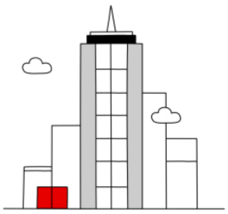
IPM monthly blog

Our monthly insights into private markets – **August 2023**

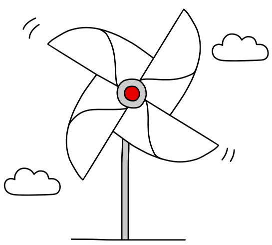
Real estate



Resilience in APAC

- A soft landing has become more likely. This could mean interest rates staying higher for longer, which may continue to weigh on capital values.
- According to MSCI, 2Q23 global real estate volumes (excluding development sites) fell another 5% QoQ (-57% YoY) to USD140bn, the lowest in more than a decade. Weakness was broad-based across all sectors.
- Sentiment on offices is particularly soft in the US and that has reverberated around the world. APAC offices have been more resilient with standout markets like South Korea and Singapore. Prices in the two markets have held up well, despite sharply higher funding costs, partly thanks to their low vacancies and robust rental growth (4-11% YoY in 2Q). This suggests investors are continuing to focus on fundamentals.
- In APAC, Japan remains an outlier market with low interest rates. Financial markets have taken the recent YCC tweak in its stride as the Bank of Japan's tone remained dovish: the stock market pulled back a little, the JPY depreciated, and 10-year bond yields inched up to 60-65bps. Overall, we think the moves were modest and should have minimal impact on the real estate market in the near term. Any eventual policy tightening would be prompted by higher inflation, which the Bank of Japan has estimated to remain highly uncertain.
- Overall, we continue to prefer industrial and residential real estate, which have the strongest fundamentals and medium-term prospects. We are selective on the office sector.

Infrastructure

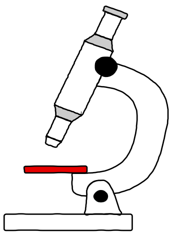


Regulatory clarity in tax credits nudges investor sentiment

- Although infrastructure experienced a strong 2022, investors have taken a wait-and-see approach in 2023, as seen from the weak fundraising data.
- Sentiment around the infrastructure asset class is becoming more constructive with inflation and interest rates peaking.
- Rising public equities also offset some of the impact from the denominator effect, which sets 2024 up for potentially more activity if the macro environment holds up.
- Policy tailwinds remain strong, as investors gained some clarity in recent months around clean energy tax credit rules and broadband internet subsidies in the US.

UBS

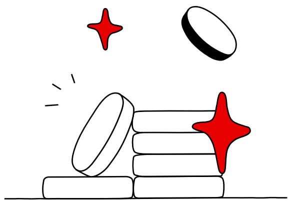
Private equity



Opportunities in secondary markets

- Fundraising has slowed in 2023. The greater share of flows is being invested in large cap funds. Sponsors across both regions and strategies are raising smaller funds over protracted periods.
- Private equity (PE) valuations are back on a growth trajectory after mark-downs in 2022 which were driven by a decline in public markets.
- Venture capital valuations remain under pressure, particularly for younger companies which have not yet reached profitability.
- Exits of venture capital – and private equity-backed companies – remain muted, but with some signs of rebound; we expect exit activity to continue strengthening in 2024.
- Secondary market activity rebounded in 2Q as PE valuations and discounts stabilized: we see a significant opportunity to invest in both LP- and GP-led transactions going forward.

Private credit



New bank regulation and its impact on private credit

At the end of July, the Federal Reserve, Federal Deposit Insurance Corporation, (FDIC) and the Options Clearing Corporation (OCC) released the latest draft proposal of updated banking regulations for review and comments. Among the many new proposals, the legislation broadly looks to increase capital risk charges for various asset classes and force banks to de-leverage their balance sheets. Specifically, the new rules will look to:

- Implement standardized risk management protocols and risk measurements across banks.
- Adjust risk weightings for capital charges across various asset classes.
- Expand the regulations from covering banks with over USD 250 billion in assets, to include banks with USD 100 billion or more in assets.

While the exact language has yet to be determined, the proposed rules are likely to result in significant new bank capital requirements and downstream impacts on markets.

Early reviews by industry participants show that on average, banks with USD 250 billion or more in assets would likely need ~20% more capital (or more likely de-risk their balance sheets by 20%) to meet the new requirements, while banks with USD 100-250 billion in assets would likely need ~25% more capital. These figures also mask a wide variance in expectations from bank to bank.

