It's not just what you know, it's who you know

Having a network of industry advisors can be a useful addition to a fund manager's risk analysis process, say **Paul Johnson** and **Andrew Konopelski**, partners at EQT Partners, investment advisors to funds within the EQT Credit platform

EQT Credit partners Paul Johnson and Andrew Konopelski reveal their views on due diligence and risk analysis below. With due diligence seen by Johnson as "a bit of a dying art", we found out how fund managers can ensure that their process of identifying risk is up to scratch.

Q What do you see as the main risks for private debt investors and how might they best be mitigated?

Paul Johnson: From our point of view, one of the biggest risks is the level of due diligence being done at the moment. A lot of firms are taking what's presented to them as read rather than doing additional due diligence. We look to use all the information and expertise that we have available within EQT, including the network of industrial advisors, to dig a bit deeper.

Q Is there a good awareness of risk among investors in the asset class, or are there some potential dangers that exist below the radar?

PJ: There is an increased and sound focus on risk in particular instruments. For example, questions are increasing around exactly what firms really mean by "unitranche". For instance, is it a true first-out instrument with no other term debt ahead of it, or has it been tranched after the deal and is therefore more like a synthetic second lien? Investors are understandably trying to work out where their risk starts and finishes in a particular business.

Paul Johnson

There is also a lot of scrutiny of the documentation. The documentation can be an opportunity to be creative and provide the owner and management with the flexibility they need to run their business, but you need to make sure there is an appropriate protection for the loan. It's all well and good to win the deal but you need to make sure the fund's investment is adequately protected in a downside scenario. It's more than just covenants. There are a lot of different tools people can use but they need to be balanced against how much risk is being taken.

Q How does a fund manager ensure that it has solid risk management processes and practices?

Andrew Konopelski: It's easy to put capital out but it's more difficult to get it back. We think the best defence is to do the homework upfront in order to really understand the business and industry the fund is lending to. Asset selection is the best line of defence because these are illiquid assets, which can't easily be traded out of if performance deteriorates. This is why due diligence, and getting beyond the standard reports you are given in a process, is so important to us as investment advisors. Beyond that, there needs to be good documentation in place and for the fund to take an active portfolio management approach after making the initial loan. It's important to develop a good relationship with both management teams and owners of businesses in order to have an open ongoing dialogue. One needs to stay on top of each credit, although the number of credits will determine the level of attention to detail that can be given to each one.

PJ: In addition to the industrial advisors engaged in the due diligence on each transaction, there are six core sector teams across EQT, so we are aware of everything that's going on within sectors and sub-sectors as we can proactively ask the experts. This means that we can see issues coming before they show up in the numbers. If you're waiting until you see them in the numbers, that's way too late. My sense is that there are various types of manager; some have a private equity background and some don't. We depend on EQT's network halo and we have a very collaborative culture.

Q How much resource should be devoted to the area of risk? Do all team members need to be on top of it – in which case, how are people given the skills?

PJ: It's all about understanding what risks companies face. When you consider an investment opportunity, you need an angle that allows you to understand the risk better than others. You need to have a granular understanding of the business. We bring the knowledge of other investment strategies within EQT into this process. For example, it may be that EQT portfolio companies could be customers of a given business; and, if they're not, why not? It's valuable to have access to that information.

We extend our efforts to understand risk well beyond the immediate EQT Credit team of over 20 people to the 400+ in our network. We carefully profile each potential investment within the credit team but we would be foolish not to use the whole organisation to increase our understanding. In direct lending, you need to make sure the downside is well understood and protected as well as possible.

AK: Understanding and diligencing risk is just a mentality, it's cultural. We like digging into companies. Investors in direct lending also like to understand which investment advisors take the process seriously – going through detailed case studies and understanding the team's approach to credit. One important thing to consider is that incentive models have shifted. Increasingly, managers are incentivised on invested capital and that changes behaviour. It means people are incentivised to go for easy wins, ask fewer questions and get the capital out quicker.

Q In what ways has due diligence changed for private debt investors over the years?

PJ: It's a bit of a dying art. Increasingly, due diligence is becoming a box-ticking approach. You can get big due diligence reports, but I would only consider them the starting point – they're not the be-all-and-end-all and they never provide the full story. We try to dig deeper, working alongside EQT's industrial advisors, to get more detailed company and industry insights. It's often only when we use the industrial network that we truly understand what the risks are.

Andrew Konopelski

Q What are some of the main priorities/areas of focus in a typical due diligence process?

PJ: It's important to understand the position of the business in its industry and understand future trends that you won't read about in a market report but will have a big impact on where the business is going. You have to ask whether the business has a reason to exist, what's unique about it, and what defensive characteristics it has? If things don't go as planned, will it still survive? And can you identify strategic acquirers for the business? You want the business to have a strong position in its industry value chain.

AK: Increasingly we're asking whether there is the possibility of disruption in a given industry, especially risk from new technology. We have a strong digitalisation team within EQT and they see a lot of trends well in advance. As a firm, we are putting a strong emphasis on digitalisation and preparing portfolio companies for the challenges to come. Industries that used to be very stable are now ripe for disruption.

PJ: We have looked at businesses where there are binary risks due to the possibility of an industry changing, and EQT's network has actively helped us in diligencing these businesses. We advise to pass when there is binary risk that the fund cannot bound. But the overall volume of opportunity is immense – we just need to satisfy ourselves that the businesses the fund backs are well positioned to deal with any future threats.

AK: The skill in all this is to make sure that you price risk appropriately.

Q Is risk and due diligence in the mid-market significantly different from the large and small ends?

PJ: At the small end, you need to dig deeper. There might be national champions at that end but generally these companies are not well known to the market. At the larger end, you still need rigour but you're competing more on terms with the bond market.

AK: Also, larger businesses attractive to private equity are often successful multinationals with significant resources and are well prepared to withstand downturns. Smaller businesses are inherently a little less stable. The information systems available to do due diligence are also often a bit less advanced, so you have to be curious and peel back the onion. ■