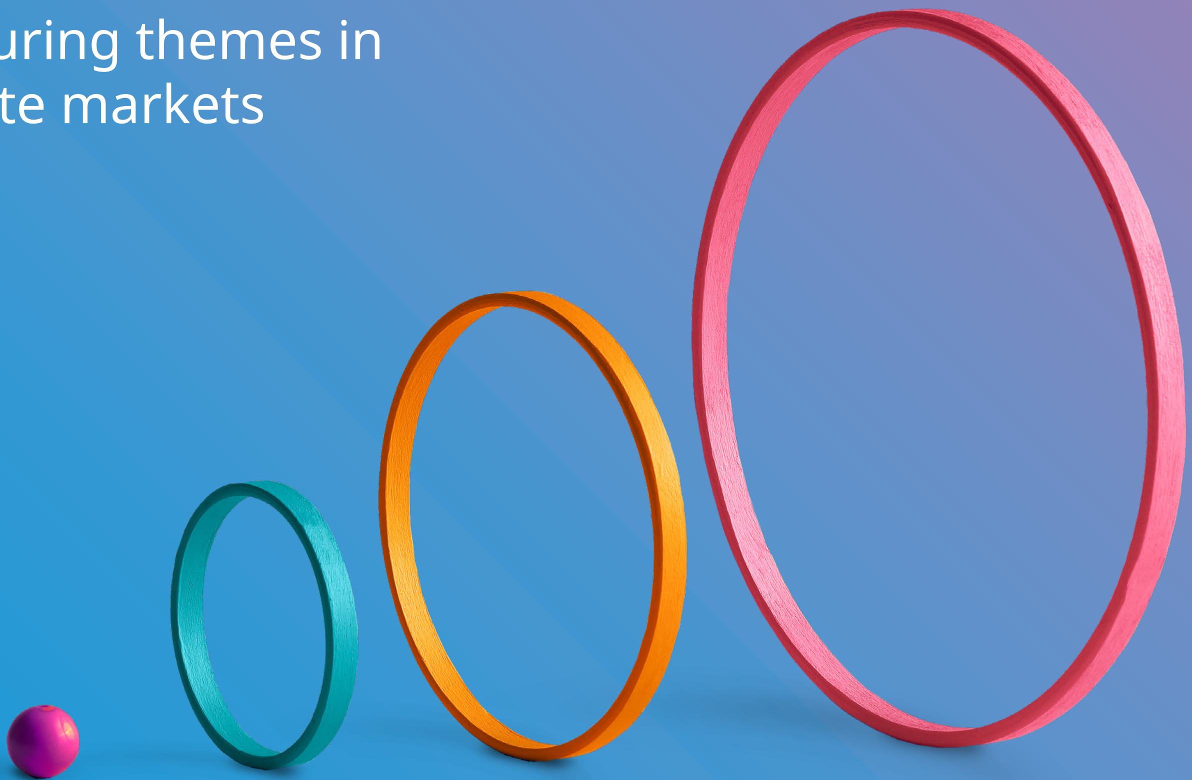
Mercer

Inflation playbook

Capturing themes in private markets



welcome to brighter

A world in transition

Investors around the world are faced with the uncertainty of inflation following a sustained period of both fiscal and monetary stimulus. More recently, emerging geopolitical conflicts are adding to volatility, and investors are increasingly concerned about elevated valuations across multiple asset classes. All this is happening at a time when investors are trying to position their portfolios for the transition to a lower-carbon economy.

In this three-part series, *Capturing Themes in Private Markets*, we translate these developments into relevant themes for investors. Private markets are well positioned to help investors address these challenges through a diverse and innovative range of strategies as they seek to unlock portfolio returns.

We have identified three overarching themes that we believe will impact investment decisions, specifically addressing:

Part 1: Inflation Playbook — How Can Private Markets Manage Inflation?

