FRANKLIN TEMPLETON

Private Markets Outlook

New ideas for a new regime

For Institutional Professional Investors only – not for distribution to retail clients

Views expressed as of March 20, 2023, unless otherwise stated.

Overview

- The structural drivers of the ongoing **evolution of private markets** remain intact, but 2022 signaled a reset in the investment environment and an end of the easy money era. The bouts of financial stress caused by higher rates is likely to put pressure on valuations and lead to tighter credit conditions for the foreseeable future.
- This new era will seriously test investors' previously held assumptions about liquidity management, portfolio construction, and manager selection. As a more challenging landscape emerges, investors need to consider **new ideas for a new regime** in private market investing.
- In **private equity,** we believe exits will remain low in 2023, potentially leading to a real reset in valuations. Lower tier companies in their industries are likely to see the largest reductions, while top tier industry leaders that are well-managed and well-capitalized should weather the storm better.
- In **private equity secondaries**, we are seeing a lopsided market that will likely heavily favor investors on the buying side of the negotiating table. From a risk/reward perspective, it appears that 2023 will be a year to remember for secondary market opportunities.
- In **private credit,** we see the positives of expanding yields and stronger documentation negotiation power alongside still-healthy leverage levels and interest rate coverage ratios. Funds with experienced workout teams and solutions-based approaches are ready to combat higher default risks. At the same time, there is an exploding opportunity set within the distressed space with more and more "good company, bad balance sheet" investments offering attractive potential returns in both, European and US markets.
- In **private real estate,** the market leaders and laggards are being reshuffled. Higher inflation and rising interest rates will have material yet varied impacts on private real estate. Opportunistic investors may be able to acquire high-quality assets at a discount—and at scale—in sectors with secular tailwinds.
- Finally, seismic shifts in how global economies operate will fuel the **next generation of growth** in private investing. Megatrends like the ongoing energy transition, the need for a more sustainable and productive food system, and the rise of decentralized frameworks in business technologies require massive amounts of capital, fueling future private investment opportunities.

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"We're pleased to share our private markets outlook, highlighting the different views of our independent alternative investment managers. Inside we will review the current landscape and expectations for each asset class in the months ahead."

Landscape

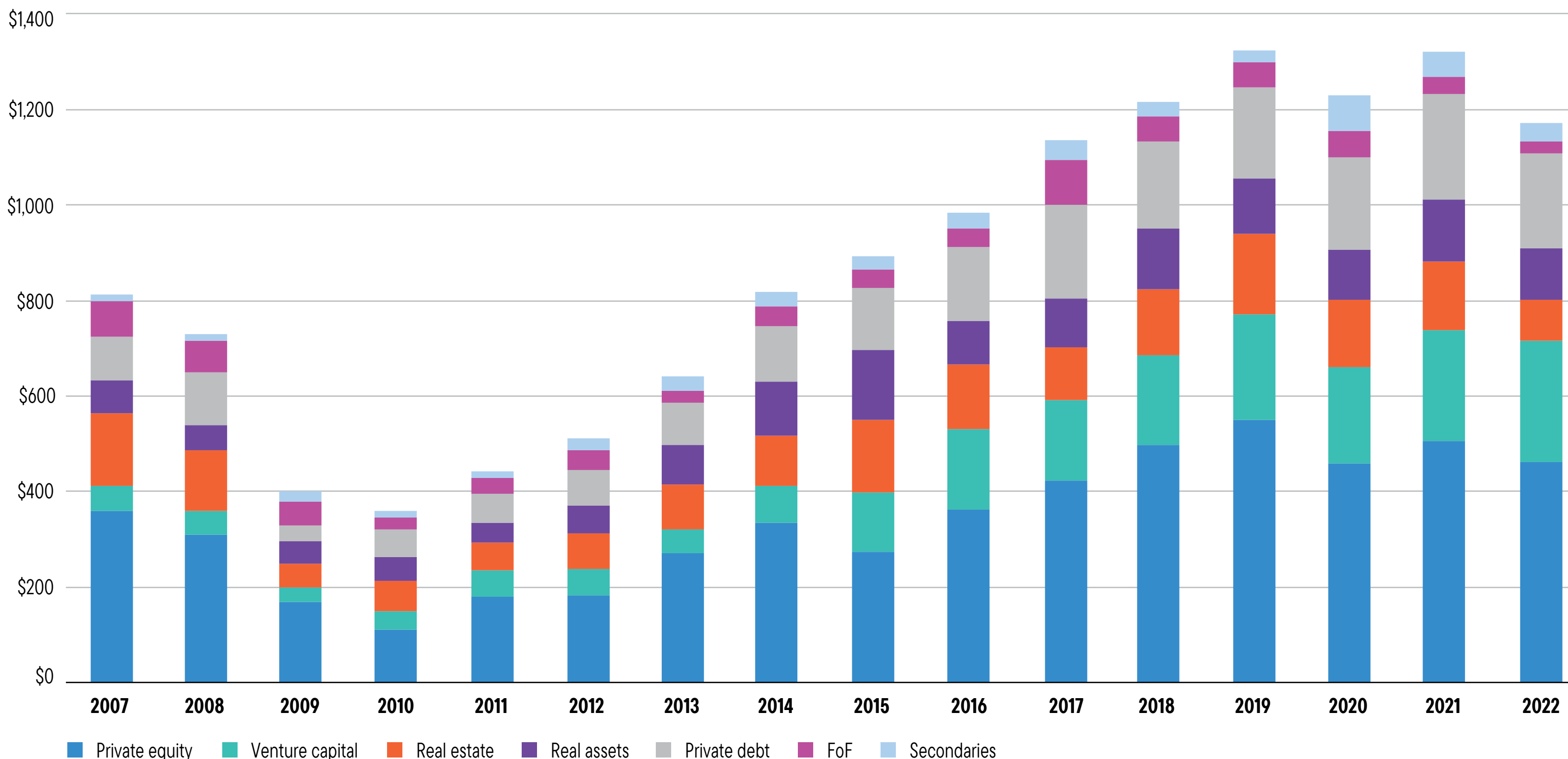
The evolution of private markets

In the last 20 years, multiple secular drivers have propelled the growth of private markets—and these drivers remain firmly in place today. The post global financial crisis regulatory landscape still makes it challenging for firms to be publicly traded companies, making some businesses opt to stay private for longer. Companies still desire the funding flexibility that non-bank lenders can offer as traditional banks have pulled back from private lending markets. Institutions still need the long-term excess return potential of private market investments to meet their growing liabilities and return targets.

Admittedly, the last decade was a bonanza for private capital markets marked by a torrent of activity, high-flying valuations, and annual fundraising topping $1.2 trillion the past several years. Despite the severe economic headwinds in 2022, private markets remained relatively resilient with fundraising off peak, but on a similar pace as 2021, and near-record amounts of dry powder still on the sidelines.

Fundraising resilient in face of economic headwinds

Global Private Capital Fundraising ($B)



Source: PitchBook, as of 12/31/22.

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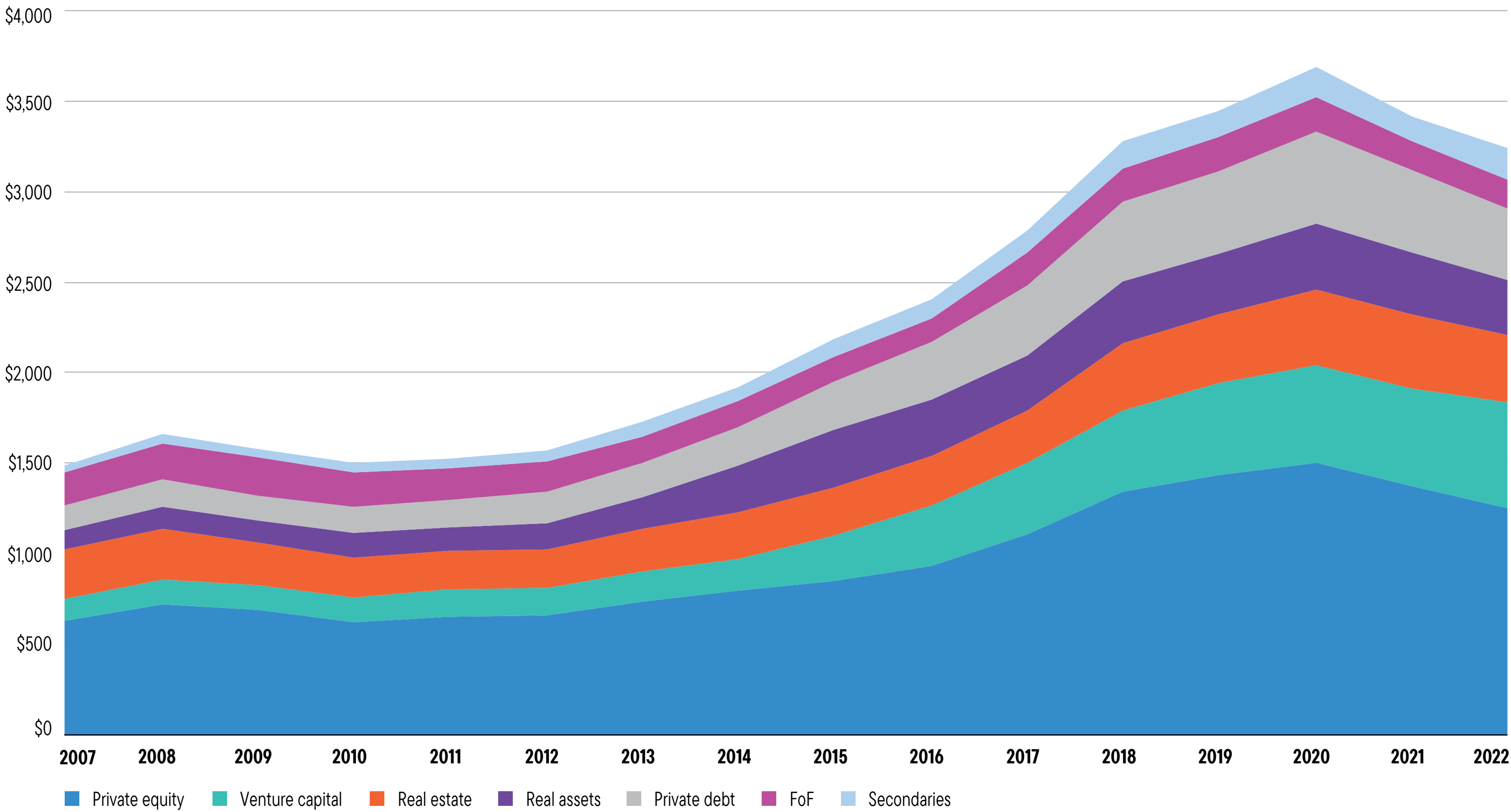
Near record dry powder still on the sidelines

Cumulative Dry Powder ($B)



Source: PitchBook, as of 12/31/22.

