

Private markets mid-year outlook: Uncertainty, discipline and megatrends



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Executive summary

- Interest rate uncertainty has contributed to restrained transaction volumes across private markets.
- In our view, the high volume of dry powder requires a disciplined approach to transaction underwriting at this point in the cycle.
- For many of our clients, we believe pooled private market funds have been their primary way to secure access to private markets.
- Marked valuation corrections may provide an attractive entry point to real estate and venture capital.
- We think tactical views need to be supplemented with longer-term tilts in favour of specific subsectors and themes within private markets.

Our investment thesis is based around four key themes:

1 Demographics

2 Deglobalisation

3 Digitalisation

4 Decarbonisation

We see these megatrends as particularly beneficial for...

infrastructure, venture capital and private credit strategies

...supporting the energy and digital transitions.

In **real estate**, we see the residential and urban logistics sectors as positioned to potentially benefit.

Private markets overview

The surge of interest in private markets over the past decade can be attributed to a number of structural factors. We see this trend as having further to run, particularly for non-institutional investors who are often modestly allocated. However, there's no avoiding the fact that the interest rate cycle has fundamentally altered the investment landscape over the past 18-24 months. The pace of fresh capital allocations slowed in 2022, and again in 2023. We also saw wide bid-offer spreads in the underlying investment markets, and low levels of transactional activity, which limited liquidity.

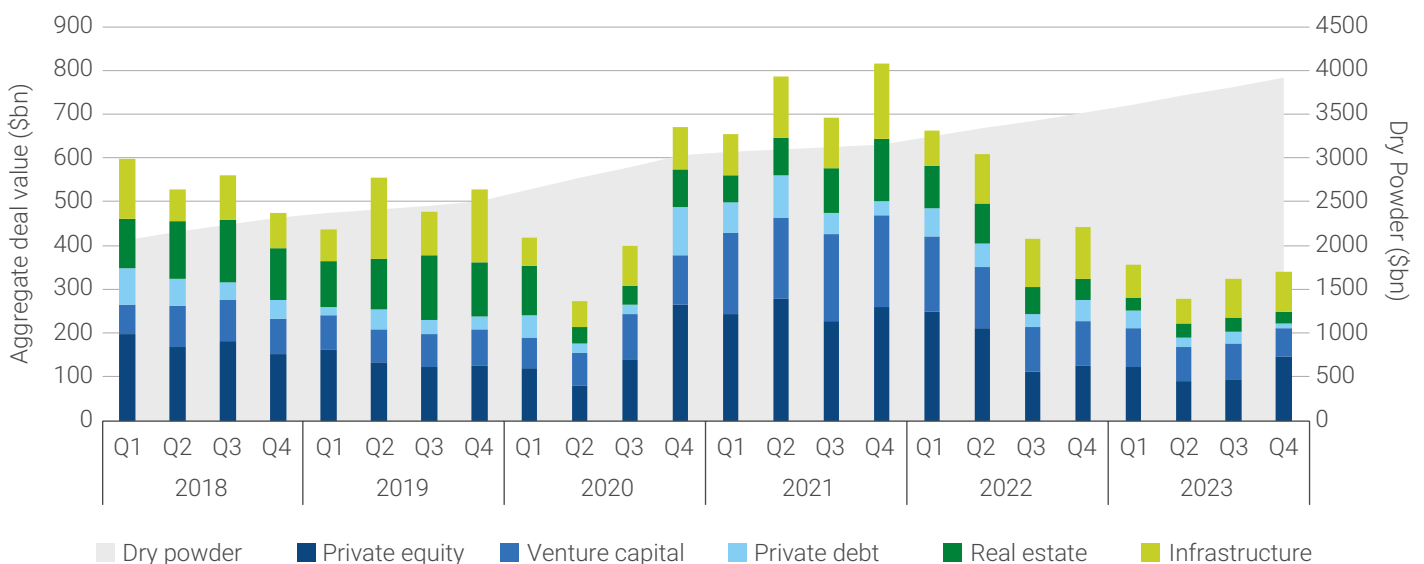
While there are some specific areas where activity is picking up, for example European clean energy, the overall picture has yet to change materially. Across private markets (debt, infrastructure, real estate and private equity), the volume of transactions and originations in the underlying investment markets for calendar year 2023 was 40% below the average for the prior five years¹. Higher-frequency data show little improvement in activity levels – in Q1 2024, US private equity exits were 40% and global real estate transactions 53% below their five-year averages².

The median holding period for private equity buyout-backed exits rose from 5.3 to 6.1 years between 2021 and 2023 as the exit environment became more challenging³. For closed-ended structures in particular, there is building pressure to divest assets where funds are reaching their scheduled termination dates.

