Offense is the new defense
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Welcome to Partners Group’s Private Markets Navigator for 2020. The Private Markets Navigator shares Partners Group’s economic outlook and investment preferences for all private markets asset classes.
Looking back on what is now the longest (US) economic expansion since the 1930s, we note the unprecedented scale of accommodative monetary policy still driving progress. Although asset prices have rallied strongly, in most cases decoupling from fundamentals, GDP growth has remained modest and far from pre-2008 averages. Valuations for most assets are at the upper end of 20-year historical ranges, and, as the business cycle extends further, they will become more sensitive to underlying growth assumptions.

A pick up in volatility is a typical development for a mature stage in the cycle, and this materialized in the Q4 2018 market correction, which was uncharacteristic in speed but not excessive in scope for a late-cycle correction. Looking ahead, our base case macroeconomic scenario assumes the low growth environment will continue, predicated on the assumption that central banks will maintain loose monetary policies. We also expect valuations to come down slightly from their current frothy levels. However, any deviation from this balancing act of fragile top-down fundamentals, low discount rates, and inflated valuations could result in a more pronounced correction in asset prices.

While we believe the global business cycle has further to run on the back of robust private demand and continued monetary policy support, we have lowered our economic growth outlook to reflect the signs of a cyclical slowdown and increased geopolitical uncertainty, including ongoing trade tensions. Slowing capital expenditure and manufacturing activity were two key drivers behind the sharp decline in US and European corporate earnings. Hiring is coming down from strong levels. Growth in China and several other emerging markets has slowed. Short term, we do not rule out the possibility of a more pronounced slowdown, particularly in parts of Europe, as already reflected in the data. This is driven by idiosyncratic developments (UK), on the one hand, and by the spillover effects of trade tensions, on the other, given the manufacturing industry’s relatively large share in select economies across the region. In particular, Germany is deeply ingrained in the global supply chain. For emerging markets, given the disparities in fundamental conditions and political risks, our investment approach relies on a case-by-case analysis. We are also weary of currency implications as trade tensions evolve.

In this late-cycle environment, investors would typically shift their focus toward increased defensiveness by investing in assets offering cash flow security and operating in less cyclical sectors, such as big brands, large-cap companies, and core assets with a bond-like payout structure. This time around, however, these assets come at a significant premium as yields are suppressed and valuations stretched. Barring another decade of multiple expansion and falling rates, the expected returns for these assets are likely to be mediocre at best, and the vulnerability of their valuations is often high. Disruption risk adds to downside

Against a challenging backdrop of low growth and geopolitical uncertainty, we believe "offense is the new defense" in private markets investing. We seek opportunities to build resilience instead of buying it by focusing on assets with value creation potential in sub-sectors with above-average growth rates.

Private markets outlook
Rethinking defensiveness.

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Longer term, there are other factors that should keep global growth on a modest path only: overall productivity growth remains low, and record high leverage levels are putting an additional barrier on sustainable credit-led growth. Simultaneously, the advanced integration of emerging markets into global supply chains and structurally lower growth in China is dampening emerging markets growth.

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vulnerability, potentially even threatening established large-cap incumbents as consumer preferences and technological innovation evolve. Recent examples include Heinz Kraft, which has not been able to keep up with changing consumer tastes, and traditional car makers, which are being marginalized by electric vehicle innovations.

In our view, investing in what has traditionally been perceived as defensive no longer represents a cautious approach. Investors will need to think differently to generate attractive returns and protect capital. We argue that “offense is the new defense.”

Our aim is to identify transformative trends generating higher growth rates across specific sub-sectors. Within these sub-sectors, we look for companies that enable us to actively build out cash flows and develop valuation resilience at the asset level through value creation and strong entrepreneurial governance. This approach is particularly well suited to private markets investments because the universe of assets operating in attractive sub-sectors is much broader compared to public markets, facilitating a direct exposure to the transformative trends identified.

To illustrate our thinking, we are taking a step back and looking at asset return drivers, which can be split into three components: yield, growth, and valuation changes. The chart below uses private equity as an example, but the return composition is applicable across all asset classes.

Today, all three return components are sobering for traditional asset classes: bond yields are low, earnings growth is muted, and valuations are elevated. In light of this, we look for assets offering higher income or growth potential at a modest valuation risk.

“Offense is the new defense” explained: how we look at return from income

The unabated search for yield has led to extraordinarily low income across many asset classes. At the center of the search for yield lies fixed income debt, with more than USD 15 trillion of global fixed income securities trading at zero or negative yields and high yield income standing at decade lows. This yield compression is not confined to the fixed income space. In core real estate, cap rates are hovering near record lows. The same is true for the dividend yield of core infrastructure companies.

A simple return framework

\[
R = Y + G + \Delta P
\]

\[
Y = \frac{\text{Annual cash flow received}}{\text{e.g. interest payments, dividends}}
\]

\[
G = \frac{\text{Earnings growth (public markets)}}{\text{Transformative trends}}
\]

\[
\Delta \frac{\text{EV/EBITDA}}{\text{Changes in the price the market pays for a cash flow stream e.g. } \Delta \text{ in price/earnings ratio}}
\]

\[
\Delta (\text{EV/EBITDA}) \text{ ratio}
\]

Source: Partners Group, November 2019. For illustrative purposes only.

Rahul Ghai Private Real Estate Asia | Alex Cho Head Client Solutions Korea
across the developed world, which today is around 5%. Similarly, the dividend yield across defensive equity sectors has come down by almost 40% over the last decade.¹

Against this backdrop, we search for assets that, to-date, have been shielded from the large yield compression. One example is private debt. For both senior and junior debt, spreads in the US and Europe remain at a healthy margin and well above pre-crisis levels as opposed to high yield bonds. Even if benchmark rates go deeper into negative territory in some regions, loan terms incorporate a zero floor.

Outside of the yield-compressed core space, private infrastructure and private real estate assets can also offer attractive income from existing concessions and leases. For example, we see relative value in residential and office properties located in gentrifying suburbs outside of central business districts, where rental yield is higher. In infrastructure, yielding brownfield assets tend to be pricey. We prefer to focus on assets that have a value-add component: building out an asset through platform expansion allows us to capitalize on opportunities with superior yields and growth potential.

How we look at return from growth

We break down return from growth into two components: market or sector growth, and active growth strategies. Market or sector growth is mainly driven by macroeconomic growth in the respective economy or sector. Because of modest economic growth, market growth has been subdued: using public equity as a proxy, earnings growth over the last ten years has averaged a mere 2.6% p.a. in nominal terms – barely higher than inflation (1.9%) over the same period. In the absence of tailwinds from macro-led growth, it is not expected to pick up in a sustainable manner anytime soon. Consequently, investors need to take a proactive approach to growing their investments in order to generate attractive returns:

- **Transformative trend-driven growth** reflects changes in structural, technological, or demand patterns that result in sectoral shifts beneath the surface, driving above-average, sub-sector growth rates. Examples include population aging, digitization, or the energy transition. To capitalize on transformative trends, it is crucial to employ a Thematic Sourcing approach. This approach requires going beyond industry sectors or sub-sectors; the themes within these sub-sectors are the key to identifying market segments benefiting from transformative trends. In a next step, the microstructure of these market segments is analyzed to identify potential investment targets, enabling us to form an investment strategy for them early on.

- **Asset-level value creation** refers to growth created by building out and strengthening cash flows. This includes organic growth strategies focused on geographical or product expansion, platform strategies to increase the top line, and operational efficiency gains to increase margins. For real assets, value creation can involve repositioning and developing an asset to meet investor demand. For private equity and infrastructure in particular, strong entrepreneurial governance is a key component in identifying and implementing the optimal strategic growth initiatives.

How we look at valuations

Creating cash flows rather than buying them is even more relevant in the context of valuations. Across the board, the search for yield has driven up valuations well beyond underlying fundamental growth. The following table shows current valuations compared to longer-term means and expresses the drag of mean reversion in terms of valuation contraction and years of income lost:

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Defensive equity</th>
<th>US corporate bonds</th>
<th>Core real estate</th>
<th>Core infrastructure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>2.3%</td>
<td>2.9%</td>
<td>4.5%</td>
<td>5.2%</td>
</tr>
<tr>
<td>Valuation (current)</td>
<td>21.0x</td>
<td>2.9%</td>
<td>4.5%</td>
<td>30.5x</td>
</tr>
<tr>
<td>Valuations (long-term)</td>
<td>16.0x</td>
<td>3.6%</td>
<td>6.0%</td>
<td>23.5x</td>
</tr>
<tr>
<td>Downside potential</td>
<td>-23.8%</td>
<td>-6.7%</td>
<td>-25.0%</td>
<td>-23.0%</td>
</tr>
<tr>
<td>Years of income lost</td>
<td>10.4</td>
<td>2.4</td>
<td>5.6</td>
<td>4.4</td>
</tr>
</tbody>
</table>

Note: defensive equity includes S&P 500 companies in the utilities, healthcare, consumer staples, and telecommunications sectors; US corporate bonds represented by the Barclays Aggregate US Corporate Bond index.

Because valuations are largely based on low discount rates rather than healthy growth prospects, their sensitivity to small changes in discount rates and low market growth is substantial, even more so when expressed as the years of income it takes to make up for valuation-induced markdowns. The more an asset’s cash flows are perceived as stable, the higher its sensitivity to valuation changes. For the avoidance of doubt, we do not expect the downside to materialize instantly. However, many investors are unaware of the duration profile within their portfolios and the downside it may entail.

Besides stretched valuations, another issue for assets perceived as defensive is the assumption many investors make around these assets’ limited susceptibility to industry disruption. However, in today’s market, industry disruption can come from completely unexpected directions, often leaving traditional operators blindsided. These industry shifts create new winners and losers – a threat (or opportunity) that even the safest large-cap companies or infrastructure incumbents are not fully immune to. To name just one example, even fashion-anchored retail, once a safe haven in the traditional brick-and-mortar retail segment, is succumbing to the pressures of e-commerce.

We approach the challenges stemming from high valuations in three ways. First, we look for assets with strong value creation potential. In these situations, we become comfortable with a slightly more elevated entry valuation based on the assumption that we can grow an asset into that valuation over time. Second, we strive to develop a unique angle on the transaction to avoid hotly competed bidding processes. This may translate into pre-empting a sales process or drawing upon our network of industry experts and operators to learn about opportunities before they come to the market. Finally, we rigorously apply a valuation contraction assumption in our underwriting across private markets.

What this means for corporate assets
The main driver of returns in private equity is growth. Today, growth mainly derives from transformative trends and asset-level value creation. Market dynamics are also an important factor: resilient or high-growth market segments further characterized by high market fragmentation offer return potential through market consolidation. Ideal investment targets are companies that are positioned to act as consolidators in these fragmented segments, either via targeted M&A or by gaining market share organically. A carefully executed buy-and-build strategy can help reduce the entry valuation and thereby mitigate valuation risk.

Our investment in Blue River PetCare (Blue River) is a good example of a company that could benefit from this approach. Blue River is a leading US operator of veterinary hospitals. From a transformative trend angle, veterinary care is experiencing above-average growth that is being driven by increasing pet ownership rates and the trend of treating pets like family members. The industry is highly fragmented, with over 87% of clinics operating in independent locations.2 Our value creation plan will therefore focus on pursuing M&A partnership opportunities to build out the Blue River platform and consolidate the market, while implementing best-in-class customer engagement and continuing the company’s emphasis on clinical excellence. The M&A strategy is aimed at lifting revenues and market share, as well as enabling synergies across the platform. Blue River’s valuation is further supported by the resilience the sub-sector has shown in difficult times. During the Global Financial Crisis, US pet health expenditures continued growing at an annual rate of 4-5%.4

As opposed to private equity, the single most important driver of returns for private debt is income. As previously mentioned, private debt spreads have largely escaped the broad yield compression that is visible elsewhere, with spreads hovering near long-term averages. Although private debt offers no or very limited return upside from growth, we adopt the same thematic investing and due diligence approach as we do for private equity, albeit with an increased focus on resilience. This enables us to get comfortable with revenue and earnings stability as a means of protecting debt servicing requirements. Given private debt’s floating-rate nature, valuation risk is less of a concern, as long as we have the conviction that capital will be repaid at maturity. For this reason, we seek solid interest rate coverage ratios and high equity cushions to complement our Thematic Sourcing angle.

Our investment in the senior loan facility of the Dutch Ophthalmic Research Center (DORC) is an example of strong lender terms in a market segment supported by secular growth. DORC is a Netherlands-based company that manufactures instruments and equipment especially designed for eye surgery. The debt facility incorporates below-market leverage levels and a strong equity cushion in excess of 60% compared to the European market average of 47%.3 It also entails a leverage maintenance covenant and a Euribor floor. The investment is further supported by favorable secular trends, including aging demographics, improved diagnostic technologies, increased access to healthcare in developing countries, and higher expectations for vision quality. DORC has increased its global market share strongly over the last four years in a market that is growing at an annual rate of 4-5%.4

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What this means for real assets
In private infrastructure, the ongoing energy revolution has created a number of appealing high-growth themes, including clean energy, and energy efficiency, processing, and storage. However, competition is high, and operational brownfield asset income has been compressed as a result of the search for yield. To enhance returns, we continue to invest in high-growth market segments where we can further create growth by expanding platforms through brownfield M&A or by developing greenfield assets. Similar to other asset classes, we underwrite a valuation contraction, and we rigorously test the assets for sensitivity to growth and interest rate fluctuations.

