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In conversation with

Hamilton Lane's Nayef Perry

With host Pierre Braun, Senior Investment Analyst

Pierre: Today we're chatting with Nayef Perry. Nayef is the Managing Director and Global Head of Direct Credit at Hamilton Lane in the US with almost 20 years of experience under his belt. Nayef is a member of the firm's investment committee. He's responsible for leading all aspects of the firm's credit platform. And prior to joining Hamilton Lane in 2013, Nayef was a vice president in the Leveraged Finance Group of GE Capital in New York. He's currently serving on the board of director for Florida Venture Forum and holds a number of board roles providing advice and strategic insight. In this episode, Nayef will impact the state of the US private credit market, the impact of current events and the potential risk that private lenders and borrowers may face. Welcome, Nayef. Good to see you. Welcome obviously in the Pitcher Partners office today.

Nayef: Thank you Pierre. It's great to be here. It's great to see you again after a year now.

Pierre: Looking forward to hearing your thoughts on the private credit market. Let's start with the basics. You know, what's private credit?

Nayef: As you look at what private credit is, it's at the fundamental core, it's lending. And as you think about in markets like the United States, if you were a middle market firm, you basically get your capital from two sources. So source number one is you go to the traditional channel, which is the banks, and those banks do what's called a syndication process. So they may hold a small piece of that loan on their balance sheet, but ultimately they're beholden to the market, and the investors to take portions of that loan. So we generally tend to refer to that as more the public domain. And then private credit is where a firm like ours will raise investor capital privately and go out and lend that capital to companies.

Pierre: And how is it different to like traditional lending?

Nayef: I think traditional lending is really more the bank dynamic, right? So historically, if you needed capital, you would go to a bank. And again, just being a little bit of a US-centric or taking a US-centric lens to this, if you go back in time a little bit, right, the banks dominated lending in the US you know, 20 years ago maybe they were over 80% of the market. And if you fast forward to today, they're probably less than 20% of the market. And the thing that has really driven that change in market share, where the shift has gone from banks to non-banks, i.e., private credit is really regulation. So if you think about the global financial crisis, what the banks were basically doing during that time period was they were taking depositors' money and going out and lending it. And so they were using short term liabilities to fund longer term liabilities. And as the system got into trouble during that time period, the regulators stepped in and said, "That's something you can't do." And so they started to put, you know, tighter regulation on the banks and that really allowed private credit to really proliferate and open up. And that's really at that point post global financial crisis where we started to see the market shift, and we started to see senior direct lending in particular really start to move from the banks to the private credit channel. And we've continued to see tremendous growth both in senior direct lending and private credit in general, particularly as other flavors, if you will, or other strategies or sub strategies have really made its way into the market.

Pierre: And just from a company perspective as well, what's the benefit of a company or what's attraction of the companies going to the private credit rather than the bank?

Nayef: That's a really important question, and I get asked that a lot from global investors. If you think about the difference between a loan that you get from a bank or a loan that you get from a private credit provider, generally private credit is characterised as being a little bit more expensive. And usually the terms are what we view as more lender friendly. So meaning as a borrower you may have tighter restrictions on your ability to do things such as pay dividends or put incremental debt into your company. And so when you think about that dynamic, it begs the question, if I'm a private equity firm buying a company, and I have two places that I can go get that capital, why would I go to the private credit market when the banks might be a little bit cheaper?

