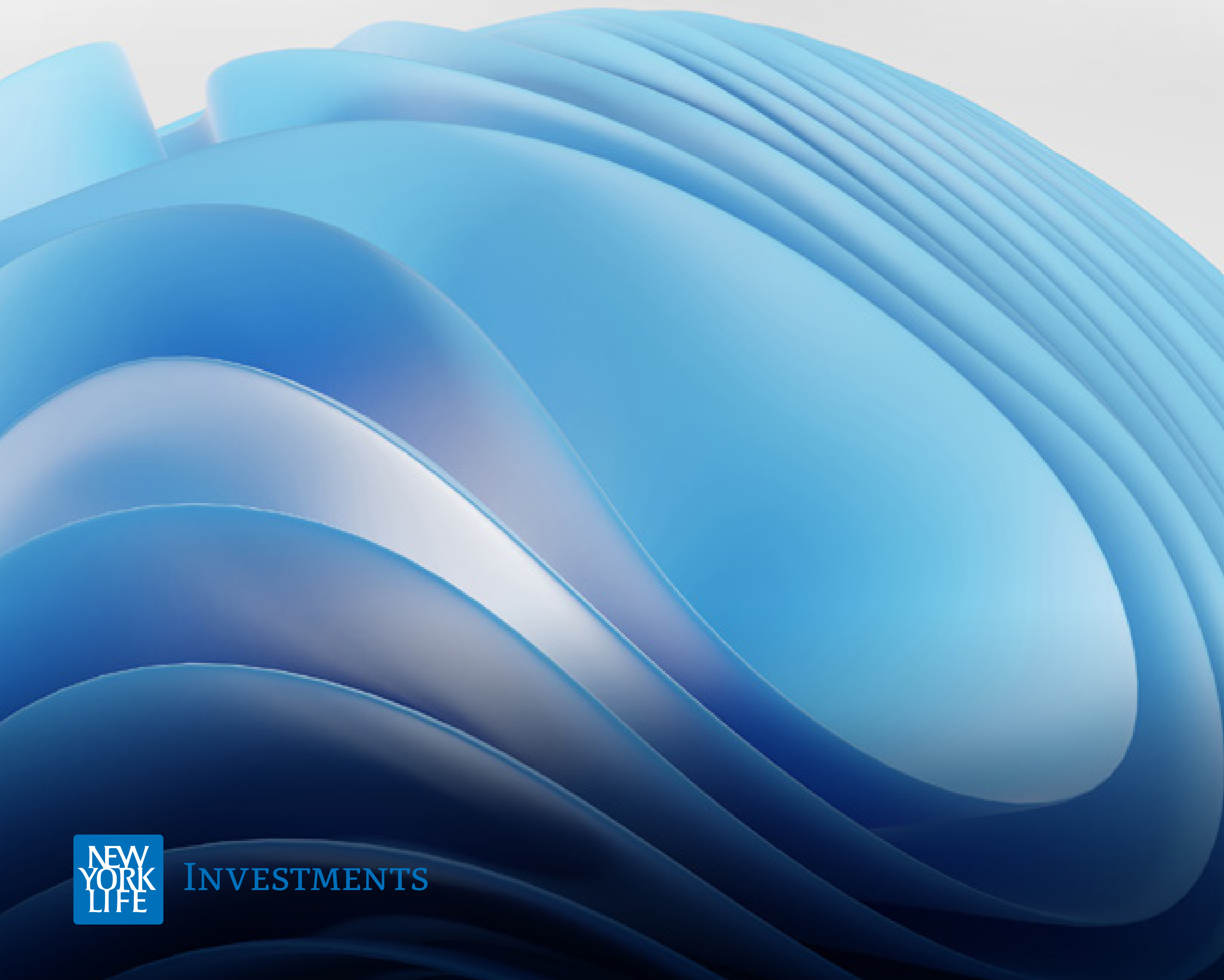
2024 HIGH-CONVICTION IDEAS

Building Resiliency into Your Portfolio Allocation

Key investment themes for a late-cycle environment



New York Life Investments

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EXECUTIVE SUMMARY

Our 2024 high-conviction ideas

Rarely have global allocators faced so much uncertainty across geographies and capital-market conditions. Timing the market is hard at the best of times, and today's environment of high economic variability and geopolitical uncertainty has led to concentrated positions among institutional and retail investors alike. That said, the very culprits of challenging conditions, such as higher interest rates, late-cycle economic dynamics and geo-economic shifts, may now be creating a pivot point to guide asset allocation.

The New York Life Investments' platform is designed to marry deep, on-the-ground asset class expertise with global markets and allocation themes. When we asked our global boutiques for their highest-conviction investment ideas, they pointed to tactical ways to lock in higher rates, alongside investing in structural themes to provide long-term resiliency. While these voices come from a range of disciplines across the public and private capital markets, some common themes emerged.

Fixed-income expert **MacKay Shields** argues that investors have a limited window to address reinvestment risk and get into position for the next phase in the rate cycle. MacKay believes that adding short duration exposure is not just an opportunity to lock in attractive yields but also a valuable asset class in long-term structural asset allocation.

Private real estate manager **Tristan** is also eyeing the limited window surrounding central banks' policy pivots. In Tristan's case, they are looking to deploy rescue capital in European real estate, cherry-picking tomorrow's recovery stories in markets that are currently in distress. Tristan is focusing on themes that benefit from secular tailwinds and long-run supply constraints.

The global fixed-income team at **Candriam** believes we are in a true bond-picker's market and is applying its rigorous bottom-up security selection approach to uncovering pockets of resiliency across a wide range of industry sectors and business models.

In the U.S. middle market, alternatives investor **Apogem Capital** is leaning in to the structural elements of the market that they think are more durable. One focus for them is the medium-sized companies that service the U.S.' industrial infrastructure base — a sector they believe is set to attract significant investment over the next 20 years.

Taking the infrastructure theme beyond the U.S., global equity manager **Ausbil** sees meaningful disconnects in the global listed infrastructure market and is leaning toward operators that stand to benefit from long-term secular trends such as the energy transition and artificial intelligence (AI).

In the direct lending market, **Kartesia** manages credit risk by focusing on non-sponsored lending to exploit durable opportunities among Europe's multitude of small-to-medium-sized businesses, many of which are family owned. In this model, the lender has the primary relationship with a company without the involvement of a private equity sponsor.

The potential late-cycle window of opportunity in short duration

For many fixed-income investors, cash and cash-like fund products were a hard option to argue with in 2023. With risk-free yields above 5% and a downward-sloping yield curve, there was little incentive to invest longer. But as the U.S. interest-rate cycle approaches a pivot point, we believe investors have a limited window to address reinvestment risk and get into position for the next phase.

MacKay Shields believes that short duration is not just an opportunity to lock in attractive yields for longer but also a useful asset class in long-term structural asset allocation. Today, looking holistically at the short-duration opportunity set across Treasuries, investment-grade credit and municipal bond markets, MacKay believes there are attractive opportunities to be found, not just from yield, but from a total return perspective as well.

Positioning for a pivot in the U.S. yield curve

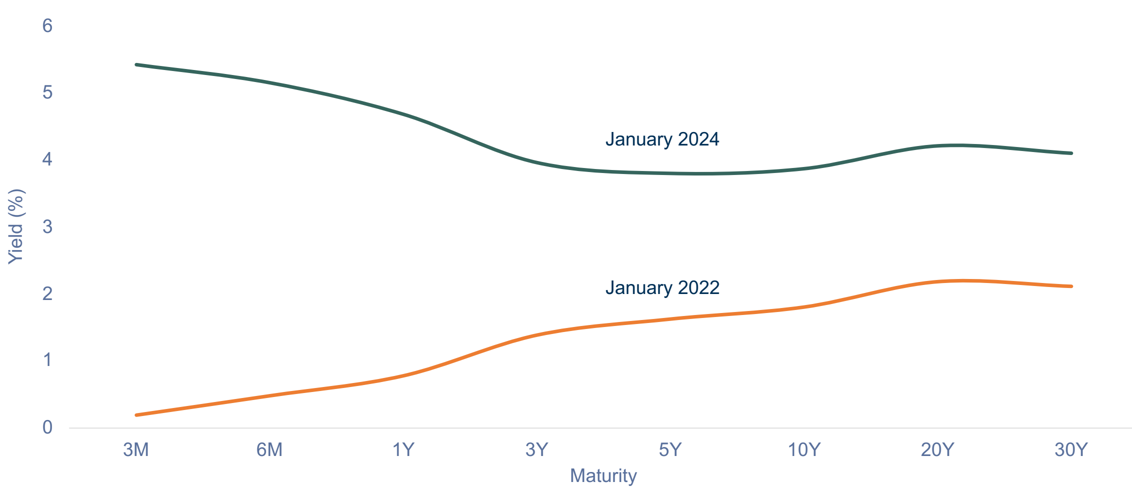
MacKay Shields agrees with the general market consensus that the U.S. Federal Reserve will start cutting rates in 2024. One of their higher-conviction investment themes is a "normalization" of the yield curve which, over the past two years, has become unusually inverted relative to history. Over the course of the year and possibly into 2025, MacKay Shields expects to see the curve steepen and long yields ultimately move back above yields on short-dated maturities.

