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Credit investing: How to avoid losers while hunting yield

By Perpetual Asset Management

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Not every credit investment delivers the outcome investors expect. Perpetual's BENJAMIN CHAN explains how to avoid the losers

- Strong management matters

- Underwriting, experience the key
- Find out about Perpetual's Credit and Fixed Income capabilities

CREDIT investors are placing greater emphasis on capital preservation right now as signs of stress emerge in certain sectors and companies.

That's why it's more important than ever to partner with an experienced, active manager says Benjamin Chan, a credit and private debt analyst with Perpetual's credit and fixed-income team.

Disciplined credit selection is critical, he says.

Investment managers need a robust underwriting and investment process, and experience knowing what to do if a borrower finds itself in trouble.

"The first line of defence is screening and avoidance through investment process and credit selection," says Chan.

"The second line of defence is knowing what to do when things appear strained.

"At Perpetual we focus on businesses with solid franchises and resiliency, as well as capable management.

"When things go wrong, understanding what to do makes for better investor outcomes."

An illustrative example

Chan highlights Perpetual's recent successful investment in a syndicated loan from Star Entertainment Group (ASX:SGR) as an example.

"Given regulatory complexities surrounding the credit profile, we considered Star to be towards the higher end of our risk tolerance," says Chan.

"But we saw some key attractions to the credit, such as exclusive licences which could underpin cash flow and a tangible asset base."

When Perpetual initially lent to Star, the gaming company had raised additional equity and reset its capital structure, leaving it with relatively low leverage.

Meanwhile, exclusive gaming licences in NSW and Queensland gave it the potential to deliver strong cash flow.

As the position in Star evolved, due diligence and underwriting informed internal discussions on what was required to improve outcomes.

“We were acutely aware through our initial due diligence process what were the risks, and mitigants, and the aspects of the investment which were required to be fortified or enhanced,” says Chan.

“This drove our internal processes and discussions and gave us a good orientation on how to position our discussions with lender advisers and other lenders.

“It allowed us to be more surgical and targeted with our conversations.

“While it was a protracted process, lenders as a whole were able to reach a place where investors’ position was improved. The position was ultimately refinanced out, and produced good returns.”

The eventual repayment provided a good result for investors.

Robust process and underwriting capabilities

The Star story illustrates why Perpetual diligently screens potential loans and applies its internal process to reduce the chance of poor investor outcomes.

There is a key focus on high-quality businesses with good cash flow, capable management and good downside protection.

“We avoid risk that we can’t get comfortable around – whether it be industry headwinds or emerging threats to the industry, or vulnerability to overall cyclicality, as well as the overall amount of leverage applied to the business.”

Discipline processes have helped avoid poorly performing names and industries.

“When we look at the investments we’ve avoided, they typically encompass a few things – highly leveraged, cyclical, and lacking some cash-flow resilience,” says Chan.

A thorough investment process and careful credit selection is the first and main defence.

But understanding what needs to happen if things don’t go to plan is also critical.

Recognisable patterns

What should credit investors look out for right now?

While catalysts for a challenged credit profile can vary, there can be recognisable patterns when borrowers begin to enter a tougher period.

As earnings weaken, management typically implements restructuring initiatives, flags potential asset divestments, seeks additional liquidity or asks for relief from lenders.

Consistent monitoring of portfolio positions also plays a big part in signalling which avenue management may go down.

“Look at the financials and how the business is performing. Get in touch with management. Try to understand whether that cash flow profile that you initially went in for is still present and observable,” says Chan.

Some of the avenues can require lender approval, or cooperation.

This process also gives lenders an opportunity to improve their position.

“These can come in the form of improved economics such as fees or better pricing, or additional legal protections for lenders,” he says.

“The initial due diligence we conduct allows us to focus on what we want or require.

“With this in hand, it leads to improvements to the overall position and economics of the investment. Most importantly, it preserves and protects investor capital.”

Valuation transparency

Finally, communication and valuation transparency are another critical consideration for investors in relation to challenged borrowers.

For more on Perpetual’s valuation process read: [Michael Murphy: Why valuation discipline matters in private credit]

About Benjamin Chan and Perpetual's Credit and Fixed Income team

Benjamin Chan is Credit & Private Debt Analyst at Perpetual Asset Management. In this role, he is responsible for performing credit analysis for corporate credit and loan issuers.

Perpetual offers a range of cash, credit and fixed-income solutions. We are specialists in investing in quality debt.

We take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Find out more about Perpetual's Credit and Fixed Income capabilities

Want to find out more? Contact a Perpetual account manager

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