start?

Milwood

Retail.

Raghav

Don't say asset-based finance.

Milwood

No. He said one or two words.

Armen

This is the most concerning area.

Loris

What's concerning? Yeah.

Armen

One or two words.

Loris

Well, as a lending vertical, I think parts of unsecured consumer lending are of concerns. Not all of them, but some of them. But more broadly across different verticals, I said our ability to get appropriately rewarded for the risk we're taking.

Milwood

That's return is what he's saying?

Loris

Yes.

Armen

Christina, what do you think?

Christina

It's funny. I also agree with Milwood, it's retail. It can be an opportunity, but it also introduces a lot of volatility to the market.

Raghav

I want to plagiarize Milwood in that we are seeing parts of the market start to price in capital that's supposed to price in risk.

Armen

Nice, nice. I like that.

Nael

Well, I don't want to upset Christina, but to me it's troubled junior or HoldCo loans in Europe with no umbrella bankruptcy protection. There's a tough place to be.

Armen

Okay. What are the most compelling areas of private credit now? Nael, what do you think is the most attractive part of private credit?

Nael

We mentioned already, I think the formal link up with banks is a really interesting hedge.

Armen

Raghav?

Raghav

Non-sponsored lending and asset-based finance.

Christina

I'm going to have to oppose Nael and say junior capital.

Loris

I'd say a core ABF below-investment grade.

Milwood

I like Raghav's answer, non-sponsored.

Armen

The only one I would add to that mix, I think all of those sound interesting, but I would add rescue lending to that. Rescue lending is going to be over the next two or three years with the maturity schedules in front of us, the need for large capital solutions that are available quickly with certainty in size will result in those managers essentially writing their own ticket in terms of pricing and legal documentation. So that's kind of on the edge of performing private credit and obviously falling into opportunistic, but I think that opportunity set is, it's kind of like an iceberg. We've only seen the tip and below the surface there's a ton to come.

Moving on to audience questions over the last few minutes. The first one, private credit deal flow seems to still rely heavily on the PE ecosystem. In a world where higher rates reduce the opportunity set for PE, does that lead to fewer opportunities in private credit? Good question.

Milwood

I actually think we're seeing more opportunities in private credit because what you have right now is you don't have robust M&A, you don't have robust equity markets. And a lot of these capital structures have been in place, as I said, quite a long time. So we're seeing refinancings, amend-and-extends, recaps. And so I think the opportunity set is growing and not shrinking at the behest of private equity.

Armen

Maybe one thing I could add, I like the question because it indicates or it suggests at least to me, that private equity returns in a high-rate environment may disappoint or maybe I'm just hearing that because I'm a credit investor. But if that's what is lurking behind the question, I think it's a good question because in a high rate environment, private equity sponsors that relied exclusively on leverage to deliver their returns and an expanding multiple that was also a derivative of rates declining or being ultra-low, I think that those private equity firms will have a very tough time delivering adequate returns over the next several years.

And it could be a reasonable response on the part of the LP community to reduce their private equity allocations as a result. Credit with higher base rates should outperform or provide equity-like returns with the benefit of contractual cash flows. And I think if that happens, in other words, if the AUM of private equity declines, I think it's going to take years and years, obviously, because they have usually five- or six-year drawdowns. But if over the next 10 years private equity AUM were to decline, then I think that that could have a knock-on effect back to private credit. But that's a ways off in the distance.

Let's go to the next question. What do you think about the prevalence of paid-in-kind or PIK in new deals? What about PIK amendments?

Christina

Well, we are seeing more, I would say PIK deals come into play, especially in this higher interest rate environment, especially on the junior side. And there's two reasons for that. One is best-in-class assets are still being sold for very high multiples. And with that and higher interest rates, there's less senior debt they can put on top of a company in order for them to pay their cash interest. And that just leads to a larger middle-of-the-balance-sheet opportunity where you can put a PIK HoldCo or preferred equity in, get a mid-teen pricing on that and still have significant equity cushion below you.

The second area that we've really seen a lot of PIK is again, what Milwood was talking about, the 2018, 2019 vintage where they put in capital structures where interest rates are zero. They can't afford their cash interest anymore. And so can you put in a PIK HoldCo or a preferred equity to pay down some of that cash pay? And there are these companies that are performing just a bad capital structure, but there's still a lot of value to that company that you could put one of those instruments in.

Armen

Raghav, what do you think? I mean, is there risk building up? Is it a bad sign of the market being willing to provide either PIK amendments or PIK in new deals? Good thing, bad thing?

Raghav

No, I don't think it's a bad thing. To Christina's point, there is what I would call a good PIK and the bad PIK. Now admittedly, there is no such thing as good PIK because everyone wants cash, not a paid-in-kind. But the good PIK is LBO sponsor buys a big business. Let's say carving out from a large public company pays 12, 15 times for it. And during the carve-out, they have to stand up their own IT systems, HR, accounting, what have you, while still relying on the parent for that period of time. And they come to us and say, look, we're paying twice as much for let's say a year. Can you give us a little bit of flexibility in terms of cash interest?

So that's a discrete example, but the good PIK is it's time constrained. It's for let's say 12 months, 18 months. It's a small portion of your coupon. So most of your coupon is still in cash and that rewards to full cash at the end of that period. So those are the good PIKs. The bad PIKs are we don't have the money to pay a coupon. So that's kicking the can down the road.

Armen

So just to summarize, it comes down to the actual deal terms and structure, how much they paid for the business, what the LTV is. We have one last question I'd like Nael to answer question is, Europe is a fragmented market compared to the US. In terms of credit, is this an advantage or a disadvantage? What do you think?

Nael

In general, look, you'd expect there to be a slight premium for Europe given the complexity, but that complexity is a friend. So if you're able to navigate that complexity as an example, the lending laws in every jurisdiction are different. Italy may require a banking license. In Germany, you've got things like subordination and so on and so forth. The point being that understanding this complexity is opening up a whole array of opportunity and you're able then to really shift to where the best risk reward is. So today we're seeing some of the most interesting opportunities in Southern Europe, the same countries that were the sick men of Europe coming out of the previous financial crisis because obviously they had less time to take on systemic debt in their economies.

So that ability to navigate where the best risk reward is, is really interesting. In 2013, when we first started, we had a high focus on the UK. As Brexit came along, we shifted from the UK because UK was very difficult to underwrite. And Germany, which previously coming out of the financial crisis was leading Europe out of recession, started to slow down. We saw opportunities in Germany. Through COVID, we saw some really interesting opportunities in the Italian hospitality sector. So if you're able to navigate what for others is a barrier to entry, it opens up a really interesting playing field really.

Armen

Well, we're out of time, but thank you all for joining us and thank you to the panelists.

Nael

Thank you.

Raghav

Thank you.