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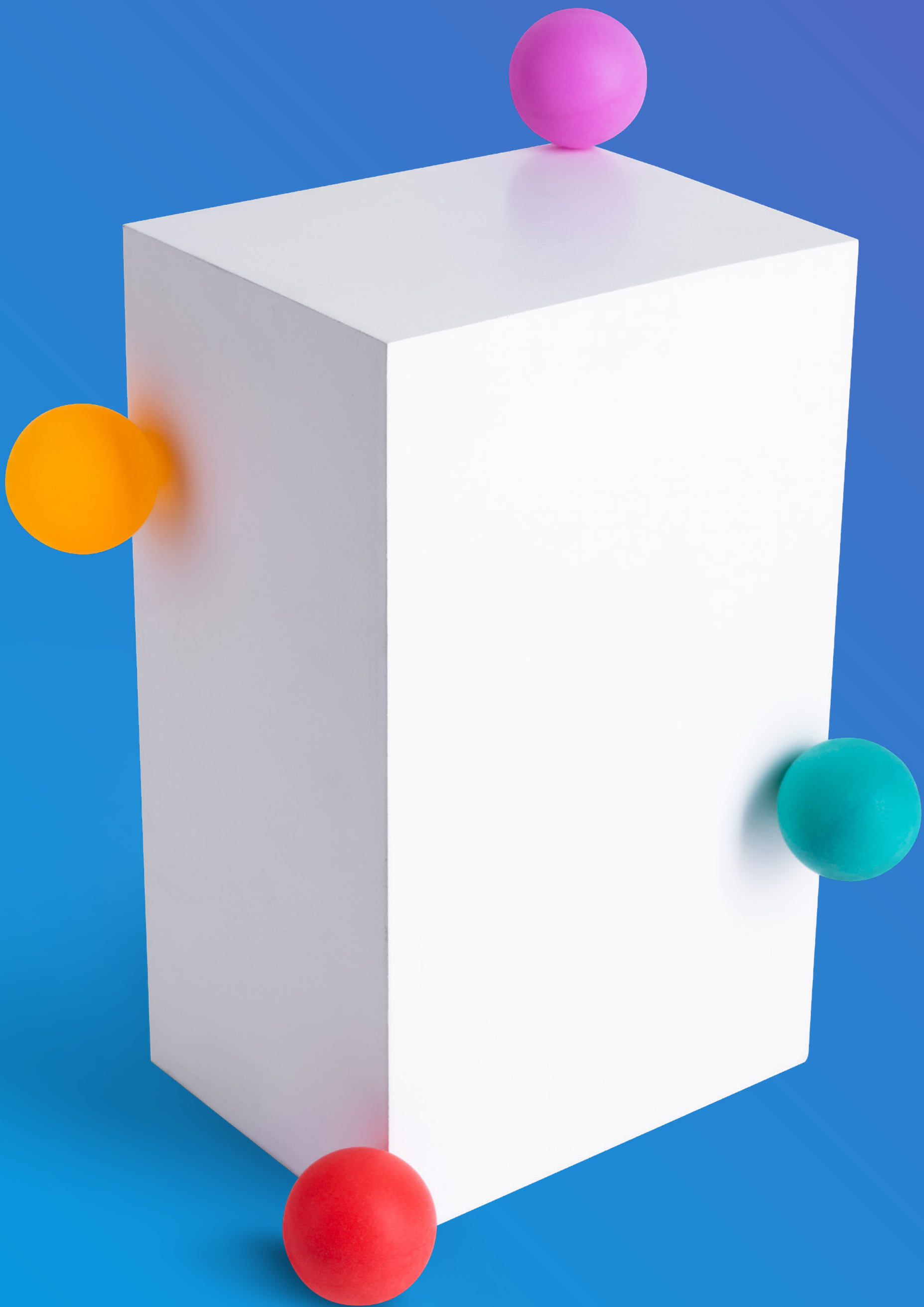
Private market top considerations for 2021



Investor insights

To say that 2020 has been an unusual year would be an understatement. We've experienced a global pandemic, a new normal for work and school, Zoom enthusiasm (and fatigue), devastating wildfires in Australia and the Western US, political unrest in major US cities throughout summer, the worst day ever for the Dow Jones stock market on March 9 and a highly contentious US election season, the implications of which will likely reverberate for years.

Though investor resolve has been tested in 2020, lessons learned from prior crises appear to have made us more resilient. Despite the uncertainty and the inability to vet new managers in person, limited partners (LPs) have continued to put capital to work, particularly with existing general partner (GP) relationships across all private market segments. As LPs increased commitments to credit dislocation funds, private debt and real estate were especially active. Toward the second half of the year, LPs began to ramp up co-investment and secondary activity, as many remained under-allocated.

From a regional standpoint, LP allocations to US private equity, venture capital and infrastructure strategies were relatively steady despite weaker investment and realization activity. In comparison, new commitments to Asia-focused GPs were more muted because of the early impact of COVID-19. But LPs benefitted from hedge fund alpha generation as well as more robust investment activity from existing private market funds as the region rebounded from the pandemic sooner than other parts of the world.

European fundraising and investment activity, however, has remained sluggish. Globally, hedge funds and real estate strategies appear to be well-positioned to capitalize on post-COVID changes in consumer and business behaviors, which will give rise to more distinct winners and losers.

As we look toward 2021, we will undoubtedly face new challenges and opportunities. In this edition of our annual *Challenges* piece, we take a look at what the coming year holds for private markets, outlining some of the issues we believe LPs will want to follow closely if they wish to optimize their portfolios:

- In **US Private Equity and Venture Capital Markets**, we discuss how the advice GPs receive from their legal counsels on terms and conditions could create a misalignment with LPs' interests.
- For **European Private Markets**, we discuss how the COVID-19 virus has compounded the uncertainty created by Brexit.
- In **Asian Private Equity Markets**, we discuss the effect of the pandemic as well as the ongoing political tension between the US and China — noting that, despite these issues, China may still offer attractive investment opportunities.
- For **Natural Resources**, we examine the reasons behind the significant challenges facing the market and the opportunities inherent in the sector.
- For **Infrastructure**, we discuss the recent growth and attractive performance of the market as well as the challenges associated with managing significant market changes.
- For **Private Debt**, we discuss how the landscape has changed in the past decade through the global financial crisis (GFC) and the more recent pandemic.
- Finally, in **Real Estate**, we examine the current market conditions and the opportunities by region.

US private equity and venture capital markets

GP legal counsel influence

Mercer reviews thousands of private markets fund offerings and conducts initial due diligence on hundreds of GPs each year. Over the past several years, we've noticed trends in limited partnership terms that are not favorable to LPs. The GPs' legal counsels may be the source of these trends potentially driving a wedge between GPs and their LPs.

Trends we've observed in key terms include:

- Management fees of 2.5% on committed capital
- Preferred return rates below 8% and as low as 0%
- Escalating carried interest rates as high as 25% and 30% of investment profits
- Accelerated vesting schedules on carried interest, often much shorter than full fund lives
- Excessive organizational expense limits, in some cases exceeding US$5 million

Law firms that serve GPs compete for business on both price (fees) and product quality (fund documentation). By pushing fund terms in favor of the GPs, these law firms believe they are serving the best interests of their clients and adding value. But by increasing the organizational expense limits, these firms are also increasing their own revenue. They have cleverly expanded their role (and billable hours) in fund documents, side letters and most-favored-nation (MFN) negotiations while charging the expenses to the funds and thereby fund LPs. These counsels likely make the case that a GP can outsource partnership agreement negotiations and fund closing processes to them at no additional cost because the GP can write off the cost in the fund documents as a higher organizational expense limit.

Securing allocations from access-constrained and oversubscribed funds is one of the greatest challenges for LPs. Because pricing (in fund terms) is a primary economic factor in balancing supply and demand, it's no surprise that the best private equity GPs are able to command premium terms. However, this justification doesn't favor emerging GPs that haven't proved they deserve premium terms. Further, the more fund terms are tilted in favor of GPs, the worse the alignment of interests with LPs becomes, even for proven, established GPs.

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Many LPs allow preferred GPs some leeway, recognizing that outperforming GPs can often negotiate better terms for themselves. Still, there's a limit to how much LPs will accept. They will undoubtedly reflect on how their GPs have treated them when those GPs need to seek amendments to their agreements. Those that behave in the spirit of partnership will build goodwill with their LPs.

