KEYNOTE INTERVIEW

Mapping growth in the secondaries market

Private debt secondaries are following in the footsteps of private equity secondaries, but with some key differences in terms of what it takes to generate alpha, says Tikehau Capital's Pierpaolo Casamento

Q How would you describe private markets secondaries dealflow today? Which strategies are featuring most heavily and what are the primary drivers?

The trajectory of private markets secondaries is unequivocally upward, with projections suggesting the market may surpass $200 billion this year. Private credit, our primary focus, constitutes approximately 10 percent, a remarkable ascent from its negligible share six years ago.

The predominant catalyst for this expansion is the growth of the underlying primary markets; as the primary market expands, so too does the secondaries market, governed by the turnover ratio of the proportion of the primary market transacted in the secondaries space annually.

That proportion should also increase over time, driven by shifts in investor behaviour. LPs, generally, are increasingly wanting to manage their portfolios more proactively.

We believe the efficiency of the secondaries market is also improving. If it is too hard to sell, or if you have to take too much of a discount, there will be fewer sellers coming to market. However, if the process is painless and pricing is strong, more sellers might be willing to contemplate a secondaries sale.

All in all, therefore, I think a growing underlying market, coupled with an increase in turnover, will lead to the continued growth of the credit secondaries market, mirroring the evolution observed in private equity secondaries.

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Q Are there cyclical factors at play as well?

Motivations vary from investor to investor, but one notable trend is the elongation of asset holding periods. This is particularly apparent in private equity, where GPs that went into deals with the expectation of a four-year hold are finding they are retaining those assets for longer. That is leading both LPs and GPs to seek alternative liquidity solutions, which is, of course, where the secondaries market intervenes.

The same trend exists in credit where loan repayments and refinancings are contingent on macroeconomic conditions and M&A cycles. In addition, macro events such as interest rate movements can lead to a strategic shift in allocations between asset classes, further influencing secondaries activity.

Q Are there any fundamental differences between the way in which the private equity and private credit secondaries markets work?

The private equity secondaries market obviously emerged before the private credit secondaries market, simply because any secondaries market is going to lag its primary counterpart, and private credit is the younger asset class. Other than that, the difference is really only in the name. The way that transactions are structured is the same, it is just that we are applying those structures to credit portfolios.

Having said that, there is one notable difference in the GP-led market. We estimate single-asset continuation vehicles represent nearly half of the overall private equity CV market. But you would never have a single-loan CV. In credit, everything is done in multi-asset form on both the LP- and GP-led sides of the market.

Q Has the private credit GP-led secondaries market evolved in similar ways to the private equity GP-led market in other respects?

GP-led transactions in private credit are a nascent yet rapidly expanding phenomenon, now comprising roughly

Q How would you describe LP appetite for private credit secondaries, and what advantages exist for investors over the private equity secondaries alternative?

I don't think you can equate the two. They are just different allocations. The more relevant comparison would be between primary and secondary credit and primary and secondary private equity. When we compare the primary credit market and secondary credit market, we generally position them as complementary. Neither is better or worse than the other, it all depends on the objectives of the investor.

Secondaries funds do offer the advantage of immediate diversification, which is hard to achieve through primary investments. When you invest in a private credit secondaries fund, you may gain exposure to 20-30 transactions, each of which could involve multiple funds. Each fund is then invested in tens if not hundreds of underlying loans, so on a look-through basis, the secondaries investor is gaining access to thousands of companies and multiple underlying GPs. They are also gaining diversification by vintage and by sub-strategy.

Credit secondaries are comparable to an index exposure to the underlying private credit market, with the added benefit of potentially being able to buy at a discount. That is how we aim to create alpha. When an investor commits to a primary fund, they are looking for a manager that will beat the market, creating alpha by minimising defaults and losses. On the secondaries side, it isn't loan picking that drives alpha, because we buy thousands of loans. We are buying the index. In contrast to primary funds, where alpha derives from manager skill in minimising defaults, secondaries alpha is driven by pricing and risk diversification.

half our dealflow, up from a mere 10 percent two years prior.

Private credit GP-led transactions are a tool for primary lenders to provide liquidity to their LPs, at favourable valuations, often while also securing some additional concessions from secondaries buyers, such as new primary capital commitments. Typically, such a transaction involves a 2017 or 2018 vintage fund or funds that remain diversified, still yielding, but which are now approaching maturity.

These GPs are taking a proactive approach to generating liquidity, allowing existing LPs to either roll over into the continuation vehicle or cash out. From the GP perspective, therefore, CVs are either AUM neutral or accretive. They help with fundraising, or at least they don't hurt. They can offer a win-win for all involved.

Q How is the buyer universe evolving in private credit secondaries?

We are witnessing the entry of managers with direct lending capabilities launching secondaries programmes alongside the large, global private equity secondaries houses launching parallel credit secondaries strategies. These are two distinct groups, with different approaches to underwriting. We at Tikehau Capital began life as a credit manager in Europe, before expanding into the US with a credit secondaries approach.

> *"From the GP perspective, CVs are either AUM neutral or accretive. They help with fundraising, or at least they don't hurt"*

Q What impact are these new entrants having on competitive dynamics and therefore on pricing?

Competition has intensified markedly. When we started six years ago there were just one or two other managers with dedicated pools of capital to address opportunities in credit. Now, there are at least 10 firms with dedicated credit secondaries funds and another 10 or so that are pursuing credit secondaries opportunistically out of other pockets of capital. This increased competition is being reflected in pricing. On average, prices have gone up over the years. It varies from transaction to transaction, however, and is primarily the result of the buyer's underwriting of a specific portfolio.

I would add that there is a difference in pricing between the GP- and LP-led markets. The GP-led private credit secondaries transactions that we have seen have transacted at close to, or at, fair value. By contrast, there is more dispersion in pricing across the LP-led market.

Q Beyond valuation, what do you think makes for a good secondaries deal?

In private credit secondaries, we look for predictable cashflows, and a relatively short duration of investment. We also look for diversification. We assess the loans themselves, but we also view the deal through a portfolio construction lens, because we want to minimise any idiosyncratic risk that might exist.

One of the fundamental differences between private equity and private credit is that with private equity you are looking for the upside. Unlike private equity, which seeks upside potential, credit strategies are fundamentally orientated towards downside protection, minimising default risk and losses through diversification, transaction selection and pricing, which is a critical driver of returns.

> *"Unlike private equity, which seeks upside potential, credit strategies are fundamentally oriented towards downside protection"*

Q Will private credit secondaries continue to follow in private equity secondaries' footsteps?

Yes, I see the path forward for this market as being very similar to that already paved by the private equity secondaries market. That means continued growth, of course, but it also means specialisation. There will be increased differentiation between managers, as some firms specialise in GP-led or LP-led transactions, for example. We are also already seeing specialisation in terms of performing versus non-performing corporate credit. Over time, as the asset-based lending market continues to grow on the primary side, and as other non-corporate strategies emerge, further specialisation is anticipated. ■

Pierpaolo Casamento is head of private debt secondaries at Tikehau Capital