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**MV:** [00:00:00] I'm not breaking new ground here, but 2023 is shaping up to be the year of liquidity and by extension, the secondary. We're seeing it across private markets from the denominator effect, forcing investors to prune back to low distributions, compelling LPs to look beyond an IPO or sale to a strategic to the effect high interest rates have had on debt and the growing need for investors to recapitalize their portfolios.

Liquidity and the need for it in a year where distributions are shaping up to be lower than usual has been a constant on this show. We've already discussed it with our private equity real estate and portfolio management teams, and today we're going to add private debt to that list. By some measures, private debt is the most liquid asset class in private markets. Yet even with durations that can be many years shorter than your typical private equity investment, private debt secondary market has been really active. One group estimates that AUM for credit secondaries will reach $14 billion by 2025, and if it does, it will have, in effect, doubled in just four years.

Joining me to discuss the rapid growth of private debt secondaries is John Bohill, a partner on a private debt team based in Dublin.

John, welcome to RPM.

**JB:** [00:01:06] Thank you, Michael. Busy times indeed. I'm very delighted to be here talking about this.

**MV:** [00:01:11] Thank you. Yeah, so let's tuck in. So, John, I was recently in New York and I was having dinner with a colleague, and invariably the topic of the podcast came up and they asked me, what's the next topic going to be? And when I told them private credit secondaries, he just asked me point blank, “What is a private credit secondary?” So I'll volley that back over to you. What are we talking about today?

**JB:** [00:01:34] It's definitely a dinner topic. The definition of private debt, secondaries, private credit secondaries.

**MV:** [00:01:40] That's definitely our industry.

**JB:** [00:01:42] Oh, 100%. I mean, do we like talking about definitions? I'm going to start with a real stickler, though, because in private equity, you can buy a secondary on a single asset basis. You can buy a single company. But typically in credit, when you talk about credit secondaries, you're talking about just portfolios of loans. So the most risk averse parts of a company's balance sheet, you're buying portfolios of those or you're buying limited partner interests in fund structures.

Conversely, the credit secondaries businesses is also complemented by a secondary credit, which is single interest, single loan acquisitions, which is a different part of the market. And that's not really the focus of the current volume that we're seeing today. What is the current volume today and what are the differences to private equity? We're talking about a huge range of differing asset classes underlying and also a differing range of underlying returns.

So we could be talking about anything from very senior secured, conservatively originated and underwritten pieces of credit to very large companies all the way up to opportunistic credit where you start veering into private equity territory. And that distinction is really important when we talk about the complexity of the private credit secondaries market in general.

**MV:** [00:03:13] So let's talk about some of the market dynamics. I mentioned the denominator effect in the introduction, but what are some of the other factors driving growth in this sector?

**JB:** [00:03:22] Look, Michael, for 15 years in credit, we had no difference of opinion and it was a very benign credit environment, very low interest rates, quite boring, in fact, because everything was predictable. I think what 2022 showed us is there is lots of subjectivity entering the market and when you get subjectivity, when you get differing views on what something is worth, you have a market. And I've been saying for the last couple of months, the last year or so, two LPs, two GP's, two banks, this volume is the expression of a differing view of value. In tandem with that, we're seeing LPs, banks, brokers raising their sophistication and raising their ability to bid on these pieces of credit or to sell them in tactical or strategic ways.

One of the things we're seeing and one of the things we're really exposed to is LPs having a permanent allocation to private debt. They're very comfortable with the industry, but they're actually now thinking of making tactical sales to rebalance their portfolio. And why are they doing that? It's because of that dislocation last year. In 2022, their liquid equities or fixed income portfolios declined by 15–20%. In contrast, their private debt holdings actually increased in value. And therefore, when it comes to selling something to relieve liquidity tension in their portfolios, I call it the relative haircut argument. It's easier to sell the better performing asset class. So actually private debt presents itself as an opportunity, as a liquidity tool, and I don't think that was recognized before.

**MV:** [00:04:58] I want to stick with this idea of like discounts and haircuts a bit longer. Private equity secondaries have historically sold for 5 to 10% discount to net asset value. Venture capital may be closer to 25–30%. What sort of discounts are you seeing in private debt?

