STAR MOUNTAIN
CAPITAL

The Rise Of Private Credit Secondaries

A Differentiated Strategy Offering Investors a Diversified Pool of Defensive and Low Market Correlated Assets with Current Yield, Equity Upside and other Potential Tax Advantaged Benefits.

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EXECUTIVE SUMMARY

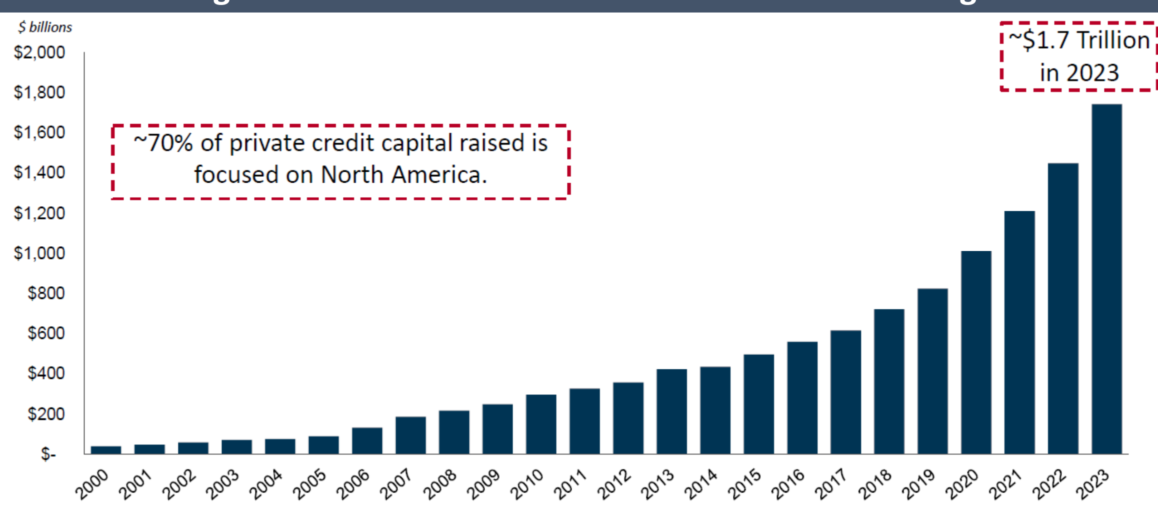
As financial markets evolve, new asset classes are formed, and innovative solutions are identified. Following the growth of the private equity market in the 1990s some investors found themselves holding long-term, illiquid fund investments at a time when they needed liquidity for various reasons. Naturally, this gave rise to a private equity secondaries market where other investors were able to provide liquidity by purchasing these illiquid fund positions, often at a discount, in volumes great enough to form an asset class of its own now known as secondaries.

Following in the footsteps of the boom in the private equity market, the global financial crisis accelerated the growth of a flourishing private credit market. Inherently, like we saw in private equity, this growing pool of illiquid private credit fund investments creates opportunities for investors to buy and sell existing investments in private credit funds in the same way, creating what we now call the private credit secondaries market. Just as there are differences in the private equity secondaries market based on the underlying fund strategies across geographies, company sizes, or type of equity investments, there are also numerous focus areas within private credit secondaries and the competitiveness and attractiveness for investors can vary based on simple supply demand dynamics. Based on data, there are approximately 1,000 lower middle-market funds with thousands of investors who have limited liquidity options, creating a large pool of opportunities to purchase discounted fund positions. Limited buyers exist with the origination capability, due diligence skills, and strategic focus to acquire smaller credit-oriented secondary assets, creating high barriers to entry and opportunities for specialized lower middle-market private credit secondaries managers to benefit from this supply demand imbalance.

PRIVATE CREDIT SECONDARIES

Private credit outperformance and asset growth has created what is now an underserved secondary market. Limited Partner ("LP") allocations to private credit managers have accelerated over the past ten years with fundraising increasing at a rate of ~ 10% annually, ending 2023 with a total aggregate commitment of $1.7 trillion [1].

