Park Square Perspectives, Volume 2: Avoiding the Zeroes

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Park Square Perspectives: Avoiding the Zeroes

One of Warren Buffet's best-known rules of investing is: "Rule No. 1: Don't lose money. Rule No. 2: Don't forget Rule No. 1."

In credit, this is particularly important because there are no home runs, the upside is contractually capped. Outperformance is achieved by avoiding losses, in particular catastrophic credit losses. In sum, the key to successful credit investing is **avoiding zeroes**. Our role as an investor is to select great businesses to lend to, monitor them aggressively, and build diversified and defensively positioned portfolios, all with an eye on minimising credit losses and in particular avoiding zeroes or catastrophic losses.

There is no shortage of private credit firms for whom the name of the game seems to be the accumulation of ever larger sums of capital, and whose deployment rate is prodigious. For these firms, the mindset appears to be to deploy the money as quickly as possible, hope for the best, and go back to the market for ever larger sums.

The concept of being selective appears to take a back seat to gaining market share and building an asset gathering platform. In my 35 years of credit investing, I have not heard great investors talk about market share.

It should not be a surprise to learn that at Park Square we take a different approach - we focus on delivering outstanding performance for our investors by selectively investing in high quality businesses in defensive industries in core geographies with a strong rule of law.

> *"The key to credit investing is avoiding zeroes."*

This entails thinking extremely carefully about who we are prepared to lend to and how we deploy our capital. Many managers focus first and foremost on leverage multiples and talk about metrics such as "spread per unit of leverage" as a measure of risk. In our view, it is far better to extend more leverage to a high-quality business, than to put low leverage on a lower-quality business. We are not just sending money out the door, that's the easy bit - the hard bit is getting paid back.

We believe it's more important to assess whether a company has a good business model in the first place rather than focusing on the quantum of leverage it can support. In particular, we ask ourselves "how prepared the company is to deal with setbacks, what is the quality of the management team, and how diversified are its operations and the customer base?".

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In part, the global financial crisis was a valuable learning experience for Park Square and we are thankful to be one of the few managers dedicated to Private Credit who have lived through it. Our most important takeaway – and it may sound obvious now – is to avoid backing businesses that have an existential threat on the horizon. It is those sorts of existential threats that can create a zero-recovery scenario and that really impair fund performance.

You cannot avoid zeroes by focusing on covenants and documentation alone. The key question we should all be asking is "are there existential risks to the business?" This question informs our focus on business quality above all else.

> *"We are proud of our annualised loss rate of 0.07% across $24bn invested in over 19 years."*

In the first few years of the new millennium, we extended credit to several Yellow Pages-type classified businesses, despite the rise of an upstart online rival called Google. At the time, the now ubiquitous search engine seemed a distant threat, and one that we could handle. But bad stuff hits a lot quicker than you can ever imagine. Positive developments, conversely, tend to take a lot longer to have an impact.

Thankfully, through careful evaluation of industries and companies, we have kept these kinds of misadventures to a minimum – we are proud of our annualised loss rate of 0.07% across $24bn invested in over 19 years.

This would be important at any time, but in the present environment, with interest rates rising to levels not seen for decades, it is inevitable that some credit investors are going to come unstuck – or worse.

The Private Credit asset class has grown significantly over the last few years; by our reckoning, there are over 650 credit managers out there globally, most of whom were not around during the global financial crisis, and consequently have never been truly put under pressure.

The current market environment will prove a great test of the resilience of many portfolios, and a lot of managers are likely to be exposed. Those managers who have stuck to Rule No. 1: "Don't lose money", and to Rule No. 2 "Don't forget Rule No. 1", will be best placed to capitalise.

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