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End-of-cycle alert

Evan Lorenz writes:

"We are in the beginning of a secular shift in how credit is provided to businesses, a shift that I believe will continue to gather speed," declared Marc Rowan, CEO of Apollo Global Management, Inc., not long ago. Doubting it, this publication is bearish on Ares Management Corp. (ARES on the New York Stock Exchange).

Private credit is the subject at hand, and few firms have better capitalized on that shiny new financial object than Ares. What is private credit? It's debt: senior secured or junior unsecured and much in between, advanced not by a bank but by an unregulated corporate lender. Since year-end 2019, Ares's assets under management have climbed by 165%, its revenues by 99% and its earnings per share by 106%.

Nonbank lending is in the Ares corporate bloodstream. Cofounder and current chairman Antony Ressler started his career at the high-yield desk of Drexel Burnham Lambert, Inc. (*Grant's*, Sept. 24, 1984), and when Michael Milken's firm declared bankruptcy in 1990, Ressler went on to cofound Apollo alongside Rowan and Leon Black. In 1997, Ressler, with a quartet of other executives, spun out Apollo's capital-markets business as Ares.

As of Sept. 30, Ares reported $395 billion in assets under management, which, in the AUM tables, placed it below KKR & Co., Inc. ($528 billion) but above Carlyle Group, Inc. ($382 billion). Credit—lending—is Ares's main focus (68% of AUM), followed by real estate and infrastructure (16%), private equity (9%) and secondary interests in other managers' funds (6%). Call the missing 1% miscellaneous.

Ares offers conventional p.e.-style funds (61% of AUM), permanent capital vehicles (publicly traded business-development companies, private BDCs and real estate investment trusts, 26%) and various kinds of managed accounts (13%). While publicly traded entities account for only 8% of assets, they deliver 26% of Ares's management fees.

The most important publicly traded vehicle is Ares Capital Corp. (ARCC on the Nasdaq), a business-development company with $22.9 billion in assets. BDCs, you'll recall, finance middle-market borrowers, e.g., p.e.-sponsored companies that are too small to tap the broadly syndicated loan market. Through the first nine months, ARCC contributed 13% of Ares's management fees and, counting the incentive fees that ARCC pays its parent, a whopping 20% of Ares's total revenues.

ARCC is quoted at 8.4 times earnings and pays a 9.7% dividend, whereas Ares is priced at 30.3 times and pays a 2.9% dividend. Clearly, the parent makes a better short-sale candidate than the high-yielding subsidiary.

In any case, for a certain kind of corporate borrower, private credit fills the bill. There are no credit ratings, no bank credit committees, no federal regulators overseeing said committees, no disclosure of sensitive financial information, no public investors. Speed, confidentiality and certainty of execution are private credit's watchwords.

In that context, Ares has proven to be a standout. ARCC, which went public in 2004, a decade before its now-parent company did, adroitly navigated the housing bust and its aftermath (*Grant's*, Oct. 19, 2012). Yes, ARCC's net assets per share sank to $11.27 in 2008 from $14.85 in 2007, but they roared back to $14.92 by year-end 2010.

Ares's credit performance has been exemplary. As the company provides little detail about its loan book, the analyst turns to ARCC's quarterly reports for broad hints. Thus, in the third period, loans on nonaccrual, net of writedowns, fell to 0.6% of book value, from 1.1% on June 30. Strong credit experience plus unrealized portfolio gains led to growth in book value per share to $18.99 on Sept. 30 from $18.58 on June 30.

How much better is the private debt market than the leveraged-loan alternative, Ares's fans marvel. (Note: A leveraged loan is a loan issued by a bank to a leveraged borrower; rather than holding that credit on its balance sheet, the originating bank sells it—syndicates it—to investors. Leveraged loans trade in public markets; private credit loans do not.)

"[W]e make investments with perfect inside information because we're entering into bilateral relationships with borrowers and companies that are looking for capital," Ares CEO Michael Arougheti told an investor audience on Sept. 21. "[W]e have investments in over 3,000 middle-market companies privately. We are getting monthly financial statements from those companies. We're talking to the management teams daily, if not weekly. That information is very quickly aggregated and then able to be transmitted out to the rest of the organization."

