# Alternative opportunities

2024 outlook and methodology | USD | Q4 update

Invesco Solutions

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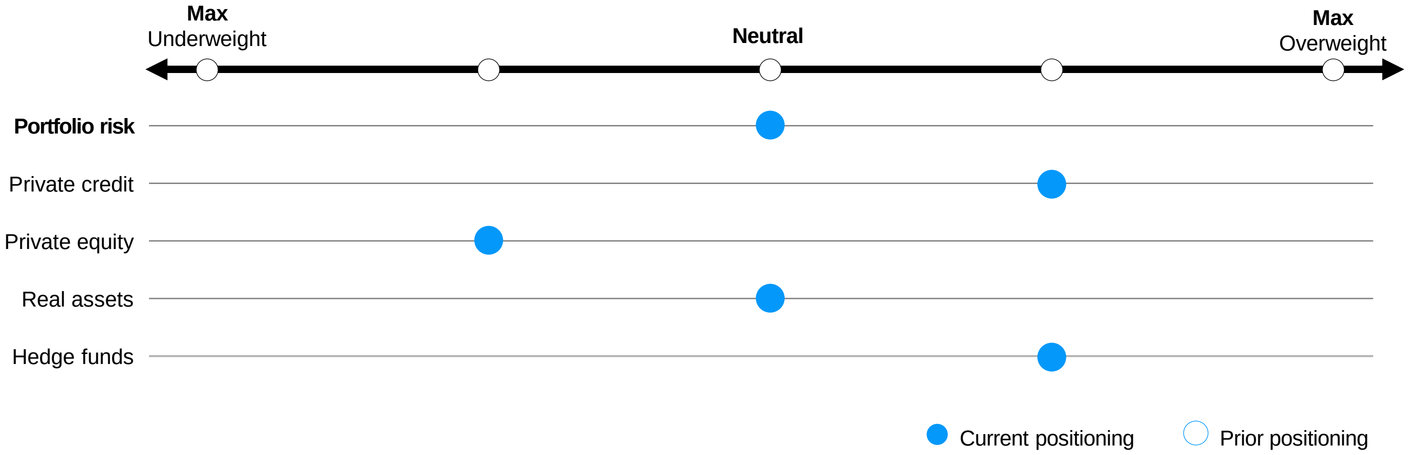
Invesco

# 2024 alternative opportunities – Q4 outlook: Alternatives

## Executive summary

**Jeff Bennett, CFA**
Head of Manager Selection
Invesco Solutions




### Portfolio risk

We remain neutral on how we're allocating risk within our alternatives portfolio due to elevated downside growth risks, high equity valuations, and benign capital markets activity. In general, we're more defensive, favoring private debt and hedged strategies versus private equity.

### Private credit

While we may see some compression in direct lending spreads and original issue discounts (OID), we still believe that all-in yields will remain attractive relative to liquid credit strategies.

Real asset and alternative credit yields continue to remain elevated relative to their long-term averages.

### Private equity

Dry powder continues to sit idle as public market valuations remain high, and "take-private" transactions are at record low levels. Lower interest rates and tighter spreads will likely improve the leveraged buyout (LBO) outlook as the thawing of the exit market will be a welcome shift for PE managers and investors.

### Real assets

Within commercial real estate, a trough in valuations and stabilization of cap rates at tight levels have driven confidence that the start of a new transaction cycle is close at hand. Despite elevated valuations and record levels of dry powder in infrastructure, an easing of policy may provide a runway for investors to deploy capital.

### Hedge funds

Spreads within event-driven strategies remain high despite limited capital market activity from mergers and acquisitions as private equity remains sidelined.

Trend-following strategies have historically benefited from a tailwind during periods of high and declining rates.



Source: Invesco Solutions, views as of Sept. 19, 2024.

# Private credit

## Direct lending and real asset debt

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# 2024 alternative opportunities – Q4 outlook: Private credit

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**Ron Kantowitz**
Head of Direct Lending
Invesco Private Debt

**Charlie Rose**
Global Head of Commercial
Real Estate Credit

**Presently overweight direct lending due to attractive valuations and terms on new vintages**

| Asset class | Overall | Valuations | Fundamentals | Secular trend |
|---|---|---|---|---|
| **Direct lending** | Overweight | Attractive | Neutral | Attractive |
| **Real asset credit** | Overweight | Attractive | Neutral | Attractive |
| **Alternative credit** | Overweight | Attractive | Neutral | Attractive |

## Market overview

The backdrop supporting a more favorable transaction environment is firmly in place, including better visibility into the macro regime, softening inflationary pressures, potential rate reductions, and heightened pressure from LPs for PE firms to generate realizations and invest in new platform companies. While private debt strategies are broadly seeing modest spread compression on the back of an increase in capital market activity and a general tightening across liquid credit markets, the spread between public and private debt remains attractive and roughly in line with long-term historical averages.

## Direct lending

While we may see some compression in spreads and original issue discounts (OID), should M&A markets reopen, we still believe that all-in direct lending yields will remain elevated on an unlevered basis. These historically high levels of yield represent attractive opportunities from a risk/return perspective both to private equity assets and public markets.

## Distressed debt and special situations

Private equity sponsors face a dilemma: They own performing businesses capitalized in a near-zero base rate environment, and now much of their free cash flow is spent on cash interest expenses. Special situations can provide capital solutions to reduce the interest expenses of these companies while also mitigating downside risk through security and governance.

## Commercial real estate debt

Declining benchmark rates may lower real asset debt yields closer to historical levels in the coming quarters, which, in our view, would remain attractive relative to other credit assets. Rate cuts are expected to help normalize capital market conditions by increasing transparency and liquidity, ultimately leading to additional transaction activity. Rate cuts will also provide relief for borrowers and lenders, likely leading to stronger debt service coverage and healthier loan-to-value ratios, in our view.

## Infrastructure debt

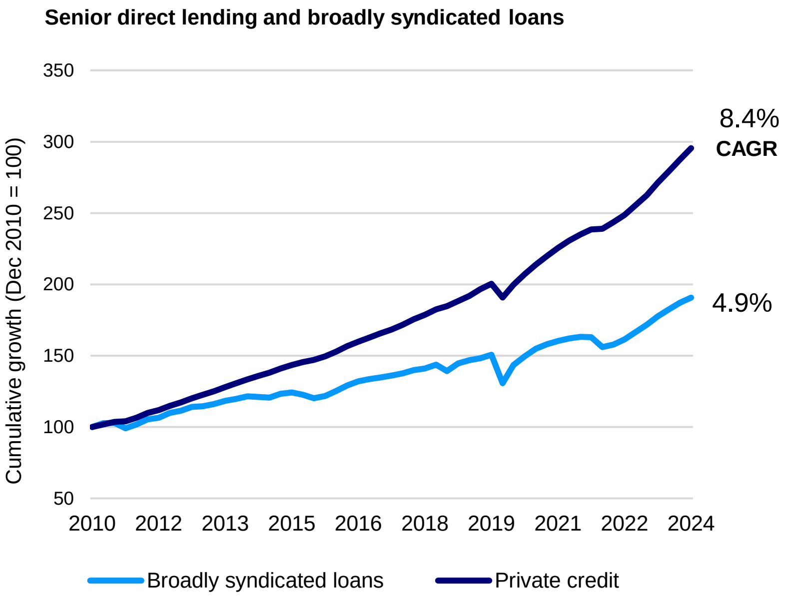
We continue to see a combination of robust fundamentals and attractive pricing across infrastructure debt verticals, with the single B floating rate part of the market offering low double-digit yields. Our expectation is that continued demand from borrowers is likely to support a favorable market environment for lenders, especially in growing sub-sectors, including digital infrastructure and renewables.

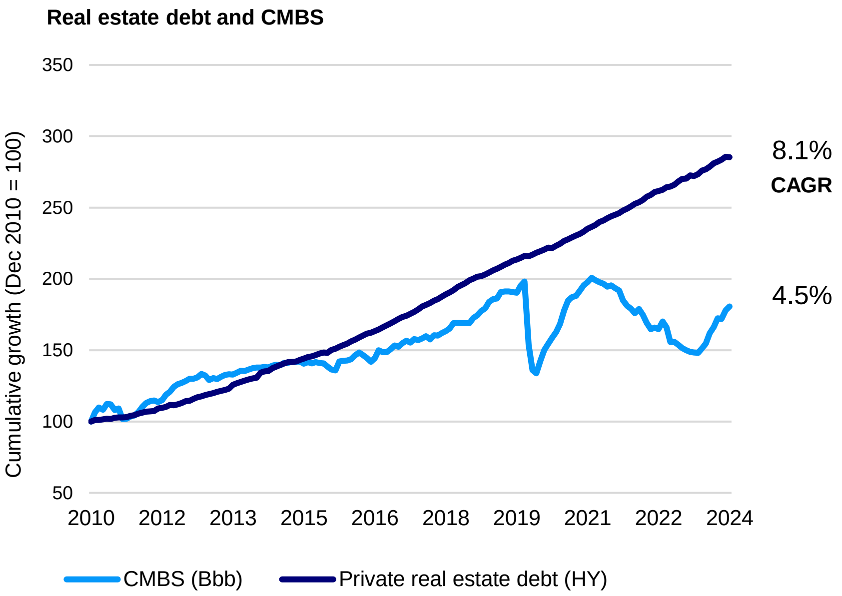
## Alternative credit

Liquid alternative credit markets have experienced significant growth combined with modest spread compression. While the rally in liquid alternative credit markets is resulting in a slightly tighter private market, we have yet to see a significant impact in many sub-sectors, including fund finance, regulatory capital relief, and non-core bank portfolios, among other areas. We believe this space continues to offer value and diversification benefits for credit investors.

