The tide is high and waters are rougher: seek stable assets and create value
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Welcome to Partners Group’s Private Markets Navigator for H2 2016. Published twice a year, the Private Markets Navigator shares Partners Group’s outlook for all private markets asset classes over the next six months.

While global economic growth remains modest but solid, we expect to see increased volatility in capital markets going forward. In this environment, we are focused on finding more robust assets that can hold their value throughout economic cycles on the one hand, and that offer the potential to create value on the other.
For the past two years, we have raised awareness of stretched valuations across asset classes. Asset prices have been inflated by unconventional monetary policy, while fundamentals like earnings and revenue growth have only gradually improved. Generally speaking, while the probability of a global recession is rather low, with continued modest but solid global GDP growth, certain developments, including the UK’s decision to leave the European Union (Brexit), lower growth in China, the depreciation of the Renminbi and the prospect of rising rates in the US, have increased uncertainty and we expect more volatility in capital markets going forward. For example, the small increase in the US target rate in December 2015 caused large risk reversal moves within capital markets and temporarily dragged down valuations. Similarly, the Brexit vote outcome on 23 June sent markets temporarily tumbling. Furthermore, as we have pointed out in the past, there is a risk that markets will front-run the Fed as wage and pricing pressures in the US intensify, driving up yields at the longer end of the curve. History shows that valuations tend to suffer in periods of rising rates.

Since our last relative value assessment, global economic growth has remained modest, political uncertainty has increased along with market volatility, and valuations may be peaking. Against this challenging outlook, we focus on finding robust assets in more resilient sectors and continue to intensify our value creation efforts.

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US: capitalizing on outsourcing and transformative trends

Growth in the US continues at a modest rate, with fundamentals only gradually improving further. The main contributor to growth is private consumption, supported by positive momentum in the housing market, rising employment, which is well above its 2008 peak, and wage growth. The rate of unemployment has fallen to pre-crisis levels, deleveraging pressures are fading and US banks are comfortably granting credit to households and companies. Corporate investment activity, however, remains muted and the strong USD continues to take a toll on exports and manufacturing. Corporate earnings in the US are stagnating across a number of sectors, also outside of the energy and basic materials space.

While mediocre in historical terms, the current growth rate does not warrant emergency low interest rates and we expect the very gradual Fed rate hike cycle to continue towards the end of the year, with the Brexit vote neither having a large impact on US growth nor on the timing of a Fed move. Rising labor costs and an expected increase in financing costs are likely to pose challenges for corporate profitability, which is hovering near peak levels. For many companies, the only way to maintain margins is to focus on their core business, thereby outsourcing services to a new breed of specialized companies. In order to benefit from this trend in the private equity space, we have identified a number of sub-sectors characterized by strong and resilient demand, such as in healthcare, business services and certain segments in the consumer space. Within the outsourcing trend, investment opportunities can be found in companies positioned to be strategic suppliers to larger entities active in these resilient sectors. For example, pharmaceutical companies are operating under costly labor models and facing pressure to control drug price hikes. As a result, the industry is outsourcing lower-margin activities such as packaging, storage, distribution and testing. Specialized solution providers with a longstanding quality and regulatory track record can meet specific handling requirements and bond customers to their business, while the need for sophisticated equipment and expertise establishes high barriers to entry for would-be competitors. Platform growth across the delivery value chain and cross-selling initiatives offer compelling growth opportunities.

In the private infrastructure and private real estate segments, more traditional transformative trends provide ample opportunities to capitalize on underlying growth drivers. As an illustration, the US is experiencing strong demand tailwinds for both renewable energy, based on a reconfiguration of the US generation mix in favor of renewables, and broadband infrastructure, such as subsea cables or terrestrial fiber, stemming from the rapid growth in data usage due to the proliferation of connected devices like smartphones and tablets. Policy support for broadband investment is strong, based on the economic activity that flows from it and the small environmental impact from installing telecommunications infrastructure, and this simplifies the permitting and licensing process for these assets. At the same time, the increasing trend in the communications sector of keeping infrastructure asset ownership separate from service provision (so-called ‘open access networks’) is creating asset ownership opportunities for third-party investors like Partners Group.

For real estate, we see large regional discrepancies in terms of population and employment development. We aim to acquire or develop multifamily residences in high population and employment growth markets, such as Denver or Nashville for...
instance, where solid supply/demand fundamentals provide for attractive rental growth. Industrial and office properties can be acquired at attractive prices on the secondary market or pursued as value-add strategies.

**Europe: with modest top-line growth, we focus on revenue stability and visible upside**

In the Eurozone, growth is moderately improving and the economic impact of the Brexit vote should be manageable. The private sector continues to benefit from the reasonably valued Euro, low energy prices, low financing costs and improving bank lending. However, deflationary pressures persist and the negative rate environment has been taking a toll on the banking sector’s profitability. With Brexit uncertainty, European banks have seen another significant decline in their share prices, at a time when regulators require additional capital buffers. Peripheral banks especially are finding it increasingly difficult to raise fresh capital. Record low government bond yields have taken the pressure off governments to implement needed reforms and to address high fiscal debt levels. Greece’s unsustainably high debt level, labor market rigidities in France and the fragility of the Italian banking sector are still looming in the background, while the refugee crisis is further deepening a political rift and giving rise to populist parties.

For the UK, the impact of the Brexit vote will be felt in the short term, as consumer and business confidence is shaken and companies postpone investment and hiring plans. The mid-to-longer-term economic implications will depend on negotiations with the EU and other trading partners. However, we take comfort in the UK’s strong position in the global economy and its continued political relevance within Europe. Consequently, we believe that after an initial shock, economic activity should resume and confidence return. In the private equity and debt space, domestically-focused UK companies should feel a more limited impact, via lower demand, which should also be the case for economically-sensitive infrastructure assets. Companies importing input goods in foreign currencies and selling them into the UK market should see margin pressure. Real estate is the asset class likely to be most adversely affected in the UK as demand for residential and commercial properties may suffer, weighing on capital appreciation and rental incomes.

For private debt, volatile capital markets and banks shying away from underwriting larger debt packages could create attractive investment opportunities. A patient and careful investment approach allows investors to pick and choose the right companies at compelling returns and wider spreads, given higher UK risk premia.

With muted top-line growth and challenging mid-term obstacles, in private equity our investment focus in Europe also lies on companies with recurring revenues and high cash flow visibility, including companies that are strategically positioned to benefit from the global outsourcing trend. Of particular interest are companies in market-leading positions that can further benefit from consolidation, as well as expanding through cross-selling opportunities as customers prefer a one-stop solution in today’s fast-paced world. Reactivity, availability and reliability are key success factors that bond customers and open doors to new ones. As an illustration, one sector where this model applies is property management, which is increasingly about offering services beyond the traditional provision of living space. Tenants and landlords are often interested in a one-stop solution for all their needs, taking advantage of high-margin ancillary services such as insurance and energy brokerage, security solutions or home automation services.

Another trend that shows customers’ shift towards ease of use is the growth of online retail. E-commerce is expected to grow from 6% of retail sales in 2013 to 11% by 2020¹ – this is also facilitated by increased smartphone usage, which requires data transmission infrastructure. Customers expect fast delivery times, in some cases, even same-day delivery. In real estate, this offers attractive opportunities to purchase or develop logistics assets in the periphery of dense urban locations.

In infrastructure, we like communications for the reasons mentioned above, but we also aim to benefit from transformative trends in the renewable energy segment. Many European countries are struggling to meet their 2020 renewable energy targets and capital needs are large. Installed capacity in German offshore wind farms, for example, is projected to increase by an annual 9.1% between 2015 and 2035.² Many governments subsidize renewable energy and regulation often provides fixed-tariff incentive regimes – this is the case in the UK and Germany, for instance. While this is an incentive for investment in renewables, downside protection is also provided by the increasing cost-competitiveness of renewable energy compared to established energy generation. In offshore wind, we look to partner with established utilities to develop sizeable projects with established technologies and limited construction and operating risks.

**Asia-Pacific/emerging markets: treading cautiously, capitalizing on secular trends**

Overall growth momentum also remains relatively subdued in Asia-Pacific and emerging markets in comparison to past cycles.

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² International Renewable Energy Agency (IRENA); March 2016.
Abenomics in Japan has had little success in spurring growth and inflation. With the ongoing slump in commodity prices, economic performance between commodity-based economies (Australia, select LatAm, Malaysia) and commodity importers (India, select emerging Asia) continues to vary. The new administration in Brazil seems eager to implement needed fiscal reform and the country could see slightly positive growth next year. China has entered a new phase of continued growth but at a somewhat lower level and with exposure to several challenges including the significant debt buildup in the corporate sector and lower labor force growth in the face of an aging population. For now, the slowdown has been warded off by credit-led growth and the government is torn between providing a temporary boost or focusing on structural measures at the cost of near-term growth. The pressure on the Renminbi has eased somewhat but capital outflows are likely to continue. This coupled with a more modest future growth rate should keep the Renminbi on a depreciation path versus the USD.

In terms of investment themes, in emerging markets we continue to focus on underlying secular and transformative trends that stand to create substantial growth opportunities. In private equity, for instance, we aim to benefit from increased financial intermediation in select economies that are also supported by regulatory tailwinds. Retail-focused lending businesses, such as housing finance or micro finance providers in India, demonstrate secular growth given the rising middle class population and strong asset quality. Housing prices have remained resilient across cycles and loan losses are low due to cultural factors and multiple levels of downside protection for lenders. Rising incomes are also transforming retail behavior, fueling demand for modern logistics, cold storage and warehousing space. Opportunities in the logistics market in China, for example, are still significant. The increased penetration of larger supermarket chains and e-commerce have upped the demand for modern logistics facilities near towns and major infrastructure hubs. Under-managed, income-generating properties with the potential to increase lettable space through development, or increase rental incomes and capital appreciation through conversion into modern logistics spaces, are compelling investment propositions.

Private infrastructure investing in emerging markets is still dominated by bottlenecks in traditional infrastructure (roads, bridges, hospitals, etc.) in many countries, as well as the need for infrastructure assets to support the increased demand for renewable energy and use of digital data. A number of emerging market governments have replicated strong advanced-world regulatory regimes and proven tariff models, allowing investors with global reach and local relationships to profit from greenfield premia and build assets that generate high demand from future buyers. In Taiwan, for example, the renewables sector is in transition, with strong government support and improving regulatory and policy conditions. The Taiwanese solar panel industry is highly developed and provides an opportunity to build a platform of scale that, once at brownfield stage, will be attractive to a wide range of investors, such as Taiwanese life insurance companies.

