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Best Practices in Private Credit (Last of a Series)

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We’ve spent the last six weeks outlining best practices top direct lenders employ so portfolios generate the highest returns complemented by the lowest risk. Nevertheless, stuff happens. In fact, we count on stuff happening. You need to be prepared to deal with those eventualities.

In a recent conversation, our head of workout, Brent Chase offered his secrets for successfully managing troubled portfolio financings. “First, you have to remain proactive as a lender. Advocate the direction you want to go to other capital providers, owners and management. Otherwise, you’ll be reacting to the strategy and direction of others, which can result in sub-optimal outcomes.

“Also, workouts require hands-on monitoring. Cash flows are more “fragile.” A relatively minor performance miss can have significantly negative liquidity implications. Spotting deviations early and communicating closely with the borrower allows time to deal with issues like cash shortfalls quickly. In our case, LP investments in numerous sponsor funds allows us to engage in more meaningfully direct and active dialogue with sponsors in tough scenarios.”

Chase continued. “Developing relationships with key capital structure constituents can help you understand their motivations and behaviors. Whether you’re developing coalitions with like-minded lenders within your class, or reaching agreement with other capital structure constituents, work the phones! Those new to private credit may not appreciate the “clubby” nature of the traditional middle market. Having long histories with lender friends in various parts of the capital structure greatly helps outcomes.

“Most middle market workouts don’t end up as “free-fall” Chapter 11s. Consensual workouts generally result in the best outcomes and recoveries. To accomplish this, you need to do business with sponsors with strong track records of supporting their problem portfolio credits.”

How do you begin your workout process? “Our team re-underwrites each troubled name. You need to understand why the company deviated from its expected path in the first place. Start with a clean slate. Is it fixable? Often the original credit risks (or strengths, for that matter) are no longer relevant. Maybe it’s unforeseen changes in the company, industry or macro environment. By re-underwriting the business, you can begin to get a handle on the new headwinds and tailwinds impacting performance today and in the future.

“Workout fatigue is a real thing. It’s tempting to dismiss businesses as “broken.” But the “good company, bad balance sheet” thing is also real. You need to be patient and work through the operating challenges methodically. Having a dispassionate view on what aspects of the business model are still valid will significantly influence the steps you take to maximize value recovery.”

Brent Chase concluded. “Do a post-mortem of what went well in the workout, and what didn’t. We have almost a twenty-year history of successfully working out loans. We’ve made mistakes in the past on some credits. But we’ve learned from every one of them. And as we grow our business and make new loans, those lessons are with us every day.”