Buckingham
WEALTH PARTNERS

Middle Market Direct Loans as an Investment Opportunity

January 2022

Background

Over the past 10 years, there has been a fundamental shift in the fixed income landscape. New regulation implemented in 2008 limited the ability of traditional banks to make loans to U.S. middle market businesses.[1] Non-bank lending, led by institutionally funded independent asset managers, emerged as a growing and formidable lending channel. The principal value of non-bank-originated loans has grown to roughly $1 trillion.[2]

The U.S. middle market is potentially a vast source of financing opportunity. According to the National Center for the Middle Market, the U.S. middle market includes approximately 200,000 businesses, representing one-third of all U.S. private sector GDP.[3]

Characteristics of Middle Market Direct Loans

Loans typically have a five- to seven-year maturity and charge floating LIBOR-based rates (with a 1% floor) plus an interest rate spread to compensate for credit risk. Interest spread varies depending upon the perceived riskiness of the borrower, industry, loan-to-value ratio, seniority, covenants, and other factors. Lenders also receive an "original issue discount" or "OID," a one-time upfront fee for originating and underwriting the loan, typically 1%-3% of principal.

The average yield spread over Libor was roughly 7.6% for middle market direct loans during the third quarter of 2021.[4] However, yield spreads vary widely, and senior secured loan spreads typically average roughly 2% less while second lien or subordinated loans will offer substantially more. The yield-to-maturity on middle market direct loans averaged 4.6% higher than high-yield bonds and 5.8% higher than leveraged loans over the last 10 years.[5]

Middle Market Direct Loan Yield and Performance

Investors are attracted to the higher yields offered by middle market direct loans, averaging roughly 11% gross of fees and expenses since 2004.[6] Realized losses (permanent impairments) have averaged about 1% per year, giving a net 10% gross return.[7] Many investors, particularly first-time investors, choose lower-risk senior, secured loans with yields averaging closer to 8%. Others may invest in second lien or mezzanine loans with yields in the 12%-15% range.

Most private loan funds report high single digit returns after accounting for credit losses, unrealized losses and manager fees.[8] For example, Business Development Companies (BDCs), despite their higher fees, report a combined annualized return of 9.5% for the period September 30, 2004 through September 30, 2021.

1 The "middle market" is generally defined as companies with profits (EBITDA) between $10 million and $100 million, often too small to access capital in the broadly syndicated market.
2 Prequin
3 http://www.middlemarketcenter.org
4 Cliffwater 2021 Q3 Report on U.S. Direct Lending; calculated assuming 1% LIBOR floor
5 Cliffwater 2021 Q3 Report on U.S. Direct Lending, www.CliffwaterDirectLendingIndex.com. 6 2021 Q3 Report on U.S. Direct Lending, Cliffwater LLC, p. 1
7 Ibid.
8 Private Debt: Opportunities in Corporate Direct Lending, Stephen L. Nesbitt, (Wiley Finance, 2019), p. 114

