

Taking the temperature of the private markets: mid-year outlook



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The story so far...

- Private markets have delivered a significant return premium over the past decade
- A higher rates / lower economic growth environment is a significant headwind to short-term returns
- We expect far greater dispersion across assets, with robust and, for equity, growing income streams driving outperformance
- In real estate, resilience to cost-push inflation is a key differentiator – residential stands out
- Energy performance and ESG standards, and the associated capital expenditure, are now top-tier investment drivers at the asset level
- In private credit, we favour investment grade and crossover credit relative to direct lending/leveraged loans at this point in the cycle
- In infrastructure, the drive towards renewables has been reinforced by the war in Ukraine
- Beyond renewables, wider system changes are needed across energy and transport, driven by technological innovation, that will create financing needs across a range of investment risk/return profiles

Private market returns versus the traditional 60/40 portfolio

Looking back, private markets have experienced robust returns, with 2021 marking a high point. While there is no investible index in the same way as for public markets, the database of private markets funds, captured by Burgiss, reported investment returns (net of fees) of over 30% for 2021¹. This compares with returns for a global 60/40 equity bond portfolio of 8% for the same period².

A longer-term comparison appears equally encouraging. As Figure 1. shows, over 10 years, global private capital returns were significantly ahead of 60/40 levels. While much of this was driven by robust returns to private equity, even private debt returns showed a circa 2% premium. Private real asset returns were only marginally ahead, although this was negatively impacted by weak returns from natural resources, which showed returns of just 2.4% over the period. Within private real assets, real estate and infrastructure delivered a more robust 10.6% and 9.6% respectively.



Figure 1. Public vs estimated private capital returns

Period to 31 December for the same period (% p.a)	1-year	3-year	5-year	10-year
Global public 60% equity/40% bond portfolio	8.0	13.7	10.3	7.9
Global private capital	31.6	22.3	18.8	14.9
- Private equity	37.4	29.4	24.0	17.9
- Private debt	14.4	9.8	9.3	10.0
- Private real assets (real estate, infrastructure, natural resources)	19.4	8.1	8.4	8.5

Source: Bloomberg, LGIM Calculations (60/40 portfolio), Burgiss (Private Capital).

Note – Public 60/40 returns are a weighted average of time-weighted index returns for the MSCI ACWI and JPM World Government Bond Index. Private capital returns are trailing period internal rates of return (IRRs) reported by Burgiss. They are therefore not directly comparable and so are presented for illustrative purposes only. In the case of private debt, constituent strategies are generally direct lending/leveraged loan funds and so returns are not comparable with investment grade or crossover credit.

¹ Source: Burgiss as at 31 December 2021.

² Source: Bloomberg, LGIM (gross of fees) as at 31 December 2021.

A tectonic shift in the investment landscape

Fast forward to this year and the six months to June 2022, and the wider economic and markets environment is barely recognisable.

The performance of the 60/40 stock bond portfolio was -16.4% in H1³. The table below illustrates the extraordinary shifts in public markets over the first half of 2022.

A toxic combination of conflict, inflation, interest rate rises, and recession risk has led to a sharp reduction in both equity and fixed income returns.

Asset Class	Current	YTD change
Equities:		
- MSCI World	2,546	-21%
- S&P 500	3,785	-21%
- FTSE 100	7,169	-3%
- CSI 300 (China)	4,485	-9%
Govt bonds:		
- US 2y	2.95%	+2.22%
- US 10y	3.01%	+1.50%
- UK 2y	1.84%	+1.16%
- UK 10y	2.23%	+1.26%
Breakeven inflation:		
- US 10yr	2.34%	-0.25%
- Germany 10yr	2.03%	+0.22%
- UK 10yr	3.70%	-0.24%
Corporate bond spread:		
- Sterling investment grade	207bps	+93bps
- Global high yield	666bps	+285bps
Commodities (\$):		
- Brent crude	109 per barrel	+46%
- Gold	1,807 per ounce	-2%
- Nickel	22,652 per tonne	+10%
- Wheat	8.84 per bushel	+15%
Crypto (\$):		
- Bitcoin	16,022	-55%

Source: Bloomberg as at 30 June 2022.

