

The Fed pivot: What are the implications for private market investors?

UBP Headlines | October 2024

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Introduction

- The Fed's long-awaited decision on 18 September marked the beginning of a new cycle. After 15 months of aggressive tightening, the Federal Reserve shifted its stance and lowered its benchmark rate by 50 basis points, a move somehow anticipated by markets. The US Fed is not the first central bank among developed markets to engage in rate cuts, as the ECB had already made a similar move. Although the absolute level remains elevated, the end of the "higher-for-longer" narrative is probably the important factor that investors will focus on, as it opens up a new path forward. European economies are also seeing their inflation expectations slashed, paving the way for more accommodative monetary policies. However, investors should remain careful about how they approach this new era; although more accommodative, this loosening of monetary policies is being used to manage a soft landing and risks of a recession have not fully disappeared.
- However, in light of these lower rates, investors and allocators will start repricing assets and shifting expectations, reallocating portfolios and arbitraging the various risk premia available to them. What are the implications of lower rates for the pricing dynamics of private markets, and what are the implications for private market investors?

Private equity: The much-anticipated event finally happens

The rapid rise in rates had a major impact on private equity, from declining deal activity, to clogged exit routes and harder fundraising. Second-order effects of the swift increase in interest rates for private equity included the inability of managers to distribute capital, with investors starting to complain that their DPI (distribution to paid-in capital) was stalling and significantly lagging behind expectations. Managers have embraced alternative routes to liquidity, such as continuation vehicles or dividend recapitalisations through ManCo loans to boost their DPI. To a lesser extent, others have resorted to financial engineering tools such as NAV financing, although using this route has become a negative signal for LPs and this is avoided by more experienced managers. The FOMC's decision is giving a much-anticipated breath of fresh air to private equity. The absolute level of rates will not have much impact in the short run, but the fact that "higher-for-longer" has been scrapped is shifting dynamics.

AVAILABLE CAPITAL

Leverage will become more affordable and accessible. Since private equity managers rely heavily on the use of leverage to finance deals (hence the term "leveraged buyout") and drive returns, lower rates will increase demand for financing and lead to an improved environment for deal activity. Preliminary reports from managers are already showing signs of lower financing costs flowing through into portfolio companies.

VALUATIONS

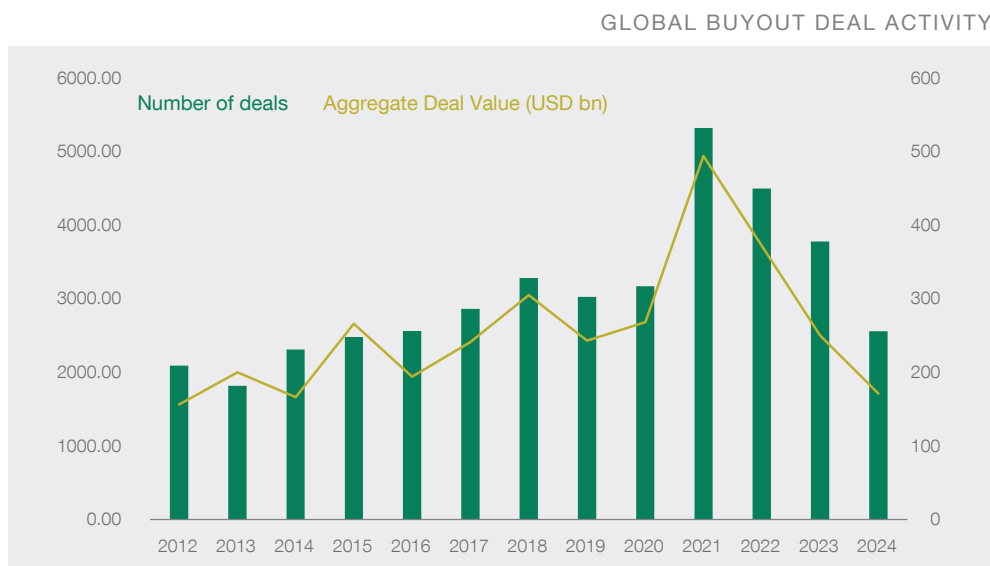
Falling rates should lead to higher valuations in the short-to-medium term. As interest rates fall, the discount rate used in a discounted cash flow model (DCF – one of the most common valuation methods) decreases, making future cash flows more valuable in present terms and consequently raising company valuations. However, all things are not equal, but rather they are conditional on a company's stage of existence. Venture capital, for instance, is highly dependent on low rates, as this type of company requires significant rounds of capital, therefore access to cheap funding is key. As investors in early-stage companies require high expected returns, lower rates prove beneficial to the valuation of immature companies. At the other end of the spectrum, mature buyouts bifurcate according to their size. Very large buyouts that are heavily reliant on leverage will welcome cheaper financing. The anticipation of lower rates can already be observed in the valuations of realised transactions. Dawson Partners report that in Q3 2024, exited companies saw an average uptick of 31% compared with their valuations from two quarters prior. This contrasts with the average 25% uptick seen in Q2 2024 and the 28% historical average between 2005 and 2023.

