22 April 2024

04
Is this a new era for private markets?

13
Private debt, the rising of the market underdog

23
Private equity, turning challenges into opportunities

28
Real Estate, with every downturn there are opportunities

33
Private infrastructure, from niche to nexus

Allianz Research

Global outlook for private debt & private equity: private(r) for longer?

Executive Summary

Jordi Basco Carrera
Lead Investment Strategist
jordi.basco_carrera@allianz.com

Pablo Espinosa Uriel
Investment Strategist, Emerging Markets & Alternative Assets
pablo.espinosa-uriel@allianz.com

Maria Latorre
Sector Advisor, B2B
maria.latorre@allianz-trade.com

Yao Lu
Sector Advisor
yao.lu@allianz-trade.com

- **High inflation and escalating interest rates have tempered enthusiasm in private markets.** These factors induced investor caution and lowered return expectations last year, breaking a decade-long asset class growth (~13% AUM yearly). Despite this, private assets remain attractive to institutional and retail investors seeking higher yields, inflation hedging, reduced market volatility and diversification. The persistence of relatively higher long-term interest rates, combined with stronger-than-anticipated corporate earnings, is expected to maintain interest in private asset segments, such as private debt, among a diverse investor base.

- **Easing monetary policy and modest growth are expected to renew interest in private markets.** Anticipated monetary policy easing later in the year could stimulate some parts of the private marketplace such as private equity through improved valuations and renewed IPO activity. For private debt, a lower yield environment could improve debt repayment capabilities and help avoid prolonged defaults if interest rates remain high for too long or even climb to higher levels. However, private markets remain vulnerable to several external pressures that could dampen investor confidence. The prospect of enduring high interest rates, rising default risks, geopolitical tensions, and widespread liquidity shortages are significant concerns that could negatively impact sentiment if conditions worsen.

- **Private debt as an asset class grew by 60% to USD1.6tn in the last 5 years, transforming a niche financing option for small and medium-sized enterprises (SMEs) into a crucial element of the alternative investment scene.** This asset class now encompasses roles from rescue financing and aiding in corporate restructurings to supporting acquisitions and covering capital and operational expenses. We anticipate continued growth (+15% AUM growth yearly), driven by "ex-ante" liquidity premium and returns, although some defaults in pro-cyclical sectors are likely. Direct lending is expected to remain dominant (~50% of private debt market) and to keep evolving into a democratized asset class.

- **Economic downturn and regime changes often create opportunities in private markets, particularly for distressed debt.** As a fact, the largest fundraising increases recorded ever for distressed debt funds occurred during recession years such as 2008 (+504% y/y), 2020 (+211%) and 2023 (+77%). While most funds have been raised in the US, a greater volume of distressed companies is expected in Europe. Indeed, European firms have been feeling more the shock from geopolitical conflicts, with SMEs in parallel being more exposed to imminent debt maturities than US peers. According to our research, ten out of the 15 countries expected to see a double-digit rise in business insolvencies in 2024 are European, with the Netherlands leading with a +31% year-over-year increase. Credit rating agencies also echo this view, with the number of rating downgrades outpacing upgrades in the high-yield segment. If high interest rates persist, highly leveraged companies, particularly in real estate, will face a distressed cycle.

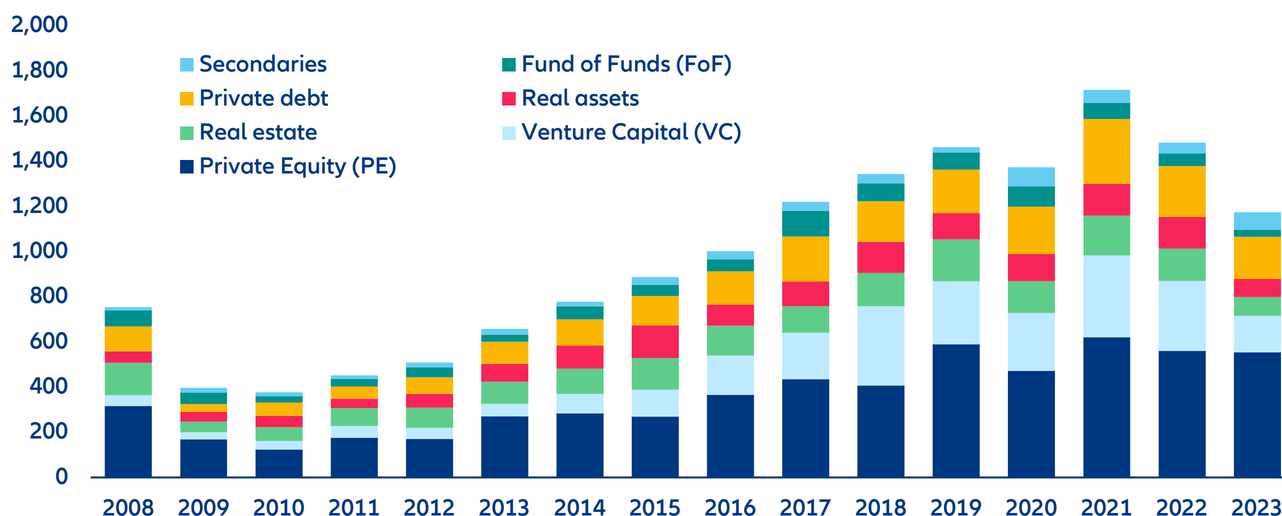
- **Private equity continues to scout for transformational growth agents like AI, ESG, healthcare, platforms and reshoring despite recent market volatility.** Sharp interest rate increases in the past two years have significantly reduced private equity (PE) activity, with global exit values plummeting more than 60% from their 2021 peak. However, renewed earnings resilience and mega-trends like artificial intelligence (AI), ESG and reshoring, alongside a shift in monetary policy, suggest a rebound in PE activity with improved valuations (~+15% in 2024) and an uptick in IPO activity, although distributions (income and capital to investors) might remain sparse in 2024 but reaccelerate in 2025.
- **As private assets become more accessible and widespread, the distinct behavior of liquid and private assets will blur and potentially reduce the liquidity premium associated with private markets.** This trend is likely to persist, especially with the expansion of secondary markets. Nonetheless, in times of economic downturns and market volatility, the inherently riskier characteristics of private assets are expected to emerge, resulting in underperformance vis a vis its traded counterparts.

Is this a new era for private markets?

The high macroeconomic uncertainty of 2023, continuing into 2024 and 2025, suggests ongoing challenges in private corporate financing. The year 2022 started with a vibrant private market fundraising and deal-making scene, only to see a deceleration as inflationary pressures led central banks to hike interest rates. Entering 2023, economic and geopolitical turbulence further strained the private assets landscape. Increasing corporate financing costs and uncertain revenue expectations have prompted investors to reduce liquidity risk, leading to a decline in fundraising for private assets throughout 2023. On the exit side, private market managers continued to hold assets rather than sell in a depressed valuations environment contributing to a slowdown that restricted activity. Limited Partners (LPs[1]) experienced a drought in distributions (money paid to investors), curtailing further investments as the asset class yielded minimal returns. Within this landscape, riskier private assets like venture capital (VC) and real estate saw the most significant declines in fundraising (Figure 1).

[1] A Limited Partner (LP) is an individual or an entity that contributes capital to a fund but does not participate in its management. These are often institutions like pension funds, insurance companies, foundations, or wealthy individuals.

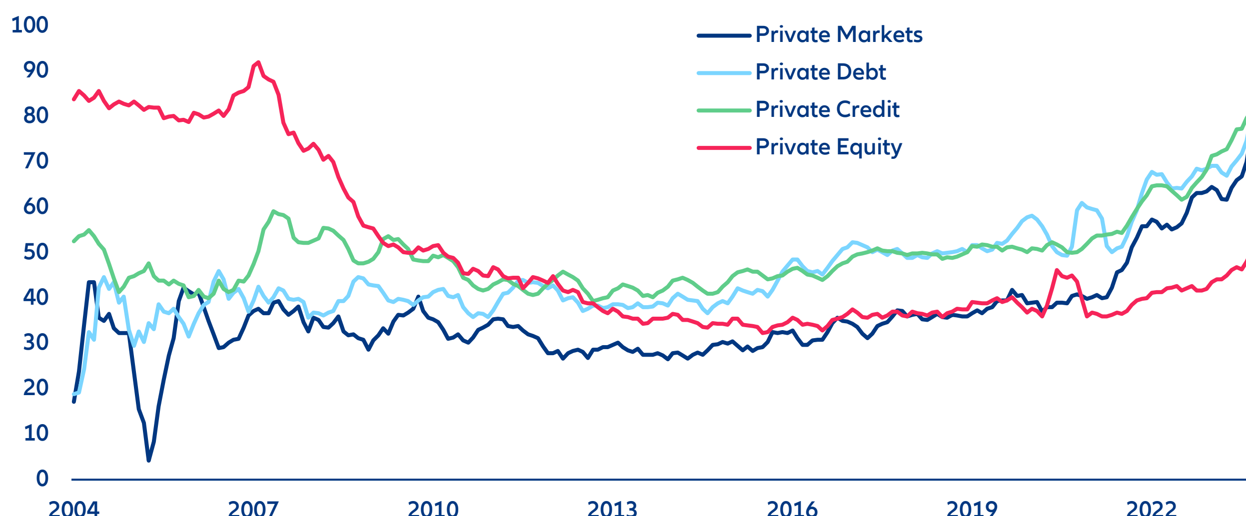
Figure 1: Private capital raised by strategy (in USD bn)



Sources: Pitchbook, Allianz Research

Despite the deceleration in fundraising and dampened enthusiasm for private markets, the sector's allure remains strong, driven by superior yields and a perceived reductions in market-related risks. This interest is bolstered by the "ex-ante" attractive liquidity premium[2] associated with these type of assets. Evidence of this heightened interest is observable through an analysis of Google Trends data, which shows search activity for private investment related terms reached unprecedented levels across most private asset categories. Private Equity (PE), a cornerstone of the private asset domain, remains an exception to this trend. As it already demonstrated a capacity to flourish in terms of returns and investor interest, particularly during periods of market prosperity, such as the equity market boom of the late 1990s and leading up to the 2008 Global Financial Crisis (Figure 2).

Figure 2: Google trends for private markets related words (a measure of "interest" / "search volume") (six-month moving average)

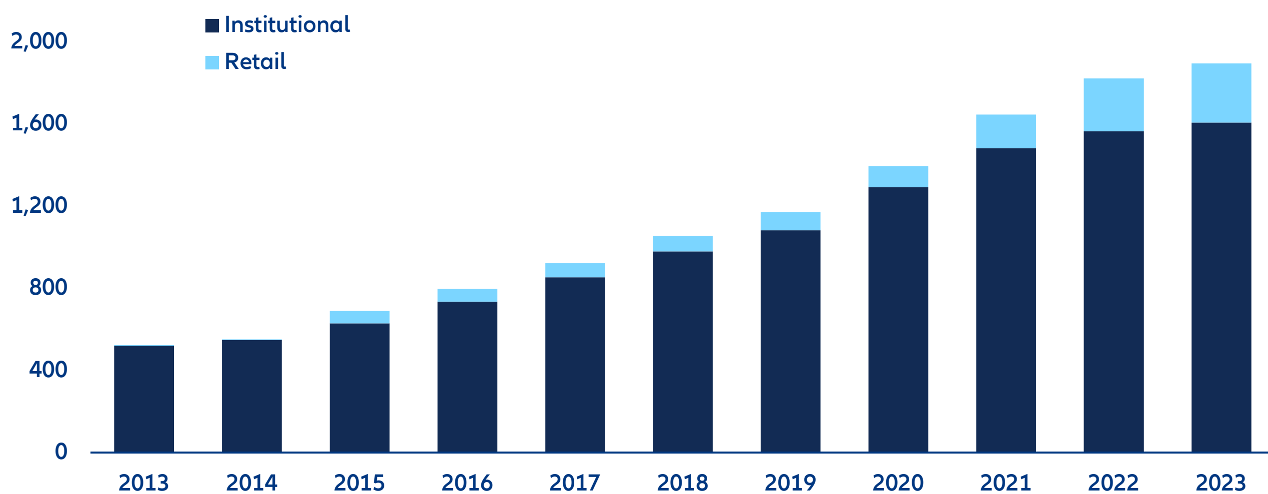


Sources: Google trends, Allianz Research

[2] Liquidity premium is the additional compensation used to encourage investments in assets that cannot be easily or quickly converted into cash at fair market value.

What has created this push for private assets? Several factors have driven the surge in private asset investments. Notably, the 2008 global financial crisis prompted traditional banking institutions to adopt more cautious lending practices, leading businesses to seek alternative funding. Private investments emerged as a solution for these capital needs, offering a simpler route than the complexities of going public. For investors, private assets attracted attention due to their perceived diversification benefits, appealing returns in a low interest rate era and potential for long-term value growth with less volatility than public markets. These benefits also caught the eye of institutional investors like pension funds and insurance companies, which increasingly allocated funds towards these assets. Their ability to commit capital over the mid- to long-term and withstand elevated liquidity risks makes these institutional investors the ideal candidates for private asset investments. However, interest in this asset class is spreading to private investors, signaling a growing demand for the democratizing of access to private markets. Retail investors are increasingly drawn to these assets for returns and diversification being willing to incur some liquidity risk (Figure 3).

Figure 3: Private debt assets under management split by type on investor (USD bn)



Sources: Pitchbook, Allianz Research

While private asset markets offer many benefits, they face liquidity and high interest rate challenges. Private assets offer less liquid than public markets, posing risks for investors, particularly retail investors unfamiliar with locking in their capital for extended periods without clear return estimates. This liquidity risk is apparent during market downturns, as seen with the lack of distributions to investors from private equity funds in 2023 and the still low volumes in the secondary market[3]. Transparency issues can also arise, leading to information asymmetry and complicating valuations. Although private asset managers may provide information as detailed as that available for publicly traded companies, this is not always the case. This can lead to poor information transmission and misrepresent the risks and returns associated with private assets.

However, private assets tend to shield investors from public market volatility and offer stability, returns, resilience and diversification. Moreover, while the illiquidity of private assets is often a drawback, it can also be perceived as a lucrative investment opportunity for experienced managers. Additionally, private real

[3] Secondary market refers to the buying and selling of pre-existing investor commitments to private-equity and other alternative investment funds.

assets provide long-term, inflation-adjusted cash flows, which enhance portfolio resilience and hedge against inflationary pressures and the possibility of enduring interest rates. Furthermore, these assets typically show low correlations with traditional listed equities and bonds, providing valuable diversification and additional sources of alpha.

What to expect moving forward? Moving forward into 2024 and 2025, the macroeconomic climate of persistently high interest rates and resilient corporate performance is expected to continue spurring demand for private assets from across all investor types. Private assets should remain a compelling source of risk-adjusted returns, income and diversification. Yet, higher financing rates and increased perceived liquidity risk may prevent early-stage companies from accessing financing, such as Venture Capital (VC).

We believe private assets will continue to cement its position in markets and grow, particularly on the debt side. However, not all private market participants will enjoy a smooth ride. Informed selectivity and experience across different business cycles will be critical in achieving the extra return provided by private assets. This is particularly relevant as financing rates may present too high a barrier for certain sectors and/or corporates.

The numerator and denominator effect in private assets

The functioning of private markets leads to notable allocation and flow effects. To set the context for the overarching narrative of recent trends within private markets, it is essential to delve into factors contributing to the observed deceleration in activity. To unravel this paradox, we explore the underlying mechanics of the traditional "numerator" and "denominator" effects in private markets. These terms stem from a simplified asset allocation equation, which is pivotal in understanding the dynamics at play.

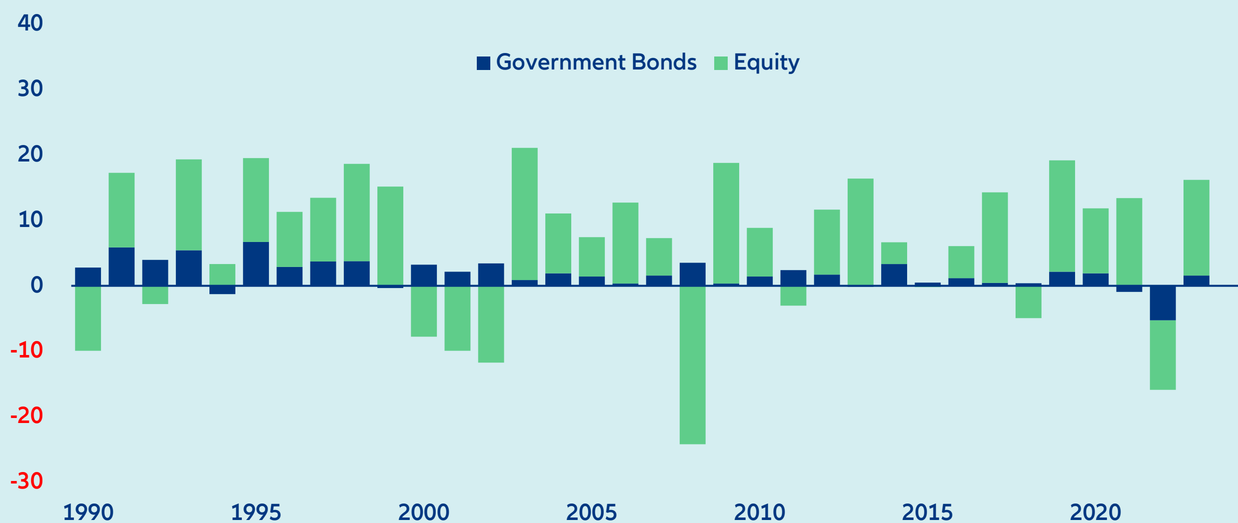
$$\text{Private Asset Allocation as \% of total portfolio} = \frac{\text{(Private Asset Value)}}{\text{(Total Value of the Portfolio)}}$$

In the context of portfolio management, an illustrative example occurs when the overall value of a portfolio experiences a downturn, while the valuation of a specific private asset either remains stable, decreases at a slower rate or cannot easily be liquidated in times of stress. Under these circumstances, the proportion of the private asset class within the overall portfolio would increase. To analyze this situation, the allocation formula can be influenced in two primary ways: either by adjustments in the "numerator" (asset value), by changes in the "denominator" (total portfolio value) or by a mix of both.