CapeOmega, one of our recent investments, is a leading offshore infrastructure platform in Norway. The company provides essential infrastructure for transporting natural gas produced on the Norwegian Continental Shelf, which

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3 S&P LCD, Q3 2019.
renewables in the context of the retirement of coal-fired and nuclear power plants across Europe. From a growth perspective, CapeOmega is poised to benefit from this demand tailwind. The asset also lends itself to a platform expansion strategy: CapeOmega is located in the largest gas reserve in the North Sea and has a busy pipeline of accretive brownfield and greenfield projects. The transaction is a good example of how resilient, core infrastructure characteristics, such as CapeOmega’s leading market position and high barriers to entry, can be combined with a platform strategy to enhance growth. To further protect our growth assumptions, we incorporated a valuation contraction over the hold period in our underwriting.

In private real estate, cap rates for core commercial real estate assets have been coming down as the sector has been a prime target of the search for alternative sources of income. With rental growth having to rely on a modest global economic outlook, identifying the right themes is especially important. From a location perspective, we focus on areas with high population and employment growth supported by transformative trends. Examples include the need for adaptable office and logistics properties or combined residential and office properties that cater to live-work-play lifestyles. Asset-level value creation continues to be a major return driver across our private real estate portfolio; growth can be enhanced by repositioning existing assets and creating a positive impact on net operating income (NOI) through rental or occupancy growth.

From a valuation perspective, we navigate the current environment using a three-pronged approach. First, we aim to buy assets sourced off-market at more favorable valuations by adopting a flexible, situation-based approach: we focus on transactions that are more complex in nature, either due to the structure these assets are held in or the seller’s specific needs. In many instances, this enables us to negotiate implied cap rates well above market averages. Importantly, the properties themselves exhibit similar risk characteristics to any other real estate investment. Second, where we are repositioning properties through active value creation, we aim to make them attractive to buyers seeking stabilized, core properties that trade at elevated valuations. Finally, we prudently assume a certain degree of market cap rate expansion in our underwriting.

To exemplify this, we recently purchased a historic office building located in Portland, Oregon. The initial income yield on the portfolio was underwhelming, a result of poor management and low occupancy. However, from a location perspective, Portland has seen strong employment and population growth, positioning our investment for above-average returns from the growth component. We are actively creating value by repositioning the assets into a highly amenitized urban campus and are converting the existing office and warehouse properties into Class A creative office spaces. Our target is to increase occupancy from 50% at entry to over 90% at exit, further increasing NOI growth. From a valuation perspective, the underwritten cap rate expansion combined with the cap rate effect of the transformation of the asset provides adequate protection.

Key takeaways from our 2020 outlook
Investing is a challenging undertaking in today’s environment of low yields, suppressed future growth expectations, and frothy valuations. Our base case scenario of modest yet positive growth and a low interest environment implies that the decoupling of the real economy and capital markets continue. Any deviation from this base case, however, could result in material valuation setbacks, erasing multiple years of income or growth. As such, it is crucial to identify actual versus perceived defensiveness. Investors have to look for longer-term, transformative growth at the sub-sector level and find strategies to create further sustainable growth through asset-level value creation. With this in mind, offense is the new defense. We continue to focus our sourcing efforts on assets that are strongly positioned to withstand business cycles and that we can actively grow during our ownership.

Economic and market scenarios: main parameters
We have defined a base case and three potential test scenarios that can be used to assess the robustness of an asset, sector, or portfolio of assets to different economic and market outcomes. The aim of this approach is to define a base case scenario to guide our investment strategy and introduce a variety of alternate outcomes to test assets on a standalone basis.

<table>
<thead>
<tr>
<th>Economic and market scenarios: main parameters</th>
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<tbody>
<tr>
<td><strong>Real GDP growth</strong> <em>(Next 5-year average)</em></td>
</tr>
<tr>
<td>US: 1.5–2.5% EU: 0.5–2%</td>
</tr>
<tr>
<td>US: 1.5–3% EU: 1%</td>
</tr>
<tr>
<td>Unchanged +100bps (2.5%)</td>
</tr>
<tr>
<td>Unchanged to +100bps</td>
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<tr>
<td>Unchanged -100bps to -50bps</td>
</tr>
<tr>
<td>Unchanged to -50bps</td>
</tr>
<tr>
<td><strong>Change in Fed funds rate</strong> <em>(in 5 years’ time)</em></td>
</tr>
<tr>
<td>Unchanged to +100bps</td>
</tr>
<tr>
<td>Unchanged to -50bps</td>
</tr>
<tr>
<td><strong>Market valuations</strong> <em>(in 5 years’ time)</em></td>
</tr>
<tr>
<td>10% lower</td>
</tr>
<tr>
<td>20% lower</td>
</tr>
<tr>
<td>10% lower</td>
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<tr>
<td>20% higher</td>
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1 For the asset testing scenarios, real GDP and inflation reflect Partners Group’s projections, NAV-weighted as per Partners Group’s asset split across the US, Europe, and other advanced and emerging markets. 
2 Market valuations refer to price-to-earnings ratios 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, November 2019. For illustrative purposes only.
Market overview

The private equity investment environment remains highly competitive, with valuations near the upper end of historical ranges. The pick-up in volatility in public markets at the end of 2018 and early 2019 had a temporary knock-on effect on private equity transaction volumes. Combined with a more challenging macroeconomic backdrop, this led to a gap between sellers’ high valuation expectations and buyers’ willingness to pay, which, ultimately, meant volumes declined by 30% year-on-year in H1 2019. Market weakness, however, was short-lived, and private equity volumes have since recovered, with high levels of dry powder and very strong competition in the market keeping valuations high.

The one trend that has persisted is the more pronounced bifurcation we see in the market. Stable, non-cyclical assets are trading at record multiples. Recently, we have witnessed several companies change hands at EV/EBITDA multiples in excess of 20x and, in some instances, even 25x. The companies fetching these prices tend to be technology enablers, supported by long-term demand drivers and a high share of recurring revenues. In our view, although these factors mitigate downside risk, they only partially justify exceptionally high valuations given these companies’ inherent sensitivity to changing fundamentals such as growth assumptions. At the opposite end of the spectrum, we see an increasing number of failed auctions for lower quality assets and/or assets that are perceived as having exposure to cyclicality or disruption risk. Over the last year, within the scope of our investment activities alone, we saw over 100 failed auctions globally. This phenomenon is also driven by asset sales from a number of relatively young private equity portfolios. Given the absence of portfolio management pressures, general partners have the flexibility to stop sales processes if the bid price falls below their expectations.

As part of our “offense is the new defense” investment philosophy, more so than ever, identifying sub-sector trends that generate higher top-line growth and value creation opportunities at the asset level is vital for achieving attractive returns. This approach allows us to build more resilient valuations and, in turn, should enable companies to be more insulated from economic swings. Finally, we remain prudent in our underwriting by factoring in multiple contraction for potential investment opportunities.
Our current investment themes

**Leveraging secular trends instead of macro trends**

We maintain our focus on identifying opportunities in segments of the market supported by high and robust growth. Often, growth in these segments derives from the global transformative trends shaping the behavior and consumption habits of businesses and consumers, as well as from industry dynamics and market consolidation. Our strategy is not to look at the market in broad segments such as “consumer” or “healthcare” but to dive deep into the sub-sectors of these segments experiencing above-average growth. This Thematic Sourcing approach allows us to categorize the sub-sectors within a segment such as healthcare by end payer dynamics (insurance versus private pay), decision makers and processes involved, and delivery requirements.

As a result of this analysis, we have concluded that certain segments often perceived as belonging to one sector can exhibit the characteristics of another. If we look at the specific sub-sector dynamics in the veterinary segment, for instance, government regulation within the industry is light; pet care is typically paid for privately; pet ownership is a life choice (which is rising); and the growing global trend of treating pets like family members is making pet care spending resilient to economic downturns. As such, although often referred to as a healthcare segment, we believe the underlying trends supporting growth in the veterinary industry are closer to consumer sector themes, which enables us to apply a consumer lens to potential opportunities in the segment.

The sub-sector matrix below shows the investment themes currently guiding our sourcing efforts. Our ambition is to identify target assets and develop a full investment thesis for them well before they become available for investment. This involves having a thorough understanding of the sub-sector and the disruption risks that exist within it. It also entails developing tangible asset-level value creation plans and fine-tuning these as the opportunity evolves given our strong belief in building value instead of buying it. Finally, it means designing an effective board of directors that is able to lead these value creation initiatives in a proactive manner together with a target asset’s management team. This stems from our belief that in private markets, hands-on value creation led top-down by the board is the key generator of returns.

### Corporate sub-sector matrix: relative value focus areas and investable universe

<table>
<thead>
<tr>
<th>Healthcare</th>
<th>Bus. &amp; fin. services</th>
<th>Consumer</th>
<th>Industrials</th>
<th>TMT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aging; value-based care</td>
<td>Non-bank financials</td>
<td>Customization; SKU proliferation</td>
<td>Automation</td>
<td>IT infrastructure simplification</td>
</tr>
<tr>
<td>Fertility; physical therapy</td>
<td>Lender specialty finance</td>
<td>Contract manufacturing</td>
<td>Industrial consumables</td>
<td>App development tools</td>
</tr>
<tr>
<td>Ophthalmology</td>
<td>Insurance brokerage</td>
<td>Flavoring/ingredients</td>
<td>Sensors; control systems; connectivity</td>
<td>App development outsourcing</td>
</tr>
<tr>
<td>Dental tech/digital dentistry</td>
<td>Financial digitization</td>
<td>Health &amp; sustainability</td>
<td>Health &amp; sustainability</td>
<td>Modern logistics</td>
</tr>
<tr>
<td>Biologics; cell &amp; gene industry</td>
<td>Cashless payment</td>
<td>Beauty</td>
<td>Systems</td>
<td>Systems</td>
</tr>
<tr>
<td>Oligos; viral vectors; equipment</td>
<td>Modular governance, risk &amp; compliance software</td>
<td>Healthy diet &amp; lifestyle</td>
<td>Peripheral components</td>
<td>Peripheral components</td>
</tr>
<tr>
<td>Cell &amp; gene manufacturers</td>
<td></td>
<td>Environmental sustainability</td>
<td></td>
<td>Enterprise digital transformation</td>
</tr>
<tr>
<td>Next generation clinical trials</td>
<td></td>
<td></td>
<td></td>
<td>Niche business process software</td>
</tr>
<tr>
<td>Unique contract research organizations</td>
<td>Outourced services</td>
<td>Premiumization &amp; specialty retail</td>
<td>Advanced manufacturing</td>
<td>Explosion of data</td>
</tr>
<tr>
<td>Remote monitoring/virtual trials</td>
<td>Risk &amp; pension services</td>
<td>Aspirational brands</td>
<td>Critical components</td>
<td>Analytical/machine learning tools</td>
</tr>
<tr>
<td></td>
<td>Facility &amp; hygiene services</td>
<td></td>
<td>Ceramics; metallurgic</td>
<td>Public &amp; digital security apps</td>
</tr>
<tr>
<td>Healthcare efficiency</td>
<td>Premiered services</td>
<td>Discount retail/bargain hunt</td>
<td>Industrial software</td>
<td></td>
</tr>
<tr>
<td>Health IT</td>
<td>Pet &amp; vet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Telemedicine</td>
<td>Services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Diagnostic automation</td>
<td>Products</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education &amp; training</td>
<td>Pet &amp; vet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private education</td>
<td>Services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EdTech &amp; modular learning management</td>
<td>Products</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Industrial distribution</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Specialty chemicals distribution</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Maintenance, repair and operations</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: bullet points in black highlight sub-sectors that Partners Group believes are particularly attractive in the current environment.
Source: Partners Group, November 2019. For illustrative purposes only.
Partners Group’s Thematic Sourcing approach

Our Thematic Sourcing approach enables us to build a strong conviction for selected sub-sectors and remain more deliberate and disciplined in our sourcing efforts compared to a traditional top-down approach. We think about the attractiveness of sub-sectors according to multiple dimensions, including secular growth prospects and consolidation potential:

- **Secular growth prospects**
  We look for themes within sub-sectors with high visibility on five- to ten-year secular growth supported by transformative trends such as technological change, behavioral change, or regulatory change, as well as strong potential for consistent and recurring growth over longer periods.

- **Consolidation potential**
  We favor sub-sectors where fragmentation levels are relatively high. Companies can benefit from industry consolidation in an accretive manner – via acquisitions – or organically, for example through unit base roll-out in retail and downstream integration in industrials.

The scatter chart below plots our current Thematic Sourcing focus areas in light of these two dimensions. Themes in the blue area exhibit a particularly high relative value proposition. While we have a global view of the sub-sectors we favor, dynamics and market consolidation may differ by country and region.

Thematic Sourcing in practice

The sourcing of assets within these sub-sectors is the result of a collaborative approach between our dedicated research team, which sits in our Industry Value Creation team, and our investment teams. While our research team is responsible for mapping out attractive sub-sectors and the most promising companies within them, our investment professionals play a key role in identifying actionable investment targets. Each private equity investment professional maintains and updates a dynamic roster of two near-term, three mid-term, and additional longer-term investment targets – we refer to this as our “2/3/+” approach. This results in a steady and predictable pipeline of lead direct investment opportunities, which currently stands at around USD 175 billion of investment volume.

As part of our 2/3/+ approach, we measure our progress across dimensions such as management relationship, industry advisor network, and seller relationship. The approach ensures that we typically perform at least one-to-two years of work before a transaction comes to market, strengthening our relationships with all relevant stakeholders. This enables us to identify both investment opportunities and industry experts who can help us with due diligence and value creation early on.

