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Second (is) Best

ATALAYA CAPITAL MANAGEMENT LP | Q3 2023

Many of us are predisposed to think that "first" is the best category to end up in. First in innovation, first place in a competition, first choice among competitors… the list goes on and on.

However, there are certain times where "second" can be better. As math nerds know, a derivative is often simpler than the original. Showing up first to a party can be awkward. And don't forget, the Godfather II was nominated for 11 Academy Awards, whereas the Godfather I was nominated for ten. Likewise, enter the secondaries investment universe. The world in which "second" rules.

While there will be many exciting opportunities that emerge in corporate credit as volatility and dislocation persists, credit secondaries present an opportunity for attractive returns via structuring and diversification, with the benefit of historical performance data.

In general, we believe that private credit presents better relative value when compared to private equity today. Historically, median private equity returns have hovered around 18%, while private credit returns remained in high single or low double digits. Today, private credit returns are reaching well into the mid-double digits, which is around historical highs.[1] On the other hand, private equity seems to be entering a more challenging environment relative to past performance. Given this dynamic, the market for private credit has grown considerably and credit secondaries provide buyers a way to access a seasoned, diversified subset of this growing market.

As one of the fastest-growing asset classes, we believe that the private credit market has reached a level of maturity that indicates secondary transaction volume will continue to pick up in a meaningful way. Current market conditions, as alluded to above, will drive General Partners ("GPs") and Limited Partners ("LPs") alike to seek alternative liquidity solutions for their investments, with many LPs becoming forced sellers due to the denominator effect. In order to capitalize on such transactions, there will need to be secondary buyers in the market that have experience underwriting complex credit-related assets at scale. With increased volatility in the market, lenders will often end up in the strategic position to drive favorable pricing and negotiate lower leverage, obtain stronger covenant packages and other protections that control downside without sacrificing returns. This same dynamic is present with structured solutions in the secondaries market.

In this whitepaper, we will (i) frame the opportunity set for credit secondaries, (ii) explain why the market is uniquely poised at this time for a continued uptick in secondary activity, and (iii) describe how secondary solutions potentially benefit both buyers and sellers of credit assets.

1. Will Credit Returns Surpass Private Equity, Even as Risk Declines? February 2023. Jeffrey Diehl. Adams Street. https://www.adamsstreetpartners.com/insights/will-private-credit-returns-surpass-private-equity/

Defining Credit Secondaries

The secondaries market refers to the buying and selling of pre-existing investor commitments in closed-end funds, which have historically been dominated by private equity. Credit secondaries is a broad umbrella term within this market, but for the purposes of this whitepaper, we cover credit secondaries in the form of two structures:

1. Opportunistic purchase of credit-related assets in the secondary market.

This may include participation in more traditional secondary structures (similar to private equity secondaries), but where the underlying asset exposure is credit-related as opposed to equity. Examples of such assets include corporate credit or specialty finance loans. These can be structured as discounted purchases of assets, continuation vehicles, or fund restructurings.

2. Lending structures as secondary solutions.

Lenders can provide liquidity to both GPs and LPs via credit structures across a variety of asset classes. These can be structured in the form of Net Asset Value ("NAV") loans, whereby the loan is collateralized by the NAV of the fund, or preferred equity.

We believe that we will see an increase in both types of credit secondaries over the medium term, driven by two separate trends. **First**, private credit as an asset class has grown meaningfully in the last 10 years and the increase in capital formation has resulted in seasoned vintages of credit becoming eligible candidates for secondary transactions. **Second**, as the broader market environment, continues to see the tightening of capital markets and retrenchment of alternative lenders, there will be greater need for credit secondary solutions as other liquidity avenues dry up.

Growth in Credit Assets Under Management

The private credit market has experienced significant growth over the past couple of decades. Since 2000, private credit AUM has grown at an 18% CAGR (see Exhibit 1 on the following page).[2] If the private equity market serves as any example of the potential for growth, we believe private credit's recent AUM growth should be followed by a broadening in the secondaries market.