Focusing on stability and value-add

In summary, we see low top-line growth and a challenging outlook, with the prospect of rising rates in the US, Brexit negotiations in Europe and a slowdown in China, coupled with elevated valuations in capital markets. In view of this, we focus on finding assets with stable cash flows and robustness of valuations throughout cycles on the one hand, and the potential to create value on the other, in order to be able to attract refinancing at the end of the holding period. This combination allows for capital protection during turbulent times, but also offers us the potential to create better returns for clients by working to grow companies and assets beyond their current positioning. This in turn should create favorable exit conditions.

Our relative value approach

In simple terms, our relative value outlook for a certain asset class and investment type is derived from three parameters, which are analyzed individually, often on a regional level, and also in relation to each another:

- Growth
- Opportunity set
- Valuations relative to risk

The first parameter, growth, is broken down into structural and non-structural drivers. Structural drivers are defined as classical growth drivers, meaning demographics and wealth evolution, as well as government policy and regulation. This type of growth occurs at the national or regional level and directly drives the overall performance of certain sectors of the economy. Non-structural growth is generated by sectoral rotation and transformative change, such as customer preferences and trends, as well as value creation at the asset level. The latter type of growth often incorporates a ‘rotational’ component, whereby certain sectors benefit over-proportionally at the cost of others while the net effect on overall growth can be offsetting.

The second parameter, opportunity set, consists of the investment opportunities sourced within our deal flow and other external factors, such as the availability of financing and competition.

The third parameter, valuations, represents asset pricing in the context of top-down and bottom-up growth potential, value creation opportunity and broader market developments, such as entry multiple evolution, always relative to downside risk.
Private equity

Value preservation and growth potential are key.

High purchase prices combined with lower levels of debt participation have put pressure on returns. In this market environment, we are focusing our efforts on finding stable companies in higher-growth niches.

Market overview

High prices continued to be a hallmark of the LBO deal environment in H1 2016, as they were throughout 2015. At approximately 10x pro forma trailing EBITDA in the US and Europe – and up to 13x-14x for larger transactions – average purchase price multiples across sizes exceeded those recorded in the pre-crisis peak years.¹ However, one notable difference in today’s market is the proportion of equity to debt in these highly priced transactions. Whereas in 2006 and 2007, high purchase price multiples were accompanied by equity participation levels of around a third, in H1 2016 the average equity contribution in buyouts had climbed (even from 2015 levels) to hover just under the 50% mark in Europe and more than 45% in the US.² Not since 2009, when average valuation multiples stood 1-3 turns lower, has the average equity participation been so high in both markets. In the US, where equity participation has traditionally been lower than in Europe, this is a direct result of regulatory intervention impacting the banking sector. In today’s market, many banks are no longer able to underwrite highly-levered transactions.

As a result of high prices and high equity participation, there is pressure on private equity yields and the typical returns for buyouts will come down relative to the asset class’ best years. While anticipated returns for purely financial private equity transactions may dip to the low teens, in our view a net IRR in the mid teens is likely to be the new normal for private equity deals, even if they have sufficient value creation upside.³ This is low compared to long-term net IRR expectations for private equity in former times, which sat in the high teens.

Despite all this, the market remains highly active: buyouts totaling USD 425 billion in value were transacted globally in 2015, the largest annual value since 2007.⁴ So why do private equity firms continue to transact in this deal environment? One reason is the volume of dry powder waiting to be deployed, which for buyouts stood at over USD 530 billion globally as of July 2016⁵ following a period of robust fundraising, including the closing of a number of ‘mega funds’. However, this alone is not enough of an impetus. If you assume that 2015’s transaction value can be repeated and that deals will have a ~50% average equity contribution, then the dry powder in the market will only fund another 2.5 years of deals with no further fundraising, which is business as usual for the industry. Of greater import is private equity’s continued potential to outperform other asset classes. Not surprisingly, with its larger element of ‘alpha’, private equity’s performance is still higher than other asset classes, even at reduced yields. Relative to anticipated net returns of 4-6% for public equities,⁶ private equity return expectations remain very attractive and GPs are supported in deploying capital by their LPs, who – in their own search for yield – still regard private equity as the performance

Average equity contribution in LBOs incl. rollover

A chart showing average equity contribution in LBOs including rollover.


³ Partners Group’s Total Expected Return Framework; H2 2016.
⁴ Preqin Private Equity Database: March 2016.
⁵ Preqin Private Equity Database: July 2016.
⁶ Partners Group’s Total Expected Return Framework; H2 2016.
driver in their portfolios. However, in this environment, there is no rising tide to lift all boats and that relative outperformance is not guaranteed. More than ever before, value creation on the part of proactive and hands-on private equity managers will be the key differentiating factor when it comes to generating returns.

Opportunities in the current market

Given the current macro-economic backdrop of low growth on aggregate, unconventional monetary policy and potential hikes in US interest rates, we have become increasingly concerned about market volatility. With prices at all-time highs, and average expected returns lower than historical averages, our focus in due diligence has further shifted to place even more emphasis on the stability of valuations. We are looking for companies that have largely preserved their value over several cycles and that will continue to hold their value (in terms of traded EBITDA multiple) in future periods of volatility. These are typically companies with long-term recurring revenue streams, sticky customer contracts and highly visible cash flows.

In addition, we maintain our focus on growth-focused investment opportunities, as well as our belief that the search for these must go beyond sectors and regions and into specific transformative trends. We are looking for sub-sectors where growth is around 2-3x higher than the overall growth rate in that region or sector and where we can work actively alongside companies on initiatives that enable them to tap into that growth.

US: outsourcing businesses are a key focus

In North America, sub-segments that fit our dual criteria of stability and growth potential include business and industrial services, healthcare outsourcing, consumer-driven healthcare, wellness and IT, and companies that can support others in the digitalization of their businesses.

In the context of increased outsourcing on the part of big manufacturers and companies (see box text: ‘The business of outsourcing’), firms involved in industrial testing and maintenance services, outsourced IT support services, and other niche business support services are increasingly attractive. These companies typically have a large and sticky customer base, with high revenue and cash flow visibility. Besides the opportunity to increase the number of clients, a value creation strategy might focus on building out the service offering in order to cross-sell to existing customers.

One sector where the trend of outsourcing has been particularly pronounced is the healthcare sector. Non-core tasks or processes that were traditionally carried out in-house by hospitals, pharmaceutical companies or insurance companies are now routinely outsourced for cost-saving purposes in response to margin pressure in the supply chain. Examples of these outsourced activities range from claims processing in the insurance industry to drug testing and packaging in the pharmaceutical sector. In line with our view of the current attractiveness of healthcare outsourcing, we have been active in the space and in June 2016, agreed to acquire PCI Pharma Services (PCI), a leading global provider of outsourced pharmaceutical services. PCI offers its clients, which include the world’s leading pharmaceutical manufacturers, outsourced services across the entire pharmaceutical supply chain, including drug development and manufacturing, clinical trials and packaging services. Following the acquisition, we plan to work with PCI’s management team to add more specialized offerings to the product range and expand the company both organically and through add-on acquisitions.

Also in healthcare, the implementation of the Affordable Care Act (ACA), with its overarching mandate to make healthcare available and affordable for the entire US population, continues to disrupt the industry and as a result, generate investment opportunities. On the consumer side, the ACA has opened the door to innovation in healthcare business models that have remained unchanged for generations. For example, technology combined with a consumer preference for convenience and speed has led to the emergence of ‘telehealth’, a catch-all term for the remote delivery of advice and healthcare services via the internet and/or technological hardware. Examples of telehealth in practice range from online support groups to remote monitoring of vital signs.
such as blood pressure and sugar levels. Separately, an increased focus on health and fitness means consumers are willing to pay more for exercise options and nutritional products, creating opportunities for niche providers with superior offerings.

In contrast, on the healthcare provider side, cost saving is the main driver for innovation, such as new information technologies and data analytics solutions, as providers struggle to handle more cases with little or no financial incentive to do so. The relevance of this trend within the healthcare sector enabled us to successfully realize an investment in this space slightly ahead of schedule, making the most of available liquidity in the market. In June 2016, Partners Group and Starr Investment Holdings sold MultiPlan, Inc., the US’ largest provider of transaction-based solutions that reduce medical costs, to affiliates of Hellman & Friedman. MultiPlan uses technology, analytics and data to generate over USD 13 billion in savings annually for commercial, property and casualty, and government payers of medical claims. Partners Group and Starr Investment Holdings have retained minority investments in the company and will therefore continue to benefit from future value creation.

Non-core tasks traditionally carried out in-house by hospitals or pharmaceutical companies are now outsourced for cost-saving purposes.

Europe: traditional business models invite value creation

While in Europe we principally focus on the same sub-segments that fit our dual criteria of stability and growth potential, including business services, financial services outsourcing, healthcare, wellness and the digitalization of consumer-facing businesses, we observe one major difference between the US and Europe: whereas many US opportunities arise from companies breaking with tradition in order to do things differently, many European investment opportunities still have business models that can be broadly described as ‘traditional’. In several cases, the updating of that business model – through the process of digitalization for example – offers a clear value creation path for hands-on and capable private equity managers.

Within our main focus areas, business services companies are particularly attractive due to their recurring revenues, stable cash flows and loyal client bases. Sub-segments where we see the most relative value include industrial testing, property management, and niche business service providers protected by technological and regulatory barriers to entry. In Europe, a buy-and-build strategy focused on consolidation of a fragmented market is often the number one value creation plan. In July 2016, for instance, we agreed to acquire Foncia, France’s market-leading provider of residential property management services. Foncia provides a range of services to residential property owners and tenants, including joint-property management, lease management and rental and transaction services. It also provides ancillary services such as diagnostic solutions, insurance brokerage, asset management and energy brokerage. Following the acquisition, which is still subject to antitrust clearance, the Partners Group consortium will work with Foncia’s management team to continue the company’s successful strategy of consolidation in the highly fragmented French property management market, develop the company’s offerings in related product areas, and accelerate its international expansion.

Separately, one area in Europe where innovation is flourishing – and that we therefore see as an exception to the general rule – is fintech. Increased financial regulation has placed an enormous administrative burden on banks and insurance companies globally. In Europe, the difficulty of meeting increasingly onerous regulatory demands within deadline has been exacerbated by the number of different regulatory regimes and structures found within the continent. While nightmarish for the financial institutions themselves, this has created fertile ground for providers offering specialized technology-based solutions which enable financial institutions to comply with a specific aspect of regulatory change. Though many of these providers are very small, this is a growth area that we are monitoring with interest.

Asia/emerging markets: demand for services grows

While many of the sector preferences in North America and Europe also hold true for Asia and the emerging markets, overall our investment appetite is still driven by the growth of the middle class and attendant growth in demand for services, goods and social infrastructure. The healthcare and consumer sectors remain of key interest, both in terms of the straightforward growth story afforded by the favorable supply/demand dynamics, as well as in terms of innovative global trends such as the shift in retail from a ‘bricks-and-mortar’ to an e-commerce model.