The long-term trajectory of private market investing remains healthy. When considering global private capital AUM held in various vehicles across private equity, venture capital, private debt, real estate, and real assets, PitchBook forecasts the figure will reach $13 trillion by 2027, up from around $10 trillion at the end of 2021.[1]

1. Source: PitchBook, What the Future Holds for Private Capital, 1/23/23.

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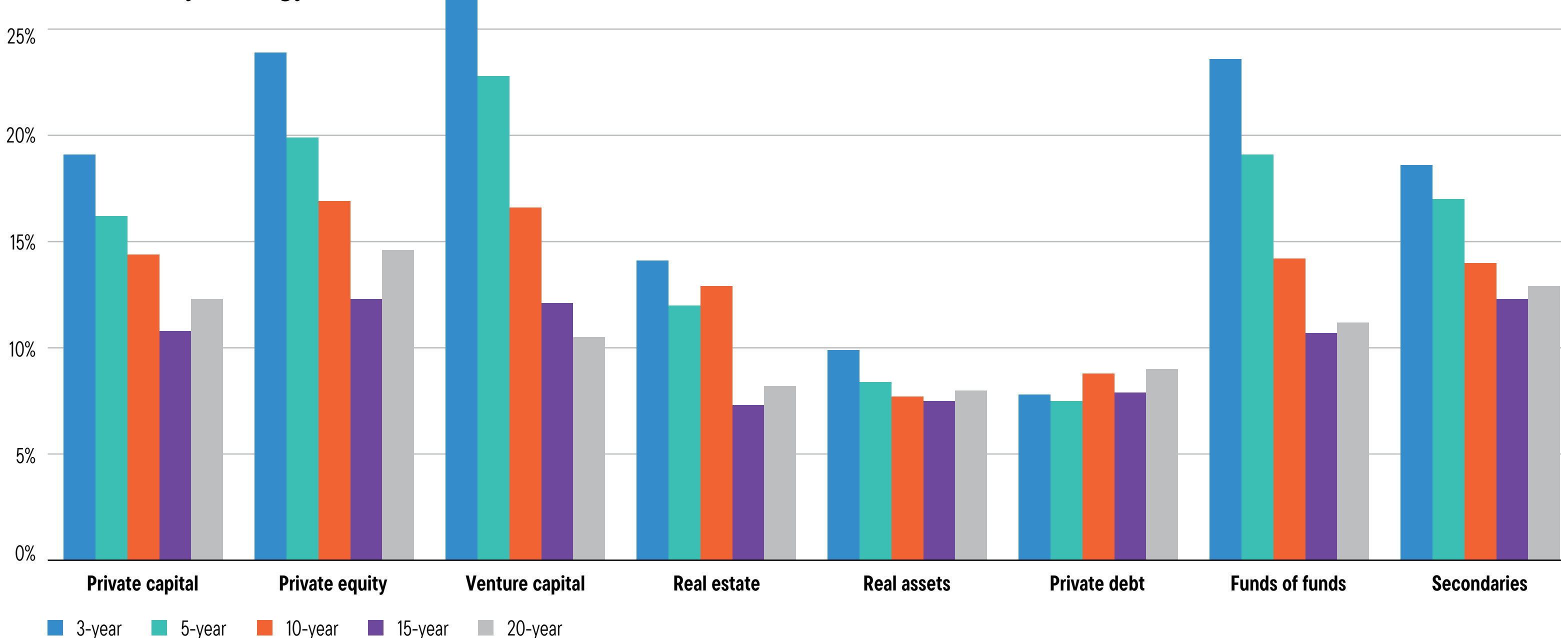
New ideas for new regime

2023 marks the next evolution for private markets, characterized by challenges and opportunities. Higher interest rates and a shrinking Federal Reserve (Fed) balance sheet are lowering liquidity in capital markets, creating financial headwinds across all major asset classes. Furthermore, the rapid pace of rate increases has started to expose hidden vulnerabilities in certain sectors of the economy, increasing the frequency of sudden shocks or short-term crises.

During the previous period, private assets delivered strong returns amid an easy money environment. However, a review of longer time horizons with more varied economic conditions reveals a wider range of outcomes are possible—challenging conventional wisdom that private investments are a surefire way to boost performance and meet return targets.

In aggregate, private asset returns have thrived in the easy money era

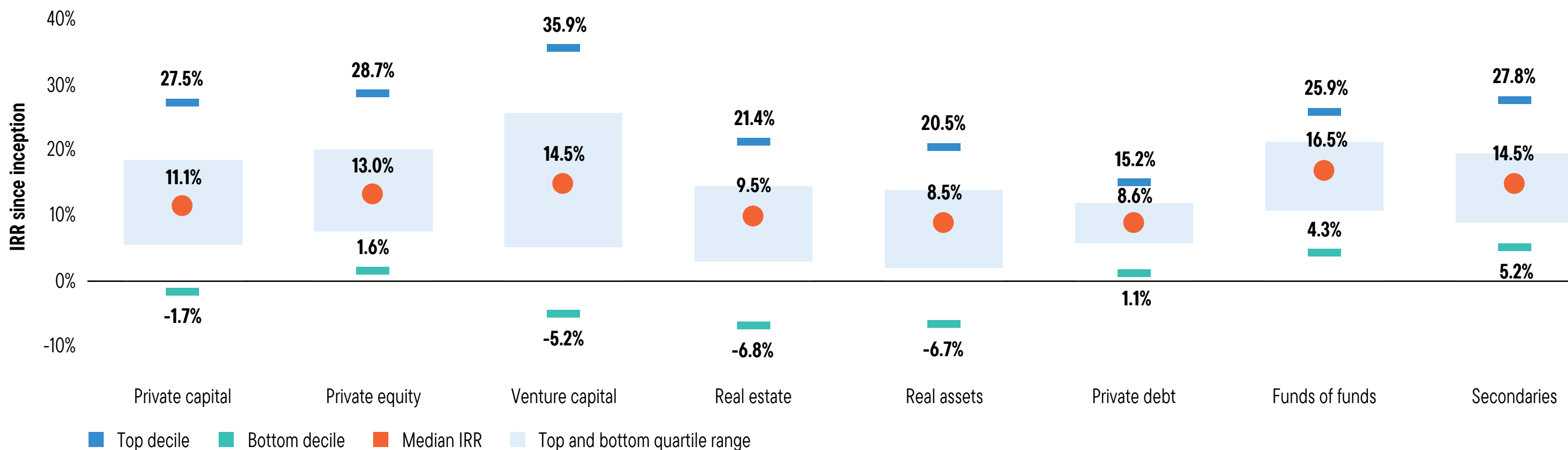
Horizon IRRs by Strategy



Source: PitchBook. Data as of 6/30/22.

But manager dispersion is wide over full boom-and-bust cycles

Fund IRR Performance Dispersion by Strategy (Vintage Years 2004–2017)



Source: PitchBook. Data as of 9/30/22.

In the previous period of stable growth and low macroeconomic uncertainty, institutions could ride the private markets beta wave without seriously testing their assumptions about liquidity management, portfolio construction, and manager selection.

In terms of portfolio construction and liquidity management, many of these private market investments were self-funding, where capital distributions outpaced capital commitments. The result was a temporary masking of the illiquidity risk that accompanies private allocations. However, the reverse may now be true for some investors—requiring them to find different funding for capital commitments—setting up a liquidity and portfolio construction dilemma.

On the fund manager level, many funds put cash to work amid a fiercely competitive dealmaking environment. As a result, private equity funds potentially paid for high valuations in lower tier companies that were unlikely to grow into their multiples. In private credit, funds signed on to "covenant-lite" agreements without proper backstops in case of default.

Overall, many of the choices investors made in their private market allocations were based on a very different set of economic assumptions than they now face. As a more challenging landscape emerges, investors need to consider new ideas for a new regime in private market investing.

As a diversified manager with specialized capabilities across the broad spectrum of private market investments, we believe there are opportunities in private markets that look more attractive today than they have been in more than a decade. In the following pages, we outline the key risks, opportunities, and portfolio implications investors need to know to thrive in the new environment.

