Portfolio Strategy and Analytics in Private Credit

An interview with David Ross and Jon McKeown of Northleaf Capital Partners focused on the differences between private and public fixed-income strategies, how to analyze relative value and how to measure risk in the private credit asset class.

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Privcap: Portfolio strategy and analytics sounds like it covers a lot of bases, but how does Northleaf define this important function?

Jon McKeown, Northleaf Capital Partners: It includes a lot of discrete tasks that span across setting the portfolio strategy, fund management and quite a lot of risk analysis. Many people at Northleaf are looking at things at a deal level and asset level, making sure they're all performing. Our team takes a step back to a higher altitude and we look across the portfolios to make sure that they're delivering on the goals we set for our investors.

Privcap: I'm guessing that the creation of the portfolio strategy and analytics function at Northleaf was an investment of time, money and effort. Why did you make that investment?

McKeown: We have a lot of sourcing opportunities and a bit of a luxury in choosing which things we invest in. We believe it's important to also overlay an element of selection to make sure that we're building a fully diversified portfolio, and to make sure we're managing the efficiency of the funds to maximize returns. The metaphor I sometimes use is Google Maps: the deal teams are at street level, kicking the tires and looking at the businesses in a very detailed way, whereas we'll be looking at the map view. It's really challenging for the same people to do that on a continuous basis, to toggle between the two. We find it valuable to have an analytics function within the investment team.

CONTINUES ON NEXT PAGE

David Ross, Northleaf Capital Partners: We're increasingly having discussions about what the risk correlations should be and how private credit might add diversification and yield, to an existing fixed-income portfolio. As private credit matures and takes on that role within a broader fixed-income portfolio, it's important that it adapts and takes on some of the benefits that you get from fixed income. One of those is a more portfolio analytical view of what you're holding and how the diversification and the correlations will play out.

Privcap: Publicly traded securities have lots of data that can be accessed by investors. What are the challenges of accessing information in the private credit market?

McKeown: Publics obviously have much more extensive disclosure requirements and it's a bigger market that's been around longer. There's a lot more standardized data out there, both at the company level and also at the market level, regarding performance. We've had to be quite creative in meshing and marrying private market data on performance with public market data. We can show clients exactly what Dave was speaking about – how private assets fit into the broader portfolio.

Privcap: Can you give a scenario of how your team would provide valuable information about relative value to the deal team, to help them to say "yes" or "no" to a new deal?

McKeown: We've got a highly collaborative relationship with the deal team. Typically, they'll come to us early in the process with their early read of the terms they're proposing for an investment, where they're planning on setting the interest rate. If they plan on having an interest floor in there, what kind of fees? We'll run it through the traps and give them a first view based on the company's most recent financial statements as to the relative value. We recognize there are other factors to weigh, but we can give them a comparison to what else is going through the investment pipeline at the moment.

We will also look back to prior deals that we've done or reviewed. We'll give a sense of value relative to similar businesses that we may have seen in the past. That helps the deal teams at an early stage. They can fine-tune the offering. It also helps them prepare for the investment committee discussion.

> "It is no longer going to be just about what the fund returns were. It will be about how much risk was taken in order to generate those returns"
>
> –David Ross, Northleaf Capital Partners

Privcap: Please elaborate on the kind of information that you track and what you do with it.

McKeown: There are two broad types of information that I would highlight. The first is enabling us to come up with a view of "relative value." That's really important to us at a deal decision-making stage. We see a lot of opportunities across the different loan types, industries and geographies, and we need a way to look at these opportunities through a common lens and assess the relative value. For example, things like leverage level, loan-to-value, cash flow. We blend those together to get what we call a "measure of composite risk," which weighs these factors based on what we see as the risk attached to each based on historical observations.

The second type of information I'd highlight is what we call "risk attributes." We look to tag and identify as many pertinent or relevant characteristics as we can for each of the assets. That allows us to segment the portfolio and see where the risk of the portfolio level is breaking down, whether it's based on a more detailed view of geography or drilling down into industry or looking at different types of business risk exposures.

Privcap: You have built and refined the portfolio strategy and analytics group within Northleaf. What have been some valuable lessons that you've learned and how have you used those lessons to fine-tune the platform?

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McKeown: We need to be exhaustive in our thinking to try and identify the signals for where concentrations of risks could be appearing. We've also learned it is important to have the right organizational characteristics to react and to adapt. Those are the hard aspects of organization design. It's about having the right culture, and this has been especially tested in a remote working capacity.

Privcap: As the private credit asset class matures, how would you like to see your portfolio strategy and analytics function develop?

McKeown: We're going to move toward having more and more data to make use of. But that, in turn, places an onus on technical skills, and it means that we will increasingly be recruiting people with very hard data-analytic skills, in addition to strong Excel and investment-analysis skills. We will need to set up the right mechanisms to provide that information to investors and to factor it into our reporting, and ultimately to provide the clients better visibility to what they're investing in.

↓ CONTINUES ON NEXT PAGE

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Ross: The critical element for the future is that we establish a protocol where we can talk to investors about risk and quantify that risk. It is no longer going to be just about what the fund returns were. It will be about how much risk was taken in order to generate those returns.

That's the fundamental key that still is lacking in private market funds – the ability to compare across investments, across funds and even across markets in terms of how much risk was taken to generate returns.

Privcap: Has Northleaf's approach to credit risk changed at all in the midst of the COVID crisis?

McKeown: The crisis highlighted the value of some of the things we were already doing. For instance, we look at geography in a nuanced way and it was very helpful going into COVID that we already had a very sharp view of the revenue exposures of all of our borrowers. We knew which businesses were localized and which ones were regional. It has certainly challenged us in terms of thinking through multiple levels more than we ever had in the past. What is a global pandemic and how does it play out? We've also added risk attributes that we weren't tracking before, such as face-to-face service to consumers. We built out a framework for thinking about COVID as to the different subtypes of risks as to the different subtypes of risks and how we are diversified across our portfolios. ■

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