First Eagle's Holzenthaler Says Credit Picture Will Get Brighter With Rate Cuts

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Chuck Jaffe, in this episode of The NAVigator podcast interviews , Portfolio Manager for First Eagle Alternative Credit, part of the team running First Eagle Credit Opportunities fund. Larry gives his outlook for credit markets in 2025, noting that after avoiding default troubles when rates were rising, it should be stronger now, with paper being particularly strong in private credit. Holzenthaler further explained why private credit benefits from the interval fund structure and discussed how liquidity and valuations are shaping up in private credit now.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: We're talking about the outlook for the credit market for 2025 with Larry Holzenthaler, portfolio manager at First Eagle Alternative Credit, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing the full spectrum of the closed-end fund business from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today it's pointing us in the direction of the credit market, and it's doing with Larry Holzenthaler, portfolio manager at First Eagle Alternative Credit, he's part of the team running, among other things, the First Eagle Credit Opportunities

Fund. That's an interval fund that trades under the ticker symbol FECRX, learn more about the firm and its investments at FirstEagle.com. Learn more about closed-end funds, business-development companies, and yes, interval funds by visiting AICAlliance.org, that's the website for the Active Investment Company Alliance. Larry Holzenthaler, welcome back to The NAVigator.

LARRY HOLZENTHALER: Pleasure to be back, Chuck. Thanks for having me.

CHUCK JAFFE: We entered 2024 with the market generally saying, "Watch the credit market, as we see interest rates change there's going to be six or seven cuts by the Fed." We never got all those cuts, and then as recently as a couple months ago people were thinking we'd have a bunch of cuts this year. Now most folks are thinking, no, not many cuts, if any, and maybe even interest rates changing direction. So what is that setting up in the credit market for 2025?

LARRY HOLZENTHALER: You know, it's interesting. There was certainly some rhetoric at different points in time around higher interest rates, higher borrowing costs, were going to slow down the economy and they were going to have a pretty negative effect on the issuers who we tend to deal with, which are floating-rate issuers. Their cost of funding floats off of the SOFR, the Secured Overnight Funding Rate, which roughly tracks the Fed Funds Rate, so the thinking was higher rates was going to slow down business, it's going to make borrowing much more onerous, and looking back it would appear as though the credit markets broadly were fairly resilient. Obviously the economy has held up well, things like default and restructuring activity remains a bit elevated, but it certainly isn't the precarious situation that many were forecasting, and really we've felt all along that the market was getting ahead of itself with respect to thinking the Fed was going to cut rates back to 2%. The reality is the economy's doing well and we could see it coming through numbers on a quarterly basis, in fact even through last quarter one could argue that revenues still growing, earnings are growing, margins are pretty healthy, certain metrics might be a little bit more worrisome, but generally overall you're looking at a pretty healthy subset of issuers, so I think that has certainly surprised a lot of people who were expecting some really elevated levels of losses with the credit market that arguably really never materialized.

CHUCK JAFFE: Yeah, it was interesting to watch, because of course raised interest rates, you'd expect more defaults, we never really had it, we didn't get junk becoming junkier. What we did get was a lot of folks who were looking, as rates started to have the cuts, for where they could goose their yield more, and the place that everyone seemed to be turning to was private credit. It seems that we have seen tremendous growth in private credit and it's the area that everybody wants to talk about, but how big has the growth been really? Is it the big story that nobody is spending too much time talking about because a lot of people don't understand how private credit works?