Cyclical tailwinds help, too. Most loans are of the floating-rate kind, priced at a spread off the Secured

Overnight Financing Rate (SOFR), the successor benchmark rate to the extinction-bound London Interbank Offered Rate (Libor). Since SOFR has risen to 5.3% from 0.05% at the start of 2022, private loans are promising yields in the low teens. It only remains for the debtor companies actually to pay that promised return.

Because debt costs more these days, private equity is using less of it: Loan-to-value ratios on current transactions are running in the mid-40% range, down from 60% before the pandemic. Who's contributing the additional equity? Why, the deal-doers themselves. With more of their own money at risk, such promoters as Blackstone, Inc. are more likely to throw an equity lifeline to a needy portfolio company than they used to be—or so the theory goes.

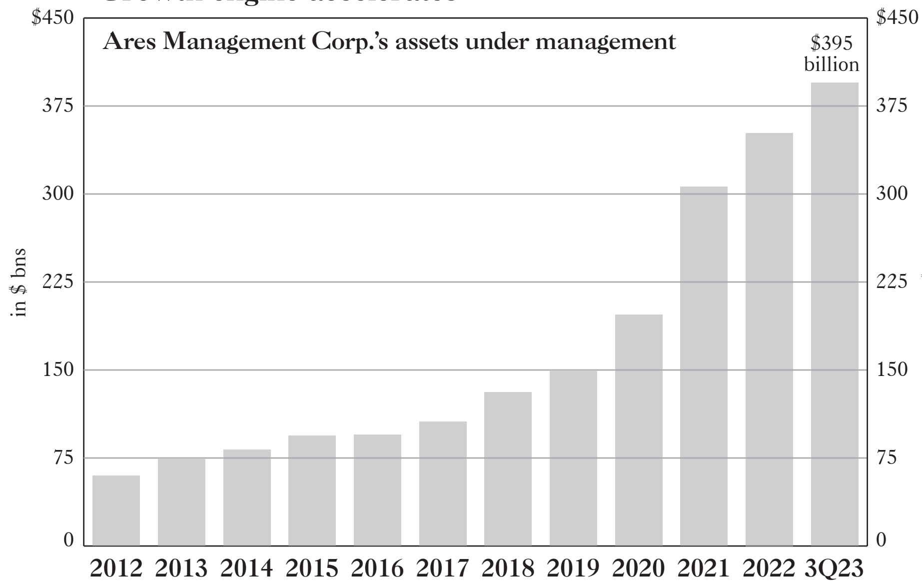
You may think that fleeing depositors ($1 trillion out the door since mid-April) and loss-making bond portfolios ($558.4 billion in the red as of June 30) are quite enough trouble for America's banks for one cycle. There's more. Regulators are floating proposals to boost capital requirements by as much as 20% for banks with $100 billion or more in assets with a target implementation in 2025.

Good, the private equity bulls retort: The more constrictive the bank regulatory environment, the better for the likes of Ares. As it is, private credit mainly serves highly leveraged borrowers; it has designs on a much broader market. Ares's acquisition, in June, of a $3.54 billion portfolio of loans from troubled regional lender PacWest Bancorp can be seen as a milestone in that anticipated evolution (for more on PacWest, see the issue of *Grant's* dated April 7). The loans run the gamut from consumer to business and are backed by collateral ranging from cars to real estate.

"Ares is the best pure play on private credit broadly," Patrick Davitt, who rates Ares as a buy for Autonomous Research, tells me. "Not just in direct lending, but in every single sub-vertical under the private credit umbrella, they have scale and generally a very long track record. If you believe that the secular increase in allocations to private credit continues and/or the investment opportunity continues to expand, they're probably the best way to play this."

Ares's limited partners seem to agree. From the company's IPO in 2014 through year-end 2019, AUM expanded to $149 billion from $82 billion, a more-than-respectable 82% rise over five years. From the eve of the coronavirus through Sept. 30, AUM leapt to the aforementioned $395 billion, a 165% increase in fewer than four years.

