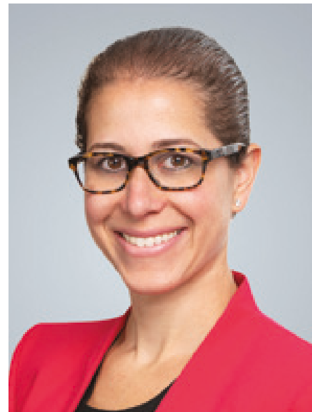
EXPERT Q&A

Increasing flexibility surrounding liquidity options is leading to a host of new opportunities for private credit investors, say Partners Group's Andrew Bellis and Lori Pomerantz



How liquidity is driving innovation in private credit

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Q Liquidity is increasingly becoming a hot topic across private credit. What is happening at the asset level and how are funds innovating to address it?

Andrew Bellis: To my mind, there are several drivers of the liquidity conversation at the asset level. The overall market has grown dramatically over the last few years in terms of size and the number of participants, so it is natural that liquidity starts to become a hot topic. We have seen how liquidity drove the development of an active private equity secondaries market over the past 20 years, and we are now starting to see the same thing happening in private credit. The other major driver is the growth of open-end evergreen funds, driven by demand from both wealth channels and institutional investors. A clear valuation process is also critical to ensuring liquidity in a fund.

Lori Pomerantz: We are seeing an increasing convergence between the syndicated loan market and direct lending, and, to the extent that the market backdrop allows, private equity sponsors have the opportunity to price both markets before determining the most attractive route. That additional choice and flexibility for borrowers is also contributing to the liquidity conversation.

AB: When it comes to innovation, the growth of evergreen funds and evergreen mandates is really driving the focus on liquidity, rather than funds necessarily innovating in response to it. There is an increasing acceptance among certain LPs that you cannot draw a clear distinction between direct lending and syndicated loans, so you may be better off having a product that can do syndicated when the market is dislocated, while also potentially looking at secondaries opportunities in

private credit. The advantages of that ability to pivot are starting to feature more in LP discussions.

Q What do you see happening at the fund level?

AB: As more of the market becomes evergreen and has an element of liquidity, the issues that need addressing at the fund level are only likely to emerge down the line and probably during a crisis-type event.

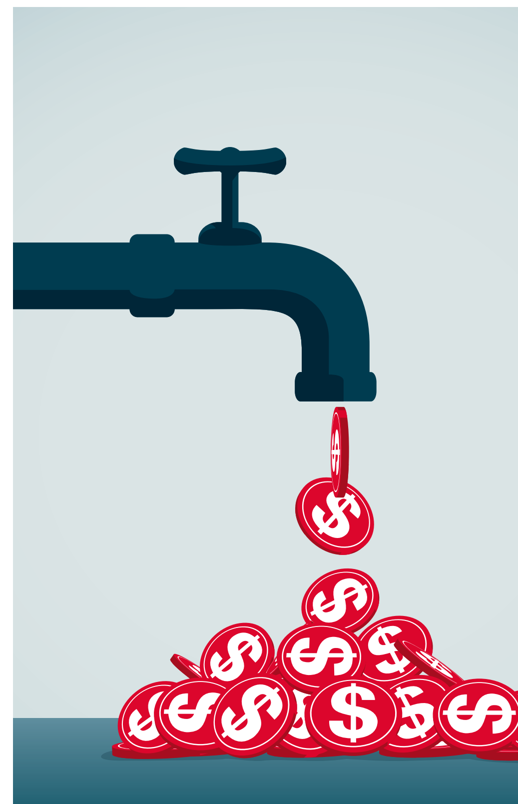
LP: The question is whether managers are structuring these vehicles correctly for when that situation arises. Are redemptions going to be manageable? Is it going to be possible to match those redemptions with new commitments, and are there sufficient sellable assets within the portfolio? The other question to consider is how quickly funds will be able to get liquidity back to investors. Lots of different structures have been created with these issues in mind, but they are yet to be tested.

One way we think about liquidity in our North American open-end fund is to match subscriptions with redemptions and manage subscriptions against quarterly redemptions with a 90-day notice period. That gives us a good line of sight and means that we can typically match redemptions without trading.

AB: One worry is that a main attraction of private credit is the fact it experiences much less volatility than the public markets, as we don't see the same pricing moves. But if there is a big push to trade private credit in future, that could lead to more volatility and we risk killing the golden goose, so to speak.

"Managers need to make sure that investors fully understand the liquidity mechanisms at work and that they are appropriate"

ANDREW BELLIS



Q How can evergreen funds address liquidity for investors, and what challenges do managers face with these vehicles today?