LARRY HOLZENTHALER: The way that the market frames private credit today is generally loans that are negotiated between managers like ourselves and the issuers, so you're kind of removing the syndication process, you're in a lot of cases removing the underwriters or the banks, but if I think about the underlying economics of a private credit transaction, we're making a loan to a company, there's nothing new about that. What I would say is as a result of these bilateral negotiations, what you're left with is a loan that doesn't mark to market the same way that a liquid syndicated loan might. And I think that's what's gotten a lot of focus from investors, is when you have these loans that really don't have a secondary trading market, it makes the optics of the NAV of these business-development companies or interval funds that can own these illiquid assets just remarkably stable. But I would argue what's more important than the marked to market aspect or what's the exact process by which that loan got structured is what's the loan itself? What does the business do? How much leverage is involved? What's the cash flow coverage? Who's the private equity sponsor? Who owns the business, and you would need to work with if you run into trouble? Those are the things that are most important, so I would argue that, yeah, from a structuring perspective, from a syndication perspective, it's a new form of lending. But at the end of the day, especially what we do, these are loans to companies, and so I would argue the more important things are the fundamental pieces within that credit agreement and that loan. So it certainly is a new asset class that's gotten a lot of attention, but we would argue that the important aspects of private credit, lending money to companies and creating a stable return stream over time are really nothing new, it's really just a different package that people are allocating to.

CHUCK JAFFE: But in that package, how good is the valuation right now? I mean, if it's harder for me as a consumer and an investor to get a handle on private credit than it is public credit, which is certainly true, I need to rely on a portfolio manager like you, but I also need to have an understanding of what's the value proposition?

LARRY HOLZENTHALER: I think that's absolutely right, with that very stable NAV comes a lack of transparency quite frankly. How are the managers valuing these assets? If an asset becomes impaired, what does that process look like before that's reflected in the net asset value of the funds I own? What constitutes an impairment? Is a loan that is paying in kind impaired or was that the plan anyway? And so there's a lot of nuances that have been created that need to get looked at as a result of this new format, if you will. Me personally, I'm a credit person, so I'm kind of a skeptic by nature, so that lack of transparency, I don't necessarily think that's a good thing. I think it's something that is different that needs to be accounted for, but I think the retail market in a lot of ways has become kind of enamored with this stability aspect and they're not increasingly starting to focus on the transparency. If I have a loan that's owned by three or four different BDCs, how are those managers valuing those assets? What we're seeing is some managers take different approaches. I think at First Eagle, one of the things I really like about the senior folks on our team, Jim Fellows and Bob Hickey, who have been doing this about as long as there's been a loan market, is they take a pretty conservative view. We understand the attractiveness of that stable NAV, but we're more concerned around making the right loans, and we're less concerned about the optics of that interim volatility. So I do think that we as a team and as a firm have taken a pretty conservative approach, even this conversation I'm having with you is not one that a lot of private credit managers might want to have, they might just want to focus on that stability. So we've tried to take I think a little bit more of a balanced approach in terms of how we run the funds, and then also how we characterize these assets to our investors, just to try to, we think, manage expectations a little bit more appropriately than people who are trying to just sugarcoat and focus on the positives of this kind of private credit market.

CHUCK JAFFE: As you're characterizing these assets, there's a difference, or there seems to be a difference to me as an outsider, between private credit and liquid credit. Can you explain that, and where there's similarities and differences in how people should be viewing that?