Significant Growth in Private Credit Fundraising



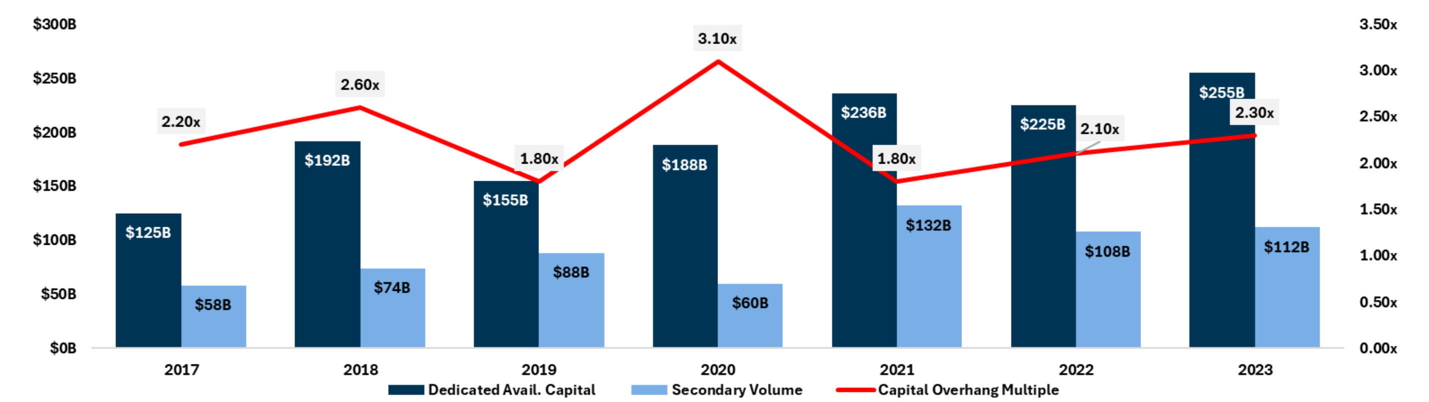
Source: Preqin. August 9, 2024.

Even with spreads of interest income over risk free assets decreasing, Preqin's most recent investor survey shows that "over half of investors surveyed (53%) predict that private credit will perform even better over the next 12 months. As a result, it is the asset class where the highest proportion of investors surveyed intend to increase allocations over the next 12 months (45%) [2]."

A rapidly growing investor base coupled with a demand for liquidity has fueled a need for private credit secondary vehicles. The current secondary dry powder which includes private credit secondaries remains small relative to potential opportunities and therefore many deals are going untraded due to the supply demand mismatch [3]. According to Bain "…the secondaries space is undercapitalized. Currently, the private secondaries asset class has about $200 billion of dry powder. In comparison, buyout funds are sitting on a record $1.2 trillion in dry powder, 26% of that being four years old or older [4].

The chart below further illustrates the capital overhang that exists in the private secondaries space. Capital overhang refers to the amount of committed, but un-invested capital that an investment firm has at its disposal. Even with this growth, private market AUM (i.e., the potential supply of secondaries) has grown more than secondaries (20% CAGR vs 17% since 2017). As a result, the secondary market remains under-capitalized relative to the broader private markets industry from which it derives its opportunity set.

Limited Current Capital Raised for Private Credit Secondaries

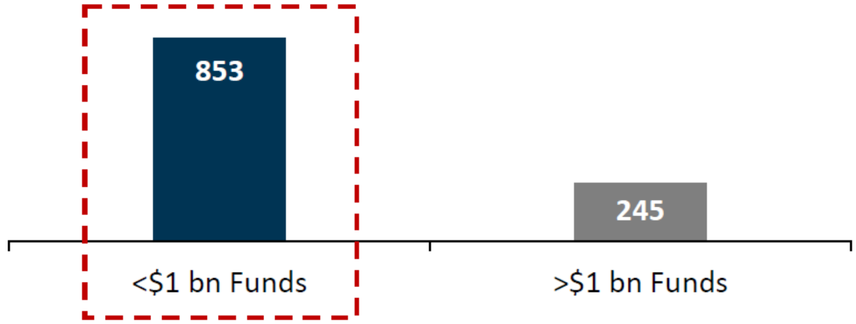


Source: Jefferies Global Secondary Market Review – January 2024. Capital Overhang Multiple defined as Dedicated Available Capital divided by Total Secondary Volume.

Large Market Opportunity in Smaller Private Credit Funds

78% of U.S. private credit funds raised in the last five years (853 funds) have been less than $1 bn in fund size creating a large opportunity set of LPs with idiosyncratic needs for liquidity.

