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FIERA CAPITAL

Private Alternatives Outlook 2021: The New Normal?

Unprecedented. Extraordinary. Uncertain.

There are many words to describe financial markets in 2020, but "normal" certainly is not one of them. Equity markets the world over were rattled by the imminent slowdown in global growth, culminating in the fastest bear market on record in March, only to recoup losses (and then some) just a few months later. In the realm of fixed income, liquidity issues were front and center at the peak of the crisis, forcing governments to step in and guarantee liquidity in order to reassure investors, but low rates still plague those seeking safe sources of income. The commodity market wasn't spared – for the first time in history, oil buyers were being paid to take on product after benchmark prices for WTI crude plunged to negative $37 a barrel. The "new normal", it would seem, is anything but.

Yet while these traditional asset classes stole headlines, equally interesting were the investments that didn't spend much time under the spotlight: infrastructure; agriculture; private debt; real estate; and private equity. These nontraditional assets flew under the radar, but for all the right reasons; as the market panicked and volatility set in, these asset classes performed as expected, generally experiencing relatively minor volatility while generating positive income. In short, they brought stability to a volatile and uncertain world.

If we had to describe 2020 in a few words, it would be "wake up call." Equity investors have been enjoying one of the longest bull runs on record with few bouts of volatility. However, in 2020, investors were reminded that volatility and market drawdowns are not a matter of if, but when. Similarly, bondholders have witnessed the seemingly endless decrease in rates over the last few years. But those seeking safe sources of income are now attuned to the fact that government yields nearing 0% won't be able to meet their needs for the foreseeable future thanks to Jerome Powell saying that he's "not even thinking about thinking of raising rates."

Looking forward, the investing landscape has changed meaningfully, with important implications for portfolio positioning and the construction of a well-balanced portfolio.

While we believe that the worst of the COVID-induced crisis is indeed behind us, the subsequent output gap stemming from the economic stop in early 2020 will allow central banks to pursue extremely stimulative monetary policies for an extended time. This implies that interest rates will remain pinned lower for longer than historically would have been the case in order to close that gap between actual and potential growth, which may inevitably spark a stronger, more profound period of economic strength and corresponding upside in inflation expectations without the fear of premature monetary policy tightening.

Indeed, in an important secular shift, central bankers will assume a more relaxed stance towards higher inflation and a willingness to let the economy run hot in order to make up for a decade of below-target inflation, creating a lucrative backdrop for both the economy and investors alike. Both the Federal Reserve and the Bank of Canada have already reiterated that rates will remain on hold near zero for "at least" the next three years.

We believe that the end result will be a new cycle of strong and above-trend growth that will likely follow for the next several years, with the ultra-accommodative impulse from major central banks ultimately nurturing the economic recovery and extending the visibility of the cycle. This reflationary backdrop bodes well for equities, commodities, and other inflation-linked "real" assets (such as infrastructure, real estate, agriculture) at the expense of traditional core fixed income asset classes. It is likely that equities make new highs over this time horizon, while the low starting point for interest rates has reduced the return proposition for traditional fixed income strategies going forward. As traditional core fixed income strategies are unlikely to play the same role of providing stability and income generation in the portfolio setting, the inclusion of non-traditional income strategies should be considered due to their solid income-generating capabilities, their ability to protect against inflation, and their low correlation to traditional asset classes. We believe that optimizing a portfolio to include non-traditional income strategies will help to improve the risk-reward proposition for investors over the next five years.

Our "new normal" thus requires an expanded set of investment opportunities, and the natural evolution for those seeking stability, income and the potential for capital gains is a pivot towards alternative assets. So for those seeking to diversify and solidify their portfolios by adding non-traditional strategies, what can we realistically expect from them going forward?

Relying on years of experience, Fiera Capital's private alternative investment teams have worked together to provide insight on how the coming year may play out for their respective asset classes. Below, we synthesize their expertise and discuss what factors will likely affect alternative assets in 2021, a year that is likely to once again be unprecedented, extraordinary, uncertain and yet, promising.