The phenomenon known as the denominator effect played a significant role in 2022 as asset allocators contended with volatility within public markets. The period was marked by substantial public fixed income and equity market losses amid stagflationary market adjustments. In this tumultuous environment, global equity markets saw an average downturn of approximately 18%, while government bonds experienced a decline of around 13%. Consequently, the conventional investment strategy, typically characterized by a 60-40 allocation between equities and bonds repectively, witnessed a performance dip nearing 15%. This level of decline is a rarity, observed only a few times over the past century (Figure 4) .[4]

[4] See our complete analysis on debt-equity diversification here: Is diversification dead? (allianz.com).

Figure 4: Global 60-40 portfolio yearly performance (in %)



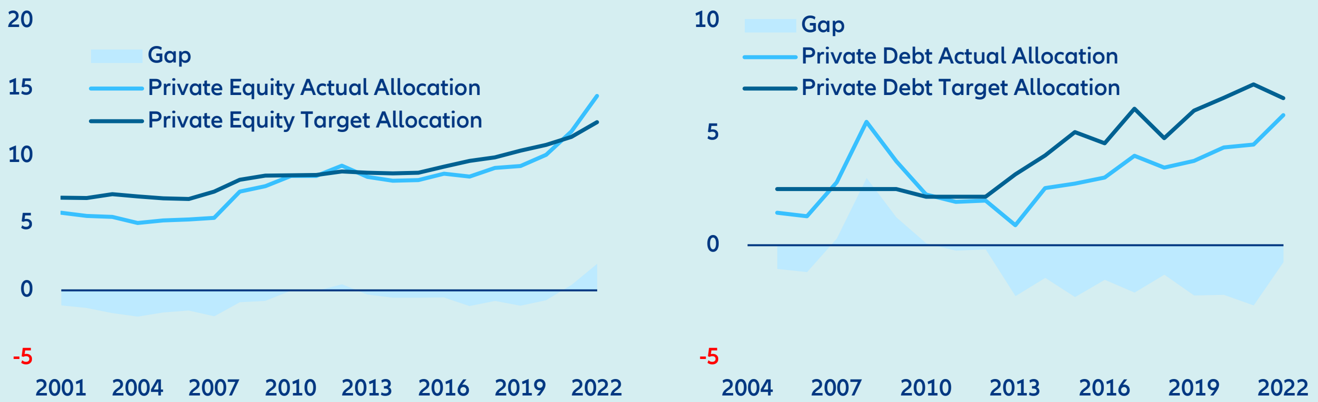
Source: LSEG Datastream, Allianz Research

This unusual situation led to a pronounced decrease in the denominator of the portfolio allocation equation, resulting in a passive increased representation of private assets within the average investor's portfolio, leading to an undue concentration in illiquid investments. From an asset allocator's perspective, the strategies to counteract such a scenario vary considerably. For large investors, if market volatility is regarded as an external anomaly, portfolio managers might opt to ride out the fluctuation, maintaining the disproportionate allocation until the liquid segment of the portfolio recovers, effectively waiting for the denominator to increase. Alternatively, investors can offload some private assets on the secondary market to recalibrate their overall asset distribution. This strategy primarily adjusts the equation's numerator more than the denominator. A more moderate approach involves allocators curtailing future commitments to private assets, thereby indirectly realigning the targeted allocation by subtly reducing the numerator while awaiting an uptick in the denominator. Intriguingly, since the secondary market for private assets lacks substantial liquidity and dynamism, most asset allocators favor the first or third approach. This is because the prospect of selling at significantly reduced valuations in the secondary market, thereby locking in substantial losses, tends to be an unattractive course of action.

Adopting a "hold" strategy, which hinges on the anticipation of falling long-term yields boosting bond values and a rebound in equity markets, has not yet produced the anticipated outcomes in the immediate aftermath of 2022. Specifically, the public fixed income segment of portfolios has struggled to rebound from the downturn it experienced in 2022, indicating that a full recovery could take several years. In contrast, equity markets have shown resilience with a swift V-shaped recovery in 2023, recouping much of the previous year's losses. However, this dynamic presents challenges, particularly for major investors in private markets, such as pension plans and insurance companies, which typically have substantial fixed income allocations. The underperformance of the fixed income portion of their portfolios represents a significant setback, necessitating an extended recovery period. This situation will lead to a persistent overrepresentation of the illiquid assets in their portfolios for some time.

Considering the denominator effect, a noticeable disparity emerges across different asset classes within private markets. While the impact of the denominator effect varies, it leads to distinct outcomes for these asset classes. Focusing on the United States and based on data from several public pension funds, it becomes clear that private equity often has a disproportionate representation within investment portfolios. Conversely, despite gaining traction, private debt remains below the anticipated target allocation (Figure 5 and 6).

Figure 5 and 6: Average private equity and debt allocation for US public pension plans (in %)

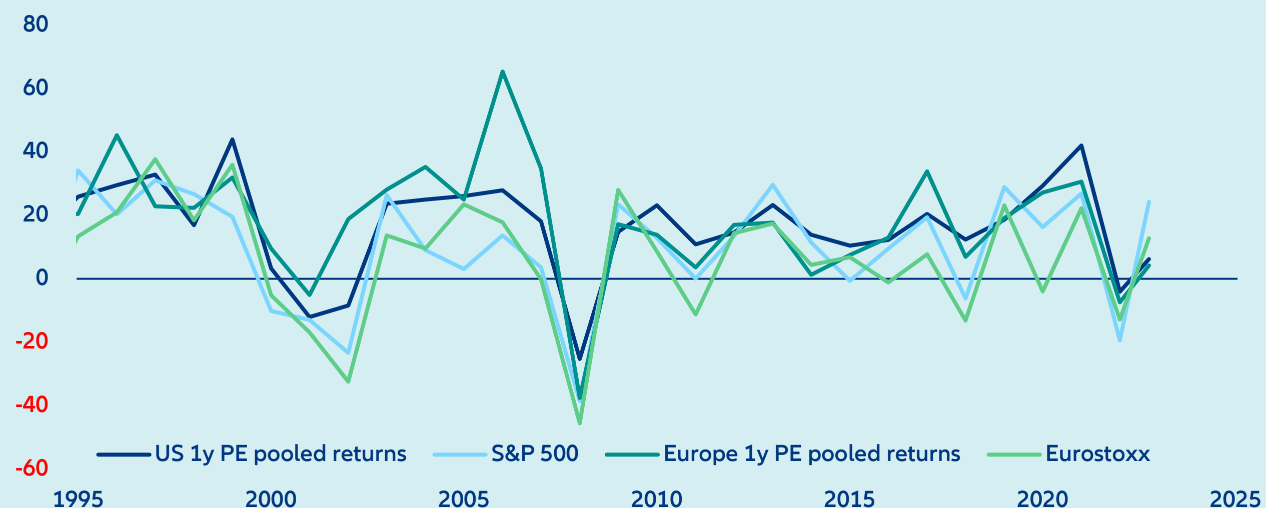


Source: publicplansdata.org, Allianz Research

In exploring the variables that influence the valuation of private assets and their allocation, it's essential to also understand the dynamics shaping the numerator of the equation. A critical factor is the pace at which price discovery occurs for private assets, which is markedly slower than that for publicly traded entities. Within secondary markets – where stakes in private assets or funds are traded – a more immediate reflection of these assets' market value is observed. This mechanism is crucial for the timely price assessment of private assets and highlights the disparity in the development of secondary markets for private equity versus private debt. The secondary market for private debt is still developing, lacking a solid framework for robust mark-to-market valuations. This deficiency leads to significant delays in price adjustments for private debt compared to equity, potentially widening the valuation gap. Such discrepancies highlight the need for a more established secondary market for private debt to enhance price discovery and reduce valuation lags. These valuation timing factors exacerbate the overallocation to private assets, as the value of these investments, acting as the numerator, often decreases more gradually than the market value of the portfolio, or the denominator, in a downtrend.

Moving away from valuations, it's crucial to note that private investments, owing to their more illiquid and riskier characteristics, generally yield higher realized and expected returns compared to public investments. This trend suggests that, on average, private assets often generate superior performance, thus amplifying the numerator relative to the denominator effect. This often results in an additional overrepresentation of the asset class within the portfolio (Figure 7).

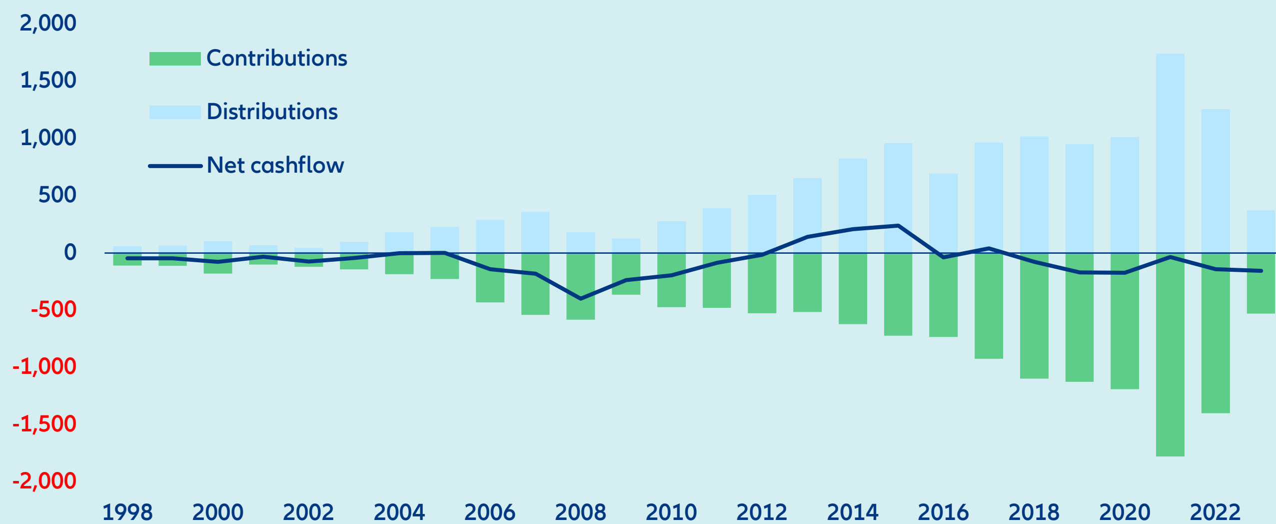
Figure 7: US and Europe private equity performance (yearly returns in %)



Source: LSEG Eikon, Cambridge Associates, Allianz Research

In private capital, a critical dynamic worth highlighting is the interaction between distributions and contributions – essentially, the capital flows – within this asset category. Over the past five years, private capital markets have experienced either stagnant or negative net inflows. This trend indicates that contributions have surpassed distributions, resulting in a modest increase in the asset base, although the impact remains relatively minor. However, this pattern of negative net capital flows prompts a deeper concern as it may lead portfolio managers to reevaluate the inherent risk associated with these asset classes. Such a reassessment could stem from doubts about the expected rate of distributions (returns), potentially deterring future investments in private assets (Figure 8).

Figure 8: Private Capital contributions and distributions (in USD bn)



Sources: Pitchbook, Allianz Research

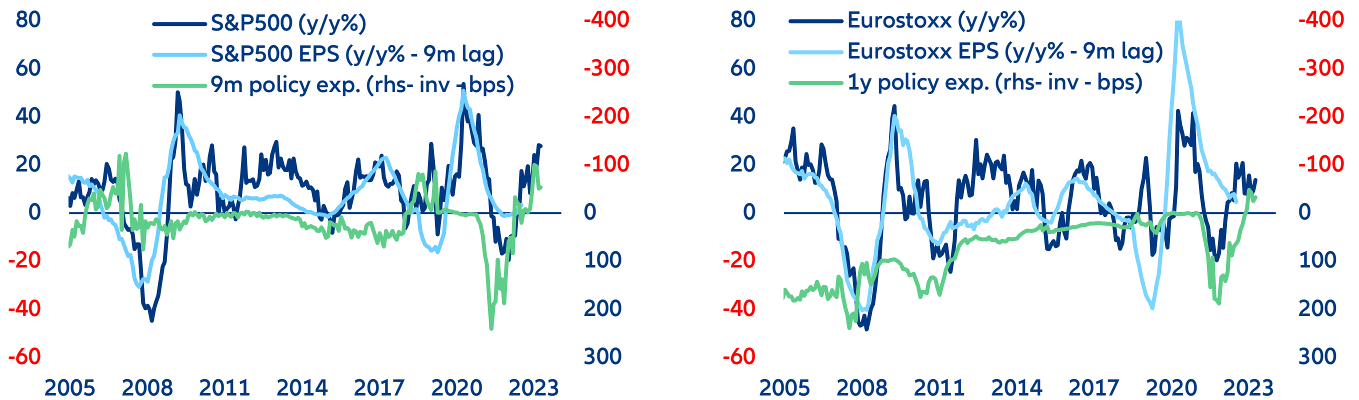
The business cycle continues to show resilience

Before delving into the complexities of private assets, investors should understand the broader business cycle, which encompasses both equity and debt cycles. Understanding the connections – though sometimes delayed – between liquid and illiquid investments and the broader economic context is essential, as these relationships consistently influence each other.

For a comprehensive evaluation of our macroeconomic and capital market forecasts, we invite you to review our Economic and Capital Markets Update[5]. In brief, we anticipate that established corporations with consistent revenue and earnings growth will maintain their robust performance and drive equity and corporate markets higher, thereby preventing a broad risk off turn. Moreover, we expect that moderate shifts in monetary policy will have a minimal impact on risky asset prices, provided these changes remain within expected limits. However, a significant shift towards more aggressive policies by central banks – should inflation prove stubborn – could disrupt the ongoing market rally, leading to a sudden downturn in both liquid and illiquid investments (Figures 9 & 10).

[5] Global economic and capital markets outlook (link)

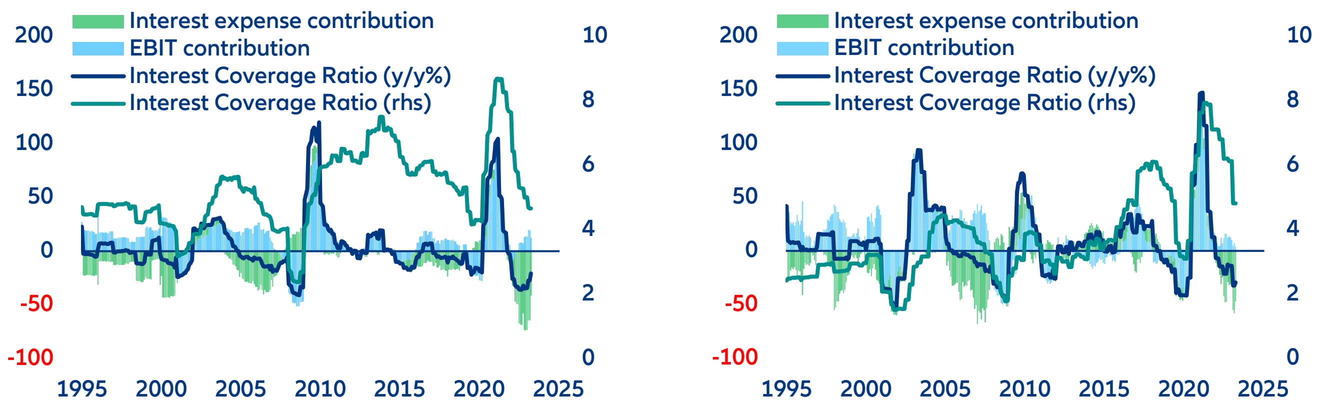
Figure 9 & 10: US and Euro area equity vs earnings and monetary policy expectations



Sources: LSEG Datastream, Allianz Research

Diving deeper into the current climate of rising financing costs driven by high policy rates, it is important to examine the debt repayment capabilities of corporations. Increased interest expenses are significantly impacting their ability to service debt, which is evidenced by a disproportionate rise in interest expenses compared to Earnings Before Interest and Taxes (EBIT) growth. This suggests a gradual yet consistent increase in financial pressure. Despite this continuous debt servicing capacity erosion, the situation has not yet reached a critical 'stress territory' as continued earnings growth is still sufficient to cover interest costs. However, should this trend persist, we could approach a critical juncture within the next one to two years, especially for low-rated corporates (Figures 11 & 12).

