



2023 outlook: private markets at a crossroads

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We believe three investment themes in private markets should offer investors compelling opportunities in 2023:

1. Private credit;
2. Co-investments and GP-led secondaries; and
3. Infrastructure throughout the capital structure;

Ten years of abysmally low real and nominal interest rates combined with the “fear of missing out” led investors to push up valuations in public markets and to embrace the illiquidity premium offered in some private markets.

2022 has been a pivotal year with rising costs hurting businesses globally and central banks’ attempts to control inflation raising the spectre of a global recession.

The sudden increase in rates and spreads which caused the negative returns in public markets observed in 2022 (S&P: -19.4%, global IG -14.1%) have also reduced, and in some cases eliminated, the private markets premium given that private markets typically lag their public peers. This lag (of one or two quarters) can be attributed to the combination of long gestation times for transactions and lower frequency of valuations but also, in some cases, the willingness of some investment managers to continue to deploy dry powder raised with out-of-date return targets (reflecting historic market conditions when funds were committed

to them) to continue to invest at these levels and ignore the general repricing of capital which occurred in 2022.

Deployment in private markets has slowed down and we have reached a crossroads: it takes (more) time to agree on value in this new context. However, Private markets have developed into a global, highly diversified and heterogenous universe where – we believe – some sub-sectors offer investors relative and absolute value in a complex macroeconomic backdrop. Terms are being reset but at an inconsistent pace. We set out below our favourite themes. In exploring these themes it is worth remembering that there is no single “private market”; there are just private variants on public asset classes or asset classes traditionally only funded by banks:

- Private equity, where control of companies and the ability of investors to directly effect change in them to create value can outweigh the benefits of the greater liquidity and diversification in public equities;

- Private fixed income assets (bonds and notes) that are not publicly listed or traded but remain more “bond-like” than “loan-like”; and
- Bank assets i.e. assets rarely seen in public markets but which can be acquired from banks or sourced by disintermediating banks or both.

1 Private credit with three areas of focus

- **European mid-cap lending:** We see banks seeking solutions to reduce their balance sheets whilst seeking to retain fee generating businesses linked to bank credit. However, some institutions may struggle to simultaneously reduce balance sheets while keeping these related fee-generating businesses. 2023 could be another year for European credit markets in which banks further withdraw from lending in the deeply non-investment grade space driven by: banks’ own increasing cost of capital, and opportunities for banks to earn easier money in safer segments in a higher rate environment. Higher returns in the lower rated segment of the credit market provide more cushion to absorb the losses which could arise in a recession.
- **Trade finance:** a short-term semi-liquid asset class with limited credit and rate risk which can be used as a tool to maintain portfolio returns while waiting for longer dated credit markets to reset. This is also a sector in which the supply-demand balance may favour investors given banks are major funders of this sector and this is an asset class where banks may wish to maintain origination for both relationship reasons and the long-term attractiveness of the asset class for

them, while easing short term balance sheet pressure. The performance to date of such strategies has been solid and stable in volatile markets. Although the importance of managers who are able to minimise fraud-related losses and avoid high-risk and tainted counterparties has been illustrated by a few high-profile scandals in the supply-chain financing sub-segment of trade finance.

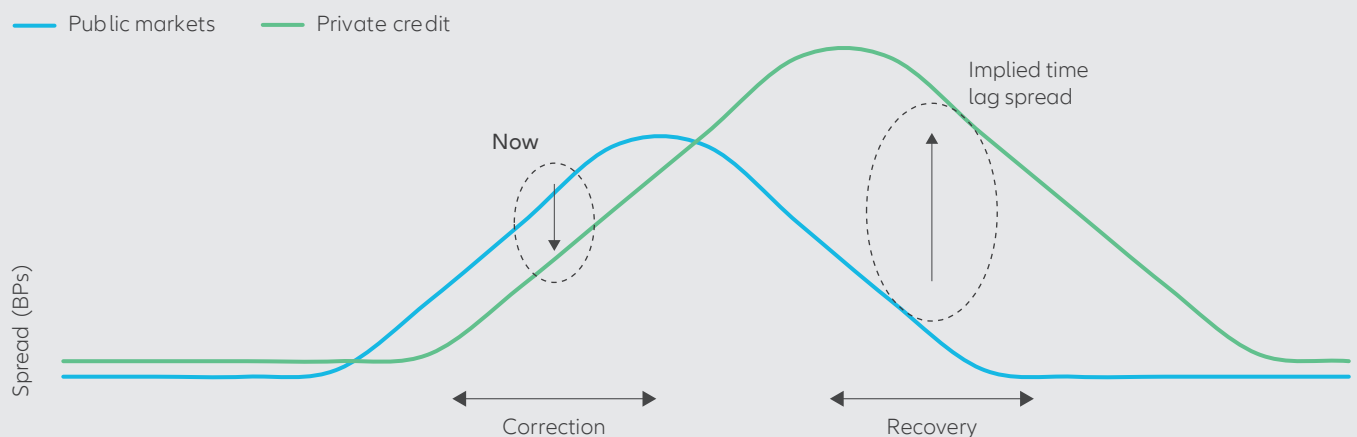
- **Infrastructure debt** which is discussed below together with infrastructure equity.

