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Easy Money From Risky Loans. Trouble Ahead?

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In the fall of 2015, in the back booth of the retro Putnam Restaurant in Greenwich, Conn., Craig Packer, a partner at Goldman Sachs, sat across from Doug Ostrover and listened to an audacious pitch.

Mr. Ostrover, then 52, had recently left the investment colossus Blackstone and was mulling a dramatic midcareer effort to build a firm from scratch, one that would take on some of the biggest names in global finance. Quit your job, the billionaire financier told the 48-year-old Mr. Packer, and join me.

As Mr. Packer later recalled, Mr. Ostrover wanted to create a firm that would lend money to highly indebted, risky businesses willing to pay hefty interest rates for fast cash. If it succeeded, the new enterprise, and its founding partners, could dominate a new financial playing field with the potential for huge profits.

Mr. Ostrover's pitch (one he would also make to Marc Lipschultz, a two-decade veteran of KKR who would eventually become another founder of the nascent firm) was to leap into the business of "private credit," a simple-sounding term that belies its complexity -- and its risk.

The new venture would not be a bank, but would operate almost like one -- without the regulatory restrictions and government oversight that had made traditional banks skittish about this market. Unlike a bank, the firm would be amassing money not from individual depositors, whose savings are fiercely protected by the federal government and can be withdrawn at will, but from institutions like insurance companies and pension funds. Thus, the new firm would be legally permitted to finance tricky, highly speculative companies without reporting the details of such activities publicly.

During the next several months, over scrambled eggs at the diner and meetings elsewhere, Mr. Ostrover, Mr. Packer and Mr. Lipschultz agreed that the venture offered them a great opportunity -- but only if they started at a gigantic scale, $10 billion or so. A bet that size would be a game-changing move in the world of private credit, where small, shady lending shops did backroom financing deals for even shadier fledgling companies.

Eventually, the three men raised $12 billion, undercutting their would-be competitors by promising big pension funds and others, like the investment fund run by George Soros, low investment fees if they backed the new firm.

Large investors -- including Brown University's endowments, New Jersey's pension fund, Michael Dell's investment firm and Iconiq Capital -- were given stakes in the firm, essentially making them owners of the new enterprise.

"They wanted to become one of the largest financial players on the planet," said Oliver Weisberg, chief executive of Blue Pool Capital, which led that initial financing round. "That was always their plan."

Over the next few years, the new firm set off a high-stakes arms race among some of the biggest names in global finance.

Interest rates had been low since the 2007-8 financial crisis, so pension funds and other institutional investors were desperate to find ways to earn higher returns on their investments. The debt markets, Mr. Ostrover told prospective clients, were much more stable, year over year, than stocks or commodities.

And the firm, then called Owl Rock Capital, took the unusual step of setting itself up with so-called permanent investor capital that it would hold even longer than a typical private equity fund, where investors tie up money for a few years or even a decade. This would allow it to make increasingly long-term loans. In return, clients were offered the prospect of far higher returns than they could earn with more conventional investments.

"Doug could talk a dog off a meat truck," said David Salomon, an investment adviser who agreed to help stake the new venture after meeting with Mr. Ostrover over beers at a strip-mall Chinese restaurant. The firm's founders had "a great vision," said Mr. Salomon, who manages money for endowments, pensions and family offices through his firm, East End Advisors.

Nearly a decade after its founding, Blue Owl Capital -- as the firm was renamed -- is succeeding in ways that might have seemed unimaginable in that cramped Connecticut diner booth. The firm, which went public in 2021 through a merger and employs more than 1,000 people, is one of the biggest private lenders on Wall Street, managing more than $235 billion of investors' money.

Blue Owl has both caught and created a once-in-a-generation wave, one that has brought a sweeping change to Wall Street. Over the past few years, roughly $1.8 trillion has been raised by private credit investment firms, including rivals like Ares and Apollo Global. That money has been lent to highly indebted companies in sectors like software, insurance and health care.

"We're financing many of the same companies that used to go to the public markets," Mr. Packer said. To doubters, he added: "Ignore us at your peril."

Looking in from the outside are major banks like Goldman and JPMorgan Chase, whose executives now worry they are ceding their lucrative franchises of big-ticket financing to these less regulated rivals.

At a closed-door Goldman management committee meeting this summer, the top brass debated a hard truth: The investment bank was increasingly falling behind in private credit, namely in arranging big-ticket loans for corporations, part of its bread-and-butter financing work, because the newcomers were willing to give out the money at easier terms -- for example, by accepting less protection against defaults.

"The more risk you take, the better you look," Marc Nachmann, Goldman's global head of asset and wealth management, advised the group. Still, the partners decided that they couldn't ignore the frenzy; Goldman would continue to organize, for a fee, investment funds in which its clients can lend money alongside and in competition with private credit firms.