Mercer believes the GP-LP relationship should be an aligned long-term association, not a one-sided agreement. We encourage GPs to solicit their LPs' views and opinions rather than accept on faith what their legal counsels represent as the new market standard. Likewise, Mercer recommends that LPs develop relationships with their GPs and resist being sidestepped by legal counsels.

By taking our concerns directly to fund GPs, Mercer has found that many are genuinely unaware of the current market terms. Their usual response is that legal counsel has told them their terms reflect the market standard. In multiple cases, Mercer and other LPs have succeeded in convincing GPs to adjust terms in a more LP-friendly direction to preserve the alignment of interests. GPs seeking genuine alignment will typically listen and respond in the spirit of building better long-term relationships.

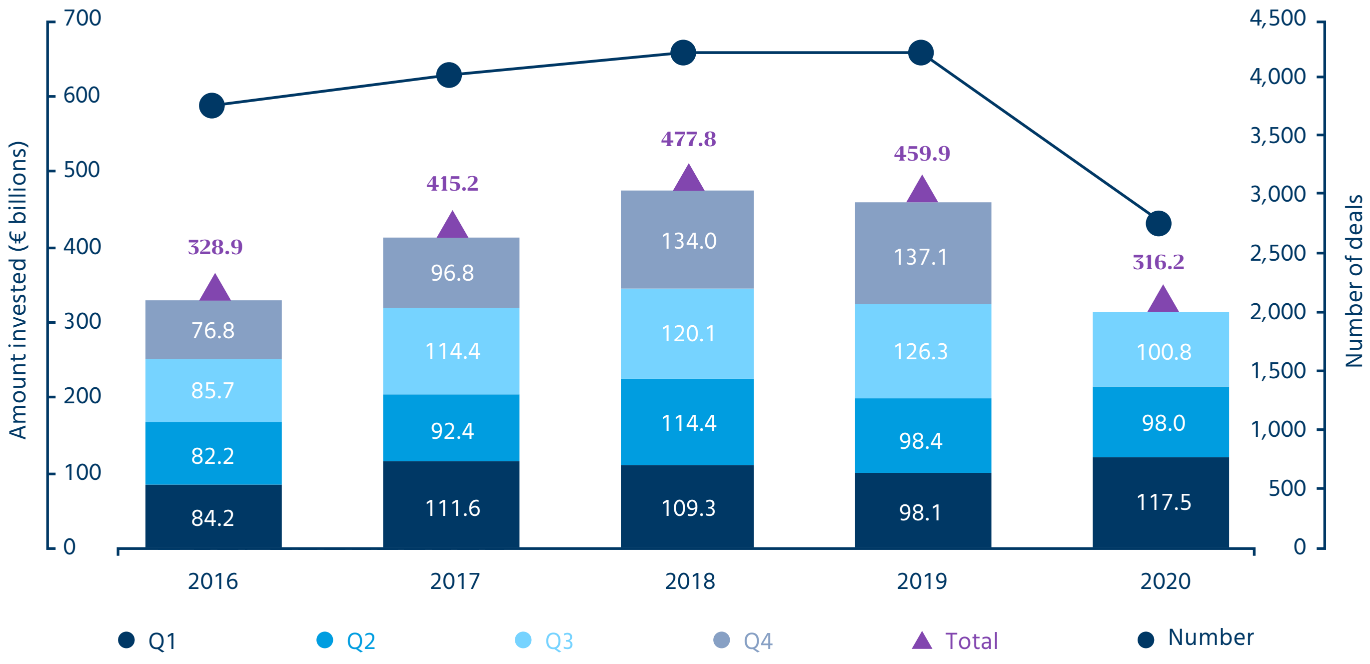
European private equity

The challenges of continued uncertainty

In 12 months, much has changed — yet much remains the same. Last year, we talked about uncertainty in Europe due to Brexit. This uncertainty continues 12 months later, with the UK leaving the European Union in 2021, and COVID-19 has compounded that uncertainty. Yet managers are still doing deals, albeit at a reduced level. This activity differs depending on geography, with some markets more active than others. Given the deal flow through September 2020, we expect annual deal flow to be significantly lower by year end than what we saw over the 2017 to 2019 period. With all the uncertainty, perhaps the biggest surprise is that deal levels have held up so well. As a consequence of a decline in deal flow, some GPs may have to extend their investment periods — something LPs will need to evaluate individually with each request.

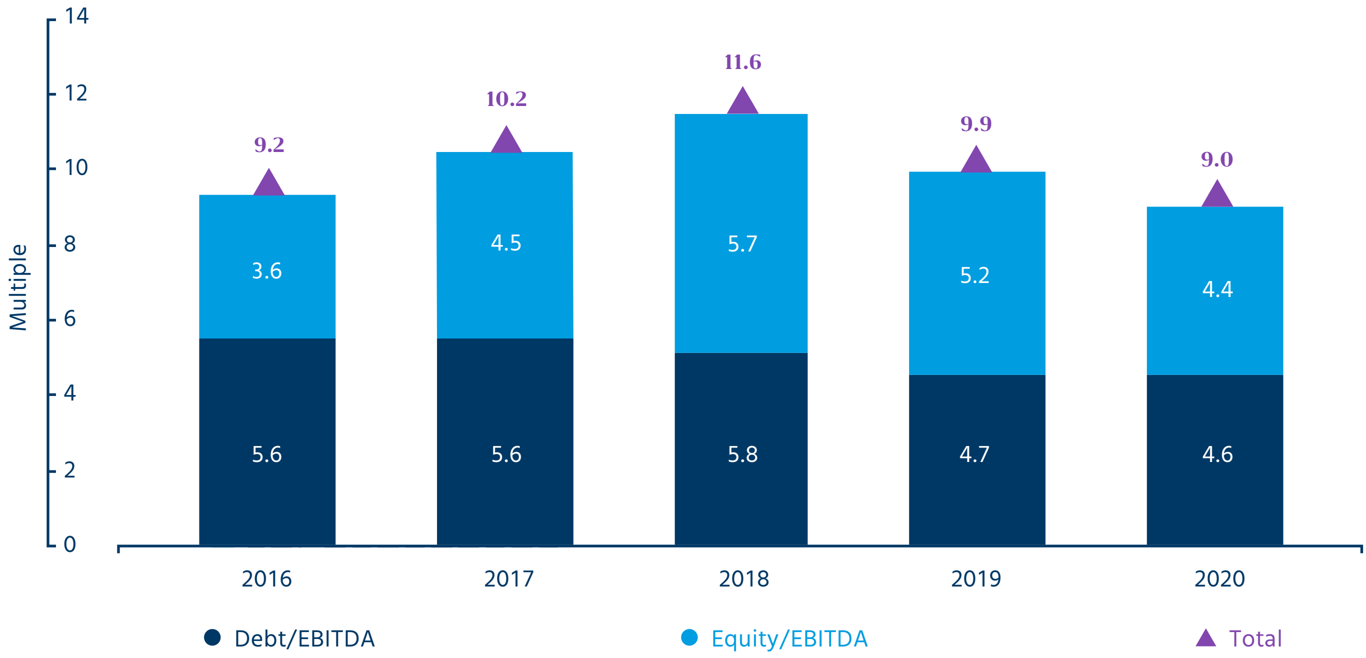
Prices have also declined. The median European private equity EBITDA multiple currently stands at 9.0x, compared to 11.6x in 2018. The dislocation may also present opportunities for some GPs' portfolio companies through mergers and acquisitions that were not expected before COVID-19. Because market dislocation can often provide opportunities for nimble GPs, uncertain times may not be a negative for all. As always, the key for LPs is in selecting top-performing managers that can take advantage of these uncertainties.

Figure 1. Europe PE deal flow



Source: PitchBook, June 30, 2020.

