

IPM monthly blog

Our monthly **insights** into **private markets** — June 2023

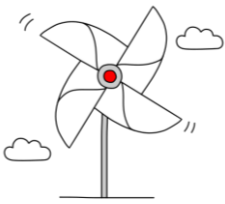
Real estate



Price correction continues

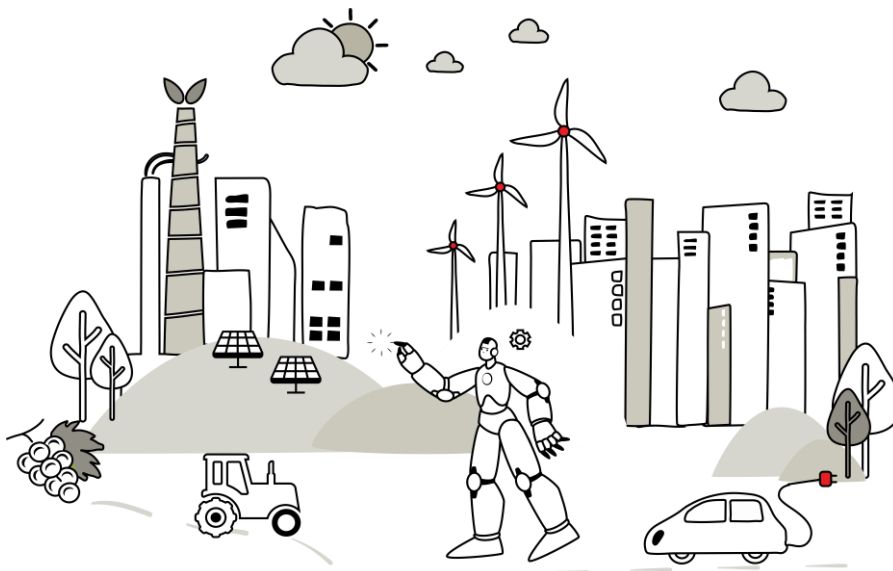
- Global real estate transaction volumes stabilized at low levels in the first quarter of the year as the market correction continued.
- The UK market has led the price correction, followed by the rest of Europe, with the US lagging. Capital values in Asia Pacific have remained broadly flat due to a stable Japanese market where interest rates have not risen.
- Interest rate expectations have risen in the US and UK, which will present a headwind for those markets.
- Overall, we think that industrial and residential have the strongest fundamentals and medium-term prospects. On the other hand, office performance will likely be held back by capex requirements needed to improve energy efficiency and the impact of flexible working.

Infrastructure

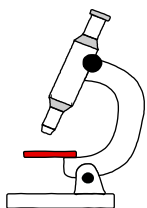


Deglobalization... a new secular trend for infrastructure?

- Decarbonization, digitalization, and demographic change, otherwise known as the “3 Ds”, are fairly mainstream investment themes.
- A more underrated “4thD” is deglobalization. Geopolitical tensions and recent supply chain issues have revitalized the demand for domestic manufacturing capacity.
- The Inflation Reduction Act (IRA) is subsidizing domestic cleantech manufacturing.
- US capital spending in manufacturing was USD 107 billion in 2022, an all-time high, while USD 150 billion of semiconductor manufacturing and USD 50 billion of battery manufacturing investments are currently planned.
- Similarly, the EU is looking to implement a “Green Deal Industrial Plan” to reinvigorate its domestic manufacturing.
- This could be a tailwind for infrastructure, as onshoring requires upgrades to transportation networks and adjacent infrastructure to support industrial growth.



Private equity



Private equity holding steady

- Private equity funds and companies are holding steady into mid-year as GPs and management teams adjust to the shifting macro and rates environments.
- Venture capital continues to face a challenging valuation environment compared to 2021 peaks but has seen some reflation in 2023.
- The deal and exit environment for private companies has slowed into 2023, as the rate of IPOs has reduced and strategic pull backs increased. Sellers are accustomed to the higher valuations of recent years while buyers bid at today's lower market multiples.
- This mismatch is resulting in longer holds (for invested funds) and slower capital deployment and fundraising (for new funds) but will create opportunity in the medium term.
- Secondaries are an attractive solution to the slower exit environment for LPs and GPs alike: discounts for LPs interests are stabilizing and continuation funds are now a commonly used tool for GPs that can offer attractions to LPs, GPs and buyers.

