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

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Last week in our special series on visibility in direct lending, we touched on the element of risk/reward. This week we examine relative credit losses and liquidity of the asset class.

The issue of private credit losses cuts to the heart of transparency. Since middle market borrowers are generally smaller, private, and unrated, and their financings illiquid, it's a challenge getting accurate default and recovery data.

In *Private Debt: Opportunities in Corporate Direct Lending*, Steve Nesbitt uses the Cliffwater Direct Lending Index to help shed light on this question. Data from the CDLI derives from 6000 loans accumulated in the 2005-2017 timeframe. It shows middle market loans with an 11.15% yield and just over a 1.03% cumulative average loss rate.

In comparison, leveraged loans had losses of 0.94% and high-yield bonds were at 1.40%. As Nesbitt points out, given the roughly 4% additional yield offered by direct loans, the risk/reward trade compensates investors for illiquidity and losses.

Interestingly, charge-off data gleaned from the Federal Reserve shows commercial and industrial loans sustained losses of 0.81% over the thirteen year period.

Illiquidity is a feature that has both advantages and disadvantages. For middle market loans, lack of tradeability is offset by a relatively short average life. Over the 2004-2017 period being measured, these loans had an average life of 2.75 years. That contrasts markedly with the five to seven years tenor these loans typically represent.

And while average life fluctuates widely depending on overall market conditions, investors should note that the capital cycle from fundraising to deployment has quickened. This makes direct lending an attractive complement to other asset classes, such as private equity, from a J-curve perspective.

There's no real secondary market for non-syndicated middle market loans. But as this column has demonstrated in previous studies, liquidity in the broadly syndicated market is often plenty when there are few sellers, and scarce when there are few buyers.

Another investor benefit of direct loans is structural. Most have a financial maintenance covenant, usually a debt-to-ebitda test. How much is that worth to investors?

In an interesting analysis, Nesbitt uses an options pricing model to determine how much yield investors lose by having no covenant. While varying with leverage, the model shows investors should require 1% in additional coupon to compensate for lack of a maintenance test.

That discrepancy is heightened as you go down the capital structure. Second liens without covenants, depending on leverage, demands more than a 2% premium vs. those with tests.

As Nesbitt covers in his book, losses and liquidity are key drivers to successful credit investing. For direct lending, it's about managers making good decisions on the ground.

Next week we conclude our series by looking at what it takes to be a good manager.