Institute

December 2024

2025 Private Markets Outlook

"As private market valuations have reset from their lofty 2021 levels, we believe that allocating capital in the coming year looks attractive across much of the private market's ecosystem. We believe that funds who deploy capital in today's market environment can negotiate favorable pricing, terms and covenants."

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Executive summary

Key points

- **Secondaries** exhibit attractive fundamentals and structural advantages.
- **Real estate** has been beaten down and valuations are now more attractive.
- **Private credit** has filled a void that traditional lenders have created.
- **Dispersion of returns** are likely to increase, separating the winners and losers.
- This is a **better environment for allocating capital** than recent years.

We will cover these key points throughout the outlook. We believe that secondaries will continue to benefit from the slowed exits and institutions' need for liquidity. We believe that private real estate valuations have come down to more realistic valuations and there are opportunities in industrials, multi-family housing and life sciences. Private credit managers are well positioned to fill the void banks have left, and to negotiate favorable terms and covenants.

Given the amount of capital that has been raised in the private markets, and the changing regimes, from an environment with easy money and benign inflation, to rapidly raising rates and high inflation, to falling rates and stubborn inflation, we anticipate a larger disparity between the winners and losers in the coming decade. With that said, we believe that managers putting capital to work today can take advantage of more attractive valuations and being a "term-maker" versus "term-taker" (i.e., the ability to dictate terms).

The global markets

In last year's outlook, we discussed the global backdrop of elevated geopolitical risks, a changing interest-rate environment, tensions due to presidential elections, stubborn inflation, and the Federal Reserve's (Fed's) attempt to navigate a soft landing. Geopolitical risks remain elevated. The war in Ukraine shows no signs of abating anytime soon, the battle in the Middle East is expanding, and Russia, North Korea and China have taken provocative actions.

Going into 2024, many pundits were calling for rate cuts to begin early in the year, and several were calling for as many as six cuts in 2024. The Fed was much more deliberate than expected, waiting until September before beginning to cut, and then making a larger than normal cut of 50 basis points (bps). The expectation is that the Fed will continue to cut rates into 2025. Inflation has leveled off and a recession seems to have been avoided.

Global elections provided changes in leadership in the United Kingdom, France, and the United States among others. The US elections were divisive and unprecedented in many ways. In a rare move, President Joe Biden stopped his presidential campaign after growing concerns about his mental acuity and ability to serve four more years. Former President Donald Trump survived an assassination attempt, while another plot was thwarted. The rhetoric between the two parties was heated throughout, serving to divide America, and to splinter the parties themselves.

With the elevated risks, tensions, and uncertainty, the US markets shrugged off the noise and soared to new heights. The S&P 500 Index was up 21% for 2024 (total return, as of October 31, 2024), and bonds, as represented by the Bloomberg US Aggregate Bonds Index, were up 1.9%[1] for the same period. Valuations are elevated, at 24x forward price-to-earnings (P/E) ratio, and the market is anticipating another 120 bps of cuts through 2025.[2]

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Private markets results

We have been focused on a few macro themes over the last several years. As private market valuations have reset from their lofty 2021 levels, we believe that allocating capital in the coming year looks attractive across much of the private market's ecosystem. We believe that funds who deploy capital in today's market environment can negotiate favorable pricing, terms and covenants.

Over the long run, based on historical results, we think investors should consider allocating capital to private markets. To illustrate the short-and long-term results of private markets and traditional investments, we have compared the one, three-, five-, 10- and 15-year results of private equity, private credit, real estate (equity), real estate debt and secondaries to the MSCI ACWI Total Return Index, and Bloomberg Global Aggregate Total Return Index.

Exhibit 1: Short-Term and Long-Term Returns

As of June 30, 2024

Strategy	1-year	3-year	5-year	10-year	15-year
Private Equity	4.90%	4.84%	16.42%	15.15%	15.90%
Private Credit	8.71%	6.73%	6.23%	5.96%	7.15%
Real Estate Equity	-9.99%	1.02%	2.27%	5.46%	6.62%
Real Estate Debt	8.21%	8.46%	8.37%	8.82%	6.77%
Global Secondaries-All Strategies	3.89%	8.01%	13.97%	12.44%	13.35%
Equity	18.26%	4.41%	9.70%	7.43%	9.34%
Fixed Income	0.49%	-5.91%	-2.45%	-0.85%	0.79%

Sources: MSCI Indexes, MSCI Private Capital Solutions, Cliffwater, NCREIF, Bloomberg, Macrobond, PitchBook. Analysis by Franklin Templeton Institute.

