Private Debt Investor

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EXTRA
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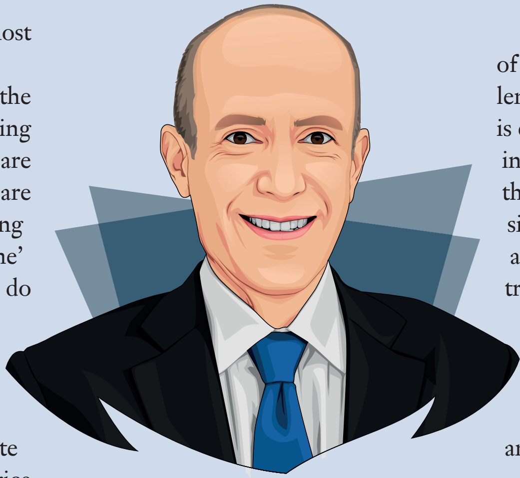
Ten views on how covid-19 will change private debt

The push for greater alignment

Covid-19 may have exposed weaknesses in aspects of the relationships between sponsors, investors and lenders. Might things change, or are certain practices set in stone?



I was once asked: "What is the most important covenant?"

The one that I consider to be the absolute must-have when underwriting any investment is alignment. Who are we doing business with, and why are they 'hyper-incentivised' – meaning they have far more 'skin in the game' relative to their resources than we do – to ensure that we realise a successful outcome? There is nothing more powerful in determining your probability of being repaid, and those who do not fully appreciate that tenet are starting to pay the price in a variety of ways (and with more to come).

GP-LP relationships are often fraught with misalignments. A GP might have little skin in the game. It might regularly 'reassure' its investors by agreeing to short-sighted requirements, and then act in a way that still maximises its fee revenues at the expense of those same clients – the essence of moral hazard.

You prefer to buy a product that is narrowly constrained to the opportunity of the day?

Of course, but it is unlikely to remain this attractive for six years. And if it does go out of favour, don't expect me to return the money – I'll just blame the 'perfect storm' and tell you about how the next vintage is going to be great.

A lower management fee? Sure thing – I'll just raise more money than I had initially planned. A higher performance hurdle rate? OK, I will just take more risk if I'm underwater. The list goes on and on.

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DANIEL ZWIRN
Chief executive and chief investment officer
Arena Investors

Another curious relationship is that of the private equity sponsor and the lender, where the presence of a sponsor is casually interpreted as greatly reducing risk. After all, sponsors perform thorough due diligence, have professionals with distinguished resumes and expertise, and bring capital to the transaction – including their 'commitment' to inject future equity when needed. Never mind that they are 'adjusting EBITDA' to whatever will raise the most debt possible and at whatever price is necessary.

You're in the money

If they find themselves in a situation where they are out of the money and you as the lender are in the money – as we are seeing today – you shouldn't expect friendly capital injections that stabilise the underlying business and mitigate lender risk. Nor should you expect pricing accommodations that compensate lenders for the equity risk they are now assuming in the absence of sponsor support.

Will this disregard for alignment change as a result of covid-19? I hope so. But hundreds of years of empirical data in creditor-borrower relations would suggest otherwise. Despite all the hundreds of billions of dollars that will be wiped out, the incentives remain too great.

As Warren Buffett's business partner Charlie Munger once said: "Show me the incentive and I will show you the outcome." This has never been more important than today, and we would all be better served by its serious consideration. ■