Source: Partners Group, November 2019. For illustrative purposes only.
Rise in chronic conditions generates demand for physical therapy

One of the transformative trends shaping the healthcare industry is an aging population and increased awareness around health and well-being. According to recent estimates, the global population aged 60 years and older is projected to more than double by 2050, reaching 2 billion people. At the same time, obesity rates are rising, and chronic diseases are becoming more prevalent. In emerging markets, we continue to focus on the rollout of healthcare coverage and treatment centers. In many parts of the advanced world, efforts to contain healthcare costs by both payers and providers of healthcare services create appealing investment opportunities. In this context, we have identified physical therapy as an interesting sub-sector in the US. The physical therapy segment is expected to grow at a CAGR of 5% going forward.2 We favor this segment in the US over Europe, given market dynamics and market fragmentation.

Our Thematic Sourcing research has highlighted that in the US, a mere 15% of individuals requiring physical therapy treatment are using these services today. The segment is further supported by the potential it offers for cost savings as it helps prevent the development of chronic physical conditions. This replaces the need for more expensive treatments. Depending on the physical condition, relying on physical therapy can be up to 97% cheaper than surgery, 85% cheaper than opioids, and 75% cheaper than injections. Another attraction is that physical therapy faces less risk of regulatory disruption compared to more traditional healthcare sub-sectors. Given the nature of physical therapy treatment, the segment is also largely insulated from technology disruption.

Our analysis has shown that the top 15 physical therapy chains in the US account for only 12% of total clinics, leaving ample room for industry consolidation. Based on these developments and a comprehensive analysis of the physical therapy universe in the US, we developed a strong conviction in acquiring Confluent Health (Confluent), one of the top five independent US outpatient physical therapy providers. The company provides a diversified physical therapy offering, including outpatient physical therapy across more than 200 clinics in twelve states, in addition to providing continuous education services to post-graduate physical therapists.

Confluent reports same-site growth in the mid-to-high single-digits, attractive EBITDA margins, and a strong consolidation track record. Our asset-level value creation initiatives will include further enhancing same-site store growth, new clinic openings, the expansion of M&A partnership opportunities in new and existing markets, additional partnerships with universities, and strategic and technology investments to support scalability.

Humanization of pets supports growth in veterinary industry

Growth in the flourishing pet care segment is mainly driven by rising pet ownership rates, especially among millennials delaying marriage and family planning. Pets are often filling this gap and, as a result, we are seeing pets being “humanized” and treated like family members. Pet care is a particularly interesting sub-sector of the market: spending on veterinary services increased at a 5% CAGR in recent years, surpassing growth in all other pet care spending categories.5 In addition to rising pet populations, longer pet life expectancy also contributes to this trend. Similar to the elderly healthcare segment for humans, healthcare costs for elderly pets are higher than for prime-age animals.

The veterinary industry is a relatively stable sub-sector in the consumer space as many people are willing to forgo other spending rather than see their pets suffer, even during economically challenging times. This is reflected in the continued revenue growth of the sector during the financial crisis in 2008 and 2009. Furthermore, the sector offers upside through consolidation: the pet care space is a highly fragmented market where 87% of clinics operate as independent locations.6 What is more, the veterinary industry in the US follows a cash-based operating model insulated from reimbursement and the typical risks associated with healthcare; due to the nature of the business, it is also insulated from technology disruption risk.

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3 Marketdata LLC, June 2019.
4 ProRehab, January 2018.
We recently invested in Blue River PetCare (Blue River), a leading US operator of veterinary hospitals with over 90 general practice hospitals in 23 states, employing over 300 veterinarians and specialists. Blue River hospitals provide basic primary care that tends to be routine and recurring in nature, with each of their hospitals staffed with three to four veterinarians. The company is well positioned to capture additional market share through an M&A strategy in a highly fragmented market. We will drive asset-level value creation by drawing on Blue River’s successful and disciplined history of acquiring add-on clinics at attractive price levels, which is mostly achieved through proprietary sourcing. As opposed to more aggressive industry consolidators, Blue River’s soft approach to acquisition by granting continued clinical autonomy to veterinarians makes it a partner of choice, resulting in a busy pipeline of potential acquisition targets. To enhance organic growth, Blue River will invest in local and digital marketing efforts, as well as online scheduling, to drive same-site volume through new and repeat customer growth.

Focusing on attractive niches in the European consumer space

While most of our sourcing efforts revolve around transformative trends, we also source high conviction assets with a strong and highly defensive position in market niches that benefit from “evergreen” demand. One example is the toy industry in Europe, where parents typically look for brands with a reputation for high quality, and for innovative and relatable products that are safe for their kids to play with.

In the summer of 2019, we acquired a majority stake in Schleich, one of Germany’s largest toy manufacturers, whose leading reputation for high quality and durability has enabled it to achieve above-market growth. Schleich has carved a strong niche in the traditional toy market, specializing in figurines and playsets. Its toys are sold in more than 50 countries through traditional and online sales channels, and benefit from Schleich’s market-leading position for figurines in the DACH region. Boasting a proven, multi-lever growth strategy and driven by expansion into playsets in Germany and growth in international markets, Schleich has demonstrated a robust revenue CAGR of 16% from 2014-2018, which compares to a historical CAGR of 3% for the overall traditional toy market. The company is led by a capable and committed management team with significant experience in the consumer retail sector, many of the team having previously worked together at Lego and other leading toy brands.

Our value creation plan for Schleich will build on the company’s strong foundation, working closely with management to expand shelf space with key retail customers. We also see strong potential to further develop Schleich’s online presence through targeted digitization initiatives that will complement its traditional figurine sales. These include the further development of Schleich’s e-commerce sales strategy through partnerships with key online retailers and the development of dedicated apps and other digital content, such as short videos and films, to support the expansion of the Schleich brand. At the same time, we will focus on increasing penetration in new regions, including the UK, France, the US, and China.

How we realize relative value potential in private equity

In global private equity markets, we focus on the following key investment strategies:

Platform companies
We acquire platform companies or assets with a strong management team and infrastructure in a highly fragmented market and then purchase add-on companies to further grow the platform and benefit from synergies.

Niche winners
We acquire companies in sub-segments of specific industries benefiting from particularly strong products or services and demonstrating an ability to grow disproportionately, often through internationalization. We institutionalize the business and extend the product/service offering.

Franchise companies
We acquire businesses or assets on a stand-alone basis – typically, single assets with value creation potential and strong defensive capabilities, high cash flow generation and the ability to quickly de-leverage. We seek to broaden their network and strengthen their positioning.

In general, the market position of these types of companies is not yet dominant at the point of our investment. Where possible, the intention during ownership is to grow the companies through a program of transformative entrepreneurial ownership in the direction of becoming category leaders, i.e., businesses that have been able to capture a very large share of the market.

7 Euromonitor, June 2019.
Private equity secondaries market overview

The private equity secondary market has been highly competitive over the past few years, and we have identified steady increases in pricing to the extent where quality portfolios often trade at premiums during the peak cycle period. As a result, we had been underweight on secondaries in a relative value context, meaning we still deployed substantial amounts of capital in conviction secondaries but gave higher weight to direct opportunities. As the cycle turns, volatility is picking up, and valuations may come down, making secondary opportunities one of the few strategies that is becoming more attractive overall.

Market overview

Strong deal flow continued in 2019, primarily driven by active portfolio management by limited partners and general partner-led transactions and non-standard transactions – a trend we expect to persist. We are seeing an increased share of younger portfolios coming to the market. Pricing has stabilized at elevated levels, with transaction volumes absorbing the increase in dry powder.

Growing secondary market fueled by strong primary fundraising

Opportunities within secondaries

In this environment, we are focused on acquiring inflection assets: diversified portfolios of fund interests in recent vintages, high-quality buyout funds in developed markets, managed by leading general partners. Inflection assets are typically two-to-five years old, with high remaining value creation potential coupled with high visibility on the underlying investments and no J-curve effect. We look for a high degree of overlap with our existing private equity portfolio, which allows for greater insights into the underlying assets.

We believe the attractiveness of the segment is supported by the following factors:

- inflection assets are less dependent on near-term exits compared to more mature assets, which reduces exit timing sensitivity and provides higher return stability;
- there are typically more assets at cost in the portfolio, leaving substantial additional value creation potential;
- inflection assets also have less public exposure (vs. tail-end assets), and hence, the portfolios are less prone to adverse public market developments.

Relative value analysis

While our corporate sub-sector matrix on page 10 highlights specific themes that we believe are particularly attractive in the current environment based on a bottom-up analysis, our relative value assessment illustrates general sector dynamics based on top-down considerations.

The overall private equity market remains highly competitive, with elevated valuation levels across regions, sectors, and investment type. We have become more positive on the mid-cap sector in Europe, on the back of slightly lower valuations. We continue to identify attractive opportunities in the healthcare and business services sectors globally. In Europe and the US, we are neutral on the consumer sector overall, but have a strong overweight in certain sub-sectors within the non-discretionary segment.

In contrast, we are cautious on discretionary spending given the maturity of the cycle. In emerging markets, consumer themes continue to evolve around affordability and the rising middle class. In Asia, ongoing US/China trade tensions and uncertainty around cross-border demand warrant a cautious approach in the IT and industrials space. We have also become more cautious on late-cycle industrials opportunities across all other regions. For emerging markets, underwriting returns need to compensate for political, macro, and currency risk (or the respective hedging costs).

In the secondaries segment, we see an attractive outlook for inflection assets in Europe and the US as these are less dependent on near-term exits. This reduces exit timing sensitivity compared to mature assets and provides for higher return stability.

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>Large</td>
<td>Mid</td>
<td>Small</td>
</tr>
<tr>
<td>Media/telem.</td>
<td>Consumer</td>
<td></td>
</tr>
<tr>
<td>Information technology</td>
<td>Healthcare</td>
<td></td>
</tr>
<tr>
<td>Business/financial services</td>
<td>Industrials</td>
<td></td>
</tr>
<tr>
<td><strong>Secondaries</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflection assets</td>
<td>Mature assets</td>
<td></td>
</tr>
<tr>
<td>Inflection assets</td>
<td>Mature assets</td>
<td></td>
</tr>
<tr>
<td>Inflection assets</td>
<td>Mature assets</td>
<td></td>
</tr>
<tr>
<td><strong>Primaries</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large</td>
<td>Mid</td>
<td>Small</td>
</tr>
<tr>
<td>Venture</td>
<td>Growth</td>
<td></td>
</tr>
</tbody>
</table>

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

Global real estate valuations remain high, supported by continued demand and low interest rates and notwithstanding softening GDP growth clouding the prospects for rental growth. After a strong investment year in 2018, we have seen a 9% drop in global real estate investment volumes in the first half of 2019 compared to the same period in 2018.\(^1\) We believe that this is due to a combination of economic growth concerns and the impact of political uncertainty. For instance, investment volumes in the UK have fallen by 35% year-on-year during the first six months of 2019.\(^2\)

Competition for core assets remains particularly high, and prime office yields are currently below 3% in key European locations such as Berlin, Frankfurt, and Paris.\(^3\) These low yields reflect investor sentiment that core assets offer defensive qualities supported by an element of income yield. However, at these valuations, core assets are particularly at risk should there be a change in the accommodative monetary policy adopted by central banks and should valuations revert to long-term averages.

\(^1\) JLL, August 2019.  
\(^2\) Real Capital Analytics, August 2019.  
\(^3\) JLL, Prime Yields, Q2 2019.

Our current investment themes

Identifying the trends shaping real estate demand

Given strong competition in the market and the threat of an economic slowdown, we believe smart investing must combine both offensive and defensive thinking. This means we seek assets that provide both value creation potential and downside protection through existing cash flows. To originate these assets, we continue to focus on strong locations that benefit from fundamental demand drivers, such as population and employment growth, and favorable real estate fundamentals, such as low vacancy rates and the limited threat of excessive new supply. We are prepared to pay market prices as long as we know the fundamentals will provide a tailwind from a relative value perspective. Conversely, we avoid seemingly attractively-priced properties in locations or segments that face headwinds and are not well positioned to withstand the cycle.
For office and residential assets, we look to identify gentrifying suburbs that offer live-work-play environments with plentiful amenities and good public transport connectivity that appeal to a growing millennial workforce. These locations also offer interesting opportunities for last-mile logistics assets, which facilitate the fast delivery of goods from logistics hubs to end users and which cater to rising e-commerce penetration rates.

The matrix below sets out the real estate investment universe. Our current key focus areas are the office, industrial, and residential sectors, while we are very cautious about the retail sector.

Office markets remain solid and offer attractive opportunities

Office markets across most parts of the world are still robust, with solid rental growth and low market vacancy rates. In fact, during the second quarter of 2019, prime office rents grew at the fastest pace since 2011. Given the advanced stage of the business cycle, signs of slowing employment growth in the US and parts of Europe, and new office supply coming to the market, it is prudent to assume that rental growth will ease. We continue to focus on those cities benefiting from employment and population growth, and a pro-business environment (e.g. low tax rates and an attractive labor market). We typically find these characteristics in tech-oriented cities and locations benefiting from corporate relocations. We favor assets in emerging sub-locations that appeal to live-work-play lifestyles and that present a clear opportunity to be repositioned to improve the tenant experience and increase occupancy.

