Why Credit Standards Matter (Third of a Series)

THE LEAD | May 14, 2015

In the previous two issues of our special series on the state of credit standards in the leveraged lending market, we took a deep dive on covenant trends. This week we take a step back and look at the overall picture of middle market credit fundamentals.

So much of leveraged lending is tied to the fortunes of the private equity sponsors we support. That's why it's easy to forget the goal of debt providers differs from that of equity investors in at least one aspect. When PE firms succeed for themselves and their LPs, they stand to gain significant upside by not only recapturing their original investment, but multiples of that investment as well.

Lenders, on the other hand, don't benefit from outstanding borrower performance. If the company just squeaks by and still pays the loan in full, fine. That's why experienced managers underwrite to a base case, rather than on an ethereal management case showing hockey stick growth.

But lenders and PE are aligned when examining certain deal elements that point to both debt and equity success or failure. Here are a few:

Barriers to Entry – If your borrower has a dominant market position with high margins, competitors know it. What's preventing a larger company getting into the market, or an existing competitor from cutting prices? In niche markets, it may not be worth the trouble. If the borrower has made considerable investment in infrastructure to meet client demand, that may discourage competition. But evolving technology may give someone else an edge. Can you identify where that threat is likely to come from?

Customer Concentrations – Middle market companies, particularly smaller ones and in certain sectors, tend to have lumpier clients. If Walmart, for example, represents 30% of sales, what happens if it goes away? How quickly can it be replaced? What's the impact on Ebitda? Can the company cover fixed charges?

Performance in a Downturn – Asking how most companies might perform in a recession is no longer a theoretical question. Yet it's disconcerting to see how many information memos only show historic financials from 2010 on. Cyclicality is not a crime. Knowing how an issuer fared in the worst recession known to mankind helps underwriters judge what would happen in a more likely, less drastic, future downturn.

Management Expertise – Managing in a leveraged environment is a different animal than with a typical corporate. The cushion for mistakes is less, the focus on cash flow is greater, and the drive for growth is more intense. PE sponsors are professional managers, but they expect management teams to run portfolio companies. Those with buyout experience are given greater credence and more running room by lenders.

Free Cash Flow – Being able to dedicate more cash flow to debt service is a real plus. High capex businesses (retailers, of course, are examples) may be hard pressed, even in a downturn, to generate enough free cash even to cover interest. Failure to keep spending some minimal level of capex (which always turns out to be more than expected) can result in significant diminution of enterprise value.

Next week: our series on credit continues with our favorite due diligence items.