Sources: Invesco Solutions, Invesco Private Credit, Invesco Real Estate Credit, views as of Sept. 19, 2024.

# Cumulative growth of private credit vs. public credit




Sources: Investment growth of 100; Private credit represented by the Cliffwater Senior Direct Lending Index and broadly syndicated loans represented by the Credit Suisse Leveraged Loan Index, quarterly from Dec. 2010 to June 2024; CMBS (BBB) represented by Bloomberg Non-Agency Investment Grade CMBS: Bbb Total Return Unhedged Index and private real estate debt (HY) represented by the Giliberto-Levy High Yield Commercial Real Estate Debt Index (G-L 2), monthly, from Dec. 2010 to June 2024. Private credit is net of normative fees, while loans are gross of fees. An investment cannot be made directly into an index. **Past performance does not guarantee future results**.

# Views on private assets: Private credit

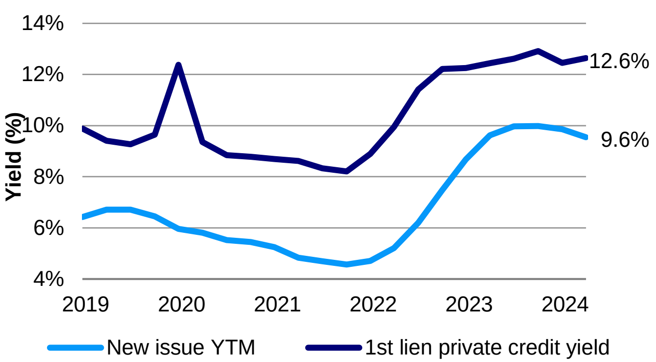
| Investment type | Spread (SOFR+, bps*) | Allocation range | Comments |
|---|---|---|---|
| | | Underweight / Neutral / Overweight | |
| **Direct lending senior (1st lien)** | 550-650 | | • Anchor for diversified private debt portfolios.<br>• Favorable environment for creditors, with strong covenants and call protections.<br>• Improving M&A transaction environment has resulted in a pickup in activity in Q1. |
| **Direct lending junior (2nd lien/mezz)** | 800-1000 | | • Borrowing that occurs behind senior/1st lien private corporate debt.<br>• Potential for opportunistic financing with attractive risk/reward. |
| **Real estate debt (Whole loan/mezz)** | 350-500 / 600-800 | | • Mortgage secured by a lien on a commercial property.<br>• High single-digit, low double-digit returns with conservative terms and modest LTVs.<br>• Low CMBS issuance and pullback from US regional banks has improved opportunity. |
| **US infrastructure debt (HY)** | 550-750 | | • Current environment allows for 1st lien secured Opco loans.<br>• Long-term contractual cash flows, CPI linkages, and lower defaults/higher recoveries.<br>• Secular trends driving growth in digital and renewables sectors and limited competition from regional banks drive favorable supply-demand dynamics. |
| **Alternative credit** | 600-1000 | | • Non-traditional markets such as loans, leases and other receivables.<br>• Asset-backed nature of collateral and amortization schedules enhances protection.<br>• Provides diversification and relies on current income. |
| **Venture debt (1st lien)** | 1000+ | | • Loans to well-capitalized venture-backed borrowers with LTVs typically below 20%.<br>• Limited access to IPO markets and increased cost of capital for venture equity drive favorable pricing and higher creditor protections. |
| **Distressed debt/special situations** | 1000+ | | • Focus on capital solutions and special situations opportunities.<br>• We see many small companies pressured by higher rates and inflation looking for capital solutions. |

# Valuations and fundamentals:

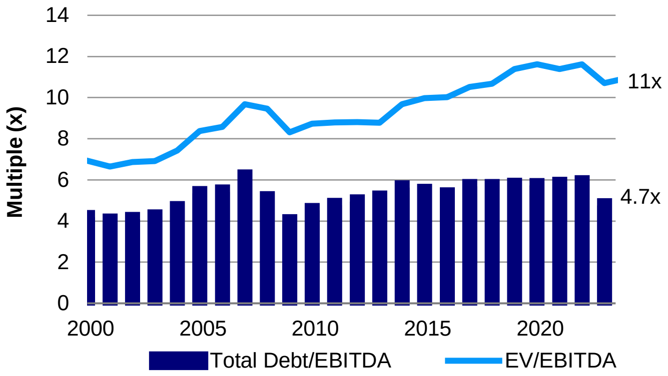
## 1st lien private credit – new issue YTM and leverage ratios

Spreads on offer to 1st lien lenders are attractive on an absolute, relative, and risk-adjusted basis.

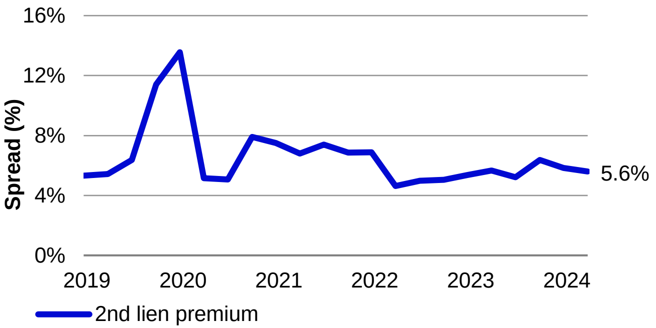
**Yields on new issues versus senior direct lending**



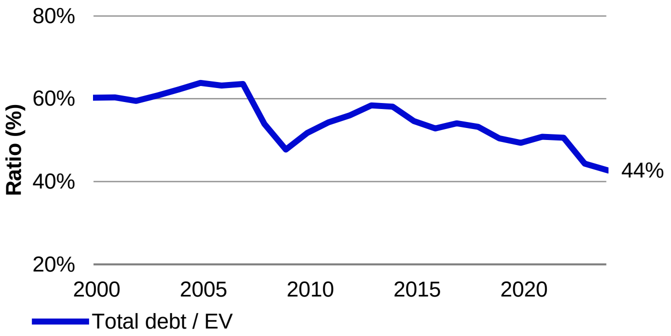

**Global private credit multiples**




**Spreads on 2nd lien debt to public proxies**




**Global private credit LTV**



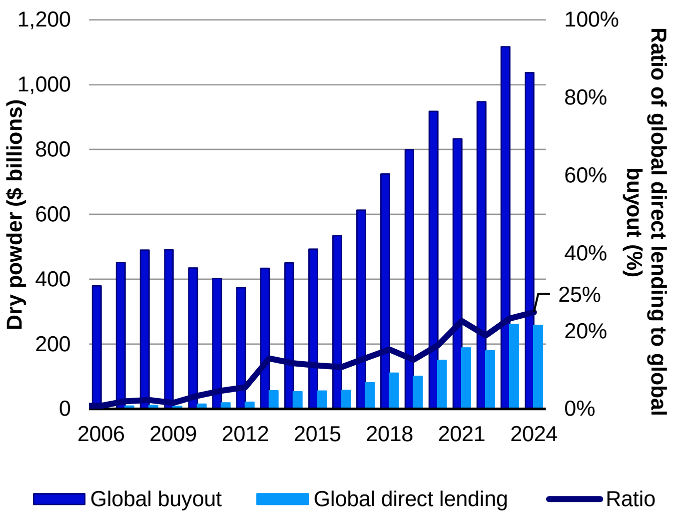

Sources: Pitchbook, LCD Leveraged Loan, SEC EDGAR, JPMorgan, Bloomberg L.P., as of June 30, 2024. Most recent global multiples and LTV data presented as a YTD figure as of Aug. 31, 2024. New issues refer to broadly syndicated loans over $200M issued within the quarter and presented as a 4Q moving average. 2nd lien spread over LIBOR estimates based on SEC filings by a representative sample of BDCs and is calculated by subtracting an HY corporate bond yield based on Option-Adjusted Spread on BBG US Corp HY Index.

# Supply-demand dynamics

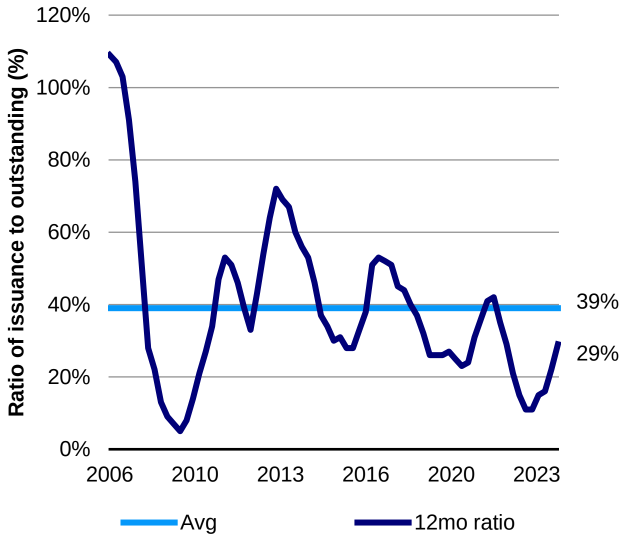
## Direct lending and buyout dry powder and loan issuance

Supply-demand dynamics support a robust environment for lenders with available dry powder. The first half of 2024 showed a notable uptick in broadly syndicated loan volume as markets reopened from depressed 2022 levels, which persisted into 2023.

