Leveraging the winds of change

Private Markets Navigator Outlook 2018
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Welcome to Partners Group’s Private Markets Navigator for 2018. The Private Markets Navigator shares Partners Group’s mid-term outlook and investment preferences for all private markets asset classes.
Private markets outlook
Leveraging global megatrends.

As the chances of a deviation from our base case economic outlook of modest growth continue to rise, we are focusing on sectors benefiting from the global megatrends that we believe will continue to generate attractive investment opportunities.

While maintaining its rather modest pace in historic terms, the global economy picked up some speed in H2 2017, partially supported by improving fundamentals and partially due to cyclical factors. Inflation and wage pressures remain benign across developed markets and have allowed central banks to maintain or gradually reverse unprecedented loose monetary policies. This smooth sailing has manifested itself in improving earnings growth, which in turn has supported strong equity returns in 2017 (rather than these being supported simply by multiple expansion). Whether this strong earnings growth is sustainable remains to be seen: following flattish developments over the past three years, earnings are growing from a relatively low base and much of the improving top-line growth and the support from the US tax reform are embedded in expectations.

According to our base case macroeconomic projection, continued low but steady growth – most likely at a slightly slower pace going forward – and gently rising inflation set the conditions for further tightening in certain regions (US), although policy is likely to remain accommodative in others (Eurozone, Japan). We continue to believe that markets are lenient about the pace of Fed rate hikes and while we do not project a more material correction of capital markets in the near future, higher rates are likely to temper rich equity valuations.

As the cycle is entering its ninth year, the chances of a deviation from our base case are rising, as described in more detail in the H2 2017 edition of our Private Markets Navigator. In particular, the combination of Fed balance sheet reduction and the rising US budget deficit in light of tax cuts raise uncertainty about the future path of longer-dated US rates. The following table lays out our base case and three potential test scenarios, showing how these could impact capital markets and valuations. The test scenarios can be used to assess the robustness of an asset, sector or portfolio of assets to different economic and market outcomes. Given the more uncertain outlook, we screen the market for assets that are or can become leaders in their field and operate in more defensive sub-segments of the market, yet experience better growth on the back of transformative trends. Implementing value-accretive strategies, like enhancing tenant experience in real estate or building scale and promoting organic growth.

Note: contributions to changes in MSCI Local Currency World Index from the last day of previous year, 2009-2017.
Source: Capital Economics, January 2018; based on data by Bloomberg and Thomson Reuters.

1 The aim of this approach is to test assets on a standalone basis against a variety of potential outcomes rather than stress-testing risk at a portfolio level, which is instead carried out on a client-by-client basis. As such, the scenarios do not include a Global Financial Crisis scenario.
and inorganic growth in the corporate and infrastructure space, makes assets more robust and strengthens valuations, even against challenging macroeconomic backdrops.

**Economic and market scenarios: main parameters**

<table>
<thead>
<tr>
<th></th>
<th>Base case</th>
<th>Test scenarios</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP growth</strong></td>
<td>2-3%</td>
<td>2-3% and 3-4%</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td>-2%</td>
<td>-1% and 2-3%</td>
</tr>
<tr>
<td><strong>Change in Fed funds rate</strong></td>
<td>+200-250bps</td>
<td>+50-100bps and +300-500bps</td>
</tr>
<tr>
<td><strong>Market valuations</strong></td>
<td>10% lower</td>
<td>20% higher and 20% lower</td>
</tr>
</tbody>
</table>

*Capital (NAV)-weighted as per the Partners Group asset split across US, Europe, other advanced and emerging markets.

Note: market valuations refer to price-to-earnings ratio for public equities, enterprise value to earnings before interest, tax, depreciation and amortization for private equity, capitalization rates for private real estate and underwriting internal rate of return for private infrastructure.

Source: Partners Group, H1 2018. For illustrative purposes only.

**US: searching for higher growth segments with downside resilience**

The US economy is in the advanced stages of the macroeconomic cycle with little signs of slowing down. In fact, this is already the third-longest expansion in post-war times. Unemployment is at a 17-year low, consumer confidence remains buoyant and business spending is finally picking up. Inflation remains near the Fed’s target and wage pressures are subdued despite the closing output gap. We expect GDP growth to remain on a modestly positive path, with a fiscal boost from tax reform presenting some upside. Against this backdrop, the Fed should continue to gradually tighten monetary conditions via rate hikes and has already announced a balance sheet reduction. We deviate from consensus by projecting a faster rate hike cycle than priced in by markets (+200-250bps over a 5-year period compared to -100bps implied by forwards), given a tight albeit somewhat divided labor market, a closing output gap and financial stability concerns among Fed policy makers. As noted previously, room for policy error is elevated, as reversing an unprecedented and unconventional easing policy is untested. On the one hand, a rapid tightening pace could impact financial conditions and weigh on growth. On the other, dovish policies could result in accelerating inflation rates.

We thus focus our sourcing efforts on assets that operate in market segments with supportive transformative or structural drivers, allowing for higher top-line growth than that implied by aggregate indicators. Additionally, we cannot rely on prolonged solid growth over a three- to five-year hold period and therefore focus on more recession-resilient assets with proven and stable income streams and limited sensitivity to rising rates.

Often, these types of assets relate to very specific transformative trends. For example, one area of interest in the corporate space is the tired state of North America’s physical infrastructure; with crumbling water mains and aging electricity grids across the country, there has so far been little focus on infrastructure maintenance and replacement. While the opportunity to fund the financing gap in the US infrastructure space is evolving, we currently see better relative value in adjacent industries that are set to profit from increased infrastructure spending. For instance, current estimates put the number of annual water mains breakages at more than 240,000 across the country.² This presents an attractive opportunity for infrastructure service providers that help locate water and gas leakages and test structures to be compliant with regulatory orders.

With regard to infrastructure projects, we aim to capitalize on the ongoing shale gas revolution, with a particular focus on downstream processing and export infrastructure for natural gas, of which the US has become the world’s biggest producer. In fact, the US is on the verge of becoming a net exporter of gas for the first time in 60 years, further emphasizing the opportunity for investment.

In real estate, our focus lies in secondary urban locations characterized by strong economic fundamentals and experiencing strong population and technology growth. In particular, we like value-add office properties in amenity-rich urban locations that cater to modern ‘live-work-play’ lifestyles and offer scope to increase occupancy and renew leases at market rates.

**Europe: structural change creates opportunity**

The Eurozone gained some cyclical strength in 2017, with expansion being more broad-based regionally, unemployment coming down and early economic indicators pointing towards continued expansion. Our outlook for the region is centered on modest growth and policy divergence from the US, as the region is lagging the US in the macroeconomic cycle. Fundamentals continue to vary among EU member states, with select peripheral economies having started the cyclical rebound from a very low base. While spare capacity in Germany and France, and to a lesser extent Spain, is being absorbed, Italy still has a sizeable output gap and total output is still 6% below pre-crisis peaks. Youth unemployment (ages 15-24) in Italy and Spain still hovers above 35%, while unemployment in Germany is at a 37-year low, with youth unemployment below 7%.³ Debt levels in peripheral economies remain elevated and Italy’s banking sector is weakly capitalized, especially if non-performing loans rise or deposits fall. While corporate earnings growth expectations have been lowered on the back of the stronger Euro and exports should be negatively affected, intra-regional trade should mitigate repercussions. Against this backdrop and due to the lack of inflationary pressures, accommodative monetary policy in the form of asset purchases and record low rates is likely to continue. As asset purchases are scaled back, European peripheral government bond spreads may widen somewhat over their German peers.

**Output in Eurozone periphery at/below pre-crisis level**

The UK economy has lost steam as Brexit uncertainty weighs on investments and rising inflation impacts real incomes. Weakness in the housing market has primarily been confined to London so far and the labor market remains resilient. However, little progress has been made on Brexit negotiations and the Bank of England’s first interest-rate hike in over a decade raises further uncertainty about future economic growth.

In the UK, our investment approach differs compared to the Eurozone: we focus on local value drivers in areas largely insulated from potential Brexit repercussions (regulation and top-line growth), such as software services, applications and outsourcing. In the Eurozone, our investment focus revolves around businesses that stand to benefit from globalization or pan-regionalization. With muted Eurozone top-line growth and little prospect for a material uplift in trend growth against the backdrop of slow reform implementation, we focus on market segments that are benefiting from structural demand changes and avoid cyclical assets. Cost rationalization in both the private and public sector and the shift towards technology-backed service offerings support the investment case for business process outsourcing and specialist software providers.

In the infrastructure space, renewable energy is still a regional overweight, driven by the region’s commitment to renewable energy targets, CO2 reduction and energy security. Wind is the most competitive source among renewables, with decreasing construction costs and larger, more efficient turbines already meeting 10% of the EU’s power demand,⁴ a share that can be more than doubled over the next decade.

**In the UK, our approach differs compared to the Eurozone: we focus on local value drivers in areas insulated from potential Brexit repercussions.**

Within real estate, affordable housing remains an attractive investment focus. Many cities are experiencing a shortfall in residential accommodation, including cities such as Stockholm and Berlin. Younger generations, in particular, appear underserved in their search for modern and affordable living space. The rise of micro housing, as seen previously in many parts of Asia, offers an interesting investment opportunity, with the new development of residential units for rent or sale being a preferred execution option.

**Asia-Pacific/emerging markets: pursuing a selective approach**

The outlook for emerging markets remains positive, as growth in commodity-exporting countries as well as Brazil and Russia is strengthening. Economic conditions in most of Asia remain supportive and low inflation rates promote continued low
rates. Growth in India has eased but the country remains the fastest-growing G20 economy and the negative impact of its demonetization is waning. A robust Chinese economy surprised the market positively in 2017. However, growth is expected to become more moderate with tighter monetary, regulatory and fiscal conditions. Eastern Europe has benefited from positive spillovers from the Eurozone; a removal of the EU sanctions currently imposed on Russia would further lift regional growth (including, to a lesser extent, Eurozone GDP growth).

From an investment perspective, countries have to be analyzed on a case-by-case basis, as political, legislative and institutional frameworks can differ materially. That said, all emerging markets are - to a greater or lesser extent – exposed to US rates and US trade policies. Emerging market currencies can see sudden swings in response to US monetary policy decisions, with possibly wider-reaching implications for economies with larger shares of US-denominated debt, like Turkey, Malaysia and Brazil. US trade restrictions would have even broader market implications. Mexico in particular, but Latin America as a whole, would feel adverse repercussions from a cancellation of the NAFTA agreements. The issue has also highlighted uncertainty around the US’ general stance on trade policies globally. Moreover, while overall debt levels are still reasonable on aggregate, with the exception of China, the fast accumulation of debt over the past ten years gives reason for concern about debt sustainability in certain sectors of the economy and the impact this may have on growth.

In emerging markets, we stick to our proven investment themes, which revolve around a growing middle class. In the corporate space, we believe opportunities will arise around personal health, education and select consumer goods, as discretionary income is directed towards these sectors. In the personal health segment, for example, higher socio-economic status in developed markets has been shown to be associated with higher demand for healthy and fresh food; a development that can now be observed in emerging markets as incomes rise. Similarly, we have often emphasized the increasing demand for English language education, both within early education and the corporate world, as this is often the starting point for those wishing to pursue an international education.

In real estate, a theme that combines rising purchasing power across the region and the resulting growth of e-commerce is logistics. One area of focus is the undersupply of modern logistics space in China, for instance.

Within infrastructure, data centers are a current focus, driven by ever-increasing digitalization across emerging markets. Combined with rising complexity, this is also spurring the demand for managed hosting, while cost and-market pressures are increasing the adoption of colocation providers.

The outlook for emerging markets remains positive, as growth in commodity exporting countries is strengthening.

Outlook
While our base case macroeconomic scenario centers around stable positive economic growth and measured monetary tightening, the maturing business cycle and the reversal of unprecedented monetary policy raises the risk there is less smooth sailing ahead. The key to identifying and developing portfolio assets lies in deep sector insights, a focus on transformative and structural trends, and the ability to adequately value assets and their inherent growth potential in light of rising competition. We search for assets with resilient business models that operate in above-average growth segments and can be built out through capex, operational improvements or platform strategies.