If that's the case, and short-term rates move lower, then cash and cash-like securities would see diminishing total returns. As a result, MacKay Shields believes now is an ideal time to begin moving toward short-duration securities as an opportunity to lock in higher yields.

The optimal scenario for this trade would be an aggressive pace of rate cuts if the economy slows faster than expected. In terms of interest-rate risk, a large move from the Fed could cause a significant downward shift at the front end of the curve, causing short-duration strategies to outperform intermediate and long duration. In terms of yield, locking in today's higher interest rates could cushion a portfolio from the loss of that yield later in the year.

The biggest risk to this theme would be a resurgence of inflation, forcing the Fed to reverse course and hike rates again. However, investors are better protected from that scenario today because higher yields provide a cushion against capital loss. For example, at the end of January, one- to three-year Treasury yields would have needed to rise by 2.3% for investors to lose money over the course of one year. This time two years ago, that breakeven would have been closer to 0.2%.

The U.S. yield curve was far from "normal" in early 2024



As of 2 February 2024. Source: U.S. Treasury

It’s not just about today’s environment: short duration as a structural allocation

While the yield curve trade could be considered a tactical tilt, “short duration also has a role to play in core asset allocation,” says Thomas Musmanno, Portfolio Manager at MacKay Shields. “We believe short duration should be considered as an asset class in and of itself within the broader fixed-income universe.”

Long-term data support the argument for a structural allocation. Over the past 30 years, short-duration taxable bonds and short-duration municipals experienced less than a fifth of the volatility of the broad indices[1], but a significant proportion of the upside. Short taxable bonds returned 76% as much as the broad market while short municipals captured 67% of the upside. The drawdowns were also more muted: Short-duration bonds were more resilient in down months, experiencing roughly 40% of the losses suffered by the broad indices.

This attractive long-term profile suggests that today’s window in short duration is not just a way for cash investors to manage reinvestment risk. In MacKay’s view, it is also a potential entry point for less risk-averse investors. For example, those looking to take some risk off the table after the strong equity and long-duration fixed-income gains of late 2023.

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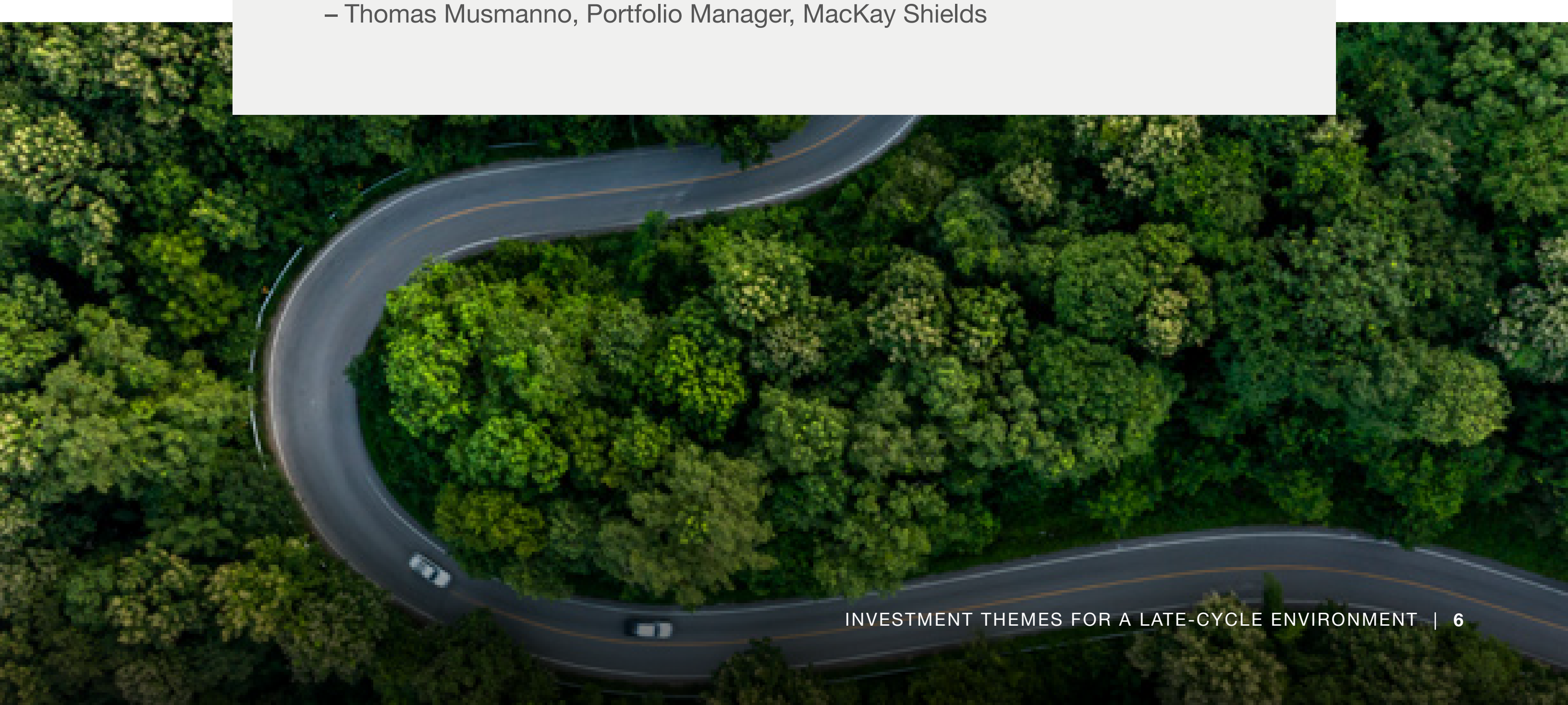
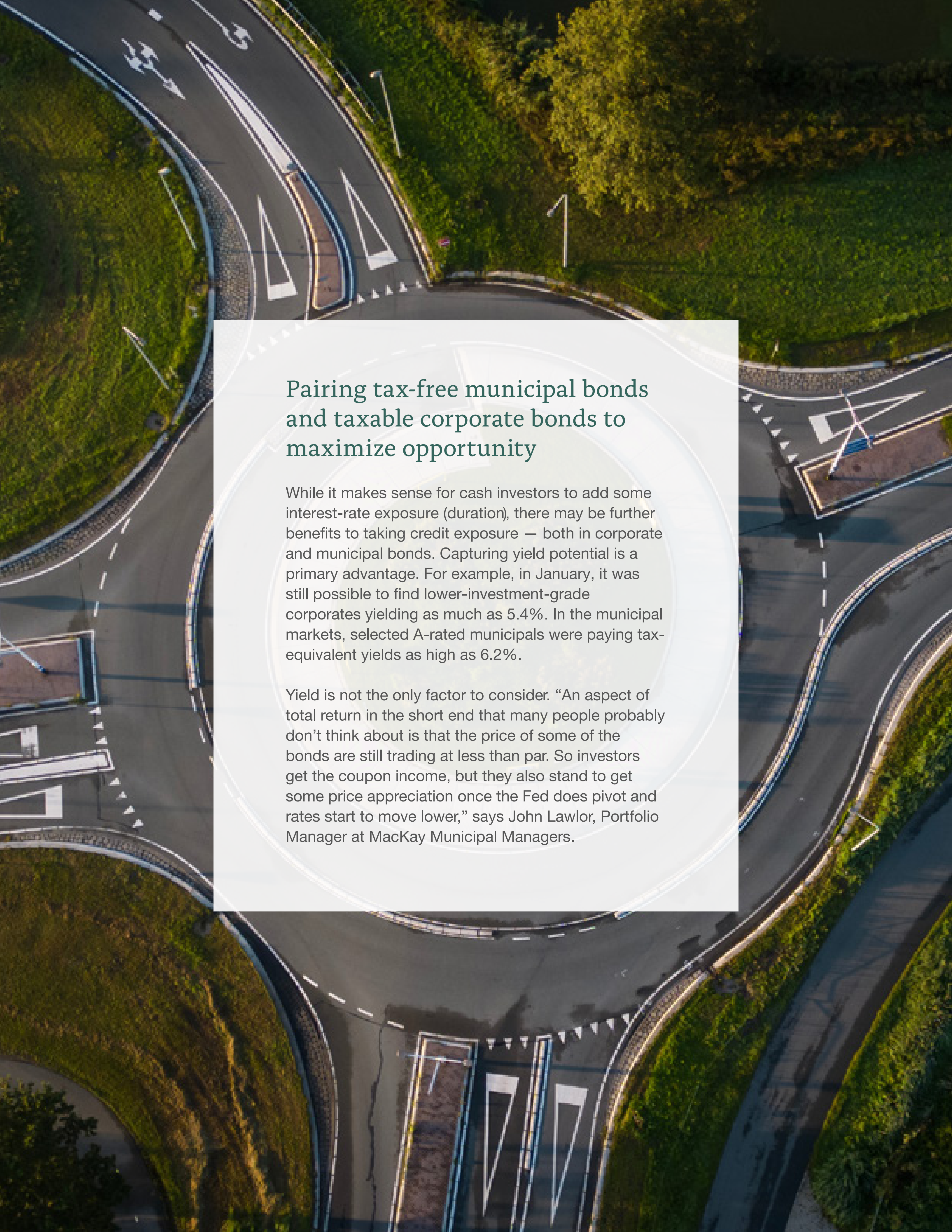
> – Thomas Musmanno, Portfolio Manager, MacKay Shields





