For Professional Clients and Qualified Investors Only. Capital at Risk.

2025 Private Markets Outlook

Foreword

As we look ahead to 2025, the road for private markets investments presents both challenges and opportunities.

Rob Martin
Global Head of Investment Strategy & Research, Private Markets

The macroeconomic environment, particularly the interest rate landscape, remains a critical factor influencing all investment decisions. We are in the early stages of a rate-cutting cycle, which has already had a positive impact on certain asset classes, notably US real estate, where we've seen sentiment improving significantly over the past quarter. However, the upward movement in long-term rates, exacerbated by recent market reactions to the US election, continues to pose challenges, in our view.

For private markets, these interest rate dynamics have influenced target returns and acquisition pricing, especially in sectors with long-term defined cashflows such as infrastructure. In the credit markets, while relatively high rates may deter borrowing, the refinancing needs of assets and businesses have driven a strong flow of transactions.

Private credit continues to deliver historically strong returns, benefiting from elevated risk-free rates and limited default experience. The asset class may offer investors some high-level tactical opportunities, in our view. We also believe real estate, particularly in the UK and US, presents potentially attractive windows of tactical opportunity due to significant repricing activity.

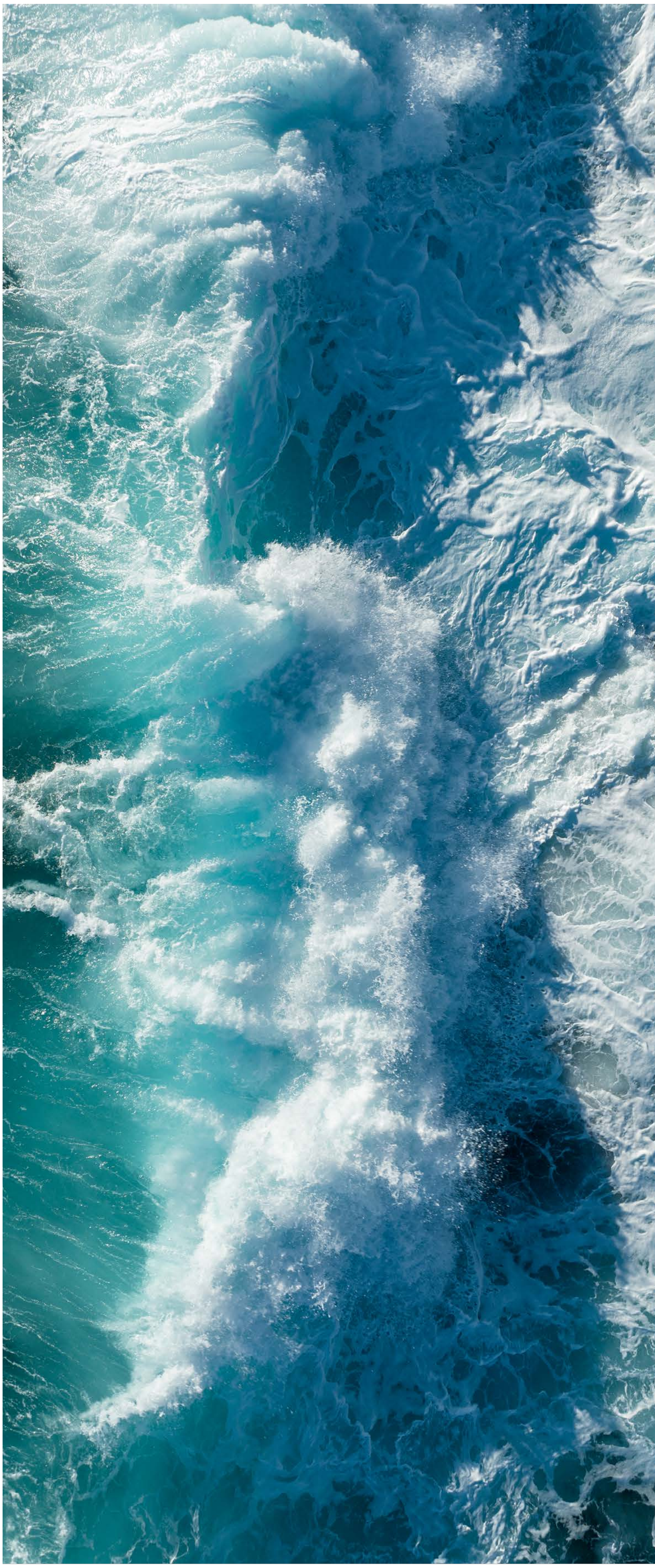
A more mixed picture is seen in the infrastructure sector, in our view. While high leverage and refinancing costs burden some parts of the asset class, others, such as clean energy and digital infrastructure, are expected to see robust asset creation. Private equity may well see a more active year in terms of transactional activity but we expect this to reflect tighter bid-offer spreads rather than a material increase in pricing and investment returns

