

US debt: 9 steps to good portfolio management

Contrary to popular belief, private debt investors are not just bystanders after the deal. Here's how managers can maximise their impact.

1 Invest in vigilance

Cynics may argue it is easy for lenders to claim they closely monitor their loans, but good lenders invest hugely in the process. "Information is the key differentiator," says Joe McCurdy, head of loan origination at Guggenheim Partners. "The ability to monitor and have access to all the information is what differentiates the performance of one lender from another. We need sufficient resources to keep up with the investments we make."

It is a labour-intensive business, he adds – a team of about 120 professionals looks after the firm's US loans.

John Finnerty, senior managing director and head of corporate finance at NXT Capital, says the process is time-consuming enough that each professional in his team only monitors eight to 12 borrowers. This monitoring includes monthly financials, changes in management or macro trends affecting the borrower's industry. Some argue that innovation is making the process easier. One executive, who did not wish to be named, says investment in technology has allowed fewer staff to monitor more deals.

2 Talk to management

"When you look at the financials you can usually see where there's an issue with the operation of the business," says McCurdy. "But what you don't know is why there is an issue, and what management expects to happen in the future."

To find that out, lenders need to talk to management. He offers two scenarios: the management may be able to reassure that a dip in quarterly revenue is nothing to worry about because one big order was delayed and will appear in the next quarter's data; on the other hand, if management reveals that revenue has fallen because of increased competitive pressure that can be more worrying.

McCurdy says Guggenheim often negotiates board observation rights when agreeing a deal, so that staff can attend board meetings to keep abreast of issues. However, he thinks this is not essential, as long as Guggenheim gets sufficient time to talk to board members in one way or another. Some lenders say they book time to talk to borrowers' boards straight after board meetings.

3 Remain prepared for bad events

"One of the things we do when underwriting is to say, 'If this company gets in trouble for whatever reason, what is going to be our second way out?'" says Greg Cashman, New York-based senior managing director and member of the investment and watchlist committees at Golub Capital.

"Will this be the sale of the business to a strategic industry buyer, or selling off some assets? Identifying this early just gives us a leg up later in terms of making a decision."

McCurdy adds that sponsors like that a firm also does this work upfront. This ensures that if issues do crop up lenders do not go into "panic mode".

"Guggenheim has stepped into situations where other lenders were, in our view and the sponsors' view, overreacting to a situation," he says.

This has involved buying existing debt or making new loans to sponsored companies.

4 Respond to problems early

"Our philosophy is to identify problems early to help ensure that those problems don't get worse and that we have a good outcome from an investor standpoint," says Cashman. This is largely through early detection – and that, in part, is based on knowing what to look for. "When you do the due diligence on a deal, you identify the weak spots," he says. Although Golub lends to low-risk companies, he notes that "no company is perfect". One potential weak spot might be a crucial contract coming up for renewal, for example.

"You should be aware of issues long before a covenant gets violated," says Finnerty. "You should be aware if the borrower has lost a major customer, or if liquidity is likely to get tight because you see a downturn in the market cycle ... It's the same as with anything: the sooner you catch it, the easier it is to fix it."

Many lenders, including NXT and Golub, have formal watchlists for borrowers that are of concern, which invariably leads to intense scrutiny by the most experienced people in the firm. Cashman estimates that at any given time probably less than 5 percent of his firm's portfolio is on the watchlist. The majority of loans do not result in material write-downs.

Those lenders that have watchlists say businesses often come off without any action being taken. However, they add that in many other cases the company's management will respond to an informal suggestion by the lender. For example, it might reduce its financial commitment in a certain poorly performing market. They also say that only in rare cases will a lender demand a credit workout for a company on a watchlist. This is partly because conservative lending policies make this necessary and partly because the great amount of work involved makes them reluctant to do this.

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5 Build sector expertise

About five years ago, Golub reorganised its team of professionals into four industry verticals to capitalise on the knowledge its people had accumulated in different sectors. “Those industry verticals have really been invaluable to us in terms of smart investment decisions, but also in terms of being able to identify potential problems or issues with portfolio companies,” says Cashman.

He cites Golub’s expertise in healthcare, one of the industry verticals: “There are potential and actual changes in the US healthcare system with pretty far-reaching implications. Some of this is very granular, and you can’t become an expert in it if you’re reviewing a one-off healthcare deal.”

Industry expertise breeds further expertise, since it means that Golub will end up doing deals in the same specialist markets. “For example, we’ve done six veterinary care deals and more than 10 dental care deals,” says Cashman. “We can look at the profit and loss of many different companies and identify why the margin is so much lower in one company than the others, and share our thoughts and best practice with that company.”

Dan Wolf, chief executive, US lending business and senior managing director of Cerberus Capital Management in New York, makes a similar point about the analytical power generated by knowing about a lot of different borrowers in the same sector: “We might be ahead of the sponsor in analysis, if we have five borrowers in one industry, and we say to management, ‘Yours is the only one that is showing a particular trend that’s worrying. Will you get back to us and explain why?’ This allows us to start very early conversations about the solution before things get worse.”

6 Don’t smother the management

Portfolio company management should be able to get on with the job without too much backseat driving from lenders. Fund managers argue that any other way would be illogical as they would not lend in the first place if the management was not competent. The need for trust impacts how covenant breaches are managed. Most lenders say they demand strict financial covenants for most deals where they are the sole or main lender. However, even if a breached covenant gives lenders the power to take over the business or enforce on collateral, they are reluctant to exercise these rights unless in extreme circumstances.

“If the borrower breaches a covenant, I view this as a trigger for further discussion,” says McCurdy of Guggenheim. “We then want to work with management and the sponsor to understand the issues and find a solution that gets us comfortable from a risk perspective, without restricting management’s ability to carry out its plans.”

7 Don’t rely on the sponsor

The sponsor’s interests align with the lender’s most of the time – they both want the sponsored company to be successful. However, interests don’t always coalesce. “The sponsor is always looking at the upside, but as a lender we look at the downside because we don’t have an upside,” says Cashman of Golub. “There are definitely times when the interests of equity investors diverge from the interests of lenders.”

Illustrating the sponsor’s search for an upside even if it increases the downside risk, one executive at a lender cites an example from many years ago, when a portfolio company was not doing well. Against the lenders’ wishes, the sponsor “threw a Hail Mary pass”. The company, which was a franchise business, decided to terminate its franchise agreement and become independent. The executive says the gamble ultimately paid off, but was nevertheless risky for borrowers.

8 Keep the dealmakers involved

“If you pay a guy to originate, we believe he just originates,” says Wolf of Cerberus. Responding to this logic, the firm’s originators receive bonuses for a deal when the loan is paid off, not at the point of origination.

Cerberus keeps originators involved post-close even in a workout situation. “Originators at Cerberus are very, very careful about getting good deals because if they book a bad deal, they could be sitting behind the desk helping on a workout, which isn’t much fun,” he says. Keeping the originator involved has another advantage as it will also have intimate knowledge of the business.

9 Be a good lender

“Goal number one is to get your money back, but goal number two is to maintain a reputation as a good lender,” says McCurdy. “If you behave aggressively in situations that don’t warrant that type of reaction, you may have difficulty finding companies that want to partner with you in the future.”

Cerberus’s Wolf notes that his firm has over 230 sponsors that form a highly interconnected web. “The vast majority of new deals are from sponsors who have done business with us, in many cases years ago before they set up their own funds. The sponsors come to Cerberus because they are confident that we will be a reasonable partner, which acts consistently, post-close”.