The private equity market enjoyed major growth in AUM throughout the early 2000's. However, it wasn't until the mid- 2010's that private equity secondary volume picked up (note the gold dashed line in Exhibit 2 - also on the following page). Once those early 2000's vintages matured, the secondaries market solved for either timing or liquidity issues in these funds that were nearing the end of their lifecycle. Those early 2000's vintages represented ~$9tn in AUM, and after they started to mature in 2013, private equity secondary volume grew at a ~20% CAGR.[3] Comparing the AUM growth in Exhibit 1 to Exhibit 2, it's clear that the private equity market matured earlier than private credit.

Although the private credit boom has been a more recent phenomenon, we are already seeing downstream secondary market growth. From 2012 to 2022, Pitchbook estimates that credit secondary volume grew to ~$17 billion, representing 30x growth for the decade.[4] Given that secondary market volumes typically run on a lag, we believe we are still in the early innings of expansion as private credit AUM has continued to reach new heights in recent years.

2. Will Credit Returns Surpass Private Equity, Even as Risk Declines? February 2023. Jeffrey Diehl. Adams Street. https://www.adamsstreetpartners.com/insights/will-private-credit-returns-surpass-private-equity/
3. Will Credit Returns Surpass Private Equity, Even as Risk Declines? February 2023. Jeffrey Diehl. Adams Street. https://www.adamsstreetpartners.com/insights/will-private-credit-returns-surpass-private-equity/
4.Private Debt Secondaries Flooding the Market Overwhelm Limited Capital. February 2023. Madeline Shi. Pitchbook. Private debt secondaries flooding the market overwhelm limited capital | PitchBook

Exhibit 1: PD AUM & Dry Powder by Year[5]

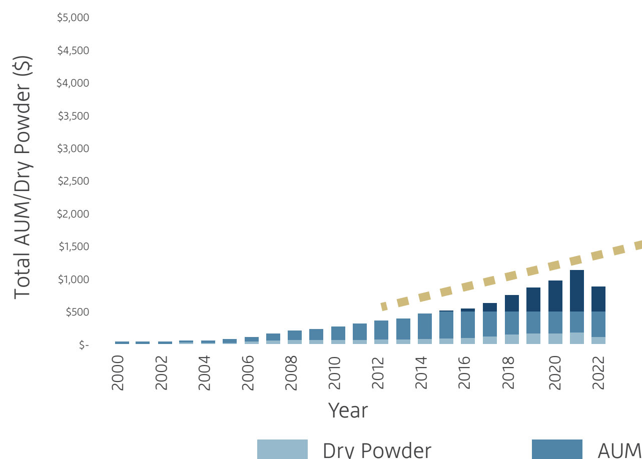


Exhibit 2: PE AUM & Dry Powder by Year[5]

Market Conditions Creating a Need for Secondaries

Since 1980, US recessions have led to steep declines in the value of global merger and acquisition ("M&A") activity—typically, around 50 percent during the first year of the recessionary period.[6] While we cannot predict how current market volatility will play out, history suggests that this uncertainty will lead to (i) lower M&A transaction volume and values, (ii) lower initial public offering ("IPO") volume, and ultimately (iii) a lower level of distributions from alternative investment managers with closed-end vehicles.

For example, in 2022 the global IPO market fell off a cliff, with volumes down 45% YoY. This trend was sustained through Q1 2023, which resulted in the lowest IPO volume since early pandemic Q2 2020.[7] It is expected that IPO activity will remain muted through the end of 2023 and will require sustained improvement in both stock market performance, inflation, and rate hike expectations before volume grows again.[8]

While early 2022 M&A volume remained strong, we are now seeing the effects of broader market volatility in the numbers. Q1 2023 was the third lowest M&A volume in the last 10 years, with only Q1 2013 and early pandemic Q2 2020 having had lower volumes.[9]

While there remains mixed consensus around where total M&A volumes will shake out in 2023, it is broadly expected that valuations will be down across the board. While companies may continue to pursue acquisition activity (as acquisitions can provide a path to growth in times of market turbulence) we believe the overall market size and proceeds via M&A are likely to decline. This trend has been seen in previous market stresses, including the Great Financial Crisis ("GFC"), during which valuations fell ~30%.[10]

This trend is becoming evident in private equity exit volumes, with 2022 aggeregate value of private equity exits down 32% from 2021.[11] In Q4 2022 alone, median late stage private equity valuations dropped ~25% year over year.[12] Given downward trends in both IPO and M&A exits, it is expected that secondaries activity will become a major liquidity avenue for both LPs looking to monetize illiquid holdings and GPs looking to crystalize success on certain assets without a "true" exit. Many major asset managers and advisors have already put their stake in the ground on the matter, predicting increased secondary volumes in 2023.

