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The Investment Conversation: Strong Private Credit Underwriting Begins with Defense, Part 1

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Steve Kuppenheimer, Head of Private Investments, explains how experienced lenders price risk, evaluate borrowers, and prioritize downside protection in today's private credit market.

KEY TAKEAWAYS

- Pricing risk extends beyond yield. While loan economics begin with base rates, spreads, and fees, experienced lenders also evaluate leverage, documentation, covenants, borrower quality, and capital structure to determine whether the risk is worth taking.
- Strong underwriting begins with defense, not return maximization. Disciplined lenders prioritize resilient businesses, conservative loan structures, experienced sponsors, and protections that help preserve capital when market conditions change.
- Today's credit cycle has revealed differences in lending strategies. As loans originated during the low-rate environment mature, loan vintage, borrower quality, and underwriting discipline are contributing to dispersion in performance across private credit managers.
- What's behind defaults? Understanding covenant structures, borrower performance, and what defines a default provides a more complete view of credit quality.
- Active monitoring, regular dialogue with borrowers and sponsors, and early intervention if performance weakens are central to preserving principal and managing downside risk.

LAUREN FERRY: Welcome to the *Investment Conversation*. I'm Lauren Ferry, Global Head of Alternatives Product here at Lord Abbett. Today we're talking about private credit, an asset class that is constantly repricing risk but usually behind closed doors. Joining me is Steve Kuppenheimer, Head of Private Investments at Lord Abbett. Steve, thanks for being here. It's great to have you back on the podcast.

STEVE KUPPENHEIMER: Thanks for having me.

FERRY: It's great to have you back on the podcast again. So, we have a great agenda to cover today. I imagine most of our audience have been following private credit in the headlines this year. This is really the first time the asset class has been tested. Retail liquidity came under the spotlight in [artificial intelligence] AI. I know we view it as an opportunity and a risk, but software really became front and center. But despite the stories about retail redemptions, what we've been seeing is that fundraising has been quite strong and net positive really overall.

And not just us but industry wide. So, spreads have widened and defaults have remained relatively contained. Steve, I want to focus this conversation on pricing risk. When you hear that phrase pricing of risk in private credit, what does that mean to you or to our audience in plain English?

KUPPENHEIMER: Well, I think most simply it means what yield are you getting to make a given investment? And these are fixed-income investments or debt investments, so it's about what spread, what base rate you're getting, what up-front fees you're getting. So, if we keep it in its most simple form to start, there's a few different aspects of how you get compensated to make a given private credit loan. And that comes in I think most obviously given your base rate. These are, you know, generally floating over [Secured Overnight Financing Rate] SOFR in almost all cases.

SOFR today is about [3.81%] 381. You then have a spread over SOFR that you get, and that can be anywhere from the high 400s [basis points] to the high 500s [basis points]. But then there's two other parts of the return that I think are less talked about. You're often not buying these loans at par. You're usually getting some sort of up-front economics. That's usually referred to as the OID or original issue discount, and that can be anywhere from 50 basis points to 200 basis points. And then most of the loans, not all, also have call protection, meaning if the loan repays early, you get an additional fee.

And when you blend that all together, that's the overall kind of pricing of a given loan on a funded basis. And I think that's probably the most direct answer to the question, but there is more to it, in that when we look at risk and how we're compensated or maybe mitigated, it's not always just from spread. In other words, if we don't like a loan, we may not like it at any economic incentive, because we're trying to avoid defaults not just maximize spread. And so, you also will look at the documentation. You will look at what's the leverage ratio, what's the overall corporate structure? Is it conservative? Are there covenants in the loans, other limitations on how you could be treated as a lender, other protections against the company's behavior or leaking value out to other stakeholders. So, in most simple case, it's really just about what's the return that you are being given to make a loan? But there's more nuance to it in all the different ways you can get that return, and then other ways we would trade some spread or economics in order to have a less levered loan.

FERRY: Right. And where does your team tend to focus? Is it on these protections? Is it on [payment in kind] PIK? Where are you least likely to give up?

KUPPENHEIMER: You're always looking at all of these topics, and you're trying to come up with the best risk-adjusted return you can when you put it all together. I think for us in general, if we look at the main strategy we're managing, which is primarily a new issue performing loan strategy, we are looking at defense first.

So, we are looking for very strong companies in industries that are less cyclical or growing that have terrific management and terrific ownership. Usually that ownership is in the form of a private equity firm but not always. You might have a founder-owned company.

And then we're looking at the structure of the loan, as we talked about before. So, are there covenants? Are there limitations on [payment in kind] PIK? Are there limitations on liability management exercises [LMEs], which is something we've talked about on the podcast before. And we view those really as paramount, that collection of defense. When you think about where spreads are we remain in a world where spreads are more compressed. There's less dispersion of spreads than there has been historically in the product.

