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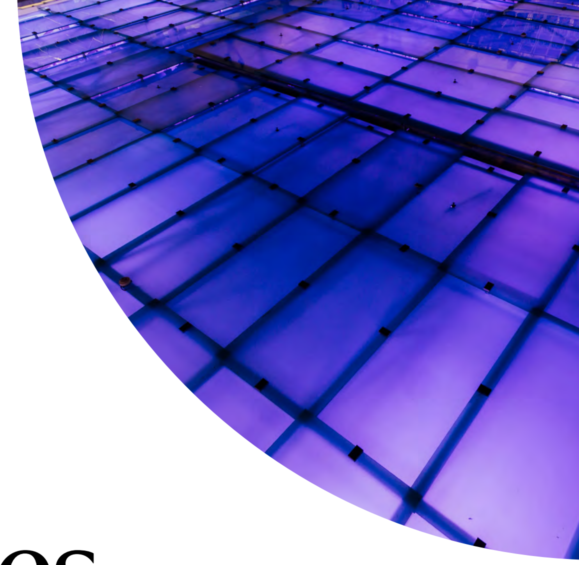

MARKETING COMMUNICATION

Public vs. Private Markets: How Rates Impact Opportunities

- Attractive investment opportunities exist in both public and private capital markets, but the balance may be shifting.
- Appropriate use of leverage often determines which market segment is attractive at different points in the interest rate cycle.
    - **Higher rates:** The leveraged nature of private equity and less-leveraged public equity means that public equities tend to be attractive during periods of high (real) interest rates.
    - **Lower rates:** Private market investors tend to benefit when borrowing costs are low.
- A 10-year period of near-zero interest rates in the U.S. from 2012 to 2022 boosted private market returns and led to spectacular asset growth across the segment. But interest rates rose dramatically in 2022, putting downward pressure on private market returns in 2023 and 2024 while public market returns soared after correcting in 2022.
- Higher-for-longer interest rates add meaningful hurdles for private equity, private credit, and private real estate, including higher borrowing costs, stressed exit strategies, and increasing competitive pressures.
- Investors should consider potential risks and opportunities if the (real) cost of debt remains elevated and continues to be a stronger headwind for private markets relative to public markets.

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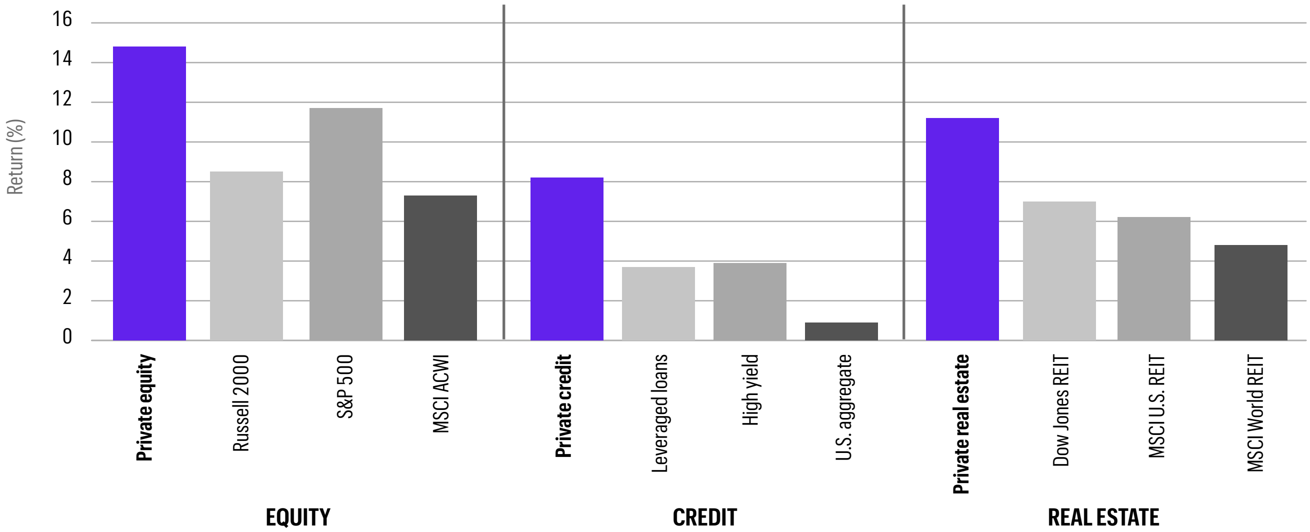
Cracks emerge in private markets

Investors use different types of leverage at different points in the interest rate cycle—aiming to generate attractive returns—which makes cost of leverage a key determinant of investment returns. During the 10-year window of mostly zero interest rates in the U.S. from 2012 to 2022, the low cost of leverage was an advantage for private market investors. This ended in March 2022 when the Federal Reserve began to increase the federal funds rate to over 5%.