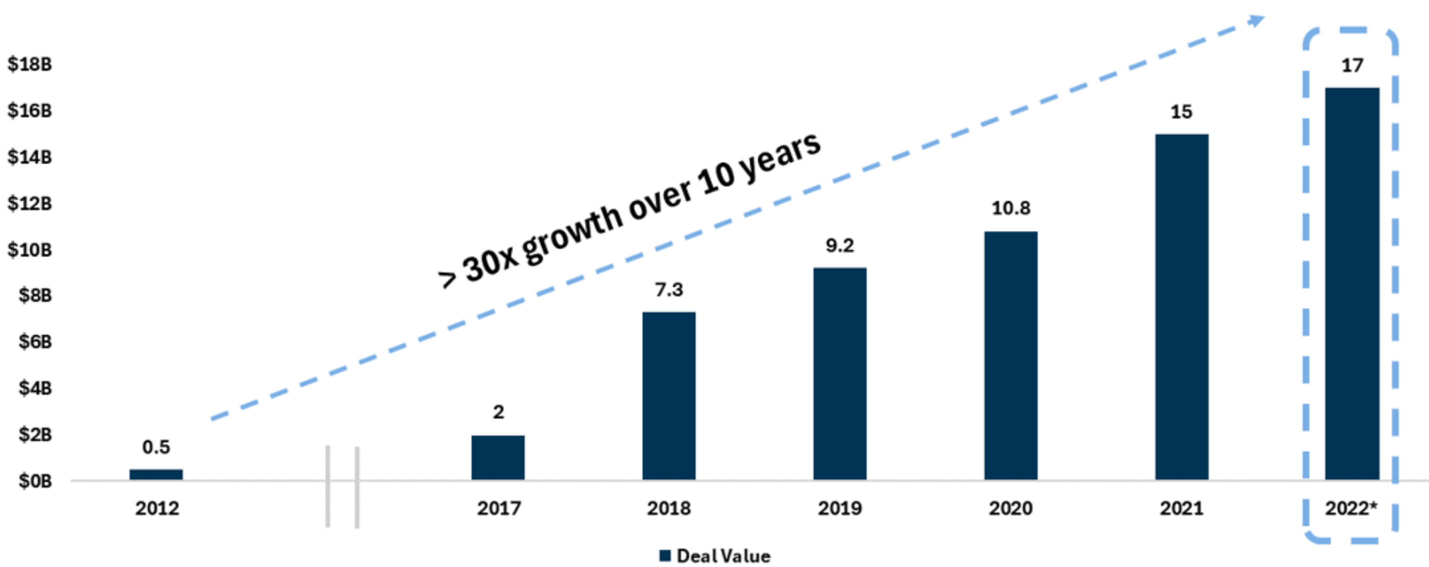
Non-institutional clients, such as individual investors, family offices, and Registered Investment Advisors, tend to be more sensitive to liquidity needs, which may make them more likely to sell or buy secondary positions, especially during periods of market dislocation or volatility. During volatile market conditions, the pressure to maintain liquidity can drive these investors to seek out opportunities in the secondary market, where they can either offload positions to free up cash or buy into opportunities.



Source: Pitchbook, December 2023. Based on U.S. Private Debt funds raised between 2019 and 2023.

The private credit secondary market has grown 30x since 2012,[5] which has led to the current supply demand imbalance as there are not enough capital providers to satisfy the deal flow in this space. Therefore, experienced buyers can be extremely selective in this market; however, new entrants will need to pay close attention to the quality and terms of their purchases as risk tolerances and rates fluctuate.

Private Credit Secondary Deal Activity Has Grown 30X Since 2012



*Source: Coller Capital - *2022 deal value includes estimates*

According to Private Debt Investor's LP Perspectives 2024 Study, investors are more interested than ever in capitalizing on the opportunities available in private credit secondaries. In all, 21% of LPs now plan to commit capital to secondaries funds in private credit over the next 12 months, the highest proportion ever seen in the survey and up from 7% as recently as 2022 [6]. Investors are now taking notice of private credit secondaries as a method of achieving immediate diversification, reducing dispersion in returns, mitigating the j-curve while capitalizing on market dislocation.

Private credit secondaries transactions can take various forms, including the purchase of individual loans or debt portfolios, the acquisition of interests in private credit funds (LP positions) as well as fund solutions like Net Asset Value (NAV) lending and continuation vehicles. These transactions often occur in a bilateral or negotiated manner between buyers and sellers, with pricing and terms reflecting factors such as credit quality, collateral characteristics, and prevailing market conditions.

