Cliffwater 2023 Study on Private Fund Fees & Expenses for Direct Lending

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In this updated fee survey for investment management services for middle market corporate lending covering 58 of the largest direct lending firms managing $924 billion in direct lending assets, we find:

- *Management fees and administrative expenses for direct lending private funds average* ***3.94%***[2] *of net assets in our 2023 study, up from 3.56% in the prior 2022 study.*
- *The 3.94% average fee and expense is comprised of* ***1.96%*** *in management fees,* ***1.50%*** *in carried interest, and* ***0.48%*** *in administrative expenses. This compares to the prior 2022 study findings consisting of 1.89% in management fees, 1.25% in carried interest, and 0.42% in administrative expenses.*
- *The 0.38% year-over-year increase in the cost of direct lending is due principally to a rise in reference interest rates and wider credit spreads boosting carried interest charges. Management fee and carried interest schedules remained relatively unchanged year-over-year.*
- *The 58-firm study group uses 1.12x average leverage, holds 87% first lien loans, and lends to borrowers that are 82% sponsor-backed with $74 million in average EBITDA.*
- *Manager use of portfolio leverage and greater exposure to lower middle market or non-sponsor borrowers are associated with higher fees, while greater exposure to first lien sponsor-backed loans is associated with lower fees.*
- *Fees (excluding administrative expenses) as a percent of net assets vary considerably across managers, ranging from 2.64% (10th percentile) to 4.32% (90th percentile).*
- *Despite the increase in year-over-year fees, at the time of the study, investors in direct lending collectively could expect to earn a* ***9.68%*** *return net of all fees and expenses and net of expected credit losses.*

Investors continue to inquire about fees and the value proposition offered by active management, particularly for the higher fees found in alternative investments. This paper updates fee data on investment services for middle market corporate direct lending; identifies unique features found in direct lending fees; presents an "apples-to-apples" fee measurement protocol to better compare managers who have different fee structures; and finally, gives statistical results that attempt to explain why some managers might reasonably have higher or lower fees compared to the average.

Data

We collect fee, expense, and portfolio information from 58 direct lending managers who collectively manage $924 billion in direct lending assets and offer limited partnership interests in private partnerships upon which our fee analysis is based. Portfolio information includes use of portfolio leverage, loan seniority, borrower size, and allocations to non-sponsor borrowers, all characteristics found to explain differences in loan yields[3] and which may also explain fee differences as well. While the 58 funds

[1] Study data is collected during the fourth quarter of 2022. Similar Cliffwater fee studies in 2018, 2020 and 2022 are based upon data collected in the fourth quarter of the preceding year.
[2] Includes management, incentive fees and fund administrative expenses.
[3] See Private Debt: Yield, Safety, and the Emergence of Alternative Lending by Stephen L. Nesbitt, (John Wiley & Sons, 2023), Chapter 11.

examined are not identical, they are substantially similar in their focus on middle market lending as an investment strategy with most of the capital provided by institutional investors.

Findings

Exhibit 1 provides results from our updated direct lending fee survey covering data collected during the fourth quarter of 2022. Fifty-eight of the largest direct lending managers are included in the survey. Fees are broken down into management (column 1) and incentive (columns 4 and 5). Management and incentive fees are combined to report total fees (columns 6 and 8).

A single set of loan assumptions underly the results. Unlevered middle market loan yields, including OID and other prepayment fees[4], are assumed to equal 10.25% with a 1.05% annual credit loss ratio.[5] Additionally, borrowing costs are assumed to equal 5.25% (assuming 1.95% SOFR) and administrative and other costs equal 0.48%, both consistent with the characteristics for the study group.

Exhibit 1: Breakdown of Fees (excluding Administrative Expenses)

	(1) Mgmt. Fee Rate	(2) Leverage	(3) Effective Mgmt. Fee on NAV	(4) Carried Interest	(5) Preferred Return	(6) Fees on NAV (excluding Adm. Exp.	(7) Gross Yield	(8) Fees as % of Gross Yield
Average	1.11%	1.12x	1.96%	13.6%	6.5%	3.46%	13.62%	26%
Asset-Weighted	1.11%	1.30x	2.01%	13.4%	6.4%	3.61%	14.36%	25%
GAV Average	1.03%	1.22x	2.24%	12.6%	6.4%	3.65%	14.02%	26%
NAV Average	1.28%	0.87x	1.28%	16.0%	6.7%	3.01%	12.64%	24%
10^{th} Percentile	1.50%	1.65x	2.61%	17.5%	7.3%	4.32%	15.73%	31%
25^{th} Percentile	1.25%	1.25x	2.25%	15.0%	7.0%	3.94%	14.15%	29%
50^{th} Percentile	1.00%	1.00x	2.00%	15.0%	7.0%	3.39%	13.16%	25%
75^{th} Percentile	1.00%	1.00x	1.50%	12.5%	6.0%	3.00%	13.16%	23%
90^{th} Percentile	0.84%	0.50x	1.22%	10.0%	5.7%	2.64%	11.18%	20%
10^{th}-90^{th} Range	0.67%	1.15x	1.39%	7.5%	1.6%	1.68%	4.55%	11%

NAV = net asset value (investor capital only)
GAV = gross asset value (investor capital + assets financed through borrowings)

