ΛLPINUM INVESTMENT MANAGEMENT

INVESTMENT INSIGHT
DIRECT LENDING 06/2019

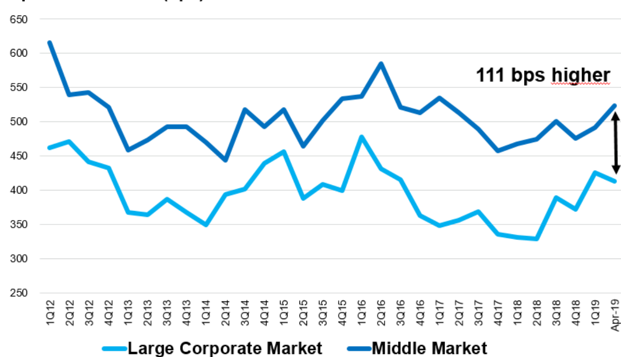
DIRECT LENDING – PERFORMANCE ANALYSIS

Investment Insight | Series VIII

In a series of articles we discuss and present investment opportunities we actively use in our building blocks to form our absolute return portfolios. We already published "Series II" about direct lending, highlighting the **attractive and stable yield income of around 7% p.a. for senior secured loans** of well backed small and medium sized companies. As shown in Chart 1, the yield pick-up between SME's and large corporate loans remains stable from 2010 to 2019 and is currently at 111 bps.

Chart 1: Average yield for middle market loans

Spread over Libor (bps)



Source: Refinitiv (formerly Thomson Reuters)

Further, we lined out the positive market dynamics with the alternative lenders filling the gap left by the traditional banks, who are reducing their balance sheets within the new regulatory environment. Last but not least, it is important to us that directly originated middle market senior secured debt offers not only a higher yield, but has on average also a lower leverage employed than large corporate syndicated loans, what leads to lower loss rates (through a combination of lower default rates & higher recovery rates).

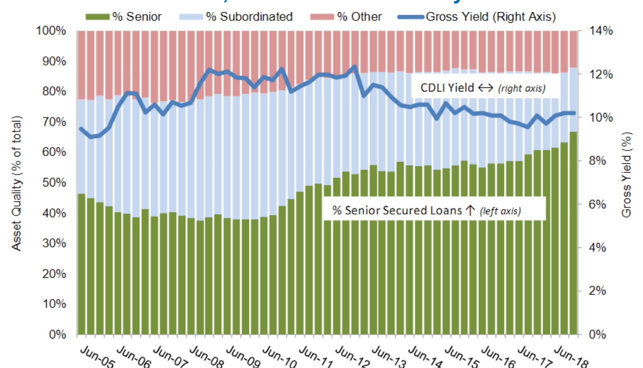
Now, in this "Series VIII", we like to dive a bit deeper into this alternative opportunity, comparing direct lending with others major asset classes.

Cliffwater Direct Lending Index

Our performance analysis relies on the Cliffwater Direct Lending Index ("CDLI"), an asset-weighted index of over 6,000 directly originated middle market loans totaling $99 billion in assets. The Index measures the unlevered, gross of fee performance of U.S. middle market corporate loans. It takes the performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs.

Direct lending returns have historically been driven by consistent double-digit income returns, with a range between 10% and 12%. The slow decline in credit spreads within the CDLI over the last several years is a product of overall credit spread compression, but also the gradual increase in the proportion of lower yielding senior loans in the CDLI and a decline in second lien and subordinated loans. The percentage of senior loans in the CDLI has grown from 38% at the end of 2009 to 67% in December 2018.

Chart 2: Increase in senior loans, both immediately after the 2008 Financial Crisis, and over the last two years

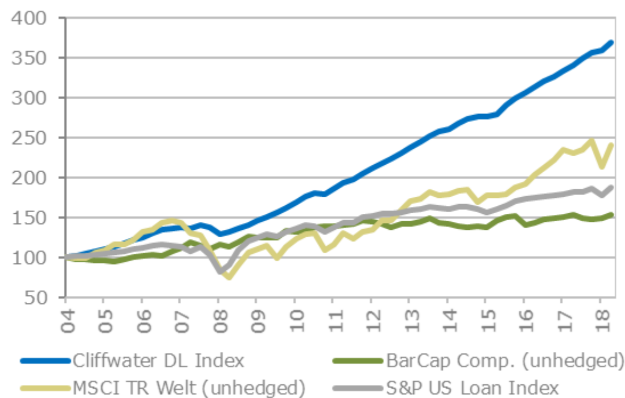


Source: Cliffwater LLC

Performance analysis versus major asset classes

Historical analysis shows that in the long-run directly originated middle market loans outperform major asset classes like the MSCI World Total Return Index and the Barclays Capital Bond Composite Global Index. It further shows the significant outperformance versus the "public" syndicated loan market, represented by the S&P US Loan Index in the chart below.

