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Private Market Talks:

Driving Alpha with AB Private Credit Investors' Brent Humphries

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In this installment of *Private Market Talks*, Brent Humphries, President and Founding Member of AB Private Credit Investors, speaks with us from his home in Austin, Texas. Over the course of the episode, Brent shares his thoughts on the connection between driving Alpha and platform design, the resiliency of software/SaaS companies in the middle market and much, much more.

Peter Antoszyk: Welcome to Private Market Talks–where we talk with industry leaders and hear their strategies and stories about the fast growing private capital industry. I'm Peter Antoszyk and I'm excited by my guest this week. Brent Humphries is the president and founding member of AB Private Credit Investors, the middle market direct lending platform of Alliance Bernstein.

Brent joined AB in 2014. Today, under his leadership, the business now has more than $14.5 billion of capital under management and is one of the leading middle market direct lenders, with a particular focus on software and SaaS companies with reoccurring revenue, fiber related sectors and healthcare.

In this episode, Brent joins me from his hometown of Austin, Texas and talks about why private credit is well positioned for continued growth; how middle market software and SaaS companies are navigating economic headwinds, and how he created a unique platform at AB Credit to drive alpha. And now, my conversation with Brent Humphries.

Peter Antoszyk: Brent, thanks for joining me on Private Market Talks.

To get us started, maybe you could just describe what you're doing at AB and give our listeners a sense of your market, your industry, the types, et cetera.

Brent Humphries: Sure. Well, first, thank you for having me. I appreciate you putting this on for industry and those that are interested in learning more about private credit, private equity, et cetera. So, AB Private Credit Investors is the middle market direct lending platform of Alliance Bernstein. The way I think about our business is that we, effectively, are providing loans that are, generally, to companies that are private equity-backed, that banks tend not to make anymore, primarily due to regulatory reasons. We think of our business as more middle market, which we will define as probably $250 million to a billion+ of enterprise value; directly originated, meaning we're not acquiring loans that are packaged and sold from an investment bank and privately negotiated. We're negotiating terms directly. We have a $15 billion-plus platform.

My founding team members and I have been doing this together, dating back to 2008 at Barclays Private Credit Partners, which was the predecessor vehicle, before we launched Alliance Bernstein Private Credit Investors in the spring of 2014. So, it had a really good run, and again, focused on what I characterize as core middle market and covered core middle market sponsorship.

Peter Antoszyk: That's great. Can you describe, just to orient our listeners, the industries that you tend to focus on, and how you structure the deals?

Brent Humphries: When we do go to market, one of our differentiations is deep, deep sector expertise. When we talk about sector expertise, we're talking about teams that have invested in specific sectors for 10, 15-plus years, and multiple team members, not one or two team members with that expertise.

Some of the sectors where we are most prolific and most well-known include software, in particular software-as-a-service (SaaS); digital infrastructure, which we would define as cell towers, data centers, managed services, all the fiber, and all the services and sectors around that industry; and health care–we do a lot in healthcare services. We do healthcare IT as well, but we think of that as part of our software platform. Then we also have very strong expertise in what I'd characterize as multi-site QSR (quick serve restaurants), so non-cyclical-type places, consumer-discretionary [spending]. Think KFC, Burger King, et cetera. I think, importantly, we didn't just, kind of, pick those industries because they're sizeable or because of their growth profiles, et cetera.

When we initially started, we took a step back and asked ourselves, “What characteristics do we think make really strong credit investments?”, and some of those credit characteristics include contractual, recurring revenues. Entrenched, repeatable, reoccurring revenue streams. Businesses that while they may not be recurring revenue business models, they may have very, very predictable revenue. So, some of the things in the healthcare, and again, that QSR restaurant sector. It was that focus on those characteristics that led us to those sectors, not the other way around.

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Peter Antoszyk: Interesting. And how are you structuring these loans? Are they first lien, second lien? Can you describe your structures, generally?

Brent Humphries: 75% of what we do would fall in that unitranche product. Another 20% would probably be characterized as traditional first lien, so a little lower levered, lower risk, and only about 5% would really be in the junior debt category.

