Corporate Direct Lending and J-Curve Mitigation

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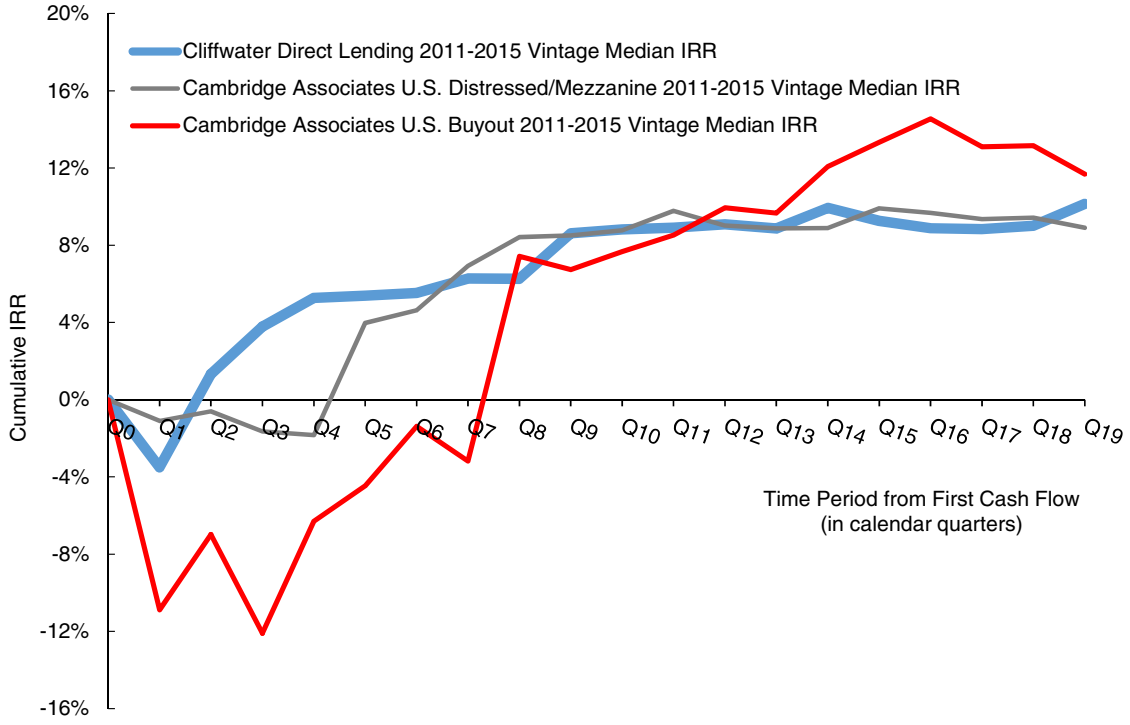
Building a private equity portfolio, or increasing current allocations, can frustrate investors due to negative or low returns in the early years of investment. This is known as the "J-Curve", attributable to upfront loading of organizational costs, management fees paid on undrawn fund commitments, and a lag in profit generation associated with growth oriented equity strategies.

Corporate direct lending funds exhibit little or none of the J-Curve characteristics found in other private closed-end funds because management fees are generally paid on invested and not committed capital, the investment pace is faster, thereby dampening the performance impact of organizational costs, and profit generation is immediate from current cash yield.

Research Results

Exhibit 1 displays cumulative internal rates of return ("IRR") for buyout, distressed/mezzanine and direct lending funds over a 4.75 year period, which is the time period for which direct lending fund data is available to Cliffwater.

Exhibit 1: J-Curves for Private Funds



The red line in Exhibit 1 represents the median cumulative (from inception) IRR for U.S. buyout funds, and is comprised of 2011 to 2015 vintage year data from Cambridge Associates. For example, vintage 2011-2015 U.S. buyout funds reported a -6.29% median IRR after one year and

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a 7.43% median IRR after two years. After four years, performance stabilizes at the 11% to 13% range that has historically been typical for U.S. buyout funds. The gray line in Exhibit 1 represents the median cumulative (from inception) IRR for a blend of U.S. distressed and mezzanine funds, and is comprised of 2011 to 2015 vintage year data from Cambridge Associates. As expected, the J-Curve effect is less significant, relative to U.S. buyout funds, with one year of negative returns. We believe this is likely due to the impact of some current income from mezzanine funds and a mix of funds with fee structures paid on committed capital and invested capital.

By comparison, the heavy blue line in Exhibit 1 represents the median cumulative (from inception) IRR for direct lending funds, and is comprised of 2011 to 2015 vintage year data from Cliffwater. Unlike U.S. buyout and distressed/mezzanine funds, the direct lending funds report a positive IRR within the first year, up 5.3%, and quickly achieve an 8% to 10% cumulative IRR after two years.

