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Best Practices in Private Credit (Sixth of a Series)

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No one loves physicals. The battery of tests, poking and prodding, with routine check-ups are low on our bucket list. We therefore approached last month's visit to the cardiologist with trepidation. Things got interesting when he spotted on the MRI what appeared to be a widening of the aorta: "Aneurysm."

A hasty Google search uncovered scary stories of ruptured arteries and sudden death. But we had grown to respect our doctor's measured, thorough routine over the years. "Sometimes CT scans give us a better view," he said. "Let's see what that shows." Turns out the scan recorded a narrower diameter, below the worrisome range. "We'll just keep an eye on it."

Our medical moment recalled the importance of how experienced private credit managers keep watchful eyes on portfolio companies. Their practices aren't flashy but rely on methodical monitoring and reporting beginning with some version of credit surveillance reports (CSRs).

Our underwriting teams start by analyzing financials from portfolio company CFOs, comparing them to prior year, budget, and downside cases. This is helpful to evaluate management: are they doing what they are saying? PMs get color on material deviations from plan, looking at items such as margin performance due to price increases and cost cuts.

They also scrutinize borrowers' key performance indicators. KPIs differ by industry. SaaS companies track monthly customer retention metrics. Manufacturers monitor plant capacity utilization. Electrical grid component providers determine monthly backlog trends. What are the tailwinds and headwinds that can impacted a portfolio company in a given situation. Are they idiosyncratic drivers or industry-wide phenomena? A good best practice is subscribing to relevant news wires and email alerts for specialized sectors.

More generally, how are working capital trends? What is the average monthly cash balance? Why did they draw under the RC? Was it to fund the build of a large customer order? If cash flow is down, why? Was there a large capex spend to grow out a facility, to expand a new product line? Does the borrower have enough cushion for financial covenants?

Like blood pressure or cholesterol readings above normal ranges, poor KPI data or covenant tightness could presage problems. Do these warrant risk rating downgrades? Below a certain rating triggers the borrower to be added to our watch list, necessitating monthly reviews with IC and closer monitoring by the underwriting team. Of course, better performance could justify a credit upgrade.

Lastly, just as MRIs and CT scans use different technologies to spot medical abnormalities, understanding real Ebitda is critical to assessing true borrower health.

Join us next week as we wrap up our series with our head of workout. He will guide us through best practices of extracting maximum value from any challenged portfolio company.