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Secondaries entice private credit investors as pandemic rocks market

Private credit funds and holders of private credit assets are increasingly looking at secondary-market sales to raise liquidity in the face of COVID-19 pandemic market dislocation, and volatility has already increased the opportunity set, sources say.

“In 2019, we saw $9.2 billion in private credit secondary volume, which is almost 2x the amount of transactions which were reported,” said Rakesh Jain, global head of private credit at Pantheon. Pantheon is a private equity, infrastructure, real assets and credit investor with roughly $47 billion in assets under management.

“Of the private credit secondary transactions we saw in 2019, ~60% was in senior/direct lending, with the remainder of ~40% spread across mezzanine, niche, special situations, and distressed (LP interests and asset deals) strategies or assets. On an annualized basis, we are looking at an increase of approximately 40% for 2020."

Private credit secondaries include sales of fund stakes in private credit portfolios and investments in all or part of loan portfolios.

Virus-related uncertainty has transformed the private credit market. As borrowers suffer low-or-no revenues, sponsors and lenders are working together to keep portfolio companies alive. Lenders have offered liquidity in the form of new revolvers. PE funds are writing checks in some cases. Conversations between the two sides will likely be more difficult in the second quarter, when the impact from shutdowns will be more severe than in the quarter ended March 31.

This will likely result in more secondary-market opportunities, of both fund stakes and loan portfolios.

“The opportunity set is already widening significantly for private credit secondary investments—from senior secured to more opportunistic investments,” Jain said.

“While secondaries are a ‘four seasons’ strategy—opportunities exist irrespective of the economic environment—dislocation in today’s markets has heightened the need for liquidity and capital solutions for assets across private credit. We are seeing increased deal volume from limited partners seeking to manage their alternative asset allocations, and balance their liquidity needs in the face of increased capital calls and reduced distributions,” Jain said.

“We are evaluating a range of opportunities to provide liquidity directly to portfolio companies and portfolios of assets as well as GPs looking to de-lever their fund structures or solutions to manage portfolio constraints.

Given the supply/demand imbalance of capital in private credit secondaries, we can be more selective in the opportunities and managers we consider, with our objective being to achieve better return outcomes potentially driven by higher discounts/lower purchase prices, among other factors we would ordinarily assess as part of our analysis."

As private debt defaults increase, LPs may choose to adjust allocations to the asset class. The secondary market may provide needed exits for hundreds of billions of capital of LP interests locked in private debt.

Driven by changes in banking regulations after the 2008 crisis, coupled with low interest rates, private debt exploded as an asset class over the last decade or so. Between 2009 and 2012, $158.2 billion was raised for private debt strategies, according to Pitchbook. From 2014 to 2019, roughly $700 billion of capital was raised for private debt strategies.

Today, private credit is a staple in alternative investment portfolios. In aggregate, private debt funds had $276.5 billion in dry powder as of end-2019, and managed over $700 billion in assets.

As the asset class developed, it transformed middle market lending. Direct lending funds, a subset of private debt, have raised $336 billion since 2010. As a result, in middle market lending, directly originated loans have become a key source of liquidity, at the expense of syndicated solutions, as borrowers and sponsors opt for the simplicity of one lender.

As private credit has matured as an asset class over the last decade, private credit secondaries funds have starting to emerge.

This isn't a surprise as the private equity asset class followed a similar trajectory. As fundraising levels continued to increase in private equity, the necessity for liquidity and private equity secondaries opportunity grew. According to PitchBook, in 2006 PE secondaries funds managed only $65 billion in assets. At the end of 2019, PE secondaries funds managed $246 billion.

"Over the last five years, we estimate that the turnover rate in credit funds, has increased approximately 4x, from less than 1% in 2015," said Jain.

"In conjunction with increased volumes of single LP and single asset deals, we have seen and sourced a significant number of GP-led transactions that are seeking to address liquidity and portfolio constraints as well as access new capital." — Shivan Bhavnani

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