MV|Credit

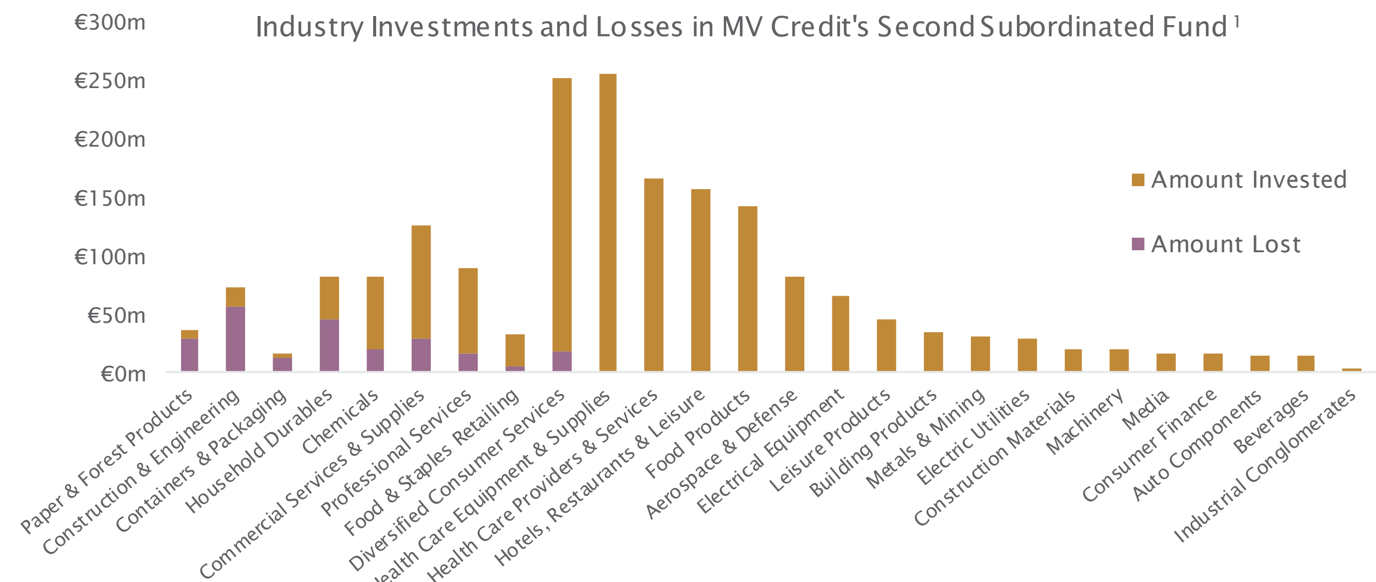
Restructuring Series: Credit Selection is Critical

TAKING STOCK: CREDIT SELECTION

The importance of credit selection cannot be stressed enough. Looking back on the companies that required restructuring in MV Credit's 2006 vintage subordinated fund (which went through the Great Financial Crisis), their industry or credit characteristics often contributed to their underperformance. A key lesson learnt from this portfolio is that strict credit and industry selection can help mitigate the likelihood of a company underperforming and going on to realise a loss.

RED FLAGS TO LOOK OUT FOR

- Looking back on that portfolio, **industry-selection is critical** when trying to avoid weak credits.
  - Some industries, such as household durables, are more correlated to economic cycles and cannot sustain the leveraged structures deployed by private equity sponsors in a downturn; some MV Credit portfolio companies in those industries suffered when the GFC hit.
  - For two portfolio companies in the paper and forest products industry, **exposure to raw material price fluctuations** contributed to their underperformance and losses were made on investments in both companies following financial restructurings. MV Credit is now very cautious towards companies in industries that rely on raw commodity prices.
- The **credit fundamentals** of a potential borrower are also crucial considerations. Some MV Credit portfolio companies that suffered during the GFC were negatively impacted by **high fixed costs** or because they were **capex intensive**. These businesses do not have the flexibility to reduce costs when revenues are hit.
- Other companies have **business models** which make them less suitable to be levered, such as one **project related** portfolio company (this company underperformed and was restructured, with MV Credit's investment eventually realising a positive return). Another borrower, which MV Credit exited in anticipation of a third restructuring, taught MV Credit to be cautious of companies that **relied on bonding lines**. This company had remained cash-rich, but its cash came from clients' down payments which could not be used to service debt. This business model helped contribute to the company's financial woes.



Source: MV Credit, data as at 31st March 2020, data period between 2000-2020. The Industries shown are those through which MV Credit's second subordinated fund invested. Losses and defaults refer to losses experienced by MV Credit funds. Industry classifications are defined by MV Credit. Losses are defined as realised investments which achieved TVPI of less than 1x, calculated as total distributed minus total invested. Past performance is not indicative of future results and there can be no assurance that any historical trends will continue. [1]Based on MV Credit's Second Subordinated Fund, which was launched in 2006, end of investment period in 2011.

THE PROOF IS IN THE PUDDING

"The four most dangerous words in investing are: this time it's different" – Sir John Templeton.

The Investment Team at MV Credit has continued to originate deals with the lessons of the GFC in mind, exercising caution towards certain industries and avoiding companies with weak credit fundamentals.

MV Credit's investment focus is now firmly targeted towards defensive industries such as healthcare providers and services and software, an approach that has secured attractive risk-adjusted returns in the past. To date, MV Credit has not made a single loss or experienced a default on a company in the information technology or health care sectors, which make up a significant portion of MV Credit's investment strategy.

MV Credit

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