KEYNOTE INTERVIEW

Private debt secondaries: A fast-emerging market

For LPs looking to diversify, the secondaries debt market presents some tempting opportunities, say Pantheon's Francesco di Valmarana and Toni Vainio

Private debt primaries are a staple of any LP's alternative asset portfolio, and now investors are narrowing focus to an expanding market niche: private debt secondaries. According to Setter Capital, in the first half of the year, the volume of private debt secondaries reached an eye-catching $2.2 billion completed transactions, up from $580 million the year before.

This surge of almost 280 percent far outstrips rising secondary volumes across the private asset spectrum, where $46 billion of transactions in the first half of 2019 signals another record year, according to Setter.

We asked Pantheon partner Francesco di Valmarana and principal Toni Vainio what is fuelling this momentum.

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Q How would you describe the market for private credit secondaries in terms of size and maturity?

Francesco di Valmarana: It is a market in rapid development. It maps almost directly to primary fundraising three or four years ago and already exhibits the characteristics of the more mature private equity and infrastructure secondary markets, notably a shift from heavily LP-led to including more GP-led processes. The more mature fund positions tend to be larger US vehicles, but we are seeing more European transactions by virtue of fund vintage. The type of fund stakes in the secondary market has also changed from, give or take, 80 percent of subordinated, mezzanine, distressed and turnaround to 50-60 percent senior debt.

Q Given direct lending positions are typically short-dated, self-liquidating loans that pay a coupon, why would an LP sell?

FV: We see a similar dynamic to the other secondary markets – LPs are not being forced to sell but are choosing to sell. There are very few distressed sales, instead, it's high-level portfolio management. LPs that are seeking to manage factors like cashflow and exposures are paring their holdings, or reducing excess exposures, while for others it maybe a reaction to merged programmes or a chief investment officers switching strategies, like moving from an indirect to a direct model. We've seen the evolution of a secondaries market first in private equity and then in infrastructure debt. In that context, there's no reason you wouldn't see a similar dynamic develop in private debt.

Toni Vainio: The other way to think about it is, with any private illiquid asset class where investors are committing themselves for seven to 10 years, there's around 1-2 percent annual churn in the LP base. Where there is strong primary private fundraising activity, the natural consequence of that is a secondary market, where 1-2 percent AUM per annum is changing hands.

As well as LPs, we're also seeing private debt GPs being more active in the way they manage their portfolios. All the techniques and tools being applied in private equity can also be applied to private debt. A GP may have a tail-end fund at its seven-year expiry still holding a number of loans, or wish to accelerate liquidity to their investors. As funds become more mature that's a natural thing for a GPs to want to manage out.

Q So, who are the buyers of the secondaries?

TV: Historically, the buyer universe is private equity-focused secondaries funds and existing investors that want to top up their exposure. From a solely private debt secondaries perspective, a limited amount of dedicated capital has been raised compared to the opportunity that's out there.

It makes sense for those LPs embarking on a private debt programme that may want more diversification and yield from day one to invest in private debt secondaries, where there are potential discounts, deployment can be accelerated and greater diversification can be achieved. It can also be a useful way for investors to complement an existing programme that's more direct in nature.

Q Are the risks in private debt secondaries more complicated to understand than those of private equity secondaries?

TV: As a private equity investor, you are looking for upside potential and those two or three companies that are going to drive outperformance. As a private debt investor, you are thinking about downside risk and keeping an eye out for those two or three loans that could deteriorate. You're thinking about whether you will recover the cost and principal on those loans. In a typical direct lending fund, a single loan concentration can represent up to 10 percent of a fund. In a private debt secondaries fund, the single exposure risk should be lower because of the diversification you get across GPs, funds and loans.

FV: Many subordinated debt, mezzanine and special situations funds are incredibly opaque, and the risks are much more difficult to understand than a private equity fund. With senior debt, it's easier to get comfortable with the downside risk. If a company is performing to plan, amortising its debt and has a lot of headroom, then it is easier to make sense of the risks.

Q Where do you see opportunities in this space and how do you go about getting exposure to them?

