Best Practices in Private Credit (Fifth of a Series)

THE LEAD | April 30, 2024

This week we continue our series on best practices of top private credit firms with a look at how underwriting teams partner closely with their internal colleagues to ensure the most favorable execution for their sponsor clients and investors.

Clear communications with private equity partners at the deal screening stage is essential. Quick and decisive feedback ("a quick No is better than a delayed one") allows them to make contingency plans if a lender group doesn't materialize along expected lines. Good credit partners can also help structure financings to win deals in hypercompetitive situations.

Consistent and thoughtful feedback over time is invaluable to our competitive position relative to other, less-predictable lenders. Helping to achieve this includes early signaling to sponsors of varying degrees of interest. "Green" (or similar indicator) where we want to proceed to an "early read" Investment Committee discussion. "Yellow" if there are key questions needing to be answered before moving forward. "Red" is a "thanks, but no thanks." It's essential all IC members be included in all discussions, otherwise, there's a risk someone dings the deal unexpectedly at a later date.

Then there's the matter of market acceptance. Direct lenders who focus on the middle market understand its clubby nature. While terms vary depending on manager appetite and risk tolerance, there are consistencies across lenders. Pricing, leverage and covenant packages offered significantly outside those parameters are recognized as either signs of desperation or market misreads. Having experienced capital markets professionals to help interpret these signs is critical confirmation to the underwriters' deal conclusions.

Another key risk management role of capital markets comes into play when managers with large hold capacities step up for outsized commitments. Then the work involves balancing the sponsor's financing demands with maintaining diversification across the manager's investor accounts.

Investment committees can be the glue that integrates the various constituents of a firm's risk management processes. The best managers have ICs whose members are experienced in a variety of investment environments. They can combine macro perspectives with a "firm view" on key variables such as interest rates, chances of a recession, and various regulatory and industry specific dynamic that could impact borrower performance.

Further, ICs can provide guidance to deal teams around financial targets for indicative borrowers. Additionally, they (with assistance from experienced chief risk officers) keep an eye on overall industry concentrations that could affect portfolio track records.

Next week we move the conversation to portfolio monitoring. How do the best private credit shops keep track of how portfolio companies are performing, and what do they do when that performance starts to slide off the tracks?