E X P E R T Q & A

Private credit secondaries had strong momentum even before the rising rate environment came along. Michael Schad, Ed Goldstein and Martins Marnauza, partners in the secondaries credit team at Coller Capital, explain why they expect more awareness, more deals and more innovation

'This will be the fastest-growing asset class'

Q Could you talk a little about the growth of the private credit secondaries market to the present day?

Michael Schad: In the early stages of the market there weren't many participants and those that did participate, like us, mainly invested in credit secondaries out of their private equity secondaries funds because there wasn't as yet product segmentation. The market was relatively small because people struggled to offer the right cost of capital, which meant it wasn't very attractive for sellers. They typically only sold when they were in severe difficulty and that meant we could buy high-performing credit at attractive prices. We estimate market volumes were around the $2 billion mark up until three or four years ago.

Then two things changed. One was that private credit as an asset class grew significantly, which meant that it reached critical mass. The other was that in February 2021 Coller closed the biggest dedicated private credit fund to date, and having that capital unlocked the supply and demand equation. In today's market there is roughly $17 billion of volume, and we think that can easily reach $50 billion by the middle of the decade driven by the rapid growth of private debt. Two years ago, when we launched the fund, we thought it was very attractive. Now, with the interest rate changes, I think this will be the fastest-growing asset class in private markets.

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Q Given the macroeconomic changes impacting the primary credit market, what knock-on effects are likely for the secondary market?

Martins Marnauza: We are seeing similar trends. The main benefit from the current environment, which is key for our strategic focus – senior secured, unitranche loans – is that those loans are typically floating rate and the increased base rate environment results in higher yields for Coller, assuming all else holds constant.

Also, the way we run the strategy at the fund level is that we don't currently employ any asset-backed leverage and, while the assets we buy are a mix of levered and unlevered sleeves, ultimately the aggregate look-through leverage in the strategy is relatively moderate. This means that most of the pick-up in base rates is yield that gets passed through to our investors.

Q The secondary market offers liquidity at a time when it's needed. Is the opportunity being exploited, and are LPs and GPs aware of it?

Ed Goldstein: There's definitely more awareness needed. On the GP side, the structure of private credit is more concentrated than private equity among the largest GPs. The top 10 managers have probably had a fund position trade in the market so most are aware. They might also be affiliated with a larger platform that has private equity as well and there's some knowledge transfer, but it's not perfect.

Also, it's a different product in

From left: Ed Goldstein, Martins Marnauza and Michael Schad

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MICHAEL SCHAD

private equity. There, we look at upside optionality and a wider range of outcomes; in credit it's quite different and the risk is generally to the downside. When we talk about pricing dynamics, it's a different conversation in credit and it takes some time for GPs to understand that.

On the LP side, another difference from the equity market is it's not as brokered or intermediated as the equity side, in part because advisers historically have not seen it as lucrative given the number of buyers. You are likely not going to get 100 bids on a credit book and so the chances of earning a big fee are lower. Our market relies to an extent on brokers to spread the knowledge to the LP community because most institutional LPs will hire someone to sell a portfolio now, particularly if it's a public entity. Part of the education is through the adviser community as well as us talking directly to LPs.

Some LPs have both private equity and private credit books and if it's the same person who manages them both, they get it – but often it's a different part of the organisation that may not be fully aware of what's happening within our market. There is still an education process that needs to happen on the LP side, but we've made progress for sure.

Q What is the balance between LP-led and GP-led processes?

EG: It's mostly an LP market today, probably 80 percent or more. In private equity it's probably more like 50/50. It's partly just a function of market maturity because GP-leds tend to be from 'later in life' funds and often single asset deals.

Because it's credit you generally want a lot of diversification and not take concentration risk. GP-leds tend to be more concentrated so they are harder to get done in credit – you need more buyers and more capital if you want to do them in scale. That will likely come in time but there's not enough capital formation to do GP-leds for some of the larger managers today while also managing their secondary funds' concentration risk level.

Also, the concept of a single asset

Q What do you think will surprise us about this market over the next year?

EG: There are always new technologies arising in the secondaries market – single asset deals in private equity didn't exist five years ago and it's a big part of that market today. Because the nature of private credit is different I'm sure there will be some new innovation that we haven't seen on the equity side and which is relevant to credit – which may be to bridge pricing gaps or otherwise to get transactions done that haven't got done in the past.

Some of the private credit SMAs are very chunky so could there be a transaction where an SMA is restructured with a large secondary buyer coming in as the replacement LP and creating a new vehicle. It's a bit different from a traditional GP-led but that could be a transaction that could become prevalent in private credit over the next year or two. I think you will also see some fairly chunky positions sold in the market given the concentration levels – a lot of LPs have made large commitments to some of these funds and they might be hard to digest.

GP-led doesn't exist in credit because of the asymmetric risk; you may as well just invest directly in the credit than do a single asset deal. So the nature of GP-leds will need to be a bit different in credit. Diversified GP-leds could work or restructuring an SMA, given there are a number of large SMAs in credit. But the nature of GP-leds is still evolving and it will take time for them to become a larger share of the overall pie in credit secondaries.

Q What are you seeing in terms of pricing dynamics? Is this likely to be a particularly good vintage?

MM: The amount of dealflow and the pricing we are seeing is unprecedented. The private credit secondaries market is relatively illiquid in the best of times and when there is a market dislocation such as today the price for liquidity gets amplified in a manner that you typically don't see in the public markets. These conditions should make it a strong vintage year

The pricing, depending on the nature of the exposure, we have seen dropping in the 5-10 percentage point range in the last year and it remains a buyer's market. It's not a dislocation strategy but obviously that kind of widening pricing is hugely accretive. It was a buyer's market 12 months ago and it remains a buyer's market today and the competitive dynamic is generally quite favourable. One measure we look at is transaction volume against dry powder and that ratio is well below one times in the private credit secondaries market compared with between one and two times in the private equity secondaries market and in buyouts between three and five.

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MARTINS MARNAUZA

Q What is Coller setting out to achieve with its private credit secondaries strategy?

MS: In general, I would say credit is a more concentrated market than equity, so you have seen that the market leaders in their fields have become very large and dominate their market. If you look at direct lenders in Europe, there's not that many of them doing the bulk of the volume and we think that will replicate itself in credit secondaries as well.

With the expertise we have through 30 years of equity secondaries, and more than 10 years of credit secondaries, we think our experience in both equity and credit solutions is a strong combination for sellers. We are focused on being the leader in this space, having been one of the first movers in both equity and credit secondaries, and exploiting that advantage. ■

Michael Schad is head; Ed Goldstein is chief investment officer; and Martins Marnauza is a partner at Coller Credit Secondaries