For each period, the top three returns are marked in green, while the bottom three returns are marked in orange. Returns exceeding a year are annualized. The indexes are total returns in US dollar terms. All returns are net of fees, valued on a quarterly basis. The indexes used and methodology for calculating the net of fee returns are in the Appendix. Indexes are unmanaged and one cannot directly invest in them. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

We have highlighted the top three asset classes and sub-asset classes for each period in green, and the bottom three in red, to draw attention to the long-term results. Note, recent performance has impacted real estate (equity), and while traditional equity results have been strong recently, they lag private equity and secondaries over the long run.

We believe that real estate (equity) results may likely be more like long-term historical averages, (high single-digit) with higher income than traditional bonds, and low-negative correlation to most traditional investment options.

With respect to the long-term outperformance of private equities versus public equities, we think it is important to explore why this has occurred, and why we think it will persist. According to research from Hamilton Lane,[3] there is a shrinking universe of public companies (roughly 4,000), and a growing universe of private companies. In fact, of all the companies with over US$100 million in revenues, 87% of them are private, and they are remaining private longer. Some will never go public due to the abundance of capital available to them.

The other important consideration is how private capital can be used to help unlock value over time. In addition to money that can be used to fuel growth, support expansions, investments in research and development, and/or make acquisitions, private equity firms are often deploying seasoned managers who provide valuable human capital to these startups. The long-term commitment to growth is crucial for their ability to unlock value. Rather than answering to shareholders on a quarterly basis, private companies can execute their multi-year strategy.

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Dispersion of returns

As noted above, we believe that the dispersion of returns may widen between experienced managers who have navigated through multiple cycles, and those newer to private markets. Historically, private markets have exhibited substantially larger dispersion than traditional options, with the difference between the 95th and 5th percentile traditional equity manager approximately 500 bps; while the difference between the 95th and 5th percentile private equity fund has been over 4,500 bps, and venture capital has been nearly 5,000 bps.

Exhibit 2: Private and Public Market Dispersion of Returns

As of June 30, 2024

Sources: MSCI Private Capital Solutions, Morningstar.

The returns for US Large and Mid Cap Active Equity Funds reflect the annualized returns for the period January 1, 2005 to June 30, 2024. The returns for Real Estate, Secondaries, Private Equity, Venture Capital (VC), and Private Debt are the Internal Rate of Return (IRR) of the funds with vintage years from 2005 to 2018, as of June 30, 2024. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Leading up to 2021, a lot of capital had flowed into the private markets, and private market funds were often forced to pay higher valuations due to the demand and limited supply. Since 2022, the pendulum has shifted, and managers can now dictate price, terms and covenants. However, not all managers have the same level of experience, and depth of resources, to negotiate and put capital to work.

Consequently, we believe that there will be a premium in selecting experienced managers who have historically delivered strong results, and avoiding managers who lack the depth and experience to successfully deploy capital through changing market regimes.

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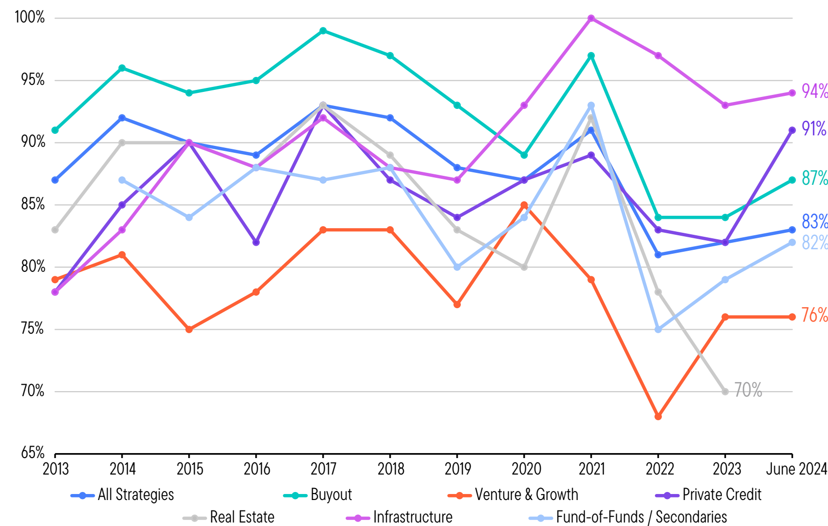
Secondaries: Attractive fundamentals

