Confidence must be earned

Amundi ASSET MANAGEMENT

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Private markets: a strong value proposition that may emerge reinforced after the crisis

INVESTMENT TALKS

Dominique CARREL-BILLIARD
Global Head of Real & Alternative Assets

- ***Private markets**: The Covid-19 crisis has caused significant disruption in private markets, but investor appetite for real assets stays unabated. Fundraising will be supported by abundant liquidity. Selectivity and diversification will be key and only the best quality assets should be considered. Real assets are a portfolio diversifier and volatility dampener. Given their long-term nature, investors should not rush tactically into these assets and be selective in order to capture the different premiums embedded in real asset investing.*
- ***Private equity**: In the private equity market valuations have fallen relatively little, with divergences among sectors. Despite the disruption, 2020 has been an active year for the industry. In the coming months, we should see an acceleration in corporate consolidations, as structured equity can help entrepreneurs get through the crisis. Performances of private equity funds should emerge stronger from the crisis. Money has been funneling into the asset class from long-term investors, such as pension funds, and this trend should continue in 2021.*
- ***Private debt:** Investment opportunities should flourish for private debt funds in the next months. For issuers, we expect the Covid-19 crisis to create opportunities in M&A and consolidation. Also, balance sheets' re-leveraging will require indebtedness rescheduling, where private debt's bullet profile could emerge as a critical tool. Today, the private debt market is much larger than it was at the time of the GFC, and there is a lot of dry powder. With such an abundant capital available, selectivity will be key. We expect a flight to quality, with people investing in safer strategies, more senior, more secured, and in asset-based financing. Diversification in geography and sector will be paramount, together with investing at the top of the capital structure, where risk-adjusted returns are the most attractive.*
- ***Real estate:** Global commercial real estate markets saw a decline in deal activity as of September 2020 and fund raising experienced a sharp drop in Q3 2020. Such repricing could attract new commitments, while the flight to quality should continue, benefitting core assets and properties whose tenants boast strong balance sheets. So far, repricing has hit risky assets, and we expect the revival of a scale of value among properties driven by location, tenant's financial robustness, and asset's intrinsic features. Despite a rise in Q3 2020, office vacancy rates remain low in the central business districts of the main European markets, limiting the impact on rents. The **office sector** should refocus on core assets and remain relatively unscathed for the best quality assets. Remote working could accelerate, but without disputing that working from the office drives corporate culture, brand and team-building. **Logistics** has benefited from high e-commerce activity, with a greater need for industrial warehousing and logistics properties, although a multichannel retailing strategy should become the norm. The **hotel industry** could suffer the effects of the crisis for longer.*
- ***Infrastructure:** we see divergences between sectors in terms of deal activity and valuation. The high level of dry powder is smoothing deal activity in 'safe-haven' sectors such as health, technology or renewables, where a stable number of transactions is happening. In the most affected sectors there might be opportunities at discount prices, whereas we might see some pricier assets in health or technology. Overall, valuations should stay flattish. Buy-and-hold strategies are gaining traction. We believe diversification will be key to deliver stable returns. The Covid-19 crisis should lead to a supportive political and regulatory environment, as the pandemic has emphasised the need for communication and social infrastructures, but also for more renewable energy. Infrastructure projects should be a key component of most governmental stimulus plans.*