Pairing tax-free municipal bonds and taxable corporate bonds to maximize opportunity

While it makes sense for cash investors to add some interest-rate exposure (duration), there may be further benefits to taking credit exposure — both in corporate and municipal bonds. Capturing yield potential is a primary advantage. For example, in January, it was still possible to find lower-investment-grade corporates yielding as much as 5.4%. In the municipal markets, selected A-rated municipals were paying tax-equivalent yields as high as 6.2%.

Yield is not the only factor to consider. “An aspect of total return in the short end that many people probably don’t think about is that the price of some of the bonds are still trading at less than par. So investors get the coupon income, but they also stand to get some price appreciation once the Fed does pivot and rates start to move lower,” says John Lawlor, Portfolio Manager at MacKay Municipal Managers.

In terms of credit fundamentals, “municipal credit quality has seldom been stronger, offering potential resiliency in the event of weaker-than-expected economic growth,” says Lawlor. Driven by strong sales tax receipts, last year’s collections reached all-time highs while budgetary reserves are nearly double that of pre-pandemic levels.

On the taxable-credit side, Musmanno expects a slowdown in the ratio of credit upgrades to downgrades but does not anticipate an increase in downgrades to below investment grade this year. Instead, he sees numerous pockets of opportunity. For example, banks generally stand to benefit from a normalization in the yield curve. He thinks resilient consumption should continue to support the asset-backed market and is positive on auto receivables and equipment lease securitizations.

In the short-duration space, MacKay Shields believes that security selection decisions should be made in the context of the whole opportunity set, across municipal and taxable markets, government and corporate. MacKay Shields believes an integrated approach yields better relative-value insights and lends itself to both tactical trades and opportunistic sector rotation.

Deploying rescue capital in European real estate

Since 2022, rising interest rates have driven a dramatic repricing in the European real estate sector. Rising rates have impeded the efficient functioning of the market, leaving many deals and refinancings stuck in hiatus. But, as we approach the turn in the cycle, this is set to change. Private investors now have the chance to find credit and equity opportunities in markets that are still under pressure.

“It now makes sense to start identifying credit and equity opportunities that offer the best risk-adjusted return. More often than not, those are found where there’s some element of distress or dislocation, where people have been stretched by the conditions they’ve experienced over the last two years,” says Simon Martin, Chief Investment Strategist at Tristan Capital Partners. He sees potential in Germany — which is now paying the price for past overinvestment in real estate and construction — and in Sweden.

What could drive capital flows into the private real estate market?

Liquidity conditions in the private real estate market can shift rapidly between feast and famine. Martin suggests that the catalyst for capital to start flowing depends less on the exact timing of rate cuts and more on a recognition by the markets that the tightening cycle is ending and a sense that yields are now compressing in the three-to-five-year segment of the yield curve. This view has been gaining currency amid weakening economic data in the euro area.

At the same time, Martin is cautious as U.S. capital flows, which have played a key role in previous European real estate cycles, may be less quick to return if more resilient growth in the U.S. causes rate cycles to diverge. Equally, there is palpable distress in U.S. commercial real estate (CRE) markets, and Martin is concerned that U.S. investors have less incentive to look elsewhere.

"But in Europe's favor," says Martin, "there's a buffer of equity capital that's been raised for European opportunities and wants to get to work. And short-run U.S. capital flows won't change the direction of travel for most of the people in the European real estate, private equity or private credit industries." In fact, the absence of U.S. flows may mean that this is an opportunity for European and Asian capital to enjoy a more open playing field.

Investing in resiliency

With the UK and Germany already in recession and weak data from other large countries such as France, Tristan thinks the region as a whole is unlikely to escape a recession over the next year or two. Against that backdrop, quality is likely to attract a premium as the market attaches high importance to underlying operating fundamentals and resiliency.

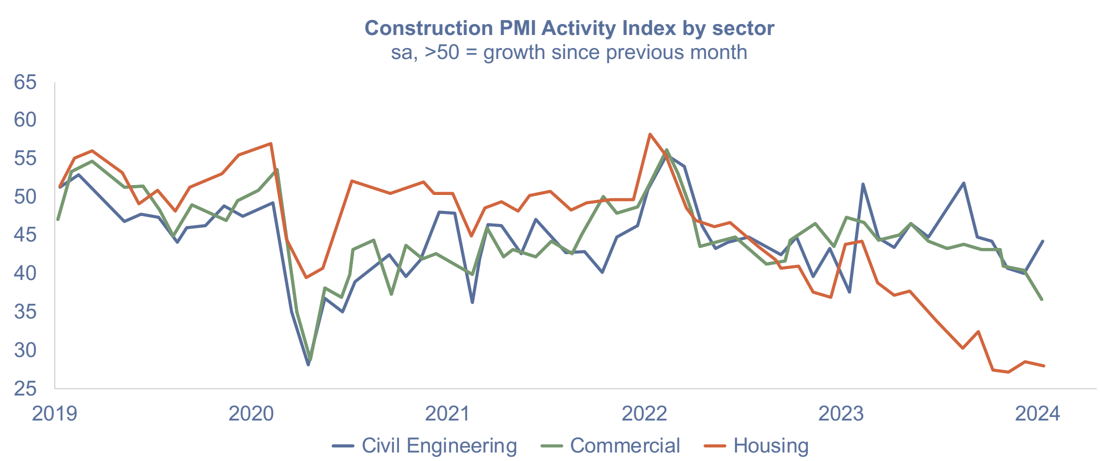
"We are focusing on themes that benefit from secular tailwinds, where there are underlying fundamentals that can create real long-run supply constraints. Looking forward, those are the areas that can deliver the strongest operating performance and are going to attract the most demand as international capital flows pick up again," says Martin.

These themes typically revolve around structural change, such as more flexible ways of working, decarbonization goals and changes in the way data and information flows are regulated.

One area of focus for Tristan is innovation infrastructure, meeting the needs of data centers, life sciences and tech-enabled research and development. "We have some of the best academic institutions and knowledge workers on the planet, but we don't have enough infrastructure to support their needs," says Martin. "We need to build the right kind of space in the right locations, and we need to do that in an environmentally sustainable way."

Another long-term opportunity lies in addressing supply constraints arising from decades of underinvestment. For example, Europe desperately needs to add to its logistics infrastructure. The proviso, says Martin, is that potential returns will depend on location. The real need is in the inner urban areas, which are relatively land constrained. Another example is the UK's severe shortage of affordable multi-family housing. Martin sees "a huge generational opportunity" in building future-proofed stock for the 21st century.