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Asset class outlooks

Private equity: Paused, awaiting a reset

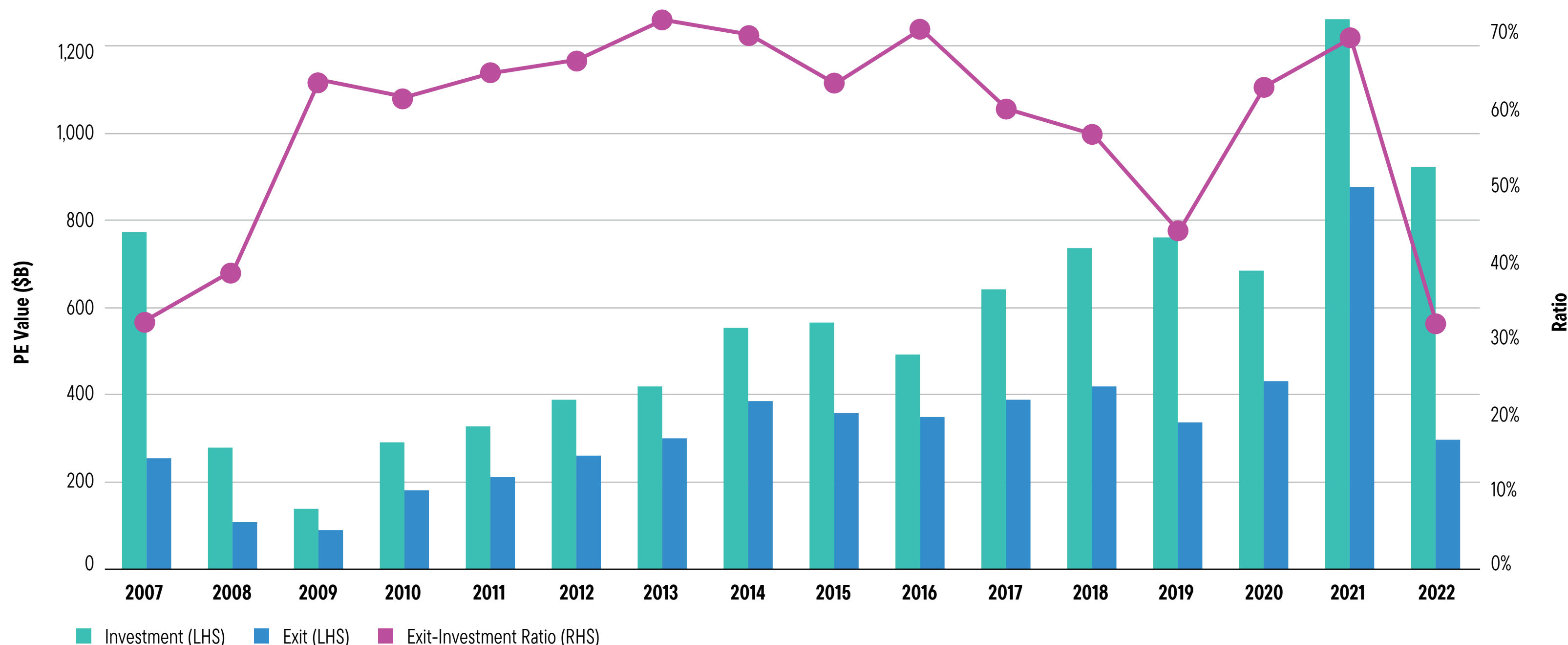
Exit environment has stalled to GFC lows

The private equity (PE) market reached an inflection point in 2022 as the idyllic era of declining interest rates and ever-growing valuations came to an end. PE exit activity dropped sharply in 2022, hindered by macroeconomic headwinds which are likely to persist in 2023. As 2022 ended, the exit-to-investment ratio stood at less than 0.40x, the lowest figure since the global financial crisis.

Furthermore, the sudden collapse of Silicon Valley Bank (SVB) was a shock to the system that will likely have further ramifications for the banking sector as a whole. While we do not see the failure of SVB as an enduring risk for private companies, we do think it is a catalyst that will accelerate the shakeout in valuations that was already underway in the private equity and venture capital space.

Exit environment drops to 15-year low

PE Investment and Exit Deal Value and Exit/Investment Ratio



Source: PitchBook, as of 12/31/22. This ratio tracks the value of PE exits in any given period against PE investments.

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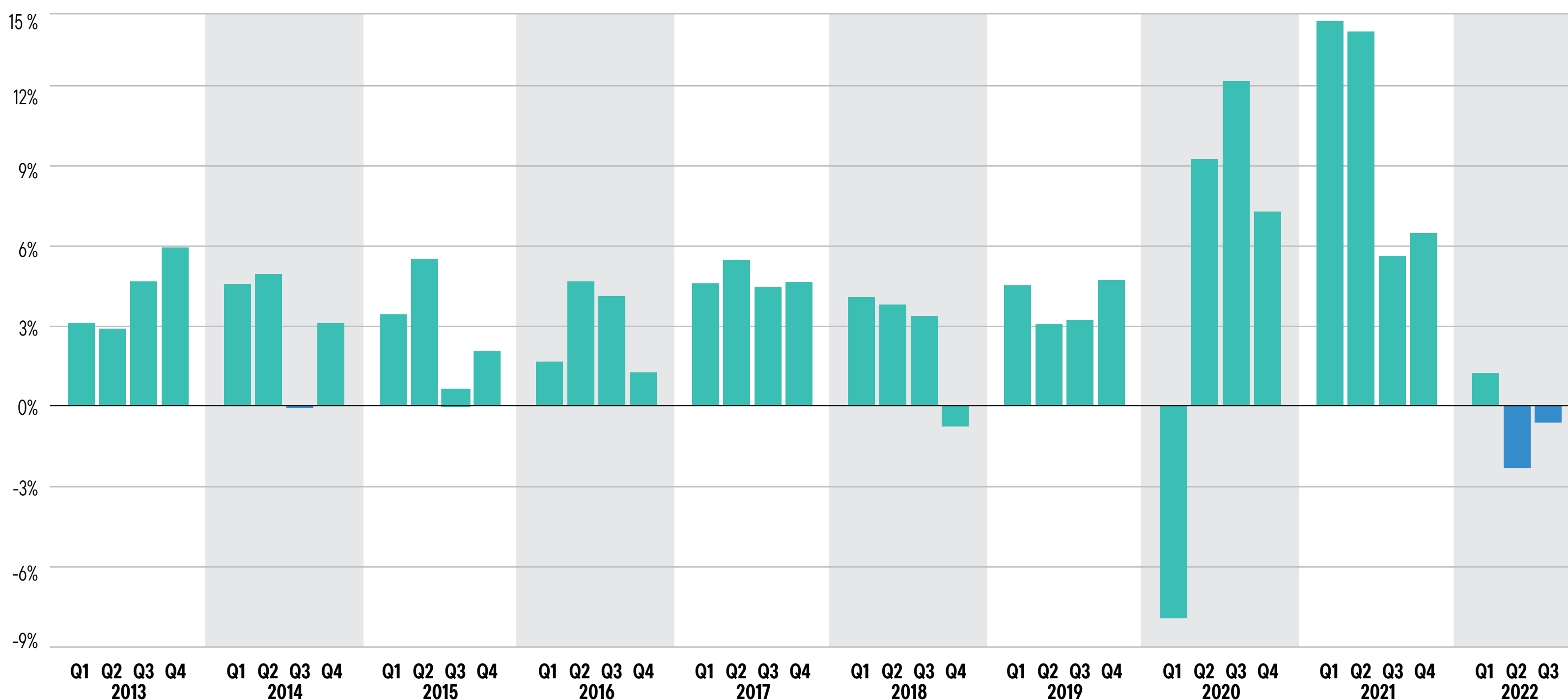
Quality is king after the pandemic "zero gravity" period

The slowing exit environment is creating a real sense of differentiation among PE fund portfolios. Previously, valuations in the buyout space were beginning to push towards pre-2008 highs with some sectors commanding EV/EBITDA ratios near 20x.[2] Within industries, quality was sometimes overlooked, and entire industries experienced "zero gravity" when it came to their valuations. Lower tier companies were being valued at lofty levels similar to top tier companies, even though it would take years for them to grow into their multiples. Now, when General Partners (GPs) need additional capital, the dreaded down round or "structured equity" capital will begin to test those valuations.

After the historic returns of 2020 and 2021, we are starting to see PE funds reprice their portfolios. However, we do not believe this will be felt evenly. Liquidity-driven fundraising will likely see down rounds, but higher quality companies with capital reserves are less likely to see valuation reductions.

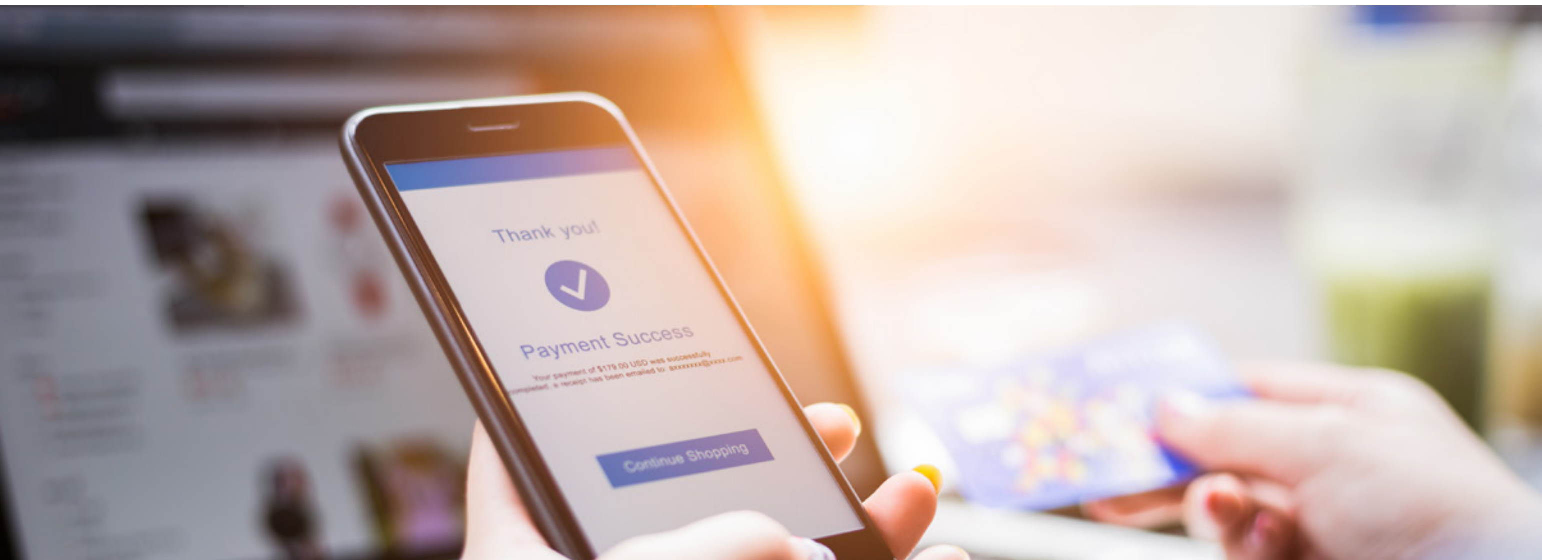
Private equity returns rolling over

Quarterly US PE Fund Performance



Source: PitchBook, as of 9/30/22.