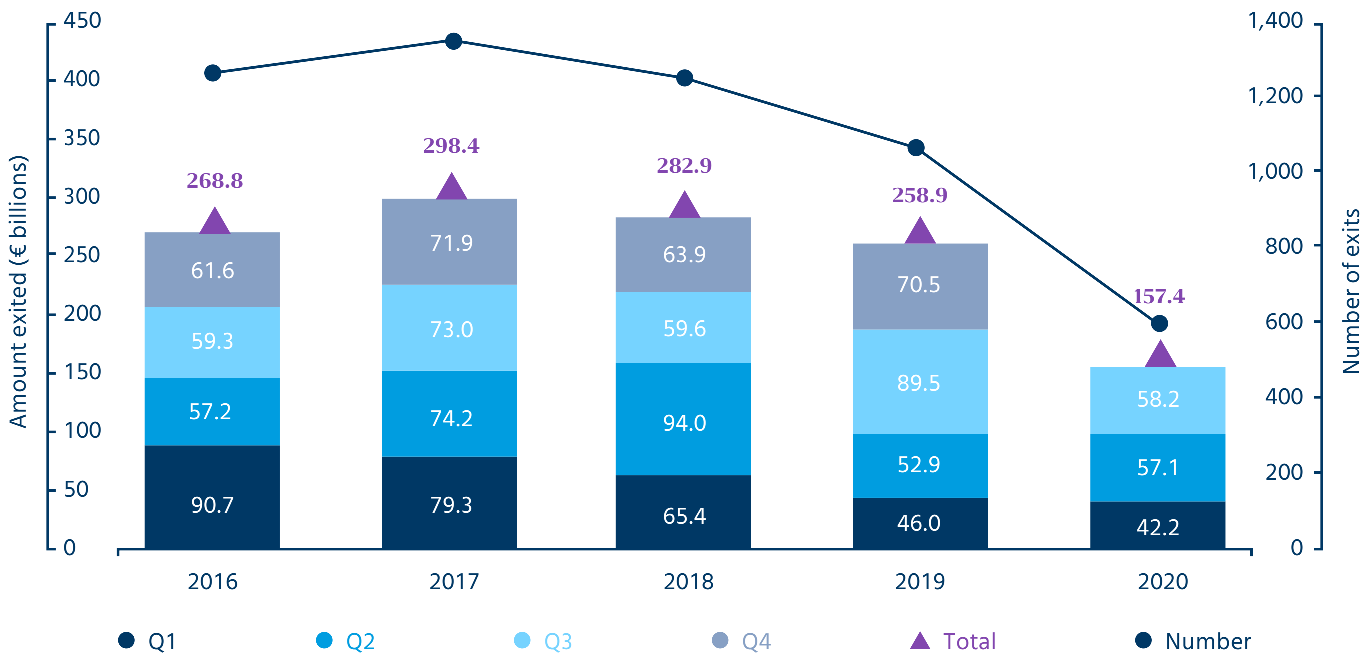
Figure 2. Europe PE median EBITDA multiples



Source: PitchBook, June 30, 2020.

Given the slowdown in deals and the uncertainty, it is not surprising that there has also been a significant slowdown in exits over the past 12 months, with only €157.4 billion for the nine months through September 30, 2020, compared to €188.4 billion in 2019 and €219 billion in 2018 over the same period. As uncertainty around Brexit and COVID-19 is likely to continue for at least the remainder of 2020 and going into 2021, both GPs and LPs need to think about the impact that a decline in exits could have on their cash flow and returns. We may also witness an increase in the number of secondary transactions — although this is already a relatively prominent feature in the European market. LPs should bear in mind that secondaries do not have to mean lower returns as long as the GP has a value-add strategy in place for its hold period.

Figure 3. Europe PE exit flow



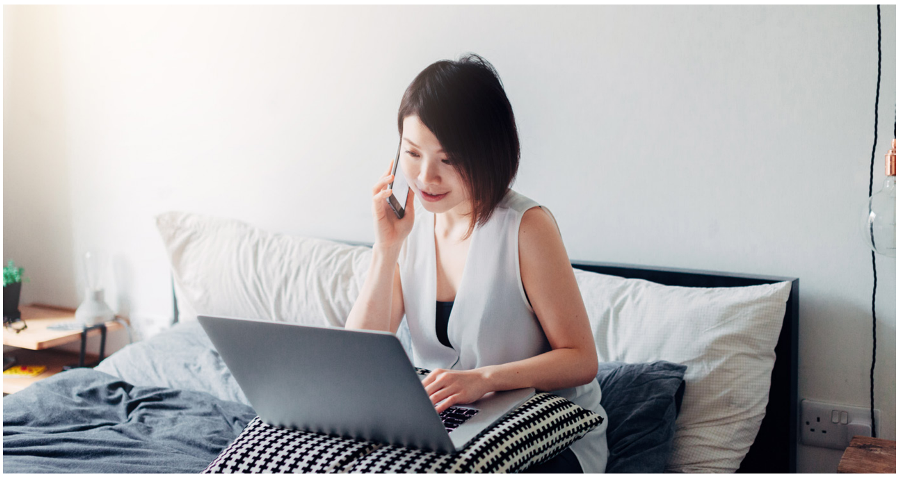
Source: PitchBook, June 30, 2020.

GPs that are unable to achieve an exit as planned may need to support some of their portfolio companies longer than initially anticipated. For some, this may need to be balanced against their ability to provide support despite the funds being almost fully drawn. LPs should also expect longer hold periods for some funds as exits planned for 2020 and 2021 are postponed. For some LPs, that might mean a decrease in internal rates of return (IRRs) and a slowdown in distributions. LPs that were hoping to use distributions to fund new commitments may find this more difficult than anticipated.

In conclusion, we think LPs should expect to receive more requests from GPs than they have over the past few years — either for fund extensions or for facilities that could be used to benefit portfolio companies. We also anticipate opportunities for those GPs prepared and ready to capitalize on the dislocation. As ever, not all GPs are equal, and LPs should carefully scrutinize each GP request, as there is no one-size-fits-all approach. The crucial factors for both LPs and GPs will be selecting which funds and companies to support and being prepared for any opportunities that emerge.

Asian private equity

A snapshot of the roller coaster ride in the China private equity market



As a result of the COVID-19 lockdown beginning in January 2020, China's private equity activities in Q1 2020 presented a bleak picture, with year-on-year (YOY) fundraising declining by 48%, investment down by 27% and nearly zero exits.[1] However, with rapid pandemic containment measures, lockdowns ended three months later, and most economic activities have returned to normal levels.[2]

Correspondingly, private equity activities have rebounded. Although fundraising for year-to-date (YTD) Q3 2020 is still down by 28%[3] due to global travel restrictions, fundraising in the third quarter is 41% higher than YOY and double the second-quarter amount. Investment activities have also seen a YOY increase of 40%[4] in YTD Q3 2020, with limited asset repricing thanks to a strong public market rebound. Distributions have seen gradual recovery in the second quarter, although the YTD Q3 2020 number is still 69% lower than the same period last year.

"Zoom" in on the shift of exit venues

Despite better performance, distributions in China have typically lagged other regions because of a larger percentage of growth and due to venture deals staying private for longer. Recent escalation of the US-China tension and cases of accounting fraud related to US-listed Chinese companies have raised questions about future exit venues, as demonstrated by the US Senate passage of the Holding Foreign Companies Accountable (HFCA) Act in July. The Act requires US-listed companies to comply with the Public Company Accounting Oversight Board (PCAOB) within three years or be delisted. Although failure to reach an agreement between the Chinese CSRC and the US SEC would make it more difficult to access the US capital market, Mercer believes any such impact could be mitigated by capital market reforms in China.

To put things in perspective, US listings accounted for fewer than 10% of Chinese company IPOs for the past five years. Currently, there are about 220 US-listed Chinese companies out of approximately 5,800 listed Chinese companies. These US-listed Chinese companies account for US$2.2 trillion of market capitalization, which is 10%–15% of total market capitalization of all listed Chinese companies.[5] Previously, pre-profit Chinese internet companies relied on US listings to fuel their high top-line growth strategies since the US capital markets registration system offers higher IPO certainty, better analyst coverage and access to deeper liquidity.

The passage of the HFCA Act has led investors to rethink the best equity markets for exiting Chinese investments, with many activities going to Hong Kong. Many US-listed Chinese companies have either sought dual listings in Hong Kong that would give them enhanced access to onshore Chinese investors (for example, Alibaba, JD.com, Netease) or looked to delist in the US and relist in China, where they can achieve premium trading multiples (for example, 58.com).

[1] AVCJ Group Ltd.
[2] Morgan Stanley research.
[3] Excluding China's semiconductor "Big Fund," accounting for US$29.1 billion of fundraising in Q3 2019.
[4] Excluding the US$8.4 billion privatization of 58.com in Q2 2020.
[5] GP, Bloomberg.

The number of US-listed Chinese companies has grown faster under the Trump four-year administration: 102 Chinese companies have debuted on NYSE/NASDAQ, raising US$26 billion, compared to 105 IPOs of Chinese companies under Obama's eight-year tenure, which had raised a total of US$41 billion.

