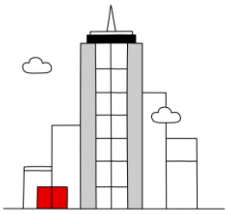
IPM monthly blog

Our monthly insights into private markets – **April 2024**

Real estate



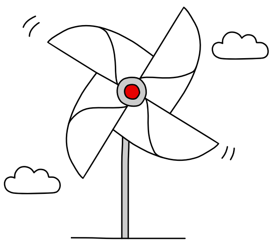
Second half recovery hinges on rates outlook

The US inflation data has surprised to the upside for three consecutive months. US treasury yields rose as a result and the rest of the world followed. Year-to-date, government bond yields have risen 79bps in the US, 57bps in Europe and 40-70bps in Asia. Forecasters are pushing out their rate cut expectations further. UBS Investment Bank now expects only two cuts in the US for 2024 with the first likely to come at the September Federal Open Market Committee.

Global REITs, as a liquid proxy to the real estate sector, fell 9% year-to-date. Deal activity in 1Q24 seemed muted as suggested by preliminary data from MSCI. While the worst of value correction is likely behind us, we think a volume recovery would likely hinge on the interest rate outlook. In our base case, we expect a gradual improvement in the later part of 2024 and picking up into 2025.

Japan remains an outlier in monetary policy. The Bank of Japan delivered its first-rate hike since 2007 on 19 March. The financial markets took it in stride as the tone remained dovish and the policy setting looks likely to remain accommodative in the near term. Real estate cap rate pressure is on the upside but possibly limited. This could also be offset by rising rental income as nominal growth returns. We think sector positioning would be crucial.

Infrastructure



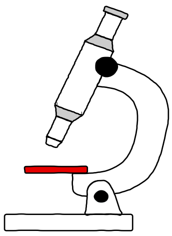
Signs of recovery in fundraising and deal volumes

We have previously discussed the return of animal spirits in the infrastructure market, with sentiment turning more positive given the stabilization of the macro environment and asset valuations holding up. We are seeing more evidence of this. According to Preqin, global infrastructure fundraising reached approximately USD 35 billion in 1Q24. This is seven times higher than the USD 5 billion raised in 1Q23. Although fundraising tends to be seasonal with 4Q typically being the most important quarter, the strong year-on-year growth in 1Q24 is welcome news after the weak fundraising we saw in 2023.

Deal activity has also started to pick up, especially in more developed markets. It is still too early in the year to see actual deal closings, but the number of deals that are live in North America and Europe (i.e. not yet closed) in 1Q24 saw an even more dramatic uplift, up 30% year-on-year vs. 1Q23 according to Inframation.

In our industry, fundraising leads to deals, and deals lead to more fundraising. According to Preqin, private infrastructure still has over USD 300 billion of dry powder (mostly raised in 2021 and 2022), which will need to be deployed. While sellers who were delaying sales processes have clearly returned to the market. We expect a pickup in activity in the rest of 2024.

Private equity



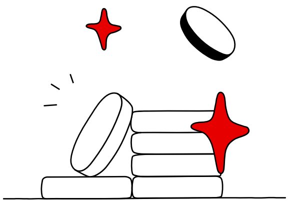
Preparing for higher-for-longer

Private companies have followed their public peers in delivering solid operating performance, benefiting from a stable macro environment with growing revenue and profits. Recent macro news has been less favorable: private equity managers had hoped for several interest rate cuts beginning as soon as mid-2024, but persistent inflation into 2Q24 has reduced investor expectations. Optimists now expect fewer cuts beginning later in the year, while others are preparing for a higher-for-longer rate environment, prompted by recent comments from key policymakers. Interest rates are a key input in private equity valuations; since return targets are relatively constant, higher borrowing costs mean reduce underwriting expectations, and buyers want a lower entry price to compensate.

Though higher-for-longer rates do not benefit private equity returns, the exit and liquidity picture may benefit. If a market consensus develops around current valuations, it is more likely to see a greater volume of private companies changing hands. That market was largely frozen in 2023, leading private equity distributions to recede significantly. As market participants prepare for the possibility of a more sustained higher-rate environment, that could lead more assets to change hands, accelerating distributions and unfreezing the fundraising market, particularly for lower middle market and middle-market funds.

For now, the fundraising environment remains favorable for well-networked limited partners which have excellent access to high-potential funds currently raising. Sponsors and limited partners continue to turn to liquidity solutions for portfolio management. These include continuation funds and secondary sales to optimize liquidity, often at a discount to net asset value, making private equity secondaries an attractive investment opportunity. We are also seeing the resurgence in investor interest in life sciences as an attractive opportunity, as well as in AI, which has captivated early-stage investors with its potential.

Private credit



Frontiers: NAV lending

Private credit investors have shown an increasing interest in a more niche lending strategy known as NAV (net asset value) lending. A relatively less trafficked market segment until recently, NAV lending (also known as NAV financing), is a form of direct lending where a lender provides a loan to a General Partner (GP) or investment fund that is looking for additional sources of liquidity. Typically, NAV lending takes the form of providing private equity sponsors with a loan, using the fund's portfolio assets as collateral, with proceeds used to support portfolio companies, manage portfolio liquidity or distribute capital to limited partners (LPs).

During COVID-19, NAV lending was thrown into the spotlight as a solution for private equity firms that were struggling as traditional pathways for liquidity, such as initial public offering (IPO) markets, and managers sought to find alternative sources of financing to support portfolio companies without dilution or selling assets at discounted prices.

Over the years, NAV financing has developed into a broad ecosystem, providing solutions to managers across private equity, real estate, infrastructure, distressed, secondaries and other assets, and even extending into providing LPs with solutions. The strategy has developed into two distinct approaches, a more traditional credit-focused senior secured approach (typically employed by managers with credit backgrounds), and a more hybrid structured or preferred equity approach (employed by managers with more equity or secondaries-focused experience).

The more traditional approach focuses on providing first lien senior secured financing with loan-to-value (LTV) ratios of <40% and spreads of secured overnight financing rates (SOFR) of more than 400-600bps. These managers generally take a more conservative approach, working with institutional private equity firms and lending against a portfolio of diversified, mature portfolio companies.

The more hybrid, or equity-focused approach generally looks to provide more custom solutions, and may employ more unique structuring against other forms of collateral, or take more extension or equity risk, in exchange for an additional premium of 200-400bps.

For investors, NAV financing typically presents attractive yields, notably low LTVs against high quality collateral and strong credit protections including covenants over the collateral pool, cash sweeps and control over other GP activity. Main risks for these strategies include credit or default risk, extension risk related to borrowers being unable to liquidate their portfolios, as well as the potential for the collateral value (portfolio companies) to decline. Other risks include concentration and blind pool risk, and structuring risk, to avoid potential pitfalls such as leakage of distributions to LPs.

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