German construction sector downturn has deepened



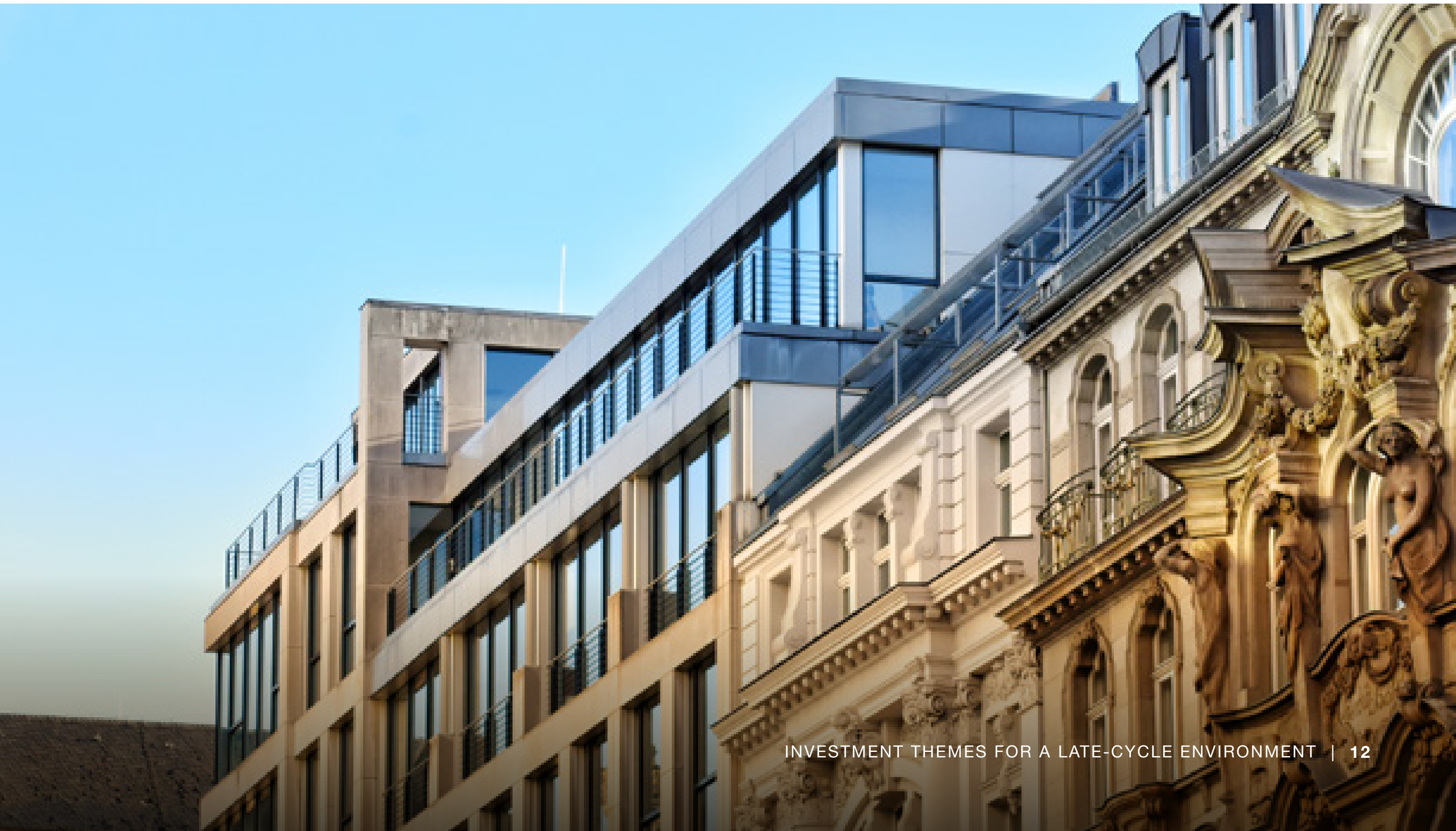
Sources: HCOB, S&P Global PMI.

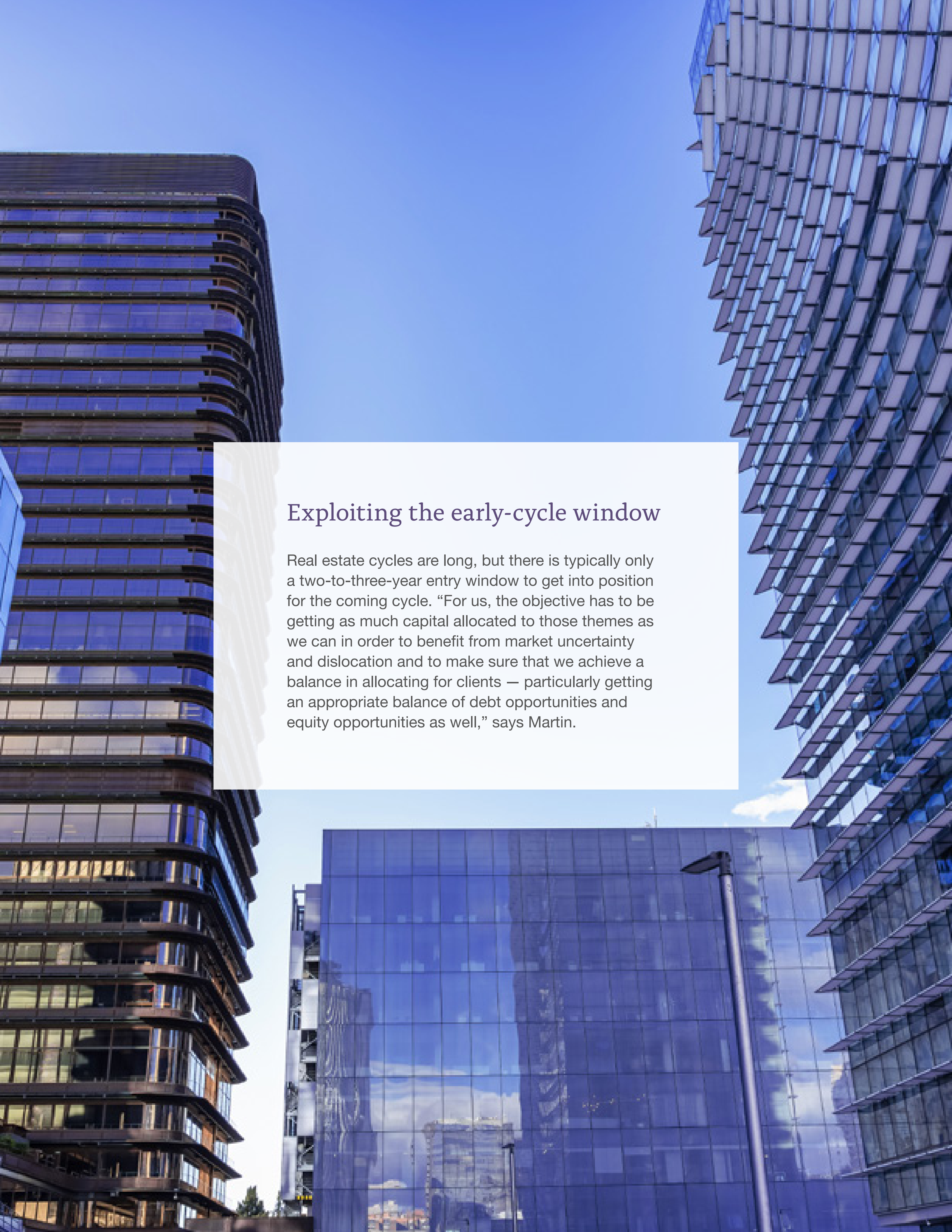
A quantum leap in operational intensity

One implication of exploiting themes like secular change is that private real estate investors need a different skill set. In January, Martin spent several days on the phone with quantum computing experts to understand how quantum computing might change the nature of infrastructure in data centers. “This is not something I would have been doing 10 years ago,” he says. “We are having to become much more involved in the nuts and bolts of our underlying tenants’ business operations, more so than we ever were before.”

In general, the once-typical scenario of being able to buy an office building and lock in a long-term lease with a single tenant is becoming much less common. Martin believes the real estate industry is becoming even more private equity-like in its mindset. Operating intensity — specifically in the management of operating cash flows — has increased enormously, making the ability to operate the underlying real estate a key differentiating factor in the marketplace. “It’s not just about how to find the opportunities; it’s how to drive value, and that now entails a lot of operational granularity, which in turn takes more resources and domain expertise to execute properly.” He cites the complexity of managing Tristan’s 6,500-bed student housing portfolio.

Particularly in a region like Europe, investors need the installed capacity to operate in multiple markets with different economic, regulatory and capital market regimes. This typically entails multiple partner relationships and the ability to build operating companies in different markets, that can execute on these strategies.