At the same time, the volume of dry powder (capital committed but not yet invested) has been rising. While this inevitably varies by asset class and geography, the overall quantity of dry powder remains at the highest level on record.

If there is one theme that should be in all our minds, in our view, it is the need to be disciplined with respect to transaction underwriting. Pressure to deploy, wedded to a high degree of macro and geopolitical uncertainty, means we believe it is more important than ever to adopt a scenario approach to revenues and interest rates that build resilience against a range of outcomes.

Dry powder has been growing as transaction volumes fall



Source: Preqin Dealfow Monitor as at 31 December 2024.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

1. Source: Preqin as at 31 December 2023

2. Source: Pitchbook as at 31 March 2024 and CBRE as at 31 March 2024

3. Source: Preqin & Pitchbook, as at 31 December 2023

Relative value

We are often asked where we see tactical opportunities and relative value in private markets. It is a difficult question to answer, not least because, by definition, there are no indices to invest into. So general statements about relative value need careful interpretation for investors faced with making granular investment decisions. That said, we can make a few observations.

Focusing on the pooled funds that many of our clients use to access the private markets, there have been some significant differences in valuation movements over the past two years. Total returns for closed-ended funds, which in the short term are significantly driven by valuation movements, have been resilient for private equity buyout and infrastructure. Private debt has also performed well, which partly reflects high coupons but also that in this cycle defaults have been very modest thus far.

Real estate and venture capital returns have been weaker. While there are fundamentals at play, for example in the impact of Covid on office real estate, this is also a barometer of supply and demand in the capital markets. That is influencing valuations and, in our view, opening up attractive entry points.



General statements about relative value need careful interpretation for investors faced with making granular investment decisions.

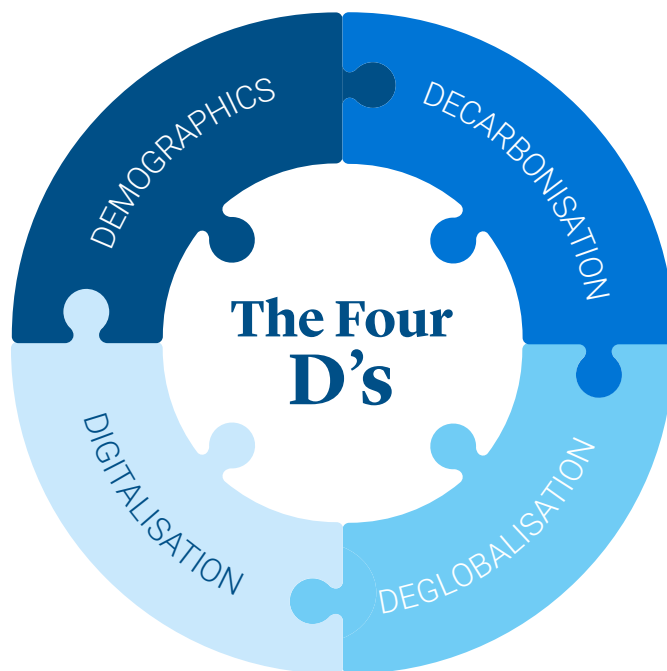
Megatrends

Crucially, however, tactical views need to be supplemented with longer-term tilts in favour of specific subsectors and themes within the private markets.

