EXPERT Q&A

Innovation abounds in private credit, but lenders that focus on the basics are well positioned to attract investors in a crowded market, says Cliffwater's Frances Beyers

Picking the right partner

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While direct lending is still benefiting from significant tailwinds, choosing the right manager has never been more important for investors. Cliffwater snapped up the award for LP/Investor of the Year in the Americas for 2024, and here Frances Beyers, head of capital markets and portfolio manager for the Cliffwater Corporate Lending Fund, sets out what the firm looks for in lender partners.

Q How would you describe the current state of the private credit landscape?

The growth in the asset class has been tremendous over the past few years, fuelled in part by the increasing democratisation of the market and the search for new pools of capital.

Just a decade ago, fund structures were simple as managers would offer traditional drawdown funds or separately managed accounts and hope a 'one-size-fits-all' solution would suffice.

Today, private credit managers now have a multitude of structures and vehicles to meet different needs, allowing these asset managers to expand the level of capital available to them. This level of innovation shows no sign of slowing down, making private credit far more dynamic, relevant and well positioned to take market share from public markets.

This level of growth can pose challenges to managers not at the forefront of innovation. While the barriers to entry may seem low, the barriers to finding scale and long-term success are much harder to overcome.

Q What should investors look for when assessing lender partners?

Starting with the obvious, we look for a track record of low realised losses and solid credit performance through time. While every credit manager will produce some level of losses through time, those platforms that have proven themselves through multiple cycles and incorporated experience into a successful underwriting framework have an edge today.

We also look for managers who are constantly reinvesting into their business and have established asset management platforms. Not only is strong underwriting and origination important, but fully built-out back-office teams are also critical to long-term success.

We also find that behind every great return in private credit resides strong leadership. Private credit is a 'people business' and the strongest platforms have a defined culture and deep bench of talent across their franchise.

We often get the question, 'are bigger or smaller' managers better in terms of where investors should play within the direct lending market. We like both. While managers at the upper-end of the market can lean on big hold sizes to offer opportunities to more resilient and scaled borrowers, lower-mid-market managers can offer interesting yield profiles and a more disciplined approach to structuring. The key is to partner with managers that are dedicated to their core strategy and area of the market where they have expertise and a dominant position.

Finally, we analyse fees. Yields on direct lending assets tend to stay within a narrow band, so one way to drive outsized returns is through lower fees. If you can find managers with reasonable fee structures that can build diversified portfolios, you are in a better position to receive a solid return.

Q Where do you currently see the greatest opportunity for capital deployment across the asset class?

At Cliffwater, we have three interval funds that focus on different strategies across alternatives. Our flagship fund, Cliffwater Corporate Lending Fund, is focused on direct lending, where we remain bullish and see a large opportunity for deployment.

Despite meaningful spread compression over the past year, the pricing premium over public markets continues to hold true and we still see a strong value proposition over public markets. The ability to move quickly, speak for large hold sizes, offer flexible capital structures and provide more privacy in competitive auction processes are driving more deals to private markets.

Our Cliffwater Enhanced Lending Fund is focused on the full spectrum of private credit, outside of direct lending. One area we find particularly interesting within this strategy is asset-based lending, which is more immune to market volatility and offers strong recovery values given hard asset collateral. These opportunities also generate a nice yield premium in most market environments due to the idiosyncratic situation of the borrowers seeking capital. We also really like infrastructure debt, where the energy transition is a big theme.

Q What barriers do those trying to enter the market have to overcome?

The flood of new entrants into private credit has been material. Banks, CLOs, hedge funds are all seeing the trend of M&A dealflow leaving their market and gravitating to direct lending executions. Many believe they need to have a private credit strategy to prevent their franchises from being left behind.

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While raising a few billion dollars of equity coupled with a leverage facility might be feasible to obtain entry into direct lending, can it be sustainable when competing against a $50 to $100 billion direct lending asset management platform? Achieving a certain level of success as a new entrant is getting much tougher.

It is also a huge disadvantage not having a large diversified incumbent portfolio. For most direct lenders, 60-80 percent of their annual deployment volume is driven by mining opportunities within their portfolio. Couple that with the information intelligence an established lender has at their fingertips through their portfolio, newer entrants are at an information disadvantage.

Q How do you see the market developing through 2025 and beyond?

Investors are much more familiar with what private credit is today versus five years ago – they like the steady yield, seek 'all-weather' return characteristics and want access to it.

Building products for the retail/wealth channel offers one of the biggest opportunities for managers as the white space is vast. Many platforms are building out their distribution teams to cater to that market.

The biggest challenge for direct lenders will be to maintain discipline on credit terms while finding enough opportunities for deployment. Ten years ago, lenders could be selective on terms and naturally deliver alpha relative to peers. Today, the market is much more homogenised and it is harder to generate that higher return premium.

Managers who remain focused on picking the best credits in defensive sectors with a low probability of default tend to show solid performance. Equally difficult is differentiation in results, but we believe through time, the outperformers will become apparent through credit performance, longevity and the consistency of returns. ■