Elements of Corporate Risk (Last of a Series)

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As we wrap up our special series on corporate risk, let's review the elements we've covered. We began with integration risk and high capex. We then examined cyclicality and specialized sectors. Our third part covered short borrower histories, hockey stick growth, single products, and customer concentrations. Technology, regulatory, and legal risks followed that, as well as geographic concentration and second ways out.

Our last two risk elements are barriers to entry and non-sponsored ownership.

Barriers to entry – Capitalism being what it is, no company is impervious to competition. But private equity sponsors value businesses with high barriers to entry. Similarly direct lenders analyze how difficult it is for other companies to take market share from the borrower.

A number of factors enhance these barriers. We discussed trademarks and patents earlier in our series [link]. While these are helpful, it doesn't mean a better mousetrap won't steal clients. Some brands protect trade secrets by *not* patenting products; Coca-Cola being the prime example.

High switching costs discourage customers from leaving for a competitor. The flip side is that new clients are hard to win.
Same is true of distributors with multiple locations near their clients. High capex can be a deterrent for others to replicate similar infrastructure. Finally, larger companies may benefit from certain economies of scale.

Non-sponsored ownership – We covered extensively the benefits of financing companies backed by private equity firms in our series, *"Why Sponsors Matter"* [link].

Let's review some of those features. First, sponsors bring significant capital to the table. They are professional managers, often with a bench of operating partners, who support the borrower's C-suite, leveraging their acquisition skills, integration experience, and knowledge of cost-cutting and synergy-recognition. Finally sponsors give lenders comfort that their interests are aligned.

What happens when direct lenders go up the spectrum with these 15 corporate risk elements? Credit analysis is a very subjective process. Every borrower profile elicits differing opinions, even from among members of the same investment committee. They are each colored by their own experiences with similar companies in a given industry.

Some managers have expertise lending in special situations to businesses with high customer concentrations or legal challenges. They accept higher risk, charge higher spreads, and rely on asset liquidation to extract value when cash flows fail. In many instances, these lenders are prepared to take control.

If you need one take-away from this special series, it's this: Senior debt funds which offer high yields at the asset level are playing at the riskier end of the corporate spectrum. As an investor you need to understand that these choices, whether on cyclicals, hockey stick growth, or regulatory headwinds, may work out. But all these risk elements are widely recognized as accurate measures of sound credit policies.