Global debt at record high and rising

<table>
<thead>
<tr>
<th>Year</th>
<th>Emerging markets</th>
<th>Developed markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>7</td>
<td>126%</td>
</tr>
<tr>
<td>2006</td>
<td>56</td>
<td>280%</td>
</tr>
<tr>
<td>2016</td>
<td>128</td>
<td>348%</td>
</tr>
</tbody>
</table>

Source: IIF, April 2017.
Global megatrends

Our investment approach across private markets is guided by both traditional structural change as well as transformative trends. In particular, we focus on sectors benefiting from the following three megatrends, which we believe will continue to generate attractive investment opportunities in the long term. The impact of these megatrends is not confined to a specific area of the market but can instead be felt directly or indirectly across all asset classes and industry sectors and sub-sectors.

- **Digital transformation**: technological change and digital innovation are rapidly transforming the world we live in. This trend stretches well beyond tech companies: it is impacting the way we live and work, and disrupting traditional business and operating models. In the corporate world, the early and adequate adoption of technological innovation can transform market pecking orders, turning smaller players into category winners or diminishing the competitive edge of market leaders. With digital innovation, change is the only constant and those companies that cannot keep up with the pace of change must outsource to expert service providers. This is an ongoing trend we have observed in almost all sectors, including, for instance, the healthcare sector, which needs solutions for data digitalization, analytics and storage, and the industrial sector, which needs solutions for industrial automation and digital maintenance. Outside of the corporate space, digital innovation is often targeted at improving and facilitating the lives of consumers, such as through smart housing, big data, online education and e-commerce, in turn creating investment opportunities in both the corporate and real asset classes.

- **New generation living & consumption**: in parallel with technological innovation, consumer habits and lifestyle preferences are also changing rapidly. The millennial generation is looking for a more service-oriented and instantly accessible consumer experience, with technological innovation at its core: restaurants and holidays are booked online, money transfers and FX transactions are completed in dedicated apps, plants are watered and pets are fed remotely with just one click. It is estimated that the number of connected devices will increase from 8 billion today to more than 20 billion by 2020; raising the demand for communications infrastructure. Consumer demand patterns are also changing in fundamental ways. Education, today available to almost anyone with internet access through online channels, will become a lifelong process, from early education to professional training, as technological innovation disrupts traditional career paths and creates the need to adapt to a constantly changing and increasingly automated business environment. At the same time, increased health awareness is raising demand for preventative care, healthier food and even genomics.

- **Energy revolution**: global energy markets have seen tremendous change over the past years. The shift towards alternative sources of energy like wind and solar as well as the shale gas revolution in the US are disrupting the traditional energy generation and transmission value chain. Renewable energy goals combined with the increasing cost competitiveness of renewable sources are encouraging the build-out of wind and solar platforms on a global scale. This trend is further supported by growing public awareness of ESG (environmental, social and governance) concerns, which is even encouraging big oil companies to shift towards the renewables space. Increasingly, private households are also being fitted with solar panels and battery storage units which can feed power into the grid when not used at full capacity. Similarly, the shale gas revolution in the US is having global repercussions as the country is turning from a gas importer into a net gas exporter, with implications for infrastructure needs in the local downstream and midstream space, but also for the natural gas trade more broadly. Another trend which will have far-reaching implications across the energy value chain is energy storage. However, it is not only energy producers and transmission companies that are affected by this. Companies providing the software and hardware to build ‘connected homes’ and electric vehicles, as well as ensuring energy availability on the road, will also benefit from the energy revolution. The production of software and hardware that interact with ‘time of use’ tariffs from electricity suppliers to select when to use power and which provider to buy it from (by analyzing and comparing energy prices in real time) is just one example of an ancillary business model.

5 Gartner, January 2017.
Private equity
Active management is the only road to growth.

Peaky valuations and the likelihood of multiple contraction continue to mean it is not enough to simply ‘buy smart’. Instead, we focus on compelling companies in growth sectors where we can proactively create value.

Market overview
In H2 2017, we continued to see quality assets trade for near-record multiples. We have heard the refrain in the market that ‘15 is new the 12’, referencing that the hallmark EV/EBITDA exit multiple has moved from 12x to 15x. One factor that has precipitated this pricing shift is the entrance of new participants into the direct private equity investment market. Sovereign wealth funds, GP-like LPs (e.g. institutional LPs with an in-house direct investment practice) and long-dated core private equity funds have all recently emerged in the direct private equity market. The mandate of these new market participants is to identify and buy long-term category winners, for which they are often willing to accept lower expected returns compared to traditional private equity managers.

In parallel, debt markets offered unabated support for private equity transactions throughout 2017, with attractive average new issue debt spreads. The regulated bulge bracket investment banks have been unable to offer financing beyond 6-6.5x EBITDA but have shown an increased willingness to offer senior debt pricing well into the capital structure. Increasingly, private equity managers have been tapping the institutional market to finance their investments, especially in processes for hotly contested companies where layering on additional financial risk is often necessary for managers to be able to underwrite their target returns. Mezzanine, PIK and preferred equity financing solutions are normally offered on a covenant-lite basis, which reduces the likelihood of default risk but does not mitigate the risk of disappointing returns being realized on these highly levered investments.

Opportunities in the current market
In spite of the near-record pricing, we have found a number of instances of compelling value in the market. We continue to favor specialist category leaders in sectors with strong growth trends and/or proven platforms in actively consolidating sectors. In all of our investment activities, we remain focused on both growth potential, even if this requires significant work on our part, and valuation. In assessing growth potential, we are increasingly finding the most value in category leaders operating in sectors that have previously underperformed but are now at an inflection point, or assets on the path to becoming a category leader in a growing sector, but still in need of concerted value.
creation efforts. Our approach is informed by our conviction that outperformance can only be achieved by having a value creation-focused investment process (i.e. focused on unlocking unrealized value), from sourcing through due diligence to ownership.

**Opportunities in North America**

In North America, we see a transformative trend towards the specialization and digitalization of services offered by companies in the business services, technology, media and telecommunications (TMT), and consumer segments of the market. This movement is happening in parallel to the Industry 4.0 trend we are witnessing in the industrial sector. Companies offering digitally-enabled manufacturing solutions are capturing specialized categories as they supplant companies that relied on labor-intensive manufacturing processes. Similarly, in the business services, TMT, and consumer sectors, we are seeing companies develop into category leaders by pairing their specialized expertise in a process or product with the development of digital solutions to address this process.

One sub-sector that is benefiting from this trend is the infrastructure services sector. We are in the early days of an emerging growth story around the re-building of the US’ tired physical infrastructure. Since 2008, the US Census reports that the value of construction put into place in the US has grown at only a 1% CAGR; ex-residential, the value of construction put in place has grown at a 0.2% CAGR. Over the same period, US GDP has grown at a 1.3% CAGR, with such anemic growth having precipitated central bank intervention.¹ We believe that the US’ past underspending on its physical infrastructure will precipitate a public and private sector rebuilding campaign in the near future. A multi-year campaign to re-build physical infrastructure in the US has bi-partisan political support along with support from the private sector. The launch of such a campaign is set to create a large opportunity set for infrastructure services companies that are able to provide technology-enabled solutions to monitor and maintain the country’s existing and future infrastructure for both public and private owners of assets. However, given the uncertainty around the timing of a re-build campaign, we currently still focus on businesses that can address past underspending today by offering essential services related to the maintenance of critical infrastructure.

¹ World Bank, November 2017.

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**Spotlight on a transformative trend: Industry 4.0**

Industry 4.0 is generating demand for business services across different sectors.

**Transformative trend**

**Select regional focus areas**

- **North America**
  - Re-building industrial and municipal infrastructure

- **Europe**
  - Public sector digitalization

- **Asia & emerging markets**
  - Advanced manufacturing

**Select relative value focus areas**

- **Infrastructure services companies**
- **Single speciality third-party logistics businesses**
- **Autonomous equipment**
- **Public sector software**
- **E-health records**
- **Technology-enabled business process outsourcers**
- **Warehouse automation**
- **Material science**
- **Enterprise resource planning (ERP) software providers**

Source: Partners Group.
In light of this, in November 2017, we acquired United States Infrastructure Corporation (USIC), a leading provider of underground utility locating services in the US. The company employs more than 7,500 technicians and performs over 70 million utility locating services annually ahead of excavation or maintenance works. USIC currently serves around 1,000 customers in all major utility segments, including cable, telecommunications, electricity, gas, water and sewage. USIC is an example of a specialized market leader which has leveraged its digital mapping of the underground landscape of many high volume locate areas to make it the lowest cost and most reliable locate service in many geographic sub-markets. Moreover, the company uses telematics fleet tracking software to optimize its employee and fleet utilization. USIC is a great example of a company that has paired deep sector knowledge with digital solutions to become a category leader ten times the size of its next largest competitor.

Another one of the most widely followed digital shifts has happened in the entertainment delivery market. Whereas ten years ago a few television networks dominated the market, today digital on-demand services like Netflix, Amazon and Hulu have rapidly become category leaders. The battle to win market share among entertainment delivery platforms has led CEOs of on-demand platforms to ramp up spending on content they believe will drive subscriber growth. As an example, in 2016, Netflix paid over half its revenue to content creators. While the leading digital entertainment delivery platforms are too large to be viable private equity investments, targeting specialist entertainment content creators has been a compelling way to benefit from this digital shift in the entertainment industry. Category leaders in entertainment content creation have benefited from the economic uplift created by the improved digital delivery of entertainment but are still reasonably priced.

In light of this market opportunity, in August 2017, we participated in the buying consortium that recapitalized the equity ownership of a diversified media company focused on talent management and the development and ownership of entertainment content. The company is one of the largest talent agencies in the world and owns the content rights to a number of sporting franchises. Data gathered by the company through its talent agency positions it to identify emerging entertainment trends and pursue the acquisition of these content platforms. We believe this is a good example of a category leader in the content creation sector commanding superior economics in the growing digital entertainment category.

Opportunities in Europe

In Europe, one transformative trend we have seen is an increased focus on cost optimization. We have witnessed this in both the public and private sector. We believe the catalyst for this enhanced focus on cost optimization has been slow growth in the continent over the past five years paired with muted forward-growth projections. This has created a number of relative value opportunities in segments that target the delivery of cost optimization solutions, in particular companies in the business services outsourcing and software segments.

In the public sector, we see governments across Europe actively looking for ways to optimize their operating costs while also enhancing the services offered to their constituency. Even the


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**Spotlight on a transformative trend: cost structure optimization**

<table>
<thead>
<tr>
<th>Transformative trend</th>
<th>Cost structure optimization</th>
</tr>
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<tbody>
<tr>
<td><strong>Europe</strong></td>
<td></td>
</tr>
<tr>
<td>Business process outsourcing</td>
<td></td>
</tr>
<tr>
<td><strong>Select relative value focus areas</strong></td>
<td></td>
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<tr>
<td>Niche software as a service solutions</td>
<td></td>
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<tr>
<td>Intellectual property management</td>
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<tr>
<td>Outsourced software developers</td>
<td></td>
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<tr>
<td><strong>Asia &amp; emerging markets</strong></td>
<td></td>
</tr>
<tr>
<td>Scale consumer companies</td>
<td></td>
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<tr>
<td><strong>Select relative value focus areas</strong></td>
<td></td>
</tr>
<tr>
<td>Health food grocery chains</td>
<td></td>
</tr>
<tr>
<td>International education platforms</td>
<td></td>
</tr>
<tr>
<td>E-commerce platforms</td>
<td></td>
</tr>
</tbody>
</table>

| **North America** |
| Aquisitive healthcare platforms* |
| **Select relative value focus areas** |
| Single-specialty medical device platforms |
| Dental platforms |
| Veterinary platforms |

Source: Partners Group.