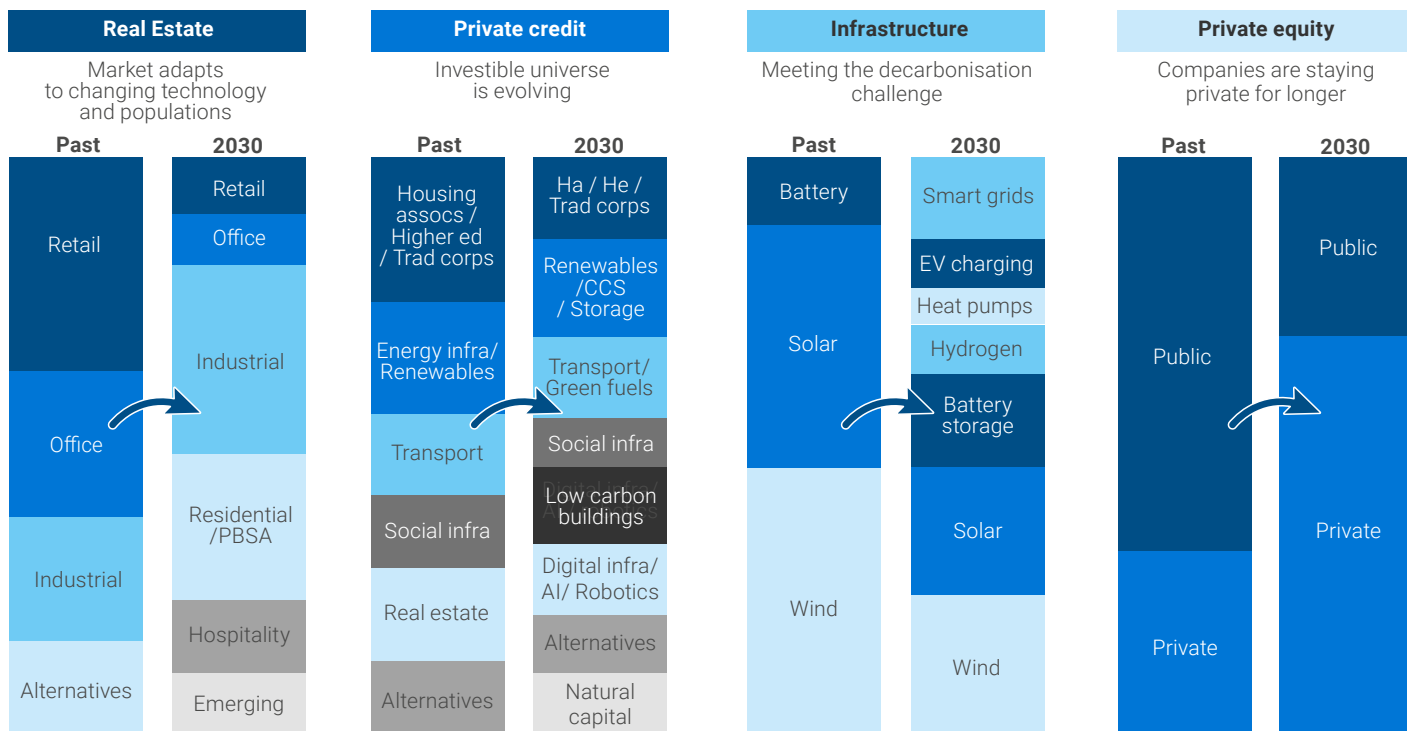
Our investment thesis is based on four themes we see as reshaping markets in the years and decades to come.

Demographics, decarbonisation, deglobalisation and digitalisation are already acting as powerful drivers in the evolution of the global economy, and we believe their impacts are only going to grow.

Within private markets, we see these megatrends as particularly beneficial for infrastructure and portfolio companies supporting the energy and digital transitions, and for real estate and the residential and urban logistics sectors.



We have illustrated one possible scenario for how private market allocations could evolve in response below:



Source: LGIM, 2024. Illustrative 2030 portfolios by private markets asset class.

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.



Starting in early 2020, Covid reshaped patterns of distribution, living, shopping and office occupation.





Real estate

Global real estate has experienced a succession of challenges for nearly half a decade, but we believe it may now be offering investors compelling value. Starting in early 2020, Covid reshaped patterns of distribution, living, shopping and office occupation, while the surge in inflation from 2022 on reset both policy and market interest rates. Real estate values adjusted on an absolute and relative basis to these changes, but geographic and sectoral differentials in pricing, value and performance remain and require careful navigation.

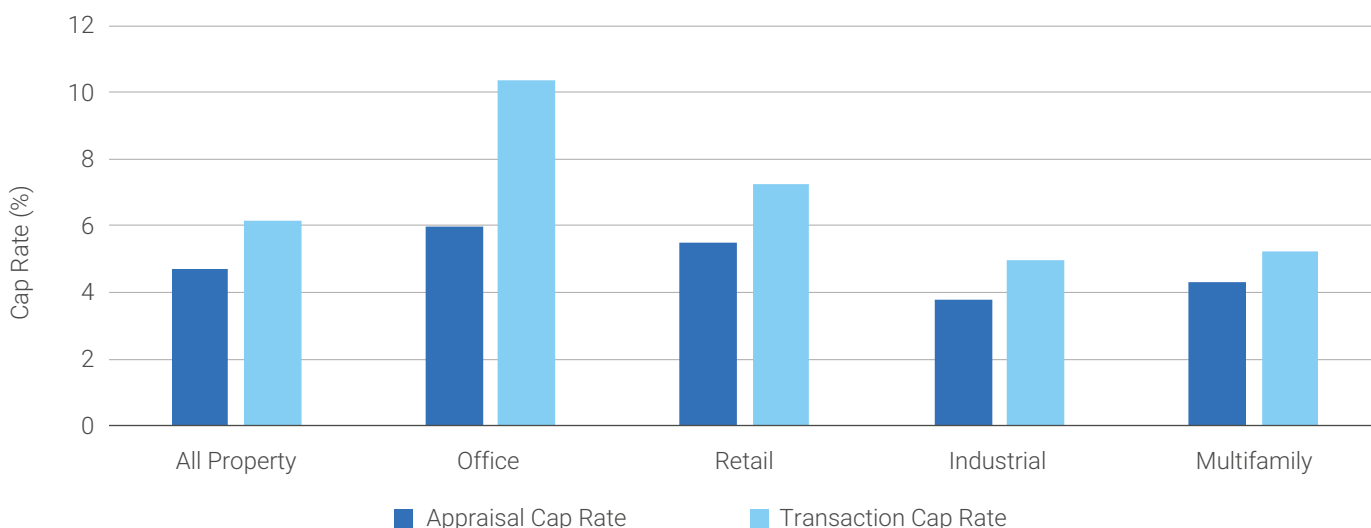
Real estate does not benefit from real-time pricing signals and requires episodic valuation by professionals. Valuation practices can differ, meaning the gap between prices and values may diverge by region while values for thinly traded sectors may respond more slowly than liquid areas.