2 Co-investments and (GP-led) secondaries

We see a tougher market for fundraising and portfolio adjustments by investors rather than a market meltdown with massive dislocations; hence we expect GPs to stretch their investment periods through co-investments and thus to become more reliant on large and trusted partners to deliver on transactions, rather than rely solely on the broad distribution possible in softer markets. Those same partners will be called upon for GP-led secondaries and continuation funds which should offer our investors appealing entry points.

Secondaries have plenty to offer: i) faster deployment at a time when investors can pick up a robust complexity premium on top of historically attractive entry points, ii) liquidity for sellers and iii) objective pricing levels for all stakeholders. The scope to capture value should be optimal – in our opinion – in those segments which have grown fastest in the last few years (eg infrastructure equity and credit) where the contribution of secondaries to aggregate volumes are yet to level off.

Exhibit 1: Private credit vs Public markets spread time lag



Source: Allianz Global Investors, September 2022.

3 Infrastructure – both equity and credit

Many factors underpin our conviction that this is a compelling sector to take more exposure to.

This is firstly underpinned by the huge capital needs in the energy sector both for energy transition and security which previously may have been looked at over several decades – we now count in years. Post second world war, we have struggled to come up with a comparable context with such near term and large capital expenditure requirements.

Infrastructure assets often have features and contractual protections which allow to navigate periods of high inflation. Coming up there might be more transactions offering some diversification from a corporate world which could come under pressure as a result of inflation compressing margins and a low growth backdrop. Investors have many ways to enter this asset class, equity, high yield or

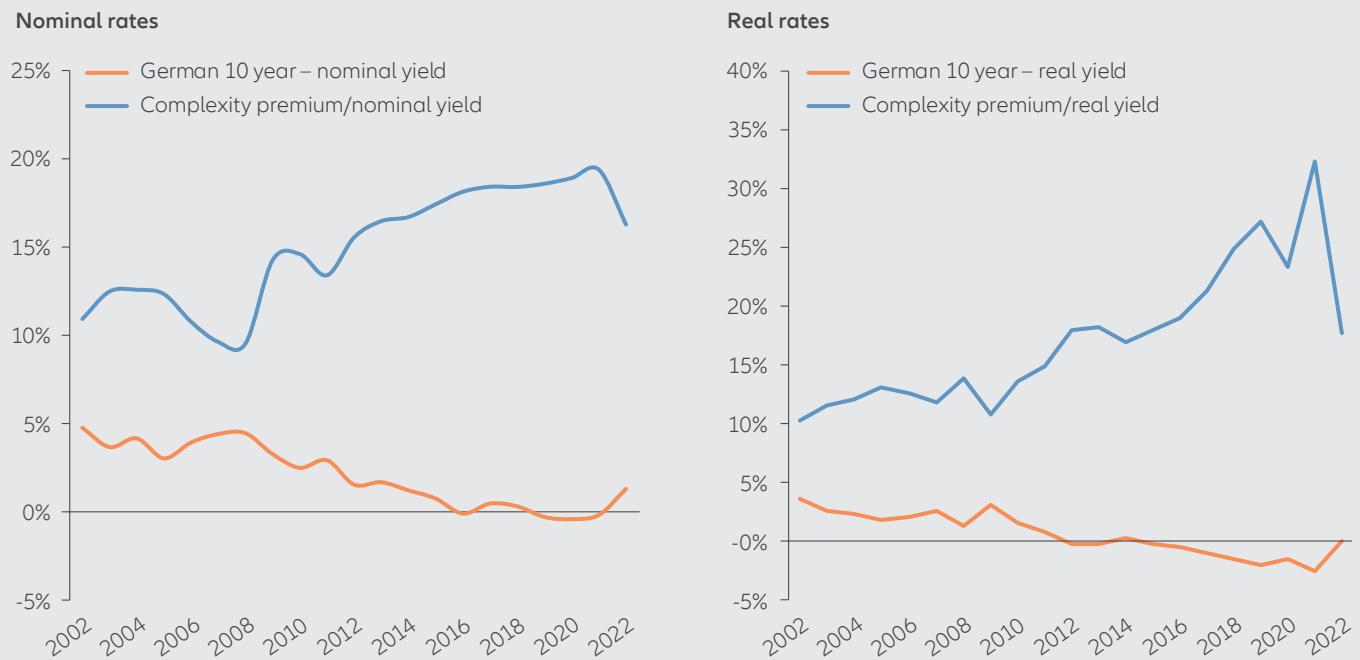
investment grade credit, and can therefore pick their spot in the capital structure, the region or duration.

Infrastructure credit in Asia has the potential to continue offering value in our opinion: the region continues to grow and build renewables; the market is complex and is thus prone to tailor-made credit solutions; the reshuffling of supply chains has generated opportunities across South-East Asia.

The infrastructure sector has kept on providing waves of opportunities, but it is the sheer scale of this latest wave which makes it unique.

Private markets have had a stellar decade of growth. The dislocation seen in public markets in 2022 and the capital demand in the energy sector should bring investors another window to enter some segments of private markets on attractive terms. Experience and understanding of these markets will matter more than ever while uncertainty remains elevated.

Exhibit 2: Private markets offers an attractive complexity premium despite rising normal rates



Source: Allianz Global Investors, Bloomberg, September 2022.

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