* Platforms are able to spread selling, general and administrative expenses over a larger base via M&A.
recent stability in European sovereign debt markets has done little to placate both governments and lenders, as the memory of the last debt crisis still lingers. The public sector focus on cost optimization has created a compelling opportunity for public sector-focused software companies that deliver digital solutions for information indexing, communication, and process management. For instance, it is estimated that in return for making a one-time investment of EUR 690 million to create a robust digital strategy, Germany’s government would save EUR 930 million annually.\textsuperscript{3} Statistics like this support the case for investing in software offerings targeted at the public sector, which are likely to experience outsized growth in the foreseeable future.

To capitalize on this opportunity, in October 2017, we acquired Civica, a leading UK-based provider of business-critical software and technology-based outsourcing services to both public sector organizations and commercial organizations in highly regulated sectors. The company has a highly diversified customer base, including local and central governments, healthcare providers, housing associations, schools, and police and fire services, serving 2,000 major customers in ten countries. Civica’s software offering is highly scalable as many public sector clients throughout the world face the same challenges in digitalizing their operations, which in turn requires minimal customization of Civica’s current offering. We believe that increasingly, public sector entities will look to such software offerings in their quest to improve services while keeping costs under control.

Cost structure optimization has also been a focal point for the corporate sector within Europe. GDP growth across the continent has averaged 1.1\% per annum over the past five years. During the same time period, companies in the IBEX and DAX have seen their reported profits grow by 5.1\% and 10.3\% per annum, respectively.\textsuperscript{4} The driver of such earnings growth has primarily been margin expansion. To continue to achieve margin expansion, many companies have begun to outsource non-core competencies to business process outsourcers, which leverage their specialization in a particular niche to drive superior results at a lower cost. The success experienced by large corporates that have engaged business process outsourcing companies should accelerate this trend.

In August 2017, we participated in a buying consortium with Leonard Green & Partners to acquire CPA Global, the world’s leading intellectual property (IP) management and technology company. Based in Jersey, Channel Islands, CPA Global uses its integrated platform of IP software and technology-enabled solutions to register, protect and administer the intellectual property of companies all over the world. Almost no company considers IP management a core function, making it a natural function to outsource. CPA Global is a great example of a business processing outsourcer that should experience outsized growth as more companies seek to reduce non-core in-house activities to improve their overall cost structure.

**Opportunities in Asia/emerging markets**

As highlighted in past editions of the Private Markets Navigator, in emerging markets, we continue to see a compelling transformative trend in the emergence of a large middle class. Between 2010 and 2020, more than 1 billion individuals will acquire middle class status, with the vast majority of this growth expected to take place in emerging markets.\textsuperscript{5} We anticipate that this new middle class will initially direct its discretionary income towards personal health, education, and select consumer goods, largely mirroring the consumer spending patterns witnessed across developed markets. As many emerging markets are still maturing, it is often challenging to find specialized market leaders in these segments. However, those select institutionalized companies that have been able to capture market leadership present compelling investment opportunities.

In the personal health segment, one trend we anticipate will gain momentum as more individuals enter the middle class is the demand for healthier and higher quality food. Our belief in this trend led us to acquire a controlling interest in Hortifruti, Brazil’s market-leading health food retailer, in November 2017.

\textsuperscript{3} German National Regulatory Control Council; McKinsey & Company, March 2015.  
\textsuperscript{4} Bloomberg, November 2017.  
\textsuperscript{5} PwC, 2014.
We had previously purchased a substantial minority interest in the company in April 2016 but decided it was the right time to increase our ownership in the company and drive a hands-on value creation strategy. Hortifruti is Brazil’s number one premium retailer of health foods, including fruit and vegetables, dairy products, groceries and meats, with products typically brought from the farm to the shelf within 24 hours. As Brazil’s middle class grows both in size and purchasing power, we believe demand for Hortifruti’s higher quality foods will substantially increase and expect to see a similar pattern develop in many other emerging economies.

Another trend we have seen emerge in parallel with the growth of the middle class is the demand for education, especially English language education. Partners Group is an experienced investor in the education sector and has a number of portfolio companies that specialize in providing English language-based education in emerging market countries. By 2020, it is estimated that 2 billion people will be using or learning to use English – more than a quarter of the world’s population. English language education is necessary for emerging market economies to capture market opportunities created by an increasingly globalized economy.

In light of this trend, in July 2017, we invested in a market leader in English language training in Vietnam. The company offers overseas study consultancy, teacher training services and corporate English training. The Vietnamese economy has grown at a 6.3% CAGR over the past ten years, with such growth creating a sizeable middle class in the country. In turn, this has spurred a substantial increase in demand for English language-based international education, as many Vietnamese view this as a way for them or their children to find better career opportunities and thus improve their expected lifetime earnings. We think the company is well-positioned to capture outsized growth as Vietnam’s middle class population continues to grow, along with demand for English language education.


How we realize relative value potential in private equity

Build out platform companies
We acquire platform companies with a strong management team and infrastructure, and then purchase 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 benefiting from trend-based tailwinds and focus on finding ‘category winners’ that are leaders in 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 economic context.

Between 2010 and 2020, more than 1 billion individuals will acquire middle class status, the vast majority in emerging markets.
Relative value analysis

Our relative value outlook has remained relatively unchanged over the past year. Adjustments within our relative value matrix are reflective of small rather than major shifts in the market. Looking at North America, we are seeing an acceleration in growth and profitability in the business and financial services sector and have overweighted the category. We have seen heightened competition in the US consumer market as scale e-commerce platforms, most notably Amazon, have been destabilizing pricing integrity as they try to take market share. Accordingly, we have moved consumer to underweight and recommend staying away from most sub-segments within consumer until pricing discipline returns to the market.

In Europe, we have raised our outlook on both the mid-cap and large-cap sectors of the buyout market. We think European growth is more likely to surprise the market to the upside than to the downside. Moreover, we are seeing a number of compelling sector consolidation opportunities within the European economic zone, which has traditionally been skewed towards more regional and local players in each market.

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 flow. White highlights a neutral segment. Yellow and light yellow mean that Partners Group underweights the segment and requires even greater conviction during bottom-up analysis to pursue an asset.

In emerging markets, we have upgraded small-cap buyouts to an overweight. With many emerging market economies growing in the high single digits, we have found that with the right owner, small-cap companies can achieve outsized growth and develop into the mid- to large-cap space through private equity ownership. As a hands-on owner, we are focusing on identifying such opportunities.

Pricing pressure in the secondary market has begun to cool off after a three-year run. Nonetheless, secondary pricing remains high and we remain focused on inflection assets in which the value creation process has just begun. We believe that many of the mature secondary portfolios being sold will ultimately disappoint in terms of performance, as the spread between public markets and private markets valuations has narrowed quite substantially for secondaries. The expected uplifts in valuations that have traditionally accompanied taking a company public may be less than anticipated.

Relative value matrix

<table>
<thead>
<tr>
<th>NORTH AMERICA</th>
<th>EUROPE</th>
<th>ASIA/EMERGING MARKETS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Directs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Media/telecommunications</td>
<td>Large</td>
<td>Large</td>
</tr>
<tr>
<td>Information technology</td>
<td>Mid</td>
<td>Mid</td>
</tr>
<tr>
<td>Financials/services</td>
<td>Small</td>
<td>Small</td>
</tr>
<tr>
<td><strong>Growth</strong></td>
<td></td>
<td></td>
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<tr>
<td>Consumer</td>
<td></td>
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<tr>
<td>Healthcare</td>
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<tr>
<td>Industrials</td>
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<tr>
<td><strong>Secondaries</strong></td>
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<tr>
<td>Inflection assets</td>
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<td></td>
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<tr>
<td>Mature assets</td>
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<tr>
<td><strong>Buyout</strong></td>
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<tr>
<td><strong>Primaries</strong></td>
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<td>Venture</td>
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<td>Mid</td>
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<tr>
<td>Small</td>
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<tr>
<td><strong>Growth</strong></td>
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The industry view
Q&A with an industry expert.

What are the major trends you see in India's financial services sector?

In the first 65 years after India gained independence, only 12 new banks came into existence in the country. However, in the last five years, the needle has really moved: more than 20 new banking licenses have been issued and over 15 banks have started operations. These new banks will complement and compete with universal banking institutions, enhancing financial inclusion while meeting the diverse credit needs of a growing economy.

Banks are also increasingly focusing on digital banking, on the back of several prominent government initiatives. These include: ‘Pradhan Mantri Jan Dhan Yojana’, a program for promoting financial inclusion; the ‘Aadhaar Act of 2016’, which issued each citizen with a unique identity number, in turn enabling eKYC verification and the linking of bank accounts to facilitate seamless financial transactions; and, the ‘Unified Payments Interface’, a robust payment infrastructure for real-time digital payments. These changes are redefining the way the banks service their customers’ needs.

The speed of transformation is set to stay at an accelerated pace: the next ten years of banking in India, and elsewhere, are going to be very different to the last 50 years.

What will we see in the next ten years?

I think banking will continue to become more focused. We will see the emergence of some strong, new players who can design niche products and provide specialist services to the new India. We will see these specialists take market share away from generalist banks. We will also see an increase in the customer-centric delivery of services, instead of the ‘one-size-fits-all’ approach of the big universal banks.

Digitalization will continue to be a big topic: ‘convergence’, ‘collaboration’ and ‘security’ are the three key words for the future of banking. For example, we will see banks collaborating with fintech companies, cybersecurity firms and payment services firms to converge on service offerings or banking features that were not part of their traditional offering. You can see this already: for example, financial services are often delivered to consumers through e-commerce platforms now.

Digitalization in the banking sector is enabling banks and non-banks to look at the whole opportunity set and create customer-centric products in a more efficient manner. At the same time, digitalization is also increasing consumer awareness of the full range of products and services available to them, putting pressure on providers to innovate, as there is no longer any guarantee of customer loyalty.
Consumer trust has become a major issue for banks. How are banks addressing this?  
Traditional values of privacy are being challenged by digitalization and the commoditization of data. With increased digitalization, it is inevitable that consumer trust becomes a bigger issue for the banking sector, as well as other industries. For example, today, there are numerous apps that track my movements and activities based on how and where I use my mobile phone, often without me even being aware of it. What is of increasing concern to consumers is how this data is being used – and potentially misused – by financial services companies. Compounding the risk is the fact that an individual’s digital data footprint often incorporates their entire identity and life history, as everything is linked together online. This means that the impact of a data breach is potentially ten-fold what it would have been ten years ago.

We need to expedite the democratization of the consent architecture, wherein customers understand the implications of data-sharing and the companies accessing this data understand the issues of privacy. The need of the hour is a Data Regulator, which would specifically oversee the evolution of regulation in the area of data security and privacy.

Kalpana Iyer is a banking professional and consultant with over 25 years of experience in the banking sector in India. Kalpana started her career at Citibank, where she was responsible for a diverse set of functions, including credit operations for the Indian credit card business, marketing for the unsecured consumer lending business, business analysis for the credit card business and payroll, benefits & compensation. In her last role at Citibank, Kalpana headed the women’s banking segment and the microfinance lending business in India. Under her leadership, Citibank India started a retail microfinance program.

Kalpana is a member of the Institute of Chartered Accountants of India. She is on the Boards of Asirvad Microfinance, Five Star Business Credits, Indian School Finance Company and Aavas Financiers, and is a Board Trustee of FWWB, Ahmedabad.

How much is cybersecurity a focus for management teams in the banking sector?  
Banks are definitely seen to be more proactive in investing in and improving security practices. However, such measures may still be inadequate due, among other technical aspects, to banking increasingly operating as a ‘boundary-less’ ecosystem, given the proliferation of digital banking and shifting customer preferences.

Globally, there has been a rise in cybersecurity incidents and several of them have been large-scale breaches and frauds. The impact of such breaches does not end only with serious financial loss, but, in most cases, can also substantially erode brand value. While banks are mostly focusing on addressing these risks from an IT infrastructure perspective, there is, in my opinion, another risk that has not yet been fully addressed. Many commercial breaches are in fact carried out through social engineering, i.e. through a human weakness in the system rather than a technical weakness. Banks and other financial services companies will need to invest more in managing and controlling this aspect of the risk.
Financial inclusion has been a focus for you in your career – you have previously launched banking products aimed specifically at women and the microfinance sector. How close are we today to the goal of making banking accessible to all?