Financial services offers growth-related investment opportunities, for example supporting the rollout of basic services to previously un- or under-served segments of the population, combined with innovative twists, such as the use of technology to leap-frog traditional business models. The classic example is the prevalence of mobile phone-banking in certain emerging markets, bypassing the traditional banking model altogether.

India is one country where the opportunity for investment in financial services is particularly attractive, due to fundamental under-supply. In India, there is particular demand within the retail financial services sector: in fact, CAGR in retail loans is estimated to continue at 18% until 2020, outstripping GDP growth.7

7 Credit Suisse Equity Research; 13 January 2015.
Though the regulatory landscape is still evolving, there has been significant government support for certain sub-segments, especially those aimed at the low- to middle-income bracket where traditional bank financing is typically unavailable to borrowers. In June 2016, Partners Group acquired a controlling stake in Au Housing Finance, a provider of housing loans in India’s affordable housing segment, together with Kedaara Capital. Au Housing Finance was founded in 2011 as a subsidiary of Au Financiers to provide housing loans to low- to middle-income borrowers, primarily in tier 3 and 4 cities and rural areas. The loans the company provides to its clients are typically taken out to purchase or construct new homes, or to repair or renovate existing homes. Following the acquisition, Partners Group and Kedaara Capital will work with the company’s management team to expand the business into new cities and states, add new credit offerings and further institutionalize the business.

The business of outsourcing

Outsourcing has been a major global trend for decades, beginning with the outsourcing of customer care services by companies in sectors with a high degree of customer interaction, like airlines, retail banks and telecoms companies, to call centers in emerging markets in search of cost-savings. The resultant customer frustrations stigmatized the practice in its early years.

That labor-cost arbitrage is no longer as readily available to companies and outsourcing has since moved on from call centers (although they still feature), shrugging off any lingering stigma in the process. Today, the practice of outsourcing is ‘business as usual’ in many segments, driven by a diverse set of factors as the list below shows: Companies specializing in outsourced business services have flourished, creating highly interesting investment opportunities for private markets firms like Partners Group with the expertise to support their oftentimes ambitious expansion plans.

- **Expertize**: outsourcing offers companies the chance to ‘hire the (global) expert’ in a particular area, rather than needing to be experts at everything themselves. With increased regulation in many sectors, the need for focused and specialist knowledge has increased.

- **Technology**: outsourced services are increasingly technology-based, enabled by advances in mobile and cloud technology, as well as data analytics. Technological advances have facilitated gains in efficiency and greatly increased the availability of service offerings to clients.

- **Cost**: in the current market environment, many large, listed companies have reached so-called ‘peak profitability’, whereby profit margins have no room to grow except through the streamlining of business activities, for example, by outsourcing non-core but essential supply chain activities.

- **Service**: quality of service delivery has become a key differentiator between outsourced service providers. B2B industries are increasingly adopting B2C data, service and loyalty metrics and practices in order to remain competitive.

- **Scale**: many outsourced service providers have themselves become global behemoths, with Salesforce, the ubiquitous US CRM software provider, a case in point. Acquisition is a frequent path to growth, as longstanding customer relationships – critical to success in the services sector – are easier to buy than to build.

- **Flexibility**: by outsourcing all or parts of functions that fluctuate with client demand, a company allows itself a variable cost base for downturns and a faster capacity ramp-up for upturns.
Relative value analysis

On the direct investment side, we are increasingly balancing the search for investment opportunities within higher-growth sub-sectors with the need to protect against increasing volatility. We are looking for businesses within industries with the defensive characteristics highlighted earlier in this chapter, in combination with sufficient value creation potential. At the current point in the market cycle, we continue to find most opportunities fitting this description in the mid-cap space.

The healthcare, consumer, business and niche financial services sectors are areas where we currently find most investment opportunities offering the combination of growth with defensive characteristics. Across all sectors, we particularly like companies that focus on the provision of outsourced services to consumers or other businesses.

As anticipated, prices in the secondary market have remained at highly elevated levels overall. We continue to be highly selective with a focus on inflection assets, which have years of value creation ahead of them. Additionally, we expect increased volatility and market uncertainty to be a stimulus for portfolio management exercises among some investors, leading to opportunistic and often proprietary buying opportunities for firms like Partners Group.

Our key investment strategies

Build out platform companies

We avoid high acquisition multiples by acquiring a platform company with a strong management team and infrastructure, and then purchasing add-on companies to further grow the platform. This allows us to bring small or lower mid-market businesses into the platform and benefit from the lower acquisition multiples of these segments compared with upper mid-market and large-cap companies.

Capture category winners

We actively screen sub-segments of specific industries benefitting from trend-based tailwinds and focus on finding the ‘category winners’ that dominate the sub-segment in terms of market share or growth potential. Our Industry Value Creation team then works with the companies’ management teams to further develop growth and increase profitability via effective value chain improvements.

Seek out defensive leaders

We search for niche leaders, not only with value creation potential, but also with strong defensive capabilities, high cash flow generation and the ability to quickly de-leverage in an uncertain and volatile economic context.

Relative value matrix

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<tr>
<th></th>
<th>NORTH AMERICA</th>
<th>EUROPE</th>
<th>ASIA/EMERGING MARKETS</th>
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<tbody>
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<td></td>
<td>Buyout</td>
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<td>Directs</td>
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<td>Media/telecommunication</td>
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<td>Information technology</td>
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<td>Secondaries</td>
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<td></td>
<td>Venture</td>
<td>Mid</td>
<td>Growth</td>
</tr>
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</table>

How to interpret the table: The relative value matrix divides the private equity market into various private equity segments, defined by regions (North America, Europe and Asia/emerging markets) and transaction type (directs, secondaries and primaries). For direct and primary investments, we classify the investment by size (small cap up to EUR 250m (Europe) or USD 250m (US); mid cap from EUR 250m to EUR 2bn (Europe) or USD 250m to USD 2bn (US); and large cap over EUR 2bn (Europe) or USD 2bn (US) enterprise value) and also include a growth segment (for firms with positive cash flows and exceptional growth potential in need of additional capital to finance further expansion). For secondary investments, we classify by financing stage (buyout and venture/growth) and we distinguish between inflection assets (early stage) and mature assets according to asset/portfolio age. Green and light green highlight a segment with high relative attractiveness given Partners Group’s specific capabilities and deal flows. White highlights a neutral segment. Yellow and light yellow mean that Partners Group underweights the segment and requires an even more dedicated bottom-up selection and due diligence effort.
Private real estate
Shifts in demand create opportunity.

With market sensitivity and late cycle volatility likely to continue, we have sharpened our focus on making investments in robust property types and still see the greatest potential in real estate that can be adapted to accommodate shifts in demand.

Market overview
Low interest rates and limited development pipelines have continued to attract yield-seeking capital to the real estate asset class. Private real estate allocations have grown consistently over the past few years and are expected to continue to increase in 2016. This is at least partially attributable to the double digit total returns provided by global real estate in 2014 and 2015. Increasing allocations combined with record levels of dry powder are putting pressure on managers to source opportunities and deploy more capital over the next twelve months. The weight of this capital in the market suggests there is unlikely to be any significant pullback in asset values absent a global recession, the risk of which we currently deem to be relatively small.

Property cap rates have meanwhile continued to compress to lows last seen in 2007, while yield spreads between cap rates and sovereign bonds still remain wide relative to historic levels. The US and European office markets are expected to continue to tighten in 2016, as demand still outpaces supply in most major markets. While upcoming supply pipelines are anticipated to finally end six years of below-average completion levels, the limited amount of new stock has kept leasing competitive and driven rental growth globally. However, most market analysts have acknowledged a leveling off in pricing for many gateway markets, which may signify the later stage of the global real estate cycle.

The most profound event impacting private real estate markets recently was the UK’s vote to leave the European Union. Since the Brexit vote, rents and capital values in the UK have come under pressure and a number of local commercial real estate funds have suspended trading due to high levels of market uncertainty. We anticipate that real estate in the UK will be the private market most affected in its operational performance by lower GDP growth and possibly lower employment levels, which could weigh on residential and commercial real estate and office space in particular. However, Brexit is also likely to open a window of attractively priced opportunities for experienced and patient investors to acquire UK real estate.

Market sensitivity and late cycle volatility are likely to continue in H2 2016. In this environment, we intend to further sharpen our focus on investments in robust and established property types, avoiding investments in more niche segments or geographies that may be more vulnerable to occupier demand shocks or unexpected interest rate tightening.

Investors continue to increase real estate allocations

<table>
<thead>
<tr>
<th>Year</th>
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<th>2014</th>
<th>2015</th>
<th>Expected 2016</th>
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<tr>
<td>%</td>
<td>8.9%</td>
<td>9.3%</td>
<td>9.6%</td>
<td>9.9%</td>
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Note: Institutional investors’ allocations to real estate as a percentage of their overall investment portfolio. Source: Hodes Weill & Associates, December 2015.
Bank of America Plaza, a 20-story office tower located in the heart of Nashville’s Central Business District.

Opportunities in the current market

Europe: shifting retail patterns impact logistics

Overall, real estate sentiment appears to remain positive in Europe, but amid a potentially softening environment, we intend to maintain our focus on acquiring defensive properties in markets where occupier demand has demonstrated its robustness. In the current environment, the logistics and residential sectors are among those in which we see the most potential to find this type of asset.

Within the retail and logistics property segments, we have been actively monitoring shifts in demand introduced by e-commerce. From an investment perspective, e-commerce’s double digit growth rates within Europe and North America from 2014 to 2016 have resulted in a global relative value view that significantly underweights traditional retail properties. Simultaneously, e-commerce has been an important driver of demand for logistics space, as e-commerce users require up to three times the physical warehouse space compared to traditional brick-and-mortar retailers. Supply chain redesigns to support omni-channel retail concepts and to further shorten customer delivery times are also providing a boost to warehousing and logistics demand.

We intend to capitalize on this trend by pursuing investment opportunities in key clusters of modern, ‘last mile’ distribution facilities. Specifically, we will aim to invest in opportunities to acquire or develop portfolios of small-scale logistics assets on the periphery of dense urban locations such as Paris, Berlin, Frankfurt and Hamburg. An example of this opportunity set includes an investment that is currently in active due diligence, consisting of an opportunity to provide mezzanine financing to acquire a portfolio of modern logistics assets located in Northern Italy that were built or fully refurbished between 2000 and 2011. The business plan consists of acquiring the portfolio of properties at a discount to replacement value, re-gearing leases and completing a capex plan to lease up vacant space and significantly extend the largest asset in the portfolio.

In the residential property segment, we are exploring opportunities to provide large-scale residential assets for rent. The European 10-Year Total Return for residential property is 6.5% per annum, in line with retail, but with far lower volatility. In addition, since 2006, home prices in Northern European capital cities have risen to the point that they are prohibitive for entry-level buyers, who are now looking to rent instead. These factors support our focus on opportunities to acquire large-scale residential assets across key Northern European cities and provide them for rent. Our preferred approach would be the acquisition of residential blocks with specialist operators, where return is generated through lease up and stabilization.

