Five Questions

Episode Seven | Private Credit: Not Just for the Dinner Table

Pete: Hi, my name is Pete Mann, and I'm the President and co-CEO of Grayhawk Wealth. Welcome to the second season of our podcast, Five Questions, where we'll see one partner at Grayhawk paired up with another to touch upon relevant topics as they relate to the economy, investments, and generally what's going on in the world as we see it. And sometimes we'll invite special guests to join us so you can also hear their views. With me today is Greg Gipson, Grayhawk's Chief Investment Officer, who's responsible for shaping our investment philosophy and portfolio strategy. So, Greg, how are you this morning?

Greg: Doing well, Pete. It feels like the weather has finally changed and I know in season one, we said don't talk about the weather, but I feel like this winter was so long that it's nice to finally have blue sky and sunny days here, at least in Toronto.

Pete: Yeah, that's great. It's brutal on many fronts, as people would say. And we have our first guest with us today and none other than our Senior Research Analyst, Ben McLaren.

Ben: Pleased to be with you. Thank you.

Pete: We're thrilled to have you and Ben's going to be a big part of our conversation today. Our topic is Private Credit. We think this is a wonderful opportunity. We've mentioned it in many podcasts. We thought we would delve in and get a little bit more detail as to what the makings of it are, how it's constructed, what are some of the risks, how can people think about this as a part of their portfolio? But Greg, maybe why don't we start out at the very top of the house, explain, please what is private credit?

Greg: Private credit is one of those terms that we use in the financial industry that can often seem a bit more complex than it is. So, in a very simple way, private credit is exactly like it sounds. It is the private sourcing of capital to businesses, both public and private, in order to secure capital, to fund future endeavors and future growth. The explosion of private credit really has come about since the great financial crisis. So, through many regulations that came out, such as Dodd-Frank, it really forced traditional banks to curtail their lending, improve their capital structure, and really retreat from areas of the market that may have the potential for higher risk. This has enabled private firms, many of the largest in the world, to step in and be that lender at times may be the lender of last resort for companies that are looking to secure capital.

Pete: Thank you for that, Greg. Ben – maybe let's pull you in on this because you've had a lot of experience around private assets and private investment in your career. So, let's talk a little bit about what would be the ideal private credit investment? How would we think about that in terms of the risk associated with some of the things attached to it?

Ben: That's a great question. I think private credit spans a very broad spectrum, and there are some areas of private credit that we wouldn't look to touch, but there are some that are very intriguing. Direct lending, for example, is the ability to direct lend to very interesting companies that are unbanked. Now, this might be because they're a little bit smaller and can't access public markets directly, and it could be for other reasons due to complexity. So, I think a lot of diligence needs to go into it. But at the end of the day, a lot of private debt is about driving better covenants, therefore safety and better returns through a dislocation to market being unbanked. And that to me is what's very interesting about private credit.

Pete: Great. Ben, thanks so much. So, Greg, why don't we talk a little bit about the how and the why? Why is it that companies use private credit? Ben alluded to some of the challenges that some of these companies face, but maybe you can delve in a little more detail.

Greg: Excellent answer by Ben. And really, why would companies use private credit? And there are many different reasons, but perhaps they can all be qualified into four different pillars. The first, ease of execution. So once a company has a relationship with a firm that they're able to secure credit that provides an ongoing opportunity or return to source capital. There's the ability to maintain confidentiality or privacy. So, in the private markets, companies that are perhaps doing very interesting work don't want some of that to make its way into the public markets. As Ben alluded to, there's an ability to really be customized source of capital as well. So, a company is able to access very bespoke and very unique and individual solutions that are tailored to meet their specific needs. And the fourth is the certainty of execution. So, while private markets have an extremely long and perhaps rigorous approach to due diligence, the ability for a firm to source capital with certainty without influence by the volatility of public markets can be quite compelling.

Pete: So, Ben, maybe jumping in behind Greg, let's get a little bit more detail around this notion of complexity and flexibility. Obviously, we realize that a number of companies having a more challenging access to capital. So why it would make sense for them to be borrowing money in the private credit market. But maybe you can talk about some of the advantages associated with that for said companies.

Ben: Absolutely. So, the advantage for certain companies is that there's an ability to kind of think outside the box and deal with people that understand you and your business. And sometimes when you go into a bank, you have to be within the box, whether it's size or scope, maybe you're expanding to a new geography, or maybe you have an existing manufacturing plant or you want to have different lines in it. And so when you expand, sometimes it's very difficult to fit within the box. And so having partners that understand your business and are willing to do thorough due diligence and put covenants around your protections

Greg: Yeah, I think we've spoken in the past on other podcasts about boxes and how the human mind always wants to put things in the boxes, so they understand or believe that they understand what something is. And within the traditional banking sector, they're solving the mass problem. So, they're solving the problem for the most number of parties. So, on average, their business grows. The challenge for many of these companies is, is they don't quite fit into the box that traditional banks are looking to fill. And that's really where the opportunity is for the private credit industry to step in and fill that gap for these companies that have capital needs.

Pete: OK, guys, thanks very much. So now let's turn this narrative and talk about it from the perspective of the investor. So why should an investor, Greg, be looking at investing in private credit?

Greg: Why should investors look at private credit? Really, the four main reasons that are consistent with any private asset class. The potential for higher return, improved portfolio diversification, reduced correlation, or reduced-price movement with public markets, and with private credit specifically, the ability to bridge the income gap between where interest rates or yields in public markets are and what can be achieved in the private market.