Peter Antoszyk: Again, for the sake of our listeners, the idea of a unitranche being a single document combining all those various tranches into a single document creates a level of efficiency that you don’t see in a multiple-documented deal.

Brent Humphries: I think from a private equity buyer’s perspective, for example, there’s got to be a really good reason. In some cases there are, but there’s got to be a really good reason to want to work with two different lenders or deal with inter-creditor issues, to put in place the bifurcated structure: the first lien, second lien, those types of structures. If they can avoid it, they probably would prefer it, and that’s why the unitranche has become so popular. Historically, one of the concerns about the unitranche product was whether it was scalable, and whether you could go from a $100 million private solution and scale up to half a billion, maybe even a billion dollars. I think as the private credit industry has continued to evolve and continued to grow, those concerns have really lessened considerably, and the unitranche product is pretty scalable and very flexible.

Peter Antoszyk: I think you’re seeing $1 billion, $1.5 billion unitranches now, where you would very rarely, if ever, see those sizes of unitranches. This has been pretty much mainstreamed in the private credit market.

Brent Humphries: There's been tremendous market share that's been taken from the banks, and that's what I would characterize as disintermediation version 1.0, but we're in the midst of disintermediation version 2.0. You alluded to it when you talked about the billion, billion-and-a-half-dollar unitranche offerings, where today direct lending is really taking share from the investment banks, and there's a variety of reasons for that. But there's a huge growth opportunity in front of the direct lending marketplace that's pretty massive, and I think, again, provides a lot of white space and a lot of runway for the industry to grow.

Peter Antoszyk: Certainly, it's a question of how sustainable that particular aspect of the industry is because the syndicated market is largely inaccessible right now. But that's not going to be the case forever. It will come back and it's a great present opportunity for the private credit market to grant market share of the existing deals. But as the market evolves, I wonder how that's going to play out as there is increased competition among the syndicated and non-syndicated deals.

Brent Humphries: In general, we focus on core middle market and we tend to be most competitive and tend to focus on the part of the market where the syndicated credit opportunity isn't the direct competing alternative. I think our philosophy is once you do start competing as a syndicated alternative, terms will ultimately get marginalized to some extent, in certain markets. Today, you're right, the syndicated market is in a little bit of dislocation, so there's an opportunity. Having said that, I do think there's also going to be a sustained place for private credit in those larger transactions. That's where private credit is good at competing against a broadly syndicated market.

Peter Antoszyk: I want to switch gears for a little bit. The market has changed. We've had 10 years of high-growth, low-interest rates, and everyone knows the story it is today. I'm kind of curious, because I don't know if there's a lot of data out there but there is some… how resilient are you finding your middle market companies in this environment? And I think it's particularly interesting to hear from you because you're focused on SaaS, digital infrastructure, reoccurring revenue, and some of those industries – at least in the public markets – have shown some real stress, and so I'm kind of curious what you're seeing in your middle market investments.

Brent Humphries: So, let's take software for a moment. Why do we like software business, or SaaS businesses? Because of this highly-entrenched install base, which typically has renewal rates 90% to maybe 100% when you consider upgrades, 100%-plus in terms of renewal rates. And so, when we underwrite a software company, we're really underwriting that install base. What's happened in the public markets is partly due to the fact that interest rates have risen, so the discount rate that you're going to be discounting future cash flow back has become much more extensive, and, partly just due to concerns about a softer economy, growth expectations have also slowed. You have slower growth rates, expectations, and you have a higher discount rate, and so valuations have been significantly impacted in that sector as an example, down 30% or so, maybe more in some cases.

