Value-add opportunities in private markets

BROUGHT TO YOU BY THE MULTI-ASSET SOLUTIONS TEAM

2022 MARKET OUTLOOK

As we wrote when the pandemic took hold, COVID-19 created a forced inflection point for many business and consumer activities. The lists of “unprecedented” developments have only grown longer. With all this change, much remains unknown.

In business and technology, we speak of the S-curve, the concept that people and processes adapt glacially until an inflection point or force for change occurs, after which change accelerates rapidly. New ideas eventually mature and stabilize over time, with increases in performance for those who captured the trend. Now, the forces that shape our futures — the economic developments, the business process, the global tensions, the political ideas — are all being magnified and reshaped.

In our 2022 Outlook, we explored how these fault lines are resulting in higher volatility and lower index returns. In private asset classes, these changes are magnifying the value-add that patient capital and seasoned investment teams bring to the table. In private credit and private equity, this is a return to business as usual, where picking the right market, robust due diligence, and ongoing manager support drive outperformance. Real estate opportunities, by contrast, have been more acutely affected by pandemic-era changes related to remote work and rapid technological adaptation.

This piece explores developments in these asset classes and how investors may capture them.

NEW YORK LIFE INVESTMENTS

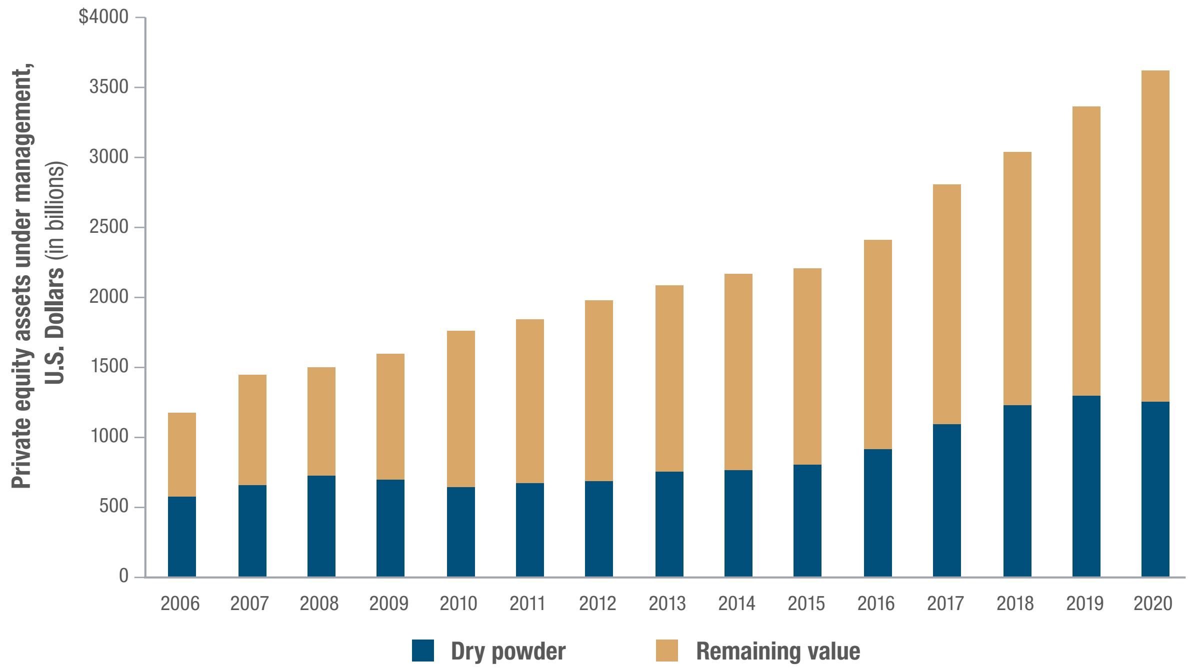
Strong fundamentals in private equity and private credit portfolios

Pandemic-driven stress at the portfolio level has all but faded. After just a few months of investors' retrenchment, record-high levels of dry powder pushed private equity sponsors back into deal-making. Private equity and private credit financing providers are thus back to business as usual, but with a different backdrop. Rising costs and interest rates generate a new set of business risks to navigate.

