EXPERT Q&A

Private debt's future is bright due to favourable market dynamics and innovations such as perpetual vehicles, says Stephen Nesbitt, CEO of Cliffwater, Americas Investor of the Year in this year's PDI awards

Perpetual fund structures are here to stay

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Stephen Nesbitt, the CEO, co-founder and CIO of Cliffwater, investment adviser for Cliffwater Corporate Lending Fund and Cliffwater Enhanced Lending Fund, is optimistic about prospects for the private debt market. Cliffwater has won Americas LP/Investor of the Year in the *Private Debt Investor Awards*, and Nesbitt believes the underlying fundamentals of the market suggest that the industry still has room to grow, particularly with perpetual fund structures.

Q Let's start with how the private debt market got to where it is today. How has the market evolved over your 20 years in the business?

The difference is night and day. Twenty years ago, the private debt market was small and focused on higher risk second lien, mezzanine and distressed debt. The major players were insurance companies, finance companies and hedge funds looking to earn both yield and capital gains from equity kickers. Today, the private debt market is dominated by top-of-the-capital-stack, first lien and senior secured loans to mid-market companies. Lenders fully expect high interest income and full recovery of loan principal.

Not only has the character of loans changed but also the lenders. In the aftermath of the global financial crisis and heightened bank regulation, independent asset managers replaced banks as senior lenders to mid-market companies. At the same time, these independent non-bank lenders found new sources of capital to support their loans, including pensions, sovereign wealth funds and retail investors, all starved for yield and safety. These changes have resulted in a private debt market that has gone from less than $100 million 20 years ago to $1.5 trillion today.

Q How would you describe the current moment in private debt markets?

Those involved in the credit markets

tend to have glass-half-empty personalities. You seldom find optimism except from those charged with raising capital. Right now, on balance, the market ahead looks positive for lenders.

Most private debt is floating rate, combining short-term rates plus a credit spread. The good news is that short-term interest rates are high by historical standards. Currently, the three-month secured overnight financing rate is over 5 percent. With inflation running at 3 percent, the real rate of interest is at least 2 percent, well above its 1 percent historical average and the large negative real interest rates during the last decade.

In addition, spreads range from 5-7 percent, at or above their historical average. Together, floating interest rates for private debt range from 10-12 percent for senior loans. Double-digit yields are bound to attract investor attention.

Lender protections in the form of covenants remain strong in the mid-market. Private debt isn't the broadly syndicated market or high-yield bond market where there are no covenants and if there's trouble, the lawyers arrive and the chance for default is high. In private debt, most loans still have covenants. Those that don't tend to be larger companies in the upper-mid-market with strong borrower financials.

Lastly, the economic environment looks pretty good. The recession that everybody predicted last year or the year before never happened. Growth rates for GDP, corporate revenue and earnings all look strong for the foreseeable future.

Q Given that alluring climate, is too much money flowing into private debt right now?

There's definitely that perception but the fundamentals argue that's not the case. If you look at the entire private ecosystem, which combines private equity and private debt, its growth has

"Perpetual funds have emerged as an alternative implementation solution"

been the mega-trend of the last two decades. We estimate that private equity, which basically feeds the demand for private debt financing, has been growing at a 13 percent annual rate over the last two decades. In contrast, public equity has been growing at a 6 percent annual rate. Then there's the fact that the number of publicly traded companies has been cut in half over the last 20 years to maybe 4,000, while the number of private companies approaches 15,000.

We find private debt financing marching in lockstep with private equity. Right now, private debt supplies about 30 percent of private equity financing and that level has been steady in recent years.

In addition, current yield spread is the market's determination of supply and demand. And the fact that yield spread is higher today than it's been over the last five years suggests that there is not too much money going into private debt. If there were, credit spreads would be falling, but they're not.

Q How do you explain the success of your two 'perpetual' private debt funds, Cliffwater Corporate Lending Fund and Cliffwater Enhanced Lending Fund, and do you think the structure is here to stay?

Those wanting to invest in private debt have historically used the private equity playbook, which entails commitments to many private funds across managers, strategies and vintage years. A by-product of this old school approach has been enormous administrative complexity and costs, an unnecessary loss in liquidity and higher management fees.

Perpetual funds have emerged as an alternative implementation solution. Their benefits are potentially many. First is convenience: investors can immediately purchase shares in an existing pool of private loans. No unfunded commitments. Second is enhanced liquidity: most perpetuals offer quarterly liquidity, subject to limitations, which compares very favourably to private funds where it can be at least three to five years before investors can begin to get their capital returned.

For investors that don't want liquidity, cashflows from interest income and principal repayment are automatically reinvested into the perpetual. Third, perpetuals managed by allocators like Cliffwater that utilise multiple lenders to source private debt opportunities are better equipped to scale assets, which in turn can be used to negotiate lower lender fees, better access to co-investments and achieve a level of diversification that no single lender can provide.

Perpetuals are not perfect. They do bring their own unique but manageable issues, including valuation and liability management. These imperfections are in my opinion far outweighed by the convenience, liquidity, diversification and cost benefits of perpetuals, particularly those offered by experienced allocators.

Perpetuals are now the vehicle of choice for wealth managers and smaller institutions. And you have to ask yourself when that wide-body public pension plan invested in 70-plus private debt funds across 50-plus unique managers paying mostly full fees with little co-investment opportunity might capitulate in favour of a few perpetual vehicles. I don't think the time is far off. ■