Adams Street

In Private Credit Manager Selection, the Devil is in the Diligence

Jeff Diehl
Managing Partner &
Head of Investments

Bill Sacher
Partner & Head
of Private Credit

KEY TAKEAWAYS

- As private credit popularity rises, investors must be even more discerning. Alpha in private credit derives from loss avoidance, not upside potential
- Benign economic and credit conditions over the last decade have allowed many managers to avoid losses, leading to a narrow return dispersion
- The benign climate has changed with higher rates, wider credit spreads and slowing revenue growth, all of which is likely to put pressure on many managers' portfolios
- Look for private credit managers with three key characteristics to avoid losses and produce alpha – a proven approach to underwriting, a differentiated approach to originating and winning deals, and a capital base that matches their opportunity set

Private Credit has been generating increasing market interest, and for good reason. It offers an attractive cash yield relative to liquid credit, a floating rate structure, improved deal terms, and a narrowing of the historic Internal Rate of Return gap with median private equity returns.

Rising popularity in an asset class often leads managers to rush to meet investor demand through new and larger products. During times of product proliferation and expansion, it can be challenging to distinguish between investment managers who are more likely to deliver repeatable alpha from those likely to produce market beta returns, or worse.

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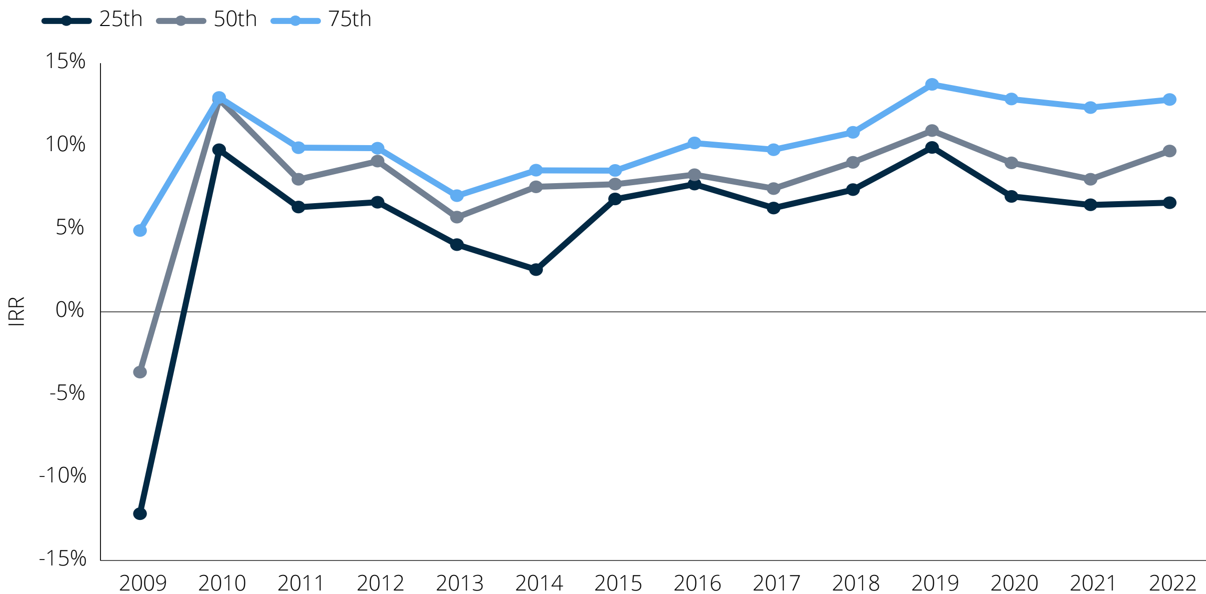
This is especially important in private credit, where alpha derives almost entirely from loss avoidance. That contrasts with private equity, where market outperformance comes from companies that capture upside potential above modeled returns.

Past returns of private credit managers can provide a false sense of security. Benign economic and credit conditions over the last decade have allowed many managers to avoid losses, leading to a narrow return dispersion as shown in Figure 1. However, the benign climate has changed with higher interest rates, wider credit spreads and slowing revenue growth, all of which is likely to put pressure on many managers' portfolios.

That makes it imperative to know which managers may be exposed to potential losses, and which may be well positioned to generate repeatable alpha.