The current residential property market also provides an ideal environment for exits, as low levels of home-building have resulted in a market that is fundamentally undersupplied, which in turn has continued to support demand and pricing. We recently exited our 2013-vintage mezzanine investment in Heyford Park, a 1,250-acre master-planned estate located in Oxfordshire, England. The property included over 300 residential units, 1.3 million square feet of commercial space, as well as a 55-acre residential development plot. The business plan consisted of a refurbishment to the existing homes in order to increase expected value through unit-by-unit sales, continuing to drive up occupancy and increase rents at the commercial properties, as well as selling a portion of the developable land to fund the development of over 360 new residential homes.

Implications post Brexit in the UK

The UK’s recent decision to leave the European Union has introduced a significant amount of uncertainty for UK real estate markets, with UK-based corporate occupiers still digesting the impact on their business. The potential for a drop in demand for office space in the UK happens to coincide with London’s most significant office-construction boom since 2002.

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1 Centre for Retail Research, “Online Retailing: Britain, Europe, US and Canada 2016.”
2 Prologis, July 2014.
3 MSCI IPD Index; April 2016.
A likely outcome is that rental growth will be suppressed by the new construction coming to market and recent record prices will fall. However, the impact on rents may be mitigated somewhat by the fact that over 40% of the office space currently under construction is already pre-leased, and projects which have not put shovels in the ground are likely to be postponed. Unless UK markets experience massive tenant defections, the recent ‘leave’ vote could act as a release valve, curtailing the potential build-up of a risky property bubble.

From Partners Group’s perspective, in the UK, commercial real estate performance over the next five years is anticipated to be comparatively robust in regional office and industrial assets. Conversely, real estate segments such as prime London offices and retail properties may experience negative repercussions from the Brexit decision. Yields in these property segments have reached all-time lows, and are more susceptible to occupier demand shocks or unexpected interest rate tightening.

US: capitalizing on key underlying growth drivers
In the US, from a relative value perspective, we currently overweight opportunities to acquire properties which capitalize on key fundamental real estate drivers such as population and employment growth, positive industry trends – high tech growth for instance – and urbanization. In particular, we are finding this type of investment opportunity within the multifamily residential, office and industrial property segments. Secondary markets that suffer from a lack of properties that adequately cater to the changing ways in which people live, work and play will also be a key focus.

In the residential property segment, multifamily investments in locations that offer attractive macro-economic conditions and robust real estate fundamentals remain compelling opportunities. Markets of focus are those that appeal to millennial renters, such as Austin, Texas, where explosive job and population growth has occurred. A recent example of our ability to capitalize on the dynamics in these markets includes our acquisition of a two-acre site on which to develop a multifamily project consisting of leasing up the remainder of the building, the Tennesse Supreme Court, as well as the brand new 1.3 million square foot convention center. The value-added business plan consists of leasing up the remainder of the building, improving occupancy from 80% to over 90%, in line with today’s Class A market occupancy rate in the area.

Secondary cities show their relative value proposition
Limited new property stock is driving vacancy rates lower and growing office rents. Nearly a dozen Central Business District (CBD) markets posted vacancy rates below 10% in the first quarter of 2016, including New York, Seattle, San Francisco, Philadelphia and Boston. Up by more than 3%, asking rents increased at the highest rate thus far in the cycle. Investors are now more seriously focusing on secondary markets, due to their strengthening fundamentals. As an example, Nashville, Tennessee, has a competitive cost of living – over 40% below cost of living in New York City – and a pro-business environment with no state income tax, which has driven job growth along with a favorable quality of life.

In the US, secondary markets that lack properties which cater to the changing ways in which people live, work and play will be a key focus.

Downtown Nashville has experienced revitalization over the last three years as there has been a push by local municipalities to create a ‘live-work-play’ environment. The revitalization is best illustrated by the significant development occurring in Downtown – currently over 4,000 apartment units and 1,400 hotel rooms are under construction. To capitalize on the strong fundamentals supporting Nashville’s office market, Partners Group recently acquired Bank of America Plaza, a 20-story, 435,525 square foot office tower. The property is located in the heart of Nashville’s CBD, in close proximity to the State Capital, the Tennessee Supreme Court, as well as the brand new 1.3 million square foot convention center. The value-added business plan consists of leasing up the remainder of the building, improving occupancy from 80% to over 90%, in line with today’s Class A market occupancy rate in the area.

Asia-Pacific: demographic trends trigger real estate opportunity
In Asia-Pacific, the growth of the middle class consumer and their spending patterns will continue to have a profound effect on changing tenant requirements and space needs across property types. Our strategic investment approach focuses on key properties that stand to benefit most from the global trends driving real estate demand across the region, such as the increase of inbound tourism and the growth of logistics demand.

Travel spending by Chinese and Indian tourists – large populations with an emerging middle class – will translate into rising tourist arrivals that will boost demand for hotel accommodation throughout Asia. Outbound tourists from China alone are anticipated to nearly double from 120 million in 2015 to 220 million by 2025 and passport ownership is anticipated

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4 Deloitte Real Estate; Summer 2016.

5 JLL “United States Office Outlook”; Q2 2016.
6 JLL “United States Office Outlook”; Q1 2016.
to grow from 4% currently to 12% in 2025.9 A number of key countries that are within a two- to four-hour flight from China, such as Japan, Korea and Taiwan, have already relaxed or are in the process of relaxing visa requirements for Chinese tourists, which will likely boost tourist numbers. To capture this trend, we will focus on opportunities to acquire undermanaged hospitality assets that offer the potential to generate revenue from inbound tourists through value-added strategies and operational improvements.

Finally, as highlighted in our last Private Markets Navigator, ongoing infrastructure improvements are transforming the Asia-Pacific logistics industry and increasing demand for well-located warehouse and industrial properties. Tenants need to locate in areas that provide for the efficient movement of goods to consumers, as well as access to major infrastructure. These trends have driven our strategic focus on acquiring industrial property along the Eastern seaboard of Australia with a focus on under-utilized, income-generating assets.

One area of particular focus has been the Brisbane-based industrial sub-market known as the TradeCoast, an economic development area in Queensland, Australia, which has historically displayed strong rental and capital market fundamentals. Rental rates have averaged 2.5% annual growth over the last ten years and yields for prime grade assets have steadily compressed after a peak of 8.5% in 2009.10 Partners Group recently acquired five industrial buildings

Our key investment strategies

**Buy below replacement cost**
We target assets with low valuations located in rebounding markets that can be repositioned and then leased-up by under-cutting market rents. These opportunities typically arise as a result of ineffective management, inadequate leasing or physical deficiencies – often these issues can be addressed in our value creation approach.

**Buy, fix, and sell**
This approach typically targets older buildings in great locations that are in need of owner-oriented asset management initiatives including capital expenditure, repositioning, lease-up and the implementation of building efficiencies to capture rental and pricing differentials.

**Develop core**
In markets with strong long-term fundamentals and trends that support additional absorption, we will selectively develop properties through ground-up construction. We focus on developments that will meet end-user demand and appeal to core investors.

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9 Goldman Sachs Investment Research; November 2015.
10 JLL REIS; Q1 2016.
Relative value analysis

From a regional perspective, pricing and competition has made opportunities in the US less compelling relative to Europe or Asia-Pacific. While Europe remains more attractive than the US, increased volatility and a slow growth outlook has bifurcated markets in terms of those exhibiting strengthening fundamentals and those still offering recovery opportunities. Asia-Pacific remains regionally nuanced with developed markets generally seeing more favorable fundamentals than emerging markets, although we underweight Hong Kong, especially due to the appreciation of the HKD in line with the USD over the last months, and Singapore, which is already operating in a very tight cap rate environment.

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<thead>
<tr>
<th>AMERICAS</th>
<th>EUROPE</th>
<th>ASIA-PACIFIC</th>
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<tbody>
<tr>
<td><strong>Core</strong></td>
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<td>Japan</td>
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<td>Australia</td>
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<td><strong>Value-added &amp; opportunistic</strong></td>
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<td>Inflection assets &amp; Mature assets</td>
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<td>Opportunistic</td>
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</table>

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Globally, among property types, office properties are a relative overweight due to below average numbers of new completions, recovering job markets, and increasing corporate demand for high-quality work places. On a global basis, there are only a few regions where we have underweighted the office sector, largely due to economic declines or overvalued pricing. Retail properties we generally underweight across regions, due to increasing threats from e-commerce, while industrial/logistics properties are the largest overweight. Each region possesses unique markets where industrial/logistics properties can be acquired below replacement cost, developed as build-to-suit properties in key logistics clusters or positioned as value-added opportunities standing to benefit from good fundamentals.

Relative value matrix

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<tr>
<th>AMERICAS</th>
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<th>ASIA-PACIFIC</th>
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<tbody>
<tr>
<td><strong>Region/country</strong></td>
<td><strong>Office</strong></td>
<td><strong>Retail</strong></td>
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<td><strong>South-east</strong></td>
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<td><strong>West</strong></td>
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How to interpret the table: the relative value matrix divides the private real estate market into various segments, defined by regions (Americas, Europe and Asia-Pacific) and investment type (directs, secondaries and primaries). Direct investments are divided into senior debt, mezzanine, preferred equity and equity. For secondaries, we distinguish between inflection assets (early stage) and mature assets according to asset/portfolio age. Primary investments are classified by investment type (debt, core, value-added and opportunistic). For locations, we classify either by geographical region or by individual countries. Green and light green highlight a segment with high relative attractiveness given Partners Group’s specific capabilities and deal flow. White highlights a neutral segment. Yellow and light yellow mean Partners Group underweights the segment and requires an even more dedicated bottom-up selection effort.
Private debt
Private lenders continue to be in demand.

As markets evolve away from the traditional bank syndicated debt model for certain types of transactions, private lenders continue to be well-placed to act as solution providers and have increased negotiating powers with regard to economic terms and credit documentation.

Market overview

LBO senior debt issuance volumes in H1 2016 amounted to EUR 114 billion across US and European markets. Issuance volumes were in line with H1 2015 levels, despite the market volatility experienced at the beginning of 2016. Debt investors demanded better compensation to deploy capital in the more volatile market environment. Margins for new senior loan issuance increased in Q1 and stabilized as concerns about global growth abated in Q2.

Another factor impacting new issue margin levels was the slowdown in CLO issuance activity, particularly in the US. Overall, CLO issuance decreased to EUR 7 billion in Europe and EUR 23 billion in the US, an 8% and 57% decline, respectively, versus H1 2015 levels. CLO issuance has fallen significantly in the US as investors demand structures that are compliant with new regulations around risk retention coming into effect in Q4 2016.