And there are a whole host of reasons as to why a borrower might go to private credit. But generally I would say that the top three that come to mind is number one, relationship is really, really important. So if I were a private equity firm that owns a company, and chances are I might be going through what's called a buy and build strategy where I'm acquiring smaller businesses to go and grow my business, it's much easier if I have one, two, maybe three lenders in my capital structure where I have a relationship where if I want to go get consents to go make acquisitions or I need incremental capital to go do that, it's much easier for me to sit down and have a bilateral conversation with that, you know, relationship or relationships to basically convince them of what I'm trying to achieve and get them on board. Whereas if you went through the bank channel, you may have a hundred investors in that loan who all hold little pieces of that loan and there's really no relationship. So trying to get to the same outcome is a little bit more challenging when you have a disparate group of investors. I'd say the second big thing is just certainty of capital. And so as you think about a private equity firm trying to go out and accomplish their investment thesis, go back in time, right? 2022, 2023, we saw a market where just in the absence of guidance coming out of the US Federal Reserve and other central banks, we saw investors basically leave the market. So the banks didn't have investors to consume those loans that they were bringing to market on the basis of volatility concerns. And so as a result of that, we basically saw the banks sideline themselves for almost two years. And so if you needed capital, you couldn't get it from the banks during that time period if you wanted to go do acquisitions, private credit became a very reliable source of capital. We've seen a similar dynamic in the last couple of months, particularly as tariffs have made its way into, you know, into the narrative. And again, some of that capital has left the market on just uncertainty, but in general, private credit is always open for business because it's committed capital. And so private equity firms rely on that to basically go out and achieve what they're trying to accomplish. I'd say the last piece is confidentiality, and that's a really big one because if you are a company and you need access to capital, maybe because you're buying another target, you may not want your sensitive information or the information on the target that you're buying out in the open market. And so if you go to private credit, you may have one or two lenders that are in your capital structure where you can maintain that confidentiality of information. Whereas if you go to the bank channel, they basically have to push that information out to the market and draw investor interest in those loans. And so at that point, the confidentiality piece diminishes because that information now is out in the open.

Pierre: And just talking about obviously tariffs and you know, trade policy in the US as well, what do you think the biggest implication for private credit?

Nayef: Yeah, I think the biggest threat, if you will, to private credit, and it's not just specific to private credit, but it's a bigger threat to the world is the possibility of economic slowdown that comes as a consequence of some of these tariff wars. And so what that could lead to is potentially higher defaults. And you know, if you kind of go back to what keeps you safe during those types of environments for private credit managers, you know, we think that number one, it's really, really important that you have scale and you have really deep sourcing network, so that you can have access to a lot of deal flow and be very selective and maintain choice. Because if you can see a lot, it means you can say no a lot and you can maintain your selection discipline. And so we think that that's really, really important in terms of navigating kind of the environment and then, you know, and then secondly, I would say beyond just having access to the deal flow, you need to have a good framework for that asset selection that really allows you to maintain a discipline, and adhere to an investment philosophy that you and your group have to make sure that you are keeping investors safe.

Pierre: Are you seeing a bit of an impact on some of the, you know, companies that are in the portfolio?

Nayef: It's interesting because when you look at the types of businesses that we invest in, number one, the businesses that we invest in tend to be very US centric, right? And so what that means is the companies kind of operate within the confines of the United States in large part even though they may have globally connected operations. Number two is we also don't tend to focus on things like consumer discretionary industries where they may have globally connected supply chains where these tariffs could cause disruption to their margins, their business, you know, their cost of goods. And so, you know, if you think about a typical scenario that we might invest in, think of a company like Pitcher Partners, but in the United States, right? We would invest in a market leading sort of corporate accounting firm in the United States where that business has just an incredible recurring revenue profile because those companies have to go through an annual tax process, they may have to conduct annual audits. So these things give these companies tremendous revenue visibility and tremendous stickiness of that revenue. But those businesses are not really subject to some of the tariff noise that we've seen.

Pierre: And obviously with the broader geopolitical tensions we're seeing obviously in the world, are you worried about specific, you know, events or risks for private credit?

