Private Debt Investor

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PUBLISHED: 8 March, 2024

FUND MANAGEMENT

Blackstone's Gray sees 'structural changes' in credit

Gray tells PEI Group's NEXUS conference that corporate and real estate debt are the fastest growing assets of the firm.

Blackstone's president and chief operating officer, Jonathan Gray, believes there are "structural changes" occurring in the marketplace for credit, and pointed out that corporate and real estate debt are the "fastest-growing" assets of the firm.

With direct lending to private equity sponsors, "when they do transactions, it's pretty powerful to be able to tell a sponsor – because we're in the storage business – that we're going to lend you the money at 500 [basis points] over [the base rate] and you're done", Gray said in a keynote discussion at PEI Group's inaugural NEXUS conference in Orlando, Florida. He compared that to "the challenges of going to a banker who says, 'it's 500 over, but if I can't distribute it, I'm going to charge you another 150 basis points'", he said.

Gray said: "That difference of being in the storage business has been very helpful to direct lending," in which Blackstone is the largest player, and he thinks that its "scale is a real advantage". He allowed that "banks will continue to do plenty" of lending, and that "there's a lot of room to grow". He also said that M&A was starting to pick up, and as it does, it "should see more value in that non-investment grade business".

Gray said that Blackstone was also seeing "a very substantial growth trajectory in investment grade, performing credit", which appeals to its insurance company clients, who have a very long-duration balance sheet. So, when Blackstone makes real estate or other hard-asset loans, "instead of paying the distribution costs of the banks, and paying the rating agencies, the borrowers can keep all of the spread," Gray said. "Essentially, we're bringing that balance sheet from our insurers up to the borrower."

That is the structural shift in the marketplace that he was referencing, and one he called "very healthy for the system". He cited the failure of First Republic, which was caused not by its super-prime mortgage portfolio, or any issues with taxes, or defaults. "They failed because of the mismatch of assets and liabilities: they had 20-year loans and 20-second deposits," Gray said.

He noted that the model of investing 60 percent of a portfolio in equities and 40 percent in fixed income was changing, and that whereas half of the allocation to public equities had gone into private equity, private real estate and infrastructure, the 40 percent of fixed income has stayed almost entirely in liquid investments.

Over time, he said that the 40 percent will find the benefit of trading liquidity for higher returns in private credit.

In response to a question about whether large private credit firms should receive a systemically important financial institution designation like the banks, Gray drew a distinction between private credit, whose liabilities are matched to their assets and who lend on investors' behalf on an unlevered basis, and US banks, which are levered, on average, 12 times their liabilities, which are primarily deposits.

"Lending in and of itself is not a risky activity; it's a lot safer than buying equities," Gray said. But he noted that although banks are "mission critical" to our financial system, "they're making six-year loans against very short-term deposits", and that technology had changed the underlying stickiness of those deposits, which can be moved on a mobile phone as quickly as information is received.

Gray said regulators are very sophisticated about the differences between private credit and banks, recognising that rigorous regulations address bank leverage and the duration of the leverage.

"Unfortunately, in commercial real estate, we do have banks that are going to take markdowns, and when they occur in their real estate portfolio, those highly levered institutions – mostly smaller and mid-size banks – may face challenges. ■