LARRY HOLZENTHALER: So specific to direct lending, where you're making loans to companies, private credit now, it's a growing umbrella that includes a lot of different things. But if I think about what we do, whether it's private or liquid, we're at the end of the day making a first-lien senior secured loan to a company. Within the private direct lending market, what you've seen is the market has grown so much that we're now seeing multi-billion dollar direct lending transactions, so now these are no longer even middle market, these are massive entities with multi-billion dollar enterprise values, so they look a lot more like your average syndicated loan issuer, these are not companies doing $50 million of EBITDA, they're doing $500 million or a billion. And we're also seeing things in that large scale direct lending market like covenant-lite, which looks a lot, feels a lot more like a syndicated loan, we're seeing more aggressive terms, more leverage. I mentioned earlier PIK toggles are paid in kind, where the loan, the interest is not paid in cash, it's paid more in the par value of the loan, which it's an aggressive borrower-friendly feature. Where we operate is what we call the lower middle market, so these really are the companies doing $20 million of EBITDA, so they're not going to have access to the syndicated loan market, everything's going to have covenants, you're going to tend to find less leverage, bigger equity checks, lower loan to value, so a better credit profile to compensate you for the fact that you're dealing with a smaller entity that has fewer levers they can pull versus bigger entities. And so we would kind of argue that if you want to look at direct lending within that private credit kind of umbrella, there are advantages, and obviously we're biased, to dealing with those smaller entities. There's more of them, more opportunities, less competition, and we think we're able to get more return per unit of risk, in terms of credit risk, not marked to market, than you might find in those bigger markets. So I think it's important for investors to understand that just because something is private, it doesn't make it better. You're going to find good transactions in the private market, you're going to find aggressive ones, and same with the syndicated market, there's good deals, there's bad deals. What's really more important is the underlying fundamentals and the risk-return proposition of the loan versus is it technically a private loan or a public loan? Because that overlap is really growing, there's a lot of loans today that kind of look a little bit like a private loan, look a little bit like a syndicated, so if you think about a Venn diagram, that overlap has really increased to the point where you have to think, we think, somewhat fluidly in terms of private credit and public credit versus thinking about it entirely in silos, if that makes sense.

CHUCK JAFFE: It does make sense. Does that also help direct an investor? I realize you were talking from your book because First Eagle Credit Opportunities in an interval fund, but does private credit particularly favor the interval fund structure because it has limited liquidity, which means that it can't be jostled about and the liquidity of the investments themselves is less of an issue because you only have so little liquidity on the fund moving around side of things?

LARRY HOLZENTHALER: No, absolutely, I think the wrapper is really important. I would even argue for an interval fund, you need to be careful. Interval funds have to be prepared to redeem up to 5% of NAV on a quarterly basis, and that's not under normal market conditions, that's every quarter. That's a little bit different than a BDC, so BDCs have much more ability to be like pure play direct lending structures because they can limit redemptions, and that's part of the documentation, versus an interval fund you need to build in some level of liquidity to provide obviously the ability to redeem on a quarterly basis. Certainly though the private credit assets belong in either an interval fund or a BDC. Actually though, even if I look at syndicated loans, I know of several managers who were looking to basically package syndicated loan portfolios into an interval fund because it's a better wrapper. Even syndicated loans themselves, liquidity can ebb and flow, there's liquidity today but that can dry up tomorrow, you can have macro shocks, so as a portfolio manager certainly you'd rather own even syndicated loans in an interval fund format. Obviously mutual funds are a compromise for people that want that daily liquidity, but even within the liquid part of the market, the interval fund structure is certainly advantageous, you can use leverage, et cetera, and you're not a forced seller when other people are. So we really think that for investors who are willing to take a little bit more balanced kind of approach in terms of their interim liquidity, the interval fund wrapper has its clear advantages, which obviously include private credit and the ability to manage even the liquid part of your book more based on fundamentals versus just managing to your inflows and outflows.

CHUCK JAFFE: Larry, really interesting, we'll talk again on The NAVigator down the line.

LARRY HOLZENTHALER: Absolutely, a pleasure as always.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and I am Chuck Jaffe, and I'd love it if you'd check out my hour-long weekday show on your favorite podcast app or just go to MoneyLifeShow.com. To learn more about closed-end funds, business-development companies, and yes, interval funds, go to AICAlliance.org, it's the website for the Active Investment Company Alliance. Thanks to my guest Larry Holzenthaler, he's a portfolio manager at First Eagle Alternative Credit, part of the team running First Eagle Credit Opportunities, an interval fund trading under the ticker FECRX. Learn more about the firm and its investments at FirstEagle.com. The NAVigator podcast is new every Friday, be sure not to miss an episode by subscribing and following on your favorite podcast app. And we've got a bonus episode that we'll be releasing in the next couple of days, so keep an eye out for that, and we'll be back with the regularly scheduled one next Friday, and until then, happy investing, everybody.

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