CASH FLOWS

Lower interest rates should have a positive impact on cash flows. For portfolio companies, which are typically leveraged through privately originated floating-rate loans, falling rates reduce the cost of debt servicing and creates a favourable environment for refinancing existing loans, leaving more free cash flows available to portfolio companies. For investors, lower rates may increase the likelihood of dividend recapitalisations, with companies taking on new debt to pay special dividends, as illustrated by the recap of Belron Group, leading to an extraordinary dividend of EUR 4.3 billion, the largest of its kind.

EXITS

It has been reported by Bain that funds hold more than USD 3 trillion in assets that could be sold, either in the form of a trade sale or a public market exit. Lower rates will certainly breathe new life into public market exits, despite not typically being the first port of call for private equity; however, public markets will not be able to absorb as much flow, and sponsors will certainly be very selective about which companies are brought to market first. Transactions between private equity sponsors will also probably resurface. In an encouraging sign of things to come, Pitchbook reports that the median holding period for completed or announced transactions contracted meaningfully in the first half of the year from 7.0 years to 5.8 years, and exit values continue to track above the same period in H1 2023. Distributions made in the next few quarters will provide confirmation of the above.



Source: Prequin Ltd

Private credit: How monetary policy will impact private credit markets

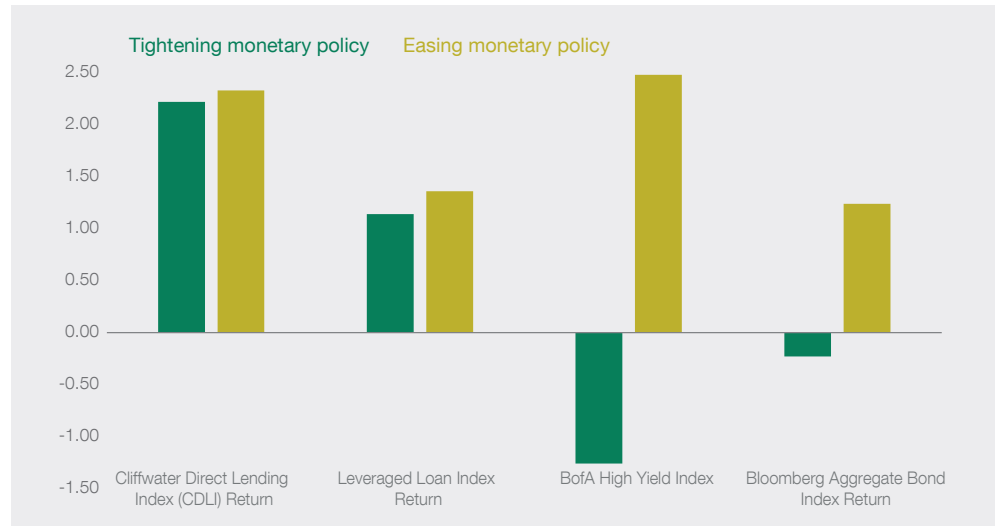
The effect of the end of “higher for longer” on direct lending and private credit more generally is not straightforward, as multiple forces come into play. First, direct lending has enjoyed significant growth over the past few years on the back of banks’ impaired ability to expand their balance sheets, combined with the ability of non-bank lenders to provide faster and more certain execution. The floating-rate nature of direct lending was extremely appealing for investors, as they were able to benefit from strong returns and solid distributions during a rate-tightening period. However, at the same time, one must be cognisant of the fact that falling rates may lower total returns for direct lending investors, assuming that the spread is untouched.

