STEPSTONE

Current opportunities in the primary and secondary direct lending markets

Private debt | MARCH 2024

Recent macroeconomic developments have created an attractive investment environment for direct lenders. Higher base rates combined with favorable lending terms are translating into higher risk-adjusted returns.

At the same time, underwriting standards (e.g., leverage levels, lower LTV, conservative valuations, etc.), have become friendlier to lenders. In sum, developments have led to an increase in yield, while reducing leverage levels.

In addition, loans originated in previous investment vintages, which also benefit from current rate levels, still offer attractive secondary opportunities. Such transactions have the potential to lead to enhanced diversification, increased deployment opportunities and the potential for outsize returns thanks to the possibility of a discount. Moreover, they tend to have shorter remaining economic life, potentially leading to faster receipt of cash flows which in turn can further enhance IRR.

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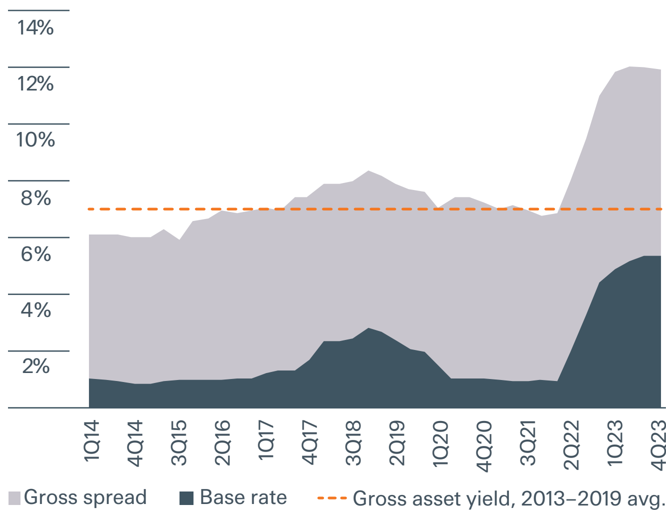
By carefully selecting investments from both current and previous vintages, direct lenders can construct a diversified portfolio with attractive risk-adjusted return potential.

Why is the primary market currently attractive?

Higher interest rates have propelled direct lending's yields to higher levels ranging from 11 to 12%. Despite the specter of base rates potentially decreasing later this year, we expect gross asset yields to remain between 9 and 11%—materially above the long term average (**Figure 1**). As a result, direct lending's ability to provide high absolute returns may persist.

FIGURE 1: US PRIMARY GROSS ASSET YIELD COMPONENTS

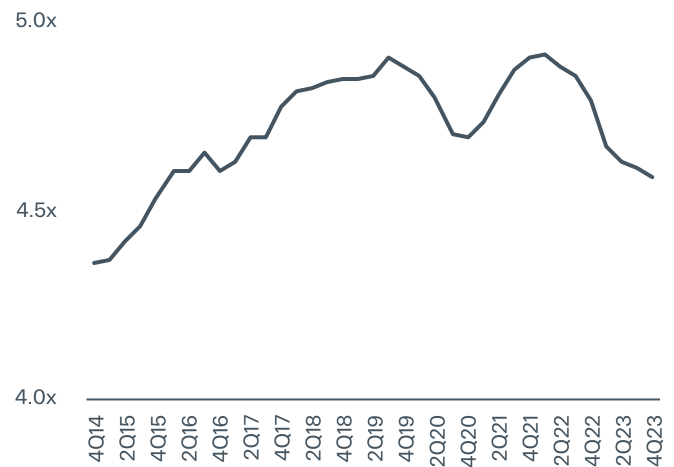


Source: Refinitiv LPC, as of Q4 2023.

DEAL LEVEL LEVERAGE IN THE PRIMARY MARKET

Direct lenders have gained greater control over lending terms, leading to a more lender friendly environment with tighter documentation. A good indication of this observation is the total leverage, which has decreased from the highs of 2021 and 2022 to levels closer to those seen before the pandemic. The last twelve months average (**Figure 2**) shows a total leverage of 4.6x at the end of 2023, down from a peak of 4.9x at the beginning of 2022. Lower leverage contributes to lower risk for a given borrower's profile and thus improves direct lending's risk-adjusted returns through potentially lower loss rates.

