

Private Markets Outlook | November 2023

Navigating the "higher-for-longer" environment



Partners Group



Navigating the "higher-for-longer" environment

- Markets are still grappling with the dynamics of the new macro regime as the "higher-for-longer" interest rates environment is here to stay. In H1 2024, we expect a slowdown in the US while Europe is likely to continue facing a more challenging outlook. Technological advances such as artificial intelligence (AI) should help counteract some structural headwinds, but tepid growth and higher inflation will prevail over the short- to medium-term. Still, we expect compelling investment opportunities to emerge.
- We compare our outlook to the J-curve, with two distinct phases: near-term weakness followed by the possibility of substantial upside spurred by technological progress in the medium- to longer-term.
- For now, macro uncertainty continues to weigh on investment volumes, with markets in the process of finding a new steady state amid higher rates. Greater certainty on the outlook for borrowing costs could trigger the release of dry powder and encourage exits. Barring a deep recession, we predict a pick-up in transactions in Q4 2023 and H1 2024.
- In private equity, higher borrowing costs and lower leverage levels will lead to increased return dispersion among managers, while private debt continues to benefit from higher rates. In real estate, the case for value-add investing is stronger as valuations adjust in the wider sector. Infrastructure continues to benefit from giga themes, despite pressure over ESG topics and the energy transition.
- As prudent investors, we incorporate economic headwinds into our base case and focus on margin resilience. Structural challenges and technological progress define this "brave new world" of investing. We reaffirm our emphasis on value creation, operating leverage and asset transformation.

Our views on the economy

This has been an unusual interest rate hiking cycle: structural shifts have lowered interest rate sensitivity and monetary policy is not having the usual effect – at least for now. Thus, while we have seen global economic resilience until now, we continue to expect a slowdown on an aggregate level, with pronounced pockets of weakness in certain regions and sectors.

Regional divergence has increased with Europe facing a more challenging outlook than the US. Still, while US consumers have demonstrated strength so far, we expect a deterioration, with corporates starting to feel the pinch of tighter financial conditions. Europe faces additional hurdles given its higher reliance on manufacturing and exposure to China. Inflation is still a key concern across major economies, with the exception of China. Price increases moderated faster than we previously expected, but progress from here will be slower as stickier components such as wages, energy and rents represent upward pressure on prices. As a result, we believe interest rates will remain at peak levels across major central banks well into mid-2024. The longer rates stay high, the



stronger the headwinds against growth. The subsequent path for rate cuts remains uncertain as central banks will stick to a data-driven approach.

Beyond the weakness in the near-term (1-2 years), we believe technological advances such as in artificial intelligence (AI) have the potential to boost productivity and counteract some structural headwinds such as a shrinking labor force. We compare our outlook to the J-curve: cyclical weakness in the near-term, with the economic backdrop in the medium- to longer-term likely to benefit from technological progress.

Still, in the near- to medium-term, structural headwinds such as debt costs and demographics should result in a modest economic growth trend. Factors such as peak globalization and the costs around the energy transition are likely to keep inflation above the 2% targets set by central banks. Policy rates would then stay higher compared to the past decade.