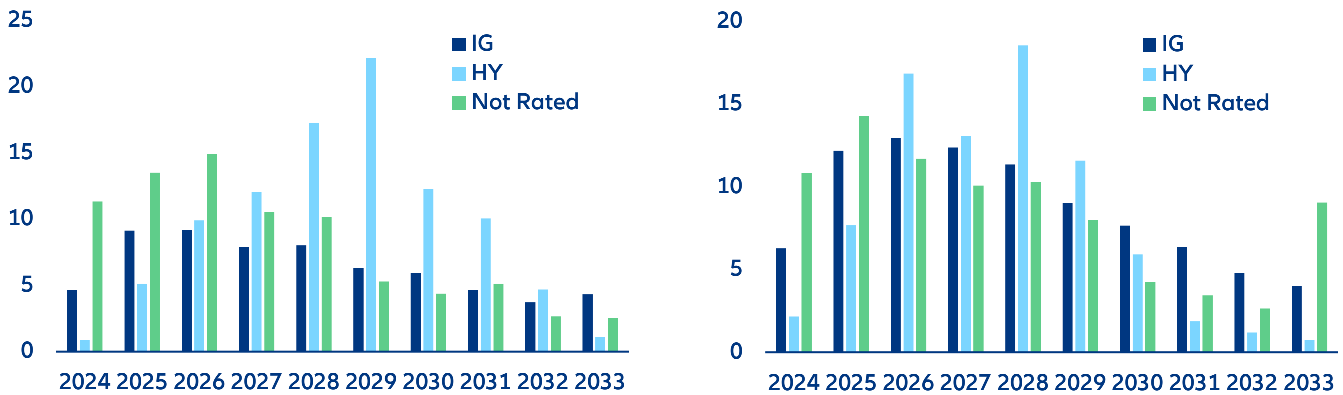
Figure 11 & 12: US (left) and Euro area (right) interest coverage ratio decomposition (in y/y%)



Sources: LSEG Datastream, Worldscope, Allianz Research
Note: The contributions are an approximation

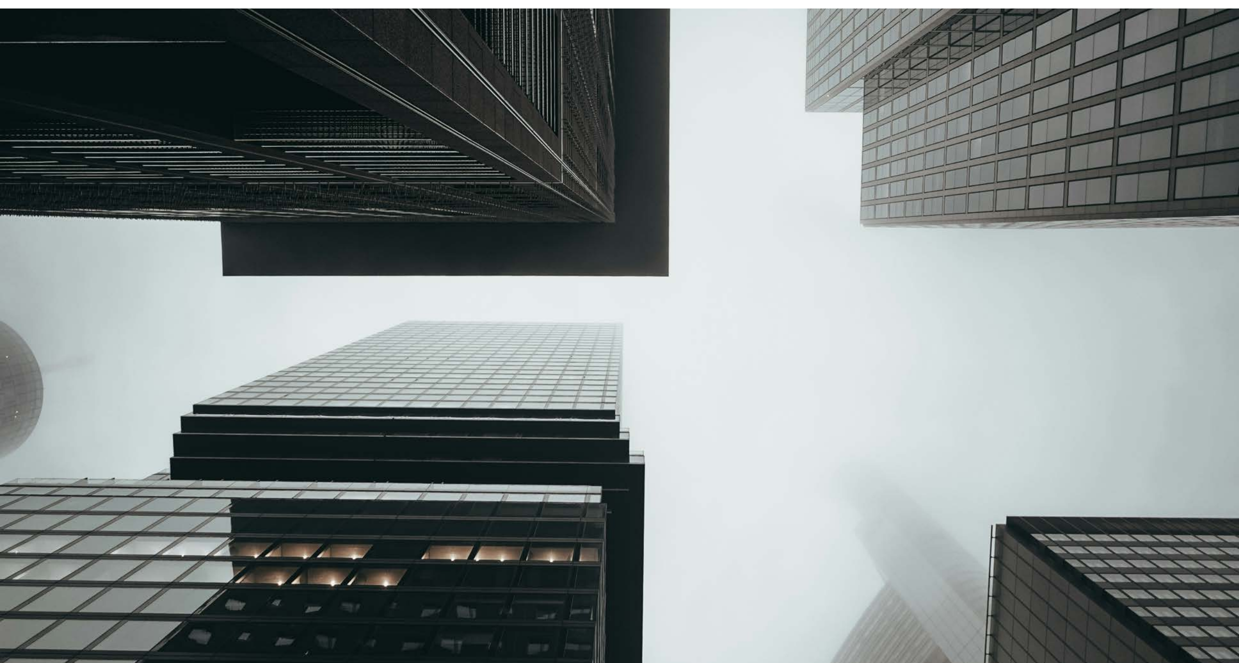
The subtleties of the current corporate debt landscape are becoming more pronounced, particularly when examining debt maturity profiles and the looming "debt repayment walls". Companies with strong ratings, classified as Investment Grade (IG), have consistently managed to refinance their obligations. This success is buoyed by strong demand from market participants, ensuring a steady flow of financing. In contrast, the situation for weaker or higher-risk firms (High Yield - HY) is starkly different. These entities have seen significantly subdued debt issuance, largely due to their reluctance to secure refinancing at higher costs and a general lack of investor appetite for such risky debt. Previously, the low interest environment, triggered by the Covid-19 pandemic, allowed riskier companies to issue substantial debt with prolonged maturities, thereby reducing current refinancing needs. However, edging closer to 2025 and 2026 –when significant amounts of this debt are due for refinancing – these companies are likely to face challenges if they return to the market under persistently high interest rates. This could jeopardize their ability to meet debt obligations (Figures 13 & 14).

Figure 13 & 14: US (left) and Euro area (right) corporate debt maturing per year as a % of total debt



Sources: LSEG Eikon, Allianz Research
Note: After 2033 and Perpetual debt has been excluded; Geographical split refers to country of incorporation; IG: Investment Grade; HY: High Yield

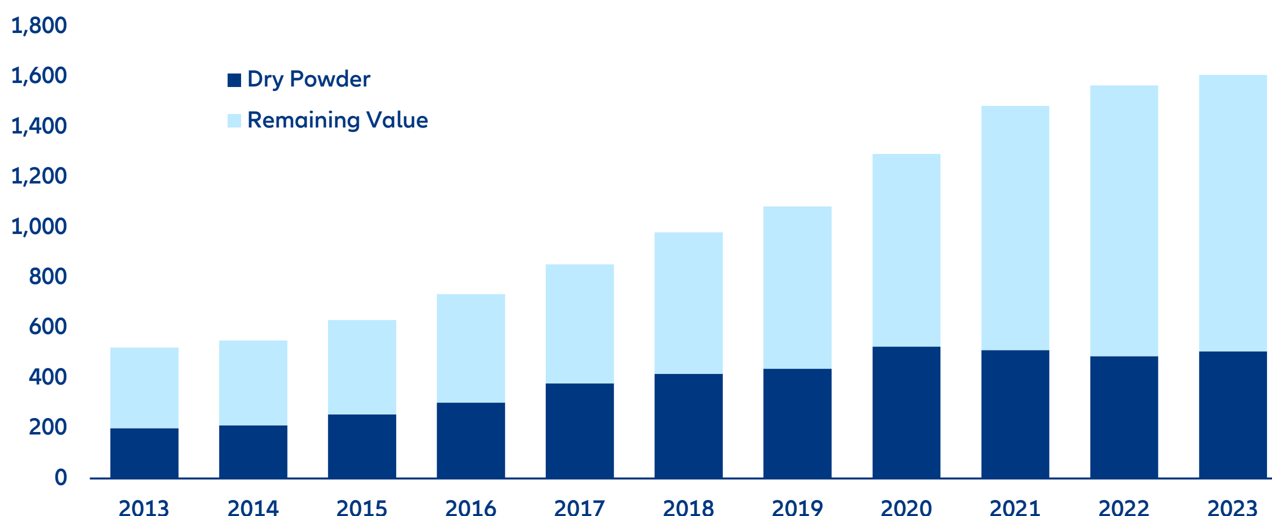
Overall, corporations are navigating a challenging path in the current economic climate as persistently high interest rates are likely to strain their balance sheets. Moreover, potential declines in consumer demand could further impact revenue streams and profitability, especially for firms with precarious financial foundations. Despite these pressures, the broader credit and equity cycles are expected to remain stable. However, these conditions may prompt a recalibration in sectors such as real estate and among companies with weaker financials and lower expected demand. This anticipated market rebalance and the reassessment of risk for certain assets is expected to lead to a more discriminating marketplace. Companies aligned with enduring trends, such as artificial intelligence, climate change initiatives and reshoring efforts, will likely outperform their peers.



Private debt, the rising of the market underdog

With interest in private assets continuing to grow, private debt is emerging as a standout performer across several metrics, notably in assets under management (AuM) growth. Since 2020, AuM for private debt has soared by ~30%, reaching USD1.6tn – a substantial figure but still small compared to the global equity market cap of around USD109tn. This surge indicates that the asset class is gaining traction and that investors continue to trust in the organic growth of this specific subset of private assets. At this point, it can be argued that private debt has successfully cemented its status as a sizable and scalable asset class for a wide range of long-term investors and will likely continue its growth trajectory (Figure 15).

Figure 15: Private Debt - Asset under Management (in USD bn)

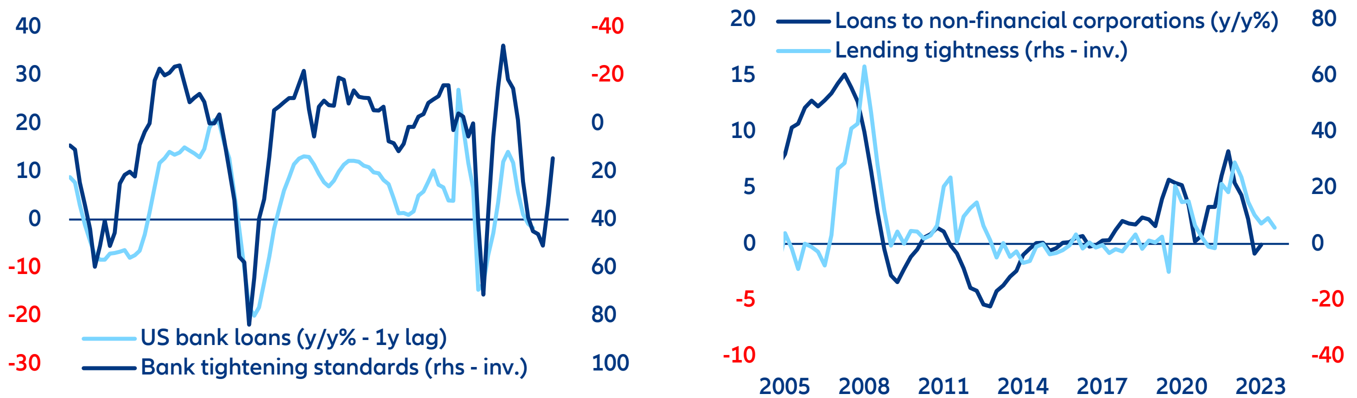


Sources: Pitchbook, Allianz Research
Note: Dry powder refers to the capital committed to the asset class but unallocated for the time being

But why is private debt so trendy? Private debt seems well suited to a climate of escalating interest rates largely due to its favorable risk/return profile. Additionally, a key feature underpinning its appeal is the predominance of floating interest rates, which makes its yields increasingly attractive for investors as interest rates remain high. This enhances the allure of private debt yields and also serves as a hedge against the potential for higher inflation expectations, rising interest rates and more aggressive monetary policies from central banks. Moreover, a notable shift among private debt managers towards prioritizing both the quality and seniority of targeted corporations underscores the asset class's evolving appeal, making it a "less" risky option than before. This strategic adjustment seems to offer a safeguard against market volatility and valuation uncertainties, allowing investors to secure an ex-ante liquidity premium over similar risk-profiled liquid assets. These dynamics underscore the strategic relevance of private debt as a compelling option for investors seeking resilience and yield in a challenging financial landscape.

Beyond portfolio management, private debt has played a crucial role in bridging a significant financing gap that has widened since 2008, with a notable expansion over the past 18 months. The significance of private debt as a financing source has become increasingly apparent amidst challenges such as surging interest rates, a crisis among US regional banks and significant turmoil within the commercial real estate market. These factors have restricted the ability of conventional banking institutions to provide credit, with banks facing difficulties due to losses realizations triggered by deposit withdrawals, losses on commercial real estate loans, heightened regulatory oversight, and potential adjustments to the Basel III framework. In this challenging environment, private debt has offered a solution by maintaining the flow of loans across diverse economic conditions and corporate ratings (Figures 16 & 17).

Figure 16 & 17: Bank lending conditions in both US (left) and Euro area (right)

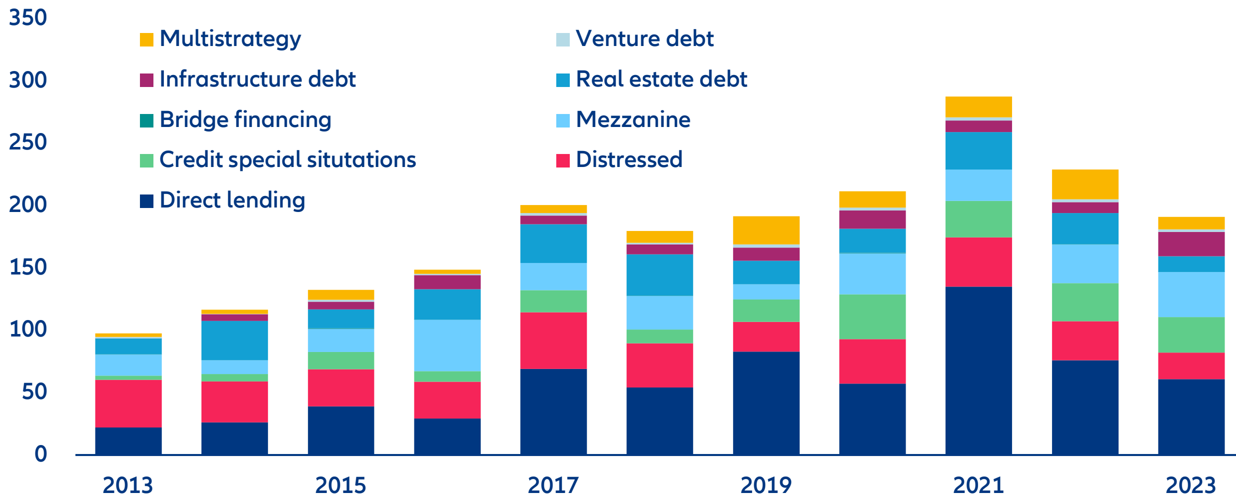


Sources: LSEG Datastream, Allianz Research

With these factors in mind, it is clear private debt has evolved significantly. Originally a specialized financing avenue serving the unique needs of small and medium-sized enterprises (SMEs), has now become a pivotal component of the alternative financing and investment landscape. Private debt now serves a wide array of purposes, including providing rescue financing, supporting corporate restructurings, facilitating acquisitions and funding capital and operational expenditures. Private debt's bespoke financing solutions, tailored to each borrower's requirements and situation, represent a vital and flexible alternative to traditional banking channels.

From the investment perspective, the value of incorporating private debt into investment portfolios has become increasingly clear to investors. The volume of capital allocated to private debt funds has escalated from USD98bn in 2013 to USD191bn by 2023. Within the private debt sector, direct lending remains the dominant strategy (~50% of the universe), accounting for a sizeable part of total fundraising, despite the recent decline. Meanwhile, mezzanine debt and special situations have seen inflows that are neutral or mildly positive in 2023 (Figure 18).

Figure 18: Private debt fundraising by type (in USD Bn)

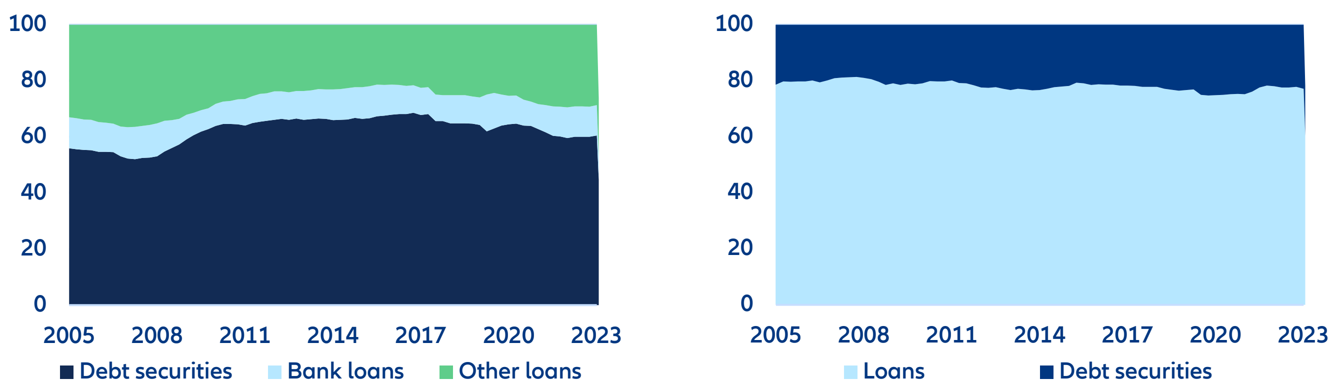


Sources: Pitchbook, Allianz Research

Despite the recent decline in fundraising activity, direct lending will continue to dominate private debt markets

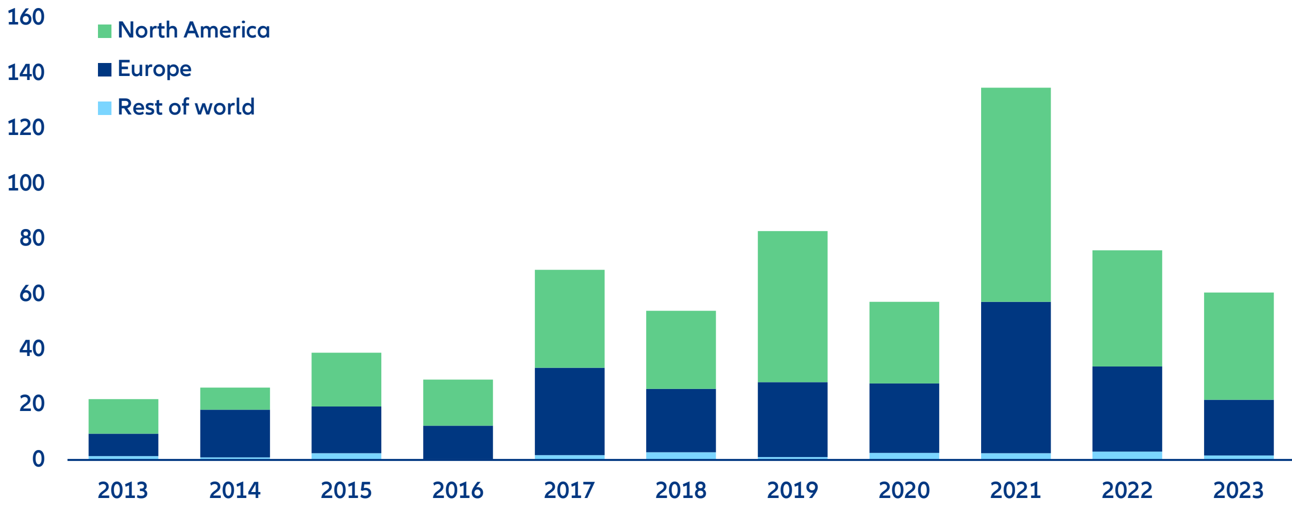
The expansion of direct lending within the broad private debt asset class is driven by the overall growth in private financing, especially as traditional banks retreated from sectors like commercial real estate. This shift has allowed non-bank financing to flourish, further supported by issuers' preference for private financing options during market dislocations where traditional pricing and execution may falter. This growing demand is being met by a healthy pipeline of deals, including from growing companies and new entrants from sectors that have traditionally engaged less with private credit, now approaching the market with more attractive valuations. This shift is particularly impacting Europe, where the financing source for non-financial corporate markets heavily relies on banks, in contrast to the US, which primarily relies on market-based financing (Figures 19, 20 & 21).