– Peter Lynch

Along with the push effect, a pull effect has also been attracting Chinese companies to "go home." Notable reforms include 1) expansion of corporate-weighted voting rights in HKSE, 2) the launch of a biotech index to allow pre-revenue biotech companies to be listed in Hong Kong (making Hong Kong the world's second-largest funding hub for biotech) and 3) the launch of the Shanghai Stock Exchange Science and Technology Innovation Board (the STAR Market). The STAR Market and the ChiNext board in Shenzhen have embraced a registration-based system for approving IPOs, reducing the perceived risk of a more opaque IPO approval process. Since its launch last year, the STAR Market has become a top-three IPO market globally.

Ant Financial, the world's highest-valued fintech company, controlled by Alibaba, delayed its dual listing planned for Hong Kong/STAR Market two days before its November 5 scheduled date due to a potential failure to meet listing qualifications. The cancellation of Ant's mega-IPO has raised questions over regulation risk in China. Although Ant is best known for Alipay (China's largest digital payment platform), more than 35% of its business is generally believed to come from credit transactions involving small loans and microfinance, which may require compliance with the same capital and leverage restrictions that apply to traditional banks. The Chinese regulators are cautious of a potential financial system meltdown caused by a financial giant like Ant not having proper regulatory oversight. This is currently widely perceived as a risk specific to Ant rather than a sign of directional change in market reforms.

Economic decoupling?

Although all the politics and financial headlines point to a gradual decoupling between the world's two largest economies, the data shows that US foreign direct investment in China has been steady. The number of US-listed Chinese companies has also grown faster under the Trump four-year administration: 102 Chinese companies have debuted on NYSE/NASDAQ, raising US$26 billion,[6] compared to 105 IPOs of Chinese companies under Obama's eight-year tenure, which had raised a total of US$41 billion.[7] This highlights the importance of looking beyond the political rhetoric and focusing on the risk-adjusted return potential. Mercer believes the structural resilience of the Chinese economy following COVID-19 continues to present an attractive investment opportunity.

China may be the only major economy to have a positive 2% GDP growth in 2020, contributing to 32% of global GDP growth.[8] The drivers are steady exports, technology advancement and rising consumer power (supported by a large millennial population five times the size of the total US population and rising consumption in lower-tier cities). China's economy is projected to surpass the US economy by 2030 and may offer investors attractive growth prospects.

[6] Financial Times, Dealogic.
[7] US$41 billion includes US$25 billion from Alibaba.
[8] World Bank, OECD Database, IME WEO, June 2020.

Natural resources

A decline is a great opportunity to pick up the bargains left behind by investors who are fleeing the storm in panic.

Investing in natural resources faces significant challenges in 2021. Perhaps the number-one issue is a decade of lackluster returns. It is always difficult to get investors or investment committees interested in an asset class, strategy or sector with poor trailing returns. However, this can also be an ideal time to invest. As the great money manager Peter Lynch once said, "A decline is a great opportunity to pick up the bargains left behind by investors who are fleeing the storm in panic."[9]

Energy investments have struggled for nearly a decade. Multiple and volatile cycles have whipsawed oil and natural gas prices and hammered energy investments. The most recent down cycle was caused by the simultaneous supply and demand shocks of early 2020. A disagreement between Saudi Arabia and Russia over oil production cuts led the former to aggressively cut prices and promise to increase production. This caused a one-day drop of 20% in oil prices. COVID-19 followed with a massive reduction in air travel and automobile transportation along with the temporary closing of many businesses. As a result, oil prices briefly collapsed further in April 2020, even trading below $0. Natural gas prices soon followed, hitting a 25-year low in June. More than 50 oil and gas firms have filed for bankruptcy since oil prices crashed in March.[10]

Timber has been a steady but modest performer for many years. The NCREIF Timberland Index has returned just 2.6% annually over the five years ending September 30. Such returns do not excite prospective investors.

Agriculture has regularly disappointed investors. The macro case for agriculture is strong: a growing middle class around the globe demanding more protein and grains. However, very few agriculture or farmland managers have been able to take advantage of the macro case and generate attractive returns. We believe this is because agriculture returns are heavily impacted by two things managers cannot control: the weather and government policies.

Private mining managers have also suffered for many years, as metal and mineral prices have fluctuated wildly. Despite the recent record highs set by gold and iron ore, performance of most mining funds has been dismal. Few are looking to raise subsequent equity funds at this time.

The dire picture painted above leads directly to the major challenge for natural resource investing in 2021: looking forward instead of backward.

There is no question that most natural resources have performed poorly for many years. However, poor performance does not persist forever for any asset class, strategy or sector. Natural resources are not going away — they are an integral building block of all advanced societies. They must be produced, refined and transported, and doing so requires significant amounts of capital.

[9] Quotefancy.com.

[10] Hampton L. "U.S. Energy Bankruptcy Surge Continues on Credit, Oil-Price Squeeze," *Reuters*, August 11, 2020, available at https://www.reuters.com/article/us-north-america-oil/u-s-energy-bankruptcy-surge-continues-on-credit-oil-price-squeeze-idUSKCN25727W.

Investors may need to consider the potential impact of climate transition risks and opportunities, as asset owners are increasingly embracing sustainable asset trends.

Looking ahead

Despite or perhaps because of today's subpar market environment, we see better days ahead for traditional energy investments as supply/demand dynamics improve. Public equity markets remain closed for energy companies. Little equity capital is being raised by private energy managers, resulting in less competition. PitchBook estimates that, at the end of 2019, oil and gas funds held the least amount of dry powder since it began tracking this data.[11] Debt markets are challenged, as banks are reducing their exposure or exiting the sector. At the same time, oil demand has recovered to about 90% of pre-COVID levels, highlighting oil's critical role in the global economy. Goldman Sachs projects full oil demand recovery by 2022.[12]

US natural gas production (supply) is now poised for a decline after many years of solid growth. This is largely due to lower associated gas production (that is, from wells where oil is the primary target). Inventories remain above the five-year average, but prices recovered by mid-October to a level about 40% higher than at the beginning of 2020.[13] Any colder-than-normal weather this winter could result in price spikes.

In short, we believe a decline in global investment and US shale production, coupled with demand recovery, creates a bullish medium- to long-term scenario for traditional energy investments. However, investors may need to consider the potential impact of climate transition risks and opportunities, as asset owners are increasingly embracing sustainable asset trends.

Timber also deserves another look. At a time when the 10-year Treasury is yielding less than 1%, mid-single-digit returns from a steady performer like timber are not unattractive. In addition, timber has many good attributes: It serves as both a deflation and inflation hedge, provides true diversification and possesses the unique trait of biological growth.

We are already seeing positive signs in the sector, as lumber and finished-product pricing is higher than it has been in several years. A timber manager reports that supply and demand dynamics in the US South are nearly balanced for the first time in more than a decade.[14] If inflation or economic growth returns in a substantial way, it is likely that timber will outperform expectations. Therefore, we believe timber is worthy of consideration as an alternative to fixed income or lower-risk hedge funds.

In the mining sector, many managers are exploring raising debt funds or other vehicles that may provide a better way to access the sector. Metals and minerals are crucial to the technologies and infrastructure of advanced societies. If electric vehicles catch on with consumers, as many are projecting, large amounts of cobalt, lithium and nickel will be required to manufacture their batteries.

However, mining companies need to apply best practices in a number of areas, including managing their environmental impact; water use, waste and tailings; impact on local communities and cultural landscape; and water systems and flows. Additionally, it's important for mining companies to be transparent in their reporting, as institutional investors are becoming increasingly rigorous in their analysis of mining companies and their impacts.

We encourage investors not to write off the mining sector but to be open to debt and other strategies in this space, bearing in mind the need to invest responsibly.

[11] PitchBook. *H1 2020 Real Assets Report.*

[12] Reuters staff. "Goldman Sachs Sees Oil Demand Returning to Pre-Coronavirus Levels by 2022," *Reuters,* July 1, 2020, available at https://www.reuters.com/article/us-global-oil-research-goldman/goldman-sachs-sees-oil-demand-returning-to-pre-coronavirus-levels-by-2022-idUSKBN2430IE.

[13] U.S. Energy Information Administration website.

[14] 2020 RMS Annual General Meeting, October 2020.

Infrastructure

Over the past decade, fundraising has grown from US$16.5 billion in 2009 to US$97.5 billion in 2019, a near six-fold increase.