Data for private markets are only available with a considerable time lag, while the lack of immediately observable market prices means there is also a degree of smoothing in reported valuations and returns. That said, in most private markets, conditions were less affected than in the public markets. Returns for global private capital overall reported by Burgiss were flat for the first quarter of 2022; real assets (real estate, infrastructure and natural resource) saw returns of 5.7%, boosted by an exceptionally strong performance for natural resources as a result of the hike in energy prices.

It is likely that returns for the first half of the year will be seen to have been far more benign than for public markets. This will have acted as a very helpful portfolio diversifier for many investors, but thoughts will quickly turn to what comes next.

On the next page, we outline our thoughts on private credit, real estate and infrastructure. While there is undoubtedly a UK tilt here, many of these trends are playing out in similar ways across countries.

³ Source: Refinitiv Datastream as at 30 June 2022.

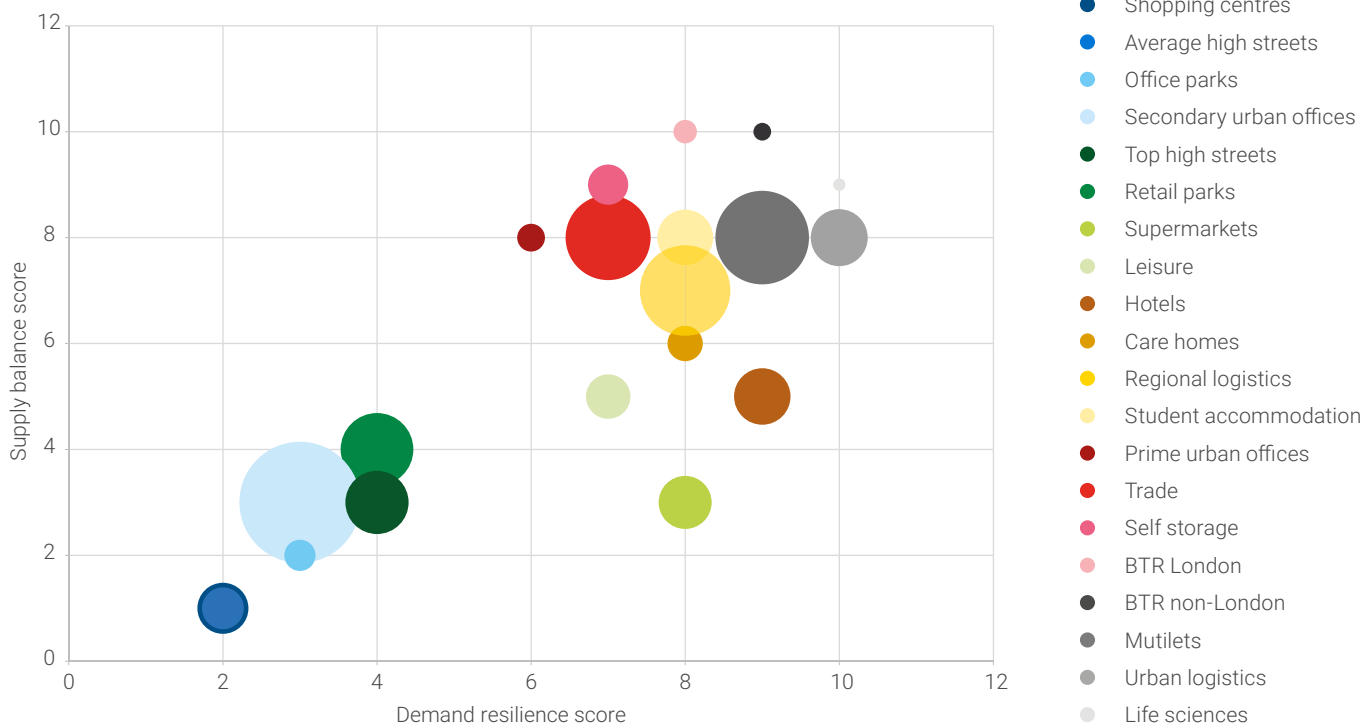
Real estate – a tougher environment but growing rents will be crucial