Chart 3: Historical cumulative return since 2004

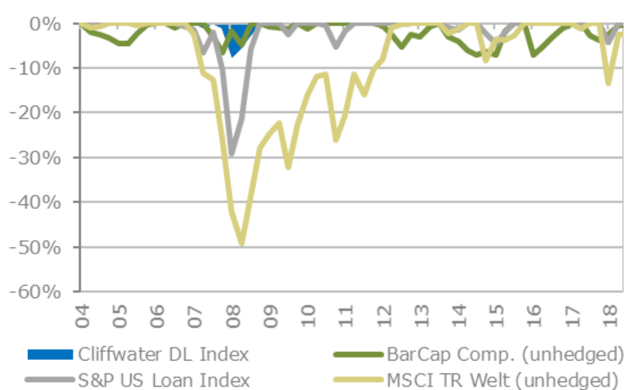


Source: Alpinum Investment Management

Lower draw down leads to lower risk profile

Further, historical analysis shows that private debt lenders suffer lower default- & loss rates as compared to the broader syndicated loan market. The result thereof is reflected in the relatively low maximum draw down of the asset class with around -8% versus -29% for public loans and -49% for equities. This resilience is not only true for the financial crisis, but also in stress periods, which financial markets experienced since.

Chart 4: Maximum Draw Down

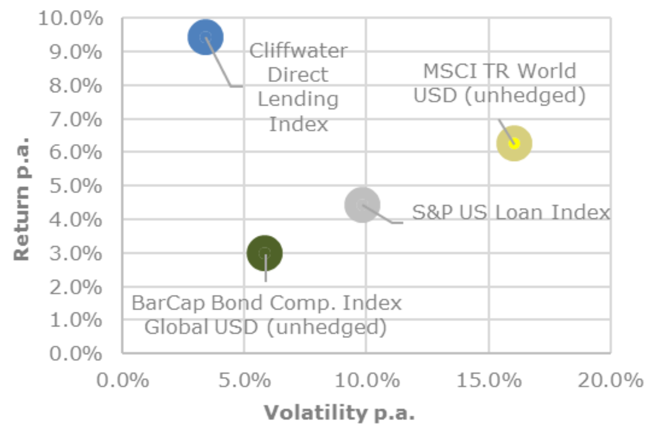


Source: Alpinum Investment Management

Favorable risk return ratio

The risk return scatterplot shows not only the outperformance, but also the lower volatility of the CDLI compared the major asset classes. With the blue dot in the top left corner, there is a strong argument for investors acting in accordance with the modern portfolio theory (MPT) to allocate a significant exposure to directly originated middle market loans. The low volatility has its roots in the private nature of the assets class and its purely institutional participants. But the argument holds its validity also in case of a higher volatility.

Chart 4: Risk Return Ratio

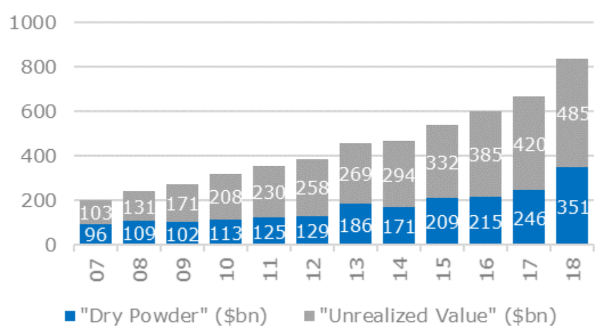


Source: Alpinum Investment Management

Selection is key

Private debt as an asset class is a well established asset class and accounts for **more than 2'000 funds** today with an aggregate value of more than USD 800 bn. Alpinum Investment Management has already been successfully investing in illiquid credit for many years and has a significant part of the exposure in direct lending funds.

Chart 5: Growth of Middle Market Direct Lending



Source: Preqin / Alpinum Investment Management

We think that manager selection is a key factor for meeting investor expectations within this large universe. Therefore, we like to outline a few factors that are important to us.

Scale: Larger players have the ability to speak for whole loans, which provides efficiency in execution to the borrower and increase the control of terms and structure to the lender. Controlling the structure generally leads to better outcome in stressed situations.

Sourcing: Lenders with a strong, longstanding network see and evaluate a higher number of deals in the market and also profit from their incumbency. This leads to advantages like participation in less competitive deals, "first looks" and "last looks" of potential transactions.

Proprietary origination: A manager with a regular lead role in deals benefits from in depth due diligence of the borrowers and structuring of the documents and covenants according to its standards. We think, that the direct origination coupled with the ability to hold the full loan, leads to a positive selection bias.

Monitoring: A close monitoring of the borrowers with good systems and a close dialogue, provides managers with early warning signs and enables them to step in timely in case of challenging situations.

Experience: We clearly favor managers, who have a tested and demonstrated track record through a full credit cycle. In addition, we put great emphasis on individuals, who have the experience in workout situations and therefore can turn stressed situations to positive outcomes.

In summary, direct lending provides attractive returns relative to its risk, particularly when being managed by experienced, trustworthy partners.

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