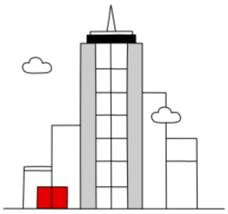
IPM monthly blog

Our monthly insights into private markets – **March 2024**

Real estate



Market conditions remain challenging, but optimism emerging

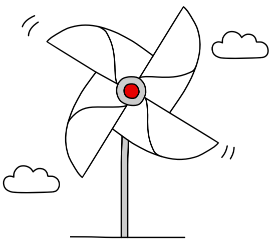
Capital market conditions and expectations remain volatile, and the real estate sector continues to face challenges. At the beginning of the year, markets expected early and strong interest rate cuts. However, as inflation has proven slightly more stubborn, expectations for cuts have been scaled back and the consensus now sees the first-rate cuts in the summer. Yet, the expected delay in interest rate cuts has not resulted in a strong pushback for real estate, with the listed market more or less holding the levels it reached at the end of last year. As the year progresses and rate cuts become real, we expect momentum to accelerate for both the listed and unlisted real estate markets.

At -2.1% QoQ, the total return for the fourth quarter was the worst in 2023, according to the MSCI Global Quarterly Property Index. This was driven by a further decline in capital values, focused on the US, and marking the sixth consecutive negative quarter of returns. Although, according to MSCI, global transaction activity rose in the fourth quarter, it increased by less than the usual seasonal bounce associated with the final quarter of the year.

We think that transaction activity should be supported by the stabilization in transaction yields we are starting to see. According to CBRE, about 60% of European markets showed stable property yields over the past three months. While we believe that some more expansion is to come, we expect the pace to slow significantly and that rises will end soon for segments with strong market fundamentals such as residential, logistics, data centers and life sciences.

Some optimistic signals can be seen in forward-looking surveys. For example, the INREV consensus indicator, which measures sentiment in the European non-listed market, improved strongly in March 2024 compared to December 2023, reaching 50.2. This is the highest level on record since it was started in March 2023 (with above 50 indicating positive sentiment).

Infrastructure



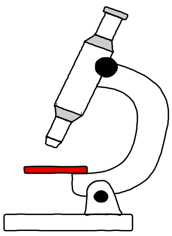
Clean energy remains top of mind for infra investors

In our recent infrastructure research roadshow in Europe, the topic of clean energy and decarbonization still dominated conversations with investors, especially with many headlines this past year about the pushback against renewable energy projects.

Overall, investors are still believers of the mega-trend, while acknowledging that negative rhetoric will most likely ratchet up this year with so many elections happening around the world. In our 2024 infrastructure outlook, we reminded investors that political and headline risks are nothing new for the clean energy industry. The industry has always faced different doom and gloom outlooks for various reasons, yet it has consistently adapted to new challenges and come out stronger. One current example is the offshore wind industry, which could not catch a break in 2023 with endless negative headlines around cost overruns, project delays, and outright cancellations.

Yet in 2024, we have seen successful offshore wind auctions in both US and Europe, while infrastructure investors have also become active in the space. This is exactly what we want to see in a healthy market – when faced with headwinds, there is a reset in expectations, renegotiations of contracts, and ultimately, reengagement by investors.

Private equity



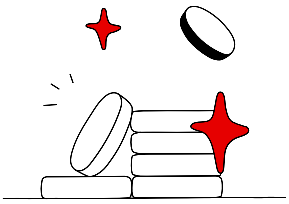
Weak realization market for private companies creates opportunity for buyers

Private equity is well placed to benefit from the continuing pause in interest rate increases and stable macro environment, both of which have bolstered public markets in 1Q24. However, there is less liquidity than in the past: a weak market for realizing currently held private companies means fewer companies are changing hands. In the short term, the result has been longer holding periods. Carrying values have generally remained steady, creating a prolonged gap between seller aspirations (for high purchase prices) and buyer expectations (for lower purchase prices). Rates and borrowing costs continue to be key. Since return targets are relatively constant, higher borrowing costs mean reduce underwriting expectations, and buyers want a lower entry price to compensate.