**Ratio of direct lending to buyout dry powder**




**US broadly syndicated loan issuance relative to total par amount outstanding (12 month rolling)**

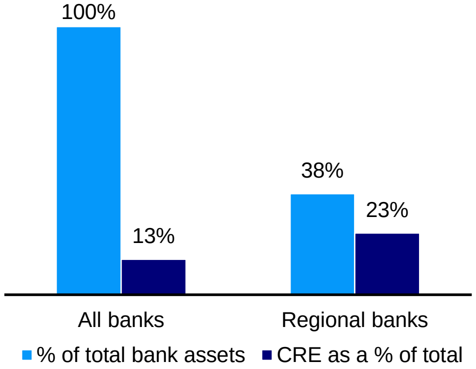



Sources: Invesco Solutions, Preqin, Pitchbook LCD, data as of Aug. 31, 2024.

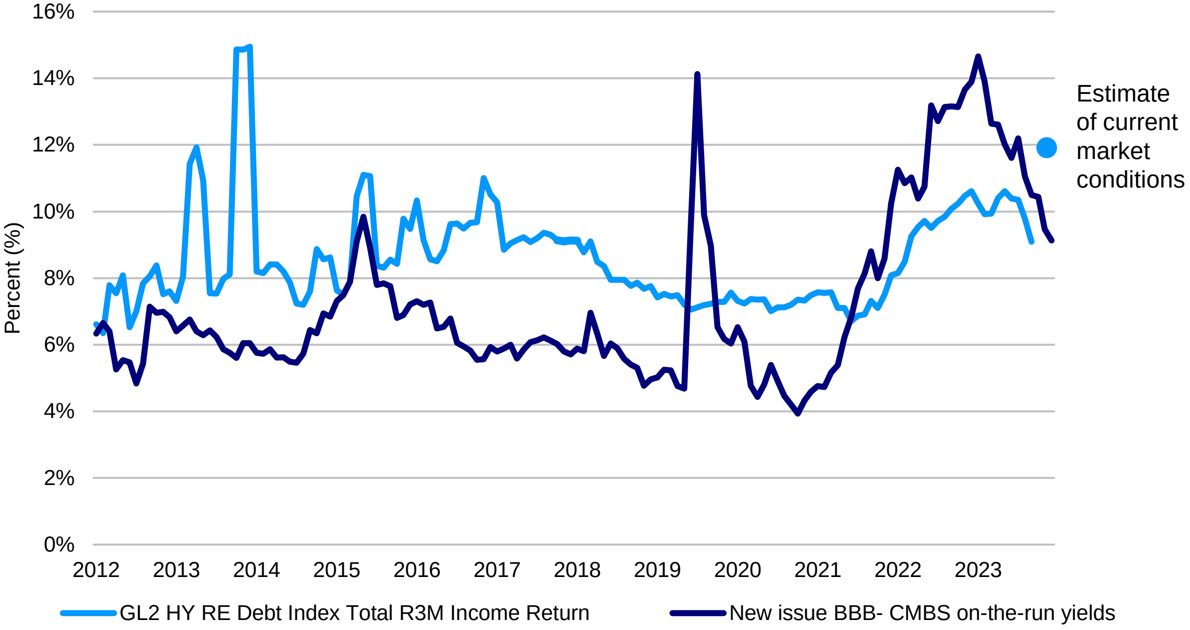
# Real estate credit

High absolute yields and “illiquidity premium” supported by reduced supply of loans from regional banks.

**Regional banks as a percentage of CRE loans**




**Real estate credit yields compared to proxy new issue BBB CMBS new issue on-the-run yields**

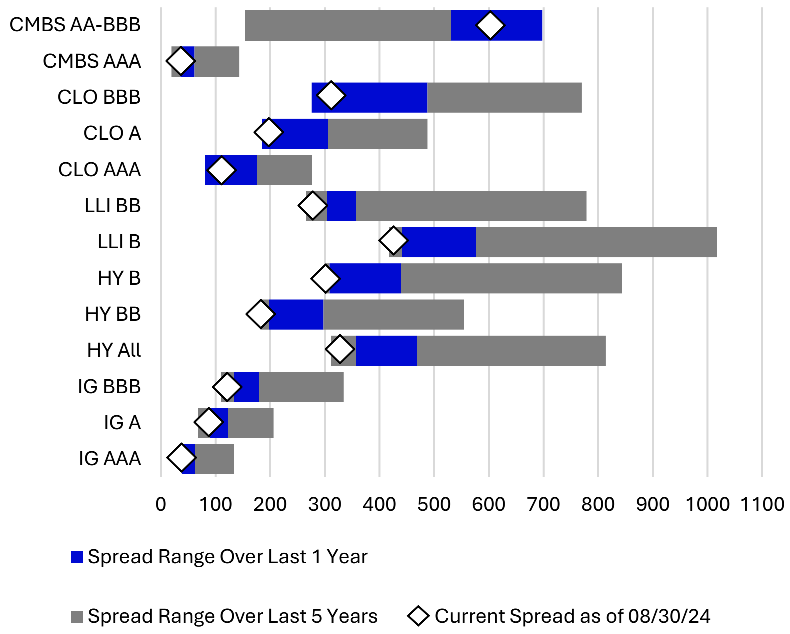



Sources: Invesco Solutions, Gilberto-Levy, FDIC, Bloomberg L.P., as of Sept. 30, 2024. Regional bank data as of June 30, 2024. Regional banks defined as “Assets $1B - $250B.”

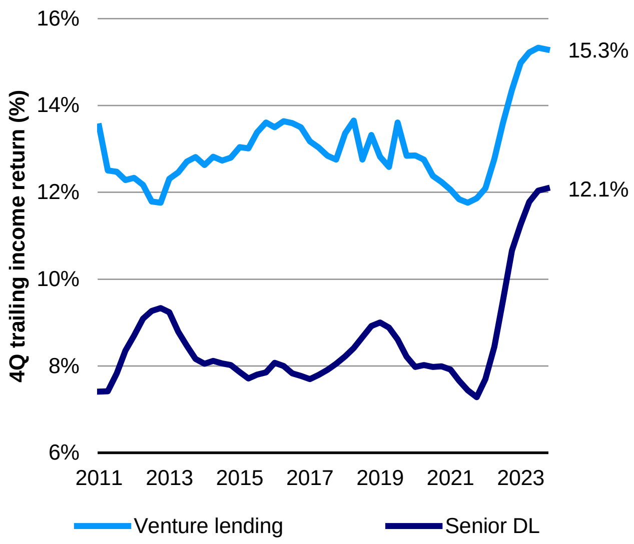
# Alternative credit

While spreads across most liquid markets have tightened significantly relative to recent history, spreads on alternative credit strategies remain wide compared to traditional corporate credit. The more illiquid parts of the alternative credit market, such as venture lending are still offering a spread premium.