Supply chain and labor cost increases. Post-pandemic stresses such as supply chain disruptions and a shifting labor market are unlikely to resolve in short order. This creates a risk, if not likelihood, of margin compression for many businesses. For now, we do not see additional persistent cost pressures as an existential threat to middle market investors. For starters, rising costs are a function of higher demand, and strong top-line growth points to a healthy portfolio even at lower margins. In addition, companies have built up a healthy war chest of liquidity throughout the pandemic, giving them some cushion to navigate a potential cash flow squeeze if demand tapers off. Strong relationships with portfolio companies provide insights into these dynamics, improving marginal investment decisions.

Rising interest rates generate non-linear risks. Interest rates have several potential impacts on private equity and private credit investment opportunities. *The first is valuations*. In theory, rising policy rates increase the cost of capital in an asset class and result in a downward push on valuations. For many investors, this would be a welcome opportunity; however, we are not convinced that a strong valuation reset in private markets will play out as interest rates rise. With high levels of capital raised in the last cycle now being deployed by private equity sponsors, and mergers and acquisitions coming down the pipeline, we expect continued support for the asset class.

Available capital was increasing into the pandemic crisis



Sources: New York Life Investments Multi-Asset Solutions, PitchBook, 12/31/20.

The second is real borrowing costs for companies. Here, too, we are less concerned in the near term. Private credit financing is dominated by pricing floors; the economy is likely more than a year away from the policy rate increases required to create a discernible increase in borrowing costs for companies. At the same time, strong demand keeps revenues and cash flow strong, even in the face of margin pressure.

The third and final impact of interest rate increases is its effect on demand. Here, we are more cautious, because strong top-line growth is one of the factors driving corporate resilience against rising costs. In our view, though, the ability to navigate fluctuating real demand is an assessment made in the due diligence process; afterwards it may be too late. This is why careful credit analysis, even in highly competitive bull markets as we saw in the last economic cycle, is critical. That said, investment teams able to assist their portfolio companies in navigating the macroeconomic cycle may help manage overall returns.

Investment strategies to capitalize in private equity and private credit

The pandemic crisis was unique in so many ways; one of them is the type of company that proved resilient to its disruption. Before the pandemic, larger private companies were broadly perceived as safer from and more diversified against a macroeconomic shock. The pandemic shifted this perception and drove a focus on manager practices.

- **Leverage repeatable playbook.** Both the Global Financial Crisis and the COVID-19 pandemic were highly unusual economic cycles with vastly different consequences. The next cycle will likely look different, too. The complexities of private capital give investment teams more opportunity to create value. Managers with a proven, repeatable playbook, tested across multiple market cycles and strong market reputation are more likely to weather the next storm.

- **Credit evaluation is still key.** In debt products, protecting principal and generating income are primary goals. Within this context, the return profile for investors is asymmetric: upside potential is capped, with downside including a default scenario. The ability to evaluate credit can add significant value in periods of vulnerability. And while quantitative analysis is a vital component of this process, qualitative analysis — including an understanding of market dynamics and the borrower's levers of value creation — is just as important. Given rising post-pandemic cost pressures, managers are heavily focused on evaluating vulnerability to margin pressures when assessing new credits.

