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## Generations Winter 2021 - Day Pitney Family Office Roundtable

Peter J. Bilfield, co-chair of Day Pitney's Investment Management and Private Funds group, sat down (via Zoom) with Greg Richter of Medalist Partners, Dan Glickman of Harvest Partners, and Douglas Brennan of Priority One, for a roundtable discussion on the credit markets generally, trends in the credit space and their approach to investing during these unprecedented times.

**Peter J. Bilfield (PJB): Thank you for joining us today. Welcome to the Family Office Roundtable. Please briefly introduce yourselves.**

**Greg Richter (GR):** I've been in the structure credits securitized markets since 1986, initially at Prudential Securities and then Credit Suisse. When I left Credit Suisse, I created an asset management company that today is Medalist Partners. The private credit business is a growth engine right now. We are on our third fund. The first fund was about \$100 million, the second \$300 million, and the third we are raising now is about \$500 million. We're investing in asset-based lending facilities and less liquid securities. We do not participate on the corporate debt side of the market, but focus instead on cash flowing loans and leases.

**Dan Glickman (DG):** I am a cofounder of Antares Capital, which invests in the leverage lending market. We started Antares back in 1996, with backing from Mass Mutual, and we built that up through three rounds of ownership.

I left Antares two years ago to join Harvest Partners. Harvest is a 40-year old private equity fund. We are on our eighth private equity fund, which is \$4.1 billion. We also have a structured capital group that manages slightly over \$1 billion. On the credit side, we are trying to capitalize on two shifts that have occurred in this industry. Banks traditionally syndicated leveraged loan facilities but in the last five to 10 years, there has been a shift toward direct lending. A lot of private equity firms are also now getting into credit businesses. So you're starting to see more of the direct business go to direct lenders and private equity managed credit. That's what we are building at Harvest.

**Douglas Brennan (DB):** I come from a largely entrepreneurial background and started most of the businesses that I have run. I come from a financial background on most of my businesses, prior to Priority One, which is much more focused on the defense and government contracting space.

I have spent a lot of time in the hedge fund structuring world, primarily in Asia. After Lehman Brothers started lending in shipping and aviation, I started Stellwagen. At that point, the financial collapse of the market left a lot of operators unable to finance aircrafts. Stellwagen started initially as a finance vehicle and grew into a leasing platform.

Right now, we are focused on infrastructure. A lot of credit groups are talking to us about funding infrastructure related to the aviation space, but not a lot in the defense space, particularly with some of the disruption we're seeing with Brexit. We are also trying to grow our defense business that is based in the Washington DC area.

## **PJB: What does credit investing mean to you and how do you look to construct a portfolio of diversified credit exposure in these strange times?**

**GR:** Interesting times, for sure. You would assume the equity markets would be spiraling downward, but far from it. There is a lot of liquidity in the market.

Credit investing for us is really investing in a broad range of loans and leases. There's a yield component, a default severity, and a voluntary prepayment component. Each of the asset classes that we're active in has a different set of assumptions for defaults, severities, prepayments.

We have tons of experience with different markets. We're active in residential mortgages and commercial real estate, aircrafts and aviation, all sorts of consumer assets, merchant cash advances, and factoring. We invest in defaulted credit card receivables and nonprime auto finance. All of these asset classes require a different analysis.

We steer clear of certain markets that are getting overheated. A good example is peer-to-peer lending. We were buying packages of unsecured consumer debt back years ago, but we stopped. We've started buying some of the unsecured consumer loans again, in leveraged structures, just because the underwriting has gotten better. There's been more historical performance that we can rely upon.

We're still able to put together these asset-based lending facilities with double digit returns, in the 10 to 15 percent range, unlevered. And why is that in a sub 1 percent environment? It's because the borrowers are those that just can't access those low bank rates. It's a very bifurcated market.

Our saying is banks lend to people that don't need money. In some cases, we do use leverage, albeit modest. If a bank will lend us money at 3 percent and our loans are yielding 12 percent, it can enhance the returns of our funds. Due to the Dodd Frank regulations, banks are very restricted in their ability to go outside their normal, very tight underwriting requirements.