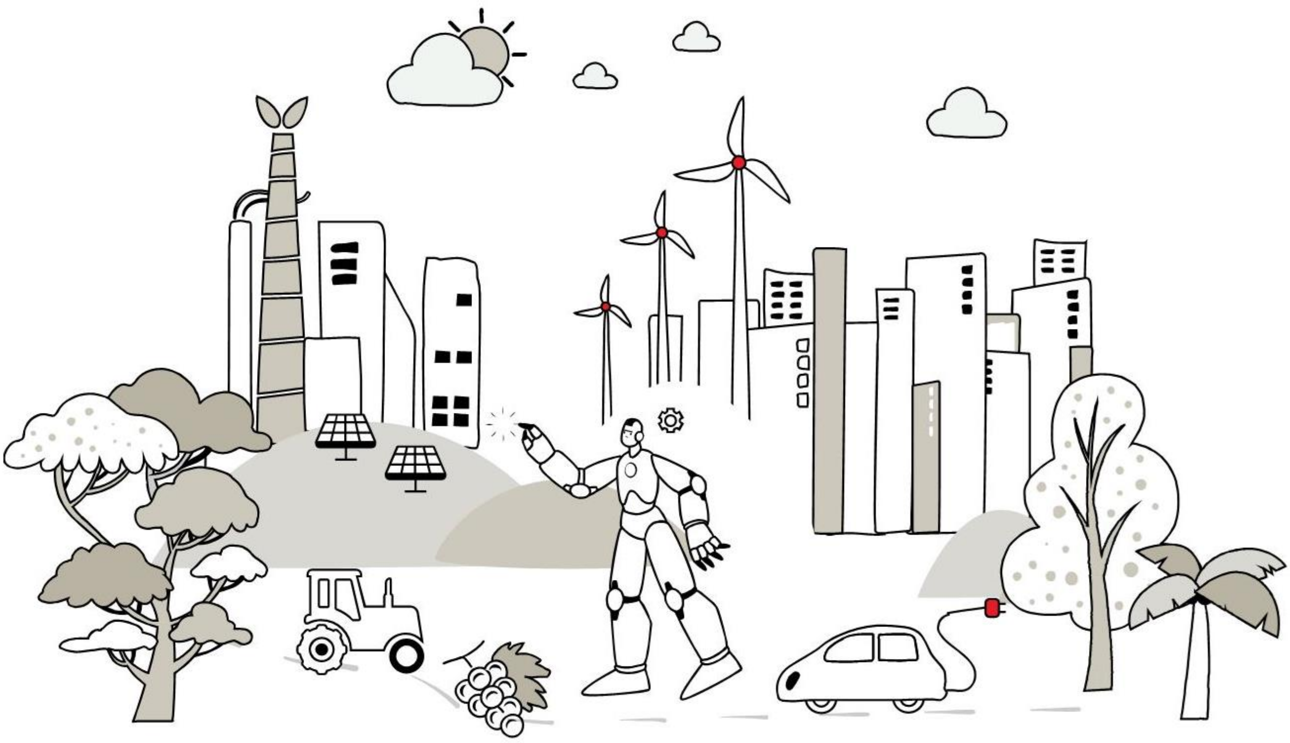
For instance, in CRE, for regulatory capital CRE loans and CMBS, the proposals will look to re-weight risk charges for properties with rental incomes (based on LTV). Initially, banks may slow new origination prior to understanding the new rules, and subsequently be forced to readjust their balance sheet holdings.

In government agencies and government sponsored enterprises (GSE) mortgage-backed securities, proposed changes to risk weights were considered to be minimal, which is expected to support the segment as those assets would remain capital efficient.

In non-agency securitizations, the legislation proposes reducing risk weighting floors for standard securitizations from 20% to 15%. It also looks to raise risk weightings to 100% for non-performing loans (NPLs). This will result in a market repricing as banks reconsider their securitization strategies.

The impacts of the latest regulations will vary significantly by asset class; however, it is expected to widely result in banks being forced to shed assets. Overall, this should create a notably attractive opportunity set for private credit managers, particularly regulatory capital relief strategies, with expected net IRRs of 11-13%, over the next 3-5 years as new regulations are implemented in phases. The opportunity set for private credit managers is expected to expand across the space, including but not limited to:

- Opportunistic trading around market dislocations, pricing inefficiencies and misunderstood new regulatory capital rules as the new legislation rolls out and investors embark on new price discovery.
- Growing volume in bilateral off-market transactions where managers can act as liquidity providers as banks de-risk (perhaps as a forced seller) to meet new guidelines.
- Flooding of supply and price pressure for riskier assets, providing entry opportunities at attractive valuations.
- Improved performance on synthetic regulatory capital transactions as tighter regulations may result in improved collateral quality for assets staying on bank balance sheets.
- Opportunities to step in as originators or lenders for orphaned asset classes as banks retrench from higher risk weight market segments.



For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)

sh-am-private-markets-research@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

ubs.com/privatemarketsresearch

UBS