From our perspective, that's not what we underwrote. We didn't really underwrite that growth. Now, we indirectly benefitted from some of the growth expectations in our loan devalue. So when we typically invest in a software business it's generally going to be around 35%, of the total value of the business that the sponsor is acquiring, maybe 40% in some cases. The core to our credit thesis is maintaining that install base. I can just use an example: at AB Credit Investors, we moved off of our CRM tool. I won't say what we moved off of, but we moved onto a product called DealCloud, which is very specific for private equity, private credit platforms. And the first thing I'd say, it was a real lift to do that. It was a lot of work to kind of make that migration and to build all of that system into all of our work processes. But having said that, it's a better solution for us, and today, it will be the last thing that we would ever stop paying before we ultimately shut the lights down on our business. One of the last things, if not the last thing, would be that software solution. And so, there's tremendous resiliency in that install base, and that's what we underwrite.

Peter Antoszyk: Interesting.

Brent Humphries: And so, when we look at our SaaS businesses, we continue to see very, very strong recurring revenues, and we just continue to see that retention. And the other thing about software specifically, is once you've installed the solution and you have a customer that's on your system, the ultimate cost to maintain that customer is actually pretty low, and the incremental profitability of that customer is very, very high, typically 89% software margins, or contribution margins.

In times like this, as well, if the new sales opportunity is slowing down, you'll see sponsors really take out the cost in the area of sales and marketing for those companies, and you can actually see them becoming more profitable in an environment like this because they're not investing heavily to drive growth, and we're seeing that in our portfolio.

Peter Antoszyk: Are they sacrificing growth for, lack of a better term, treading water while they wait for the economy to come back a little bit?

Brent Humphries: They're either sacrificing growth or they're optimizing their marketing spend, is what they would try to say, for the opportunity that's in front of them. I'll give you another example, though, because in the past we've done so much in software.

I can recall a time when we were looking to do a take-private for a software company. We had one sponsor. We were really going to add about 50 or 75 sales people to take growth from, call it, 15% to 25-30% in their models, and when they did that they were going to show negative EBITDA, because if you think about the economics of the software business: if I sign a software company up and it has 90% renewal, I'm kind of expecting on average they'll be with me for 10 years. The day I, kind of, turn them on, I booked 1/120th of that revenue, if you will, a month worth of the lifetime value of that revenue. So, I have really a present value, an expected present value asset that I'm not allowed to capitalize, but I've invested 100% of the cost to acquire that in my sales and marketing period cost. And so, if I'm growing rapidly, by definition, in most cases unless you're very skilled, you're going to be losing money. So, in this case, we were looking at a take-private, where with this particular company, one sponsor was going to step on the pedal and grow the business and invest in sales force, and I believe they were showing maybe a negative $5 million EBITDA company. The other sponsor was going to manage it for profitability. They were probably going to show 5 to 7 to 10% revenue growth, really replacing churn and going a little bit off that. They were going to cut heads out of the sales and marketing organization, not add them. For the exact same company, we had one model that showed $25 million of EBDA, one model that showed negative 5, because the head count investment in growth is largely discretionary, and you can dial it up or dial it down based on the opportunity that's in front of you. So, in a softer economy where the opportunity isn't as strong, you're going to see a lot of sponsors reduce cash burn, reduce sales and marketing, and again, in many cases, you'll see companies that were previously burning cash are going to inflect profitability.

Peter Antoszyk: Also, I've read that, and this has been more relative to the larger technology companies, the publicly traded ones, where during the years of '20, '21 and '22, they really increased headcount in a disproportionate ratio to their actual revenue. The ability to cut back in terms of head count hasn't – or shouldn't really impact their business because some commentators view that as a right size from an overly aggressive hiring time.

Brent Humphries: In this example of this business that I was describing when the sponsor was going to add the heads to drive growth, that was a discretionary investment that they made to drive growth. If I recall correctly, this happened a number of years ago, so I hope I'm not mixing up my deals. But if I recall correctly, they weren't actually right on their ability to achieve the growth, and so then they flipped it and they went back to an operating model that looked a lot more like the original sponsor, the other sponsor that was running for profitability. So, you have the ability to dial it up and down in software, and software is unique. It's unique because once you have that installed you don't have to go resell that customer again; you have to service them, and you have to maintain their service. You don't have to resell that customer again, as opposed to in your business, you couldn't do this. You have to bill hours and you have to go find a new client, and so this model doesn't work in the legal profession, for example.