Property faces a tougher environment. Weaker economic conditions will impact occupier demand and rents, limiting rental growth. At the same time, relative value has come under pressure from the sell-off in public markets. While our indicators of the risk premium from property still look reasonable, despite higher nominal gilt yields, these focus on rental growth over the medium-term. The short-term pressure on rents in real terms, with nominal rental growth unlikely to keep up with rates of inflation over the coming 12-18 months, is likely to put upward pressure on yields and conversely downward pressure on valuations.

We expect a more challenging environment to drive wider dispersion in performance across portfolios. Positioning will therefore be key to investment performance. While we don't often use the same terminology as the equities market, defensives are likely to materially outperform cyclicals, in our view. In real estate, what that translates to is the probability of receiving, and being able to grow, rents in a weaker economy.

The matrix below illustrates an analysis of how different sectors position in that sense. Supply balance reflects the proportion of vacant space in each part of the market – this remains one of the most powerful barometers of the relative health of markets. A lower number indicates a higher level of vacancy and therefore more distance to travel before rents can rise.

Figure 2. Real estate resilience matrix



Source: LGIM RA as at May 2022. Size of the bubble = total capital value (£) of sector as measured by MSCI.

⁴ Source: ONS, Monthly Bulletin of Building Materials and Components, April 2022.

On the demand side, we score different sectors in terms of the sensitivity of occupier demand for space to economic conditions, as well as structural factors such as the substitution effect in real estate. Internet retailing is the classic example here from the past 20 years. Post COVID-19, the greater proportion of remote and hybrid working is a challenge for significant areas of the office market.

Using this framework, we see build to rent residential (BtR) and purpose-built student accommodation (PBSA) as being especially well-placed to deliver stable and growing income. We also believe that areas of the industrial market, in particular, multi-let industrial estates and urban, 'last-mile' logistics will benefit from tight supply and consistent demand. Conversely, we believe retail and secondary and suburban offices are likely to face more severe headwinds as spending on goods comes under pressure from a slowing economy and bottlenecks appear as consumers spend more on leisure after the restrictions imposed by COVID-19.

Construction price inflation and rising energy performance standards are likely to exacerbate the situation. All things equal, higher construction costs make it less profitable to build new properties, limiting additions to supply. The ONS reported material price inflation of more than 25% over 12 months⁴ and we also see growing structural pressure on wages. In areas where supply is already tight, that adds further impetus to rents as occupiers compete to secure space.



Tightening regulation

Energy performance standards are also being progressively tightened. From 2023, landlords may not let, or continue to let, space with an Energy Performance Certificate (EPC) unless they reach at least a D rating. Under current proposals, these are expected to be tightened to a minimum of C by 2027 and a minimum of B by 2030. Half of certificates registered in 2021 would fail the standards expected in just five years' time. That doesn't even start to address the levels of performance needed to meet standards required for a net-zero pathway.