Figure 19 & 20: Non-financials corporate financing source mix in the US (left) and Euro area (right) (in %)



Sources: LSEG Datastream, Allianz Research

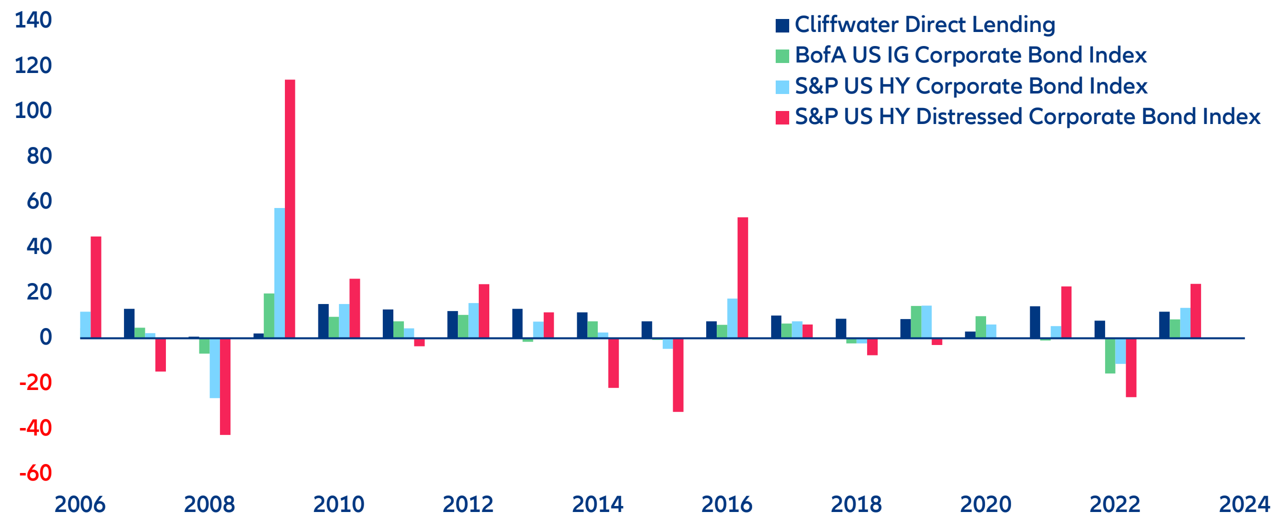
Figure 21: Direct lending capital raised by region (USD bn)



Sources: Pitchbook, Allianz Research

With more than a decade of subdued interest rates giving way to a higher-rate landscape, the floating-rate direct lending sector stands to benefit significantly. This sector is characterized by its ability to produce stable cash flows and reliable returns alongside quicker capital distributions than other private investment vehicles. Because of this, direct lending strategies are especially advantageous in the current financial climate. The combination of attractive current yields and robust and improving underwriting practices suggests that direct lending will continue to outperform with yields in the lower double-digit range (Figure 22).

Figure 22: Direct lending vs public corporate debt yearly performance (%)



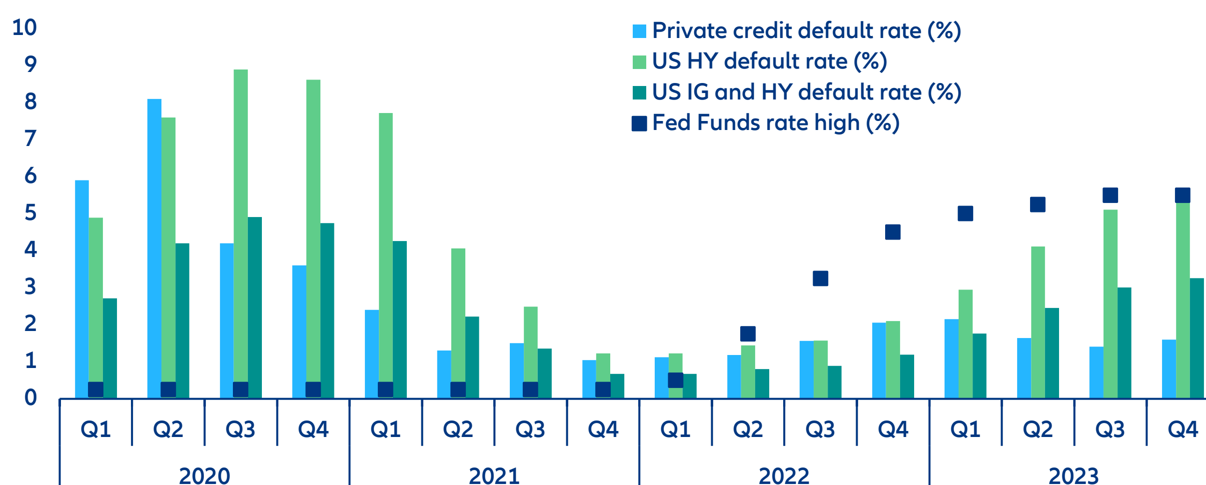
Sources: LSEG Datastream, Allianz Research

A notable trend in direct lending is the predominance of refinancings, indicating a strategic shift towards building portfolios centered around more defensive companies. This is viewed positively by investors as it limits exposure to higher-risk companies, reinforcing their confidence in a low-default direct lending environment. Moreover, the sustained interest in private credit, particularly within the middle market, is expected to deliver long-term benefits. Companies are increasingly adopting financially prudent strategies, which include cutting costs, minimizing non-essential spending and boosting cash reserves to effectively manage the challenges posed by prolonged high interest rates.

But not all is positive, the direct lending market's resilience will be tested moving forward. As a relatively new asset class, private credit will face significant stress, particularly as managers dependent on cyclical sectors grapple with elevated financing rates and sluggish earnings growth. Losses are expected to materialize gradually over several years, highlighting potential performance disparities among sectors and fund managers. However, more defensively structured fund vintages are predicted to outperform older ones throughout the economic cycle as these funds tend to focus on market mega-trends that are expected to outperform other styles, sectors and markets.

Ex-ante, the private credit's inherent illiquidity premium is expected to bolster income. More critically, the ability to influence deal structures and enforce strict covenants is expected to sustain lower default rates and higher recovery rates than public market counterparts. However, in a high-cost financing environment, it is important to remember that past performance may not necessarily indicate future performance. Low interest rates and a strong economic climate have historically helped maintain low default rates, resulting in a tight cluster of returns on direct lending investments. Despite the attractive all-in yields that continue to draw prospect lenders to this asset class, the continuous raise in borrowing costs could heighten financial risks, potentially exacerbating defaults as seen in the first half of 2020. This situation could lead to underperformance relative to the traded market if rates are kept high for longer (Figure 23).

Figure 23: Private and public corporate credit default rates and Fed Funds rate (%)



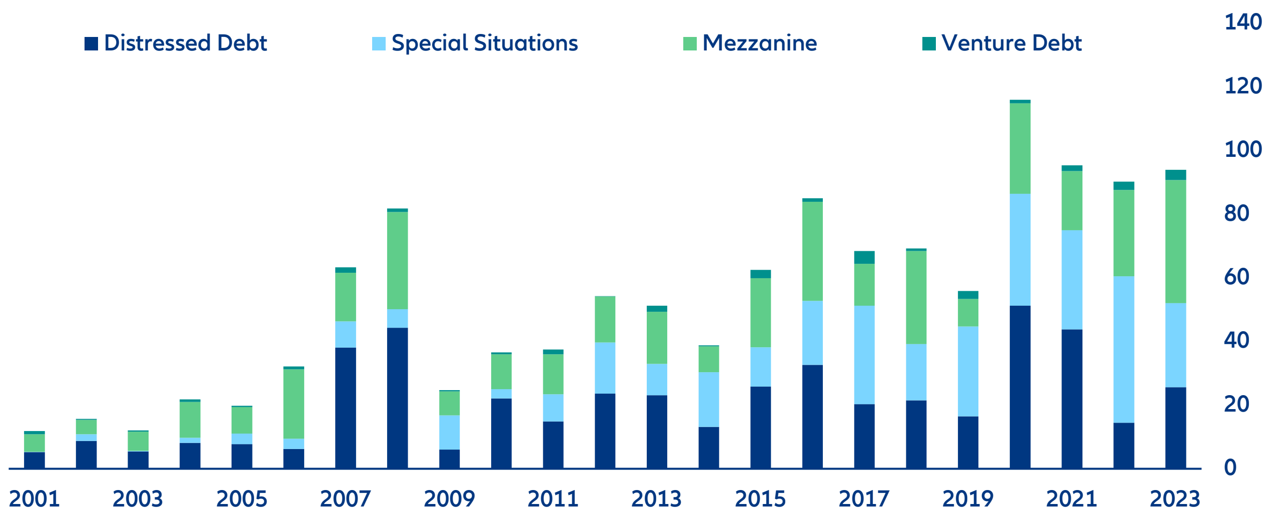
Sources: The Proskauer Private Credit Default Index, Allianz Research
Note: Proskauer's private credit default index tracks senior-secured and unitranche loans in the US

In summary, we maintain that the private credit sector, and direct lending in particular, will sustain its role in the portfolios of retail and institutional investors, offering potentially higher returns than their publicly traded peers. However, it's important to acknowledge that these elevated returns come with risks. Specifically, the promise of future gains could be jeopardized during a market downturn, particularly if triggered by stringent monetary policies. This scenario may result in liquidity challenges due to the scant secondary market for private debt. Additionally, significant mark-to-market adjustments may occur at the asset's maturity or in the event of a default.

Other type of private lending: Distressed debt, mezzanine, venture debt

Direct lending remains the most prominent private debt strategy, accounting for 52% of the funds raised in the entire private credit universe in 2023. However, other types of private lending funds have gained investor interest based on the volume of money raised in the past few years. Among those, special situations funds[6] have been most appealing, followed by distressed debt[7], mezzanine finance[8] and venture debt[9] (Figure 24). Although 2020 saw unprecedented fundraising levels, the upward trend continued with USD93.9bn raised in 2023 (excluding direct lending), a year-over-year increase of +4.1%. Each strategy has specific characteristics that attract different investor profiles and variable performance depending on the macroeconomic context. This variability helps explain the differing levels of 'dry powder' across strategies, as the economic context has a major role in defining when and where to allocate the raised funds.

Figure 24: Private debt – Fundraising by fund type (USD bn), excluding direct lending



Sources: Preqin, Allianz Research

[6] Special situations: a private loan based on a "special situation" not directly related to the company's fundamentals. The fund focuses on companies whose value may be affected by certain events such as a spin-off, an M&A or a takeover bid.

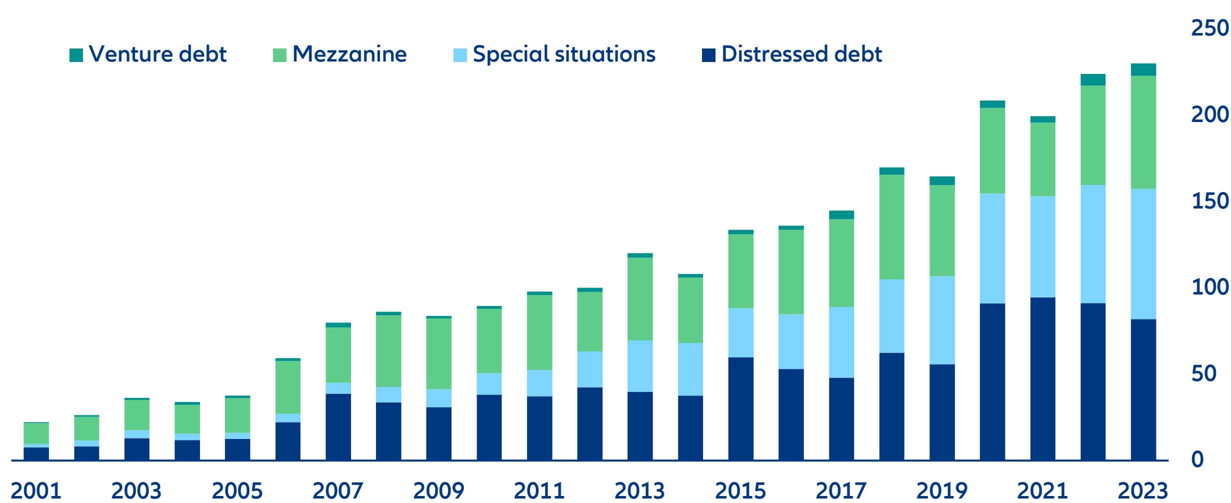
[7] Distressed debt refers to funds that target distressed companies, or in other words, firms likely to be or are already bankrupt.

[8] Mezzanine refers to a hybrid or convertible debt that provides some protection to the investor in the event of repayment default; in other words, investors provide funds in the form of debt with the special condition of getting a share conversion in the event of default by the borrower, allowing the investors to become shareholders of the company.

[9] Venture debt involves granting loans to private start-ups or companies in the early-stage phase. The loan comes with specific terms such as higher interest rates and stock options to compensate for the high risk associated with early-stage businesses.

Excluding direct lending, the dry powder of these alternative debt strategies totaled USD230.3bn in 2023, an increase of +2.8% y/y (Figure 25). This upsurge was largely driven by significant increases in mezzanine financing and special situations. Specifically, dry powder for mezzanine debt jumped by +13.5% year-over-year, bolstered by a +43% increase in funds raised compared to 2022. In contrast, although special situations fundraising declined by -43% last year, the dry powder increased by +10.4% year-over-year due to reduced lending activity.

Figure 25: Private debt – dry powder by fund type (USD bn), excluding direct lending



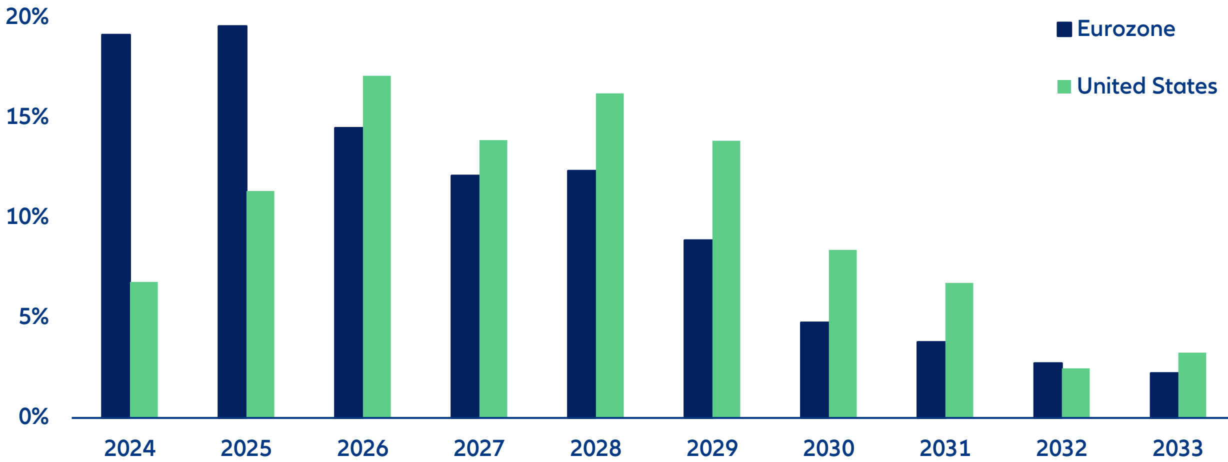
Sources: Preqin, Allianz Research

Distressed debt strategies typically see increased opportunities in periods of economic downturn, as demonstrated by historical fundraising trends. For example, Figure 24 illustrates that recessions, such as 2007-2008 and 2020-2021, often coincide with peaks in capital raised for investing in distressed companies. In 2020, for instance, fundraising for distressed debt soared by +211% year-over-year totaling USD51.2bn – the highest amount since the 2008 peak of USD44.3bn. However, as these funds are supposed to be allocated to distressed companies, the dry powder for distressed debt has been recently declining, experiencing a reduction of -3.5% y/y in 2022 followed by -10.3% in 2023. Indeed, 2023 was a good opportunity to deploy this tactic, as financing conditions tightened in developed economies with central banks maintaining high interest rates, and companies faced lower business activity amidst global GDP growth of only 2.8%.

For 2024 and 2025, we expect that highly leveraged companies may enter a distressed cycle if high interest rates persist. According to our most recent global insolvency outlook[10], 2023 recorded a high-speed and broad-based rebound in business insolvencies, with an increase rate of +29% globally, the sharpest y/y increase since 2009 (+33%). This trend could worsen in 2024, driven by the effects of prolonged higher interest rates and a looming debt maturity wall. This issue is particularly acute in the Eurozone, where around 20% of debt held by high yield and unrated companies is due this year, compared to only 7% for the US (Figure 26). While these conditions are challenging for companies, they represent opportunities for investors in distressed debt.

[10] See our latest Corporates Insolvency outlook here: Global insolvency outlook: Reality check (allianz.com)

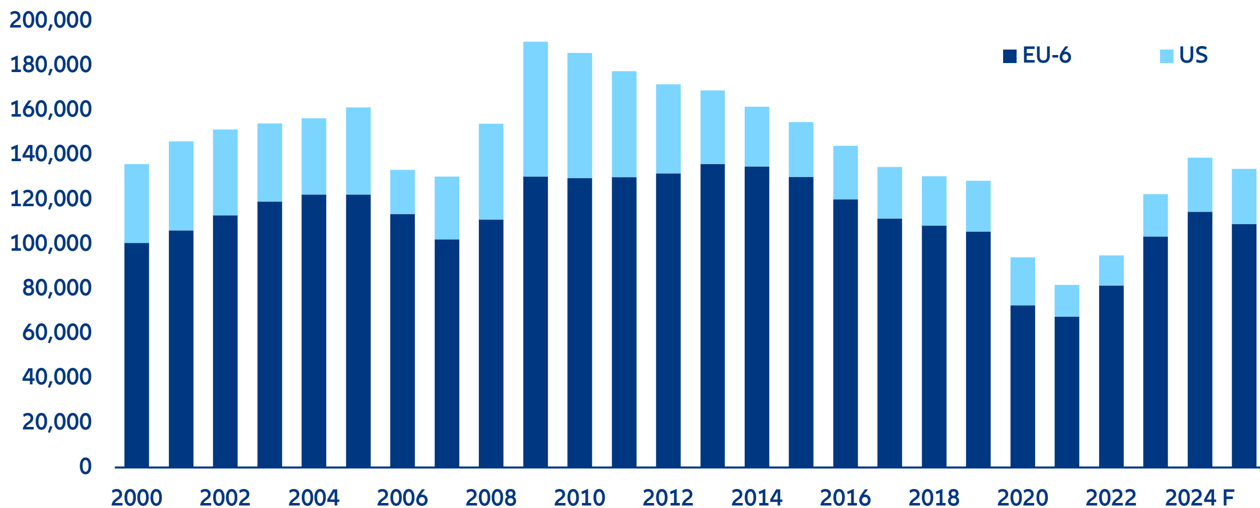
Figure 26: Debt maturity wall, % of total debt maturing per year for high yield and unrated companies



Sources: Refinitiv (as of 04 April 2024), Allianz Research
Note: Investment grade companies have been excluded as its credit risk is supposed to be lower.
Excludes maturities longer than 2033 and perpetuals.