In the UK, the all-property equivalent yield (a valuation series) ended Q1 2024 at 6.6%⁴. This was almost exactly the same as a weighted transaction yield based on deals completed since the start of the year⁵. We observe something similar with our yield model, where expected yields now match actual yields for the first time since the emergence of Covid-19.

This compares to the 200bps gap seen at the height of the LDI crisis in 2022⁶. In the US, NCREIF data shows a valuation yield of 4.7% while market pricing suggests 6.1%⁷. There are key differences within this data, however, with the gap narrowest for residential and industrial and widest for offices.

At the all-property level, this suggests that fund valuations may reflect market pricing more closely in the UK and Europe but are further away in the US – albeit with dispersion based on fund specialism. We would also note that expected returns, which take as their base market yields rather than valuation yields, now screen as fair value in both the US and UK relative to fixed income for the first time since early 2022.

USA: Appraisal v transaction cap rate, Q1 2024



Source: NCREIF, our calculations, May 2024

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4. Source: MSCI Quarterly Digest, Q1 2024

5. Source: LGIM calculations based on MSCI's RCA database of completion UK transactions between 1st January 2024 and 14th May 2024, removing deals below £10m

6. Source: LGIM Real Assets yield model, May 2024

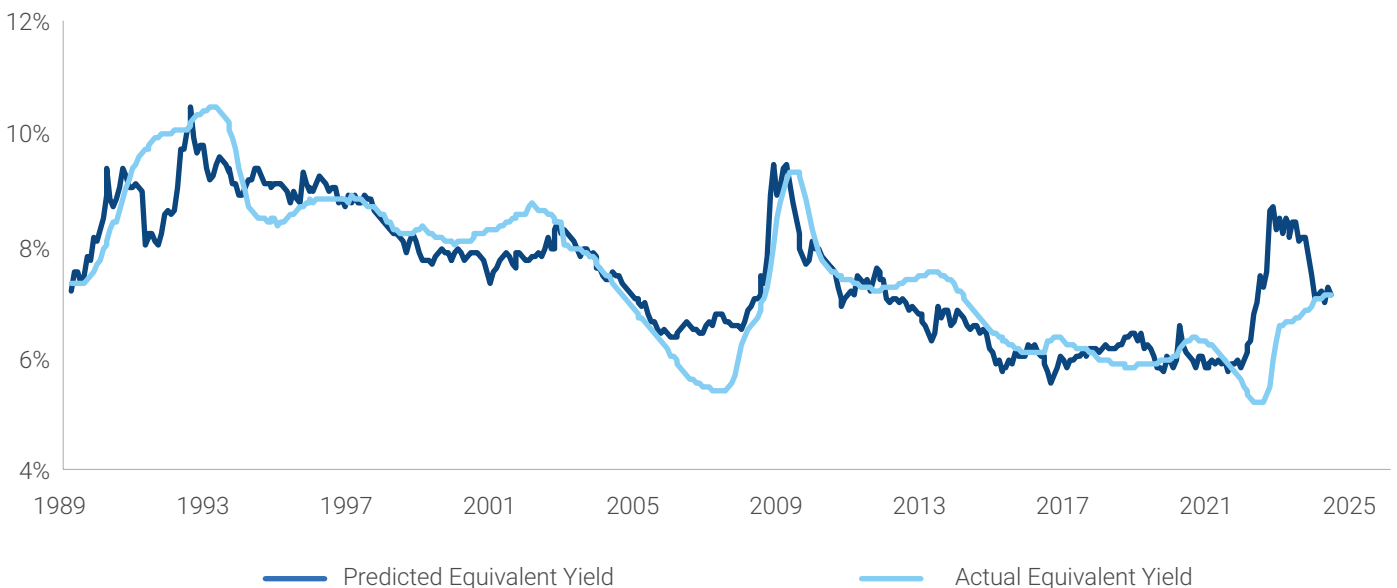
7. Source: NCREIF NPI Property Index, Q1 2024



Going forward, there remains uncertainty as to where market interest rates will settle. Although there are signs of stabilisation, recent experience tells us we cannot be confident in predicting their path. We therefore seek to align with global megatrends – the ‘4Ds’ – to determine sectors, segments and strategies that could be more likely to see income resilience and growth over the medium term.

