

What Questions Should Allocators Ask When Evaluating Direct Lending Managers?

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Who is Swimming Naked?

From 2010 through 2024, conditions were extraordinarily favorable for private credit funds. As a result, most managers delivered strong returns.

While it is extremely difficult to predict when the credit cycle will change, cycles will inevitably happen, and today's credit market faces a range of risks:

- Geopolitical uncertainty
- AI-driven disruption across industries
- Impact of ever-changing tariff policies
- Economic risk, including the potential for stagflation
- A meaningful increase in lower-quality credit

When the cycle turns, it is increasingly clear that not all funds will perform equally well. As Warren Buffett famously observed: "Only when the tide goes out do you discover who's been swimming naked."

If the tide is indeed going out, how should allocators evaluate private credit managers? How can they distinguish between those who have been relying on favorable market conditions and those with durable, repeatable investment processes?

In my book, [*The Credit Investor's Handbook*](#) (Wiley, 2024), I outlined a seven-step framework for analyzing individual credit investments. In this piece, I adapt that thinking to the manager selection process. I highlight seven key factors allocators should evaluate, along with specific due diligence questions that can help differentiate between managers.

Seven Key Evaluation Criteria:

1. **Differentiated Sourcing**
2. **Strong Underwriting Discipline**
3. **Appreciation of Credit Documentation**
4. **Portfolio Diversification and Correlation Risk**
5. **Active Monitoring and Risk Management**
6. **Independent and Experienced Workout Capabilities**
7. **Ability and Willingness to Lend During Downturns**

Private Credit: From Market Darling to Market Scrutiny

I have invested across credit cycles for nearly three decades, including my time at Goldman Sachs and my career at Silver Point Capital. During that period, I have seen firsthand how senior secured lending can offer compelling risk-adjusted returns. Historically, the asset class has delivered equity-like returns with meaningful downside protection because it sits at the top of the capital structure and benefits from strong contractual protections.

However, basic economics still apply. When an asset class consistently generates attractive returns relative to perceived risk, it attracts capital.

That is exactly what happened in private credit. Since the Global Financial Crisis, the market has grown roughly eightfold to approximately \$2 trillion. Along the way, some lenders prioritized winning market share, especially with private equity sponsors, and growing AUM over consistently originating high quality deals.

In many cases, a healthy fear of making bad loans was replaced by a fear of missing out. In that environment, discipline eroded and increasingly aggressive structures and underwriting became more common.

In a 2025 [Bloomberg Intelligence](#) podcast, I noted that the market was becoming overheated and that weaker credits would face significant stress in a less forgiving environment. As I said at the time, we see most deals that get done. There are good deals and there are bad deals. If someone is doing too many bad deals, they simply won't be able to raise their next fund and will disappear. That is true of every cycle.

Shortly after that interview, First Brands collapsed and became a clear example of what can happen when red flags are ignored. For a detailed discussion, you can see my first *SPC Credit Lesson*, [What Can a Credit Analyst Learn from the Rise and Fall of First Brands?](#)

Since then, a series of troubling developments has rippled across the direct lending and asset-backed private credit markets. Tricolor Auto Group, a subprime auto lender, filed for bankruptcy amid allegations of double-pledged collateral. In the e-commerce space, Amazon aggregators Perch and Thrasio, which together raised over \$1 billion in private debt, collapsed. Renovo, a private equity-backed roll-up of regional home-improvement businesses, deteriorated so rapidly that its board bypassed restructuring in favor of immediate liquidation. The sudden implosion of UK mortgage lender MFS has added to this expanding list of bad deals. Most recently, reports have emerged that the private equity owners of customer experience software provider Medallia are preparing to hand the keys to their lenders rather than continue supporting the businesses.

At the same time, structural vulnerabilities are becoming more visible. One area of growing concern is the concentration in software lending. For years, private equity sponsors and sponsor-focused lenders favored subscription-based software businesses because revenues were contractual, churn appeared low, and products were seen as mission critical. That narrative supported leverage levels of 8 to 9x EBITDA in many mid-market SaaS buyouts, compared to market-wide averages of 4x to 5x in almost all other sectors.

