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Elements of Corporate Risk (First of a Series)

THE LEAD | April 5, 2017

Institutional investors are combing through the private credit market searching both for higher returns and experienced managers to deliver those returns. The key to understanding why some firms are targeting higher yield investments is to also appreciate the kind of credit risks those managers are taking to achieve those yields.

In this special series, we'll review various major categories of business characteristics and how veteran underwriters analyze where companies fall on the risk spectrum. We hope to help investors better understand the implications of stretching for yield.

Management experience – This is the most critical element of corporate risk. It's a serious misunderstanding of the role of private equity to think that sponsors manage portfolio companies. As one managing partner told us, "That's what we hire management teams to do. We spend more time getting the right people in place than any other issue." Having the wrong C-suite members can destroy enterprise value faster than any exogenous factor.

It's also key to any successful growth strategy. Management needs to understand how to steer companies through product extensions, expansions into different markets, and respond to unexpected competitive challenges. Sponsors often turn to executives with whom they've enjoyed past portfolio company successes to run new investments.

Integration risk – Beyond generating organic growth, successfully integrating acquisitions and add-ons is high on the list of capabilities sponsors and lenders demand of management teams. This is particularly true of retailers or multi-location strategies. Seemingly simple tasks such as reconciling accounting systems have been known to wreak havoc on cash flow. How can you manage what you can't track?

Integration risk has taken on greater urgency in this low-growth era. As we covered in our special series on add-ons [link], sponsors are increasingly looking to blend down high purchase price multiples and improve overall returns by tacking on smaller businesses. But returns will founder if companies can't quickly eliminate duplicate overhead costs, or if they lose control of "one-time" integration costs.

High capex – Senior secured debt providers are repaid through free cash flow. And nothing impacts free cash flow like high capital expenditures. Some businesses – retailers, for example – make it hard on lenders because most of excess cash goes to build out new locations, or refresh old ones.

Capex is divided into two categories: "maintenance," the minimally required spend to keep the existing stores up and running, and "growth." Inexperienced lenders often underestimate what it takes to keep a business going, particularly ones relying on costly frameworks like truck fleets and heavy-duty manufacturing facilities.

While some debt providers gain comfort from hard assets, most middle market lenders know PP&E doesn't repay debt. Reliance on liquidation values often ends in tears.

Next week we continue our series on corporate risk looking at cyclicality.