Infrastructure is currently the rock-star asset class among institutional investors. Over the past decade, fundraising has grown from US$16.5 billion in 2009 to US$97.5 billion in 2019, a near six-fold increase.[15] There has also been almost a five-fold increase in the cumulative number of funds closed over the same period, from 245 to 1,145. Despite COVID-19, the infrastructure market has still seen US$75 billion of capital raised to date, with 69 funds closed so far.[16]

Investor demand has been driven by a number of interrelated factors over both the short and long term. The need for diversification, the hunt for yield, the focus on real returns and the emphasis on sustainable investing have attracted pension funds, insurance companies, sovereign wealth funds and endowments from across the world. The asset class is certainly hitting some high notes.

Infrastructure has also generally performed in line with expectations, demonstrating relative resilience during 2020 and providing an attractive, stable return profile over the longer term. Data from EDHEC Infrastructure show that the asset class bounced back in Q3 2020, with a 7.7% US$ return but has remained in negative territory over the past 12 months (-4.3%).[17] However, over the past decade, infrastructure has returned 12.0% per annum, with an estimated volatility of only 13.9% on an annualized basis.

In comparison, the MSCI World has been strong over the past year, with an 11.0% US$ return. But over the past decade, it has only delivered 10.0% per annum at a volatility of 15.1% on an annualized basis. The correlation between the two sectors has been -0.20% over this period, with infrastructure's largest quarterly drawdown of -13.2% also comparing favorably to global equities at -20.9%.[18] It seems that infrastructure can not only talk the talk but also walk the walk.

However, even rock stars can underperform. Sometimes the result is a bad single, occasionally bad albums and rarely (but disastrously) the end of a career. This section highlights two key areas where things could indeed go wrong for infrastructure: one well understood, the other less so. Several other factors will be discussed in the future, but let's hope these are just off-key guitar solos in an otherwise multiplatinum, multidecade career for the asset class.

[15] Preqin. *2019 Preqin Global Infrastructure Report.*
[16] Preqin. *Preqin Quarterly Update: Infrastructure,* Q3 2020.
[17] Infrastructure 300 Index, equally weighted, quarterly data in USD terms.
[18] Databank and EDHED Infrastructure.

Fund size and style drift

The infrastructure fundraising market is clearly bifurcated and has been for some time. On average, the top 10 funds in the market have accounted for approximately 60% of the total annual capital raised over the past decade, and this was approximately 70% in 2019.[19] Unfortunately, we have observed that it is increasingly common for successor funds to be 50%–100% larger and return to market within a two- to three-year timeframe rather than four to five years. This is concerning for three interrelated reasons.

First, there is evidence across the market that several infrastructure managers are engaging in style drift, typically by market cap focus or risk profile. Even when we account for the evolution of the asset class over time, it is clear that certain assets are now being labelled as infrastructure and included in portfolios when they are more akin to private equity. Ironically, the lack of volatility in the asset class may be problematic for its future, because it allows such assets to remain disguised as infrastructure without penalty.

Second, compressed fundraising cycles are making it more difficult to evaluate the underlying performance of assets acquired in a predecessor fund to fully inform the view on the latest offering. Specifically, there may be little (if any) evidence of successful EBITDA growth, capital expenditure deployment, greenfield-to-brownfield de-risking or stakeholder management, as asset ownership may only last one to two years.

[19] Preqin. 2019 *Preqin Global Infrastructure Report.*

Just because managers can raise capital in the market doesn't mean they should — unless capital can be deployed successfully.

Asset valuations may have improved more as a result of falling discount rates and comparable transactions analysis than tangible value creation. The task is further complicated if such assets do not fit with the manager's broader (more-seasoned) track record because of style drift between funds over time.

More to the point, how relevant is a manager's fund performance with a vehicle of €1.5 billion from nearly a decade ago when the latest vintage is now three to five times larger? In some cases, investors are having to rely on the story rather than the evidence when new funds are being raised. However, does one story sound better than another because it actually is, or is it instead because of the narrator (or singer)? In a bifurcated market, investors may not be given the opportunity to listen to the story several times over to gain access to capacity-constrained offerings.

Finally, there is a risk that some infrastructure managers are sizing their fundraising for commercial reasons rather than perceived market opportunity. In general, investors understand and appreciate that net-of-fees performance (rather than fees in isolation) are what matter when considering fund opportunities. In addition, they recognize that they need to reward talented individuals for their successful efforts if they want to retain them and that AUM growth provides scope for reinvestment.

However, pursuing such growth should not compromise performance. There may be a point at which the incentive and alignment effects of carried interest mechanisms start to weaken because of large recurring management fee income streams. Just because managers can raise capital in the market doesn't mean they should — unless capital can be deployed successfully. Raising capital is a repeat-interaction game, not a one-shot exercise.

Succession planning and transfer of ownership stakes is an issue investors must increasingly face in the coming years as key individuals retire. Sadly, even rock stars can't live forever. This exodus has already begun. Many infrastructure managers have been proactive in establishing broader business and investment leadership groups to facilitate succession planning. Because many of these managers were founded at least 10–15 years ago, the transition process is likely to accelerate, creating a vintage effect across the market.

Investors need to consider two main issues: What does the departure of key individuals mean for the business culture, and what does it mean for its ownership? Many founders are integral to the manager's business culture and investment philosophies. How will these be maintained after they step back or leave? Culture and philosophy are intangible but arguably vital to an infrastructure manager's value proposition.

In addition, a founder's exit can cause uncertainty around ownership structure. Many infrastructure managers were established as independent, employee-owned firms with relatively concentrated shareholder bases. Retiring founders may want to retain an independent business model, but current employees may not be in a position to make this happen. How will such situations be reconciled?

Some infrastructure managers have sold minority shareholdings to third-party groups, providing near-term liquidity with a pathway for further ownership transfer over the longer term. Other managers have been approached by larger asset management groups seeking to "buy into" infrastructure capability to capture investor demand.

Because organizational change can significantly affect both business culture and operating models, successfully managing these processes is vital to continued longevity. It remains to be seen which managers will handle these issues most effectively in the coming years.

Why does any of this matter? Surely infrastructure managers should just rock out in terms of capital raising, and investors should just enjoy the mosh pit while it lasts?

Most investors expect infrastructure to be a genuine diversifier within an overall portfolio, providing a long-term return comparable to public equities but with much lower volatility. It should also exhibit low correlation to other asset classes, particularly during periods of market stress. Anything that compromises these expectations will damage its reputation.

Despite similar challenges, private equity and hedge funds continue to attract investors and capital. But as much as infrastructure wants to be a rock star like these other asset classes, investors view it as more of a band manager. They expect infrastructure to perform a difficult job to a consistent standard under challenging circumstances while remaining in the background. A rock star may refuse to go out on stage for hours but will still be loved by its fans; the band manager who arrives five minutes late will get sacked.

By addressing these and other key issues, hopefully, the industry can keep infrastructure rocking for many years to come.