Strong investment performance fueled the growth of private market assets, which rose from $3 trillion in 2012 to around $13 trillion in 2023. Figure 1 shows how private markets (violet bars) outperformed their public market counterparts (gray bars) from 2012 to 2022.

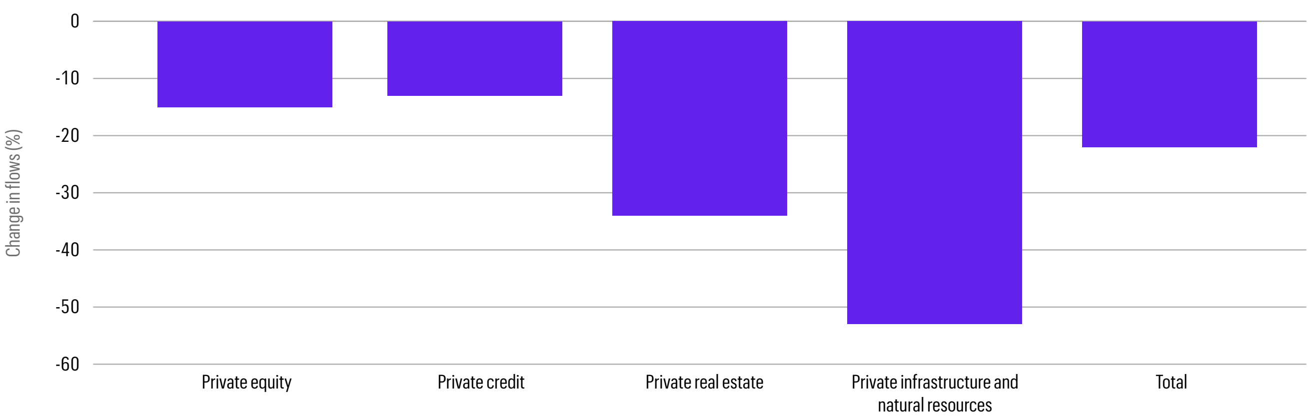
Flows into private markets, which soared between 2012 and 2022, have begun to slow (Figure 2).

FIGURE 1. PRIVATE MARKETS OUTPERFORMED PUBLIC MARKETS, 2012–2022



Sources: Allspring and Bloomberg Finance L.P., Oct-12 to Sep-22. Private equity is Bloomberg PEBUY Index. Private credit is Bloomberg PEDEBT Index. Private real estate is Bloomberg PERE Index. Public equities are Russell 2000, S&P 500, and MSCI ACWI Net USD Index. Public debt are S&P UBS Leveraged Loan Index, Bloomberg Corporate U.S. High Yield Index, and Bloomberg U.S. Aggregate Bond Index. Public real estate are Dow Jones Equity REIT Index, MSCI U.S. REIT Index, and MSCI World REIT Index.