The economy is now embarking on a journey to manage a soft landing through this first phase of loosening monetary policies. The first-order effect is that more liquidity will become available in the system, bringing refinancing opportunities at a potentially lower cost of capital. Borrowers having floating-rate loan agreements will enjoy immediate interest-charge relief. Investors must monitor the pace of cuts and the strength of the economy, as a hard landing would mean a massive slowdown in business activity, in turn translating into more covenant breaches and, ultimately, defaults, leading to loan losses.

Another interesting element to look at is the interlocked relationship between direct lending and private equity, since direct lenders are typically extending loans to sponsor-backed companies. Lower interest rates, as mentioned above, will boost valuations along with M&A and LBO activity, which will generate demand for financing from private credit. Not only is this a positive for market liquidity, but it will also help to increase capital deployment velocity, decreasing the pressure on dry powder.

This rate cut also coincides with banks starting to compete more aggressively with direct lenders, and borrowers refinancing some loans more cheaply. Although direct lenders were usually financing at 550 bps over the risk-free rate, banks are now able to offer cheaper financing (below 400 bps on some transactions). A new paradigm in credit markets is being built, as banks are starting to team up with large non-bank lenders and, instead of competing, are starting to cooperate. The underlying rationale is that banks were usually serving corporate clients on both equity capital markets and debt capital markets (ECM and DCM). Due to the burden of regulatory pressure and heavier capital requirements, banks are now passing on debt business to direct lenders in exchange for a fee, while being able to maintain the ECM relationship with their corporate clients, creating a win-win situation.

MONETARY POLICY AND QUARTERLY RETURNS OF CREDIT INDICES



Sources: Bloomberg Financial LP, ICE Fixed Income Indices, Pitchbook LCD, Federal Reserve Board

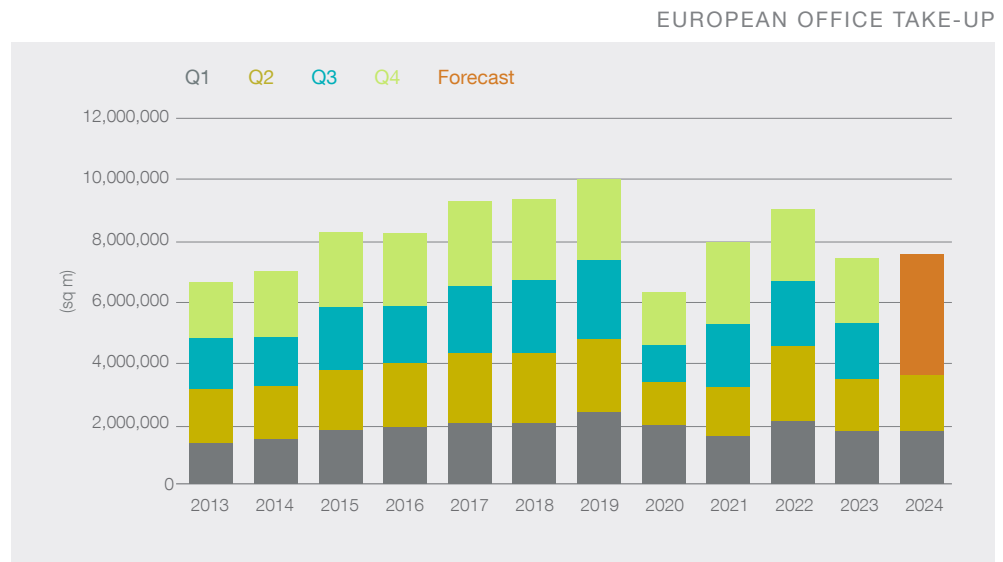
Real estate: Is the trough finally here?