We have not yet succeeded in making banking accessible to all, although we have made great strides forward. If you look at the retail banking sector, and microfinance in particular, it is certainly fair to say that there is a lot of credit available today to historically underserved borrowers. However, if you drill down and look at individual borrower profiles, we have not been able to cater to all the financial needs of customers. We are lacking products that take this underserved segment all the way through their lifecycle, going beyond credit to insurance products, and even to wealth creation opportunities.

In June 2016, you joined the Board of Directors of our portfolio company Aavas Financiers, a provider of housing loans to a traditionally underserved portion of India’s housing loan market, i.e. the low- to middle-income bracket. What are the historic reasons for this portion of the market remaining underserved?

Historically, the real estate sector did not focus on affordable housing as a huge business opportunity. While affordable housing promises a lot of growth, the margins were considered too low by many developers. As with every financial product for the underserved segment, it has required more effort from the financial services sector to understand the customer profiles, and find solutions beyond the traditional lending models to meet the demands of the segment.

Over the last few years, the Indian Government has put renewed focus on ‘housing for all by 2022’, with its ‘Pradhan Mantri Awas Yojana’ scheme. With this government intervention, the affordable housing sector is now garnering more focus and traction. In addition, a slowdown in demand for real estate in the affluent sector has also led developers to shift their attention to the growing demand in the affordable housing space. In turn, this has led housing finance companies to focus on this segment too.

What is unique about Aavas Financiers’ offering?

Aavas is one of the few affordable housing finance companies that understands its customer segment and has enabled its customers to fulfill their dreams of home ownership. Aavas provides housing finance to customers from economically disadvantaged backgrounds and those that do not normally have access to formal financial services. In this way, Aavas is enabling the financial inclusion of its customers, which aligns with the government initiative of ‘housing for all by 2022’. In doing this, the company has carved out a distinct market niche for itself.

As an Aavas Financiers Board member, what will your key focus areas be?

There are three key focus areas for the Board. The first is to help Aavas truly understand its customer profile by leveraging technology. We can use data analytics to assess how the debt portfolio is likely to behave and what we should be watchful for, with a view to building on the current risk assessment process and staying customer-centric in terms of product offering. The second major topic for me as a Board member, and one that will be a focus in 2018, will be to help Aavas continue to invest in engaging and motivating its workforce. It is critical for any company to be able to attract and retain talented professionals and the best way to do this is by providing opportunities for growth and ensuring employee wellbeing. Thirdly, the Board is working with the management team to put in place infrastructure that will enable the company to dramatically scale up in size. In this regard, the key question we will be asking is, are we doing enough to build a company that can grow to ten times the size it is now?

Traditional values of privacy are being challenged by digitalization and the commoditization of data. Consumer trust is becoming a bigger issue.

What changes do you wish to see in the financial services sector in the future?

Inequity comes from a lack of access to opportunities. I would like to see the financial services sector succeed in making the full range of financial services, and not just credit, accessible to all. The impact of this will go far beyond the banking sector and will translate into real socio-economic outcomes. The challenge for the industry is to make products that are enabling and inclusive, but at the right price point to be competitive and profitable.

Secondly, I would like to see the financial services industry continue to work together, with competitors becoming collaborators. Not only does this serve the customer better, but financial services players can also reap more in terms of benefits if the collaboration is real and targeted, with each player bringing its best-in-class products into the partnership.
Private real estate
Unlocking hidden potential.

High levels of dry powder and the search for yield continue to drive up prices in the real estate market. To find value, we continue to shift our investment focus towards special situations, defined as off-market transactions, where hidden potential can be unlocked.

Market overview
The real estate market continues to exhibit high levels of liquidity. Global real estate transaction volumes have maintained their positive momentum and further increased in H2 2017, mainly driven by activity in Europe and the Asia-Pacific region.

In Europe, investment activity rose for the first time after having fallen for the past six quarters. Although transaction volumes are still significantly lower than pre-Brexit levels, the UK was one of the main beneficiaries of the slight increase, as a number of Asian investors have started to acquire office space in central London, benefiting from falling prices. UK institutional investors, by contrast, are opting to buy in continental Europe instead of their domestic market. In Asia-Pacific, Hong Kong retains the top spot in terms of transaction volumes, which grew significantly for income-producing properties.

In the US, transaction activity remains stable, in part driven by the amount of dry powder available: almost USD 150 billion.1 We believe this may lead to further price rises in prime markets in the short term. The average prime office cap rate for the major US metro areas stands at 4.7%, which is very low compared to historical benchmarks.2 We see more value in secondary markets where capital value growth in the current cycle is more muted, as evidenced by materially higher average cap rates compared to prime markets.

In terms of property types, retail cap rates continue to be under pressure due to the growth of e-commerce. We see cap rate expansion for fashion-anchored shopping centers, particularly in the US and UK, for instance. On the other hand, we believe demand for regionally dominant, fresh food-anchored shopping centers with a strong leisure component remains in better shape. This type of retail tends to be more resilient throughout economic cycles and is less prone to pressure from internet retail. Recently, we have looked at different portfolios of this type, especially in Asia-Pacific and Europe, as we believe opportunities in this space can be attractively priced.

Leaving the retail segment aside, we still maintain that the current environment offers a reasonable variety of investment opportunities in the office and residential segments. New office supply is generally under control, with many office market vacancy rates still trending down. Similarly, we see a supply and demand imbalance across many European cities where new housing demand exceeds supply.

The global real estate banking industry continues to remain disciplined in light of regulatory scrutiny. The share of equity deployed in real estate transactions across the globe is trending upwards, signaling that banks continue to exercise caution. Indeed, banks are limiting their loan-to-value ratios to around 50%, implying debt serviceability is high.3

Generally, both the occupier and capital market seem stable, with institutional investors incrementally raising their target allocations to real estate, supported by the spreads between long-term government bond yields and cap rates. This leads us to conclude that the real estate market is currently fully priced but not consistently overpriced.

1 Preqin, October 2017.
3 Preqin, October 2017.
Burns and McDonnell Plaza, a Class A office building in Houston, Texas.

Opportunities in the current market

From a relative value perspective, we continue to prefer properties and locations benefiting from social and demographic trends. As highlighted in past editions of the Private Markets Navigator, we focus on value-added office properties in major tier 1 cities and economically vibrant tier 2 cities across all regions. For logistics, we favor centralized and ‘last mile’ distribution properties that support demand from e-commerce.

In the residential sector, we pursue opportunities in markets with strong population and employment growth where we seek to develop affordable Class A apartments and upgrade Class B apartments, catering to the need for affordable alternatives to traditional Class A apartments.

As markets are flush with capital, we feel that competitive processes should be avoided as a means of sourcing such opportunities. Instead, we are further emphasizing our focus on special situations, which we define as situations that require bespoke solutions and that offer the potential to unlock hidden value. Our strategy is to provide investment and liquidity solutions to operating or general partners that do not have the appetite, tenure or means to support asset-level business plans. For these off-market situations, we typically seek the following characteristics: a bespoke structure, i.e. opportunities that others are dissuaded from pursuing given their global and complex nature; a trigger event, i.e. opportunities that are unlocked by a trigger event such as investor fatigue and/or discord; a unique angle, i.e. opportunities that are sourced off-market in an exclusive manner; and uplift potential, i.e. opportunities with clear value-added potential to generate outperformance.

With our focus on these special situations, we seek to unlock hidden potential and generate attractive risk-adjusted returns in today’s competitive market environment. We believe that implementing specific value creation initiatives, such as projects focused on capex and rental growth, is as relevant as ‘buying smart’. Over the past decade, our integrated investment approach has enabled us to develop a strong network of asset owners, general partners and operators, which, next to our disciplined global relative value approach, is becoming increasingly valuable as a means of identifying these situations.

In terms of specific investment themes, we focus on assets benefiting from the two main trends that are shaping the real estate market: technological improvements generating demand for logistics space and new urbanization generating demand for modern offices and apartments.

Office: targeting pockets of growth

Major cities in Europe, Asia-Pacific and the US are exhibiting economic and population growth, often aligned with growth in the technology industry. The top global cities for venture capital investments include San Francisco and New York in the US, with a global share of around 20%; London and Berlin in Europe, with a global share of around 3%; and Beijing and Shanghai in Asia-Pacific, with a global share of around 3% as well. These cities are among the most appealing for millennials, as they have adapted to combine life, work and play. Berlin, for instance, has embraced this combination and has, in our opinion, become an attractive market from both a short- and long-term perspective. In the short term, its real estate fundamentals are currently among the most attractive of any European capital city.

Office, industrial and retail cap rate spread over risk free rate

<table>
<thead>
<tr>
<th>Country</th>
<th>Cap rate</th>
<th>Yield spread</th>
<th>10-year government bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>6.53</td>
<td>5.28</td>
<td>6.60</td>
</tr>
<tr>
<td>France</td>
<td>5.99</td>
<td>5.04</td>
<td>6.22</td>
</tr>
<tr>
<td>UK</td>
<td>5.00</td>
<td>5.00</td>
<td>6.60</td>
</tr>
<tr>
<td>Spain</td>
<td>3.92</td>
<td>2.89</td>
<td>4.98</td>
</tr>
<tr>
<td>Sweden</td>
<td>5.28</td>
<td>5.00</td>
<td>6.22</td>
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<tr>
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<td>3.92</td>
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<tr>
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</tr>
<tr>
<td>Japan</td>
<td>6.22</td>
<td>4.98</td>
<td>5.28</td>
</tr>
</tbody>
</table>

Source: Costar; Real Capital Analytics; Bloomberg, October 2017.

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* Martin Prosperity Institute, January 2016; Partners Group estimates, October 2017.
rates are below 2.5%, its development pipeline seems limited and despite strong historic growth, rents are still low for Europe and are forecast to continue to grow at 4% per annum for the next few years on the back of strong tenant demand. In the long term, Berlin’s population is expected to continue to grow at around 0.5% per annum until 2030. There are also substantial infrastructure developments underway to improve the city’s international connectivity.

In light of these positive trends, we have entered into a programmatic joint venture targeting office buildings across Berlin which can be refurbished and/or repositioned. We are looking at out-of-center locations that benefit from good public transport links and where rents can be less than half those of prime central locations. With this joint venture partnership, we aim to create a diversified portfolio of assets with equity investments of around EUR 10-40 million per property and a mixture of income durations, locations and tenant usage. We believe this segment of the market is too complex for private buyers but individually too small for institutional buyers, giving us a unique angle.

In the US, we like cities experiencing population and technology growth such as San Diego and Austin. Our focus here lies in acquiring and generating income growth from substantially leased assets. In many markets we see good potential to improve the value of office properties by marking to market existing leases with equity investments of around EUR 10-40 million per property and a mixture of income durations, locations and tenant usage. We believe this segment of the market is too complex for private buyers but individually too small for institutional buyers, giving us a unique angle.

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Significant demand drivers for ‘last mile’ logistics facilities in the area include Chicago O’Hare International Airport, one of the busiest airports in the world, as well as the headquarters of 36 Fortune 500 companies and over 400 major corporations. In addition, Chicago is the leading US railroad hub, sitting at the convergence of six class-one railways.

To capitalize on this dynamic, we recently acquired an industrial portfolio of over 20 properties spanning 230,000 square meters across various submarkets of the greater Chicago metropolitan area, with clear uplift potential. The transaction was sourced off-market through our close relationship with the operating partner, which we had worked with on previous transactions. It fits well with our strategy of acquiring Class B industrial properties that offer us the opportunity to execute a value-added business plan at a discount to replacement cost. In fact, our entry point of USD 387/sqm represents a meaningful discount to replacement cost, which is estimated to be USD 807/sqm. The portfolio benefits from a roster of mostly local and regional tenants across a diversified mix of industries, in particular distribution and manufacturing. The occupancy rate is at 82%, with a weighted average unexpired lease term of around four years. Our value creation initiatives include a targeted leasing plan aimed at marking rents to market and bringing occupancy up to around 90% over our holding period. It is anticipated that these leasing efforts will produce strong cash-on-cash yields for our clients.