These are dominated by parts of the residential sector, such as build-to-rent residential and student accommodation, and the industrial sector, where we see support for strategies such as developing urban logistics assets. In our view, assets that are socially useful and that are on a path to net-zero carbon are desired by investors, with positive pricing differentials increasingly evident.

LGIM Real Assets UK yield model as at May 2024



Source: Bloomberg, MSCI, LGIM RA. Data to 13 May 2024.

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Infrastructure

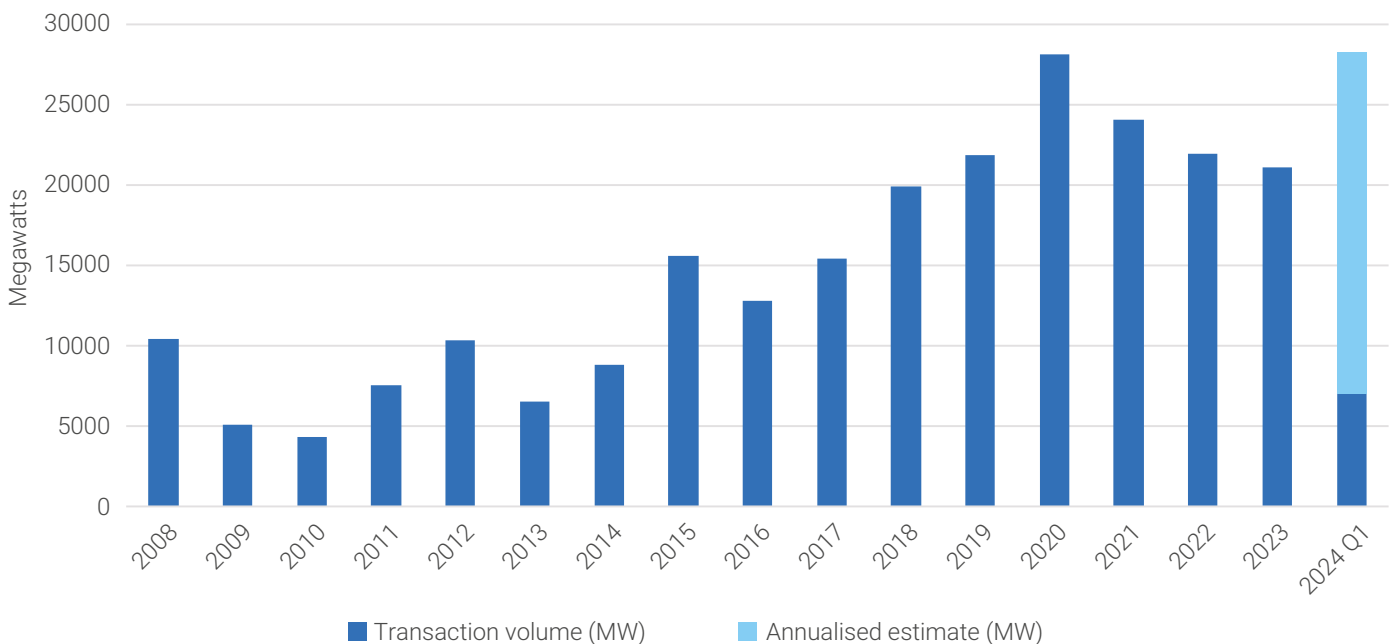
The question on most investors' minds is whether infrastructure investment is turning a corner after a difficult 2023. Early data for 2024 suggest that investment activity is recovering, with both fundraising and transaction volumes showing signs of recovery, albeit from subdued 2023 levels.

A pricing reset is helping to drive this. The rise in interest rates has led to a recalibration of investors' required returns for infrastructure assets and sent discount rates higher. During the first half of 2023, buyers' higher return requirements typically translated into lower price targets, whereas sellers were reluctant to transact at those prices, leading to subdued deal volumes.

Late 2023 and early 2024 saw that gap start to close, and the valuation reset, already visible in public markets, began filtering through to private markets. The available data suggest that against the backdrop of macroeconomic volatility, investors favour assets with high visibility of revenues and explicit inflation indexing.

Assets with largely contracted revenue streams such as social infrastructure and PPP projects are reporting modest increases to discount rates. On the other hand, assets with higher revenue volatility, particularly those impacted by energy price volatility, have seen a somewhat larger increase in discount rates.

European wind and solar transaction volumes - turning a corner?



Source: BNEF as at 31 March 2024.