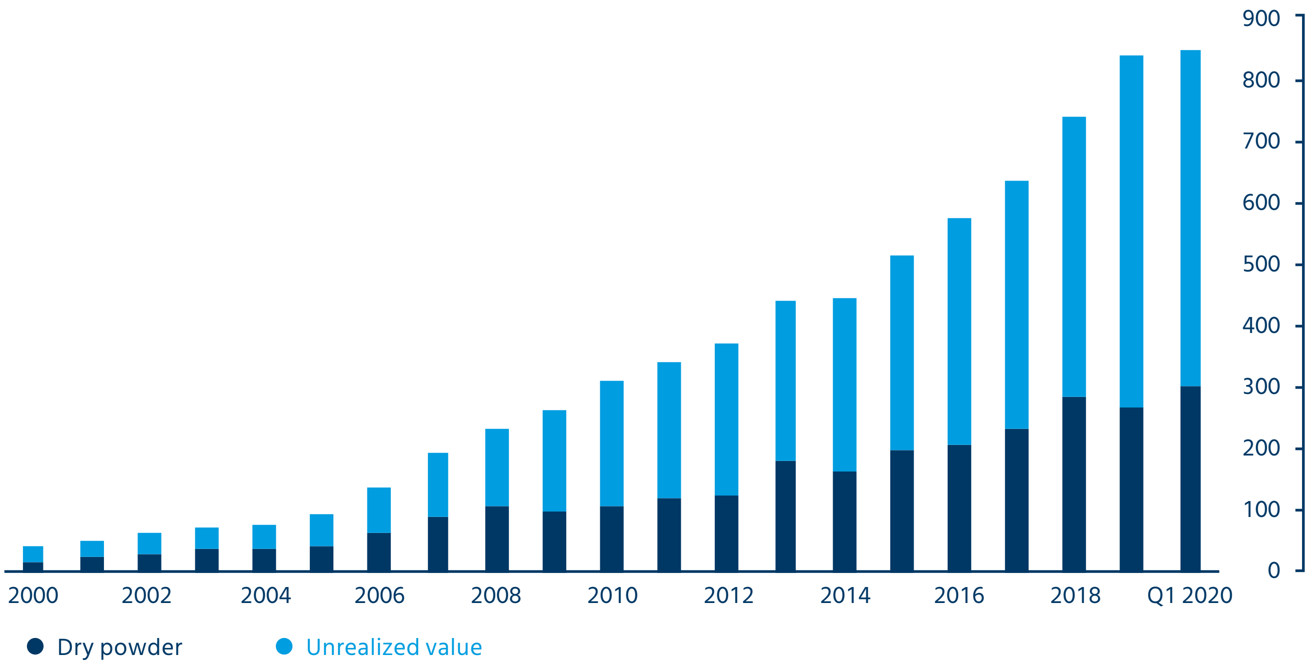
Private debt

Taking stock

In a year like no other, global private debt faced its first substantial test since the GFC. Managers that maintain standards of credit underwriting and portfolio construction despite mounting competitive tensions will be more likely to outperform. In private debt, you win by not losing capital.

It's worth noting the significant momentum private debt gained in the wake of the GFC. It made sense — the ensuing regulatory crackdown on bank lending activity required new capacity to fill the void, propelling private debt AUM to US$848 billion, more than doubling in just over seven years (Figure 4).

Figure 4. Private debt AUM (US$ billion) as of March 31, 2020



Source: Preqin.

Over the past decade, many institutional investors had the foresight to step into this financing void, aligning their longer-term investment allocations with the expanding requirement for capital. Private debt has consistently given investors access to higher returns coupled with lower risk compared to high-yield bonds or broadly syndicated leveraged loans (Table 1).

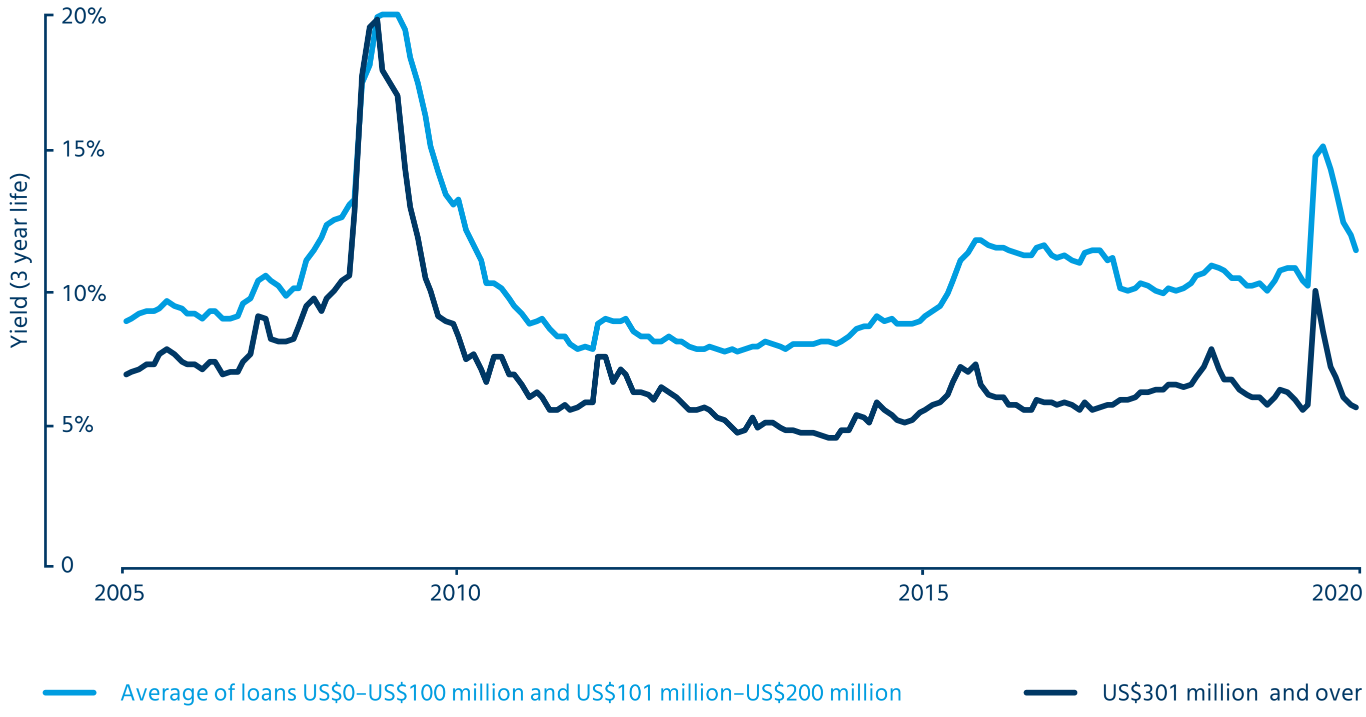
Table 1. 10-year risk and return comparison as of June 30, 2020

	US high yield	US leverage loans	US senior direct lending
10-year return (p.a.)	**6.5%**	**4.2%**	**8.7%**
10-year risk/standard deviation (annualized)	**8.1%**	**6.3%**	**5.1%**
10-year return/risk	**0.8**	**0.7**	**1.7**

Source: Mercer Analysis, DataStream (ICE BofAML US High Yield Master II, S&P Leveraged Loan) and Burgiss (US Senior Private Debt).

From a return perspective, private debt investors have enjoyed a consistent average yield premium. As a proxy for this, in Figure 5 below you can see the difference in yield for leveraged loans of different sizes; that is, the spread between the yield on loans under US$200 million, generally provided by private debt lenders, and loans greater than US$300 million, generally provided by the syndication market, has averaged over 300 bps since December 31, 2005.

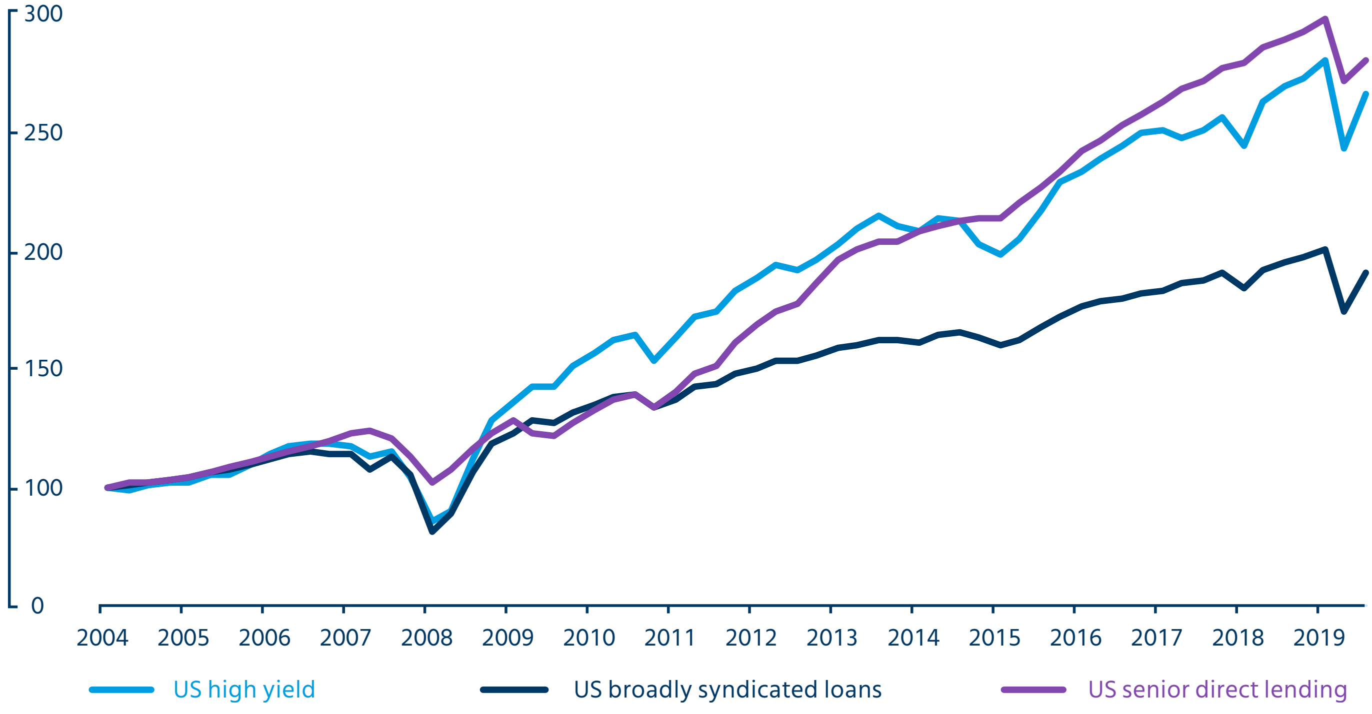
Figure 5. Yield differential for different size loans



Source: Credit Suisse Leveraged Loan Index.

