PRIVATE MARKETS

Understanding private debt secondaries

Secondary market transactions, often referred to as "secondaries," involve the trading of existing investment fund shares. These shares offer intriguing opportunities for investors to enhance their portfolio returns.

The allure of secondaries – potentially higher returns

In general, secondary programs target 200-400 bps higher than primary investments in similar funds. The potentially higher returns are achieved via discounts on net asset value (NAV) that are negotiated during the deals. These discounts, frequently in the double-digit range (around 15%[1]), surpass those found in the private equity secondary market due to liquidity constraints. Beyond the initial negotiated discount based on the portfolio's NAV, the effective discount depends on 'post-account' cash flows until closing.

Post-account cash flows refer to the cashflows received between the reference date (the defined date whose NAV is used for signing the deal) and the closing date. For example, let's say the reference NAV is 30 June 2023 and the closing date is 20 December 2023. The underlying funds keep on calling capital to make new investments and distributing proceeds from realised assets between the reference date and the date the deal is closed. These intermediary cash-flows are called 'post-account cashflows' and are netted from the price paid by the buyer.

J-curve mitigation – early yields and distributions

As the portfolios being purchased under secondary deals are usually already fully invested or significantly invested, the J curve effect is minimised. Investors receive yield and distributions much faster than similar primary investments.

Anselm Feigenbutz
Senior Portfolio Manager

Joaquin Ardit
Senior Portfolio Manager

Kulbhushan Kalia
Senior Portfolio Manager

TWO TYPES OF SECONDARY MARKET TRANSACTIONS

1) LP-led secondaries

These transactions occur when **Limited Partners or LPs** (fund investors) seek liquidity in the short or medium term or wish to rebalance their portfolios. They offer their fund units on the secondary market.

2) GP-led secondaries

Fund managers (**General Partners or GPs**) initiate GP-led secondaries by offering portions of their portfolios that haven't been liquidated as expected. This may happen, for instance, when closing funds and distributing returns to investors. Notably, "tail-end" transactions often arise during GP-led secondaries, involving the sale of a fund's last remaining portfolio companies. Rigorous screening is essential here, as these companies may have specific reasons for not being liquidated earlier.

Potential for better risk-adjusted returns

Secondary market allows investors to reduce blind pool investment risk substantially. Secondary portfolio buyers generally evaluate each underlying deal in a portfolio and price it appropriately. This allows the potential for better risk-adjusted returns vs. similar primary investments.

Players in secondaries

The Private Debt Secondaries segment consists of a small number of different players.

- **Fund-of-funds secondary strategies:** They have been the most successful players in the secondary market. Specialised teams within these firms can move fast and underwrite deals under tight timelines, which is an essential component of the secondary underwriting process. Successfully navigating the secondary market business also requires a robust network. A strong position in the primary market, an expansive international network, and in-depth market knowledge empowers assertiveness in negotiations. Therefore, deal sourcing and consummation of deals becomes a challenge for players who are not specialists.

- **Opportunistic investors or private equity secondary funds that buy up loan portfolios:** These players usually have capital costs that are too high to operate successfully in this segment.

- **Real money investors:** These are typically sovereign wealth funds and sometimes pension and insurance funds who also run secondary programs. The secondary processes run under very tight timelines. Therefore, these players tend to act very opportunistically, generally focusing on very large deals in funds that they are already invested in.

- **Direct lending managers:** Large direct lending platforms face challenges in scaling their secondary strategies. In general, it is seen that GPs whose shares are being sold tightly control who the new buyer(s) will be. GPs do this to avoid disclosing sensitive information such as names of borrowers, terms of the loans, etc. to direct competitors.

Key insights

Growing market and presence
Secondaries are gaining prominence and are starting to feature in more institutional portfolios. According to S&P's private markets outlook, both GP-led and LP-led secondary strategies will remain in high demand in 2024.

Quicker allocation to private markets
Attractive returns, accelerated capital deployment, and broad diversification make secondaries a valuable addition to rapidly expanding portfolios. They facilitate quicker allocation to private markets compared to primary fund investments.

Strong market opportunity
The current market volatility and shifts in target allocation within private market portfolios have led more LPs to explore exit options via private debt secondaries. Simultaneously, secondaries are gaining traction on the GP side.

Growing importance of Private Debt Secondaries
Against the backdrop of economic uncertainty and banks' reluctance to lend, the private debt market assumes a pivotal role for institutional investors. The turnover of private debt secondaries currently stands at approximately 1.7% of assets under management (AUM)[2] per annum, in contrast to the 5% turnover observed in private equity. Following the trajectory seen in private equity, turnover of private debt secondary transactions is expected to accelerate over the coming years. GPs and LPs alike explore secondary solutions for liquidity reasons. Industry experts predict that the volume of secondary market transactions in private debt will continue to surge, potentially reaching USD 50 billion by 2026. As AUM continue to expand structurally, private debt secondaries are poised to become a significant asset class in themselves.

[1] Source: Campbell Lutyens – 2024 Secondary Market Overview
[2] Source: Prequin, PitchBook, Allianz Global Investors, 2024

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