In Australia, meanwhile, our strategic focus is on XXL warehouse properties along the Eastern seaboard cities of Sydney, Melbourne and Brisbane. The logistics sector in Australia is experiencing demand on the back of e-commerce growth, which has a CAGR of 4%. In addition, the country faces a shortage of available zoned industrial land that can accommodate logistics users requiring over 5,000 square meters. The lack of available large sites is having a positive effect on leasing rates, as top logistics companies search for strong locations. Even though Australia’s e-commerce penetration rate of 11% remains below other major economies in the world such as China (33%), it is expected to further increase with Amazon’s recent market entry.11 Given the current market opportunity, we continue to look into the sector and recently completed the acquisition of a 21-hectare infill site in the industrial sub-market of Southport in South East Queensland. Due to the lack of available zoned industrial land in the sub-market, pre-leasing enquiries look strong. The business plan anticipates the development of a multi-tenanted logistics estate consisting of seven premium facilities across almost 70,000 square meters on a build-to-suit basis. Given the supply constraints in the market, we could also envisage dividing half of the space into smaller parcels and selling them to owner-occupiers.

Implementing specific value creation initiatives, such as capex and rental growth projects, is as relevant as ‘buying smart’.

Residential: developing affordable housing
In 2016, an estimated 55% of the world’s population lived in urban areas. By 2030, this is expected to rise to 60%.12 While urbanization is nothing new for major cities across Asia, more and more young people are flocking to growing cities across Europe as well. Major cities like Berlin, Copenhagen and Stockholm are experiencing high regional migration, consisting mainly of millennials in search of affordable and convenient living in ‘desirable’ cities with high employment growth. Stockholm, for instance, is one of Europe’s fastest-growing cities in terms of population. Net migration is forecast to grow at an average rate of 2% per annum until 2020, which would

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We focus on providing solutions to operating or general partners that do not have the appetite, tenure or means to support asset-level business plans for their existing assets or portfolios. We continue to prefer asset strategies that fall into one or more of the following sub-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.

Buy, fix, and sell
We seek older buildings in great locations that are in need of owner-oriented asset management initiatives.

Develop core
We target markets with strong long-term fundamentals and trends that support additional absorption to selectively develop properties through ground-up construction.

While our current focus in Europe is on developing new residential units for rent or sale, our focus in Asia-Pacific and the US is on the active management of existing properties where capex investment can drive rental growth. For the US in particular, we overweight multifamily properties in defensive urban markets with solid demand drivers and focus on upgrading Class B houses in markets such as Atlanta, Denver, Nashville and Austin. In these markets, net absorption levels over the past 12 months have increased between 160-380%.

Similarly, rental growth rates for apartments in these markets are above the rate of GDP growth.

A recent example of our ability to benefit from this trend is a transaction to recapitalize a real estate portfolio of eight assets, comprising six multifamily properties, a multifamily development and a retail property. The majority of the assets are located in Austin's East River Corridor. This corner of the city will be linked to a rail network running along a ten-mile route that will significantly decrease transport times to the city’s downtown and the airport. The portfolio was sourced off-market on a proprietary basis, providing us with a unique angle. It offers the opportunity to drive rental income through interior and exterior renovation works as well as through improvements to property operations, including upgrading common areas, addressing maintenance issues, reducing energy costs and improving amenities across the six existing multifamily assets. Austin continues to benefit from strong population and employment growth and is one of our key target markets for US multifamily properties.

While urbanization is nothing new for major cities across Asia, more and more young people are flocking to growing cities across Europe as well. As highlighted in the H2 2017 edition of our Private Markets Navigator, building affordable micro housing is one way of addressing the needs of young urban inhabitants. Micro housing diverges greatly from traditional European housing but has been popular in Asian cities for many years. Micro houses have a typical floor space of less than 60 square meters with a very efficient layout. This type of housing is aimed at a generation of flexible and mostly young people who spend most of their time outside of their apartments.

In August 2017, we agreed to develop over 1,700 residential apartments in the Greater Stockholm area in a joint venture with SSM, a leading Stockholm-based residential developer. The total value of the completed properties is expected to be in excess of EUR 700 million. The project comprises three separate residential developments, Tellus Towers, Järla Station and Metronomen, all located within a 15-minute train ride from central Stockholm. The developments seek to provide small, but fully functional residential units at a modest price where the need for affordable housing is significant. Tellus Towers will be the largest of the three projects and will include two high-rise residential towers, a hotel, retail space and a preschool over a total floor area of 57,000 square meters. At 78 stories, the taller of the two towers is expected to be among the highest residential buildings in Northern Europe. The buildings, which also include a seven-story multi-dwelling unit, have been designed by prize-winning architect Gert Wingårdh and modeled on architect Gary Chang’s concept of using and maximizing smaller spaces. In addition to stores, cafés and grocery stores, the skyscrapers will offer a restaurant, sky bar, spa and rooftop swimming pools. Completion of the three developments, which were sourced proprietarily through an existing secondary relationship, is anticipated between 2020 and 2023. However, development will not commence until material pre-sale thresholds have been met.

How we realize relative value potential in private real estate
We focus on providing solutions to operating or general partners that do not have the appetite, tenure or means to support asset-level business plans for their existing assets or portfolios. We continue to prefer asset strategies that fall into one or more of the following sub-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.

Buy, fix, and sell
We seek older buildings in great locations that are in need of owner-oriented asset management initiatives.

Develop core
We target markets with strong long-term fundamentals and trends that support additional absorption to selectively develop properties through ground-up construction.

While urbanization is nothing new for major cities across Asia, more and more young people are flocking to growing cities across Europe as well.


14 Costar, October 2017.
Relative value analysis

From a sector perspective, office properties are a relative overweight in all regions. Given that leasing fundamentals remain strong, there are good opportunities to acquire partially vacant secondary office properties in amenity-rich city center locations that benefit from population and job growth. The logistics sector benefits from the ongoing increase in e-commerce across all regions. This creates resilient demand for both XXL fulfillment centers and ‘last mile’ distribution facilities, although investor demand has pushed up capital values to all-time highs in many markets. On the other hand, retail remains challenging. With increases in both e-commerce penetration and competition from discounters, the segment continues to be an underweight. The residential sector offers interesting repositioning opportunities in fundamentally strong locations that benefit from urban renewal and population growth, especially in the US and Europe. Given that return expectations in the sector are decreasing, we are more willing to take select development exposure, as highlighted by our investment in a development project in Stockholm.

From a regional perspective, we underweight the UK as Brexit uncertainty remains. In contrast, key real estate markets in tier 1 and select tier 2 cities in developed countries across all regions have remained remarkably resilient to external shocks thus far. These markets continue to benefit from positive economic indicators such as low unemployment rates, high consumer spending and enough liquidity in the market.

Finally, due to our continued shift in focus towards special situations, we have a strategic overweight towards non-traditional secondary assets across all regions. These assets can often benefit from more time and capital, offering opportunities for recapitalizations and reduced duration risk.

Relative value matrix

<table>
<thead>
<tr>
<th>Region</th>
<th>Directs</th>
<th>Regions</th>
<th>Debt</th>
<th>Secondary</th>
<th>Primaries</th>
<th>Sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Americas</td>
<td>Core</td>
<td>Core</td>
<td>Core</td>
<td>Traditional</td>
<td>Core</td>
<td>Office</td>
</tr>
<tr>
<td>Europe</td>
<td>Value-added</td>
<td>Value-added</td>
<td>Value-added</td>
<td>Non-traditional</td>
<td>Value-added</td>
<td>Retail</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>Opportunistic</td>
<td>Opportunistic</td>
<td>Opportunistic</td>
<td></td>
<td>Opportunistic</td>
<td>Logistics/industrial</td>
</tr>
</tbody>
</table>

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), investment type (directs, secondaries and primaries), debt and sectors. Direct and primary investments are classified by investment type (core, value-added and opportunistic). For secondaries, we distinguish between traditional and non-traditional secondaries. 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 even greater conviction during bottom-up analysis to pursue an asset.
Private debt
Flexibility is key.

As leveraged loan volumes reach new heights, we are emphasizing our ability to remain flexible and offer one-stop-shop direct financing solutions complemented by active portfolio management for liquid loans.

Market overview
Private debt markets remain robust, both in terms of investment activity and fundraising levels. Demand for private debt financing remains strong on the back of significant amounts invested by private equity funds and a growing number of private equity transactions that require refinancing. On the supply side, fundraising continues at a strong pace, particularly for senior debt, with a large CLO volume differential in the US and Europe, as well as potentially diverging regulatory trends in the US vis-à-vis the rest of the world.

US market overview
2017 was a record year for senior leveraged loan volumes in the US, with issuance surpassing USD 645 billion for the first time.\(^1\) A large proportion of newly issued loans has been absorbed by a growing CLO market, which had already exceeded 2016 full-year new issue CLO volumes by the third quarter of 2017.\(^2\)

In this record-setting environment, the risk-return profiles of liquid loans have developed sideways. While spreads remain at the lower end of the historic range dating back to 2008, they continue to be comfortably above the lower levels witnessed in pre-crisis years. Furthermore, the increasing base rate has had a positive effect on expected returns for private debt investments.

Leverage levels in 2017 remained at 2016 levels, in line with the high levels seen since 2014, with covenant-lite issuance now accounting for a significant majority of newly issued liquid loans, particularly in the large-cap segment of the market. Equity cushions, however, continue to be at very high levels as well—higher than 2014 levels and, importantly, higher than those observed in 2007 before the Global Financial Crisis.\(^3\)

The risk-return profiles of direct loans have largely followed these developments. Overall, however, given their bespoke nature, private direct loans continue to offer an additional premium over liquid loans and generally better downside protection through tighter documentation, including maintenance covenants that protect buy-and-hold credit investors until repayment.

Bespoke subordinated debt financing solutions continue to be employed in the market, with second lien remaining a prevalent component. Second lien volumes in the first three quarters of

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\(^1\) S&P LCD Global Interactive Loan Volume Report, December 2017.
\(^2\) S&P LCD, Q3 2017.
\(^3\) S&P LCD, Q3 2017.
2017 alone reached a level of more than twice full-year 2016 volumes. Return potential remains attractive in the second lien space, where spreads offer more than a 400bps return difference compared to new issue first lien liquid loan spreads.4 The existing regulatory framework in the US continues to favor non-bank institutional lenders; however, a recent statement issued by the US Government Accountability Office relating to the 2013 leveraged lending guidelines has opened the door for review by Congress. In light of the current administration’s stance on deregulation, any rollback of the current lending constraints would encourage increased bank activity in debt markets. Nonetheless, we do not expect banks’ market share to return to pre-crisis levels due to continued risk aversion, strong penetration of non-bank lenders and the unlikely scenario of a full-scale rollback of Dodd-Frank regulatory protections.

European market overview
In contrast to the US, the European regulatory environment shows no signs of deregulation, as highlighted by the leverage lending guidelines issued by the ECB in May which became effective in November 2017. Leaving regulatory developments aside, liquid loans in the European market have seen a strong new issuance volume. While margins and leverage levels are similar to those witnessed in the US, differences remain in base rates and equity cushions: Euribor rates are still in negative territory and the European market standard 0%-floor continues to be valuable for private debt investors. Equity cushions remained more significant and roughly four percentage points higher than in the US on average (44.4% in Europe versus 40.5% in the US through Q3 2017). Liquidity has also been supported by an increase in new issue CLO volumes; although, unlike the US, third quarter year-to-date volumes remain below 2016 full-year volumes. Furthermore, overall CLO issuance in Europe represents approximately 20% of total CLO issuance in the US.5

Direct senior loans and subordinated debt can be very attractive in the current market environment given banks’ ongoing lower market share and the overall risk-reward enhancement provided by original issue discounts, base rate floors and the option to participate in equity upside. Club transactions in particular are typically characterized by benign competitive dynamics and in our opinion offer attractive risk-return profiles.

