In Focus

Private markets investment outlook Q4 2024

Reasons to be optimistic

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A continued decline in inflation, the beginning of normalising central bank rates, and an improved capital demand/supply balance create a favourable environment for private market investments. However, persistent geopolitical tensions underscore the need for diversified allocations.

At the start of this year, our outlook for private market investments became optimistic. This perspective was underpinned by our expectation of a controlled decline in inflation and moves towards a normalisation of central bank policy rates. Today, there is evidence that inflation has declined significantly, and that an easing cycle has begun. However, geopolitical tensions persist, with the risk of escalating conflicts around the world underscoring the importance of a diversified allocation within private markets.

As we enter Q4 2024, private markets reverting to pre-pandemic levels in terms of fundraising, investment activity and valuations has continued, creating a favourable capital demand/supply balance for new investments. We expect the recent reduction of policy rates by central banks in the US and Europe, anticipation of further interest rate reductions and the recent stimulus measures in China to provide tailwinds to the global economy, and by extension private market investments globally. We expect this to benefit private equity, real estate and infrastructure equity investments, supported by declining lending rates. It may also be advantageous for debt investments as default rates, which have remained below long-term averages, are expected to remain muted.

In sectors that have corrected beyond 2019 levels, such as real estate and venture capital, we see early signs of a recovery, though in real estate the situation varies across sectors and regions. Following significant valuation corrections in real estate, our proprietary valuation frameworks suggest that 2024 and 2025 will be attractive years for new real estate investments in European markets. Venture capital is seeing new momentum with an increasing share of investments focused on artificial intelligence (AI).

We find private market investments aligned with long-term mega-trends such as the AI revolution, decarbonisation, deglobalisation and demographic changes particularly attractive. AI is driving investment activity not only in venture capital, but also in data centres, which will also require further investment in renewable energy to address rapidly growing energy demand in a sustainable manner.

Income remains appealing, and the default cycle seems to have been avoided again. With risk premium declining, we continue to favour investments that benefit from market inefficiencies, focusing on fundamentals first rather than distressed assets.

While our private market investment outlook is optimistic, we believe that given ongoing geopolitical risks and escalation risks from ongoing conflicts, it remains essential to be highly selective and maintain a robust diversification within private market allocations. In the following sections, we highlight the most attractive opportunities within each private market class.

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Private equity

Private equity has experienced positive momentum in 2024, with deal and exit volumes continuing to normalise. Venture capital fund performance turned positive for the first time since the end of 2021, and buyout fund returns remain steady and positive. While distribution activity is below the long-term average, it has steadily increased each quarter. We anticipate this upward trend in private equity to persist into Q4, particularly with the anticipated further monetary easing.

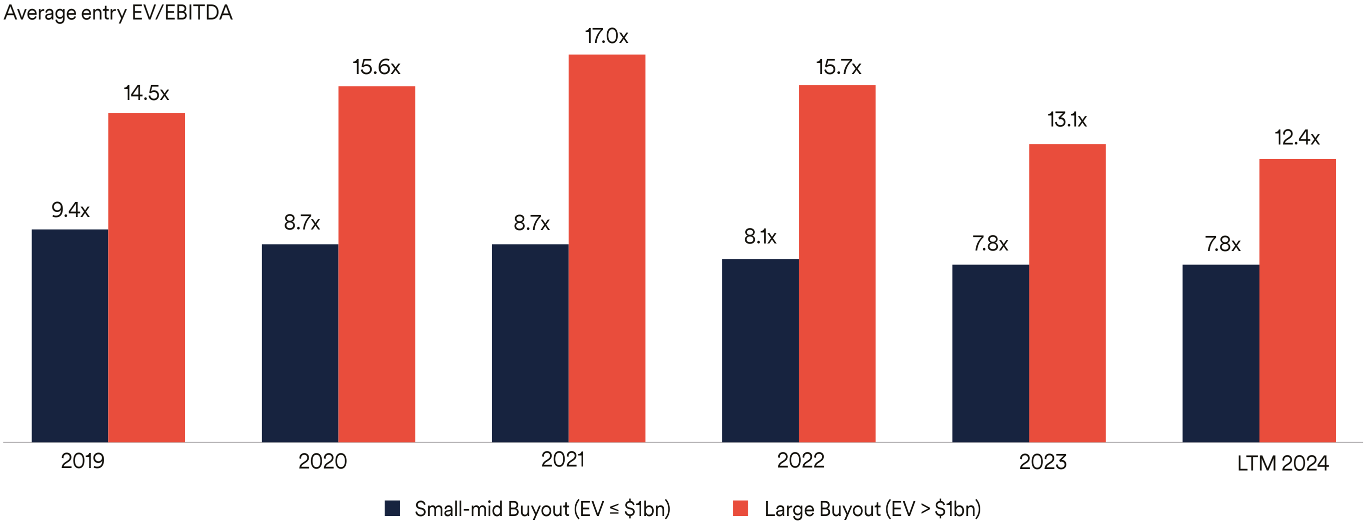
We continue to advocate for a highly selective approach to private equity investments, focusing on opportunities that resonate with global trends and can capture a complexity premium.