Our approach to private markets is built on our foundational principles. We recognise the growing role of the asset class within multi-asset portfolios and advocate for a targeted, thematic approach when allocating to the asset class.

Performance within asset classes is increasingly divergent based on our core long-term themes: digitalisation, demographics, decarbonisation, and deglobalisation. This thematic focus links to specific sectors and segments, including residential and industrial real estate, digital infrastructure, clean energy, natural capital, and health tech.

Geographical diversification remains a key strategy to mitigate specific market risks, particularly in a more uncertain political and policy environment and given a historical 'home bias' among investors. We also emphasise the importance of public-private solutions, especially given the challenges asset owners have faced during periods of market dislocation. The interest rate reset has led to a dramatic slowdown in transactional activity and asset realisations in private markets, resulting in reduced liquidity and the ability to reposition portfolios.

As private markets play a growing role in portfolios, solutions that balance exposure to private markets with mechanisms to deliver liquidity for investors are becoming increasingly important, in our view.



Private Credit

Competition, dealflow and defaults

We think macro conditions are supportive of another strong year for private credit, but are watching out for higher-for-longer rates and strong bank competition.

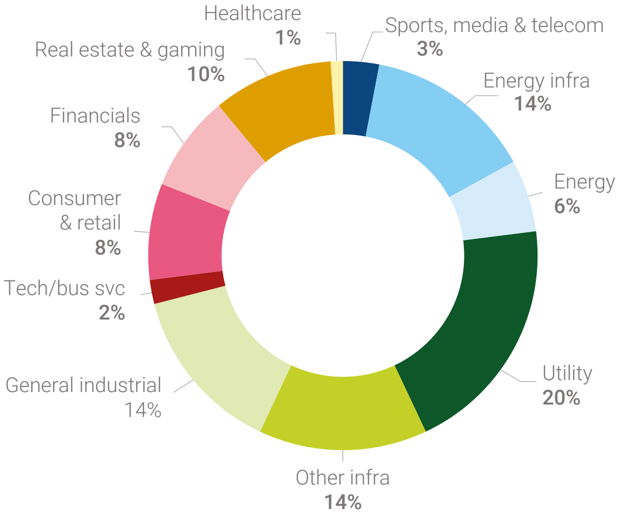
Lushan Sun
Private Credit Research Manager

Private credit demonstrated remarkable resilience in 2024, despite high interest rates. Performance has been strong across both investment grade (IG) and sub-investment grade (sub-IG). With more rate cuts expected on the horizon, we believe future returns are likely to be lower. We still think, however, the all-in yield (about 5-8% for IG, 8-12% for sub-IG debt) should be attractive in comparison to the very tight spreads in public credit.

New issuance activity was buoyant in 2024. Both IG and sub-IG markets recorded notable year-on-year growth.

Decarbonisation and digitalisation have been the leading force in driving opportunities across renewables, data centres, power networks, transportation and social infrastructure. We expect this to continue into 2025 and beyond, driven by the huge capex needs of the green and digital transitions.

