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Why Credit Standards Matter (Last of a Series)

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One of the fundamental differences between investing in broadly syndicated and middle market loans is the nature of the due diligence associated with those asset classes.

The world of lending to large, liquid issuers is driven by public information. Investors use widely available ratings and price data on companies over $100 million in Ebitda to make decisions to buy or sell these loans based on these factors. Frequent issuers in the public capital markets are readily compared to other borrowers of similar credit standing.

Middle market lending, on the other hand, involves “tire-kicking.” Because these companies tend to be privately held in niche industries, lenders visit plants, meet management teams, run customer checks, and use third-party research to confirm value and competitive position. As mid-cap players say, you can’t do that on a Bloomberg.

One of our favorite stories of hands-on due diligence came from a middle market team visiting a manufacturer of HVAC equipment. Bankers spent the morning touring the plant, and then went next door to the company’s headquarters to meet the senior management team for lunch.

“What struck me,” the senior banker told us, “was the big white rug in the lobby of the executive suite. The plant was your typical grimy, sooty, production facility. And that white rug was pristine.” He laughed. “It was obvious the managers weren’t spending any time in the plant, otherwise that rug would have filthy. We decided to pass on the deal.”

So, we wanted to know, what happened to the company? “Competition eventually caught it up with it,” he said. “Filed for bankruptcy a couple years later.” What if the rug had been gray? “We were lucky, I guess. Just shows you. Pay attention to every detail.”

Another sign of a borrower’s creditworthiness is quality of financial information. One risk officer related how his team recognized a big red flag when the CFO was asked to produce monthly numbers, and took three weeks to do so. “On the flip side,” he told us, “we’ve seen companies that could slice and dice data in a zillion ways and pump it out in seconds. Having a strong finance office is instrumental to a borrower’s success.”

As we wrap up our series on credit standards, it’s worth asking – given the frothy market conditions we find ourselves in – whether competitive pressures will continue to erode those standards. Every day we see transactions from aggressive arrangers who seem to have forgotten Risk Management 101. The drive to win business and book assets is one thing. The need to book *good* assets is something else.

In decades of middle market lending experience through many business cycles, we know there’s no short-cut to a strong credit culture. It isn’t easily or naturally attained. It demands training, discipline, and careful adherence to a well-constructed risk policy.

Borrowers and sponsors push the envelope on pricing and structure. That’s their job. But it’s ultimately the responsibility of lenders to manage risk, protecting shareholders and depositors. As one veteran manager put it, “there may not be bad risk, but there is most certainly inappropriately priced and structured risk.”