**DG:** We operate in a very different sector of the market. We're looking at leveraged loans, noninvestment grade. Most of the loans in the direct market are not rated. All of these are floating rate, tied to LIBOR and have LIBOR floors that are set at roughly at one percent. That has protected lenders from the decline in rates.

The key in any credit business is diversification. You want to diversify by industry, by companies. You get that in our industry by maximizing deal flow. When you have good deal flow, it's easy to build diversification and be more selective.

If I were an investor looking to deploy into credit funds, I would be looking at firms which not only have good credit standards and have been around the industry, but those with strong originations flow. Do they have a structure that's going to throw off enough opportunities so that they can be selective and allow them to diversify the portfolio?

At Harvest we do this through relationships that we have with other private equity firms who also have credit businesses. With COVID-19, there are certainly a few sectors that are out of favor now. Hospitality, leisure and fitness were very active pre-COVID-19 and there is limited interest today. The healthcare sector also got hit very hard, as many of the multisite healthcare facilities had to close temporarily. However that sector has come back strong and folks are investing in them again because protections are now in place and it is highly unlikely we will see doctor offices get closed down again.

Outside of those hard hit sectors, most other sectors have popped back pretty well.

## **PJB: Doug, your thoughts on building a credit portfolio and the markets generally right now.**

**DB:** We take a very different approach. We have a portfolio of operating businesses. We are in different spaces; we operate and focus on all these business. We operate primarily airborne assets in our Priority One business, but we have an e-learning business that has actually taken off during COVID-19.

One of the shifts that I made back at Stellwagen was to get away from aircraft cash flows, because I didn't think they were going to be reliable. So we are now focused heavily on the government contracting space.

I'm much more on the other side of the world than Dan and Greg, and I would be a potential target for their money. We are always looking for lenders to help us secure different assets to support some of our government contracts.

We're looking at airport infrastructure. Our partners are our long-term equity players. And we would use that infrastructure to support some of our government work. So as we build out a portfolio, it's really around operating incomes and those cash flows have to be strong or backed by the U.S. government.

## **PJB: Where do you see opportunities in the next 12 months? Do you see any opportunities for family offices in the credit market?**

**GR:** In March and April 2020, what took place was almost a universal meltdown of the credit markets and equity markets. It wasn't based on fundamentals, it was speculative analysis of fundamentals.

In our market, hedge funds typically have some sort of leverage to finance some securities. The vicious cycle started in March 2020, when prices started going down and you got margin calls, so you sold a few securities. That created more downward pressure on prices; you got more margin calls so you had to sell more securities. It was a death trap. Several credit funds did not survive as a result.

Private equity firms and larger pools of capital came in, stabilized the market. Although March and April 2020 were difficult for credit funds that utilized leverage, it was also a great buying opportunity, and a lot of people took advantage of it.

When the world is upside down, there's more fear than greed. People just raise cash and stay away. When you look at today's environment, we're back. The Federal Reserve has provided plenty of liquidity. There are a few markets, like hospitality, leisure and travel, including aviation, that are still in transition, and I believe there's opportunity even in transition. No such thing as a bad bond, just a bad price.

So you've got to have a view on these markets. If stuff is trading at 20, 30 cents on the dollar, and does that make sense? It's a subjective analysis, and the range of opinion is very significant in markets that are still trading at distressed level.

The areas that we think are still too dicey are the lower, more levered part of single asset or commercial real estate deals. Some of them are still going to do well, but there's still not the right risk adjusted returns in some of those markets. Higher up in the capital structure there is more comfort, but down on the capital structure, you've got to have the ability to get wiped out if things don't turn around in the next 12 months. So the more levered you are in the capital structures, the more uncertain your returns will be, but there are still good opportunities out there.

Post-financial crisis, the consumer, residential, commercial real estate lending markets have been quite disciplined. Some of the rules that were put in force, whether you agree with them or not, have created a disciplined lending market. The asset classes tend to be more secure, with more credit worthiness on the borrower side.

