

Goldman Sachs Exchanges

The case for private credit

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Allison Nathan: The rise of private credit has become one of the biggest stories in global financial markets and has led to significant changes in the ways investors allocate their portfolios and companies raise money. So, will the increasing uncertainty about the economic outlook reverse this trend or accelerate it? I'm Allison Nathan and this is Goldman Sachs Exchanges.

Today I'm joined by James Reynolds, global co-head of private capital in Goldman Sachs Asset Management and by Lotfi Karoui, our chief credit strategist and the head of credit, mortgages, and structured products research.

James, Lotfi, welcome back to Exchanges.

Lotfi Karoui: Thanks for having me.

James Reynolds: Thank you.

Allison Nathan: Lotfi, lots of volatility in the markets right now. But today we're going to focus on private credit markets. So, give us some context. How much has the asset class grown in the past few years? And what's really driving that growth?

Lotfi Karoui: Well, it's been in focus because it's a young and new asset class that has experienced dramatic growth over the last 15 years. And so, I think the reason why it's attracted so much attention is that everyone is expecting to see how it behaves in a full-blown sort of recession or a cyclical downturn.

But let me take a step back, actually, and kind of define what we mean by private credit. If you define it as any sort of debt claim that is privately negotiated, without any third party being involved, such as a bank, the total AUM if I use a conservative estimate is probably to the tune of 2.1

trillion. So, that is smaller than private equity which is over \$11 trillion. But that is on par with comparable public debt markets like the high yield bond market, for example, or the BSL, or the broadly syndicated loan market.

And so, private credit if you define it that way, has unquestionably grown into becoming a distinct and scalable asset class for most asset allocators globally. That figure in 2010 was less than 100 billion, just to put things in context.

What type of strategies does that involve? Obviously, corporate lending is a big part of it across various parts of the capital structure. So, senior direct lending is a big component of it. But also, mezzanine, distressed, and special situations. And to that I would also add real estate and infrastructure. So, you put all that together and you get that 2.1 trillion figure.

Allison Nathan: Interesting. James, you've been at the forefront of this asset class's growth. Tell us a little bit about your role, what you do at Goldman Sachs related to this, and how private credit has changed over the past few years from your seat.

James Reynolds: So, I oversee the private credit business within Asset Wealth Management together with my co-head Vivek Bantwal. And by the way, I've been doing private credit for the last 25 years. But at Goldman, we've been investing in private credit since the mid '90s pretty much.

You ask about what has changed over the past few years. Certainly, we've seen a lot of growth in the past 25 years, but also really in the past five to 10 years. A lot of this growth is associated with the growing acceptance of private credit as a solution for the borrowers, for privately owned companies and in particular for the ones that are owned by private equity firms. And the reason for that would be what private credit can bring to the table, which is certainty. And again, in a world of volatility, that certainty of funds is something that is very important for the owners of these businesses, but also flexibility, confidentiality, the ability to move fast, creativity, flexible capital.

And so, for all these reasons, we've seen really a growing acceptance of private credit as a solution for the borrowers. And I'm talking now sub investment grade. And those same attributes that have helped propel direct lending at the

forefront, we're now also seeing it in the IG business. And so, mostly I would say driven by insurance companies that are attracted by the benefit of privately placed financing, but this time around for investment grade borrowers.

Allison Nathan: So, if we do think about the markets today, obviously, exceptionally volatile. Fears of recession are growing given the volatility in policy and the behavior of markets. Lotfi, talk to us what that is doing broadly in the credit space. And in the private credit space in particular, how exposed is it? James just said it's a place where you can find more certainty.

Lotfi Karoui: Yeah. I mean, look, by design, private credit and private markets actually more, generally, are insulated from these fluctuations in sentiment. And actually, if you look back the last couple weeks, that's exactly what we've seen. We've seen a repricing of risk premium across the board in public credit markets, in equities everywhere you look off of levels that were historically quite expensive, because actually as violent as the price action has been the at least three to four weeks, if you look at basic valuation metrics on the public side, this is still not a cheap market.

If I look at public IG spreads, they're still below their medians of the last 35 years. So, we're not even close to pricing in the beginning of a recession. But we definitely broke out of the range.

And actually, even if you look at the real economy, most of the deterioration has been in the survey data. And that's also sentiment. Actually, the irony is that the hard data looks pretty okay. We had a pretty robust, actually, payroll report last Friday. And so, we have yet to see signs of deterioration in the real economy. And that's when private markets and private credit will respond.

And so, until you see signs that this sort of weakness in sentiment is translating into weakness in the real data or the hard data, I think private credit will remain insulated by that.

Allison Nathan: James, how are investors responding in private credit from your observation?