**JB:** [00:05:15] I'm going to be a little bit cruel to my private equity colleagues. I've been investing in the secondaries market on the equity side for, you know, going on 20 years and in in private equity, everything seems to align to a certain objective. In other words, private equity managers generally try to achieve a 20–25% return in private debt. That's not necessarily the case. Some strategies are low risk; hey emphasize diversification; they emphasize capital deployment; they emphasize low levels of undrawn capital. And therefore, discount is a is one very large factor in the pricing equation, but it's often not the major pricing discussion.

We often price based on levels of concentration is the underlying fund, very concentrated portfolio of debt. If you have capped returns, it's unlikely that very concentrated portfolios will sell well. And why is that? Because if you get one deal that goes wrong, your entire deal is wrong. And so that's a very critical metric. We also and I know this is something that private equity groups share. We don't like undrawn commitments, and that's because we feel at StepStone in particular, we can invest quite well in a primary basis that we don't need to invest via managers and via their undrawn commitments on a primary basis.

**JB:** [00:06:46] The other key factor, which mean you would say, I will say this because I'm at StepStone, but it's very critical for us to have good relationships with the GPs, the managers we're investing with. Often as part of this conversation, we're not just talking about a transaction, we're talking about one transaction amongst many with our key relationships in the market, with our key managers, the managers we know well, the managers with whom we have a very balanced and mature relationship. And so those are the, you know, the less obvious dynamics we think about in the private debt market. Now, having said that, what are the discounts? It could really go from anything, you know, from 8% or even 5% with a structured deferred structure in the transaction to upwards of 30% for something that has, you know, quite a lot of hair on it or, you know, has shown dislocation in the last year. I think that's the range we're talking about much wider than private equity.

**MV:** [00:07:45] And I guess with that sort of range, upwards of 30% are the managers raising these funds. They may be inclined to market equity like returns. Two part question. If that's true, then one might expect to see equity investors using credit as a replacement strategy. I'll let you take that part first. What's your observation been there.

**JB:** [00:08:06] Let's if we pull the lens back here, Michael, a little bit, I think there's a repricing between debt and equity ongoing. I think the key term I would use is quality. And what we're doing at the moment is essentially acquiring quality. So we're not necessarily increasing our returns expectations, we're increasing the quality of the portfolios that we're acquiring. Generally speaking, because interest rates are rising, that is taking value away from any equity owners in the private equity industry in general. It's a generalization. And that means the available returns from any debt instrument, whether it's secondaries or primary, has increased substantially too. How does this manifest itself in the transactions that we're looking at?

We're often pricing senior secured loan portfolios, which on a primary basis are probably in or around 9 or 10% gross returns, and we're achieving double digit returns, you know, all the way up to mid-teens. And that is indicative of a general move. Now, we're not talking about returns at that level but we are talking about very high-quality portfolios.

**MV:** [00:09:13] So that focus on quality actually dovetails with the second question I wanted to ask you, and that's about the risks. I mean, you know, let's take direct lending, setting aside some of the other strategies for a moment it's well regarded for its lower volatility relative to bonds, stable cash flows, floating coupons, which are attractive enough on their own. But now you throw in higher, maybe return expectations closer to leveraged buyouts. It's easy to see why investors are enthusiastic about the sector credit secondaries. But let's pump the brakes a bit. Can you dig into the risks and how investors can mitigate them by focusing on quality and other ways to do so?

**JB:** [00:09:59] Absolutely. I mean, again, I'm going to say this, but it's data. It's definitely data. We talked about this subjective environment that developed in 2022. Everyone's taking a different view. And if I look at a portfolio and a peer of mine across the industry takes a look at the same portfolio, we're going to be assessing different levels of loss rates in that direct lending portfolio. So if in a very benign environment, you get loss rates across well-diversified portfolios of, say, 50 or 80 basis points, that means off your gross returns, you take your fees, you take an assumption of loss rate, and that's give or take where you should be on a net basis.

