2024

First the worst, Secondaries the best?

The Case for Private Credit Secondaries

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From clothes and cars to computers, the demand for second hand goods has risen over recent years. However, this shift in popularity is not limited only to what you can buy on eBay, this phenomenon has made its way into financial markets.

Since the Global Financial Crisis, Private Credit has expanded and matured significantly, which has led to an increased range of strategies developing. In recent years, with rising interest rates and increased regulation we have seen Private Credit mature even further, and become much more attractive. We explore this in more detail in our recent paper titled "Private Credit - Why now?"

As a result of the Private Credit market maturing, we have seen its secondary market develop substantially. This follows the footsteps of other private market asset classes, e.g., Private Equity and Real Estate both of which have established secondary markets. In recent years we have also seen an increased need for investors to rebalance portfolios due to liquidity constraints and the 'denominator effect', as public assets have decreased in value.

Against this backdrop, Private Credit Secondaries has become a very attractive investment opportunity given the potential discounts and return profiles. This paper aims to explain the dynamics of private credit secondaries, including their current appeal within the market and the underlying benefits for investors.

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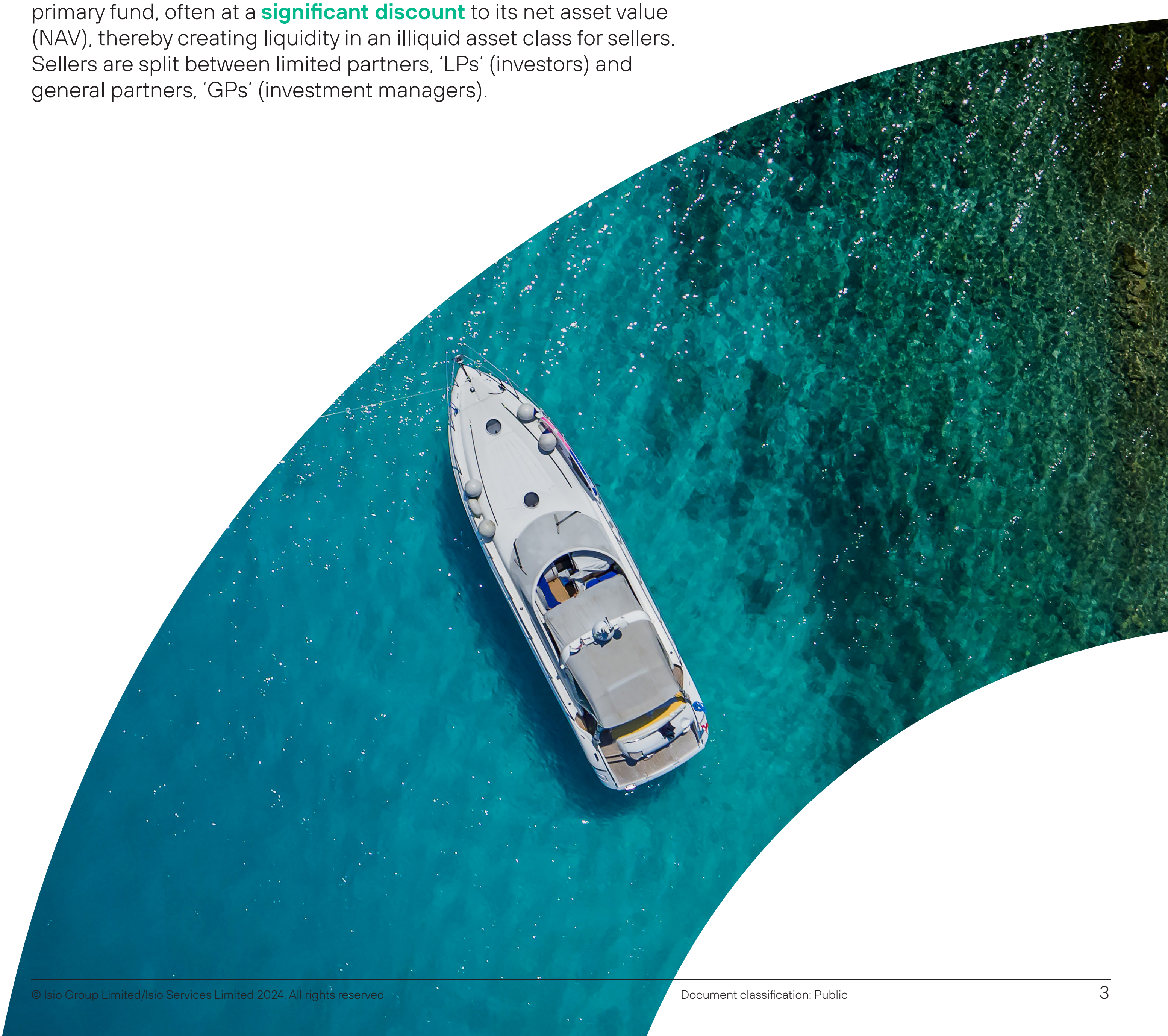
What are Private Credit Secondaries ("PCS")?