Figure 1: Private Credit Fund Vintage IRR Quartiles[1]



Three Key Factors

Three factors differentiate private credit managers who can produce sustainable alpha, in our experience:

- A disciplined approach to underwriting the credit worthiness of a company across market cycles
- A differentiated platform for sourcing and – importantly – winning credit-worthy deals
- A pool of capital that matches a manager's opportunity set

Credit losses can result from any of these factors being deficient and pinpointing the specific one can be challenging. One way to gain insights is to conduct thorough diligence on a manager's existing portfolio.

So how do you do that? We suggest the following five diligence steps.

STEP ONE: CAN COMPANIES AFFORD THEIR DEBT?

The interest coverage ratio, defined as earnings before interest, taxes, depreciation and amortization (EBITDA) to cash interest, is an important metric to assess the health of a private credit loan book. The ratio shows how much cash flow cushion a company has available to service the interest on its debt.

An EBITDA to cash interest ratio below 1x indicates potential trouble while a ratio more than 1.5x indicates a company can cover its interest payments and sustain either a rise in rates or erosion of EBITDA.

We believe an evaluation should compare EBITDA to current interest charges for all portfolio companies (it is more conservative to use the current SOFR base rate to determine interest expense in a rising rate environment). It is also helpful to examine whether borrowers have employed interest rate hedges that are scheduled to expire and lead to future interest cost increases once that occurs. After doing this, a thorough review should determine what SOFR level causes each company to drop below a 1x ratio. We think a healthy portfolio company should maintain a ratio above 1x with an additional 100-200 basis points increase in SOFR from its current 5% range.[2]

STEP TWO: DETERMINE LOAN-TO-VALUE (LTV)

Since even solid businesses can temporarily encounter interest coverage challenges (e.g., pandemic disruptions, rapidly rising rates, etc.), the most important metric for loss avoidance in our experience is loan to value (LTV). LTV for each deal can be calculated by comparing the debt to EBITDA multiples with the historical trading average enterprise value to EBITDA multiples of its industry sector.

LTV provides a view of how much equity cushion is underneath a loan. An LTV below 0.5x means the value of the business could fall by 50% and the loan would still be money good. An LTV of 0.7-0.8x or greater implies limited equity cushion to support loan repayment, which should cause concern.

Investors can also review how LTV has changed from deal entry. A healthy portfolio will experience reductions in LTV over time due to EBITDA growth. An unhealthy portfolio shows the opposite.

STEP THREE: ASSESS LENDER PROTECTIONS

Loan books with traditional maintenance-based covenants provide lenders negotiating leverage in the event a covenant is at risk of being tripped.

For example, covenants allow lenders to negotiate a cure with the company and its major shareholders if interest coverage drops below a prescribed threshold or debt-to-EBITDA rises above a certain level.

Potential cures include injecting more equity or junior debt capital into the business. In extreme cases, a resolution can involve the lender taking control of the business and selling it to recover capital and/or produce equity gains.

Lenders without covenants are powerless and must wait for the company to miss an interest payment ("default event") before having a voice in the cure process.

That does not mean that all covenant-light or covenant-free deals are bad. It is a risk calculation. A bad outcome is less likely if a business is growing, has low LTV, and a high level of interest coverage. These characteristics may make covenants less critical.

STEP FOUR: READ THE TERMS

An astute portfolio review should also pay heed to three key contractual terms in loan documents.

First is whether a lender is allowed to be "primed." This means a lender has no blocking or preemptive rights on senior capital coming into the company above them, including on more favorable terms. We see this sponsor-friendly feature in some broadly syndicated loans, and it can be destructive to returns.

Proper due diligence should also examine what collateral, if any, has been pledged against the loan and whether that is a primary or secondary pledge. When multiple lenders are in a deal (providing line of credit, first lien, second lien capital) collateral can be divided between lenders with varying levels of seniority. In addition, a thorough assessment should include whether any collateral can be carved out of current lending agreements to be used as collateral for new debt.

Finally, for any senior loan, it is important for the senior lender to have an inter-creditor agreement with junior lenders to protect its rights in the event of default.

STEP FIVE: INVESTMENT PACING

Finally, in our experience, private credit managers who do a lot of deals are likely being less selective due to managing more capital than their opportunity set. In our experience, managers who rapidly deploy capital into a lot of private companies may be at risk of producing returns that are at or below median levels. Examining how many deals a manager did over the last one or two years can also prove useful. If the pace seems rapid, we believe the manager may have difficulty producing alpha.

