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# League of Their Own

THE LEAD | March 28, 2017

At the start of 2017 spring training, the NY Yankees had a undrafted prospect on their roster named Ruth. Not the Babe, of course, though the coincidence has been noted. “It’s kind of cool to have the same last name,” said Eric Ruth, a 26-year-old pitcher.

Interestingly other than the Bambino there have been no Ruths in major league baseball. 149 Smiths, 110 Johnsons, 97 Jones, 0 Schwimmers. Alas, having the Sultan of Swat’s surname doesn’t insure success. Last week Mr. Ruth was sent back down to the minors.

There’s a cruel reality to leveraged lending as well. Calling yourself a senior debt provider doesn’t mean the assets you book carry the same risk/reward as cash-flow loans managed by top middle market firms who support private equity. As a pitcher’s ERA is a fair indicator of his capability, so is the yield parameter of an asset manager.

For example, middle market senior debt now fetches about a 6.5% all-in yield. It’s generally been in the 6-7% range for almost four years. When we are asked about asset managers generating 8 – 10% unlevered returns, we infer these investments by definition must be higher risk that those with lower returns. But without analyzing every single loan in that managers’ portfolio, it’s hard to demonstrate to the uninitiated.

Assuming the loan is indeed a “senior secured” instrument, i.e. top of the capital stack and secured by all the tangible and intangible assets of the borrower, there are characteristics of the borrower itself that help determine what yield an investor will demand to offset the risk implied by those elements.

These elements combine in varying degrees to make a “story” credit. These include customer concentration, operating history, cyclicality, and so on. Depending on the answers to these questions (e.g. 70% reliance on Walmart, started in 2014, 40% revenue dip in 2009), lenders will assign corporate risk somewhere along the relative risk spectrum. The more extreme the story, the higher the return requirement.

In the next few weeks, we’ll examine some of the more interesting aspects of corporate credits and sponsor-backed businesses that help determine the level of risk lenders are actually taking. It’s our experience that this risk is reflected in the actual coupon the lenders demand, regardless of how “senior” their investment appears.

We’ve also found over decades of portfolio management, that the more of these major business risk factors that fall outside our established credit parameters, the more likely it is that the loan will default. And depending on the circumstances, the more likely a loss will be taken.

So just because a lender wears a uniform that looks like other middle market club players, doesn’t mean it’s in the same league.

*Next week we begin a series on the elements of corporate risk.*