THE LEAD
https://theleadleft.com/why-portfolio-construction-matters-third-of-a-series/

Why Portfolio Construction Matters (Third of a Series)

THE LEAD | June 27, 2022

Many direct lenders have oriented their platforms around financing only businesses backed by private equity sponsors. While non-sponsored strategies have certain benefits, the presence of an owner with its own separate track record, select industry experience, and deal sourcing prowess to draft behind, gives relationship lenders distinct advantages.

This is particularly true when it comes to building a healthy, diversified, all-weather portfolio. Besides the mix of industries, structures, and terms credit managers can play with, there's the additional dimension of varying sponsors based on a number of investment categories.

Each private equity sponsor comes to the table with different strategies. Some are growth investors seeking businesses with upside revenue potential. These sport loftier purchase price multiples, but higher cash equity-to-capital ratios add cushions for lenders.

Others are more value-oriented, though it's been hard to find less expensive businesses amid the past several years of froth. But that may be changing in light of market adjustments and a potential recession down the road. It's also easier for similarly oriented lenders to win these tougher financings with tighter structures, lower leverage, and higher pricing.

It's our experience that every PE firm has a unique investing style when it comes to sourcing, cyclicality, balance sheet construction, and the composition of their own funds. Some have mastered the art of using junior level employees armed with market data bases to comb the middle market for businesses fitting certain criteria. Others leverage operating partners with long histories of sectoral experience and C-level relationships to attract sellers.

At a further level down, sponsors can create diversity in their own portfolios not only by sub-sectors, but by geography and company size. The largest firms that traditionally were oriented to large caps have increasingly found benefits in the middle market, even building growth teams raising separate funds towards that effort.

Also inherent in investing with sponsors over time is the value of different fund commitments. Different funds mean different vintages and different cycles. Investing successfully through a variety of business cycles produces a portfolio that is battle-tested.

Finally, experienced GPs create value by continually improving operations and financial performance.They earn their mettle in downturns when tough decisions need to be made. The best ones are the first to acknowledge mistakes, and the quickest to make changes – for example, replacing management teams – when something is not working. This inures to the benefit of lenders by providing an extra layer of scrutiny.

All of which gives private credit portfolios additional levels of cushions during periods of market uncertainty or economic slowdowns.

Next week: We wrap up our special series with a look at BSL vs. MM portfolio construction.