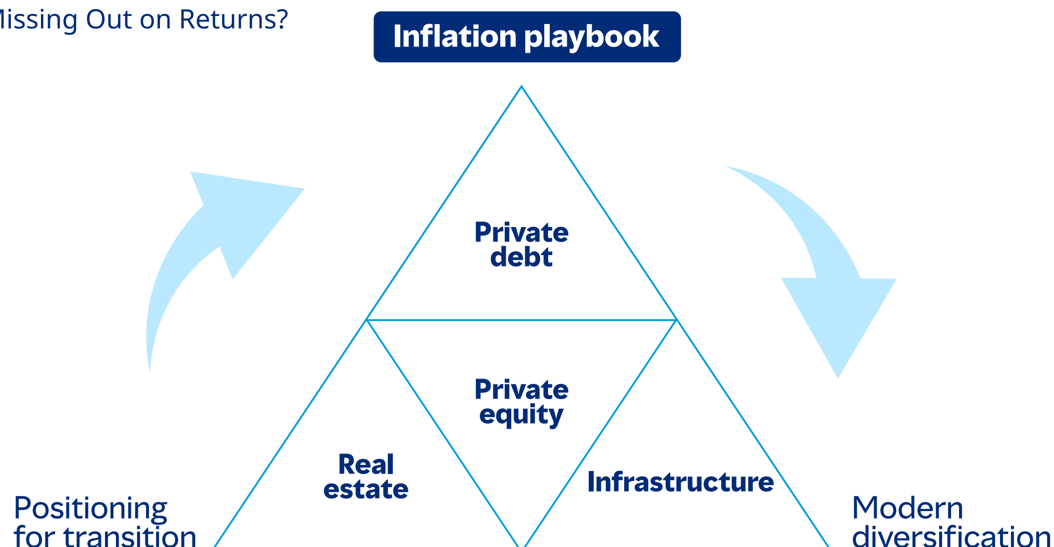
Part 2: Positioning for Transition — How Can Investors Pursue a Sustainable Path Without Missing Out on Returns?

Part 3: Modern Diversification — How Do Investment Themes and Innovative Companies Bring Diversification to a Portfolio?

After more than a decade of low inflation, the cost of living is now soaring around the world, threatening both the purchasing power of institutional investors and how far their portfolio returns will stretch to meet obligations. While not a new challenge for investment strategies, the current bout of inflation is being fuelled by a maelstrom of factors that are neither easy to mitigate nor easy to control.

It is clear, however, that traditional solutions may not fix this current problem, so new avenues to offset this asset-eroding measure must be found. But investors also don't have to reinvent the wheel to do so.

In this article, we examine how using a lens of innovation to look at private assets may help portfolios to withstand, and even benefit, from the current inflationary environment.



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Inflation playbook — How can private markets manage inflation?

Inflation reached a 40-year high in 2022

The combination of supply-chain disruptions and excessive monetary stimulus led to a strong rebound in growth and spending. The result was inflation reaching a 40-year high in early 2022 and central banks rapidly tightening monetary policy. Both in lation and higher rates result in higher capital costs and impact valuations. With market volatility increasing, investors assess how the in lation scenario will play out across asset classes.

Private markets have various built-in inflation-protection characteristics. Examples are the long-term investment horizon, diversification across economic and business cycles for private equities or floating rates, and lower default rates for private debts. Therefore, if price increases become a longer-term trend, inflation may have a lesser impact on private markets.

The magnitude of the link between inflation and private markets depends on the asset-specific capital structure, cash flows and the capital expenditures ratio. We define the relationship as the three Cs.

