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Private Markets 2024 Outlook

UBP

Union Bancaire Privée

Transition year for private markets

Soaring rates have reshuffled the distribution of risk premia across public markets, and private markets are not immune to this change. The coming years are extremely unlikely to have any similarity with the past decade, when left tails were artificially suppressed by the "Fed put" and were awash with liquidity.

Markets are now evolving into an environment that is likely to reward a hands-on approach rather than a passive one. In private equity, specifically in venture capital, managers will have to pay close attention to maintaining a strong cash discipline in their portfolios' companies, whilst buyout investors will face speed bumps on the way out. Private debt managers should expect foreclosures on some loans, take control of assets, and be ready to work alongside companies to repair balance sheets. Real estate will become more active, climbing higher up the complexity ladder and executing value-add strategies to reposition assets and extract value. The natural corollary to this observation is that the world is entering a context that necessitates the thorough selection of managers and deals, as well as realistic underwriting assumptions and expectations.

Recent economic and geopolitical developments hint towards profound fundamental shifts in the investment universe. Investors should expect fewer efficiencies, which typically favour specialised managers rather than generalists. Private markets have this unique feature to create alpha in this environment and benefit from structural inefficiencies detached from market gyrations.

This is what investors should expect from their private market allocations and the time is ripe to deploy capital in such opportunities.

Nicolas Roth
Head of Private Markets Advisory

Key Takeaways

1 BE CONSTRUCTIVE, BUT SELECTIVE

What worked in the previous decade will not necessarily deliver in the coming years. Investors must adapt to the new reality of rates being higher for longer, and adjust their assumptions and expectations accordingly.

2 FOCUS ON OPPORTUNITIES UNCORRELATED TO MARKETS

Private markets allow the building of exposure to uncorrelated or loosely correlated risk premia and structural opportunities. This approach enables a private market allocation to decrease the overall risk in traditional portfolios.

3 ADOPT A PORTFOLIO APPROACH BLENDING CORE BUILDING BLOCKS AND SATELLITE OPPORTUNITIES

Implement portfolios using long-term core building blocks and allow some units of risk to invest in opportunistic, shorter-term satellite strategies (when available) to maximise sources of returns.

Private Equity in 2024

Historically, good private equity vintages are the ones associated with a more challenging environment.

KEY DEVELOPMENTS: CHALLENGES AHEAD

2023 will not be a memorable year for private equity. On the one hand, the rate shock acted (or is still acting) as a reality check for the private equity ecosystem, and, on the other hand, the newsflow was mixed throughout the year, pointing towards growing difficulties for managers and their portfolio companies. It appears rather clear now that the private equity world has been able to enjoy solid growth on the back of low rates during the past decade. How it will adapt to the new reality remains to be seen. However, it seems intuitive that companies with highly leveraged balance sheets will have a hard time refinancing and servicing their debt without impairing cash flow generation, meaning the private equity industry will at the very least be facing a few speed bumps.

The industry was also on the hook earlier in 2023, when it was reported that several managers were resorting to financial engineering techniques to return capital to investors. Among the tools used, NAV financing and ManCo financing are the most often mentioned. Although there is nothing wrong with using alternative financing sources, the issue with this financing was with the fact that it highlighted how some managers are struggling to exit portfolio companies through trade sales or IPOs. As NAV loans are used to accelerate distributions to investors, some investors have expressed concerns about the rationale of borrowing against leveraged cash flows to repay investors. Last, according to Preqin, there is an aggregate of USD 2.7 trillion of dry powder sitting in the private equity space waiting to be deployed, which could create a headache for some groups, as the pressure to invest will mount.

The flip side of the above is the level of dry powder. As discussed, it creates pressure to invest, but it also enables managers to capitalise on opportunities at the right level of valuation and invest swiftly, without the need to raise new funds. Historically, good private equity vintages are the ones associated with a more challenging environment from an economic and fund-capital-formation point of view.

The secondary market is the sub-segment of the private equity space that is providing the most attractive opportunities at present.

LOOKING AHEAD: BE CONSTRUCTIVE, BUT SELECTIVE

The secondary market is the sub-segment of the private equity space that is providing the most attractive opportunities at present. The biggest driver behind the growth of the secondary market is mostly structural: large institutional accounts must rebalance their portfolios or they will not be able to deal with the various extensions of their underlying managers and have no other choice than to tap the secondary market for liquidity to do so. Both LP- and GP-led are attractive, but LP-led transactions are more interesting in a wealth management context, as they offer diversified exposure in terms of vintages, managers, and industries.

Given what has been discussed above, it can also be anticipated that the coming vintages of buyout strategies will have access to a compelling pool of investment opportunities. However, investors should keep an eye on how their preferred managers acted when exits were more complicated, so that they can assess their ability to crystallise value, rather than resorting to cumbersome financial engineering to generate liquidity.

Private Debt in 2024

Looking beyond traditional direct lending will be key to generating attractive returns and extracting uncorrelated risk premia in private debt markets.

