DIVIDENDCAFE | PODCAST TRANSCRIPTION

FRIDAY, OCTOBER 11, 2024

Please note that this podcast transcript was machine generated. As a result, it may not always read smoothly, as it reflects unedited spoken content. For the clearest understanding of the podcast's content, we recommend listening to the podcast itself. For complete clarity on the topics addressed, we encourage you to always read the related Dividend Cafe missive and related communications at dividendcafe.com.

Well, hello and welcome to the Dividend Cafe. I am David Bahnsen, the managing partner at the Bahnsen Group and the person who brings you the Dividend Cafe every week and today, Friday, I'm recording actually from my apartment in the city cause I will heading to the airport, to go back to our California office, where I'll be for the next almost two weeks.

I haven't been there for a while. It'd be really nice to be with the California team for a couple of weeks, see a lot of clients and record Dividend Cafe in that beautiful studio that we have in Newport. In the meantime, I want to talk to y'all today about something that I kind of teased a little last week, which was the fact that one week ago at this moment, we were wrapping up a week of meetings with our portfolio managers, asset management partners here in New York City sometimes hedge funds, sometimes alternative managers, other times bond managers, different asset classes, some people that we had just met others that are people we've known for many, many years. It's, for those of you who are clients who know all about this, forgive me for the redundancy, but, it is something we've done for many years and, and written about, talked about quite a bit, and it allows us the ability as an investment committee to to not only have a lot of time together in discussion and debate in

consideration, but also to have this time with others where we can bounce ideas off them, hear their perspective, critique what they're doing, and just really force ourselves to kind of do a whole week of real, portfolio introspection.

There's macroeconomic considerations. There's particular portfolio execution considerations. look for someone who has made their living managing money for like me, it's, and who loves doing it. It's a lot of fun. It also is a very serious week. I have talked about over and over again over the years, I don't really believe there are times when everything's kind of calm and cool when people will say like, oh, wow, things are a little crazy right now, it's usually describing something that is always happening, just taking on a different shape or size or manifestation. And so it isn't so much that, Oh, well, you know, this year we had to go talk about inflation or this year talk about subdued growth, or this year we'd talk about the election or, about, China.

There's various things that have to be discussed every year that represent, potential headwinds that represent, tail risk and sometimes it represent opportunities or, or questions, you know, it's vulnerabilities, but also, you know, the the untapped opportunity it, so. I think a week ago I may have mentioned, you know, I was writing about China and really still kind of processing a lot from the week and Brian and Kenny and I spent a lot of time this week, decompressing further.

We were together all day, every day into the evenings, the week prior, but really when all said and done, there's a few particular portfolio adjustments for making and that we're going to write about for clients, Wednesday next week. And, and there are a few macro. Considerations, but the major things that get talked about it every Meeting and with different perspectives from different people that we're, we can talk to, I write about all the time.

So I can tell you that, Oh yeah, a lot of people think that whatever inflation expectations end up being is going to impact bond yields. That's not exactly news and there's differing opinions about what inflation expectations will be and what therefore the impact of bond yields and other economic considerations and financial market considerations will be.

I. I've already gone on record with our perspective about this kind of thing that effectively, I think the, you know, goods inflation producer price inflation is already effectively at 0 percent if not lower and then the, housing market. Is frozen and will but can't will disinflate, but can't disinflate until the Fed is successful in sort of defiling that market and allowing buyers and sellers to start transacting again.

And that's really where I see the inflationary backup is just in housing in the data. And I think that that's just simply a matter of getting transactions to happen but then a lot of discussion. So that's kind of number one universally being discussed. Inflation universally being discussed.

Number two, growth, and I'm well on record here. Our long term growth expectations are subdued because we are of the belief that we are in a Japanification. period, bought, brought about by both excessive government debt and the policy response to such. but the short and medi term outlook is much more, tricky.

There are people who believe that there is the possibility of a boost in growth in a, in a shorter intermediate term that could be catalyzed by CapEx. I've talked about this at great length. I'm not at all against this thesis. I don't think it's a foregone conclusion. But I think that some form of business investment that juices productivity for a time is entirely possible a catalyst to the cap, the catalyst of CapEx could very well be, on shoring, reshoring and, and other change in manufacturing activity. But then there are plenty of things that could prevent such from happening, a fiscal, issue around tax and regulatory policy after the election. And not to mention a shortage of labor.