Private placement issuance in the first three quarters of 2024 was largely concentrated in utilities, energy and infrastructure



Source: Private Placement Monitor, October 2024

Market competition

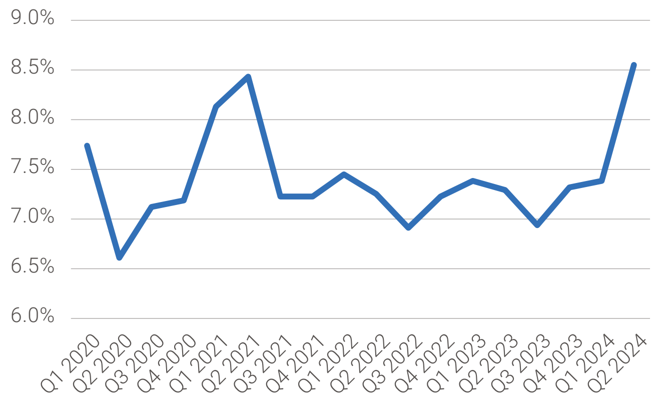
A recovery in bank lending in 2024 has increased competition. The pressure is more acute in sub-IG, where asset managers are trying to deploy over US$400bn of dry powder[1] in what we see as a weak M&A environment (a big proportion of sub-IG private credit deal activity is driven by private equity transactions). This has led to a significant compression in direct lending spread over 2024 and, in our view, raises the risk of lenders underwriting riskier deals which could create problems in future years.

We expect a revival in M&A activity in 2025, supported by deregulation under Trump and further rate cuts. This should, we believe, tilt market dynamics in favour of private credit lenders, as an increase in investment opportunities is likely to reduce the pressure on credit spreads. However, given the general macro uncertainty and competitive pressure from banks, we stress the importance of robust underwriting and structural protection and being sufficiently rewarded for any risk taken.

Wary of complacency

Defaults in sub-IG private credit have been, in our view, surprisingly low given elevated interest rates – most indicators range between 2% and 4%[2]. Strong earnings growth and cost management are the primary drivers. Another contributing factor is the increasing use of payment-in-kind (PIK), which has helped borrowers conserve cash and avoid defaults. While the use of PIK is not necessarily a sign of financial distress, we are wary of complacency. Trump's re-election has, in our view, raised the risk of higher debt costs for longer. We don't believe borrowers who over-leveraged during the pandemic years are completely out of the woods yet.

Payment-in-kind interest is becoming more prevalent in sub-IG private credit



Source: Cliffwater, September 2024

> **"We stress the importance of robust underwriting and structural protection and being sufficiently rewarded for any risk taken."**

1. Source: Preqin, as at November 2024
2. Source: Proskauer, Goldman Sachs, KBRA

Finally, 2024 was the year that private credit lenders joined arms with banks as they looked to additional growth avenues. Many partnerships have been announced, most notably the US$25bn direct lending programme between Citi and Apollo. The 'coopetition' model should, in theory, allow banks to retain client relationships and offload balance sheet unfriendly assets. Private credit lenders can leverage banks' enormous network and underwriting expertise, enabling diversification into a broader array of asset classes and a wider client base.

Good risk management will be core to the success of these partnerships, in our view. However, they could expand capital to parts of the economy underserved by banks, therefore proving a positive for growth in GDP and the asset class generally. Risk management does not fully eliminate the risk of investment loss.

Private equity and venture capital

Private equity and venture capital went through another challenging year in 2024, as both dealmaking and exit activity remained sluggish.

Despite the difficult backdrop, private equity and venture capital both registered positive returns over the last 12 months, according to Preqin data. In our view, this reflects general partners' (GP) reluctance to mark down asset values which has caused a mismatch in buyer and seller pricing expectation and contributed to the market slowdown. Lower rates should help close the gap, although we expect buyers to remain focused on fundamentals as GPs try to exit the backlog of portfolios companies that has built up since 2022, holding valuation multiples in check.

One bright spot has been AI and machine learning. Capital invested year-to-date in this sector across both private equity and venture capital reached over US$150bn, nearly 60% higher than 2023[3]. There may be question marks over the valuation and long-term profitability of AI companies, but we expect the sector to continue driving investment activity in 2025.

UK university spinouts

The UK university spinout sector, in our view, is a highly impactful asset class that can offer exposure to growth businesses across key industries such as healthcare, clean energy and advanced computing. As a result of maturing ecosystems around key university hubs and supportive government policies, we are now seeing the UK spinout market enter its next phase of evolution.

This unique combination has fostered an environment conducive to the growth of innovative businesses, where companies are now being built to scale and take products directly to market, as opposed to developing products for earlier acquisition by tech giants or large corporates.

As the sector enters the next phase in its evolution, we expect to see a UK spinout market which we believe will better facilitate the creation of global industry champions of the future, putting it on the cusp of significant growth.