If you're looking at a portfolio in a dislocated environment like we have now, you will need to input maybe between 150 basis points, 200 basis points or more to get to your comfortable level of loss assumption. How do you do that? You can only do that by having data on the underlying portfolios. You can only do that by taking a view on what we call fixed charge cover. How are the underlying companies paying this increased floating interest rate? How are their profit and loss accounts doing? How is their income statement looking and do they have the ability to see this this current dislocation through. Many will. Most will, we believe very long term in this private data asset class. But if you price to finally on the secondary, you could find yourself in a bit of trouble. Intrinsic in that as well is what I would call or manager level risk is the manager we're looking at in this dislocated environment capable of dealing with what we call watchlist names, the names of credits, the companies that are veering into difficulty, that are needing some support, that are needing frequent interaction with their managers, that can be overloading, particularly for smaller managers. And that gives us pause when we look at pricing these secondaries interests.

**MV:** [00:11:56] So you by bringing up quality, you kind of brought up another, I guess, another thought. So I recently had an interesting conversation with Natalie Walker on our small buyout team, and she was talking about how quality can be fleeting. In other words, tailwinds change and what makes one company attractive an attractive investment at one point in the cycle may turn into a headwind at another point. Given where we are have the deals you've seen favored one sector or another?

**JB:** [00:12:25] It's an interesting point of view, and I can understand why Natalie in particular made that. I think, you know, there's a lot of persistence in the private equity market in terms of manager. You get somewhat the same persistence when it comes to intra-vintage performance by private debt managers. But I think what investors really value these days is big diversified portfolios because in a post Covid environment, everyone hates concentration risk. And what do I mean by that? That that really manifests itself if during a Covid period you might be overweight hospitality or you might be overweight cruise ships or you might be overweight hotels or, you know, chains of pubs or restaurants, if that happens, then you're looking at losses. And since, as we've already discussed, returns are capped in this industry, you really don't want that. And what private debt investors really want is what I call “boring predictability.” You just want loads and loads of similarly originated, similarly looking at low leverage, I would call it market beta style exposure to private debt. If you can get those predictably at low cost and recycle and recycle and recycle, you're going to end up compounding return. And so that's what we really value is that in rather than quality, it's quality multiplied by quantity. Sorry to be so base but that is actually the truth. I think a lot of the private debt market is arriving at a more beta like concept rather than picking out idiosyncratic return. Natalie's job is to pick out idiosyncratic return, really high quality, really high performing managers. Ours is really to avoid idiosyncratic losses.

**MV:** [00:14:12] John, you've been really generous with your time and perspective. Before I let you go, is there anything else we missed that you think we should cover?

**JB:** [00:14:21] Well, I mean, it's really a complement to the discussion we've been having. There's been quite a lot of innovation this year and last in terms of providing LPs and GPs with liquidity. You know, one obvious example is banks entering this market as sellers of loan portfolios and we're certainly very active in that. But another one which is equivalent to the liquidity that perhaps private equity fund managers are generating at an individual company level, the development of the NAV lending or portfolio financing business has really emerged, and that's a way for private equity funds themselves to lever the funds; generate liquidity to finance extensions in their own distributions. Think that's something that certainly StepStone is keeping its eye on. It's participating in and would see it growing as a as another means of generating liquidity and another key piece of the liquidity arsenal.

**MV:** [00:15:16] Yeah, certainly Lisa Larson and I, Lisa from our portfolio management team, she and I did an episode on NAV-based lending just a couple months ago.

**JB:** [00:15:26] Absolutely. That's where it got most of my ideas.

**MV:** [00:15:29] Thanks again, John, for joining me today. Be well and hope to see you again soon.

**JB:** [00:15:34] Michael, I see you every year in New York. I'm looking forward to that moment again. Thank you very much.

**MV:** [00:15:38] That does it for this episode of RPM. For more color on today's conversation, head to stepstonegroup.com, where you can find our recent article on credit secondaries as well as all our research on private markets. RPM is available on Apple Podcasts, Spotify, Stitcher and other podcast platforms.