

Private Debt Secondaries: Moving beyond GP/ LP transactions and into the world of liquidity management

As one of the fastest-growing areas of the private markets, the attractiveness of private debt is well recognized. As noted in one of [our recent articles](#), the asset class’s limited duration, low volatility and limited drawdown risk relative to other alternatives appears desirable, particularly when considered with empirically stable returns.¹ A natural evolution of a maturing primary market is developing volume in secondaries transactions.

Private debt secondaries (PDS) have prospered in recent years, providing liquidity to investors in a putatively illiquid asset class. Investment managers have responded—raising dedicated secondary funds and partnering with strategic players. At StepStone, we have experienced the secondary market bloom from a nascent opaque market, focused initially on bilateral transactions and purchases of LP interests by private equity secondaries funds at steep discounts. Following Covid, the market transformed. Dislocation brings opportunity, and StepStone prepared itself to respond.

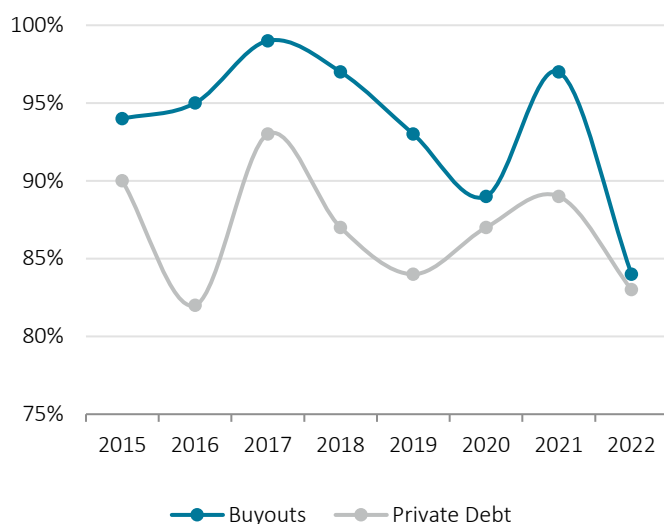
Our coverage of broker-led LP processes indicated a readiness to transact. In 2022, substantial challenges in the liquid markets exacerbated the so-called denominator effect, leading institutional investors to be inadvertently overweight several illiquid asset classes. Counterintuitively, the relatively strong performance of private debt meant that accepting a haircut on those valuations would require a comparatively modest markdown (particularly against devalued fixed income and equity holdings), and thus transactional volume arrived, reaching \$17 billion in 2022 (more than 30x larger than 2012 levels), [per Collier Capital](#).² StepStone and our peers became buyers of performing direct lending LP interests at prices reflective of private equity returns.

Relative “Haircuts” When Markets Head South

Secondaries volumes in 2022 were down across all asset classes, except for private debt, where volumes increased by 30.3%.³ Investors utilized the secondary market for reasons varying from strategic redirection to rebalancing due to portfolio limitations and portfolio optimization. Investors sold private debt exposure because valuations remained stable relative to the public market (both debt and equity) and other private market asset classes.

Figure 1 illustrates this point: The 2022 price decline in buyouts was more pronounced than in private debt. Notably, there is large price variance from the average prices listed below and the type of private debt strategy is influential to pricing; in 2022, senior lending funds priced in the low 90s, mezzanine strategies in the 80s and distressed/special sits in the high 70s. Compared with private equity discounts, which range from 15–25% during dislocations, private debt can offer an attractive alternative.

Figure 1 | Secondary Market Price Trends



Source: Greenhill Global Secondary Market Review, 2022.
 Note: Although the point we wanted to make is clear—i.e., buyout prices fell more sharply in 2022 than private debt—distinguishing between sub-strategies can be illuminating. Senior lending portfolios, for instance traded at a 10% discount in 2022; opportunistic and distressed portfolios, on the other hand, traded at a 20% discount. The devil is in the detail!

¹ StepStone Group. 2023. “Relative Attractiveness of Direct Lending: Liquidity, Volatility and Drawdowns.”

² Claire Coe Smith. 2023. “Private Debt Secondaries: Macro disruption generates momentum,” *Private Debt Investor*, 2 May.

³ Setter Capital. 2022. “Volume Report FY 2022.”

Discounts Matter, But Not as Much as One Would Think....

Price bands are important but insufficient to determine returns on their own. Consider that direct loans have an average economic life of 3 years (4 years in the current environment)⁴. Against a less liquid private equity portfolio, the distribution profile should be more condensed and predictable.

- Thus, we may vary price greatly depending on the stage in the fund term and corresponding drawn and undrawn commitments, its current yield and any expected refinancings in the portfolio.
- In addition, we will consider historical loss rates and flex them for manager particulars such as concentration and industry exposure.
- Finally, transaction dynamics come into play, including approved buyer lists, speed of execution and any “stapled” primary investment requests attached to a current manager fund. There may be an amount of book building by the broker due to varying demand for specific funds and available ticket sizes.