Real estate sub-sector matrix: relative value focus areas and investable universe

<table>
<thead>
<tr>
<th>City</th>
<th>MSA Population (m) ('19)</th>
<th>Population Growth ('13-'18)</th>
<th>Tech jobs as % of workforce ('18)</th>
<th>Tech job growth ('17-'18)</th>
<th>Tax environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dallas, TX</td>
<td>7.7</td>
<td>10.6%</td>
<td>9.3%</td>
<td>2.7%</td>
<td>Very favorable</td>
</tr>
<tr>
<td>Austin, TX</td>
<td>2.2</td>
<td>15.0%</td>
<td>14.3%</td>
<td>3.5%</td>
<td>Very favorable</td>
</tr>
<tr>
<td>Nashville, TN</td>
<td>2.0</td>
<td>9.8%</td>
<td>6.1%</td>
<td>4.2%</td>
<td>Very favorable</td>
</tr>
<tr>
<td>Atlanta, GA</td>
<td>6.1</td>
<td>8.0%</td>
<td>9.4%</td>
<td>3.2%</td>
<td>Favorable</td>
</tr>
<tr>
<td>Denver, CO</td>
<td>3.0</td>
<td>8.6%</td>
<td>11.4%</td>
<td>3.1%</td>
<td>Favorable</td>
</tr>
<tr>
<td>Charlotte, NC</td>
<td>2.6</td>
<td>10.1%</td>
<td>8.3%</td>
<td>5.6%</td>
<td>Favorable</td>
</tr>
<tr>
<td>Portland, OR</td>
<td>2.5</td>
<td>7.3%</td>
<td>10.8%</td>
<td>2.9%</td>
<td>Favorable</td>
</tr>
</tbody>
</table>

One of the locations that matches these criteria is Portland, Oregon, in the US. Portland is a growth city with strong underlying market fundamentals anchored by the presence of tech companies, a flourishing sports apparel industry, popular amenities, and the city’s close proximity to the outdoors. We expect Portland to continue to gain popularity as tech-oriented and non-tech-oriented companies alike look for alternatives to rising rents and employment costs in cities such as San Francisco and Seattle.

We recently acquired a historic office building in the Pearl District in the center of Portland. Previously an industrial area, the Pearl District has turned into one of Portland’s most desirable neighborhoods, showcasing modern apartments and storefronts. The investment comprises an undermanaged, 50% leased, 188,000 square foot property with large floorplates and high ceilings, features typically desired by tenants in creative industries. Our value creation plan envisages a repositioning of the asset into Class A office space. As a first step, we have reconfigured the occupied space of the anchor tenant, one of the largest US retailers, from three floors to one smaller unit on the ground floor. We expect the freed space on the second and third floor, once fully transposed into creative office space, to be leased at attractive rental rates. An additional 16% of floor area will be created by extending the glazed roof top. The property transformation is rounded off with a refurbishment of the lobby, elevators, and common areas. As a result, our target is to raise occupancy from 50% at entry to over 90% over the investment period.

Office markets across most parts of the world are still robust, with solid rental growth and low market vacancy rates.

Our lease-up conviction is supported by micro-location supply and demand dynamics and the property’s sought-after combination of historic facade and large floorplates. We identified this opportunity through one of our operator relationships and offered a tailored solution to the seller’s requirements, thereby putting us in a position to negotiate an attractive entry price. The in-place cash flows from the existing tenant and the existing long-lease gave us comfort in terms of downside protection.

Across the Atlantic, GDP growth has been slowing in Europe, and employment data is starting to cool in a number of countries like Germany, albeit that Germany starts from a strong base. Occupier sentiment and vacancy rates are still strong, and rental growth remains favorable. In this environment, we are pursuing a more nuanced regional approach. One of the bright spots in terms of growth, as well as office and residential real estate developments over the past year, is Spain. The country is also expected to continue to outperform most of its regional peers in 2020. Yet, in terms of yield, major Spanish cities offer attractive relative value compared to other European metropoles.

In light of this, we recently purchased a diversified portfolio of Spanish real estate assets, consisting primarily of office and hospitality assets. The two largest assets in the portfolio make up around 60% of the portfolio and are located in Barcelona. Barcelona has seen outsized job growth in the period between 2011 and 2017, with a CAGR of 1.5%, compared to the Spanish average of 0.8%. This growth is driven by job creation in the services and tech-oriented sectors, with a CAGR of 5.2% in the information and communications technology sector specifically.

The largest asset in the portfolio is a fully leased office building located near the sought-after 22@ office district. The 22@ district is a former industrial area that has evolved into an emerging tech hub and become home to a number of foreign multinational companies. The second largest asset is a four-star hotel that opened its doors in November 2018 and that is close to the popular tourist destination La Sagrada Familia.

The value creation plan consists primarily of enhancing occupancy and raising rental incomes. For the office building, a capex renovation project and lease renewals are expected to capture rental uplifts and extend weighted average lease terms. The value creation plan for the hotel will stabilize occupancy and daily room rates at market levels. Although we are cautious on hospitality in general given the sector’s cyclicality, a license ban on new hospitality supply in Barcelona supports our investment thesis for this specific property in terms of occupancy and valuation resilience.

The investment was sourced outside of a competitive process through our existing relationship with the seller via a fund investment. Given our familiarity with the portfolio, we were well positioned to provide swift underwriting and execution, and managed to exclude a tail of weaker retail assets, where we had concerns on location, lease terms, and liquidity. The portfolio’s relatively high occupancy at entry and the existing cash flows provide appealing downside protection.

Logistics sector shows solid occupier demand

The demand for logistics assets remains strong, and vacancy rates are near record lows as the rapid growth of e-commerce drives the growing need for logistics space. Generally speaking, online retailers need approximately three times the warehouse space of “traditional” brick-and-mortar retailers. As we believe
the rise of e-commerce will continue to support absorption and rental growth, logistics remains attractive from a relative value perspective across all regions. We retain a degree of caution due to high capital value, acknowledging the impact automation may have on occupier demand. As automation evolves and human involvement declines (warehouse workers and transportation), logistics may move further away from urban areas.

Two locations benefiting from the strong demand for logistics are Nashville, Tennessee, and Norfolk, Virginia, in the US. Nashville’s economy has historically been healthcare-focused, but has shifted in recent years toward technology and business services. The city sits conveniently along I-65, an 880-mile north-south highway that runs from the Gulf of Mexico to Chicago. Meanwhile, Norfolk benefits from proximity to the Port of Virginia, which is the fifth largest port in North America and within a 750-mile radius (one day’s drive) of two-thirds of the US population.

We recently acquired an industrial portfolio consisting of nine existing assets in Nashville and Norfolk, with adjacent development land at the Norfolk site. The existing assets are fully leased, providing an attractive in-place operating cash flow from day one of the investment. The value creation plan consists primarily of the development of around 40% of the free land, with the potential for further development. We are planning to construct around 2 million square feet of Class A industrial development on a build-to-suit basis, meaning that we will only commence building once a tenant has been contracted. The property will be developed specifically to the tenant’s needs. This is expected to deliver a yield-on-cost of 7.9%, which is a 190bps spread above the underwritten exit cap rates of 6.0%.9 The transaction was sourced off-market through one of our operating partner relationships and was triggered by a fund maturity combined with a broken sales process.

Residential is competitive with affordability concerns

Our investment thesis for residential real estate is focused on the provision of affordable housing as we are witnessing a chronic undersupply in this sub-sector in many cities globally. On the one hand, this is driven by an actual undersupply in the affordable housing inventory, which is often caused by a scarcity of land for development in many parts of the world, especially in Europe. On the other hand, globally, price growth and rental growth have outstripped income growth in many regions over the past few years, with previously affordable housing space becoming unaffordable for many people.

Notwithstanding our positive relative value assessment of the segment, we only invest selectively in residential assets due to a combination of factors. These include our desire to limit development exposure and our cautious outlook on rental growth projections, especially in markets where trailing five-year rental growth has put a stress on affordability. As a result, the opportunities that we assess often do not meet our risk/return criteria, based on expensive entry prices, subdued rental growth prospects, and expected cap rate developments over the hold period. For instance, we recently declined an investment in a portfolio of 820 units located in New Jersey and Pennsylvania, which included both unfurnished and furnished suites. We were unwilling to match the seller’s price expectations as we felt uncomfortable underwriting significant rental growth from unit refurbishments because of concerns regarding affordability.

Retail remains tough

We remain very cautious on retail property. Although our portfolio allocation to retail is in the single digits, the insights we have gained from our fashion-anchored assets and the substantial deal flow we see, combined with those gained from our network of operators and general partners, give us an in-depth understanding of the impact of e-commerce and other disruptors within the retail sector.

The speed at which e-commerce is replacing traditional retailers is happening at a much faster rate than envisaged only a few years ago. Tenant departures are increasingly prevalent, driven by lease expiries or bankruptcies, resulting in rising vacancy rates. This can lead to a negative spiral where pedestrian footfall drops, putting further pressure on revenues and affordability.

9 For illustrative purposes only. There is no assurance target returns will be achieved.
At the same time, landlords are limiting capex as historic capex projects have failed. For many landlords, although conversion of retail space to alternative uses is a possibility, high per square foot capital values have limited the viability of conversion. Given these issues, the retail sector generally remains outside of our focus. We will only consider retail on a very select basis, focusing on sub-sectors, such as factory outlets, which are expected to continue to perform strongly. The most interesting opportunities may in fact arise from the need of retail owners to sell their non-retail assets in order to generate the cash needed to address their loan defaults.

How we realize relative value potential in private real estate

In global real estate markets, we favor the following investment strategies:

Select growth cities
We target assets located in cities supported by employment growth in the technology and education sectors.

Source off-market
We source assets off-market through our extensive industry network to avoid highly competitive auction processes.

Drive value creation
We seek assets that provide us with the opportunity to actively drive NOI growth through asset-level value creation.

Across all investment opportunities, we look for the right balance between existing cash flows (“defense”) and value creation potential (“offense”), avoiding both highly priced core assets and riskier development assets. This typically involves assets that have been starved of capital over recent years and that enable us to focus on improvement projects that can be executed with relative speed rather than having to address structural issues. We limit our exposure to more significant development projects to those that have permits, fixed-price contracts, and substantial pre-leasing in place.

An analysis of our direct transactions since July 2018 illustrates that around 60% of the gain in these investments is expected to stem from active value creation. In 2019 thus far, measurable results include the realization of seven assets where the execution of value creation initiatives resulted in an average gross asset value uplift of roughly 70% and an NOI uplift of around 60%. In addition, the remaining 40% of returns is expected to come from any acquisition discount and from in-place rental cash flows, which provide downside protection and often benefit from fixed or indexed uplifts. This return component is supported by our relatively low average entry occupancy rate, which is around 70% for the pool of investments completed since July 2018, offering substantial uplift potential.

Our desire to implement adequate downside protection is also supported by how we use debt across our portfolio. We employ senior debt at an average level of 60% loan-to-value (below the industry average of 65% loan-to-value) and aim to maximize covenant headroom to retain flexibility.

Our strategy of sourcing the majority of our investments off-market allows us to find special situations that are usually complex in terms of the owner or seller situation. This gives us the opportunity to provide flexible, tailor-made solutions that differentiate us from the competition. Special situations are usually unlocked by a trigger event. For instance, this can be a fund reaching the end of its life, investor fatigue, or investors not having the means to adequately recapitalize a property or a portfolio of properties.
Relative value analysis

We continue to focus on value-add opportunities, especially in times when economic headwinds are rising and value creation at the asset level is becoming even more important. For years, we heavily underweighted core real estate. While we are still cautious on the segment, we have adjusted our view to a slight underweight, reflecting the reduced risk of interest rates rising.

We continue to overweight office, logistics/industrial, and residential properties in all regions (besides Asia-Pacific). For office properties, we focus on repositioning assets that also benefit from a stable base of existing rental cash flows in cities that benefit from strong underlying demographics and employment growth. We will undertake development on a selective basis only when we have permitting, fixed price contracts and pre-leasing in place. We overweight the logistics/industrial sector as we see strong occupier demand across all regions. Finally, we overweight residential in the US and Europe and pursue affordable opportunities in cities with supply shortfalls and strong population growth. Our concerns over retail have hardened to be heavily underweight due to the depth of the challenges in the sector.

Relative value matrix

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 types (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
Maintaining a disciplined approach.

In a late-cycle environment and borrower-friendly private debt market with low covenant protection, we are placing even greater emphasis on the proactive sourcing of defensive credits and on applying strict underwriting discipline.

How we classify the debt market
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 and can be used as a cash management tool by fixed income investors because of their high liquidity and low interest rate duration. As part of our CLO business and as a liquidity management tool in our programs, we target smaller investments in large liquid loans, which can be in excess of USD 1 billion and issued by stable companies.

- **Direct loans**: loans that are senior in the capital structure but privately originated by a single lender or a small group of institutions and thus are generally illiquid. Here, we target companies with EBITDAs in excess of USD 20 million.

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

Market overview
Despite signs of slowing global growth and rising volatility in capital markets, demand for private debt remains strong, with total assets under management at a record high. Although senior loan issuance has eased in 2019, the private debt market continues to be borrower-friendly. Loan documentation in many parts of the market is weak, with high shares of covenant-lite structures in the syndicated space. In this environment, underwriting discipline and access to attractive transactions remain key. This means having strong relationships with sponsors to help source transactions and the ability to provide comprehensive, tailor-made financing solutions at an appropriate risk-adjusted pricing.

US market overview
After two record-setting years in 2017 and 2018, first lien leveraged loan issuance decreased during the first half of 2019, in line with a slowdown in global buyout volume and a vibrant high yield market. Retail money has been moving out of floating-rate loans and into fixed-rate high yield bonds due to expected interest rate cuts. Demand from collateralized loan obligations (CLOs) and business development companies (BDCs) remained strong, benefiting from an increase in spreads to 3.9% from 3.3% at the beginning of last year.1

1 Bloomberg; S&P LCD, Q3 2019.
In terms of credit metrics, the market remains mostly disciplined. Leverage levels for US buyout transactions are just shy of 6x, with equity cushions at 46%, both significantly better for investors than pre-Global Financial Crisis (GFC) when they were at 6.2x and 33%, respectively. In the large-cap space, US banks continue to underwrite the majority of financing packages in the syndicated debt market well beyond previous leverage lending guideline limits of 6x leverage, which were adopted by US regulators in 2013. Banks are likely to continue to do so until there is a market correction.

