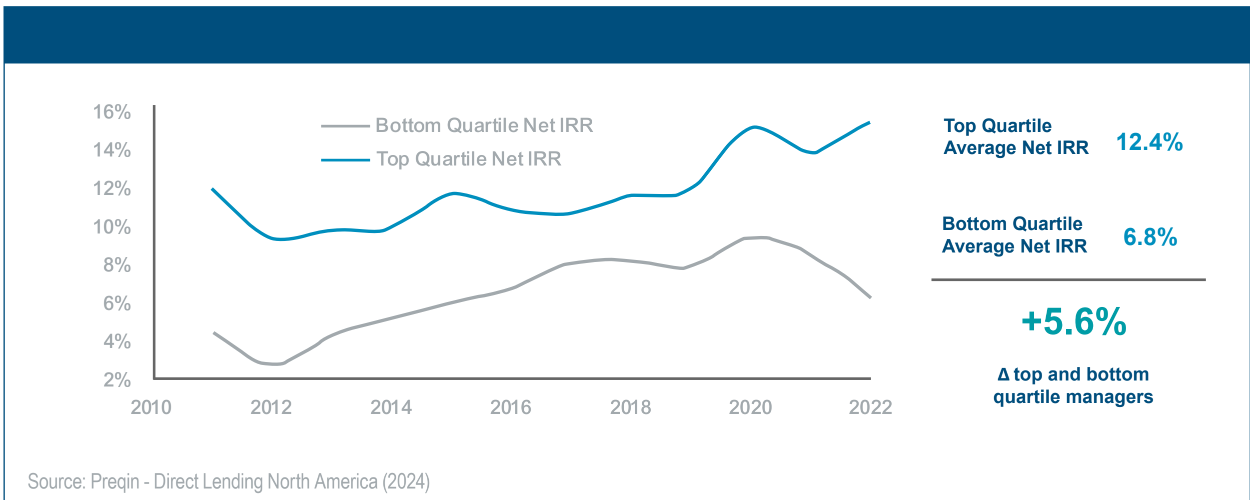
What Drives A Private Credit Manager's Outperformance?

By: Zia Uddin, Monroe Capital

Secular tailwinds in Private Credit from higher base rates, regulatory changes, portfolio resiliency, and an increasingly supportive economic environment have led to the rapid growth of Private Credit. However, not all managers within Private Credit are the same, and extensive diligence is required by public pension plans on where to allocate capital within the asset class. We expect there will be increased divergence between managers over the coming years as elevated interest rates reduce operating flexibility for borrowers and increase the potential for defaults. There is also more competition for deals today due to asset class growth from new entrants. Outperformance in any asset class is typically most pronounced in periods of higher volatility. Managers that deliver top quartile performance will likely have a differentiated strategy, extensive track record, scaled origination platform, and a focus on capital preservation with lender protections to avoid losses.



Source: Preqin - Direct Lending North America (2024)

We believe the following factors are critical for alpha generation in Private Credit:

Differentiated Strategy

Private Credit managers that specialize and avoid commoditized lending will experience lower levels of competition and provide differentiated offerings to borrowers leading to higher returns. Examples of differentiated strategies include specialized sector expertise (e.g. Software, Healthcare or Recurring Revenue lending), highly bespoke/structured loans (e.g. Opportunistic, Distressed lending), or focus on highly fragmented markets with supply/demand imbalances (e.g. smaller transactions). These competitive attributes lead to higher pricing, lower leverage, and superior lender protections than more commoditized offerings.

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Extensive Track Record

With many new entrants into the direct lending space, it is important to assess whether managers have delivered consistently strong performance across multiple economic cycles. This will demonstrate that a manager has the ability to consistently apply a credit philosophy across vintages and not just during the recent bull market. According to Preqin, experience is also rewarded by the market when fundraising. New managers have flatlined in terms of average fund size, while experienced managers have grown rapidly.

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A strong track record of deals can also generate incumbency lending opportunities. The ability to deploy capital via add-ons is an important tool for managers to grow their portfolio as M&A levels declined from the peaks observed in 2021 and 2022. In 2023, add-on acquisitions represented 35% of all transactions, versus 21% at the end of 2021. Along with generating deal flow, incumbency lending provides significant history and information on a borrower, resulting in materially lower risk of loss.

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Scaled Originations Platform

A large origination team allows a manager to generate diverse deal flow and enables a manager to be highly selective and allocate towards high-quality borrowers. A dedicated originations platform *separate* from underwriting and workout teams reduces bias in credit evaluation and allows experts in workout/recovery to handle the distressed credits in the portfolio.

Focus on Capital Preservation to Avoid Losses:

With rates expected to stay higher for longer, alpha will be generated through a persistent focus on capital preservation rather than reaching for incremental yield that may lead to losses down the road.

- *Emphasis on Defensive, Recession Resilient Sectors*: Managers should focus on industries that have products and services that can generate sales no matter what stage the economic cycle is in. For example, portfolio mixes that prioritize industries including healthcare, business services, and technology are often more recession resilient and defensive than investments that focus on retail and consumer companies.

- *Bottoms-up Underwriting Approach*: Deal fundamentals must be underwritten from the bottom up rather than relying on the caliber and reputation of a sponsor. Managers who work with a wide array of sponsors are not beholden to a few sponsors for deal flow and are more able to have constructive conversations if a deal is underperforming.

- *Dedicated Workout Capabilities*: In-house workout experience can be a key differentiator when evaluating GPs. Dedicated workout teams can focus on early intervention, allowing a lender and borrower to have flexibility to discuss potential solutions before a borrower breaches a covenant or defaults on payment. The enhanced and more frequent oversight of underperforming deals can lead to fewer defaults and higher recoveries than the market.

In conclusion, Private Credit will continue to grow due to secular tailwinds in the asset class, however, not all lenders are created equal. In this higher current yield environment, strong managers with differentiated strategy, track record and capabilities will outshine commoditized lenders. ◆

Zia Uddin *currently serves as President of Monroe Capital. He is also responsible for the Institutional Direct Lending activities, as Co-Portfolio Manager, Institutional Portfolios of Monroe Capital. As President, he focuses on Monroe's day-to-day and strategic long-term growth initiatives. He joined the firm in 2007 and is a member of Monroe's Investment Committee. Mr. Uddin has 32 years of management consulting, corporate finance, private equity, turnaround and investing experience.*