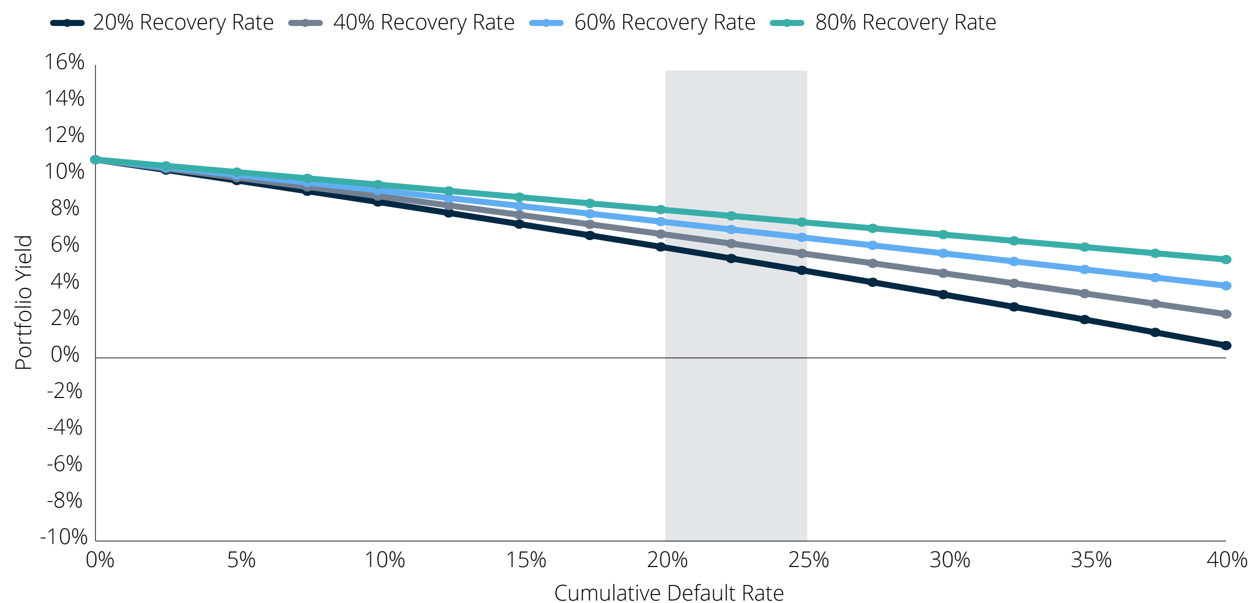
So, what is the potential impact of getting your diligence wrong?

The Importance of Loss Avoidance for Producing Alpha

Loans to unhealthy companies can result in an inability to collect cash interest (“default”) or worse, an inability to recover loan principal (“recovery”). Either scenario erodes the contractual return lenders generate, jeopardizing a private credit firm’s ability to produce alpha. While capital loss rates for private credit managers have been in the low-to mid-single-digit range over the last decade, it would not be surprising to see that rise, possibly materially, in the current climate.[3] We define capital loss rates as the cumulative default rate (% of deals in a portfolio that default) times one minus the recovery rate on the principal for defaulted deals.

To demonstrate the challenge that credit losses pose for returns, Figure 2 shows the impact varying levels of cumulative default and recovery rates have on an unlevered private credit manager’s portfolio yield (effectively gross return before management and incentive fees). We show four lines representing various recovery rates on defaulted deals. Complete loss avoidance for a recently assembled loan portfolio results in a modeled unlevered portfolio yield of 10.8%. A cumulative default rate of 20-25%, an assumption we believe could be median for current private credit portfolios, causes modeled portfolio yield to drop to a range of 4.8%-8.1% depending on recovery rate for defaulted deals. Clearly, loss avoidance through either/both low default rates and high recovery rates is critical for producing alpha.

Figure 2: Impact of Defaults and Recovery Rates on Portfolio Yield[5]



