OUR CASE FOR DIRECT LENDING IN THIS MARKET ENVIRONMENT

By Ted Denniston

While the case for direct lending as an investable asset class can be made in most market environments, we believe it is especially strong now. The confluence of rising interest rates and current market conditions offers investors a degree of opportunity that in our opinion is timely and compelling.

Direct lending is the provision of loans directly to middle-market companies (i.e., those with annual revenues between $10 million and $1 billion) either with or without private equity sponsorship. These loans are not available via secondary markets or through conventional banking syndications and as an asset class, direct lending is a subset of the large and active private debt market.

As a focused participant in this asset class through many business cycles, at this time we think the higher yields, relatively lower risk, and return profile over the years position direct lending for strong consideration as a core component of institutional investment portfolios with a long-term focus.

The Appeal of Direct Lending

There are a few key reasons why institutions should consider an allocation to direct lending:

Big universe. The rationale is underpinned by the sheer size of the investable universe. According to the National Center for the Middle Market, there are nearly 200,000 U.S. middle-market businesses, comprising one-third of private-sector U.S. GDP. By comparison, there are only approximately 4,900 U.S. companies[1] with publicly traded equity.

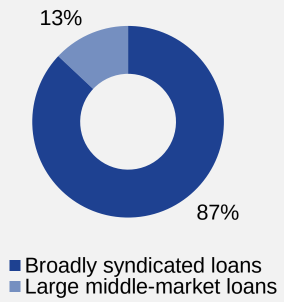
Strong risk profile. We believe loans to middle-market companies carry relatively less risk than those to larger businesses according to multiple metrics. One key factor is that the vast majority of middle-market loans—nearly 80%[2] —are well-collateralized senior debt.

1 https://www.statista.com/statistics/1277216/nyse-nasdaq-comparison-number-listed-companies/ Comparison of the number of listed companies on the New York Stock Exchange (NYSE) and Nasdaq from 2018 to 3rd quarter 2022, by domicile

2 As of September 30, 2022, 78% of the loans included in the Cliffwater Direct Lending Index are Senior

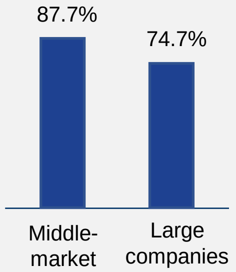
Middle-market loans have accounted for just 13% of leveraged loan defaults since 2007	Recoveries are higher for middle-market loans

Leveraged loan defaults 2007-2022



Source: Fitch U.S. Leveraged Loan Default Insight, January 25, 2023

Nominal recovery rates for first-lien term loans 1987-2022



*Data through September 30, 2022

Source: U.S. Recovery Study: The Bump in Post-COVID Corporate Debt Recoveries Starts to Fade, December 16, 2022

Chart 1.

Direct Lending Has Consistently Outperformed Bonds (annual % returns, 2005-2022)

Year	Cliffwater Direct Lending Index	Bloomberg US Agg	Cliffwater - Bloomberg US Agg Comparative Difference
2005	10.10	2.43	+7.67
2006	13.70	4.33	+9.37
2007	10.23	6.97	+3.26
2008	-6.50	5.24	-11.74
2009	13.18	5.93	+7.25
2010	15.79	6.54	+9.25
2011	9.75	7.84	+1.91
2012	14.03	4.22	+9.81
2013	12.68	-2.02	+14.70
2014	9.57	5.97	+3.60
2015	5.54	0.55	+4.99
2016	11.24	2.65	+8.59
2017	8.62	3.54	+5.08
2018	8.07	0.01	+8.06
2019	9.00	8.72	+0.28
2020	5.42	7.51	-2.09
2021	12.78	-1.54	+14.32
2022	6.30	-13.01	+19.31
Average	9.41	3.10	+6.31

Source: Cliffwater LLC

Chart 2.

Compared to large loans, senior lien middle-market loans have lower default and loss rates as well as higher recovery rates (Chart 1). In addition, middle-market loans do not trade in public markets, which in our experience means more stability and less volatility in pricing.

Portfolio diversification. Direct lending can be an effective portfolio diversifier, as correlations between middle-market loans and both equities and fixed income are desirably low. Since 2005, correlations with the S&P 500 and the Bloomberg US Agg have been 8.14%[3] and 3.1% (Chart 2), respectively.