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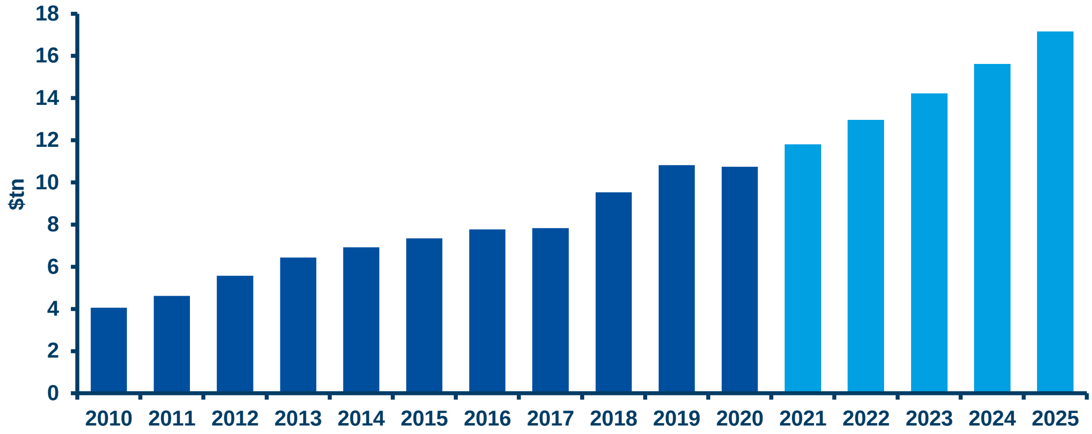
Guy LODEWYCKX
Head of Private Markets Multimanagement

The Covid-19 crisis has caused significant disruption in private markets, with fundraising and deal making being impacted since the start of 2020. While activity is not at the record highs seen in recent years**, funds are still raising capital, and managers are putting money to work, as investor appetite for real assets stays unabated.** Global private markets have topped $10tn in terms of assets under management (AuM) as of October 2020 and should grow up to $17.2tn by 2025, according to Preqin.

Alternative assets under management and forecasts



Source: Amundi based on Preqin data and forecasts as of 12 November 2020, 2020 figure is annualised based on data up to October.

Most investors build their exposure to private markets via regular commitments, irrespective of market conditions. For investors looking for a good market timing, the GFC showed that private capital funds that deployed money throughout the crisis produced among the strongest returns. The GFC and the Covid-19 crisis are different in many ways. Currently, liquidity is abundant and central banks have been much more accommodative than they were in 2008-09. Fundraising will be supported by this liquidity and market activity will benefit from the high level of dry powder.

"Real assets are key in the strategic asset allocation as they are a portfolio diversifier and volatility dampener. Given their long-term nature, investors should not rush tactically into these assets and be selective in order to capture the different premiums embedded in real asset investing".

Given the current market circumstances of low or negative interest rates and volatile equity markets, real assets offer among the best risk-adjusted returns in the universe of investable assets. **To capture the different premiums embedded in real asset investing, increased selectivity is mandatory**. Only the best quality assets should be considered: core and core plus assets in real estate and infrastructure, senior secured instruments in private debt, growth capital and LBO investing in the winning industries for private equity.

Private markets are witnessing strong divergences among sectors, and a dichotomy between healthy sectors with stable price and deal volumes, whereas some sectors are strongly affected by the crisis with almost no deal activity. Distinguishing the former from the latter is key to protect the income generation engine that real assets offer. **Diversification in exposure and asset selection is key to benefit from what private markets can offer to long-term investors. According to a recent joint survey by Amundi and Create Research private markets will see continued growth over the next few years.**

Real assets are key in the strategic asset allocation as they are a portfolio diversifier and volatility dampener. Given their long-term nature, investors should not rush tactically into these assets and be selective in order to capture the different premiums embedded in real asset investing.

Stanislas CUNY
Head of Direct Private Equity

"Overall, performance of private equity funds should emerge stronger in the aftermath of the Covid-19 crisis, and we believe it is an attractive time to invest in private equity for investors who can bear some liquidity constraints".

Private equity

The private equity market is sending messages that are complicated to interpret, as valuations have fallen relatively little, with a situation that is similar to the listed equity market that has experienced huge divergences among sectors, and the crisis exacerbates the winners vs. losers state of play. We see companies that are doing well with good cash flows or even emerging strengthened by the crisis vs. companies that are doing less well but may offer good opportunities in terms of entry prices.

Despite the disruption, 2020 has been another active year for the private equity industry both globally and in Europe. European private equity raised about €50bn in the first half of 2020, in line with the first half of 2019. Investment remained resilient, with almost €40bn deployed and more than 3,000 companies backed and over 50% of the money directed at the IT, healthcare and biotech sectors, showing the key role that private equity plays in innovation (European venture capital enjoyed a record half year, with investment approaching €13bn). In the coming months, **we expect an acceleration in corporate consolidations in most sectors**, as many unlisted companies will emerge weakened from the crisis, with higher debt levels. Companies will need to strengthen their equity and many will not be able to find refinancing solutions through bank credit lines. **Many small to medium businesses will have to call on private funding and private equity.** Structured equity can help entrepreneurs get through the crisis, and this is what private equity funds using minority stakes investment strategies would typically do, mainly by using preference shares.

