EXPERT Q&A

As a range of institutional investors and GPs start using the secondary market to manage portfolios, further growth is on the horizon, say Rakesh 'Rick' Jain and Toni Vainio of Pantheon

Private debt secondaries: An evolving opportunity

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Q How would you describe the private debt secondaries market in 2021 and what are the key themes you are seeing so far in 2022?

Rick Jain: The main theme is that dealflow is strong and growing. 2021 was another record year in terms of deal volume for our business, up about 20 percent versus 2020. This was driven by a growing market recognition that private debt secondaries can be an effective tool to manage liquidity and portfolio construction, especially for LPs. Growth in our deal volume and closed investments was also a function of our growing capital base, which can target both US and European opportunities across all strategies. The early part of 2022 has also been marked by significant LP dealflow and a number of liquidity solution opportunities in partnership with GPs.

Toni Vainio: What is front of mind with regards to the current macroeconomic situation is how potential interest rate increases are going to affect the ability of borrowers to pay their interest and how inflationary pressures are going to affect the margins of businesses and their ability to pay.

On the one hand, because this is a floating rate investment, we should see better yields going forward, but on the other we can potentially also anticipate more losses and defaults based on company performance. The beauty of being a secondary buyer is that you can look at portfolios and identify those that should do better in this environment in order to potentially achieve a higher yield for your investors.

Q Who are the sellers of secondary interests on the LP side, and why?

RJ: LP sellers are as varied as the investors in the asset class. They include pension plans, endowments, asset managers, insurance companies, banks, as well as high-net-worth individuals and family offices. They sell for a variety of reasons, which may include the need to better manage portfolio construction, eliminate unfunded exposure, address regulatory pressure or to lock-in performance. Some sell because they are strategically going in a new direction and some are looking to trim the number or style of manager they are invested in. Going forward, we expect to see more non-traditional selling counterparties given the proliferation of various alternative investment vehicles entering private credit.

TV: On the LP side, occasionally you have some highly motivated sellers who need liquidity, but more often than not the rationale is around rebalancing portfolios in response to team changes or changes to asset allocations decided at board level. The secondary market is becoming a normal route to rebalance one's portfolio and the turnover rate of assets under management is increasing year-on-year.

At the GP level, pressures around fund terms and funds reaching maturity with quite large portfolios left means managers are looking for proactive ways to manage assets with the help of the secondary market. There is also always an element of denominator effect in the secondaries market, whereby if public markets are falling then illiquids increase as a percentage of portfolios and some investors sell to rebalance their exposure.

Q Why are investors turning to credit secondaries?

RJ: Private credit investors generally fall into two categories based on their return objectives: those focused on stable, consistent yield and those that desire higher-returning/opportunistic strategies.

We believe that credit secondaries achieve these objectives with a number of attractive benefits. Investors obtain access to highly invested portfolios immediately, high levels of diversification across numerous factors (company, industry, strategy, vintage year), attractive credit metrics and shorter durations than what they might experience with other private credit investment options.

Investors also like that we can provide a range of liquidity and creative solutions to both credit GPs and LPs, which creates more sourcing and selectivity of investment opportunities. We see an increasingly high level of interest in credit secondaries from investors – we've grown from a standing start in 2019 to approximately $3 billion of AUM today.

TV: One of the overriding drivers of dealflow is just the size and scale of the private debt market, with not only illiquid closed-ended funds but also separately managed accounts and investors in vehicles like BDCs, both public and private, currently driving a turnover rate of assets under management of between 1 and 2 percent just on the LP side. You also have significant activity on the GP side that falls outside those figures.

Q Why and how are GPs using the secondaries market to manage their credit portfolios and balance sheets?

RJ: GPs are increasingly looking at a range of liquidity solutions in partnership with capital providers such as Pantheon – half of our closed investments have been in this category – so, a partnership orientation and significant experience is important.

Because GPs manage assets across a range of vehicles – everything from closed-end funds, SMAs, levered/unlevered, evergreen, offshore/onshore – you can sometimes get a mismatch of objectives between GPs and LPs and a mismatch in fund/portfolio management.

This complexity and the need for a partner – who can underwrite, price, structure and negotiate an investment – has driven GPs to seek any number of solutions to address these unique circumstances. Some of the investments we have completed include acquiring portfolios of loans from legacy vehicles into an SMA (whole or strip loan sales), providing capital to deleverage and support portfolio growth with new capital, and creating continuation funds to better align portfolio management and GP /LP interests.

Q How do you expect the secondary market for private debt interests to mature and develop? What will this space look like in five years?

TV: Current assets under management in closed-ended credit funds are estimated to be around $1.2 trillion. If you add in BDCs and separately managed accounts it is substantially more. Some sources suggest that could double in the next five years, so the secondary market being a derivative of the primary market could also double or even see a higher level of growth given the potential for an increasing turnover rate and more GP-led solutions.

Within a growing private credit market, we expect secondaries to be an important tool for the large and growing number of investors coming into the asset class to rebalance their books.

RJ: The macro environment for credit secondaries will continue to be favourable and we expect continued growth. There are thousands of credit managers operating globally and the trends to private credit assets under management formation are positive.

The GP side alone is vast and under penetrated – expertise and specialisation in credit, a partnership orientation and transaction experience are important factors for success. Manager consolidation and ownership transition is already underway and will be another tailwind to credit secondary dealflow and investment opportunities. ■

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