So, again, going back to some of my earlier comments, let's say SOFR today's 381 [basis points] on average you're lending at a spread of 500 [basis points], so that would get you to 881 [basis points]. And then with some of these other fees and ways we can get rewarded for our risk, let's say you're getting somewhere around 950 basis points to make a given loan. If that spread is 25 or 50 basis points wider out of almost 1,000 basis points, that's not really going to change your fundamental experience, but if you're making loans that are either going to default or not protect you when things get choppy, that could fundamentally change your experience.

FERRY: There is more downside risk there, right?

KUPPENHEIMER: Correct. So, for this strategy, where we're trying to deliver a stable [net asset value] NAV and a high current income, in other words really a performing credit strategy, that's why we focus on the things that we do.

FERRY: So many questions running through my mind right now.

KUPPENHEIMER: Let's go!

FERRY: One of them is I imagine that most private credit managers are going after the same thing, right? They want that yield. They want the protection on the downside. Why is it now that we're seeing dispersion, right? It's happening. We've been talking about it but we're actually seeing it now.

KUPPENHEIMER: Well, I'll answer your question directly first, and then I'll go back and maybe disagree with you a little bit on one of your premises. But you're seeing it now because you're seeing more of a credit cycle now, and that hasn't happened in years really.

You could go back to COVID, but COVID wasn't really a test of credit. It was more a test of liquidity, and it was fairly short-lived. So, the last real test of credit we had you could go all the way back to the [global financial crisis] GFC. There was probably a couple other moments since then, but it's been years since we've had more pressure on credit in general. But the premise I want to go back to is--

FERRY: I want to know what you want to argue with me about!

KUPPENHEIMER: Yeah, I do, let's go. So, I don't know that every private credit manager is looking at the same thing. There are differences in strategies. So, there are more opportunistic strategies, which may be looking at more stressed companies where you can come in in a different structure, get a different range of returns, a higher range of returns because you are taking more risk. There are managers that focus on secondary purchases rather than do originations. So, there are differences, and I think it's common that the words private credit need to be defined further in a given context because it applies now to so many different strategies and different parts of the market that it's important to understand whatever context you're in that you know what the specific strategy is.

But to go back again to why we're seeing more dispersion now, if I were to go a little deeper, you saw an enormous amount of money get raised for private credit with the onset of COVID, because you had very low base rates. So, there was a search for yield. You had a lot of liquidity in the world, and you had private credit with a very strong profile of delivering stable [net asset value] NAV and high current income. So, it attracted a lot of dollars. And because this was happening with the onset of COVID, you had the liquid capital markets dislocated for a period of time. And so that meant private lenders really had the upper hand. They had capital and they were open for business when the liquid markets were not, and that resulted in an enormous amount of lending when rates were very low. And so now you fast forward a bit and a couple things have happened.

Those capital markets are working just great now, so that's a lot more competition for the larger companies where we don't focus because of that dynamic, and also you have rates that have come up quite a bit. And I think it's important to share our perspective, which is you're in a more normal rate environment now. It was actually a much more unusual rate environment when rates were between zero and 25 basis points. That's the exception. So, people talk about now being a different rate environment. This is actually a more normal environment, short-term rates in the 300s [basis points] and the [ten-year U.S. Treasury Bond] ten-year in the 400s [basis points]. That's more typical than it is to have a zero percent interest rate environment.

So, putting that together, these tend to be six to seven-year loans. So, let's say a lot of lending happened 2020, '21, '22. We're now getting to the final maturity of that vintage of loans, and those loans were made when base rates were very low, as we spoke about. So as rates go up, that borrower has to pay a higher dollar amount of interest. That puts more pressure on their credit. And you also had during that time period a lot of lending to asset-light companies like software companies, which we of course can talk about more now.

FERRY: Right. So, we actually got a question along the same line this week from a client. So, this week, the [U.S. Federal Reserve] Fed announced yet another rate hold, but I'd say that sentiment is a bit hawkish right now. And they've already tightened financial conditions just from their words alone, meaning that the markets have done a lot of the Fed's work for them.

When it comes to private credit, if we see a tighter environment, rates go up. What's the impact on private credit? You talked about the vintage from 2020, 2021. Could we see a repeat of that? Not to the same extent, but could we see a situation where borrowers are more stressed?

KUPPENHEIMER: You certainly could. And we're talking about rates right now, but the more likely scenario to cause stress is a turn in the economic cycle, and rates being kind of part of that story but not maybe the driving force of that story.