While lenders recognized that these leverage levels were aggressive, they justified them based on enterprise values, with sponsors paying 15x to 25x for high-growth software businesses. To make these structures viable, lenders often relied on a meaningful PIK component given the borrower's cash flow could not support the full debt burden. At the same time, intense competition led to a weakening of document protections, including a shift away from EBITDA based covenants, with many deals relying solely on revenue covenants throughout the life of the investment.

In hindsight, this has left some managers with concentrated exposures and a level of software risk that is often understated in how it is reported to investors. That risk is now being compounded by AI-driven disruption. The rise of AI is accelerating competition and compressing differentiation, which calls into question the durability of the "mission-critical" revenue streams that underpinned much of this underwriting and the thesis that companies in the sector could support debt loads averaging 2x traditional norms.

In addition, certain non-traded BDCs have come under scrutiny as liquidity mismatches have forced them to limit investor redemptions.

All the above has resulted in some pretty damaging headlines, such as:



Despite these negative headlines, I continue to believe that private senior secured lending is a great asset class. What is changing is dispersion. The past decade has masked differences in underwriting quality and risk management, but those differences will be highly visible in a more challenging environment. As a result, allocators will need to be far more discerning to find top-tier managers and avoid those whose performance was merely a byproduct of market conditions.

Below, I outline how I expect private credit funds to perform during the next market downturn, based on my seven key evaluation criteria. In my view, firms that score highly across all seven factors should significantly outperform those that do not.

		Underperform	Outperform
1	Differentiated Sourcing	✗	✓
2	Strong Underwriting Discipline	✗	✓
3	Appreciation of Credit Documentation	✗	✓
4	Portfolio Diversification and Correlation Risk	✗	✓
5	Active Monitoring and Risk Management	✗	✓
6	Independent and Experienced Workout Capabilities	✗	✓
7	Ability and Willingness to Lend During Downturns	✗	✓

There can be no assurance that private credit will generate positive returns in any scenario.

The remainder of this piece explains the rationale behind each of the seven key evaluation criteria. It also offers recommended due diligence questions to help allocators assess managers more effectively. As with any due diligence process, greater access to information is beneficial, but it must be balanced against practical constraints on an allocator's time. Finally, this framework is not intended to be exhaustive and does not address compliance, operational due diligence or other related considerations.

CRITERIA #1:

Differentiated Sourcing

Every direct lender needs to source deals to deploy capital. Managers without a differentiated sourcing strategy often end up building portfolios that mirror the typical private equity sponsor book, with heavy concentration in sectors favored by equity investors, such as software and healthcare. Because this is their primary channel and they face internal pressure to grow, each opportunity from a key sponsor relationship can become a must win. That dynamic can drive a race to the bottom on both economics and credit protections.

By definition, these deals tend to offer more beta than alpha.

By contrast, other opportunities are not widely marketed. This may be because the borrower has a more limited set of relationships, or because they prioritize speed, certainty, and confidentiality over fully optimizing terms. In these cases, lenders are often able to negotiate stronger economics, tighter documentation, and conduct more robust diligence processes. When properly underwritten, these transactions can offer meaningfully higher risk-adjusted returns.

A manager should segment its deals into buckets based on the competitiveness of the channel:

	Sourcing Bucket	Competitiveness
1	Core LBOs	Most Competitive
2	Complex LBOs ⁽ⁱ⁾	Lower Competition
3	Capital Solutions	Even Lower Competition
4	Non-Sponsor	Least Competitive

(i) Complex LBOs would include take privates, spin-offs, out of favor industries, etc

Recommended Due Diligence Questions: Evaluating Sourcing Differentiation

To evaluate a manager's ability to source unique deals with more alpha potential, consider asking:

- **Segment deal types:**
Can you provide a table of your historical portfolio segmented by deal type (e.g., Core LBOs, Complex LBOs, Capital Solutions, Non-Sponsor)? What percentage of these deals originated from highly competitive auctions versus proprietary or relationship-driven processes?
- **Trace deal origination:**
For deals characterized as proprietary, how exactly was the opportunity sourced? Did it originate directly from the company, a sponsor, an investment bank, or legal counsel?
- **Test the narrative:**
Why was the process limited for these transactions?