Partners Group views the private debt market in three distinct categories:

- **Liquid loans**: senior loans broadly syndicated by banks, which typically offer relatively low returns but can be used as a cash management tool by fixed income investors because of their high liquidity. As part of our CLO and liquid loans business, we target smaller investments in large liquid loans, where tranches can be in excess of USD 1 billion and issued by stable companies.

- **Direct loans**: loans which are senior in the capital structure but privately originated by a single lender or small group of institutions and are thus generally illiquid. Direct loans remain our primary driver of outperformance. In this segment, we target companies with EBITDAs in excess of USD 20 million.

- **Subordinated loans**: debt tranches which are subordinated in the capital structure, including second lien, mezzanine, and holdco tranches. These investments tend to have very limited liquidity, but offer the highest return potential. In subordinated transactions, where tickets can be in excess of USD 100 million, we leverage our platform and scale to provide subordinated solutions to sponsors.
**Opportunities in the current market**

**Direct loans in the US: providing add-on financing in attractive sub-sectors**

We believe direct loans in the mid- and upper mid-market continue to offer the most attractive return potential. In particular, add-on acquisitions in fragmented sub-sectors, such as business software services and clinical trial outsourcing, can provide complementary services across regional platforms, vertical specialists, or fold-ins to platforms. Due to the high level of fragmentation within these sub-sectors, market leaders in these industries can target a number of smaller companies with little financial or administrative infrastructure.

One such example is a recent add-on financing to support our portfolio company eResearch Technology (ERT) in the acquisition of its competitor, Biomedical Systems (BMS). The acquisition helped to diversify ERT’s revenue mix, strengthen its position in areas where it overlapped with BMS and allow for cross-selling among ERT’s and BMS’s customer bases.

ERT is a Philadelphia-headquartered company offering data solutions for clinical trial sponsors and contract research organizations. It collects, analyzes, interprets and distributes data related to numerous aspects of clinical trials. Data is collected through both hardware and software distributed to testing sites and individual patients. ERT’s technology enables patients and doctors to take more standardized and accurate readings than paper-based forms. The company operates in an attractive healthcare sub-sector, which is experiencing tailwinds as trial sponsors adopt technology-enabled solutions, and one in which we have made several investments (see box text). The acquisition of BMS has enhanced the company’s presence in the respiratory and cardiac categories, while expanding its portfolio to include medical imaging. Additionally, ERT realized cost synergies from the transaction through a reduction in overheads.

We had initially invested in ERT in May 2016, providing the entire second lien tranche, including an equity kicker. As the sole second lien provider to the company, Partners Group was the natural choice for the incremental subordinated debt financing. Transactions like this enable us to upsize our investments in attractive assets, while supporting our portfolio companies and sponsor relationships. Through a combination of organic growth and acquisitions, ERT has increased in size considerably and extended its market leadership since our investment. For the second lien incremental debt we are targeting an IRR of 11.3%.6

It is key to remain disciplined in an environment characterized by increasing issuance volumes for covenant-lite transactions and loosening documentation. For instance, we were recently engaged to determine our willingness to provide subordinated capital in support of the acquisition of a medical software developer and device manufacturer. Following three rounds of due diligence, the deal was ultimately approved on a commercial basis. However, legal negotiations over the covenant package led to a mismatch in expectations as weak negative covenants were proposed as part of the terms. We ultimately stepped away from the transaction and focused on more attractive opportunities.

**Spotlight on an attractive sub-sector**

Our Industry Value Creation team is constantly looking for attractive sub-sectors within the industry sectors in which we invest. An example of an attractive sub-sector identified by our healthcare specialists is the outsourcing of services relating to US clinical trials, a necessary but complex step in the approval process for the admission of new drugs. This sub-sector continues to benefit from the outsourcing trend, as large pharmaceutical companies outsource clinical trials in an effort to reduce costs and focus on their core competencies. So far, we have been able to capitalize on this investment theme by providing financing solutions to clinical trial technology specialists Bioclinica, Bracket Global and eResearch Technology – which we also supported in its add-on acquisition of Biomedical Systems – and will continue to look for other opportunities in the sector.

**Direct loans in Europe: offering solutions for complex transactions**

In Europe, we have provided financing solutions for various complex transactions such as the carve-out of Morpho from French conglomerate Safran and subsequent merger with Oberthur, as well as complex regulatory environment transactions such as our provision of holdco financing to an Italian payment services provider. Moreover, we recently structured and arranged a second lien investment, which allowed for the refinancing and separation of VFS Global from Kuoni Group, a service provider to the global travel industry. EQT had acquired Kuoni Group in 2016 and then split the group, selling two of the three remaining businesses separately as part of a strategic repositioning enabling each business to unlock future growth. The carve-out left the remaining standalone company, VFS Global.

VFS Global manages administrative and non-judgmental tasks related to visa, passport, identity and citizen services on behalf of its government clients. The company operates close to 2,500 application centers in 130 countries and has

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6 Target returns are based on various Partners Group estimates. Calculated gross of Partners Group fees. There is no guarantee that targeted returns will be realized or achieved or that an investment program will be successful. For illustrative purposes only.
processed over 160 million applications since its inception in 2001. It is a clear market leader with around 48% market share globally. The industry also has high barriers to entry due to the government tender process for these services and the high number of centrally awarded multi-country contracts. The global visa outsourcing penetration rate is expected to increase from 29% in 2015 to 32% by the end of 2018, driven by the high and increasing volume of visa applications, the increased focus on border security, as well as the specialist know-how needed to set up a visa application center’s infrastructure. Key due diligence items on VFS Global included potential political changes to visa requirements across traditional visas, e-visas and visas-on-arrival; exposure to global travel volumes; and information security risk due to the handling of confidential personal information.

Our subordinated financing addressed and solved VFS Global’s specific needs throughout a complex separation. It also supported the company’s acquisition of a complementary business in the emerging markets, which reinforces its global leadership in visa processing outsourcing across the world. We provided the second lien financing with attractive terms at Libor (1% floor) + 8.5%.

Direct loans in Asia-Pacific: demand for unitranche structures

In Asia-Pacific, we had previously identified a number of emerging transactions which cater to non-bank institutional lenders in senior debt, particularly in the term loan B market. In the past half year, we have seen firm demand from private equity sponsors for institutional debt in Australia, in particular ‘unitranche’ debt structures, which combine elements of both senior and subordinated debt into a single stretched senior debt tranche. The increase in institutional unitranche has been driven by demand from sponsors as it can offer higher leverage to improve positioning in competitive situations, ease of execution and flexibility, and the ability to provide incremental or add-on acquisition debt capital to fund further growth. This provides a competitive and differentiated offering for sponsors as compared to traditional bank offerings, which remain conservative in this space. Recent examples of institutional transactions in the market include iNova Pharmaceuticals, a developer of over-the-counter and prescription drugs, and Infotrack/LEAP Legal Software.

An example of this trend was our unitranche financing of Laser Clinics Australia (LCA), which supported the acquisition of the company by KKR. LCA is the leading provider of non-invasive aesthetic treatments in Australia, offering a range of safe and affordable treatments. The company operates a franchise ownership model and has seen strong historical financial growth. The provision of the unitranche loan avoided the need to raise separate senior and subordinated debt financing from the market and highlights our ability to be a flexible financing solution provider to private equity sponsors across the region.

Liquid loans: primary and secondary relative value

As referenced earlier, the liquid first lien loan market has been characterized by increasing amounts of liquidity supported by the inflows of numerous institutional investors in the market. Drivers for these inflows include, among others, attractive spreads compared to traditional corporate bonds, attractive liquidity levels, stable cash income and capital preservation. In addition, these loans are considered a high-return alternative to traditional cash management tools. Institutional investors seek diversification from traditional fixed income portfolios and are attracted to the potential for outperformance in an increasing interest rate environment.

This dynamic has led to a notable uptick in the average price levels in the secondary loan market where currently more than 70% of loans are trading above par. As a result, we have focused mainly on the primary market to lock in attractive original issue discounts and capitalize on the Partners Group platform, securing above market allocations to attractive deals. On the primary side, we have selectively taken positions in companies such as Avantor, a provider of integrated tailored solutions for the life sciences and advanced technology industries, and McAfee, the global computer security software company, where tranches are in excess of USD 3 billion and margins are above 400bps. Recognizing the current strength of the secondary market, we have also sold out of positions on a relative value basis or where we see potential risks to fundamentals.

Private direct loans continue to offer a premium over liquid loans and generally better downside protection through tighter documentation.

8 Partners Group, December 2017.
Relative value analysis

For 2018, we divide our views into the following categories: mezzanine direct, second lien direct, first lien direct, first lien liquid and liquid loan secondaries. In the US, we overweight large-cap second lien direct debt investments. Despite tightening spreads, the US market continues to offer an attractive risk/reward opportunity set. In both the US and Europe, we overweight large-cap liquid loan investments and mid-/small-cap first lien direct investments. In the second lien space in Europe, we remain highly selective given the limited issuance activity and more competitive environment. Within our key investment strategies, we continue to focus on companies with three defining characteristics: recession resilience, stable recurring cash flows and high cash conversion levels. We seek companies with these characteristics within the industry sectors identified by our industry experts and highlighted in our relative value matrix.

How we realize relative value potential in direct & subordinated loans

We provide financing solutions that fill gaps in traditional debt market coverage and are often more attractive and flexible than those offered by the broader capital or syndicated loan markets, providing excess yields to our investors. We focus on three key strategies:

Offer creative structures

We offer flexible and tailor-made capital structures that support companies’ specific cash flow profiles and working capital needs.

Target attractive sub-sectors

We target sub-sectors within industries where we have depth of experience and confidence in underlying growth fundamentals. We actively seek to invest into loan structures in these spaces in resilient companies growing both organically and via acquisitions.

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.

Relative value matrix

<table>
<thead>
<tr>
<th>Industry sector</th>
<th>NORTH AMERICA</th>
<th>EUROPE</th>
<th>ASIA/EMERGING MARKETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mezzanine direct</td>
<td>Large</td>
<td>Large</td>
<td>Large</td>
</tr>
<tr>
<td>Second lien direct</td>
<td>Large</td>
<td>Large</td>
<td>Large</td>
</tr>
<tr>
<td>First lien direct</td>
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<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>First lien liquid</td>
<td>Large</td>
<td>Large</td>
<td>Large</td>
</tr>
<tr>
<td>Liquid loan secondaries</td>
<td>Large</td>
<td>Large</td>
<td>Large</td>
</tr>
</tbody>
</table>

GLOBAL

<table>
<thead>
<tr>
<th>Industry sector</th>
<th>Media/telecommunications</th>
<th>Consumer</th>
<th>Information technology</th>
<th>Healthcare</th>
<th>Financial services</th>
<th>Industrials</th>
</tr>
</thead>
</table>

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), debt strategy (mezzanine direct, second lien direct, first lien direct, first lien liquid and liquid loan secondaries) and industry sector. 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 flow. White highlights a neutral segment. Yellow and light yellow mean that Partners Group underweights the segment and requires even greater conviction during bottom-up analysis to pursue an asset.
Private infrastructure
A good time for realizations.

Institutional appetite for infrastructure investment shows no sign of flagging. To benefit from the attractive selling conditions, we have concentrated on capturing attractive returns for operational assets through well-timed exits.

Market overview
The search for stable and strong risk-adjusted yield has been a near-constant theme over the past decade. It has brought many new investors into private infrastructure and led existing investors to increase their allocation to the asset class. Since the end of the financial crisis, infrastructure has seen continued activity (both in terms of fundraising and deal making), which is indicative of both a maturing asset class with a broad range of capital sources, sustained investor interest and a cyclical high.

As we head into 2018, we expect appetite for stable, brownfield infrastructure to remain extremely high. 2017 is set to be one of the largest fundraising years on record, with USD 49 billion of aggregate commitments raised in the first ten months (for comparison, USD 52 billion was raised in 2016). Similarly, global dry powder stood at a high of USD 154 billion as of September 2017, representing over three years of deployment based on 2016 figures, and marking a 111% increase to where it stood at the same time five years ago. Moreover, this figure does not take into account capital from sovereign wealth funds and other investors selectively investing directly in private infrastructure.