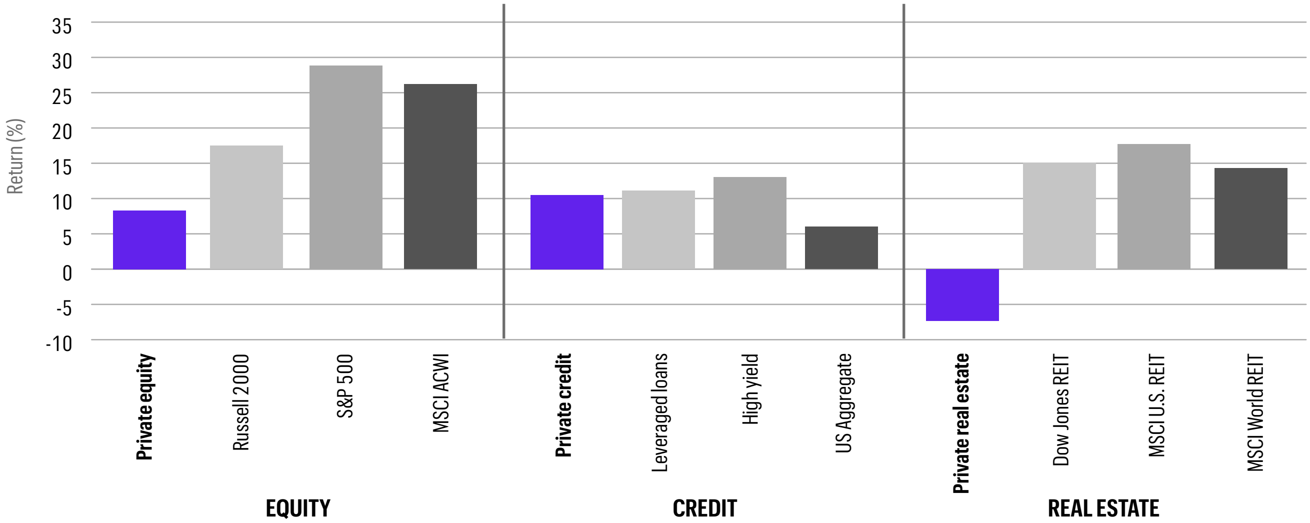
FIGURE 2. FLOWS INTO PRIVATE MARKETS SLOWED, 2022–2023



Sources: Allspring and McKinsey Global Private Markets Review, 2024; calendar-year 2022 versus 2023

Performance of private market assets has also retreated overall for the two years ending September 2024 relative to investments in public markets (Figure 3).

FIGURE 3. MANY PRIVATE MARKETS UNDERPERFORMED PUBLIC MARKETS, OCT-22 TO SEP-24



Allspring and Bloomberg Finance L.P., Oct-22 to Sep-24. Private equity is Bloomberg PEBUY Index. Private credit is Bloomberg PEDEBT Index. Private real estate is Bloomberg PERE Index. Public equities are Russell 2000, S&P 500, and MSCI ACWI Net USD Index. Public debt are S&P UBS Leveraged Loan Index, Bloomberg Corporate U.S. High Yield Index, and Bloomberg U.S. Aggregate Bond Index. Public real estate are Dow Jones Equity REIT Index, MSCI U.S. REIT Index, and MSCI World REIT Index.

Underlying this shift in performance and asset flows sits the rise in interest rates—the higher interest expense has weighed on financial performance and asset valuations. Rates are likely to remain higher for much longer than many expected given the ongoing strength of the economy, a resilient labor market, and sticky inflation. The longer that rates remain elevated, the less likely that stress on private markets is "transitory" and the more likely that structural challenges introduced by higher interest rates will be a meaningful headwind for private markets. Conversely, public market investments should benefit from less leverage at a point in the cycle when real borrowing costs are relatively high. Below we consider challenges related to a higher-for-longer interest rate environment for private equity, private credit, and private real estate.

Private equity challenges

Interest rate challenge: Private equity is heavily dependent on leverage. The 500-basis-point (bp; 100 bps equal 1.00%) increase in rates over the past three years creates significant challenges for firms that lack financial flexibility to navigate the increased interest expense. This impact can weigh on portfolio companies' earnings (Figure 4).

FIGURE 4. HEADLINE INTEREST EXPENSE AS A PERCENT OF EBITDA

	AVERAGE 3-MONTH RATE + 3%	
DEBT-TO-EBITDA RATIO	2019–2021	2023–2024
4:1	15.2%	32.6%
5:1	19.1%	40.7%
6:1	22.9%	48.8%
7:1	26.7%	57.0%

Sources: Allspring and Bloomberg Finance L.P., Jan-19 to Nov-24. Interest rate is the Secured Overnight Financing Rate (SOFR) plus 3%.

Additionally, higher rates have severely compressed valuations. According to Allspring's discounted cash flow analysis, companies are now worth just 19–32% of their pre-rate-hike values, depending on leverage levels. This decline stems primarily from higher discount rates reducing present values and increased debt service costs reducing free cash flow.

Exit challenge: The traditional private equity playbook of selling into higher multiples has been disrupted. For nearly a decade leading up to 2022, managers consistently sold assets into higher-multiple environments, with roughly two-thirds of total returns for buyout deals (entered 2010 or later, exited by 2021) attributable to market multiple expansion and leverage. This tailwind has reversed dramatically:

- Private equity buyout entry multiples contracted from 11.9x to 11.0x earnings before interest, taxes, depreciation, and amortization (EBITDA) through the first nine months of 2023.
- Information technology sector multiples have declined by nearly three turns in the past two years—after experiencing more than eight turns of expansion from 2009 to 2021. (Each turn represents a decrease/increase of 1.0x the multiple.)
- The gap between seller expectations (based on historical exit multiples) and buyer valuations (reflecting higher rates and lower growth expectations) has widened significantly.
- Managers have been increasingly forced to hold positions longer, as evidenced by net asset value (NAV) loan growth driven by reluctance to exit in a depressed multiple environment.