Note to allocator: Evaluate whether the explanation is credible. It is rare for financing in a broadly auctioned LBO to be proprietary, whereas in take-private transactions, limited dissemination is more common to avoid premature public signaling. If the manager claims the process was less competitive, assess whether that is reflected in the economics and structure of the deal (e.g., better pricing, lower leverage, stronger documentation). When possible, try to verify through outside sources or market contacts how widely the deal was actually shopped.

CRITERIA #2:

Strong Underwriting Discipline

Once a direct lender sources a deal, the next step is deciding whether to commit capital. This is where underwriting discipline becomes critical.

For an allocator, the key question is whether the manager has both the analytical rigor and the willingness to walk away.

My boss, Ed Mulé, has emphasized this point throughout my career. In direct lending, you outperform not by the deals you do, but by the deals you decided not to do. Unlike venture capital or private equity, where a few exceptional investments can offset mistakes, lending does not offer that luxury. Avoiding bad deals is far more important than capturing every good one. That often means passing on opportunities that may ultimately perform, in order to maintain discipline and protect capital.

Recommended Due Diligence Questions: Evaluating Underwriting Discipline

The goal of evaluating underwriting discipline is to determine whether a manager has the analytical rigor and the judgment to avoid poor investments.

Track Record Analysis

While past performance is not a guarantee of future results, it remains one of the most important indicators of quality. Allocators should prioritize performance data in three tiers:

- **Fully resolved funds that experienced a downturn:** This is the most informative data set as it reveals how the manager performed under real world stress.
- **Fully resolved funds that did not experience a downturn:** These are useful but less revealing because strong performance in a benign environment may not translate to periods of stress.
- **Partially resolved funds:** This is the least informative category. The marks on positions still outstanding might be too high and therefore mask true performance until realization.

The Reality of Marks

When evaluating a partially realized portfolio, the allocator must determine whether the remaining marks reflect reality. Unfortunately, some funds are slow to mark down underperforming positions, and valuation policies lack consistency across the industry. In club deals where multiple managers hold identical loans, it is not uncommon for marks to vary significantly. Because BDCs are required to disclose their marks publicly, these discrepancies are often exposed. For example, on October 22, 2024, CreditSights published a report titled *US Insight: The Opaque Side of BDCs, Private Credit's Most Transparent Market*, which highlighted several instances of the same loan being marked differently by different managers.

Allocators should also be cautious about relying too heavily on default rates when evaluating funds that are not fully realized. Some managers emphasize that their portfolios have few or no defaults; however, defaults can often be delayed through actions such as converting cash-pay interest to PIK, extending maturities, or providing additional capital to support liquidity. While these actions may postpone a default, they can materially increase loss severity if a default ultimately occurs.

Delaying defaults also increases the risk of a “cliff” mark, where a loan appears to be performing and is carried at or near par, only to be marked down significantly over a short period. Over the past year, there have been instances where funds held positions at or near par for multiple quarters, only to mark them down by 50 or more points in a single quarter. It is worth questioning whether the underlying credit truly deteriorated so dramatically within a 90-day

period. A more concerning explanation is that the manager made accommodations to the borrower that allowed the loan to remain classified as performing without appropriately adjusting the mark, while hoping for a turnaround that never materialized.

Recommended Due Diligence Questions: Evaluating Sourcing Differentiation

To highlight red flags on the portfolio marks, consider asking:

- **Audit underperformers:**

What are the current marks for every position where the borrower has missed its underwriting budget by more than 20%?