James Reynolds: You know, a moment of volatility like we're seeing today, or we saw in '22/'23 or during Covid, I would say our investors, especially the ones that have

locked up capital in closed-end funds, they see credit as being very defensive. And the ability also to get access to cash pay and regular distribution. And they see private credit as being a good hedge against potential inflation as well, given that most of what we do and we lend to a borrower is exposed to a floating rate.

And so, as we go around the world and we speak to pension funds, insurance companies, sovereign wealth funds, I would say they are very constructive about private credit. And we've seen over the last decade a pivot towards exposure from public credit to private credit. And again, here I'm referring to sub-IG.

I would say another trend in the last decade has been the availability and the creation of these open-ended evergreen vehicles that are giving access to mass affluence or wealth management investors starting with the BDCs or business development companies in the US. But also, similar type vehicles outside of the US.

It's a bit of a newer, I would say, history here for these vehicles. But certainly, we see a lot of interest, in particular when times become a bit more volatile, we see a lot of

interest towards private credit.

And then I mentioned on the investment grade side, what we're seeing now is a pivot from insurance companies in particular, from portfolios that are entirely public fixed income, towards portfolios that are more balanced between public fixed income and private credit.

And the one thing that I would add to what Lotfi said earlier is, again, if you step back and you look at private credit, the performance of these platforms and these funds is solely linked to the absence of what I would say, losers or default and subsequently losses. And so, these portfolios tend to be relatively defensive, certainly when it comes to the sectors in which private credit invests. They tend to be shying away from what is a bit more cyclical, maybe a little bit more exposed to market volatility.

And so, if you step back and you look at the last decade, these portfolios have performed relatively well at times of increased volatility.

Allison Nathan: At the end of the day, we're just talking about the debt of privately held companies. And these

privately held companies are also going to be exposed to a lot of the risks in the world today. So, talk to us a little bit more about the structure, for those of us who do not live and breathe private credit, the structure of these transactions and these investments that really do shield from volatility.

Lotfi Karoui: Yeah, I mean, look, on the fundamental side, of course you're not insulated from the world in which earnings growth contracts and the economy slows down and the unemployment rate rises. Now, the reality is we've never really tested what that looks like for the asset class because it's a relatively new asset class. The last real recession that we had was 2008/2009. Back then, the asset class was actually quite small.

Covid is an interesting case study. I would argue, personally, that it's a pretty unique shock to be honest because it was very short lived. And then more importantly, it was followed by a spectacular policy response, both on the monetary and the fiscal fund. So, it's really hard to look at a data point and say, okay, this is how the asset class will perform if the economy goes into recession.

I would offer two observations. The first one is that at least as far as direct lending is concerned, direct lending is part of a bigger umbrella, and that's leveraged finance. Losses and defaults do go up every time you have a recession. So, it shouldn't come as a surprise that whenever you see a cyclical downturn that you'll see some pressure in terms of losses.

Now, the question in my mind is how will direct lending do relative to other adjacent markets on the public side? And that's really the high-yield bond market and the broadly syndicated loan market, where you could argue you have four decades of history actually. You know exactly how things play out.

I agree with James. I think there's more flexibility on the private side. And so, you can reduce frictions that typically arise when you have rising financial distress. And so, whether it's cost of bankruptcies or challenges in coordinating among the creditors, etcetera. So, that's one, I think, positive aspect that plays in favor of private credit.

Two, there is a misconception. I think a lot of people think of private credit as being more cyclical, lower quality. It's

smaller issuers, yes. The bread and butter is still for the most part middle market. But I completely agree with James. If anything, it's actually more defensive than a lot of parts of public markets, certainly in high yield which is 14 percent commodities exposed in the broadly syndicated loan market.

And then I think the second important nuance that I would highlight is in aggregate losses will go up across the board in a bad state of the world with the economy in a recession. I guess the one difference between private and public is that on the private side, those losses are going to be very unevenly distributed. And what I mean by that is that a full-blown default cycle will likely catalyze a lot of dispersion across managers on the private side in a way that you will unlikely see on the public side. Why is that the case? Because on the public side, there are well-established benchmarks that fund managers are trying to beat. And so, there is a high yield index that as a fund manager on the public side you're trying to outperform every year. There is no analog to that on the private side.

And so, it's hard to find sort of two private or direct lending portfolios that kind of look alike a little bit. And so, from

the perspective of a capital allocator, I would say that makes manager selection a far more important ingredient than on the public side. And I think one of the outcomes of a full-blown recession is basically this idea that dispersion is going to go up across managers.

Allison Nathan: And so, James, if you take what Lotfi just said, are there particular areas or sectors of the market that look compelling right now relative to others?