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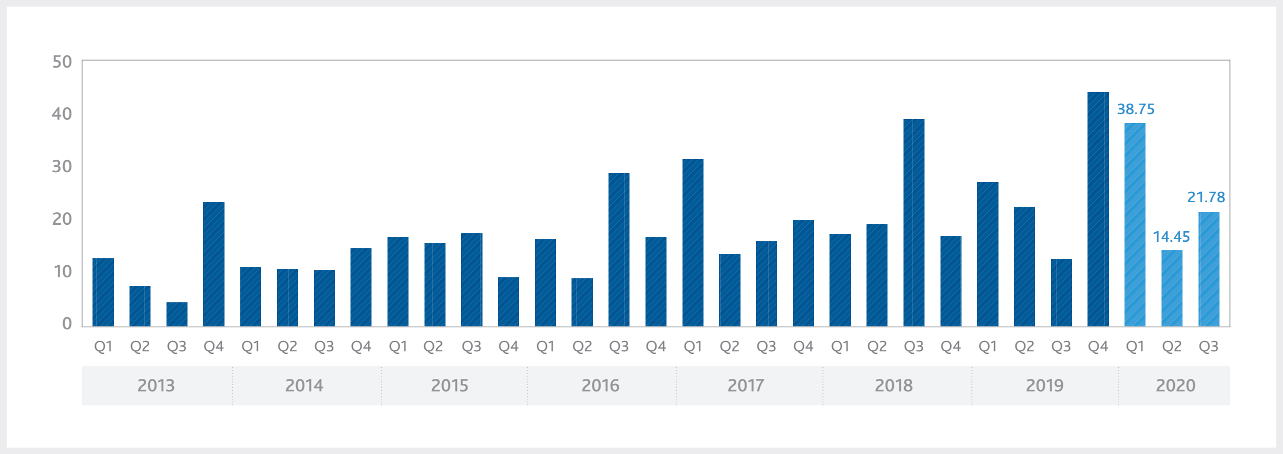
Infrastructure

Infrastructure assets generally provide vital and essential services to the populace, while payments to the asset owners are underpinned by long term contracts or regulated revenue – two aspects that have helped the asset class succeed through the market turmoil of 2020. In fact, throughout the last quarters, we continue to see significant capital being deployed, likely due to the wide recognition of this resilience and the low correlation with other asset classes, including publicly listed equities in infrastructure-related businesses. Investor interests in the asset class remains high and 2020 was set to be an impressive year for fundraising – according to data from Preqin, infrastructure funds raised US$38.75 billion in the first quarter of the year, the third-highest quarterly amount since at least 2013. While the global growth slowdown put a damper on fundraising in Q2 and Q3, the fact that investors were so keen to allocate capital early in the year suggests that we might see pent up demand being deployed in 2021.

Currently, there is lots of discussion in the industry around the need to revitalize the public private model of project delivery to continue to build and renew our infrastructure at a time when governments are even more fiscally-challenged. In fact, the need for job creation associated with an infrastructure build is looked at as a critical component of economic recovery after the pandemic. Record low interest rates across all developed economies continue to maintain valuations in the sector.

Market participants and investors are finding creative ways to perform critical due diligence on both potential investments as well as managers, employing technology and various remote methods to ensure that high due diligence standards continue while allowing transactions to occur. Critical changes and technologies have been accelerated even in infrastructure; this includes faster deployment of fiber connectivity in telecommunication networks and adoption of renewable energy in electrical grids and associated supporting technologies such as batteries. The importance of constant communication with management teams and operators has been further reinforced during these uncertain times. Strong relationships with lenders, regulators and other stakeholders is more critical now than ever.

Global Infrastructure had an impressive first quarter
Aggregate Capital Raised (USD Billion)

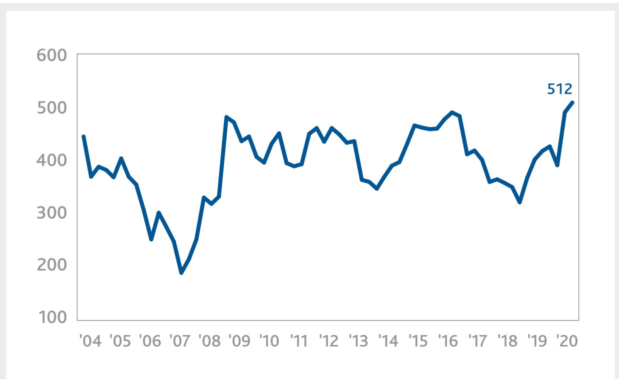


Source: Preqin, as of October 26, 2020.

