The Investment Conversation: Strong Private Credit Underwriting Begins with Defense, Part 2

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Steve Kuppenheimer, Head of Private Investments, discusses the portfolio management decisions behind private credit outcomes, from portfolio construction to leverage, valuation, and the convergence of public and private markets.

KEY TAKEAWAYS

- Portfolio construction is as important as individual loan selection. Successful private credit portfolios are built through disciplined diversification across industries, issuers, sponsors, and loan vintages while emphasizing resilient businesses and strong management teams.
- It is important to evaluate a manager's investment "strike zone," portfolio management philosophy, and ability to source differentiated opportunities, not just historical returns.
- Leverage, when used prudently, can enhance returns. In business development companies (BDCs), conservative leverage, regulatory oversight, and disciplined balance sheet management can contribute to portfolio efficiency while helping manage risk.
- Loan valuations can reflect company fundamentals as well as market conditions. Changes in borrower performance and shifts in credit spreads are among the primary drivers of net asset value (NAV).
- As public and private credit converge, an integrated and deep credit platform can strengthen underwriting, idea generation, and portfolio construction.

LAUREN FERRY: Welcome back to *The Investment Conversation.* I'm Lauren Ferry, Global Head of Alternatives Product at Lord Abbett.

In our last episode, Steve Kuppenheimer, our Head of Private Investments, and I discussed how experienced lenders price risk and why disciplined underwriting is at the core of successful private credit investing.

Today, we'll look at how those individual lending decisions come together in a portfolio, and why portfolio and risk management are critical to overall investment outcomes.

Steve, thanks for being here!

STEVE KUPPENHEIMER: Thanks for having me.

FERRY: Thinking about risks, not just at the loan level but also at the portfolio level, portfolio construction is really key. We talked about software, and obviously sector allocation is important. When you are bringing these loans together, how do you think about what's the next loan you're going to make? What are you looking at in your existing portfolio?

KUPPENHEIMER: So, you're right. We're definitely looking at industry concentration. We're looking at issuer concentration. We're even looking at sponsor concentration to a degree. But we're now at a point where we're fairly diverse and scaled, so in most cases those things are going to look okay. The next one loan you make is not going to dramatically change those numbers, but we still look at those. So, I would say, we're very much a bottom-up investor. So, I think I mentioned this a little bit earlier before, but being more direct about it, we're looking for a little bit of a Venn diagram and the overlap in the middle of I would say four main topics. And that's going to be industry. There we're looking for less cyclical industries or counter-cyclical industries or industries with long-term tailwinds because we are making a six or seven-year loan that we cannot sell. So, we have to assume there's a material economic cycle during our hold period. We consider ourselves largely industry agnostic, but there are certain industries that are going to not perform well when you're going to assume there's a [global financial crisis] GFC-like event during your hold period. And those are more highly cyclical industries.

And then the second wheel or the second circle is the quality of the company. Is it a market leader? Does it have a moat around its business? Is it growing? What are its margins? How does that compare to what they should be? Meaning we look at similar companies and how they're performing, and are they outperforming other companies with a similar business? And is their business somewhat protected?

Then we look at management. That's a key element that I don't know gets talked about enough. It's not just numbers. You need to know who is driving the bus, and that they're very good. And when you think about this, I think it's more intuitive. You can have a great product. You can have a great company, but if the management is not strong, those things may be very temporary. And at the same time, great management can also steady the ship for a company that may be still growing or still establishing itself. So, we focus on management maybe a little bit more than others that I'm aware of. There we're looking for tenure, proven effectiveness, the relationship with the sponsor, how they work together, is there a succession plan, and things of that nature.

And then the fourth circle on that Venn diagram would be ownership, and that is going to usually be meaning the private equity firm that owns them, but it could also be a family that owns them or a founder or maybe there's not a control owner but there's a group of private equity firms that own it and not one of them controls it. But there, if it's a sponsor-owned company, you're looking for a number of things. You're looking for what is the liquidity base of that private equity firm? Do they have more money to defend their position, if things get choppy? What is the historical performance of that private equity firm? Are they a good investor? Are they good at selecting companies? And then finally, what's that private equity firm's history with how it treats their lenders? There's been, I think, more news around that to focus on in the years since COVID than there was before.