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Instead, we would point investors back to the macro trends that make up the lens through which we view the private markets.

Decarbonisation

is a policy priority across many global jurisdictions and is gathering pace as the cost of key technologies continues to decline after pandemic-induced supply chain shocks drove costs upwards.

Deglobalisation

is putting a particular urgency on the need to diversify away from fossil fuel imports in Europe. The Ukraine war and possible re-election of Donald Trump have made energy security a policy priority. Accelerated buildout of renewables is at the heart of the EU's approach and we believe both EU level and member states' governments will seek to maintain a regulatory environment that facilitates the financing and development of new renewable capacity.

In our view, stabilising valuations, a pickup in investment activity and a strong regulatory backdrop are creating a favourable backdrop for European clean energy investments going forward.

Digital infrastructure

is attracting increased investor interest, in part driven by AI developments and news flow. Data centres in particular are in the spotlight. While there is a case for AI driving demand for data centre space, we believe investors must also consider the implications of AI adoption for data centre design and increased power requirements.

The International Energy Agency forecasts that global data centre power demand will double by 2026, partly due to AI adoption. The AI industry is expected to consume at least ten times its demand in 2023⁸. This has ESG implications for global data centres. Older assets require further capex to meet emerging compute requirements, while greenfield data centre projects increasingly must factor in the impact on power demand, water, and land usage. Together, this means the ESG credentials of data centre assets have never been more important to the overall investment case.



8. Source: 'Electricity 2024 – Analysis and forecast to 2026', International Energy Agency, May 2024

Private credit

In contrast to the volatility with respect to interest rates, credit spreads have been remarkably resilient in the first half of 2024. Global investment grade and high yield bond spreads have compressed by c.20bps and c.40bps in the year to date⁹, offsetting the negative performance impact from rising rates. A similar trend can be observed in the private credit market, with overall yields still in our view remaining attractive and potentially offering a meaningful premium over public credit. Investor demand remains strong.

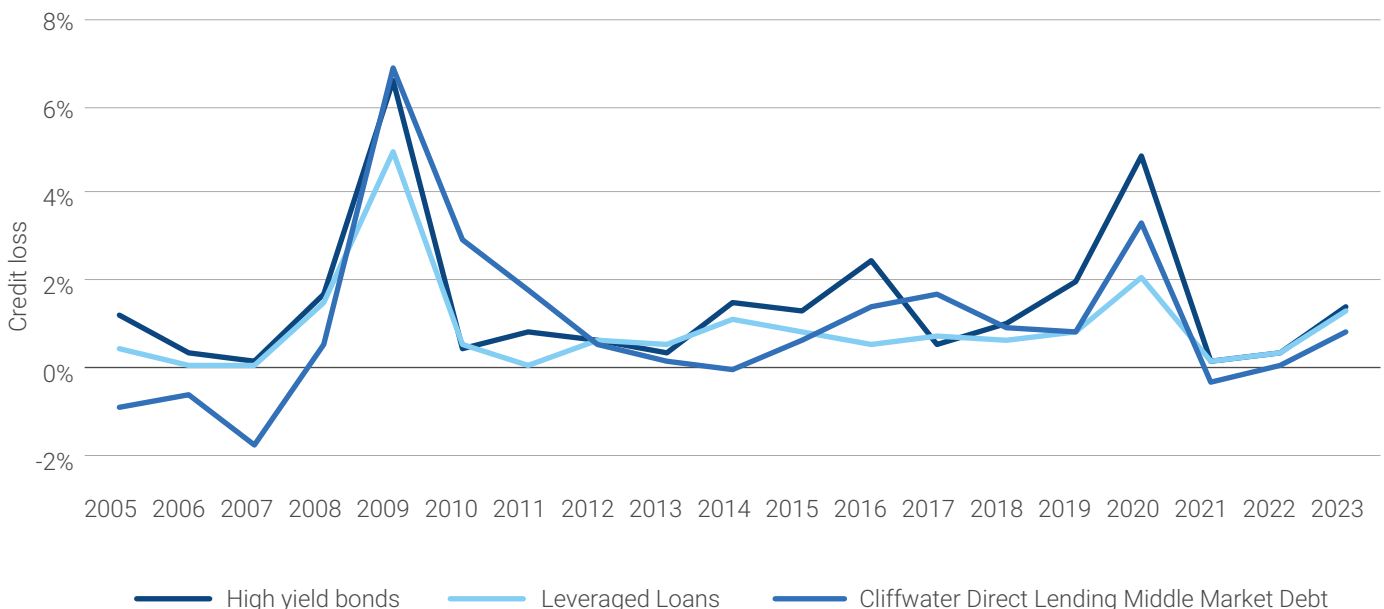
The higher-quality part of the market has seen elevated issuance year-to-date as the borrower base continues to broaden. US private placement issuance (typically investment grade debt) over the first five months of 2024 is 20% higher than the same period last year¹⁰. Activity in the sub-IG/direct lending space has been impacted by lower private equity deal flow and recovery of the syndicated bank loan market offset by growing refinancing needs.

