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Private Debt: Search for Transparency (First of a Series)

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In all the excitement surrounding our just-ended special series on covenant-easing [link] we must have missed it. But several readers pointed out we had neglected to cover the highly unusual sighting last month of a great white shark in Long Island Sound.

Cabot, a nine-foot, eight-inch, 533 lb. tagged fish had been tracked for months. Beginning in the Florida Keys last fall, he made his way finally to the upscale Greenwich, CT shore.

The harbor master there, Ian Macmillan, told the local paper that such an event was uncommon for the region, but assured there should be no cause for alarm.

“Not a problem,” Macmillan reported. “It’s probably well fed.”

A condition some buyers of leveraged loans would kill to be in. Tracking loans is not always as easy as tracking sea creatures. Investors have long searched for an optimal index for middle market credit. While some firms, such as S&P, have worked to develop such data, the private and illiquid nature of the asset class presents a challenge.

One metric we’ve featured in this space is the Cliffwater Direct Lending Index (CDLI). Representing over 6000 directly originated middle market loans totaling about $100 billion, the CDLI uses data and filings from BDCs going back to 2004.

Cliffwater’s CEO and CIO, Steve Nesbitt, has just published a book on these and other issues. *“Private Debt: Opportunities in Corporate Direct Lending”* is a primer on the asset class, looking at questions of liquidity, pricing, and valuations.

We spoke to Mr. Nesbitt recently about the state of the market. Spreads are tightening, we noted. Does this signal too much money chasing too few deals?

“The market is more efficient than it’s generally given credit for,” Nesbitt told us. “What market participants forget is that spread compression is more a result of low volatility. We’ve been in this low vol world for some time. When the risk-free rate rises, spreads contract. The pre-crisis 2006-07 period was an example of that. There’s clearly a correlation between the VIX and spreads. It’s not about money coming into private credit.”

How did you come to create the CDLI? “We actually modeled it after a commercial real estate index. Fortunately, there’s a very transparent source for private debt data: public BDCs. Roughly two-thirds of those loans are senior secured (see *Chart of the Week*).

“We’ve also now developed the Senior-Only Direct Loans index (CDLI-S),” he said. “That tracks loans from BDC managers with a senior debt focus. The performance record is shorter than the CDLI because most seniororiented BDCs were launched post-crisis. But both indices show a five-year total return average for direct loans in the 8.0-8.5% range."

What about other indices? "The S&P Leveraged Loan Index is widely accepted so a common and convenient approach is to use that index plus a 1% spread as a benchmark for direct lending," Nesbitt said. "Direct lending should beat that benchmark easily over time with a third of the volatility. Instead, a proper benchmark should be comprised of the type of collateral being benchmarked, with similar risk characteristics, and that's why we created the CDLI."

"Using a liquid asset class to benchmark an illiquid investment has been a recurring problem for fiduciaries. One example is using the S&P 500 plus 3% to benchmark private equity. Maybe that's a good long term benchmark but nothing looks right quarter to quarter."