So the, that's a little trickier, but our longer term growth expectation is one, we have a kind of point of view on and have for some time, you know, you can look at the stock market valuation subject. I've, I talk about it so often, dividend cafe, I hesitate to even bring it up. But there's not a question that valuations are rich.

There is plenty of question as to when that will matter, it is simply untimable by definition until it can be identified with the vantage point of the rear view mirror. And I think history is very

clear on this. I think, right now, the excessive valuations Are very concentrated in a couple of particular sectors and spaces and yet, and then, and then, perhaps more democratized in their impact because of the massive increase in cap weighted index investing that's taken place since the last time we had a valuation bubble like this and then the fourth and final category I'd say that's pretty universally discussed is China bond managers hedge funds equity managers U.S. Based, international based everybody is talking about China. I wrote about it last week you know our feeling we do not consider them to be going through cyclical challenges that therefore have cyclical, exciting opportunity.

We believe they're going through structural challenges and, and that's why we essentially consider ourselves to be very, avoidant of, of the Chinese equity story in particular. So what is something that came out of these meetings that I think is unique, different, interesting, and worthwhile. It's going to sound for a brief second, like it's very, bespoke, and very granular and not of interest to everybody.

And if you bear with me, I do believe that there's a pretty broad application, you know, for us, our exposure to public equities in the U. S. is largely the mass majority of that exposure is through dividend growth investing, which is what we believe in as a, almost religious principle in our investment philosophy, private markets are something that many of our clients have exposure to some do not. There is a tolerance for illiquidity for some people and not for others. There's a lot of considerations that go

into the risk profile and suitability of one being engaged in private markets. So when I talk about private markets, it's easy for a lot of people to say, I don't think this really affects me.

Or if you're not a client of ours, you may just think I am not interested in this private alternative stuff. But what I'm about to say is actually something that does impact everybody, everyone in the industry is aware. There's plenty of conversation inside baseball about, the fact that a lot of deals were done.

There was very low interest rates and a real heavy appetite for deal and a lot of liquidity sloshing around that enabled a fair amount of, transactions and private equity. Let's call it 2020, 21, early 22. A lot of companies were bought and the sponsors, the private equity folks that buying these companies, you're now in the third, fourth, soon to be fifth year of some of these deals, you know, their investors want money back and they bought at a certain valuation.

And they would like it to be at a higher valuation when they sell. They bought at a certain earnings level. They'd like it to be at a higher earnings level when they sell that part is mostly executed very well, but the valuation issue and then the interest rate, they may have borrowed at a certain rate when they bought, but now it's a higher borrowing rate.

And so the exit multiple. It may not be what they kind of penciled a deal to, and you see a absolute backup of exit transactions for the private market space. You don't see a big

deterioration of value where deals are happening. They're largely happening at good marks at where companies had priced them to be or even better.

But there isn't a panic sale. To get out, people are not desperate, but we're at a very abnormal level of deals that need to kind of be brought to fruition. And so as I thought about that and discussed it with several top tier managers and including some managers who lend on these deals, as opposed to being on the equity side it was very clear to me that, one of the common exits of private equity transactions has been off the table selling to a bigger private equity company because of high borrowing costs.

And the desire to get a better multiple buying than what the exit multiple would be to sell. So a difficulty matching buyers and sellers there. And then IPOs I've talked about, written about lately that there's a much lower appetite for IPOs. What that leaves you is an option that I had not considered enough.

That I think is going to be a really substantial part of capital markets activity in our country for several years. And that's strategic acquisitions of private companies by public companies. And I think that. You may see a little bit of give in, in the exit multiple for the seller because buyers in public markets don't like to pay a multiple for a company they're buying higher than the multiple they already trade at.

And public multiples are high, but in some sectors, they're not as high as where private deals are. You're going to see some good

deals. You're going to see some bad deals. You're going to see, you know, bearing multiples, you're going to see, you know, different credit conditions around it. But I think that there is no way.