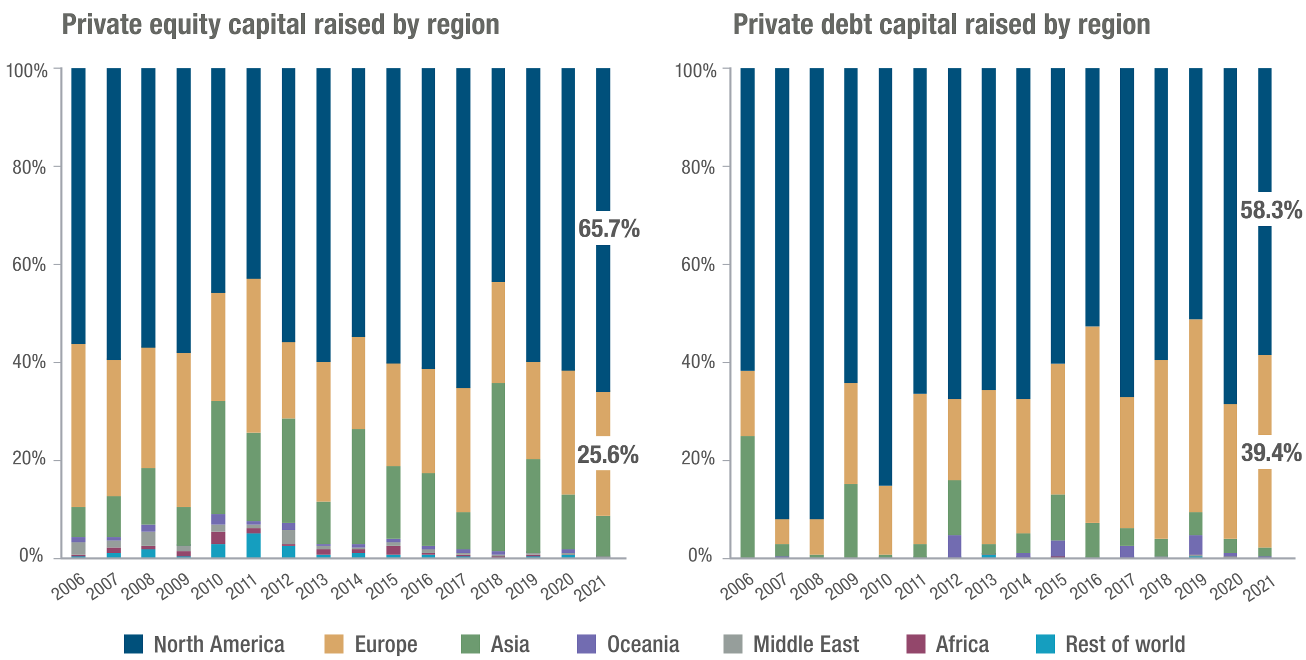
- **Find a durable capital base.** Investors backed by a long-term, persistent capital base can leverage two benefits during various market periods: (i) provide flexible, durable partnership to select borrowers facing near-term constraints, and (ii) more readily invest when tailwinds are strong, and debt issuers have their choice of capital providers. A long-standing approach to the market can also help in sourcing the best opportunities over time. In order to turn down unattractive deals, investors must have a strong pipeline that allows them to be selective. This takes time and infrastructure, which aren't always available for new entrants.

- **Consider cross-asset relationships.** Some asset classes, such as private debt and private equity, are deeply intertwined. This can result in correlated risks; where distress in one asset class can impact another. However, it can also create coordinated levers of value. Leveraging general partner (GP) relationships across asset classes could generate new opportunities, including an essential link into co-investment.

Geographic differences regionally and within regions

Not all markets develop in the same way. As the post-pandemic environment shifts, so too will investor opportunities. For this reason, we believe diversification is a best practice in private markets just as in public markets. While the North American market for private equity and private credit has historically dominated, European private financing is on the rise. The regions' differing historical backdrops and funding environments raise the stakes — and opportunities — for investors.

Private equity and credit financing are gaining traction in Europe



Sources: New York Life Investments Multi-Asset Solutions, PitchBook, 6/30/21.

The U.S. is large, mature, and fairly homogenous in structure, increasing competitive pressure for larger deals. By contrast, the European market is more fluid — growing, maturing, and expanding where its U.S. peers are more rigid. It is also more fragmented, with documentation, origination strategy, and banking structure varying by country. This creates an opportunity for private credit partners who can navigate a decentralized region, offering distinct advantages to investors.

Across geographies, our investment teams see a benefit in investing into more specialized markets. In some markets, investors can trade in and out of deals and loans more quickly. For others, assessing opportunities, selecting managers, and evaluating solid borrowers can take years of infrastructure creation. This operational know-how can generate higher or more durable returns, but it's not available everywhere. In private debt and private equity in particular, we consider the middle market to provide a stronger source of potential value-add.

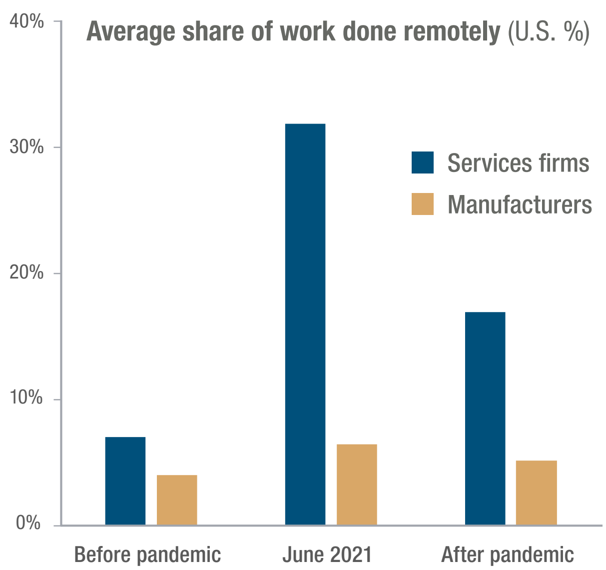
Special thanks to our colleagues at Kartesia (European private credit), Madison Capital (U.S. private credit), and PA Capital (U.S. private capital), whose expertise in middle-market private lending shaped this perspective.