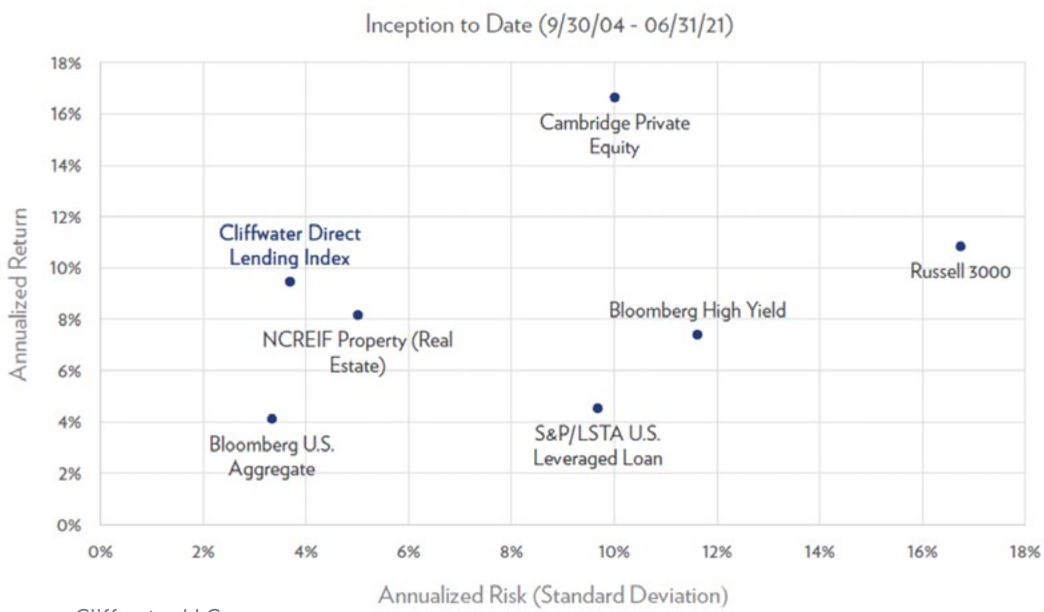
Cliffwater LLC

Founded in 2004, Cliffwater is a leading investment consulting and asset management firm focused on alternative investment strategies, with over $107 billion in assets under advisement as of December 2021. With offices in Los Angeles and New York, Cliffwater serves numerous clients, mostly large pension plans (public and private), endowments and foundations. Cliffwater has been recognized for its research leadership in private debt. In 2018, CEO Stephen Nesbitt authored the book "Private Debt: Opportunities in Corporate Direct Lending" (Wiley 2019).

The Cliffwater Direct Lending Index (CDLI)

Cliffwater created an index to track the performance of U.S. middle market direct loans called the Cliffwater Direct Lending Index, or CDLI. Though not investable, it provides useful data covering over 8,000 loans with aggregate principal value exceeding $172 billion (as of Dec. 31, 2021). The CDLI launched in 2004, and thus its track record includes the Great Recession. The table and figure below report return and risk for the CDLI covering the roughly 17 years since the CDLI returns began, together with the same statistics for other major asset classes.

The Cliffwater Direct Lending Index (CDLI)



Source: Cliffwater LLC

	Annualized Return	Risk	Max Drawdown	Stock Beta
Cambridge Private Equity	16.65%	10.01%	-27.34%	0.48
Russell 3000	10.84%	16.74%	-45.95%	1.00
Cliffwater Direct Lending Index	**9.46%**	**3.69%**	**-7.73%**	**0.16**
NCREIF Property (Real Estate)	8.17%	5.01%	-23.88%	0.05
Bloomberg High Yield	7.40%	11.62%	-27.15%	0.55
S&P/LSTA U.S. Leveraged Loan	4.53%	9.68%	-29.23%	0.41
Bloomberg U.S. Aggregate	4.12%	3.34%	-3.37%	-0.04

Source: Cliffwater LLC

Over this period, the CDLI earned a 9.5% annualized return with 3.7% volatility (standard deviation). While private equity performed better, at 16.7%, the CDLI's lower risk gives it the highest return-to-risk ratio of all asset classes. It is important to note, however, that some portion of this low realized volatility is almost certainly because middle market direct loans are not publicly traded securities. If they were, volatility would likely be more comparable to high-yield corporate debt.

The CDLI total return is broken down into its three major components (income, realized losses and unrealized losses) in the table below.

	Third Quarter 2021	Trailing Year	Trailing 5 Yrs.	Trailing 10 Yrs.	From Sep 2004 Inception*
Interest Income	2.14%	9.22%	9.95%	10.67%	10.87%
+ Net Realized Gains (Losses)	0.27%	-0.67%	-1.40%	-1.11%	-1.11%
+ Net Unrealized Gains (Losses)	0.26%	5.40%	0.34%	0.27%	-0.20%
= CDLI Total Return**	**2.68%**	**14.25%**	**8.82%**	**9.77%**	**9.49%**

* Annualized returns through September 30, 2021.
** Return subcomponents may not add exactly to total return due to compounding effects.

Source: Cliffwater LLC

The table demonstrates that gross returns for middle market direct loans are driven largely by interest income, though reduced primarily by permanent impairment of loan principal, represented by net realized losses.

Loan Size

Loans made to mid-sized companies can vary from $50 million to $500 million but average approximately $175 million.[9] Loan amounts may exceed the manager's desired hold size and the loan is then "clubbed" with a few other lenders or offered as no-fee co-investments to clients.