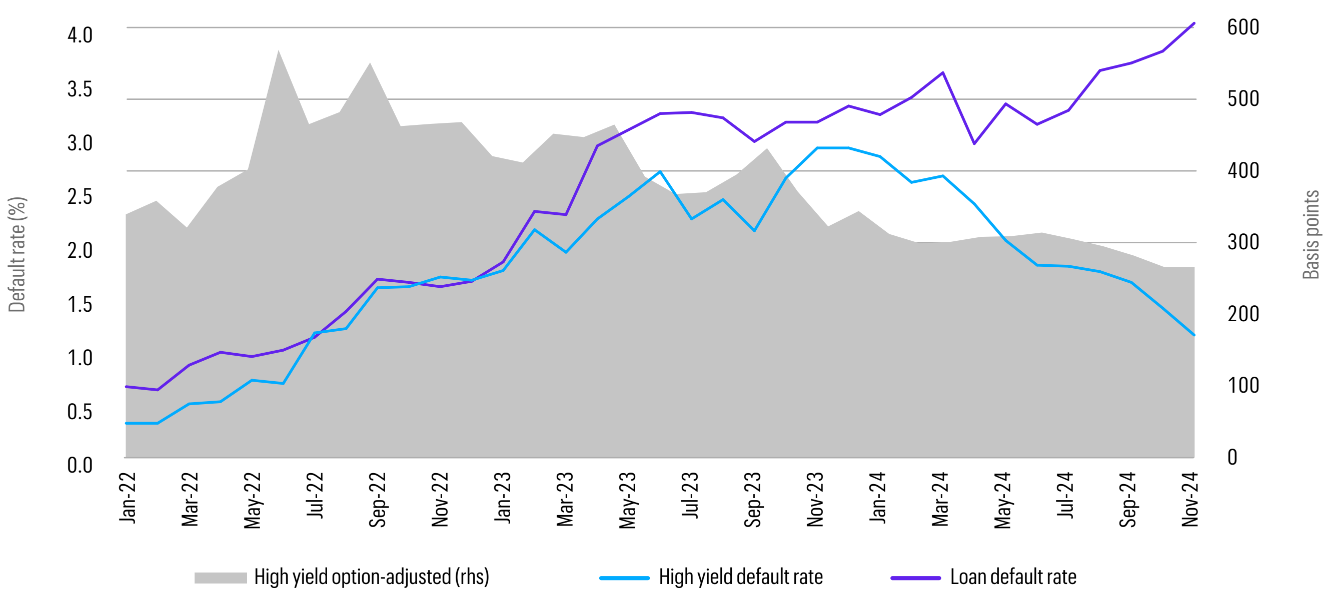
Competition challenge: In 1980, there were 24 private equity firms in the U.S.; now there are over 17,000. Too much money chasing too few deals can lead to:

- Pressure to deploy capital in less-attractive opportunities
- Higher entry valuations despite the challenging environment
- Risk of compromised due diligence and deal terms
- Lower expected returns as more capital chases fewer attractive opportunities

Private credit challenges

Interest rate challenge: Private credit is predominantly floating-rate debt, so the increase in rates raises the cost of leverage and strains borrowers, especially in situations where other aspects of free cash flow are contracting. Private market loan defaults have been on the rise recently, while public market defaults have declined (Figure 5). This reflects the higher quality in public markets at this point in the cycle relative to private borrowers as well as the fixed versus floating coupon structure of the markets.