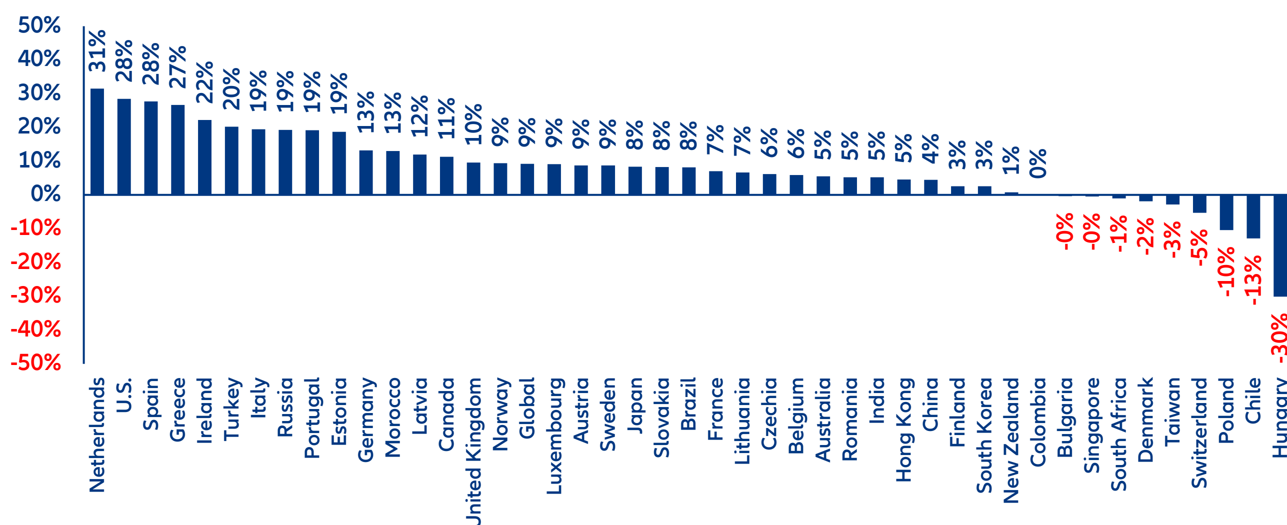
Looking at the number of business insolvencies by geography (Figure 27), it is evident that Europe consistently experiences more company insolvencies than the United States. In 2023, Europe nearly returned to its pre-pandemic level, reaching 98% of the insolvency figure registered in 2019, while the US was at 83%. In absolute terms, France and Germany led last year's increase in business insolvencies in the region. In relative terms, the highest y/y growth rate was observed in the Netherlands (+52%) and Germany (+23%). Furthermore, Figure 28 indicates that in 2024, ten out of the 15 countries expected to report a double-digit upsurge in business insolvencies are European, with the Netherlands projected to lead this group with an increase of +31% y/y.

Figure 27: Total number of business insolvencies by geography per year



Sources Allianz Research. Note: EU-6 includes Germany, France, Italy, Spain, Belgium, and the Netherlands.

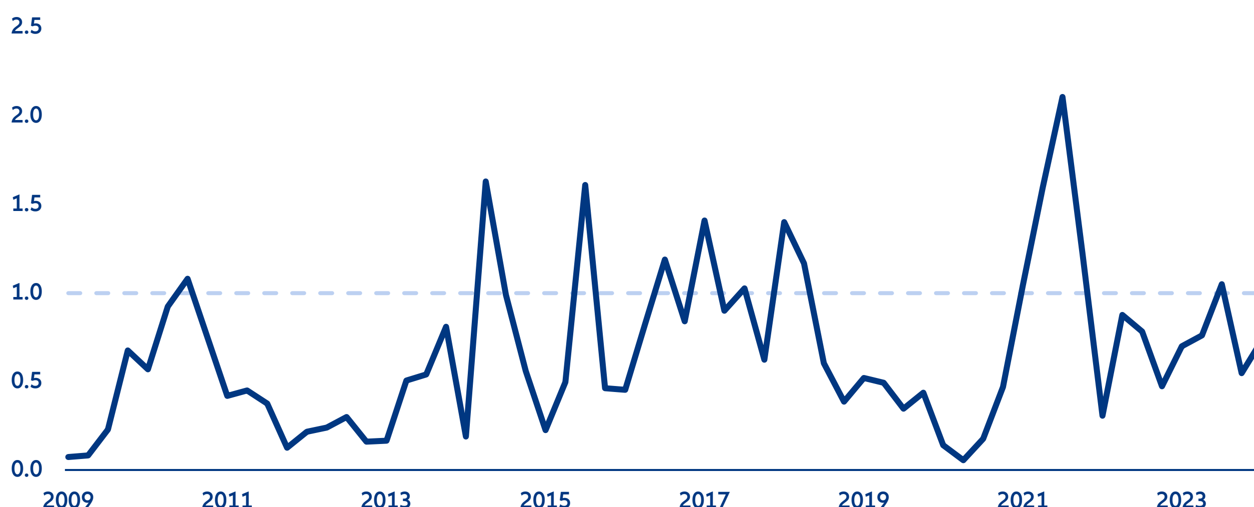
Figure 28: Growth (or contraction) rate of business insolvencies expected for 2024 (y/y change)



Source: Allianz Research

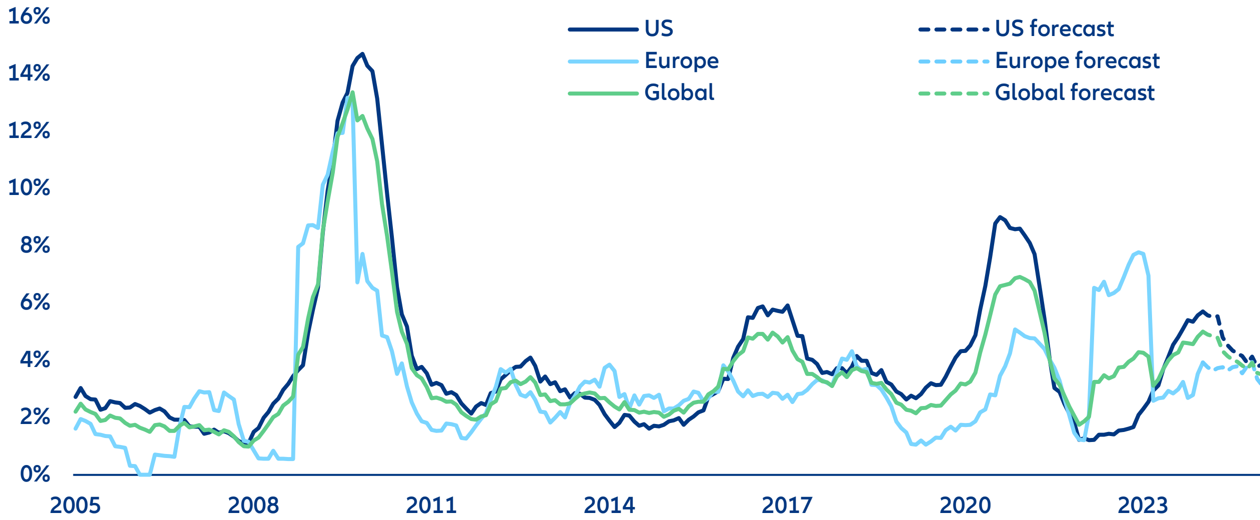
Credit rating agencies have echoed the deterioration of credit risk in Europe. While the credit quality for the investment grade segment should remain robust, with average upgrades outpacing downgrades across the three major rating agencies, the trend is reversed for the high yield segment. Indeed, the junk credit quality has been worsening. As shown in Figure 29, the upgrade-to-downgrade ratio has been below 1x in the past two quarters for high-yield companies (0.55x in Q4 2023 and 0.73x in Q1 2024). Given the ongoing economic uncertainties in the region, we expect the ratio to remain below 1x in the short term. In parallel, according to Moody's default rates for speculative-grade companies (Figure 30), the forecast suggests that the volume of troubled companies in Europe is unlikely to decline soon. In contrast, the landscape for companies in the US and globally is expected to improve.

Figure 29: Average 'upgrades vs downgrades' ratio in the European high-yield segment



Sources: Bloomberg, Allianz Research. Note: The average includes rating actions from Moody's, S&P and Fitch.

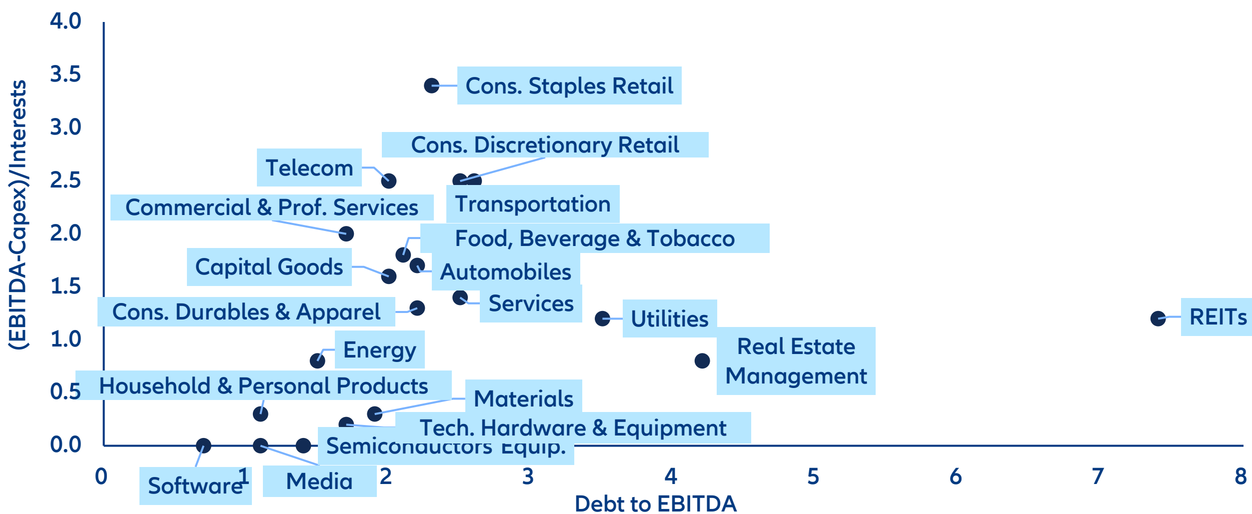
Figure 30: Moody's speculative grade default rates (in %)



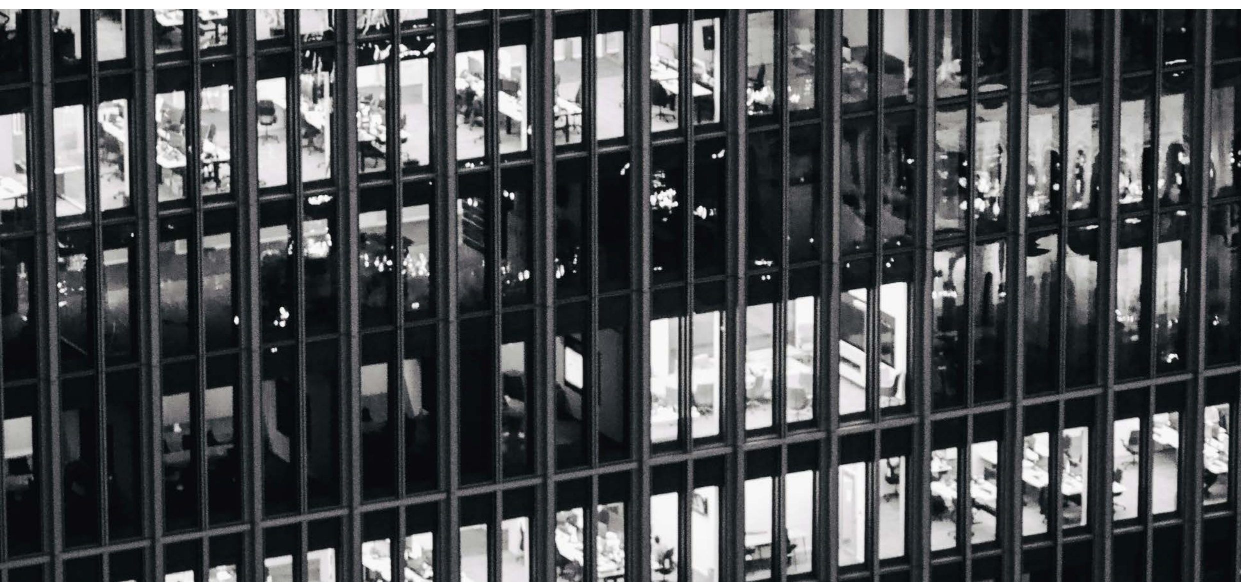
Sources: Moody's, Allianz Research. Note: Forecast is represented by Moody's baseline scenario

Distressed but viable borrowers are the gem for opportunistic investors. Sector performance is crucial in identifying investment opportunities. As a matter of fact, if a company is financially distressed but operates in a sector that is outperforming or has a positive outlook, it should be considered a prime candidate for investment. Another example is the real estate sector, which is currently struggling due to high leverage levels and low interest coverage capacity (Figure 31), but that in another economic cycle could register a rebound despite these challenges. Investors should also look for opportunities in companies that may not be in booming sectors but possess sound business models. Such companies are especially appealing if their capital structure issues are primarily exacerbated by temporary macroeconomic pressures, but their business activities have promising prospects.

Figure 31: Last twelve months leverage and interest coverage capacity by sector, median values



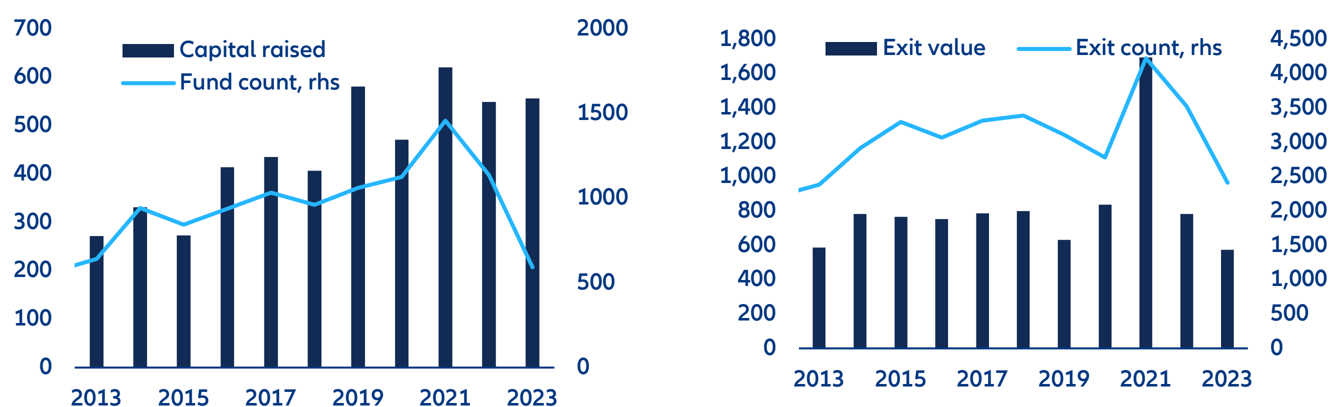
Sources: Bloomberg, Allianz Research



Private equity, turning challenges into opportunities

While there is little doubt about the opportunities arising in an era of technological disruptions and ESG transformations, volatile markets conditions complicate the outlook for private equity (PE). The last two years have seen a meltdown in private equity activity. The shift follows the end of the era of lower interest rates, prompting investors to reassess valuations critically. From its peak in 2021, global PE exit values have plummeted by more than 60%, reaching the lowest levels (in nominal terms) since 2013. While aggregated fundraising value has hold better (see Figure 32), the number of funds has also decreased by 60%, highlighting a significant concentration in high quality funds and the challenges faced by the rest in raising funds (Figures 32 & 33).

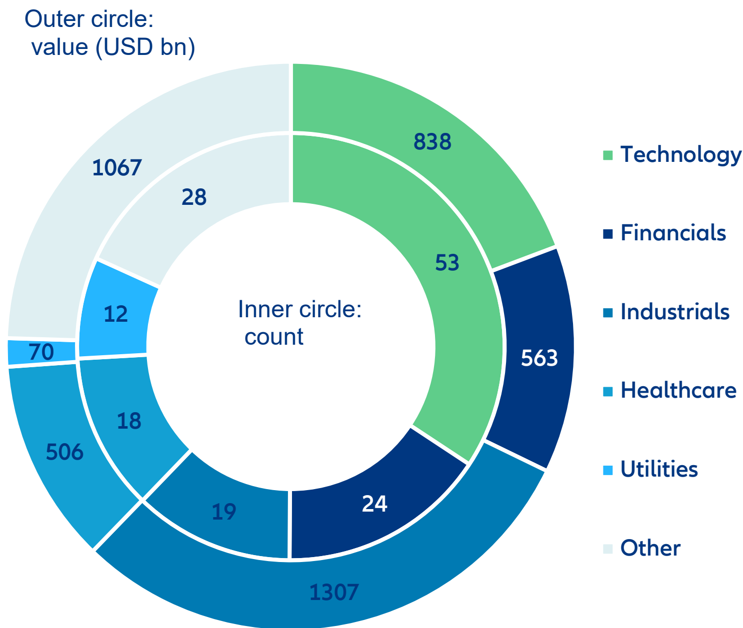
Figure 32 & 33: Global PE fundraising (left) and Global PE exit activity (right). USD bn



Sources: Pitchbook, Allianz Research

Buyouts, the most common form of PE investment in terms of capital, have also fallen sharply in the last two years (by more than 40% in terms of number of deals). Understandably, the most affected were the so-called leveraged buyouts, where significant debt is used to finance the acquisition of the company. Regarding sectoral composition and focusing on the US, the largest market by far, technology remains dominant in deal value despite recent challenges, including the collapse of a major startup financier. This enduring predominance of technology is fueled by the recent AI frenzy, but also by the fact that tech companies generally require less capital investment than firms in other sectors. Meanwhile, the industrial sector is in relatively good shape as ongoing efforts to "re-shore" production back home will provide plenty of opportunities (Figure 34).

