Why Due Diligence Matters

Recently, I traveled to the southern US to attend a conference in Private Debt (PD) hosted by a company I will call ABC. It is worth mentioning that industry regulation prohibits companies from influencing advisors and cannot pay for any travel or accommodation. We feel it is important to mention because it demonstrates our thorough due diligence and our unbiased approach to investing.

Private debt is considered an alternative to traditional stocks and bonds and typically available to only "accredited investors" whom must have a minimum level of: income, investable assets or net worth.

PD typically finances loans or mortgages by non-banks and is less liquid because it doesn't trade on the public markets. There are many companies that specialize in this field where they lend money to a person or company and take collateral and personal guarantees. Since the 2008 financial crisis, many banks have strict lending guidelines. As such, entrepreneurs are not able to get all their financing from the Big Banks. Generally, the debt hierarchy looks like this:

Lower Risk	**DIrect (Real Assets)**
↓	**Mezzanine**
	Distressed
	Hybrid
Higher Risk	**Venture / Speculative**

ABC focuses on direct real estate and has been in business over 21 years. We met the founder, partners, portfolio managers, clients, CEO and Chief Credit Officer. They outlined how ABC is different and relies on a four-level structure to maximize success:

1) Origination – brokers are paid to find good deals. Approximately 30% of their commission occurs upon repayment of the debt.

2) Underwriters – They look at the 5Cs of credit: Character, Capital, Capacity, Collateral and Conditions. The 5-member committee must unanimously agree to proceed or the deal is rejected.

3) Investment Committee- review concentration, maturities, risk and which fund to place the debt in.

4) Board of Governors – there are four independent members ensuring there are no related party transactions, as well as, proper valuations. When a default occurs, it must be reviewed by the auditors and decided whether to take an impairment charge.

The founder repeatedly said, "This is NOT our money" reminding his team that they always have to remember the trust that is bestowed upon them. We were told about 90% of the deals that are offered to ABC do not even go to underwriting. Of the ones that do, 80% of deals are accepted but only 30% get funded due to competition, dislike of terms or the deal dies. The returns vary but typically range between 5% and 8%.

When a deal goes into default (missed payment) it may be resolved quickly or it could deteriorate and require enforcement which can lead to impairment (permanent loss).

Different jurisdictions (provinces and states) are better than others in terms of collecting. According to Moody's between 1987-2016, the recovery on bad debts has averaged:

Commercial Mortgages	75%
Corporate Bonds- secured	63%
Corporate Bonds- unsecured	48%
Corporate Bonds-subordinate	28%

As one employee said, "It is easy to make a loan but hard to collect!" Since inception, ABC has had a 99.5% recovery rate! They attribute this to the fact that they are in control of the recovery process and they know their clients - approximately 70% are repeat customers.

We also met some of their customers who valued the business partnership. Among the most important criteria to the borrower are speed of execution and certainty that the deal will be approved. ABC is able to accomplish this by having boots on the ground in all the areas they lend. They have a deep understanding of the demographics, economics, immigration, real estate laws, governments, etc. For example: Texas' economy is nearly the size of Canada, has no state income tax, among the fastest growing in the US and can foreclose within 45 days without court.

Despite the old real estate adage of location, location, location, the company felt the most important thing is people, people, people. On a personal note, despite all knowledge, statistics and solid historic results; what we got to experience was a sense of their culture… An intangible and cannot be found on a website or document.

Until next time…Invest Well. Live Well.

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