The more positive scenario for capital currently in the ground is for rates to begin to recede, which would lower borrowing costs and improve return on equity. Buyers may then become more willing to pay up, as company fundamentals are in reasonable shape. Accelerating economic growth could also entice buyers to transact at today's prices. A more negative scenario for currently invested capital would be if more rate increases or a broad faltering of private company performance pressures sellers to transact at more modest prices, which would reduce returns. Conversely, both scenarios are attractive for funds being raised today.

The current private equity fundraising environment is challenging. On the other side, well-networked limited partners today have excellent access to high-potential funds currently raising. For fully invested funds, exits and distributions remain front-of-mind but difficult to achieve; only the highest-quality companies have a strong market today. Sponsors and limited partners continue to turn to liquidity solutions for portfolio management. These include continuation funds and secondary sales to optimize liquidity, often at a discount to net asset value, making private equity secondaries an attractive investment opportunity for investment. We are also seeing resurgence in investor interest in life sciences as an attractive opportunity, as well as in AI, which has captivated early-stage investors with its potential.

Private credit



Direct lending: sponsor vs non-sponsor

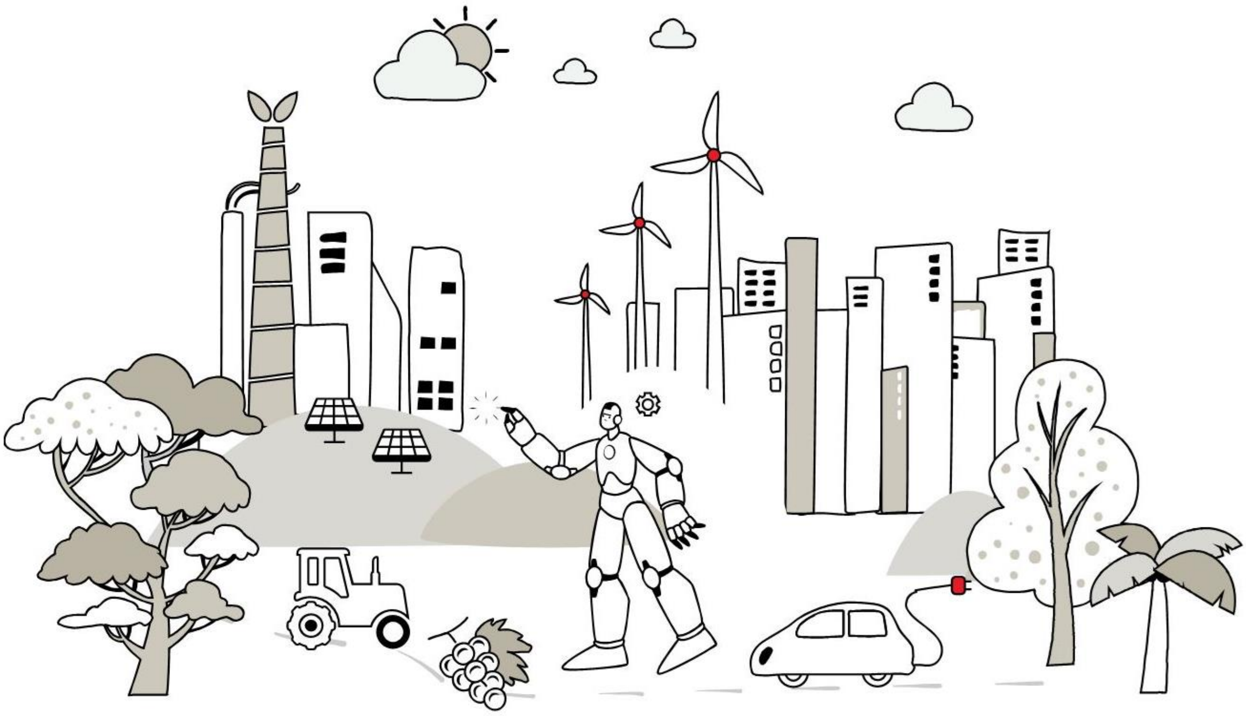
Within traditional corporate direct lending, managers typically focus on either sponsor-backed (companies that are backed by private equity firms), non-sponsor companies or a mix of both. Regarding the relative risk between sponsor and non-sponsor company investments, investors generally take the view that on average, sponsor-backed companies are less risky, as they present less credit risk (private firms have underwritten them and generally invest in less risky companies) while also providing lenders comfort that they are back-stopped by sponsor equity beneath them. There is also some implicit market capitalization / size bias involved as private equity firms generally invest in larger middle market companies, while non-sponsor companies are more prevalent in the lower middle market.