We see relative value in directly placed large-cap/upper-mid-cap second lien transactions with a cash spread of roughly 850bps, limited execution risk, and an absence of flex language (i.e. the ability to amend financing terms if necessary to successfully syndicate loans). Selectively, we seek upside participation through equity kickers. We also find attractive opportunities in senior unitranche financings in the mid-cap space, where we can provide the entire and only debt tranche in the capital structure of a business and actively control documentation. This mitigates downside risk in case of unexpected challenges.

European market overview
Similar to the US, year-to-date senior loan volumes in Europe are roughly 40% of full-year 2018 volumes, a marked decline compared to the strong pace witnessed over the past two years. Meanwhile, CLO issuance remains strong and on track to surpass 2018 volumes. CLO issuance comprises 40% of the overall syndicated loan market and, as long-term capital vehicles, should add stability to the market.

Credit fundamentals remain broadly unchanged and more disciplined than those seen in pre-GFC years. Leverage levels in Europe remain stable at 5.8x and equity cushions remain at 47%, still well above 2007 levels of approximately 35%. First lien spreads have seen a mild widening from 3.7% at the beginning of last year to 4.0%.

Early repayments of senior and subordinated loans remain market standard – both in Europe and the US – and require an even stronger focus on sourcing transactions and re-investing capital going forward. For our high-conviction credits in the subordinated debt segment, where we assume solid growth in our base case (which typically results in a refinancing), significant prepayment penalties and equity kickers compensate for early repayments and enhance returns.

We see relative value in mid-cap direct loans, especially in "sole" and "club style" executions, where the limited number of lenders in a debt tranche have significant negotiation power, resulting in a return premium and stronger documentation. We also expect more attractive risk/return profiles and solid volumes for mid-cap stretch senior debt and unitranche financings. Having the flexibility to offer multiple European currencies and implement customized prepayment profiles can give private debt providers an edge.

Our current investment themes
Proactive sourcing and private-equity style underwriting are key
In a competitive, borrower-friendly environment and maturing business cycle, we are placing even greater emphasis on the proactive sourcing of defensive credits and on applying "private equity-style" due diligence. As debt providers, we are limited in our ability to drive asset-level value creation and corporate

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3 Ibid.
4 Ibid.
5 Ibid.
6 Ibid.
In fact, direct lending affords the opportunity to achieve downside protection above that available in the syndicated market. Covenants remain an important protection in the direct first lien segment. Our first lien portfolio exhibits a materially lower share of covenant-lite transactions at 20% for H1 2019, compared to the broader syndicated market, where the share amounts to 83%. Conversely, for second lien loans, we prefer a covenant-lite first lien structure, where there are fewer enforcement rights for the lenders that are senior to us in the capital structure. Across our second lien portfolio, about 75% of investments have a covenant-lite first lien loan structure.

We think like owners when conducting due diligence and focus on gaining a holistic understanding of an asset’s business model.

Other underwriting metrics that enable us to enhance protection include having strong legal documentation for subordinated debt facilities to ensure that we are not disadvantaged against senior creditors in a restructuring scenario; ensuring conservative basket sizes for restricted payments (limiting the sponsor’s ability to pay themselves dividends or redeem equity) in direct “club style” lending to give us strong negotiating power against value leakage (i.e. cash leaving the restricted financing group); and holding significant positions in order to exercise control over voting rights and have more efficient dialogue with private equity sponsors in the event of facility agreement term breaches. In addition, we implement adequate portfolio diversification across sponsors, credits, regions, and industries.

Transformative trends impact our sourcing efforts

We focus our sourcing efforts on companies operating in sub-sectors that benefit from transformative trends and secular shifts. In the debt space, this approach helps us mitigate downside risk as solid growth prospects translate into valuation resilience and capital preservation. Through our integrated platform with over 40 in-house industry experts and a private markets database with data points and qualitative insights on over 36,000 private companies, we can identify and follow the companies operating in these attractive sub-sectors early on. This enables us to be ready to provide tailored financing solutions at fair risk-adjusted pricing to these companies when debt financing opportunities arise.

One recent transaction in an attractive sub-sector is our second lien investment with an equity kicker in Nestlé Skin Health, which was acquired by EQT through a carve-out. Nestlé Skin Health develops, manufactures, and commercializes dermatology products globally across three divisions: aesthetics, consumer, and prescription. The investment thesis centers on the company’s leading market positioning across its core segments. These segments are all supported by secular growth drivers, including an aging population, increasing awareness around health and well-being, and a rising middle class in emerging countries with a growing interest in cosmetics. Annual market growth rates across Nestlé Skin Health’s core segments range from 6%-10% globally. Value creation initiatives for the investment will focus on add-on acquisitions in the company’s core markets in the US and Europe, as well as emerging markets in South America and Asia, R&D spending on specialized dermatology products, and marketing initiatives focused on social media and brand ambassadors. Our second lien capital benefited from an equity cushion of approximately 50% and pays a cash spread of 7.50%.

We do not fall for perceived defensiveness by solely relying on credit statistics and headline classifications. For example, we recently realized our second lien debt exposure in IGM Resins, a mid-cap manufacturer of chemicals/raw materials (photoinitiators) for ink drying and coating in various retail end-markets. At first glance, the industry might not appear promising for a successful debt investment due to the industry (chemicals typically come with high capex and environmental considerations), size (lower mid-cap is typically less resilient than large-cap), and end-markets (cyclical). However, we believe IGM Resins operates in an attractive market niche. Compared to traditional methods to dry ink (using solvents or thermal curing), the IGM Resins’ technology, which uses UV photoinitiators, is environmentally friendly, consumes less energy, and dries ink faster. Since the initial investment, the company has gained market share and outperformed the base case significantly, which enabled the sponsor to refinance our second lien (L+775bps) with a first lien facility (L+400bps). As part of the refinancing, we received a prepayment fee and continue to participate in the upside through an equity kicker.

From a credit statistics perspective, when we underwrote the whole second lien financing for IGM Resins, the total leverage...
was at 6x EBITDA. However, the high leverage levels did not cause us to shy away from the investment due to the strong conviction we had developed in the company’s business model. Within twelve months, due to the strong performance of the business, leverage came down to 4x. Similarly, favorable credit statistics do not necessarily translate into better downside protection. Retail beauty company Anastasia Beverly Hills accessed the leveraged loan market to syndicate a term loan at 3.6x EBITDA in mid-2018. Due to declining sales and a moderate industry outlook, rating agencies expect the company’s leverage to remain above 5x over the next two years. Although Partners Group did not participate in the syndication, the example demonstrates the importance of understanding sub-sector dynamics and disruption risks when conducting due diligence.

**Offering tailor-made structures**

We differentiate ourselves from the competition by complementing our approach to sourcing transactions in attractive sub-sectors with offering tailor-made financing structures that broader capital markets are unable to provide.

For instance, we recently provided add-on financing to Apex Group (Apex), a US middle-office and regulatory reporting solutions provider for the alternative asset management industry, to support its acquisition of European, UK-based fund administration business Link Asset Services (Link). To match Link’s revenue profile, the sponsor asked the existing lenders to fund the add-on unitranche in GBP. As a part of the lender club was unable to do this, we structured a currency swap, allowing the existing lenders to fund it in USD while Partners Group received the GBP exposure. For the structuring efforts, we were compensated with an above-market Libor floor and margin.

We also continue to draw upon the global presence of our private debt team to source and execute cross-border financings. In this space, our deal flow benefits from the significant volume of buyouts in the US and Europe by Asian sponsors. As an example, we recently acted as sole provider of the unitranche financing to support the buyout of AGS Health, a technology-enabled provider of clinical documentation and revenue cycle management for US healthcare clients, by Baring Private Equity Asia. The transaction was led by our debt team in Singapore with support from the global Partners Group platform. AGS Health operates in an industry benefiting from secular growth drivers (digitization of healthcare providers’ operations) and a trend toward outsourcing. AGS Health provides services which, while essential, do not belong to the core business of their client base; this means their clients have a strong incentive to outsource them. Overall, the market for outsourced clinical documentation and revenue cycle management in the US is expected to grow at a rate of 12% annually over the next five years, driven by increasing regulatory complexity, the cost efficiency of outsourcing, and more healthcare plans that require out-of-pocket payments by the insured person, making revenue collection more difficult. AGS Health is ideally positioned to benefit from these trends with its strong track record and leading reputation.

10 Fitch Ratings, July 2019.

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**How we realize relative value potential in direct and subordinated loans**

**Offer tailored 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 see above-average sector resilience and where we have the depth of experience and high confidence in the underlying growth fundamentals.

**Support cross-border financings**

We support successful sponsors in executing on cross-border investment opportunities, providing local support across regions.
Liquid loans: diversification is key

The first lien liquid loan market continues to be characterized by strong levels of liquidity through continued new issue CLO formation and inflows from other institutional investors into the market, alongside good levels of new issue loan transactions, albeit at lower volumes than in 2018. With accommodative central bank policy squeezing yields globally, liquid loans are increasingly seen as a way to enhance cash management given their high level of liquidity and low duration risk. In addition, they are viewed as an alternative to more traditional high yield bond allocations given their lower levels of price volatility at comparable yields. Liquid loans also benefit from first-ranking security and have consistently demonstrated lower default rates and higher recovery rates than high yield bonds.

Liquid loans offer attractive yield at lower volatility

While the last quarter of 2018 saw prices fall in the secondary loan market due to a general “risk-off” mentality alongside more retail-focused funds moving out of loans, average price levels in the secondary loan market recovered fairly quickly in the first quarter of 2019. In general, our investments in the liquid loan market have been focused on the primary market, where we can leverage our relationships from our direct loan business and, in certain cases, gain preferred allocations of the syndicated loan tranche. In the secondary market, we seek to purchase loans at attractive prices where we have a positive view of the underlying credit.

On the liquid loan side, where we only take a small stake in a loan tranche and are terms takers, defensiveness is mainly implemented through a rigorous bottom-up credit analysis complemented by a highly diversified portfolio, with allocations to sectors guided by our top-down macro views. The liquid loan market comprises over 1,500 companies, whereas our portfolio currently consists of approximately 350 different companies on a global basis. Our largest industry exposures (healthcare, business services, and technology) are aligned with our overall industry views across the private debt business. In addition, we actively manage our portfolio by closely monitoring our loan positions and accessing secondary market liquidity when required.

The current state of the leveraged loan market

Toward the end of 2018, several institutions expressed concerns about the leveraged loan market. In particular, high market growth, the potential for systemic risk, and loose underwriting standards were criticized. In response to these concerns, we issued a White Paper analyzing the growth in the leveraged loan market and comparing that growth with that of other credit markets. We also looked at how credit conditions have changed in the leveraged loan market in recent years and compared the market as a whole with the subprime market that was observed before the last financial crisis. We concluded that although growth has been rapid in the leveraged loan market and certain credit metrics have weakened, we do not believe that the market at the end of 2018 even closely resembled the 2008 subprime market due to the following reasons:

Market growth: the leveraged loan market doubled in size over the past ten years, the US corporate bond market tripled from 1995 to 2005, and the subprime mortgage market increased tenfold from 1999 to 2007.

US CLO market vs. RMBS market

Systemic risk: the subprime mortgage market was very concentrated (only US housing), had almost no equity contributions, no asset due diligence, and multi-layer securitization. In contrast, the leveraged loan market is diversified across over 20 industries and has average equity cushions of more than 40%, detailed asset-level due diligence, and only single-layer securitization.

Underwriting standards: while today’s loan fundamentals (equity cushions, interest coverage) are significantly stronger than during the pre-GFC period, terms deteriorated, with covenant-lite being the new market standard and creative documentation allowing borrowers to move assets out of security packages.

To read more, download the full paper here: www.partnersgroup.com/research
Relative value analysis

On the direct debt side, we strongly overweight first lien investments across the US, Europe, and Asia in the mid-cap space. We also overweight large-cap/upper-mid-cap second lien investments in the US and Europe. In both of these market segments, we see relative value in opportunities where we can act as lead or sole underwriter, driving documentation and negotiating a return premium, while benefiting from strong security packages and attractive capital attachment points. Elsewhere, we underweight subordinated and unsecured opportunities in the lower mid-cap and small-cap space due to the higher sensitivity of these businesses to an economic downturn.

For liquid debt instruments, we see strong relative value for primaries in Europe. In the US, next to the primary issuance market, we also see relative value in the secondary market as opportunities arise from increased volatility added by retail funds.

While we remain highly diligent with regards to sourcing, due diligence, and documentation, we continue to focus on companies with three defining defensive characteristics: recession resilience, stable recurring cash flows, and high cash conversion levels within the industry sectors identified by our industry experts, which are highlighted in green below.

Relative value matrix

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 (PIK/preferred equity direct, 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 (mid-/small- and large-cap)). Mid/small relates to companies with EBITDA under USD 50m. Large relates to companies with EBITDA over USD 50m. 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
Proactively building value.

As core infrastructure asset valuations increasingly decouple from fundamentals, we continue to focus on building value instead of buying it. To complement this strategy, we look for infrastructure assets or businesses operating in sub-sectors of the market benefiting from trend-based growth.