**Liquid alternative spreads (current, 1-year and 5-year ranges)**



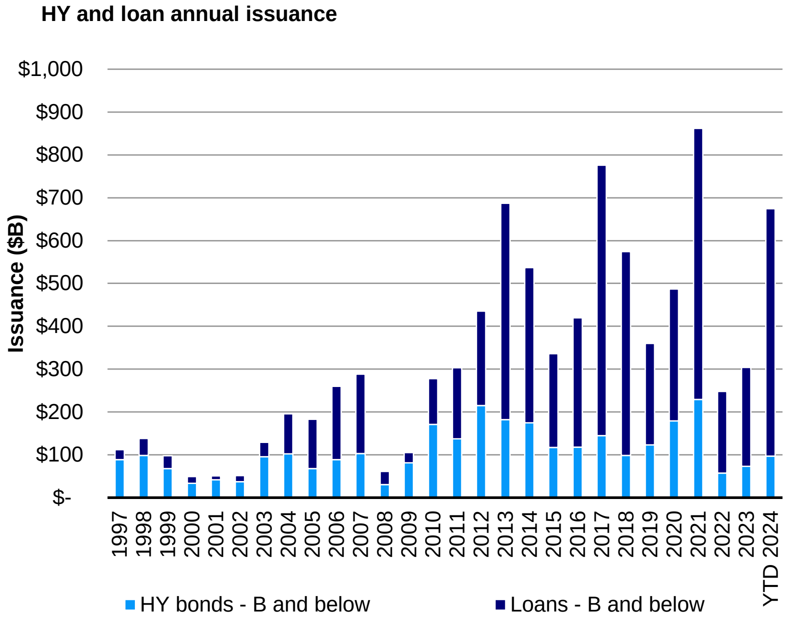

**Venture lending versus senior direct lending income return**

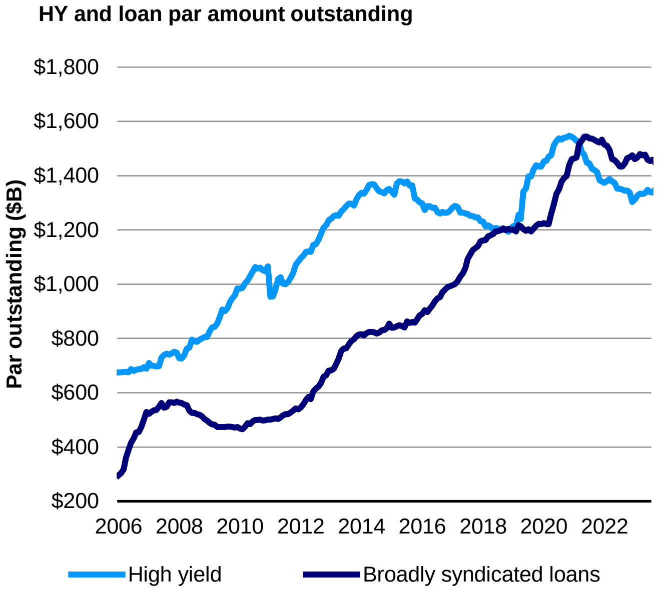



Sources: Invesco Solutions, Bloomberg L.P., FRED, ICE, Morningstar, JPM, Cliffwater direct lending index, as of Aug. 31, 2024. IG, HY, CMBS, and ABS spreads are OAS to spot treasury, LL is spread to maturity over SOFR, and CLO is discount margin to SOFR.

# Distressed

Significant issuance in the loan market rated single B and below, showcasing the opportunity set relative to history.




Sources: Invesco Solutions, ICE BofA, JP Morgan, as of Aug. 31, 2024.

# Private equity
## Large buyout

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# 2024 alternative opportunities – Q4 outlook: Private equity

**Jeff Bennett, CFA**
Head of Manager Selection
Invesco Solutions

**Underweight private equity (PE) as valuations are moderating, with pockets of opportunity in private-to-private transactions**

| Asset class | Overall | Valuations | Fundamentals | Secular trend |
|---|---|---|---|---|
| **Private equity** | Underweight | Unattractive | Neutral | Neutral |

### Limited exit opportunities

In the first half of 2024, the mergers and acquisitions (M&A) transaction market has been 34% lower than the already depressed 2023 numbers, leaving the private equity markets somewhat frozen. Green shoots may be springing up in the middle market (companies with enterprise values from $25 million to $1 billion), where activity is up 10% over the prior year. It's aided by the valuation disparity between more expensive large caps and less expensive small-cap public equities. Dry powder continues to sit idle as public market valuations remain high, buyout exits and "take-private" transactions are at record low levels. A renewed secondaries market has been an outlet for aging private equity inventory.

### Improving financial environment

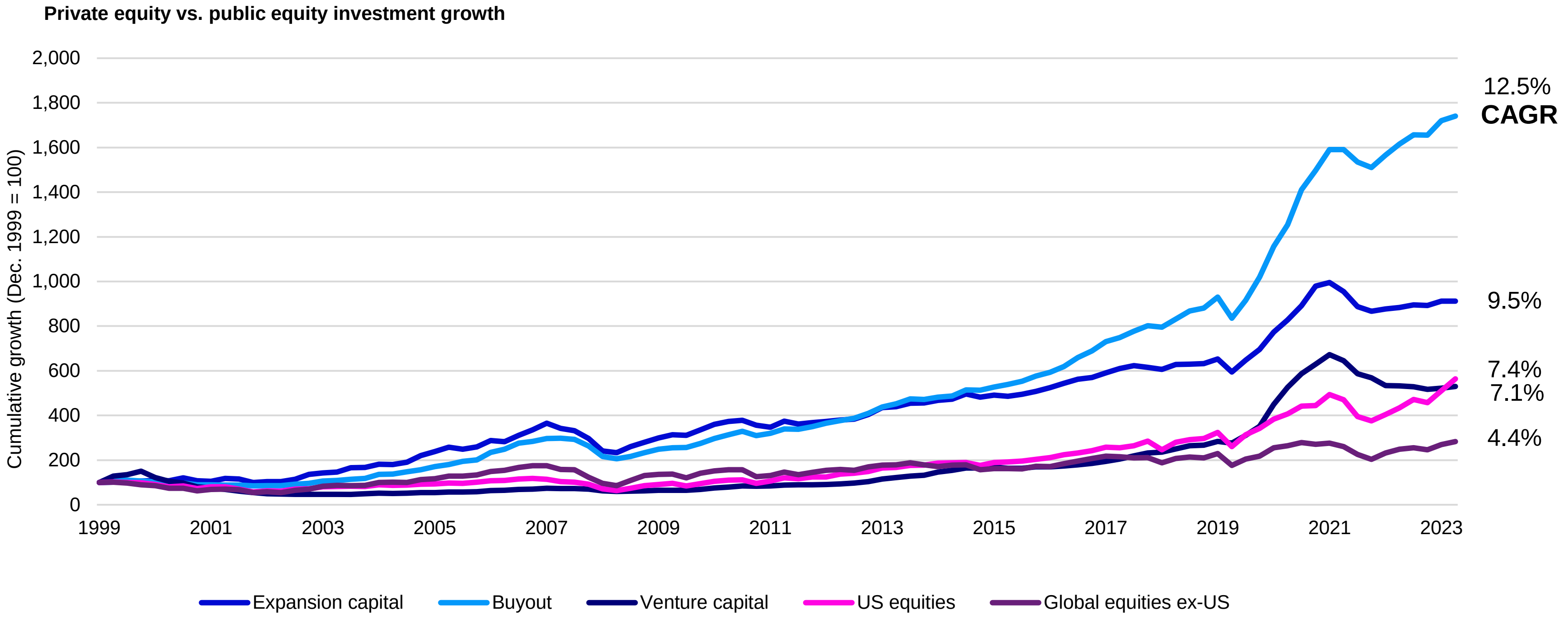
Lower interest rates and tighter spreads for direct lending will likely improve the leveraged buyout outlook as the thawing of the exit market will be a welcome shift for general and limited partners. As rates begin to fall, levered assets will be able to utilize additional debt to generate EBITDA growth, following a multi-year decline in LTV levels. Financial conditions, in general, are improving, likely paving the way for an improved transaction market. With median hold times of PE-owned companies around seven years in 2023, the highest level recorded since 2006, exits cannot come sooner for GPs and LPs.

### Continued focus on growth

Growth equity and expansion capital strategies are our preferred sub-asset classes within private equity. In 2023, growth equity strategies passed LBOs for the first time in terms of their share of all PE deals, with continued momentum for this trend into this year. Venture capital valuations are stabilizing after resetting significantly in 2022, now beginning to attract fundraising with improved supply/demand dynamics.

Sources: Invesco Solutions, Pitchbook, views as of Sept. 19, 2024.

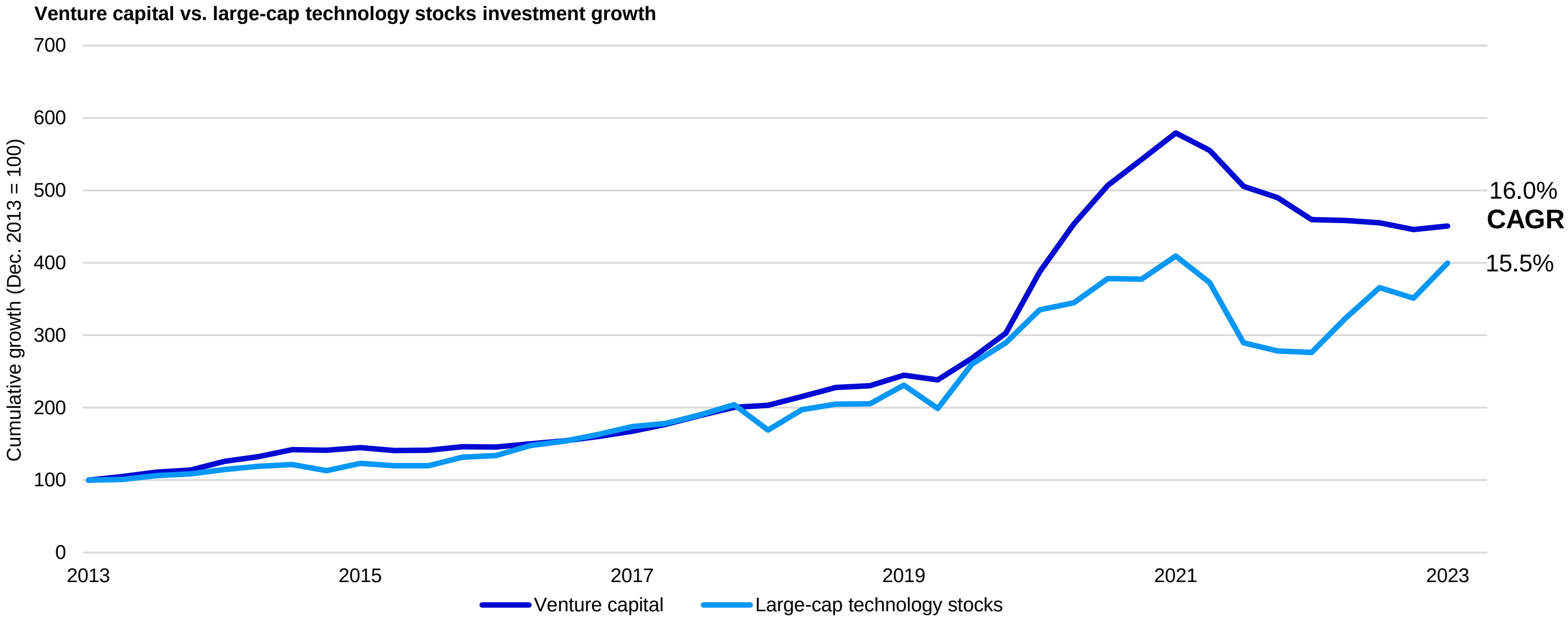
# Cumulative growth of private equity vs. public equity




Sources: Investment growth of 100; Private asset index return data (large buyout, expansion capital, and VC / growth equity) from Burgiss and are net of fees; US equity returns represented by Russell 3000 TR index; Global ex-US equity returns represented by MSCI ACWI ex USA net TR index are gross of fees, quarterly from Dec. 1999 to Mar. 2024. **Past performance does not guarantee future results**.

