

Direct Lending's New Price Discovery: What Rising Secondary Trading Activity Means for Valuations, Liquidity and Market Transparency

One of the defining themes in direct lending markets this year has been the growing need for liquidity. As investors increasingly seek redemption flexibility and fund managers actively manage portfolio exposures, the secondary market for direct lending assets has become noticeably more active.

A More Active Secondary Market is Emerging

Historically, many direct lending instruments were expected to be held through repayment or refinancing. Today, however, a growing number of assets are changing hands before maturity, creating additional avenues for liquidity and generating a broader set of observable market data points.

Several factors have contributed to this trend, including investor liquidity demands, fund duration management, continuation vehicle activity and an increased willingness among sponsors and lenders to transact in private instruments.

Why This Matters

The rise in secondary activity is creating a form of price discovery that has historically been limited in private markets. For investors, these transactions can provide useful information regarding how market participants are assessing credit risk, liquidity and issuer performance.

Importantly, established valuation frameworks recognize the value of observable transactions while also emphasizing that transaction prices should be interpreted within the broader context of market participant behavior and orderly market activity.

More Trades Create More Data—But Context Remains Critical

Secondary market activity in direct lending has accelerated as fund managers seek greater liquidity and portfolio flexibility. While observable transactions provide valuable market intelligence, investors should avoid viewing any single trade as a definitive indicator of fair value. The most meaningful insights come from understanding the context surrounding a transaction, including market conditions, issuer fundamentals and participant motivations.

The International Private Equity and Venture Capital Valuation (IPEV) Guidelines note that the price of a recent investment is not automatically fair value. Similarly, the AICPA's valuation guidance emphasizes that fair value is a market-based measurement that reflects assumptions made by market participants.

In today's environment, transactions may occur for a variety of reasons. Some sellers are

actively managing portfolios, while others may be responding to redemption requests, fund maturity timelines, regulatory considerations or broader liquidity needs. Understanding those dynamics is often as important as understanding the transaction price itself.

Further, many of these trades are for very small portions of the total facility. As an example, one manager traded \$2.5 million in a fund that sought less exposure to the software industry, a trade that was clearly not done for any distress or liquidity reasons. However, the manager's total hold was over \$50 million of a roughly \$1 billion facility. The dynamics of arranging a \$2.5 million trade are very different from arranging a \$1 billion facility.

This is perhaps why, to date, Lincoln has observed most of these trades occurring in instruments with fair values above 95%, often close to 100%, of par and in club deals with a greater number of lenders, thus providing a greater number of potential buyers. Given such trades generally require approvals from the agent and / or sponsor, it is highly unlikely any of these facilities will see regular trades or trades of substantial volume.

Liquidity-Driven Does Not Necessarily Mean Distressed

A common misconception in today's market is that any transaction motivated by liquidity needs should automatically be viewed as distressed or non-representative.

Importantly, valuation guidance does not suggest that "any transaction motivated by liquidity needs is automatically disorderly." Institutional investors routinely buy and sell

assets for portfolio management, duration management, redemption management and broader liquidity objectives. Such transactions can occur within otherwise orderly markets and may provide meaningful insight into prevailing market sentiment.

The more relevant question is not why a transaction occurred but whether the transaction was conducted through an orderly process involving willing buyers and sellers acting in their economic interests.

Questions Investors Should Ask

When evaluating secondary market transactions, investors should consider:

- Was the transaction broadly marketed?
- Were multiple buyers involved?
- Were participants acting voluntarily?
- Does the pricing align with issuer fundamentals?
- Is the transaction consistent with broader market conditions?

Transactions that result from competitive processes and are supported by company performance and broader market observations may provide stronger evidence than isolated or highly constrained transactions.

Looking Ahead

The increase in secondary trading activity is a sign of a maturing direct lending market. Greater liquidity and more frequent transactions can improve transparency, enhance portfolio management flexibility and provide additional market-based inputs for investors.

As secondary market activity continues to expand, investors are likely to benefit from a richer set of pricing observations. The most informative transactions, however, will continue to be those evaluated in the context of issuer fundamentals, market conditions, transaction structure and participant motivations.

Observable prices matter—but understanding the story behind those prices remains equally important.

Key Takeaway

Liquidity-driven transactions are becoming more common across direct lending markets. Their existence should not automatically be interpreted as evidence of distress; rather, they should be evaluated within the broader context of market participant behavior and transaction circumstances.

Ready to discuss the opportunities ahead for you?

Connect with a senior professional at connect@lincolninternational.com