Market overview

The search for stable returns and recurring yield in a low interest rate environment has prompted investors to steadily increase their allocations to the infrastructure asset class over the last ten years. This has contributed to a significant expansion of the private infrastructure market. At the end of 2018, unlisted infrastructure fund managers had a record amount of USD 460 billion in assets under management, around four times more than ten years ago.1

The market expansion has helped lift infrastructure asset valuations to the upper end of historic ranges. On the one hand, this makes for an attractive exit environment, which we have actively taken advantage of: over the last two years, we have successfully sold six mature assets into the core market, realizing an average gross multiple of 2.3x on invested capital and returning USD 914 million of capital to our clients.2 Before the sales, we had been working with these assets for several years, managing three of them through their construction phase, which allowed us to capture a meaningful construction premium.

On the other hand, although higher asset valuations are justified by the low interest rate environment to some extent, we observe a material decoupling of valuations from fundamentals. In turn, this is putting downward pressure on future returns. This growing disconnect is particularly problematic for core brownfield infrastructure assets, which have been trading at record prices across sectors and regions. Although generally perceived as safe and defensive, we argue that some of these assets are at risk in the current environment. There are two main reasons for this: first, a normalization of valuation levels back toward long-term averages could result in a substantial drag on returns and, second, these assets are often more susceptible to disruption risk given the absence of true operational levers. Disruptive trends such as the digitization and electrification of many aspects of life are quickly eroding the traditional ways in which infrastructure is utilized, putting some legacy core systems under strain. A good example is the advent of distributed energy generation – essentially, the direct generation of power by consumers, for example, through residential solar installations – which is challenging the business models of core infrastructure assets such as conventional power plants.

Our current investment themes

We continue to focus our origination efforts on infrastructure assets and businesses that offer value creation potential; operate in sectors and sub-sectors supported by long-term transformative trends; and have business models that are either less likely to be disrupted or that may benefit from disruption. Currently, we see the most attractive investment opportunities in themes arising from the ongoing energy transition. These include midstream energy infrastructure, clean energy infrastructure, and energy reliability solutions. We also continue to see particular value in services-focused infrastructure businesses, both in the energy space, for example in energy management companies, and in other sectors, for example in transport logistics and mobility-as-a-service businesses.

1 Preqin; October 2019.
2 For illustrative purposes only. Past performance is not indicative of future results.
Continued demand for clean, efficient, and reliable energy

Renewable energy is on a steep global growth trajectory, which is underpinned by its increasingly competitive cost, the phasing-out of coal generation in most developed countries, and a general trend toward electrification. Recent estimates project that USD 5.6 trillion of investment into renewable energy systems will be required annually to satisfy demand and that the global share of renewable generation capacity will increase from 27% today to 64% in 2050.3

However, with the penetration of more renewable generation into the system comes the challenge of intermittency. Energy grids become more volatile, and the risk of major economic and social impact increases, as evidenced by the blackout in the UK in August 2019, for instance. Therefore, in addition to our continued focus on building out renewable generation capacity globally, we also focus on infrastructure investments that ensure greater energy reliability. We believe that a range of strategies and technologies will be required to tackle the intermittency challenge, including battery storage, additional peaking gas-fired generation, smart meters, and increased interconnection. We recently made two investments in the theme.

The first of these is the Greenlink Interconnector (Greenlink), a project to construct a 500MW subsea interconnector between Ireland and Great Britain, which we acquired in March 2019. Greenlink will use a subsea high-voltage direct current (HVDC) cable system to connect the power markets of Ireland and Great Britain, allowing the transfer of electricity and improving the security of electricity supply in both countries, while also reducing average electricity costs for consumers. The project is considered of critical importance in Europe and has been awarded “Project of Common Interest” status by the European Commission. Greenlink’s revenues, which are mainly derived

3 Bloomberg New Energy Finance; October 2019.

Infrastructure sub-sector matrix: relative value focus areas and investable universe

<table>
<thead>
<tr>
<th>Transport/logistics</th>
<th>Power</th>
<th>Energy infrastructure</th>
<th>Social infra/PPPs</th>
<th>Communications</th>
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<tbody>
<tr>
<td>Transport logistics</td>
<td>Ancillary power</td>
<td>Energy management</td>
<td>Public services</td>
<td>Specialty communications</td>
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<tr>
<td>• Integrated supply chain services</td>
<td>• Distributed generation</td>
<td>• Metering/sub-metering</td>
<td>• Digitization of public services</td>
<td>• Emergency communications</td>
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<tr>
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<td>• Remote power</td>
<td>• Energy equipment leasing</td>
<td>• Smart cities</td>
<td>• Network management &amp; monitoring</td>
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<tr>
<td>• Multi-modal transportation</td>
<td>• Energy-as-a-service</td>
<td>• Utility location services</td>
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<td>• Air/rail/water transportation</td>
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<tr>
<td>Ports</td>
<td>Intermittency management</td>
<td>Transmission</td>
<td></td>
<td>Fiber</td>
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<tr>
<td>• Port operations</td>
<td>• Interconnection</td>
<td>• Electric transmission</td>
<td>• Wholesale connectivity</td>
<td>• Wholesale connectivity</td>
</tr>
<tr>
<td>• Terminal logistics development</td>
<td>• Conventional power as grid</td>
<td>• Stand-alone transmission</td>
<td>• Network builds for telcos</td>
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<tr>
<td>• Automation of towage &amp; freight handling</td>
<td>stability solution</td>
<td>networks</td>
<td>• End-user/bridging rural divide</td>
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<tr>
<td>Surface transportation</td>
<td>Renewable wind/ solar</td>
<td>Distribution</td>
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<tr>
<td>• Private &amp; regional transport</td>
<td>• Wind &amp; solar platforms</td>
<td>• Gas &amp; electric utilities</td>
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<tr>
<td>• Roads &amp; rail passenger services</td>
<td>• Partnerships with developers &amp; manufacturers</td>
<td>• District heating/cooling</td>
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<tr>
<td>• Next generation mobility: parking/vehicle infrastructure</td>
<td>• Operational assets partially contracted</td>
<td>• Piped energy distribution systems</td>
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<tr>
<td>Airports</td>
<td>Conventional low carbon</td>
<td>Midstream</td>
<td></td>
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<tr>
<td>• Terminal concessions</td>
<td>• Gas</td>
<td>• Demand-pull (transport, downstream processing, etc.)</td>
<td></td>
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<tr>
<td>• Regional airports</td>
<td>• Co-generation</td>
<td>• Supply-push (gathering &amp; production)</td>
<td></td>
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<tr>
<td>• Consolidation opportunities for fixed-base operators</td>
<td>• Biomass</td>
<td>• Storage and export</td>
<td></td>
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<tr>
<td></td>
<td>• Waste-to-energy</td>
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<td></td>
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<tr>
<td>Civic and utilities</td>
<td></td>
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<tr>
<td>• Wastewater treatment/disposal</td>
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<tr>
<td>• Desalination plants</td>
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<tr>
<td>• Community &amp; sports facilities</td>
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<tr>
<td>• Local government facilities</td>
<td></td>
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</tbody>
</table>

Note: bullet points in black highlight Partners Group focus areas.

Source: Partners Group, November 2019. For illustrative purposes only.

Abbreviations: PPP: public private partnership.
from the sale of transmission capacity to market participants, are generated under a stable regulated revenue regime with a revenue floor that guarantees full capital protection for our investment. This core asset is expected to be completed by 2023.

Across the Atlantic, in Latin America, EnfraGen is our second recent investment in this area. EnfraGen is a leading developer, owner, and operator of power generation assets in investment-grade countries such as Colombia, Chile, and Panama. EnfraGen specializes in providing back-up power for grid stability and baseload renewable power generation through a portfolio of thermal, solar, and hydropower assets. Overall, EnfraGen has 1.4GW in power generation capacity across its platform, plus an executable growth pipeline. The investment in EnfraGen is supported by structural market tailwinds, namely the continued build-out of renewable power generation capacity across Latin America, and benefits from long-term stable revenues derived from a mix of regulated and contracted USD-linked cash flows. One of the reasons Partners Group secured the acquisition through a bilateral transaction was our proven experience in the construction and operation of power generation assets globally, particularly renewable generation assets. Going forward, we will leverage this experience to drive improvements across the existing EnfraGen platform and to further the development and construction of new projects as we continue to invest in the renewables space across the globe.

Need for midstream infrastructure generates opportunity
The disruption in the US energy landscape and the resulting growth of hydrocarbon supply has re-directed the flow of resources within the US and the rest of the world, creating a multitude of investment opportunities along the value chain. We continue to see the best relative value in midstream energy infrastructure, meaning in those assets that move, treat, process, store, and market hydrocarbons. Within the opportunity set, we distinguish between “supply push” assets, namely those that transport hydrocarbons away from supply sources, and “demand pull” assets, namely those that service the end users of the products. Currently, we see better relative value in “demand pull” infrastructure. Being further away from the well-head and closer to the end-users generally translates into higher cash flow visibility as contracts in this segment tend to have a larger percentage of guaranteed throughput compared to the contract structures available closer to the well-head.

In Europe, the shift in the energy mix toward renewables (and away from coal-fired and nuclear power) underpins strong demand for natural gas, which is increasingly being adopted as a complementary fuel source. The Norwegian Continental Shelf (NCS) constitutes the largest natural gas reserve in the North Sea, with only one third of the resources in production, ensuring stable production over the next four decades. The NCS will require additional investment to develop natural gas infrastructure and to support the Norwegian government’s decarbonisation initiative to electrify the NCS and, as a result, reduce emissions.

We recently closed a new investment that fits squarely within this theme through our acquisition of CapeOmega, a leading offshore infrastructure platform in Norway. The company holds significant stakes in some of Norway’s key midstream infrastructure, including Gassled, the world’s largest offshore gas transmission system; Nyhamna, one of three key gas processing plants in Norway; and Polarled, a 480km pipeline that runs from the Aasta Hansteen field to Nyhamna. These assets provide essential infrastructure for transporting natural gas produced on the NCS, which currently supplies around 27% of Europe’s gas demand. With natural gas being increasingly adopted as a complementary fuel source to renewables, CapeOmega is poised to benefit from this demand tailwind. In addition, our investment in CapeOmega benefits from stable and predictable cash flows as almost all of the company’s revenues are derived from fixed, regulated, and inflation-linked tariffs, of which 70% are booked on a “ship or pay” basis until 2028. The asset lends itself to a platform expansion strategy, and our value creation efforts will focus on further expanding the portfolio through new developments and brownfield acquisitions.

Attractive opportunities in the infrastructure services space
We continue to see relative value in services-focused infrastructure businesses. Within the segment, regardless of whether a business is asset heavy or asset light, we test all opportunities against key infrastructure criteria such as long-term cash flow visibility, dominant market position with sustainable barriers to entry, and high capex requirements. Relevant opportunities are available across all sectors, such as our 2018 investment in Techem, a leading provider of underground utility locating services. We are also increasing our focus on infrastructure services opportunities in non-cyclical segments within the transport sector, including the mobility-as-a-service (MaaS) space. We see several global transformative trends creating investment opportunities in this segment, including technological disruptions such as the electrification of vehicles and transport infrastructure, along with new ownership models such as shared mobility platforms. We are actively screening opportunities in selected assets and services businesses, such as mobility payment service providers, and see attractive investment potential in the sector going forward.
How we realize relative value potential in private infrastructure

In global private infrastructure markets, we focus on the following key investment strategies:

**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.

Regardless of the investment strategy, we look for a value-add component in all potential opportunities. We have long argued that a “defensive” approach to investment, i.e. merely underwriting long-term stable revenue streams, is not enough to preserve, let alone grow value in this environment. Instead, we focus on generating cash flows actively through our three key strategies. We have spent the last few years building a portfolio that allows us to implement these strategies while still providing our clients with the key defensive attributes that characterize the infrastructure asset class.

Similarly, increasing urbanization and environmental awareness are triggering demand for cost-effective and environmentally friendly goods and passenger transport services solutions. In some geographies, regulation provides additional tailwinds to the sector. For example, the EU has a long-term target to reduce transportation-related greenhouse gas emissions by 60% by 2050, which may mean that regional railway freight


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**Partners Group’s infrastructure portfolio**

**Long-term fixed rate financing**
- Unlevered: 11%
- Floating: 3%
- Fixed/hedged: 86%

**Low GDP exposure**
- Some correlation: 8%
- No/limited correlation: 92%

**Long-term contracts:** c.71% for ≥10 years

**High cash flow visibility:** c.7% p.a.

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Source: Partners Group, 2019. Past performance is not indicative of future results. For illustrative purposes only. There is no assurance that the above strategy will materialize.

1 Weighted average across all unrealized direct infrastructure investments as of 30 June 2019. Weighted by investment commitment.

2 Target cash yield development of the Partners Group Direct Infrastructure 2011 portfolio.
operators will experience growth through a favorable shift in mode of transport from trucks to trains. Given the significant environmental and congestion benefits of trains, we see opportunities in railway freight operators and high-speed rail connections on selected routes.

Relative value analysis

For 2020, our outlook remains positive for the power and energy infrastructure sectors. In the power sector, we focus on building out renewable generation capacity globally, particularly in solar and onshore and offshore wind. As opportunities to invest in sizable single-asset renewables are increasingly scarce and attracting broad interest, we focus on platform build-out. Here, we see value in both acquiring existing platforms and in transforming development companies into integrated platforms. To complement our focus on renewables, we also look at intermittency management solutions, such as battery storage, increased interconnection, and smart meters and networks, as well as select peaking/demand-response assets, such as gas-fired power plants. Although we generally agree that baseload thermal/gas-fired power plants, particularly in developed markets, face an uncertain future as they will need to compete for dispatch time with renewables, we think there will still be a need for flexible, fast-ramping generators to provide grid support.

