MA Financial Group

Why debt restructuring experience is crucial in private credit investing

Success in private credit investing is driven by avoiding losers rather than picking winners. This makes it crucial for private credit managers to be equipped with the right skills to minimise potential losses.

Private credit managers with debt restructuring experience have a significant advantage across all areas of credit investing – from sourcing and underwriting to monitoring and recovering value in distressed situations.

Restructuring experience provides investment managers with valuable historical data and the tools needed to avoid distressed investments. In the case a distress situation does occur, these managers have the knowledge and confidence to navigate challenging conditions, ensuring the best outcome for investors.

While the recent benign economic climate may have allowed many managers to avoid losses, this environment is unlikely to last. Avoiding distressed situations today will be key to maintaining stable returns should economic conditions decline and default rates rise.

In this whitepaper, we explore how first-hand restructuring experience significantly enhances credit investing performance.

The four stages of company distress and debt restructuring

Restructuring transactions are complex, involving deep operational insights and significant involvement in strategic decisions. This experience gives private credit managers a strong understanding of why businesses fail and key drivers of credit risk.

When a company is in distress it typically goes through four stages:

1. Financial pressure
2. Strategic review of options
3. Implementation phase
4. Outcome (stabilisation, monetisation or insolvency).

Figure 1: Overview of a typical debt restructuring process

1. **Financial pressure:** financial stress generally starts with an increase in leverage due to earnings decline, asset impairments or a sudden one-off event like the loss of a major customer contract. This stress weakens credit metrics, may strain headroom to covenants, and in more severe cases can result in covenant breaches or payment defaults.

2. **Strategic review:** as financial stress escalates, a company will explore a range of options to maximise value, including amendments to extend debt facilities, a sale of assets, divisions or the entire company as well as recapitalisation or restructuring. Additionally, detailed financial analysis, stakeholder assessment and legal strategies are often explored.

This phase involves a deep dive into the company's operations with access to granular information beyond that included in routine lender reports.

The review phase engages a wide array of stakeholders with competing interests, rights and obligations including company directors, shareholders, lenders, senior management, customers, suppliers and regulators. A strong understanding of dynamics between these stakeholders is essential for a lender to recover value.

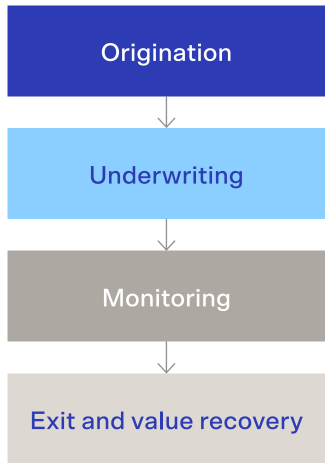
3. **Implementation phase:** here a company agrees on a strategy with the primary goal being to stabilise the firm in preparation for an operational turnaround or monetisation e.g. via a sale.

4. **Outcome:** ideally the company is stabilised before an event of default or uncontrolled insolvency occurs. If a stabilisation isn't possible, a formal insolvency processes may result, such as an administration or receivership.

Capitalising on restructuring experience enhances private credit investing

Private credit managers can apply learnings from restructuring transactions across the entire credit investment process, from origination to exiting a position.

Figure 2: Investment process overview



Origination: spotting critical flaws early

A robust initial screening and filtering process is key to credit selection. Identifying key risk factors early in the process is important to avoid overlooking fundamental, high-level risks, and as such, a deep understanding of the features that often lead to distress is invaluable in screening investments.

Examples of high-level risks include:

- Industry and business model risks: experience in observing how different companies perform across various economic cycles teaches important lessons in how to reveal structural weaknesses in a company. It also helps in identifying key competitive threats and understanding the resilience of different industry sectors to market shocks and downturns
- Alignment of interests and signalling: it is important that borrowers and lenders remain aligned over the life of a financing transaction. The structure of incentives can substantially impact the attractiveness of a credit investment. For instance, have shareholders minimised their exposure by taking large dividends, reducing their potential losses if things go wrong? Have shareholders already lost a substantial amount of their initial investment, motivating them to place larger bets to recover value?

Private credit managers with a background in distressed situations are better equipped at spotting critical flaws in transactions early and avoiding potentially loss-making situations.

Additionally, the ability to discern which risks can be managed and which are deal breakers is a key advantage gained from experience with distressed situations.

Underwriting: robust diligence and asking the right questions

A key part of the underwriting process is asking the right questions. This means going beyond surface level analysis to validate the thesis for an investment opportunity.

Through experience in distressed transactions, patterns start to form. Recognising how to uncover key risks that can't be mitigated greatly enhances a manager's ability to avoid problem credit investments.