New LBO loan issuance in H1 2016 was driven by acquisition-related issuance, which constituted around 60% of new issuance in the US and approximately 70% in Europe. Refinancing related issuance was more limited due to the elevated new issue margin environment and low secondary pricing levels.

In our last Private Markets Navigator, we highlighted the fact that the high-yield bond market was affected by market volatility impacting issuance levels and the underwriting capacity of banks. In H1 2016, while overall issuance levels in the European high-yield market remained below levels seen in previous years, the market saw a resurgence of activity from March 2016 onwards driven by the ECB announcement of additional quantitative support, particularly the inclusion of investment grade corporate bonds as part of its monthly bond purchasing program. As a result of buying activity by the central bank, yields in the investment grade bond space have compressed. Some buyers of investment grade debt have therefore dipped down into the riskier, lower-rated high-yield market to achieve better yields, resulting in yield compression across the risk curve.

While there was volatility in European credit markets in the immediate aftermath of the UK’s decision on 23 June 2016 to leave the European Union, credit markets have since stabilized. In response to the Brexit vote, central banks have adopted a more accommodative approach to monetary policy. The new issue market for LBO debt issuance is open, albeit with heightened sensitivity to issuers with UK exposure and potential GBP currency risk. Going forward, there is risk of further volatility relating to the uncertainties around Brexit, however, this environment is also expected to be a source of investment opportunity for private debt investors with a longer-term view.3

1 As rated by S&P and Moody’s.
2 All figures in the ‘Market overview’ section are sourced from S&P Capital IQ, Q2 2016.
Opportunities in the current market

US: private debt gains market share

In the US, sponsors continue to look for alternative financing sources as traditional financing methods remain less attractive or available. The leveraged debt market in the US continues to evolve away from the traditional syndicated debt model, in which banks originate and distribute to a broad lender base, and has pivoted instead towards increasing reliance on larger club-style transactions, even in the middle and upper-middle markets.

This shift away from the traditional syndicated debt model is the result of factors such as continued market volatility, partially due to reduced CLO formation and increased CLO regulation, continued trouble in the energy markets and associated knock-on effects throughout the CLO and high-yield markets, and increased regulatory guidelines with regard to leveraged loan underwriting. As such, sponsors are relying instead on support from private debt capital, especially for junior capital tranches such as second lien financings. Banks are adapting to this as well, and pre-syndicating deals to active junior/second lien capital lenders with the ability to take larger hold sizes.

Due to these changing dynamics, private debt providers also have increased negotiating power with regard to economic terms and credit documentation. As the current situation is relatively new and continues to evolve, additional pricing volatility is expected throughout the year.

An example of a situation in which we were able to act as a solution-provider and offer a tailor-made financing structure was our recent investment in eResearch Technology (ERT), a provider of cloud-based solutions for clinical trial sponsors and contract research organizations. ERT is a trusted partner to many pharmaceutical companies who rely on its high-end services to ensure quality and expedience of clinical trials. The company is the current market leader in a rapidly growing sector, driven by increasing adoption of electronic solutions and underlying demand within the healthcare industry. It benefits from multi-year contracts, which provide a high degree of revenue visibility. ERT provides a strong value proposition to clients, enabling greater consistency of clinical trial results and real time access to patient data. Partners Group invested in the second lien tranche, removing market risk for sponsor Nordic Capital in a volatile funding environment.

Our key investment strategies

We provide financing solutions that plug gaps in traditional debt market coverage and are often more attractive and flexible than those offered by the broader capital or syndicated loans market. We focus on three key strategies:

Offer creative structures
We offer flexible and tailor-made capital structures. This is a key differentiator, especially in the US where banks are restricted in terms of their ability to provide leverage.

Focus on niche markets
We focus on resilient companies active in niche markets, protected by high barriers to entry and able to offer premium products or services crucial for their clients.

Support buy-and-build strategies
We support successful sponsors and management teams in their buy-and-build strategies by providing add-on acquisition financing in a timely manner, particularly under strict time constraints.
Europe: acquisition financing remains a focus area

In Europe, it is especially the mid-market space that continues to offer attractive investment opportunities. Within this space, we have supported a number of companies in expanding their market presence across borders and in scaling up and consolidating their segment. Mid-market companies are constrained in accessing the high-yield bond or wider syndicated loan markets due to their limited scale. Private debt providers offer flexible and creative financing solutions across the capital structure as an alternative or as a supplement to traditional bank club financing.

As an illustration of Partners Group supporting mid-market companies in achieving their growth objectives through buy-and-build strategies, we lead-arranged the junior debt to finance the acquisition of Safegate by ADB, a global leader in airfield ground lighting products and systems. PAI Partners, which had owned ADB since 2013, secured the add-on acquisition of Safegate, the second largest player in the market, in 2015.

The combined business, ADB Safegate, presents an attractive investment opportunity as it benefits from a large installed base with captive customers and high barriers to entry due to sticky customer relationships, the need for certification, as well as the limited inter-operability between systems from different suppliers. In addition, the two businesses offer a complementary product range. This financing also illustrates our focus on companies operating in specialized and relatively small segments of the market, with strong visibility in terms of revenue and cost projections. ADB is a mid-cap company, but at the same time a world leader in its niche market.

In the large-cap space, sponsors rely increasingly on private lenders to provide private junior capital. Similar to the environment in the US, sponsors seek to avoid market risk in volatile market conditions. The volatile environment has also reduced bank appetite to underwrite junior bond bridges for potential new issuers, unless protected by generous flex terms. We note that while there has been a resurgence of activity in the high-yield markets, issuance activity has been more focused on established issuers.

Sponsors have taken advantage of the supportive M&A environment in H1 2016 to exit portfolio holdings that have matured and achieved their growth ambitions. In May 2016, EQT reached an agreement to sell Atos Medical (Atos), the global leader in the niche market of laryngectomy care, to PAI Partners. Partners Group provided mezzanine financing in support of EQT’s initial buy-out of the asset in September 2011. Since then, the company has almost doubled in size. Its growth was driven by acquisitions in new geographies, significant investment in the global sales force, in particular in the US, Japan, the UK and Southern Europe, and continued investment in R&D and product innovation. The management team was also strengthened and supported by a strong Board of Directors with a wealth of experience in industrials. Atos’s strong growth profile and high cash conversion resulted in rapid de-leveraging of the capital structure. In view of its familiarity with Atos, and its belief in the company’s continued growth potential, Partners Group has committed to provide senior loan financing to support its current acquisition.

In Europe, the mid-market space continues to offer opportunities for private lenders to support companies in expanding across borders.

As discussed in the previous section, while credit markets have reacted calmly to the Brexit vote so far, it remains a source of potential volatility going forward. This could create investment opportunities for private lenders, which are well-positioned to provide certainty of execution for issuers who would prefer to avoid taking market risk and to step into the shoes of bank lenders if they decide to reduce lending to mid-market companies.
Asia: providing flexible financing across the capital structure

The loan markets in Asia continue to grow in terms of liquidity, driven by the strong balance sheets of regional commercial banks and stimulus measures by key Asian central banks. Regional banks – more noticeably Taiwanese and Japanese banks – are looking outside of their traditional markets to maintain yield on their loan portfolios, for instance by providing more traditional senior debt financing to sponsors in LBO situations. Chinese banks are increasingly involved in offshore financing situations to support growing Chinese outbound M&A volumes.

Within the region, Partners Group differentiates itself by remaining flexible across the capital structure and offering alternative financing solutions. We have seen substantial interest from financial sponsors for these solutions. These include the provision of non-amortizing and/or stretch senior term loans which give added flexibility for follow-on growth. Our ability to provide long-term junior debt is a key differentiator, as banks are constrained by regulatory capital requirements. Additionally, with our presence across global debt markets, we are well-positioned to offer cross-border customized financing solutions to match the increasingly global ambitions of financial sponsors in the region.

Relative value analysis

We continue to overweight mid-cap first lien debt investments and mid- and large-cap second lien investments in both Europe and the US. While risk appetite generally in the US and Europe has improved more recently, resulting in some tightening of spreads in the first and second lien space, margin levels continue to remain attractive. In Europe, we have found good relative value in club-style loan executions which offer an execution premium.

In assessing investment opportunities in the private debt space, we focus on companies with three key defining characteristics: valuation resilience, stable recurring cash flows and high cash conversion levels. In particular, we have identified segments within healthcare, for example in the medical device and healthcare services segments, and the financial services sector, for example in the payment services and insurance broking segments, which offer attractive investment opportunities aligned with the characteristics identified above.

How to interpret the table: the relative value matrix divides the private debt market into various private debt segments, defined by regions (North America, Europe and Asia/emerging markets) and debt strategy (mezzanine, second lien, first lien and senior secondaries). In each segment, we classify the investments by size (small/mid and large cap). Green and light green highlight a segment with high relative attractiveness given Partners Group’s specific capabilities and deal flows. White highlights a neutral segment. Yellow and light yellow mean that Partners Group underweights the segment and requires an even more dedicated bottom-up selection effort.
Private infrastructure
Capitalizing on transformative trends.

As investor appetite for infrastructure assets continues to lead to lofty valuations in the crowded core segment, we maintain our focus on select greenfield or brownfield value-add opportunities with the aim of capitalizing on transformative shifts in infrastructure use or needs.

Market overview
The big picture for private infrastructure investments has remained largely unchanged over the last six months: large investor appetite for the asset class has maintained upward pressure on asset valuations and caused a resulting squeeze on expected equity returns. This development has been most pronounced in the core infrastructure segment in developed markets, and, within this segment, particularly in large-cap assets in sectors with the most stable regulatory frameworks and revenue models that are largely independent of demand risk. These include water utilities, energy infrastructure assets – electricity and gas transmission or distribution lines for instance – and availability-based social infrastructure. We have also observed very high valuations in high profile transport-related assets in sectors with the most stable regulatory frameworks and revenue models that are largely independent of demand risk.

These very high valuations illustrate our ongoing concerns of a fundamental disconnect between asset valuations and the inherent risks in certain infrastructure businesses. In developed markets, for example, valuation multiple expansion has been more pronounced than EBITDA growth, most likely owing to the low interest rate environment and the resulting increase in demand for the infrastructure asset class, as illustrated in the chart below. In Asia and the emerging markets, on the other hand, we have seen greater fundamental EBITDA growth but only limited increases in valuations, potentially due to the subdued economic outlook as well as the exposure of many emerging markets to changes in monetary policy in developed markets. Looking at this data, it seems evident that asset prices, and not underlying asset performance, have been the key drivers of the majority of returns.