FIGURE 2: US PRIMARY LTM TOTAL LEVERAGE



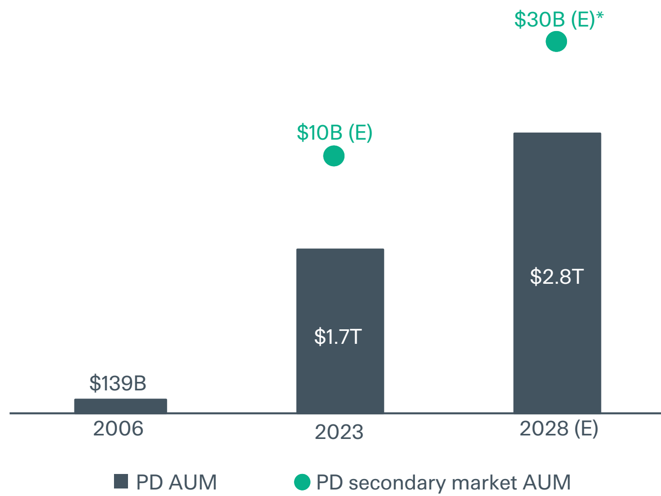
Sources: Refinitiv LPC and StepStone, as of Q4 2023.

> Recent macroeconomic developments have provided an attractive investment environment for direct lenders, which we expect to persist.

Opportunities in the secondary market

Attractive opportunities are not limited to primary deals. The secondary market has grown substantially since the Global Financial Crisis. And while the secondary market is but a minute fraction of the overall private debt market, there are no signs of it slowing. Current estimates suggest its size will potentially triple by the end of the decade (**Figure 3**). There are two generic forms of secondary transaction: LP-led and GP-led.

FIGURE 3: SECONDARY VOLUME



Sources: Preqin Global Report: Private Debt, 2024 and PJT Park Hill Secondary Market Insight, 1H 2023.

*$30B represents a 2030 estimate for the PD secondary market AUM.

LP-LED SECONDARIES

In an LP-led secondary an LP sells some or all of its portfolio to another LP or fund manager. Often, the need for liquidity or to rebalance one's portfolio is the catalyst. This is particularly relevant when the traded markets are underperforming (i.e. when public market valuations are challenged), leading some investors to be overweight private markets (aka, the denominator effect). Since valuations in the direct lending market tend to remain relatively stable, investors can opt to sell their direct lending portfolios to generate liquidity, instead of realizing losses on their public asset holdings.

GP-LED SECONDARIES

GP-led secondaries can take various forms and are tailored to solve specific issues. For instance, GP-led secondaries could happen when the GP is looking to free up capital in order to execute on new investment opportunities. Alternatively, the GP may be seeking to increase diversification in its portfolio by reducing its exposure to single borrowers.

> The secondary market is offering attractive return enhancement opportunities thanks to discounts.

SECONDARY DISCOUNT AND THE BREAK-EVEN LOSS RATE

Similar to current primary deals, previous vintages benefit from higher base rates. However, because these older loans were usually not underwritten with high base rate scenarios in mind, which combined with less favorable lending terms, they may entail higher risk. Thus, secondaries involving such loans could require a discount that reflects both the credit risk and the seller's liquidity need.

In a simplified analysis, **Figure 4** illustrates the incremental discount necessary to offset increases in the marginal loss rates given a similar pricing as for the primary market. This break-even analysis shows how much additional loss the secondary portfolio could take before it would provide the same return available in primary markets. Assuming an average loan life of three years, which is conservative since secondary portfolio loans tend to have lower economic life, a secondary opportunity with a 6% discount could withstand an additional 2% loss rate relative to primary deals. Losses at this level would represent material stress in the market and would not be expected. Hence, this is how secondaries can enhance returns.

FIGURE 4: SECONDARIES DISCOUNT AND BREAK-EVEN LOSS RATES

Metric	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
Discount	2%	4%	6%	8%	10%
Break-even loss rate	0.7%	1.3%	2.0%	2.7%	3.3%

Source: StepStone, as of January 2024. The loan life is the historical loan life of approx. 3Y. For illustrative purposes only.

Note: Loss rates above the standard primary long-term average of 1.04%.

Conclusion

All in all, when you consider the attractive primary market opportunity, coupled with the burgeoning secondary market, private debt offers investors several avenues to pursue superior risk-adjusted returns.

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All data is as of March 2024 unless otherwise noted.

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