



Cliffwater's Condrell: Middle-Market Credits Smooth Portfolio Returns

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Alex Condrell, managing director at Cliffwater. Read the Q & A below as Alex discusses the firm's Direct Lending Index and Corporate Lending Fund, and how investments in middle-market corporate credit should stand up to the challenges of rising inflation and interest rates, providing something close to



Alex Condrell

historic return levels of 9% for the asset class without extending recklessly out the risk spectrum.

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CHUCK JAFFE: Today on The NAVigator we're talking middle market corporate credit and why it's an asset class you might want to add to your portfolio, and we're doing it with Alex Condrell, managing director at Cliffwater. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. From users and investors to fund sponsors and creators, if you're looking for excellence beyond indexing, The NAVigator is going to point you in the right direction. And today, well, it's

pointing us in the direction of middle-market corporate loans, and we're having that discussion with Alex Condrell from Cliffwater. An alternative asset manager, investment advisory, and research firm that created the Cliffwater Direct Lending Index, which looks at the performance of assets held by business-development companies. We're going to discuss the benefits of adding middle-market exposure to the income generating portion of your portfolio. By the way, Cliffwater also runs the Cliffwater Corporate Lending Fund, that's CCLFX, which provides access to private debt. You can learn more about the firm at Cliffwater.com and about the fund at CliffwaterFunds.com. And if you want to learn more about closed-end funds, interval funds, and business-development companies generally, go to AICAlliance.org, the website for the Active Investment Company Alliance. Alex Condrell, welcome to The NAVigator.

ALEX CONDRELL: Nice to be with you, Chuck.

CHUCK JAFFE: Alex, there's a lot that I mentioned in that introduction about the index, the firm, the fund, so let's help people get some understanding of what Cliffwater does. Because the Cliffwater Direct Lending Index, well, you can't really have a market until you can measure it. But one of the things that's interesting to me is the Cliffwater Corporate Lending Fund is not an index fund, it's not based on the index. So let's talk a little bit about the market, how you guys define it, and then how you guys seek to invest in it, and maybe why the structure of an interval fund is particularly useful here.

ALEX CONDRELL: Yeah, thanks Chuck. So Cliffwater goes back to 2004 as an institutional investment consultant. We found the middle-market credit to be a really attractive space for institutions who want consistency, they really want to hit the mid-single digit target return and many assets are volatile during tough times. Middle-market credit has tended to be pretty steady and consistent with good results, and that's something we've been involved in for a long time as a consultant and making recommendations. In about 2015 we wanted to put more of a picture around what this universe of credit looked like, and that's when we put together this index. What it does is takes all the loan-level data that's reported to the SEC, which is quite a lot, it's about 8,000 loans and about \$200 billion worth, so it's not every single loan but it paints a good picture. The data goes back to 2004 and it gives you a good sense of how much income is being generated by middle-market loans, what changes are taking place and how they're marked, if they're being marked from par down to 98, to 96 or

back up again and so on. And then if there's any losses, those are all recorded as well. So it takes all the good loans, all the bad loans, and what you get, kind of the punchline is it's been about a 9% return since that time going back to '04, about 9% with about 3% volatility. And if you stack those up, a nine return and a 3% in volatility, that stacks up pretty well compared to many asset classes. So we think this is kind of why it justifies a place in a portfolio. That index by the way is an unmanaged, no fees, it's an uninvestable index. But to segue to the fund, we want to give investors access to the space. For the most part an individual has to go into a fund that's run by one manager, but what we've observed is that the institutions really get a much better deal in this space. They're getting a more diverse portfolio, so less chance of any single company causing a problem, and they pay lower fees, and they get the structure that helps them. Them being institutions. For individuals they kind of get the short end of the stick. They generally get a more concentrated portfolio, which is not what you're looking for. They pay higher fees, and they're forced to use a structure that does not necessarily benefit them, it really is designed for institutions. So the Cliffwater Corporate Lending Fund, which is something you can invest in, is really designed to bring this institutional opportunity. Which is let's get diversified, do senior lending to middle-market companies in a very diverse way using top quality lenders, keep the fees under control and put it in the structure, this interval fund that really works for individuals.

CHUCK JAFFE: I love that it's not an investable index. For folks who don't understand what that means, typically companies are creating indexes so that they can then create funds, and you're buying the underlying constituents. And that's not what's going on here, which means that the index is a better definition of the marketplace, and there's a lot less that goes into that.

ALEX CONDRELL: Correct.

CHUCK JAFFE: Separate from that, let's help define the marketplace a little bit. Middle-market companies talk about what the middle market is, and then what does that mean in terms of your investment focus? Because I don't believe you've got everything that qualifies as middle market, I think there is some selectiveness that goes in there as well. So like, yes, this could be middle market but it doesn't mean that's what we're interested in.