Other big players are also moving in. This month, BlackRock, a publicly traded asset manager and one of the biggest names on Wall Street, staked its claim with a deal to buy the private credit upstart HPS Investment Partners for $12 billion. In its announcement, BlackRock predicted that the private credit market would more than double to $4.5 trillion by 2030.

Already the success of Blue Owl has brought mammoth riches to its founders. Mr. Lipschultz and Mr. Ostrover -- both cited as billionaires by Forbes -- recently bought a majority stake in the Tampa Bay Lightning in a deal that valued the National Hockey League team at nearly $1.8 billion. (Mr. Packer is also an investor in the team.)

And the origin story of the firm has become part of local lore. In Greenwich, a gold plaque that was recently installed at the Putnam Restaurant read: "The booth that launched a $25 billion company."

The sign is already out of date. Blue Owl's public arm, which trades on the New York Stock Exchange under the ticker "OWL," was recently valued at $35 billion.

'Hidden Dangers'

It can be a risky business, making loans to risky businesses. Consider the go-go junk bond era of the 1980s, as captured in books like "Den of Thieves" and "The Predators' Ball."

Famously, Michael R. Milken's Drexel Burnham Lambert organized loans for companies like Steve Wynn's casinos, Rupert Murdoch's News Corp and the ultimately doomed telecom company MCI Communications. These bonds helped fuel the era of corporate raiders and became the backbone of the private equity industry, which used the debt to buy public companies, take them private and borrow more money again.

This worked until it didn't. Mr. Milken went to jail for violating federal securities laws, Drexel went belly up, and some of the companies financed with junk bonds eventually declared bankruptcy.

By the mid-2000s, Wall Street bankers had found yet another way to expand access to credit and rake in billions through risky lending, this time with mortgages to borrowers with low credit scores. Bankers pooled mortgages from borrowers with a mix of high and low credit scores but financed the group as a whole as if they were all highly rated.

This fueled a rapid increase in mortgages, inflating home prices. The subprime mortgage bubble eventually burst in 2007 and 2008, leading to a global financial crisis.

To its detractors, private credit carries some of those same red flags. Officials at the International Monetary Fund ("could become a systematic risk"), at the Federal Reserve ("financial stability implications") and on the Senate banking committee ("may pose hidden dangers") have all chimed in with warnings.

Regulators have raised a number of potential issues. Chief among them is that the industry's rapid growth has not been tested in a long market downturn -- a financial crisis or a prolonged recession. It's unclear how the companies they lend to would fare in a weak economy.

Even making a guess about what would happen, critics say, is difficult because of the opaqueness of the industry. While banks are required to publicly report the value of their loans, private credit firms are not.

There is also the specter of contagion. Since so many private credit funds are backed by public pensions and other such entities, losses to the industry would ultimately be borne by millions of retirees. The hundreds of billions of dollars that Blue Owl manages include the pension funds of teachers in New York State, Texas and California. In New Jersey and South Carolina, Blue Owl invests on behalf of firefighters and other state employees.

Private credit's boosters say their lending portfolios are well diversified and unlikely to sour all at once, and they rightly point out that everything thus far has gone smoothly. They say they report the health of their loans to their private investors, who have the right to examine their obligations in detail -- and do.

As measured by the relative interest rates charged by this new class of lenders, there has been a paradigm shift. Banks and private lenders charge higher rates to risky borrowers, expressed as the "spread" or difference from the interest rate on U.S. Treasury bonds, generally considered the safest base-line investment. The larger the spread, the riskier the loan, or so goes the calculus.

With so many new private credit firms competing to make loans, the average spread on such loans and high-yield bonds has shrunk drastically in the past two years. That perplexes longtime industry researchers such as Ed Altman, a professor emeritus at New York University's Stern School of Business.

"The markets are not risk-free," Mr. Altman said.

Perhaps most prominently, JPMorgan's chief executive, Jamie Dimon, has emerged as a vocal critic of private credit.

Last December, Mr. Dimon appeared before the Senate Committee on Banking, Housing and Urban Affairs and urged the senators to do something about the unregulated and swift growth of private credit. Regulators, he said, will be "unable to see the next brewing crisis," because so much activity has moved outside the banking system. If these private loans run into trouble, he said, lenders will be unlikely to refinance them, as banks do.

Over the past year, private credit has become almost an obsession for Mr. Dimon, who has repeated those warnings on JPMorgan's earnings calls, in meetings with clients and in television interviews with CNBC and Bloomberg. In May, he told Wall Street analysts that there would be "hell to pay" if a large number of these loans turned sour.

Mr. Dimon is not a disinterested party, of course. By making huge loans with their own money, firms like Blue Owl have been encroaching on JPMorgan's business of arranging loans of $1 billion or more to companies and private-equity firms.