Real Estate

One could be forgiven for thinking that real estate values would suffer through a continued global growth slowdown that is seeing stores, restaurants and entire downtown cores operate at fractions of their capacity. Yet in the realm of real estate, it is a tale of varying sectors. Overall, capitalization rates are likely to compress (resulting in increased values) in 2021 despite COVID-19 impacts due to historically-wide capitalization rate spreads over government bonds. Real estate valuations are also expected to benefit from market expectations around interest rates remaining low into the foreseeable future. Moreover, Canadian pension plans – some of the largest and most-respected in the world – are expected to continue increasing their real estate allocations relative to other asset classes in order to seek protection against rising inflation (12-15% target for large, sophisticated plans).

Cap rates hitting historical highs
Spread over 10-year Government of Canada (basis points)



Source: Fiera Capital. Cap rates via CBRE, Government yields via Bloomberg, as of September 30, 2020.

Some potential threats to the market include the end to (or replacement of) government programs aimed at helping individuals (e.g. the Canada Emergency Response Benefit) and business (e.g. Canada Emergency Commercial Rent Assistance), while a still-recovering labour market could also trigger hindrances in the real estate market by mid-2021.

Turning towards specific sub-sectors:

› Industrial

This sector has significantly outperformed heading into 2021 and the prominence of online retailing and demand for distribution/logistics space continues to grow dramatically. The UK in particular is home to the world's third largest online retail market[1], and the already-deep demand has expanded in 2020, with online sales now accounting for 26% of all retail sales.[2] This has resulted in an explosive demand for last mile logistics, with companies like Amazon accounting for large portions of this.

› Residential

Demand continues to be strong for residential properties as the undersupply of housing remains while institutional investors with low cost capital seek income-producing, inflation-linked assets in a scalable format. Although the current boom in private sales may be replaced by a growing rental market as affordability becomes an issue, we forecast this sector to become mainstream in the years ahead as developers meet the housing and investor need.

› Office

Office properties are the "wild-card" sector, with significant uncertainty around the work-from-home model and its longer-term impacts. For example, we will see a balancing act of tenants requiring less space offset by the need for more space per employee to accommodate social distancing requirements. The impact remains difficult to determine, and we thus remain cautious.