5. Preqin Data as of Q1 2023.
6. What's Different About M&A in this Downturn. January 2009. Capaldo et al. McKinsey & Company. https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/whats-different-about-m-and-a-in-this-downturn
7. Our Thinking: Global IPOs: Seeking signs of stabilization. April 2023. Al-Louzi et al. White & Case. https://www.whitecase.com/insight-our-thinking/global-ipos-markets-pause-take-breath
8. How can you prepare to seize the right moment? EY Global IPO Trends 2022. Ernst & Young. https://www.ey.com/ipo/trends]
9. Bloomberg Law Analysis. April 2023. Emily Rouleau. Bloomberg. https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-there-was-no-sign-of-an-m-a-market-rebound-in-q1-2023
10. Harvard Business Review. The Case for M&A in a Downturn. May 2020. Brian Salsberg. The Case for M&A in a Downturn (hbr.org)
11. Harvard Law School Forum on Corporate Governance. March 2023. Cain et al. https://corpgov.law.harvard.edu/2023/03/22/private-equity-2023-outlook/
12. TD Private Capital Markets – 2022 Year in Review and 2023 Outlook

Credit Can Bridge the Bid Ask

Secondary sales do not occur in a vacuum and buyers are watching the same market dynamics as everyone else. As asset owners are highly motivated to sell, buyers will generally have the ability to purchase at steeper discounts and negotiate for more favorable terms. We expect this will lead to a larger bid ask spread between sellers and buyers.

In the second half of 2022, the secondaries market saw a steep decline in average price (down 10%+)[13] but also saw a significant decline in volume, as a result of what we believe to be a significant bid ask spread. GP-led transaction volume decreased ~25% in 2022, and these declines were a result of buyers underwriting significantly lower valuations in the second half of the year than sellers, resulting in disconnect on pricing.[14]

However, the clock is likely running out. GPs may believe in the long-term value of their assets, but they are receiving more pressure to create liquidity. Further, while LPs may need liquidity, GPs still have interest in retaining upside in the asset or continuing to keep the asset under their management to continue to maximize upside. In some scenarios, the GPs may not even be looking for a complete exit but rather have a need to obtain dry powder for acquisitions or company level investment. On the LP side, we believe the "denominator effect" has created forced sellers of fund assets, flooding the secondary market with product. In Q1 2023 and beginning of Q2 2023 we have observed many major pensions running $1bn+ portfolio sales, seeking liquidity.

Finally, many asset management firms will determine valuations on their portfolios quarterly, leading to a longer lag time between private and public market valuations in the context of secondary sales. This results in assets being held at valuations which may be artificially high or low, allowing secondary market sales to take advantage of illiquidity in private markets by potentially finding arbitrage opportunities.

These factors all lead to a need for credit solutions in the secondary market.

Private market lenders are often tapped to provide credit or a structured solution so they can avoid an outright sale of the assets. These structures can include NAV loans, preferred equity, or asset purchases with earnouts and/or deferrals (versus traditional secondary sales of LP interests). These provide considerably more flexibility (and potential upside) for would-be-sellers since they result in potential for upfront cash but not a true sale.

In addition to providing flexibility for GPs, these same solutions can help LPs rebalance their portfolios as they grapple with the "denominator effect", where their allocations to private markets have become overweight as public market valuations fall. The liquidity can also be helpful to LPs who want to make additional commitments or distributions, but have capital locked up in funds that have persisted past their term.

GPs typically want to hold onto high quality assets during uncertain times, increasing the need for secondary entrants as the various factors described above drive demand for liquidity. A key focus for lenders will be to focus on working with top performing managers that participate in non-cyclical industries that can withstand a recessionary environment. Appropriate secondary structures can allow much needed capital to flow into funds or to institutional investors, while protecting the downside via credit structures, and earning attractive returns.