To kind of remove this backlog, address the backlog of companies that have been bought that need to be sold apart from public companies making strategic acquisitions. So why do I bring that up as something that I think affects everyone? Well, first of all, for our, you know, for us as dividend growth investors in public equity, we happen to own quite a few companies that would be either directly or tangentially connected to.

The deal side of this investment banks, M&A lenders on these transactions, asset managers. So within financial, the financial services sector, there is a play here on just increased activity. M&A has been very subdued the last couple of years. It had been really hot couple before then. We think we think you're in a period where there's gonna be a lot of deals.

So that's Number one is just simply being exposed to what the public market opportunity is there, where there are good dividend growing companies to capitalize on it. But then number two is anyone invested in public equity is likely going to end up having to deal with the possibility. Of their of companies they own making bad deals and then making good deals And so it is not something you bring up to say this is a risk or this is a good thing It is both at once it requires adjudication and discernment and and I believe it will happen at a level that we're not fully

appreciating at this time and so there's always been a strategic acquisition of private companies in the public market, but I think you're going to see it elevated.

I think you're going to see it impact, especially, organic earnings growth constrained companies that want to use M& A as a means of buying growth inorganically. And that can be done very, very well, but it often is not. And so this is a theme that I want to pay a lot of attention to actively, proactively in the years to come.

Now, a tangential issue that I'll close with, it is also related is, you know, Most of these deals get done with borrowed money. And, and I've talked ad nause over the last couple of years about how private credit, has really out competed a lot of the bank loan market and the high yield bond market to underwrite a lot of these deals.

They're lending to private equity sponsors through private channels. And what I mean by that is it's debt that doesn't trade and isn't held on a bank balance sheet. So the money comes from investors. And investors that don't have a timeline for return of capital, it's not callable. And that's where, of course, it differs in the bank market where deposits, the funding mechanism, are always, you know, callable at any moment.

This private credit market I consider to be a great victory for capital markets in America and an enhancement to the systemic safety of our banking system. When a lot of deals can be done

that are productive and and yet not held from a risk profile inside the banking system why would someone prefer this to the bond market?

There's speed, there's execution, there's value creation, there's a number of argents as to why someone would go private credit versus the bond market. , transparency, disclosures. You know, there's a lot of issues that play there, but those are strategic things for the borrowers and the lenders to think about systemically, all of us in society, I'm just arguing that there's something that has been, conducive to economic growth at play.

That is not adding to systemic risk, in my opinion, but the question that comes up a lot is, well, are we at the end of the opportunity set here? A trillion and a half dollars has gone into underwriting, leverage buyouts, private credit funding, private equity deals. Aren't we kind of into the thin part of the, of the opportunity set now?

And I think it underestimates the many, many, many, many trillions of dollars of lending opportunities that exist against assets, against different types of collateral, different types of terms, the level of depth of lending in the banking system and in the bond market. No, there's a richness of opportunity.

There, but there is still a principle at play at maintaining high quality, underwriting, diversification, attractive terms, you know, suitability for who exactly is doing it. I am not a private credit bear or a bear about other things because of private credit and

there's people in both those two categories, sometimes both at the same time, I would be none of the above, but, but one of the takeaways from this last week that Brian, Kenny, and I.

Really shared was appreciation for the opportunity and structured credit in asset based lending at private credit. And the fact that there are perhaps bad lenders coming into fray is somewhat immaterial. , there's always bad deals. but we want to avoid those. We want to avoid the bad players, stick with the operators that are worthy of our investment and that's what we think we're doing, but don't see it as a systemic story.

In fact, see it as a huge growth story there are other nuggets and dividendcafe.com that I won't have time to hear right now in the video, that I encourage you to check out. There are a couple of different charts, including a chart that visualizes the whole private credit universe. That I don't know if they're going to be able to put into the video or not.

And so if you haven't seen it here in the video, I definitely would love for you to check it out at dividendcafe.com, then I'll look forward to being with you back in California next week. If you missed the last couple episodes, we did, thoroughly discussed China last week. We did our big, huge election issue the week before, talked about the Fed the week before that. So there's been a few doozies here at Dividend Cafe the last few weeks, and we'll see what's in store for next week. I do thank you for listening and watching and reading the Dividend Cafe.