

E X P E R T Q & A

As the private debt secondaries market expands on the back of a fast-growing primary market, the number of dedicated secondaries funds is set to increase rapidly, says Paul Buckley of FIRSTavenue



Market appetite increases for dedicated players

Q How has the private debt secondaries market grown and developed over the last year?

What we are seeing in private credit secondaries at the moment is the raw material for credit secondary trading opportunities has grown to a level of critical mass. That comes in three ways. First, the private debt market is now worth about \$1.2 trillion, and that understates it because it doesn't include separately managed accounts. Two-thirds of that market is invested capital and the rest is dry powder, so there's at least a \$1 trillion private credit market from that which can now already transact secondaries.

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Credit also comes in two other forms: credit hedge funds and event-driven hedge funds, and also listed and unlisted vehicles, including business development companies (BDCs), structured credit and so on. So, the overall opportunity in credit secondaries is across all three of those asset classes – private credit, credit vehicles and hedge funds – and is likely now to be about \$2.5 trillion in size. That raw material creates a lot of trading opportunities and huge potential for growth in the secondaries market.

The challenge is that most of the capital out there dedicated to acquiring secondaries is focused on private equity secondaries. Roughly \$500 billion has been raised to invest in secondaries but most of that is focused on private equity secondaries where investors are looking at 15-20 percent internal rates of return. In credit secondaries, investors can only identify seven or eight dedicated funds and those are targeting 10-15 percent IRR. That is currently a constraint on growth but we still expect to see the sector expand exponentially over the coming years.

We are aware of Pantheon, Collier Capital, Landmark Partners, Tikehau Capital, Star Mountain Capital,

Dorchester Capital Advisers and Apollo Global Management as players with dedicated credit secondaries funds. That number could easily quadruple and still not be enough to cope with the growth of the market.

Q What have been the key innovations and what further evolutions do you expect to see?

There are all sorts of transactions taking place. The reason the private credit secondaries market is going to grow so rapidly is that the private equity secondaries market provides an established blueprint and the market infrastructure for that growth. There are lots of specialist buyers out there, the lawyers are well versed in how to handle the transactions, and both the LPs and GPs have experience in private equity secondaries and the capability to switch that into credit.

A lot of the transactions are going to involve LPs looking to liquidate positions, as you would expect. Then, in the private equity market over the last year or two, we have seen a real growth in GPs seeking capital solutions in the form of continuation funds or other GP-led secondaries. Those are probably less well known in private credit but there will be other ways that GPs seek to restructure and access the secondaries market.

We see strip sales coming into vogue, where someone sells a slice of a portfolio, and also people transacting not the funds but the underlying credit instruments in order to get out of certain parts of the market, like fossil fuels credit.

The real innovation is only going to occur when you have more dedicated, focused buyers and we expect that to be the case in the next year or two.

Q What types of secondaries are now most common, and what do fund managers and investors hope to achieve from the secondaries market?



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The most common are limited partners selling their fund stakes as part of portfolio reallocations and general partners restructuring their funds in the context of over-exposure to different sectors. Then there has been some activity in the stapled secondaries space, where in order to raise money for the next fund the GP finds opportunities to sell off interests in the prior invested fund and asks buyers to also make a commitment to the new fund being raised.

Q Is there any common thread in terms of types of investor most likely to turn to the secondaries market?

If you broadly look across the private credit markets there are two types of investors. There are those that invest in direct lending funds as a fixed-income alternative, and those that invest in special situations credit funds who are really looking for a public equity alternative.

The private credit secondaries market offers the opportunity for both, with the opportunity to acquire direct lending portfolios to establish a broader proposition than just going into a blind-pool fund, with more visibility over the underlying assets in the

portfolio. The idea that you can put money into special situations through a credit secondaries fund while first seeing into the portfolio of the primary funds also offers a great opportunity.

Putting money into a dedicated private credit secondaries fund can generate anywhere from 10-25 percent IRR, meeting all the absolute risk-reward appetites of a wide range of investors, which is what is so exciting. There is \$500 billion sitting in private equity-focused secondaries funds and within five years you could well have \$100 billion earmarked for private credit secondaries. For now, it is in its infancy and we have had a very benign credit market with central banks flooding the world with liquidity to keep everyone solvent. When that goes away, we will start to observe a much more diverse spread of private credit performance and that will further stimulate activity in the secondaries market.

Q How are valuations of secondaries looking currently, and do they differ greatly from one type of strategy to another?

In private equity secondaries the market has developed so much that portfolios

are now sold and GPs are now restructured through formal processes. What is interesting about private credit secondaries is none of those processes are yet in place, so when a portfolio is transacted the investor audience often doesn't have the skill set to really value the credit. Those emerging dedicated funds have the capabilities to price credit in all its forms, but many potential buyers are yet to build up those capabilities.

Associated with that, acquirers are buying secondary credit assets at discounts of 15-30 percent and that scale of discount is now unheard of in private equity.

Q Have you seen much private debt secondaries fundraising? What makes investors more or less likely to commit to these funds?

We advised on Collier Capital's recent private credit secondaries vehicle, Collier Credit Opportunities I, which was the world's largest pool of LP capital dedicated to private credit secondaries when it closed in February 2022. We are also now about to bring to market Dorchester Capital's sixth private debt secondaries fund. Investors are attracted to those opportunities in credit because they are getting portfolio transparency and wider spreads. Add to that the fact that the funds are already deployed and so there is a very limited J-curve and all of that is very attractive to investors.

Q Do you expect the private credit secondaries market to essentially mimic the more mature PE secondaries market? Or does it have distinctive features?

As the underlying markets grow, these asset classes tend to stratify. All the main asset classes have seen a diversification of strategies available to investors and a deepening of the available capital pool for those sub-strategies. Private equity is in the lead on that, but the trend is clearly going to be replicated elsewhere

and we are starting to see that in both private credit and infrastructure.

What is different in private credit is that the universe expands to include hedge funds and other types of credit vehicles. Illiquid credit, which is the raw material you need for secondaries markets, comes in three formats, and therefore GPs are going to have to originate with an ability to source across all three of those. That makes credit secondaries a tough market to enter.

Most of the current players have a focus on private credit and some of them in defined areas of private credit. In theory they can all do credit vehicles, but they are largely all absent from the hedge funds space, with the exception of Dorchester which we believe has something of a USP there.

Q Will the market evolve in a similar way across different regions, or do investors have different expectations?

This market is neither European nor American, it's a global market so both European and US hedge funds, credit vehicles and private credit markets have grown in tandem. There is very little emerging markets credit so the focus is really just on those two principle geographies.

To date there has been only a handful of these private credit secondaries funds coming to market, so investors have had very little exposure to them. But we expect investors to get really interested in this as an asset class, attracted by the enhanced returns on offer and the ability to get that additional transparency into credit portfolios. Those who can get comfortable with credit opportunities will have everything they need to make investments into credit secondaries funds, and it is likely the market will draw in capital from other areas as it continues to expand. ■

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