2. Source: PitchBook, based on the median private equity fund valuations, as of December 2021.



Contrarian opportunities in venture capital

Venture is in a period of deep revaluation that will require time for both buyers and sellers to agree on an appropriate multiple. Furthermore, increasingly negative sentiment around cryptocurrencies and exchanges has hit many startups even distantly associated with blockchain technology.

Looking through a longer-term lens, blockchain is an important technology with far greater applications than cryptocurrencies. Blockchain technology is the key to ushering in what we consider to be the next phase of commercial technologies: the period of decentralization. Similar to the "virtualization" period of the 2000s and 2010s in which cloud computing became the norm, the phase of decentralization will profoundly impact the way consumers, industries, and global economies operate.

We believe venture opportunities with companies related to the decentralization trend—like those developing blockchain infrastructure, smart contracts, and Web3 technologies—may one day be as prominent as household names from the virtualization period, such as Meta, Netflix, and Amazon.

Investment implications

As in public markets, quality matters during difficult times. We think exits will remain low in 2023, potentially leading to a real reset in valuations. Lower tier companies in their industries are likely to see the largest reductions, while top tier industry leaders that are well-managed and well-capitalized should weather the storm better.

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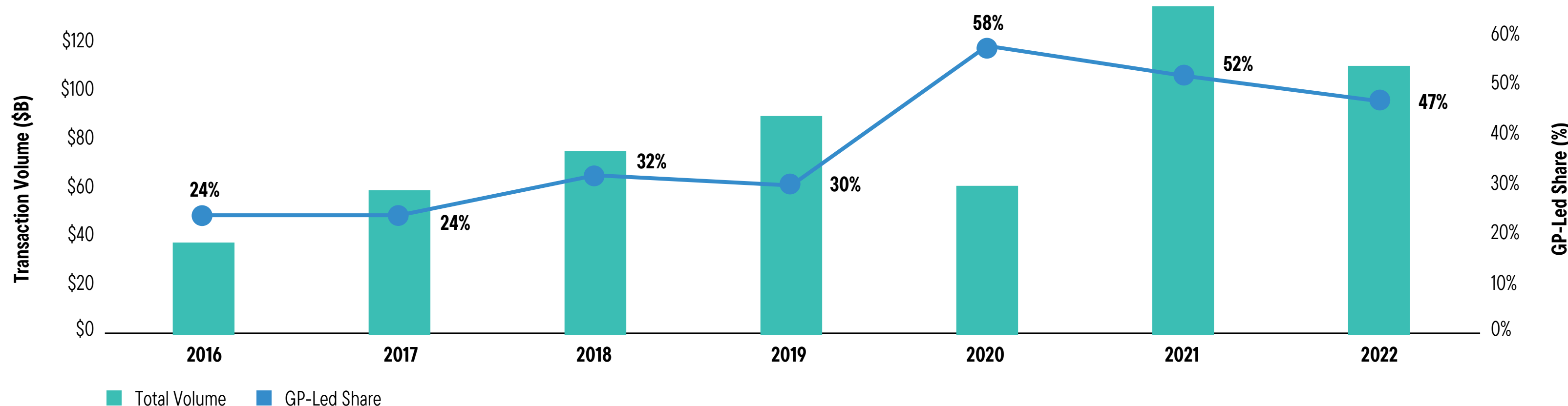
Private equity secondaries: No longer niche

Secondaries can no longer be overlooked

It appears that 2023 will be a pivotal year for private equity allocators to take advantage of the growing secondaries market. Today, secondaries markets have evolved and deepened substantially with more than $100 billion in volume in 2022 alone.[3] This emerging marketplace provides an alternative to investing purely in primary fundraises.

PE secondaries market has grown more than 3x since 2016

Annual Secondary Market Volume ($B)



Source: Jefferies 2022 Global Secondary Market Review. As of January 2023.

Secondaries are "on sale" as institutions seek liquidity

2023 presents a significant shift in the supply-demand dynamics of secondaries markets. Leading up to mid-2022, deal volumes were dominated by GP-led transactions (mainly in the form of continuation funds and single asset deals) and discounts for Limited Partner (LP) portfolios were in the single digits.

In contrast, we expect secondaries supply to significantly outpace demand in 2023. Looking ahead, three key factors are poised to sustain this dynamic. First, GP-led secondary sales are likely to rise as GPs look to extend funds to hold high-quality companies longer. Second, dry powder in the space currently stands at approximately $100 billion, down from $130 billion in 2021. With less than a year's worth of dry powder available, sellers are outnumbering buyers, which should continue to drive greater discounts in the secondary market. Third, LPs are likely to continue seeking liquidity in an effort to manage the denominator effect created by public market drawdowns. Plus, many LPs made capital commitments during the era of easy money, and the current sluggish exit environment means they need to find funding for the commitments or get out of certain positions.

3. Source: Jefferies 2022 Global Secondary Market Review.

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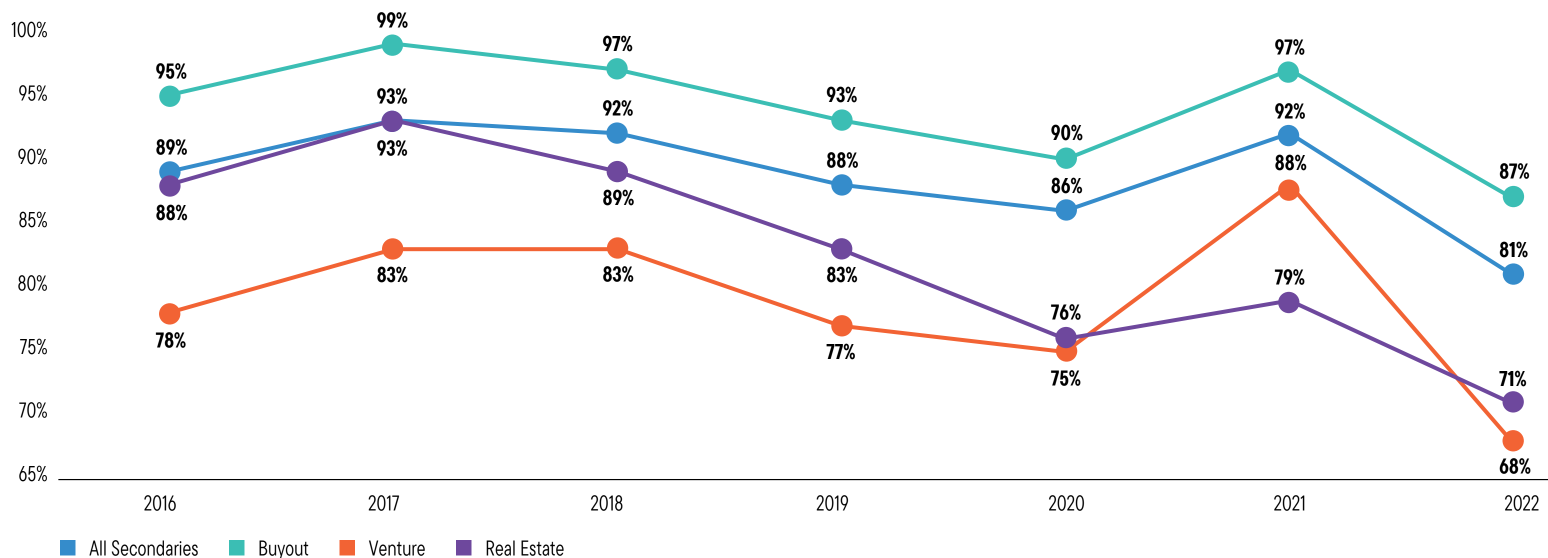
The tumultuous conditions of 2022 have created a significant opportunity in secondaries. We estimate we will see attractive discounts for buyers in the space. In 2022, the average discount on secondaries was around 19%, or priced at 81% of current NAV. That's the greatest average discount in more than seven years.

For asset allocators, secondaries allocations can help build more diversified private market portfolios by providing access to mature companies from many different managers, vintages, asset classes, industries, and geographies.

Secondaries discount largest in 7+ years

Secondary Pricing for LP Portfolios (% NAV)



Source: Jefferies 2022 Global Secondary Market Review. Transaction pricing data is sourced from Preqin database and is self-reported and/or gathered from industry professionals including fund managers, investors, and service providers. As of January 2023.

Investment implications

We are seeing a lopsided secondaries market that will likely heavily favor investors on the buying side of the negotiating table. From a risk/reward perspective, we believe 2023 will be a year to remember for secondary market opportunities.

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Private credit: Hardwired for hard times

Macroeconomic headwinds, direct lending tailwinds

The dramatic change in the macroeconomic backdrop has created headwinds for borrowers but has provided unique tailwinds for private debt managers in US and Europe. Just a year ago, private debt was maligned with a number of factors that presented an uninspiring risk/return profile, including tight spreads to public debt, "covenant-lite" loans, and substantial competition for deals. And yet, investors continued making investments and re-upping with existing managers given the lack of yield available elsewhere.

Today, the private debt asset class presents a far different picture and shows how this segment is essentially "hardwired" for a rising rate, risk-off market environment where traditional modes of financing have been shut off for corporate borrowers.

