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

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“There is no passive option in direct lending.”

So begins “Selecting Direct Lending Managers,” Chapter 13 in Steve Nesbitt’s *Private Debt: Opportunities in Corporate Direct Lending*. This asset class is indeed available only through active management.

As we’ve discussed in this series, the Cliffwater Direct Lending Index (CDLI) is an excellent proxy for middle market loans. It derives from 6000 loans in BDCs accumulated in the 2005-2017 timeframe, so is a reasonably public benchmark.

But it is not an index through which loans can be accessed by investors. That can only happen, at this point in the development of the asset class, by investing directly with private debt managers. Hence the importance of picking the right one.

But how to pick?

As with all investments it’s tempting to chase yield, particularly given the low-yield environment that’s been the norm for over a decade. But all private debt is not created equal. The higher the yield, generally the higher the risk.

Nesbitt identifies four risk profiles among middle market lenders. (See our previous *Chart of the Week* [link]). Managers come in a variety of shapes and sizes: by AUM, spread out across both borrower size and percent of portfolio dedicated to sponsored vs. non-sponsored lending.

Credit risk, measured by a manager’s focus on senior vs. subordinated debt, demands the highest premium among the four. It is likely that market yields are the most efficient at the senior end of the risk spectrum, for larger middle market borrowers. Meaning that, as Nesbitt puts it, managing credit losses is more important than chasing yield.

In choosing a direct lender, Nesbitt selects four general categories for investors to use as a due diligence checklist (see *Chart of the Week*).

Organization is critical. “Ideally,” he says, “the investment people have been working together under one roof for a long period of time.”

Next is the investment process, including origination (“the number and depth of relationships with private equity sponsors is very important”) and underwriting (“structuring financing to fit the needs of the borrower while assessing risk”).

Then there’s portfolio construction, which differs depending on the type of funds and financing the direct lender employs. And finally, the manager’s track record. “The lack of a track record through the Great Financial Crisis has been a hindrance to evaluating many of the direct lenders formed over the past decade,” says Nesbitt.

As far as the future, Nesbitt concludes, you can’t predict the cycle, so don’t get too hung up on timing. “The best managers are good at balancing supply and demand, toggling back and forth depending on market conditions. They are also experienced at finding a central investing theorem. Without it, private debt can end up as just a hodge-podge of assets.”