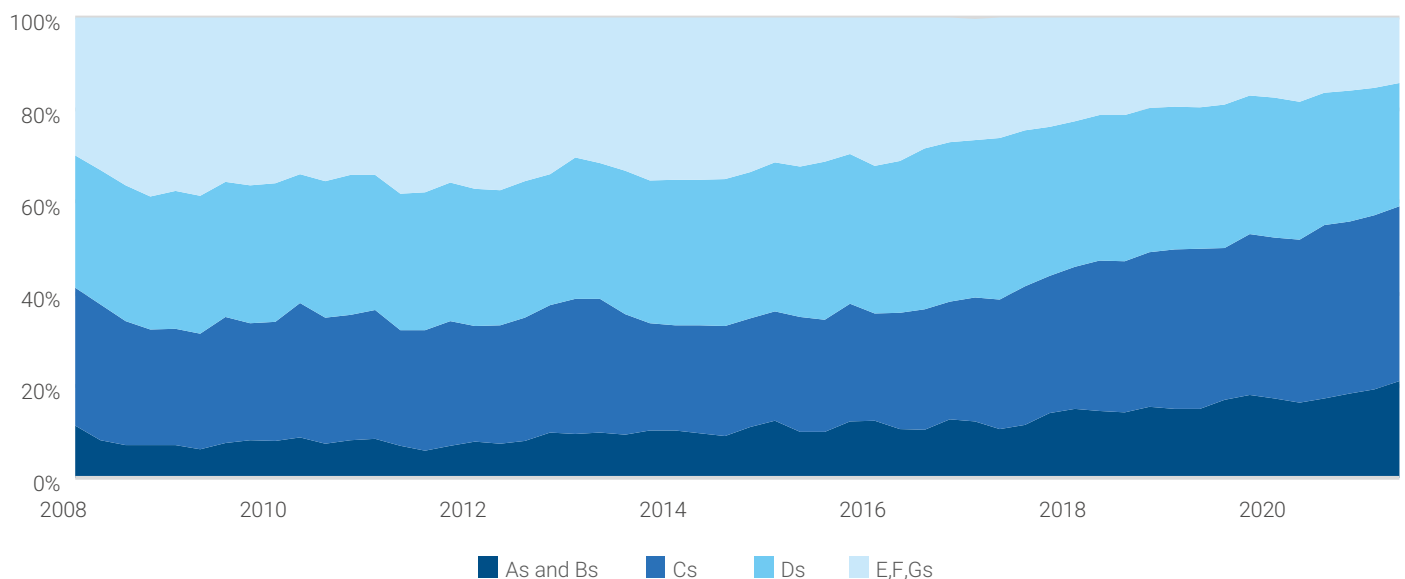
As noted above, construction price inflation is already increasing the cost of the physical alterations needed. Changes to glazing, insulation, lighting, electrical heating and cooling systems are needed for most existing assets in order to make significant gains in energy performance. For older assets, in weaker areas of the markets, this is a major liability and one where necessary capital expenditure by asset owners to meet regulatory requirements is unlikely to be matched by higher rents from occupiers. This is more risk management than value creation, in our view.

ESG – a key differentiator of investment returns

Portfolios tilted to older assets in weaker areas of the market, and with lower energy-performance standards, face significant structural pressures to investment returns. Conversely, modern assets, in areas where property prices are relatively higher, (typically city centres) are better placed. These are also the areas where occupiers, particularly large companies, are recognising the impact that their property occupation has on their overall carbon footprint. Increasingly, we're seeing assets with strong environmental credentials achieving stronger occupier demand and rents. Environmental, social and governance factors are becoming increasingly both positive and negative differentiators of individual buildings' investment returns.

Figure 3. EPC ratings – better down than up

Proportion of EPC ratings in England and Wales, commercial real estate, quarterly



Source: <https://www.gov.uk/government/statistical-data-sets/>

Private credit – a call for quality and robust risk management

For those private credit investors who use public credit as a basis for valuing their private market exposures, valuation performance for private credit assets has followed the downward trend for public credit seen in the first half of 2022. Despite widening spreads however, credit ratings have been resilient overall, and defaults have stayed low. Short-duration and floating rate assets have outperformed. Over recent months, we have found the best priced opportunities in the real estate, alternatives and crossover debt spaces.

Demand from investors has remained strong. Private credit fund managers have been busy deploying their cash and US investors have increased their presence in the European market to take advantage of the strong dollar⁵. High-quality issuances continue to be oversubscribed.