In the current environment, lenders have much greater influence to secure stronger covenants versus years past. Back on the negotiating table are fewer and smaller delayed draw term loans, maintenance covenants, and enhanced call protections. Adding to lender power is the dramatic pullback in traditional banks' liquidity in the middle market. In late 2022, major banks had approximately $40 billion of hung deals on their balance sheets.[4] Moreover, the failure of Silicon Valley Bank and recent stress on other financial institutions will likely cause banks to retreat further from the middle market lending space.

4. Source: Credit Suisse Leveraged Loan Strategy. Data as of 9/1/22.

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Although private debt has seen markdowns, fundamentally the asset class remains healthy and out of default territory. In the US market our sensitivity analysis of interest rate coverage ratios shows there is significant cushion to avoid default even if rates rise to 5.50% and EBITDA ratios decline 20%.[5] On the back of 2022's rate hikes, yields on private unitranche loans have moved into low double-digit territory versus about 8-9% for US high yield.[6]

In Europe, spreads per unit of leverage have increased, reflecting a more dynamic pricing pricing environment. The movement in the Euribor & Sonia base rates in Europe has made the total yields extremely attractive. With Euribor at 2.99% and Sonia at 4.23% the 3-year loan yields are 10.74% and 11.98% in EUR & GBP respectively.

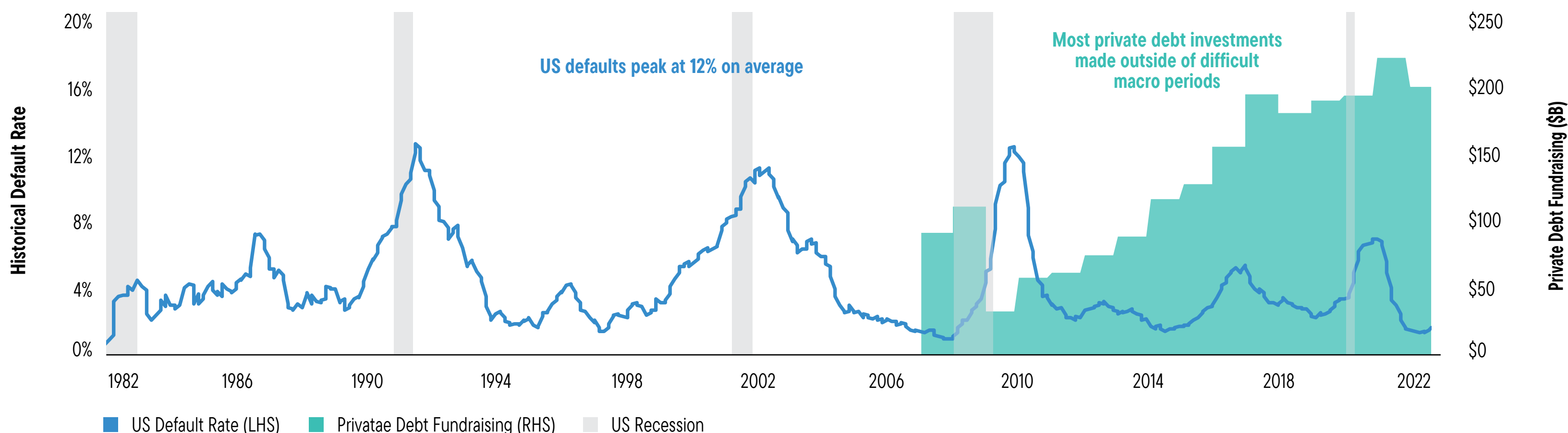
Finally, the risk-return opportunity in private debt markets remains attractive even with a revival in yields in public bond markets.

US direct lending: Potential for defaults will reveal which managers add real value

What has materially changed in private credit investing is the need for skilled and experienced workout teams in case the macroeconomic landscape worsens and defaults arise. A large portion of private debt market investments were made during a sanguine market environment without serious recessionary pressure or risk of defaults. Competition for deal flow led to more "covenant-lite" deals and demand for the asset class led to new entrants with little experience in workout situations.

A rush of private debt fundraising made during zero rate, low default environment

S&P Speculative Grade Historical Default Rates, Private Debt Fundraising, and US Recessions



Sources: S&P, Deutsche Bank, PitchBook, as of 12/31/22.

Looking ahead, tough economic environments may lead to greater dispersion in manager returns—challenging the idea that the direct lending space has become commoditized. Previous high yield default cycles peaked at 12% on average following recessions, making underwriting discipline a must-have in the coming phase. Direct lending funds with experienced workout personnel and demonstrated high recovery rates may be better able to weather the shifting credit cycle.

5. Views expressed are those of BSP as of December 2022. Cost of debt is defined as average spread of 675bps over SOFR. Assumed interest rates for SOFR ranged from 400bps to 550bps. An analysis of interest rate sensitivities is hypothetical in nature and provided for illustrative purposes only.

6. Views expressed are those of BSP based on current 2022 deal environment. Such statements cannot be independently verified and are subject to change. Bloomberg data as of 11/30/22. Based on BofA US High Yield Index Yield and BSP Private Unitranche Loan Yield to expected 3-year takeout.

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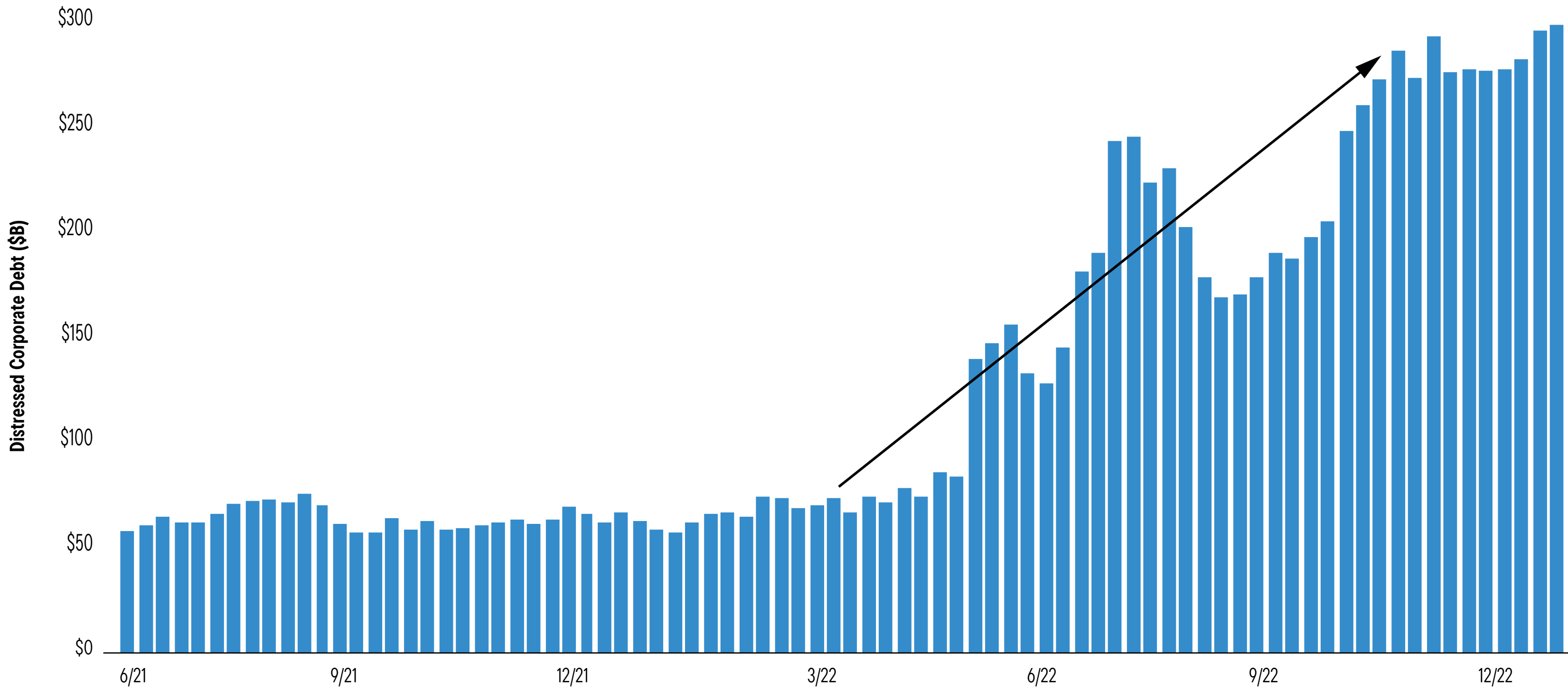
US distressed market: More good company, bad balance sheet distressed debt opportunities emerging

In other parts of private debt, there is now a much larger opportunity set in distressed debt than during the previous decade. In less than two quarters, the stressed/distressed opportunity set increased almost 400% from $75 billion to $300 billion.[7] A recession would expand this opportunity set even more.

Size of distressed debt market up +400% in past year

Value of US Corporate Bonds and Loans Trading at Distressed Levels



Source: Bloomberg, as of 12/31/22. Note: Dollar-denominated corporate bonds and loans in the Americas trading at distressed levels includes corporate bonds trading at spreads greater than 1,000 basis points and loans trading below 80 cents on the dollar.

7. Defined as loans wider than 1,000 bps and bonds trading below 80. Source: Bloomberg, as of 12/31/22.

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A phrase that many had forgotten (or never heard of) is beginning to resurface: "good company, bad balance sheet." Prior to 2022, to meet typical special situations return objectives, investors were forced to target more challenged businesses through highly labor-intensive and episodic opportunities, oftentimes at higher attachment points. Today, higher costs of capital and tighter financial conditions have limited corporate flexibility. As a result, good businesses that have made mistakes can become stressed, providing very attractive opportunities for special situations investors. An expanded investment universe and the ability to buy good businesses at a discount may provide the opportunity for attractive return potential and limited downside risks.

