E X P E R T Q & A

A proactive approach to risk across portfolios and assets is key to staying on the front foot, say Gordon Brothers' global head of credit Mark Bohntinsky and chief transaction officer Kyle Shonak

Navigating hidden risks in private credit

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Q What common risks to the health of an asset are often overlooked by private credit firms?

Mark Bohntinsky: It depends on which asset you are looking at. For example, for receivables, you need to consider questions such as: is the company accumulating concentration risk? Are you starting to see gradual changes in the calculation of dilution? Are you seeing the receivables starting to age out at all?

For inventory, some of the biggest items to track are sales and margin trends. You need to know what impacts the value of inventory over time. When it comes to machinery and equipment, meanwhile, the main thing you need to understand is the depreciation of that piece of equipment relative to the amortisation or the advance rates that you have.

Kyle Shonak: Not all assets are created equal and there may be some assets that are sitting on the balance sheet that are either slow-moving inventory or machinery and equipment that are not maintained because capex priorities lie elsewhere. You might also have inventory sitting on the shelf because management simply isn't focused on moving it.

It is about understanding how all the collateral fits together with the company's operations. This should be an ongoing exercise – certainly more frequent than every six months – and it should not just be achieved through a single point-in-time appraisal.

Q What are the benefits of a third party assessing a private credit firm's portfolio?

MB: A third party can come in and identify gaps or weak spots in the portfolio, such as industry risk or if a firm is overweight in a sector with negative trends. When firms are looking at individual deals, having valuation work or some type of analysis done on that deal provides updated information on asset values relative to what they are lending against and identifies risks.

KS: An outside party can also offer a more global, broader perspective, as well as insights that look beyond the scope of an individual company. As an asset appraiser, we will have seen similar types of collateral and how that collateral reacts under different circumstances.

Q What are the most effective ways private credit firms can deal with risk?

MB: As Kyle mentioned, it is important to stay current with your analysis. That means getting additional information from the company, such as factors that can impact value, on a weekly or monthly basis. That helps you see what changes are happening or how things might be impacted, and allows you to get ahead of the curve in terms of identifying risk.

One of the things that we always talk about is the ability to look through the windshield and not the rearview mirror. From a credit perspective, all the information that we get from a client generally is in the past. We have all this data internally and can see how certain things behave through cycles.

So, as you start to see a company go on the downslope, you can start having conversations. You then take the information and get a forward view of what's happening and identify that risk sooner. Then you can start to figure out how to deal with it.

Q What are the early signs that a private credit firm can use to identify if an asset is likely to underperform?

MB: Financial decline is an obvious indicator. But it is often the more subtle things, too. What is happening with sales? What is happening with margins? Looking at the turnover, are you starting to see ageing trends? Are payables stretching out? Are you starting to see usage of the equipment decline?

It is important to track information, including company or industry data. Particularly for workouts or restructurings, it is always better when we have more information and options, and especially when we get there earlier so that we can have that conversation with the client. It is key to get that information, to be ahead of it and then to start looking forward instead of backward.

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>
> **KYLE SHONAK**

KS: In industries where assets are extremely hot, you also need to be careful leaning in if the values seem to be a lot higher than usual because generally those values end up coming down. If everybody's lending up, it is like everybody is clamouring for a stock and it is getting pumped up. Sometimes it creates a bubble. The same thing can happen with assets.

Q A lot of private credit firms quantify the risk of individual assets, often in a one to five system, but can this be too reductive a method when considering the idiosyncratic qualities of each credit?

MB: Any risk-rating model must factor in the probability of default and the loss given default – in essence, what you would expect to lose once the asset is in default. You must also maintain consistency. There will be some overrides to the model, but if every single deal is overridden, the model doesn't work.

A good model probably covers 80 percent of the deals you look at. There is an art and a science to coming up with a final risk rating because you cannot factor every scenario into a risk-rating model.

Be consistent in your approach and know that the risk rating is a point in time. When you update it every quarter, you need to look at what is going on at that moment. You cannot sit there and say, 'oh, I'm just going to roll it over and have the exact same risk rating quarter after quarter' – that can be a trap that people fall into.

Q How can artificial intelligence benefit portfolio monitoring?

MB: The benefits of AI are still being explored and determined at individual organisations. The technology can be good for understanding industry trends and it can quickly provide summaries.

However, you still need people to understand how certain parts of the cycle behave, how to interpret the information and what it means from a structure standpoint. Can it add efficiencies? I think it can. Can it add value over time? Yes, I think it can. But you still need people to interpret what it spits out. ■

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