

Client Alert

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For more information, contact:

Kasia Thevissen
+44 20 7551 2135
kthevissen@kslaw.com

Costa Burkov
+44 20 3929 5345
cburkov@kslaw.com

Daniel Daneshard
+1 212 556 2274
ddaneshrad@kslaw.com

Dounia Mansour
+971 4 377 9987
dmansour@kslaw.com

Conrad C. Axelrod
+1 212 556 2314
caxelrod@kslaw.com

King & Spalding

London
8 Bishopsgate
London, EC2N 4BQ
United Kingdom
T. +44 20 7551 7500

What is new in: Private Credit Secondaries

Private credit funds have ballooned across the industry to bridge the funding gap which followed the great financial crisis and the resulting regulation of traditional financial institutions. The maturing private credit market has led to increased supply of secondary opportunities across a range of different credit products.

In this article we discuss recent trends observable in the wider private credit secondary market, including considerations applicable to GP-led transactions (such as continuation fund sales), LP-led deals (including portfolio transfers of LP interests), secondary funds executing direct deals (e.g., purchases of existing loans, NAV finance for secondary opportunities or structured liquidity solutions for credit portfolios) as well as upcoming regulatory changes likely to affect this market.

GROWTH OF THE MARKET

The annual volume of credit secondary transactions is estimated to grow from \$30 billion today to \$50 billion by 2027. The growth in transactions has been driven by fundamental market changes, including increased global private credit fund AUM (which has quadrupled over the past decade) and the proliferation of other credit linked products such as leveraged loans, preferred equity, non-performing loans and CLOs. The resurgent depth and breadth of primary credit markets has fueled, with some time lag, a corresponding expansion in the direct secondaries market. In 2024 the total addressable primary market was estimated to be \$3.4trn¹.

RISE OF SPECIALIST CREDIT SECONDARY STRATEGIES

Historically, sponsors wishing to access credit secondary transactions would often look to their existing credit fund or flagship secondary products to see whether existing strategies could accommodate a credit secondaries deal. Depending on the existing strategy, this approach would work with respect to some credit secondary opportunities but not others. Recently, however, certain sponsors have raised dedicated credit

secondaries funds, with a number of peers looking into entering the space as well. As a result, the strategy now begins to attract specialist buyers, including sovereign wealth funds, and advisers are setting up dedicated teams to support the growing industry.

PURCHASE PRICE ADJUSTMENTS

The pricing of GP-led and LP-led credit secondaries is based on valuations and is usually expressed as a percentage of the net asset value of the underlying portfolio or asset.

The sale and purchase agreement used to transfer the assets will typically set a reference date to determine the valuation basis for the purchase price calculation. Such calculations usually include a price adjustment provision to account for any flows of capital from the reference date to the date of the closing.

While adjustments are relatively simple for LP portfolio transactions, GP-led transactions (often involving sales to continuation vehiclesⁱⁱ) require attention from specialist advisers to capture all inflows and outflows relevant to underlying credit instruments. Drawdowns on revolvers, interest and principal payments as well as any fees charged to borrowers will need to be accounted for in the purchase price.

NAVIGATING CONFLICTS IN CROSS CAPITAL STRUCTURE INVESTMENTS

Parties to GP-led secondaries transactions generally need to be mindful when navigating a maze of conflicts. This is even more true for credit managers who may find themselves investing across the capital structure of particular issuers as well as multi-strategy firms managing private equity funds and private credit funds invested in different levels of the portfolio company's capital stack.

In the context of continuation vehicles, exits and follow-on investments with respect to the vehicle's assets need to be addressed in light of any other debt or equity holdings the sponsor's other funds may have in the relevant issuer. Existing LPs participating in the continuation vehicle may request that dispositions of interests by the continuation fund are stapled to the dispositions made by the sponsor's main fund, however, this may not always be possible. Parties should discuss how future follow-on and exit opportunities will be allocated between the continuation vehicle and the sponsor's other funds as pro rata allocation may not always be available. The possibility of future restructuring or recapitalization of underlying investments can reignite latent conflicts of interest and should be considered carefully from the outset.

In other circumstances, credit investors may also consider using an independent third party to mitigate conflicts. For example, a third party investment manager may control the decision making relating to conflicted assets, which could, in some cases, be executed through a joint venture structure or a managed account arrangement. More commonly, however, structures including the use of independent directors or requiring approvals from the limited partner advisory committee (LPAC) are employed to mitigate conflicts. UK fund managers are subject to FCA rules on conflicts and should ensure that these new circumstances are considered and reflected in the policy on managing conflicts of interest. Larger US sponsors increasingly employ internal conflicts committees with specialist expertise and independent members to manage conflicts of interest.

SELLER FINANCING

Both strategic buyers and motivated sellers have been prepared to offer some form of seller financing on the deal. Examples include:

- *Deferred consideration.* Sellers may be able to accept deferred consideration (typically by 6 to 12 months) which, in some cases, may require a guarantee or a letter of credit from the buyer or one or more of its affiliates. Deferral arrangements are typically individually negotiated and so structures vary from deal to deal. A deferred

consideration arrangement may provide the purchaser with the flexibility to use payouts from the acquired investments to make the consideration payments.

