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No One Details a Rental Car

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In his 1985 best-selling *"A Passion for Excellence,"* Tom Peters tells the story of General Bill Creech, who led a reorganization of the US military's airplane maintenance crews. His NCO's process improvement plan involved assigning personnel to the same planes over extended periods of time, rather than switching them out more quickly.

When the general asked why this approach made more sense, the officer replied, "General, when's the last time you washed a rental car?" Peters continues, "None of us washes our rental cars. There's no ownership. And there's no ownership if you're a specialist, no matter how well trained, if you're responsible only for two square feet of the right wing of a hundred planes. Only whole planes fly."

The recent First Brands/TriColor kerfuffle brought this anecdote to mind. The failure of these two auto-related, non-private companies with bank-led syndications had been linked inexplicably to increased risk in private markets. As we discussed last month, there's zero connection between these situations and how private credit operates. Ownership, as Tom Peters made clear in his example of corporate excellence, is a critical element.

The distribution model for broadly syndicated loans is an "underwrite-to-distribute" process by bank lenders and their sales desks. This determines the suitability of the loan for distribution based on criteria such as rating, pricing, size, and other terms. Since public credit is sold mostly to CLOs and retail funds, tradability is of primary importance.

Private credit, on the other hand, is based on an "underwrite to hold" model with little, if any, of the exposure distributed. It entails thorough due diligence, based on in-depth analysis of the borrower, its position in the industry, its management team, and so on. For LBOs, the risk analysis parallels the intensive scrubbing undertaken by private equity sponsors buying the business with a significant cash investment of 50% or more of the total enterprise value.

Because direct lenders expect to hold the loan until the company is sold or the debt refinanced, it becomes a form of ownership. Lenders, sponsors, and management teams (who also have equity stakes) are aligned in their goals and behaviors. To preserve corporate value, they need to work together over time and through cycles. That's why private credit defaults and losses tend to outperform the broadly syndicated market where banks rent their balance sheets.

We modified Tom Peter's phrase because in private credit, details matter. Underwriting and monitoring of middle market loans is way more than a wash-and-dry. Every nook and cranny of a business is examined, every assumption questioned, every potential outcome modeled, and every finding verified. If you make a mistake, you own it.

The lesson of recent corporate failures is not that direct lending is risk-free. It's that the ownership model, as with airplane maintenance, makes everyone responsible for the whole plane flying safely.