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PRIVATE CREDIT

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Private credit markets have seen rapid growth in recent years as many institutional investors seek a broader opportunity set to increase returns in their fixed income portfolios. Consequently, private credit is enjoying a strong fundraising market. However, it appears that some fundamentals in private credit markets may be weakening. The increased interest in private credit has led to a decrease in spreads as well as an increase in covenant-lite deals. If the recent economic recovery does not sustain, we could be seeing the initial phases of a perfect storm in global credit markets. If so, distressed fund managers may be well-positioned to take advantage of current overly lenient terms. The challenge in credit markets for 2018 will be finding fund managers that are able to issue loans with terms that provide some protection in the event of an economic decline.

Private credit has been the hot topic over the past year in private markets. It has dominated the agendas of several conferences around the globe, even when the conference was billed with a different topical focus. Clearly, the investor appeal of private credit has reached a new level. A common theme that has resounded across these conferences is credit managers' admission that the terms in credit agreements absolutely have loosened. While readily admitting this, many fund managers also assure the audience that **they** are assuredly **not** the ones culpable. This leads to a head-scratching moment for investors: if it's not the managers at the conferences who are agreeing to relaxed terms in their credit agreements, then who are these "mysterious fund managers" and where are they? This conundrum is analogous to the storyline of Murder on the Orient Express when Hercule Poirot deduces who killed Mr. Ratchett (i.e. all passengers were culpable). However, this truth is at odds with what was presented on the surface and ultimately accepted by the authorities (i.e. a contrived intruder was the killer). Furthering this analogy, how can investors emulate the detective skills of Mr. Poirot and see beyond the surface to identify these mysterious managers who are culpable of agreeing to less favorable credit terms?

While history cannot accurately foretell the future, it can provide guidance and additional data points to assess a fund manager's underwriting skills, particularly over various cycles.

One approach is to study historical loss rates calculated by the loss of total dollars over total invested capital since inception. Loss rates should be assessed on both realized and unrealized investments, and a further discussion with the credit manager about expected recoveries on the unrealized portfolio as well as lessons learned on realized losses. While history cannot accurately foretell the future, it can provide guidance and additional data points to assess a fund manager's underwriting skills, particularly over various cycles. More importantly, if all of the fund manager's prior funds have been raised after the Global Financial Crisis in 2007-2008, and the manager touts a zero-loss rate as a key merit, the investor may want to approach the opportunity very cautiously. Most credit managers have experienced relatively few losses during the ensuing nine-year market rally. Investors' time may be better spent assessing managers who have invested throughout one or more downturns.

Another approach is to speak to a credit manager's external legal counsel as part of reference discussions during the screening and due diligence process. Asking legal counsel about the terms of the loans that credit managers are asking for and which ones the companies are agreeing to can provide some insight into loan quality. It is important to assess the overall relevance of the final negotiated terms to the specific deal. For example, fund managers often tout low loan to value (LTV) ratios as a measure of the quality of a deal. The higher the LTV ratio, the higher the risk. The problem with this is that while a deal may have a low LTV ratio, the deal can still have a relatively high purchase multiple, and value may be prospective and include hypothetical adjustments bolstering projected cash flow. Investors should inquire which metrics a credit manager assesses most critically, and why and how those metrics may differ based on the type of business or the sector in which the targeted company operates.

Yet another approach is to ask the credit manager for detailed monitoring records for all of the firm's portfolio companies, and then review the risk rankings as well as the underlying financial fundamentals over various time periods. Assessing the company's performance relative to the credit agreement's terms to determine what levers the credit manager can pull to protect against losses can prove valuable. If the fund manager resists this disclosure, or provides a limited record, then an on-site review of the records may be warranted. A fund manager refusing this option constitutes a red flag, and an investor may be better off applying their resources to alternative opportunities in the space.

Additionally, relying on the Socratic method of inquiry is a solid, foundational standby, particularly when credit managers throw a lot of jargon around to potentially obfuscate your assessment of the investment opportunity. For example, if a manager indicates that they are most certainly **not** agreeing to relaxed credit agreement terms and passing on deals, a good question to ask is how that manager is staying in business. Wouldn't sponsors just stop calling? One fund manager's response to this inquiry was that the firm is not really relaxing terms but, instead, providing revolving loans to key sponsors as a means to maintain the relationship while shifting its focus to senior secured debt.

It is important to be thoughtful and avoid a herd mentality in private credit markets. If consensus is saying that larger companies are better than small companies and senior debt is better than subordinated debt, question who is saying this (e.g. are they credit managers focused on the large corporate market?). In our experience, while broad generalizations may simplify the screening and due diligence process on the surface, they may unnecessarily divert investor attention away from some appealing and interesting opportunities.

Focus on credit managers who have been cycle-tested and whose historical returns have relatively low variability.

And what, if at the end of this, an investor is left with yet another conundrum: all of the managers in the pipeline appear to be part of the mysterious lot and there are no credit managers left to assess? Firstly, while this is certainly not an impossibility, it is highly unlikely. Focus on credit managers who have been cycle-tested and whose historical returns have relatively low variability. Also, evaluate the full-spectrum of value-added credit strategies, such as portfolio financing solutions or debt capital solution providers that create investments around specific situations and/or provide operational and strategic support, akin to private equity strategies. Even an investor less keen than Mr. Poirot can be successful in this market, although more due diligence detective work may be required to filter through the lot of mysterious managers and find quality private credit managers.

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