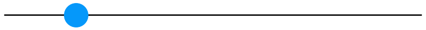
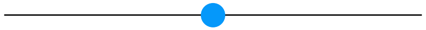
Invesco

# Cumulative growth of venture capital vs. large-cap technology stocks




Sources: Investment growth of 100; Private asset index return data (VC) from Burgiss and are net of fees; Technology stocks represented by Nasdaq Composite TR Index are gross of fees, quarterly from Dec. 2013 to Mar. 2024. **Past performance does not guarantee future results**.

# Views on private assets: Private equity

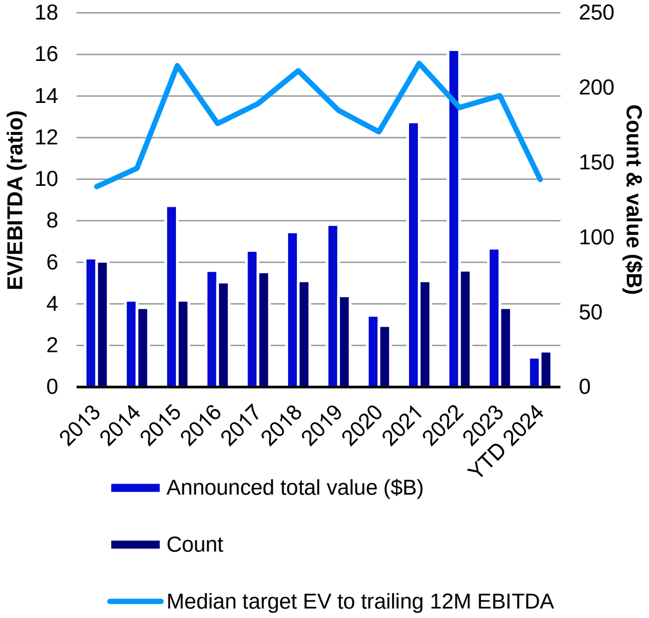
| Investment type | Allocation range<br>Underweight / Neutral / Overweight | Comments |
| --- | --- | --- |
| **Large buyout** |  | • Exposure to high quality companies backed by strong management teams.<br>• Renewed opportunity for take-private transactions and private-to-private exits at favorable valuations balanced by headwinds from high cost of debt. |
| **Growth/expansion equity** |  | • Profitable franchises exposed to secular growth themes.<br>• Less competition for deals from the IPO or SPAC markets.<br>• Heightened focus on platforms. |
| **Venture capital** |  | • Exposure to a wide variety of disruptive technologies and secular growth themes at an early stage.<br>• Challenging exit environment with the potential for a sustained period of “down rounds.”<br>• Valuations have corrected meaningfully in recent quarters. |

Source: Invesco Solutions, views as of Sept. 19, 2024. For illustrative purposes only.

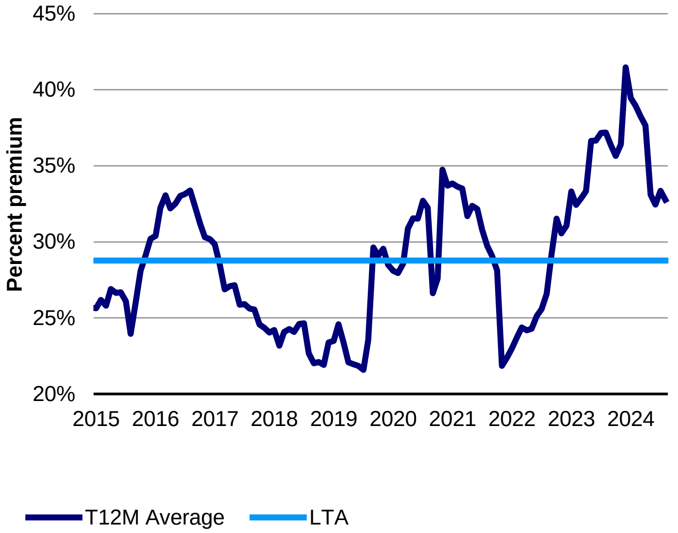
# US large buyout take-private volume and EV/EBITDA valuations

Transaction volume has plummeted while premiums are reverting to their long-term averages from recent peaks.

**Take-private deal volume compared to EV/EBITDA**




**M&A deal premium vs. long-term average**

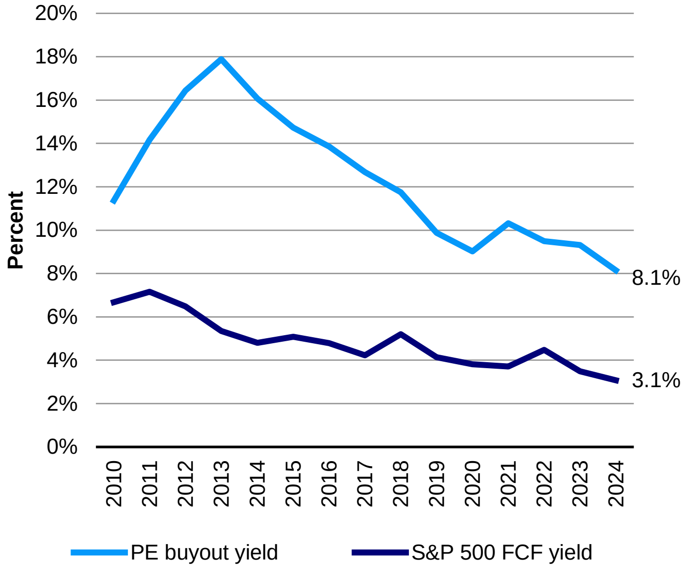



Sources: Invesco Solutions, Pitchbook, Bloomberg L.P., as of Aug. 31, 2024.

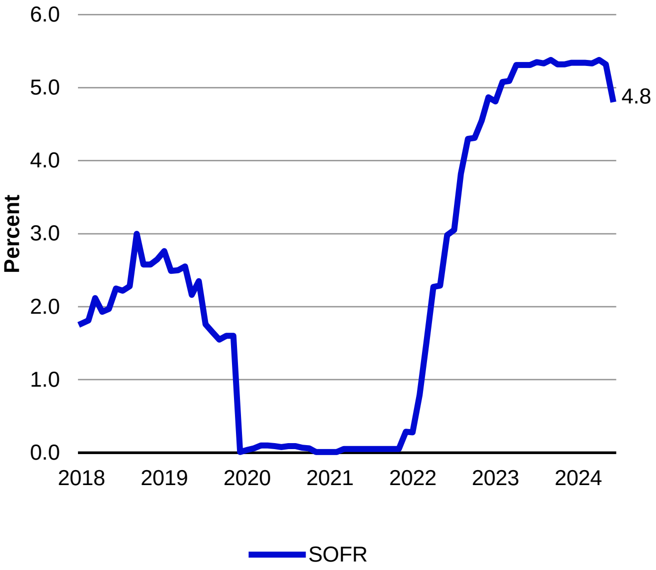
# US large buyout vs. equity market yield

While purchase prices have moderated slightly, this is more than offset by elevated financing costs. We anticipate this pressure will ease as base rates are lowered.

### Buyout yield vs. US equity market yield




### Financing rates (SOFR)

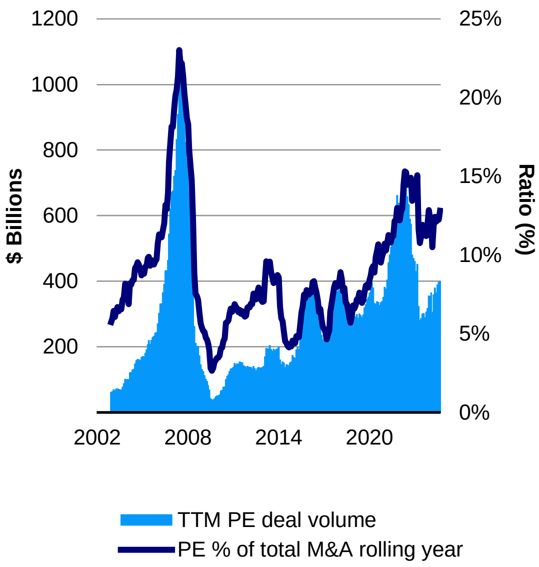



Source: Invesco Solutions, Pitchbook LCD, Bloomberg L.P. as of Sept. 30, 2024.