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>Transport/logistics</td>
<td>Transport/logistics</td>
<td>Power</td>
<td>Energy/infra-structure</td>
</tr>
<tr>
<td>Power</td>
<td>Power</td>
<td>Energy/infra-structure</td>
<td>Communications</td>
</tr>
<tr>
<td>Energy infrastructure</td>
<td>Energy infrastructure</td>
<td>Power</td>
<td>Energy/infra-structure</td>
</tr>
<tr>
<td>Communications</td>
<td>Communications</td>
<td>Social infra/PPPs</td>
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<td>Social infra/PPPs</td>
<td>Social infra/PPPs</td>
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<td>Strategy</td>
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<tr>
<td>Directs</td>
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<tr>
<td>Equity</td>
<td>Equity</td>
<td>Junior debt</td>
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<td>Junior debt</td>
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<td>Secondaries</td>
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<td>Inflection assets</td>
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<td>Mature assets</td>
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<td>Building core</td>
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<td>Platform expansion</td>
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<td>Operational value creation</td>
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<td>Platform expansion</td>
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<td>Operational value creation</td>
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<td>Core</td>
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<td>Building core</td>
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<td>Platform expansion</td>
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<td>Core</td>
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</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/logistics, power, energy infrastructure, communications and social infrastructure/PPPs), 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. Yellow and light yellow mean that Partners Group underweights the segment and requires even greater conviction during bottom-up analysis to pursue an asset.
The industry view
Q&A with an industry expert.

A seasoned energy industry executive with extensive board experience, Tore Holm is the Chairman of Partners Group portfolio company CapeOmega, a leading midstream infrastructure company in Norway. Here, he shares with us how the energy industry has evolved over the course of his career and what role companies like CapeOmega play in the energy transition.

How has Europe’s energy sector evolved over the course of your career?

It is hard to reconcile the energy sector in the early 1980s with the present situation. The changes over the last four decades have been fundamental. There are a few elements I would highlight: one is structural change through the liberalization of the industry. The oil & gas market used to be dominated by national oil & gas companies and the majors like Exxon, Shell, Chevron and BP, and the electricity business by national monopolies. Today, we see all sorts and sizes of specialized companies focused on different parts of the energy value chain. Enormous technological development, not only in the midstream industry, but also in the energy sector more broadly, has both been a result of and an enabler of these structural changes.

Hand in hand with structural changes, there has been a significant cost reduction throughout the energy value chain, first in the upstream segment, then in the downstream segment and, ultimately, in the consumer segment.

Finally, mainly in the last ten years, we have seen a rapidly evolving renewable energy landscape, which is gradually revolutionizing the energy industry globally.

Today, technological advances are displacing or reshaping entire industries. Do you see this happening in the energy sector?

Yes, one example that comes to mind is the displacement of the coal industry in Europe and other parts of the world. This is partly because of cost and political change but also because of technological disruption.

Even if the coal industry has had solid technological development, it has not experienced the dramatic development we have seen in other segments of the energy industry. In addition, when it comes to cost, it has been surpassed first by the gas industry and more recently by the wind and solar industry. Today, a coal-fired power station in Europe cannot compete with a wind farm. Conversely, if we look at the renewables sector, new technologies have allowed the industry to reduce costs year over year to the point where renewables will likely take over electricity generation, starting in Europe, China, and the US.

In sum, cost and technological developments have gone hand in hand in reshaping the industry. At the same time, politics have played an important role in this – in the energy business, politics are always very closely interwoven with shifts in the industry.

Hand in hand with structural changes, there has been a significant cost reduction throughout the energy value chain.
What predictions would you make for the future of the energy industry?

I believe public perception will play a key role in shaping the future of the industry. With the discussions around climate change, we are clearly in the middle of a revolution. The energy transition will be messy, and we will see a lot of misguided attempts that will lead us nowhere, but it definitely is a revolution and, ultimately, we will get there.

In turn, this will have financial implications, particularly from an investor perspective. Those who are investing capital will become firmer on wanting protection from the carbon bubble and from reputational risk. In other words, it will be harder to get financing for those who are not in the right “green” lane.

I also believe natural gas will continue to play an important, niche role in the industry, not only to support the transition to renewables during the build-out phase but also to ensure sufficient flexible generation capacity: you still need to have a means to generate electricity when there is no wind or sun.

In 2015, you were appointed Chairman of the Board of Directors of midstream infrastructure company CapeOmega, a recent Partners Group investment. What attracted you to this role, and what keeps you there?

Two things: first, I had a career of more than 30 years in the oil & gas business, but there was one element that I had not been exposed to, and that was private equity. I wanted to get an inside view of the industry.

Second, what attracted me to CapeOmega was the team. I have never met a more enthusiastic, creative, and caring team in my life. When I first joined the company, I had a steep learning curve despite thinking I already knew everything about the natural gas business. Today, I still find so many things I can learn from working with them.

Following Partners Group’s investment, I also sense a clearer environmental and climate perspective than we have had in the past, and that makes me even keener to stay and experience our next phase of growth.

The energy transition will be messy, and we will see a lot of misguided attempts, but it is a revolution and, ultimately, we will get there.

What is the market opportunity for CapeOmega?

First, it is more of the same: there is so much untapped potential to further expand offshore infrastructure and related assets around the Norwegian Continental Shelf (NCS), which has the largest natural gas reserves and resources in the North Sea.

Tore Holm, is the Chairman of the Board of Directors of CapeOmega.

Holm is a seasoned E&P executive and has extensive board experience. He has 30 years of experience in the E&P business, where he has held a number of positions in Shell International and Norway, including Director E&P Shell Norway, VP Commercial International, and Project Manager Ormen Lange. Holm has been a director and advisor to several E&P companies, and is a senior advisor to Carbon Limits, an environmental consultancy company.

Tore Holm holds several board positions, including being the chairman of the board of ENOVA, a public enterprise owned by the Norwegian Ministry of Petroleum and Energy.
Second, the electrification of the NCS presents a huge opportunity. This is desperately needed from a climate and a political perspective, and we see an opportunity for CapeOmega to become both an architect of and a significant player in the electrification of the natural gas industry in Norway.

Finally, we will also look at other types of infrastructure. The team has a fantastic ability to come up with new ideas, and I am excited to see what the future brings.

**What role does a company like CapeOmega play in the energy transition?**

Going forward, CapeOmega will support the transition of the energy industry in two ways. On the one hand, we are thinking of ways to simplify and make the energy transmission system more effective, enabling us to get more natural gas into Europe for electricity generation and ensure there is enough capacity in the market. We also think we can provide innovative crossover transportation and transmission solutions, for example, between different gas transmission systems and between electricity and natural gas.

On the other hand, we are also looking at potential electricity generation ourselves. In this case, we would be looking at electricity generation from renewables, for example, hydro or wind. If we are able to support both electricity and natural gas transportation, I believe there would be few players better positioned to develop new ideas to support the energy transition from this combined perspective.

**What are your key focus areas as Chairman?**

Together with the rest of the board and Partners Group, my first major focus area is shaping the direction and strategy of the company. When I first came to CapeOmega, this was a bit all over the place. It took a year to get some structure and focus into it, and that has really paid off. That will continue to be one of my key roles in the future.

The second, which is always a key role for any chairperson, is controls. However, it is so easy to kill creativity if you impose too many tight, bureaucratic controls. Together with Partners Group, we have to be artists and make sure that the controls we have in place are effective but do not dampen the team’s creativity.

Finally, I also see my role as a motivator: I have seen over the last four years that when the team is empowered and motivated, nothing can stop them.

**Besides your role at CapeOmega, you hold several other board positions. In your view, what is the role of the board in supporting company growth?**

It is to set direction; to encourage and engage; to align owner and management team; to provide effective, but not burdensome, controls; and to challenge.

That is the general role of the board. If we look specifically at CapeOmega, which is basically a business development machine, it is also to have effective processes for business development so that the company can continue to be nimble. We have won a number of deals in the past because we can move so quickly, and that is something which is important to maintain.

**What makes Partners Group the “investor of choice” for growing CapeOmega?**

Partners Group has identified the strengths of CapeOmega’s business development capabilities. It also sees where the company needs to be strengthened. I believe it can further develop the company’s strong position and existing talent, but also bring in new expertise and capabilities, particularly in the electricity generation and transportation segment.

What I have experienced so far makes me very optimistic. I have witnessed something I really value at the very heart of Partners Group: integrity and determination. In Norway, we would call this “hard wood”: solid, dependable, and trustworthy. Through the Partners Group team, I have met some very smart and hard-working people who always have smiles on their faces and a good sense of humor; they will definitely gel with the CapeOmega team. I am convinced we will succeed together.
**Liquid private markets**

**Market overview**

Despite a weakening global economy, listed infrastructure has risen by approximately 27% year-to-date,\(^1\) outperforming major global equity indices. The increase was supported by underlying companies’ stable fundamentals and favorable interest rate developments that have resulted in high valuations. We have now become more cautious on listed infrastructure overall, especially as valuations are relatively high and economic growth is slowing. We remain more positive on Europe, where valuations seem less elevated after certain sectors re-rated throughout the year due to heightened regulatory concerns and uncertainty around Brexit.

**Listed private equity** has also performed strongly year-to-date, generating a total return of approximately 39%,\(^2\) significantly outperforming the broader equity market after the Q4 2018 drop. All regions contributed substantially to the increase, with North America being the best performer. In particular, asset managers and, to a lesser extent, business development companies (BDCs) spurred performance in the region. US asset managers continue to benefit from a strong fundraising environment and from C-Corp conversions, which are expected to result in index inclusions for a number of managers. BDCs have re-allocated their portfolios toward floating-rate investments over the last few years and have benefited from rising interest rates and regulatory changes. New US regulation allows them to raise their debt-to-equity ratio from 1:1 to 2:1, which has resulted in portfolio growth and, in turn, net investment income growth. Following these very strong results, we have become more cautious on the listed private equity market as a whole.

**Our current investment themes**

Despite the strong performance of listed infrastructure year-to-date and slowing economic growth, we remain optimistic on certain transportation sub-sectors, such as European toll roads and airports. European road passenger traffic continues to increase, albeit at a slower rate. In Brazil, meanwhile, toll road valuations are supported by upcoming auctions. Globally, airports suffered recently due to regulatory uncertainty and pressure on returns; however, valuations have now become more compelling. We are also positive on the US tower sector as global data consumption continues to rise strongly and the deployment of small cell towers (used for network densification) is increasing across North America. Finally, utilities are expensive, especially in North America (many are currently trading at around a 90% premium to RAB), but have the most regulatory stability and the clearest visibility on earnings growth among all sub-sectors.

In the listed private equity market, we have turned neutral on US asset managers after valuations re-rated following full C-Corp conversions; however, we still see some upside. The sector continues to benefit from positive momentum as indices rebalance. In addition, a number of managers have been broadening their product platform over the last few years and have successfully raised new funds, which, in turn, will translate into management fee growth and future carry potential. We have become more positive on European fund of funds. The sector was very stable throughout Q4 2018, and, despite delivering decent NAV growth and solid share price performance, discounts have widened.

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### Relative value matrix

<table>
<thead>
<tr>
<th></th>
<th>NORTH AMERICA</th>
<th>EUROME</th>
<th>ASIA/EMERGING MARKETS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Listed infrastructure</strong></td>
<td>Transport</td>
<td>Utilities</td>
<td>Comm-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>unications</td>
</tr>
<tr>
<td>Listed private equity</td>
<td>Public partnering</td>
<td>BDCs</td>
<td>Managers</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.

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\(^1\) As measured by Partners Group Listed Investments SICAV – Listed Infrastructure I-T EUR, as of 14 November 2019.

\(^2\) As measured by Partners Group Listed Investments SICAV - Listed Private Equity I-T EUR, as of 14 November 2019.
Partners Group’s Expected Return Framework

Our Expected Return 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, such as 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 enhanced by sector selection (Thematic Sourcing) and 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.

Despite rising macroeconomic headwinds, the unabated search for yield has kept public and private markets valuations at elevated levels, with limited room for further multiple-driven upside. As a result, expected returns across asset classes remain compressed and at the lower end of historical ranges. This is particularly worrisome for pension funds and other institutional investors that have contractual obligations toward their beneficiaries: in a low-return environment, return requirements to meet long-term liabilities are becoming difficult to achieve. Increasingly, these investors are looking to private markets in search of better return prospects. Our Expected Return Framework (ERF), which projects five-year forward-looking broad industry returns by asset class, sheds more light on this development. The chart below illustrates the expected return ranges for private and public markets asset classes and reflects the premium that can be achieved by investing in private markets.

Partners Group Expected Return Framework: expected broad industry returns p.a. by asset class

Note: all of the above data is derived from Partners Group calculations and assumptions and should not be construed as representative of Partners Group investments. Partners Group utilizes historical market data and academic research to generate the above calculations, a full list of which can be provided on demand. Please note all value creation inputs are based solely on Partners Group’s internal research. There is no assurance that expected returns will be achieved. Public asset classes are assumed to be invested passively, with a performance fee of 1.5% p.a. and a management fee of 0.25% p.a. for investment grade bonds and 0.50% p.a. for high yield. The fee structure assumed for private equity includes a management fee of 2.0% p.a. and a performance fee of 20% subject to an 8% hurdle. Real estate and infrastructure fees on equity investments include a management fee of 1.5% p.a. and a performance fee of 20% subject to an 8% hurdle for real estate and 15% subject to a 6% hurdle for infrastructure. Private equity junior debt fees include a management fee of 1.25% p.a. and a performance fee of 12.5% subject to an 4% hurdle. For real estate and infrastructure junior debt, fees include a management fee of 1.25% p.a. and a performance fee of 10% subject to a 4% hurdle. Senior loan fees for all asset classes include a management fee of 0.75% p.a. and a performance fee of 7.5% subject to a 4% hurdle. Hypothetical or simulated performance results have certain limitations. Unlike the results shown in an actual performance record, these results do not represent actual trading. Past performance is not a reliable indicator of future performance. High-yield and investment grade credit taken as a public proxy for junior debt and senior debt to retrieve spreads.