Nayef: I think there are a number of ripple effects, if you will, that come from geopolitical risk. Again, I think just given the types of companies we focus on, you know, I would say some, not all of the businesses that we tend to focus on are probably more insulated from some of those, but I think the greatest risk that comes to mind is things like supply chain disruption. And again, a lot of the businesses that we invest in are probably less, you know, dependent on globally connected supply chain, but you can see shipping lines get disrupted, you can see transportation of goods and movement of those goods or sourcing of those goods. Those are the types of things we see that geopolitical events can cause disruption to. And also like as you think about the ripple effects, they happen in other ways. Like we've seen some of the ripple effects manifest in areas like fundraising. So you know, as an example, if you look at what's happened in Israel, you know, I was in Israel not too long ago talking with one of our longstanding investors and that investor was contemplating coming into one of our more recent funds and they basically couldn't digest the due diligence process because the entirety of their team was in the Army Reserves and they were out. So geopolitical events kind of affect our industry in different ways.

Pierre: Interesting and just from obviously talking about disruption and you know, tariffs, and are you seeing more opportunities maybe opening up for private credits as well? Are you seeing more sectors maybe showing or you know, maybe seeing a bit of, you know, changes there?

Nayef: I think it's, you know, if you look at what's happening and you almost kind of put the tariff issue aside for a moment. I think the bigger issue has been, if you look at like a market like 2021, right? This was a record year of deal flow for the world and in the two years that followed particularly LBO activity was hit pretty hard, right? So we saw leveraged buyout transaction just diminish by over 90% from 2021 to 2023. And amidst that transition, if I kind of reflect on our own platform, what was interesting was that we continued to see not only annual increases in deal flow, but we continued to see platform records. And when you look, if you peel back the onion, you look at what drove some of that growth in our volume amidst a backdrop where LBO volumes were pretty muted, it was really three things. And I think these three drivers are going to continue to kind of fuel the opportunity set for private credit. But number one is we've continued to see situations, where maybe a private equity firm owns a business successfully and that company has continued to buy and acquire smaller businesses, at some point that borrower may need access to incremental capital. And we've been in a position to be able to provide that incremental term loan to support that acquisition strategy. So that's been one driver of deal opportunities. I'd say the second one has been just organic recapitalisations. So capital structure needs of companies change, private credit can be a great solution to help companies with those capital structure need changes. And then the final piece is there is a very large and growing maturity wall in our ecosystem. And that maturity wall is basically loans that were previously done that are coming up on their maturity dates. And those loans will need fresh capital to retire that old debt. And so when you look forward at the next few years, you know, our expectation is that there is comfortably over a $600 billion market opportunity just in that maturity wall alone. So we think that those three drivers will continue to fuel the opportunity set even in the absence of sort of this LBO market. I'd say specific to the tariff piece, I don't know that we're seeing necessarily enhanced opportunities, but what I would say is when you kind of go back to my comments at the beginning and your question around where, you know, where do you get capital, right? Is it you get it from the banks or you get it from private credit? The banks have been sidelined in large part in the last couple of months and that generally is a good thing for private credit because as the banks move away, we become the only game in town. And so what that has allowed us to do is it's allowed us to pick up 25 to 50 basis points of incremental spread in this environment. So we think that that's been a neat opportunity coming out of maybe just some of the tariff noise.

Pierre: Yeah, interesting and just, I'm obviously keen to hear your thoughts as well on or insights on default rates you're seeing in the private credit market. Is there any, you know, anything you can share on that front?

Nayef: It's interesting. It's been a very benign default environment contrary to what I think investor sentiment was a couple of years ago. You know, I reflect back on some conversations that I was having with investors in 2022, 2023 as rates were really, you know, starting to rise. And the common question that I got from investors across multiple continents was, you know, if interest rates continue to escalate or increase, is that going to break companies and are we going to see higher defaults? And one of the things we saw in the background was a lot of the stress managers really started ramping up their fundraising activity with an expectation that they would have an incredible investment opportunity in front of 'em. I don't know that that has played out for them. I think when you look at the default data, you know, particularly in recent periods, you know, we've been at a default rate probably inside of about 1.5%. This is against a long-term average, whether you're looking at on a 20 or 30 year basis of somewhere between 2-3%. So again, it's been pretty muted. I'd say the next question is what is the expectation as we look ahead and, you know, I certainly think that it's possible we could see a modest pickup in default activity, particularly if some of the uncertainty prevails in the marketplace, and you know, consumer and corporate confidence continues to wane. But you know, generally the thing that we look at just as a key indicator of future default activity is something called the distress ratio.