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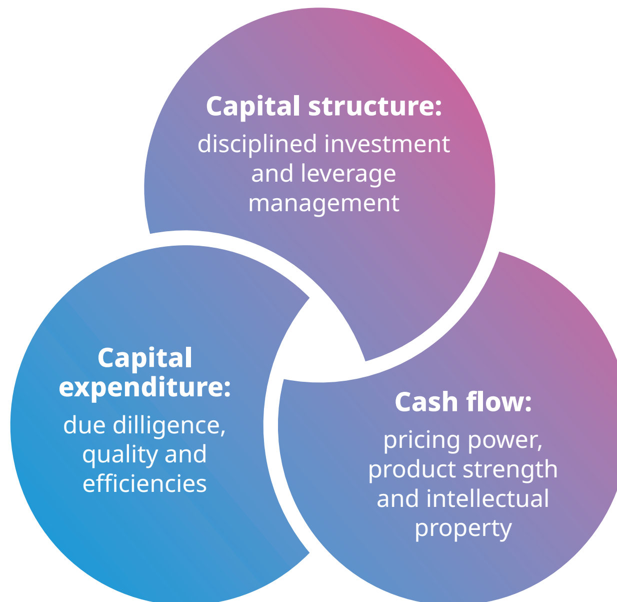
Figure 1. The three Cs



Source: Mercer.

No asset class scores highly on all of these factors all the time. In fact, the valuation of businesses is sensitive to higher interest rates and inflation. However, the unique structure of private markets allows them to actively manage the necessary financial and business adjustment and benefit from dislocations and reflationary trends.

Investors may consider the following factors when investing in private markets in an inflationary environment:

- **Limited partners (LPs)** — Private markets investors need to consider the time lag between capital commitments and capital calls as well as the accessibility to fund managers. Building new investment programs will take time, and LPs may miss out on short-term inflation protection.
  - LPs need to be very selective when committing capital as they need to ensure their general partners have the playbook to adjust how they run their companies in an inflationary environment.
  - Lower risk-free rates enabled private equity managers to reduce their hurdle rates in recent years. This trend has likely bottomed, and LPs may see a reversal of the trend.
- **General partners (GPs)** — Deal selection becomes more critical in periods of rising rates.
  - Efficient use of leverage: Higher cost of capital will impact leverage and financing decisions. Higher borrowing costs will be a drag on return.
  - Inflation is less of a concern for businesses with strong products/pricing power and intellectual property.
- **Returns** — The long-term nature of private investment may mitigate sensitivity to changes in the inflation rate.
- **Valuations** — Cost of debt and inflation also impact valuations. As inflation increases, EBITDA multiples will come down from historical highs.
- **Deal selection** — Pricing power is key. In general, B2B businesses are better positioned to negotiate price increases. Companies that can scale their products and services efficiently should advance. Business models depending on high long-term growth projections may struggle.
- **Illiquidity** — Investors cannot rely on private assets as a source of funds during a spike in inflation. Additionally, portfolio rebalancing between public and private assets presents challenges.

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Investors may access inflation protection in a number of ways:

- **Real estate**

  Real estate is one of the most popular inflation protection assets, with particular benefits for liability-driven investors with inflation-linked obligations. Historically, this asset class has performed well in a rising-rate environment, particularly when economic growth is strong. However, the inflation-hedging quality varies across sectors, countries and style exposure.

  – **Cash flows** from real estate are not fixed and can be sensitive to growth and inflation. Since inflation can affect rental income as well as operating costs, comparing net operating income with historical inflation may offer another lens through which to evaluate real estate's response to inflation in the past.