Exploiting the early-cycle window

Real estate cycles are long, but there is typically only a two-to-three-year entry window to get into position for the coming cycle. “For us, the objective has to be getting as much capital allocated to those themes as we can in order to benefit from market uncertainty and dislocation and to make sure that we achieve a balance in allocating for clients — particularly getting an appropriate balance of debt opportunities and equity opportunities as well,” says Martin.

Uncovering pockets of resiliency across global bond markets

Bond yields are higher than they have been for many years, rightly putting the asset class back on investors' radar. By contrast, average credit spreads are relatively tight, which means they aren't adequately pricing risk. Yet the 2024 investment environment is one of high economic and geopolitical uncertainty, with more than usual potential for negative surprises.

Two ways for investors to succeed in this environment are to focus on case-by-case issuer/security selection to ensure they are getting paid for the risks they take, and to look for ways to build resiliency into their portfolios.

“We are entering a true bond-picker’s market, where idiosyncratic risks have moved to the forefront and company-specific analysis is needed to separate the winners from the losers. In the absence of central bank support, dispersion has returned. Bond returns are once again going to be driven by the fundamentals. Markets which were until recently driven by central banks are now more influenced by economic data, balance sheets and business models.”

– Charudatta Shende, Head of Client Portfolio Management for Fixed Income, Candriam

Resiliency can take many forms in addition to getting those all-important issuer-specific fundamentals right. It may mean gravitating to issuers in less cyclically sensitive sectors, leaning toward those that are adapting to (or helping to deliver) structural change, or finding issuers that stand to gain from geopolitical events.

Reducing cyclical sensitivity in portfolios

At the industry level, two areas of focus for Candriam this year are telecoms and healthcare, which have historically been relatively insensitive to the ups and downs of the economic cycle.

In addition to being cyclically resilient, these sectors have relatively low ESG risk exposure because they are not major greenhouse gas emitters. This means that in highly regulated jurisdictions like Europe they are less exposed to tightening regulation than, for example, auto manufacturers, and they face less onerous capex costs in order to align with European Union (EU) decarbonization targets.

Leaning toward more future-proof business models

"Digitalization, automatization and artificial intelligence trends have a strong influence on business activities. Issuer ability to adapt will be vital," says Shende. One group of issuers that is not just adapting to secular change but helping to drive it, is the mobile phone tower operators. These operators enjoy high barriers to entry and are resilient to economic and inflation pressures given the long-term nature of the contracts they have with mobile network operators. For example, operators in Europe can typically lock in contracts with tenors of eight to 15 years with anchor tenants, and pricing is often CPI linked.

Growing demand for data is likely to be supported by factors such as greater use of artificial intelligence and more data-hungry applications, helping to drive the roll-out of fifth generation (5G) wireless technology. The new generation requires a greater density of towers than 4G, and the 5G spending cycle still has room to grow, so tower infrastructure is a theme set to run for several years.

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Exploring the second-order effects of geopolitical uncertainty

A key risk factor in the European market since 2022 has been the ongoing Russia-Ukraine war. But geopolitical events can create opportunities as well as risks. For example, as EU sanctions cut off purchases of Russian gas, European countries have turned to the U.S. liquid natural gas (LNG) industry to meet its considerable needs.

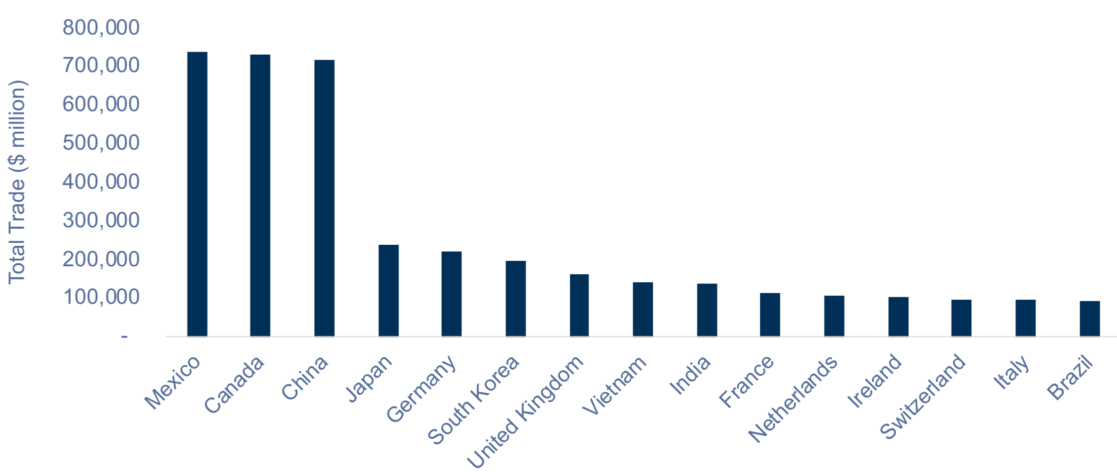
The U.S., which did not start selling LNG overseas until 2016, has now become the largest exporter in the world, overtaking Australia and Qatar, and the Ukraine crisis has dramatically increased profits for LNG companies. While these issuers are not a good fit for more environmentally focused investors, from an emissions perspective, gas is less polluting than coal or oil. This makes it a “bridge fuel” option for users that have not managed to make the transition to renewables yet.

Tilting toward Latin America

Among emerging markets, Candriam believes that Latin America could be a relatively resilient region this year. For one thing, there is somewhat less potential for surprises on the political front. In a year that is setting all-time records for global election activity (roughly four billion people are scheduled to vote in more than 60 countries) the LatAm election calendar is comparatively quiet.

More importantly, the region is positioned to benefit from major secular change as the world has been moving away from peak globalization. “Nearshoring” and continued trade tensions between the U.S. and China have created a huge boost for Mexico, which has been experiencing a manufacturing boom since 2019. Last year, Mexico overtook Canada as the US’ top trading partner, while U.S.' purchases of goods from China dropped by about 20%. While Mexico has been the biggest nearshoring beneficiary, countries such as Colombia and Brazil also stand to benefit.

Mexico is now the biggest trading partner with the U.S.



Source: Bloomberg

Redemption stories in Europe's periphery

During the 2009-2014 European debt crisis, investors started using the acronym "PIGS" for Portugal, Italy, Greece, and Spain — the troubled peripheral countries that saw their bond spreads skyrocket, pricing in extreme pessimism about their prospects relative to the safe and sensible core countries like Germany and France.

But, following fiscal reforms, by the beginning of this year, Portugal's sovereign debt was trading at spreads that were close to those of France. Greece, too, has been rewarded by the markets for several years of political stability and fiscal responsibility as its spreads have tightened materially, trading below those of Italy.

"We are entering a period in which fiscal policies and political risks will return to the forefront," says Shende. "Indeed, markets are paying greater attention to budgets, and to the impact of higher rates on debt sustainability. In the past, the distinction was primarily between core and peripheral markets, but we expect a rather more diverse context in the future."

