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Best Practices in Private Credit (Second of a Series)

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This week we acquainted ourselves with fun facts about solar eclipses. One is the fortuitousness of size and distance. If the Moon was slightly smaller or further away from Earth, there would be no totality.

This coincidence is also impermanent. Apparently, the Moon is creeping away from our planet at the rate of 1.5 inches per year. It'll take time, but eventually this retreat will eliminate the possibility of future total eclipses. Their infrequency (the next one happens on August 23, 2044) is also the reason so many people in the US made special plans to view this one.

Many variables, including weather, went into witnessing the extraordinary spectacle in the sky this week. The same can be said of successful private credit portfolio construction. Experienced managers have developed well-honed processes to deal with expected (and unexpected) risks.

This process begins at the front end. Originating teams tasked with sourcing new credit opportunities need to synch those deals with the firm's agreed-upon risk parameters. For strategies dedicated to private equity sponsor-backed businesses, the sponsor's investment themes and theses should match those of the credit manager.

Of course, it begins with selecting the right private equity firms. For those of us with experience through many business cycles, that means partnering with private equity firms with deep industry expertise on less cyclical industries such as technology, healthcare and B2B. And avoiding cyclical industries such as energy, retail, commodities and real estate.

It's also helpful for these sponsors to have a bench of experienced operating partners and track records of success in challenging situations. How much support do they provide portfolio companies when the going gets tough? How do they treat their lenders in those situations?

Scaled credit managers with broad experience, especially going back before the GFC, have gained a wealth of portfolio insights that help them navigate in uncertain rate and economic environments. This includes employing sophisticated portfolio analytics and systems to produce key performance indicators for select industries and borrowers.

Best practice platforms make real-time informed decisions from historical and recent performance of portfolio companies. For example, are certain portfolio companies benefiting from industry tailwinds such as government stimulus programs?

Next week we get granular: how do the best underwriting teams analyze specific borrowers? What questions are key to uncovering issues that could inhibit loan recoveries? Why do certain financing structures create more flexibility than others in maintaining enterprise values? Though a North American solar eclipse won't happen for another twenty years, at least two happen yearly somewhere on Earth. For best viewing results, the key is picking the right one.