James Reynolds: And by the way, I fully agree with Lotfi about the likely dispersion amongst private credit platforms. And I think we're already starting to see in areas where we track, for instance, situations where a direct lender has taken the keys of an asset following a debt-equity swap or restructuring. And what we've noticed, by the way, is that in Europe, for instance, these situations tend to be with companies of smaller size, and they tend to be in sectors that are more cyclical. And they tend to be, for instance, buyouts that were consummated pre-2019. So, the whole kind of vintage of '16 to '19, it takes about four to five years, effectively, for a discussion between the lender in a private equity owner to materialize into a hard default. And we're starting to see those situations in the

sectors that I mentioned.

Where we find opportunities today, I would say, we continue to think that there will be opportunities in particular as volatility comes back in the market in our core business, which is senior direct lending. In the US, in Europe, to a lesser extent in Asia because that's a smaller market. Why is that? Because again, if you can provide certainty to a private equity owner or to a borrower that needs capital to acquire maybe a smaller asset, that certainty is going to be even more critical.

And we saw it in 2022. The M&A volumes came down in '22. But the market share of private credit increased to a very high level. And in particular, in Q2 and Q3 in 2022 there were very few deals underwritten by the banks. And that's in particular in particular in large cap, large sized buyouts. So, that's one.

I would say the strategies around junior debt, flexible capital, creative solutions whereby you can provide capital to borrowers, good companies, but maybe they need a bit more time, in particular in an environment like this one because IPOs may be delayed or an exit may be delayed

and the owners of these businesses need more time to create value within that asset, I think we're starting to see an increasing number of situations around the world where our capital can be very helpful to these borrowers and the owners of these businesses.

We see opportunities around energy transition. We see opportunities in the investment grades around this kind of pivot that is happening between public fixed income and private credit. By the way, today you can replicate a portfolio of public fixed income. You can replicate it almost entirely on the private side.

Allison Nathan: Interesting. So, as James said, there's a lot of opportunity in private credit markets today. But Lotfi, we do hear a lot about systemic concerns around private credit that too much risk is being accumulated there, in part because it's less transparent than public markets and other parts of the market. Is that concern about risk, which could spill over to other parts of the financial market warranted?

Lotfi Karoui: We've been pushing back against that narrative. Obviously, again, I said it earlier, private credit

as an asset class is not immune to a cyclical downturn. And so, we have to define what the risk is. Are we talking about a risk of increased losses in direct lending portfolios? I think that risk is of course there. The risk profile of the asset class is very linked to the state of the economy, etcetera. But if we're talking about the risks to financial stability or what you refer to as systemic concerns, I would push back a little bit because to me what is the counterfactual to a world in which an asset manager is lending to a middle market company or increasingly, as James was saying, to a large-cap company?

The alternative to that would be a world in which that role is taken on by a bank, basically. And so, I would argue that an asset manager doesn't have any mismatches between assets and liabilities. You take the capital from the LPs and then you deploy it generally for the same duration. And so, there's no misunderstanding there. Leverage is of course there. But it's used in a pretty reasonable dose. I mean, I'll take the BDCs as an example. There are legal caps on leverage. But it's typically 2X. And most BDCs actually never exceed 1.5X.

And so, I struggle a little bit to see some of the amplifying

channels that we had back in 2008/2009. And those were really mismatches between assets and liabilities, or call them liquidity mismatches, and then leverage. Those two amplifying channels are just not there today. So, I do think that those concerns are overstated to some extent.

And I also think that oftentimes, unfortunately, there's a bit of a confusion between cyclical risks, the risk of a rise in defaults and losses, and then risks to financial stability. I think risks to financial stability are largely overstated. The best example I can give you, and I think we had a conversation about this in March of 2023 when we had a regional banking crisis, if that crisis had happened 15 years ago, where you have, like, failures of two, decent-sized banks, the odds of a recession would have increased dramatically, in my view, because people would have looked at things like the senior loan officer survey and credit availability, etcetera, and you would have most likely a credit crunch and eventually a recession.

We did not have that in the aftermath of March of 2023. And I think part of the reason why we didn't have it is because private credit has acted as a very solid line of defense against the risk of a credit crunch, in my view. So,

the fact that credit has been disintermediated away from the banking system is in some ways a good line of defense against these sorts of fluctuations in the business cycle.

Allison Nathan: And the lower transparency doesn't bother you because of all of these factors?

Lotfi Karoui: Again, it's a privately negotiated contract between a borrower and a lender. And the lender is obviously acting in the best interest of the investor. And so, as long as that triangle, basically, functions very well, as long as information flows well within that triangle, I don't think there's necessarily an opacity problem. But it is a privately negotiated contract, obviously.

Allison Nathan: Very enlightening, Lotfi. Thank you so much. Lots of food for thought. Thanks, James. Thanks, Lotfi. Always a pleasure to have you on Exchanges.

Lotfi Karoui: Thanks for having us.

James Reynolds: Thank you very much.

Allison Nathan: This episode was recorded on Monday,

April 14th, 2025. I'm Allison Nathan.

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