In the 2000s, we saw a boom in private equity secondaries, as investors looked to obtain liquidity from their stakes private equity funds, and investment managers being able to purchase these funds at a discount. Private equity secondaries is now a well-developed and large asset class in its own right.

Direct lending (private credit) has flourished since the global financial crisis and as it has developed, so too have opportunities for investors to engage in private credit transactions via a **secondaries mandate**, following the footsteps of the private equity market. This involves a buyer (typically an investment manager) purchasing stakes in a primary fund, often at a **significant discount** to its net asset value (NAV), thereby creating liquidity in an illiquid asset class for sellers. Sellers are split between limited partners, 'LPs' (investors) and general partners, 'GPs' (investment managers).



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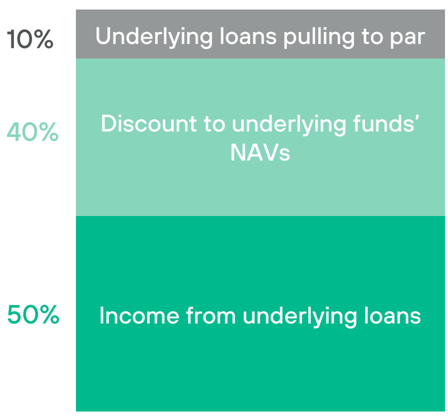
What are the key benefits of PCS?

There are multiple benefits in obtaining exposure to private credit through PCS strategies, we have summarised the key benefits below:

- PCS offer a **return premium**, driven by the ability to purchase funds at significant discounts to NAVs. For example, unitranche direct lending funds typically have gross IRR targets of 10-12%, where PCS funds expect to **achieve 12-14%**.
- There is also a **high level of diversification** within PCS as secondaries funds buy stakes in **multiple private credit funds**. This provides exposure to a range of issuers, sectors, and geographies.
- As PCS invests in funds which are typically **mostly or fully deployed**, there is much **greater sight** over the underlying investments, and therefore less uncertainty of what investors are exposed to.
- PCS offer a more **attractive fund maturity**, the remaining loan maturity is typically 1-3 years as opposed to 3-5 years for private credit. Similarly, they offer an **accelerated timeline** in terms of time taken for capital investment and receipt of distributions.

Indicative breakdown of returns for a PCS fund[1]



Underlying loans, purchased at a discount, **pull to par** over time.

The **discount to NAV** secondaries managers are able to achieve.