Note to allocator: *If every one of these positions is still marked at or near par, you might question the manager's valuation rigor.*

- **Review amendments:**

Can you provide a list of all unresolved positions that have undergone material amendments, specifically maturity extensions and shifts from cash pay to PIK?

Note to allocator: *A maturity extension combined with a shift to PIK is a clear negative signal. If these deals are still marked at or near par, it should raise concerns about the manager's willingness to acknowledge credit deterioration.*

- **BDC cross-reference:**

Are any of the positions in this fund also held in any BDCs (either your own or a peer's)?

Note to allocator: *You should cross-reference these positions in public filings. If the private fund's marks are higher than the BDC's marks for the identical loan, you should point it out to the manager and ask them why.*

Deals Passed

A simple but powerful question is to ask investment professionals about deals they evaluated but chose not to pursue.

This question is most effective when asked without advance notice. In a disciplined organization, deal teams should be able to discuss specific transactions they passed on, explain the risks they identified, and articulate why those risks were unacceptable. The quality of these answers often reveals more than a discussion of successful deals.

Credit Culture

Senior leadership defines the culture of any investment firm. In direct lending, that culture typically falls along a spectrum between growth-oriented and credit-focused. Most successful firms maintain a balance, but when growth dominates, there is often implicit pressure to deploy capital. That pressure can lead to weaker underwriting and a higher tolerance for risk. Over time, that approach tends to break down when market conditions become less forgiving.

Assessing culture from the outside is not easy, but there are ways to develop a clear view. One primary indicator is the level of senior management's involvement in driving credit committees and how they prioritize their time between fundraising and relationship management versus actual investing. It is important to determine if the head of the firm is

known as an analytical, investment-focused leader or a marketing and relationship-driven leader. In most cases, the head of the firm sets the tone for the entire organization's culture.

Off-the-record conversations with former employees can also be highly informative (note that some firms may have non-disclosure agreements that prevent such conversations). These discussions often provide unfiltered insight into how decisions are actually made inside the firm. A strong credit culture tends to surface in consistent ways. One of the most positive signals is when employees leave a firm because it was too difficult to get deals approved due to a demanding process. While that may sound negative on the surface, it is often a sign of a disciplined organization that prioritizes risk management over asset growth.

Deal Team and Process

Finally, it is important to evaluate how underwriting decisions are actually made.

Select one or two recently completed investments and request the corresponding credit memos. Review the level of analysis, the identification of risks, and the mitigation strategies. Then meet with the deal team and ask detailed questions about the investment.

CRITERIA #3:

Appreciation for Credit Documentation

So far, we have discussed sourcing a deal and underwriting the investment. The next critical step is documenting the transaction.

Those of us with workout experience have a deep appreciation for the value of strong documentation. Every loan is a contract between the borrower and the lender. The credit agreement defines what a company can and cannot do.

If the company performs as expected, the lender receives its coupons and is repaid at or before maturity. In those cases, the underlying documentation may rarely be revisited. However, when a company underperforms or encounters stress, the credit agreement becomes critical. It can mean the difference between being repaid in full, including accrued interest, and suffering a significant impairment.

For purposes of this discussion, I will focus on two key elements of credit documentation that are particularly important for lenders to evaluate. There are many others, but these two are among the most consequential:

Two Key Elements of Credit Documentation:

1. **Financial Covenants**
2. **Restrictions on Leakage**

Financial Covenants:

Financial covenants give lenders a "seat at the table" when a company begins to experience financial stress. A typical example would be a leverage covenant such as Debt to EBITDA less than 6.0x, stepping down over time to 4.0x.

If a company violates a financial covenant, it constitutes a default. While lenders technically have the right to accelerate the loan and demand immediate repayment, that outcome is rare. In practice, once it becomes clear that a covenant breach is likely, the borrower will approach its lenders to negotiate a waiver or amendment.

At that point, the lender regains some level of control and has the right to re-negotiate key aspects of the deal. It can reassess the credit and determine what actions are in its best interest. If the lender maintains confidence in the business, it may agree to simply provide the relief requested or it may seek slightly improved economics, tighter documentation, or additional protections. If confidence has deteriorated, the lender may instead seek to de-risk its position, for example through a partial repayment or other structural changes.