FERRY: Your comment before about not asking enough or not talked about enough triggered a thought. If the roles were reversed and you were the investor in a private credit fund strategy, what questions would you be asking that manager?

KUPPENHEIMER: I would want to talk about a few topics. One, what is their strike zone? What is it that they look for and how are they able to get it?

FERRY: When you say strike zone, what do you mean?

KUPPENHEIMER: Strike zone is some of what we talked about before, which is how do they define a good credit and how do they define good pricing for the risk that they're taking. And then how do they make sure that they're able to achieve that? What is their right to win? What is their reason why these companies are going to borrow from them and not somebody else? And then I'd also want to go deep on their understanding of portfolio management, because this strategy is a long, illiquid, oftentimes moderately levered strategy.

So, if you're looking at a [business development company] BDC, you're really talking about investing in an operating finance company. It's not really just a fund. It's a living and breathing company that has a lot of moving parts to it. The asset mix is one of those parts, but you need to know what's the board structure, who are the executives, how is that BDC owned and capitalized, what's their access to leverage, and how do they manage it? And those things often have a very material impact on returns, similar to the assets themselves.

FERRY: Right. You brought up a bunch of points that I would love to double-click on. One is leverage. I imagine many in our audience, they hear that and they think it translates to risk. But I know in our conversations, we've always talked about how utilization of leverage means a more efficient portfolio outcome.

KUPPENHEIMER: It's a balance.

FERRY: Yes, let's talk about that.

KUPPENHEIMER: It's a balance of those things, so this is a strategy and asset class that historically has been levered very effectively. So now let's take a big step back and call all of this senior secured corporate lending to U.S. companies. And if we, for a moment, look at the broadest context of that, you could look at [collateralized loan obligations] CLOs. You could look at banks as proxies for what we're talking about. Banks are in many ways pools of senior credit that are then levered. CLOs are pools of corporate loans, senior corporate loans that are then levered. And both of those structures are levered about ten to one.

BDCs are levered about one to one or maybe [approximately] 1.25 to one. So, it's much more modest leverage than this type of investing typically is subject to. And that's really for regulatory reasons. So BDCs are I think a very effectively regulated product. It requires an independent board of directors, public filings.

FERRY: There's a lot of transparency with BDCs, right, that you don't get elsewhere?

KUPPENHEIMER: Correct. Even if you're a quote-unquote "private BDC," all that means is your shares are not traded. You still make quarterly public filings that everybody can see. You still have an independent board of directors. And your leverage is limited to a regulatory max of two to one. As a matter of conservatism, no BDC wants to operate right at two to one, because that's too close to the limit, so you wind up operating at one to one or 1.25 to one, which tends to be the target of most BDCs. So, I start with that framing, Lauren, because that amount of leverage is very conservative for what the asset class is.

And so, in many ways, your ability to access and effectively deploy that pretty modest amount of leverage is a sign of the manager's capabilities around portfolio management. If you look at the GFC, banks got to be levered 30 to one. And now, in a post-GFC era, they've been way de-levered but still down to ten to one. So, we're not really talking about nosebleed leverage or where the risk is hyper magnified.

FERRY: Yes, it's far from it, actually.

KUPPENHEIMER: Correct. You're talking about what is an intelligent way to access this asset class to efficiently maximize [potential] returns without taking on too much risk.

FERRY: That's an interesting element of a BDC. You were discussing the [net asset value] NAV, the components of a NAV before and also just buying at par, below par, above par. Things move around and I think that we get a lot of questions about the movement in NAV for a BDC.

What's driving it? If you look at historical returns of private credit through the BDC lens, they've been positive for every year for the last 15, 20 years. And you're, like, how is that possible even through periods like the GFC, COVID, et cetera.? The NAV can move around slightly, but it's really the distribution yield that's being generated. But how does the NAV move? Maybe we can talk about that, because we do field a lot of questions on that.