1. ***Management Fees.*** Column 1 reports survey results for management fees. Direct lending management fees are most often charged on invested, not committed assets, and all 58 direct lending managers in our survey charge on invested assets. Private equity managers almost universally charge fees on committed assets during a fund's investment period. This difference is likely explained by legacy practices, more robust deal flow, shorter investment periods, and a shorter deal life compared to private equity. Fees on invested assets reduces both overall fees and mitigates or eliminates the J-curve phenomena.[6]

[4] Original Issue Discount (OID) and fees paid to lenders from early prepayment of principal.
[5] Yield equals annualized interest income on the Cliffwater Direct Lending Index for Q4 2022. Credit losses equal average annualized credit losses on the Cliffwater Direct Lending Index for the 2005-2022 period.
[6] See "Corporate Direct Lending and J-Curve Mitigation", Cliffwater Research, January 2017.

Forty-one of the 58 direct lending managers (71%) charge fees on gross assets (GAV)[7] while the remaining 17 managers base their management fees on net assets (NAV). Outside direct lending, other forms of structured finance (such as CLOs), and some real estate structures, we seldom find management fees charged on gross assets. The argument for charging fees on gross assets is that the resources required of a manager to deploy assets is the same regardless of whether those assets are invested or levered, and in fact, additional resources may be required to maintain the leverage. Weighted by assets, 68% charge management fees on GAV and 32% on NAV.

Column 1 shows considerable variability in management fees, only a fraction of which is explained by whether fees are charged on net or gross assets. The 10th-90th percentile fee range equals 0.67%, which is a very meaningful difference for any asset class.

2. ***Leverage.*** Column 2 reports leverage statistics for the survey group. Most managers use leverage in their private funds (only three do not) with an average equal to 1.12x.[8] Not surprisingly, managers that charge management fees on gross assets use more leverage than those that do not. However, those same managers have a lower average management fee (column 1, rows 3 and 4).

3. ***Effective Management Fee.*** Column 3 adjusts the headline fee in column 1 and expresses fees as a percent of net assets (NAV). Average management fees increase from 1.11% to 1.96% of net assets due to some managers charging fees on levered assets (GAV). Of course, for them, the stated average 1.03% management fee on GAV becomes 2.24% as a percent of net assets.

4. ***Carried Interest.*** Column 4 reports carried interest statistics for private debt funds. The vast majority of managers in our survey charge an incentive fee. The average incentive fee equals 13.6%, which is well below the ubiquitous 20% incentive fee found in private equity, with 10% and 15% incentive fees being the two most found. As might be expected, managers that charge management fees on gross assets tend to have lower incentive fees than those charging management fees on net assets, at 12.6% versus 16.0%, respectively.

5. ***Preferred Return.*** The average preferred return equals 6.5%. This is lower than the typical preferred return of 8% for private equity, likely reflecting lower return expectations for direct lending. In almost all cases direct lending funds require a 100% "catch-up" after the preferred return is achieved. Private equity funds generally apply a 50% catch-up which is more investor friendly.

6. ***Fees and expenses on NAV.*** Direct comparisons of fees can be difficult with the variety in structures and use of leverage. Therefore, we have created a single measure in column 6 that represents the sum of asset fees and incentive fees as a percentage of net asset value. We calculate total fees on NAV by averaging combined management and incentive fees as a percentage of NAV across managers. We find that the average direct lending manager imposes a combined management and carried interest fee equal to 3.46% of net assets. The average gross of fee expected return equals 13.62%.

7. ***Total Fees as % of Gross Income.*** Column 7 looks at the proportion of gross return that is paid to lenders through management and incentive fees. The **26%** average (excluding administrative fees) is not materially different from what is found in private equity.[9]

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[7] Gross assets (GAV) include both investor capital (NAV) plus assets from leverage (borrowings).

[8] Leverage is expressed as a multiple of net assets (NAV). A value equal to 1.07x means that the private fund uses borrowings equal to 1.07 multiplied by its net assets, for a gross asset value equal to 2.07 multiplied by net assets.

[9] See "The Better Deal: Hedge Funds or Private Equity", Cliffwater Research, November 2011.

8. ***Factors Explaining Fee Variation.*** We find that a significant proportion of manager fee variation can be explained statistically by four factors. Leverage is the dominant factor explaining higher fees; explaining lower fees are size of borrower, allocation to senior loans, and allocation to sponsor-backed borrowers.[10]

In addition to these management fees, Cliffwater found that direct lending private partnerships charged an additional **0.48%** of net asset value in non-management expenses, including administrative costs, custody, professional fees, and other costs. Together with management fees, Cliffwater estimates that total fees and expenses for direct lending private partnerships equals **3.94%** of net asset value.

Conclusion

Our study finds that 2023 fee rates for direct lending private partnerships will average 3.94%, consisting of 3.46% for management fees and 0.48% for fund expenses. The 2023 rate is higher than the 3.56% rate from the prior year, primarily the result of higher middle market loan yields. The study also finds considerable fee variability across managers suggesting that investors should assess the unique contributions of managers, such as low loss rates, when considering higher fee private funds.

Study results also help inform investors on expected returns for direct lending private partnerships. The average private fund expected return, net of all fees and expenses, equals **9.68%** (13.62% minus 3.94%)

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[10] Regression statistics are available upon request.

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