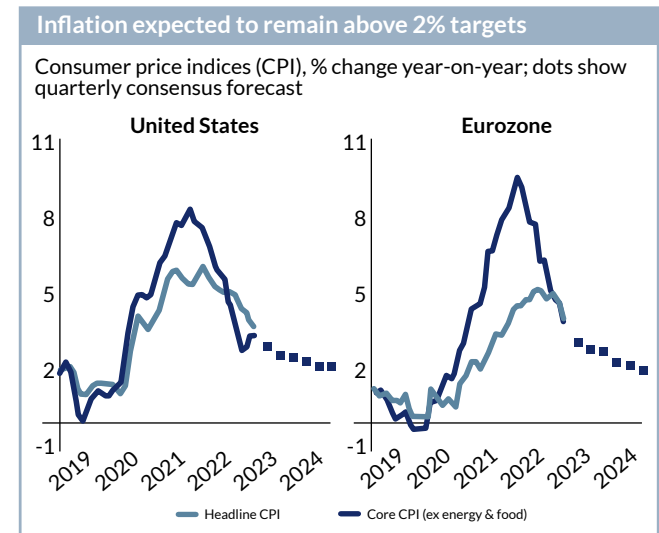
We acknowledge that there are some moving parts in our base case. At a global level, we see a more balanced risk scenario compared to the beginning of the year. But we caution that there are risks at country and regional level that could tilt the balance with potential spillovers (for example, in China and the Middle East). This reinforces the importance of our framework of asset-testing scenarios, which we use to create comfort around downside risks as well as reflect possible upside opportunities.

What this means for private markets

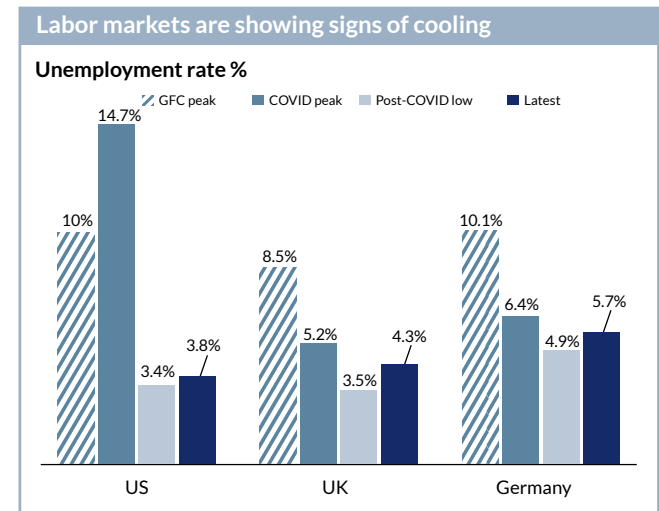
Higher interest rates and macro uncertainty still weigh on investment volumes and entry valuations. We have noticed a recent improvement in lending activity, albeit capital providers remain highly selective. The good news is that any improvement in lending markets will likely trigger the release of investment dry powder, which sits at record highs, and encourage exits. Under our base case assumptions, we expect a pick-up in investment volumes in Q4 2023 and H1 2024, barring a deeper recession.

We remain prudent and we continue to incorporate potential economic headwinds in our underwriting and focus on margin resilience. Structural challenges and accelerated technological progress will drive this "brave new world" of investing. Therefore, we reaffirm our emphasis on value creation, operating leverage and asset transformation.

For private equity, the higher-for-longer scenario means increased return dispersion among managers, while private debt continues to benefit from higher rates. Real estate is still dealing with valuation adjustments, with value-add strategies being the most attractive segment. Private infrastructure remains resilient and continues to be driven by broad themes reflecting long-term structural trends.



Source: Partners Group, Bloomberg (October 2023).



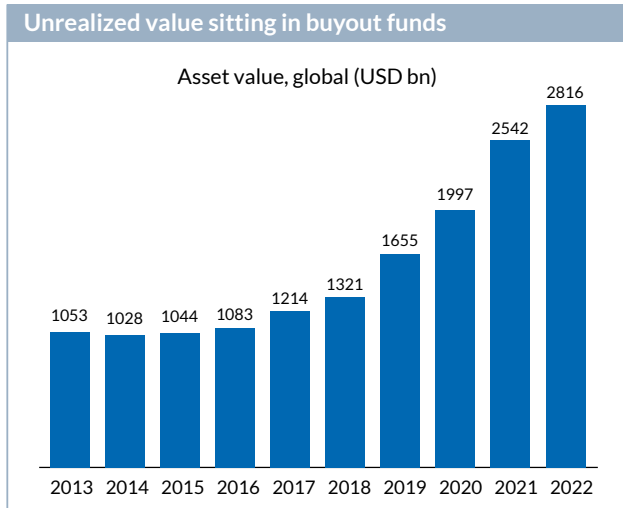
Source: Partners Group, Bloomberg (2023). Dots show quarterly consensus forecasts for headline CPI. For illustrative purposes only.