There are some markets, like aviation financing, which got a little competitive. Guys are jumping over each other to buy planes with low lease rates. Planes are trading at 30, 40 percent discount to pre-COVID-19 levels. What's your return? What's your ability to lease them? That's an area that we're certainly taking a look at. We think there should be some pretty good opportunities, but it does typically require a change of control, meaning you're going to be buying somebody else's plane through a bankruptcy or a restructuring.

The same could be said about commercial real estate in some of these markets. We're not an owner operator. We'll have equity interest in some of these companies, but we have professionals that know how to run those companies.

One of the areas that we think that is underserved is small commercial real estate loans. These are \$2 to \$3 million loans. We own an originator on the West Coast that originates \$50 million to \$75 million a month of these loans. The banks have stepped away from the market, and these are high quality loans. Through COVID-19, our delinquencies have been almost zero, in part because of the PPP programs. PPP round two is in process right now; it's creating a much cleaner credit profile on the loans that we've originated. We're excited about the prospects of that business, an example of an underserved market and risk adjusted returns that are well above market.

**DG:** We started our credit business in March last year. We didn't have a book prior to that and we got to start deploying right when COVID-19 hit. Our timing was great and we were able to pick up a number of credits in the secondary market that were marked down for funds who had to unload exposure. Those loans have come back to par or close to par, which has been

great. It's hard to build a model looking for a market interruption event like that. No one knows when that's going to happen. It is great when the timing works well and you are positioned to take advantage of the disruption.

It seems like the rule of thumb in terms of cycles, at least for the leveraged lending industry, is you want to walk the opposite way of the herd. When everyone is aggressive and running, that's the time to pause. And when the markets are pulling back, those can be the most profitable years for a credit fund. There's always going to be an element of luck with timing, but don't follow the herd off the cliff.

**DB:** From a credit point of view, the environment has created opportunities in different sectors around aviation. We own a company that's a constructive simulation and e-learning business. Our customers use us for leveraging their ability to teach military personnel, and that trend is increasing dramatically.

In our government contracting space, we were looking at an unprecedented year of aircraft utilization. We spent the last year preparing for a pretty dramatic shift in government budgets. We've had a lot of pullbacks in places like Africa, because of defunding in the United States, but there have been significant shifts in favor of other areas within the government, particularly our telemetry business. We're a good fit for family offices and credit funds that want to deploy into that space.

**PJB: Greg had mentioned some opportunities in the aircraft financing space, but Doug, I know you said in the past that that's an area that you probably wouldn't touch.**

**DB:** We own a lot of aircraft, but they're flying almost exclusively for the U.S. or allied governments in support of critical missions. That's what's going to be falling out over the next year in the international travel market.

You're going to see a lot of pain in the international wide body long haul market, as we've already seen. We do have a commercial arm to our business, but we are focused on credits, like Original Equipment Manufacturer-backed transactions on the leasing front, as well as large carriers who can support lease payments for another two years without normalized traffic.

For the leasing community itself, I do think there are going to be large scale restructurings and financings. I do not believe the banks are going to step up in another year or two years when some of these facilities expire to support the leasing community. There's probably way too little equity behind these companies and far too much senior liquidity, and I'd be interested in Greg and Dan's views on that.

**GR:** I agree; stay away from aircraft deals with high percentage of wide body exposure. The market is bifurcated. If you look at where some of the liquid markets are trading right now, it doesn't make any sense to us. If you look at where high yield is trading at a low 3 percent coupon, high yield indexes are trading at 109 and a half. What's your balance between making 3.5 percent and losing principal if some of these credits go down?

In the structure credit securitized world, you're seeing rated bonds and investment grade bonds, trading at 1 percent. If you have to put money to work, that's where you have to play. If you're rules based and you have to buy investment grade cash flows, you've got only so many opportunities, and those are crowded trades.

The borrowers are being smart. They're trying to crank up production and issue as much debt as possible into what seems an insatiable demand. But again they're ratings based. Below investment grade, it is still crowded. The BB, B high-yield market, are areas you should stay away from.

I would argue parts of the equity market are similar, where they're clearly being priced at historical multiples and yet money still is coming in, because the money has to go into that space. It's focused on technology, particularly disruptive technology. There's only so many areas that are available, so stay away from those areas. Certainly that's our view.