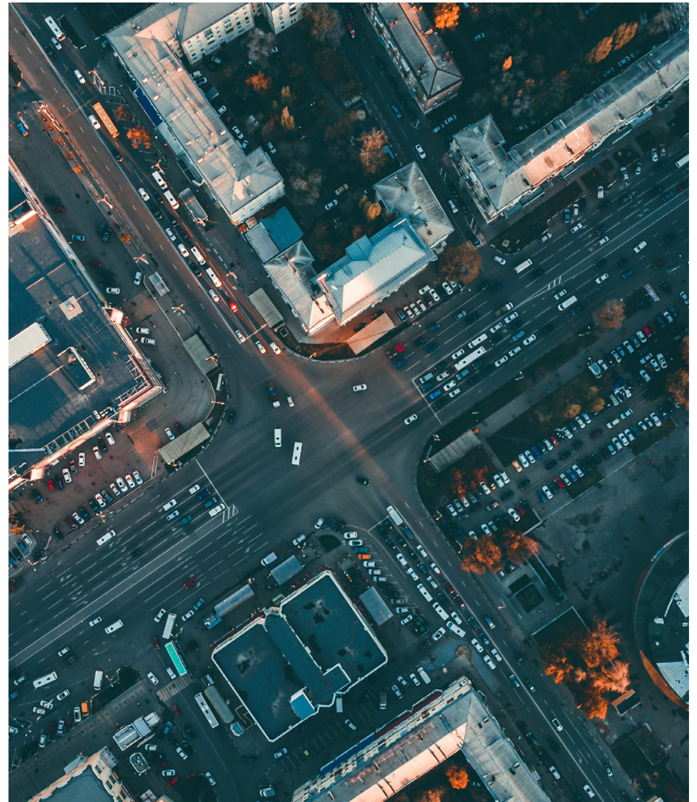
    Any assets with fixed income streams, such as long-term leases that don't include inflation-linked rent increases, are going to suffer through any period of sustained high inflation. Some real estate funds will have to revise their strategies accordingly to include properties with shorter-duration leases that enable cash flows to frequently adjust to inflation.

  – The **inflation beta**[1] indicates that private real estate is inflation sensitive. However, this finding could be a result of appraisal-based pricing, because we don't observe the same result in REITs, where movements in public equity markets influence pricing.

  – **Style** — Core and core-plus strategies have stronger inflation-protection qualities than value-added. Most investors should not consider opportunistic strategies for inflation-hedging purposes, but investors can benefit from distressed opportunities caused by higher inflation.

  – **Cap rates, capital appreciation** — Periods of inflation and rising interest rates have also been characterized by improved real estate fundamentals. These entice capital flows to the sector, resulting in compressing cap rates and increasing capital appreciation.

  – **Sectors** — Properties that are driven by certain long-term themes, such as e-commerce, healthcare, housing, technology and demographics, have strong long-term growth prospects. Growth from these properties is expected to provide total returns in excess of inflation. Private residential leases offer the potential for rental growth amid higher inflation. Commercial leases may be pressured as office vacancy rates are high and retail is facing serious challenges. Meanwhile, higher capital values can offset the increased costs of construction, with developers able to pass the higher labor and materials costs on to buyers.



- **Infrastructure**

  Investors are also considering infrastructure. Most of the inflation protection that comes from infrastructure assets is owned by companies that are well established. Typically, these "core" infrastructure companies provide very stable revenue, derived from their long-term contracts signed with governments and companies with high credit ratings.

  – **Inflation linkage within some core infrastructure projects** — In general, contracts have the ability to pass inflation on to the end customer. This is typically the case with companies operating in areas such as toll roads in major cities, telecommunication towers, major international airports and main rail routes. Utilities (electricity and natural gas companies) can also provide inflation protection. These types of companies are providing essential services, and consumer demand is largely inelastic. Therefore, they are able to pass on higher prices without impacting demand.

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- **Regulations and limitations** — Some core infrastructure companies, such as utilities, will often have to appeal to a municipal or state government regarding a proposed price hike. Airports and toll roads, however, are more concession-based; local government agreements allow for the increase in service rates based on references to inflation. This means price increases will not always fully compensate for inflation.
- **Sectors** — Although infrastructure does not always provide perfect inflation protection, certain sectors, subsectors and jurisdictions can provide a consistent return during volatile periods.
- **Duration** — The long-term nature of infrastructure investments means that, like bonds, they may be vulnerable to significant changes to their discounted cash flows in line with interest-rate movements.
- **Style** — In general, we expect unlisted core infrastructure equity to provide reasonably good inflation protection.