This profusion of factors affects bid-ask spreads, but ultimately pricing is only one variable. In short, discounts matter but not as much as you think!

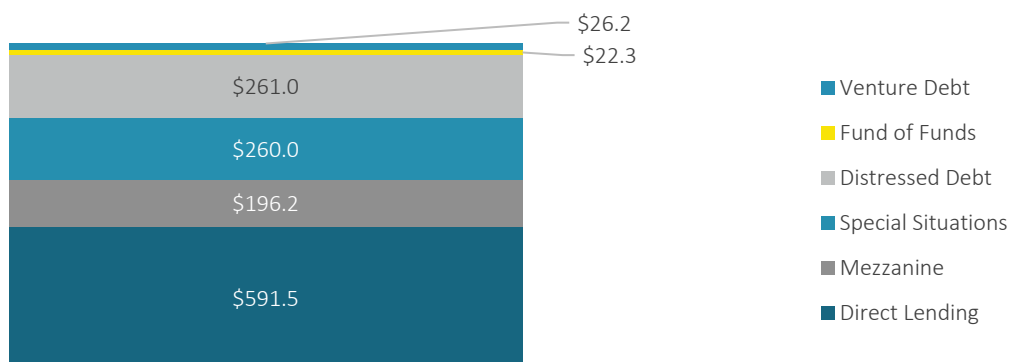
PDS Market Formation

With a plethora of opportunities and an advantageous supply-demand imbalance, dedicated PDS investors stepped into the market in 2022, armed with lower cost of capital, the ability to apply portfolio leverage (at the investing entity), transaction leverage (through deferred payments), and alternative views on loss rates and cashflow modeling. For these investors, capital at work is as important as IRR and TVPI. Therefore, their desired outcome differs from your stereotypical private equity secondary buyers. So do their target returns: Over 50% of buyers seek a net IRR/TVPI below 12.5%/1.5x.⁵ This market intervention is a positive secular change for existing private debt investors in need of liquidity.

The term private debt covers an array of vastly different sub-strategies, some of which are covered in **Figure 2**. The market is in fact more disparate, with many more sub-strategies. Having broad coverage and asset class expertise is required to cover the universe.

Vetting broadly diversified direct lending portfolios requires in-depth market data and views on repayment speeds and expected loss rates. Conversely, concentrated distressed portfolios require familiarity with each company and line-item equity-style underwriting. The ability to accurately forecast returns across multiple strategies allows secondary buyers to provide broader and encompassing liquidity solutions. Market coverage is paramount.

Figure 2 | Private Debt AUM by Sub-strategy (US\$ Billions)



Source: Preqin, 2023.

Financial Innovation and Bespoke Liquidity Management Techniques

The PDS market may be in its infancy but innovative financing solutions from the private equity market are already being implemented.

⁴ Cliffwater. 2023. “2022 Q4 Report on U.S. Direct Lending”