Peter Antoszyk: I just want to pivot back to something you said earlier, which is that the private credit market has become highly competitive, and the implications for your ability to drive terms. I'm wondering how you're able to drive excess alpha in an environment in which the competition will tend to drive down terms.

Brent Humphries: Yeah. So, first, again, I think what I tried to suggest is that I think many institutional investors, just given the maturation of the sector, kind of view sponsor-backed direct lending as yesterday's news, and I do believe that in some cases they may outsmart themselves with that perspective. And what I mean by that is that I do think there is still an opportunity within the private credit industry to generate highly attractive risk-adjusted returns for investors, and if it was truly commoditized we wouldn't be able to deliver the returns we've been able to deliver since 2008. Having said that, it is clear that there's more competition today than there was when I entered this business in 2004 when I joined Goldman Sachs, prior to launching a platform at Barclays, and then subsequently the ABPCI platform. And so, that is true. And, how do I think about that? The way I think about it is, back in 2004 private credit investors added a lot of excess return at the individual asset level. What I mean by that is, it was by just being scrappy, or being one of the few players out there to uniquely source an opportunity, maybe because, again, you happen to have an industry edge, and there weren't as many players with that industry edge. In 2004, there weren't many people lending in the software industry, for example. There are more people that do it today. And maybe you get 50, 100 basis points extra, versus maybe what that asset might actually intrinsically trade for on a risk-adjusted return basis. And also documentation terms. You could really negotiate more attractive documentation terms back in 2004, 2005, 2006 than you can today. Now, today you still have the ability to add value at the asset level, but it's not as much as you used to be able to, so we are now, I hope, being very fair with our sponsors in terms of the way we approach documentation, but we do focus on documents, and we like to think we are able to get a more balanced document than certainly a broadly syndicated loan document. But that gap between the two, is a lot narrower. The private credit doc today is a lot closer to the BSL doc than it used to be previously, just as one example. So, how do you now continue to generate those returns and add value? So, you definitely do it at the asset level, and I'll come back to how you do that, but more and more I think you do it at what I refer to as the platform level. So I'll also refer to it internally as platform alpha. And what I mean by that is in the private credit industry, we're pursuing kind of sanitized investing business. Is this the right risk-adjusted return asset? Do you like this loan better than this particular opportunity? Et cetera. But we're also running an operating business, and we're really running two types of businesses. We're running an operating business that when I think of a balance sheet that is the left-hand side of the balance sheet driving the sourcing and the underwriting, the execution, and that’s kind of the driving value of the asset level. And then we’re also managing a finance business, and how do we fund the right-hand side of our balance sheet, and how do we use that business model in terms of your funding to generate excess returns for your investors? So, from our perspective, we have a philosophy where all the vehicles that we manage are perpetual or evergreen in nature. That allows us to develop highly, highly diversified portfolios for our investors. So, one of the value adds we think we provide investors is effectively almost broadly syndicated loan kind of CLO or loan mutual fund-type diversity, with the ability to capture the illiquidity premium that you can achieve in the private credit space. And then, because we have perpetual vehicles with no end of life, and without getting into all the details just in the interest of time, we have a very well-matched equity structure with the assets that we’re also originating, and from a duration perspective that allows us to finance ourselves principally in the structured finance market, so think middle-market CLOs and the ABS or asset-mapped market. And there’s a big advantage to that versus financing yourself in the bank market. So, specifically, none of our vehicles have mark-to-market triggers in them. Moreover, they don’t even have what I refer to as mark-to-performance triggers, so many bank facilities, they may not have a mark-to-market trigger for, for private illiquid loans, but if a particular loan starts to underperform, the lender can require you to resize that, effectively have a margin call to resize the borrowing base against that one individual loan, not irrespective of how the broader portfolio is performing. And the other key distinction is these structured financing vehicles, these middle market CLOs that committed, they’re long-term, they’re six-, seven-, eight-year vehicles, as opposed to bank facilities tend to be much shorter, and they tend to actually require the lender to approve each individual loan.