I think we've all been surprised at the robustness of the equity markets, which seems to shrug off any sort of bad news thrown its way. And there's always people evaluating that and saying, well, are we starting to see a turn in economic conditions and growth? And for now, it doesn't feel that way. We watch a number of things very closely. I would say one of them is the U.S. consumer. U.S. consumer's a huge driver of economic activity and sentiment and reflects sentiment in the country. And the U.S. consumer has been surprisingly robust. People talk about the K-shaped economy. You're continuing to see that. At the same time, I think it's important to note, what's unusual in a time like this. Equity markets up nicely. Economic conditions seem favorable, yet you are seeing heightened defaults. So, to your point earlier about there being more dispersion now.

FERRY: Contained, yes.

KUPPENHEIMER: Yes, you are seeing that, so we're coming off a period of years where dispersion of performance in this strategy has been limited. One manager's return profile compared to another, they've been pretty tight, except in unusual circumstances. And now you're seeing more dispersion, and I think that's driven from the types of lending being done, the vintage of those loans, as you mentioned. And so, even though you're in strong economic conditions, I think loans from that vintage up to 2020 to '22 vintage as they're now coming up on their maturities, that's where you're seeing those heightened defaults come from. Where loans were made projecting a certain amount of interest load. That load has gone up. There was a lot of software lending then, and there's been a lot written about pressures on software companies. I would say that it's a certain kind, which are the ones that were levered before they were profitable, which is a tough loan to begin with. But then you take into account rates spiking and concern about [artificial intelligence] AI. That's put additional pressure on that vintage. And so, I do think we'll continue to see a bit of defaults for the next couple years just because of the maturity of that vintage.

FERRY: Right. Where are levels right now with defaults?

KUPPENHEIMER: You'll get different answers on this depending on the research that you see. And so, I'll give my own view, but I will say the research available in the market is pretty notable and the dispersion issue. It's somewhere between 1.5% and 5%, depending on what you look at.

FERRY: And the definition.

KUPPENHEIMER: And the definition, that's a great point, Lauren. So, some reports are defining a covenant breach as a default, and I think that's a misleading indicator. Because the large part of the private credit market generally operates without covenants. And so, what that means is those companies can deteriorate, meaning let's say they're [earnings before interest, taxes, depreciation, and amortization] EBITDA drops, their profitability drops, which causes their leverage ratio to go up. That can often be the reason why a covenant would be breached. But when you don't have that covenant, then that loan is not breached, even though by that measure it is underperforming.

And so, covenant breaches I think can be an inaccurate description of defaults. We like to look at what I call hard defaults, which are failure to pay, bankruptcy, or a distressed restructuring. And those are more objective standards that are directly credit-related that you can measure. And from that point of view, I think defaults are what I would call elevated, between 2% and 3%. The historic average for this type of lending is a little under 2%. So, I think we're somewhat elevated, but I think that's the better measure.

FERRY: Yes, I'm sure the audience is still surprised with how low those percentages are. And then let's talk about recovery rates, and you mentioned covenant breaches. I'm curious, this is all the stuff that happens behind closed doors that we don't see. What happens when there is a covenant breach? What does your team do? How do you work with the other lenders and the borrower?

KUPPENHEIMER: Covenants are a very good structural item that effectively bring you to the table as the lender earlier in the process or earlier in the life cycle of the company's performance. And so, a covenant breach is what's called a technical default or nonpayment default. And the most common one, as I mentioned earlier, is a leverage ratio. So, let's say, when you lent money to the company, they were levered four times, meaning you've lent them four times their annual EBITDA. And the covenant is set at five times or six times, and their EBITDA drops to a point where they're now levered that five or six times. That is a breach that they are in default of that they need to cure, or you can push them into full default. And that's rarely how they're used. They're usually struck at a place where you now can talk to that company about what's driving their underperformance.

FERRY: Before it's too late.

KUPPENHEIMER: Before it's too late and how to address it. And so, we try to get way ahead of that. So, let's say we make a loan to a company and let's say it's growing at a 5% to 15% annual rate. So, it's actually delevering that. So, in that example we started at four times leverage, and maybe we're headed towards 3.5 or 3, which is a great credit positive.