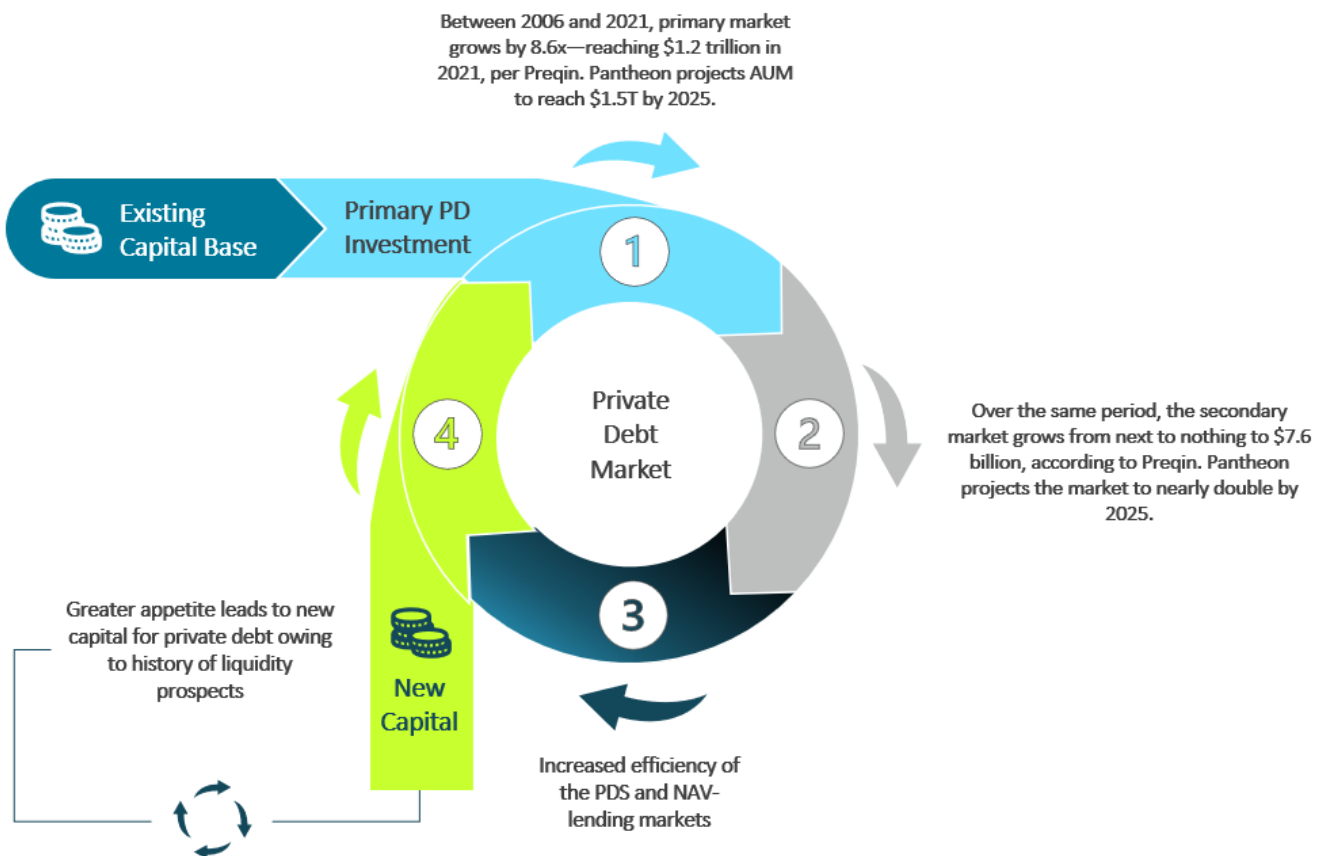
⁵ Campbell Luytens. 2022. “Secondary Market Overview.”

- **NAV-Financing** is a broad term for financing underpinned by a diversified portfolio, which can contain private equity companies, real estate assets or even private debt funds. The portfolio’s NAV is used as collateral for the loan, generating liquidity for the GP or LP while retaining the future upside from the original portfolio exposure. Realizations in the underlying portfolio are used to fund the repayments of the NAV facility. This product is established in the private equity and real estate markets, but only recently adopted in the private debt secondary market as an alternative to secondary sales.
- **Collateralized Fund Obligations (CFOs)** have similar goals to secondaries, i.e., to enhance liquidity for GPs and LPs. CFOs are securities that create leveraged exposure to a portfolio of fund investments through the issuance of an equity tranche and one or more debt tranches. Think: CLOs with funds replacing the underlying loans.

For sellers, structured solutions may be preferable to a secondary sale in order to generate liquidity. Investors can maintain exposure to private debt while generating interim liquidity to rebalance their portfolios. Secondary investors are attracted to this investment style, as it meets the desired returns with a relatively attractive risk profile. With private equity secondaries, buyers and sellers often have differing views on the future valuations and potential upside of the assets. Since upside is relatively limited for private debt, differences of opinion tend to be narrower and more focused on repayment speeds and loss rates. When both parties’ views on future valuations are aligned, the variance in pricing is much lower and a structured solution which accommodates both parties’ requirements is often optimal.

PDS—The Flywheel Effect

In 2022, private debt represented only 4% of the total secondary market.⁶ As the asset class matures, we expect this share to expand. We suggest the continued growth and effectiveness of the private debt secondaries market will open private debt to a new investor cohort that previously had concerns about liquidity, term or liability mismatches.



Conclusion

The private debt market is forecast to continue its growth due to its attractive yields throughout credit cycles, low volatility, limited drawdowns and relatively high risk-adjusted returns. By that same token, volume in its secondary market is expected to increase. Institutional investors are supporting this growth in both the primary and secondary

⁶ Campbell Luytens. 2022. “Secondary Market Overview.”

markets. We have observed LPs making tactical sales of relatively stable private debt portfolios, without exiting the private debt market entirely. We also observe several other very important value drivers, in addition to discount, emerging. Furthermore, activity has moved beyond traditional secondaries and into the more bespoke world of liquidity management through financial innovation.

By providing innovative liquidity solutions, institutional investors are improving asset class accessibility to a new investor base. Now investors can confidently enter the private debt market and avail of its illiquidity premium with the comfort that there will be liquidity if they seek to rebalance. Furthermore, due to the illiquidity of private debt and its corresponding valuations, investors can often transact at relatively attractive prices. As the PDS market matures, structured solutions will develop. Traditional secondary sales, while prevalent in the current market, may only cater to a certain investor group; investors in need of interim liquidity may prefer financing solutions.