There hasn't been forced selling yet of aircraft. But it's coming. It will be really interesting to see who steps in and to what price this sector comes. Aviation's not going away. We'll see when travel returns to anything close to normal levels.

When you're looking at other credit opportunities and areas to stay away from, our mindset has always been figure out a price, figure out your risks, and price them accordingly. Where we like to add risk in our funds may be very different than where other people are, and it's an assumptions-based, subjective analysis.

In our private credit space right now, these are not backed by securities, but it's loan agreements, backed by single-family rentals, commercial real estate, consumer debt. That market's been largely unaffected by the COVID-19 global pandemic. It's the sourcing network that we have that has created an opportunity for us, meaning, we put out a lot more money than we have. That's a good place to be.

**DG:** Everything that Greg is saying about this market would relate to what we're seeing in the leveraged lending markets. You can break the leveraged loan market into two groups. The syndicated market's exactly what Greg was just saying. People are tripping over themselves to deploy capital there. The spreads are as low as I've seen and credit protections are not as good. Borrowers are taking advantage of that, and going out and raising capital at unprecedented levels.

The other group is in direct leveraged lending. That's where you've have non-bank lenders doing financings directly with private equity funds. That world has stayed fairly disciplined.

The direct space is a much better risk reward than the broadly syndicated world. The direct space can be more selective. This space would be for folks that have allocations set up for noninvestment grade paper. It has limited liquidity but if investors can manage a less liquid book, the direct space is absolutely the way to go.

**GR:** I do think that the areas that do not have massive pools of money chasing the assets are the areas that will provide better risk adjusted returns right now. And even within some of these broader markets, like leveraged loans and securitized products, there's still ample opportunity. You just can't chase what everybody else is chasing.

**DG:** Agreed. That's the point I was making about following the herd. When you see everyone running in one direction, it's probably best to pause.

**DB:** With this liquidity persisting throughout COVID-19, that brings other risks to the sector. Certainly, in aviation I think there's going to be a grab at assets that are not going to be priced correctly. There's already talk in the aircraft space that people want to move in to finance some of these aircraft. I think it's a huge mistake right now, to purchase and finance them.

## **PJB: How can family offices, family office investors profit from this shift in lenders?**

**DG:** Typically a family office would invest in Collateralized Loan Obligations. Since they're highly structured vehicles, you get different areas where you can play there. And they buy their deals off bank desks that are syndicating a loan. Given the changes I've discussed, that market has largely shifted to just the largest deals.

Investors can play by investing in a direct lending fund. That is the fastest growing sector right now.

Because we have access through our relationships with other private equity firms, it gives us a unique advantage, not to mention a really thorough understanding of a certain business or industry.

**DB:** I think there's going to be a big space to the extent that senior lenders are still around. We're looking at, for example, airport infrastructure, but we are struggling with the extent to which we can get the equity leveraged efficiently. I think there's also a play for mass lenders and junior lenders in this space.

There are some infrastructure plays right now that do offer good sustainable cash flows. And there's still a fear trade going on in some of this space, anything associated, for example, with aviation. But we've made some investments that are doing extremely well. There are spaces to play here for junior lending, as well as for high yield investors, and then, of course, the equity.

**GR:** I think the opportunities are numerous out there. It's a very difficult asset class for direct investment. If you're going to go into a commingled vehicle that has a lot of different exposures, the various funds out there are the best way to approach it.

The ability to source, but more importantly, the underwriting, the vetting and the ongoing surveillance after you put money to work is something that we do, and I would not suggest jumping into these relationships without a very vigilant surveillance on a go-forward basis.

We analyze the credits on a rigorous monthly basis. If we see things veering off in the wrong direction, we try and right the ship and bring it back. We have all sorts of rights and remedies in our loan agreements to make sure we can do that.

Our returns are on a net basis 10 to 12 percent. A lot of people are getting sucked into looking at tech companies going up 30 percent in a day. They will go down 30 percent in a day at some point. So we're a little boring. Our risks are a little bit more flat-line in that low double digit area, but we think it's an attractive opportunity.

**PJB: On behalf of Day Pitney and our Family Office Practice, thank you all for participating.**

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