Source: Partners Group, November 2019. For illustrative and academic purposes only.
In light of our approach of focusing on high-growth market segments and value creation at the asset level, we are also showing the expected net returns across the opportunities considered for investment by our Global Investment Committee as a comparison. This illustrates how we expect to outperform the broader market. These expected returns also factor in our specific underwriting assumptions, including macroeconomic conditions and multiple contraction.

**Net target return ranges based on Partners Group investment opportunities**

![Graph showing net target return ranges for private equity and real assets for 2018 and 2019.](image)

Note: shows net target return ranges for direct investment opportunities only. Shaded areas represent two thirds of investment opportunities considered. Past performance is not indicative of future results. There is no assurance that similar investments will be made. Target returns are based on various Partners Group estimates. There is no guarantee that targeted returns will be realized or achieved or that the investment will be successful. Data is based on Global Investment Committee documents and hence may deviate from funding dates. For emerging market investments with local currency other than USD/EUR/GBP, hedged returns were taken (i.e. mainly translated into USD) to allow for comparison with Partners Group’s funding currency. Only platform investments were considered as add-ons are typically factored in. Early IRRs are weighted by investment amount translated into EUR as a base currency. Figures calculated net of underlying fees and net of Partners Group fees. Source: Partners Group, August 2019. For illustrative purposes only.

There are many ways to capture the expected return premium in private markets. For pension funds, one suitable solution is investing in Long Term Value Assets (LTVAs), as we explain in the next section.

**What are Long Term Value Assets?**

Long Term Value Assets (LTVAs) are private markets assets that offer the opportunity to compound attractive returns over longer-term holding periods (often in excess of ten years). These seasoned assets have matured to a point where they provide a more stable risk/return profile.

LTVAs usually comprise category leaders that have been able to capture a substantial share of the market and fall into one of the following categories:

- **Platform leaders**: a platform company that has built its dominance successfully via add-on acquisitions in a market at an advanced stage of consolidation;
- **Market leaders**: companies that have built on a particular niche expertise to seize market dominance and share their leadership with very few others;
- **Franchise leaders**: businesses serving a segment with network benefits. These are companies, which either contractually, or by the nature of the industry they are in, hold unique franchises and substantially benefit from their ability to scale.

LTVAs are found in sectors with long-term visibility and growth potential. They differentiate themselves from other assets through their ability to protect their market leadership, exhibiting resilience in difficult market environments.

In terms of their risk/return profile, within private markets, LTVAs are positioned between private infrastructure and private equity. Expected net returns in the lower double-digits place LTVAs at the low end of the traditional private equity return range, as per the below illustration.

**Risk/return mapping of different asset classes**

![Diagram showing risk/return mapping of different asset classes.](image)

Source: Partners Group, November 2019. For illustrative purposes only.
The chart above illustrates a typical pension fund’s liability profile – the pension payments relating to current (shorter-dated payments or “liabilities”) and future pensioners (longer-dated liabilities) – and the suite of assets in which a pension fund can invest to meet these liabilities or pension payments.

In fact, the longer holding period associated with LTVAs can be a more economical way of meeting long-term liabilities. Investments in LTVAs benefit from uninterrupted ownership, which enables institutional investors to keep their capital fully invested. It allows investors to benefit from efficient governance and to minimize transaction costs (up to 2-5% of transaction value), and, ultimately, compound attractive returns over the long term. Depending on what assumptions are used around reinvestment time lags (the time between receiving proceeds from a company sale and finding another company to re-invest) and transactions costs, we estimate that a long-hold LTVA strategy can outperform a traditional (short-hold) private equity strategy by up to 2x the capital invested over a 15-year period.

Other defensive, longer-dated assets, such as infrastructure debt, government bonds, or long-lease property, are also perceived as resilient by many investors, as we explain in the Private Markets Outlook section of this publication. Today, however, these assets come with a high price tag and therefore provide low returns/yields in the current environment. LTVAs can be an attractive alternative to these assets or complement them by offering both resilience and higher return potential.

The role of LTVAs in a pension fund glide path

The defined benefit (DB) pension fund landscape is changing. Pension plans globally are increasingly looking to de-risk their pension schemes as membership profiles mature and negative cash flows become more prevalent. Their aim is to reduce the funding gap and increase their chances of being able to fund liabilities when they fall due.

In order to meet these liabilities, the types of assets being used within glide path strategies are evolving, with more schemes exploring non-traditional asset classes such as private markets that can offer income and/or generate excess returns. In this context, LTVAs can offer many of the key characteristics required by pension fund glide paths, including increased return potential, diversification, and resilience.

DB pension plans have a long-term horizon, with liabilities often running for more than 40 years. However, most investment opportunities have a shorter lifespan, which leads to a mismatch between asset holding periods and liability horizons. For example, traditional private equity funds typically have a lifespan of ten-to-twelve years, with asset holding periods of four-to-six years. To maintain exposure, regular re-investments are required, which in turn increase administrative burdens and transaction costs for pension schemes.

That is why LTVAs are particularly well suited to pension plans with long-term liabilities. LTVAs generally sit alongside other long-hold assets, such as infrastructure or long-lease property, and can be used to target longer-dated liability cash flows.
Generally, investors in LTVAs should expect net returns in the low double-digits, with some strategies offering a yield component generated from high cash conversion and a stable dividend, as often found in mature companies. Relative to other long-dated assets, this represents a high single-digit pick-up in returns.

We are convinced that a substantial share of the compelling long-term return and growth potential of LTVAs can be attributed to the superior governance framework adopted by many private companies. In fact, LTVAs benefit from entrepreneurial private markets ownership, which prioritizes active value creation over the adherence to public markets’ blanket corporate governance codes. A governance structure designed to enable value creation provides an excellent basis for management teams to focus on long-term growth. It is our belief that this has been one of the major drivers of private equity outperformance over the past decade.

Besides providing growth potential, LTVAs can also provide the benefits of diversification and downside risk reduction to a traditional pension fund glide path strategy. The category-leading status of LTVAs often results in high barriers to entry and positions them well to withstand growth setbacks: when growth and inflation move adversely, LTVAs exhibit cash flow resilience because of their market leadership and can mitigate the impact of inflation through their higher pricing power.

For pension plans, therefore, an allocation to LTVAs results in a more stable asset portfolio. This enables plans to employ a lower margin of prudence in actuarial assumptions, leading to higher liability discount rates and lower pension fund liabilities, all other things being equal.

Private markets benchmark portfolios 2020

As with previous issues of the Private Markets Navigator, we are providing a return-focused and a yield-focused private markets portfolio to illustrate the 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 toward capital appreciation, while the yield portfolio focuses on income-oriented opportunities. We calculate expected returns for the model portfolios using the five-year broad industry returns derived from the ERF and then apply the asset testing scenarios defined in the Private Markets Outlook section on page 8.

In the return-focused portfolio, we continue to overweight private equity over real assets given the greater scope to create growth and harness transformative trends in the late-cycle environment. We focus on direct investments in companies with high pricing power and margin stability that offer potential for value creation enabled by an entrepreneurial approach to ownership and a long-term view. Our focus on value-add and market segments that benefit from transformative trends should largely offset the negative impact of multiple contraction. Given our softened views on rising rates, we now underweight junior debt due to its less attractive risk/return profile—lower total returns and lighter covenants mean we need to be more selective in this segment of the market. For equity investments across asset classes, we are factoring in longer holding periods and multiple contraction given the current high valuation environment.

1 Asset class return expectations are based on broad industry returns as projected by the Expected Return Framework. Partners Group target returns exceed return expectations for the broader market in line with our disciplined investment approach and value creation assumptions.
Return-focused portfolio allocation in our base case

Private equity 50% [20-60%]
Private real estate 20% [10-40%]
Private debt 10% [0-25%]
Private infrastructure 20% [10-40%]

Note: the outer circle represents long-term portfolio weights. The inner circle represents current portfolio weights. The ranges in brackets show the target bandwidths. There is no assurance that targets will be met.

Applying these weights and using the ERF broad industry returns results in an annualized expected return of 8.9% and generates a strong outperformance of 4.9 percentage points over a 60/40 public markets portfolio (60% equities, 20% government bonds, 20% investment grade bonds). This represents an increase of 40bps over our 2019 outlook. The chart 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>Return-focused private markets portfolio</th>
<th>60/40 public markets portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base case scenario</td>
<td>8.9%</td>
<td>6.5%</td>
</tr>
<tr>
<td>Adverse rate hikes</td>
<td>+4.9%</td>
<td>+4.0%</td>
</tr>
<tr>
<td>Recession</td>
<td>+7.3%</td>
<td>+3.0%</td>
</tr>
<tr>
<td>Stock market rally</td>
<td>+12.6%</td>
<td>+2.4%</td>
</tr>
</tbody>
</table>

Note: asset class return expectations are based on broad industry returns as projected by the Expected Return Framework. Partners Group target returns exceed return expectations for the broader market in line with our disciplined investment approach and value creation assumptions.

In the yield-focused portfolio, floating-rate debt remains a major building block. We favor corporate debt over asset-backed debt as the yield differential more than compensates for the “perceived” additional risk, in line with our view that “offense in the new defense.” Real asset debt is a continued underweight. We overweight senior debt compared to our long-term allocation given the better downside protection the segment offers at this stage in the cycle. Within second lien, we focus on select credits that exhibit sufficient covenants and/or sizeable equity cushions to provide appropriate downside protection.

Yield-focused portfolio allocation in our base case

Private infrastructure equity 15% [5-30%]
Real asset debt 5% [0-30%]
Corporate second lien & mezzanine 35% [15-55%]

Note: the outer circle represents long-term portfolio weights. The inner circle represents current portfolio weights. The ranges in brackets show the target bandwidths. There is no assurance that targets will be met.

Similar to the return-focused portfolio, the chart below illustrates the expected returns for the different scenarios and compares these with a 20/80 public markets portfolio, consisting of 20% equities, 40% government bonds, 30% investment grade, and 10% high-yield bonds.

Economic scenarios applied to yield-focused portfolio

<table>
<thead>
<tr>
<th>Economic scenario</th>
<th>Yield-focused private markets portfolio</th>
<th>20/80 public markets portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base case scenario</td>
<td>6.0%</td>
<td>6.5%</td>
</tr>
<tr>
<td>Adverse rate hikes</td>
<td>+2.8%</td>
<td>+4.0%</td>
</tr>
<tr>
<td>Recession</td>
<td>+4.0%</td>
<td>+3.0%</td>
</tr>
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</tr>
</tbody>
</table>

Note: asset class return expectations are based on broad industry returns as projected by the Expected Return Framework. Partners Group target returns exceed return expectations for the broader market in line with our disciplined investment approach and value creation assumptions.

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

Client relations contact
Andreas Uhde
T +49 89 383 892 51
andreas.uhde@partnersgroup.com

Media relations contact
Jenny Blinch
T +44 207 575 25 71
jenny.blinch@partnersgroup.com

partnersgroup@partnersgroup.com
www.partnersgroup.com

Follow us on LinkedIn
Follow us on Twitter
Follow us on YouTube

Zug
Zugerstrasse 57
6341 Baar-Zug
Switzerland
T +41 41 764 60 00

Denver
1200 Entrepreneurial Drive
Broomfield, CO 80021
USA
T +1 303 606 3600

Houston
Williams Tower
2800 Post Oak Blvd., Suite 5880
Houston, TX 77056
USA
T +1 346 701 3900

Toronto
Exchange Tower
130 King Street West, Suite 1843
Toronto, ON M5X 1E3
Canada
T +1 416 865 2033

New York
The Grace Building
1114 Avenue of the Americas, 41st Floor
New York, NY 10036
USA
T +1 212 908 2600

São Paulo
Rua Joaquim Floriano 1120, 11° andar
CEP 04534-004, São Paulo - SP
Brazil
T +55 11 3528 6500

London
110 Bishopsgate, 14th Floor
London EC2N 4AY
United Kingdom
T +44 20 7575 2500

Guernsey
P.O. Box 477
Tudor House, Le Bordage
St Peter Port, Guernsey
Channel Islands, GY1 6BD
T +44 1481 711 690

Paris
14, rue Cambacérès
75008 Paris
France
T + 33 1 70 99 30 00

Luxembourg
350, avenue J.F. Kennedy
L-1855 Luxembourg
B.P. 2178
L-1021 Luxembourg
T +352 27 48 28 1

Munich
Skygarden im Arnulfpark
Erika-Mann-Str. 7
80636 Munich
Germany
T +49 89 38 38 92 0

Singapore
8 Marina View
Asia Square Tower 1 #37-01
Singapore 018960
T +65 6671 3500

Manila
18/F Net Park Building
5th Avenue Corner 26th Street
Bonifacio Global City, Taguig
1634 Metro Manila
Philippines
T +63 2804 7100

Shanghai
Unit 1904-1906A, Level 19
Tower 1, Jing An Kerry Center
No. 1515 West Nanjing Road
Jing An District, Shanghai 200040
China
T +86 21 2221 8666

Tokyo
Daido Seimei Kasumigaseki Bldg. 5F
1-4-2 Kasumigaseki, Chiyoda-ku
Tokyo 100-0013
Japan
T +81 3 5532 2030

Sydney
L32, Deutsche Bank Place
126 Phillip Street
Sydney, NSW 2000
Australia
T +61 2 8216 1900