We believe secondaries look attractive from a valuation perspective and provide several built-in advantages for individuals and institutions alike. As discussed in our mid-year outlook, secondaries have benefited from a deceleration in exits, institutions' need for liquidity, and the fact that secondaries have been available at discounts.

Exhibit 3: Global Secondary Discounts

Historical Secondary Pricing (% of Net Asset Value)

As of June 30, 2024



Source: Greenhill Global Secondary Market Review Data.

With the strong private equity returns leading up to 2021, many institutions found themselves overallocated to private equity. Coupled with slowing distributions, these institutions often needed to seek liquidity to remain within their investment policy guidelines, and to free up capital to fund future commitments. Secondaries provided that needed liquidity and filled a vital role for institutions.

We believe that there will likely be an acceleration in exits in the coming year. President-elect Trump has signaled a pro-business environment, loosening regulation, lower taxes and spurring growth. Coupled with the lower cost of capital, this should fuel merger and acquisition activity and lead to increased initial public offerings.

While there should be a pickup in exit activity, we believe that institutions will continue to use the secondary market to diversify their private equity holdings and create liquidity to fund future deal flows. Individual investors benefit from the shortened J-curve,[4] shorter period before receiving distributions, and diversification (general partner (GP), vintage, geography, industry, etc.).

Secondaries have become a vital part of the growing private markets ecosystem, matching buyers and sellers of private equity, private credit, real estate and infrastructure, and fulfilling the liquidity needs of institutional investors. Note, while secondary private equity has matured a great deal over the last decade, the secondary market for private credit, real estate and infrastructure are still relatively nascent. We believe that the growth of this important market will continue to evolve and expand.

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Private credit: The emergence of a new lender

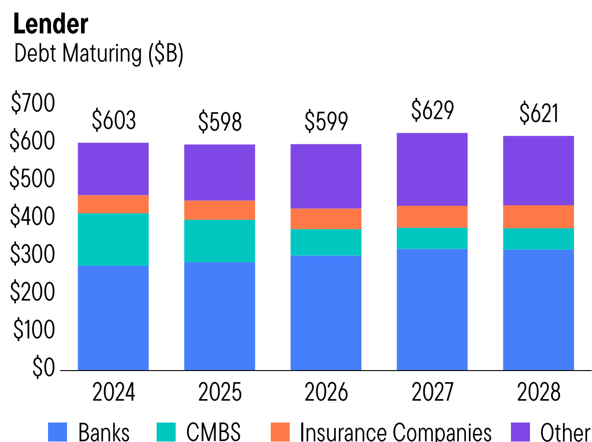
Private credit has experienced significant flows over the last several years, and some have questioned whether too much money is chasing too few deals. The reality is that private credit—in many respects—has filled the void banks created. The private credit industry exploded after the global financial crisis (GFC), when banks were reticent to lend capital. Private credit managers seized the opportunity.

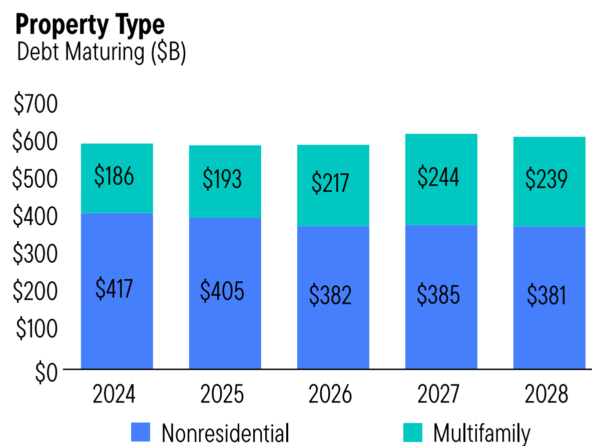
This trend only accelerated after the collapse of Silicon Valley Bank and concerns about contagion across real estate. With banks unwilling to lend to help refinance troubled assets, private credit managers stepped in to fill the void. This has created an interesting opportunity for commercial real estate (CRE) debt.