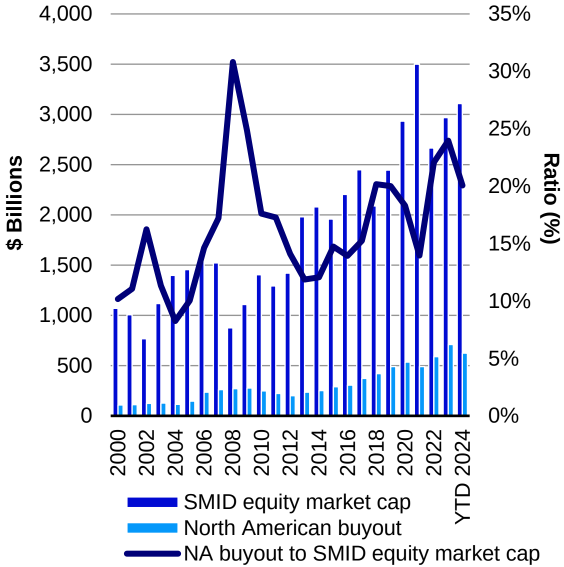
# Buyout and IPO deal volume

Limited exit opportunities favor those with dry powder and should drive an increase in private-to-private deal activity

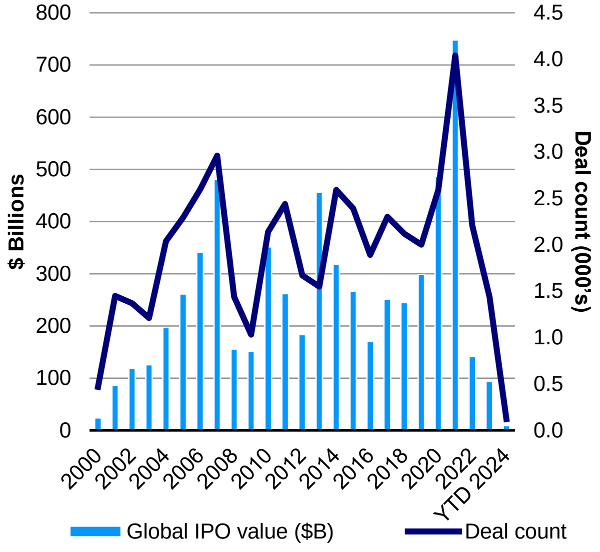
### PE deal volume




### PE dry powder to target's market cap




### Trailing year IPO activity




Sources: Invesco Solutions, Pitchbook, Preqin, Bloomberg L.P., latest data available, as of Aug. 31, 2024.

# Real assets

## Real estate and infrastructure

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# 2024 alternative opportunities – Q4 outlook: Real assets

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MD, Investment Strategist
Invesco Global Real Estate

**Neutral real assets as valuations approach trough**

| Asset class | Overall | Valuations | Fundamentals | Secular trend |
|---|---|---|---|---|
| **Real estate** | Neutral | Neutral | Neutral | Neutral |
| **Infrastructure** | Neutral | Unattractive | Attractive | Attractive |

### Real estate

Easing inflation and economic conditions, sharp declines in US Treasury yields, and the fed funds rate cut are driving confidence in a real estate recovery, and the start of a new real estate value cycle is close at hand. Transaction activity is expected to reaccelerate either late this year or in early 2025. Capitalization rates have stabilized and are significantly tighter than in previous cycles, so we aren't expecting compression to drive returns. Near-term economic growth is expected to ease, and current pricing largely reflects different sector expectations for income growth and liquidity. This accentuates the need for property income growth and reliance on secular demand drivers that can help mitigate the softening economic environment. It also elevates the need to seek differentiated performance through market selection because of the large historical gap between top- and bottom-performing markets.

### Infrastructure

Despite above-average valuations (which are lagging public markets), record levels of dry powder, and limited fundraising in private infrastructure, an easing of policy and regulatory clarity post-election may provide a runway for investors to start deploying capital.

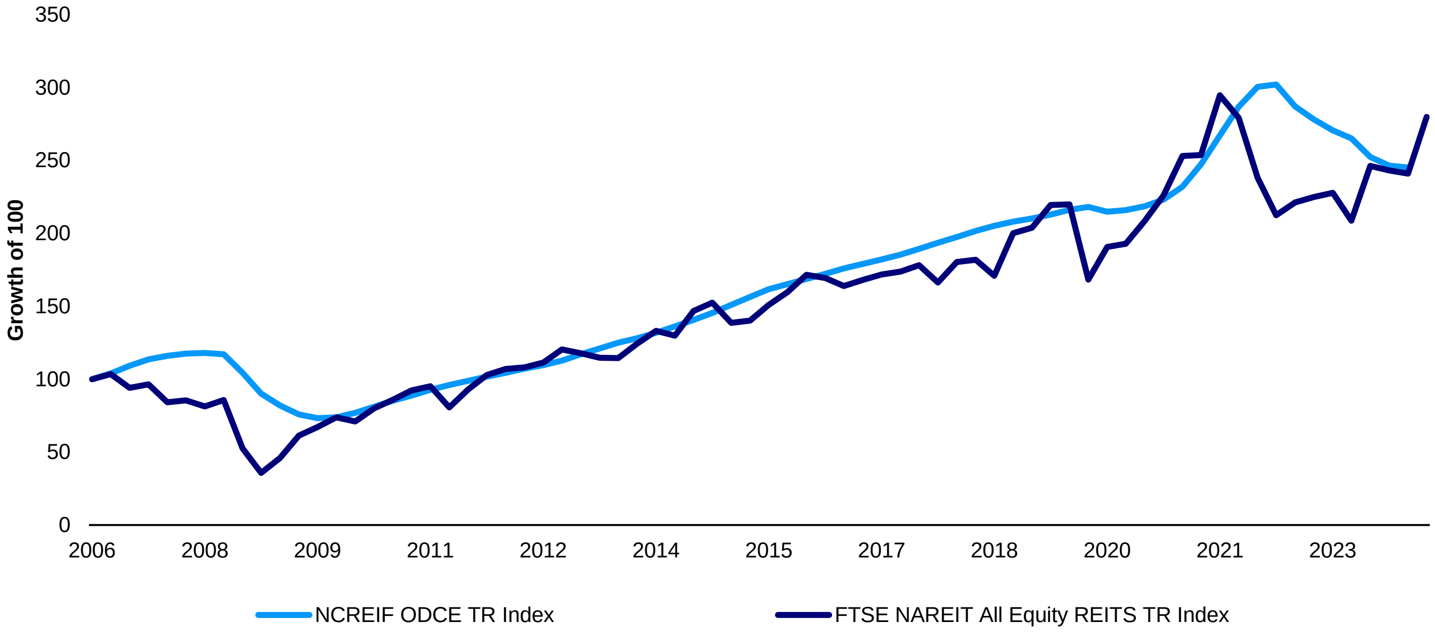
Secular tailwinds within infrastructure include:

- Estimated domestic and global need for infrastructure investment over the next decade supported by the Infrastructure Investment and Jobs Act and the Inflation Reduction Act.
- Strong fundamentals within the transportation sector, driven in part by the post-pandemic rebound in travel and commerce.
- Energy infrastructure in the wake of conflict in Ukraine and the Middle East.
- Continued momentum in both the digital and energy transition/renewables sectors.

Sources: Invesco Solutions, IRE, views as of Sept. 19, 2024.

# Cumulative growth of listed vs. unlisted real estate

**Listed and unlisted real estate performance 2006-2024, Dec. 2006=100**




After a significant divergence, public and private have converged.

Source: Invesco Solutions based on data from NCREIF ODCE TR Index representing unlisted real estate performance, as of June 30, 2024, and FTSE NARIET All Equity REITS TR Index representing listed real estate performance as of Sept. 20, 2024. Listed real estate is gross of fees while unlisted is net of fees.