This explains our emphasis on value creation as the fundamental differentiator in infrastructure investments and our subsequent over-weighting of select greenfield investment opportunities, or brownfield opportunities with a clear growth plan and/or need for operational improvements. Only by creating value during our investment can we ensure that there is substance behind subsequent increases in valuations and bypass the froth characterizing the overcrowded core space.
Opportunities in the current market

In the current environment, we continue to overweight opportunities in market segments where we can create value via capex projects and operational improvements. We look to profit from scale through platform investments or by identifying add-ons for our existing platforms, and we selectively look at less traditional, off-market transactions with the aim of capitalizing on transformative shifts in infrastructure use or needs.

Europe: demand for communications and renewables

In Europe, we have further enlarged our focus within the communications and renewable power sectors. Communication infrastructure investments are attractive due to rapidly increasing demand for mobile voice and for data. For the years 2015 to 2020, the European Telecommunications Network Operators’ Association predicts CAGRs for mobile data traffic of 52% and 45% in Central & Eastern and Western Europe, respectively. Specifically, we have observed high levels of demand for fast data bandwidth for mobile and fixed users, while at the same time significant underinvestment in fast broadband infrastructure. Outside of major metropolitan areas, broadband penetration is still limited in many parts of the continent, especially in Eastern and Southern Europe. To address this issue, many national, regional and local governments are putting mechanisms in place to encourage fiber broadband investment in communications backbones and distribution.

Particularly attractive is the trend towards ‘open access’ networks, which separate asset ownership from service provision, opening the door to third-party asset ownership. In this space, we prefer distribution grid or fiber-to-the-premise connection projects over backbone investments. The former offer a compelling risk/return profile as they often operate as the sole provider within a region under long-term concessions, thus benefitting from secure revenue streams. We recently capitalized on the fiber opportunity via our investment in Axia NetMedia (Axia), a fiber network operator formerly listed on the Toronto Stock Exchange, which we acquired in July 2016.

Axia’s business model fits squarely with our relative value preferences: the company designs, installs and operates open access fiber-based internet and data networks across North America and France, specializing in bringing fast broadband to rural and semi-rural areas. Telecoms companies and other service provider customers rent capacity in Axia’s networks in order to provide internet and data services to their corporate and household customers. Axia and its subsidiaries already operate approximately 26,000 km of fiber networks and have numerous opportunities for growth, both in terms of expanding their existing networks in Canada and France, as well as pursuing further network developments around the globe. We will endeavor to grow Axia into a leading global fiber infrastructure platform by exploring potential add-on opportunities in both Canada and France.

Renewables become increasingly competitive

The renewable energy sector is also a focus area in Europe, where deal flow is expected to remain strong over the coming decade as a result of the still unmet EU 2020 renewable energy targets. Generous support schemes, for example in the form of feed-in tariffs above the electricity pool prices, have over the past years significantly incentivized investment in the sector and investors are well advised to critically assess the potential tail-end risks of such schemes. Experience has shown that many of the early renewables projects were overly-reliant on subsidies and high leverage and thus unable to withstand unexpected retroactive changes in regulation, as happened in Spain and Italy. We focus on renewables in core European markets such as Germany, France and the UK, where we believe regulation and tariff regimes are generally more stable and reliable. Meanwhile, the significance of subsidies is decreasing as renewable energy technologies are becoming more cost-competitive compared to established energy generation. A regularly updated study by Bloomberg New Energy Finance shows that the levelized cost of electricity (LCOE) for renewable technologies continues to nudge downwards, helped by cheaper technology and lower finance costs, while gas-fired and coal-fired generation become relatively more expensive as illustrated in the chart below.

Silicon Ranch Corporation, a leading developer, owner and operator of solar energy facilities in the US.
Levelized costs take into account not only the cost of generating a marginal megawatt hour (MWh) of electricity, but also the up-front capital and development expense, the cost of equity and debt finance, and operating and maintenance fees. Onshore wind and solar PV have in particular managed to substantially close the cost gap, with onshore wind fully cost competitive in Germany and the UK, where it was the cheapest new electricity to produce in H1 2016 with an LCOE of USD 79/MWh and USD 85/MWh, respectively, compared to USD 89/MWh for coal in both countries.

**EMEA levelized cost of electricity ranges by technology**

We recently closed an investment in **Merkur Offshore** (Merkur), a construction-ready 400MW offshore wind farm development located in the German North Sea. The project has already secured grid connectivity and foundations will start to be installed in mid-2017, with completion scheduled for March 2019. Once constructed, Merkur will benefit from the German offshore feed-in-tariff.

**US: energy needs fuel investment opportunities**

Investments in energy generation and infrastructure continue to be a key theme in the US, where low natural gas prices have persisted. Additionally, environmental restrictions continue to drive the retirement of older thermal power generation facilities such as coal, oil, and gas-steam plants. H1 2016 figures from the US Energy Information Administration show that roughly 45,000 MWs of coal capacity alone was retired between 2010 and 2015. As discussed in our last Private Markets Navigator, this combination of low natural gas prices and increasing environmental regulation is driving a reconfiguration of the US generation mix, which opens up opportunities to invest in gas-fired, solar, and wind generation assets. Deal flow is abundant, but we only consider brownfield value-add or greenfield power assets with long-term off-take agreements to be attractive.

In addition, the attractiveness of solar and wind assets has increased based on the December 2015 extension of the federal renewable energy tax credits. The extension, granted for the next five years, has eliminated a key uncertainty that had been problematic for the sector in the past. We capitalized on this newfound certainty with our recent investment in **Silicon Ranch Corporation** (SRC), a leading developer, owner and operator of solar energy facilities in the US. SRC is one of the fastest-growing independent solar power producers in the US and currently operates over 100 MWs of commercial- and utility-scale solar projects. The company developed the first large-scale solar facilities in Tennessee, Georgia, Arkansas and Mississippi, and recently completed its first projects in Colorado with plans to significantly expand its portfolio across the US in the next few years through both organic growth and acquisitions. SRC’s projects benefit from 20- to 30-year power purchase agreements with high-quality utility and corporate off-takers.

In the energy infrastructure sector, we are focusing on opportunities in midstream assets active in the gathering, processing, storing, transporting and exporting of oil, natural gas, natural gas liquids, and refined products. Opportunities may also be found further downstream in petrochemical plants and associated infrastructure. Valuations of midstream Master Limited Partnerships (MLPs) have declined by 30-50% over the last twelve months based on low oil & gas prices.1 This is limiting MLPs’ ability to access capital markets for the financing of their business activities and, in turn, creates opportunities for firms like Partners Group to invest in the sector. We prefer asset-level investments – greenfield assets or brownfield asset carve-outs – with limited exposure to commodities and in strategic locations. Structured investments at the corporate level are also attractive, especially in MLPs with diverse business interests or asset portfolios and an ample equity cushion in their capital structure. An example of this is our recent investment in **NGL Energy Partners** (NGL), a vertically integrated energy company based in Oklahoma. NGL is a full service provider to producers and end-users active in five different business areas – crude oil logistics, water solutions, liquids, retail propane and refined products and renewables – and across different energy basins and markets in the US. This diversity creates a natural hedge and mitigates NGL’s exposure to specific market risks and commodity price movements.

As in Europe, supply-demand dynamics in US broadband communication infrastructure create attractive investment opportunities. Demand tailwinds for broadband infrastructure come from rapidly increasing wireless data usage due to the penetration of smartphones, tablets, wearables, M2M modules, and other connected devices. We see opportunities throughout the value chain, from subsea cables to terrestrial fiber networks and towers, although we consider subsea and terrestrial fiber assets most attractive currently on a relative value basis.

**Asia-Pacific: generation mix shifting to renewables**

In Asia-Pacific, renewable energy also continues to be an attractive sector, as countries in the region re-balance their energy generation mix away from coal and nuclear to include renewable energy, in significant quantities in some cases. The shift towards renewables is also supported by competitive generation costs compared to thermal energy, due to high

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1 UBS Global Energy Group; May 2016.
imported fuel costs. Partners Group is an active investor in this sector in Asia, where it has to-date invested capital to develop over 620MW of renewable power, with another 750MW in construction. We particularly like investments in countries where renewables capacity build-out is motivated by more than just a generous subsidy regime.

One jurisdiction that we believe offers particularly attractive risk/return is Taiwan. The Taiwanese renewables sector is in transition: swayed by public opinion following the 2011 nuclear disaster in Fukushima, Japan, the Taiwanese government is winding down nuclear generation, which is currently the third largest electricity source in the country, and replacing it with renewable sources, particularly solar capacity. The recently elected government has defined a target to develop up to 2GW of solar capacity p.a. for the next ten years, a substantial increase from the current level. This is by far the largest installation target among the various renewable energy sources and also supports the domestic solar PV panel manufacturing industry in Taiwan, the world’s second largest producer of elements used in solar panel production. Furthermore, the feed-in tariff (FiT) that is currently offered for solar power is, at USD 0.14/kWh, comparable to FiTs in the Philippines and Thailand. It is governed by the Renewable Energy Development Act (REDA), which offers developers a 20-year power purchase agreement with a fixed tariff as well as mandatory grid connection.

We believe that in combination, these factors make a strong case for investment in Taiwan and we see an opportunity to build a renewable power platform of scale, where attractive risk-adjusted returns will be available to first movers. With this in mind, we recently agreed to invest in a Taiwanese solar power development platform. The platform has entered into an agreement with Sinogreenergy (SGE), a Taiwanese developer of photovoltaic power plants, to develop a portfolio of up to 550MW of solar power plants across Taiwan over the next three years. Partners Group and SGE have already sourced a number of sites throughout Taiwan for the development of rooftop and ground-mounted solar plants and have others in due diligence.

Once completed, the portfolio will be supported by a 20-year Power Purchase Agreement with the state-owned utility. Australia also offers an attractive environment for investment in the sector following the ratification of the government’s Renewable Energy Target, whereby 33,000 GWh, or more than 23% of Australia’s electricity, should be derived from renewable sources by 2020. We estimate that 6GW needs to be built to meet this target, with less than 0.5GW currently in construction. To-date, the renewable sector in Australia has had limited appeal to infrastructure investors due to a lack of long-term off-take contracts in the market, as contracting so far has been driven by government regimes. There are signs that this is beginning to change, with two of the three major electricity retailers in the country, Energy Australia and Origin, offering medium-or long-term off-take contracts. The remaining energy retailer, AGL, is expected to provide long-term contracts in the market in the near term. As a result, the number of renewable greenfield energy projects being developed and constructed has increased, providing a number of potential investment opportunities.