3. Source: Pitchbook, November 2024

Real Estate

Growing confidence

Despite the risks, we expect 2025 to be a much stronger year for asset performance and market liquidity.

Bill Page
Head of Real Estate Research

Lower policy and market interest rates over 2024 had helped real estate yields stabilise, with tightening in some cases. We think uncertainty regarding the future path of rates weakens conviction for meaningful real estate yield compression next year.

This has already been broadly anticipated in many forecasts, however. In the UK, PMA predicts a modest -20 bps over 2025-2029[4] while in the US, Green Street eschews yield forecasting and places its emphasis on operational income growth. This allies with our view on markets: Real estate returns are expected to be reasonable, based on yields that have already reset and subsequent income growth – not yield compression.

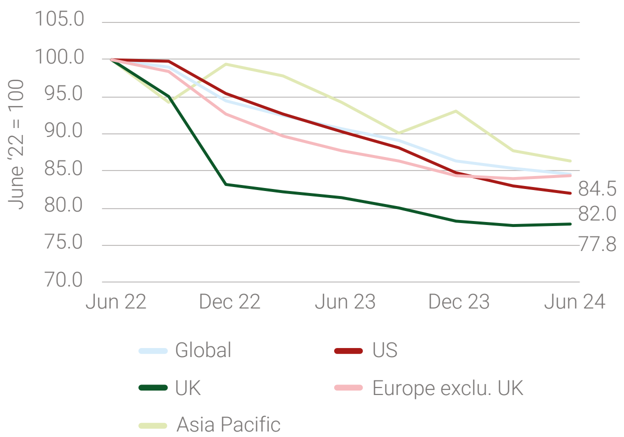
In our view, market pricing and valuation, which bifurcated in 2022, now appear closer, suggesting most of the correction has now happened and that there is greater confidence in fund and asset valuations. Valuation yields also look very close to where our models suggest 'they should be', albeit with the UK marginally ahead of the US and Europe.

The risks to such models are market interest rates settling higher for the near–to-medium term (i.e., ignoring current volatility) with income growth insufficient to compensate.

4. Source: Property Market Analysis, as at September 2024

Although economic growth is unexciting, it is not recessionary. The UK's budget was deemed to have a broadly neutral effect on growth expectations. Trump's re-election is broadly seen as pro (nominal) growth, albeit more inflationary. The situation in Europe is more sluggish, although recent readings beat expectations. We therefore expect modest income growth. PMA, for instance, forecasts 2.4% annually for Europe and 2.7% per annum for the US over the 2025-2029 period for prime real estate.

Valuation changes since market peak, H1 2022- H2 2024



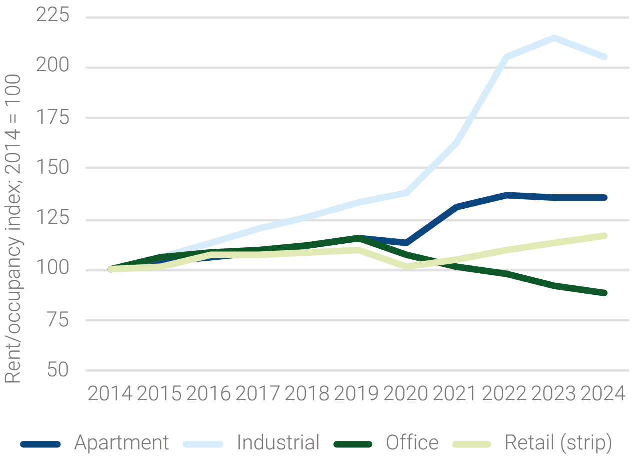
Source: MSCI, Legal & General as at June 2024

"In our view, market pricing and valuation, which bifurcated in 2022, now appear closer."

Our sector views

Identifying the locational and sectoral tilts to beat these averages is, of course, key. The market consensus remains broadly focused on living and industrial sectors, which is understandable given compelling structural tailwinds. We believe selectivity is critical for relative performance, preferring multi-let and urban logistics relative to regional logistics and a very geographically targeted residential allocation across specific tenures.