We favour small to mid-sized buyouts over larger ones due to a more favourable dry powder environment and a valuation discount, which despite a slight drop in entry multiples for larger buyouts has been maintained at around 5x EV/EBITDA (see graph). Small and mid-sized buyouts also have an additional exit strategy – selling their portfolio companies to larger buyout funds.

Figure 1: Buyout valuations trend lower in 2024

Small/mid buyouts especially attractive

Small-mid buyouts maintain 5x EV/EBITDA valuation discount



Past performance is not a guide to future performance and may not be repeated.
Source: Capital IQ, Global M&A Outlook 2024, Robert W. Baird & Co., Schroders Capital, 2024.
Note: North America and Europe M&A. Completed deals. LTM through 30 June 2024.

Co-investments continue to be attractive as banks have withdrawn from the lending market and credit funds have been more cautious. The equity requirement in deals remains heightened, leaving a capital gap that active co-investors can step into.

GP-led transactions are compelling due to the narrowing of traditional private equity exit routes and ongoing demand for distributions. We find both single-asset and multi-asset GP-led investments attractive. Single-assets can provide runway for star assets, while multi-assets provide an efficient end of fund-life solution for private equity funds.

We continue to believe ongoing innovation in AI, disruptive energy technology, and biotechnology will be driven by seed and early-stage ventures. Early-stage investments benefit from a disciplined fundraising environment, leading to more conservative entry valuations. Conversely, while valuations for late-stage/growth investments are rebounding, these investments face higher refinancing and valuation risks due to decreased venture capital fundraising and a still-limited IPO window. Within venture capital, generative AI investments have surged and are expected to reach nearly 15% of total investment volume in 2024, up from just 2% in 2022, evidencing that innovation in AI is mainly driven by startups.

From a geographic perspective, we find North America, Western Europe, China and India attractive. China remains the second-largest private equity market globally, with the RMB market playing a pivotal role in driving growth. India has a rapidly maturing private equity industry with a broad set of high-growth companies.

Private debt and credit alternatives

We anticipate income will remain attractive even as interest rates normalise, given that rates are anticipated to remain higher for longer compared to levels seen over the past two decades. Income is particularly attractive in the US given strong GDP, and policy support.

With regional banks overexposed to commercial real estate (CRE), we expect lending rates in CRE to remain higher. CRE loans will therefore provide an attractive opportunity in new lending to strong borrowers on well-positioned assets. Infrastructure debt remains a constant source of stable cash flow, and specialty and asset-based finance offer high income, with strong diversification and low correlation as well as lower exposure to volatility.

Banks in the US and Europe continue to reduce their lending volumes as they attend to increasing regulatory pressure. While syndicated markets have offered considerable financing (more than 700 CLOs issued in fewer than 200 business days), this supply has been met with very strong demand and risk premiums in the liquid debt market have collapsed, dragging CLO and direct lending premiums lower as well. Alternative private debt and credit appear very attractive on a relative basis, and returns and cash distributions remain attractive in these areas.