The **interest income** from the underlying loans

Sources: [1]JP Morgan Asset Management

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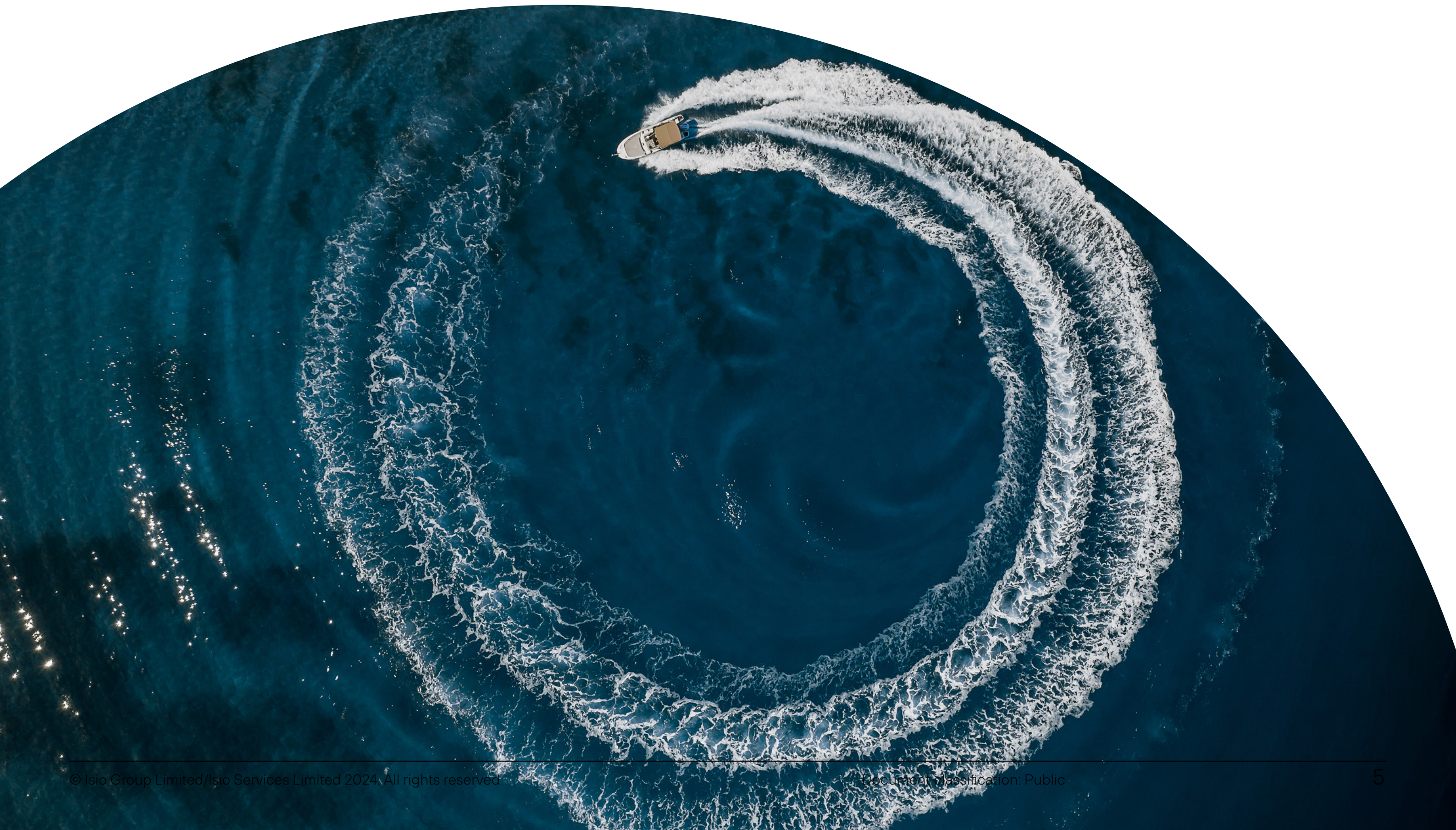
What are the key considerations?

- Given PCS is a **relatively new asset class**, managers tend to have **short track** records.
- The current tactical opportunity driven by **heightened liquidity demands may not last over the longer term**. That said, we do believe there is a structural demand/supply mismatch which we expect to persist.
- As PCS strategies are a fund-of-funds approach, there is **a ‘double layer’ of fees**. However, this is incorporated in the discounts negotiated.
- PCS funds are typically closed-ended, therefore investor capital is locked up for a certain period and distributed back over time, with **disinvestments generally not permitted**.
- Stated fund maturities may be subject to **extensions**.
- Committed capital is drawn down over a period, and therefore investor capital is **not fully invested on day one**.
- There is no guarantee that investing in PCS will generate positive returns, so you could get back less than you invested.



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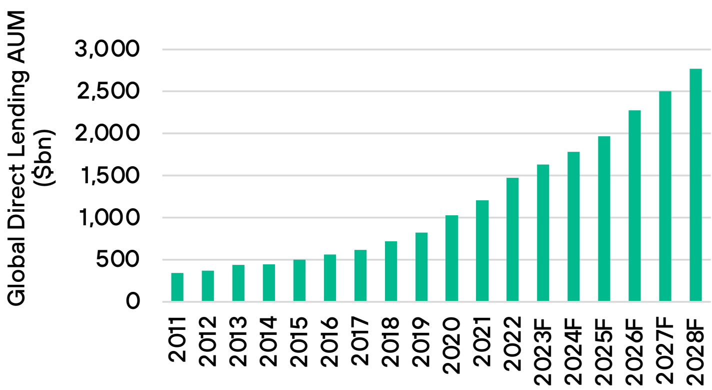
Why now?