According to a Morgan Stanley report, there is a "wall of debt" that will need to be refinanced in the next couple of years. It estimates that the valuations of office and retail could be down by 40% peak to trough, increasing the chance of defaults. The research also notes the wall of debt is scheduled to get worse before getting better, peaking in 2027 at $550 billion.[5]

Exhibit 4: Wall of Debt Maturities for Commercial Real Estate Loans

As of Q1 2024





Source: Trepp.

Other category is primarily comprised of multifamily lending by Fannie Mae and Freddie Mac. This could also include finance companies (private debt funds, REITs, CLOs, etc.), pension funds, government or other sources.

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The wall of debt creates opportunities for seasoned lenders. With banks' reluctance to lend, private credit firms now have leverage, and they can negotiate favorable terms and covenants. We believe that this opportunity for seasoned managers with capital to deploy will persist for the foreseeable future.

Real estate: Valuations have fallen dramatically

With real estate generating a lot of negative headlines, and ongoing concerns about the office sector, valuations have fallen dramatically over the last several years. While difficult to call market peaks and troughs, it is tough to argue that there are better opportunities to deploy capital today than in the last several years. In addition to the valuation story, falling rates and the lower cost of capital should be a positive for the real estate market (equity and debt).

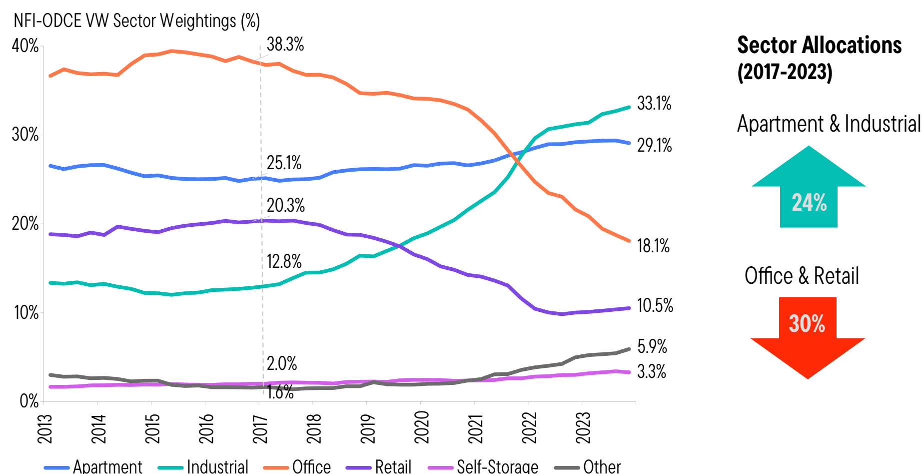
As we have discussed in past outlooks, we need to dig a little deeper when we begin discussing allocating to private real estate. The office sector has had considerable headwinds which pre-date COVID-19, and the industrial sector has had tailwinds with the explosive growth of ecommerce and re-shoring due to concerns about our supply chains.

As illustrated in Exhibit 5, the office and retail sectors have been falling over the last several years, while the industrial and apartment sectors have been rising. These are secular trends that we think will persist in the coming years.

Real estate is not a monolithic investment decision—it is a diverse set of strategies that will respond differently to macro and geopolitical trends. We believe that seasoned managers who can identify good properties, at attractive valuations, should thrive in this challenging environment; those who lack the experience and resources may struggle in deploying capital.

Exhibit 5: Private Real Estate Sector Allocation in Recent History

As of Q4 2023



Sources: Clarion Partners Investment Research, NCREIF, 2023Q4.

NFI-ODCE VW is NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE) Value Weighted. The NFI-ODCE is a capitalization-weighted index based on each fund's net invested capital, which is defined as beginning market value net assets (BMV), adjusted for weighted cash flows (WCF) during the period. Important data provider notices and terms available at www.franklintempletondatasources.com.

Summary

We see attractive opportunities across the private markets. With product evolution making these investments more accessible to a larger group of investors, and with more flexible features, advisors should consider allocating to these versatile and valuable tools.