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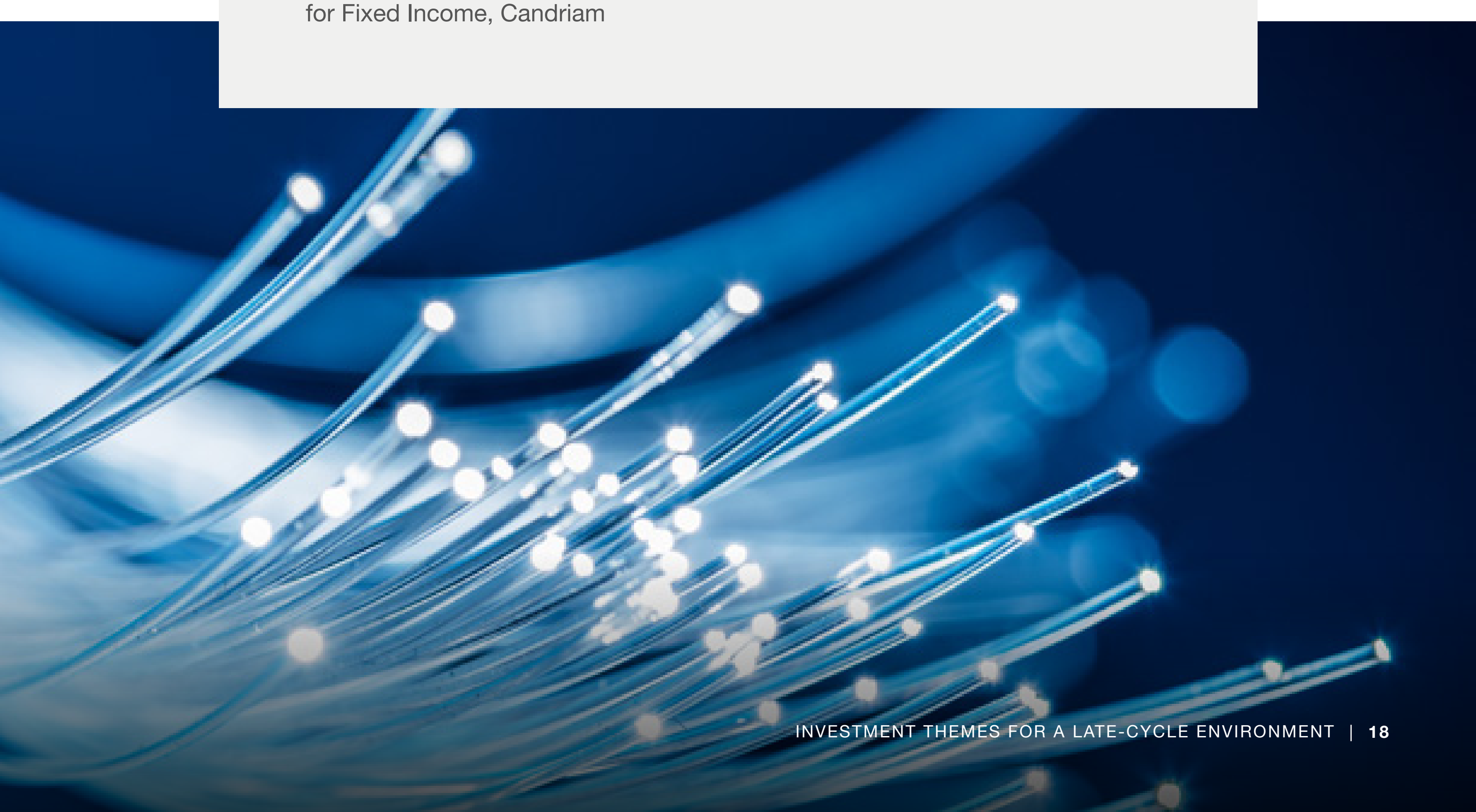

Finding structural resiliency in the U.S. middle market

The nature of the U.S. slowdown in 2024 is still under debate. On the one hand, we have not yet seen the full extent of increased costs of capital, which are still working their way through the economy. On the other hand, factors such as strong government spending in areas like infrastructure have contributed to resiliency in the real economy, and this could make the credit cycle milder than it has been in past recessions.

For medium-sized businesses and the private capital investors that finance and invest in them, what will be the sources of long-term resiliency in the years ahead?

"While we are not thematic investors, one area we've been focusing on recently is companies servicing the U.S. industrial infrastructure base. We think this sector is going to attract significant investment over the next 20 years."

– Richard Wiltshire, Managing Director of Private Equity, Apogem Capital

The long-term opportunity in U.S. industrial infrastructure

In the past, companies that provide services or products to the U.S. infrastructure base might have been considered too cyclical for Apogem's strategy, but in recent years the dynamics have changed.

Trade tensions and growing geopolitical uncertainty have seen a rise in reshoring and onshoring. COVID-19-related supply shocks have increased the emphasis on redundancy of supply chains, with the mindset shifting from "just in time" to "just in case." Trends such as these have been driving higher utilization rates and capacity expansion for many businesses, increasing the scarcity value of these assets and mitigating potential cyclicality.

For example, in 2022, Apogem co-invested in a provider of high cost-of-failure flow control parts and repair services for industrial and marine applications. Utilization rates in industrial facilities, such as refineries and chemical plants, are increasing to support a growing North American manufacturing base, making the cost of downtime more expensive for infrastructure owners and potentially resulting in more stable demand patterns and pricing power for suppliers.

"It's an area we weren't focused on five or six years ago. But, over the last two to three years, it has become an area of real interest to us," says Wiltshire. "We believe this sector will be more resilient across macroeconomic cycles. Strategically allocating to this sector represents one way we are seeking to build resilient portfolios through fundamental underwriting of both companies and industries."

A roadmap to a more resilient portfolio

When underwriting new businesses, Apogem is applying three key principles as it seeks to manage the downside participation in the current environment.

1. "The first 12 months are crucial," says Wiltshire. "While we typically invest with a five- to 10-year horizon, it's typically in the first year that the company will be at its highest leverage position, so we are increasingly focused on developing conviction on what a company can do in that initial period."

This depends on visibility into factors like order backlogs and recurring revenues. During the first year, General Partners (GPs) are typically implementing value-creation plans that may require changes to the business, so visibility into those plans is crucial to understand the potential investments required.

2. Apogem is focusing on companies that can grow independently of the overall macroeconomic environment, often targeting businesses with significant free cash flow, recurring revenues and regulatory-driven demand for a business's products or services.

For example, Apogem is a co-investor in a company that provides technology solutions to increase traffic and pedestrian safety across America, including making pedestrian crossings safer and more accessible.

"New restrictions and regulations are being enacted that give us confidence about the tailwinds for that business over the next several years. And we think the fact that the spending is mostly government mandated could make the business relatively recession-proof," says Wiltshire.

3. Apogem is prioritizing investments with GPs and/or management teams that have strong track records and a history of successfully managing businesses through prior recessionary environments.

After the sharp dislocation during the 2007-08 financial crisis, Apogem believes the private equity industry is in a stronger position to manage through macroeconomic shocks. “Most GPs have been preparing for a recession for several years,” says Wiltshire. “COVID-19 was a test of GPs’ readiness and most reacted decisively.”

Demand shocks can be opportunities to act offensively to gain market share and improve pricing power. In 2019, Apogem made an equity co-investment in a company that distributes produce for restaurants, primarily in the hotel industry. When COVID-19 struck, the company’s customer base shut down, taking its revenues to near zero overnight.

“The GP acted decisively, formulating a plan with the management team in which we went in, proactively worked with the lenders, injected equity into the business and really invested in playing offense,” says Wiltshire.

The capital injection enabled the company to support their suppliers, locking up supply in long-term agreements by helping to fund producers through the pandemic. The company worked aggressively to gain market share with new and existing customers. When the economy rebounded, the company’s earnings power had significantly improved from prior to the pandemic.

A more resilient industry

From this success story, one lesson for private equity investors is the importance of ensuring that they have plenty of capital reserves to support existing positions in the event of a macroeconomic shock.

“In our experience, the analytical toolkits and the resources that operators have today are more developed than they were during the Global Financial Crisis, and they have more experience managing through challenging macroeconomic environments,” says Wiltshire. “We think companies and GPs today are better positioned to weather the storm. Whatever the timing or nature of the landing, the industry is going into it with eyes wide open.”

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> – Richard Wiltshire, Managing Director of Private Equity, Apogem Capital

ausbil

Leveraging three disconnects in global infrastructure

Disconnects between price and intrinsic value in the global listed infrastructure market are creating compelling opportunities for equity investors, says Ausbil Investment Management. In terms of earnings potential relative to price, many of the regulated water utilities, electrical utilities and mobile phone towers are still trading well below long-term average price-earnings multiples. And many of them stand to benefit from long-term secular trends such as the energy transition and artificial intelligence (AI).

"We're at an inflection point where the outlook for earnings growth has turned more positive in infrastructure assets as we have reached a stabilization phase in interest rates. Our outlook for return on equity invested in infrastructure is rising with stronger cash flows from the impact of inflation and the more normalized rate environment which we have entered."

– Tim Humphreys, Head of Global Listed Infrastructure, Ausbil

Inflation tends to benefit essential infrastructure cash flows, either through pre-agreed increases in tolls and receipts, like toll roads, or through agreed inflation in the overall asset base against which some infrastructure assets are able to earn a percentage return, including regulated water utilities. There is also a compounding element: as companies are allowed to increase their pricing, the incremental increases in tolls or fees collected from customers can compound over years and decades to come. This effect bolsters companies' ability to fund future projects, distribute dividends and preserve their value in real terms.

Electricity grids are benefiting from disruptive technology

Ausbil believes that investing in the "poles and wires" of electricity transmission grids is one of the most exciting opportunities today.

For the grids, one driver of increased capex growth is the additional load growth from data centers and AI. "We recently met with the CEO of a U.S. electric utility who reported that Microsoft is proposing to build a data center in their state to house some of its burgeoning AI capabilities. The required power for this data center is estimated at around 1 gigawatt — roughly the same as the output from a large nuclear reactor, and this is just for Phase 1 of the project," says Jonathan Reyes, Co-Head of Global Listed Infrastructure.