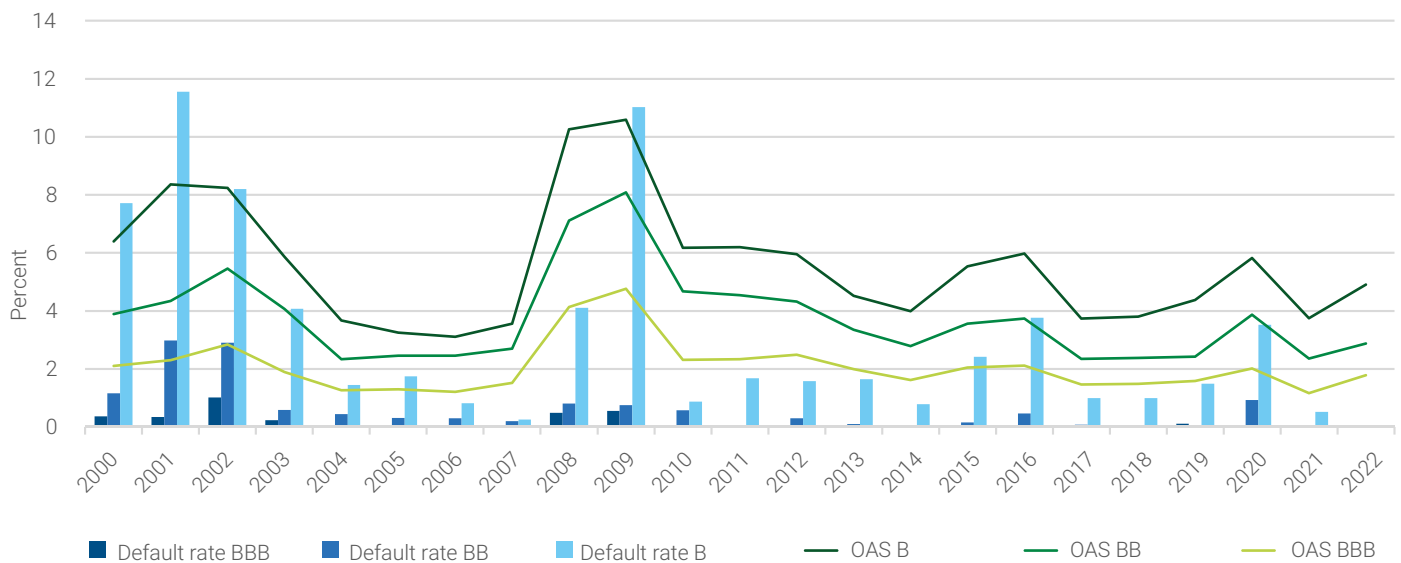
At the start of the year, we anticipated a return of borrowers who had postponed their debt-raising plans due to the pandemic, and other borrowers who brought forward issuance in 2022 in order to lock in lower rates. Despite the macroeconomic uncertainty this has materialised to some extent, leading to strong issuance levels and a broader base of corporate borrowers in the first half of 2022, which has been positive for portfolio diversification. However, we have also observed other borrowers delaying their capital-raising plans which should add to the future pipeline.

Looking ahead, we believe investor focus is starting to shift from duration risk to credit risk. Already this year, private credit lenders have tended to be more inclined to accept a lower spread rather than a weaker debt structure. With increased uncertainty around the economic outlook, the value in retaining strong downside protection has increased for investors.

Corporate fundamentals and debt servicing capacity were strong going into 2022 but higher costs will continue to put pressure on corporates and development projects. We expect aggregate corporate margins to be challenged, since not all the price increases can be passed onto customers. Sectors with inelastic demand, strong pricing power and more fixed costs will be better positioned, in our view.

Slowing growth and tighter financial conditions could weigh on the performance of less resilient assets. Public market performance over the last 20 years suggests that during times of market stress, investment-grade (BBB), crossover (BB) and high-yield (B) bonds have all experienced spread widening, although BBB- and BB-rated bonds have suffered far lower defaults than B-rated bonds.

Figure 4. How wide do you go?



Source: Bloomberg and S&P "2021 Annual Global Corporate Default and Rating Transition Study". The 2022 option adjusted spread (OAS) is as at end May 2022.

⁵ Source: Burgiss Global Private Capital Performance Report, Q1 2022.

We expect a similar pattern in private markets. Private investment-grade and crossover-debt issuers are primarily well-established corporates and infrastructure assets with long track records and strong debt servicing capabilities. Loans are commonly structured with covenant requirements that add an extra layer of protection. This contrasts with direct lending and leveraged loans which are deeper in the sub-investment grade space and typically involve lending to smaller, less well-established companies and have increasingly become “covenant-lite” in recent years.