How this all plays out from a return perspective, we feel like we've set our business up where we're going to have access to capital in all market conditions, and we can talk about what's going on in the current market, but the fact that we raised capital continuously on a quarterly basis, the fact that we don't have end-of-life vehicles, we feel like we're always going to have capital to invest in all markets. We want to be selective in all markets, and highly selected in this market from a credit perspective, but we also never want to put ourselves in a position where we are a for-seller in a bad market. And I think the way we've designed the equity funding combined with the way we finance our business, we sleep really good at night, even in a challenging environment like this, that we will never be a for-seller in a bad market. And importantly, we expect to have the capacity to take advantage of dislocated markets.

I should also say we feel like we get better financing terms than most of our competitors. There's a handful of our competitors that have similar philosophies on portfolio financing, but if you're managing a typical private equity-style ramp-up, draw-down, wind-down-style fund, you just can't get the diversity to be competitive on the financing side. And not only can you not get the diversity, you won't benefit from the long-term committed structures that we talked about. And so, I do think it's a competitive advantage, and I do view it as creating value at the platform level by creating a better business model.

Peter Antoszyk: Yeah, that's a very unique structure.

Brent Humphries: Yeah, we're not the only issuer of middle market CLOs. There's a handful. I don't want to give commercials to my competitors, but there are some good competitors out there that have done something similar. But it is not the bulk of the market. I was at a conference recently and somebody asked me, "why do so many people – so many of your competitors – still finance themselves in the bank market instead of the structured finance market," and I may be wrong, but my response was, because they can't finance themselves in a structured finance market. Otherwise they would. It's a better way to finance your business. It's safer for investors, you get better execution in my opinion. It's a better match, and the reason they can't is that they don't have this perpetual structure and this technology that we have to manage. We have thousands of investors in our funds. We have a significant institutional backing and partnerships, but we also have thousands of smaller investors, and it takes a significant sophisticated back office to manage that.

Peter Antoszyk: Correct me if I'm wrong on this, I think you were one of the early ones to tap into the retail high-net worth individual market, which I think everyone is driving towards now as best they can, and not just the institutional or pension funds.

Brent Humphries: Yeah, I think of it a little differently. We created this perpetual vehicle, it really combines the best elements of a draw-down-style fund with the best elements of a perpetual vehicle. We were one of the first to create this type of structure, and certainly at scale, and we originally launched this platform in the high-net worth, ultra-high net worth kind of community. So we don't do a lot of retail, what we would consider retail. This is all QP investors that we invest for in these vehicles, but it's not institutional. And part of the reason that we did that is we felt like, look, at the end of the day we did believe this was a better way for investors to access this asset class, we were fortunate to have a white sheet of paper when we joined Alliance Bernstein and asked ourselves what worked post-credit crisis or during the credit crisis, what didn't, how do we kind of learn from that and can we design something that we think is better? But at the same time, it was novel enough and unique enough that I don't think we would have gotten tremendous take-up in the institutional market. I think in the ultra-high net worth market we had a better opportunity to engage one-on-one with investors through our financial advisors, and I think it's played out really well for those investors. But today we're seeing a lot of interest from institutions in this particular offering for the reasons I noted. Another reason why institutions like it is because once they go through the process of underwriting that private credit manager, if they like the experience they're having with that manager, if they wanted to allocate more, they don't have to wait for another fund to be up and running. We close capital on a quarterly basis, so that's an efficiency for them, and I like to say, look, whenever you're ready, Mr. or Mrs. Investor, we're going to be ready. We're open whenever you're ready, and so that's an efficiency that we're starting to see institutional investors really embrace.

Peter Antoszyk: And on the flip-side, how do you address in this structure, the illiquidity aspect of it, if somebody wants to draw out of that investment effort? How do you address that?