We believe the best risk/reward today lies within a portfolio of uncorrelated and bespoke process-oriented investments, event-driven themes, and names that stand to perform during a recessionary and inflationary environment. Current dynamics are creating these investments with greater convexity, at lower prices, and lower attachment points. It is prudent to allocate capacity today to be able to deploy dollars now and into an accelerating opportunity set.

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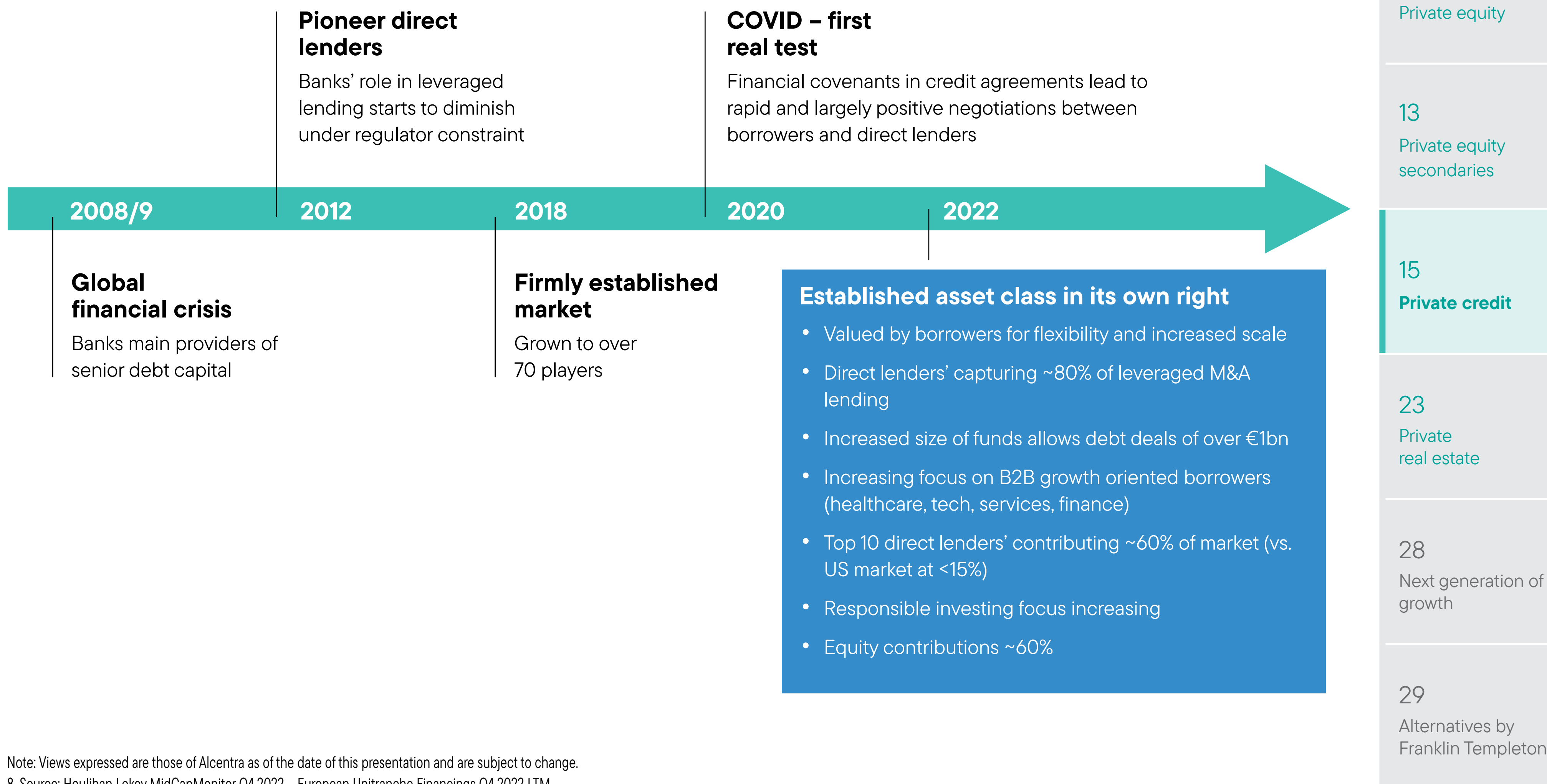
European direct lending: A favourable context for large players

The European direct lending market is about a decade old. This compares to the US market, which is about 30 years old. Europe still has largely a 'bilateral relationship' market with lenders being the sole lender with financial covenants and bespoke documentation. To give an example, 60% of transactions are controlled by the top 10 direct lenders.[8]

Today, European direct lending is an established asset class and the market has grown by nearly 85% over the last three years. It now has a good balance in terms of sectors and countries. This geographic diversification makes knowledge of credit country regimes a key requirement for private credit managers.



Note: Views expressed are those of Alcentra as of the date of this presentation and are subject to change.
8. Source: Houlihan Lokey MidCapMonitor Q4 2022 – European Unitranche Financings Q4 2022 LTM.

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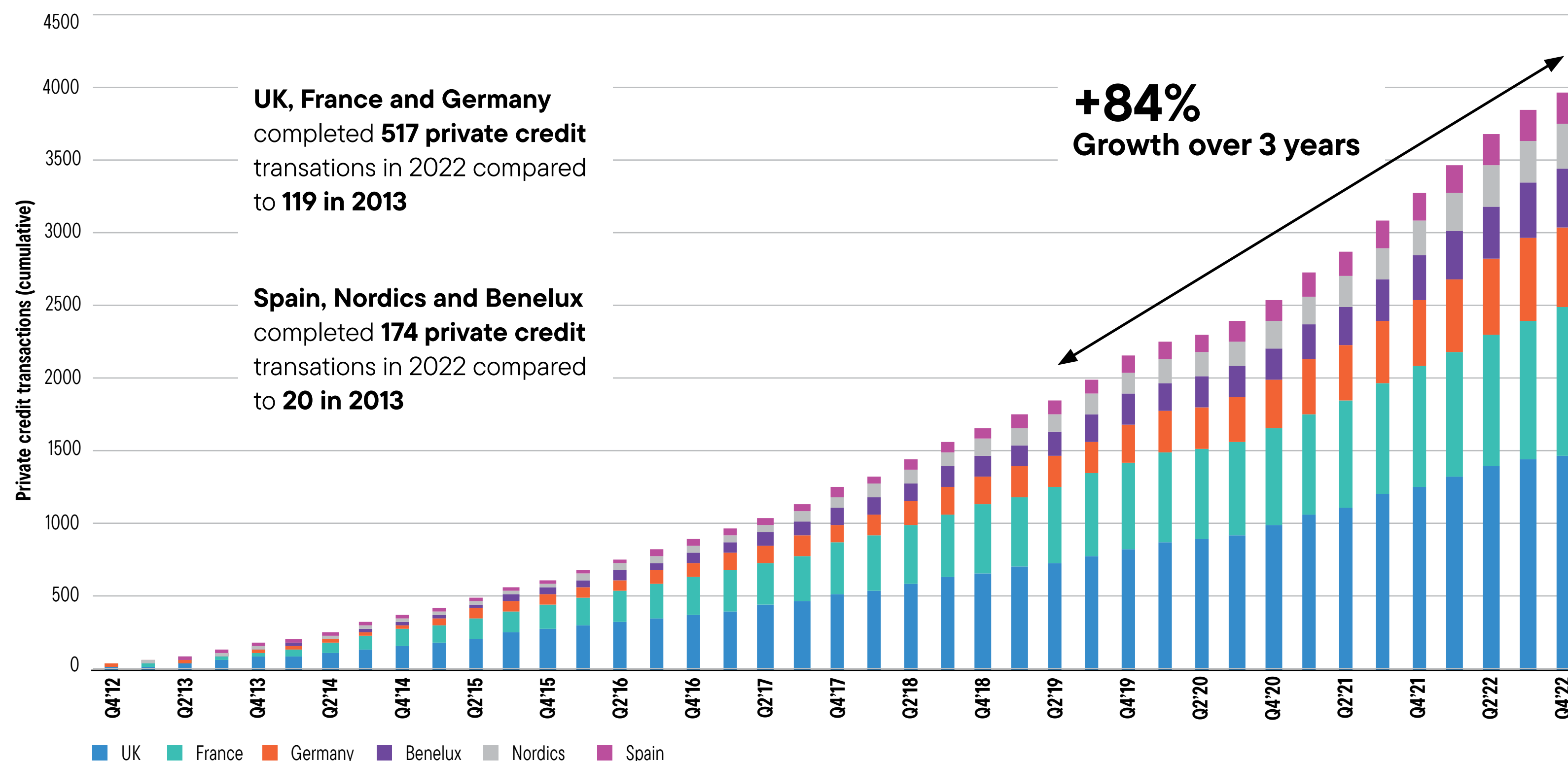
European direct lending has grown +84% over 3 years

Cumulative Growth of European Private Credit Market in the Last Decade



Source: Deloitte, as of 31 December 2022. Deloitte Alternative Lender Deal Tracker. Nordics comprises of Denmark, Finland, Norway and Sweden. Benelux comprises of Belgium, Luxembourg and Netherlands.

In terms of the current scenario, spreads per unit of leverage have increased, reflecting a more dynamic pricing environment. The movement in the Euribor & Sonia base rates in Europe has made the total yields attractive. With Euribor at 2.99% and Sonia at 4.23% the 3-year loan yields are 10.74% and 11.98% in EUR & GBP respectively.[9]

Private debt largely needs private equity as a bedfellow. As the valuation multiples in the European market have come down, private equity sponsors have chosen to hold onto portfolio companies for longer. As a result, M&A volumes have been more subdued. In this context, we have seen sponsors and advisors moving away from widely run processes and instead having targeted discussions with core lenders with whom they hold long-term relationships. We continue to see new deal flow from market-leading—private equity firms in addition to opportunities to deploy to existing portfolio companies. In fact, private debt represents a mere 20%[10] of combined dry powder available for acquisitions, where a "normal" ratio would be more like 40%-50%. The capacity for ongoing debt fundraising is apparent.