Shifting tenant needs in real estate

Before the pandemic, conditions in U.S. and European real estate were healthy. Although capitalization rates were historically low across a full range of property types, this was largely a reflection of low interest rates and flat yield curves. The lessons of the Global Financial Crisis remained top of mind and capital was being deployed in a disciplined way.

The onset of COVID-19 created a deep sense of uncertainty in the sector when much of the world's workforce was locked down overnight. While the logistics and high-quality residential sectors have benefited from this shift, office and hospitality real estate have been challenged. In addition, no two countries and indeed no two cities reacted in the same way to this change. For example, Co-Star reports that office rents in New York City have declined by -2.7% year-over-year as of Q3 2021, whereas those in nearby Providence, Rhode Island have increased by 5.3%.

Changes in working environment impact real estate needs



	U.S. Vacancy rate	Rent growth, (YOY, %)
Multifamily	4.5%	10.6%
Industrial	4.6%	7.1%
Retail	4.8%	2.0%
Office	12.3%	-0.4%

Sources: NYL Real Estate Investors, CoStar, Federal Reserve Bank of New York, 11/15/21. Vacancy rates are as of Q3 2021.

Investors initially met this unprecedented wave of uncertainty by reducing risk tolerance. However, as economic reopening gains traction, the cyclical and structural change created substantial opportunities for investors with access to patient capital, and the ability to leverage that capital in the right locations, sectors, and value-add uses across diverse geographies.

Pandemic-driven conditions intensify structural investment themes

After two years of inactivity and uncertainty, the winners and losers of the post-pandemic environment are becoming more apparent. For example, the recovery is visible in modern logistics and high-quality hospitality and residential markets. Demand for office space has been slower to rebound but is increasing now that tenants are rebalancing their occupational footprints. In almost all cases, office space choices are being heavily influenced by ESG considerations and energy efficiency.

Three major trends that have emerged in this reopening environment.

1. **Undersupply.** Before the pandemic, high-demand real estate, and particularly multi-family housing and urban logistics, was chronically undersupplied. Construction activity was rising in response, but stalled or slowed due to pandemic lockdowns. Now, as demand recovers, the construction time lost has intensified supply shortages. In many markets, changes in demographics and technology-driven workplace changes are driving even greater demand. The breadth of areas that need more space is therefore increasing.

2. **Short-run supply chain shock.** Just like other economic sectors, tenants across property types are observing that supply chain disruptions limit their leasing choices in certain geographies. Recent rises in construction costs exacerbate bottlenecks and create further delays to construction timelines. As a result, the shortage of ready-to-lease space is now acute in many markets. Major real estate developers report vacancy rates in residential real estate, warehousing, and logistics at or below 5% in many markets. Some agents are already reporting tenants competing aggressively for space, and rising rents are once again a feature of the property markets.

3. **ESG effect.** This scarcity “shock” effect on rents is being accentuated by a strong emphasis from tenants on quality of space, amenities, and ESG credentials. This is visible in all sectors but is particularly pertinent in office markets, where spaces with highest-level energy certification are limited. Landlords of high-quality certified assets are therefore able to charge higher rents. Knowledge-led office markets and innovation-oriented firms, that rely on first-tier amenities to attract talent, are particularly susceptible to this trend.

Investment strategies to capitalize in real estate

In our view, focusing on changes in global real estate supply-demand imbalances provides a significant opportunity to allocate capital, reduce downside risk, and create upside opportunity. This opportunity is likely to be largest early in the recovery cycle, when tenants are eager to position themselves for recovery, and the long shadow cast by the COVID-19 pandemic continues to affect institutional risk appetite and asset pricing. Teams with the capability to identify and broker high-quality assets where demand is likely to improve, allow investors to capitalize on those opportunities.

Our investment teams are leaning into a few key strategies:

Investing for growth and tenant need. Shifts in tenant demand, and deferred decisions about space, increase the likelihood of an upgrade cycle. Supply-demand imbalance amid historically low vacancy levels likely points to an increase in rents for the best space across logistics, residential, and office markets. Investing ahead of this rental growth cycle presents a significant tailwind opportunity for investors.