Examples of key diligence areas where restructuring insights can be invaluable include:

- **Financial flexibility:** understanding the optimal debt level and when leverage is too high
- **Operational flexibility:** validating cost cutting initiatives and a company's ability to pivot to other business lines or products in the event of a downturn
- **Robustness of operating contracts:** assessing the strength of contracts in different market scenarios
- **Exit strategies:** ensuring the business can be sold or exited to repay debt at maturity.

Restructuring experience provides detailed insights into the traits most valuable for assessing risk and guiding diligence efforts.

Underwriting: optimising loan structuring and protections

Proper loan structuring is crucial for maximising recoveries in stressed scenarios. Lenders rely on security and recourse over assets as part of their safety net. To protect capital, it is critical to optimise legal agreements and documentation to preserve control over the recovery process in the event of distress.

In a debt restructuring, company advisors will often exploit weaknesses in facility documentation which can harm lenders. Restructuring experience equips lenders with knowledge such as recent market precedents to 'bullet proof' loan agreements, minimising risks that may arise in future restructurings.

Key provisions to carefully negotiate and draft include:

- **Covenants:** ensure accurate definitions (e.g. EBITDA) and optimal headroom to give businesses flexibility while preserving lender control
- **Intercreditor terms:** when multiple lenders with different priorities (e.g. senior vs. mezzanine) are involved, structuring rights to maximise recovery in default scenarios is essential
- **Restrictions:** managing the company's ability to raise new debt or shift assets is vital to protect a lender's claim from being diluted.

Ensuring loan agreements function as expected in stressed scenarios is vital for capital preservation.

REFINANCING CASE STUDY

Avoiding distress through robust underwriting

In this refinancing opportunity, the borrower initially appeared to have attractive credit features. The business was well-established in a defensive sector with largely contracted revenues. However, deeper analysis revealed several fundamental risks.

- **Revenue risk:** despite predictable volumes, pricing pressure significantly pressured gross margins
- **Cost pressures:** labour costs were steadily rising, adding strain to the business
- **Property leases:** significant lease obligations materially added to total financial obligations.

Given the sensitivity of the business to future earnings declines, we determined the proposed debt level was inappropriate and declined the opportunity. Twelve months later, the businesses continued to suffer pressure on earnings which eventually led to restructuring discussions with its lenders. By stepping away from this deal, we avoided adding a distressed situation to the portfolio.

Monitoring: identifying distress early

Identifying potential distress before it escalates is crucial for effective portfolio management. Early recognition of warning signs allows managers to intervene proactively, providing time to collaborate with borrowers on addressing operational challenges or raising additional capital.

Early intervention also creates options for a manager to reduce exposure before risks escalate. Delays in taking action often result in further performance deterioration and a narrowing of recovery options, ultimately limiting the potential to preserve value.

At MA Financial, we leverage our restructuring experience to build bespoke systems for monitoring including for example:

- **Proprietary dashboards and watchlists:** loans are ranked by stress levels, allowing us to prioritise monitoring and mitigation efforts
- **Stress testing:** semi-annual stress tests simulate macroeconomic downturns and asset-specific risks, helping us proactively address vulnerabilities.

Exit and value recovery: knowing how to act

Knowing how to act when things go wrong is crucial to maximise loan recoveries.

A wide range of skills is needed, including:

- **Strategic planning** to evaluate all options
- **Stakeholder and game theory analysis** to predict actions and optimise outcomes
- **Expertise in legal frameworks** to navigate restructuring processes
- **Capital markets knowledge** to assess feasibility of raising capital or selling assets
- **Decisive operational decision-making** such as replacing management to prevent further value loss
- **Coordination and leadership** to rally support among all stakeholders and successfully execute the preferred proposal.

When these skills are available in-house, managers benefit from reduced costs and quicker decision-making, as external financial advisors often charge substantial fees deterring early engagement of experts.

Why restructuring experience is key

Restructuring transactions are complex and require specialised expertise. Private credit managers with a background in distressed situations are better equipped at spotting critical flaws in transactions early and avoid potentially loss-making situations.

MA Financial's Global Credit Solutions team brings extensive experience in debt restructurings, with deep expertise integrated into both investment and portfolio management processes.

Members of the team including those on the investment committee, have collectively advised on more than $40 billion of debt restructurings[1] playing key roles in some of the largest and most transformative transactions in the Australian market.

Through MA Financial's corporate advisory division, MA Moelis Australia, the Global Credit Solutions platform benefits from direct access to the number one ranked restructuring advisors in Australia and the US[2] ensuring unparalleled insights and strategic advantages for investors.

More information

For more information about our investment solutions, please get in touch.

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NOTES

1. Experience includes via prior Corporate Advisory roles at MA Moelis Australia (division of MA Financial Group)
2. LSEG/Refinitiv, as of FY 2023 – announced and not withdrawn $ volume excl. sovereigns.