Private credit



The golden age of direct lending?

Over the past decade, direct lending strategies have been the driving force behind the surging growth of private credit. Post-2008, direct lenders saw a renaissance and stepped into the vacuum created by restrictive regulation that pushed banks out of lending to middle market companies. However, as the space gained more acceptance, investors ended up commoditizing the market, compressing spreads and ultimately resulting in managers extending further into the risk spectrum to meet return expectations. For these reasons, we focused on other segments of private credit strategies. However, following the successive events of COVID-19, historic central bank tightening, the current economic slowdown, a credit cycle in its later innings, and broad asset repricing, the direct lending market now appears to be positioned to deliver attractive loss-adjusted yields and total returns.

Market tailwinds:

- After years of headwinds in the form of market crowding, over competition, zero interest rates and easy money, direct lenders are now enjoying several market tailwinds.
- Direct lenders are seeing competition dwindle, both in the form of money center, and recently, regional banks exiting the space following the regional bank crisis.
- Recent entrants or less experienced managers extending into riskier deals have also found themselves with underperforming portfolios post-COVID-19 that will keep them otherwise too occupied on workouts to deploy additional capital.
- Traditional funding markets for middle market companies, namely high yield bonds and leverage loan markets, have also seized up as new issuance has slowed significantly and cut off access to capital for borrowers. These market forces have provided an opportunity for direct lenders to step in and provide private solutions, both in new issuance or refinance opportunities.
- In the high yield bond market, banks positioned themselves defensively following a spate of hung deals. For the few deals being issued, they are coming with steep discounts and tight underwriting standards, which largely price out middle market borrowers with higher risk capital structures.
- In the leveraged loan market, CLO managers typically represent 60% of loan purchases. However, with rising liability costs, CLO managers have been disincentivized to issue new CLOs, resulting in a marked drop in loan demand from investors. This impact may be compounded over 2023 as 40% of all issued CLOs are scheduled to exit their investment period.

Improving deal quality:

- Prior to the new interest rate regime, the private and syndicated middle market loan segments saw increasingly loose underwriting with market participants extending into worse quality companies in search for yield. This dynamic has now largely flipped, with lenders firmly in control of negotiations and able to secure loans to better quality company with improved structures.
- From 2015-2020, typical loan structures would include EBITDA multiples of 5-6x, LTVs of up to 75%, and cov-lite documentation that may include the ability to be primed or have limited or no governance on profitability or debt coverage ratios.
- In 2Q23, structuring and deal quality has markedly improved. Managers have typically been reporting that EBITDA multiples have reduced to 3-4x, and LTVs of 40-50% where managers can largely dictate terms on covenants and structuring.

Improved economics:

- With rising base rates and broader concern around corporate credit, direct lenders are now enjoying some of the most attractive risk / reward profiles in a decade. Managers are able to access equity-like returns without extending down the capital structure, by investing in first lien senior secured or unitranche loans.
- From 2015-2020, direct lending strategies faced headwinds from challenging economics and easy money policies. For reference, the typical structuring of loans would include a floating rate (0-0.25%) with 400-500bps of spread, no interest rate floor, 1-2 points of entry / exit fees, OID of 1-2% and equity participation of 2-5%. Managers could typically target net returns of 6-8%.
- In 2Q23, economics have vastly improved with base rates now at 500bps, widened spreads of 600-700, floors of up to 2%, increased entry / exit fees of 2-3, OID of 2-3% and equity participation of 2-5%. Managers can now secure equity-like expected returns of 12-15% while taking senior secured risk.

Opportunities:

- New issues and direct origination: With public funding markets largely shut off, traditional finance providers either exiting the space or significantly tightening lending standards, direct lenders will have an unprecedented opportunity to serve as an alternative financing solution to companies that can no longer access primary markets.
- Stressed refinancings: Similarly, many leveraged issuers originated debt during the zero-interest rate regime, and are now being squeezed at both ends as growth and profitability wane and their cost of financing has increased 500bps. As these issuers reach maturity, direct lenders will be increasingly relied upon to provide stressed refinance or private capital solutions for these companies as traditional markets remain closed.
- Opportunistic secondaries: As markets continue to reprice, direct lenders will also be able to opportunistically invest in club or lightly syndicated loans or private secondaries from forced sellers.

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