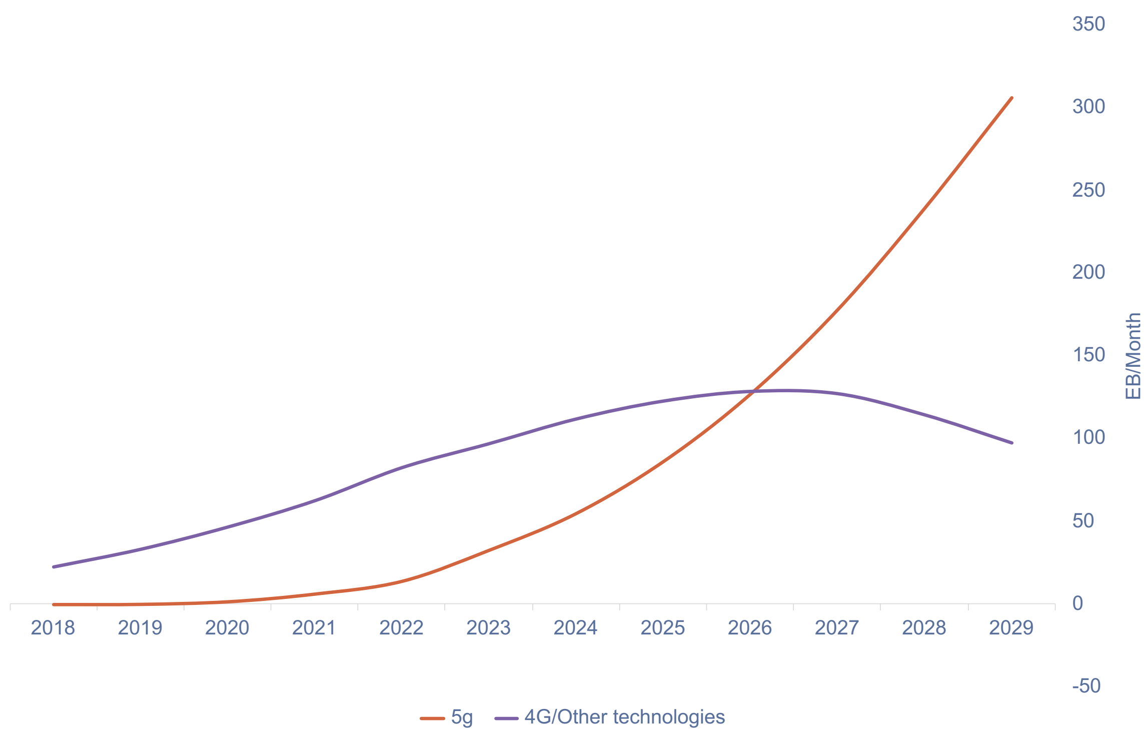
A second driver of capex is the need to connect and integrate a far greater amount of renewable energy as countries seek to decarbonize their economies. In Europe, for example, historically, asset base growth in electrical utilities was typically 0% to 2% before inflation, driven mainly by asset replacement due to aging infrastructure. Today, the grid operator Elia Group is forecasting growth in its regulated asset bases of around 25% per annum in Germany and 18% per annum in Belgium for the period 2023-28. The main drivers are a combination of decarbonization and data demand.

Tower operators will be winners from 5G

Like earlier generations of communications technology, 5G adopts radio wave technology rather than transmitting through physical conduits, so it is invisible and not something you can touch or feel. However, there is a visible aspect to 5G: the tangible tower and small cell network that powers the transmission of information that makes the whole system work. Ausbil considers this a key area of opportunity for essential infrastructure investors.

5G waves are able to carry more data than 4G, but the trade-off is that they are not able to travel as far — a few hundred meters with present technology — compared with lower frequency 4G which can carry data several kilometres. This means that a 5G network requires up to 10 times more towers, base stations and small cells to provide blanket wireless coverage for users to achieve the same reach as 4G. Mobile phone tower operators stand to benefit significantly from the need to "densify" networks to support the growing demand for data.

Global mobile network data traffic is soaring



Source: Ericsson

Potential upside from the UK's water challenges

Water is typically monopolistic in nature, given that most utilities in this area typically operate as the only provider of water and waste services in their jurisdictions.

One area that Ausbil believes offers attractive elements of yield and growth is the UK, where the need for much greater investment in water and sewage infrastructure presents "an unprecedented growth opportunity for UK water companies."

After decades of underinvestment, the UK needs much higher investment to protect water quality, enhance the resiliency of the networks, address storm overflows, reduce leakage rates and manage the risk from climate change. The three listed UK water companies are projecting a step-up in total expenditure on their networks of between 73% to 92% in real terms from 2025-29 compared with 2021-24. "This increase, if approved by regulator OFWAT, could translate into real Regulated Capital Value growth of between 25% to 37% over the period," says Ausbil.

A window of opportunity for infrastructure investors

"In summary," says Humphreys, "we see the compelling value proposition for infrastructure over the next 12 months as being a combination of three things."

"First is the short-term underperformance of listed infrastructure relative to global equities, which has led to a significant valuation upside opportunity."

"Second, the benefits of recent inflation are yet to feed through into revenues and cash flow, and — with inflation set to remain above trend for the next few years — this benefit will take several years to be fully reflected in higher profits."

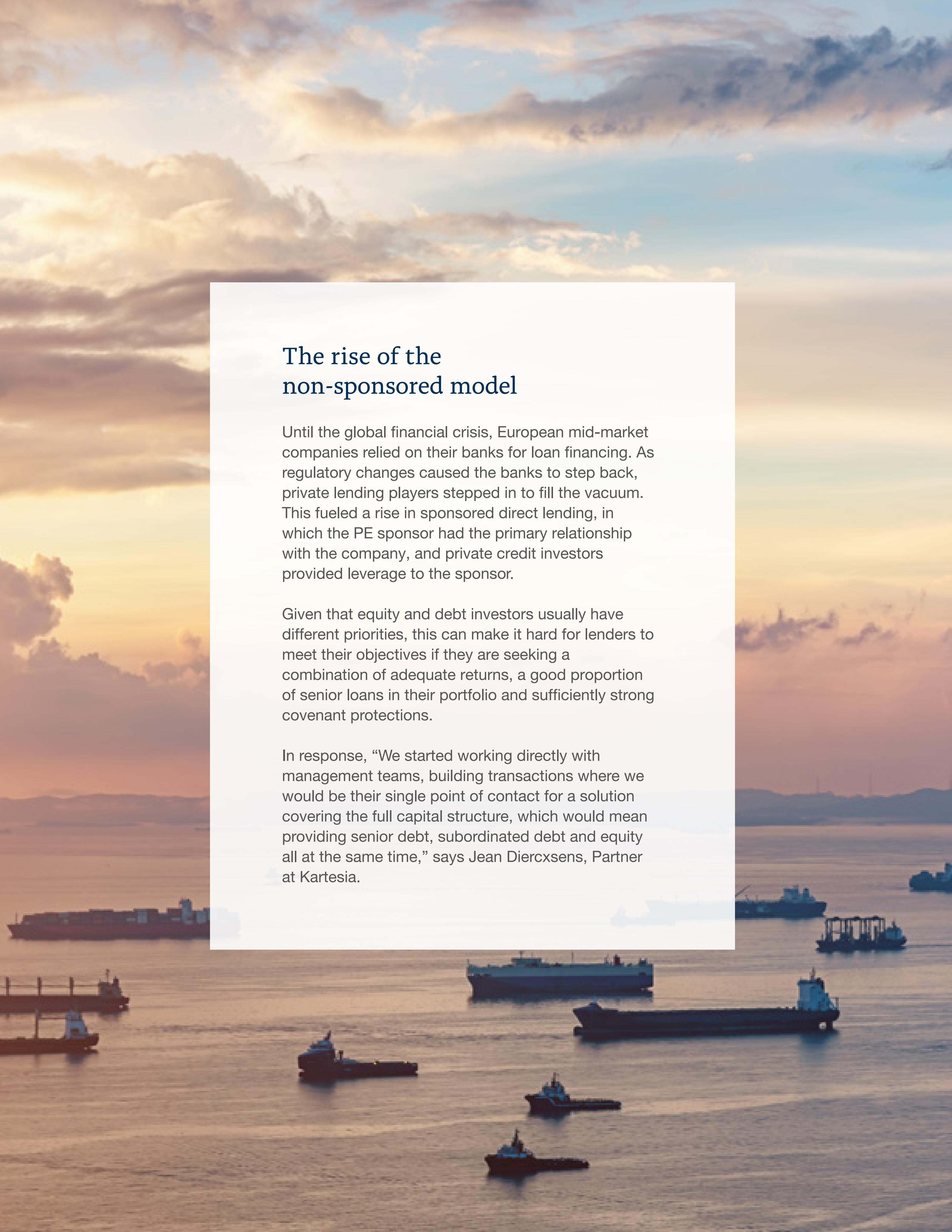
"Finally, the sector stands to benefit significantly from long-term secular growth drivers such as the energy transition, repowering Europe, mobile phone technology transition from 4G to 5G and the impacts of AI."