Historically, combining private and public markets in a meaningful way has provided higher returns and lower risks than a traditional portfolio. The efficient frontier analysis in Exhibit 6 illustrates the impact of including a 30% allocation to private markets, evenly divided between private equity, private credit and private real estate. The addition increases the return and lowers the risk of a traditional-only portfolio.

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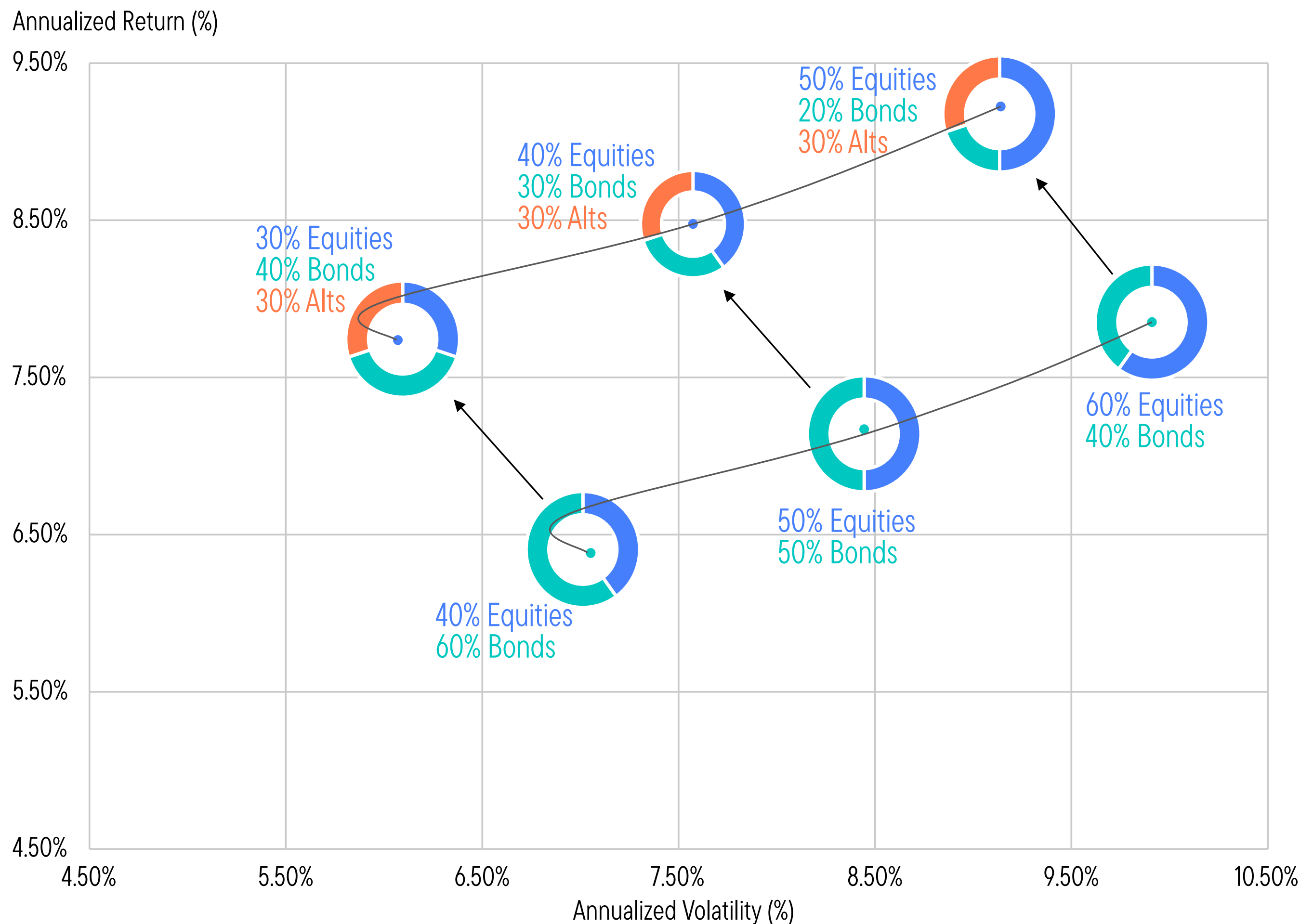
Exhibit 6: Efficient Frontier Analysis

Annualized Volatility and Returns

As of June 30, 2024



Sources: MSCI Private Capital Solutions, SPDJI, NCREIF, Bloomberg, Cliffwater, Macrobond. Analysis by Franklin Templeton Institute.