Private debt

Although all risk assets are likely to be challenged in a rising-rate-and-inflation environment, private debt is well positioned on a relative basis compared to other asset classes given the higher spread cushion and floating rate structure.

- **Floating rate structure** — Private debt is, in the vast majority of cases, a floating-rate asset class. Coupon payments adjust upward as the underlying "reference" interest rate rises (often above a minimum floor value). To the extent that inflation has an impact on these short-term reference rates, it will therefore have a different impact on bonds than on these floating-rate loans.
- **Spread cushion and shorter maturities** — A combination of higher starting yields and shorter maturities will likely fare better than many traditional fixed income instruments, which are longer dated in nature and have greater interest-rate sensitivity.

  The aim of a private debt investor should be to maximize the probability of harvesting this additional spread through diversification, flexibility and careful manager selection.

Private equity

The inflationary impact depends on how the manager has positioned its underlying portfolio companies against inflation. Well-positioned private equity managers will focus on the following opportunities:

- **Growth counts** — In our view, private equity that benefits from strong secular tailwinds is likely to see compounding growth over the coming decade. Definitive themes, such as renewables, healthcare innovation, electric mobility and emerging tech, are likely to offer strong long-term growth potential — even if they face shorter-term pressures. GP deal selection will be more critical here.
- **Leverage** — Private equity and leverage often go hand in hand. The cost of leverage will rise as rates rise. Portfolio companies will need to work with less debt to service their liabilities and maintain an appropriate level of default risk. GPs that rely heavily on debt are likely to deliver weaker returns.
- **Higher cost of capital** — GPs will have to focus more on true value creation than on financial engineering.
- **Fundraising** — Higher rates could weigh on PE fundraising since investors may prefer the improved returns now offered on bonds. Weaker-performing GPs may be more exposed as they have a poorer value proposition. Managers that consistently deliver outsized returns are likely to continue to see their funds fully subscribed.
- **Buying opportunities** — A deleveraging process and fall in multiples are likely to make exit gains less impressive.

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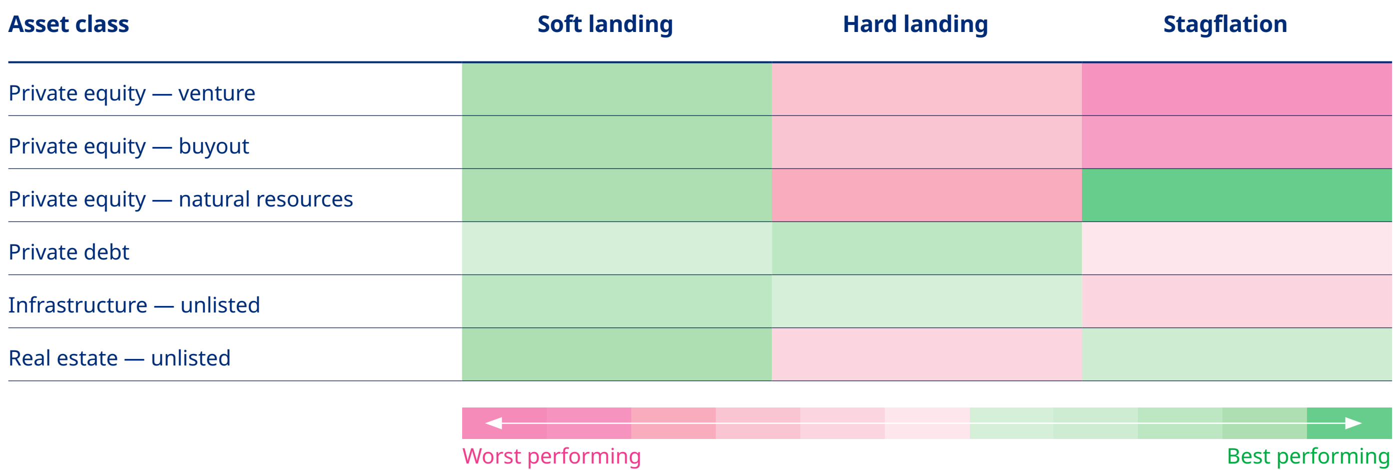
How will inflation impact private markets?