GOLDEN AGE OR LATE CYCLE?

It was recently mentioned that private credit is entering a "golden age". Judging by the heavy newsflow, private credit was certainly one of the hottest topics of 2023 and it is impossible to disagree. Although most of the headlines in 2023 focussed on large managers raising significant amounts of capital to launch direct-lending strategies, the other segments of private debt were equally dynamic, yet less talked about. Direct lending is the classic bank disintermediation trade that has been going on since the Dodd-Frank Act was passed and that got the "golden age" qualification, but this is only the tip of the iceberg of what is happening in private debt. Beyond the classic sponsor-backed transactions (companies that are owned by private equity) that make it into the headlines, we see a huge swathe of opportunities to invest in specialised lending strategies.

Direct lending might not be as attractive as it has been over the past five or eight years, as it has become an extremely crowded segment, with tier-one players competing for transactions, compressing margins, and loosening covenants. The so-called "illiquidity premium" that one can reap from direct lending is therefore decreasing, thus reducing the appeal of the strategy. Additionally, significant capital has been raised for direct-lending funds in 2023, leaving an overhang of more than USD 200 billion of dry powder waiting to be invested. If it is not invested, this could lead to underwhelming returns.

The good news is that private credit encompasses all forms of lending on all type of assets and cash flows, thereby offering tremendous opportunities to deploy capital in niche, market-specialised strategies.

MOVING AWAY FROM PLAIN VANILLA STRATEGIES

Looking beyond traditional direct lending will be key to generating attractive returns and extracting uncorrelated risk premia from private debt markets. Although it is to a certain extent true for other strategies, private debt offers an unmatched level of granularity that allows investors to build diversified exposure from a strategy perspective, but also from a risk typology one. Additionally, private credit allows

investors to build exposure to strategies that are tightly or loosely correlated to the economic cycle.

Hybrid capital and structured financing solutions remain an extremely attractive corner of the private debt space.

Hybrid capital and structured financing solutions remain an extremely attractive corner of the private debt space. They address the need on the part of non-sponsored companies to access bespoke forms of financing (usually a combination of debt and equity) and the size and complexity of those transactions make it an attractive niche for savvy investors.

Non-sponsored companies experience solid growth and need bespoke financing solutions. The ability to serve this segment by providing tailor-made solutions makes it an attractive investment proposition for clients willing to look beyond the mainstream lenders.

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Speciality and asset-based finance will continue to benefit from banks' retrenchment and the inability of traditional lenders to swiftly underwrite complex cash flows, businesses and assets. Trade finance is a prime example, with several large corporate players retreating from the business while demand continues to grow thanks to global trade. Asset-based finance differs from direct lending, as loans are secured by hard assets instead of cash flows; loans are usually largely over-collateralised, embedding strong downside protection combined with contractual yields. Legal assets are also gaining traction, mostly in the form of financing secured by a portfolio of outcomes. Last, although a form of hybrid between debt and equity, non-performing and re-performing loans (NPL) offer compelling investment opportunities. The NPL cycle in Europe is coming to its end and it is now possible to buy seasoned portfolios from servicers and players exiting the market.

Investors should embrace this level of granularity and take advantage of it to build portfolios that will be resilient in the various phases of the cycle. These investment opportunities complement traditional portfolios nicely.

Private Real Estate in 2024

Asset selection will be of the utmost importance in 2024.

KEY DEVELOPMENT: THE SHIFTS IN SECULAR TRENDS CONTINUE

The rise in interest rates in developed economies has reshuffled the cards for real estate as the asset class is finding a new equilibrium. Since the introduction of zero-interest-rate policies, investors have been generating performance by borrowing at low costs and investing in income, producing stabilised assets. Returns were a combination of income and asset value appreciation. This era has now come to an end, as central banks have embarked on an unprecedented rate-hiking cycle. Active management, combined with sector/typology selection, has become of the utmost importance in creating value for real estate investors.

Higher costs of capital, together with sustained inflation and subdued growth, spells difficulties for the real estate space. However, given how heterogeneous the asset class is, it is difficult to draw a single conclusion about the outcome, if based solely on the trajectory of interest rates. On the one hand, rate caps on US commercial real estate are below mortgage rates for commercial real estate, which means that is not economically viable to hold commercial real estate now, and the cohort of strategic defaults on some large and even trophy assets is expected to rise. On the other hand, pockets of opportunities are appearing in specific sectors thanks to macro tailwinds combined with an under-allocation by institutional investors – the same investors that are currently rebalancing their portfolios.

Pockets of compelling opportunities exist around hospitality and alternative assets, such as student housing, logistics and data centres.

Although the market is leaving an era in which passive and almost indiscriminate investing was sufficient to generate a solid spread above financing costs, it is simultaneously entering an era in which an asset's typology and geography selection, as well as financing structuring/capital formation, will be a key ingredient in generating returns.