Overall, performances of private equity funds should emerge stronger in the aftermath of the Covid-19 crisis, and we believe it is an attractive time to invest in private equity for investors who can bear some liquidity constraints. As evidenced by fundraising numbers, money has been funneling into the asset class from long-term investors, such as pension funds or insurance companies, and we expect the trend to continue in 2021 with the continuation of the crisis.

Thierry VALLIERE
Head of Private Debt

"Broad diversification in geography and sector will be paramount, together with investing at the top of the capital structure, where risk-adjusted returns are the most attractive".

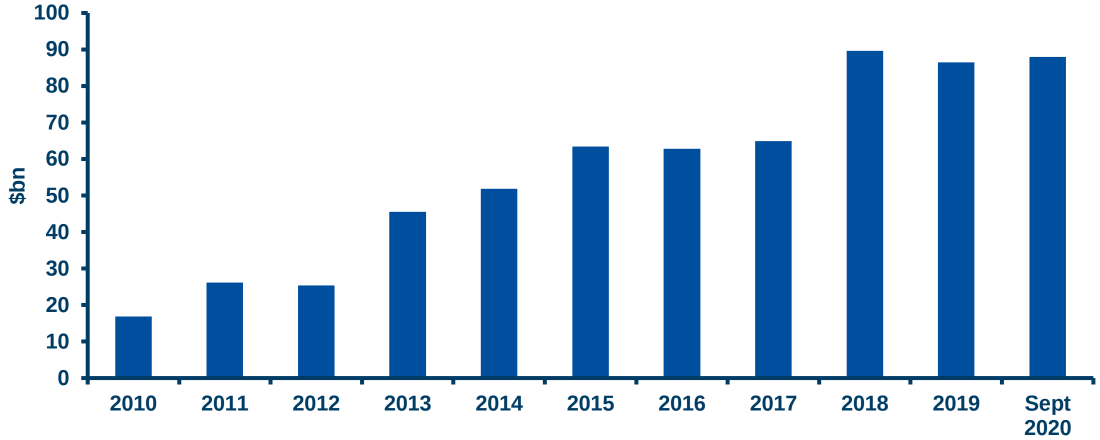
Private debt

There are a record-high 486 funds on the road, seeking $239bn in aggregate capital globally. This is quite aligned with limited partners' intentions that point to further growth over the medium term for the asset class, with a 2% median current allocation vs. a 3-4% target. Limited partners have appetite for private debt because it **provides better diversification, reliable income streams, high risk-adjusted returns, and low volatility**. Investors also appreciate the embedded option that is offered by private debt over traditional liquid credit in the uncertain environment of the Covid-19 crisis --i.e., the stringent financial documentation, the ability to restructure pricing or terms, the floating rates, the ability to repossess hard assets if needs be, and the option to exit *at par*.

In 2021, we will enter a new phase of the Covid-19 crisis environment for private debt, where we will see a lot of work being done on the portfolios with significant restructuring. In terms of dealmaking activity, investment opportunities should flourish for private debt funds in the next one-to-eighteen months, where we should see less banking competition, coupled with huge financing needs from issuers. Banks balance sheet have been highly mobilised in the past months with a lot of provisioning and an increased cost of risk that has led banks to reprice their credit offer. We should see a lower level of banks' underwriting for mid- to large-cap deals. For issuers, **we expect the Covid-19 crisis to create opportunities in M&A and consolidation.** The crisis has also highlighted the need to adapt most business models which will require capital expenditure, e.g., the length and complexity of supply chains or digital underinvestment, which will require capital expenditure. Finally, balance sheets' re-leveraging will require indebtedness rescheduling, where private debt's bullet profile could emerge as a critical tool.