Interest-rate and inflation hedge. As most middle-market loans have floating-rate payment structures, they can provide a hedge against rising interest rates and inflation and as a result, duration risk, can be reduced.

Yield premium. In our view, middle-market loans' illiquidity enables them to carry a significant yield premium versus larger loans and high-yield securities.

Outperformance. Ultimately, an asset class is only as useful as its performance—and in our opinion direct lending's performance has been stellar. Since 2005, the Cliffwater Direct Lending Index has outperformed the Bloomberg US Agg in all but two years, averaging 9.41% versus the Agg's 3.1% (see chart). It's worth noting that in 2022, a terrible year for bonds, the index returned 6.30% and outperformed the Agg by 19.31 percentage points.

If Timing Is Everything, We Believe Now Is the Time

Rising interest rates and the possibility of a more severe economic downturn have caused many investors to become more risk averse. Low earnings growth forecasts are impacting equity markets and tightening monetary policy makes it more difficult for companies to afford and service their debt.

Yet these same conditions can be favorable for direct lending. First, rising rates are positive for senior secured floating-rate loans. We are seeing unlevered yields on these loans currently in the 10%–12% range, similar to those from what the industry considers as riskier sectors. Theoretically, investors thus don't have to sacrifice credit quality to generate potential attractive returns.

As for the weakening economy, we believe it hasn't dented middle-market borrowers' demand for credit. This creates an unusually advantageous environment for investors, as lenders can usually obtain better terms for high-quality loans to solid companies that still have the need to borrow.

We are especially optimistic about the lower tier of the middle market, which we define as companies with annual EBITDA between $5 million and $35 million.

[3] As of February 21, 2023 https://www.wsj.com/market-data/quotes/index/SPX/historical-prices

From a lender's perspective, in our experience these companies compare favorably to the upper middle market due to their stricter financial covenants (upper-tier companies typically have few or no covenants) and more frequent financial reporting (i.e., monthly instead of quarterly). Both of these characteristics are particularly advantageous at a time of economic weakness by providing more protection and transparency.

Several other factors highlight our current conviction in direct lending:

Fewer lenders, better terms. Competition among middle-market lenders has dramatically fallen in recent years, as tighter capital requirements have forced most banks out of the market and large fundraisings have pushed many private credit managers to focus on making bigger loans. The non-bank lenders in the market who continue to provide loans to this segment are, by nature of supply and demand, able to negotiate better transaction terms.

Lower loan-to-value ratios. Rising interest rates reduce private equity sponsors' appetite for leverage, resulting in higher levels of equity in financings for middle-market acquisitions. With loan-to-value ratios near historical lows[4] lenders improve the equity cushion and desirability of the risk profile of the loan all else equal.

Abundant dry powder. Private equity firms had about \$2 trillion[5] in dry powder at the end of 2022. With the market for large-scale M&A activity subdued, these firms are looking more closely at putting some of that cash to work by buying middle-market companies and building platform businesses via add-ons.

Borrower optimism. Eighty-one percent of respondents to a 2022 National Center for the Middle Market survey[6] expected year-over-year revenue growth in 2023, the highest such level in at least five years. Respondents' average projected revenue growth rate, moreover, was 12.2%—just below the 12.3% all-time-record level at the end of 2021.

What a Good Manager Should Look Like

For institutions seeking to establish or increase exposure to direct lending, we feel it's critical to hire a manager who meets a number of key criteria.

Close sponsor relationships. We believe that working with private equity sponsors is the most effective direct lending model, as sponsors can provide deal flow, market insights as well as financial and operational support to borrowers and have a strong commitment to borrowers' success.

Expressed differently, we believe not working with sponsors can put lenders at a significant disadvantage.

Extensive experience. There is no substitute for experience in the direct lending business as highly seasoned managers can offer investors substantial benefits, notably the perspective gained from managing through all phases of the economic and credit cycles; long-term relationships with sponsors and borrowers alike; and the flexibility to develop creative lending solutions tailored to each borrower.

Team continuity. In addition to long experience in the business, direct lenders should have investment teams who have worked together for many years. Team continuity reinforces the lender's investment philosophy and process; builds trust with sponsors, borrowers and investors; and increases the credibility of long-term performance records.

Disciplined, consistent underwriting process. Direct lenders—and investment managers in any asset class, for that matter—cannot achieve and sustain success without being committed to an underwriting process that is formal, comprehensive, disciplined, consistent and well documented.