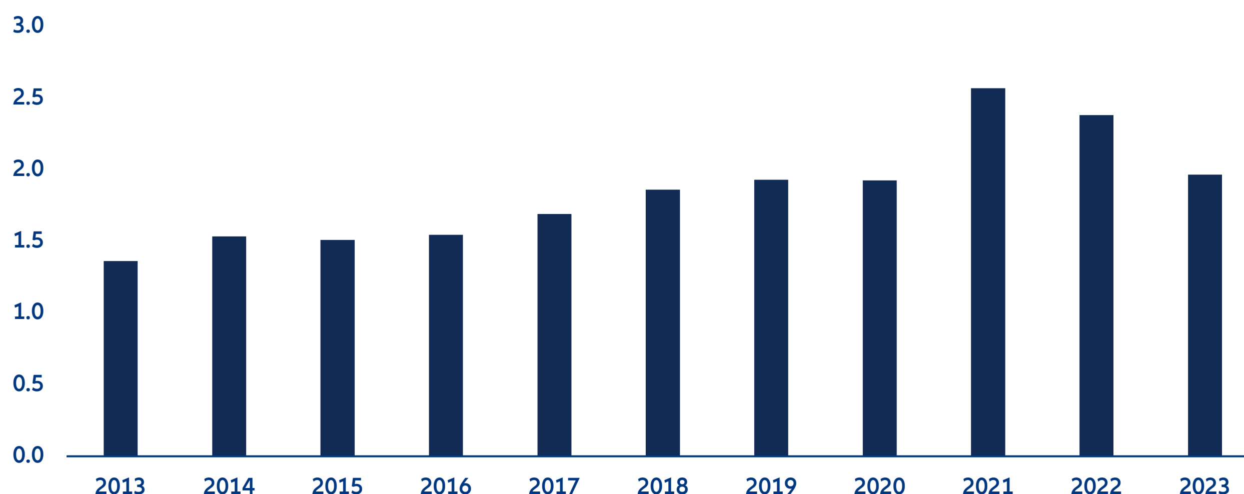
Figure 34: Buyout investment by sector, US



Sources: LSEG Eikon, Allianz Research

Price adjustments in private markets, including private equity, do not occur as swiftly as in publicly listed assets, but they do occur. When interest rates rise, future cash flows are discounted at higher rates, reducing the present value of companies; this is by construction and no company can, ceteris paribus, escape to it. This impact is particularly severe in cases where the prices paid were driven not by fundamental valuations but by expectations of selling in a "close-to-bubblish" market. On the other hand, private equity investors typically have long investment horizons and can afford to make gradual reductions, waiting for more favorable market conditions. However, this approach also implies risks such as stranded investments, reduced liquidity and opportunity costs. Given that interest rates are unlikely to return to pre-Covid levels anytime soon, the necessary adjustments in enterprise valuations should translate into the recognition of losses, potentially marking 2020 and 2021 vintages as less than stellar years. In the current economic environment, one might ironically wonder whether a crisis prompting central banks to cut rates aggressively would be more favorable for private equity outlooks than a robust economy that sustains high interest rates (figure 35).

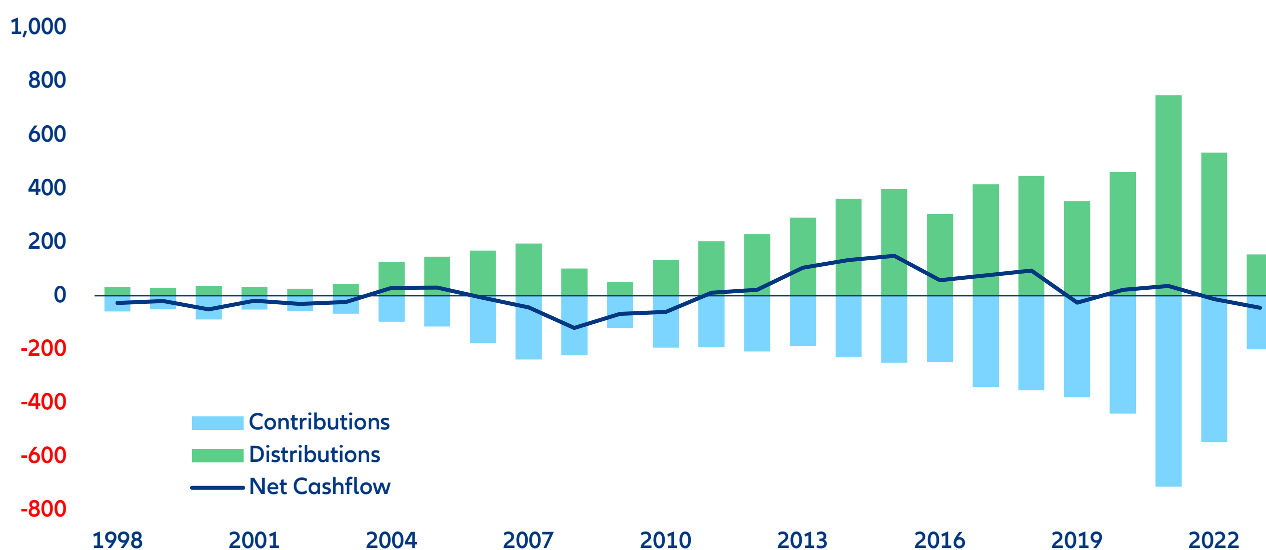
Figure 35: Median PE buyout EV to revenues ratio



Sources: Pitchbook, Allianz Research

Dry powder (uninvested capital) but also un-exited assets are set to remain at record levels in the coming years. Uncertainty around the start of the easing cycle is less of a problem for the private equity outlook than the structural increase in long term yields. The sharp change in monetary policy during 2022 and 2023 significantly altered market conditions. However, as the long-term outlook for interest rates seems to depict a structural increase compared to pre-Covid levels, the exact timing of the cuts has become, in comparison, less important. Regarding PE fundamentals, current dry powder data indicates the challenge is not the lack of money ready for investment but the difficulties of finding good opportunities at the right price. This situation will likely drag on until the M&A and IPO market substantially accelerates and private equity capacity for distributions to investors recovers (Figure 36).

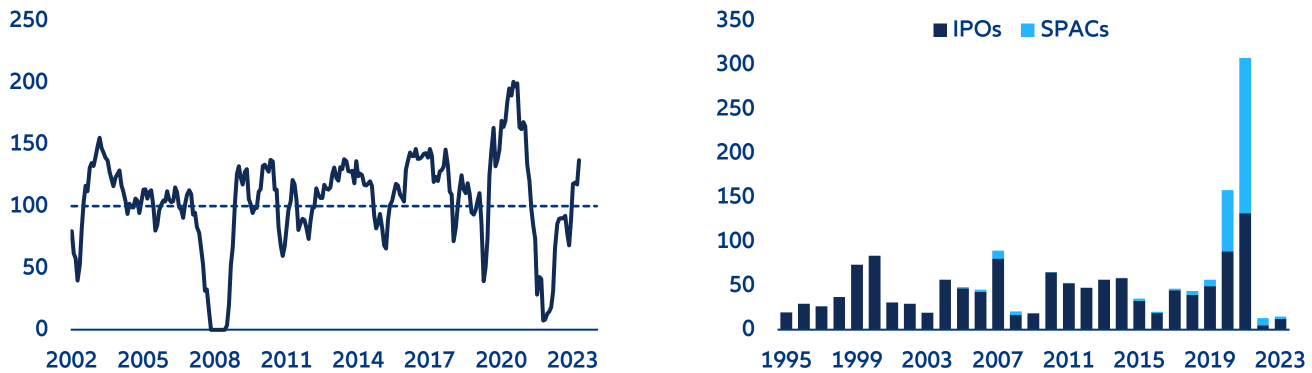
Figure 36: Private equity contributions and distributions (in USD bn)



Sources: Pitchbook, Allianz Research

Despite challenges, macroeconomic data shows a benign outlook. IPOs are expected to slightly accelerate this year due to balance sheets that are more resilient than expected and tailwinds from the policy pivot. These factors are likely to improve valuations making it more appetizing for companies to raise capital through markets (Figure 37).

Figure 37: Goldman Sachs US IPO barometer (left) vs. US IPO issuances (volume, in USD bn, right)



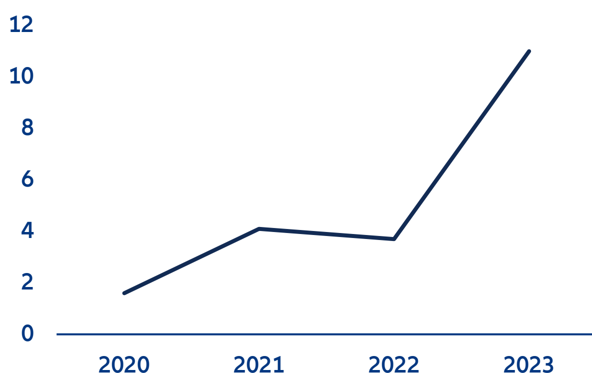
Sources: Goldman Sachs Research, Bloomberg, Allianz Research. Notes: 1\ In the left-hand chart, above 100 indicates favorable market and economic conditions for IPOs. 2\ in the right-hand chart, only IPOs above USD50mn taken into account. 3\ To understand why we narrow the focus when it comes to IPOs, please refer to our recent analysis Europe needs to step up its game: lessons from the America playbook, page 9.

We expect private equity to accelerate, with a rebound in valuations, potentially leading to interesting returns. This is anticipated in conjunction with a resurgence in IPO volumes. Specifically, we expect the asset class to produce 500 to 700bps of extra return over their publicly traded counterparts, with asset revaluations around 15% in 2024 and 12% in 2025. Regarding distributions, we foresee a slower recovery, with 2024 and 2025 remaining on the dry side but recovering as exit markets further accelerate.

Global venture capital returned to its pre-2020 fundraising levels. This adjustment mirrors broader market trends, where an uncertain macro environment and the lengthy process of digesting the excesses of 2020-2021 have led to an investment drought. The sharp fall in exits, following a sharp increase in deals, has left some early-stage investments stranded. In response, there is a growing emphasis on enhancing operational efficiencies and extending the runway of existing funds to weather the downturn. As the market stabilizes, we may see an increased focus on mergers and acquisitions as a viable exit strategy. This approach could provide a critical lifeline for early-stage companies struggling to secure further funding rounds or achieve profitability independently.

The aforementioned easing in Central Bank rates is expected to also rejuvenate capital flows within the venture capital market, bolstering investor confidence and encouraging increased investment in promising startups. This resurgence in funding availability could stimulate innovation and gradual growth across the VC landscape. In our baseline scenario, we believe we have already hit the low in terms of flows. While this does not mean that the situation is bright – or that startups will stop laying off workers – it means that investors have adapted to the new environment and deal activity will slowly take off. This recovery will be uneven. In terms of investment stages, seed appears to be more resilient. In sectoral terms, green technologies and generative AI are outliers as startups leverage machine learning to innovate and gain competitive advantages (see the explosion of AI-related startups in Figure 38). However, more mature investment phases, such as later stages, will likely experience cautious growth due to the ongoing drought in the IPO market.

Figure 38: Annual funding for AI startups, USD bn



Sources: Bain (link), Allianz Research. 2023 excludes USD10bn of OpenAI

Private equity markets are generally deeper and more developed than private debt markets. Two important factors for investors to decide between debt and equity investments have, until recently, favored equity when it comes to private markets. The first is the risk-return profile. Both private debt and private equity have high levels of risk, but private debt, being a fixed-income instrument, offers limited returns. This makes it less attractive than the potentially substantial capital appreciation achieved with successful startups or turnaround situations. Indeed, high-profile success stories have given private equity greater visibility and helped make private equity an interesting alternative for investors. The shorter investment horizon, which theoretically favors debt, is less of a factor in beneficial in private assets. where consistent return generation is more challenging. In addition, private equity has a longer history presence, allowing PE managers to create an investment track record or, simply, to cite successful stories as an example of what can be achieved to attract new investment. Finally, a fundamental difference between private equity and private debt is that with private equity, investors usually acquire control (often complete control in these stages), which can add substantial value – or at least the possibility to add it.

Assessing the success of private assets presents substantial challenges and has attracted considerable scrutiny within the financial industry. The lack of dynamic mark to market checks smooths valuation adjustments through time compared to listed assets. As such, it also allows to maintain arguable overvalued valuations that inflate performance for a prolonged period. Private equity, precisely for being more developed – and trendier – has received more criticism. A great part of it grounded on the use of the internal rate of return (IRR) by fund managers as main measure in communications; not because it is not useful but because it provides only a partial view and can be altered in different ways. The most common one is the role that timing of cash flows and investments plays – basically the fact that "calling" the capital just before the actual deployment shortens the calculation period by excluding the part when it was committed but not generating returns. Additionally, early successful investments, even if small, disproportionately influence the IRR throughout the fund's life due to the nature of IRR calculations – which in a way is key for a successful survival to continue attracting investor's confidence. More broadly, private assets reporting has been under scrutiny by their use of "gross-of-fee" returns and its lack of standardization in reporting, both being important drawbacks when it comes to comparing funds, which also limits the utility of these measures for investors. In our view, a more standardized reporting could lead to greater accountability among fund managers and promote a more competitive environment that may drive overall fund performance. Additionally, it would help demystify the private equity market for less experienced investors, potentially attracting a broader investor base. Which, at the end, would be broadly positive for the asset class and would narrow the differences in behavior and risk-pricing (illiquidity premium) with respect to publicly listed assets.

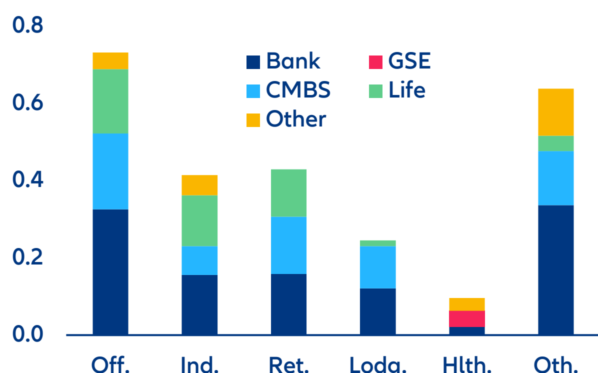
Real Estate, with every downturn there are opportunities

Globally, the real estate sector is navigating a turbulent economic period, significantly hit by elevated interest rates. This has introduced widespread uncertainty regarding property valuations, adversely affecting buyers and sellers and notably diminishing transaction volumes. While rising interest rates are a major factor, they are not solely to blame. Idiosyncratic trends in various regions, including China and Germany, also play significant roles.

Banks have tightened their lending standards, indicating they will keep them tight even after the Federal Reserve's policy pivot. After the excesses in the last decade, banks are focused on offloading risky assets and recalibrating their lending practices[11]. As outlined in the baseline scenario of our Economic Outlook, the major impact on banks from commercial real estate (CRE) will be on profitability rather than solvency, except for smaller banks. Nevertheless, the revival of real estate activity will depend increasingly on interventions from private lenders. Market participants may need to explore alternative financing methods and investment structures to navigate the evolving landscape. As Figure 39 shows, banks and commercial mortgage-backed securities (CMBS) investors continue to play a crucial role in the US and even more so in the Eurozone. Without the involvement of other actors, the adjustment could be more painful.

[11] As outlined in the baseline scenario of our Economic Outlook, the major impact on banks from commercial real estate (CRE) will be on profitability rather than solvency, except for smaller banks. See our latest scenario here: Allianz Research Q1 2024 Economic outlook: it's a wrap!

Figure 39: US CRE outstanding debt by source of capital, USD tr

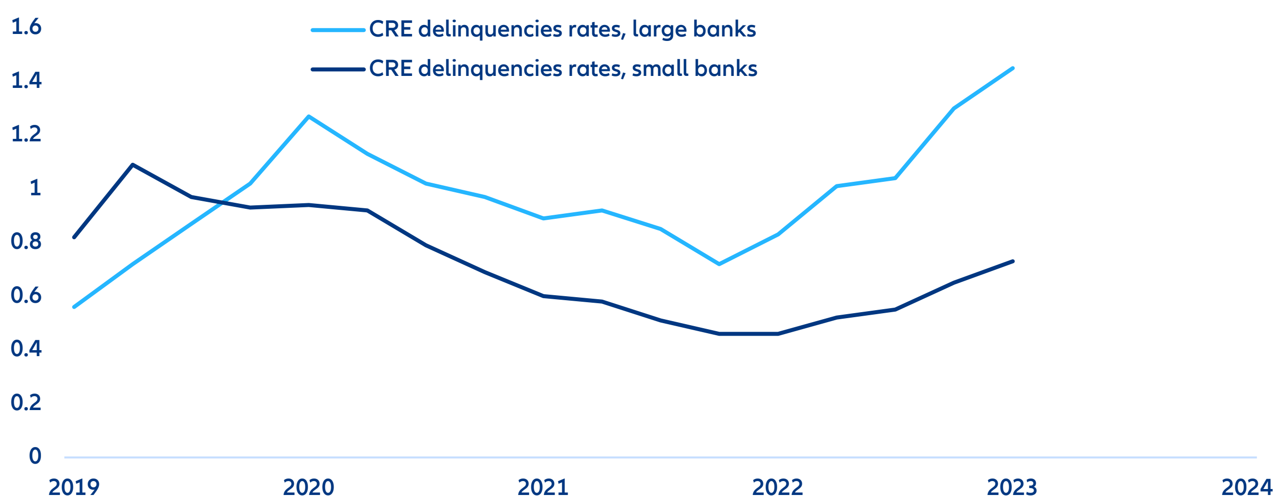


Sources: Mortgage Bankers Association (link), Allianz Research

A revival is crucial as market participants face the dual pressures of needing to repay debts and acknowledging that property prices have already undergone significant adjustments. Despite a reluctance to be the first to sell at distressed prices, the reality of the market's conditions is becoming undeniable. Furthermore, during the last quarters of subdued activity, funds have been loading their magazines. Dry powder calculation estimates[12] at the end of Q3 2023 pointed to USD402bn awaiting deployment. With interest rates yielding decent returns on risk-free amid ongoing uncertainty, the pace of the deployment will be influenced by central banks easing cycle and the clarity of the economic outlook. As we highlighted last year[13], the prevailing theme was a preference for quality (core) investments and a focus on select opportunities. However, this approach may be shifting as the market evolves.

