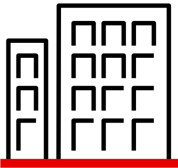
IPM monthly blog

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

Real estate



Investors waiting in the wings

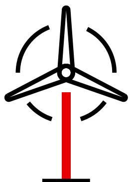
The last two years have been testing for real estate investors. But there are now numerous signs of recovery taking place in selected market areas. Transaction volumes are flattening and, in the UK, where valuations tend to be adjusted relatively quickly to transaction market data, investment volumes are already rising anew. The marginal improvement indicates that we have passed the bottom of this cycle in terms of investment volume.

While the gap between transaction prices and book values is slowly closing, investors in many markets are still on hold, waiting for the anticipated rate cuts to come into effect. After the first cut in June, the European Central Bank (ECB) cut its rates by another 25bps on 12 September. In view of continuously calming inflation pressures and the slowdown of the US labor market, the Fed cut its policy rates by 50bps on 18 September. The Bank of Canada made a total of three cuts of 25bps each so far in 2024, and the Bank of England cut by 25bps in early August.

With the decline in inflation and the flattening if not the outright drop in long-term interest rates, the pressure on property yields has diminished significantly. They are now flattening in most markets, consequently bringing us to the end of the capital value correction phase. Paris CBD prime offices even saw a marginal (-25bps) yield compression in September compared to August.

However, while real estate prices are expected to recover, appreciation gains in line with those during the time of low or negative interest rates, which were associated with strong investment pressure, are unlikely in the short to medium term. This makes the income return (i.e., rental income) more important as a proportion of total returns and puts segments or markets, where leasing fundamentals are favorable, into the center of attention. We continue to favor segments that are displaying shortage of supply, such as residential, as well as those profiting from structural economic changes, such as logistics.

Infrastructure



Are the stars aligning for private infrastructure?

The Fed's decrease in rates follows the action of other central banks, which have already started reducing interest rates earlier in the year. Although the future pace of rate cuts around the world will not be as dramatic, this should at least give infrastructure investors some comfort that financing markets will improve steadily, and important consideration given infrastructure assets tend to employ high levels of leverage.

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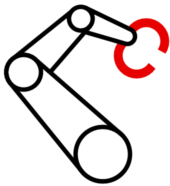
We have previously highlighted that private infrastructure tends to perform well during inflationary environments, since infrastructure typically consists of hard assets that have strong pricing power. Although inflation has slowed down significantly, it is still higher than the 2% target that many central banks have adopted. Meanwhile, GDP growth is also holding up, and has even exceeded consensus expectations from a year ago in some markets (i.e., US and UK).

In other words, we are seeing elevated inflation, higher than expected GDP growth, the beginning of a new rate-cut cycle, and an improvement in overall sentiment for infrastructure. Combined with secular tailwinds from decarbonization, digitalization, deglobalization and demographic change, widespread government support for infrastructure, and continued fiscal strain of governments opening up opportunities for the private sector, the stars appear to be aligning for private infrastructure investors.

Private equity



Rate cuts could jump start exits

The Fed's decision to cut interest rates could be just what private equity needs to break out from its exit slump.

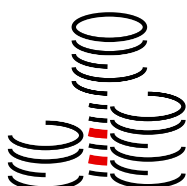
Higher borrowing costs have weighed on private company performance, but especially exits, since rate increases began in 2022. As interest rates rose, more equity has been required to finance deals, putting downward pressure on returns. Prospective buyers of private companies reacted immediately, demanding compensation in the form of lower purchase prices; many sellers decided to wait for better pricing. The result has been declining deal activity in 2022, 2023, and 2024.

We believe the Fed's rate cut and guidance to expect more of the same in the coming quarters has the potential to significantly boost deal activity, particularly due to the Fed's position as the most influential and widely followed central bank (the ECB also cut rates for the second time in September).

A recovery in private equity deal activity and buoyant public markets could also combine to boost fundraising activity. Still, we believe gains may flow to large and established managers, who have taken a larger share of LP capital in recent years.

Transaction activity remains robust; co-investment dynamics favor LPs, especially those already partnered with high-quality sponsors as primary investors. Secondary deal-flow is especially active, and while discounts have closed somewhat (especially for high-quality LP interests), today's market holds plenty of opportunities for selective investors.

Pivate credit



Lower rates and impact on residential real estate credit

With the Fed's recent announcement, the rate cutting cycle has officially commenced in the US. This dynamic should largely be beneficial from a credit perspective as corporate borrowers, real estate owners, small businesses, and consumers will likely have the opportunity to refinance recently originated fixed rate debt at a lower cost of capital in the coming quarters.

Furthermore, borrowers with floating rate debt will experience an immediate relief in borrowing costs as the base rate declines. While the lower rate trajectory is expected to be positive from a credit perspective, there will likely be various impacts on residential real estate and the various asset classes associated with the sector.

As it pertains to residential fundamentals, lower interest rates should positively impact the market. Lower mortgage rates will improve affordability for borrowers through lower borrowing costs and potentially increase demand for housing. This should provide further stability for home prices and all be a credit-positive event for transition lending and project finance strategies.

It is worth noting that lower interest rates could also bring more supply to the housing market. The US residential market has contended with depressed levels of existing home sales due to constrained supply in many markets, which has been driven by the lock-in effect caused by the spike in mortgage rates. As mortgage rates decline, the lock-in effect becomes less impactful for certain existing homeowners and could lead to more existing homes going for sale. Ultimately, lower rates is positive for home prices given the improvement in affordability. However, there could be greater dispersion in terms of home prices by market, as increases in homes available for sale could cause home price growth to be weaker than expected.

Finally, the decline in mortgage rates will also have an impact on prepayment speeds. It will likely result in prepayment speeds increasing compared to what has been observed over the past two years. Specifically for securities investments, faster prepayment speed is positive for legacy, discount dollar price bonds and negative for mortgage derivatives.

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