Our preference, given the uncertainties we face, is to go up in the quality spectrum and retain robust risk management. The widening in credit spreads, we believe, has provided investors with a window to add exposure to quality assets at attractive prices. We expect an increase in demand for investment-grade private credit from pension schemes looking for assets that can be transferred to an insurer in a bulk annuity transaction but also generate an additional yield relative to bonds. At the same time, crossover debt, in our view, is currently providing an attractive premium (adjusted for default risk) relative to the rest of the sub-IG market which makes it suitable for investors looking to position conservatively but still generate a decent return.

Infrastructure – a need for clean energy

The infrastructure conversation in Europe has been dominated by the implications of the war in Ukraine. It has exposed Europe’s current dependence on Russian gas, in particular, and added a new urgency to the need to remove it from the energy mix. While the European Union’s (EU) response includes steps to diversify gas supplies, the emphasis is much more on accelerating the rollout of clean energy generation and energy efficiency investments.

The headline commitment from REPowerEU is to end imports of Russian fossil fuels by 2027, enabled by a new renewable energy target of 45% by 2030, up from the previously envisaged 40%. The scale of asset creation needed to deliver this is immense. For electricity generation, this means an additional 169GW of targeted renewable capacity – more than the current total installed power capacity of France. Solar, wind and battery storage will play a prominent role in delivering these goals. As an example, annual additions of solar capacity would need to almost triple from current levels to deliver the EU’s 2030 ambitions. Renewable gases will also play an important role in displacing fossil fuels and delivering the clean energy transition. REPowerEU aims to significantly scale-up nascent hydrogen and biomethane markets by 2030, with investments planned in production, import and storage infrastructure.

There’s no doubt that there will be significant hurdles to overcome, as highlighted in our [blog](#). The pressure on supply chains and materials prices being seen in real estate is echoed in the capital cost and availability of the components needed for renewables. Equally, the scale and speed of investment required will require a high level of coordination amongst EU member governments and within different levels of government to support the process. One area the EU has identified specifically is to accelerate the permitting of new renewable energy projects.

Finance will of course be key. REPowerEU comes at a hefty price tag of €300 billion, much of which will ultimately come from the private sector. This will only be achieved if policy and regulation deliver an appropriate balance of risk and return for investors.

For infrastructure more widely, it is hard to overstate the implications of decarbonisation as a theme. The push out of fossil fuels will not only depend on clean electricity generation, but also investments in grids to store and distribute electricity. In transportation, both electrification and switches to alternative fuels will have significant implications for road, rail, shipping and aviation. We are also likely to see a number of public-private partnership models being used to finance energy efficiency projects for social infrastructure, as well as a mechanism for government to accelerate the adoption of new technologies. There will also be a growing role for private capital in nature-based solutions such as forestry and habitat restoration, which we expect to feature more frequently in institutional investor portfolios.





The final word – an emphasis on delivering consistent income

Investors consistently report diversification as one of the key reasons for investing in private markets. They will have felt the benefits in the first half of 2022. Going forward, however, the key focus is likely to be on how individual strategies are positioned from a relative value perspective and how they will fare in a more challenged economic environment.

For private credit, real estate and infrastructure, the delivery of consistent income streams is key to the investment proposition. Each of those asset classes includes a spectrum of sectors, cashflow structures and sensitivity to the economic cycle. Given that the turnover of assets in private portfolios is relatively low, the portfolio an investor owns now is largely the portfolio which will be held through the next phase of the cycle.

That is why we have always placed a great deal of emphasis on consistent and robust income streams, with the potential for sustainable growth in the case of equity. We believe it's those portfolios that can be expected to perform most strongly through the cycle.

The last point to make is one that is so often made that it verges on cliché. But it continues to hold true. Phases in which markets are challenged, and where dislocations can arise between buyers and sellers, can present moments for long-term investors to make outsized returns. Having a long-term mindset should not detract from the ability to act quickly when opportunities present themselves.

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