The private markets industry is relatively young, and most GPs and companies have not lived through a period of high inflation. However, the heat map below analyzes how we expect different strategies to perform across these different scenarios based on expected returns over a five-year time horizon.

Figure 2. Scenario analysis



Source: Mercer; using US as the example to control for currency effects in asset classes where currency volatility is a major contributor to unhedged returns. Real assets are equally weighed across either listed or private core.

Soft landing (base case) — Economic growth and inflation are consistent with consensus expectations and gradually fall back to their respective long-term equilibria from current elevated levels. Short-dated interest rates rise, and yield curves move toward equilibrium levels (around a 2.5%–3% cash rate and 3%–3.5% long bond yield in the US).

Hard landing — Global growth continues to disappoint over the next few years, with weaker overall growth than underbalanced growth, perhaps descending into another recession; deleveraging intensifies. Unemployment and deflation risks are at the forefront of central bankers' concerns, keeping policy rates very low (or negative). This scenario can be driven by either an involuntary return to austerity due to political gridlock, the emergence of a virus or other events that have a deflationary rather than inflationary impact.

Stagflation — This is characterized by rising debt levels, supply shortages, a commodity shock and/or geopolitical event, and central banks allowing inflation to rise above targets for sustained periods while bond vigilantes drive rates higher. Economic growth remains considerably below long-term consensus for the foreseeable future. Central banks are reluctant to curb inflation due to high unemployment.

Figure 2 highlights that, in general, private markets are well positioned to provide inflation protection. However, the magnitude depends on sector-specific factors, where companies are positioned in the business cycle and the skills of the GPs to improve operations in a challenging environment. Thoughtful due diligence will help investors take advantage of opportunities.

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Key takeaways

Traditionally, investors turn to private markets to seek return opportunities and diversification.

As investors continue to increase their allocations to private markets, they are also finding added benefits. Private markets investments provide elements of inflation-protection hedging in investors' portfolios. They also offer a diverse range of opportunities to meet investors' sustainable and impact goals while aiming to deliver a higher return profile than with public markets. In addition, investors can achieve enhanced diversification by investing in managers with innovative strategies at companies that are leading change in their sectors.

The opportunity set in private markets is deep. It is therefore important to diversify across a range of managers using a variety of strategies. The starting point is an effective portfolio construction process to identify the themes and opportunities that investors plan to capture. Investors should also apply a rigorous due diligence process to ensure a balanced blend of strategies diversified across geographies, sectors and vintage years.

Despite recent market volatility, future growth in private markets looks strong. Experts predict that private equity assets under management (AUM) will grow at 16% per annum (p.a.) between now and 2025 to US$10 trillion, with private debt expected to grow by 11% p.a.[2] Similarly, strong AUM growth is expected in infrastructure equity and real estate.

Macroeconomic headwinds, such as inflationary pressures and more modest growth prospects, are foremost on investors' minds. The transformational investing approach of private markets, which combines thematic sourcing with value creation, can help investors navigate this environment.

In parts two and three of this three-part series, *Capturing Themes in Private Markets*, we look at:

Positioning for Transition — How Can Investors Pursue a Sustainable Path Without Missing Out on Returns? Start to Change the World With Your Investments

Modern Diversification — How Do Investment Themes and Innovative Companies Bring Diversification Into a Portfolio? Beyond Beta: Private Markets — The Roadmap for Modern Diversification

Endnotes

[1] Mercer's capital market assumptions.

[2] Preqin. *The Future of Alternatives 2025*, December 2020.

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