The private credit secondaries market presents a significant opportunity for investors seeking exposure to the private credit asset class. Investors in private credit secondaries may seek to achieve several objectives, including portfolio diversification, yield enhancement, j-curve mitigation, and liquidity management. By acquiring existing credit assets through a secondary fund offering, investors can gain exposure to a wide range of credit opportunities across multiple vintage years, potentially generating attractive risk-adjusted returns while mitigating some of the illiquidity and duration risk associated with traditional fixed income investments.

Overall, private credit secondaries play an increasingly important role in the private credit landscape, providing investors with access to a diverse array of credit opportunities and facilitating liquidity in the private credit market.

MARKET OPPORTUNITY

Increasing Demand for Private Credit:

As traditional fixed income yields remain volatile, institutional investors are increasingly turning to private credit strategies to enhance portfolio returns and diversification. Private credit, including secondaries, offers access to a wide range of credit assets with potentially higher yields and lower correlation to traditional equity and fixed income markets.

Growing Market Size:

The private credit market has experienced substantial growth in recent years, fueled by the rise of non-bank lending and disintermediation in the financial sector. As a result, the universe of investable private credit assets, including distressed debt, direct lending, and mezzanine financing, has expanded significantly, providing ample opportunities for secondary transactions.

According to a recent survey by placement and advisory specialist Ely Place Partners, $30 billion of deal flow is predicted for 2024 in the private credit secondaries space, reaching $50 billion of volume as early as 2026. The firm further notes, "The establishment of a dedicated buyer universe providing a fair price for credit assets has given LPs confidence to bring large portfolios to market [7]."

Liquidity Needs and Portfolio Optimization:

Institutional investors, including pension funds, endowments, and insurance companies, often face liquidity needs and portfolio rebalancing requirements. Private credit secondaries offer a solution by providing liquidity for existing investments, enabling investors to optimize their portfolios and redeploy capital into new opportunities or asset classes.

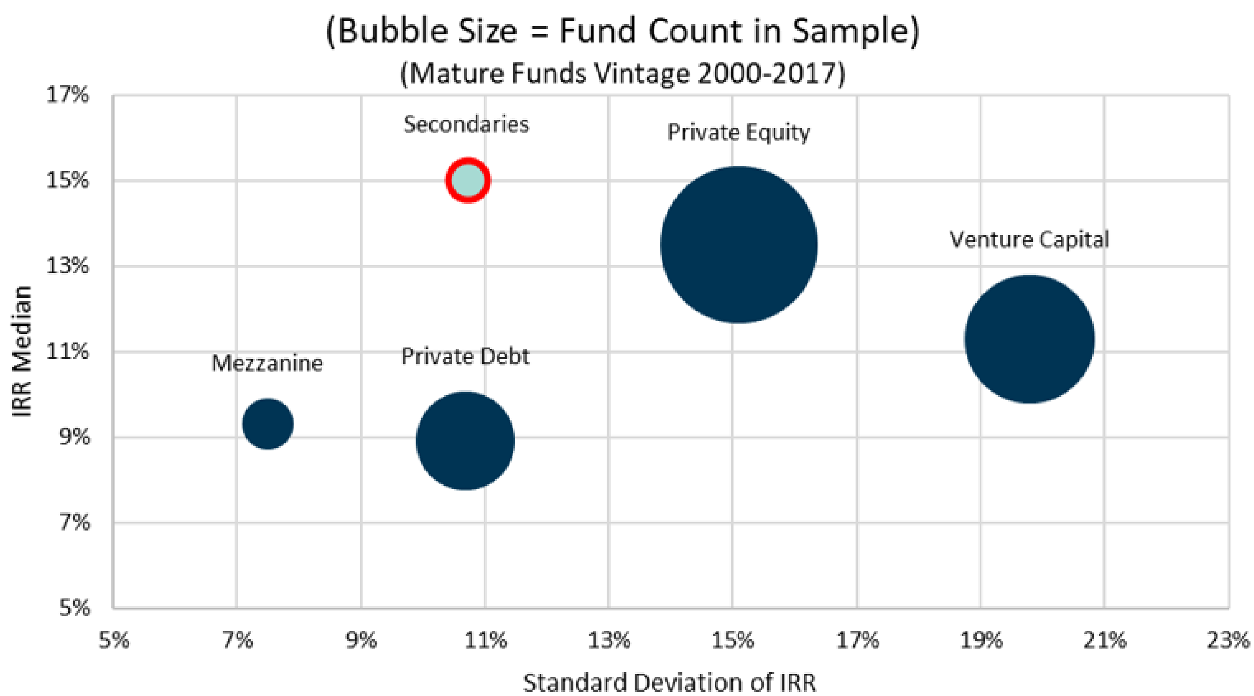
Diverse Investment Opportunities:

The private credit secondaries market encompasses a wide range of investment opportunities, including the purchase of individual loans, distressed debt portfolios, structured credit products, and private credit fund interests. Investors can gain exposure to various credit sectors, geographies, and risk profiles, allowing for customized portfolio construction and risk management.