Multiple capabilities. A sound direct lender must have robust capabilities in multiple areas. In addition to underwriting, these include sourcing, due diligence, credit research, workouts and easy access to the broader spectrum of credit sectors and vehicles.

Successful performance. The bottom line for choosing a manager is the bottom line: a manager should have a long-term track record of delivering strong returns for investors.

In Summary

In our view, direct lending is an asset class with multifaceted appeal. It can offer a large investable universe, strong risk profile, potential portfolio diversification, a hedge against rising interest rates and inflation, attractively high yields as well as enviable comparative historical returns. In the current environment of high rates and probable economic downturn, institutional investors should consider these factors when considering an allocation to direct lending as a core, long-term component of their overall portfolios.

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[4] Refinitiv LPC's 4Q22 Private Deals Analysis
[5] S&P Global Market Intelligence December 21, 2022
[6] National Center For The Middle Market Year-End 2022

ABOUT ORIX CORPORATION USA

Since 1981, ORIX USA has served the middle market with creative and flexible capital solutions, delivering through a capital base that combines the strength of its balance sheet with funds from third-party investors seeking access to attractive alternative investments. With a focus on private credit, real estate and private equity, ORIX USA and its subsidiaries — ORIX Advisers, ORIX Capital Partners, Signal Peak Capital Management, Boston Financial, Lument and NXT Capital— have approximately 1250 employees across the U.S. ORIX USA and its family of companies have $85.5 billion in assets, which include $27.6 billion of assets under management, $47.3 billion in servicing and administration assets, and approximately $10.6 billion in proprietary assets, as of December 2022. Its parent company, ORIX Corporation, is a publicly owned international financial services company with operations in 28 countries and regions worldwide. ORIX Corporation is listed on the Tokyo Stock Exchange (8591) and New York Stock Exchange (IX). For more information, visit orix.com.

ABOUT NXT CAPITAL

NXT Capital, based in Chicago with over 90 professionals, is a leading provider of senior structured financing solutions to the U.S. middle market. Since inception to 12/31/2022, the company has originated approximately $27.6 billion in total direct lending financing volume spread over 1,080 transactions. NXT Capital also manages capital for third parties through its broad platform with multiple funds and separate accounts. Investment programs are managed by NXT Capital Investment Advisers, LLC, which is registered with the SEC as an investment adviser. Registration with the SEC does not imply a certain level of skill or training.

Loans will be arranged or made pursuant to a California Financing Law License. Lending/financing services provided by NXT Capital, LLC. Advisory services provided by NXT Capital Investment Advisers, LLC.

The Bloomberg US Aggregate Bond Index or "the Agg" is a broad benchmark index for the U.S. bond market. The index covers all major types of bonds, including taxable corporate bonds, Treasury bonds, and municipal bonds.

The Cliffwater website provides information regarding the yield and performance of the Cliffwater Direct Lending Index (the "Index"). This information is provided for informational purposes only and is provided as of the date indicated. This information is derived from sources that are considered reliable, but Cliffwater LLC ("Cliffwater") does not guarantee the veracity, currency, completeness or accuracy of this information. Asset Seniority is the composition by seniority of the assets included in the Index. Information is updated quarterly based on SEC filings.Inception is the annualized total return from the Sept 2004 start date of the CDLI.3 Year is the annualized total return over the preceding three year period.5 Year is the annualized total return over the preceding five year period.
10 Year is the annualized total return over the preceding ten year period.Yield is calculated by dividing quarterly interest income by average asset value, and multiplying by four to get annualized yield.Std. Dev. is the annualized standard deviation of Index returns, or Index component* returns, since inception.2008 Drawdown is the largest peak to trough percentage decline in value of the Index since inception. The drawdowns of the relevant Index components also are shown for the same period (Q3 through Q4 2008).* The Index components are income return, unrealized gain/loss and realized gain/loss.

The S&P U.S. Aggregate Bond Index is designed to measure the performance of publicly issued U.S. dollar denominated investment-grade debt. The index is part of the S&P AggregateTM Bond Index family and includes U.S. treasuries, quasi-governments, corporates, taxable municipal bonds, foreign agency, supranational, federal agency, and non-U.S. debentures, covered bonds, and residential mortgage pass-throughs.

Investors cannot invest directly in an index and does not include applicable expenses that would be incurred by investing directly with an investment advisor or investment vehicle.