KUPPENHEIMER: Yes. I think there's a lot going on here. I think what you're referring to is the data for the asset class. Let's make it manager agnostic. The data for the asset class shows a range of total return, meaning realized losses adjusted for interest received or yield received. That's varied somewhere between a low of 5%, a positive 5%, and at GFC to a positive 12% at its peak.

FERRY: I'm smiling. The audience probably can't see me smiling, but I'm smiling because Steve was a [Chief Financial Officer] CFO of a BDC, so he geeks out when it comes to the financial statements of BDCs and the calculations of the NAV.

KUPPENHEIMER: I think that when you look at the NAV, what is going into it is, again, going back to the regulation of BDCs, it requires independent valuation. So, it's not the manager determining the value. You have an independent valuation firm who really will drive a tight range of values, a valuation team that does work but is bound by that tight range. And then, again, that's all submitted to an independent board of directors. But NAV changes come from changes in the value from the independent valuation firm. And if you do have defaults or bankruptcies, then it's going to be held at an assumed recovery value or eventually at a realized recovery value.

So, when you think about that valuation firm, what goes into those NAV calculations, there are two things that drive it primarily. There are many things that drive it. I don't want to unfairly summarize it, but I'd say the two main drivers are, one, that company's performance. So, we talked about earlier, [earnings before interest, taxes, depreciation, and amortization] EBITDA growing or shrinking. So, if a company's profitability is growing, it's going to either have stable value or increasing value. If it's shrinking, then it will get marked down. It'll be based on its specific performance not relative to other companies but its specific performance.

And then the second most important input is, has the cost of risk changed? If today we're in a market where a spread of 500 [basis points] is roughly the average, let's say if we look at COVID what happened in the months immediately following the onset of COVID, the market widened out by about 100 or 150 basis points. It was something like that for a brief period of time. And so now let's say you've got a loan with three years left on it. The cost of risk is wider by 100 basis points. The valuation firm's going to ask you to mark that loan down by three points, three years times 100 basis points of widening. That's the second most important impact of NAV. So, usually those are the driving forces of NAV.

FERRY: Right. And then what have been the dynamics this year, would you say broadly in terms of performance of the asset class?

KUPPENHEIMER: I think the dispersion you're seeing is, so first of all, again, we're seeing this period of dispersion that we have not seen in years. And I think it's been driven by a couple of factors. One is, we talked about, the vintage of loans. I think books that are more recent, that are cleaner, that were started when rates were already high and avoided asset-light industries like software, you're seeing those hold a lot of stability and perform very nicely. More vintage books that were ramped heavily during COVID or immediately post-COVID when rates were very low and asset-light industries like software were red hot, that's where you're seeing more issues and more valuation issues and more credit events.

And then you have to look also at the specific strategy, again, we talked about this earlier, of the manager. There really are differences between the portfolios and between the specific strategies. If a manager is targeting larger companies, those loans as we talked about often come with more aggressive leverage, no covenants. They tend to be PIK-able. Those are things where value can erode more quickly than your more middle market companies where covenants are more common, PIK is less common, and value is retained more stably. And I think you were getting to this earlier about the difference in recovery values when you look at a loan with covenants versus without covenants, it can be very dramatic. I think historically that difference can be as high as 20 or 30 [basis] points of recovery.

FERRY: That's interesting. As you're talking about core middle market and upper middle market, what segment of private credit has experienced the most movement from a credit risk perspective?

KUPPENHEIMER: Well, I think it's definitely the large market. I think then it gets called the upper middle market. These are just large companies. They're not really middle market companies. Everyone asks what middle market means. They want to put a number on it. To me, it's a much more practical answer, which is: "does that borrower have access to liquid markets?" You know, I just want to put that in. And large companies do have access to the liquid markets and smaller companies do not, not because they're not strong credits, they're not large enough for the capital markets to care about them. And historically, that's been what's driven the outperformance of private credit is that you're lending money to very good companies on a less competitive basis because you're not competing with liquid money.

You get more spread against less leverage, more covenants, and you [potentially] outperform. So that large market or upper middle market, which did not really exist in private form pre-COVID, that's where you have far fewer companies, far fewer sponsors, so you have a lot less choice and you have a lot less negotiating power because you're negotiating against liquid capital that's often 200 basis points cheaper than your money. That's where I think you've seen more aggressive leverage, more aggressive documentation that kind of, you know, ramping during low rates in the post-COVID era, where you're seeing more of the risk sit.