Our views on private equity

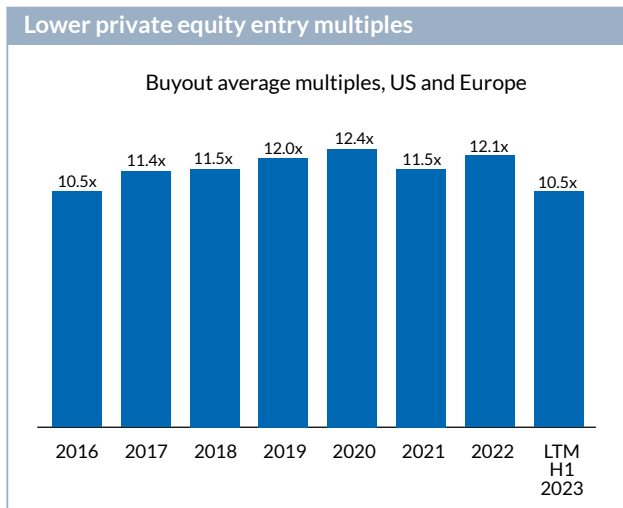
Monetary policies aimed at fighting inflation and the uncertainty around an economic slowdown hindered global transaction volumes over the last 12 months. Now with public markets up, the IPO market showing signs of receptivity and inflation reads cooling, there is a clearer path to the stability investors have been looking for.

We are seeing the “bid-ask” spread that has separated the price expectations of buyers and sellers finally narrowing, with the overall entry valuation multiples dropping, although with some bifurcation in terms of sectors and the quality of assets. This environment could create vintages resembling those that immediately followed the Global Financial Crisis (GFC), with private equity investors able to benefit from unique opportunities and an increased value creation runway.

We see a desire from investors to generate portfolio liquidity, as the number and value of assets sitting in buyout funds reach record levels. However, we don't expect an M&A frenzy unfolding in the same way as previous activity spikes. In the new macro regime of higher borrowing costs and changing valuations, the private equity buyout model will have to readapt. As our Portfolio Management team explained in a [recent article](#), now more than ever, disciplined



Source: Partners Group, Preqin (2023).



Source: Partners Group, PitchBook (2023). EV/EBITDA multiples based on disclose of 1-2% of all buyout transactions completed, including c. 60% add-ons.



Our Views on Private Equity

underwriting and operational value creation will be central to any successful strategy.

Limited partners' (LPs) liquidity needs will be another driver of this next wave of investment activity. We anticipate the secondaries market to play an [increasingly important role](#), with LPs more proactively managing their portfolios while managers explore ways to extend their hold on prized assets.

In terms of sectors, amid the fast-paced technological progress and markets transformation, we believe specialization is key. For new investments, we concentrate on sub-themes such as industrial technology, business efficiency and healthy living to ensure we remain focused on the areas where we have strongest conviction, with a preference for sectors with the potential to become less labor intensive and more tech-enabled. For existing portfolio companies, we have increased our focus on organic growth, asset transformation and digitization, while shifting away from growth through debt financed add-on acquisitions given the current high cost of capital.

We also pay attention to opportunities in public-to-private transactions, as we see public markets lose relevance with value concentrated in just a few stocks, while private markets take a center role in financing the real economy. Carve-outs could also be a source of opportunities, as companies critically assess their portfolios and consider options to raise funds without increasing debt levels.



Our views on private debt

Amid a changing macro environment, private debt has been able to cement its place as a proven alternative to more traditional fixed income products during 2023. The asset class has stayed highly attractive from a return perspective due to the floating rate nature of its offering, which meant yields were significantly higher than historic levels. Direct lending continued to gain market share following the retreat from underwriting banks.