Potentially Attractive Risk-Adjusted Returns:

Private credit secondaries, especially in the lower middle-market, have the potential to generate attractive risk-adjusted returns similar to the returns in Private Equity Secondaries as shown in the chart below compared to traditional fixed income and public market alternatives. Distressed debt and special situations investments may offer compelling return potential in times of market dislocation on or economic distress, while direct lending strategies provide stable income streams with downside protection.

IRR Median Return and Standard Deviation of Private Strategies



Source: Pitchbook
Note: Sample includes funds 2000-2017; 146 Secondaries Funds, 1,897 PE Funds, 764 PD funds, 203 Mezzanine Funds, and 1,289 VC Funds

Market Inefficiencies and Information Asymmetry:

The private credit secondaries market is characterized by information asymmetry and limited liquidity, creating opportunities for skilled investors to capitalize on market inefficiencies and mispricing. Active management, rigorous due diligence, and specialized expertise are critical for identifying and unlocking value in private credit secondaries transactions.

Structural Tailwinds:

Favorable macroeconomic trends, such as rising corporate indebtedness, credit market dislocations, and regulatory changes impacting traditional banks, can create structural tailwinds for private credit secondaries. Additionally, demographic shifts, technological innovation, and evolving capital market dynamics are driving demand for alternative credit solutions and financing alternatives.

RISKS & CONSIDERATIONS

Within private credit secondaries transactions there are a multitude of risks a manager needs to evaluate when determining whether a position is worth the price. Investing in secondary sales requires a thorough examination of these various risks. One of the primary questions fund managers should be asking is why the current owner is selling the asset?

By implementing a proper risk management and vetting process, teams can analyze insights into potential underlying issues with the investment pool. Additionally, it is crucial to determine if the asset in question is challenged that can affect the position's value. Evaluating the portfolio's valuations is another essential step in assessing whether the assets are valued prudently. The risk levels associated with the position also need to include vetting firm-specific risks. This can include proper firm and incentive alignment which can significantly impact the management and performance of the assets. Lastly, understanding fund level leverage and leverage per unit of risk is crucial in determining a proper valuation for an LP fund interest.

We believe that to properly address these risks, investment firms need highly experienced, well-resourced, and strategically aligned teams to review opportunities. These teams need to analyze opportunities to assess fair market value and growth potential, determining whether they are high-quality assets. It is also difficult for a lender to force a disposition of assets within a fund which is a risk that investors need to evaluate and understand as this could affect the exit timeframes and therefore impact the overall Internal Rate of Return performance. By meticulously examining these factors, a firm can mitigate these risks and enhance the likelihood of profitable investments in the secondary market.

CONCLUSION

It is expected that the private credit market will continue to grow given increased bank regulation and demographic trends with aging business owners looking for transition capital. The private credit market is currently at $3 trillion, so even if 2% of that was to come to market, in line with private equity secondaries [8], that would mean the private credit secondaries market grows by significant multiples. The private credit secondaries market is meaningfully undercapitalized relative to the significant transaction volumes managers are seeing. Traditionally, banks have been the main source of lower middle-market lending. However, there's been a significant reduction in the number of small to mid-sized banks that are able to lend to the marketplace since the Global Financial Crisis. This has been further exacerbated since the failures of Silicon Valley Bank, Signature Bank, and First Republic in 2023. Additionally, this end of the market is more complex and fragmented requiring resource intensive teams with strong direct underwriting capabilities and an ability to source and secure access to information to determine the appropriate valuation and pricing for these private credit assets.

Investors like the risk-return proposition providing significantly more immediate diversification than investors would get by committing to several direct lending funds, which is how most investors gain exposure to private credit. Investors are focused on manager selection and credit risk, private credit secondaries generally provides diversification across a diverse array of managers and vintages, which is particularly interesting for those just coming into the asset class.