Today, the private debt market is much larger than it was at the time of the GFC, with much dry powder. With such an abundant capital available in the asset class, stringent selectivity will be key to deliver on private debt's promises. We expect a flight to quality, with people wanting to invest in safer strategies, more senior, more secured, and in asset-based financing. This crisis will be a test for some limited partners and general partners (GPs). We expect an increase in European defaults in some sectors (e.g., airline, oil & gas, travel and leisure) and typology of companies (e.g., poor governance, SMEs). **Broad diversification in geography and sector will be paramount, together with investing at the top of the capital structure, where risk-adjusted returns are the most attractive.**

European private debt dry powder



Source: Amundi, Preqin. Data and forecasts are as of 13 November 2020.

Marc BERTRAND
CEO, Amundi Real Estate

Real estate

In the unprecedented context of the Covid-19 crisis, global commercial real estate markets saw a YoY decline in deal activity as of September 2020 and fund raising experienced a sharp YoY drop in the third quarter of 2020. While some investors opted for a wait-and-see attitude, the ongoing repricing in some market segments could attract new commitments. We believe the flight to quality observed since March should continue, on the back of the current uncertainty around the second wave of the pandemic. This should benefit core assets and properties whose tenants boast strong balance sheets. **Investors still feel comfortable transacting high-quality assets,** as the assets' value should be more resilient than for second rate assets. So far, **repricing has hit risky assets, and we expect to see a scale of value among properties according to location, tenant's financial robustness, and asset's intrinsic features, something that had been dissipating before the crisis**. This is especially true for properties on the periphery and those not dedicated to a specific business sector. We believe investors will monitor the leasing markets, particularly rents.

"We expect to see a scale of value among properties according to location, tenant's financial robustness, and asset's intrinsic features, something that had been dissipating before the crisis".

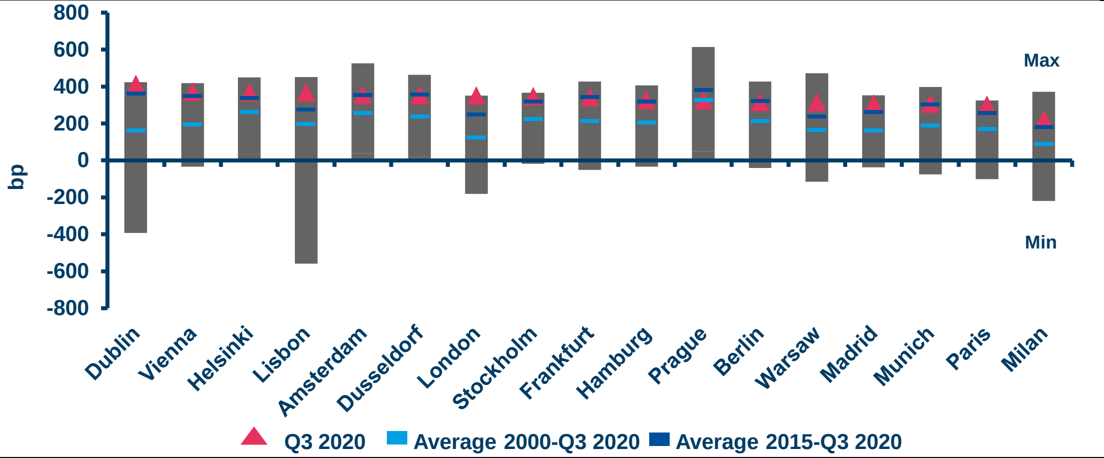
The crisis has occurred in a healthy leasing market for logistics and offices in Europe, with an office vacancy rate that is on average lower than before the Great Financial Crisis. Despite a rise in the third quarter of 2020, office vacancy rates remain at low levels in the central business districts of the main European markets, limiting the impact on rents. **Low interest rates should support the recovery**, starting from high-risk premiums on European prime real estate yields, many above 300bp as of September 2020. Finally, **the impact of the pandemic is not linear, with some real estate sectors hit harder than others**.