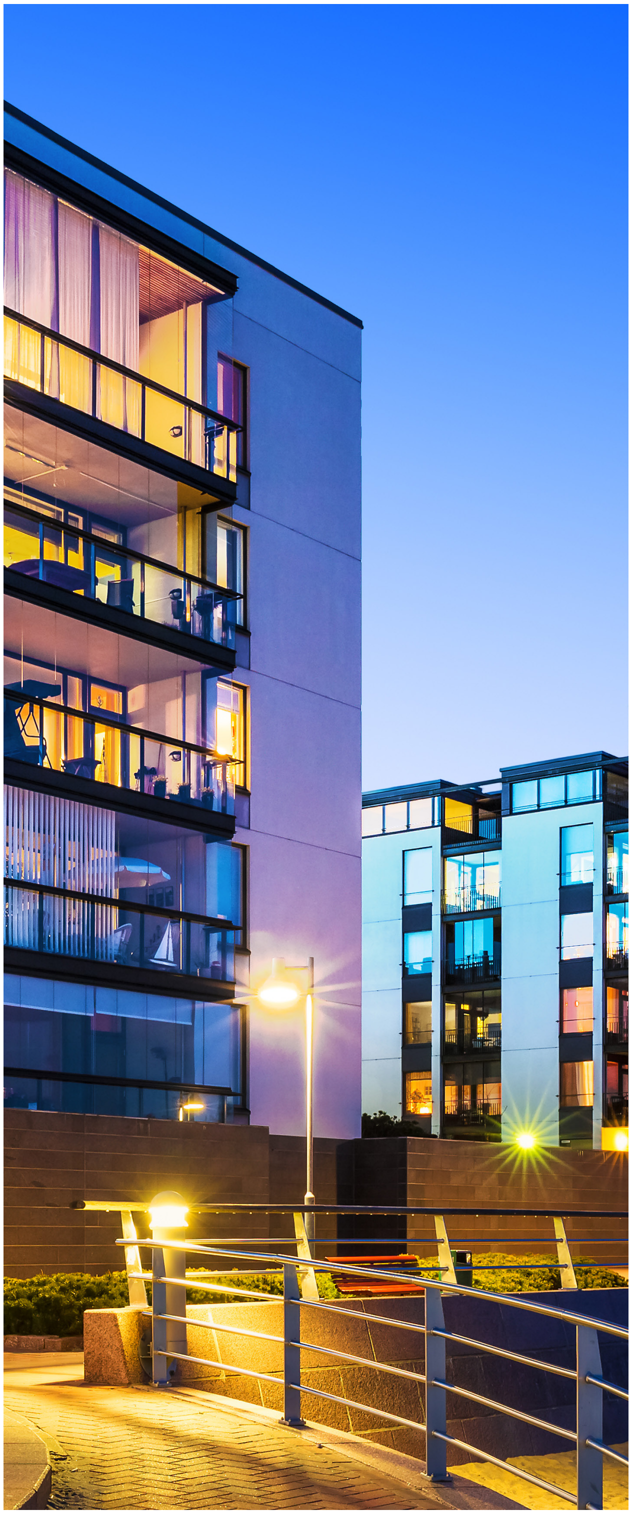
› Retail

Traditional retail asset values, even before 2020, were declining due to rapidly-changing consumer behaviour; this trend has accelerated with COVID-19. The decline of non-food-anchored brick and mortar retailers (enclosed malls in particular) is expected to continue.

1 https://www.spaceshopcommerce.com/blog/top-ecommerce-stats-for-2020
2 As of September 2020. https://www.ons.gov.uk/businessindustryandtrade/retailindustry/timeseries/j4mc/drsi

Asian and Australasian markets are worth a particular mention, as the region is ahead of the rest of the world in terms of the progression of COVID-19 and its economic effects. The way in which it's being contained and their return to work is thus an important indicator for us. Considering the speed with which many Asian and Australasian nations tackled the pandemic, much of the world's growth will stem from there (the Chinese economy grew at a rate of 3.2% in Q2, the only positive growth rate among G20 nations) in the near future. New Zealand and its economy was also extremely resilient to the pandemic resulting in a very strong real estate market. Yet thanks to the relative unfamiliarity of the region as an asset class to North American investors, we are seeing investing opportunities with higher pricing than we would see at home. Asia and Australasia are very much a region to watch going forward.

Finally, in terms of ESG, landlords' ability to adapt to tenant needs regarding health and safety related issues will become a key differentiator to growing occupancy. Landlords' focus on climate change initiatives is increasingly critical to maintaining and growing property value. Investors globally will need to invest in countries and properties that are prepared, either by nature or by their actions, to this change.



Agriculture

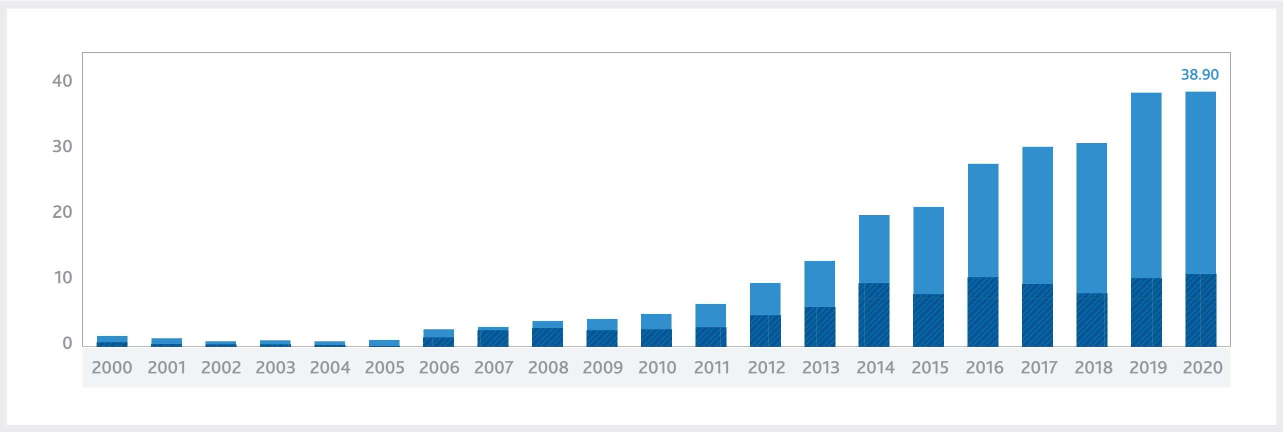
Agriculture as an asset class navigated through 2020 relatively unscathed from the COVID crisis. Though there were both positives and negatives arising from the pandemic and its impact on economies, on the balance, the impact on agriculture was relatively neutral overall, though higher-quality farmland assets demonstrated particular resilience. As the crisis potentially continues in to 2021, we expect this relatively neutral impact trend to continue.