KARTESIA

Unlocking Europe's lower mid-market with non-sponsored lending

In the European lower-middle market, direct lenders are carving out a niche among the region's multitude of small-to-medium-sized firms, including many family-owned businesses. The model they are using is non-sponsored lending, in which the lender has the primary relationship with a company, without the involvement of a private equity sponsor.

Kartesia, which is a pioneer of the non-sponsored model in Europe, argues that this approach can be more advantageous both for lenders and the businesses they finance. And, for asset allocators, non-sponsored lending in this segment of the market can offer attractive diversification potential.



The rise of the non-sponsored model

Until the global financial crisis, European mid-market companies relied on their banks for loan financing. As regulatory changes caused the banks to step back, private lending players stepped in to fill the vacuum. This fueled a rise in sponsored direct lending, in which the PE sponsor had the primary relationship with the company, and private credit investors provided leverage to the sponsor.

Given that equity and debt investors usually have different priorities, this can make it hard for lenders to meet their objectives if they are seeking a combination of adequate returns, a good proportion of senior loans in their portfolio and sufficiently strong covenant protections.

In response, “We started working directly with management teams, building transactions where we would be their single point of contact for a solution covering the full capital structure, which would mean providing senior debt, subordinated debt and equity all at the same time,” says Jean Diercxsens, Partner at Kartesia.

The opportunity in the European mid-market

Private capital transaction volumes in Europe's mid-to-large market tend to be driven by the M&A and equity valuation cycles. The smaller-ticket, higher-volume deal flow at the smaller end of the market is less dependent on M&A, with capital needs driven by a wide range of factors.

Some businesses are under pressure to grow or to be outgrown in fragmented markets that are consolidating. Others are seeking to grow market share by internationalizing, either into the larger countries in Europe or into Asia and the U.S. Family-owned businesses may need capital, either to make acquisitions or to keep the business within the family. Cash may be needed to buy out younger generations who are unwilling to continue their family businesses.

For the large private capital players, the high labor intensity of analyzing multiple smaller opportunities is often a constraint. Only a small portion of lower mid-market companies are sponsor-backed, making Kartesia's addressable market opportunity "multiple times larger," says Diercxsens.

With greater control comes great responsibility

Non-sponsored lending allows lenders to be in closer control, but it also makes greater demands on them.

In a sponsored deal, the lender can look to the PE sponsor to perform comprehensive due diligence and, in a distressed scenario, to provide governance and operational support, together with further capital injections to see the business through to recovery.

Non-sponsored lenders therefore need the analytical resources, expertise and dry powder to support portfolio companies both operationally and financially, without the support of a third party.

More than half of Kartesia's investments so far have been in non-sponsored companies. "Coming from an opportunistic credit background, we're comfortable getting our hands dirty and taking on a lot of the work that a sponsor would otherwise do for us," says Diercxsens.

Non-sponsored lending can be a better fit for business owners

From a borrower's perspective, the non-sponsored model can also be attractive.

Private equity can negatively impact shareholders in that they may lose control, or they may need to sell the business to provide the minority equity holders with the required returns. Non-sponsored lenders can support businesses in a more flexible way than banks can on the senior side of the equation. And they can provide solutions across the capital structure that are less dilutive than private equity while allowing companies to reach the same growth goals.

Kartesia argues that the direct partnership approach creates a better alignment of interests, making counterparts less reluctant to accept meaningful controls from the lender, including board-level representation. This in turn helps the lender manage its risk.

"Family-owned or management-owned businesses see us not just as a provider of capital but as a partner that has gone through cycles and dealt with distressed credit situations in the past," says Diercxsens. "So, they value the fact that we won't run for the hills if things don't go as planned, and that the continuity of the company will be the first thing Kartesia will have in mind."

The current opportunity

Kartesia invests in just 5% of the deals it evaluates. One guiding principle is to find lower mid-market companies that have the potential to reach the midcap or upper midcap status. "We invest tickets as low as EUR 10m that can grow to over EUR 200m in one single platform company," says Diercxsens.

Kartesia lends to companies with an entry EBITDA[2] anywhere from EUR 5m to EUR 20m with an emphasis on clear-cut value propositions and defensible cash flows, typically involved in B2B (business-to-business, software and industrial activities). Deal flow in the past year has involved a wide range of businesses including managed IT and telecommunication services, a provider of high-speed internet solutions in rural areas, a market leader in the field of skin and laser therapy, and a leading producer of end-of-line packaging machinery.

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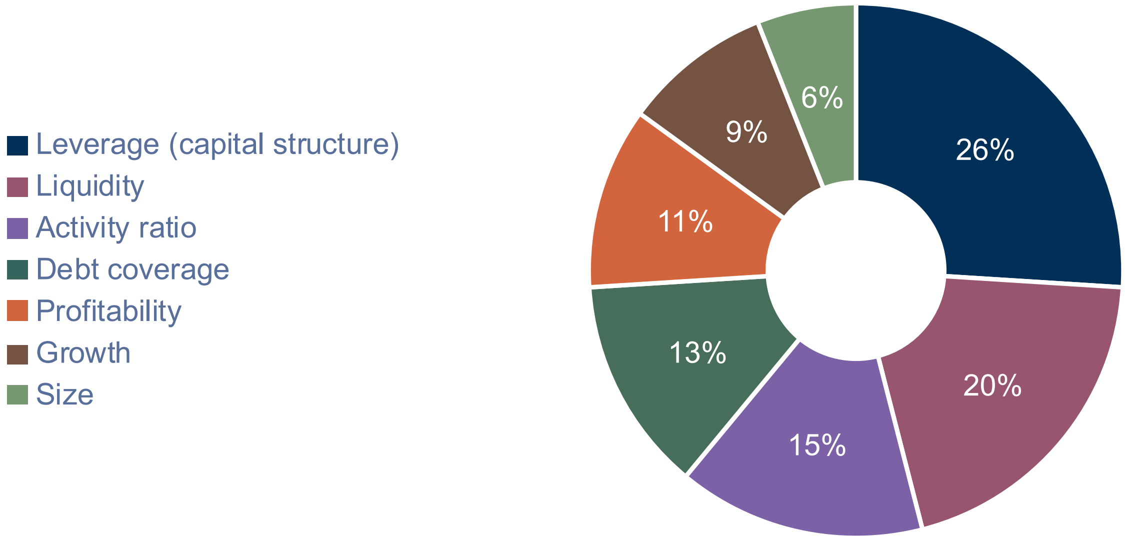
Company size explains only 6% of default frequency



Source: Deerpath Capital; Moody's Analytics RiskCalc 4.0 U.S., April 30, 2012; Campbell Lutyens

To asset allocators who perceive smaller companies as risky, Kartesia cites a Moody's study[3] finding that only 6% of defaults are explained by size, while the vast majority of defaults are explained by leverage, liquidity, activity ratio, debt coverage, profitability and growth. The study covered more than 9,000 defaults over 16 years.

"On average, bigger companies have been operating for longer and on average they have better market diversification," says Diercxsens. "But it's our job to select businesses that are not the average. Kartesia finds businesses that have a growth plan and that have typically been able to build a strong, defendable position for themselves in their niche."

> "It's our job to select businesses that are not the average. Kartesia finds businesses that have a growth plan and that have typically been able to build a strong, defendable position for themselves in their niche."
>
> – Jean Diercxsens, Partner, Kartesia

NOTES

[1] As of December 31, 2023. Municipal 2-4 Year Index vs. Municipal Bond Index and Bloomberg 1-3 Year Gov/Credit Index vs. Bloomberg U.S. Aggregate Bond Index. It is not possible to invest directly in an index.

[2] Earnings before interest, taxes, depreciation, and amortization.

[3] Moody's Analytics RiskCalc 4.0 U.S., April 30, 2012. The study covered more than 133,000 individual borrowers with over 9,000 defaults over a 16-year period.

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