Occupancy trends in the US, last 10 years

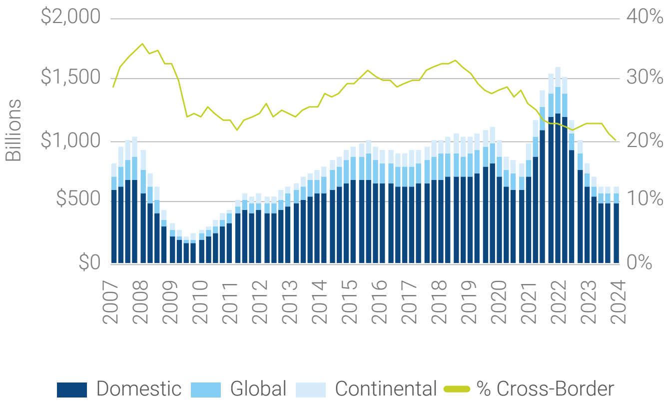


Source: Green Street, Legal & General, as at September 2024

We acknowledge slowing performance in industrial leasing but see this as a temporary pause after exuberant take-up during the pandemic. We are broadly more cautious on retail than the consensus, with less bullish views on the consumer. We are, however, aligned with strategies around repriced assets in suitable lot sizes. Offices remain difficult – on average – but extensive repricing creates opportunity for resilient assets in specific locations. It is difficult, however, to see investors taking binary locational risk in this sector; this could become a crowded trade.

Investment volumes remain low, with global capital historically hesitant. This is inconsistent, we think, with our more positive narrative for sector performance. We reason it reflects the slow journey between positive pricing signals to fund raising strategy to deal execution. We expect 2025 to be a much stronger year for asset performance and market liquidity.

Global real estate investment volumes by source (to Q2 2024)



Source: MSCI (RCA), as at September 2024

Leasing activity in industrial sectors has slowed. But rental growth remains positive, suggesting rental tension remains with occupiers accepting of higher rents despite pressure on their costs. We see the sector as well supported by the '4D megatrends' with, for instance, deglobalisation encouraging the on- or near-shoring of supply chains and decarbonisation encouraging more efficient delivery networks close to population centres.

We see residential sectors offering investors outperformance while providing societal benefit. There is diversification across tenures with, for instance, Build-to-Rent residential offering rental growth linked to wage and economic growth while Affordable Housing has a more explicit inflation linkage. Demographic pressures will support long-term demand, in our view, with spatial differences in urban growth, identified by investors' modelling, allowing for tilts relative to benchmark.

Infrastructure

Revisiting the lessons of 2022-2023

The trajectory of inflation and interest rates will likely play a crucial role in determining infrastructure capital flows and valuations next year.

Marija Simpraga
Infrastructure Research Manager

In 2024, while total returns remained resilient on average, fundraising and transaction volumes remained under pressure, likely due to the elevated interest-rate environment. Infrastructure valuations stabilised, albeit at a somewhat subdued level compared to historical averages. Given the US election result, our view is that inflation and interest rate trajectories will remain crucial for infrastructure capital flows and valuations in 2025.

Amid growing uncertainty, investors will likely keep lessons learned from the 2022-23 period front-of-mind. During this time of elevated inflation and rising rates, infrastructure assets with resilient, inflation-linked cash flows underpinned by structural tailwinds continued to perform well. The uplift in earnings growth in most instances compensated for the impact of rising rates on capital returns.

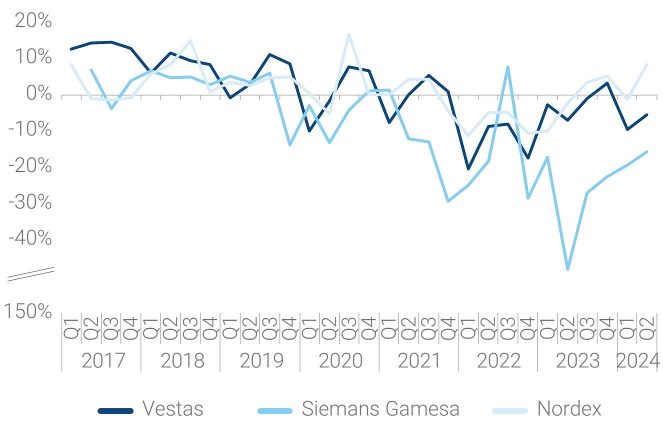
Digital and clean energy sectors remain key areas of growth, in our view. Nuances, however, are emerging with respect to their earnings and growth potential.