The key point is that a covenant breach forces a conversation. That “seat at the table” is extremely valuable.

Not all loans provide this protection. In covenant-lite structures, lenders do not have financial maintenance covenants, which inherently increases risk. Even when covenants are present, their effectiveness depends on how they are structured. A covenant set at a level that does not trigger until the company is already in severe distress has limited practical value. For example, for a company levered at 5.0x, a maximum Debt to EBITDA covenant set at 12.0x provides far less protection than one set at 6.5x, as it may only be breached when it is too late for lenders to meaningfully influence the outcome.

Equally important is how EBITDA is defined. Most agreements allow borrowers to adjust EBITDA for certain non-recurring items. While some adjustments are reasonable, others can significantly weaken the integrity of the covenant. In extreme cases, borrowers may negotiate add-backs that include projected future initiatives without meaningful limitations. At that point, EBITDA can become a highly subjective number, and the covenant loses much of its intended purpose.

Not all add-backs are inappropriate, but they require careful scrutiny. In my prior piece on First Brands, I used the following analogy to illustrate this point:

Imagine you’re interviewing a recent MBA graduate for a job, and the candidate claims their GPA is 3.5. Upon review, you discover their actual GPA is 2.9, but they insist the 3.5 better reflects their performance. If you learn that the student earned a 3.5 GPA every semester except for one, during which they experienced a verified tragic life event, for example, a personal or family emergency, you might reasonably accept their explanation that the one poor semester that brought down their GPA was an anomaly. However, if the student consistently earns a 2.9 GPA every semester and claims to be adjusting for past behavior (partying and not working hard) arguing that, in the future, they are confident the GPA will improve to 3.5, you will likely reject the argument and rely on the actual GPA of 2.9.

The same principle applies to EBITDA adjustments. The credibility of the number depends on whether the adjustments are truly non-recurring or simply an attempt to present a more favorable picture of the business.

Restrictions on leakage:

As a senior secured lender, you are relying on the value of the business to support your loan, particularly in a downside scenario. That makes it critical to ensure that significant value cannot easily leave the entities that guarantee your loan.

“Leakage” refers to the ability of a borrower to move assets, cash, or other value outside the lender group. Many loan documents permit some level of this activity through baskets designated for investments, dividends, or asset transfers.

Consider a simple example. A deal is marketed at 50 percent loan-to-value, with a lender providing a \$500 million loan against a company valued at \$1 billion. On the surface, this appears conservative. However, if the documentation allows for \$300 million of permitted investments into unrestricted (non-guarantor) subsidiaries, the effective loan-to-value is materially higher.

In a stress scenario, equity holders are incentivized to preserve value for themselves. If permitted under the documents, they will move assets out of the guarantor subsidiary. As a lender, you should assume that any value that can be moved, will be moved. In this example, the \$300 million is unlikely to be available when it is needed most, implying a true loan-to-value closer to 70 percent rather than 50 percent. The relevant value base is \$1 billion less the

\$300 million that can be moved, or \$700 million. On that basis, LTV is \$500 million divided by \$700 million, or approximately 71 percent.

The risk can be even greater if the documentation does not adequately restrict the transfer of critical operating assets, such as intellectual property or trademarks. While these assets may receive third-party valuations when transferred, the remaining business may have significantly less value without them. In practice, the lender's collateral package can be severely weakened even though the transfers were technically permitted under the credit agreement.

The key takeaway is that stated loan-to-value metrics can be misleading if documentation allows for meaningful leakage. A disciplined lender should underwrite to a "worst case" view, assuming that all permitted leakage will occur and that only the remaining asset base will be available to support the loan.

Recommended Due Diligence Questions: Evaluating Appreciation for Credit Documentation

To assess a manager's appreciation of the value of tight documents, consider asking:

- **Quantify covenant coverage:**

What percentage of the loans in your current portfolio include maintenance financial covenants? When setting levels, what is the standard "cushion" you provide relative to your underwriting base case?