Pete: So, Ben, there's a specific component of this that I'd really like to dig into, and this is this notion of mark to market. Greg alluded to it through lower volatility and less correlation with public market, fixed income, or credit. But perhaps you could talk a little bit about what that component of private credit is and why it's so beneficial to the average investor.

Ben: So, you don't have to listen to the day-to-day noise of public market pricing. And you can be essentially a submarine and pop your periscope up once a quarter and see what's going on. So, you aren't subject to the same volatility as public markets. And you can concentrate on what is going on in the underlying business of a company, who is essentially your partner at that point. You can have monitoring conversations, daily if you want, but probably periodically throughout the month and assure that KPIs are being met through covenants. So, there is a lot more transparency in certain aspects and there is less volatility.

Pete: So, Greg, the obvious question would then be, why don't I just do this myself? There's all these peer-to-peer lending channels. You know, there's lots of people out there that I know a little bit about their business. I could easily give them some money and probably charge them a higher interest rate. So maybe you can tell me a little bit about why I shouldn't just do this myself. Seems pretty straightforward.

Greg: Everything is straightforward and until it isn't. Now I would draw a distinction between private equity and private credit. Similar to other private investments. We view the four main challenges to investing in private credit as due diligence, access, portfolio construction, and liquidity. So as an equity stakeholder, you'll often have rights to certain assets of the firm that in the event of bankruptcy could be sold in the market. So, there is the potential for a recovery in an event of distress. In the private credit space, it's entirely possible that the money you lend disappears. And we've seen a number of those cases with firms here in Canada as well as in the U.S. And so having the ability to assess and analyze opportunities is critical in private credit. So, you will often see extremely attractive interest rates married with words like levered or distressed. And so, the potential of return is there but the level of risk that you're taking is quite high. In that vein, it's often best to partner with firms, large established firms with long track records of lending to companies, both public and private. So, remember, private credit doesn't mean private firm, it just means not listed. So, partnering with the large asset managers like an Apollo, like an Oak Tree, really can provide you that assurance that the due diligence they're doing is robust and you're able to leverage their expertise in order to gain exposure to this asset class.

Pete: So, Ben, you have been at the heart of the construct of Grayhawk's private credit portfolio, which we're launching soon. Why don't we talk a little bit about these two main elements around portfolio construction and liquidity?

Ben: Absolutely. When constructing a portfolio, it's important to have best in class managers that due diligence properly and build out a portfolio in the right way. Diversification is not about choosing 20 names and allocating 5% each. It's about finding a mix of uncorrelated assets and collectively reduce the volatility within a portfolio. Private credit is an alternative asset class. It provides another tool in the toolbox to help achieve this diversification. Best in class names are what we look to invest in, that do fulsome due diligence and have pipelines that encompass the best opportunities and are able to drive top market returns with the least amount of risk. That is what we're searching for in the portfolio.

Pete: Well, and, you know, it's so interesting because, Greg, that really gets into the heart of what you were referring to earlier around access and, of course, the due diligence process. So, there are two levels of due diligence, obviously, that are needed for an investor. The first one, obviously, is that the manager level, determining where they will invest in each private investment opportunity. And then there is the Grayhawk or someone like Grayhawk's role, where their focus is predominantly on assuring that the managers that are being used have a historical track record and as you pointed out Ben, a terrific pipeline that enable them to continue to be able to deploy capital and how that portfolio gets constructed is essentially the basis of where risk minimization comes for the client itself.

Greg: Investing is about answering questions. So, in this case, what questions are answered? Can we invest? Should we invest? How do we put these things together? How do we get our money back?

Those four questions apply not only to private credit, but also private equity, public market equity, really any asset class. And what we're striving to do with our approach to private credit is to build that diversified portfolio by allocating risk to more stable investments like mid-market lending and then applying a certain portion of our risk or capital to higher returning potential opportunities like specialty finance. So, think of music royalty, movie royalty, those types of opportunities that can add value but should not be a material portion of your private credit exposure given the volatility or risk of that asset class.

Pete: So, Greg, maybe as a final question, there's been a lot of news lately around private credit slash private debt investors that have made very concentrated levered bets within their portfolio. And many of those have obviously ended very poorly. I'd love for you to talk a little bit about what it is that we are ultimately trying to solve for at Grayhawk as it relates to diversification and portfolio construction.

Greg: Our objective from a portfolio construction perspective is really to minimize the impact of any one investment that any one manager is making. As you mentioned, Pete, there have been instances of highly levered firms lending money to families and friends in a very concentrated portfolio and that is an extreme level of risk. Our goal is to minimize that risk potential, partner with world class managers and provide them the discretion to leverage their infrastructure to make investments across a broad array of companies and a broad array of sectors so that our investors are gaining exposure to the asset class and not to any one opportunity with any one manager.

Pete: Well Ben I'd just like to thank you so much for joining Greg and I today.

Ben: It's been my pleasure. Thanks for having me.

Greg: Thank you so much for joining us. We look forward to joining again in the future. And really displaying a level of expertise and understanding of private markets that we're looking to bring to our investment process.

Pete: Well, that's it for this episode of season two of Five Questions. I'm Pete Mann, President and co-Chief Executive Officer of Grayhawk. On behalf of my partner, Greg Gipson, our Chief Investment Officer, we want to thank you very much for listening. We'll be back in two weeks with a new episode. This podcast is for informational purposes only. It is not meant to be relied upon for investment or tax advice. It is the opinions of those on the podcast and does not necessarily reflect the opinions of Grayhawk Wealth. If you'd like to offer any feedback or pose a question for inclusion on the podcast, please reach out to our Chief Experience Officer, Allison Comeau at acomeau@grayhawkweatlth.com. Look forward to chatting again in a couple of weeks.