We favour investments offering high income and benefiting from capital provision inefficiencies. These include:

- Defensive income from infrastructure debt with stable, low-volatility cash flows
- Opportunistic income from sectors with negative headlines that cause emotional bias, like real estate
- Uncorrelated income from sectors such as insurance-linked securities
- Diversifying income, like asset-based finance, which benefits from inefficient capital provision, or sectors with limited capital access, such as microfinance

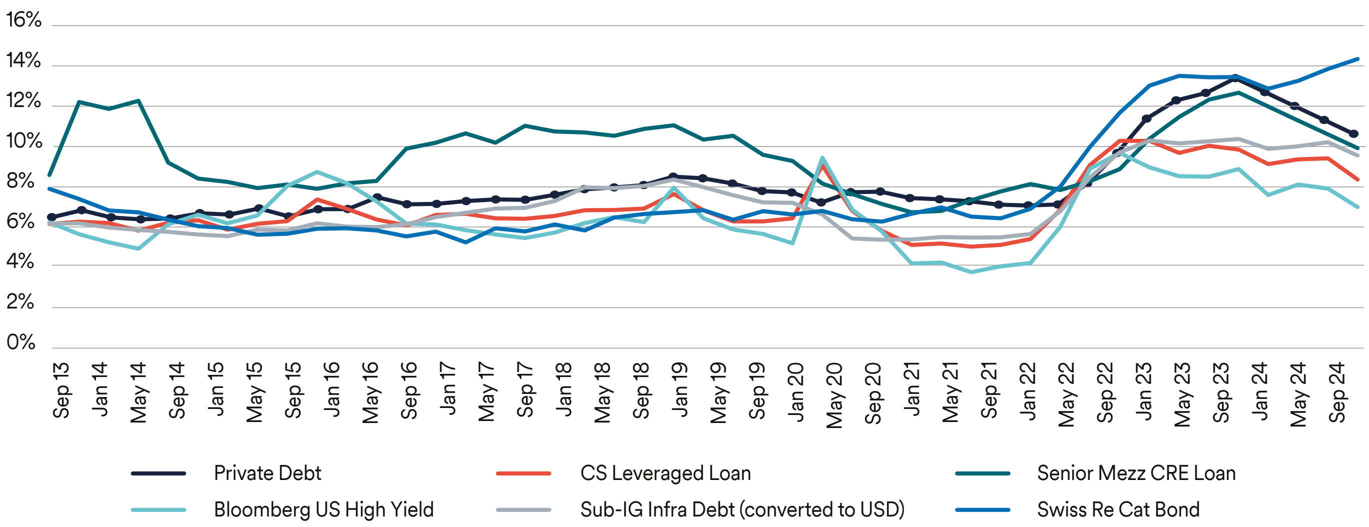
Our focus is on assets with strong fundamentals and strong borrowers, rather than distressed assets or large-scale trades. For example, we like newly originated transitional loans (bridge loans), or development and construction loans that would have been provided by banks. We don't like buying loans originated years ago from banks. We want strong borrowers with their highest priority assets, such as a prime consumer and their home, or a business' critical equipment, rather than unsecured consumer loans made to weaker borrowers that are financially insecure.

Today, many liquid markets have historically tight risk premiums, whereas excess return can be found in specialised sectors such as insurance-linked securities (ILS). Following Helene and Milton, the two major hurricanes that have recently hit the United States, the insurance and reinsurance industry will face significant losses. Top layers ILS strategies, including cat bonds, are generally exposed to even more severe events. We therefore expect to see a limited impact from these natural catastrophes on such strategies. Nonetheless, we anticipate that this hurricane activity will contribute to keeping spreads of the ILS asset class at historically high levels, making it one of the alternative fixed income asset classes that will continue to offer higher risk premiums. With lower default rates expected as policy rates decline, we also see CLO warehouse and CLO equity as strong return opportunities.

Figure 2: Private debt premium is higher, relative value favours secured debts

Risk premia vary, some have peaked

Private debt and alternative credit yield comparison



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Source: Schroders Capital, Bloomberg, Giliberto-Levy as of September 2024. The views and opinions shared are those of the Schroders Capital Securitised Products & Asset-Based Finance Team and are subject to change.

Infrastructure

The energy transition segment in infrastructure remains particularly compelling, due to its strong inflation correlation and secure income traits. As we have noted previously, it also provides positive diversification to portfolios through exposure to distinct risk premiums like energy prices.

The push for decarbonisation, coupled with energy security concerns, which are amplified by the ongoing conflict in Ukraine, continues to benefit renewable energy. Continued concerns over cost-of-living across a number of economies also highlights the issue of energy affordability. In many regions globally, renewables are the most cost-effective option for new electricity production.