Brent Humphries: So I'm focused on our private funds at the moment. Our structure is different from many. You're starting to hear now a lot of people talk about, hey, we have a perpetual fund, or we want to launch a perpetual vehicle, or we only have perpetual vehicles. But in many cases, these are vehicles that have end redemptions, the ability for investors to redeem. In some cases they're trying to match up capital that's being raised on one hand with capital that's being redeemed on the other hand, and trying to match up the timing of that, and we think that's pretty complicated, and we also think that can put pressure on the investors that are looking to stay in the vehicle. So, we don't do that. The way our vehicle works is: investors commit to us for a three-year period. We draw the capital as we have new opportunities during that three-year period. So, as we're adding assets, we're drawing capital, and then the investors are buying in on the performing loans that we can easily value. We actually have a third-party value our portfolio. They're buying into that performing loan, kind of half-diversified pool, but the existing investors that are already there are not getting economically deluded because new assets were being brought into the structure when the capital was called to fund those assets.

Peter Antoszyk: Right.

Brent Humphries: So, that's on the funding side. After the three-year commitment, investors have a really important option. They can either extend for a year or they can exit. And so, if you think about that, if you're an investor, I can now stay fully invested with a one-year commitment without having to commit to a new fund, a new six-, seven-year kind of typical kind of committed vehicle, and hope that my commitment on Fund 2 offsets my wind-down on Fund 1, and I stay fully invested. So, now I can continue to commit on an annual basis, or stay invested on an annual basis.

If investors decide to exit, this is the important part, so if an investor decides to exit, and they can do this in whole or in part, so they have flexibility to really manage their own individual liquidity needs, their own exit off-ramp, as another way to describe it. Or maybe said differently, they can create their own private equity-style wind-down at the time of their choosing, not…

Peter Antoszyk: Oh, that's interesting.

Brent Humphries: …arbitrary fund growth. So what happens is, an investor exits, they have the ability to segregate the assets attributable to their NAV, and as those loans are repaid in the ordinary course, those investors start getting a portion of the proceeds paid down on the portfolio financing, and a portion immediately is paid down to the investor as a distribution. So the investor is able to maintain their leverage through the wind-down as well, which is another unique feature of the way we’ve set this up. And so importantly, that structure does not put any pressure on the investors that are remaining in the fund. There’s no mismatch. It’s almost perfectly matched, funded to the day, assets and equity, if you think about it, and then you can layer in long-dated committed financing, six-, seven-, eight-year financing in the structured finance market to finance your portfolio.

So, we think it works. We think it’s the right way for investors to get access to this asset class. We do it on a broadly distributed, diversified investor base for our comingled funds. We also have an unlevered fund that has the same structure, just no leverage, but gives the investor the same kind of perpetual dynamic supreme ability to exit, and so we think it’s a good solution, and it certainly helped us scale. And going back to your original question, we do think it adds incremental return for our investors. We think it is platform alpha – is how we think about it.

Peter Antoszyk: Yeah, and it gives a quasi-liquidity exit option if the investor so wants, so that’s pretty unique.

Brent Humphries: Yep.

Peter Antoszyk: So, Brent, we covered a lot. Before we wrap up I don’t know if there’s anything else you wanted to cover or comment on, since we can cover anything you want.

Brent Humphries: No. Thank you very much for inviting me to participate, really appreciate what you're doing for the industry, appreciate the guidance and the relationship we've had over the years which has been significant and highly valued. I do think there continues to be a really good opportunity in private credit. Certainly now there is a unique point in time. But, over the long term, I think, again, there should be a core allocation that investors have in private credit, not unlike their core allocation they have in private equity. And then they can build around that, certain either adjacencies or extensions off of that core into different kind of unique or just different kind of investing strategies. But we're excited about the future and look forward to continue to deliver for our investors, and if we do that, hopefully we'll continue to grow our business.

Peter Antoszyk: Yeah, well, I think you should be excited. It's an exciting industry and there's a lot of money going into it, and there's a lot of opportunity. So, I think you're well placed, and so, appreciate the talk. I learned a lot, and we'll look forward to having you on perhaps next year, looking back and forward, and seeing how things have developed. Appreciate it, Brent.

Brent Humphries: Wonderful.

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