We believe the asset class can continue to outperform, especially in a higher-for-longer interest rates

scenario. We see private debt fundamentals remaining relatively strong, with steady EBITDA growth and leverage levels of recent transactions below historical averages. Moreover, macro uncertainty will increasingly direct borrowers to the execution certainty offered by direct lenders. While we notice underwriting activity by banks slowly coming back, this option will likely only be available to the highest-rated borrowers for the time being.

Amid a flurry of opportunities likely to emerge, we reaffirm the importance of discipline and selectivity



in building portfolios. Given the prevailing economic uncertainty, we believe senior debt currently offers the best potential for risk-adjusted returns, as well as being a more affordable option for borrowers compared to junior positions. We also strive to conduct robust due diligence, carefully evaluating the quality of businesses. For that, we rely on the capabilities of our global platform, which gives us access to sector expertise and knowledge about other sponsors, via our wide network of relationships with general partners (GPs).

We expect the syndicated market to make a comeback, with borrowers likely to explore the optionality of the loan markets and direct lending. With a presence on both sides, we are well-positioned to benefit from this.

We closely monitor the evolution of default rates and seek to offset risks by applying Partners Group’s ownership mindset to direct lending, which includes comprehensive private-equity style credit due diligence. While close to historical averages, default rates are anticipated to rise in both direct lending and syndicated markets. Forecasts point to an increase to 2-4% by the end of this year, which is still significantly below GFC levels. Still, increased defaults will put to test direct lenders, many of which have not invested through cycles.

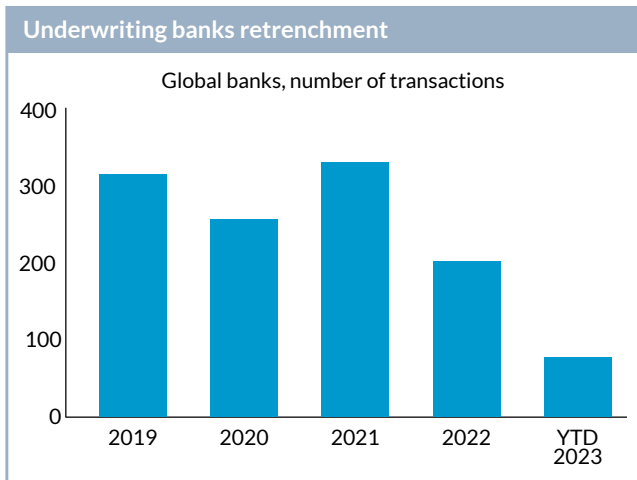
This is just one front where large, established managers like Partners Group are expected to have an edge. We also anticipate a competitive advantage for those with the ability to draw upon longstanding and trusted GP relationships and the well-rounded capabilities of an integrated private markets platform.

Our views on private infrastructure

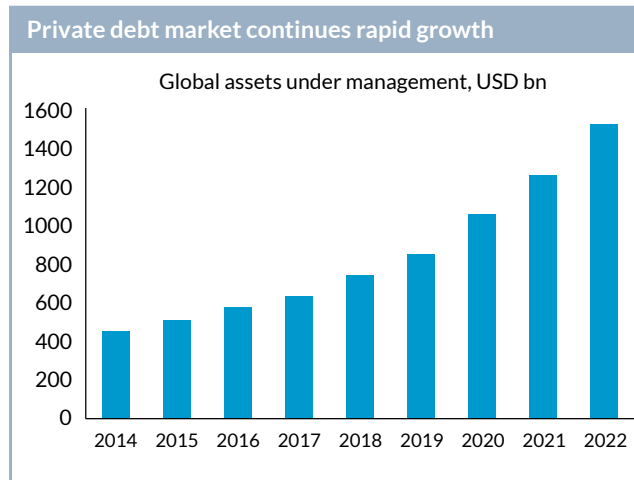
Private infrastructure markets have slowed down in 2023 as many managers took stock of a higher interest rates and a rising inflation environment, holding off on new investments and exits. Fundraising also lagged previous years, and themes such as the energy transition and ESG started experiencing some resistance from some areas of the market. However, we believe 2024 is set to be a strong year.