Note to allocator: *Request a loan-by-loan table and ask follow-up questions related to any positions where the cushion is materially higher than the stated standard.*

- **Scrutinize EBITDA definitions:**

Do you insist on hard caps for synergies and other non-cash add-backs? Can we review the EBITDA definitions of your five most recent deals?

- **Review basket size and flexibility:**

Can you identify all deals in the portfolio where permitted investment baskets exceed 15% of the starting value? How do you quantify potential leakage during underwriting? Do you model a "stressed" loan-to-value (LTV) that assumes all permitted baskets and investments are fully utilized?

Note to allocator: *Failure to underwrite to a fully utilized basket scenario can materially understate the risk of impairment.*

- **Understand ability for material assets to be moved:**

Do any deals in the portfolio permit the borrower to move material intellectual property or trademarks out of the collateral package? If so, what was the specific rationale for accepting that structure?

Note to allocator: *Loss of control over core intellectual property significantly impairs a lender's leverage and recovery value in a restructuring.*

CRITERIA #4:

Portfolio Diversification and Correlation Risk

Any student of portfolio theory understands that diversification reduces risk. Direct lending portfolios should be diversified across borrowers, with no single position large enough to materially impair fund performance if it underperforms. Just as important, managers must think beyond position size and focus on correlation across investments, including industry and sponsor concentrations.

That second point is often overlooked. Portfolios can appear diversified on the surface yet still be highly exposed to the same underlying risk factors. This has become particularly relevant in software, where many borrowers share similar business models, customer bases, and sensitivity to changes in growth expectations and valuation multiples.

True diversification requires discipline at both the position level and the portfolio construction level.

Recommended Due Diligence Questions: Evaluating Portfolio Diversification and Risk Concentration

To assess whether a manager is maintaining appropriate discipline regarding concentration and management of correlated risks, consider asking:

- **Analyze position sizing:**
Can you provide a table showing every position as a percentage of the total fund? What is your target position size, and what is the current performance of any credit that exceeds that target? Please explain the rationale of oversized positions.
- **Map cyclical exposure:**
How do you classify exposures between cyclical and non-cyclical industries, and what does that mix look like today?
- **Assess correlation risk:**
Within your risk management framework, how do you assess and manage correlations across portfolio companies and industries?

Note to allocator: Look for "hidden" correlations, such as multiple borrowers that appear diverse but are all sensitive to the same end markets, economic cycles, or commodity costs.

Given the recent scrutiny around software exposure, I recommend adding a more detailed layer of due diligence focused specifically on the correlation risk of software loans.

Request a standardized table for every software investment across managers.

Be explicit in defining the scope. If a company describes itself as a "software provider," it should be included. Managers often classify loans differently. For example, a healthcare software company may be placed in a healthcare bucket rather than software. Without a consistent definition, cross-manager comparisons are not meaningful.

Once the information below is collected across managers, it becomes much easier to assess relative exposure and risk.

Allocators should request the following for each software investment:

Size (as a percentage of the fund)

- In aggregate, the average private credit fund is estimated to have roughly 20-25% of its portfolio in software. Given current concerns, less exposure is generally preferable to more.

Loan Origination date

- Software loans originated before 2023 tend to be riskier. Many were underwritten at peak valuations and often include weaker documentation than more recent vintages.

Performance since origination

- Track total revenue, recurring revenue, EBITDA, and debt-to-EBITDA. Trends matter.
- It is estimated that the average software LBO is levered around 8x. If software valuations ultimately settle in the 6x - 10x range, a more appropriate maximum leverage level is likely closer to 4x - 5x.

Amount of PIK interest

- Given the potential for AI-driven disruption, lenders should be focused on capturing as much current cash flow as possible before performance deteriorates.
- If a loan is heavily or fully PIK, the lender is not receiving current cash returns. In addition, allocators should consider the risk of PIK interest being recognized as income. If the company ultimately underperforms or defaults, the write-down can be significantly larger, as the debt balance increases each year from accrued PIK.