The unprecedented volume of capital available for private infrastructure is fueling competition for investments and supporting high asset valuations, while also pushing down returns. A recent analysis of the 2017 investment opportunities we put through due diligence shows that for approximately half of the transactions we ultimately did not transact on, the winning buyer paid a price that implied a return between 200-350bps lower than that we were prepared to accept. While higher valuations can in part be justified by potential transaction synergies, we believe that in most cases, the valuation gap is due to lowering return thresholds or more aggressive business assumptions in the underwriting. In fact, our experience over the last twelve months has shown that in order to win processes for high-quality operating assets, many investors seem to disregard downside risk. Based on Partners Group’s underwriting assumptions, many transaction valuations we have seen in the market for operating assets would result in base case expected returns in the mid-single digits.

In general, we believe higher levels of assumed risk are not adequately reflected in current return expectations, especially at a time when interest rates in many economies appear to be increasing. In line with the assumptions we model into our Expected Return Framework, at Partners Group, we typically assume that the selling conditions for an asset acquired now will not be as favorable as the buying conditions. This leads us to create a solid capital preservation case for our investments, increasing their resilience to adverse economic and capital market developments. However, this also reduces our competitiveness in terms of pricing.

Opportunities in the current market
The record amounts of available capital and high prices for operating assets make for a good exit environment. To benefit from the attractive selling conditions and to capture outsized returns, we have thus increased our focus on portfolio exits. In

1 Inframation, November 2017.
3 Based on Partners Group assumptions, subtracting a 2% blended management and performance fee and assuming an 8% hurdle rate; based on public sources where available.
order to remain flexible over the course of an investment, we routinely develop exit scenarios based on different exit windows for all our direct assets. Our goal is to realize an asset at the right maximize risk-adjusted returns for our clients. With this in mind, we recently realized some of our more mature and operating assets at attractive terms. For example, we recently sold our 21% stake in the Victorian Comprehensive Cancer Centre (VCCC), a cancer research, treatment and education centre in Melbourne, Australia, to AMP Capital’s Community Infrastructure Fund. We were part of the winning Plenary Health consortium selected by the Victorian Government in late 2011 to deliver the VCCC in a public-private-partnership (PPP) project. As Australia’s first dedicated, state-of-the-art cancer research and treatment facility, the VCCC was envisaged to save lives through the integration of research, education and patient care. The PPP project scope included the design, construction and commissioning of the VCCC facilities as well as their ongoing maintenance under a 25-year concession agreement. The completed centre has 13 levels, 160 inpatient beds, 110 day beds and eight operating theatres, and can host up to 1,200 researchers. Plenary Health completed the VCCC on time and on budget at a total cost of AUD 1 billion and operations began seamlessly in June 2016. With the facility now fully operational, and having received strong interest from potential buyers, we decided to divest our stake in this groundbreaking centre ahead of the original investment plan.

We have long emphasized the superior relative attractiveness of Australian availability-based PPP projects versus their European counterparts, based on good deal flow, larger investment sizes, and higher returns. Yet, absolute returns for these projects have compressed in line with the general market and we believe that entry buy-and-hold IRRs for availability-based PPPs in Australia today are around 400bps lower than they were in 2011. However, while returns have compressed, the Australian PPP market still offers a premium compared to other regions and we will continue to closely monitor the sector.

In terms of deal origination, our efforts over the next year will be guided by two key relative value convictions. Firstly, to create value, we prefer to build core assets or expand platforms over buying ready-built infrastructure. The value uplift from building and then exiting a large, stabilized core asset in this market can result in an IRR increase of 300-500bps, depending on the sector and geographic location of the asset. Secondly, we maintain our focus on sectors that are supported by transformative growth trends which drive demand for new and better infrastructure in that particular sector. Currently, we see such trends in the renewable energy, communications infrastructure, and energy infrastructure sectors.

Selectively, we will also pursue regional themes – we see some attractive relative value in the US conventional power sector, for example – and keep a close eye on emerging themes such as energy storage and batteries, or coverage for the ‘Internet of Things’ (smart meters, smart cities, etc.).

Opportunities in Asia-Pacific

In the Asia-Pacific region, we continue to focus on renewable power and communications infrastructure in select key markets such as Taiwan, Singapore, Japan and Australia. We have, to-date, developed close to 2GW of solar and wind energy capacity in the region, and relative value in these areas should persist throughout the first half of 2018. However, as competition from low cost-of-capital buyers for operating assets intensifies, we focus predominantly on capturing the premiums available for building core and select platform expansion opportunities.
Within communications, we see the most attractive opportunities in data centers and fiber infrastructure, particularly subsea fiber cables. We have substantial experience in communications infrastructure, having completed seven investments in the sector globally in the last ten years, and will continue to actively monitor the space.

The attractiveness of data centers is based on the growing demand for capacity in the region (as well as globally). Data creation and storage is experiencing explosive growth: 90% of the world’s stored data today has been created in the last two years. With new devices, sensors and technologies emerging, the data growth rate will likely accelerate even more. Meanwhile, the growing adoption of cloud services and emerging technologies such as big data management or artificial intelligence are expected to further exacerbate demand for data center capacity. Traditional owners of data centers, such as governments, banks, telecommunication and internet service providers, have historically kept their data centers in-house for reasons of control, flexibility and quality assurance. However, to reduce cost and time to market, they are increasingly turning to externally managed facilities, thus spurring demand for wholesale colocation data centers. To capitalize on the high growth in this market, we focus on opportunities that combine good quality and efficient sites with a positive track record serving a diverse set of customers, ideally including government, enterprise and hyperscale (large public cloud providers such as Amazon, Google or Microsoft) clients. The market in the Asia-Pacific region is relatively fragmented. This offers scope to consolidate and create pan-Asian data center platforms of scale, which should cater to the needs of international customers, who often prefer to use one global colocation provider to reduce time to market across the region. Key success factors in this strategy are deep customer relationships with global internet content providers and regional telecommunication providers, and a proven ability to deploy capacity.

We are currently reviewing a number of potential opportunities in the data center sector, focusing on facilities with a diversified customer base on medium- to long-term take-or-pay contracts, which provide for stable, long-term revenue streams and limit the investment’s exposure to any volume risk. We seek operational value creation potential in terms of expanding the footprint organically or through M&A and enabling MW growth, as well as through power cost optimization measures.

Opportunities in Europe

In Europe, we see the best relative value in the communications and renewable energy sectors. In communications, we prefer terrestrial fiber infrastructure, as the segment offers strong inherent upside based on relatively low penetration levels and widespread government support for build-out initiatives. Demand for additional fiber capacity outweighs supply, creating tailwinds for new installations, particularly in rural parts of Europe. However, as the industry matures and the complexity of installing new networks decreases, prices for fiber capacity are declining, putting pressure on future expected revenues for network owners. We focus our efforts on more bespoke situations, such as building core and platform expansion projects across multiple jurisdictions, and on scaling our existing fiber platform Covage/Axia.

In the renewable energy sector, we focus on offshore wind, which we believe offers the most attractive opportunities based on a number of factors, including available investment sizes and expected returns.

**Expected returns for European renewables projects**

<table>
<thead>
<tr>
<th>Type</th>
<th>Operational</th>
<th>Construction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Solar</td>
<td>3-5%</td>
<td>7-11%</td>
</tr>
<tr>
<td>Onshore wind</td>
<td>4-6%</td>
<td>~300bps premium</td>
</tr>
<tr>
<td>Hydro</td>
<td>7-10%</td>
<td>-</td>
</tr>
<tr>
<td>Offshore wind</td>
<td>5-8%</td>
<td>-</td>
</tr>
<tr>
<td>Construction</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: Showing lifetime buyer IRR, assuming stable regulatory regimes. Source: Partners Group research, December 2017. For illustrative purposes only.

Although significant declines in capex have elevated offshore wind from a niche segment into renewable energy mainstream over the past 18 months, the sector is expected to grow globally at a 19% CAGR from 2017-2025 and capital demand for new projects is set to remain high. We see better relative value in late-stage development projects that offer us the opportunity to enter a project without taking development risk. Compared to operational wind farms, projects at this stage offer superior risk/return for investors like Partners Group that have the ability to add significant value in the pre-closing phase, for example by shaping the debt process or the final EPC (engineering, procurement, and construction) negotiations.

Through our investment in Merkur Offshore, an offshore wind farm in Germany, and through our participation in several other European offshore wind processes, we have developed deep expertise in the sector, which we are currently using in our investment in Borssele III/IV (Borssele), a 730MW construction-ready offshore wind farm in the Netherlands, which signed in December 2017. Borssele will comprise 77 Vestas turbines placed across two sites in the Borssele Wind Farm Zone, which is 22km off the coast of Zealand at the southern border of the Netherlands’ Exclusive Economic Zone. Grid connectivity has already been secured for the project, which is due to begin construction in the second half of 2018. The wind farm will benefit from the Dutch offshore feed-in tariff for a period of 15+1 years from the commencement of commercial operations in early 2021. Once it is fully operational,
Borssele is expected to generate more than 3TWh per annum, enough electricity to power approximately 825,000 households.

**Opportunities in North America**

In North America, we see compelling relative value in the communications and energy infrastructure sectors. Within communications, we look at terrestrial fiber and data centers. Deal flow for the latter is robust and, similar to Asia-Pacific, opportunities arise from corporate owners disposing of their non-core communications assets.

Within energy infrastructure, our focus remains firmly on the midstream segment. The shale revolution has created a value chain of investment opportunities that ranges from upstream gathering and processing infrastructure, through intermediate transportation and storage assets, to downstream processing, logistics, and export infrastructure. Deal flow is relatively strong in all areas, but we believe the best relative value is currently found away from the wellhead, where there is a growing fundamental need for infrastructure that helps create pathways for the export of natural gas and its derivatives and where contractual underpinning is strong. Recent projections indicate that the US is on the verge of becoming a net exporter of gas for the first time in almost 60 years.

**Net trade of natural gas**

We also selectively pursue opportunities in the conventional power sector. We focus on gas-fired power assets, where a large part of the deal flow is in new-build opportunities. However, these often require investors to take a view on improving power market conditions. New-build gas-fired power generation assets are usually directly exposed to the power market once the initial hedges and debt terms expire, thus moving such opportunities higher up the risk-return spectrum. Our preference is for existing assets with good principal protection from existing hedges and offtake agreements, but also with re-contracting opportunities underpinned by strong asset positioning and market fundamentals beyond the initial term of such hedge contracts. An example is our investment in **Sentinel Energy Center**, a peaking power plant in the Los Angeles Basin of California, which generates all its revenues under a 10-year availability-based power purchasing tolling agreement.

**How we realize relative value potential in private infrastructure**

**Capitalize on platform expansion opportunities**

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.

**Proactively build core**

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.

**Focus on operational value creation**

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.
Relative value analysis

For 2018, we continue to see better relative value in direct investments and underweight secondaries. Although traditional secondaries containing inflection assets can be attractive, these opportunities are rare in the current market and valuations are typically very high (well in excess of NAV). We only pursue them if we have a special angle into the situation, such as existing insights into the portfolio and unique access to the manager. We estimate that up to 70% of infrastructure fund secondary deal flow is currently in tail-end solutions, however, due to their core characteristics, pension fund investors absorb the bulk of these opportunities at around 7% investment return. Tail-end solutions with non-core characteristics are less common, but we pursue them actively if they can be sourced.

With regard to direct investments, operating core infrastructure is relatively unattractive in all regions due to the continued high valuations attributed to these assets by the market. As interest rates in many economies appear to be increasing, we are conscious that assets acquired at very high valuations may not have enough of a built-in buffer to absorb this development, especially as the scope for active value creation is limited in core infrastructure.