In the medium- to longer-term, the volatile environment will drive investors to reposition allocation to areas with enhanced downside protection such as private infrastructure. These moves take time, and we expect more allocations to infrastructure to come late this year or next.

We acknowledge the growing pressures around ESG topics and how concerns around energy security and affordability have somewhat reshaped the definition of energy transition. We remain committed to making investments in these areas as we believe they are attractive topics with regulatory and government support as seen, for example, in the Inflation Reduction Act in the US and the European Green Deal initiative. To navigate these uncertain times, we reaffirm our thematic investing approach, which seeks to identify



Source: Partners Group, Preqin (September 2023).



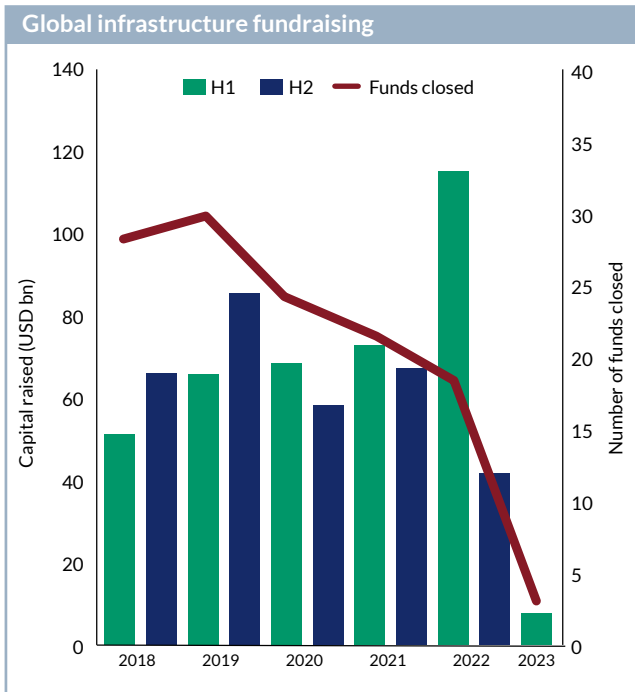
Source: Partners Group, Preqin (2023).

Our Views on Private Infrastructure

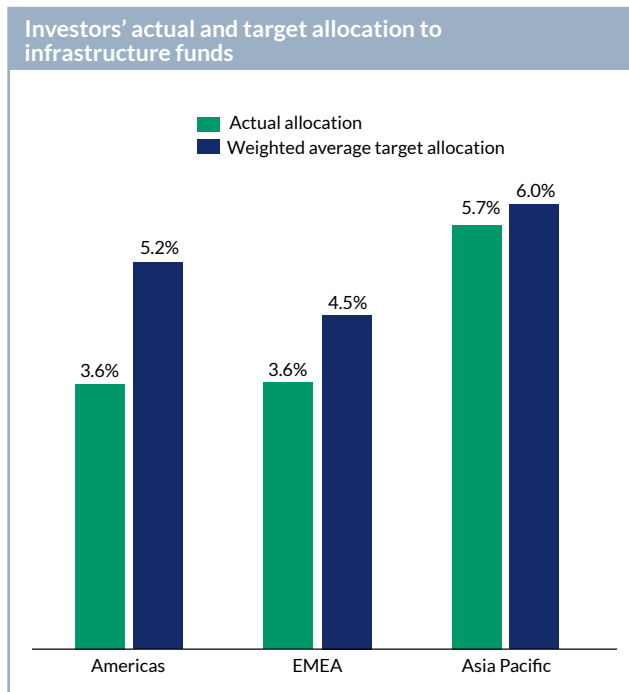


the winning business models of the future along three broad themes: Decarbonization & Sustainability; New Living; and Digitization & Automation. This approach allows us to be ahead of the curve in identifying investment opportunities in topics that are underpinned by double-digit growth prospects, for example, in data storage and services, which are benefiting from the rise in AI. We believe these long-term structural trends can create attractive entry points for investments in high-conviction themes such as renewables, digital infrastructure, new mobility and critical supply chain.