# Views on private assets: Real assets

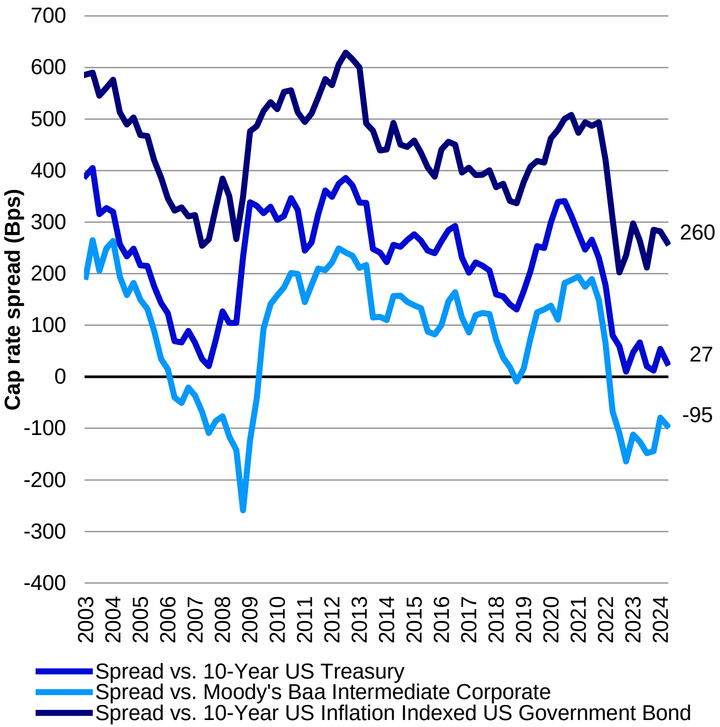
| Investment type | Allocation range: Underweight | Neutral | Overweight | Comments |
|---|---|---|---|---|
| | **Underweight** | **Neutral** | **Overweight** | |
| **Real estate core** | | ● | | • Public and private valuations have converged, and we expect the trough in valuations is imminent.<br>• Exposure to high quality real estate assets with stable current income.<br>• Potential headwinds to existing cap rates resulting from rapid rise in interest rates.<br>• Mixed outlook varies by sub-sector. |
| **Real estate value add/opportunistic** | | ● | | • Focus on dislocations in credit markets.<br>• High levels of economic and market volatility may create attractive opportunities. |
| **Infrastructure core** | | ● | | • Exposure to current inflation-linked income backed by long-term contracts and/or concessions.<br>• Broad-based fundamental tailwinds across sub-sectors balanced by high valuations. |
| **Infrastructure value add/opportunistic** | | | ● | • Includes exposure to brownfield and greenfield projects.<br>• Tailwind from secular growth themes (renewables, digital) and increased government support (IIJA). |

Source: Invesco Solutions, views as of Sept. 19, 2024. For illustrative purposes only.

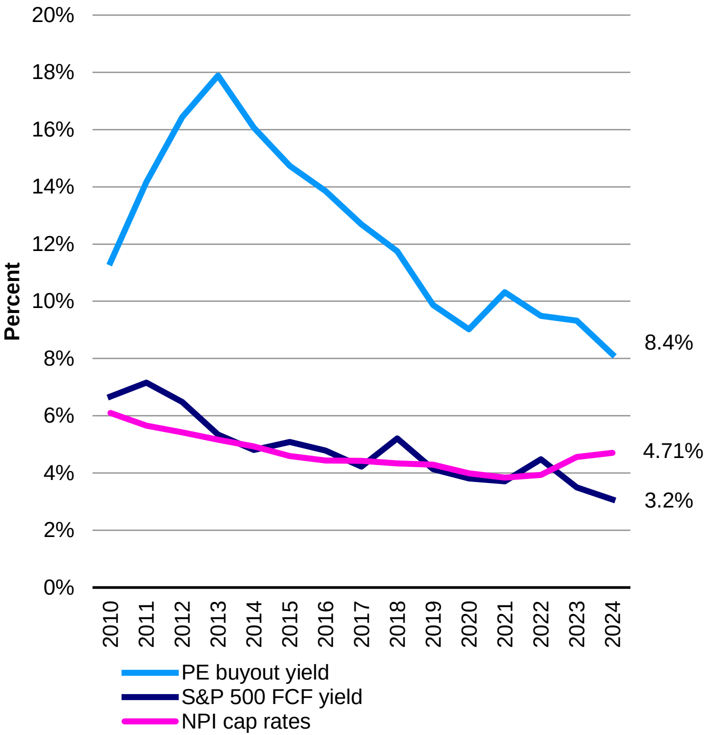
# Real estate cap rate spreads

Direct real estate valuations remain elevated relative to other income-generating alternatives; however, they appear to have bounced from recent lows and stabilized. Cap rates relative to public equity yields are the most attractive they've been post-GFC.

**Real estate cap rate spreads to fixed income**



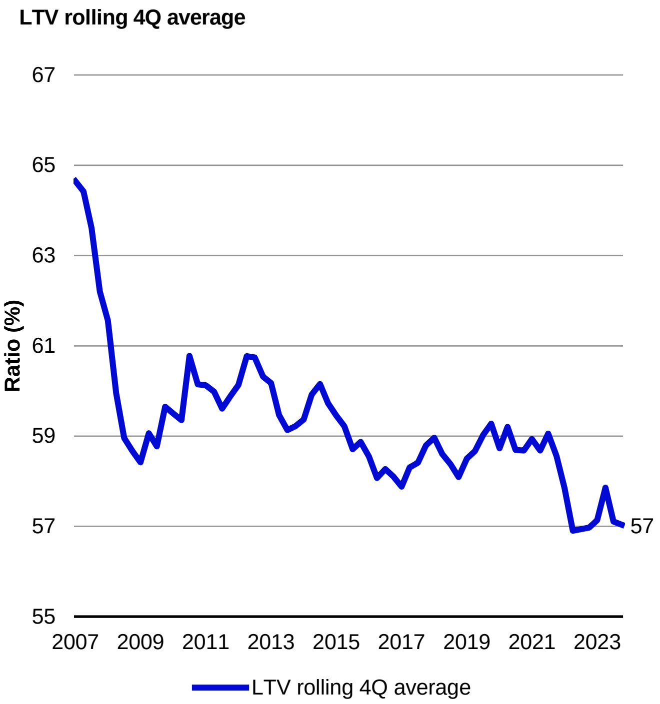

**Real estate cap rates relative to public and private equity yields**

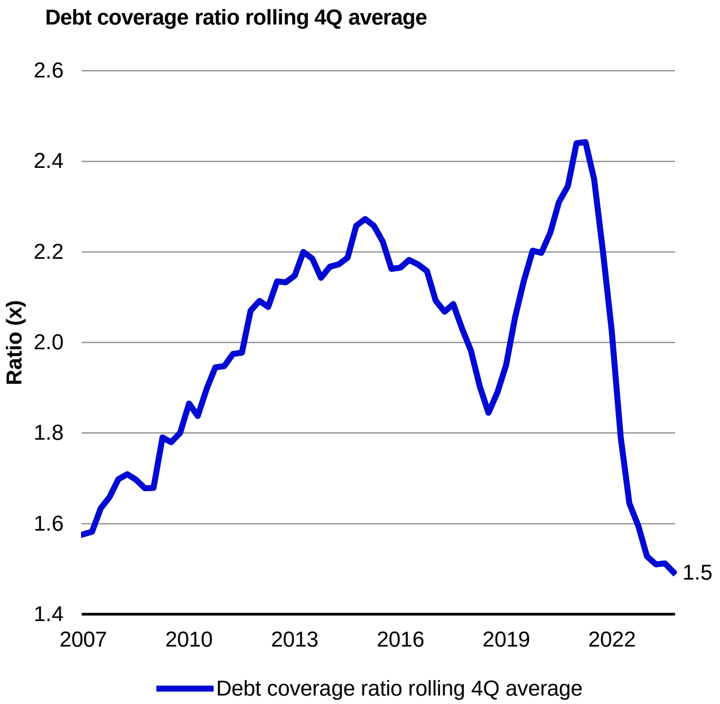



Sources: Invesco Solutions, NCREIF, Moody's Analytics, S&P, Pitchbook LCD, as of June 30, 2024.

# Real estate leverage (loan-to-value, LTV) and debt coverage ratio

Modest levels of leverage in the system post-GFC should moderate systemic risk. We are currently monitoring interest coverage ratios.



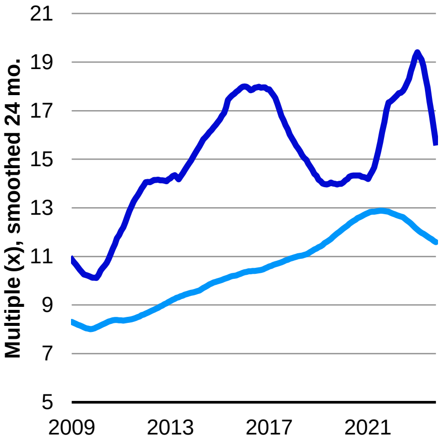




Sources: Invesco Solutions, NCREIF, Moody’s Analytics, as of June 30, 2024.

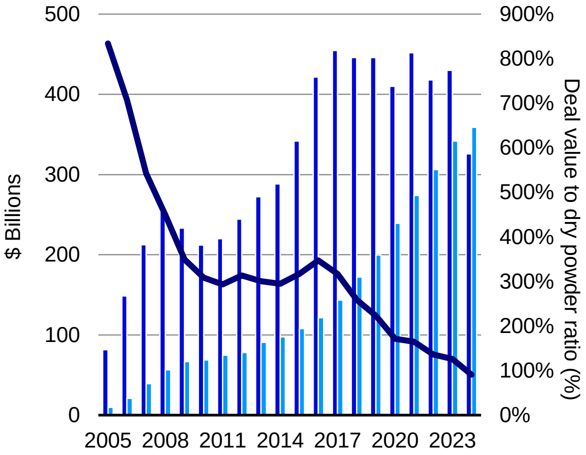
# Infrastructure

Elevated valuations combined with robust dry powder are offset by an expanding opportunity set with long-term secular tailwinds

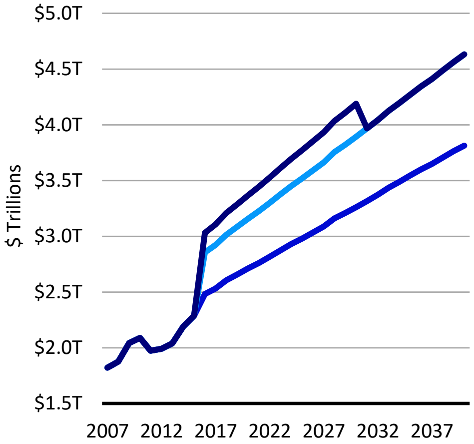
### Infrastructure EV/EBITDA




### Deal value to dry powder ratio




### Investment need in infrastructure




Sources: Invesco Solutions, Pitchbook, Preqin, Global Infrastructure Hub, as of Aug. 31, 2024.