Value-added asset management & repositioning. We are seeing signs that the market is already adapting to new real estate needs. Climate resilience and green-sensitive building practices are important examples in which increased attention to certain specifications is driving demand for change. This trend has two important implications for real estate investing. For one, refabrication needs generate substantial value-add opportunity for alert investors. For two, shifting real estate needs and uncertain pricing are driving portfolio rebalancing activity. The incidence of failed and disrupted sales processes is rising, as is the probability of off-market trading.

Given low interest rates and relatively tight lending spreads for senior financing, our investment teams believe this window presents significant opportunity for those who have access to debt and equity capital, the capacity to price CAPEX risks, and the appropriate asset management skills to manage the process of repositioning.

Financing evolution. All of this change, transition, and repurposing needs to be financed, and that requires substantial and patient capital. The relative availability of that capital drives opportunities across sectors and geographies. For example, in Europe, stronger regulations have made banks more hesitant to participate in higher-risk strategies. This uncertainty, particularly in a financing market that has historically been dominated by banks, creates space for private markets investors to scale and increase their exposure to stable income with limited downside risk. This is just one example, but developments like this could constitute a welcome income stream for institutional investors who are struggling with the convexity challenges and negative real yields in public fixed income markets.

Geographic differences regionally and within regions

No two markets provide an identical backdrop for investing. Our investment teams point to a few major differences between how pandemic-driven real estate trends are playing out in different regions and cities.

	United States	U.K. and Europe
Location	Pandemic accelerated migration to sunbelt states. First-tier cities remain attractive, but rents may plateau at levels lower than pre-pandemic highs.	No significant migration away from larger cities. Opportunity remains diverse as rents are historically low and supply is tight in a large number of cities.
Inflation	Strong economic growth, fueled by sizable government support, contributes to uncertainty about cyclical and structural inflationary pressures. Inflation concerns are driving investor interest in real assets.	Spare economic capacity makes inflationary concerns less pronounced, but the market is sensitive to fixed income risks and is experiencing increased allocation due to investor hedging.
Valuations/price	Valuations have risen quickly over the last 12 months, reflecting the economic recovery. However, value gains vary widely by property type. Population mobility in the U.S. is higher than in other markets, supply varies widely, and repositioning dynamics are in play in sectors where demand continues to build. This creates localized imbalances and opportunities for investors.	European urbanization trends remain intact, and growth remains focused on the top 50 cities in the region. However, the pattern of sector divergence in valuations has been dramatic. Investors remain uncertain about office valuation. Risk tolerance has reduced. Prices for non-core assets that require value-add/repositioning have fallen, while core asset prices are now higher than pre-COVID-19.
Biggest risk	Relocation catalyzes the shift of high-income workers away from gateway cities. Policymakers raise taxes, causing more people to leave, and driving property of all types to underperform.	Construction cost inflation makes it difficult to execute much needed value-add upgrades, frustrating investors who cannot execute their strategies to accommodate tenant demand and creating “stranded asset risk”.
Financing	The U.S. market has a highly evolved capital markets sector that is now the dominant provider of real estate debt capital. As a result, the U.S. debt market opportunities are more granular and focused on individual asset situations.	Regulatory restrictions on the banking market create opportunities for private investors to make attractive high yield real estate loans with limited risks.

Special thanks to our colleagues at NYL Real Estate Investors and Tristan Capital Partners, whose research and expertise in real estate investment themes shaped this perspective.

Why the Multi-Asset Solutions team?

We are New York Life Investment's specialists in multi-asset investing, assisting our partners in their persistent pursuit of investment success.

Access

We leverage the depth and breadth of the New York Life Investments platform to support our clients and partners.

Skill

We identify smart investments while providing profitable and secure long-term outcomes.

Navigation

We guide our partners through the rapidly changing investment environment using research and innovation.

Partner with us

Our mission is to build, preserve, and grow financial assets alongside our partners with integrity and respect through quality investments, education, and innovation.

Multi-Asset Strategies

Asset allocation strategies designed to capitalize on market opportunities within a variety of investment objectives.

- Model delivery
- Separate accounts

Market Insights

Investment services designed to support our partners and our investors.

- Thought leadership
- Risk analysis
- Investment strategy
- Financial education
- ESG analysis

Customized Solutions

Strategic partnerships designed to help meet investment objectives through holistic solutions.