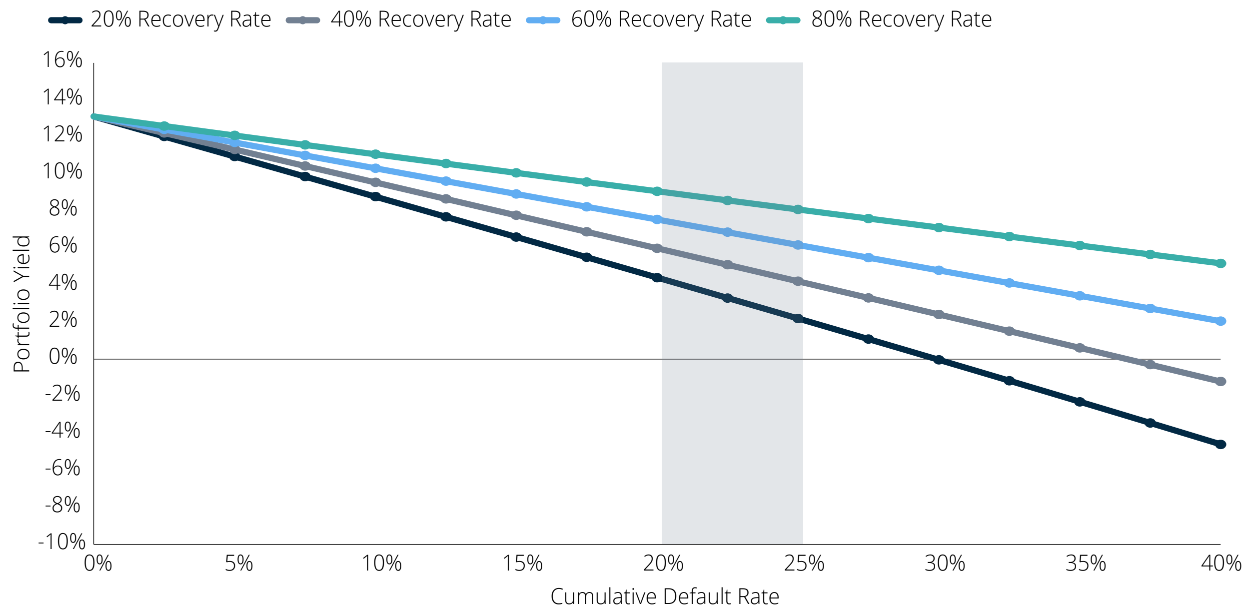
Leverage Can Be a Double-Edged Sword

However, most private credit managers today invest out of levered vehicles, which use floating rate asset-based debt (ABL or asset-based loan) to boost investor returns, assuming investment yields exceed the cost of borrowing.

In our experience, some commingled funds operate at ABL leverage levels of up to 1:1 while Business Development Companies (BDC) can operate at ABL leverage levels of up to 2:1.[4] While ABLs enhance yields of low loss portfolios, they can be punishing to yields for portfolios with material default rates and/or low recovery levels.

Figure 3 shows the same analysis shown in Figure 2 but we replaced the unlevered portfolio with a portfolio levered using a 1:1 ABL. Complete loss avoidance results in a modeled portfolio yield of 13.1%, a nice premium over the 10.8% unlevered portfolio yield from Figure 2. A cumulative default rate of 20-25% causes modeled portfolio yield to drop to a range of 2.2%-9.1% depending on recovery rate for defaulted deals. While this yield range is wider than the unlevered case, the degradation of the return from a loss-free portfolio is more substantial. Similar to the unlevered picture, loss avoidance through either/both low default rates and high recovery rates is critical for producing alpha.

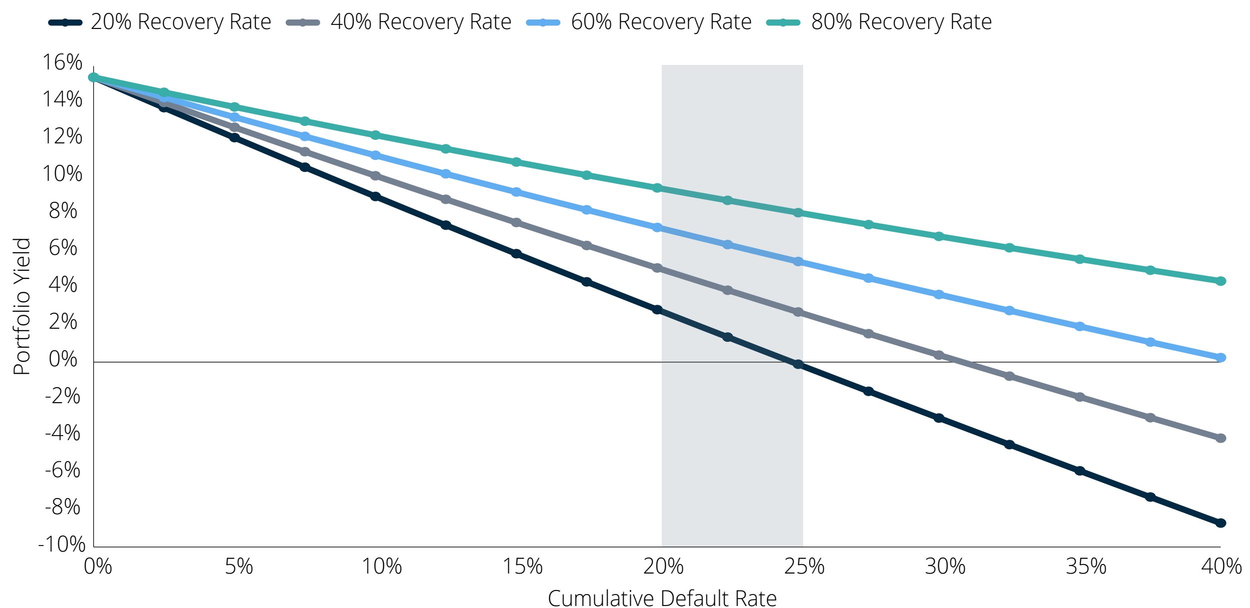
Figure 3: 1:1 Leverage Magnifies Yield Upside, but also More Downside[5]



