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Best Practices in Private Credit (Fourth of a Series)

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Understanding the connection between business and structural risks is one of the keys to successful credit investing. “Good company, bad balance sheet” is how opportunistic credit managers describe troubled but attractive situations in which to invest. It’s helpful to examine these transactions for clues as to how the borrower got a bad balance sheet to begin with.

Determining the appropriate amount of debt or leverage to put on the company is a good place to start. This is based on a number of factors, some obvious, some less so. How much cash flow will the business throw off under a variety of stressed “hypos”? Can it afford to pay interest and principal in a downside scenario? Underwriters often look at portfolio companies in similar sectors for insights into new transactions.

Sponsors always have a plan to grow their businesses. Is that plan fully supported by whatever financing structure (e.g. delayed draw term loan) is being proposed? Particularly crucial in the current environment is what are the rate and capex assumptions, and the resulting debt service ratios?

For new buyouts, what is the expected purchase price? A low multiple relative to comparable businesses is not necessarily a bargain. How much equity is the sponsor contributing? Is that amount proportionate to the sponsor’s fund size? What is the loan to value in the transaction? Senior and total leverage from a debt-to-Ebitda perspective?

Appropriate capitalization is a critical component of an all-weather balance sheet. Besides limiting the total amount of debt, it’s important to consider the characteristics of the debt package. For example, how much of the debt is floating rate versus fixed? How much is subordinated versus senior? How much is cash-pay versus PIK?

The no-cash pricing option has gained popularity for issuers and arrangers alike amid higher-for-longer. Unfortunately, some less experienced (or desperate) practitioners seem to believe what’s worth doing in capital markets is worth over-doing. PIK has drifted from junior capital instruments to senior. And from large-cap borrowers to the middle market. And from “break glass in case of emergency,” to being stocked with the breakfast cereal.

Structural innovations and adaptions are what make the US capital markets so incredibly efficient. But not every feature available for large, liquid issuers suits the middle market. Covenant-lite is the most obvious example. BSLs qualify for incurrence-only financial tests because they are often attached to bond deals with the same tests. Smaller, illiquid loans lacking maintenance tests could result in the lender without a seat at the restructuring table.

Occupying a competitive landscape, direct lenders are always balancing deployment demands with maintaining credit standards that minimize portfolio losses. Next week we continue our Best Practices series with a look at how top practitioners can successfully do both.