13. Private Debt Secondaries Flooding the Market Overwhelm Limited Capital. February 2023. Madeline Shi. https://pitchbook.com/news/articles/private-debt-secondaries-market-2023
14. Global Secondary Market Review. January 2023. Jefferies.

Exhibit 3: Illustrative Benefits to Limited and General Partners

Limited Partners

- Liquidity to meet obligations (pension payout, operational cost of university, etc.)
- Liquidity to invest in a manager's future fundraising, including re-ups
- Manage sizing and exposure of certain asset classes due to denominator effect

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 sell into unfavorable pricing environment

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

Credit Secondaries in Practice

Below is an illustrative example of a credit secondaries transaction in the form of a NAV-based loan to a private equity fund. This loan provided the GP with growth capital and provided an alternative solution to bridge its fundraising gap.

Investment Overview[15]	Key Features
Senior secured delayed draw term loan to a private equity fund whose manager had already returned top quartile performance to investors	Robust Covenant Protections - Maximum LTV of 60% - No other fund-level debt or preferred securities allowed - Specialized, stringent requirements for largest position in portfolio
The GP used the capital to refinance existing debt and secure funding for potential follow-on investment opportunities at portfolio company level	**Contracted Terms.** Low double digit interest margin with market standard fees
Loan backed by a portfolio of the fund's assets and features strong covenant protections as well as mechanisms to capture upside potential	**Downside Protection**. Loan backed by a diversified portfolio of investments
Structure allowed GP to return some capital to LPs in seasoned fund via exits but also required significant amortization on the manager's loan	**Upside Optionality**. Strong buyer position allowed for negotiation of minimum MOIC requirements, ensuring the lender is properly compensated in upside scenarios

15. The credit secondaries example provided above is solely for explanatory purposes. Actual credit terms may vary significantly, and no representation is made that any investment will receive similar contractual terms or features.

Secondaries Throughout the GFC

We believe that in addition to providing much needed liquidity solutions, credit secondaries will also provide attractive returns. As discussed above, credit secondaries remain a nascent asset class, so we expect this thesis to be proven over time.

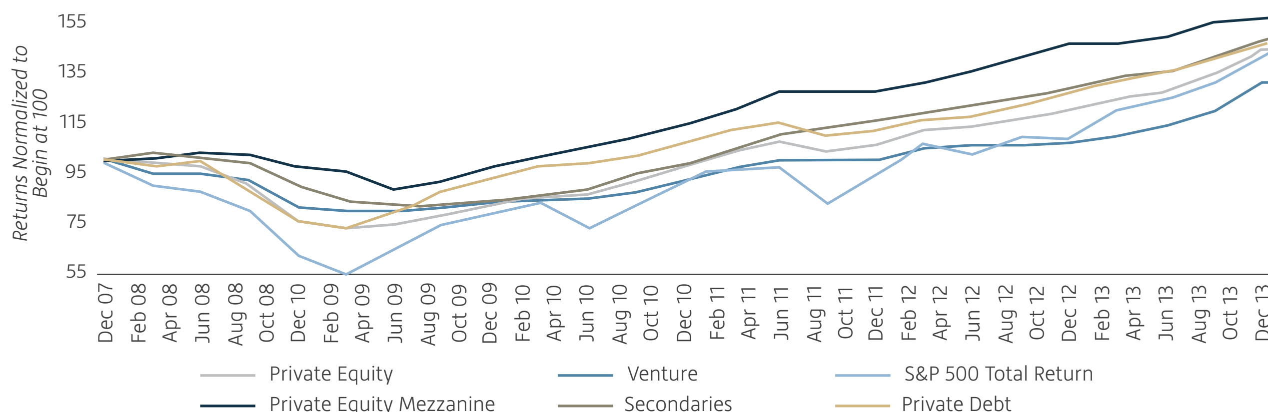
However, we can look to the broader secondary market and credit fund performance during the GFC to predict how the market may react during a potential upcoming downturn. Secondaries and private debt (in particular mezzanine debt), performed better and exhibited less volatility than private equity, public stocks, and venture capital during, and shortly after, the GFC indicating the resiliency of the asset class.