# Hedge funds

## Event-driven and systematic trend

4

# 2024 alternative opportunities – Q4 outlook: Hedge funds

**Jeff Bennett, CFA**
Head of Manager Selection
Invesco Solutions

**Overweight hedge funds, given current levels of arbitrage spreads and a central bank easing cycle**

| Asset class | Overall | Valuations | Fundamentals | Secular trend |
|---|---|---|---|---|
| **Event-driven and arbitrage** | Overweight | Neutral | Neutral | Attractive |
| **Systematic trend** | Overweight | Neutral | Neutral | Attractive |

### Hedge funds

With low correlations to traditional assets and the possibility for higher-for-longer interest rates, we believe hedge funds are particularly attractive. Since hedge funds operate off a spread, elevated base rates provide a generous tailwind. While not our base case, a market correction due to a recession or inflation resurgence may prove hedge funds to be a valuable alternative within a portfolio.

### Event-driven and arbitrage

Spreads within event-driven strategies remain high despite limited capital market activity from mergers and acquisitions as private equity remains sidelined. With the possibility of an improved corporate action environment due to aging private equity capital, lower interest rates and a clearer regulatory environment post-election, these strategies may have tailwinds into 2025.

### Systematic trend

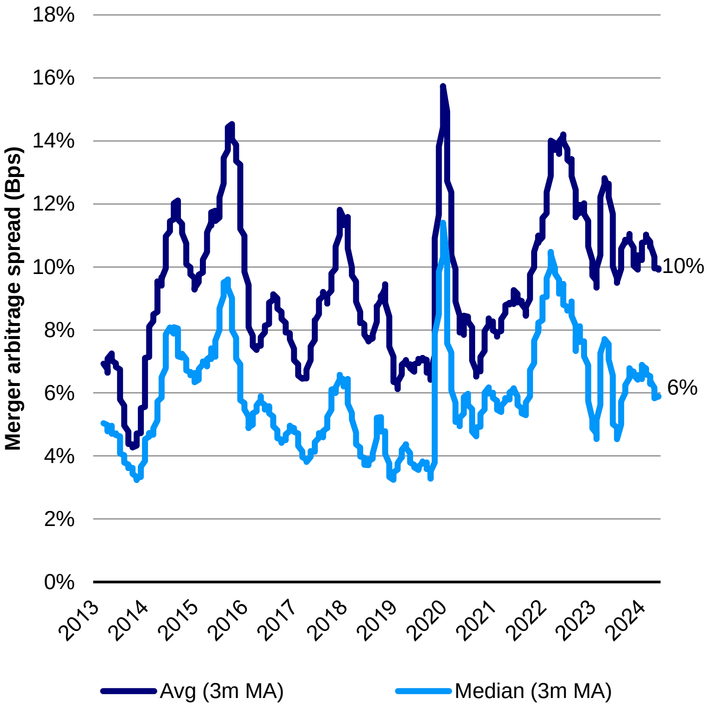
With the Federal Reserve (Fed) beginning to cut interest rates from elevated levels, we analyzed how systematic trend strategies perform in this market environment. Our first finding is that trend strategies outperform when base rates are above average and falling. Additionally, the correlation of systematic trend funds to US equities is significantly negative as the fed funds rate is lowered, allowing for diversification benefits within asset allocations.

Source: Invesco Solutions, views as of Sept. 19, 2024.

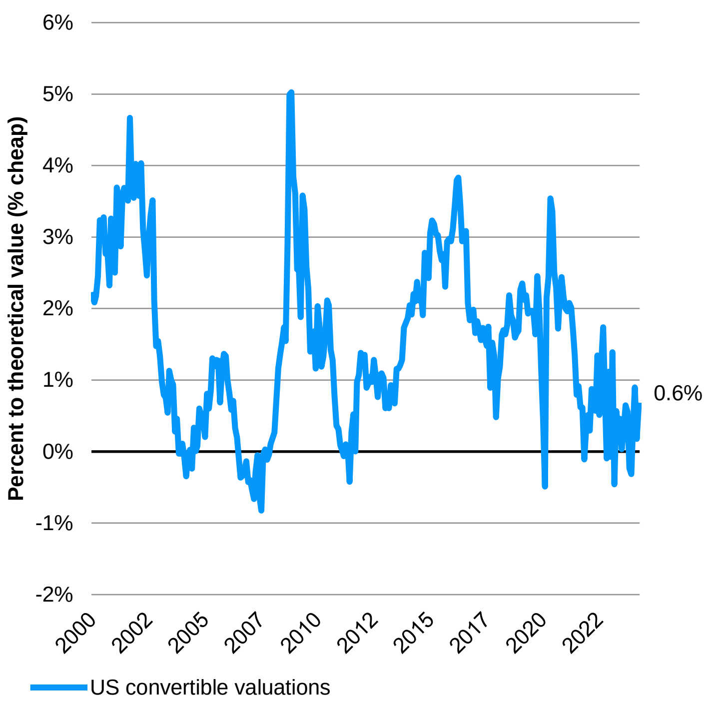
# Merger arbitrage and convertible arbitrage

Spreads are wide on a variety of measures within merger arbitrage. Convertible valuations relative to theoretical value are slightly below average.

Merger arbitrage spreads (annualized, net of SOFR)




US convertible valuations

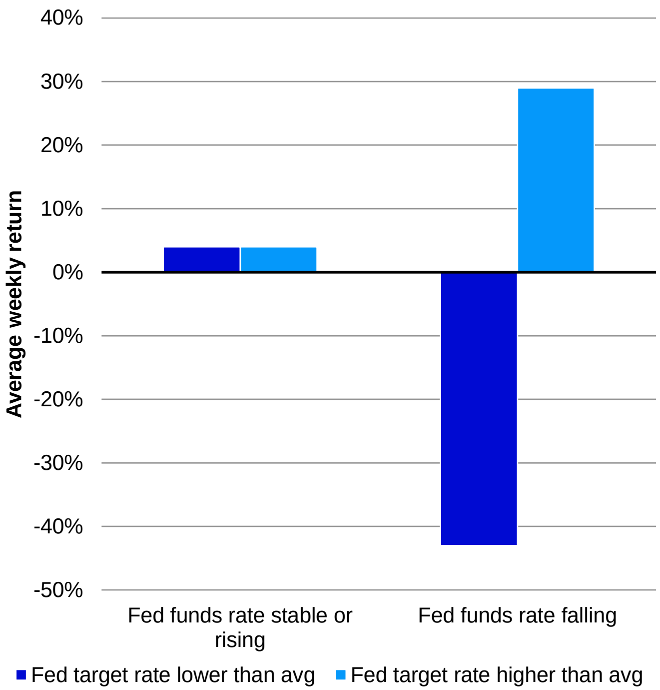



Sources: Invesco Solutions, UBS Special Situations, Moody's Analytics, S&P, Pitchbook LCD, latest data available as of Aug. 31, 2024.

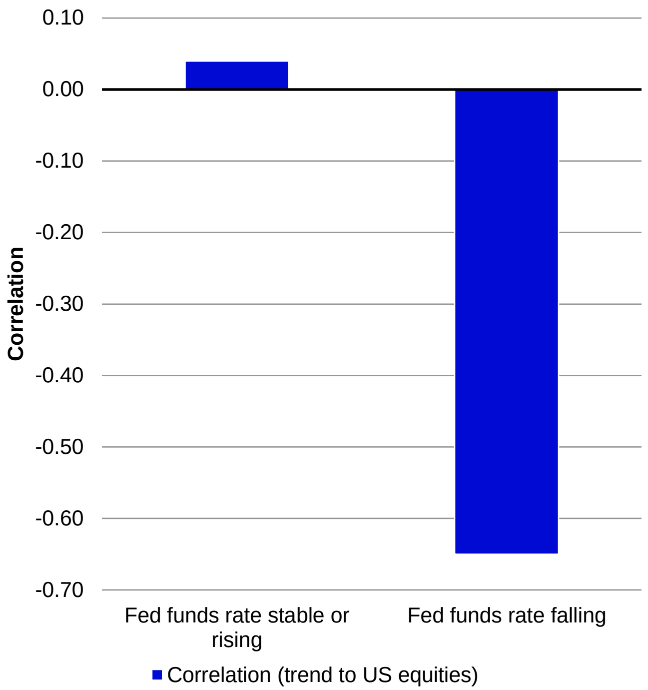
# Systematic trend

Trend strategies tend to outperform when base rates are above average and falling. Further, their correlations to US equities are significantly negative as the fed funds rate is lowered.

**Trend category returns during different Fed cycles**




**Correlation of systematic trend with US equities**




Sources: Invesco Solutions, Morningstar, Bloomberg, as of Aug. 31, 2024.

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