Institutional investor interest in farmland assets will likely continue its long-term trend upwards. Farmland markets in nearly every major developed market in the world demonstrated positive appreciation and income in 2020, demonstrating that the asset class is generally uncorrelated with traditional investments thanks to its fundamental necessity in our daily lives. We expect to see institutional investors continue to allocate more capital in 2021. We foresee a similar increase in interest in food production, with a particular focus on food-tech, agri-tech and food processing.

We forecast broad agricultural commodity prices trending sideways in 2021. Agricultural commodities that were negatively impacted by COVID will likely see broad price appreciation as producers and consumers adjust supply chains and consumption patterns to increase demand for these commodities. We believe agricultural input costs (other than energy) will trend slightly downward over the course of 2021 as adjustments to supply chains allow for additional supply to hit agricultural markets. We foresee agricultural lenders focused on land-backed loans continuing to increase their exposure to the asset class.

Finally, a trend that we're likely to see continue is that of consumers in developed countries shifting more of their food consumption towards organic products across all food categories. This will put positive pressure on land values, particularly land capable of organic production. Traceability and freshness in food consumption will increasingly be viewed as important amongst consumers as well. Consumers living through a COVID world are increasingly focused on the healthiness of their food. Scaled agricultural businesses located in core producing regions can serve this increasing need in a more efficient manner than small-scale operations.

Interest in Agriculture as an investment continues to climb
Global Agriculture/Farmland assets under management (USD Billions)



Source: Preqin, as of October 26, 2020.

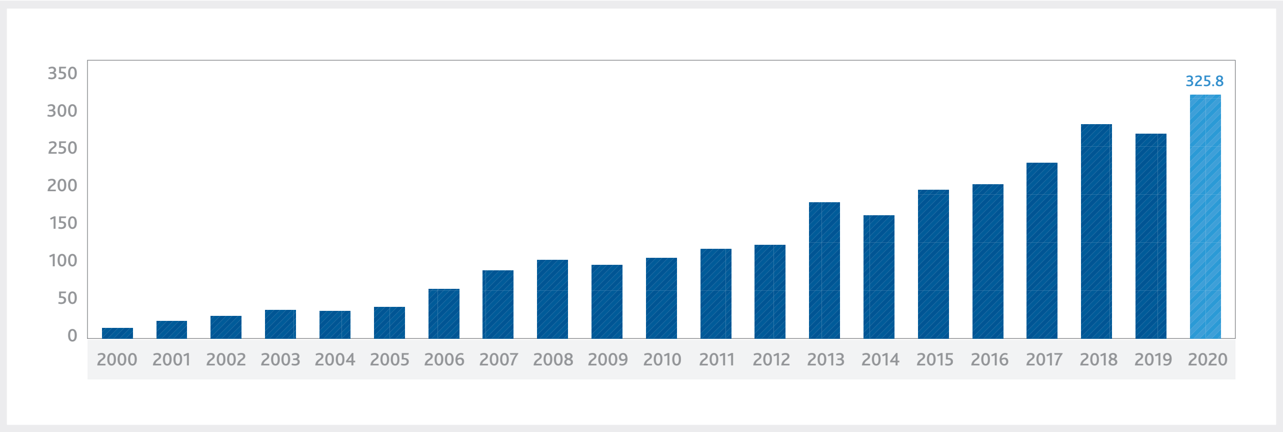
Private Debt

Private debt has demonstrated a strong resiliency to date in 2020, cementing the asset class as an all-weather investment strategy through the cycle. While the outlook for 2021 is difficult to predict, we believe that the most attractive opportunities will likely emerge from the middle market segment, where many credit funds continue to be focused on managing their pre-COVID-19 investments and more cautious on new transactions. In 2021, private debt funds in middle market loans should continue to be more conservatively structured with lower leverage, higher interest coverage, and tighter covenants.

We believe that the higher spreads we've seen develop since the beginning of the pandemic should be maintained through 2021 as some of the longer-term impacts of COVID-19 take effect. Throughout the pandemic, we saw evidence of a continued pullback in the banking industry, mainly due to the increase in risk weighted assets and loan loss provisions that arose from the economic impact of COVID-19. This paves the way for non-bank lenders to step in, and indeed, we have already seen some private lenders being more active, showing openness to lend in certain growth sectors. As such, borrowers dealing particularly well with the consequences of the pandemic will be in a position to have better access to capital in 2021.