And what that is in basic terms is we look at the leveraged loan market and we say how many credits are trading below 80 cents on the dollar, and then we divide that by the total number of credits in the market and that arrives at the distress ratio. And again, when you look at that data on a graph, whether it's the 10 year average, the 20 year average, that distress ratio is comfortably inside that average. And so when you look at that, it doesn't suggest that we're headed for an elevated default cycle. That's one of the things though that we're paying attention to. And I think for investors in private credit, the other thing you can kind of look at is there is this concept called payment in kind interest. And something that I think is becoming more visible to investors is if you are looking at other private credit funds, pay attention to the amount of payment in kind or pick interest in those portfolios, because if you start to see an increase in that payment in kind or pick interest, it could be an indication that some of the companies in their portfolios may be going through liquidity or other issues and that may be signs of stress in their portfolio.

Pierre: Interesting, you lend to private equity sponsored companies obviously, and I'm interested to hear thoughts around, you know, vintage risk and you know, what are you seeing? Are you concerned about some of the vintage risk there for your portfolios?

Nayef: Less so. I think the bigger issue for private equity right now, if you're an investor in private equity, you haven't seen liquidity come back. And that's been a function of just a dislocation in perceptions of value in the market. If you look historically, public equity values have historically traded above private market's values and in the last two or three years, we've seen an environment where the inverse has been true, where private market's values have been trading above public market's values. And so I think a little bit of that imbalance is causing hesitation between buyers and sellers. And so as a result of that, investors haven't gotten capital back at the rate at which they would like. And you see that manifesting in just fundraising volumes globally in the private markets. We've seen three consecutive years of down fundraising relative to the highs of 2021. And so to me that feels like the bigger issue for private equity as opposed to any type of vintage risk in the market. I think when we think about it from a credit perspective, you know, credit is not about upside capture, it's about downside protection. And so for us, we are laser focused on maintaining a selection discipline that carries through different economic cycles and different periods. And so for us what that means is, you know, we think about selection along four dimensions. So number one is when we invest in a company, we want to make sure that that company is owned by a leading private equity firm in their area of expertise. And importantly with a demonstrated track record of success owning a similar type of asset. Number two is the companies that we invest in, whether it's in Europe or in the US, we want to ensure that those companies have a market leading position, and we typically favor companies that have a number one or number two position in their markets. I'd say the third criteria for us is we want to be very mindful of sector selection, because not all sectors just maintain stability during different economic cycles. And so we want to invest in areas that we view as being very recession resilient with very predictable revenue characteristics. So we wouldn't typically invest in areas like energy or retail or even consumer discretionary, which dovetails with the tariff question that we talked about. But by contrast again, we want to be in places that we find stability. And then finally, we want to be focused on conservative capital structure selection. And for us, we want capital structures that can live through different economic cycles. And so one of the ways we validate that is we focus on stress testing all the companies that go to our investment committee through multiple model cases to ensure that these companies can sustain some type of economic shock and proceed by continuing to pay, you know, their interest and ultimately repay their loans.

Pierre: And just obviously interest and just touching on that as well, just in terms of, you know, in the worst case scenario, if private equity firm obviously hand over the keys to the lenders, what things can you do to obviously mitigate that risk and maybe sell the business or take ownership of the business? And can you share some thoughts on what you can do?