FERRY: Right. Last podcast, we had [Lord Abbett Partner and Portfolio Manager for bank loans, Kearney Posner] Kearney and [Lord Abbett Partner and Portfolio Manager for private credit, Vincent Lu] Vince. Vince is on your team, and Kearney leads the public side for our loan team. And they talked a lot about convergence, just exactly what you were just hitting on, right?

Upper middle market, large market, however you want to call it. I know how we like to call it, and when we think about Lord Abbett's research platform, how does it help your team, given access to Kearney's team and the public side? How does it help your team improve the outcomes for our clients?

KUPPENHEIMER: It's a huge benefit because that credit research team is over 30 people. They average over 20 years of experience. They're covering [approximately] 2,500 leveraged finance credits, which is about the entire liquid market and they're specialized by industry.

What that means is, we can look at a given private company, and we can put it in context very quickly. And what I mean by that is, say if one of our deal teams is looking at a healthcare company, that's $70 million of EBITDA, so a middle market company, they can go to the healthcare research team, the healthcare leveraged finance research team, and they can show our deal team five companies that have a similar business plan but maybe they're larger. And you can instantly compare growth rates, profit margins, regional distinctions, maybe pending regulation that would take us a while to uncover who the good sponsors are in the space, all things that we could figure out if we were stand-alone, but it would take us much more time.

And so that context and depth is extremely impactful to us. They also can be the source of idea generation. They also have their own relationships with the street and some companies. And so, what I'd say is that we as a firm, we've been in leveraged finance since 1971. There are very few firms that have been in leveraged finance for that long. There are very few firms that have existed for that long. And it is an enormous advantage for us. So as the liquid markets and private markets converge, having relevance across the liquid and private markets becomes its own differentiator because you can see trends, you can see behaviors from both markets that make you better in the other one. And that results in better access to deal flow, more effective deeper underwriting that's more efficient, and better outcomes for our clients.

FERRY: You made a comment that sometimes they bring ideas to you, to your team. My interest is piqued there.

KUPPENHEIMER: Yes, so our first deal was a transaction for an insurance broker that was owned by a private equity firm that our team is extremely close with. But also, the company itself was one that had historically issued both private and liquid debt.

And we as a firm have been an investor in its liquid debt for years, and we're very close to the company, especially the [chief financial officer] CFO. And so, as we were getting started as a private credit team, this private equity firm reached out and said, "We know you guys are getting started. We've got a great credit that's oversubscribed, but we will fit you in because we want to grow with you."

And a day later, the CFO of the company called our lead research analyst for the space with a similar message saying, "I know you guys are getting on the private side. We have this private loan that's oversubscribed but you've been a good investor with us for years, so we'll fit you in." And it was a great anecdote around the joint relevance or maybe magnifying our relevance in the market because of our relationships. And I think as Kearney and Vince said, that works both ways. We, as a team, are talking to private equity firms every day. And they like to have less conversations with firms that can provide both liquid and private solutions, and so it's not uncommon for us to get ahead of a liquid opportunity and to share that with our liquid team. And it's not uncommon for us to use the research that they have, as we just talked about, to your point, in a way that gets us a lot deeper a lot faster.

FERRY: That makes total sense. It's much more efficient from a sponsor coverage perspective of us. All right, so one last question for you. So, what is one risk factor in private credit that you think the market is underpricing right now?

KUPPENHEIMER: Well, I think we covered a lot today, and I don't know that there's anything that I would say that I haven't said already. So maybe I'll highlight just a couple of those points. One, and this is always the case. You said right now, and so I'll get back to right now, but I think historically my answer to this question gets to that portfolio management point.

I think that investors often want to talk about individual credits and how you access those. But it's really important to understand the structure you're investing in, and that brings another dynamic to the table about how leverage is used, the manager's ability to do that. Are they matching assets and liabilities so there's not a liquidity issue? What is the overall approach to diversity? Those are questions that I think historically get asked less that I think are very impactful.