LP: Client interpretations vary as to what 'evergreen' means, and there is significant dispersion on what these funds look like. Some are closed-end structures with the ability to roll forward at a certain point in time, while at the other end of the spectrum you have a wide range of business development companies (BDC) and other semi-liquid structures.

In private credit you do get some natural liquidity, as most loans are seven-year maturities but tend to have a three-year life. You are also generating income through interest payments along the way, so there is an element of meeting redemptions using that natural liquidity as well as position roll-off.

When investors subscribe to an evergreen fund, they need to ask questions about both the route in and how quickly their money can get to work. We use a ramp and rotate process, using broadly syndicated loans to allow investors to get straight in and access the opportunity set before rotating into direct lending as and when opportunities arise.

AB: There is an added complexity with private credit in that there is not just investor liquidity to manage. A lot of these loans have revolvers or delayed draws and in a crunch, companies will likely draw on their revolvers just as investors want to get their money back, so you could be at risk of a bigger impact than just addressing investor liquidity needs.

Investing in evergreen funds relies on the manager not to take in capital too quickly, which can lead to diluted returns. At the same time, the manager also needs to be able to continuously raise capital, because any lack of subscriptions can be an issue in terms of being able to balance potential redemptions. So, to run a private credit evergreen successfully, a manager needs significant portfolio management

Q Given not all evergreen funds are constructed in the same way, how do you see that market evolving?

AB: There is a huge amount of growth in the BDC segment in the US, but the question is how the market will evolve outside of the US. A BDC is limited from a regulatory perspective around the amount of non-US investments it can make. That means market development should trend towards products that are non-US-focused, both from an investor and an investment perspective. However, these products outside of the US market may take time to grow and gain traction, particularly in the wealth channels.

LP: The other area where we see innovation is on the mandate side. Institutional clients in private markets have traditionally subscribed to closed-end funds and have been able to re-up when opportunities came along. But for smaller clients that don't have huge due diligence teams, having to re-underwrite for every re-investment is unappealing. As such, we are seeing more clients interested in evergreen mandates.

Investors are increasingly looking for customisation and many want to be fully invested from day one while others prefer the traditional drawdown model. Some also prefer more flexible mandates that may be focused on investing in North America today but that are moving towards being more global or are focused on other opportunity sets outside of direct lending. There is an added appeal in evolving with a manager as the market matures without having to do a full re-underwrite and go back to the investment committee each time in order to retain that exposure. Those evergreen mandates, as opposed to evergreen funds, are gaining traction.

"We are seeing an increasing convergence between the syndicated loan market and direct lending"

LORI POMERANTZ

expertise alongside broad distribution capabilities.

Finally, private wealth investors are different to institutions and managers need to make sure that investors fully understand the liquidity mechanisms at work and that they are appropriate. Retail investors don't necessarily want the same liquidity profile as institutions. The run-off sleeves in our institutional products are a much easier way to manage through liquidity because you don't necessarily need that asset level liquidity but it's unlikely that structure would work for retail or wealth investors. That being said, the market will evolve as we go through periods of volatility and continue to learn and adapt.

Q Finally, what is driving growth in private credit secondaries and what does the future look like for that space?

AB: We have seen a real pick-up in secondaries opportunities recently. Some of the early activity was due to UK-specific events driving a need for liquidity solutions, but there is also a broader trend among LPs to manage their overall private markets exposure.

That is driving demand for credit secondaries across a combination of portfolios that are tail-end and ready to sell, and newer portfolios, where it is much more of a portfolio management exercise. If you look at the scale of private equity secondaries, there is no reason, given where private credit currently is, to think that the credit secondaries market will not also grow substantially.

LP: Clearly, on the secondaries side, someone must have a reason to sell. Another interesting area, however, is NAV lending, where there are opportunities to provide liquidity to the GP or to a specific fund. For example, if an investor needs liquidity but has an exposure that they don't necessarily want rid of, a NAV loan on that exposure can be a neat solution. This is definitely coming up in conversations more frequently.

We are also seeing a growing interest from LPs in getting access to previous vintages via secondaries.

AB: Broadly speaking, there are simply more LPs looking for liquidity solutions on their portfolios. There is an overwhelming concentration on direct lending portfolios, but there is also activity in opportunistic credit, mezzanine and a whole variety of other sub-strategies.

There is more of an asymmetry of information here than there is on the private equity side, which potentially creates a less efficient market for a certain period of time, but which should ultimately be good for investors. We will see growth in this space and an increasing variety of opportunities for innovation. ■

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