Many GP-led private equity secondary transactions focus on a single company or highly concentrated portfolios. While some of these deals are still very attractive despite their concentration, there is also value in secondary transactions that offer a diversified portfolio of assets. Within private credit secondaries, successful transactions typically involve a diversified, seasoned portfolio of loans across industries. Diversity of the underlying assets can be provided by the number of underlying borrowers at a minimum, but can also include industry or geography diversification, allowing for additional downside protection. Well-seasoned loans are valuable in the underwriting process, as fraud or first pay default loans tend to be weeded out, and often, the reporting during the existing life of the loan provides valuable information about future performance.

We believe that similar to private credit lenders, credit secondaries buyers in this market will have meaningful bargaining power. Secondary advisors continue to estimate deal flow will be well above the amount of capital raised, creating purchasing power for those with available capital.[17]

We expect that there will be an increase in volume in the credit markets in the coming years due to trends experienced in secondaries during prior shock events. During both the GFC and COVID, secondary volume displayed a short-term initial decline of activity followed by a quick rebound to high volume levels.[18] We believe sellers will emerge first with smaller portfolios for sale at very deep discounts. As the market stabilizes, there tends to be a sustained period (2-3 years) of deal flow with discounted pricing.

Exhibit 6: Performance Through the GFC by Asset Class[16]



16. Private Capital Quarterly Index. Preqin data.
17. Private Debt Secondaries Flooding the Market Overwhelm Limited Capital. February 2023. Madeline Shi. Pitchbook. https://pitchbook.com/news/articles/private-debt-secondaries-market-2023
18. How Will the Secondary Market React to Persistent Volatility? July 2022. GCM Grosvenor. https://www.gcmgrosvenor.com/2022/07/13/how-will-the-secondary-market-react-to-persisting-volatility/

What is different this time?

Credit secondaries were a relatively unknown asset class in 2008, but we now have data that supports confidence in the asset class being poised to grow out of the current market cycle. What is different this time? In addition to the growth in actual private credit fundraising, there are a few items that make this cycle different and exciting for credit secondaries.

First, the overall secondaries market has evolved. GP-led secondaries deals are now much more common and viewed as a useful tool in a GP's toolbox instead of a last resort. The advisor community has come up with many new and effective structures which help LPs, GPs, and buyers meet their respective needs. All players have become more educated on the market and its offerings.

Perhaps most importantly, prior to the GFC, a much higher percentage of loans were held in traditional banks rather than credit funds. While we have recently seen the first bank failures in many years, including notably Silicon Valley Bank and First Republic Bank, we have only just started to see sales of their loan portfolios. While the future remains unclear, we believe that there may be opportunities to purchase portfolios of credit assets from similarly positioned regional banks, but also significant volume will come from the credit secondaries arena via non-bank lenders, funds, and other originators.

Given the shift in holders of credit from banks to funds, Atalaya believes that the liquidation of distressed assets in a downturn will come largely via the secondary market versus the bank non-performing loan market. Unlike banks who might be predisposed to sell assets outright, we believe credit funds will instead look to the secondary market for more time to work through assets without exiting fully.

Conclusion

Private credit as an asset class has grown substantially over the past decade, with many early-days funds coming to the end of their term, and in need of a liquidity solution. The size of today's private credit market, coupled with market volatility motivating holders of assets to sell, creates an exciting potential actionable opportunity for experienced credit underwriters, who can accurately price complex assets.

About Atalaya

Founded in 2006, Atalaya Capital Management is a New York City-based private credit and special opportunities investment firm with approximately $10 billion in assets under management. Atalaya invests across specialty finance, corporate, and real estate opportunities and has deployed, in aggregate, more than $17 billion since inception.

