Why underwriting is vital to private credit success

Fred Chung, Head of Credit Underwriting, Adams Street Partners, explains why strong underwriting is a key determinant of success in private credit, an asset class that may be at the onset of a strong vintage era as yields rise and lenders benefit from improving deal terms.

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Fred Chung, Head of Credit Underwriting, Adams Street Partners.

Andrew Putwain: Why is this a good time to be investing in private credit?

Fred Chung: The conditions for investing in private credit are probably more attractive today than what we have seen in over a decade.

Private credit returns are floating rate in nature and indexed to short-term interest rates, which have climbed significantly in major markets over the past year or so. As

a result, investors are earning 11% to 12% on first lien senior secured debt, which is a very compelling return profile for a loan in the safest part of the capital structure.

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So, yields are up, and virtually every other deal parameter is also improving. Debt multiples are down, lowering the overall debt burden on the businesses we are financing, which is good from a risk perspective. Equity contributions, or the cash equity that private equity sponsors are investing beneath the debt, are materially up. This creates a value cushion for lenders and a stronger alignment for the private equity sponsors who have more skin in the game.

The pendulum on terms and covenants has also swung in favour of lenders. Tighter financial covenants and more robust creditor protections overall give lenders increased control in the event a company performs below expectations.

Taking all these factors into account, we believe we could be at the outset of a prolonged strong vintage era for private credit.

Andrew: How are you approaching investing in the current environment?

Fred: Our investment philosophy is well suited for the current environment we are in. We take a credit intensive, loss avoidance approach to investing, which we believe will be necessary to create portfolios of money good loans. Given the uncertain economic outlook, an intense focus on fundamental due diligence and asset selection will be a differentiator for managers of client capital. We believe the risk of recession is higher today than it has been in recent years, and therefore, we are intensely focused on creating strong loan portfolios of high-quality borrowers that operate in sectors that can remain resilient, even in a down economic environment.

Because our investment philosophy is not one of high volume, and we approach the market as a lead lender, we tend to have the differentiated private-side access to employ the credit intensive approach to underwriting that underpins our investment style.

Andrew: What role does the underwriting process play in the success of a private credit strategy, and why is this important for insurers?

Fred: While the benefits of private credit that I mentioned earlier – high yields, low multiples, strong credit protections – can be very attractive to investors in the asset class, those benefits diminish if a portfolio incurs credit losses. Therefore, selecting high quality borrowers really is the key.

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A debt return is contracted return through the coupon payments on the loan, which means one of the only ways we see managers underperform their return target is by incurring losses. That is why the underwriting ability of the manager is critical to the health of the portfolio.

The goal of underwriting is to ensure that, when you put a loan in your portfolio, you are taking a critical view on the five-year-outlook and validating that the lender can get their money back intact at par, even in the worst-case scenario.

The only way to do that with consistency is to ensure that you have an in-depth approach to underwriting and that you clearly understand the businesses in which you are investing. This means visiting companies, interviewing management teams, and conducting third-party due diligence in the accounting, legal, market, environmental, and technology areas to name a few. These are all critical to validating the quality of the underlying business.

Andrew: Are you observing any notable trends in your current portfolio?

Fred: Every lender is observing tighter cash cushions, which is one of the impacts of higher interest rates. No one would have predicted three years ago that short-term rates would be at 5%, because when a lot of these loans were made, base rates were close to zero basis points. As rates have risen and credit spreads have widened, this has created a larger cash burden for borrowers.

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This means the free cash flow cushion is tightening, so we have made sure that the portfolio is underwritten with enough cushion to sustain further rate increases.

We are also seeing hints of pressure on margins caused by inflation, whether that's wages, input costs, or other areas of cost increases. This is one reason we focus on businesses with “pricing power”, or the ability to pass on costs to their customers.

So, while the portfolio is growing overall, growth rates are starting to slow, which might be an early sign of a softening economic environment. But again, our underwriting means this is not a surprise, and we are prepared for this shift. Our portfolios are designed to be resilient in any type of economic environment.

Andrew: Are there specific sectors you are focused on?

Fred: We are generalists in our sector focus and therefore tend to keep an open mind and look across the board. However, we do gravitate toward sectors with characteristics that fit our investment philosophy. These tend to be non-cyclical and defensive. Some examples are healthcare, aerospace and defence, technology/software, and non-discretionary consumer businesses.

"We have not historically done a lot in energy, hospitality, and brick and mortar retail – because these can be highly cyclical sectors."

These sectors tend not to correlate heavily with GDP and the overall economic environment and have historically remained resilient in times of economic contraction. We would expect to continue observing that trend going forward. We have not historically done a lot in energy, hospitality, and brick and mortar retail – because these can be highly cyclical sectors.

We also tend to weigh towards businesses whose absence would have an impact on the wider sector. Every business we invest in must pass the “reason to exist” test. That means we ask what the impact on customers and supply chains would be, as well as broad areas of certain markets, if that business ceased to exist.

Being selective about the sectors we invest in has benefitted us, for instance, during a very tumultuous 2020 with COVID-19 and in 2022 as well.

Andrew: How important is the “relationship” when sourcing deal flow?

Fred: Relationships are critical in middle-market direct lending. It is not a market where you can buy debt on an exchange, and it is not an overly intermediated market. It is a directly originated market where a lender needs to be invited directly by a financial sponsor to pursue a financing. Those invitations are largely based on relationships.

We have been an investor in middle-market private equity for over 40 years. Over that time, we have established institutional relationships with private equity funds; it is one of our most critical differentiators.

Not only are those strong relationships, but they are often long tenured. We have been some of the earliest investors in certain private equity funds. Those are the folks that we are sourcing deal flow from on the private credit side. Based on the strength of that relationship, we tend to be the first call for those private equity funds seeking financing on their deals. As such, we benefit from a broad opportunity set of deals to select from. Relationships are one of the most critical elements of sourcing deal flow.

There is a saying in the business that some of the best loans are made in the worst of times. There is a truth to that, and those economic circumstances are potentially on the horizon. As a result, we think this could be an exciting vintage for private credit for those who approach it the right way, which we would argue Adams Street is well suited to do.

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