Credit and Manager Diversification

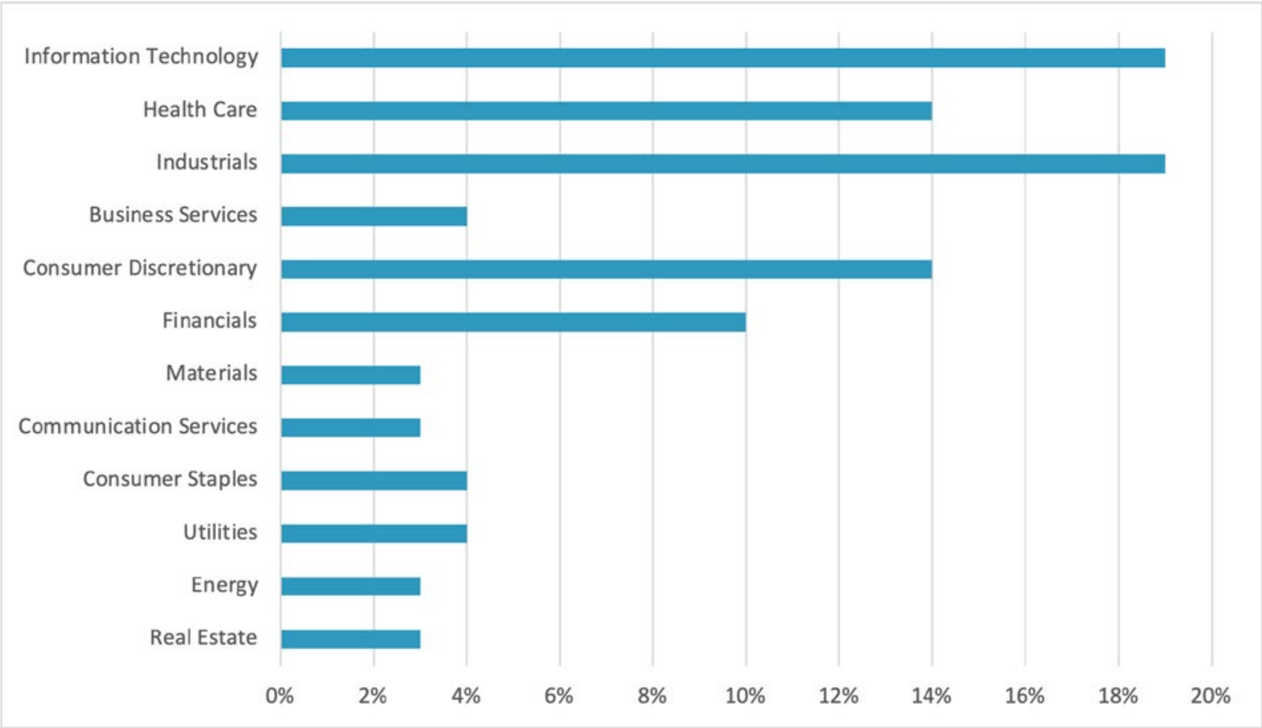
Direct lending managers vary widely and, like with private equity managers, any one manager is likely to be under-diversified relative to investor objectives. A typical manager may have 30 to 40 loans, but a diversified portfolio of middle market direct loans should hold 200+ individual loans to control risk. Because each manager has a unique investment style, combining managers requires understanding lending style to maximize diversification and avoid redundancy.

9 Source: Cliffwater LLC, from its database of over 6,000 middle market loans.

Industry Diversification

Diversification across industries is an important way to manage risk. Fortunately, the middle market provides broad industry exposure for a diversified portfolio of loans as shown below.

CDLI Industry Weights (Sept. 30, 2021)



Source: Cliffwater LLC

Vintage Diversification

As with private equity, potential risks exist if loan origination is concentrated over a short time period. Because loans have a shorter effective life compared to equity investments, diversification can be achieved over three years, shorter than the five-year recycle period for private equity vintage diversification.

Portfolio Leverage

Investors in middle market direct loans frequently use leverage to enhance return. BDCs have successfully operated with leverage at one times net assets for many years, with leverage increasing recently due to regulatory changes. Most private middle market direct loan funds allow investors to choose between an unlevered fund and a levered one, where the levered fund typically uses financing up to two times net assets.

Leverage will both enhance return and increase return volatility. Published research by Cliffwater ("The Investment Opportunity in U.S. Middle Market Direct Lending," Stephen L. Nesbitt, Journal of Alternative Investments, Summer 2017) reports that a back-tested, one-times levered middle market direct loan portfolio, after fees, would have produced a return of 11.8% with a 6.7% standard deviation for the period from 2004 to 2015. The same portfolio, after fees but unlevered, would have produced a 7.6% return and 3.3% standard deviation. Risk, of course, doubled under the levered portfolio. However, even at a 6.7% standard deviation, a managed middle market direct loan portfolio that is leveraged one time has about one-third the volatility of a broadly diversified equity portfolio. Once again, it is important to emphasize that a portion of this low realized volatility is almost certainly due to middle market direct loans not being publicly traded. If they were, volatility would most likely be comparable to high-yield corporate bonds.