Currently, renewable energy in Europe has a €600 billion base, representing 45% of infrastructure transactions. By the early 2030s, this is forecasted to more than double to €1.3 trillion, potentially making renewables and energy transition infrastructure the majority of investable assets in the sector.

Additionally, renewable-related technologies, such as hydrogen, heat pumps, batteries, and electric vehicle charging, will play a crucial role in facilitating the decarbonisation of sectors like transport, heating, and heavy industries.

The market has shifted to a buyer's market during 2024, recalibrating expected equity returns due to higher interest rates and reduced dry powder, creating a supply and demand gap between renewable projects and limited capital investment. The current environment remains attractive for core/core+ strategies, with equity returns up over 200bps since the beginning of 2023. We favour core/core+ strategies that benefit from strong asset performance and enhanced cash generation via active management. Selectively, there are higher return opportunities in infrastructure projects like hydrogen, although we remain cautious on early-stage developments.

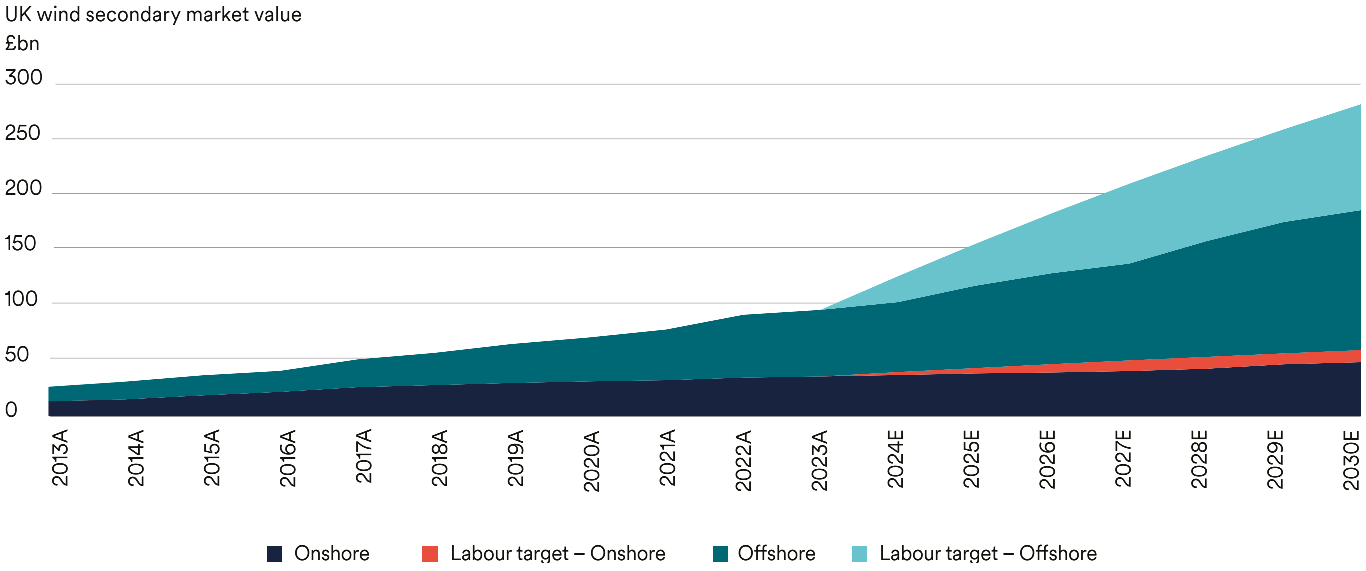
The return dislocation between listed and private markets, with listed assets trading at a discount, has led to significant volume of take-private transactions. However, with the expected move towards normalisation of interest rates, we expect a re-rating of the asset class.

AI advances are boosting renewable sector demand, notably increasing electricity consumption for data centres. This demand shift continues to support long-term green electricity pricing, underpinned by corporates' net-zero ambitions.

We see European governments strengthening their commitments to renewable energy, including the UK following the recent election (see graph). Those ambitious targets require mobilising institutional capital.

Figure 3: UK wind market forecasted to grow by >£100bn by 2030

Expected UK wind market growth driven by Labour's targets



Past performance is not a guide to future performance and may not be repeated.
Source: Schroders Greencoat, 2024. For illustrative purposes only. There is no guarantee that this rate trajectory will remain the same in the foreseeable future.