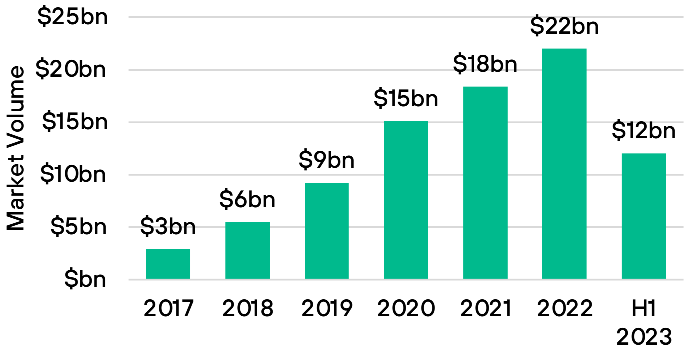
Key drivers of supply and demand imbalance

The private credit market has grown substantially since the global financial crisis and is expected to continue to grow substantially given the tailwinds such as increased bank regulation and uncertainty in the public market pushing more deals to private markets.

Historic and Forecasted Growth of Private Credit AUM[3]



Private Credit Secondaries Volume[3]



Source: [3]Preqin

Market volatility has driven LPs to selling illiquids to raise liquidity, or trim overweight allocations.

Due to fundraising slowing, GPs need to provide liquidity to LPs so they can invest in newer vintages.

GPs want to hold onto good quality assets, and secondaries solutions allow them to do that.

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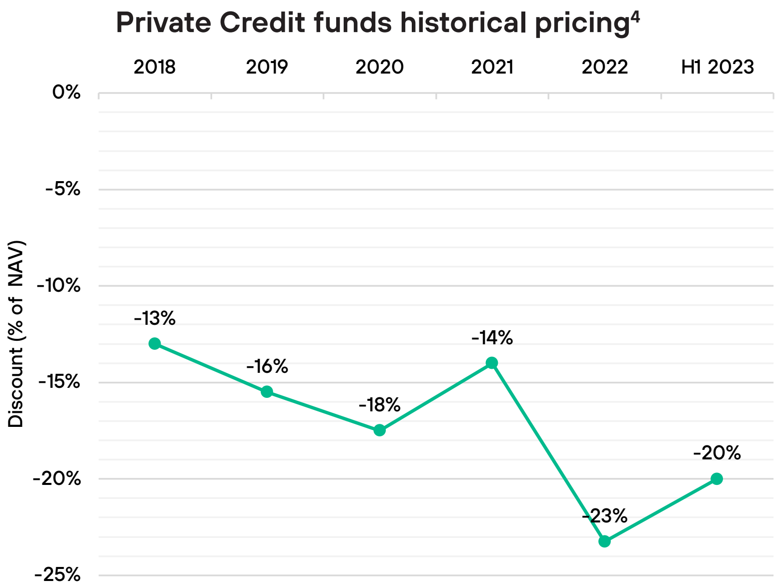
The supply & demand imbalance in the secondaries market has led to a significant increase in the discount relative to a fund's NAV.

The secondary market for private market funds is currently very attractive to buyers.



Sources: [4]Greenhill Secondary Market Review (H1'23), Jefferies Global Secondary Market Review July 2023

The pricing in the chart above reflect all types of private debt, and we have seen **recent discounts ranging between 10-20%.**

We estimate that there is approximately $15-20bn of global dedicated PCS capital in the market, but c.$40bn of PCS secondaries dealflow available to buy annually, which is expected to grow in line with the private credit market.

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What does this mean for you?

Fundamentally the secondaries market is an efficient way to access most asset classes, including private credit, offering an attractive alternative way of accessing a strategy that we are familiar with and believe provides **multiple potential benefits** over traditional primary strategies.

There is sufficient evidence to show that the supply & demand imbalance has driven the discounts to NAVs even wider compared to historic levels, and **very attractive to buyers** of private credit funds.

We have seen institutional interest in this still nascent asset class growing and have seen the **number of investment managers and volume of dedicated capital increase** since we initially started covering PCS in late 2021, and expect the **strategic case for the opportunity to continue and grow** in the foreseeable future.

As mentioned in our previous paper "Private Credit – Why now?", we view PCS as a potential **core allocation** to a private credit portfolio. Please get in touch with us if you want to discuss how to allocate PCS to your portfolio in more detail.

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Contact

Rob Agnew
Head of Private Capital
Rob.Agnew@isio.com

Ajith Nair
Head of Investment Research
Ajith.Nair@isio.com

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