Study Methodology

Our calculation of the impact of the J-Curve in private funds is a comparison of Cliffwater direct lending fund data, Cambridge Associates U.S. buyout fund data, and a blend of Cambridge U.S. distressed and U.S. mezzanine fund data over the same vintage years. For each Cambridge Associates benchmark, the data is a calculation of the median cumulative IRR for each vintage year. Some data was not available for certain quarters in the Cambridge Associates benchmarks.

Cliffwater direct lending data comes from direct lending funds recommended by Cliffwater in which one or more Cliffwater clients have invested. The number of direct lending funds used to calculate the performance ranged from one to six funds depending on the time period, with data for more funds included in the earlier time periods (i.e., Q1 performance). For each fund, the data is calculated from the date a Cliffwater client first made an investment, which may not have occurred at the first closing of the fund[1].

For the Cliffwater and Cambridge Associates data, the quarters have been aligned so that the Q1 performance reflects the median first quarter of performance across the vintage years and the Q2 performance reflects the median cumulative first and second quarters of performance across the vintage years. This process was repeated for each subsequent quarter.

Conclusion

We show that private direct lending funds most likely display performance trajectories that differ from other private funds, with positive returns during early years, tapering to high single digit IRRs shortly thereafter. By contrast, U.S. buyout funds experience typical J-Curve negative IRRs in early years, working to low double digit returns after 4 to 5 years. U.S. distressed and mezzanine funds fall somewhere in the middle, experiencing a shorter J-Curve relative to U.S. buyout funds and working to high single digit or low double digit returns after 2 to 3 years.

Our findings are, of course, limited by the small data set used to construct Exhibit 1.[2] However, the findings are consistent with what we would expect is experienced in the general industry.

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[1] The J-Curve characteristics of these investments may have been different if the investments had been made at the first closing of the fund.
[2] Our data is limited by both number of vintage years and number of direct lending funds.

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The Cliffwater Direct Lending 2011-2015 Vintage Median IRR reflects the median IRR of a hypothetical model portfolio of primary investments by Cliffwater's clients, both discretionary and non-discretionary, in all 2011 to 2015 vintage year funds or accounts recommended by Cliffwater that use direct lending strategies and that Cliffwater designates as a direct lending investment. The IRR is net of (i) all underlying fund or account expenses, management fees, and performance-based fees and (ii) Cliffwater's actual fees, determined on the basis of allocation of Cliffwater's compensation to assets under advisement and by strategy. Vintage years are determined by Cliffwater generally based on the year in which a fund or account makes its first investment or capital call, including capital calls for fees or expenses. The IRR for each fund or account is calculated using the combined Cliffwater client daily cash flows and residual values for the investments included in the model. The residual values used in the model are the valuations reported by the sponsor and/or administrator of the fund or account. The IRR relies upon the accuracy and completeness of financial information provided to Cliffwater by such sponsors and/or administrators and the custodian banks of Cliffwater's clients and, therefore, Cliffwater has not conducted an independent verification of this information.

The hypothetical performance results of the model portfolio do not represent actual trading, and may not reflect the impact material economic and market factors might have had on Cliffwater's decision-making if it were actually managing clients' money. The actual performance of Cliffwater's clients may have been materially different from the results portrayed in the model portfolio. Past performance is not indicative of future returns, which may vary. Future returns are not guaranteed, and a loss of principal may occur.

References to market or composite indices (such as the S&P 500), benchmarks or other measures of relative market performance over a specified period of time (each, an "index") are provided for information only. Reference to an index does not imply that a portfolio will achieve returns, volatility or other results similar to the index. The composition of an index may not reflect the manner in which a portfolio is constructed in relation to expected or achieved returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility or tracking error targets, all of which are subject to change over time.

The Cambridge Associates U.S. Buyout benchmark is based on median horizon returns data compiled from U.S. institutional-quality buyout funds, including fully liquidated partnerships (if any), formed between 2011 and 2015.

The Cambridge Associates U.S. Distressed/Mezzanine benchmark is based on median horizon returns data compiled from U.S. institutional-quality distressed and mezzanine funds, including fully liquidated partnerships (if any), formed between 2011 and 2015. In Cliffwater's judgment, this benchmark is the available data set that is the most comparable to the Cliffwater direct lending data set for purposes of conducting a time series analysis.

Benchmark IRRs are net of all fund expenses, management fees and carried interest and are calculated by Cambridge Associates LLC using quarterly cash flows. Benchmark vintage years are determined by Cambridge Associates LLC based on the year a fund had its first cash flow. Thomson Financial Inc. is the owner and/or licensor of the Cambridge Associates LLC data contained or reflected in this material.

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