Distressed asset opportunities are growing in the office space as defaults loom. Multiple indicators confirm an increase in delinquencies in the US, while deterioration is observed in other markets. The Mortgage Bankers Association in the US has reported a rise in delinquencies on CRE loans (particularly offices), while Bloomberg, citing CRED IQ[14], highlighted the increase in the share of delinquent loans in collateralized loan obligations (CLOs). These trends confirm Fed aggregate data on banks (shown in figure 40). Historically, the strongest performance in the real estate markets has followed periods of dislocation. However, as always, timing will be crucial.

Figure 40: CRE loans delinquencies in US banks' portfolios



Sources: US Federal Reserve, LSEG Datastream, Allianz Research

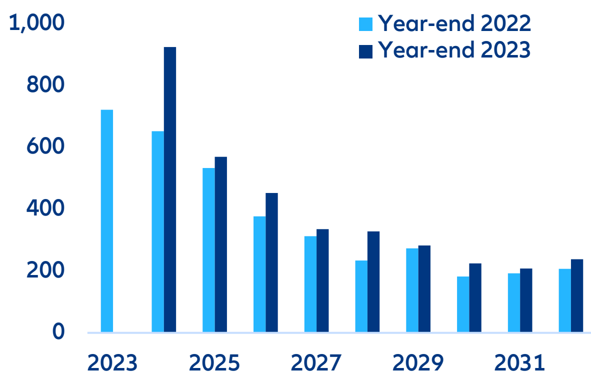
[12] It is always complicated to get these estimations, so we have taken the number from JLL: Dry powder for investment (jll.com)
[13] Real estate: selectivity matters!
[14] Real Estate pain is showing up in an obscure investment product

In our view, it is premature to call an end to CRE turbulence. Under our baseline scenario, we anticipate the market will bottom sometime in 2024, with the recovery that will follow being very gradual. a gradual. However, the CRE sector's challenge is not only about office. Recent developments in multifamily investments have also made headlines, particularly as banks adjust CRE book values. Although low vacancy rates are supported by the high cost of single-family homes, which drives rent, things could change. Supply has grown significantly, yet rental growth is struggling to keep up – unlike expense growth, which remains steady. Moreover, regulatory risks, such as caps on rental growth, are heightened in times of social instability and elections.

No wonder it's time for industrial real estate! The Inflation Reduction Act, CHIPS and Science Act, European CHIPS Act, European Green Deal and multiple National Strategies on AI and hydrogen are thrusting (re)industrialization back to the forefront of government agendas worldwide. The Covid-19 pandemic and rising geopolitical tensions have exposed the fragility of relying heavily on offshoring and "always-reliable" supply chains. Furthermore, the pressing requirements for digitalization and a green transition underscore the necessity for a modernized manufacturing sector. Consequently, a wave of investments is flowing towards this sector, supported by public funds and private sector incentives. Despite its inherent heterogeneity, the industrial sector is witnessing a structural shift in demand. In our view, this heralds a new era for industrial CRE investments. This revival in industrial activity translates directly into higher demand for specialized real estate. Manufacturing facilities, logistics hubs, data centers and green technologies infrastructure are all poised for expansion.

Unlike private debt in other niches, the pullback of traditional funding sources (banks) has not led to increased fundraising across private debt funds. Here, the reluctance to originate new loans is coupled with an implicit agreement between borrowers and lenders. Borrowers, facing difficulties in meeting payment obligations but unwilling to refinance at peak interest rates, and lenders, eager to avoid defaults and aware that refinancing under these conditions might lead to defaults, have often opted for extending the maturity of existing loans. This strategy has effectively reduced the immediate need for refinancing (Figure 41), but it cannot last. Especially as uncertainty around interest rates decreases and the prospects of a soft landing improves, the incentives to extend maturities under the same conditions diminish.

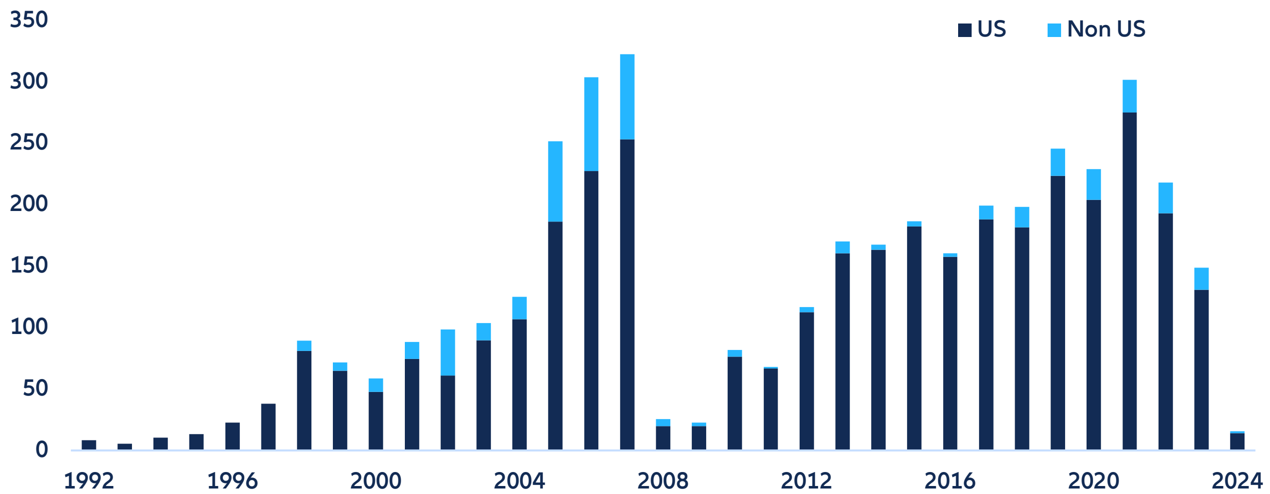
Figure 41: US CRE debt maturity wall, 2022 vs. 2023, USD bn



Sources: Mortgage Bankers Association, Allianz Research

In the world of real estate debt, it is essential to consider that securitization, especially in the US, is more developed than in other areas and that CMBS, among other instruments, have played an important role (as shown in Figure 42 below). This figure shows that CMBS issuance can reach a yearly maximum of USD30bn, compared to the amounts raised via private debt deals reported by Pitchbook. While CMBS and private real estate debt are distinct, CMBS offers debt investors a structured entry point into the real estate market. Other factors in favor of private real estate debt make us believe this market could gain relevance in the coming years: flexibility and proactive default risk management, which in the current uncertain environment becomes crucial (Figure 42).

Figure 42: CMBS issuances, USD bn



Sources: Bloomberg, Allianz Research

Repurposing office space. Many potential gains but hardly a gamechanger.

Repurposing office spaces is a trend gaining momentum, driven by evolving work patterns and market demands. As office properties face increasing vacancy rates, owners (or, more commonly, new buyers) are prompted to explore creative alternatives. It is important to note that not all building transformations involve repurposing, a concept that, while not new, has been relatively rare historically. When transformation occurs, the complexity can vary greatly. In simpler cases, this might involve converting empty floors into amenities like gyms or large conference rooms to enhance the property's value. However, more than minor adjustments may be needed, particularly as demand weakens beyond – central business districts. In case repurposing of the building might be more viable, addressing supply-demand gaps in different asset types. However, these extensive projects, although can transform properties to better meet current market needs, they are Herculean and come with significant challenges.

Transforming an office building into a residential, retail or mixed-use space involves complex challenges. Cost is often the primary concern, as renovations can be extensive and expensive, requiring significant investment in structural modifications, electrical and plumbing systems. This can make the economic viability of projects questionable. However, in many cases, it is not just cost but also architectural limitations that prevent the transformation. Regulatory issues also play a major role, with local laws frequently restricting changes of purpose. Architecturally, many office buildings were not designed to meet the plumbing and ventilation needs of residential units, posing another layer of difficulty. Lastly, environmental concerns require careful handling.

One key facilitator that could ease the transition of repurposing buildings is the public sector, which is currently focused on increasing housing supply as a key policy goal. Government actions include easing the repurposing of office buildings through regulatory changes and providing direct incentives, such as tax advantages. In the US where rising housing prices coincide with high office space vacancy rates, there have been several initiatives already. For instance, in 2023, Washington D.C. launched a tax abatement program for property owners that change a building's use to add housing units, although this is limited to certain parts of the city[15]. Similarly, California, one of the worst hit by the office space downturn, has launched a fund to support developers' efforts to convert commercial spaces into affordable housing[16].

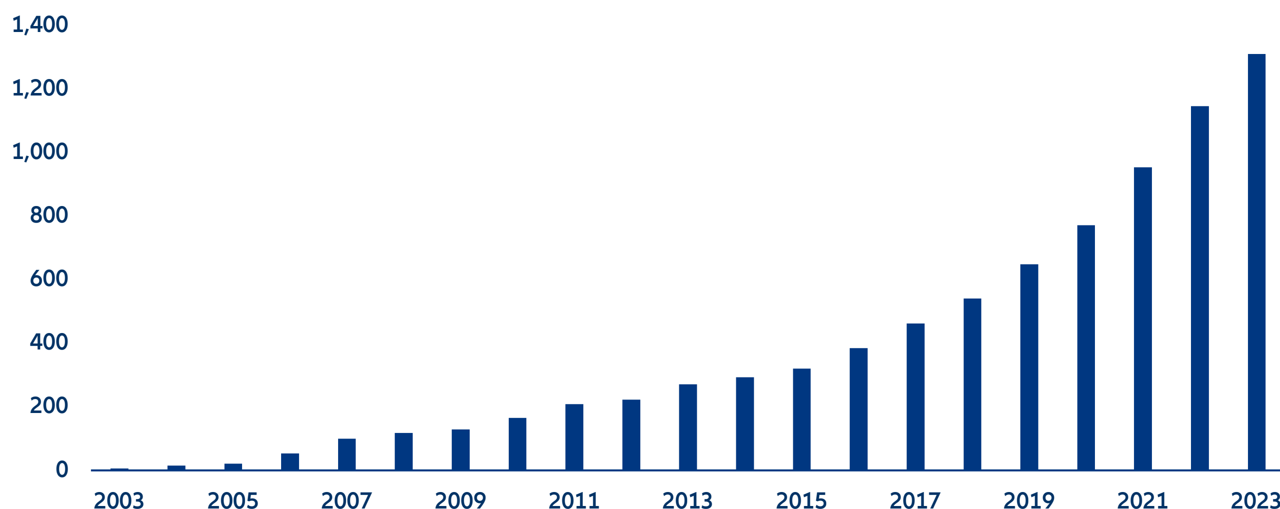
While there have been examples of successful and profitable repurposing[17], these are the exception rather than the norm. Given the substantial costs involved, repurposing has not emerged as a game-changer in relation to the issue facing office space. However, the environmental benefits of repurposing office buildings enhances its appeal significantly. This process involves reusing existing structures, drastically reducing the demand for new construction materials and lowering the carbon footprint associated with new builds. Repurposing conserves resources and aligns with recycling principles, as it extends the lifecycle of existing materials and minimizes waste[18].

[15] D.C. Launches Conversion Abatement Fund As Planned Downtown Projects Stall (bisnow.com)
[16] California's $400 Million Office-To-Housing Conversion Fund Lures Investor Applicants (costar.com)
[17] The National Association of Realtors listed some of these stories in this report: here.
[18] (PDF) Where Do Environmental Benefits from Repurposing Office Buildings into Apartments Come from? (researchgate.net)

Private infrastructure, from niche to nexus

Infrastructure has emerged as the fastest-growing asset class within the private asset universe over the past two decades. In 2003, private infrastructure was still a niche investment area, dominated by a small circle of asset managers with merely USD6.6bn of assets under management (AuM) globally. This was substantially less than the AuM for private equity funds, which already exceeded USD650bn at that time. Though less discussed than today, private debt and private real estate had USD72.3bn and USD85.3bn in AuM, respectively. Two decades later, private infrastructure has become a notable share of investors' allocation in alternative assets, with its AuM surging to over USD1.3tn (Figure 43). This represents a compound annual growth rate (CAGR) of 30.7%, compared to 14.0% for private equity, 17.3% for private debt and 16.3% for private real estate.

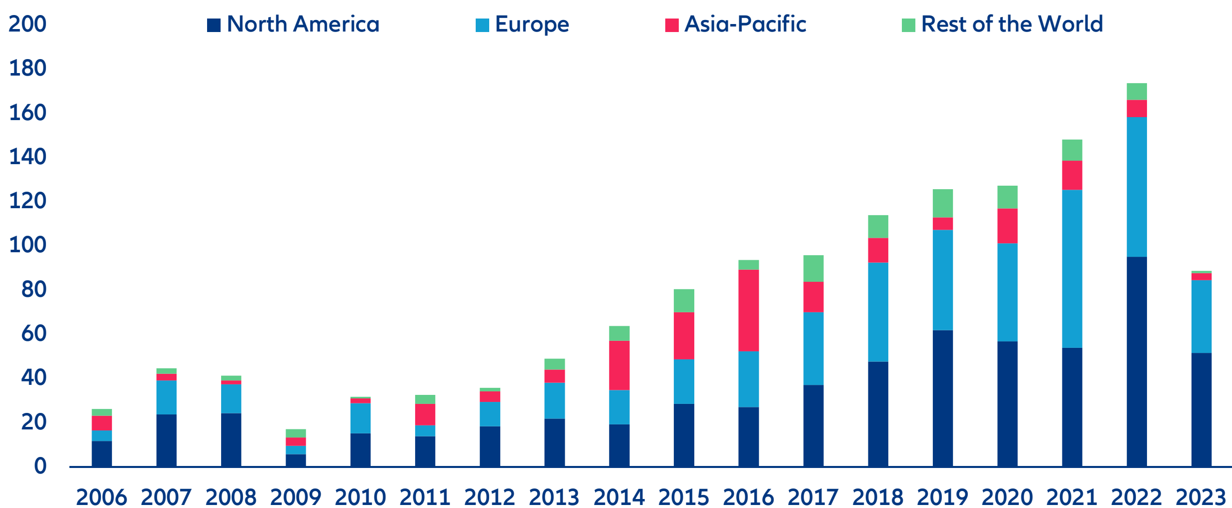
Figure 43: Infrastructure assets under management (USD bn)



Sources: Preqin, Allianz Research

After a major downturn in 2023, fundraising activities have seen signs of recovery as we move into 2024. Private infrastructure has seen significant growth in annual fundraising since 2012, thanks to a decade of ultra-low borrowing costs. Fundraising peaked in 2022 with USD165bn pouring into 146 infrastructure funds (Figure 44), largely driven by North American and European markets, which accounted for more than 90% of the global capital raised. However, as interest rates rose against a radically shifted macroeconomic environment, infrastructure experienced a significant U-turn in fundraising in 2023. Only USD86bn was raised through 84 funds in 2023, a stark contrast to 2022. Despite this, there has been a resurgence in demand for infrastructure investments since late 2023. Several key market players have raised record amounts in their infrastructure funds or set ambitious goals. Additionally, some of the largest general partners (GPs) have stuck deal to acquire specialized infrastructure investors, suggesting a growing interest in expanding their footholds in the private infrastructure realm.

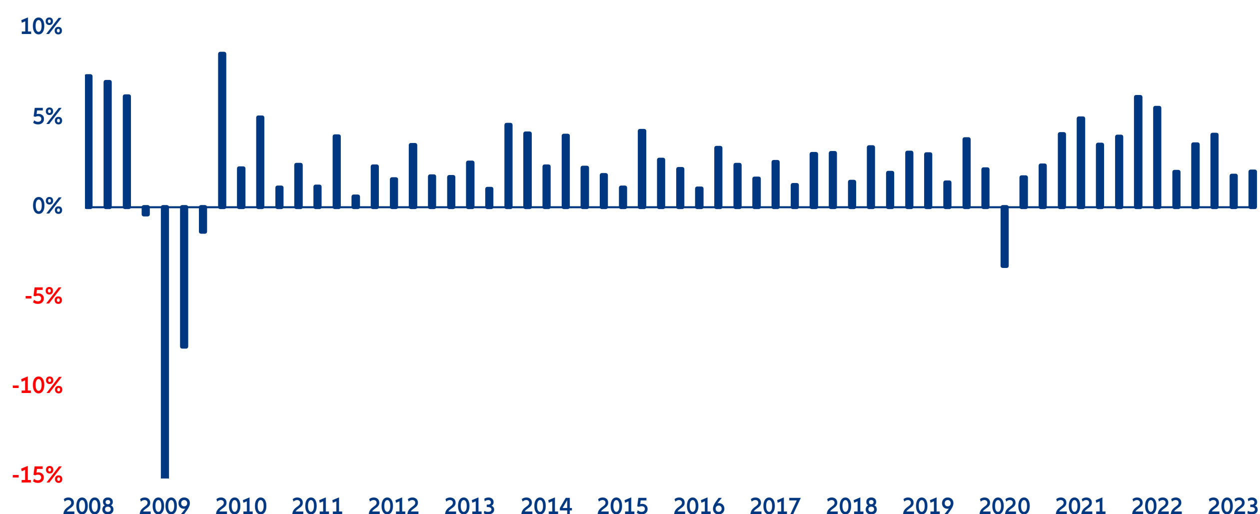
Figure 44: Infrastructure fundraising by region (USD bn)



Sources: Preqin, Allianz Research

The rising popularity of infrastructure can be attributed to several inherent attributes: stable demand, predictable cash flows and, often, inflation-hedging capabilities. Infrastructure assets, such as utilities and power producers, transportation facilities, including toll roads and airports and parking garages, are linked to people's daily lives and are crucial for economic activities. Given infrastructure's exposure to these essential services, the demand is relatively inelastic, which generates stable cash flows and offers downside protection during economic downturns. Moreover, many of these assets operate under long-term contracts or within regulated frameworks, ensuring predictable cash flows. Even assets without contractual payments, like airports and some other transportation infrastructure, often command a large market share due to their capital-intensive nature and economies of scale. Therefore, these assets typically face little competition, which provides some protection for their cash flows. Additionally, many infrastructure contracts include index-based adjustments, allowing operators to pass on increased costs to consumers. Due to their non-cyclical nature, infrastructure assets have historically delivered resilient performance across various economic cycles (Figure 45). Moreover, private infrastructure has recorded low or negative correlations with other asset classes (Table 1), which offers diversification benefits to investors' portfolios. These attributes make infrastructure investment especially appealing amid broader market volatility.