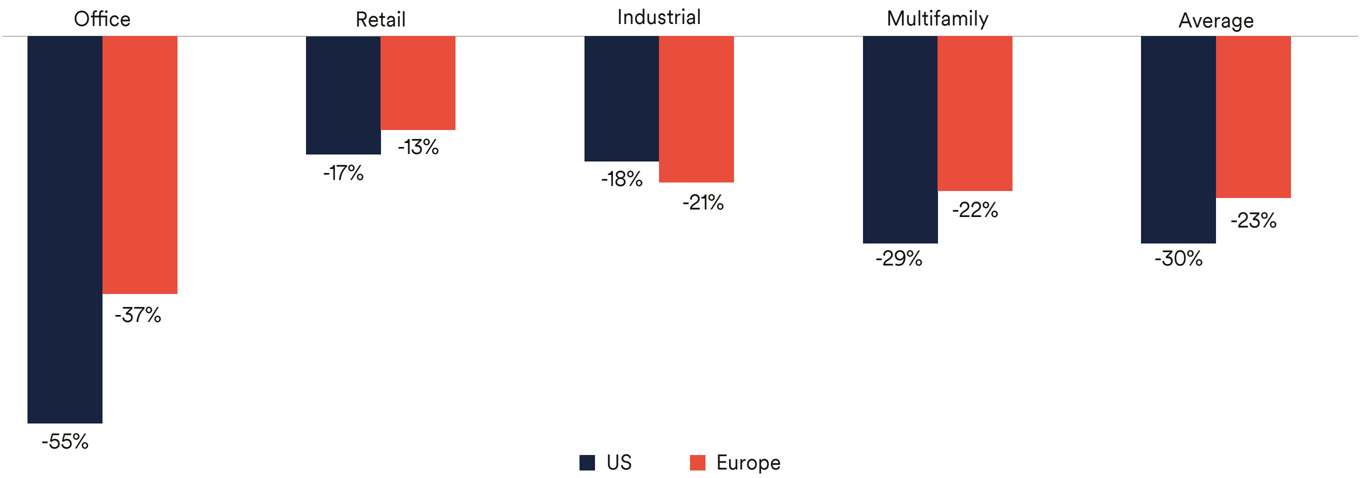
Real estate

As we have previously observed, the real estate market has been experiencing value corrections across the globe, albeit to varying degrees across regions, sectors, and investment structures. In many segments, pricing is stabilising at low levels (see graph), which present an opportunity to access assets with strong fundamentals at attractive valuations. Our proprietary valuation framework suggests that 2024 and 2025 will be opportune years for real estate investments, with a broader array of markets now offering fair or better value.

Figure 4: Extent of real estate price declines creating a window of opportunity

Pricing is now stabilising at low levels reflecting potentially attractive value across a range of sectors

US and European transaction price declines from recent peak through Q2 2024



Source: Green Street Advisors, Schroders Capital, September 2024.

Income has been rising in most markets supported both by value adjustments and muted economic conditions. This underscores that recent market repricing has been primarily a capital markets story and has been somewhat dislocated from the underlying fundamentals, bar in the much-maligned secondary office sector. While demand has not been immune to slow economic growth, tight supply conditions due to higher construction and debt finance costs has resulted in a scarcity of high-quality ESG-compliant space.

We continue to see a clear ordering of opportunities. For example, repricing in the UK is well progressed with the geography now offering strong relative value, as is industrial from a sector perspective. We are also seeing a significant repricing in the warehousing and logistics sector, which is supported by strong fundamentals.

Investors also stand to benefit from value-add growth opportunities across our preferred sectors, for example by creating platforms that combine specialist operational capabilities with the portfolios they manage, and funding these teams to capitalise upon rebased opportunities as they expand. Opportunities also arise from upgrading buildings to modern fit-for-purpose use, with a specific focus on sustainability. This is pertinent given the prevailing limited availability of debt capital, increasing regulatory pressure, and shifting occupier preferences.

We believe all real estate is operational and, armed with a hospitality-led approach, investors can drive additional income from services by contributing to the success of tenants' businesses, with sustainability and impact considerations a high priority.

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