- Global tactical allocation
- Risk modeling
- Income generation
- Inflation protection
- Insurance asset management

Definitions

Active investing (also called active management) is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continuously monitor their activity to exploit profitable conditions. Active management typically charges higher fees.

Alpha, often considered the excess return on an investment, gauges the performance of an investment against a market index or benchmark that is considered to represent the market's movement as a whole. The excess return of an investment relative to the return of a benchmark index is the investment's alpha.

Capital expenditures (CAPEX) are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment.

Diversification is a risk management strategy that mixes a wide variety of investments within a portfolio.

Dry powder refers to cash or marketable securities that are low-risk and highly liquid and convertible to cash.

Environmental, Social, and Governance (ESG) refers to the three central factors in measuring the sustainability and societal impact of an investment in a company or business.

Gross margin is a company's sales revenue it retains after incurring the direct costs associated with producing the goods it sells, and the services it provides.

The U.S. 10-year Treasury Note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance.

Index definitions

The Consumer Price Index (CPI) is an aggregate of prices paid by urban consumers for a typical basket of goods, excluding food and energy.

The S&P 500 Index is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States. It is widely regarded as the standard for measuring large-cap U.S. stock market performance.

FOR DISTRIBUTION IN JAPAN:

当資料は、一般的な情報提供のみを目的としています。

当資料は、投資助言の提供、有価証券その他の金融商品の売買の勧誘、または取引戦略への参加の提案を意図するものではありません。

また、当資料は、金融商品取引法、投資信託及び投資法人に関する法律または東京証券取引所が規定する上場に関する規則等に基づく開示書類または運用報告書ではありません。New York Life Investment Management Asia Limited およびその関係会社は、当資料に記載された情報について正確であることを表明または保証するものではありません。

当資料は、その配布または使用が認められていない国・地域にて提供することを意図したものではありません 。当資料は、機密情報を含み、お客様のみに提供する目的で作成されています。New York Life Investment Management Asia Limited による事前の許可がない限り、当資料を配布、複製、転用することはできません。

New York Life Investment Management Asia Limited

金融商品取引業者　登録番号　関東財務局長（金商）第2964 号

一般社団法人日本投資顧問業協会会員

一般社団法人第二種金融商品取引業協会会員

FOR DISTRIBUTION IN KOREA:

The content of this document shall not be construed as marketing or soliciting investment of any products or services and is being made available to you for general educational/economic purposes only. Any products or services that may be offered will be done separately in accordance with the applicable laws and regulations of Korea. Not all products and services are available to all clients and in all jurisdictions or regions.

IMPORTANT INFORMATION

The Multi-Asset Solutions team is a part of New York Life Investment Management LLC, an indirect wholly owned subsidiary of New York Life Insurance Company. Real Estate Investors is an investment division within NYL Investors, a wholly owned subsidiary of New York Life Insurance Company and an affiliate of New York Life Investments. Madison Capital Funding is a wholly owned subsidiary of New York Life and its subsidiary, New York Life Insurance and Annuity Corporation ("NYLIAC"). PA Capital LLC is a registered investment advisor under the U.S. Investment Advisors Act of 1940 as a relying advisor of New York Life Investments Alternatives LLC ("NYLIA"), its reporting adviser. PA Capital is an affiliate of New York Life Investments. Tristan Capital Partners is an affiliate of New York Life Investments.

Impact investing and/or environmental, social, and governance (ESG) managers may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating. Opinions expressed are current opinions as of the date appearing in this material only and are subject to change.

This material represents an assessment of the market environment as of a specific date; is subject to change, and; is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any funds or any particular issuer/security. The strategies discussed are strictly for illustrative and educational purposes and are not a recommendation, offer, or solicitation to buy or sell any securities or to adopt any investment strategy. There is no guarantee that any strategies discussed will be effective.

Any forward-looking statements are based on a number of assumptions concerning future events, and although we believe the sources used are reliable, the information contained in these materials has not been independently verified, and its accuracy is not guaranteed. In addition, there is no guarantee that market expectations will be achieved.

This material contains general information only and does not take into account an individual's financial circumstances. This information should not be relied upon as a primary basis for an investment decision. Rather, an assessment should be made as to whether the information is appropriate in individual circumstances, and consideration should be given to talking to a financial professional before making an investment decision.

NEW YORK LIFE INVESTMENTS

For more information

newyorklifeinvestments.com

1923360 MS186-21 MS74t-12/21