Leverage covenants

- Given the risk that some of these businesses may face structural decline, a debt to EBITDA (not a recurring revenue) covenant is critical.
- For companies most vulnerable to AI disruption, debt and equity may have diverging incentives. Lenders may prefer a “harvest” strategy that prioritizes cash flow and debt repayment. Equity holders may push to reinvest aggressively in an attempt to offset disruption. As discussed previously, covenants give the borrower a seat at the table and are often the mechanism that determines which path is ultimately taken.

Business description and exposure to AI disruption

- Allocators should develop an independent view on which portfolio companies are most exposed to AI risk. Request a clear description of each business and ask the manager to rank investments from lowest to highest AI risk.
- This analysis can be independently pressure tested by using AI tools to generate a relative risk ranking based on business descriptions.
- Most importantly, allocators should have a direct discussion with the manager about how they plan to manage the credits with the highest AI risk.

CRITERIA #5:

Active Monitoring and Risk Management

In public markets, every day brings a fresh decision to buy, sell, or hold. Market prices force a constant discipline; if news breaks and a loan trades down, you are immediately called into your boss's office to discuss the implications. Because private debt does not trade, it is easy for a manager to lose that same sense of urgency.

Active monitoring is critical even if a manager intends to hold a loan to maturity. I believe this discipline is essential for three reasons:

1. **Better decision-making at critical junctures.** Private credit is not static. Borrowers frequently return for acquisition financing, document amendments, or covenant waivers. A manager who has been on top of every piece of news is in a much stronger position to make an informed, value-maximizing decision when these requests arrive.
2. **Institutional learning.** You learn the most from your problems. Regularly discussing emerging issues in a credit allows the entire team to incorporate those lessons into their future underwriting. It turns a localized challenge into a firm-wide intelligence upgrade.
3. **Assessing underwriting talent.** Systematic monitoring provides a clear feedback loop on the investment team. It reveals who is consistently too conservative, who is too aggressive, and where the investment committee might need to provide extra oversight or a "second pair of eyes" on a specific sector or deal lead.

Recommended Due Diligence Questions: Evaluating Monitoring and Risk Management

To evaluate whether a manager has a disciplined, proactive approach to oversight that identifies credit deterioration before it leads to capital impairment, consider asking:

- **Review monitoring frequency:**
How frequently does the portfolio undergo internal credit reviews and external third-party valuation reviews?
- **Assess organizational structure:**
Do you have a dedicated loan monitoring function, or is monitoring handled solely by the deal team? How do you ensure independent risk assessment and avoid conflicts?
- **Evaluate risk-rating discipline:**
Can you walk us through your internal risk-rating system? How many credits have been downgraded in the past twelve months, and what were the primary catalysts for those changes?
- **Incorporate lessons learned:**
How are lessons from underperforming credits formally incorporated into your underwriting process for new investments? Can you provide specific examples?

Note to allocator: *A structured feedback loop is essential to ensure that the same underwriting mistakes are not repeated.*

- **Examine watch list process:**
How do you manage "watch list" credits? What specific resources are deployed when a borrower begins to underperform, and what are your escalation protocols?

CRITERIA #6:

Independent and Experienced Workout Capabilities

Many private credit firms do not have a dedicated workout group. In many cases, this reflects a lack of experience through a full credit cycle rather than a deliberate design choice. Instead, the deal team remains “cradle to grave” on the investments they originated. I believe this model is flawed for three reasons.

First, workouts require a different skill set than originating and underwriting. Restructuring situations require experience, negotiation skills, pattern recognition, a deep understanding of bankruptcy laws, and a willingness to make difficult decisions under pressure. The profile of a strong workout professional is often very different from that of a deal originator.

Second, the originating team may not be fully objective. They recommended the investment and may be influenced, consciously or not, by personal incentives such as the impact on their current year’s compensation or their internal and external reputation. This can lead to overly optimistic assessments and delay difficult decisions that could better protect the firm.