ALEX CONDRELL: Right, the index captures what is being held by business-development companies. So if lenders who manage BDCs, business-development companies, if it's in their

portfolio, then it's in our index. So whether that is a first-lien senior secured transaction, that's the type we tend to focus on in our fund, or whether it's a second lien or mezzanine or even some type of equity, preferred equity or even real equity, if that's in a BDC, then it gets reported and that goes into our index. So the index captures all of that. Like I said, it's about 8,000 loans, some of which we would use in our fund and some we would not use. So the companies are private companies, they don't trade publicly, and they generally have \$100 million or less of EBITA, which is like operating cash flow, you can think of it as operating cash flow. So the reason these transactions are done by middle-market lenders, the companies bigger than that, if they want debt they're getting the debt that's arranged by J.P. Morgan or Bank of America. If it's a private bank loan it'll be held in the hands of mutual funds that do bank loans. Or if it's large enough it'll be done in a high yield market, offered publicly, also held by mutual funds for the most part, or hedge funds or some private investors. But the companies that are \$100 million or less of EBITDA, basically the smaller the deal, there's less fee income for the banks. And so when you get down to about \$100 million of size or less, the banks just tend to do less and less of those deals, so they're generally done by middle-market lenders.

CHUCK JAFFE: What's an expected return for the asset class? And what would be an expectation in the kind of markets that we're looking at, which are either going to be more volatile or perhaps headed for a downturn? I don't think anybody's expecting 2022 to beat what we've seen the last couple of years, so let's talk a little bit about history and then a little bit about expectation.

ALEX CONDRELL: So the history has been about a 9% return, again, that's with no leverage and there's no fees in that. And again, that's the uninvestable, you can't invest in that. So many managers will use a little bit of leverage, sometimes up to a dollar of debt for a dollar of equity. We don't use that much but some do. And then they'll also charge fees. So the leverage tends to bring up your income and then you basically subtract from your yield, your levered income minus your fees and then minus any credit losses if there are any, and that's your return. Returns vary depending on the quality of the manager and how much leverage they use and so on. In our fund, we only use about a quarter of a turn, we sometimes call it, about 25% is levered. Twenty-five percent of our total portfolio is the leveraged amount and the rest is equity. With the leverage we get our income up into the 9% range, and then after

expenses brings it down to about 7.3%. As of year-end we were at 7.3%, was our net yield after expenses. We think that's fair for being conservatively positioned in the space, highly diversified and top managers.

CHUCK JAFFE: Because we're looking at interest rates are going up and higher inflation is lasting longer than expected, does that have any impact or potential impact on how you set expectations for the future?

ALEX CONDRELL: Let's talk about rising rates first. If it comes to pass, which is certainly not guaranteed, but if that happens it tends to diminish the value of fixed-rate assets, but ours are floating rate. So most of the borrowers, they can choose fixed-rate loans if they want, but the lenders are going to charge them, 3, 4, 5% more, so almost no one does. So it's really a floating rate universe of debt. So rising rates, if anything it's a modest positive. It's not really going to diminish like you would get with bonds and Barclays Agg, or treasury bonds or mortgages and fixed-rate corporates. The other question about inflation is sort of related to potentially rising rates, but it's also a business question. So we're lending to businesses, right? The major pools of debt are real estate and consumer, we're not really doing either of those, and then the third big one is corporate. This is a corporate exposure, so companies, if they have to pay more for raw materials or if they have to pay their employees more, and those two things are happening, then that can hurt their profit margin. And hurting the profit margin in general is not what you want to see. But what's been interesting is that companies have also raised the price of their own service and product to the point where for the most part profit margins have been stable, not diminished. In some cases profit margins are up, and so corporate earnings for many, many private companies are at all-time highs. So that's very positive from a credit standpoint. So could inflation bite into profit in the future? It could. At the beginning that's an equity story, that diminishes the returns to the equity investors. We are lenders, we just want to get our loan paid back. So if the company survives and pays us back then we're good. So for the most part, diminishment of profit margins is not what we want to see, but usually not a direct impact. But that hasn't even happened yet, and so whether it does happen, we'll see. We're not making any forecast of that happening, but we feel good that the strong economy, if it's sort of a demand-led inflation, that that in general is a good thing for credit, so we feel like this is a good environment right now.

CHUCK JAFFE: Alex, really interesting. Thanks so much for joining me on The NAVigator to talk about it.

ALEX CONDRELL: Thank you, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. That's me and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Alex Condrell, managing director at Cliffwater, which runs the Cliffwater Corporate Lending Fund, CCLFX. You can learn more about the fund at CliffwaterFunds.com and about the firm at Cliffwater.com. The NAVigator podcast is new every Friday, ensure that you don't miss anything by following along at your favorite podcast app, and until we do this again next week, happy investing everybody.

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