Private credit secondaries also offer investors a different entry point into the asset class, with portfolios already fully ramped up, allowing for quicker deployment than other routes into private credit. Investors are now more educated about the private credit secondaries asset class, and they are attracted by the returns as well as the ability to access an extremely diversified pool of underlying assets. The growth is volume-driven and a natural evolution of the underlying market becoming more mature, with longer-hold vintages and fewer exits than planned, driving a need for investors to find liquidity.

Overall, the private credit secondaries market offers investors a potentially compelling opportunity to access a diverse universe of credit assets, generate attractive risk-adjusted returns, and enhance portfolio diversification in an evolving investment landscape. This can be even more pronounced in the smaller end of the private credit secondaries market where limited buyers exist with the origination capability, due diligence skills, and strategic focus to acquire smaller credit-oriented secondary assets, creating high barriers to entry and opportunities for specialized lower middle-market private credit secondaries managers to benefit from this supply demand imbalance.

FREQUENTLY ASKED QUESTIONS (FAQs)

How to Define Private Credit Secondaries?

- Refers to the buying and selling of pre-existing investor commitments in private credit funds. These can be structured as discounted purchase of assets or fund LP solutions.

What are the Types of Secondary Transactions?

1.) Purchase of LP Interest:
  - The sale of a fund commitment to a secondary buyer to achieve LP objectives. Sale of the LP commitment also generally removes future liability associated with this interest.

2.) Continuation Fund:
  - Allows a GP to give additional time and or capital to generally attractive assets outside of the current fund while also providing LPs a liquidity option.

3.) Fund / LP Solutions:
  - Investors can provide liquidity to both General Partners (GPs) and Limited Partners (LPs). Liquidity can be structured in the form of Net Asset Value ("NAV") loans or preferred equity, whereby the loan is supported by the NAV of the fund or LP.

4.) Direct Secondary:
  - Purchase of direct loans to companies from the original institutional shareholders. It is not the purchase of an LP interest or a portfolio of LP interests.

What is Creating the Opportunistic Purchase of Credit-Related Assets in the Secondary Market?

- Liquidity Needs.
- Portfolio Rebalancing.
- Market Conditions.
- Enhanced Returns.
- Growth of Private Credit Markets.
- Maturity Extensions and Loan Refinancing.

What Are the Potential Benefits to LPs and GPs?

- Limited Partners:
  - Liquidity to meet obligations.
  - Liquidity to invest in a manager's future fund.
  - Manage sizing and exposure of certain asset classes due to denominator effect.
- General Partners:
  - Allow GPs to provide liquidity to LPs in legacy funds.
  - Provide additional capital for acquisitions or add-ons after investment period.
  - Provide dry powder to portfolio companies that may face distress.
- Shared:
  - Allow the owner to retain upside in assets while receiving liquidity for various needs.

- Afford the owner more time to hold asset rather than selling into unfavorable environment.

Why is Lower Middle-Market Credit Secondaries a Potentially Attractive Investment Opportunity

- Supply demand imbalance creating increased selectivity to deals.
- Large fragmented market with over 850 funds of less than $1 billion in fund size.
- Diversification benefits by investing in a portfolio of assets with typically higher credit ratings and producing quarterly yields.

End Notes and Disclosures

1 Preqin Fundraising Data as of 3/18/2024

2https://www.prnewswire.com/apac/news-releases/a-quarter-of-surveyed-investors-plan-to-increase-pace-of-private-capital-allocations-as-market-confidence-grows--preqin-reports-301905835.html

3https://www.gsam.com/content/gsam/global/en/market-insights/gsam-insights/perspectives/2023/private-secondaries-markets.html#section-#change

4 https://www.bain.com/globalassets/noindex/2024/bain_report_global-private-equity-report-2024.pdf

5 https://pitchbook.com/news/articles/private-debt-secondaries-market-2023

6 https://www.privatedebtinvestor.com/the-growing-appeal-of-credit-secondaries/

7 Growth opportunities: Credit secondaries (privatedebtinvestor.com) June 3, 2024

8 https://www.preqin.com/news/fundraising-boom-as-private-equity-secondaries-market-heats-up

Investing in the Growth Engine of America ® – Star Mountain is a $4+ billion (as of 5/31/24 inclusive of debt facilities) specialized lower middle-market investor providing: (i) Strategic Debt & Equity Capital to private businesses that have at least $15 million of revenue or under $50 million of EBITDA and (ii) Liquidity Solutions to investors and fund managers ("Secondaries") including purchasing LP interests and direct investments in lower middle-market private credit and private equity funds in addition to providing fund managers with NAV loans.

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