Quarterly data analysis from Q4 2004 to Q2 2024; 30% allocations to Alternatives split evenly among Private Real Estate, Private Equity and Private Credit.

Indexes used: Private Credit: Cliffwater Direct Lending Index; Private Real Estate: NCREIF Fund Index Open End Diversified Core Equity (ODCE) Index, US Stocks: S&P 500 Total Return Index, US Bonds: Bloomberg US Aggregate Index (Total Return); Private Equity: MSCI Private Capital Solutions' fund search results for US Private Equity funds (all categories). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

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Private equity: A continued focus on secondaries

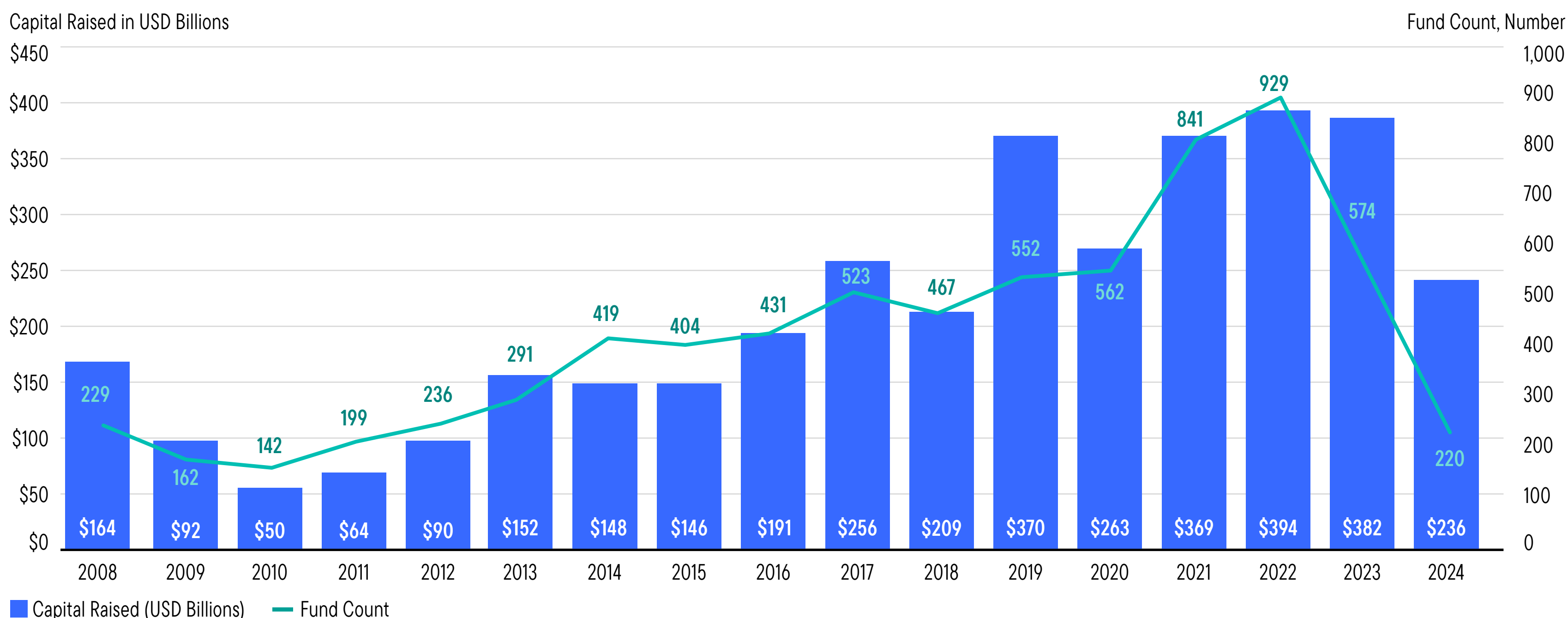
As we evaluate the investing landscape in 2024, and anticipate the market environment in 2025, we see a lot of the same factors that informed our outlook over the past couple of years. Private equity broadly has been impacted by slowing exits and merger and acquisition (M&A) activity, and secondaries have become an increasingly important part of the private equity ecosystem, providing liquidity to institutions.[6]

How did we get here?

