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Credit Investing: "5C" Credit Evaluation Framework - Looking Beyond Ratings

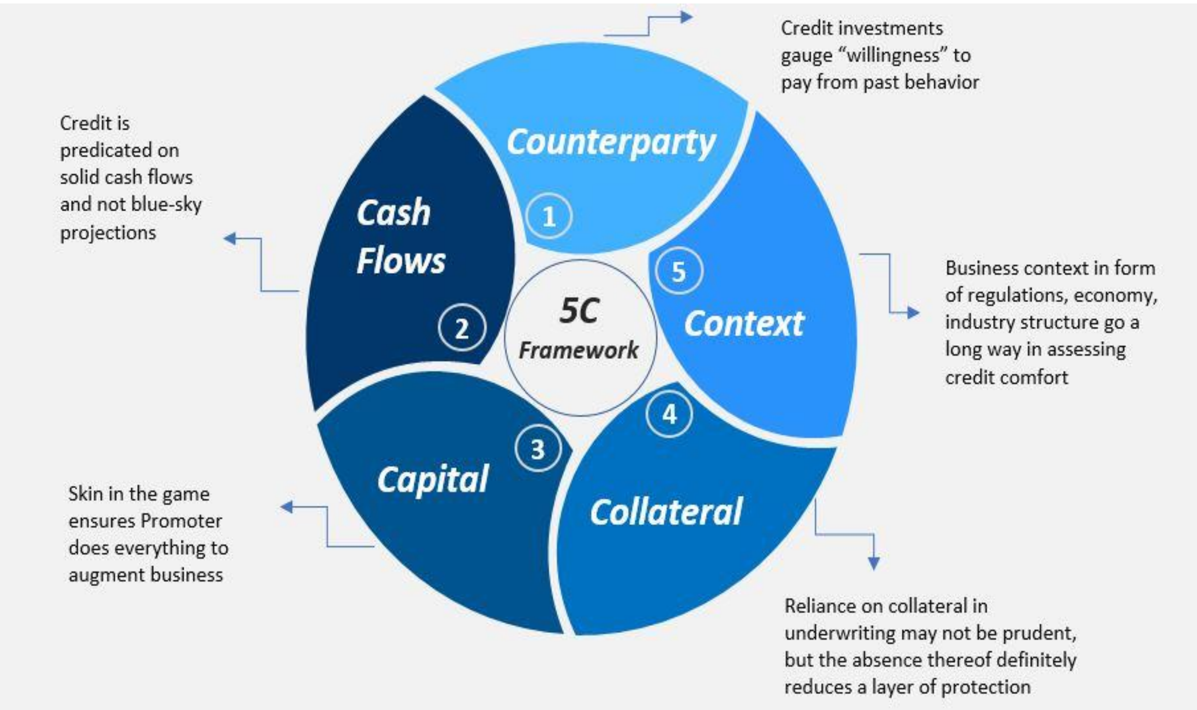
EXECUTIVE SUMMARY

"Credit Investing looks at capital protection while earning reasonable risk adjusted returns. Investors need to have their own checklist to avoid red flags. A seasoned investment manager uses past experience and its own networks to dig deeper into any anomalies. Ultimately, being skeptical and asking the right questions are essential for achieving good returns"

Last month, we posed the question whether it's the Right time to invest in Credit. We cited various statistics, news and events towards our thesis that Credit is at the cusp of great returns. **Elevated credit spreads today are indeed a harbinger of potentially good returns in coming years**. The objective of this article is to dispel "fear" implicit in elevated credit spreads by sharing our learnings over a decade of credit investing.

And haven't we been doing Credit investing all our life? Those numerous fixed deposits were credit investments; so was timely help extended to friends. When you accept delayed payments for your work or give monthly billing to your customers - **all of that is credit**. The same credit framework is applicable to credit investments - whether it is funds, bonds, FDs or trade credit.

Our proprietary framework has evolved over a decade of credit investing across the risk spectrum; be it structured finance, distressed situations or vanilla Opco financing. Having seen multiple credit cycles, our framework has matured over time. Our proprietary framework incorporates the **5C's which are crucial to a credit decision**.



Implicitly, you may have already been using parts of the above to evaluate a borrower: sometimes only past behavior guides our decisions, sometimes the bungalow that they live in and sometimes, the fact that they are salaried and have stable cash flows.

All the above are simple and intuitive till the point borrower also realizes how they will be evaluated. At this point, nothing is simple. The pillars of 5 C's might not be visible across the fog of narrative woven by the borrower anymore.

Credit underwriting is all about shining light into the fog, about separating fact from fiction, about seeking the truth. Where we are today is more informative than stories of where we are headed and therefore, we don't rely on long range projections. Broadly correct is better than precisely wrong.

We consider various ratios and statistics pertaining to each pillar. Ratios like Debt to equity, debt to EBITDA, cash flow accrual, return on capital, growth are useful but tell only one side of the story. **As Goodhart's law states, "when a measure becomes a target, it ceases to be a good measure"**. A smart borrower knows what the lender is looking for and dresses up ratios accordingly. Negatives are glossed over, and positives are naturally emphasized.

With our extensive experience over 100+ credit deals, we have found our own beacons to discern between available credit opportunities. Some of our key learnings are:

- Debt can be hidden in subsidiaries and off-balance sheet vehicles, and even holding companies. Since cash flows are often fungible across entities, it is useful to analyze the overall debt and cashflows of the group instead of individual companies

- We are wary of overtly complicated group structures, numerous subsidiaries

- Unrelated and frequent acquisitions, frequent re-organizations of business etc. can be tools for confusing investors

- Any opinion rendered by a third party which is paid by the issuer isn't trustworthy. Whether it's a consultant opining on projected traffic or a valuer for the factory, everything must be taken with a pinch of salt

- Collateral must be truly accessible and saleable for it to have any bearing on trade

- Numerous field visits are the only way to truly assess the counterparty. When we talk to ex-employees, vendors/suppliers, bankers and rating agencies, any big red flags tend to reveal themselves

- Most importantly, **credit situations unfold gradually and then suddenly**. The first short sell report on Evergrande came in 2012, but the eventual default happened only recently in 2021. The trick is to not give long tenor money, keep engaging with issuer and act swiftly if circumstances change.

Our focus beyond numbers is on issues like management quality, group structure, group history and challenges they face in all their businesses – whether the business is ultimately productive or not, are financiers supportive of them or not. These are vivid stories and **ultimately, credit underwriting is to create a mosaic of all such viewpoints in marketplace**.

The hard part of underwriting is not in making nuanced adjustments to ratios and statistics - it is in reaching out to the marketplace. What a large organization offers is a footprint across various sectors, a bouquet of relationships which we can tap. An organization which dabbles in multiple sectors, has sizeable AUM, is commercially significant for the marketplace, is straddled across the risk spectrum and has an army of professionals who have stories to share is perhaps one which is poised to succeed.

So, what is the right way to invest in Credit? Ask a lot of questions. Don't accept easy answers, be skeptical, tap into the marketplace and build your own mosaic.

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