Defaults and losses from private credit have been muted and below high yield and leveraged loans. Borrowers have managed to cope with historically high borrowing costs, benefiting from the strength of the economy and earnings growth.

However, this base case is vulnerable to shocks. The persistent strength in inflation and further delayed start to rate cutting could create market volatility. Should rates stay at current levels or higher, stress on the most levered borrowers could intensify – which could pose upside default risk and threaten investor sentiment. Having said that, we expect overall default level to be contained and any short-term volatility may represent an opportunity to deploy capital over the coming year at more attractive spread levels.

Given the ongoing uncertainties, we continue to focus on core parts of the economy: defensive, high-quality issuers that are well aligned with the major structural forces. We are seeing many potential private credit opportunities across both corporate and infrastructure debt emerging from the transition to a low-carbon, digitally connected world. Bank disintermediation is also producing more opportunities, particularly in alternative debt.

Muted defaults and losses in private credit



Source: Cliffwater as at 31 December 2023.

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9. Source: Bloomberg as at June 12 2024

10. Source: Bloomberg as at June 12 2024



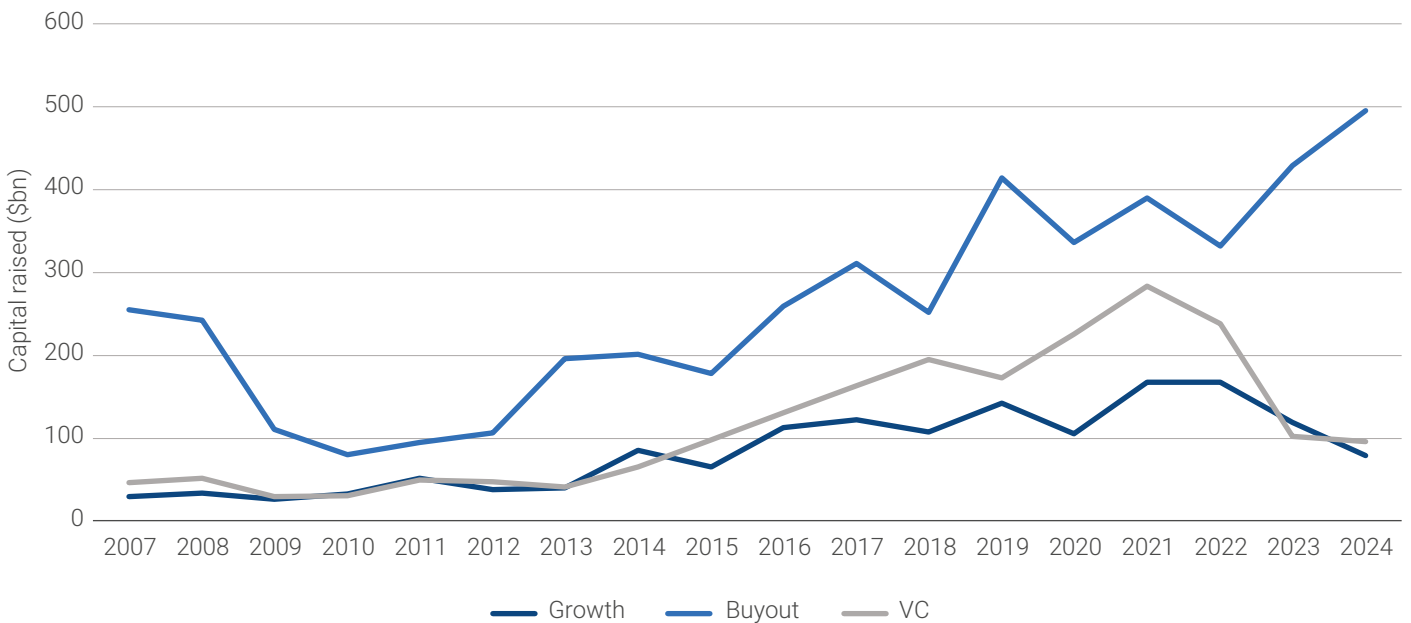
Venture Capital

New allocations to private equity have been remarkably resilient in recent years. In a long-term perspective, this is likely to be driven substantially by the robust returns that many investors have experienced over the past decade, in our view. For 2011-20 vintage funds, even the lowest quartile of fund returns essentially matched the median returns from the other three private market asset classes¹¹.