If you were to look at things today, I do think it's this difference around vintage. I think that when we talk about vintages and we always lose sight of the implicit joke that we're talking about it like it's wine. And the truth behind that is market conditions for lending change over time. And for some quarters, some years they can be more borrower friendly and for some periods of time, they're more lender friendly. So, I would say we're in a period where we're reaching the maturity dates of a period of time, that 2020-2022 period where there were more borrower friendly conditions. In other words, more aggressive lending, with lower base rates. And if you look at where we've been for the last couple years, it's been more lender friendly. Higher base rates, which means more conservative lending overall, and now you're seeing a pullback in capital because of the redemptions in some of the larger, more vintage BDCs. And that's resulting in a less competitive investing environment, which means we can get better terms. So, I think that vintage dynamic is probably the other one I'd point out and is more timely.

FERRY: Right. That makes complete sense.

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GLOSSARY OF TERMS USED IN THIS BROADCAST

Business Development Company (BDC) is a closed-end investment company that primarily invests in the debt and equity of private U.S. companies. BDCs are regulated under the Investment Company Act of 1940 and are subject to leverage, governance, and reporting requirements.

Collateralized Loan Obligation (CLO) is a security backed by a diversified pool of corporate loans that issues multiple classes (tranches) of debt with different levels of risk and return. CLOs are commonly used as a point of comparison when discussing leverage in private credit portfolios.

Credit Event is an occurrence that negatively affects a borrower's creditworthiness or ability to meet its debt obligations, such as a missed payment, bankruptcy, distressed restructuring, or other material deterioration in credit quality.

Credit Spread (Spread) refers to the additional yield above a benchmark interest rate that compensates investors for assuming credit risk. Changes in credit spreads can affect loan valuations and net asset value.

Cyclical Industry is an industry whose financial performance tends to rise and fall with changes in the economic cycle. Companies in cyclical industries may experience greater fluctuations in revenues and earnings as economic conditions change.

Default occurs when a borrower fails to meet its obligations under a loan or other debt agreement, such as failing to make required interest or principal payments. Certain other events specified in a debt agreement may also constitute a default.

Dispersion refers to differences in investment performance, valuations, credit quality, or other characteristics across securities, portfolios, or investment managers.

EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) is a commonly used measure of a company's operating performance and profitability. EBITDA is frequently used to evaluate borrower quality and leverage.

Global Financial Crisis (GFC) is the 2007–2009 financial crisis, often referenced as a stress period when discussing portfolio construction, leverage, and credit performance.

Issuer is a company, government, or other entity that raises capital by issuing securities, such as bonds or other debt obligations, to investors.

Leverage is the use of borrowed money to enhance investment returns. In private credit portfolios, leverage can improve portfolio efficiency when used conservatively but also increases investment risk.

Levered Strategy is an investment strategy that uses borrowed capital in addition to investor capital to increase investment exposure and potentially enhance returns. The use of leverage also increases the potential for losses.

Liquid Markets are markets in which securities can generally be bought or sold relatively quickly and efficiently without significantly affecting their market prices.

Net Asset Value (NAV) is the value of a portfolio's assets minus its liabilities, typically expressed on a per-share basis. In private credit, NAV is influenced by changes in borrower fundamentals and market pricing of credit risk.

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

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

Private Equity Firm is an investment firm that typically invests in privately held companies, often acquiring controlling or significant ownership stakes with the goal of improving the businesses and ultimately realizing a return on its investments.

Public Credit refers to tradable debt securities, such as corporate bonds and broadly syndicated loans, that are issued and traded in public markets.

Senior Corporate Loans are loans to companies that have a senior position in the borrower's capital structure, generally giving them priority of repayment over subordinated debt in the event of a default or bankruptcy.

Sponsor generally refers to a private equity firm or other financial investor that owns or controls a portfolio company and may provide capital, strategic guidance, and other support to the business.

Strike Zone refers to a manager's preferred investment opportunity set, defined by the types of borrowers, industries, loan structures, and risk-return characteristics they seek when making investments.

Vintage is the period in which loans are originated. Lending vintages often reflect prevailing market conditions, making them an important consideration when evaluating portfolio performance and credit risk.

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