- *Warehousing Arrangements.* Continuation funds sometimes have a limited fundraising period to solicit additional investors. In such situations, the selling GP may be willing to warehouse a portion of the asset for a specified period (e.g., 6 months) following which the buyers can exercise an option to purchase additional stakes in the secondary deal at the same price, subject to any significant revaluation events, plus warehousing costs. The same mechanics can be used for an acquiring GP to sell down an oversized interest held by a flagship fund (or its balance sheet) to subsequent investors admitted into the continuation vehicle.

AIFMD II

- *Do credit secondaries funds “originate loans”?*

AIFMD II, which must be implemented in EU Member States by April 2026, includes leverage limitations for closed ended and open ended “loan-originating AIFs”. These are AIFs that originate loans as a fundamental element of their strategy or where originated loans represent at least 50 % of the AIF’s net asset value. However, most loan origination provisions (such as the 5% risk retention rules, concentration limits and restrictions on loans to related parties) apply to all AIFs that originate loans, whether such loan origination is key to their strategy or not.

A private fund within the scope of the AIFMD will be considered to engage in “loan origination” activity where the fund: (a) grants a loan directly as original lender; or (b) grants a loan indirectly through a third party or a special purpose vehicle which originates a loan on behalf of the AIF/AIFM, *where the AIF/AIFM is involved in structuring the loan or defining or pre-agreeing its characteristics prior to gaining exposure to the loan.*

While certain credit secondaries strategies will undoubtedly be classified as involving loan origination (e.g., providing NAV finance to secondaries opportunities), it remains to be seen whether and to what extent private credit secondary funds, which would not typically be seen as originating loans but may get involved in restructuring existing loans they purchase, would be caught by this definition.

- *Is AIFMD II going to stifle the growth of the credit secondaries market?*

Under AIFMD II “originate to distribute” is prohibited as a strategy. This may negatively impact some of the private credit market participants (especially larger players) who do not always hold loans to maturity and often rely on other roles in these arrangements to generate additional income. In addition, there has been increased discussion by market commentators around the potential for a liquid secondary market for direct lending loans in the near future. This discussion has been driven in part by the marked increase in large unitranche loans originated by private funds, involving multiple private credit lenders, particularly following the retreat of the syndicated large-cap loan market in 2023. Such large-cap private credit financings with multiple participants may not be sustainable over the longer term without a functioning secondary loan market to sell down into, potentially blurring the lines between the direct lending model and the broadly syndicated loan model.

- *Will reporting get better for credit investors?*

Pursuant to AIFMD II, loan originating funds will need to report to their investors on a periodic basis (i.e., in line with their regular reporting cycle) the details of portfolio composition of their originated loans. This could potentially be quite helpful and address some concerns related to insufficient levels of reporting shared by a number of credit secondaries fund investors, however, as of now no further guidance or clarifications on the level of detail to be included in such investor reports has been offered by the regulators. Conversely, credit fund GPs

pay be concerned about keeping the right balance between investor transparency and governance considerations versus the GP's ability to hold on to information it may consider to constitute hard won secrets of the trade.

The AIFMD II changes in this regard seem to be in line with the general market trend to provide investors with increased and more homogenized transparency relating to the underlying portfolio. For example, in early 2025, the Institutional Limited Partner Association (ILPA) published an updated Reporting Template, two Performance Templates (relating to the granular and gross performance calculation methodologies) and various guidance documents in an effort to enhance quarterly reporting to LPs and facilitate compliance with reporting requirements under the SEC's Private Fund Advisers Rule, which has now been vacated.

- *Regulatory technical standards on open-ended loan-originating AIFs.*

On 12 December 2024, ESMA published its Consultation Paper on draft regulatory technical standards on open-ended loan-originating AIFs (OE LO AIFs) under the AIFMD II, which aims to set out the requirements which an OE LO AIF must comply with in order to be able to maintain an open-ended structure by demonstrating that it is able to manage liquidity risks effectively and is part of the process of reshaping the European private funds landscape for credit fund managers started by AIFMD II.

The AIFMD II introduced a general rule that loan originating AIFs should be closed-ended unless the AIF managers (AIFMs) can *demonstrate* to the competent authorities that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy. Whilst ESMA determined that the existing provisions on liquidity management which are set out under the Commission Delegated Regulation (EU) No 231/2013 (Level 2 Regulation) do not contain any gaps, the Consultation Paper proposes to introduce specific parameters/elements that AIFMs managing OE LO AIFs will need to take into account when applying the existing liquidity management requirements.

For a summary of issues outlined in the Consultation Paper see our update [Open End Credit Funds – ESMA Is Looking For Answers](#).

For further background on AIFMD II see our update [Navigating AIFMD II: A Regulatory Odyssey](#).

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ⁱ "The market for private credit secondaries", Collier Capital, August 2024.

ⁱⁱ Continuation vehicles remain one of the most popular structures used by GPs to execute private equity secondaries transactions and are becoming prevalent in the private credit secondaries markets as many credit funds mature and approach (or exceed) their original term.