Growth engine accelerates



source: company reports

For all its exposure to high-yield assets, Ares owns an investment-grade balance sheet (triple-B-plus by S&P Global Ratings). As of Sept. 30, it showed a net debt balance of $2 billion; in the third quarter, operating income covered interest expense by 4.2 times though that coverage ratio understates, rather than overstates, Ares's financial strength, because a substantial offset to borrowings—in the shape of $1.7 billion's worth of investments in Ares's own funds—goes unrecorded.

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Private credit is, indeed, the hottest department of lending, just as the bulls say, but "hot" and "credit"—like "high growth" and "bank"—are concepts that rarely pair well. Someone has said that lending is the second-oldest profession. Certainly, it is a cyclical profession. Racing for growth and market share, a lender invariably courts trouble.

Data are sparse for non-traded loans since borrowers are under no obligation to file public financial reports or to obtain credit ratings. Even so, the curtain of discretion sometimes parts, as when managers of, say, a collateralized loan obligation procure a "credit estimate" of the contents of their portfolio. Such estimates are what they sound like: best guesses by a ratings agency of the creditworthiness of a portfolio of non-rated borrowers undertaken from financial documents alone at the request of a third party.

In a Nov. 2 report, S&P compiled findings from more than 2,000 such estimates that it had issued between August 2022 and August 2023, covering slightly more than $400 billion's worth of debt. Some 78% of the cohort bore the characteristics of a single-B-minus grade while 13% looked more like triple-C credits. Using reported Ebitda, the median company was leveraged 7.1 times and covered interest expense by 1.5 times. The median liquidity ratio, i.e., current sources of cash, divided by current uses of cash over a prospective 12-month horizon, was 2.4 times. Only slightly more than half—55%—of the sampled universe was producing positive free cash flow. Of course, p.e. sponsors are well aware of the financial vulnerability of the companies in which they invest—by larding on debt and stripping out "excessive" cash, the sponsors themselves render their charges vulnerable.

Ares provides scant information on its overall credit portfolio, but the above-quoted vital signs seem to match the information we've found. ARCC, for example, reported that its interest coverage ratio, expressed as a multiple of Ebitda, declined to 1.6 times in the third quarter from 2.0 times in the third quarter of last year and 2.3 times in the third quarter of 2019. As of Sept. 30, the average company in ARCC's portfolio carried debt equal to 6.1 times Ebitda.

Ares's foremost BDC did exhibit strong credit performance during the housing bust, but—importantly—underwriting standards in the years preceding the crisis were more conservative than the ones prevailing in the bygone era of free money. Thus, in the final three months of 2008, expressed, again, as a multiple of Ebitda, ARCC's average borrower covered interest expense by 2.4 times and carried a debt burden equal to 4.2 times.

An interest coverage ratio of 1.6 times is very thin, indeed, a global seller who prefers to go nameless observes. "You've got to factor in taxes, maintenance capex and growth investments," he tells me. "You've got to reckon that the private equity sponsor is going to be there for growth first and foremost."

Adjusting interest coverage for those inputs paints an even less flattering picture. Each quarter, investment-banking advisory firm Lincoln International, LLC pores over data from more than 4,500 p.e.-sponsored companies and tabulates fixed-charge coverage ratios. This is the calculation: Ebitda, less capital expenditures and cash taxes, divided by interest expense and scheduled debt amortizations. Using the current SOFR rate, Lincoln finds that the fixed coverage ratio was just 1.06 times in the third quarter and that companies have been cutting capex to free up funds for debt service.

Interestingly, the full impact from rate increases is yet to be felt since interest payments on private loans are payable semiannually. Nevertheless, 675 of the companies that Lincoln tracks, or 15% of the total, have gone to their creditors and received credit amendments in the first nine months of 2023, while about 60 companies have asked for and received more than one amendment this year.