The first thing you may notice is that they go from growth to flat. They were growing at 5% or let's say the business plan projected they'd grow at 10% or 15% and they grow at zero. So, they haven't increased their leverage. They're no closer to that covenant, but they're underperforming their projection. We'll start having conversations then. We're not really concerned about the credit at that point, but we want to understand the difference in their projections and what they've achieved. And we'll talk to the private equity firm that owns them. We'll talk to management of the company and try to get an understanding around that. And that's fairly business as usual, but if they continue to deteriorate and now, they're getting close to that covenant, you're again having conversations trying to understand the dynamic and get them to re-project what their performance is going to be. And at that point, you may be talking to the owner of the company, again usually a private equity firm about, are they going to put more equity in to keep the company stable and protect the debt? But the point is, Lauren, we don't wait for the covenant breach to be concerned about the covenant breach. And then when the breach happens, we usually have a good idea of what our ask is going to be. And that could be, again, we really focus on defense first. So, will we reprice the loan? Maybe, but in all honesty, that's not our primary objective. Our primary objective is getting our principal back at the end of the loan. That's really going to drive performance, so we'll focus on the company delevering. That usually is going to come in the form of more equity being put in by the current owner. We'll look for further protections of the document, so maybe we'll tighten that document up further, reset the covenants, maybe add another covenant, things of that nature. And in most cases, it's a fairly long process.

FERRY: I was just wondering that. Is this days, weeks?

KUPPENHEIMER: Years, quarters. Quarters or years. Usually, the whole life cycle I just described there where you go from company projecting growth to let's say underperforming that projection, to then not growing, to then shrinking, that usually is something you're witnessing in quarterly financial reports over a number of quarters. It's pretty unusual for a company to just fall off a cliff in one quarter. Usually, there's something very dramatic that's happened or been misreported. So usually these are conversations and processes that are being handled over multiple quarters if not a year or two.

FERRY: Right. And how often is your team communicating with the sponsors, with the borrower, with the co-lenders?

KUPPENHEIMER: I would say that quarterly is the norm. So, if things are going as expected, and that makes sense, because even public companies, private companies basically report quarterly financials. So that's really when you get new material information that is worthy of a phone call, getting updated, making sure you understand it.

I would say, if it's business as usual, it's quarterly. If there's dynamics that we're concerned about, it may be monthly, maybe twice a quarter. It may even be more frequent if we're really concerned. Fortunately, we haven't had a lot of those situations occur to us so far.

FERRY: Right. That makes complete sense. Well, thank you for your time today, Steve.

KUPPENHEIMER: Thank you, Lauren.

FERRY: Thank you for listening to the *Investment Conversation.* Find more episodes on lordabbett.com or wherever you get your podcasts, and follow us on LinkedIn, Instagram, and YouTube for more perspectives across the firm.

GLOSSARY OF TERMS USED IN THIS BROADCAST

Collateralized Loan Obligation (CLO) is a security backed by a diversified pool of leveraged loans. CLOs issue different classes (tranches) of debt with varying levels of risk and return.

Covenant refers to a contractual provision in a loan agreement that requires a borrower to meet certain financial or operating conditions or restricts specific actions. Covenants are designed to help protect lenders by identifying potential credit deterioration early.

Credit Spread (Spread) refers to the additional yield investors receive above a benchmark interest rate, such as SOFR or a U.S. Treasury security, as compensation for assuming credit risk.

Default is a borrower's failure to meet the terms of a loan agreement, such as missing interest or principal payments or entering bankruptcy or a distressed restructuring.

EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) is a commonly used measure of a company's operating performance and cash-generating ability before financing costs and certain non-cash expenses.

Global Financial Crisis (GFC) is the worldwide financial crisis of 2007–2009 that severely disrupted global credit markets and economic activity.

Leverage is the use of borrowed money to finance investments or business operations. In lending, leverage is often expressed as debt relative to a company's EBITDA.

Levered lending refers to the practice of providing loans to borrowers—typically businesses—that already have high levels of debt or lower credit ratings, making them riskier than traditional borrowers. Because of this elevated risk, these loans generally carry higher interest rates and often include stricter terms or covenants.

Liability Management Exercise (LME) is a transaction in which a borrower restructures or refinances its existing debt obligations, sometimes changing lenders' rights or priorities.

Original Issue Discount (OID) is a loan or bond issued at a price below its face value. The difference between the purchase price and par value represents additional compensation to the lender.

Payment-in-Kind (PIK) refers to a loan feature that allows interest payments to be made by increasing the outstanding principal balance rather than paying cash.

Private Credit refers to loans and other debt financing provided directly by non-bank lenders, typically outside the public capital markets.

Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of overnight borrowing collateralized by U.S. Treasury securities. SOFR serves as the primary benchmark interest rate for many floating-rate loans.

Senior Secured Loan is a loan backed by specific collateral that has first priority in repayment if the borrower defaults.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Spread Compression refers to a decline in credit spreads, resulting in lower compensation to investors for assuming credit risk.

Vintage is the year or period in which a loan or investment was originated. Different vintages may exhibit different risk and return characteristics because they were made under different market conditions.

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