9. Bloomberg, as of 31 April 2023.

10. Source: Preqin, European data retrieved as of September 2022. Private Equity includes Balanced, Buyout, Co-investment, Co-investment Multi-Managers, Fund of Funds, Hybrid, Hybrid Fund of Funds, and PIPE strategies. Private Debt includes Direct Lending (Senior, Unitranche, Blended/Opportunistic, Junior/Subordinated, Mezzanine) and Private Debt Fund of Funds.

Managing a downside scenario: Focused on B2B sectors and restructuring expertise

In the current weaker economic environment, there are concerns about borrowers who are exposed more than usual to high energy costs (e.g., aluminium smelters, cement works, data centres, etc.) as well as borrowers who face supply chain issues. These concerns are less of an issue for B2B-focused borrowers in Europe, where the availability and cost—in an inflationary environment—of suitably qualified staff is a greater concern.

In this period, it's of key importance that downside scenarios are taken into account. Default levels will rise due to the higher cost of debt coupled with mixed economic conditions. This will bring into focus restructuring expertise which will be required to ensure the safe return of investor capital. This will likely favour larger and more experienced managers which have specific workout personnel to focus on the names in the portfolio requiring additional attention. As the jurisdictions vary across Europe, specific knowledge of the creditor regimes in each country is especially valuable.

European distressed market set to expand in size and opportunity set

The size of the European stressed and distressed credit market has grown from €70 billion pre-Covid to above €120 billion currently, based on the share of corporate leveraged loans and high yield bonds trading above 12% yield to maturity.[11] We expect the opportunity to continue expanding as eroding corporate earnings trigger downgrades and borrowers struggle to refinance at significantly higher interest rates.

Against the backdrop of rising base rates, we are already seeing early evidence of structural cracks in the European high yield and leveraged loan markets, which we believe provide the set-up for attractive risk-adjusted returns in the European stressed and distressed space. Anecdotally, the average cost of new funding for a high yield issuer stood at 3% at the start of 2022 and now stands at 8%.[12]

On the one hand, with base rates at record lows since the Global Financial Crisis in 2008–2009, most if not all leveraged buyouts had been structured based on thin debt servicing cushions. **Most businesses today are neither used nor set up to absorb a doubling of interest rates from cash-flow generation alone, which will lead to eroding liquidity and in some cases ultimately default.** On the other hand, highly levered issuers facing upcoming maturities often have a difficult time refinancing their existing indebtedness at reasonable terms, both because of rising base rates, but also due to a higher risk-aversion across the credit markets generally.

While this effect may not fully play out through 2023, there is still more than EUR 150 billion in high yield debt maturing between 2024–2026.[13] With the default rate across European high yield and leveraged loan markets standing at only 1.4% in September 2022, we could see a scenario where this could double or even triple in the next 12–24 months.[14]

11. Alcentra, as of 13 January 2023, percentages based on market value of above specified criteria. For illustrative purposes only. The universe is representative of the types of investments Alcentra will seek for its stressed and distressed strategies and is subject to change at any time. The universe is defined as capital structures with high yield bonds or loans in excess of €100 million nominal value, trading at or above a 12% yield to maturity.
12. Bloomberg, as of 11 April 2023.
13. Bloomberg, as of 11 April 2023.
14. Bloomberg and S&P, January 2023.

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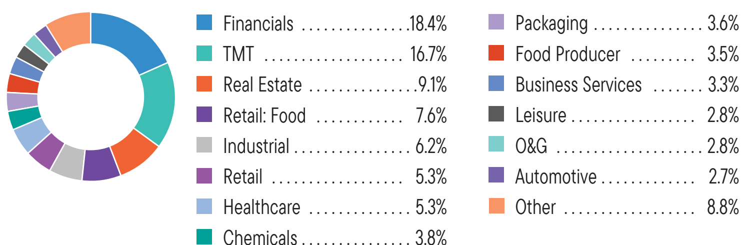
A different opportunity set versus the GFC

Unlike in many past cycles such as the global financial crisis from 2007–2009, there is a significant diversity of opportunity across sectors, some of which have historically been defensive such as food producers, telecommunications, grocery retail and healthcare.

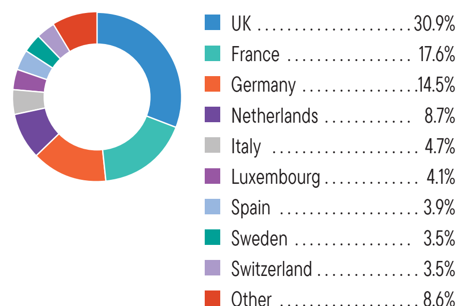
Diversified market opportunity by sector and country

HY Bonds and Syndicated Loans Trading at or Above 12% Yield to Maturity

Industry



Geography



Source: Alcentra, as of 24 April 2023, percentages based on market value that only includes large syndicated loans and bonds that are widely quoted in the market. For illustrative purposes only. The universe is defined as capital structures with high yield bonds or syndicated loans in excess of €100 million nominal value, trading at or above a 12% yield to maturity.

In addition, included in the opportunity set are recent deals with large sponsor equity commitments as well as subordinated debt, which implies a low LTV (Loan to Value) through the senior secured part of the capital structure. Since the end of Q1'23, we have witnessed a significant increase in the number of private financing opportunities at stressed pricing levels.

This context will provide an exceptional opportunity to offer creative capital structuring financing solutions and purchase senior secured debt of good businesses with equity-like target returns but without taking equity-like risk.

Investment implications

In direct lending, we see the positives of expanding yields, stronger documentation negotiation power, and still-healthy leverage levels and interest rate coverage ratios. Funds with experienced workout teams and solutions-based approaches are ready to combat higher default risks. At the same time, there is an opportunity set explosion within the distressed space with more and more "good company, bad balance sheet" investments offering attractive potential returns.

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Private real estate: Remodeling for rising rates

US commercial real estate: Higher rates will test markets, but 2008 crash unlikely

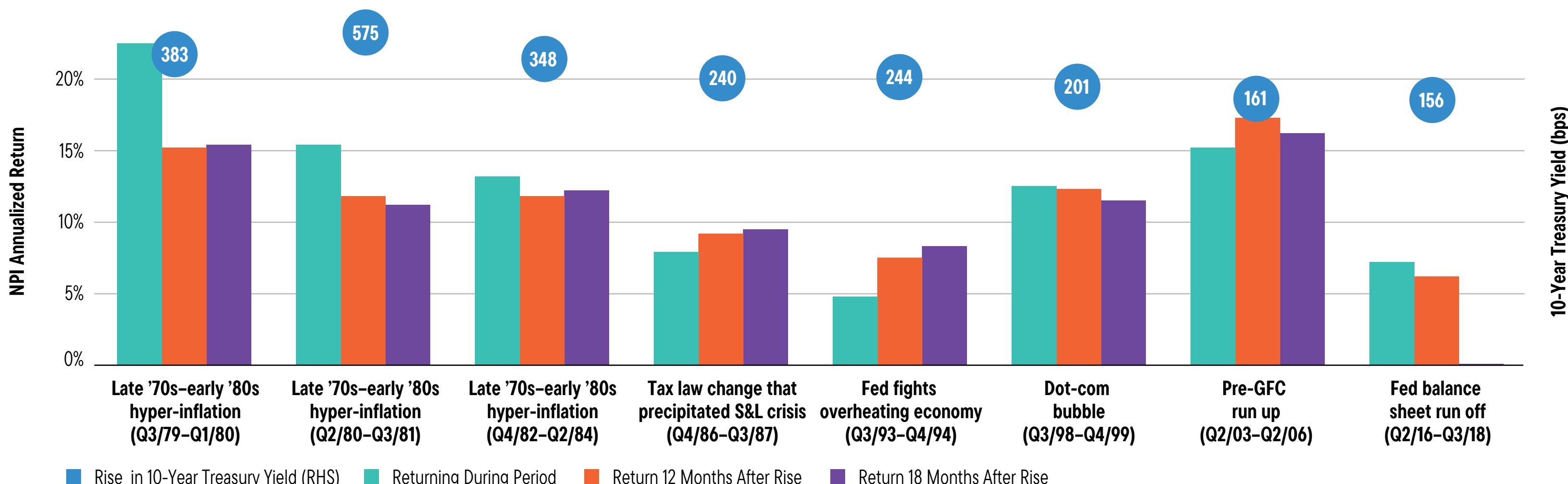
2023 looks to be a challenging year for real estate. The combination of higher inflation and rising interest rates will likely have a material yet varied impact on the US commercial real estate market in 2023. There have been some disruptions across real estate debt and equity capital markets. In 2022, ten-year financing costs ranged between 3.3% and 6.3%, up 300 basis points at their peak.[15] Higher financing costs along with tighter lending standards have added some upward pressure on capitalization (cap) rates and downward pressure on property values.

There are, however, still significant positive tailwinds. National consumer spending, labor markets, business activity, and corporate balance sheets have all continued to be relatively healthy. For these reasons, we do not believe the coming downturn will be as severe. Baseline forecasts for US economic growth are generally positive, including the expected creation of more than 2.5 million new jobs between 2023 to 2025.[16]

While every real estate downturn has its own unique dynamics, historically, US private real estate investment performance has been positive during periods of rising yields, as well as during the 12 to 18 months thereafter. In fact, looking across periods where rates rose at least 150 basis points, real estate typically rebounded with nearly double-digit returns in the subsequent periods.

Real estate performed well during periods of rising interest rates

NCREIF Property Index (NPI) Returns During Periods of Rising 10-Year Treasury Yield Greater than 150 Basis Points



Sources: Bloomberg, NCREIF, Clarion Partners Investment Research, Q2 2022. **Past performance is no guarantee of future results.**

15. Sources: CBRE, CREFCOA, Cushman & Wakefield, Greenstreet, as December 2022.
16. Source: US Bureau of Labor Statistics. Occupational employment projections to 2025, as of December 2022.