Intuitively, lower interest rates are beneficial for real estate. Although this is, by and large, true, the relationship is not completely linear. Real estate returns come from two sources: price appreciation of the assets and rental income. In theory, the end of the “higher-for-longer” narrative should be welcome news for the valuations of real estate properties. This is because, historically, a decrease in interest rates has typically and over time been counterbalanced by downward-trending cap rates, one of the most widely used metrics to value and compare real estate asset prices. Because the value of a real estate asset is usually calculated as the ratio of a property’s net operating income to its cap rate, lower cap rates imply higher valuations.

The reality is more nuanced, and it is rather unlikely that price appreciation will return at the same pace as during the ultra-accommodative period. The reason behind this is that this period was associated with massive investment pressure that rapidly compressed cap rates. As bond yields cratered, investors looked for the next safe-but-high-yielding assets and bought massively into real estate, driving valuations up. This capital has been largely invested in, and investors who entered at a cap rate of 3–4% are probably holding on to their assets as they wait for a good exit point. The direct implication is that it is likely that real estate investors do not have a lot of dry powder to invest nor sufficient capital to generate similar investment flows than a few years ago, which will likely slow down the valuation recovery despite a more supportive environment.

On the rental income side, the picture is mixed. Some assets do not have significant rent escalation provisions (mostly assets that were in strong demand, such as multifamily housing), while other assets, such as logistics and warehousing, offer room for upside. Data centres, an infrastructure/real estate hybrid play, will continue to benefit from very solid momentum on the real estate side, while the massive demand for data services supports the infrastructure aspect.

In addition to these factors, base rates will decrease borrowing costs and relieve some pressure on borrowers which have financed real estate investments through floating-rate notes. This should also drive enhanced usage of leverage and increased transaction activity, while providing attractive conditions for borrowers to refinance existing loans. Cheaper debt may also increase the supply of new construction.



Source: Savills

Infrastructure: Momentum continues unabated

Movements in interest rates typically have a direct impact on private infrastructure assets in two notable ways: financing costs and valuations. Similarly, for private equity, lower rates will bring down financing costs and improve valuations of infrastructure assets given the long-term duration of cash flows. Since decreasing interest rates may be reflective of lower inflation rates and/or slowing economic growth, one should also look at the impact of both variables on infrastructure assets.

Infrastructure assets – such as data centres, telecommunications towers, water distribution or power generation assets – offer essential services that are the backbone of the global economy. As a result, infrastructure investments have historically performed well and grown revenues throughout various market cycles, and it is expected that the demand for these services and the value of underlying assets remain stable even during economic slowdowns.

In general, infrastructure tends to perform particularly well during inflationary periods thanks to the nature of contractual cash flows that include inflation-linked price escalators, and the pricing power of asset owners because of their strategic market position. As inflation expectations are slowing down, one could expect that infrastructure cash flows would increase at a slower pace. This relation is not, however, linear and this reasoning cannot be applied to all infrastructure assets. In some cases, asset operators were unable to pass on the full scale of inflation into prices, as the burden would have been too sharp for users. In these instances, the price increase is passed on in stages and some assets will continue to increase prices thanks to reserves escrowed during the past inflationary period.

Beyond these considerations, lower rates will be of benefit to the financing of infrastructure. Again, the path of future rates probably matters more than the absolute level and investors will find comfort in the fact that financing for facilities will improve.

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