Secondaries: high competition and high prices
The situation in the infrastructure secondaries market has been largely the same throughout the year: buyer competition is high and assets are traded at high prices, often at premiums to net asset values. That said, we observe a bifurcation in the market, with high-quality funds yielding high transaction prices and lower quality portfolios often unable to attract sufficient buyer interest. Similarly, we also see a widening gap between top-line deal flow volume and executed volume, which underlines sellers’ generally high price expectations. At this point, we believe that the upfront return premium for mainstream secondaries over direct investments has largely disappeared. However, opportunities to acquire stakes in funds fully invested in a portfolio of diversified core infrastructure assets can still offer an attractive risk/return profile due to a significant yield component and their low risk nature. Besides this, we continue to focus on more complicated situations such as portfolio disposals or long-term liquidity solutions, several of

3 Bureau of Energy, Ministry of Economic Affairs, Taiwan; October 2015.

How to interpret the table: the relative value matrix divides the private infrastructure market into various regions (North America, Europe and Rest of World) and segments, which are then divided into sectors (transportation, communication, power conventional, power renewable, energy infrastructure, water, waste management, and social), financing stage (brownfield and greenfield) and investment types (directs or secondaries). For directs, we distinguish between equity and debt. For secondary investments, we distinguish between inflection assets (early stage) and mature assets according to asset/portfolio age. Green and light green highlight a segment with high relative attractiveness given Partners Group’s specific capabilities and deal flows. White highlights a neutral segment. Yellow and light yellow mean that Partners Group underweights the segment and requires an even more dedicated bottom-up selection effort.

Relative value matrix

Our key investment strategies

Focus on value enhancement potential
We focus on investment opportunities that offer us the potential to enhance operational value through growth and efficiency improvements. A key source of these opportunities is the ongoing trend for corporate owners of infrastructure to sell assets as part of a restructuring.

Search for transformative growth
We seek out opportunities where strong long-term fundamentals in a particular market support the demand for building a select type of infrastructure, for example, due to evolving infrastructure needs or changing market fundamentals.

Build out market-leading infrastructure platforms
We look for investments that offer us the opportunity to build scale, for example, through investing in fragmented markets that have the potential for consolidation and platform-building.
The industry view
Q&A with an industry expert.

A well-known face within the subsea cable industry, Larry Schwartz is Chairman and CEO of Seaborn Networks, which recently partnered with Partners Group to develop Seabras-1, the first ever direct subsea fiber optic cable between New York and São Paulo. Here, he shares some insights into the critical role subsea cables play in global telecommunications.

Q: How has the telecommunications sector changed in recent years?
The biggest change has been the move from generalization to specialization. In the late 1990s, telecoms companies had an indiscriminate approach to capital expenditure and would try to do everything for everyone. The telecoms crash at the beginning of the new millennium changed this but it still took a while for the message to sink in. In addition, with telecoms deregulation well established, the days of having one big incumbent carrier controlling telecoms in a country are gone in much of the world. Telecoms companies are increasingly focusing on their core expertise. As a result, we no longer talk about who has succeeded in ‘owning’ a market, but about who is the best player in each sector within that market.

Q: How has this impacted subsea cable providers?
This is very much the case for the subsea cable world too, where the biggest change has been the shift to an ‘independent cable operator’ model. Until recently, large telecom firms such as BT or AT&T would own cables themselves, typically in a consortium or joint venture with their counterparts at the other end of the system. Although there are still some telecoms providers with a wholesale business model building their own cables, that model is showing increasing signs of strain. The fact is that big industry players are now fiercely competing in markets far away from their legacy home markets, and this creates potential consortium relationships that are inherently dysfunctional. Added to that, large content providers are looking to dis-intermediate carriers by being anchor tenants on subsea systems. We are at a real inflection point in our industry: just as mobile carriers have recognized they do not need to own their own towers, so telecom providers have recognized they do not need to own their own subsea cables. This shift has opened opportunities for independent cable operators like Seaborn Networks in the same way it opened the door to independent tower operators.

Q: How important are subsea cables in the overall context of the telecoms industry?
Subsea cables are without doubt the backbone of global communications. Over 95% of all communications traffic travels via transoceanic routes. Subsea cables are without doubt the backbone of global communications. More than 95% of all communications traffic globally travels via transoceanic subsea systems connecting countries and continents, while only a small fraction travels via other methods including satellite. Satellite is ideal for point to multi-point communication, but in terms of the ability to move massive quantities of data from point A to point Z with the lowest cost and highest quality of service, subsea cables will remain the best option within all of our lifetimes.

Q: What is the shelf-life of a subsea cable?
The average engineering design life of a subsea cable is 25 years. However, cables are typically replaced before this, not because...
Larry Schwartz is the Chairman and Chief Executive Officer of Seaborn Networks. He previously served as CEO, board member and one of the owners of the parent company of Global Marine Systems Ltd., one of the world’s largest fleets of cable ships and a leading installer of submarine fiber optic cable systems. He also previously served as a board member of International Cableship Pte Ltd, a JV with Singapore Telecommunications that provides subsea cable maintenance in Southeast Asia. Before entering the cable ship business, Larry was a Senior Vice President of Genuity Inc., a Fortune 1000 and Nasdaq-listed wholesale carrier with a global network infrastructure. Prior to Genuity, Larry was an equity partner with Choate Hall & Stewart, where he specialized in international communications & media transactions. He began his career with White & Case, where he worked on international project finance transactions, large-scale privatizations and M&A.

their life comes to an end but because of the huge growth in demand for capacity coupled with technology improvements. It is often more cost-effective to replace older cables altogether rather than continuing to operate older, existing routes. If you take systems on the US-Brazil route that were engineered in the late 1990s, for instance, you have an initial maximum design capacity of under two terabits, which could be upgraded up to a maximum of 4-6 times that initial capacity depending on the system architecture. Today, our Seabras-1 system has an initial design capacity of 72 terabits and we expect to get 4-6 times that amount over the life of our system.

Q: How does a cable provider address critical challenges such as data protection and privacy?
These issues are critical for everyone but they are also part of the reason why the independent cable operator model works. If you are a large telecoms carrier or a content provider in the internet world, you have a huge amount of information about your end customers. In contrast, as an independent subsea cable operator, we are just a ‘bridge’ and have no servers filled with confidential customer data. Of course we are very much focused on maintaining high levels of security in our landing stations, but essentially we do not come into contact with the end customer data of our clients.

Q: What is unique about Seabras-1, our joint venture project?
Seabras-1 will be the first ever direct point-to-point route between São Paulo and New York, meaning that we can run a direct connection between the largest commercial centers of North America and South America without any landings of the system in between the A and Z ends. In 2000, when most of the existing cables between the US and Brazil were installed, it would not have been technically possible to run a system this long without the whole system landing in at least one midpoint location. Today, we are able to run significantly more than 10,000 km without additional landings. This also means that there are fewer active elements on the system, so fewer things
can go wrong. All of this is only possible thanks to the vast improvements we have seen in subsea cable technology and services over the years.

**Q: Seabras-1 will connect the US and Brazil – why these two markets?**

Apart from connecting two of the largest financial and commercial centers in the Western Hemisphere, Seabras-1 will also be one of the critical paths for communications between South America and the rest of the world. From a geographical standpoint, landing in São Paulo provides you with easy access to neighboring countries such as Argentina and Uruguay, as well as to the rest of the South American continent. On the New York side, you can immediately access the transatlantic cable routes that connect the US and Europe, as well as the rest of the US and Canada and the transpacific cable routes that land on the West Coast. The cable will therefore not only service the US and Brazil, but also offer connection points to much broader, international markets.

**Q: What kind of impact will the Seabras-1 cable have?**

With Seabras-1 we can offer the most competitive and bespoke access to the Brazilian market. We can attract a broad range of competitors, which helps lower costs for end consumers and increase broadband capacity. This, in turn, can have a positive impact on a country’s economic growth. Other than having the potential to contribute to economic growth, our system offers a new path to and from both the US and Brazil. Countries do not want to be reliant on limited paths of communication but want to have a variety of diverse, next-generation paths that provide different access points to their markets.

**Q: Are there plans for additional similar projects in future?**

The system we are building has a number of branching units for potential future expansion throughout the Western Hemisphere. These include branching units that can connect Seabras-1 to Las Toninas (Argentina), Rio de Janeiro and Fortaleza (Brazil), St. Croix (USVI), and Miami and Ashburn (US). We foresee building these branches out in the not too distant future when there is contracted demand to do so. In addition, we are exploring the possibility of building other route options and see the potential for strategic acquisitions as well.

**Q: What predictions would you make for the future of your industry?**

I believe we will see a continued trend towards independent ownership of subsea cables. We will also see a greater percentage of subsea cable capacity being contracted by content providers such as Google, Facebook, Microsoft, Amazon or Apple, as well as an increasing number of content providers with the desire to actively put together their own global telecoms infrastructure. We are still in the very early stages of cloud computing and the ‘internet of things’, so it will be interesting to see how rapidly these fields evolve and the impact this has on global capacity demand too. Ultimately, these are not isolated islands of technology but are networks, and networks are dependent on subsea cables.

We no longer talk about who has succeeded in ‘owning’ a market, but about who is the best player in each sector within that market.
Liquid private markets
Transportation sector stands out.

Market overview
Despite healthy fundamentals, high realizations and strong balance sheets, listed private equity companies experienced relatively high volatility in H1 2016 and discounts widened from 18% as of December 2015 to 25% as of June 2016. While US asset managers and business development companies showed a recovery in H1 2016 after their weak performance in 2015, valuations in both sectors remain attractive. Valuations of direct investment companies declined during the period, predominantly in Europe, as investors realized gains following record divestment activity in the segment. Brexit had a substantial impact on UK-listed private equity entities following the referendum results.

Despite the highly volatile equity markets in H1 2016, listed infrastructure equities continued to provide growth and development (+7.9% versus equity markets measured by the MSCI World TR EUR of +1.7%). During the period, oil prices recovered sharply, which led to a rally in the share prices of pipeline operators. Additionally, the prospect of a swift US interest rate increase dimmed, leading to a good performance from US transmission and distribution stocks.

Sector focus: North American railways
We continue to favor GDP-linked sectors, such as transport, where valuation levels are relatively attractive and fundamentals remain strong. One particular example is North American railroad companies, which we believe offer good value presently, as share prices have hit multi-year lows following weakened demand for coal freight as a result of the slump in oil prices, which spilled over to coal demand and prices. Despite the weak demand environment due to coal weakness, low grain volumes and pressure on intermodal in 2015, North American railroads remain the preferred mode of transport for industry, given the cost advantages compared to trucks and the breadth of network. Class I North American railroads transport more than 60% of all freight across the continent. Furthermore, railroad companies have been successful in maintaining price increases comfortably ahead of cost inflation (>-3% CAGR), and have carried out large cost-cutting programs that have helped to grow earnings and maintain a healthy balance sheet. Given high operating leverage in the sector, we believe share prices might over-proportionally benefit from a volume recovery. Finally, the railroads continue to generate good free cash flow, which they are using to buy back shares. This should further increase EPS growth.

Relative value matrix

How to interpret the table: the relative value matrix divides the listed infrastructure and listed private equity markets into regions (North America, Europe and Rest of World) and types of investment available. Green and light green highlight a segment with high relative attractiveness given Partners Group’s specific capabilities. White highlights a neutral segment. Yellow and light yellow mean that Partners Group underweights the segment and requires an even more dedicated bottom-up selection effort.