Asset Allocation

Institutions are increasingly allocating to private debt. Cliffwater data shows that one-quarter of large pension plans have allocations to private debt with targets ranging from 5%-20%.

Investor Access Private Funds

Investor access to middle market direct corporate loans has been largely limited to institutional investors who allocate to alternative lenders through private partnership vehicles with high minimum commitments and rather high all-in fees, which, according to Cliffwater, average over 3.5% of invested capital.

BDCs

Until recently, smaller investors have been able to access middle market direct loans only through private BDCs or exchange-traded BDCs. These SEC-registered vehicles offer attractive dividend yields, ranging from 7%-10%. However, price volatility is high for exchange-traded BDCs. And according to Cliffwater, fees average over 5% of net assets.

Interval Funds

Interval funds have become an attractive option for accessing middle market direct loans. Interval funds are SEC-registered investment funds designed to provide investor liquidity that better matches the underlying liquidity of fund assets by offering investors quarterly liquidity between 5% and 25% of fund assets. In a particular redemption window, if redemptions exceed the amount of liquidity the fund plans to provide, redemptions would be pro-rated for all investors. Proration can and does occur and can continue for multiple, consecutive redemption windows, meaning that interval fund investors may not be able to fully redeem positions for an extended period of time.

Cliffwater Corporate Lending Interval Fund (CCLFX)

Cliffwater has created an interval fund that uses multiple managers, each of whom invests only in middle market direct loans. CCLFX provides broadly diversified access to U.S. middle market direct loans. Cliffwater, as manager of the fund, is responsible for controlling the credit quality, manager risk and overall diversification of the interval fund.

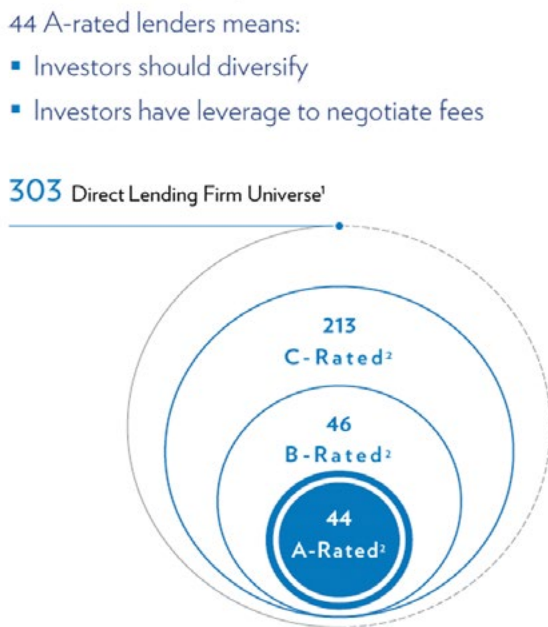
The interval fund format appears well-suited to middle market direct loans. The regular interest and principal payments should provide sufficient liquidity to satisfy the minimum 5% per quarter share repurchase.

CCLFX's net assets exceeded $4.7 billion as of Dec. 31, 2021.

Manager Selection

Cliffwater has selected several top-tier direct lenders to be sub-advisors to the fund at attractive asset-based fees and no incentive fees. Cliffwater is not restricted to invest exclusively with these sub-advisors, but it expects the sub-advisors to manage the majority of fund assets.

From a database of over 300 U.S.-focused direct lenders, Cliffwater conducts a due diligence process to screen the universe of potential lenders to 44 A-rated candidates and selects a subset for client allocations. The Cliffwater due diligence process covers multiple facets of a firm's capabilities, as depicted in the figure below.



[1] Approximate amounts are indicated.

[2] A-rated lenders are judged by Cliffwater to meet the highest institutional standards. B-rated lenders are judged by Cliffwater to be of institutional quality but fall short on one or more criteria, either qualitative or quantitative. The nature of the deficiency can impact whether and when the lender's rating might change. C-rated lenders are deemed by our analysts to fall far short of institutional standards.

Cliffwater selected the 16 current sub-advisors for CCLFX from its 44 A-rated candidates based upon its ability to negotiate attractive fees, the manager's new loan capacity, and the manager's experience with separate accounts.

Portfolio Construction

The majority of CCLFX's assets are managed in sub-advisor separate accounts (not commingled private funds) custodied at State Street Bank, where all loans are owned directly by CCLFX. The sub-advisors are allocated assets in roughly equal amounts—the same loans originated by the sub-advisors that also go into private funds, BDCs, and SMAs managed by the sub-advisor.[10] Currently, the average loan size in CCLFX ranges between $1 million and $5 million, representing a small fraction of each total loan size.