Amid strong returns and near-zero interest rates, private equity assets rose dramatically after the global financial crisis (GFC). In the United States, private equity assets under management have risen for 15 straight years, eclipsing US$3.3 trillion in 2023.[7] However, with higher interest rates, less M&A activity, and an anemic initial public offering (IPO) market, fundraising activity has slowed dramatically since 2022.

Exhibit 7: US Private Equity Fundraising Activity

As of September 30, 2024



Source: PitchBook Q3 2024 US Private Equity Breakdown Report.

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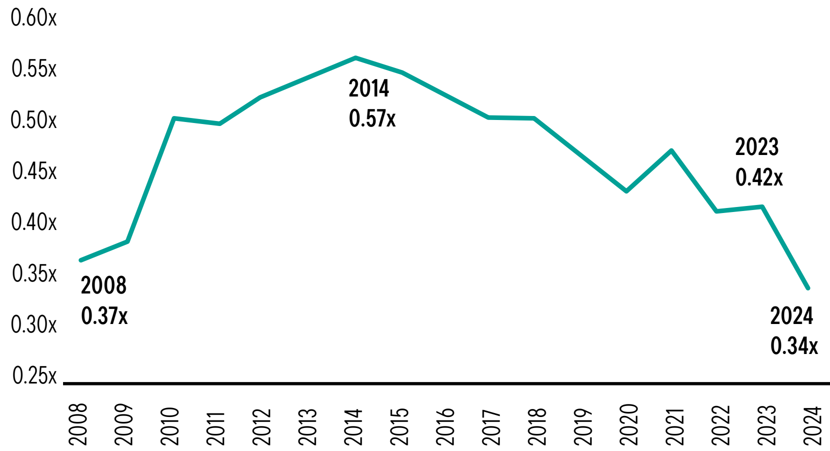
As shown in Exhibit 8, the number of exits per investment reached a new low in 2024, and the median holding period for private equity investments increased to seven years in 2023, versus less than four years in 2006.

Exhibit 8a: US Private Equity Exits/Investments Ratio (Number of Exits to Number of Investments)

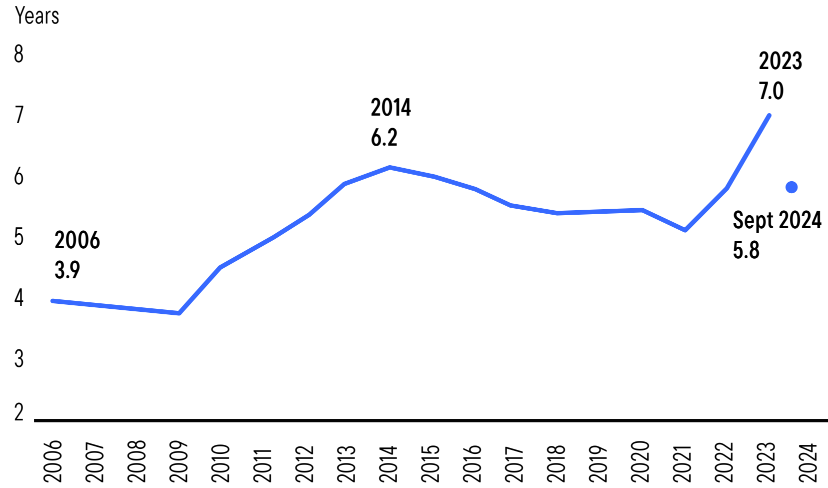
As of September 30, 2024



Source: PitchBook Q3 2024 US Private Equity Breakdown Report.

Exhibit 8b: US Private Equity: Median Exit Hold Period (Annual)

As of September 30, 2024



Source: PitchBook Q3 2024 US Private Equity Breakdown Report.

While this has been a challenging environment for private equity managers seeking to deploy capital, we believe that the landscape will improve in 2025. With interest rates coming down, and a favorable regulatory backdrop, we anticipate more M&A activity, which would be a positive development for the overall private equity market. We believe that there will be more exits in the coming year, freeing up the deployment of capital.

