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Private investments continue momentum

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Private markets continue to perform well despite a challenging environment as investors search for uncorrelated returns. Private debt, private equity, and private real estate also continue to see deal flow and interest from investors looking to put capital to work.

Private debt, typically direct lending funds with floating rate features, have insulated investors from the heavy losses seen in traditional fixed-rate bonds. These private debt strategies have attracted record amounts of capital over the last ten years as investors seek higher yields over traditional bond funds.

Private credit funds provide loans directly to businesses and typically earn annual returns in the high single digits to low teens. Even as financing rates have increased for private companies, private debt continues to see deals getting done through year-end 2022 while syndicated loan (public debt) deal count dropped off sharply. In December, there were two significant private credit deals announced (Thoma Bravo's USD 8 bilion take private of Coupa, and Advent's USD 6.4 billion take private of Maxar Technologies) that would have traditionally been done in the syndicated loan market, that can be taken as an indication that private debt has good momentum going into 2023.

Within private equity, funds are gravitating towards sectors with stable cash flows and growth potential, such as technology, healthcare, and business services. Technology, in particular, continues to be the favorite in inflows and deal volumes. While activity is robust, valuations have significantly declined. The median entry EV/EBITDA multiple in information technology sector buyouts have dropped from a high of 17.4x in 2021 to 11.6x as of the latest data from Preqin. In contrast, sectors with high debt levels or exposure to interest rate pressures like retail and energy have fallen out of favor. Given the economic slowdown, it is our view that investors should focus on value-oriented buyout funds which tend to be more robust to higher rates and the economic cycle and offer a premium over public market equities.

We also see opportunities in the secondary market. With public markets still closed for IPO activity, trade sales and secondary buyouts are likely to be the main exit routes for private equity in the near term. Secondaries offer several potential benefits for investors and may represent a particularly attractive entry point relative to primary private equity funds because of their unique risk and return characteristics. For new investors who want to mitigate the Jcurve effect and multiyear timeframe to achieve their target asset allocation, they can look toward mature secondaries as a way to put capital to work almost immediately. In secondary positions that are close to fully funded (meaning close to all of the commitment has been called), new investors can purchase these positions and have their capital put to work from day one.

Finally, private real estate investments have remained robust despite the average mortgage rate rising to 6.47%2. Rising interest rates and valuation concerns are likely to hit both fundraising and deal activity. However, fund managers who positioned portfolios with a tilt toward residential rental income and leases could fare better, as the high cost of home ownership and inflation has supported continued growth in Net Operating Income (NOIs).

According to Preqin, private real estate funds have continued to attract allocations in-line with pre-pandemic levels, with USD 175 billion of capital raised through year-end 2022. Additionally, institutions have committed capital, with a notable USD 4.5 billion cash injection by the University of California's investment into Blackstone's BREIT product in January 2023.

While higher interest rates can slow the economy and cap rate expansion, the illiquidity and short duration of many lease contracts of private real estate means less interest rate sensitivity relative to public markets. Core investments with strong cash flows, such as residential housing and warehousing, remain a focus to generate income and position for growth potential.

Despite frothy market conditions, the longer-term focus to seize on value opportunities in private market investments is expected to insulate portfolios from short-term volatility and enhance portfolio return potential in a diversified portfolio.

Risks for private investments

- A longer recessionary market can make it more difficult for managers to find good exit opportunities or realize attractive returns.
- Higher interest rates also increase the risks of defaults for private debt, which is why funds must be selective in their underwriting and investors should review their position to be in line with their risk appetite and objectives.

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Read the full blog Private investments continue momentum 3 February 2023.

For further information, please see our report: An introduction to private markets, 16 September 2022.

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Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.