

Lead Left Spotlight - Lawrence E. Golub



This week we speak with Lawrence E. Golub, CEO of Golub Capital. Golub is a nationally recognized credit asset manager with over \$10 billion of capital under management and four complementary business lines: Middle Market Lending, Late Stage Lending, Broadly Syndicated Loans and Opportunistic Credit.

GOLUB CAPITAL

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The Lead Left: Lawrence, what is the best way to think about Golub Capital's scale today?

Lawrence Golub: Using the Thompson Reuters definition of traditional middle market LBO loans, we have been the number 1 bookrunner for the past four years in a row by number of deals. In larger middle market LBO loans up to \$500 million^[1], we have been number one for two years in a row, after a few years before that at number 2 or 3^[1]. In the first nine months of this year, we have sole agented or lead left agented 6 disclosed deals over \$200 million each, with the largest about \$350 million. We have a \$10+ billion balance sheet. Our hold size is up to \$250 million per borrower.

TLL: Tell the story, if you will, how Golub got to where it is today.

LG: Randy, to set the scene for that, twelve years ago, as the recovery from the 2000-2001 dot com recession was gathering steam, we were a little late learning about leveraging loan portfolios. But our mezzanine skill set was just as applicable. Our previous funding sources were not as interested in that venture, but we figured out how to apply CLO technology to middle market leverage lending. It was not our plan to be one of the leaders of the middle market senior debt industry. Our goal was to deliver consistent, reasonable returns by having low default rates and by providing solutions to private equity firms.

TLL: What was your focus when you started in the loan space?

LG: We had a private equity sponsor focus and emphasis on senior secured debt, particularly first and second lien, and one-stop loans.

TLL: Including unitranche?

LG: We prefer the term "one-stop," since it's not always a single tranche. The key is we lead and hold the facility ourselves. And we have stayed focused on defaults. They're cyclical. Credit losses happen on a correlated basis. Our ability to be a reliable, buy and hold solution provider means we need long-term borrowing facilities, and we always borrow long-term.

TLL: How did you make out in the credit crisis?

LG: Our competitors blew up or were badly wounded. We took some painful punches, but our capitalization was strong and our low credit losses allowed us to continue to raise money. That meant we were just about the only lender open for business to private equity firms in 2009. Twelve months of deals came to us. Since then, our balance sheet strategy has been to get even more resilient, to move from Category Two Hurricane-proof to Category Four Hurricane-proof.

TLL: That's a challenge given your sponsor clientele.

LG: I can understand why you might think so, but actually for us, our capital stability makes us even more valuable to private equity sponsors. First and foremost, we are good partners. We are in existence to make our borrowers succeed. Our success with repeat customers shows that. 75% of our business is with repeat sponsors. We have made sure that we will be there for our clients in the next downturn, too, by further diversifying our investor base and keeping billions of dollars of dry powder on hand at all times. We do have to be mindful of credit conditions, though. In today's market, we have reduce the amount of junior debt we're doing. In 2009 we ended the investment period of our mezzanine fund two years early.

TLL: How did that happen?

LG: We did a management company review of the risk return for our mezz fund investors. Ending the investment period early was an expensive proposition for us, but it was good for our investors. They trust us, and that keeps them loyal and open to new ideas.

TLL: How do you explain the amazing popularity of the middle market asset class right now?

LG: Investors and managers are thinking about whether they *can* get into the space, rather than whether they *should*. There are credit managers, like us, who are trying to build a business over a cycle. Then there are those who are just trying to grow, grow, and grow. It's all about shareholder value versus manager value.

TLL: Could you give us an example?

LG: Take BDCs. Fifth Street did a giant issuance of shares at 85% of NAV. That certainly created manager value, but it would be hard to believe it did anything good for BDC shareholders. The issue is that some managers have ground down the net asset value of their stock. And this is a challenge for private equity GPs as well as BDCs. We're seeing a group of managers who risk hurting the space. They really don't care about true net income.