The trend toward tighter legal documentation should continue in 2021, and, as a result, credit funds should continue to have opportunities to invest in well-structured credit instruments, with improved risk/return parameters. We expect that "covenant-lite" deals will diminish, and lenders should be able to dictate terms in complicated transactions. That said, this tendency has the potential to be short-lived., as there are a number of private lenders with significant dry powder to deploy in 2021. The industry has not suffered as much as some had predicted when COVID-19 hit the market at the end of Q1 2020. Competition from private lenders could increase through 2021, especially in sectors that have been less/not impacted by the pandemic. The discipline of underwriting and monitoring will be paramount.

Private Debt dry powder is hitting record levels
Global dry powder (USD Billions)

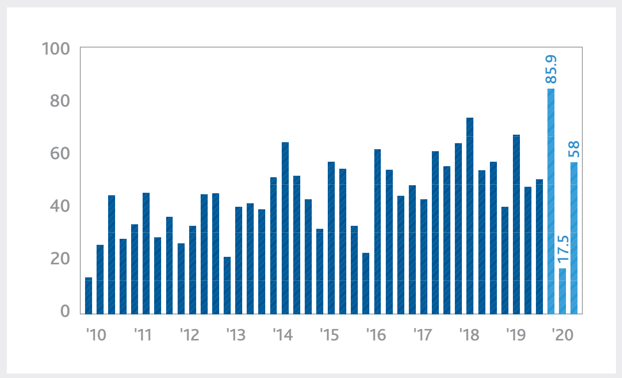


Source: Preqin, as of October 26, 2020.

Private Equity

Before the pandemic hit, global private equity buyout deals volume hit historic levels – US$86 billion in Q1 2020. The economic slowdown took a toll on the number and value of deals in Q2, the latter decreasing by nearly 75% year-over-year. But Q3 was a different story: deal value increased by nearly 20% from Q3 2019, to US$58 billion, according to Preqin.

Private Equity Buyout - Weakness in Q2 but significant rebound in Q3
Global buyout deal values (USD Billion)



Source: Preqin, as of October 26, 2020.

In the world of private equity, scarcity of companies looking for private equity investors or buyouts will play a major role. Premiums are likely to vary across sectors, with higher multiples paid for recession-resilient companies (e.g. healthcare and technology) and lower multiples for companies which have been impacted by the pandemic (e.g. retail, hotels, oil & gas). It is likely that there will be fewer desirable available companies in cyclical (i.e COVID-impacted) sectors as owners will not be able to garner maximum value for their companies, and may thus delay plans to sell their businesses and/or seek new investors.

In terms of General Partner (GP) dynamics, private equity exits are likely to slow meaningfully relative to the previous 10 years. GPs are going to focus first on restoring earnings to ultimately maximize value for their investments at exit. This is likely to increase the investment horizon of current investments relative to the preceding decade. With this probable slowdown in PE exits, a surge in dividend recaps becomes more likely; as PE firms seek liquidity and maintenance of their IRR track record, funds will be looking to partially monetize their investments, so dividend recaps might be the avenue in which to do just that.

Attractive investment opportunities could arise in secondaries, which in previous downcycles have generally become a "buyers' market." This dynamic will largely depend on volatility in the equity portfolio of institutional investors. The sharp rebound in equity portfolios since March 2019 has resulted in a short-lived opportunity set to date, but as COVID-19 continues to spread and affect the real economy, a set of opportunities may present itself in 2021.

Finally, it behooves us to mention an under-the-radar yet crucial development for the PE space. In June 2020, the U.S. Department of Labor gave the green light for private equity inclusion in defined contribution plans such as 401(k) plans.[3] The Department of Labor now says that, if part of diversified vehicles such as target date funds, access to private equity can be appropriate. This major announcement somewhat levels the playing field for retail investors, who have historically been excluded by regulators from investing in private equity. It's thus likely that we see an increasing presence of private equity among retail investors in the $6 trillion U.S. 401(k) retail market.[4]

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3 https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020
4 https://www.bloomberg.com/news/articles/2020-06-26/private-equity-is-coming-for-the-6-trillion-401-k-market

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