Figure 45: Total returns of private infrastructure (in %)



Sources: Preqin, Allianz Research
Note: Preqin infrastructure Index is proxied for private infrastructure's performance

Table 1: Historical correlations between returns of private infrastructure and other asset classes

	Private infrastructure	Private equity	Private debt	Private real estate	Listed equity	IG bond	HY bond
Private infrastructure	1	0.26	0.07	0.40	0.02	-0.09	-0.22
Private equity	0.26	1	0.62	0.70	0.79	0.15	0.63
Private debt	0.07	0.62	1	0.45	0.52	0.16	0.54
Private real estate	0.40	0.70	0.45	1	0.36	-0.16	0.18
Listed equity	0.02	0.79	0.52	0.36	1	0.36	0.87
IG bond	-0.09	0.15	0.16	-0.16	0.36	1	0.45
HY bond	-0.22	0.63	0.54	0.18	0.87	0.45	1

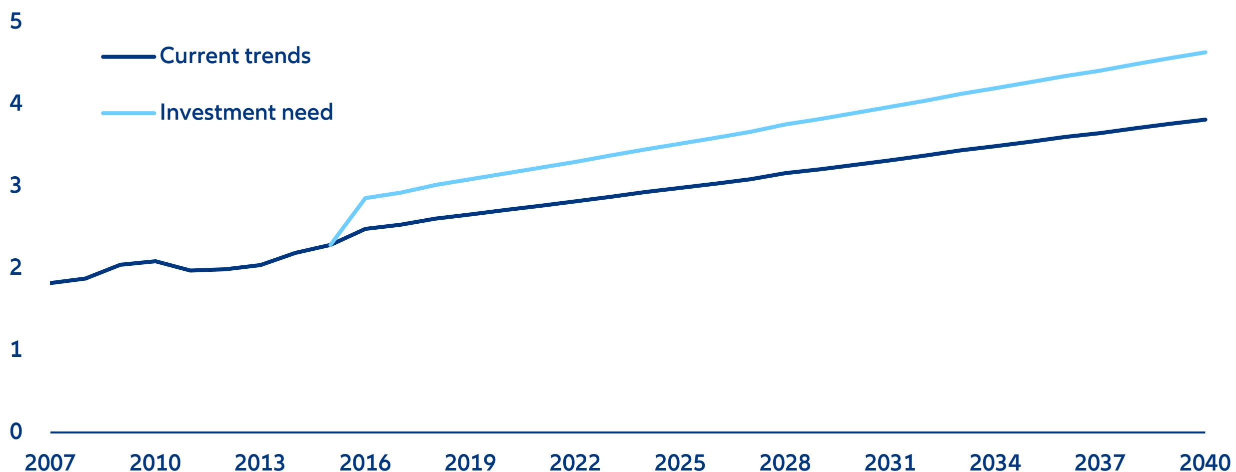
Sources: Bloomberg, Preqin, Allianz Research

Note: Correlations are derived from historical quarterly returns from 2008Q1 to 2023Q2 and are based are following proxies: Private infrastructure: PrEQIn infrastructure Index; Private equity: PrEQIn private equity Index; Private debt: PrEQIn private debt Index; Private real estate: PrEQIn real estate Index; Listed equity: MSCI ACWI Index; IG bond: Bloomberg Barclays Global Aggregate Index; HY bond: Bloomberg Global High Yield Index.

We expect the momentum in private infrastructure investment to continue, given its critical role in bridging the public funding gap and supporting structural shifts towards decarbonization and digitalization. The Global Infrastructure Hub identifies a staggering USD15tn gap between the projected investment and the amount needed to provide adequate global infrastructure by 2040 (Figure 46). This significant shortfall and constraints on government spending presents an unprecedented opportunity for private capital to invest in infrastructure projects.

Crucially, private infrastructure is strategically positioned to benefit from the expanding green and digital economies. As these major secular trends accelerate, General partners have broadened their definition of infrastructure to include traditional assets like utilities and transport, and data centers, telecom towers and renewables to meet the surging demand for computing power, digital connectivity and sustainable energy sources. A recent survey found that the majority of infrastructure managers have identified the energy transition as the primary driver of private capital investment in infrastructure over the next decade. The trends of decarbonization and digitization are set to persist for decades and will require substantial capital investment, which the public sector alone cannot provide. Furthermore, unlike private equity or debt, investors who primarily seek to profit by identifying potential industry leaders and high performers, infrastructure investment adopts a less risky approach by supporting fundamental services required by all participants in this shift.

Figure 46: Global infrastructure investment (USD tn)



Sources: Global Infrastructure Hub, Allianz Research

Despite its relatively low-risk profile and growth potential, private infrastructure investment faces several notable challenges. Private infrastructure appeals to investors primarily for its stable returns and inflation-hedging attributes. However, recent surges in interest rates have made the yields of public and private debt more competitive, undermining the relative attractiveness of private infrastructure. On the other hand, investors are increasingly moving from the riskier value-added strategies amid the emergence of a risk-off market, creating a dilemma for infrastructure managers. This challenge is compounded by heightened competition within the sector as large asset managers enter the market pursue investment opportunities in areas like solar, wind energy and data centers. This influx of capital could lead to mispricing in these investments. Additionally, the transition of ownership of essential services from governments to private capitals, typically characterized by high indebtedness and a lack of transparency, occasionally sparks public and political backlash, as seen recently in the British water industry.

A look at blended finance

Climate finance is at a pivotal crossroads. Despite a consistent increase in global climate finance flows over the past decade, they fall significantly short of the levels required to achieve the Paris Agreement targets. Despite the clear need for robust climate action, there has been a slowdown in the growth rate of public climate finance, a reduction in private climate finance, and a regression in climate blended finance – particularly from private investors, development finance institutions (DFIs) and multilateral development banks (MDBs).

The potential of climate-blended finance to achieve international climate targets is significantly underutilized. Despite the availability of private capital for climate-focused investments, the investment landscape in many emerging markets tells a different story. These markets face numerous obstacles that hinder substantial private investment, primarily due to insufficient risk-sharing mechanisms and a lack of willingness by the public sector to shoulder potential losses. Additionally, the existing incentives for attracting private capital are inadequately scaled and fail to address the urgency of the climate crisis effectively. Climate change will not pause while developing nations implement institutional reforms or achieve desired investment-grade ratings. The urgent need to cut emissions by half within the next decade demands bold, immediate action within the current frameworks of these countries. Time is running out, and it is crucial for public investors to proactively support blended finance structures that mitigate risks deterring private sector involvement.

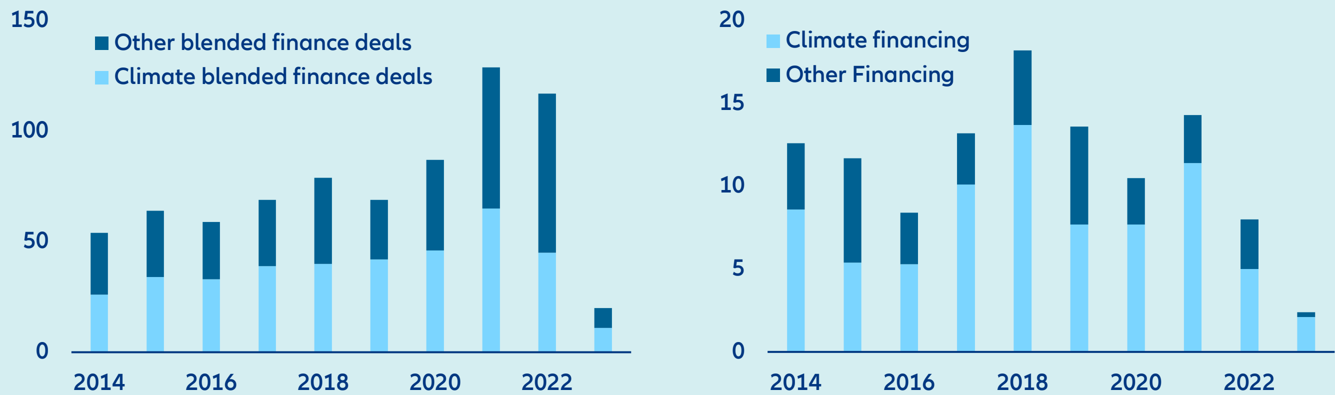
How can blended finance assist? It is crucial to define blended finance as a financial approach combining capital from public or philanthropic sources with private sector investment to fund projects aimed at achieving social and environmental outcomes alongside financial returns. This strategy is widely used in development finance to direct private sector capital towards sustainable development goals (SDGs) that might otherwise not receive funding due to perceived risks or lower returns. Blended finance reduces private investors risk through mechanisms such as guarantees and first-loss capital. It employs various financial instruments such as loans and equity to multiply the impact and drive private investment towards meaningful projects.

But there are also several challenges, as blended finance tends to involve complex financial structures that can be challenging to manage and make it difficult to measure the social and environmental impacts accurately alongside financial returns. Additionally, there is the risk that projects can become overly dependent on public subsidies, potentially threatening long-term sustainability. Despite these challenges, blended finance is crucial to bridging the funding gap in global development challenges, particularly in regions and sectors underserved by traditional capital markets.

Blended finance accelerated in 2022 but is slowing down at an alarming rate. According to a recent Convergence[19] analysis, while the number of deals in 2022 mirrored those in 2021, the total deal volume fell sharply by about 45% in the general market and around 55% in climate-related financing, reaching a decade low. This decline aligns with broader financing market trends, reflecting the macroeconomic hurdles impeding capital flows to emerging markets and developing economies (EMDEs). Contributing factors significantly influencing these trends include rising inflation policy rates, increasing debt levels and geopolitical uncertainties (Figures 47 & 48).

[19] State of Blended Finance, Convergence (link)

Figures 47 & 48: Number of transactions (left) and aggregate deal volume (right – in USD bn)



Sources: Convergence, Allianz Research
Note: Convergence data until October 2023

Climate-related blended finance deals now constitute less than half of all such transactions, a significant decrease from the previous five-year average of over 50%. Geographically, the past three years of transactions seem to concentrate in Sub-Saharan Africa, which accounted for around 50% of the deals. Latin America and the Caribbean follow with 24% of the transactions. Regarding financing, public-sector entities, including development agencies, continue to be the main contributors, providing 49% of the funds during the past three years. Conversely, private investor participation has decreased from ~7 USD bn in 2017-2019 to ~6 USD bn in the past three years.

Adaptation-focused[20] blended finance remains significantly less common, with only a small portion of deals dedicated exclusively to adaptation. This contrasts with the much larger sums directed towards mitigation and hybrid projects. Meanwhile, hybrid transactions, which tackle both climate mitigation and adaptation, are increasingly seen as a promising opportunity for private sector investment, attracting a substantial share of institutional climate finance compared to those focused solely on mitigation or adaptation.

As investment in blended finance, particularly in climate-related topics, falters, a push for the asset class to invigorate this asset class is crucial. According to insights from Convergence, for blended finance to be effective, MDBs and DFIs ought to incorporate key performance indicators (KPIs) related to climate and private sector engagement into their operational strategies. Additionally, enhancing data and analytics capabilities is essential. Moreover, it is critical to address non-financial risks and political dependencies to fully leverage the potential of blended finance. The report also emphasizes integrating philanthropic capital as a crucial, catalytic component within blended finance frameworks. Lastly, lower- and middle-income countries should be enabled to implement decentralized, grassroots strategies in developing their own national financing platforms[21].

[20] Using blended finance structures to deliver private sector investment to climate adaptation transactions in developing countries.
[21] For more information on the topic please refer to Converge (link) and CPI (link).

Our
team

Chief Economist
Allianz SE

Ludovic Subran
ludovic.subran@allianz.com

Head of Economic Research
Allianz Trade

Ana Boata
ana.boata@allianz-trade.com

Head of Insurance, Wealth & Trend Research
Allianz SE

Arne Holzhausen
arne.holzhausen@allianz.com

Macroeconomic Research

Maxime Darmet Cucchiarini
Senior Economist for US & France
maxime.darmet@allianz-trade.com

Roberta Fortes
Senior Economist for Ibero-Latam
roberta.fortes@allianz-trade.com

Jasmin Gröschl
Senior Economist for Europe
jasmin.groeschl@allianz.com

Françoise Huang
Senior Economist for Asia Pacific
francoise.huang@allianz-trade.com

Maddalena Martini
Senior Economist for Italy, Greece & Benelux
maddalena.martini@allianz.com

Luca Moneta
Senior Economist for Africa & Middle East
luca.moneta@allianz-trade.com

Manfred Stamer
Senior Economist for Middle East & Emerging Europe
manfred.stamer@allianz-trade.com

Corporate Research

Ano Kuhanathan
Head of Corporate Research
ano.kuhanathan@allianz-trade.com

Aurélien Duthoit
Senior Sector Advisor, B2C
aurelien.duthoit@allianz-trade.com

Maria Latorre
Sector Advisor, B2B
maria.latorre@allianz-trade.com

Maxime Lemerle
Lead Advisor, Insolvency Research
maxime.lemerle@allianz-trade.com

Yao Lu
Sector Advisor
yao.lu@allianz-trade.com

Capital Markets Research

Jordi Basco Carrera
Lead Investment Strategist
jordi.basco_carrera@allianz.com

Bjoern Griesbach
Senior Investment Strategist & Eurozone Economist
bjoern.griesbach@allianz.com

Pablo Espinosa Uriel
Investment Strategist, Emerging Markets & Alternative Assets
pablo.espinosa-uriel@allianz.com

Insurance, Wealth and Trends Research

Michaela Grimm
Senior Economist, Demography & Social Protection
michaela.grimm@allianz.com

Patricia Pelayo-Romero
Senior Economist, Insurance & ESG
patricia.pelayo-romero@allianz.com

Kathrin Stoffel
Economist, Insurance & Wealth
kathrin.stoffel@allianz.com

Markus Zimmer
Senior Economist, ESG
markus.zimmer@allianz.com

Patrick Hoffmann
Economist, ESG & AI
patrick.hoffmann@allianz.com

Recent Publications

18/04/2023 | What to watch
17/04/2023 | Latin America: Shall we dance?
11/04/2023 | What to watch
11/04/2023 | The best is yet to come
05/04/2024 | What to watch
26/03/2024 | Economic Outlook: It's a wrap!
22/03/2024 | What to watch
21/03/2024 | Global auto outlook: Steering through turbulence
14/03/2024 | What to watch
13/03/2024 | Trumponomics: the sequel
07/03/2024 | What to watch
06/03/2024 | When the penny drops - analyzing longevity literacy in six countries
29/02/2024 | What to watch
28/02/2024 | Global insolvency outlook: Reality check
22/02/2024 | What to watch
16/02/2024 | What to watch
14/02/2024 | European labor markets: Migration matters
08/02/2024 | What to watch
07/02/2024 | China: keeping the Dragon awake
02/02/2024 | What to watch
31/01/2024 | Country Risk Atlas 2024: Assessing non-payment risk in major economies
26/01/2024 | What to watch
24/01/2024 | Europe needs to step up its game - Lessons from the American playbook
19/01/2024 | What to watch
16/01/2024 | Allianz Risk Barometer - Identifying the major business risks for 2024
11/01/2024 | What to watch
11/01/2024 | Climate Change Trade-Offs: What does it take to keep our world insurable?
15/12/2023 | Global Economic Outlook 2023-25: Looking back, looking forward
08/12/2023 | What to watch
30/11/2023 | What to watch
29/11/2023 | Climate fatigue: Allianz Climate Literacy Survey 2023
24/11/2023 | What to watch
23/11/2023 | Food industry: Gravy for corporates, leftovers for consumers?
17/11/2023 | What to watch
16/11/2023 | Global construction outlook: Liquidity cracks
10/11/2023 | What to watch
09/11/2023 | India: A rising star
03/11/2023 | What to watch
31/10/2023 | Greening global trade, one container at a time
18/10/2023 | Global Insolvency Outlook 2023-25
13/10/2023 | What to watch

Discover all our publications on our websites: Allianz Research and Allianz Trade Economic Research

Director of Publications
Ludovic Subran, Chief Economist
Allianz Research
Phone +49 89 3800 7859

Allianz Group Economic Research
https://www.allianz.com/en/economic_research
http://www.allianz-trade.com/economic-research
Königinstraße 28 | 80802 Munich | Germany
allianz.research@allianz.com

Allianz Trade Economic Research
http://www.allianz-trade.com/economic-research
1 Place des Saisons | 92048 Paris-La-Défense Cedex | France
research@allianz-trade.com

About Allianz Research
Allianz Research encompasses Allianz Group Economic Research and the Economic Research department of Allianz Trade.

Forward looking statements

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.
Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

No duty to update

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.

Allianz Trade is the trademark used to designate a range of services provided by Euler Hermes.