Clean energy

Renewable valuations and growth prospects are more subdued, coming under fresh pressure following the US election. The main concern following the election, in our view, is the prospect for higher costs pressuring new project economics for new clean energy assets in the US due to possible tariff hikes and Inflation Reduction Act subsidy rollbacks. While the risks are very real, we still expect clean energy demand to be boosted significantly due to strong growth in power-intensive data centre capacity in the US. Wind and solar remain among the cheapest forms of new capacity in the US and many key markets globally.

Lower clean energy demand in the US could put downward pressure on wind equipment prices. In the short term, that could be seen as beneficial for European wind projects, which may benefit from lower costs. However, equipment suppliers are operating with stretched balance sheets and low margins. We believe that longer-term, sustainable cost declines will require a stable and healthy supply chain.

Wind equipment manufacturers' EBIT margins



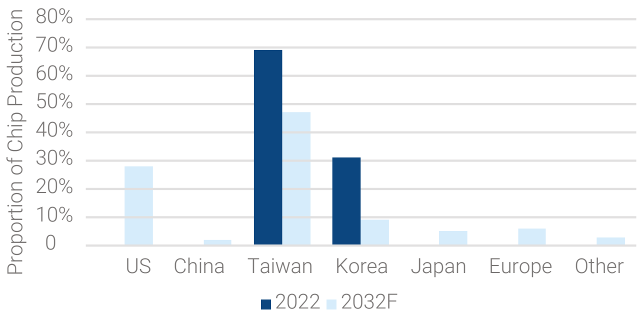
Source: BNEF, as at September 2024

Digital infrastructure

Digital Infrastructure bucked the broader trend of falling capital flows and transaction volumes in 2024. As artificial intelligence-related (AI) growth is expected to accelerate, we expect the demand for digital infrastructure assets to remain robust in 2025. Given the hard constraints on available asset supply, we believe the demand-supply imbalance should continue supporting asset pricing and capital flows.

The insatiable demand for data has driven data centre power capacity forecasts towards at least doubling by 2030[5]. With record-low vacancy rates, rising construction costs, power supply constraints, and Big Tech signalling further AI infrastructure spending, data centre rental growth is expected, particularly in primary markets. The advance of AI is also providing tailwinds to fibre, with generative AI expected to require at least 10 times more fibre connections within data centres than is traditional[6]. But the AI tailwind is not without risk, in our view, with geopolitical tensions surrounding chip manufacturing becoming increasingly evident and an equivalence forming between national security and data centre power capacity for AI [7,8].

High-end chip manufacturing locations



Source: BCG[9], as at May 2024

With the rapidly evolving landscape and concerns on cybersecurity and secure communications, we see a deglobalisation of data through the rise of data and AI sovereignty[10]. This could, in our view, drive relatively greater growth of digital infrastructure in Europe. Despite EU regulations on AI, we expect the technology, as well as cloud migration and data sovereignty, to drive a strong net positive demand in Europe.

Finally, we see the data centre buildout aligning with environmental, social and governance targets, suggesting greater regulation on power efficiency and increasing renewables developments to come, particularly in Europe. The balance between fully embracing AI's capabilities while ensuring safety, security, and adhering to climate targets will be central to the future of digital infrastructure development, in our view.

"The insatiable demand for data has driven data centre power capacity forecasts towards at least doubling by 2030."

5. AI power: Expanding data center capacity to meet growing demand | McKinsey
6. Corning and Lumen Reach Supply Agreement on Next-Generation Fiber-Optic Cable to Support Data Center AI Demands - Aug 1, 2024
7. Opinion: New energy sources for AI, data centers are vital to U.S. national security - MarketWatch
8. Memorandum on Advancing the United States' Leadership in Artificial Intelligence; Harnessing Artificial Intelligence to Fulfill National Security Objectives; and Fostering the Safety, Security, and Trustworthiness of Artificial Intelligence | The White House
9. BCG, Emerging Resilience in the Semiconductor Supply Chain, May 2024
10. Considerations regarding Sovereign AI and National AI Policy, November 2024

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

LGIM talks

The LGIM blog