Consensus at last: The market has matured

Guest comment by **Daniel Roddick**

A few years ago there were doubts about whether the credit secondaries market had become fully established. There seems little room for such a view these days

In December 2020, I wrote an article for *Private Debt Investor* titled 'The credit secondary market comes of age'. It's clear however that not everyone was on board with this notion – as recently as a year ago, I was asked to participate in an online debate asking, "Are secondary private debt markets finally coming of age?" where the very logic of a secondaries market in a self-liquidating asset class was being questioned. But I believe we are now building towards a consensus: the market has most certainly come of age.

Just as its proponents predicted, the market has evolved with all the expected traits of a mature asset class: portfolios are trading hands with a size and sophistication to match the private equity market, large LPs such as sovereign wealth funds are backing it, the number of specialist buyers keeps growing, advisers have set up dedicated teams, and it has finally become a mainstream topic at industry conferences.

But this growth has of course coincided with extreme volatility in the credit markets. So what effect has this had? What secondaries deals have been taking place and what have buyers been paying for them? I asked seven leading private debt secondaries investors about current dynamics and where they were pricing their deals.

In 2020 and 2021, GP-led deals accounted for the lion's share of the secondaries flow in overall private markets. But in recent months, a combination of reduced distributions, extended hold periods and the denominator effect have been putting investors under liquidity pressure, which in turn has led to an increased flow of LP stakes. Since for the first time there is now a large, dedicated buyer universe with an appropriate cost of capital to accommodate this flow, we are now seeing auctions comprised solely of private debt funds. In fact, we understand that many sellers are prioritising the sale of their debt funds over PE given that a credit fund will typically trade at a lower discount to NAV.

According to Pierpaolo Casamento, head of private debt secondaries at Tikehau Capital: "We believe credit LP-led transactions, as opposed to GP-leds, offer a more attractive relative value in the current environment."

Andrew Carter, head of private debt secondaries at JPMorgan Asset Management, adds that while recent market volatility has led to wider pricing, the development of a dedicated private debt buyer universe makes it much easier for a seller today to receive a fair price. "The establishment of dedicated credit secondaries buyers as an outlet for shares of these funds is leading to significantly better pricing than was possible even five years ago," says Carter. "Back then the only potential buyers were those focused on equity-like returns without an investor base that appreciated the attractive characteristics of credit secondaries as an asset class."

Spectrum of pricing

So how are credit secondaries transactions being priced in today's market? According to data from Greenhill, on an aggregate basis, pricing for credit fund stakes was at 83 percent of NAV in 2022. This is consistent with the consensus among our surveyed buyers, who told us they see deals at around the mid-80s mark on average. However, the investors we spoke to were keen to

point out that this includes everything from distressed credit funds to mezzanine, opportunistic and direct lending funds. Riskier assets could be priced as low as the 60s, while the high-quality senior funds tend to be priced in the 90s.

According to Anselm Feigenbutz, portfolio manager at Allianz Global Investors: "The mid-80s price point average is across the risk spectrum, including both unitranche and special situations. Unitranche portfolios with some level of concentration or overall lower portfolio quality are often priced close to the mid-80s price point, while mature portfolios from high quality GPs with current credit metrics are priced rather in the 90s range."

Timing makes all the difference

The other theme that came up in discussions with secondaries investors was the differentiation between the reported discount and the effective discount. Since there is a lag between the reference and closing date, buyers and sellers usually agree standard adjustments where the price is lowered by any distributions and increased by any drawdowns. Unlike in PE, most debt portfolios throw off regular interest payments so the lag between reference date and closing can have a material difference. In crude numbers, if a portfolio was yielding, say, 10 percent, a six-month lag between reference date and closing date gives the buyer an effective additional 5 percent discount.

This lag is a tool commonly used by buyers to match a seller's optimal price expectations. As Toni Vainio, a London-based partner focused on private debt secondaries at Pantheon, says: "A longer lag between reference accounts and closing, as well as purchase price deferrals, are ways we commonly structure our deals when a prime objective of the seller is to minimise the reported discount to the reference NAV."

Our surveyed buyers also said that in other situations, sellers have been more focused on immediate liquidity, accepting a lower price if buyers are able to complete their execution and close the transaction quickly.

Still a place for GP-led deals

Although the lion's share of the flow has been LP sales, a number of buyers told us that GP-leds still have an important role in their strategies. A continuation fund transaction, for instance, tends to be more bespoke with stronger LP/GP alignment. The fee and carry are typically lower than in the primary market, and the buyer usually has more scope to diligence the assets in partnership with the GP.

Sebastien Burdel, partner and co-portfolio manager of credit secondaries at Ares Management, says: "In a market where refinancings and exits have materially slowed down, GP-led transactions are a tool that credit managers are increasingly turning to in order to generate liquidity for their investors or free up re-investment capacity for their existing funds." Burdel adds that "the allocation issues currently faced by many LPs mean that managers who are proactive about freeing up their investors' capital and finding creative ways to generate dry powder may be rewarded".

No more growing pains

So what do we make of private debt secondaries in this current market? Firstly, while the flow of LP stake sales has put some downward pressure on pricing, we need to look beneath the headline numbers to really understand the dynamics of the market. In these volatile times, investors have oriented themselves towards higher quality senior assets where pricing has held up in the 90s, while portfolios perceived as riskier could be priced 20-30 points below that.

Secondly, buyers have adapted to the needs of sellers. There has been an increased use of deferred structures to minimise reported discounts, while other sellers have accepted a higher discount in return for immediate liquidity.

Finally, while the figures appear to be currently skewed towards LP-led deals, GP-led deals will continue to be an important part of the market as private debt managers actively manage the liquidity of their funds.

Overall, while recent economic volatility has been a test for this relatively new market, the surveyed investors certainly agree it has now proven itself. It has grown up. It has come of age. ■

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