Cliffwater, as advisor to CCLFX, may also allocate a portion of fund assets to loan co-investments and other loan vehicles (e.g., BDCs) it finds attractive. Cliffwater also intends to use leverage within CCLFX, up to the regulatory maximum of 0.5 times net assets, but significantly below the two-times net asset leverage regulatory limit for BDCs.

Seniority

The fund primarily invests in senior, first-lien loans. As of Dec. 31, 2021, 92% of loans were secured by a first lien on borrower assets and cash flows, with an average loan-to-value (LTV) ratio of 43%. An LTV ratio is the loan amount divided by the total value of the business and represents the "cushion" a lender has between its debt and the total value of the business. The manager intends to maintain a substantial overweight to first-lien loans, with the intention of generating lower risk and less cyclical returns. Underlying senior loans within CCLFX are likely to yield approximately 8% on average, substantially below the 12% average income available in subordinated/junior middle market loans.

Cliffwater estimates long-term loss rates on senior loans to be 0.25% (versus 1% for the CDLI, which combines senior and subordinated credit). Lower credit losses are accompanied by lower volatility and lower sensitivity to broader credit markets. These findings are unsurprising, as senior loans have a much more substantial "equity cushion" and therefore are more likely to be repaid.

CCLFX Fees

Fees for CCLFX are comparatively attractive in level and structure. The fund has a 1.64% expense ratio as of 6/29/2022[11],which is well below the 3.5% average fee for most private funds and 5% average fee for BDCs. Neither Cliffwater nor any of the sub-advisors receives an incentive fee.

Currency Risk

CCLFX will invest largely in U.S. middle market direct loans denominated in U.S. dollars and therefore without currency risk.

Regulatory Regime

CCLFX is not a mutual fund. It is a non-diversified, closed-end management investment company registered under the Investment Company Act of 1940 and structured as an interval fund. Thus, CCLFX is regulated by the SEC, just as mutual funds are, with a separate board, compliance officer, auditor, custodian, and independent fund administration.

10 Loans are allocated to accounts across the manager's platform according to account size, subject only to special account restrictions. Cliffwater, as advisor, designates an account size for the sub-advisor, which determines how much of the loan CCLFX will hold. This allocation policy is ubiquitous among private debt managers and is similar to how reinsurance policies are allocated across accounts.

11 The prospectus net expense ratio for CCLFX is 2.21% if fees and interest payments on borrowed funds are included.

Liquidity

CCLFX is a closed-end interval fund instead of an open-end mutual fund. The primary distinction is that the fund can only be sold quarterly and there is no guarantee that an investor would be able to liquidate his or her entire position in one quarter or even over multiple quarters. CCLFX is required to provide quarterly liquidity of 5% of the total value of the fund. This is large enough that in most quarters, investors should be able to redeem their entire position should they choose to do so, but if a large number of investors chose to redeem in the same quarter, the fund would provide pro-rata redemptions to each investor. The fund is organized in this form because the underlying illiquidity of its holdings makes it incompatible with a daily liquid fund structure.

To illustrate the pro-rata redemption process let's assume that 5% of the value of the fund was $250 million. In this particular quarter, investors requested $500 million of total redemptions. In this case, all investors who requested redemptions would get redeemed 50% of what they requested (i.e., 250 ÷ 500). Keep in mind that redemptions could be prorated over multiple quarters if redemption requests exceed the liquidity the fund is able to provide over multiple quarters.

Daily Pricing and Valuation

While liquidity is only available at proscribed intervals, pricing is available daily on websites such as Bloomberg and Yahoo! Finance under the ticker CCLFX. Daily NAV (i.e., share price) is determined by the fund using a board-approved valuation policy consistent with "fair value" asset pricing and one that is approved by the fund's auditor.[12] For non-traded illiquid (Level 3) assets, pricing is determined based upon inputs from sub-advisors, an independent valuation firm, Cliffwater and Markit.[13] Sub-advisors and Cliffwater use third-party valuation agents who assist them in determining loan prices on a quarterly basis. Sub-advisors will all update valuations within one week of the fund's quarterly repurchase date to ensure redeeming investors are receiving the most accurate price.

Distributions

CCFLX is expected to make quarterly distributions, which can be reinvested.

12 FASB ASC 820 Fair Value Measurement. The CCLFX auditor is Cohen & Co.

13 Cliffwater currently uses Houlihan Lokey, a leading independent valuation firm. Markit is a leading pricing service for broadly syndicated and middle market loans.