To claw back at least part of this market, JPMorgan has also been hunting for a private credit shop to buy.

By mid-2024, JPMorgan nearly completed a deal to acquire Monroe Capital, a Chicago-based private lender, according to a person with knowledge of those negotiations. The deal faltered, however, when the two parties couldn't agree on certain terms. In the meantime, JPMorgan has set aside around $10 billion of its own money -- a pittance for the bank -- to compete with the likes of Blue Owl on private credit deals.

So while Mr. Dimon may think private credit is dangerous, he still wants in.

'We're the Banks of Old'

While Blue Owl frequently promotes its track record -- saying it has lost money on only a handful of deals it has financed over the past decade -- that performance has been tested by strife between the lender and its partners in at least one major deal.

In 2021, Blue Owl and a consortium extended a $1.7 billion loan to Vista Equity Partners, a private equity firm, to buy Pluralsight, which makes educational and training videos for large **technology** companies. Rather than weigh the start-up's profits, they based the loan on Pluralsight's revenues and the projection for its growth.

But Pluralsight's customers, which included Deutsche Bank, Teach for America and 1-800 Contacts, soon began to bail. They became frustrated with Pluralsight's course offerings and customer support. The company's revenues plummeted.

In July this year, the Blue Owl-led group allowed Vista to defer its quarterly payments on its debt. Vista tried to push lenders to cut its debt load and allow it to retain control of the company. Instead, by August, Blue Owl and its other lenders had become Pluralsight's new owners. Vista lost billions on the deal, and the lending group, as of now, has lost roughly half of that $1.7 billion loan. (Blue Owl put $339 million into the original deal.)

Blue Owl said Pluralsight was one of just six companies it had lost money on, out of more than 500 it had lent to over the last eight years.

But many on Wall Street question whether Blue Owl and its peers' loan numbers are too good to be true. Blue Owl says its loss rate is 0.1 percent. While that can't be independently confirmed, it's remarkably low even for a safe debt investment portfolio, let alone one like Blue Owl's, which is made up of loans to companies that are considered generally poorer bets than those that qualify for investment-grade ratings.

In an interview, Mr. Lipschultz said the firm's portfolio was generally uncorrelated, arguing that it is unlikely to sour all at once. He summed up the business airily: "We're the banks of old."

Because private credit firms don't have to regularly reveal their loans to regulators, they can create their own rules for how to "mark," or value, their portfolios. These loans, said Thomas Majewski, founder of Eagle Point Credit and a three-decade veteran of the lending industry, "are sometimes less rigorously marked" than they would be at regulated banks.

Blue Owl charges its investing clients an annual fee based on the value of its portfolio of loans. So the higher the value, the more it makes. Blue Owl says that it uses third-party evaluators to mark portfolios, and that the independent board members sign off.

Even Blue Owl says defaults are likely to rise if the economy enters a recession. Still, the firm said that even if a number of its deals ran into trouble, it was different from the banks that once financed these deals.

"We don't have depositors," Mr. Lipschultz said. "We don't have anybody who says, 'OK, I need my money back today.'"

Blue Owl's founders insist that if any more of their companies run into trouble, the long-term commitments their investors have made give them the time and the flexibility to work through those issues.

Regulators Increasingly on Edge

How long can the boom in private credit last? Practically everyone on Wall Street concedes that this "golden moment" -- as Jonathan Gray, president of Blackstone, once put it -- is bound to dim as more lenders emerge to compete with one another for a finite number of loans. The question is whether it will cause a shakeout that could spill into the broader economy, with dire consequences.

Few influential voices in the financial world seem to have any immediate concerns.

In a speech to the Brookings Institution in May, the Federal Reserve governor Lisa Cook said: "Overall, I think the growth of private credit likely has not materially adversely affected the financial system's resilience. Private credit funds appear well positioned to hold the riskiest parts of corporate lending."

Later that month, the Fed's chair, Jerome H. Powell, commented that, in private credit, "many of the lending structures are not subject to a run in the way that banks have traditionally been." He added that because their funding largely came from backers with a long-term commitment, "it's not obvious to me that at this point it's a net loss to financial stability."

But regulators are increasingly on edge. In November last year, Senator Sherrod Brown of Ohio, the chairman of the banking committee, wrote to regulators that "private credit funds operate in the shadows" and "in the absence of sufficient oversight and accountability." The International Monetary Fund stated in April that the sector "has meaningful vulnerabilities, is opaque to stakeholders and is growing rapidly under limited prudential oversight."

"It's crazy," said Philipp Krohn, chief executive of Alantra US, an investment bank. "Every time we look, they are getting bigger."

Failures could have a cascading effect throughout the financial markets. Because private credit firms borrow from banks -- JPMorgan lends to Blue Owl, for instance -- "there is actually an umbilical cord back to the banking system," said Viral V. Acharya, a New York University finance professor and former deputy governor of the Reserve Bank of India. Blue Owl's war chest is roughly doubled by leverage, meaning that for every dollar its clients have staked the firm directly, two dollars are lent out.