- We expect the **office sector** to refocus on core assets and remain relatively unscathed for the best quality assets. There are many long-term leases in the market and many firms have been able to adapt to social distancing and are operating with a mobile workforce using technology. Remote working could accelerate, but without disputing that working from the office drives corporate culture, brand and team-building.
- **Logistics** has benefited from high e-commerce activity, with a greater need for industrial warehousing and logistics properties, although a multichannel retailing strategy should become the norm. Since investors see online retailing as a long-term

trend, logistics properties can be pricy. The boom in online sales has hit non-food shops harder. With new lockdowns in Europe, some retailers may have more difficulties paying high rents this time round.

- Lastly, **the hotel industry** could suffer the effects of the crisis for longer, assuming its model is not called into question. Although the Covid-19 crisis strongly affected retail and hospitality, they could present some investment opportunities in the longer run, when market fundamentals get rebalanced.

Office prime yield vs. ten-year government bond yield spreads



Source: Amundi Immobilier computation on ECB and CBRE Research data as of Q3 2020.

Matthieu POISSON
CIO – Infrastructure

Infrastructure

Few investors were exposed to infrastructure during the Great Financial Crisis. Today, the asset class is undergoing its first global crisis and investors prize its ability to resist market turbulence. As for most private markets, we see divergences between sectors in terms of deal activity and valuation. The high level of dry powder that existed before the crisis is smoothing deal activity in ‘safe-haven’ sectors such as health, technology or renewables, where a stable number of transactions is happening.

In the most affected sectors, such as transportation or midstream energy, there might be opportunities at discount prices, whereas we might see some pricier assets in health or technology. Overall, valuations should stay flattish. **Such stability confirms a core feature of infrastructure: its long-term time horizon.** Prices may be more attractive in some sectors today, but it will not make a big difference in terms of returns in the long run. Buy-and-hold strategies are gaining more traction in this environment.

Infrastructure is a multi-faceted asset class that encompasses a complex mapping of risks, such as regulatory risks, political risks, country-level risks, and industrial risks. We believe diversification is key in this asset class in order to deliver the stable return pattern that investors expect. Finally, the Covid-19 crisis should lead to a supportive political and regulatory environment, as the pandemic has emphasised the need for communication and social infrastructures, but also for more renewable energy. **Infrastructure projects should be a key component of most governmental stimulus plans, and we expect to see a rise in greenfield projects. In that context, private capital should play a vital role, as the crisis has put a strain on national debt in most countries.**

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

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Definitions

- **Basis points**: One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Core plus real estate investment strategy:** 'Core plus' is synonymous with 'growth and income' in the stock market and is associated with a low to moderate risk profile. Core plus property owners typically have the ability to increase cash flows through light property improvements, management efficiencies or by increasing the quality of the tenants. Similar to core properties, these properties tend to be of high quality and well occupied.
- **Core real estate investment strategy:** 'Core' is synonymous with 'income' in the stock market. Core property investors are conservative investors looking to generate stable income with very low risk. Core properties require very little hand-holding by their owners and are typically acquired and held as an alternative to bonds.
- **Dry powder:** It refers to cash reserves kept on hand by a company, venture capital firm or individual to cover future obligations, purchase assets or make acquisitions. Securities considered dry powder could be Treasuries or other short-term fixed income investment that can be liquidated on short notice in order to provide emergency funding or allow an investor to purchase assets.
- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio, in an attempt at limiting exposure to any single asset or risk.
- **GP:** General partner, a fund manager that raises capital from institutional investors through open-ended or closed-ended fund structures or non-fund vehicles with fund-like economics.
- **LBO**: Leveraged buyout. It is the acquisition of another company using borrowed money to meet the cost of acquisition. The assets of the company being acquired are often used as collateral for the loans, along with the assets of the acquiring company.
- **LP:** Limited partner, an institutional investor that commits capital to private funds through limited partnerships.
- **Opportunistic real estate investments:** Opportunistic is the riskiest of all real estate investment strategies. It is synonymous with 'growth' in the stock market. Opportunistic investors take on the most complicated projects and may not see a return on their investment for three or more years. Opportunistic properties often have little to no cash flow at acquisition but have the potential to produce a large amount of cash flow once the value has been added.

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