This yield premium is compensation for illiquidity and complexity. However, from a risk perspective, the resilience of the asset class is apparent. At the peak of the GFC, in the second half of 2008, the US high-yield bond market experienced a drawdown of 25%, and the US broadly syndicated loan market experienced a drawdown of 28%. US senior private debt, however, experienced a shallower drawdown (approximately 16% in the data set represented below in Figure 6).

Figure 6. Growth of US$100 invested in high-yield bonds, broadly syndicated loans and senior private debt



Source: DataStream (ICE BofAML US High Yield Master II, S&P Leveraged Loan) and Burgiss (US Senior Private Debt).

Private debt is not subject to the same mark-to-market pressures and volatility associated with tradeable credit markets. Furthermore, default and recovery rates have been more favorable than either syndicated loans or high-yield bonds. Middle-market loans have been able to maintain stronger terms and lender protections than either market (see Figures 7 and 8).

Figure 7. Recovery rates

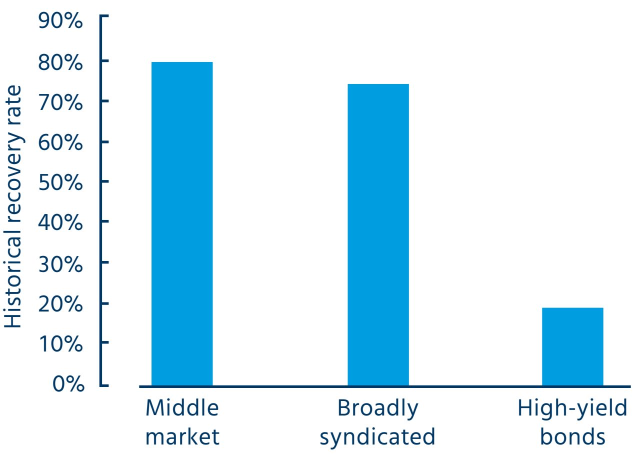
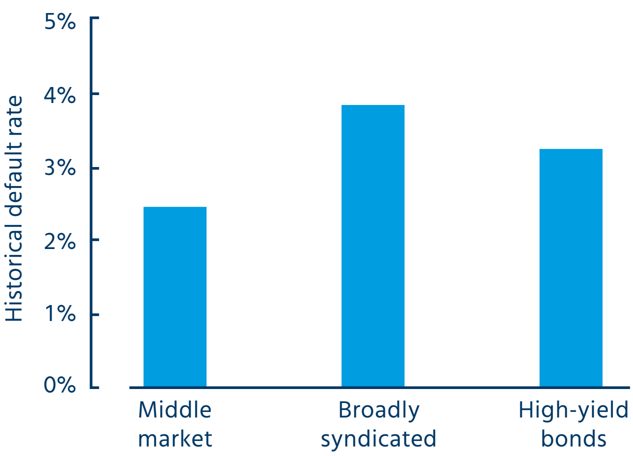


Figure 8. Default rates



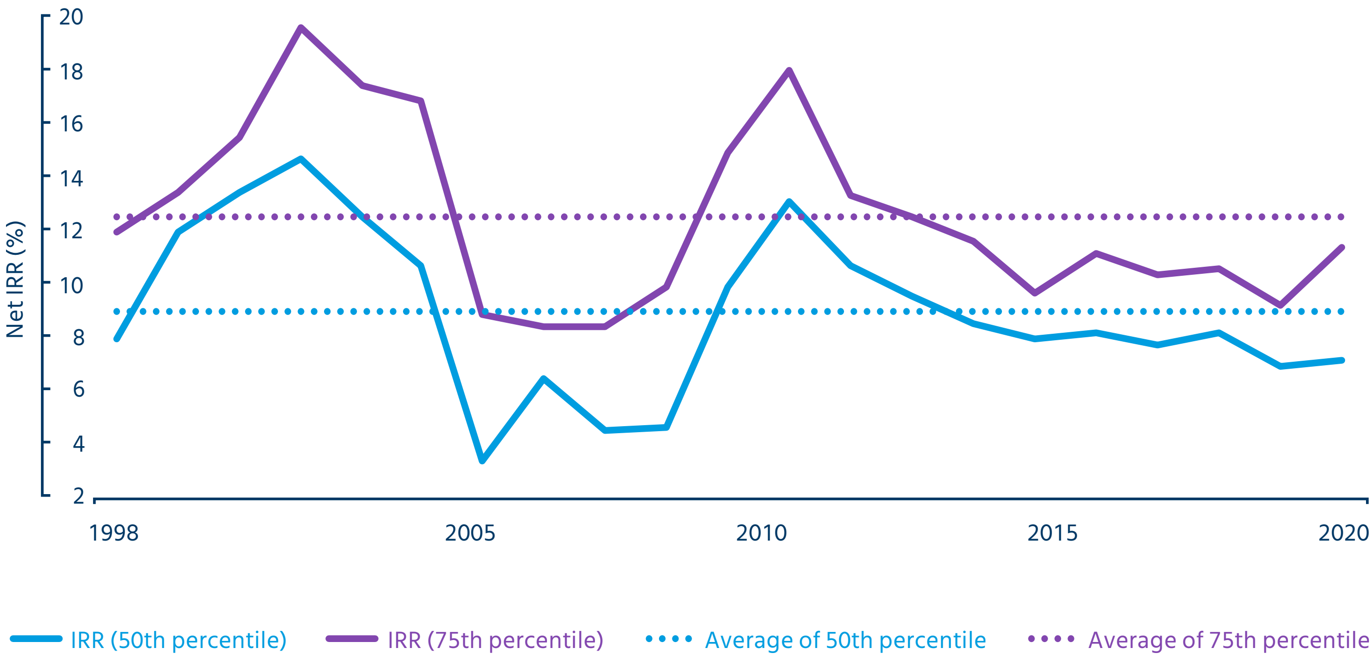
Source: S&P CreditPro (1995 to 2019).

Looking forward

The case for the asset class is as strong as ever — underpinned from both a supply and demand perspective. The amount of private equity dry powder stands at a record high of US$1.8 billion,[20] and the requirement for capital solutions for these companies unable to tap the liquid credit markets remains strong. From an investor demand perspective, the ongoing low-interest-rate environment has resulted in alternative sources of income becoming an ever-greater necessity.

Furthermore, private debt vintages raised in the aftermath of shock events have a tendency to perform well, and we expect forthcoming private debt fund vintages to benefit similarly (Figure 9).

Figure 9. Private debt 50th and 75th percentile net IRR per vintage year as of June 30, 2020



Source: Burgiss (Global Private Debt).

One of the main challenges investors face today is selecting strategies that best suit their individual risk and return requirements. The landscape of private debt strategies is more diverse than ever. When constructing portfolios, we consider strategies in three building blocks — "core," "core plus" and "credit opportunities and value-add" (Figure 10) populated by the broader landscape of private debt strategies (Figure 11).

[20] Preqin, October 2020.

Figure 10. Private debt building blocks

Core
c. 5%–8%

- **Income focus:** The majority of return is through regular cash coupon, with additional return through arrangement fees.
- **Capital preservation:** Provides security through senior or first lien position in capital structure, equity cushion and/or stable features such as covenants.
- **Portfolio construction:** Reduce idiosyncratic risk through line-item diversification as well as geographic manager and vintage diversification.