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Appendix A: Exhibits and Charts

Exhibit 5: US M&A Deals (Volume), 2000-2022[19]

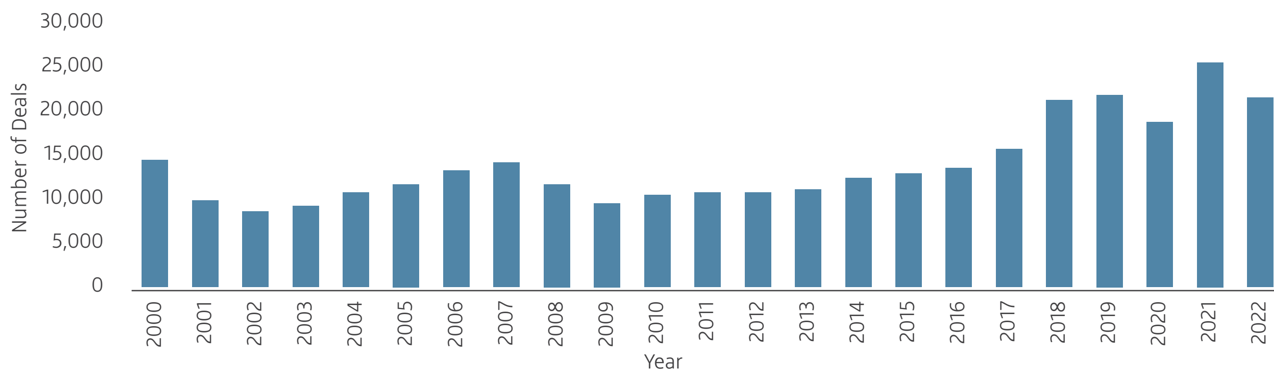


Exhibit 6: US M&A Deals (Value), 2000-2022[19]

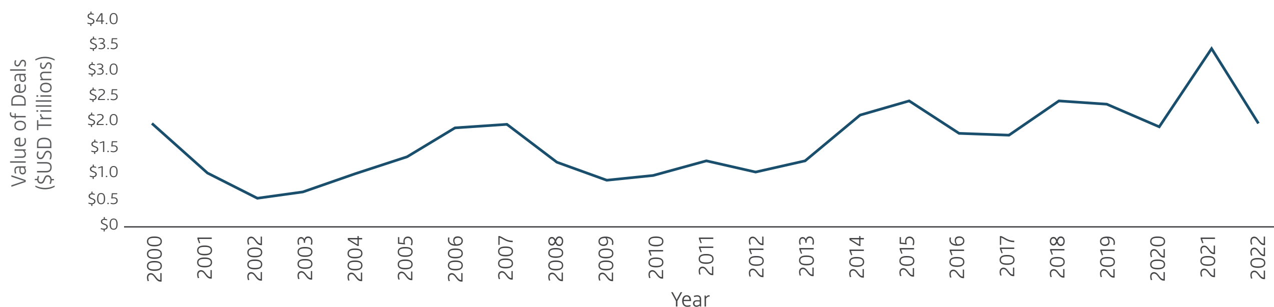
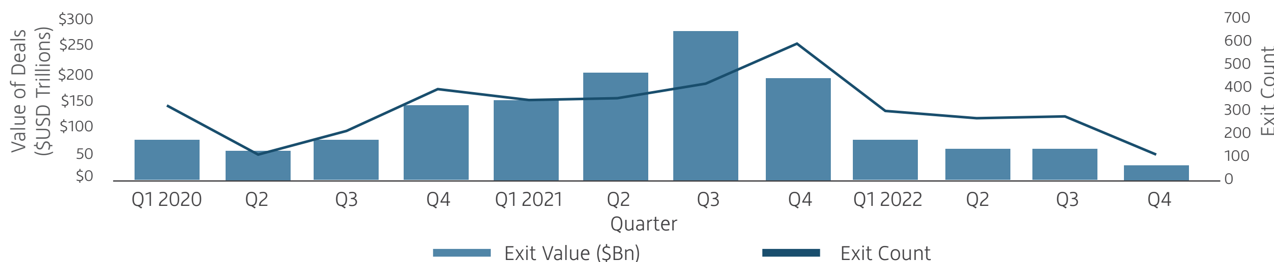


Exhibit 7: US PE Exit Activity (2020-2022)[20]



19. United States – M&A Statistics. Thomson Financial, Institute for Mergers Acquisitions and Alliances (IMAA) analysis. 2023.
20. Pitchbook data.