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Denominator effect expected to drive LP-led private debt secondaries

by Michelle de'Souza

Institutional investors are expected to engage in rebalancing trades to counter the 'denominator effect', a move that should lead to an increase in private debt secondary trades. So far this year, limited partner-led deals have formed the bulk of private debt secondaries deal flow, mainly from investors needing liquidity as a result of the coronavirus pandemic.

Vainio: ' it takes some time for sellers to emerge'

The denominator effect comes into play when asset allocators have diverse portfolios purposely weighted towards specific assets. In a sell-off, these weightings can go off-target as some assets depreciate to a greater extent than others. In this case, investors need to sell some assets in order to get portfolio weighting back on track.

"We saw this in the last global financial crisis: it takes some time for sellers to emerge," says Toni Vainio, partner at Pantheon Ventures. "Investors will wait for the Q1/Q2 2020 marks to see where their portfolio really stands and, at that point, they may decide to reduce exposure or sell funds that they have been disappointed by or in which they feel they have more risk than they are comfortable with."

There have so far been a few motivated sellers but more rebalancing investors are expected to come to the market in the second half of the year.

Private debt holdings can be an attractive sell, given that some private equity holdings command a higher discount than debt holdings.

Funds with 2015-2017 vintages are typically being sold, sources say, but some investors have wanted to release some of the unfunded commitments that have not been drawn, so there have been a few 2018 or 2019 vintage fund transactions. (If an investor has made a new commitment to a new fund, but had a denominator effect, instead of selling an older fund that has a high NAV and taking a discount, an investor may want to sell funds that are less mature, to release some unfunded commitments.)

On average, it is estimated that around 20-30% of businesses have had some material covid-19 impact across the direct lending industry, sources say. The first valuation hits should be in the equity holdings – sponsors are quite likely to continue to support the businesses through the liquidity crisis, which will buffer any impact that direct lending funds may suffer.

"Dentistry chains are good examples of businesses a sponsor is likely to support," Vainio says. "People still need the dentist – so there's a pent up demand. Those companies are more likely to receive follow on funding support from sponsors."

There may be more question marks around other sectors including restaurants, hospitality, where general partners expect a recession or longer recovery period.

Preferred equity deals where secondary funds are injecting capital into funds to support existing business has also picked up - both for defensive (liquidity) and offensive (buy and build opportunities can be quite attractive from a valuation perspective) purposes.

"Private equity firms are looking for additional capital where the existing funds no longer have sufficient unfunded commitments to support the businesses or do add-ons, and we expect a similar trend in debt funds," says Vainio. "Direct lending GPs [general partners] may have funds that are out of capital and may require some preferred capital solutions to enable them to support existing portfolio companies they've lent to."

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