It's true that covenant protection for private loans is generally stronger than it is for leveraged loans, but the private borrowers need it. Any business that can obtain a rating of B2 or higher chooses the leveraged-loan, or broadly syndicated, market,

Ares Management Corp. at a glance

all figures in $ mns except per share data

	TTM*	2022	2021	2020	2019
revenue	$3,515.6	$3,055.4	$4,212.1	$1,764.0	$1,765.4
operating income	801.9	306.4	802.0	313.6	302.6
net income	417.9	167.5	386.7	130.4	127.2
earnings per share	2.18	0.87	2.15	0.87	1.06
shares outstanding	175.5	175.5	180.1	149.5	119.9
cash	311.8	390.0	343.7	539.8	138.4
debt	2,340.2	2,273.9	1,503.7	643.0	316.6
total assets	23,383.9	22,002.8	21,605.2	15,169.0	12,014.2

*12 months ended Sept. 30, 2023.

source: company reports

Moody's Investors Service observes. The spreads are tighter and the documentation looser than in the world of private credit. It's the riskier credits (those rated B3 and below, as well as unrated smaller companies) that patronize the private markets, and they pay for the privilege.

In fact, private credit has taken over second-lien buyout lending, as Moody's also relates, though such liens afford less protection than they used to: "In these top-heavy debt structures of single-B- and below-rated debt issuers, the second lien is no longer positioned in the middle but rather sits at the very bottom of a liability waterfall, similar to subordinated unsecured bonds, despite the second lien on collateral." The upshot? Moody's expects recoveries of just 15 cents on the dollar in case of default.

Junior credits honeycomb the ARCC portfolio. As of Sept. 30, the BDC reported that 58% of its portfolio comprised first-lien investments; 17%, second-lien obligations; 11%, preferred equity; 9%, other equity; and 5%, subordinated debt. During the 2007–09 meltdown, too, ARCC had heavy exposure to junior debt, but the issuing companies, compared with today's investees, carried less leverage and covered fixed charges more easily. Nor does it inspire confidence that, in the first nine months of 2023, the interest and dividends that such companies paid in kind, rather than in cash, amounted to 22% of the lender's pretax profits.

In its defense, Ares Management points out that ARCC lent to smaller borrowers during the financial crisis (average Ebitda was $45 million then and is $156 million now) and that larger borrowers are better able to manage a cyclical downturn. While declining to break out the details of its portfolio, Ares says that it has a higher proportion of first-lien loans than ARCC's book.

Perhaps the private debt managers are spending more time calculating their fees than they are the coverage ratios of their portfolio companies. The typical private credit fund, Bloomberg reported last month, has a management fee of 1%–2% of assets and an incentive fee of 10%–15% for returns above a 5%–7% hurdle. Since SOFR has risen by more than 500 basis points since the start of 2022, all managers are accruing incentive fees and investors are starting to complain.

While some managers are conceding on fees and hurdle rates, Arougheti told his audience on the Oct. 31 earnings call that Ares isn't one of them. Nor, said the CEO, is Ares feeling pressure to conform. Be that as it may, Ares's ample fee structure may be crimping its investors' returns. Thus, the Ares Private Credit Solutions II fund, which manages $5.5 billion and began investing in 2020, has generated a net 6.4% internal rate of return. While the levered Ares Senior Direct Lending Fund II (2021) has produced a double-digit IRR (14.9%), the unlevered version of the fund has generated only 9.1% (the funds manage a combined $15.6 billion).

With 9 of the 15 analysts covering the stock saying buy and not a one saying sell, the Street smiles on Ares. Judging by the short interest, which amounts to 2.6% of the equity float, bears are giving the alternative asset manager a wide berth. Insiders, however, are dumping stock, selling a net 3.3 million shares over the past 12 months for proceeds of $309.6 million, or about 1% of the current market capitalization.

Private credit has soared on the back of rising interest rates and low prevailing default rates, but those conditions may be changing. Speculators in the Fed funds futures market bet that Chairman Jerome Powell will slash rates by 100 basis points by year-end 2024. Last week, Walmart, Inc. warned investors that consumer activity dropped off sharply in late October, adding to cyclical warning signs like the still heavily inverted yield curve, sputtering industrial production and rising delinquencies on subprime loans (see the Nov. 10 issue of *Grant's*).

After rallying by 57.6% this year, Ares trades at 30.3 times the 2023 estimate, slightly more than three times the JP Morgan Chase & Co. earnings multiple. In credit, especially, good ideas become bad ideas when carried too far, too fast; examples include junk bonds in the 1980s and subprime mortgage structures in the 2000s. Now comes private credit, hotter than July 4 and (as it seems on some days) more popular than Taylor Swift. Wise heads will steer clear.

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