

E X P E R T Q & A

*A robust macro backdrop and strong Nordic PE community combined with expert pricing capabilities and leading ESG scoring means a lower mid-market premium, says **Sandro Näf**, co-founder and CEO of Capital Four*



The lower mid-market: Core factors for attractive returns

Q How is the current volatility and uncertainty in global markets impacting private debt?

Volatility has a very negative impact on the lending environment. We want the companies that we are investing in to be stable and highly resilient. A leveraged company in a volatile environment performs much worse than a leveraged company in a robust environment. Investors can increasingly benefit from making an active choice regarding geography and the associated features.

Let's put it another way. Driving along a winding street at high speed with a heavily-loaded truck is a recipe

for disaster. If you have a straight road and you drive responsibly, then you can carry a much heavier load.

The war in Ukraine has, unfortunately, had a significant impact on companies, both directly and indirectly. For example, consider a company that has contracts for cleaning motorways. One of the main input costs for running the business is the cost of fuel for vehicles. As energy prices rise, likelihood of company underperformance also increases. We are observing a lot of indirect effects on the operating

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environment of companies, and we need to be mindful of this in our underwriting.

Q Given current market conditions, how can you maintain stability within your portfolio?

Thankfully, the Nordics, our home market, has shown itself to be very resilient to external shocks.

The economy saw low single-digit drawdowns during the covid-19 pandemic, which compared very favourably with the drawdowns seen in other European countries. Low debt-to-GDP levels also means that there is a lot of fiscal flexibility in the Nordics.

The Nordics has a lot of healthcare and technology companies, which tend to be less cyclical than, for example, a lot of the manufacturing businesses seen in other parts of Europe.

Returning to the driving analogy, the Nordic economy is like a straight street with good visibility and without excessive curves. Responsible driving is much easier when you don't have a lot of curves to negotiate.

This said, there is no overlooking the fact that overall volatility and market uncertainty has increased. Preparation is key to addressing this.

Even in a benign market, it is very important to make investments that can withstand a negative cycle. This is even more critical when it comes to the private credit markets, where investments cannot easily be sold should things take a turn for the worst.

We model all credits that we invest in under a conservative case scenario. Over the last seven or eight years, we have developed a scoring methodology to evaluate the resilience of the industry and of the companies in which we are investing. This allows us to compare our private debt investments with the more liquid universe, and affords good visibility on investing in companies that can withstand adverse economic conditions.

We create four scores for our investments: a fundamental credit score, a score on overall balance sheet riskiness, an ESG score and a covenants score. Once we have made a commitment to a particular company, ongoing monitoring and dialogue is a vitally important part of the follow-up process.

Q As competition increases, how can managers ensure they are offering the best pricing for investors?

We obviously want to price loans as accurately as possible. If we price them too wide then there is a good chance we don't get to do the deal. On the other hand, if we price them too tight then we won't get commitments from our

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LPs. It is, therefore, extremely important that we price things at exactly the right level so that we can continue to thrive as an organisation.

Accurate pricing requires hard work, expert decision-making and robust data sets. We work relentlessly to develop the best processes in order to make our decision-making as accurate as possible.

One of the reasons that consumer lending often has such high interest rates is because not all borrowers pay their loan back. This results in less risky parties having to pay more than they should be. If we can eliminate from the lending market the ones that are most likely to default, then all the others will have to pay less. This is our responsibility as a direct lender. The more that we do this, the cheaper we can make the loans for everyone else and the better the return for clients. This ultimately allows us to win more business.

Q The lower mid-market involves a lot of smaller companies with very different set-ups. Is this a problem when it comes to evaluating default risk?

This is a very good point. Obviously, bigger organisations have more resources at their disposal. Although the yields are usually higher when lending to smaller companies, investing in the lower mid-tier market exposes oneself to companies that may not be quite at

the same standard in terms of governance standards and overall professionalism.

One of the mitigants to address this is a focus on sponsored deals. Sponsors can have a positive impact on the selection and sourcing of management of a company and can provide additional strategic support and capital to develop a company. Furthermore, they can ensure good governance and supervision and help us often to promote our 'Sustainability Agenda'. Across the Nordics you actually have quite a substantial community of smaller, very sophisticated private equity sponsors, many of them dating their roots back to the 1980s. One of the reasons we have been so successful is because we have strong relationships with the local sponsor community.

Q To what extent do you factor ESG considerations into your funds?

ESG is no longer optional. All our clients have ESG very high on their agenda, and we work closely with them to get the best ESG practice into the direct lending process that we apply.

The entire private lending community is working very hard on this, and we want to be the best among all the good ones. One of the things that we are very keen on is cross-pollination across all of our different investments – from the very liquid high-yield bonds to semi-liquid leveraged loans and illiquid private debt. If we spot a good idea in one particular area, we will deploy this idea across our platform.

We want to do everything we possibly can to make private debt investment more ESG-friendly. From the ESG scoring of every individual direct lending commitment that we make to the promotion of Article 8 direct lending funds under SFDR [Sustainable Finance Disclosure Regulation], we want to make sure that we have the best ESG technology and practices throughout our entire range of direct lending products. ■