TV: Our key sourcing methodology is to speak with private debt GPs, explain to them the types of transactions available and position ourselves as a preferred partner, either as an LP replacement or as a solution in a tail-end situation or a strip sale of loans. We also work very closely with intermediaries to ensure that they show us debt transactions. This could be a mixed asset class portfolio of 10-30 funds that includes, say, up to five debt vehicles, which we might acquire as part of a mosaic bid. The third strand is speaking directly with LPs about rebalancing their portfolios and acting as a replacement LP for them.

FV: To date, private debt funds have generally been sold as part of broader private equity secondaries portfolios, principally because the immaturity of the market hasn't warranted private debt being broken out. However, these funds have typically attracted a higher discount because of their lack of upside, particularly for senior debt. As secondary buyers, we are able to bid at a price more in line with the expectations of a debt buyer [rather than a private equity buyer], which improves the pricing of the overall portfolio for sale. This benefits both the vendor and the intermediary.

Q How liquid is the market – how easy is it to find deals?

FV: There's a growing amount of dealflow in the market, which is a derivative of the growing volume of primary fundraisings and has a familiar profile to private infrastructure and private equity secondaries in terms of legal structures and transfer documents. The big difference is the lack of familiarity of the private debt GP universe with the players in the secondary market and with the way it functions. We spend a lot of our time proactively reaching out to GPs and explaining to them how we see the private debt market maturing and how we can help them get ahead of the curve in terms of proactively managing secondary processes and anticipating the issues involved.

Q How easy is it to come to a price?

TV: There's a bifurcation between private debt managers regarding reporting detail. In general, the information provision on distressed debt funds is not typically as robust and transparent as those in direct lending where the reporting on a line-by-line basis regarding yields and key financial metrics is easier to diligence. This is why it is so important that secondary buyers should have access to GPs who can walk them through their portfolios to enable them to analyse potential risk and upside.

Q Which part of the market are you targeting?

TV: In line with Pantheon's overall investment platform focus, we're looking at funds in direct lending primarily in the small and mid-cap buyout space. In general, these managers have historically received a return premium and benefited from more robust financial protections from a covenant perspective than at the larger, syndicated loan end of the private debt market.

FV: In general, we're looking to see that these aren't syndicated loans. In a mid-market deal, GPs are much more likely to be a sole lender [to a business], meaning that should things go wrong they are in control of the security and so investors are typically better protected. Rather than having to try and get seven or eight people [in a syndicated deal] to agree on a way forward, the lender is in control of its part of the capital stack, and we like that control dynamic.

"Back in 2008 there were around 30 GPs in the direct lending space, now there are more than 350"

280%

Rise in private debt secondaries in H1

Q The primary market is packed with new managers. What does that mean for the secondary market in terms of risk?

FV: We're sitting at the back end of a nine-year bull market where every manager who comes to you shows you a 10-year track record with a very low default rate. That makes diligence and market mapping difficult, especially for investors new to the asset class. That's the key risk. You need to be able to differentiate between the groups that have set up shop in the past five years and don't have much expertise, and those that have experience managing a downturn. It's the same way we look at first time funds in private equity. We need to be sure that they are not going to be learning on our clients' capital.

Q What is your view on a possible downturn and how prepared are private debt investors to deal with it?

TV: In terms of leverage ratios, we're at or close to the peak seen before the financial crisis. In the mid-market, the leverage ratios tend to be a turn or so lower than at the larger end so that should mitigate some risk. Back in 2008 there were around 30 GPs in the direct lending space, now there are more than 350. Not all of them will survive a downturn to the extent the default rates are high and recovery rates on the loans are not. GP quality and resilience are important to us when we're looking at backing a secondary investment.

Q Are you concerned about default rates?

FV: Naturally. But primarily because for the past nine or 10 years we haven't seen a real default environment. A number of private debt franchises particularly the younger ones, haven't navigated a crisis before; inevitably for some there will be lower recovery rates. There is a lot of discussion around the benefits and drawbacks of covenant-light structures. Certainly, one of the dynamics of being in a covenant-light structure is that you tend not to have the warning signals that would allow you, as the lender, to step in and begin to address the capital structure ahead of a full default. The risk is that everything will look fine until it doesn't. And then it really doesn't. ■