EXPERT COMMENTARY

Lenders that focus on asset risk rather than credit risk are liberated from the cycle of refinancings, write Paul Lisiak, CIO, and Daniel Leger, senior managing director, at Metropolitan Partners Group

Measuring the value of private debt against its cost

Private credit's lending practices remind one of the old quip that an economist is a person who knows the cost of everything, but the value of nothing.

Lenders, of course, are fully aware of the cost of their loans and all of their constituent elements – after all, it's how they make their living. Things like SOFR, spreads and origination fees are often taken for granted. But are lenders in today's market aware of the value of debt other than as an instrument for refinancing and as a means for financial engineering? Is there a purpose to debt other than to maximise the return on investment for private equity owners and shareholders?

SPONSOR
METROPOLITAN PARTNERS GROUP

The numbers suggest that they are not. In the third quarter of 2024, S&P Global reported that more than three-quarters of US speculative-grade bond issuance was for refinancing purposes. The actual number is likely much higher when one remembers that the vast majority of private credit today consists of lending large amounts of money to big private equity firms as they acquire larger and larger businesses.

While the growth in refinancings represents a noticeable departure from lending practices in the days before the global financial crisis, the challenge of looking past the cost of debt to the value of debt is a very old one indeed.

As Warren Buffett has said many times, he has rarely come across a CFO of any major company that understands the true cost of capital. That true cost – its 'value' – is your second-best investment; essentially, it represents the value that the CFO gives up by deploying capital in one place versus another and not the typical loan components on which most CFOs focus.

Put differently, the value of debt is the marginal revenue productivity (MRPD) that will result from the assumption of new debt. MRPD is a concept that informs every loan we make at Metropolitan. In an age where refinancings are the virtue of private credit, we want to refocus investors on debt's original – and in our view, better – purpose.

MRPD represents the additional revenue generated for each additional dollar of debt that a company takes on, and the higher the ratio the better. When a company assumes debt for balance sheet or lender optimisation purposes, such as for refinancings, the capital is typically being used for financial engineering purposes and increases in shareholder ROI rather than for direct investment, capital expenditures, or accretive working capital. For our part, we believe in focusing our sourcing, underwriting and deployments on what we refer to as MRPD-positive scenarios.

Addressing the biggest issues

Of course, Metropolitan also receives lots of inbound deals that seek straight refinancings. In these situations, we always ask ourselves two basic questions: why would we loan money simply to repay old debts? What happens in the future if markets are not as sympathetic to borrowers who maximised borrowing capacity during good times?

By prioritising capital deployment to borrowers where the use of proceeds is for non-refinancing purposes, our debt can be used as growth capital for borrowers as they seek to achieve the next level of success. By targeting companies where debt directly translates to revenue growth – as well as new asset value creation or acquisition of dislocated assets – we can maximise the return potential of each dollar deployed.

While this may at first appear to be growth-orientated, the reality, from our perspective as a senior secured lender, is that the positive value creation enhances our downside protection. Creating new value insulates Metropolitan against the risk of future excessive leverage as every new dollar lent by us (typically through multi-draw term loans) must be measured against the marginal benefit of the additional debt.

Our continued focus on MRPD-positive scenarios provides value not just to portfolio companies, but for our investors beyond what can be found in the more beta-orientated portfolios of sponsor-backed lenders.

The beauty of the non-sponsored, US lower mid-market is that opportunities abound for precisely this form of lending. According to data from JPMorgan, the US mid-market comprises around 300,000 businesses with revenues of over $13 trillion, with 90 percent of these businesses generating between $11 million and $20 million in revenue.

Together with a highly regulated and actively consolidating US banking sector, the number of businesses desperate for growth capital that they can deploy at very high rates of return vastly exceeds the current supply. When the new tariff regime is added into the mix, US domestic businesses will require even greater amounts of capital to grow into an ever-expanding market.

Challenges and opportunities abound in the US lower mid-market, but often driven by the micro picture, rather than the macro. For this reason, it is not a marketplace for tourists or for those without years of experience. It is a capital-starved part of the market without many sophisticated investors – therefore, for those of us who have successfully navigated this market for years, we tend to be makers of our luck rather than the takers of banked processes and private equity-driven flow.

Resourceful thinking

In the shadows of the lower mid-market, success requires tremendous resources to source quality opportunities, underwrite them and, when needed, to intervene and work out troubled credits. This emulates old school fundamentals of block and tackling lending.

That said, by adhering to our investment '10 Commandments', we can ensure that we properly identify compelling businesses at a moment of catalytic growth where our loans, and their above-average costs of capital, will generate substantial revenue growth and returns for all stakeholders. This follow-on growth has the additional benefit of bolstering the value of our equity kickers, which we typically receive in more than 60 percent of our loans.

Our commitment to making MRPD-positive loans not only enhances returns for our investors and strengthens the underlying businesses we finance, but it also fosters a more resilient and productive ecosystem in various sectors and subsectors of the US lower mid-market. Ecosystems are an important function of the lower mid-market as opportunities are manufactured via networks of successful businesses, operating partners and other value-add vendors to businesses undergoing fundamental catalysts. The best deals tend to come from a call from the CEO!

Taking all of the above into account, we feel that our emphasis on MRPD-positive scenarios allows us to focus on asset creation and subsistence risk, rather than credit risk. Credit risk is a market-based concept, one we find to be inadequate as it is premised on the notion that the past is prologue and the capital markets are always forgiving. With an emphasis on the value of a company's underlying assets, our collateral is a measure of intrinsic, fundamental value and offers strong downside protection even if execution is not as expected.

Our approach allows us to focus on how our senior secured loans can help owner-operators unlock their assets' growth potential at every step of the process, thereby de-risking our loans while allowing us to grow into the relationship with meaningful upside for LPs and borrowers alike. ■