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David Ross, Head of Private Credit, Northleaf Capital Partners

Vet Care, Royalties and Private Credit

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BY WOUTER KLIJN | MAY 4, 2022

Finding businesses with strong recurring or sticky revenues is key to successful investing in private credit, Northleaf Capital Partners says.

When the global pandemic hit at the start of 2020, it was clear some sectors of the economy were going to be heavily impacted. But for many businesses, it wasn't immediately obvious how and to what degree they would be affected.

Take the healthcare sector for example. A global pandemic leads to lots of sick people, which at first sight would seem to benefit healthcare businesses, but this did not turn out to be the case across the sector.

Northleaf Capital Partners had provided debt financing to a United States West Coast-based company that offers linen cleaning services to hospitals.

"You'd think that during this period it would have been busy because there were so many people in the hospitals. What happened was that certain segments of the hospital were overcapacity, but other parts of the hospital were totally unused," David Ross, Managing Director and Head of Private Credit at Northleaf, says in an interview with [i3] Insights.

“Eye operations, knee operations are all essential healthcare procedures, but they are not emergencies.”

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As it happened, this linen cleaning business had negotiated higher margins on cleaning linen related to emergencies and so it held up reasonably well. The impact of the lockdown measures was more pronounced across other non-emergency healthcare businesses, such as ophthalmology clinics, which lost up to 85 per cent of their revenues during March and April 2020.

Yet, other sectors that you would think might struggle during extended lockdowns and business disruptions managed to reinvent themselves. Ross gives the example of one of the largest providers of branded corporate products and employee recognition services in the US.

“This is a business that we thought would have performed weakly, but it turned out that they became an important business conduit for the purchasing of personal protective equipment and other COVID equipment for businesses. They experienced an explosion in demand for that particular type of product.”

And while competitors were struggling to replace revenues, the company made use of the opportunity to gain market share and acquire some of the companies that proved less resilient to the global pandemic.

“Many of their competitors were a lot smaller or didn’t have that same go-to business demand. The company bought a number of very good businesses as tuck-in acquisitions and was able to build market share at attractive purchase prices,” Ross says.

Sticky Revenues

These two companies might have had different experiences during the pandemic, but they both managed to survive and ultimately thrive because of a shared characteristic that Ross looks for when investing in private credit: strong recurring or sticky revenues.

This typically involves businesses that provide services on a contract basis, such as software companies, but it also includes companies that have sticky revenues due to consumer behaviour. A favourite of Ross in this regard is veterinary care businesses.

“If you look at the historical trends of vet care, the humanisation of the industry, the increased number of pets per person and dollars spent per pet, there is a very clear trend that this has effectively become an essential service that has very stable demand characteristics,” he says.

He says while he seeks to make debt investments in veterinary platforms that have diversified revenues across hundreds or thousands of locations, individual clinics do play a role in why these revenues turn out to be so sticky.

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“Customers [of vet care] are attracted to two things: the convenience of location and knowledge of having consistency in the care provided. Typically, customer loyalty is to an individual veterinarian in a certain location,” Ross says.

“We look for vet care businesses where there is very low churn and where the vets like working in that specific practice. When you combine these factors with highly diversified locations, the companies typically have high cash flow and consistent demand.”

Managing Risk

The private credit market has grown rapidly in the US in recent years as investors are looking for higher-yielding assets than traditional fixed income, especially in a low interest rate environment.

But private credit is mostly unrated and, therefore, tends to be viewed as riskier than traditional fixed income instruments.

“The asset class performed very well [during the pandemic]. From an asset standpoint, almost 85 per cent of our borrowers proved stable or grew their operations during this period,” Ross says.

“At a high level, our borrowers had no impairments and there were no missed coupons.

Northleaf also looks for new ways to diversify its portfolio and in recent years has added some niche, speciality finance assets, including royalties, litigation financing and healthcare receivables.

It recently invested in a portfolio of music royalties for about US$500 million that includes over a 100,000 songs. Although the music industry has experienced some significant headwinds from digitalisation, there is also a new demand for licensed music driven by the boom in content as new streaming services continue to launch and seek to offer unique shows.

As CD sales were dropping but streaming hadn’t started yet, there was a massive collapse in the industry in terms of the revenues that were generated on the backs of these royalties. But we are now in an era where streaming is increasing and demand is continuing to grow in India and China and other markets that are tapping into Western-based music royalties

“The music industry has changed significantly over the course of the past 20 years,” Ross says.

“As CD sales were dropping but streaming hadn’t started yet, there was a massive collapse in the industry in terms of the revenues that were generated on the backs of these royalties. But we are now in an era where streaming is increasing and demand is continuing to grow in India and China and other markets that are tapping into Western-based music royalties.”

And the demand doesn’t just come from new geographies, it is also the broader application of music in technology-based services.

“People have Pelotons [exercise bikes] or iPhones, so there is just a broader consumption of music,” Ross says.

“Take Netflix, every movie or TV show has songs associated with them to build mood and create excitement.

“We’ve seen stability in the basic demand, but significant growth drivers from a geography standpoint and from an underlying proliferation of the streaming demand from different sources.”

ESG

Institutional investors are increasingly concerned with the environmental, social and governance (ESG) dimensions of their investments and although policies often tend to be more geared towards equity investments rather than debt, the private credit market has taken notice of this trend.

ESG assessment of company practices is now a key part of the analysis of Northleaf Capital. Ross illustrates this with the above-mentioned US linen cleaning company.

“The most obvious ESG factor would be water. The West Coast of the United States has a significant water shortage and any sort of cleaning that uses water is a drain on that scarce commodity. We of course wanted to make sure that they had best practices in place for water usage,” he says.

“However, a key characteristic of ESG research are the idiosyncratic nuances of each business and in that cleaning business the social aspects are as important as the environmental ones.

“If you think of the hiring practices of that particular business, it is critical that they hire people that have the appropriate qualifications and that they are following the appropriate labour practices in each geography.

"We put in place protections to make sure that they meet certain thresholds with respect to labour practices."

Increasingly, private credit investors are also introducing financial incentives to improve the ESG practices of borrowers and Northleaf works with company managements to set targets for all three ESG metrics, the E, S and G, and ties it back to the level of interest paid on the loan.

"The debt industry has started to become more proactive and we have been among the earliest to put ESG ratchets in place for our borrowers," Ross says.

"Each quarter those measures are tested and if the company meets these tests each quarter, they get a reduction in their interest costs of between five and 10 basis points. But if they don't meet them, their interest costs increase by an equal amount.

"The important thing is that you work with the management of a company to establish criteria that they believe can be important value drivers for their business, that can be rigorously tested and that you can step up the targets each quarter so that it is a constantly evolving set of requirements that shows improvement," he says.

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