When it comes to comparing sponsor and non-sponsor strategies, we have not seen a material difference in defaults and recovery rates, and there is more nuance in identifying what drives manager performance dispersion. Specifically, as briefly mentioned above, company size has been an interesting factor driving credit performance, rather than sponsor involvement. For instance, we have found that deal quality (and thus credit performance) typically deteriorates in parallel with company size (specifically, loan sizes over USD 75m found in upper middle market direct lending and broadly syndicated loans). This deteriorating deal quality typically comes in the form of less lender control over the loan documentation and deal terms, as lenders are price takers rather than price makers for larger deals. This can result in worse structuring (ability to prime, transferring collateral, no additional debt restrictions, etc.), higher leverage (as high as 7x!), and generally covenant-lite packages. These lower quality deals have historically resulted in higher defaults and lower recoveries.

On the opposite end of the spectrum is the lower middle market, which is generally more lender friendly. Given the inherent increase in going concern / credit risk of smaller companies, this segment of the market is generally less trafficked, and underbanked. To compensate for this incrementally higher risk, non-sponsor managers can typically source higher quality deals, being price makers with more credit protections, in the form of lower leverage (<4x), stronger loan structures and covenant-heavy packages. As a result, if you're working with top quartile managers, non-sponsor strategies can not only generate higher returns, but do it with similar or better credit performance.

Also worth mentioning is the variety of non-sponsor strategies, which range from traditional direct lending, mezzanine (junior or equity risk) and capital solutions (stressed). These approaches target different risk profiles and exhibit varying default and recovery rates. For instance, capital solutions strategies, invest in more stressed situations, and naturally exhibit higher default rates. In contrast, sponsor-backed strategies are typically focused on lower risk, performing approaches.

So overall, we've observed a larger divergence in defaults and recoveries when comparing strategies that operate in the upper middle market (higher defaults, lower recoveries) and strategies in the core and lower middle market (lower default rates, higher recoveries). The variance in performance between sponsor and non-sponsor strategies, from our perspective, has been less evident. And as mentioned before, non-sponsor strategies, typically in the lower middle market, also potentially benefit from the ability to secure better lender protections and structural enhancements. Ultimately, we've found that it comes down to the manager, where they operate in the market, and their ability to underwrite and structure their investments.



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

This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS Asset Management Switzerland AG or its affiliates in Switzerland, the United States or any other jurisdiction. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Please note that past performance is not a guide to the future. With investments in real estate / infrastructure / food and agriculture / private equity / private credit (via direct investment, closed- or open-end funds) the underlying assets are illiquid, and valuation is a matter of judgment by a valuer. The value of investments and the income from them may go down as well as up and investors may not get back the original amount invested. Any market or investment views expressed are not intended to be investment research. **The document has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.** The information contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. A number of the comments in this document are considered forward-looking statements. Actual future results, however, may vary materially. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class, markets generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund. Source for all data/charts, if not stated otherwise: UBS Asset Management, Real Estate & Private Markets. The views expressed are as of March 2024 and are a general guide to the views of UBS Asset Management, Real Estate & Private Markets. All information as at March 2024 unless stated otherwise. Published March 2024. **Approved for global use.**

UBS