Core+
c. 9%–12%

- **Higher contractual returns, with some capital appreciation:** The majority of return is contractual, with additional upside potential through equity-linked exposure.
- **Exploit a broader opportunity set of private debt**, including mezzanine securities, fund or asset-level leverage to enhance return, or complexity and niche expertise.
- **Portfolio construction:** Seek further diversification, and reduce overall credit market correlation. Evolve portfolios to exploit market opportunities.

Credit opportunities and value-add

- **Approaching equity-like returns, through debt securities:** Capital appreciation forms a higher proportion of return through pull-to-par or conversion of debt equity.
- **Capitalize on dislocations:** These include market volatility, pricing dislocations, liquidity mismatch or episodes of stress/distress. Includes flexible special situations (corporate or asset based) and distressed debt strategies.
- **Portfolio construction:** Credit opportunities are more abundant during periods of elevated stress. Although allocations may be opportunistic in nature, build a portfolio that incorporates strategies likely to perform well in different market environments.

These assumptions are for illustrative purposes only. Actual returns may differ.

Figure 11. The landscape of private debt strategies

North America	Europe	Asia-Pacific	Emerging markets	Global

Core	Core+	Core+
Direct lending	**Structured credit**	**Speciality finance**
Upper middle market	CLO debt	Music/film/media and royalties
Middle market	CLO multi	Healthcare lending and royalties
Lower middle market	CLO equity	Insurance linked
Venture lending	ABS multi	Litigation finance
Senior and unitranche	Consumer ABS	Aviation, maritime and rail
Mezzanine and preferred equity	Commercial ABS	Lender/platform finance
Sponsored and non-sponsored	Esoteric ABS	Regulatory capital relief
Opportunistic	Portfolio NAV lending	Factoring and trade finance
Private BDGs and SBICs	Asset-based lending	Real assets and energy
Credit opportunities and value-add		
Credit dislocation funds	Special situations	Distressed debt

We think the following themes are worth considering in 2021:

- **Core:** Private debt represents a good return opportunity at this point in the cycle, where investors can build the foundation for a mid-single-digits-yielding portfolio that exhibits lower risk with regard to the nature of the underlying loans.
- **Core plus:** During uncertain times, complexity can be your friend when capital is scarce and higher-risk-adjusted returns are available while still diversifying portfolios and boosting yields. Portfolio net-asset-value lending and structured credit are some examples.
- **Credit opportunities:** Credit opportunities are a complement to a growth portfolio. Situations of stress or distress are likely to increase as the pandemic continues to impact world economies. Although JP Morgan's default expectations have edged lower in recent months,[21] this year's total defaults are already the second-highest since the GFC. Historical data suggest shock events can represent attractive entry points for opportunistic credit strategies that incorporate higher elements of capital appreciation.

Forthcoming vintages across the landscape of global private debt stand to perform well. For investors focused on core-income-generating portfolios, discipline will ultimately be rewarded by ensuring losses are minimized. For those with a desire for higher returns and the tolerance for more complexity, the opportunity set has shifted in the wake of the COVID crisis. It's worth recalibrating portfolio plans to accommodate the opportunities that have arisen across credit markets.

[21] JP Morgan. *Default Monitor,* October 2020.

Real estate

As we move into 2021 and the macroeconomic backdrop becomes more supportive of growth, we project the "middle ground" of real estate strategies will join the current areas of focus, providing a strong vintage for real estate investment across the risk spectrum.

Attractiveness

Toward the end of 2020, we saw a split in investor interest in the real estate asset class. On the one hand, its ability to produce more or less secure income streams is highly attractive. On the other hand, investors expect that the disruption in capital markets will provide an opportunity to acquire assets cheaply, allowing for later capital gains. As we move into 2021 and the macroeconomic backdrop becomes more supportive of growth, we project the "middle ground" of real estate strategies will join the current areas of focus, providing a strong vintage for real estate investment across the risk spectrum.

With varying options available for investors to gain exposure to the asset class, real estate can provide an attractive proposition throughout the market cycle. Many institutional investors have longstanding experience with real estate investing. Over the past couple of decades, we have seen how larger institutions have become more sophisticated in building up their real estate allocations, increasingly moving outside their domestic markets and varying allocations among risk styles. At the same time, a growing share of small and midsize investors have started to address their underweight position.

The opportunity set

Real estate is already the largest private market asset class for institutional investors, but allocations are still growing. MSCI's latest estimate puts the value of the real estate market around US$8.7 trillion.

Much of this is held by publicly listed real estate companies, with the privately traded share accounting for approximately half of the overall market cap. Investors pursuing income-producing core and core-plus strategies tend to hold private real estate in open-ended, evergreen vehicles, whereas investors focused on capital growth generation (value-add or opportunistic strategies) tend to prefer closed-end/finite-life funds.

Following the GFC, real estate debt funds also proliferated across the risk spectrum as opportunities opened up when banks retrenched from providing finance in certain parts of the market.

Current market conditions

The COVID-19 pandemic has accelerated pre-existing structural shifts, particularly regarding online retail and office work flexibility. These shifts are affecting valuations both positively and negatively in office, retail and logistics assets and are expected to become permanent.

In contrast, the impact felt in the hospitality and leisure sectors is likely temporary. Valuations in some parts of the market are still moderating, but we expect this trend to taper off in the next few months.

One thing is clear: The current correction is much less severe than what followed the GFC and is also unlikely to reach such magnitude. The sector entered this episode with stronger fundamentals, lower loan-to-value ratios and broader investor diversification than during the GFC. Because interest rates have nosedived since the GFC, real estate's ability to generate long-term income streams has become increasingly significant in today's renewed low-interest-rate environment.

Although the overarching picture is one of relatively stable capital values, an undeniable wave of distress will enter the market in certain sectors. Particularly in Europe, the market is experiencing "calm before the storm" as governments and banks continue to prop up certain asset values that would otherwise be unsustainable. Few deals have completed yet, but dislocations in these sectors are growing. Even if asset owners of real estate are generally better capitalized this time, many corporates are facing immediate liquidity issues leading to asset sales. Further down the line, banks may also become sellers of distressed or nonperforming real estate. These conditions can all create favorable circumstances for opportunistic buyers.

Opportunities by region

North America: Within the context outlined above, we see an abundance of attractive investing opportunities opening up in the North American real estate market. Overall occupancy across sectors has only recently fallen from peak values and stood at 93.5% in June.[22] We see particularly robust opportunities in life sciences, affordable housing and logistics, as demand is so far sheltered from general economic conditions. In Canada, we also like these sectors and are particularly impressed by the robustness of the Greater Toronto market. In addition, the specialist sectors of life sciences and lab space will provide an interesting opportunity for both resilience and growth in the period ahead.

Europe: The UK market is one of the most transparent in the world, and this responsiveness to economic conditions makes the market relatively volatile. Specialist funds, including those in the hard-hit sectors of retail or leisure, recorded a negative return of 15% in the year to June.[23] In contrast, UK long-lease funds, typically comprising assets with long-term lease contracts to high-grade tenants, maintain positive returns, and we expect this universe to continue to grow. [24]

Another part of the European market that we like for its resilience is Germany; the country is showing relative economic strength and strong investor demand. Across Europe and across risk styles, we continue to see growth potential in operationally intensive niche sectors as these come to maturity.

Asia-Pacific: Australia maintains strong demand from both domestic and offshore investors seeking its relative safe-haven status and positive long-term thematic. Transaction volumes for the year to June 2020 remained close to peak at A$30.2 billion, largely focused on core strategies.[25]

In Asia, key economies are leading in containing the virus, which bodes well for their recovery. Valuations are slow to respond in this part of the world, but once the recovery sets in, we are particularly interested in opportunities in China and Japan, where supply/demand dynamics remain favorable. Across the region, data center and logistics space are viewed as attractive, as the quick adoption of e-commerce during the pandemic has prompted a spike in demand.

Priorities for 2021

In the year ahead, we recommend investors overweight real estate and stretch their risk appetites. Although the pandemic will continue to challenge the space markets, 2021 is likely to be an opportune time for entering the asset class with a medium- to longer-term investment horizon. Initially, investors should prioritize allocations to the largest, most-liquid markets, where price discovery is furthest along. However, we expect the opportunity set to broaden as the year progresses.

[22] NCREIF, National Property Index, Q2 2020.
[23] MSCI/AREF, UK Property Funds Index, Specialist Funds, Q2 2020.
[24] MSCI/AREF, UK Property Funds Index, Secure Income Funds, Q2 2020.
[25] Dexus, Q2 2020

Important notices

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