LOOKING AHEAD

From now on, the landscape for real estate investors will be much more fragmented and differentiated than it used to be. Core/core+ stabilised assets, such as office space or retail, are generally unlikely to generate strong excess returns. In the

In the case of office space, ESG considerations and the Covid-induced paradigm shift are creating headwinds.

case of office space, ESG considerations and the Covid-induced paradigm shift are creating headwinds. Retail, which was losing out to e-commerce, has shown some unexpected resilience after Covid and some sub-segments, such as retail parks and luxury products, continue to be attractive even if transaction volumes are lower. Residential as a sector is a micro story and relies heavily on country dynamics.

Pockets of compelling opportunities exist around hospitality and alternative assets, such as student housing, logistics and data centres. In the case of data centres, the asset class is enjoying the secular shift towards a greater digitalisation of society as a whole. From gaming to 5G and artificial intelligence, the demand is unlikely to fade and could even show recession-proof characteristics. However, demand is not easily satisfied, due to increasing construction costs, stricter regulations, and tighter credit markets. Barriers to entry remain high, supporting the asset class in the medium term.

Infrastructure in 2024

This traditional asset class offers investment opportunities surfing on the megatrends.

INFRASTRUCTURE NOW A CRUCIAL PIECE OF THE INVESTMENT PUZZLE

The private financing of infrastructure emerged a few decades ago in the face of a lack of budget and expertise on the parts of governments to build, maintain and operate the assets. Infrastructure plays a crucial role in modern economies: its development is critical to enhance the quality of life of citizens. Infrastructure assets provide essential services and offer downside protection with long-term visibility on cash flows, high barriers to entry, low volatility, and inflation pass-through, leading to attractive risk/return profiles. As such, it has attracted an increasing number of investors and passed the USD 1 trillion milestone. These amounts will continue to increase as the asset class has proven its strong resilience through economic downturns, Covid, geopolitical crises, and high-inflation environments. Being a long-term asset class, its resilience and performance have also been driven by its capacity to constantly adapt to the emergent needs of future generations.

FOCUS ON DECARBONISATION, RECYCLING AND DIGITALISATION

This traditional asset class offers investment opportunities surfing on the megatrends. While supported by strong regulatory frameworks, the definition of essential infrastructure is evolving to meet a modern vision of society and allows investors to look for attractive returns still enjoying downside protection.

The fundamental drivers of infrastructure investments that will be the focus for investors in the next decades are:

Decarbonisation and efficiency: according to the IEA and S&P, more than USD 5 trillion needs to be invested annually in energy transition by 2050 to meet net-zero targets. Energy transition investments are also driven by the need for more energy independence and security. These offer attractive investment opportunities in renewable projects, such as wind and solar (in 2023 solar projects outpaced investments in oil production for the first time), but also in other clean energies (e.g. geothermal, hydrogen and biofuels), as well as investments in storage

(batteries) and in grids. Moreover, energy efficiency is crucial to control and reduce consumption (smart meters).

Decarbonisation offers other opportunities in the transport sector (this still accounts for around 20% of global emissions): fleet electrification, urban mobility (de-polluting city centres), and the roll-out of EV charging infrastructure (Europe is targeting zero emissions from new cars by 2035 and major car manufacturers have committed to becoming 100% electric).

Resilience and performance have been driven by the class' capacity to constantly adapt to the emergent needs of future generations.

The good news is that energy transition is not incompatible with investment performance. According to Preqin, the average target 10-year IRR for Europe-focused infrastructure funds with an energy angle is 15.5%.

Circular economy: demographic growth is also a driving trend in infrastructure, along with decarbonisation, as it triggers investments in more circularity. Opportunities can be found in the water and the waste sectors to reduce consumption, reuse and recycle water treatment plants, recycling plants, and converting waste to energy.

Digitalisation: data has been the fastest growing commodity ever and connectivity is an essential service. To meet the huge demand for data transport and storage, more than USD 1 trillion of investments are needed in digital infrastructure in the next five years according to Brookfield. There are opportunities in fibre deployment, 5G roll-out and data centres, while also controlling energy consumption and sources.

Directional views

LOW CONVICTION | BASE LINE ALLOCATION | HIGH CONVICTION

Strategic (12-18 month) on broad asset classes, December 2023

	STRATEGIC				
Private equity			■		
Venture pre-seed / early stage		■			
Growth equity			■		
Buyout (mid/large caps)				■	
Distressed				■	
Secondaries					■
Private debt					■
Direct lending				■	
Asset-based lending					■
Mezzanine					■
Specialty / asset-based finance					■
Venture debt					■
Distressed debt			■		
Real estate			■		
Core/Core+		■			
Value-add				■	
Opportunistic				■	
Development (green/brown field)			■		
Senior lending (real estate debt)			■		
Mezzanine (real estate debt)				■	
Non-performing loans				■	
Infrastructure				■	
Core/Core+					■
Value-add				■	
Opportunistic					■

AUTHORS

Charlotte Dewynter

Head of Infrastructure

Nicolas Roth

Head of Private
Markets Advisory

Geoffroy Troesch

Head of Investment
Management PMG

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Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com