Private Debt Investor

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EXPERT Q&A

The private debt market has changed beyond all recognition over the last decade, especially in Europe, say Ares Management's Mitchell Goldstein and Blair Jacobson

The rise and resilience of private debt

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Q How has Ares' approach to direct lending evolved as more competition has entered the market?

Mitchell Goldstein: While Ares has grown in size and expanded geographically, the core tenets of our approach to direct lending have remained consistent: deep origination capabilities, robust due diligence and long-term, constructive engagement.

When we started Ares in 2004, we had a $160 million BDC and the companies we were able to finance were significantly smaller. As of 31 March, 2023, our global direct lending strategies manage nearly $160 billion.

Likewise, the addressable market has grown significantly in the US – and Europe has followed – as our capital base and presence have grown. Despite global declines in M&A volumes and broadly syndicated lending transactions, we reviewed more than $500 billion of transactions in 2022, which was comparable with our 2021 volume, the best year in terms of opportunity set in the history of our US direct lending strategy.

The market has obviously grown significantly but there is a perception that strong growth means there are more people in the market competing for the same deals, which is the opposite of what has happened. The addressable market for scaled players has increased dramatically, and, in a volatile market like today's, our market share continues to increase. Companies and sponsors realise that while the liquid markets will open and close, direct lenders can offer a consistent, reliable source of capital throughout cycles.

While we have benefited from significant growth, our selectivity has remained the same: we close on 3 to 5 percent of the loans we see and review. In line with market growth, we have invested heavily in our teams: we now have more than 180 deal professionals in the US and more than 80 professionals in Europe.

In the past 19 years, we've participated in more than 1,800 transactions, and we believe that we are much more knowledgeable about industries, becoming valuable partners to the owners of our portfolio companies. In the US in particular, we have identified six

industry verticals where we believe that our focus may lead to real diligence advantages: healthcare, software, financial services, consumer, sports and media, and infrastructure debt.

Q Through the global adoption and evolution of the asset class, what differences are there between the US, Europe and Asia-Pacific private credit markets?

Blair Jacobson: We have just celebrated 15 years of operations in Europe. The global financial crisis occurred shortly after we opened and was a catalyst for the growth of the European private credit market.

We have always viewed the European market as five to 10 years behind the US. In addition to the banks retrenching from lending, just as they did in the US, we saw increased regulation and consolidation and the rapid growth of private equity, each of which has accelerated private credit's growth and gain of market share.

Our conviction in the market has grown alongside this trend. Notably, certain other sources of capital that are sizeable in the US – like listed loan vehicles similar to BDCs, mid-market CLOs or large pools of retail capital – have a much smaller market share in Europe than in the US, so those could also be areas to propel future growth.

Our origination approach is also different from the US. When we invest in Europe, we are investing in many different regional markets with, for example, Nordic private credit varying in opportunities from, say, the UK or Spain. This is both from a relationship perspective and from the legal and regulatory side. We believe it is critical to have local professionals on the ground who know the markets and the players.

Similarly, we see Asia-Pacific private credit as five to 10 years behind the rest of the world and share the same conviction that a growing private equity market combined with a retrenchment of the banks will drive demand for private credit. So we see a lot of exciting opportunity ahead on a global scale.

Q How does a scaled private lender such as Ares manage and demonstrate value through volatile market cycles?

MG: In periods of volatility, a good lender will reduce leverage, tighten rights and remedies in credit agreements and get more selective. Our US and European direct lending portfolios have performed well, but you would expect any company getting financed today to be an exceptionally good credit. We always underwrite on the assumption of a recession one or two years from closing.

This is one of the best markets for direct lenders we have seen in more than 25 years because of the yields we can get, the leverage we are providing and the quality of companies we are investing in.

BJ: We are also in a market where the competitive environment is increasingly favourable for Ares. Particularly in Europe, commercial banks are risk off and the liquid credit markets have limited appetite. Large companies are now turning to direct lenders like us.

Every direct lender is experiencing the current market a little differently, depending on their existing portfolio and their ability to raise capital, but our strategy and capital availability enables us to be active in this favourable competitive environment.

Q With the continued growth of private credit, how does Ares see its relationship with traditional bank lenders evolving?

MG: We seek to maintain strong relationships with banks with insignificant bank funding across parts of our business today. The banks have also changed the way they approach this market. They are increasingly going through direct lenders rather than lending to a $30 million EBITDA company off their own balance sheet.

BJ: The narrative that this is a zero-sum game between banks and institutional direct lending managers is increasingly antiquated. We have cultivated profitable, mutually beneficial relationships with the banking community.

They help finance our funds and assets and can be a source of dealflow for us if there are loans to companies that they cannot hold on their own balance sheet, and we can help them as buyers if they need to move assets off the balance sheet. The banking sector has been under increasing stress in Europe and the US this year, which will likely lead to more regulation and tighter lending structures and create new

opportunities for our asset class and for long-term partnerships.

Q With defaults expected to increase over the coming 12 to 18 months, how does Ares' approach to portfolio management mitigate losses and support companies' long-term growth?

MG: In periods of volatility, you expect more defaults. That said, what separates out successful managers is the quality of portfolio management teams. We have more than 55 professionals globally who are focused on asset management. They are responsible for marking to market every quarter, helping us identify any issues early and leading ongoing efforts to limit losses.

Firms must build strong portfolio management teams and integrate them into investment committees from the early stages to help make the most informed decisions.

BJ: A big benefit of our asset class is that we typically get monthly numbers from our borrower companies. We also have board representation in about one-third of our companies, so we have consistent access to information and management teams. That monitoring has provided a powerful model for capital preservation over time.

Q What can we look forward to as it relates to greater ESG integration in private credit?

BJ: As a firm we have been incorporating ESG into our investment processes for more than a decade. In contrast, in Europe, roughly 20 percent of our sponsors – and 40 percent of our portfolio companies – don't have ESG policies. We believe material ESG factors can lead to enhanced long-term value creation and mitigated risk. To that end, we recently shifted our approach: given we are often providing more than half the capital into certain portfolio companies, we believe we should have more say on ESG and the associated business risk. As a scaled player, we have a level of sophistication that we can bring to bear with mid-market companies. We believe we can be a force for good in an area traditionally considered the domain of private equity.

We have several focuses as it relates to ESG. First, we have evolved from a pure negative screen to a more holistic evaluation of ESG factors, including whether a company is already making a positive impact. Second, we may give companies concrete financial incentives – both rewards and penalties – to improve their ESG KPIs through sustainability-linked loans, where we are a market leader. We believe that achieving ESG objectives could bring tangible benefits to a company, including direct cost savings. In turn, this could strengthen the credit profile of the company and potentially improve the risk-return of an investment.

Third is data. We now track more than 30 ESG KPIs from our companies and are looking at more ways to continue enhancing our investment processes. Ares was asked to chair the UN PRI Private Debt Advisory Committee, helping to build consensus around the information data that managers should be collecting and how it can help to improve risk-return outcomes.

MG: While we have focused on environmental issues, we have also put a lot of work into social and governance. Previously, we relied on banks to train talent for us. But that limited our ability to recruit diverse talent, despite knowing that there were strong candidates out there. So we revamped our hiring practices and are now focusing on attracting and retaining students from a wider selection of colleges and universities that have a strong interest – but didn't necessarily have the same access – as the candidates we'd been recruiting for years. ■

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BLAIR JACOBSON

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MITCHELL GOLDSTEIN

Mitchell Goldstein is co-head of credit and Blair Jacobson is co-head of European credit at Ares Management