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Business of Private Credit: Safety, Not Size

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Even the best credit managers have loans that go bad. What separates them from everyone else is the history and experience they bring to working these problems out.

A lot comes down to the size of the borrower. In our *Sectors and SIC Codes* piece, we wrote about how the upper middle market and the core middle market approach underwriting new deals differently. In workouts, those same differences surface.

Imagine two troubled companies. One is an enterprise software borrower with $2 billion in revenue and 20-plus lenders spread across CLOs, banks, and distressed funds. The other is a $200 million commercial landscaper with a club of relationship lenders who have worked together for years.

Common sense suggests bigger companies are less risky. After all, they have broader access to capital sources, more asset sale options, and can syndicate loans across dozens of lenders to diversify credit risk.

But CLOs, retail funds, and banks that comprise the original lender groups have different strategies than distressed investors who purchase the loan at a discount in the secondary market. Those funds are happy to sell anywhere above their purchase price, even if it’s well below the original issue price. In a workout, this motivation puts them at odds with other lenders who are trying to maximize recoveries through patience and borrower support.

Secondary trading compounds the problem, with new lenders showing up at different cost bases, each with their own agenda. These tactics include layering in credit agreements with weak financial covenants, allowing factoring outside the collateral package, and including first-out provisions that position some lenders ahead of others.

In the core middle market, lenders are hand-picked by sponsors, based on their relationships in prior club deals. As buy-and-hold capital providers, they also share similar workout playbooks: engage the sponsor early, protect the collateral, and use covenant trips to compel negotiations before problems compound. Credit agreements carry real covenants and tighter provisions. That leaves less room for uptiering, where lenders cut ahead of the rest, or drop-down financings, a liability management transaction moving collateral beyond lenders’ reach.

Recovery data supports this approach. As our *Chart of the Week* shows, direct lending recoveries have generally performed better than those in the broadly syndicated market. Experienced lenders anticipate problems upfront and build covenants that catch them early. BSL loans typically lack that feature, so a borrower can slide much further downhill before the credit agreement forces a conversation.

Losses eat returns for breakfast. Investors understand that workouts are part of the credit cycle, and that manager track records demonstrate the ability to operate successfully through downturns. With the right workout playbook, success in the core middle market is largely determined well before the workout ever starts.