TLL: Lawrence, talk about your "cargo pants" strategy. That's what I call managers enhancing lending capacity by adding multiple side-pockets of capital from outside investors.

LG: Cargo pants – I like that! We have three strategic imperatives. First, be utterly reliable lenders to sponsors. Second, deliver good returns for investors. And finally, be a satisfying and lucrative place for deal professionals to work. You can't do just one! We started doing all three at once.

TLL: Tough in such a cyclical business.

LG: You can't be at the mercy of investors' changing attitudes regarding the attractiveness of the asset class. You can't be dependent on insurance company or bank regulations changing. It's all about being diversified in your sources of capital. But it's hard to achieve scale with multiple sources of capital.

TLL: That's an excellent point. You build up horizontal, but not vertical, capacity. But you act as a direct lender as well as an asset manager.

LG: When we say "Yes", we'll be there. But we don't say Yes to every deal. At the large end of the middle market – firms like Credit Suisse and Jefferies – the question they ask themselves is, "Can we sell the paper?" Instead, we worry about what we're doing with the sponsor.

TLL: Are we back to 2007's market conditions?

LG: We were heading in that direction before the correction in mid-October. But the core health of the economy is pretty good, relative to 2007. Nobody knows what the impact of qualitative easing will ultimately be. It's all conjecture. There are potential bubbles, certainly. Credit risk, other than real estate, is different. No question 4x leverage is better than 5x. We're big fans of our GOLD (Golub One-Loan Debt) loans, for that reason. But our borrowers are strong, profitable businesses with real enterprise value that should hold up even when the next recession comes.

TLL: That's your middle market direct lending funds, correct?

LG: Yes. Of course, it's a trade-off with those loans. For the one stops, the market gets thin in terms of the number of participants.

TLL: Will the big guys continue to come down market? Can we finally say the middle market is a mature market?

LG: Flows of funds are cyclical. You go from so much smart money chasing deals, to not-so-smart managers. There will certainly be tears at the next downturn. There will be some good periods, and some dumb periods – like the first half of 2007. By the way, you should look at the latest report Stifel Nicolaus published. It's fascinating!

TLL: Yes, will have to re-read that one.

LG: People can do stupid things before the safety belts get attached. Einstein said that only two things are infinite: the universe and human stupidity, and he said he was not so sure about the universe. Some BDC's are not creating value for their shareholders. One has to wonder about taking two-and-twenty dollars and putting the money into CLO equity that pays its own level of fees.

TLL: That's a two percent management fee on assets managed and 20% incentive to the manager over a specific hurdle rate.

LG: It's a double fee structure, with the underlying assets being BSL loans. Leveraging those up as a way to try to deliver yield to shareholders. So you're getting the same assets as are in prime rate funds but at a multiple of their fees. We have less interest in taking this money. We really are concerned about broadly syndicated loan spreads hurting BDCs.

TLL: Lawrence, any final thoughts?

LG: The middle market is cyclical. Which is why it's all about smart managers getting outstanding returns in good markets and okay returns in bad markets. And versus getting blown up in bad markets. It's all about natural selection – survival of the fittest managers.

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[1] According to Thompson Reuters LPC and Golub Capital internal data, based on number of deals. Market participants submit transaction data voluntarily to Thomson Reuters LPC ("Reuters"). As a result, the data referenced herein may not reflect all deals entered into during the time periods indicated. Beginning in 2012, Golub Capital has excluded certain deals submitted to Reuters to prevent the disclosure of confidential and/or proprietary information, but these deals are included in this table. For YTD 3Q 2014, the data that Golub Capital submitted to Reuters does not include 31 deals. For 2013 and 2012, the data that Golub Capital submitted to Reuters does not include 45 and 36 deals, respectively. Rankings are based on the number of deals. In the event of a tie, each company is listed with the same rank and Golub Capital is placed first. These league tables include debt used for LBOs with total facilities less than or equal to \$100MM.

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