Nayef: Yeah, it's a great question. I mean, if you just take a step back and look at the lending space, typically in my experience as a lender, you're not usually in a situation where the equity sponsor just wakes up one morning and throws you the keys to the business, and you're caught off guard by what's happening in that company. Usually the companies have what are called affirmative covenants in our loan agreements, which mean that they have to report financials on a periodic basis to us. So we usually have a pretty good pulse on the health of these business and trends in the business. In addition to that, these companies are also often required to adhere to financial maintenance covenants. And so by reporting against those covenants, again, it gives us a measure of health in these businesses. So usually when these companies are starting to experience any type of issue, oftentimes we usually have a heads up in advance as to what's going on and we're usually getting to the table early to try and come up with a solution. And so in these situations what typically happens is you're kind of faced with two paths. Path number one is you think that the issues the company is undergoing are fixable and they're short term in nature. And at that point you have the flexibility to maybe give them some, you know, some flexibility in their document and you also have a chance to reprice the risk. The other path is you don't have confidence in what's happening in that business, and now you have to take more, you know, serious measures. No one situation's going to be the same. But if I paint with a little bit of a broad brush in that situation, you're usually trying to understand what's afflicting that business and you might be bringing in third party resources to try and correct those issues. In parallel to that, you know, you're doing things like tightening your documentation. The company may be having to go through some type of restructuring or they may need some type of super senior facility that you are contemplating putting into that business for liquidity reasons. And then again, on the side, you know, you're also working with usually an advisor on what we call strategic alternatives. And so in that situation that advisor may be out looking for a refinancing partner or they may be looking at and or looking at ways they can find a buyer to to purchase that business. So usually all these things are happening in harmony and that's usually the path you'll go down if things are not working out.

Pierre: Interesting and just taking obviously a step back in terms of the size of the private credit market, obviously a lot of people are talking, you know, there's a lot of money moving in this space. Are you concerned, are you seeing any risks of that?

Nayef: I love this question. It's a great one. I kind of laugh a little bit because you're obviously a very sophisticated investor. You look at a lot of opportunity on behalf of your firm, on behalf of your clients, but not all investors have that level of exposure to the market. And so what happens is, when I talk to folks like you that have a lot of choice, sometimes they, the sentiment is that it's a crowded marketplace, and when you look, when you just take a step back and look at the data, it tells a different story. So if you look at, for example, as of last year, you look at the amount of private equity buyout dry powder that was raised and you compare to the amount of credit dry powder that was raised, there's roughly a $1.4 trillion gap in US dollars between those two things. So that suggests that there is a tremendous supply demand imbalance in the marketplace. If you kind of go back to what we talked about earlier is some of the deal drivers in our market, one of those deal drivers I highlighted was a large and growing maturity wall, meaning these loans are maturing, they will demand fresh capital to go out and retire that debt. That in and of itself is over a $600 billion USD opportunity. If you marry those two figures, you know, we comfortably think that there could be a two plus trillion dollar total addressable market just over the next few years alone. And we don't think the banks are going to fill that gap for some of the reasons I described earlier. So we think that there's a lot of runway in private credit. And the last thing I'd just say is, you know, as you look at structurally at opportunities like evergreen structures, which are now coming to market en masse, we still think that that's still a very nascent part of the market when you compare total capital raised in the evergreen channel relative to the total net asset value of the private markets, it's gotta be sub 5% or so in today's environment. So there's still a lot of runway, we think both of the growth in the evergreen channel, but also just for private credit to continue raising capital for deployment.

Pierre: And last question obviously, what do you wish, you know, people knew or understood a bit better about private credit?

Nayef: I think performance, it is still an asset class that is opening up to a part of the market that historically has not had access to this asset class. And when you look at private credit performance over the last nearly quarter century, what you'd see is that private credit has had positive performance in every single vintage year, and it has had benchmark outperformance in every single vintage year over that same time period. So it is an incredibly stable asset class, and it's managed to do that over that time period with the narrowest dispersion of returns in both up and down markets relative to anything else you could have invested in in the private markets. And so I think it just, it's a great opportunity for investors to find an asset class where there is safety and yield. I mean, if you look at today's environment, this is a flight to quality moment, and we think that investors are going to lean into strategies like private credit to go get that. And I think as investors become aware of the stability of the asset class, it becomes a really attractive place to invest.

Pierre: Thank you, thanks very much Nayef for joining us today.

Nayef: Thank you Pierre.

Pierre: Thank you. Thank you.