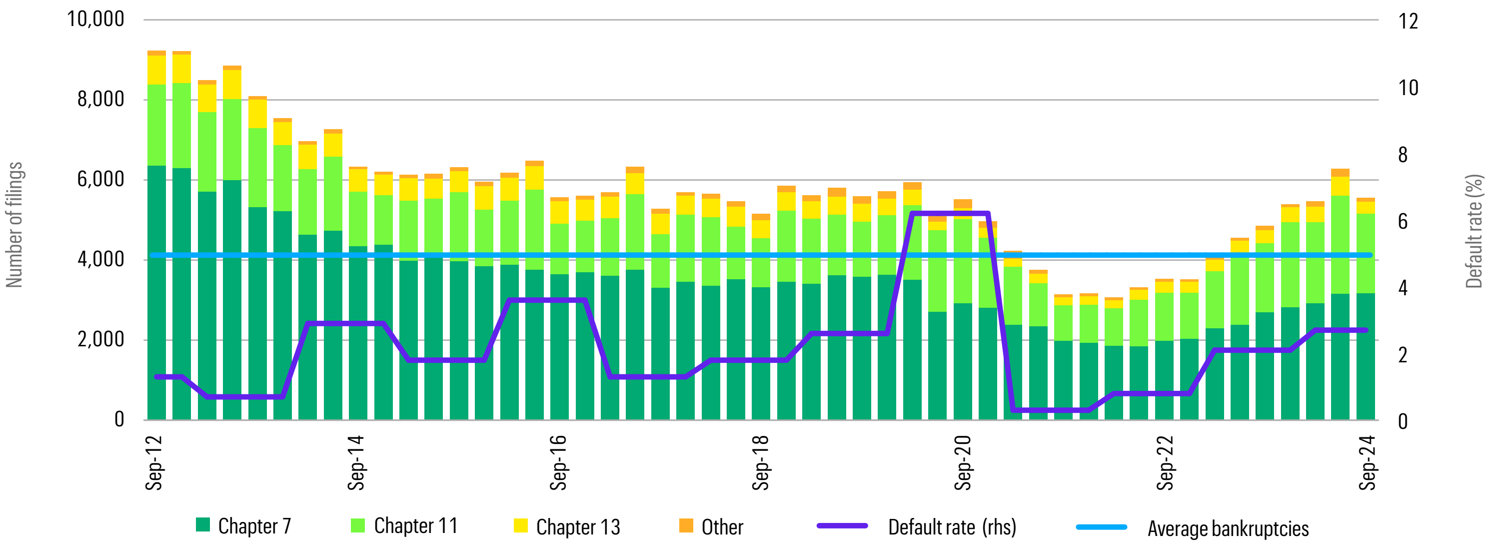
FIGURE 5. DEFAULT RATES DIVERGED AS CREDIT SPREADS TIGHTENED



Sources: High yield option-adjusted spread, Bloomberg Finance L.P.; high yield and loan default rates, JPMorgan. As of 31-Dec-24.

U.S. bankruptcy filings also appear to be on the rise after an extended period of low defaults (Figure 6).

FIGURE 6. BANKRUPTCY FILINGS HAVE BEEN RISING



Source: Bloomberg Finance L.P. Other tickers are BANBT7, BANBT11, BANBT13, BANBT 12. As of 31-Dec-24.

Competition challenge: Competition is especially acute in private credit where growth has been rapid. This is likely to get more intense, as we expect looser regulation to increase competition from banks. Too much money chasing too few deals can lead to:

- Risk of compromised due diligence and fewer protective covenants
- Pressure to deploy capital into less attractive opportunities
- Higher entry valuations despite the challenging environment
- Lower expected returns as more capital chases fewer attractive opportunities