In terms of sectors, we continue to overweight communications, energy infrastructure, and renewable energy globally, although renewable energy in Asia-Pacific has become relatively less attractive compared to the previous half-year due to a further return compression for de-risked, operating renewable energy assets in the region. Our focus, therefore, is on investing in construction-stage assets to sell into this market once they are operational.

Relative value matrix

<table>
<thead>
<tr>
<th>Sector</th>
<th>NORTH AMERICA</th>
<th>EUROPE</th>
<th>ASIA/EMERGING MARKETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transportation</td>
<td>Power</td>
<td>Energy</td>
<td>Social</td>
</tr>
<tr>
<td></td>
<td>conventional</td>
<td>infrastructure</td>
<td>infrastructure</td>
</tr>
<tr>
<td>Communication</td>
<td>Power</td>
<td>Water</td>
<td>Waste</td>
</tr>
<tr>
<td></td>
<td>renewable</td>
<td>management</td>
<td>management</td>
</tr>
<tr>
<td>Strategy</td>
<td>Building core</td>
<td>Platform expansion</td>
<td>Operational value creation</td>
</tr>
<tr>
<td></td>
<td>Core</td>
<td>Core</td>
<td>Core</td>
</tr>
<tr>
<td>Directs</td>
<td>Equity</td>
<td>Subordinated debt</td>
<td>Equity</td>
</tr>
<tr>
<td></td>
<td>Subordinated debt</td>
<td>Subordinated debt</td>
<td>Subordinated debt</td>
</tr>
</tbody>
</table>

How to interpret the table: the relative value matrix divides the private infrastructure market into various regions (North America, Europe and Asia/emerging markets) and segments, which are then divided into sectors (transportation, communication, power conventional, power renewable, energy infrastructure, water, waste management, and social), strategy 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 flow. White highlights a neutral segment. Yellow and light yellow mean that Partners Group underweights the segment and requires even greater conviction during bottom-up analysis to pursue an asset.
Liquid private markets

Market overview

**Listed infrastructure** continued to perform strongly in 2017, increasing 8.4%. The sector had a solid start to the year, as political risk eased in France and the Netherlands, but gave up some performance in the second half. European equities outperformed their North American peers last year, while emerging markets also performed strongly. Although valuations are elevated and we are cautious on the sector overall, we remain optimistic about the prospects for GDP-sensitive sectors in Europe, as well as certain niche sectors in emerging markets.

**Listed private equity** achieved the sixth consecutive year of double-digit performance, increasing 16.5% in 2017. This strong result was predominantly driven by underlying NAV growth, while discounts actually increased. Europe was by far the strongest contributor as North America faced headwinds from the relatively weak performance of business development companies as a result of elevated valuations, slower than expected interest rate increases and a very competitive financing market. While valuations have increased substantially over the last few years, we believe that listed private equity continues to be reasonably valued compared to the overall equity markets but that volatility is likely to increase substantially in a less favorable equity market environment.

Opportunities in the current market

It is difficult to argue that **listed infrastructure** valuations are cheap after they have increased for the past eight years.

However, we believe certain sub-sectors can still offer good value. Specifically, we are still positive on the US tower sector, as leasing activity is expected to increase further as carriers deploy four new spectrum bands in the US and 5G is becoming increasingly relevant. Data consumption continues to grow strongly and small cell networks, as well as the related fiber backbone, play an increasingly important role despite the fact that their profitability is lower compared to macro towers. Finally, valuations also became more attractive following speculation about a potential merger between Sprint and T-Mobile, which has since been abandoned.

We have not changed our sector focus in **listed private equity**, retaining our positive view on alternative asset managers as we expect realized carried interest to increase substantially, given the number of large and mature funds, as well as the benign exit environment. Despite strong share price performance, we believe that there is further upside as the AuM growth trend continues and carry income generation accelerates.

Relative value matrix

<table>
<thead>
<tr>
<th>Market Overview</th>
<th>NORTH AMERICA</th>
<th>EUROPE</th>
<th>ASIA/EMERGING MARKETS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Listed private equity</strong></td>
<td>Public partnerships</td>
<td>BDCs</td>
<td>Managers</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Transport</td>
<td>Utilities</td>
<td>Communication</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Listed infrastructure</strong></td>
<td>Public partnerships</td>
<td>Fund of funds</td>
<td>Managers</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Transport</td>
<td>Utilities</td>
<td>Communication</td>
</tr>
</tbody>
</table>

How to interpret the table: the relative value matrix divides the listed infrastructure and listed private equity markets into regions (North America, Europe and Asia/emerging markets) 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 even greater conviction during bottom-up analysis to pursue an asset.
As highlighted in the previous sections, the search for yield has long found its way into private markets. Valuations have been on an upward trajectory, as increasing amounts of capital chase investments. Credit availability is abundant and leverage levels are rising. Taking private equity as an example, EV/EBITDA multiples of 12–15x are often the new norm for quality companies with inherent growth potential, with a larger share of transactions financed by larger debt packages. As a result, future return potential is comparably low in historical terms.

Our Expected Return Framework, which calculates expected broad industry returns by asset classes, confirms that net return expectations over a typical private markets holding period are below their long-term potential, for public as well as private markets.

That said, the superior value creation component inherent in private markets investments, realized through value creation initiatives over long-term hold periods, still provides for material outperformance over public markets. In fact, the current return spread of most private markets asset classes over public equities is even above their long-term outperformance potential, as illustrated in the chart below. This emphasizes the relative attractiveness of private markets, with outperformance being particularly strong in an environment characterized by muted top-line growth, limited room for margin expansion in the public space and elevated valuations.

**Steering asset allocations through active portfolio management**

In the current environment characterized by elevated valuations and rising uncertainties about the future macroeconomic landscape, an active approach to asset allocation is needed to find the best risk/return profile. At Partners Group, we apply increased scrutiny to risk considerations both in our investment selection as well as in our underwriting and scaling for our mandates and programs. At the underwriting stage, we take a more prudent approach than the broader market by embedding a certain degree of multiple contraction in our base case assumptions for an increasing number of direct investments. At the portfolio management stage, we assess assets on a
In the return-focused portfolio, we continue to slightly overweight private equity and private (corporate) subordinated debt over real assets given our base case projection of gradually rising rates. That said, real assets’ inherent protection against inflation and infrastructure’s low volatility are important attributes for portfolio diversification. In private equity, we selectively target quality assets where we have a strong value creation angle, usually with strong and sticky product demand and where market fragmentation facilitates organic and inorganic growth. Private equity secondaries remain highly priced and thus, are underweighted. In private debt (corporate second lien and mezzanine), we focus on companies with solid cash flow profiles and resilient business models. Mid-market companies in select sub-sectors offer premiums as they fall under the radar of competitors (CLOs) and allow us to leverage the insights of our industry specialists. In infrastructure and real estate, the focus lies in sectors/regions supported by fundamental growth trends (renewables, affordable housing in the US and Europe).

Applying these weights and using the expected broad industry returns as derived from our Expected Return Framework results in an annualized expected return of 8.5% and generates a strong outperformance of 5.3 percentage points over a 60/40 public markets portfolio (60% equities, 20% government bonds, 20% investment grade bonds). The table below illustrates the expected returns for the different scenarios, using the same asset allocation.

### Economic scenarios applied to return-focused portfolio

<table>
<thead>
<tr>
<th>Economic scenario</th>
<th>Net return in percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock market rally</td>
<td>10.8%</td>
</tr>
<tr>
<td>Faster rate hike cycle</td>
<td>7.0%</td>
</tr>
<tr>
<td>Mild recession</td>
<td>6.6%</td>
</tr>
<tr>
<td>Base case scenario</td>
<td>8.5%</td>
</tr>
</tbody>
</table>

Source: Partners Group, Expected Return Framework, H1 2018. Past performance is not indicative of future results. For academic purposes only. Portfolio does not represent actual Partners Group investments.

A more positive capital markets outcome (stock market rally) would result in a narrowing of the outperformance over public markets, as public equities should rise strongly. Under the faster rate hike scenario, the more material impact on rate-sensitive real assets is somewhat offset by higher-yielding floating-rate corporate debt, thereby narrowing outperformance compared to our base case. Under the mild recession scenario, the robust value-add component of private market returns, coupled with the more defensive characteristics of infrastructure and wider spreads in the corporate debt space would cushion the impact.

In the current environment, an active approach to asset allocation is needed to steer capital into attractive market segments.

### Applying relative value and scenario thinking to private markets portfolios

As in previous issues of the Private Markets Navigator, we are providing a return- and a yield-focused private markets portfolio to illustrate the portfolio implementation of our relative value weights and themes. Both portfolios maintain an overall diversified approach and take into account technical factors such as deal flow, the breadth of asset classes and incremental risk/return factors. The return portfolio combines investment themes and segments of private markets catered towards capital appreciation, while the yield portfolio focuses on income-oriented opportunities. Comparing portfolio allocations in light of different economic scenarios (defined in the Private Markets Outlook section on page 5) highlights the benefits of both a multi-asset portfolio and wide allocation bandwidths that facilitate the generation of high, risk-adjusted returns throughout market cycles by enabling the investor to focus on the most attractive investment opportunities within private markets at any given time.

#### Return-focused portfolio allocation in our base case

Note: the inner pie represents current target allocations. The outer pie represents long-term, strategic asset allocation. Numbers in parenthesis represent target bandwidths. Private equity consists of allocations to equity, growth capital and private equity secondaries. Private real estate consists of allocations to value-add (equity directs), opportunistic (equity directs) and real estate secondaries. Private infrastructure consists of allocations to core asset build-out (equity directs), platform expansion (equity directs) and private infrastructure secondaries. Private debt consists of allocations to subordinated debt.

Source: Partners Group, H1 2018. For illustrative purposes only.
on expected returns, thereby widening the outperformance potential of private over public markets.

**Yield-focused portfolio allocation in our base case**

![Pie chart showing portfolio allocation]

Note: the inner pie represents current target allocations. The outer pie represents long-term, strategic asset allocation. Numbers in parenthesis represent target bandwidths. Real asset debt consists of real estate and infrastructure debt (subordinated and senior). Private infrastructure equity consists of allocations to operational value creation and core.

Source: Partners Group, H1 2018. For illustrative purposes only.

In the yield-focused portfolio, floating-rate corporate debt remains the major building block, offering upside in a rising rates environment. Given the length of the current business cycle, the safer stack of the capital structure is gradually gaining relative attractiveness; a shift further supported by secondary spreads narrowing over first lien, where we source bespoke situations and can generate return premiums by offering customized financing solutions, such as multiple currency loan facilities. Real asset debt, which is usually fixed-rate, is underweight, given tight spreads and their usually fixed-rate nature. Under the base case scenario, the annualized expected return for such an allocation equates to 5.9%. \(^3\) 3.2 percentage points higher than a public markets portfolio consisting of 20% equities, 40% government bonds and 30% investment grade and 10% high yield bonds.

Within the alternative scenarios, the faster rate hike cycle scenario emphasizes the compelling floating-rate return characteristics of the private debt portfolio, thereby widening the expected outperformance over a public markets portfolio. Under the mild recession scenario, expected returns retrace for public and private markets alike, leaving the outperformance potential roughly unchanged. Strong equity returns under the stock market rally scenario would reduce the outperformance, as debt investments would benefit under-proportionately (lack of valuation expansion).

**Economic scenarios applied to yield-focused portfolio**

![Bar chart showing economic scenarios]

Source: Partners Group, Expected Return Framework, H1 2018. Past performance is not indicative of future results. For academic purposes only. Portfolio does not represent actual Partners Group investments.

3 Using broad industry expected returns and not Partners Group target returns. For academic purposes only. Portfolio does not represent actual Partners Group investments.

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**Partners Group’s 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 five-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, in addition to the beta-related earnings growth that can also be observed in public markets, return from growth is generated through value creation strategies, such as 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 price-to-earnings ratio, for private equity it is Enterprise Value (EV) to Earnings before interest, tax, depreciation and amortization (EBITDA) changes. For private infrastructure and private real estate it is the asset’s sensitivity to a change in underwriting internal rate of return (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 fully revert to long-term averages over a longer-term horizon.
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