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Location, location, location ... and sector rotation

If the first rule of real estate is location, the second rule in the new environment is knowing which sectors are in need of rotation. Post-pandemic trends like remote work, e-commerce growth, and the migration of people to non-traditional urban business centers are reshuffling real estate markets.

Because of strong job growth and overall demand for commercial space, property cash flows have remained relatively healthy. While some property sectors, such as office and mall, have not fully recovered from the pandemic impacts, other property sectors have reported sizable ongoing rent growth, including industrial, apartment, life sciences, and self-storage.

Trends like remote work and e-commerce are reshuffling sector leadership

US Real Estate Fundamentals and Pricing Power by Property Sector

Weakening	Improving	Strong	Robust	
Regional mall	Infill necessity retail	Data center	Industrial	Single family housing
High-street retail	Hotel	Student housing	Multi-family housing	Manufactured housing
Office	Senior housing	Medical office	Life sciences	Self-storage

Source: Clarion Partners Investment Research, views as of December 2022.

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Overall, we expect cap rates to expand; the magnitude, however, will depend on various factors. The risk profile of individual assets (sector type, market, and lease terms) will matter significantly. High-quality assets with strong net operating income (NOI) growth should fare relatively better.

Additional support for the real estate sector includes a near-record amount of dry powder sitting on the sidelines, waiting to be invested in commercial real estate. At the same time, most property owners are not over-leveraged and are under little pressure to sell right away. For these reasons, it is likely that the transaction market will remain slow and re-pricing will not be as severe as during the global financial crisis.

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European private real estate: Further bifurcation expected as the market reprices

European real estate markets face similar challenges. The European Central Bank reversed a multi-decade policy of low interest rates and investors and occupiers have had to adjust quickly to this new regime. The yield gap of prime yields over government bonds and swap rates has reduced significantly in the past year, ending up at almost zero at the end of 2022. Furthermore, concerns around the banking sector have reduced risk appetite and further increased financing costs and limited the availability of cheap debt.

Understanding how to invest in the face of high inflation and asset repricing has led many investors to slow or pause their decision-making. Consequently, transaction activity has slowed down, with transaction volumes in many markets and sectors at their lowest since the GFC.

At the same time, we observed significant rental growth in certain sectors and markets, driven by supply/demand imbalances and demand for high quality, and even sustainable assets. By way of example, Irish residential rents increased 6.7% yoy to Q3 2022[17] and even rents in certain office markets saw significant increases—prime office rents in Central London grew c. 14% yoy to March 2023.[18]

While we believe yields will continue to soften, **we expect further bifurcation—well located, sustainable, long-term let or reversionary assets will attract significant investor interest.** But older assets with obsolescence risk in unfavoured sectors will suffer disproportionately, both due to a lack of end user demand and a lack of debt and equity capital interest.

We think transaction volumes should pick up in H2 2023 and H1 2024, driven by up to Euro 800m of commercial loans[19] coming up for refinancing in the next 12 months. In addition, we think sellers will be willing to accept higher yields as income growth mitigates some valuation losses.

Some real estate sectors could benefit from supply-demand imbalances and a focus on sustainability

One area of the market where some of the above catalysts—**shortage of supply, long term let and alignment with sustainability agenda**—are likely to converge is **social infrastructure**. These assets are defined as the physical real estate where social services are provided to local communities. Tenants at these assets provide healthcare, education, affordable housing, civil services and public safety. Unlike other real estate sectors such as office, retail or hospitality, their essentiality persists regardless of the stage of the economic cycle, making them historically less volatile and more resilient.

17. Residential Tenancies Board, Q3 2022 report.
18. BNP Real Estate, as of March 2023.
19. S&P Global Market Intelligence.

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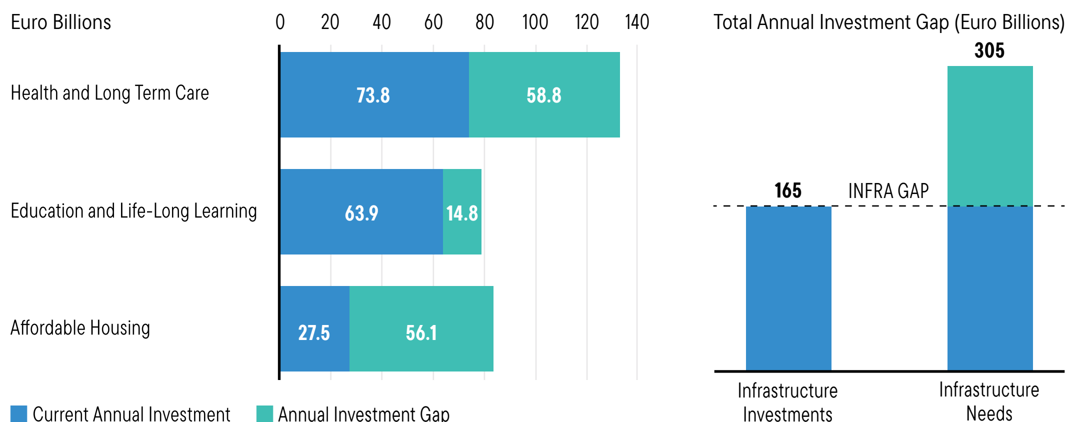
As shown below, the persistent investment gap in social infrastructure supports the view that there is little risk of oversupply.

Estimated European social infrastructure gap by 2030



Sources: European Commission, Eurostat, GIH. E=estimated. There is no assurance that any forecast, estimate or projection will be realized.

There are also specific catalysts that we feel may make the next 12 months a good time to seize on investment opportunities.

- **Price dislocation.** With many investors waiting on the sidelines, we believe having ready-to-deploy capital will be key to taking advantage of an attractive entry point for high-quality assets.
- **Transition risks.** As awareness and regulation around climate change grows, older buildings are experiencing transition risk, or the risk of obsolescence or non-compliance due to poor environmental performance. Additionally, we are seeing a parallel risk emerge that we term social transition risk, or the risk of obsolescence with a building that no longer provides adequate social value to its community or tenants. These risks lower demand, and therefore put downward price pressure on older buildings. We believe these transition risks—both social and environmental—coupled with the broader repricing across real estate, will create opportunities specifically for impact-focused investors with experience in assessing and improving the performance of underutilized assets.

Investment implications

As the market leaders and laggards reshuffle, higher inflation and rising interest rates will have material yet varied impacts on private real estate. Opportunistic investors may be able to acquire high-quality assets at a discount—and at scale—in sectors with secular tailwinds.

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Next generation of growth: The long(er)-term lens

Looking through a multi-decade lens, we see several emerging megatrends that will propel private investments for the next 10+ years. Such seismic shifts represent monumental evolutions in behavior, technology, and lifestyle that become amplified as new paradigms replace obsolete ways of the past.

Megatrends are not fads that temporarily influence the trajectory of a society then fade. Rather, these are deep-rooted transformations unfolding around us, reshaping our lives and redefining how global economies operate.

In particular, we see growing momentum in three areas. These megatrends will demand massive amounts of investment capital, fueling unprecedented opportunities for private market investors to address critical issues.

The next generation of growth drivers

Trends and technologies that will accelerate private investment opportunities

Energy transition

The long road to decarbonization

- Renewable energy
- Battery storage & science
- Circular economy
- Green industrials
- Green building technologies
- Carbon removal and capture

Food innovation

The future of food is technology

- Regenerative farmland
- Agricultural technologies
- Vertical farming
- Plant-based meats and milks
- Sustainable supply chains

Decentralization

The next evolution of commercial technology

- Blockchain
- Web 3.0
- DeFi
- Digital assets
- Metaverse
- Platforms and smart contracts

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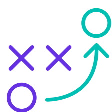
Alternatives by Franklin Templeton: Redefining investment choices

A growing alternatives platform

As alternatives have become a more important tool to help clients meet their financial goals, we have built our alternatives footprint. We will continue to build innovative products through our expanding collection of independent specialist investment managers, each of whom has deep expertise in managing alternative asset classes and investment outcomes

Specialized expertise by leading managers

Access key alternative asset classes



Choice of investment strategies and structures[20]

40 years of alternative investing[21]

$258bn alternative AUM[22]

45+ Alternative strategies[23]

	Real Assets (Real Estate& Infrastructure)	Private Equity	Venture Capital	Private Credit	Hedge Strategies	Digital Assets
Benefit Street Partners (2008) / Alcentra (2002)[24]				■		
Clarion Partners (1982)	■					
Franklin Real Asset Advisors (1984)	■					
Franklin Templeton Digital Assets (2018)						■
Franklin Templeton Global Private Equity (2000)		■				
Franklin Venture Partners (2014)			■			
K2 Advisors (1994)					■	
Lexington Partners (1994)		■				
Templeton Hana (2006)						

20. Not all structures are available for all strategies shown. Please contact your Franklin Templeton sales representative for further details. An investment in any product or account is subject to minimum investment amounts and other eligibility qualifications applicable to the particular vehicle/account or investment strategy. No offer or solicitation to offer any interests or shares of any fund is made hereby. Interests or shares of a fund are offered only through the Fund's offering documents, such as a prospectus or confidential Private Placement Memorandum.
21. Years of alternative investing based on Clarion Partners inception in 1982.
22. Source: Franklin Templeton. Preliminary month-end assets under management as of March 31, 2023.
23. Not all structures are available for all strategies shown. Please contact your Franklin Templeton sales representative for further details. An investment in any product or account is subject to minimum investment amounts and other eligibility qualifications applicable to the particular vehicle/account or investment strategy. No offer or solicitation to offer any interests or shares of any fund is made hereby. Interests or shares of a fund are offered only through the Fund's offering documents, such as a prospectus or confidential Private Placement Memorandum.
24. Franklin Templeton acquired Alcentra on November 1, 2022.

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