As a mature allocation for many owners, this will also have been coloured by experience over several cycles. Many asset owners scaled back their allocations during and after the Global Financial Crisis (GFC). This period, however, proved to be a strong vintage for private equity returns. Recent behaviour is consistent with many investors choosing to maintain the pace of allocations, despite the cyclical challenges, to avoid missing out on potentially high-performing vintages.

However, there has been a sharp divergence in risk appetites and valuations between buyout and earlier-stage venture investing. Having dipped in 2022, buyout fundraising accelerated in 2023 and Q1 2024.

Buyout fundraising has accelerated as VC activity has fallen



Source: Preqin as at 31 March 2024.

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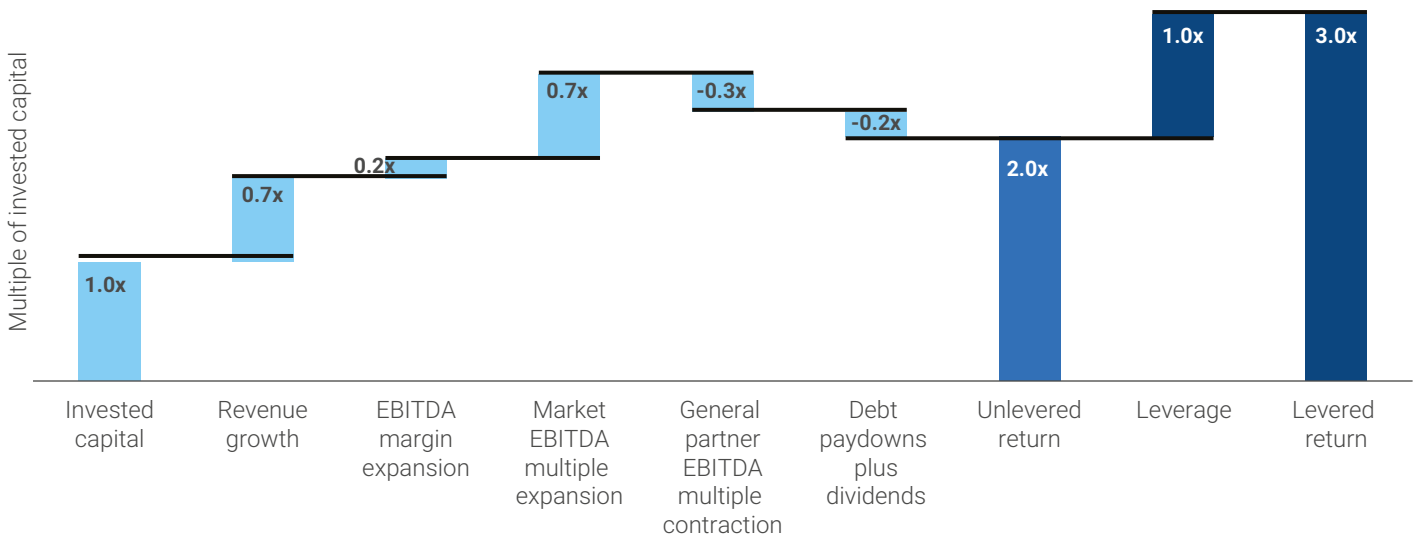
11. Source: Source: Private Placement Monitor, May 2024

The question is: can these returns be replicated going forward. Stepstone have published some valuable data here, covering a sample of 2,500 buyout transactions entered and exited between 2010 and 2021. On average, investors received triple their initial investment, indicating a highly favourable return experience¹². Two primary drivers of this success were selling at higher EBITDA multiples and the use of leverage. Both of these are highly sensitive to conditions in the broader capital markets, and substantially driven by going-in pricing and movements in interest rates over the investment horizon. It will be fascinating to see if this performance can be replicated.

We would also expect a greater focus on operating cash flow fundamentals – revenue growth and margin expansion are likely to be critical in differentiating outperforming strategies.

Cash flow is likely to be an enduring and more general theme as well. The weaker exit environment has slowed the rate of distributions to limited partners sharply, even while additional allocations have been made. We would not be surprised to see attention shift now towards more income-generative areas of the private markets.

Levered returns remain healthy



Source: McKinsey Global Private Markets Review 2024.

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Sectoral and long-term themes are also likely to be key within private equity, supporting revenue potential and margins.

Sectoral and long-term themes are also likely to be key, supporting revenue potential and margins. From a venture perspective, strategies focusing on digital innovation and meeting the challenges arising from climate change and decarbonisation can benefit from powerful secular tailwinds, in our view. Universities act as the lynchpins for the creation of intellectual property and technology, and we see significant synergies with venture capital investing. Given the slowdown in venture investing over the past several years, we believe now could potentially be an opportune time to be reappraising the sector for investors with a tolerance for illiquidity and access to expertise.

12. Source: McKinsey Global Private Markets Review, March 2024

Contact us

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