We also increasingly believe infrastructure investing is now about creating scale, rather than focusing on single assets. By building scalable platforms with multiple assets and customers in different geographies we are well positioned to create value and capture the difference in returns between our buy-and-build approach versus buying fully scaled operating assets. The complexity of building such platforms can also mean less competition for assets that require significant asset transformation and lower entry multiples as a result.



Source: Partners Group, Preqin (2023).



Source: Institutional Infrastructure Allocations Monitor, Cornell University's Program in Infrastructure Policy and Hodes Weill & Associates (2023).





Our views on private real estate

Global commercial real estate investment volumes declined further during this year as rising interest rates and the US banking turmoil led to limited debt availability and pricing uncertainty. We believe this has created a moment of market dislocation that is highly suitable for a thematic investment approach to segments with high occupational demand and limited supply combined with our asset transformational strategy.

We prefer the living and logistics sectors which, as well as favorable supply and demand characteristics, offer the opportunity to hold short leases that allow investors to capture inflation-led rental increases and any rent reversion.

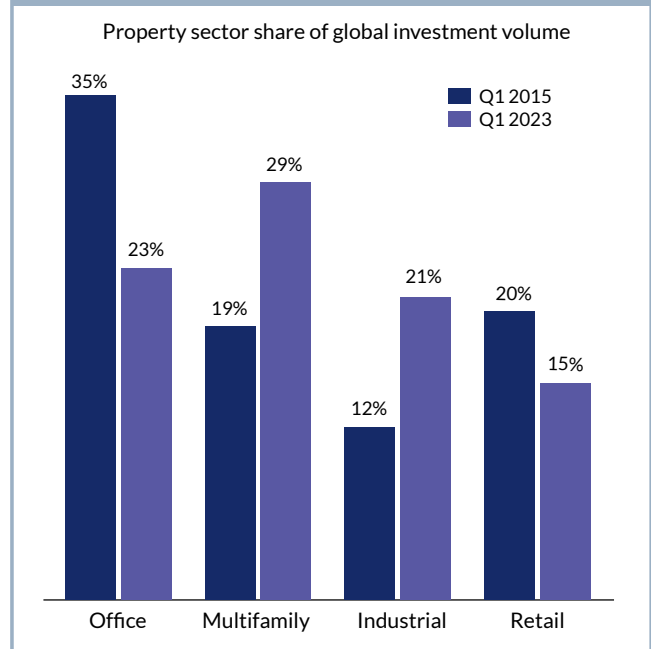
We are alert to pricing risks as some asset prices may not have fully reflected the cost of debt. We keep a selective approach and use our broad network of managers and operators to source opportunities that we can acquire at entry prices that reflect the outlook of higher for longer interest rates.

We also believe that this backdrop of higher borrowing costs makes asset transformation more important than ever. Investors targeting double-digit IRRs must work with managers who stand

behind value creation and a thematic focus on the sectors with long-term occupational demand.

Distress situations could open a new opportunity set in high-conviction sectors. But for now these opportunities are scarce in our priority sectors, and rather centered on older office and retail assets. Our focus, instead, remains on long-term value creation with assets that align with market leading ESG standards and that accommodate the ongoing changes in the ways people live, work and shop.

Growing appetite for the living and industrial sectors



Source: Partners Group, CBRE, MSCI, Oxford Economics, Knight Frank (2023).

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