

Best Practices in Private Credit (Third of a Series)

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Why is portfolio construction such an important concept for analyzing private credit managers? The answer seems obvious, but it's more than ensuring defaults and losses are minimized.

As the asset class has grown to dominate the debt capital markets, questions persist around its durability. How will the asset class perform in a real downturn? Will BSL competition compress spreads and raise credit risk in a "race to the bottom"? Are private credit valuations supportable, or will they crash and contaminate the financial system leading to another GFC?

We believe these conclusions are unfounded. The best private credit portfolios act as firewalls when market volatility impacts liquid assets. 2022 was a prime example of that dynamic. By selecting borrowers whose businesses weather rate or economic storms reasonably well, direct lenders can maintain consistent and stable returns for their investors.

What underwriting practices define the best private managers? While industry and macro trends are important, for smaller companies, how diverse are revenue streams and customer base? Do they have diverse groups of suppliers (a critical Covid-era need)? Same for product portfolios and SKUs. How sustainable are cash flows? Can maintenance capex be throttled back to lower levels to generate enough cash to service debt in a downside scenario?

Market leadership is critical. Can the company's brand and corporate attributes be easily replicated? What are the competitive barriers to entry? If the borrower disappeared tomorrow, would it matter to its clients? Has it been through a variety of business cycles? What was its track record through Covid? Being a market leader is a direct contributor to pricing power. How much leverage does the company have over its customers to cover cost increases or increase margins? This is often a critical sign in assessing the borrower's "value add".

Under-appreciated is the role of management. Nothing can support a successful business plan like a top-notch C-suite. Or sink it with the wrong one. Do they have experience with other leveraged borrowers in similar industries? Can they execute on complex growth strategies including integrating numerous acquisitions without losing track of cost controls? How integrated are the company's IT systems?

Less tangible, but a huge issue today, is employee retention. The cost of acquiring and retraining (and the failure to retain) talent has become a leading concern for private equity sponsors. This results in problems of underutilization and cost absorption, particularly if key revenue producers exit. Note how relevant this has become with so many direct lenders focusing on people businesses in service sectors. Just as LP's looking to invest in private credit managers must evaluate retention and incentives for senior management and portfolio managers, lenders themselves need to focus on the corporate cultures of their borrowers. It's not just having the right team going into an investment that matters. It's making sure you keep them for the long haul.