Mr. Acharya compared the seeming steadiness of the booming industry now to "saying the market is great to lend in the U.S. in 2007 and 2008." He added, "Because the cycle hasn't turned yet, we simply do not know."

Mr. Lipschultz said he wasn't worried about that. With a muted laugh, he pointed out that the government needed to rescue major banks in 2008 -- and that his firm continued lending even at the nadir of the pandemic.

"Where have the problems been since the financial crisis?" Mr. Lipschultz asked and quickly answered his own question: "The banks."

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EXCHANGE --- Markets & Finance: Goldman Pitches a CFO for Ultrarich

By AnnaMaria Andriotis
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For years, Goldman Sachs's private-wealth team has focused on providing investment advice to the ultrarich. Now, it wants to organize their financial paperwork, manage their house staff and find them home insurance.

Goldman recently rolled out a family office within its private-wealth management division, part of a broad effort to expand services it provides to the most affluent. Those clients are increasingly important for the firm's strategy to diversify its revenue beyond dealmaking and trading.

The bank is pitching clients a personal chief financial officer as part of a team that manages their day-to-day lives and prepares for big life events -- everything from tax and estate planning to paying their bills to helping them get financing for a jet. Have a charitable foundation? Goldman can help run it. Need a **cybersecurity** firm to make sure hackers can't break through your personal Wi-Fi? It will do that too.

Goldman is touting this offering as an alternative to the headaches wealthy clients may get from hiring employees for their own family offices. Other banks that cater to the ultrawealthy also offer family-office services.

The fees Goldman charges clients for their private family office go into a critical revenue-generating bucket it calls management and other fees, which hit a record $2.62 billion in the third quarter. The bank made $7.6 billion in these fees through September and says it is on track to hit its annual target of $10 billion. That is up from $6.8 billion in 2020.

That kind of recurring revenue is less volatile than fees produced from dealmaking and trading, which can rise and fall on world events out of Goldman's control. Expanding them is central to Chief Executive Officer David Solomon's plans for the bank.

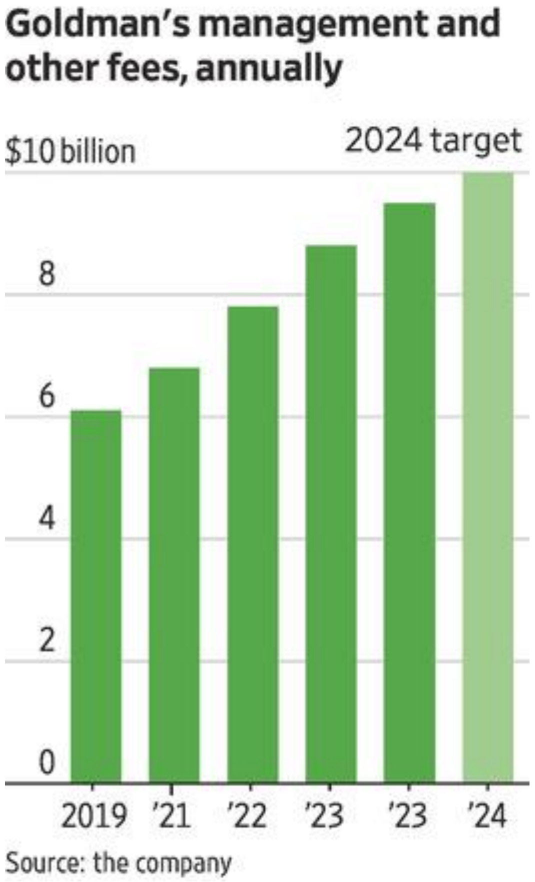
"It very much feeds into the firm's broader strategy to continue to invest in this space," said John Mallory, co-head of global private-wealth management.

Goldman had tried to expand in consumer lending but after incurring billions of dollars in losses is walking away from lending to the masses. Instead, it is pouring money into catering to the wealthiest. Its private-wealth clients on average have about $70 million with the bank.

The family office is mostly aimed at clients with a net worth of at least $100 million, a group that Goldman executives say has been asking for a broader range of services to help run their complex financial lives. The bank has spent more than a year building plans for how to serve those needs.

Goldman has for years provided family-office services to senior executives and other employees of large companies through a unit known as Ayco. And the private-wealth team would refer clients to Ayco for that sort of work. Now, the private-wealth team is taking over the family-office business from Ayco.

The bank sees another potential benefit from that change. Goldman wants to turn more Ayco clients into Goldman private-wealth clients, which could boost assets under supervision in Goldman's asset and wealth-management group broadly. Total assets under supervision exceeded $3 trillion in the third quarter.



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