Third, during a downturn, the lack of a dedicated workout team creates a resource problem. Firms are forced to divert their best investment professionals away from new opportunities and toward managing stressed credits, often at precisely the time when the opportunity set is most attractive.

Recommended Due Diligence Questions: Independent and experienced workout capabilities

To assess whether a manager has the resources, experience, and independence to manage stressed credits effectively, consider asking:

- **Assess restructuring resources:**

Do you have a formal restructuring or workout team? How many professionals are dedicated solely to this function, and what are their specific backgrounds?

Note to allocator: *It is critical to meet these individuals directly. Determine whether they are true restructuring professionals or simply deal team members reassigned for optics.*

- **Evaluate responsibility for stressed credits:**

If there is no dedicated restructuring team, who is responsible for managing stressed or impaired credits? How do you ensure sufficient time and attention is allocated during periods of elevated defaults?

Note to allocator: *Lack of dedicated resources can lead to delayed recognition of problems and suboptimal outcomes.*

- **Clarify decision authority:**

Who makes the final decision when the deal team and workout team disagree on how to proceed with a stressed credit?

- **Test real-world experience:**

Can you walk us through recent examples where a credit became stressed? What actions were taken, and what was the outcome?

Note to allocator: *Focus on whether the manager acted decisively and proactively, preserved value, and demonstrated pattern recognition from past situations.*

CRITERIA #7:

Ability and Willingness to Lend During Downturns

As a credit professional that has lived through many cycles, I learned the easiest way to create alpha is through lending when the cycle turns as there is a drought of capital. When the cycle changes, all funds will have more problems in their portfolio than they have today. Some funds will stop lending because:

1. Their senior management is concerned with the quality of the portfolio, and they are more focused on getting their arms around the situation versus originating.
2. They don't have dedicated workout groups, so they are forced to use originating resources to deal with problems.
3. The firm's psychology shifts from one of chasing all deals because a fear of missing out to plain fear and don't have the stomach to do anything.
4. They don't have access to capital to originate.

When this shift happens there is too little capital for the opportunity set and those with capital that have their (i) arms around their existing portfolio and (ii) the appropriate amount of workout people should have the ability to do some amazing risk-adjusted deals. For instance, during the Global Financial Crisis, I observed lending opportunities that offered what I believed to be some of the best risk-adjusted returns I have seen in my entire career.

Recommended Due Diligence Questions: Evaluating Ability and Willingness to Lend During Downturns

Much of this diligence overlaps with earlier criteria:

- **Does the firm truly have its arms around the existing portfolio?** – covered in criteria #5
- **Does the firm have a dedicated and capable workout team?** – covered in criteria #6

To assess the manager's willingness and ability to continue lending when others pull back, consider asking:

- **Have you deployed capital through prior downturns?**
If so, can you provide a list of deals originated during periods of market stress (e.g., the Global Financial Crisis or other dislocations)?
- **How were those investments priced relative to normal market conditions?**
- **How were they structured?**
Were there tighter covenants, lower leverage, or enhanced lender protections?
- **What were the realized outcomes, including IRR and multiple of money?**

Note to allocator: *This line of questioning helps distinguish between managers who talk about being "cycle-tested" and those who have actually leaned in when the opportunity set was most attractive.*

Conclusion

Since the Global Financial Crisis, the environment for senior secured lending has been unusually benign, and most managers have performed well. That backdrop is changing.

Today's market faces a range of risks:

- Geopolitical uncertainty
- AI-driven disruption across industries
- Impact of ever-changing tariff policies
- Economic risk, including the potential for stagflation
- A meaningful increase in lower-quality credit

Credit cycles are inevitable. When the next downturn occurs, dispersion of returns across managers is likely to be far greater than what investors have experienced over the past decade.

The goal of this framework is to help allocators distinguish between managers who have merely benefited from a favorable environment and those with the discipline, structure, and experience to outperform when conditions become more challenging.

Important Notes and Consideration

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