EXPERT Q&A

Private debt investors are increasingly turning to the secondary market to provide tactical portfolio management solutions, say Pantheon's Rakesh 'Rick' Jain and Toni Vainio

Solving the liquidity puzzle

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Q Why is the private credit secondaries market so appealing currently?

Toni Vainio: There are two parts to this from an LP perspective: why is the secondaries market appealing as a portfolio management solution for existing investors in credit funds, and why are more investors looking to gain exposure to credit via the secondaries market?

On the sell side, the denominator effect means that many investors, especially those with more mature private market programmes, are overallocated to illiquid assets. As a result, they are becoming more proactive about accessing liquidity, reallocating their portfolios, managing their books, and making tactical decisions around the type of new investments to make and existing investments to retain. The secondaries market has become a valuable tool for achieving many of these objectives.

On the buy side, the secondaries market is an attractive way for investors to deploy capital quickly and generate immediate income across diversified portfolios. Investors can fully capitalise on the increased base rate via acquisitions of fully funded and high-yielding portfolios. A primary fund might typically take up to four years to ramp up, whereas for secondaries transactions this would often be quasi-immediate, given that the strategy is to buy mature fund positions.

These complementary dynamics have led to tremendous growth in the amount of capital being allocated to the secondaries private debt market, with some figures suggesting the size of the market has nearly doubled over the past three years.

Q Do you think this pace of growth will continue?

Rick Jain: We continue to see an acceleration of dealflow – both in the number and size of potential investment opportunities. As Toni noted, this is due to a combination of tactical rebalancing and portfolio management needs. In addition, we are seeing credit GPs proactively using secondaries solutions to create liquidity for their investors and at the same time grow their platforms. As one of the largest and most experienced credit secondaries investors in this market, we have been able to take advantage of this demand by providing the kind of liquidity that people are seeking.

With respect to the increased investor interest and deployment in credit secondaries, many investors are taking the view that they can allocate to private credit to generate both attractive absolute and risk-adjusted returns. This plays well for secondaries funds, which typically have large, diversified underlying portfolios of seasoned, performing and shorter-duration loans, which can benefit from attractive entry pricing dynamics.

Q How can credit fund managers use the secondaries market to gain a competitive edge?

RJ: Private credit is much more complex than, say, private equity. Investors must work out how to make best use of the asset class depending on their strategic needs. Do they want to allocate capital onshore or offshore, or both? How much leverage do they want in the portfolio? What funding vehicle do they want: evergreen investment, retail-orientated financing, or something else?

Given such complexity, credit managers are increasingly realising that the way in which they grow their platform depends on the relationship they cultivate with new investors, including secondaries buyers, who create capacity to do new deals that are competitive and relevant in the marketplace. In particular, secondaries buyers drive liquidity for existing clients, who can then reinvest their capital in a particular fund manager's platform.

TV: One area where we are seeing innovation is in continuation funds, which are well known in the private equity world but haven't seen much traction in the credit space – until now. Macroeconomic headwinds mean that asset duration is lengthening, which makes it more challenging for LPs to get their capital back to re-invest in new fund allocations. This increases the prevalence and attractiveness of using continuation funds to allow managers to retain control of existing loan portfolios, while providing a much-needed liquidity mechanism for investors.

> *"[We have] partnered with more than 20 different credit fund managers over the last five years, investing in excess of $1 billion"*

A variation on this is pursuing strip sales of loans within existing vehicles to provide balance-sheet relief, which is a highly customisable strategy that allows GPs and their clients to reduce their exposure to certain assets in which they may be overweight.

We're very experienced in partnering with GPs to meet their liquidity objectives, having partnered with more than 20 different credit fund managers over the last five years, investing in excess of $1 billion across a range of transaction types such as continuation vehicles, strip sales, tender offers, joint ventures and other GP liquidity-solution secondaries transactions.

Q How can secondaries firms and their investors take advantage of the market opportunity?

RJ: This comes down to the quality of the investment platform and the expertise and judgment behind it. A platform that is solutions- and partnership-oriented to both LPs and GPs, with no conflicts, allows for high-quality deal sourcing and access to new and existing data and information sets to make the best investment decisions.

At Pantheon, we have a global team that is exclusively focused on private debt, combining a mix of direct and secondaries credit investment skills. This team has long and substantive experience in evaluating GPs and fund complexes – and it is important to have all these skills on a dedicated basis.

We also gain competitive edges by having a sophisticated credit investment and information platform. Pantheon has arguably one of the deepest repositories of private credit relationships institutionally in the world. We have exposure to more than 2,100 companies within our credit business, across 65 fund managers – and have screened in excess of 12,000 companies over the last five years, representing hundreds of managers and thousands of funds, which informs high-quality investment decisions.

Q What is the outlook for the private debt secondaries market?

TV: Private credit as an asset class has seen tremendous growth over the past decade, with unrealised assets in private credit funds standing at around $1.5 trillion. There are nearly 1,400 private credit managers competing globally, across almost every strategy and risk spectrum, and the amount of new fundraising in the market is around $200 billion each year. Increasing exposure to an illiquid asset class like private credit means that more people will ultimately need liquidity to accomplish their portfolio management objectives, which will drive secondaries dealflow.

RJ: These structural dynamics, coupled with the wider market environment, are highly favourable for continued growth in investment opportunities. Secular trends in private credit will continue to drive strong dealflow. In addition, in an environment with more macro uncertainty and continuing liquidity constraints, the opportunity set is further enhanced as counterparties look to accomplish their liquidity goals in the secondaries market. ■

Rakesh Jain is a partner and global head of private credit, and Toni Vainio is a partner in the global private credit investment team at Pantheon

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