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1 As measured by the Partners Group Listed Investments SICAV – Listed Private Equity.
2 As measured by the Partners Group Listed Investments SICAV – Listed Infrastructure EUR-I.
3 US Department of Transport – Bureau of Transportation Statistics; July 2016.
The portfolio view
Summary across all private markets.

Modest top-line growth, lofty valuations, the prospect of rising rates in the US and uncertainty following the Brexit vote are likely to increase volatility in capital markets. Investors are trapped in an environment where capital appreciation themes in the public sphere may be running out of steam as asset prices are at peak levels, and the return from dividends and earnings growth is capped. At the same time, many fixed-rate debt instruments are offering low returns, putting pension funds and insurance companies in a precarious position in their aim to meet return requirements.

Valuations have also been pushed up in private markets, in certain market segments even to record highs. Nonetheless, headwinds stemming from high valuations and their impact on lower prospective future returns are less intense for private markets where returns can be enhanced by value creation and asset selection. As such, the historical outperformance of private over public markets should persist: as opposed to their public peers, private markets offer superior upside potential as active ownership, a long-term investment horizon and the ability to create value by implementing strategic or operational improvements strengthen the underlying portfolio assets and their respective returns from bottom-up growth. Our analysis shows that private market outperformance tends to be strongest in an environment like today’s, characterized by at least modest growth but with elevated valuations, as in the 2003 to 2007 period.

Private equity outperforms public markets in solid growth periods

The Partners Group Expected Return Framework

Our Framework calculates expected asset class returns for private and public markets based on fundamental drivers (income, growth and valuation change) over a seven-year horizon. The Framework complements our qualitative relative value investment approach by adding a quantitative component, reflecting broad industry returns.

Return from income: annual cash flows from the investment and other income-like components of an asset’s return, like buyback-adjusted dividend yield on equities or interest received on a bond.

Return from growth: the rate at which the value of an investment increases due to fundamental drivers. For fixed income instruments, return from growth is usually zero. For equities, this is earnings growth. In the case of private markets, return from growth is complemented by any returns generated through value creation strategies, like platform growth or operational improvements.

Valuation change: the change in the price the market pays for a cash flow stream consisting of both income and growth. For public market equities, this is the change in the PE ratio, for private equity it is EV/EBITDA changes. For private infrastructure and private real estate it is the asset’s sensitivity to a change in underwriting IRR and cap rate, respectively. Given the floating rate nature of private debt, valuation change is usually close to zero while fixed-income, public market bonds are impacted by duration. The underlying assumption is that valuations revert to long-term averages over the seven-year horizon.

Value creation as the major return driver

In a straightforward and intuitive model, expected returns for the various broader asset classes can be broken down into three components: return from income, return from growth and valuation change, as illustrated in the Partners Group
Growth

Second Half 2016

today’s investment landscape supports the case for private markets investing. In the case of public equities, the low growth,

Continued outperformance of private markets over public peers

Applying the Partners Group Expected Return Framework to today’s investment landscape supports the case for private market investing. In the case of public equities, the low growth, low inflation environment suppresses cash yields and puts an upper barrier on top-line growth. Above average valuations, which we expect to mean revert over a seven-year horizon, should further limit the upside. We expect private equity, in contrast, to outperform public equities by 5-7 percentage points on a net basis annually, despite the larger expected negative drag from valuations, as a result of value creation. In the public debt space, returns from income are depressed by low yields. Yields to maturity on the high yield bond index, for instance, are currently yielding nearly two percentage points below their long-term average level. Expected returns will be further depressed by duration impact should rates indeed normalize. Floating rate private debt, on the other hand, remains in a sweet spot with attractive spreads and low duration.

Expected broad industry annual returns by asset class

For academic purposes only. All of the above data is derived from Partners Group calculations and assumptions and should not be construed as representative of Partners Group investments. Partners Group utilizes historical market data and academic research to generate the above calculations, a full list of which can be provided on demand. Please note all value creation inputs are based solely on Partners Group’s internal research. Past performance should not be a guarantee of future results. There is no assurance that expected returns will be achieved.

Constructing resilient private markets portfolios in a low growth, high valuation environment

As in the H1 2016 Private Markets Navigator, we have opted to provide two hypothetical private markets portfolios, illustrating the potential application of the relative value investment themes identified. The portfolios maintain an overall diversified

THE PORTFOLIO VIEW

Gross return by component

Public markets

Gross return by component

Public equity

Gross return by component

Private market equity

Expected Return Framework below. In private equity, private infrastructure and private real estate, bottom-up growth is the main return driver, as it captures most of the impact of value creation, especially in times in which the impact from valuation change is more likely to be negative.

Taking private equity as an example, value creation can be generated through platform growth via add-on acquisitions, operational improvements like margin expansion (optimizing cost of sales or reducing overhead costs), or the impact of financing by optimizing the capital structure and deleveraging. For instance, in July 2013, we invested in Universal Services of America (Universal), a US-based provider of manned guard services, janitorial services, systems and monitoring services, and fire and life safety programs. Over our two-year holding period, we worked in close partnership with management to complete over 20 acquisitions, as well as to grow the company organically. This strategy enabled Universal to create 17,000 new jobs and to increase revenues by more than 80%, achieving a growth rate five times greater than the industry average.

PG Expected Return Framework

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Expected Return Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public markets</td>
<td>∆P/E ratio</td>
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<tr>
<td>Private equity</td>
<td>Earnings growth</td>
</tr>
<tr>
<td>Private real estate</td>
<td>Cash flow financing cost</td>
</tr>
<tr>
<td>Private infrastructure</td>
<td>Cost of equity + financing cost</td>
</tr>
</tbody>
</table>
approach and take into account technical factors such as deal flow, breadth of asset classes and incremental risk/return factors. In the current environment, peak valuations and rising headwinds in capital markets make us focus on assets exhibiting relatively stable valuations even during turbulent times in order to mitigate – if not avoid altogether – the expected negative valuation impact as projected by the Framework.

In the **return-focused** portfolio, asset classes with high upside potential such as private equity and private real estate have the largest weight. In direct buyouts we focus on companies with recurring and visible revenue streams, such as companies that bond customers to their products. For instance, we have seen a strong trend towards outsourcing non-core activities in the healthcare sector in the US. This creates opportunities in healthcare services businesses, where the client base is traditionally sticky, as service providers usually customize their offerings to suit client needs. With the aim of protecting and building on capital invested, these investments should be complemented by initiatives to grow the underlying company through buy-and-build strategies. Within private real estate, we still believe that opportunities are currently best captured via the secondary market. For example, pre-financial crisis vintage funds are gradually feeling the pressure to liquidate tail-end portfolios. Also, in relative terms, bespoke private real estate secondaries can offer better expected returns compared to their private equity equivalents currently, given the fact that there are fewer secondaries managers able to customize solutions to sellers’ needs. For direct real estate investments, cap rates have further compressed. We look to selectively invest in value-added strategies and sub-sectors that benefit from global trends, such as e-commerce and growing urban centers. In the infrastructure space, we have slightly increased the allocation to greenfield investments. Communications and renewable energy are the most appealing sub-sectors at present, also supported by strong demand dynamics. Within communications, we prefer terrestrial fiber and subsea cables over towers, which are expensive at the moment. A general drive for cleaner energy across advanced and emerging economies results in a busy pipeline of opportunities and enables return enhancement via greenfield premia.

**Yield-focused** investors should place greater emphasis on income-generating asset classes like private debt and private infrastructure. The yield-focused portfolio remains broadly unchanged from H1 2016. Corporate debt in particular remains in a sweet spot. Since early 2015, banks have reduced their role as intermediaries for second lien underwritings, driven by macro-economic and regulatory restrictions in the US. At the same time, with volatile markets, syndication cannot be guaranteed and sponsors cannot count on public markets to fill the financing gap. As a result, investment opportunities are plentiful and the lack of private debt providers especially in the mid-market space not suitable for CLOs translates into compelling spreads and payment in kind upside and, thus, return from income. We have therefore slightly increased the allocation to subordinated debt (second lien), while somewhat reducing the overweight to private infrastructure. Within private infrastructure we focus on defensive, brownfield assets operating under strong regulatory frameworks in order to protect investments from demand risk. For instance, lower power prices are driving a continued cycle of non-core asset divestment on behalf of utility entities, for example in the heat generation and/or gas distribution space. Senior debt on infrastructure and real estate remains pricey and we underweight the segments.

### Illustrative private markets portfolios

<table>
<thead>
<tr>
<th>Return-focused</th>
<th>Yield-focused</th>
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</thead>
<tbody>
<tr>
<td><strong>Private equity</strong></td>
<td><strong>Corporate debt</strong></td>
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<tr>
<td>Growth capital (0%-10%)</td>
<td>Subordinated debt (5%-20%)</td>
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<tr>
<td>(5%-20%)</td>
<td>13%</td>
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<tr>
<td>Secondaries (5%-20%)</td>
<td>Subordinated debt (5%-20%)</td>
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<tr>
<td>8%</td>
<td>13%</td>
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<tr>
<td>Opportunistic (5%-15%)</td>
<td>Debt</td>
</tr>
<tr>
<td>8%</td>
<td>(5%-20%)</td>
</tr>
<tr>
<td>Private real estate</td>
<td>Senior debt</td>
</tr>
<tr>
<td>(0%-15%)</td>
<td>(0%-10%)</td>
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<tr>
<td>13%</td>
<td>2%</td>
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<tr>
<td>Secondary infrastructure</td>
<td>Brownfield</td>
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<tr>
<td>(5%-25%)</td>
<td>(5%-25%)</td>
</tr>
<tr>
<td>18%</td>
<td>15%</td>
</tr>
<tr>
<td>Special situations/mezzanine (0%-10%)</td>
<td>Debt</td>
</tr>
<tr>
<td>5%</td>
<td>(5%-20%)</td>
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<tr>
<td>Corporate debt</td>
<td>Senior debt</td>
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<td></td>
<td>(30%-60%)</td>
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<tr>
<td></td>
<td>50%</td>
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<tr>
<td>Value added (5%-20%)</td>
<td>Subordinated debt</td>
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<tr>
<td>12%</td>
<td>(5%-20%)</td>
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<tr>
<td>Buyout (15%-45%)</td>
<td>30%</td>
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<tr>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Secondary infrastructure</td>
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</tr>
<tr>
<td>(0%-5%)</td>
<td>2%</td>
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<tr>
<td>Greenfield (5%-25%)</td>
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<td>18%</td>
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<td>Opportunistic (5%-15%)</td>
<td></td>
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<tr>
<td>8%</td>
<td></td>
</tr>
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*Source: Partners Group, for illustrative purposes only.*
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