Yield erosion is magnified even more significantly when a lender uses 2:1 leverage, as Figure 4 shows. Complete loss avoidance generates a modeled portfolio yield of 15.4%, higher than the two prior examples. A cumulative default rate of 20-25% causes modeled portfolio yield to drop to a range of 0.0%-9.4%, depending on recovery rate for defaulted deals. This range is wider than the prior two cases as is the gap in the yield from a loss-free portfolio.

Clearly, ABLs can boost returns, but they also pose material risk when losses appear. One other challenge with leverage is that levered beta managers tend to experience portfolio loss issues simultaneously, often leading to them pulling back on new lending at exactly the wrong time. This can further benefit untroubled alpha managers who remain active, enjoying less competition, wider spreads, higher deal win-rates, and ultimately better returns.

Figure 4: 2:1 Leverage Further Magnifies Yield Upside and Downside[5]



Be Mindful of ABL Facilities with Mark-to-Market Rights

One final area of diligence that is often overlooked is whether a private credit manager's ABL facilities have a mark-to-market right. Many large funds and BDCs have these types of ABLs, which allow ABL lenders to adjust the private credit loan marks to the prices observed in the broadly syndicated loan market, regardless of a loan's credit worthiness.

If a manager employs mark-to-market ABL facilities, investors should ensure they operate with conservative leverage levels or liquidity cushion. Absent one of these, mark-to-market ABLs can potentially become toxic, resulting in forced sales of high-quality loans below par in a tough market, leading to a death spiral of de-leveraging and negative returns. ABL facilities without this feature are much more benign on private credit returns as they simply exclude credit-challenged loans from the underlying borrowing base. With this type of ABL facility, de-leveraging only occurs when underlying company performance is challenged.

Conclusion

In our view, private credit provides the potential for attractive returns per unit of risk in the current climate. However, we think historically narrow manager return dispersion will widen in the coming years given current macro risks.

We believe a private credit manager must have three key characteristics to avoid losses and produce alpha – a proven approach to underwriting, a differentiated approach to originating and winning deals, and a capital base that matches their opportunity set. Conducting diligence on a private credit manager's existing portfolio and credit agreements is essential to expose the absence of one or more of these. If, after conducting such diligence, there is doubt that all three are present, we would not recommend committing to such a manager, especially one that uses leverage to boost returns. ■

1. Source: Burgiss is a recognized source of private equity data, and the Burgiss Manager Universe includes funds representing the full range of private capital strategies; it may not include all private equity funds. The Burgiss data presented here includes a set of funds in North America with vintage years 2009-2022 which are invested on a primary basis in senior debt partnerships and excludes secondary investments. Burgiss returns are not necessarily intended to be representative of, or directly comparable to, any Adams Street Partners fund and may differ from Adams Street Partners funds in terms of composition, risks, strategy, liquidity, or other factors; and is included for illustrative purposes only as a reference point for certain sectors of the private market including sectors similar to those in which Adams Street invests. Numbers are subject to updates by Burgiss. Burgiss results are net of fees, carried interest and expenses to limited partners. Data and calculations by Burgiss. Data sourced in May 2023.
2. As of 5/19/23
3. Source: https://cliffwater.com/files/cdli/docs/Cliffwater_Report_on_US_DirectLending.pdf
4. Source: http://cdn.hl.com/pdf/2023/direct-lending-update-spring-2023.pdf & Wells Fargo BDC Q1'23 Report
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