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Lead Left Interview – Stephen Nesbitt

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This week we chat with Stephen Nesbitt, Chief Executive Officer of Cliffwater LLC. Cliffwater is one of the largest alternatives advisory firms, assisting clients globally in their allocations to hedge funds, private equity and real assets.

The Lead Left: Steve, tell our readers a bit about Cliffwater.

Steve Nesbitt: We advise pensions and endowments. Think of us as an institutional advisory and consulting firm. We cover alternative investments such as private debt, private equity, and hedge funds. Essentially anything that's not stocks and bonds. We help institutional investors with portfolio construction.

TLL: You've also created something called the Cliffwater Direct Lending Index. Tell us about that.

SN: We created the CDLI because there was no benchmark for direct lending and the collateral it represents. The index is a by-product of our effort to institutionalize the direct lending space.

Over the years we tried to collect information from investors but the quality and breadth of that data was very spotty. But we were also following the BDC market. There, in contrast, the quality of information in 10-Ks and 10-Qs was very good. So we reverse-engineered the collateral and asset information and were able to create a very high quality index.

TLL: What is driving investor decisions right now?

SN: There's obviously an urgent need to get returns over the 7% hurdle rate. That's the magical number for pensions, endowments, and foundations. This average rate represents 5% plus inflation, which right now is about 2%. Compare that to what is generated by an investment grade fixed income portfolio, which is about 2-3%. And in a rising rate environment, that could be zero! The math is not conducive to meeting institutional return objectives.

TLL: So what are the advantages of direct lending, as you see it, over bonds?

SN: Well, first of all, direct lending returns as measured by the CDLI are 10%, versus what could be zero for IG bonds. Second, there's virtually no J curve for direct lending. As an investor, you start getting instant gratification. You get interest income immediately. Compare that to, for example, private equity, where you have 3-5 years of negative returns until realizations are earned from the capital gains on selling portfolio companies.

Then, of course, there's very low volatility associated with direct lending.

TLL: Let's back up for a moment. How are you defining direct lending?

SN: The institutional consensus is that "lending" means loans as we used to see from commercial banks that carry floating rates of interest. "Direct" suggests no intermediary, no investment banks, between borrower and lender. It further suggests there's a direct negotiation of terms between lender and borrower.

TLL: What about size of the borrower?

SN: We say direct lending involves companies less than $100 million ebitda. Above that you can typically access the public markets. If the borrower is less than $10 million, it's more in the realm of community banks. But in that $10-100 million range, there are 600,000 entities.

TLL: Wow, that's a number I hadn't heard before. What about leverage?

SN: The characteristics of these loans is that they are generally senior secured and first lien, versus high yield bonds which are subordinated debt. Leverage on average for first lien is approaching 4x, totaling 6x if you include second lien. The other contrast with high yield is that loan investors are paid Libor plus a spread. As the Fed hikes rates, Libor moves up.And unlike high yield, you don't have a twenty-year maturity. The stated term of leveraged loans is in the five-to-seven year range, but the effective life is around three years. And investors only have to lock-up principal for three or four years. Private equity capital gains rely on the final sale of the company, which could take a decade or longer. As I mentioned, the investor in loans gets the benefit of interest income right away.

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To be continued the week of March 13.

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