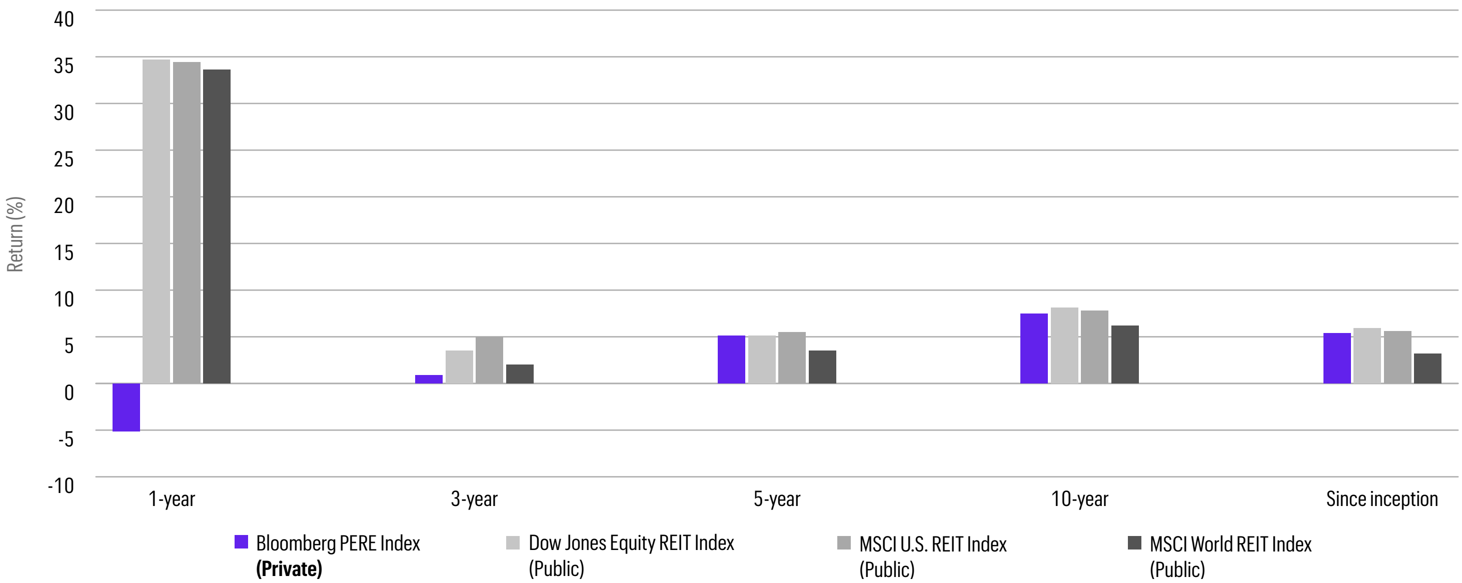
Private real estate challenges

Interest rate challenge: Higher financing costs have resulted in fewer attractive deals and depressed resale prices in commercial and other segments, slowing the overall real estate market.

- **Work-from-home:** The work-from-home trend has further weakened commercial office real estate, with many companies reducing or even eliminating their corporate real estate footprint. Knock-on effects have impacted business and infrastructure that depend on commuters for economic activity and residential real estate in and around city centers.
- **Demographics:** Shifting demographics will also have a significant impact, with increased demand driven by retirement and regional preferences in sectors such as medical office space, senior housing, and multifamily units and decreased demand for commercial real estate.
- **Liquidity:** Particularly as private market firms try to gain retail assets, liquidity challenges provide a cautionary tale of investing in illiquid assets:
    - Retail investors are subject to liquidity gates imposed by private real estate investment trusts (REITs). Blackstone BREIT, for example, allows redemptions of 2% of NAV monthly and 5% per quarter. Starwood SREIT had a similar policy, but in 2024, it further restricted redemptions to 0.33% of NAV monthly.
    - When redemptions exceed cash flows, properties must be sold to satisfy liquidity needs. Selling illiquid assets to meet liquidity demands is rarely a winning strategy and impacts all fund investors.

Performance challenge: Real estate broadly has suffered as interest rates have risen; financing tends to be 70–80% debt to value. Public market real estate fell by about 25% in 2022 while private real estate notched a +9% return for the year, defying the impact of higher interest rates on a heavily leverage-dependent asset class. But in 2023 and 2024, private real estate had to recognize losses while public real estate has rebounded from the lows of 2022, with up to double-digit returns in both 2023 and 2024. Asking investors to give up liquidity and transparency in return for similar or worse performance makes the case for private real estate a challenging one.

FIGURE 7. PRIVATE REAL ESTATE IS REFLECTING PERFORMANCE CHALLENGES



Sources: Allspring and Bloomberg Finance L.P., Jan-07 to Sep-24. Private market is Bloomberg PERE Index. Public markets are Dow Jones Equity REIT Index, MSCI U.S. REIT Index, and MSCI World REIT Index.

Interest rates and leverage impact markets

It's important for investors to consider the cost of debt and use of leverage across economic and interest rate cycles:

- An extended period of very low (real) interest rates led to outsized returns and rapid growth in private investments. These flows increased competition within the private markets and created unfavorable imbalances in the market.
- Significantly higher interest rates impact funding costs, resale prices, and default rates, as well as financial performance.
- Asset values are in the process of adjusting to higher interest rates, which will impact financing strategies; default rates; and, ultimately, exit strategies for investments made during a period of very low interest rates.
- Recent investment underperformance in private markets suggests this adjustment is underway and is likely to continue over the coming months and years. Conversely, public market prices already reflect the impact of higher funding costs.
- Looking forward, we don't see the forces in place to reverse the outperformance of public versus private market assets in the near to medium term.

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