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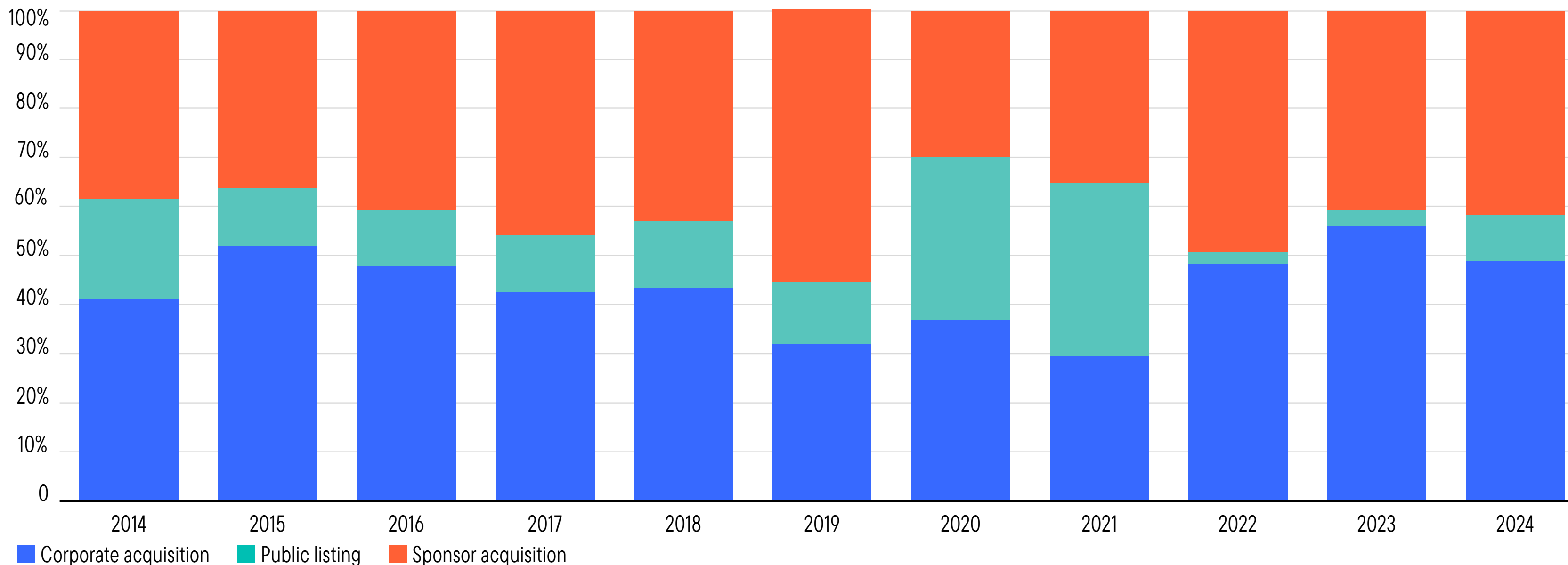
Venture capital

In our view, the biggest challenge facing venture capital is the path to exit, with both M&A activity and IPOs slowing precipitously in the last couple of years. With a challenging M&A landscape, increasing IPOs may be the most viable path for large venture-backed tech companies to exit.

Most venture capital had lofty valuations in 2021, leaving many venture-backed companies facing difficult IPO prospects. There are signs that the IPO market will be more robust in 2025, although likely below the levels of 2020 and 2021. According to Pitchbook,[8] there were over 200 private equity exits via public listing in 2020 and 2021, while there have been less than 40 since the start of 2022.

Exhibit 9: Share of US Private Equity Exit Value by Type

As of September 30, 2024



Source: PitchBook Q3 2024 US Private Equity Breakdown Report.

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While private companies have been cautious to enter public markets in this environment, we believe there remains a healthy pipeline of high-quality companies that will benefit from any loosening in the IPO market. Further, this is an exciting time for investors in innovation, as we are only in the early innings of a long cycle driven by artificial intelligence, sustainable energy, and digital finance, among others.

Secondaries

The high levels of fundraising in private equity and the slowdown in exit activity have combined to make this a very attractive period for secondary managers. With the rapid growth, many institutions found themselves overallocated to private equity, due in part to the outsized returns of private equity relative to public markets returns. To remain within their investment policy guidelines, many institutions were forced to seek liquidity in the secondary market.

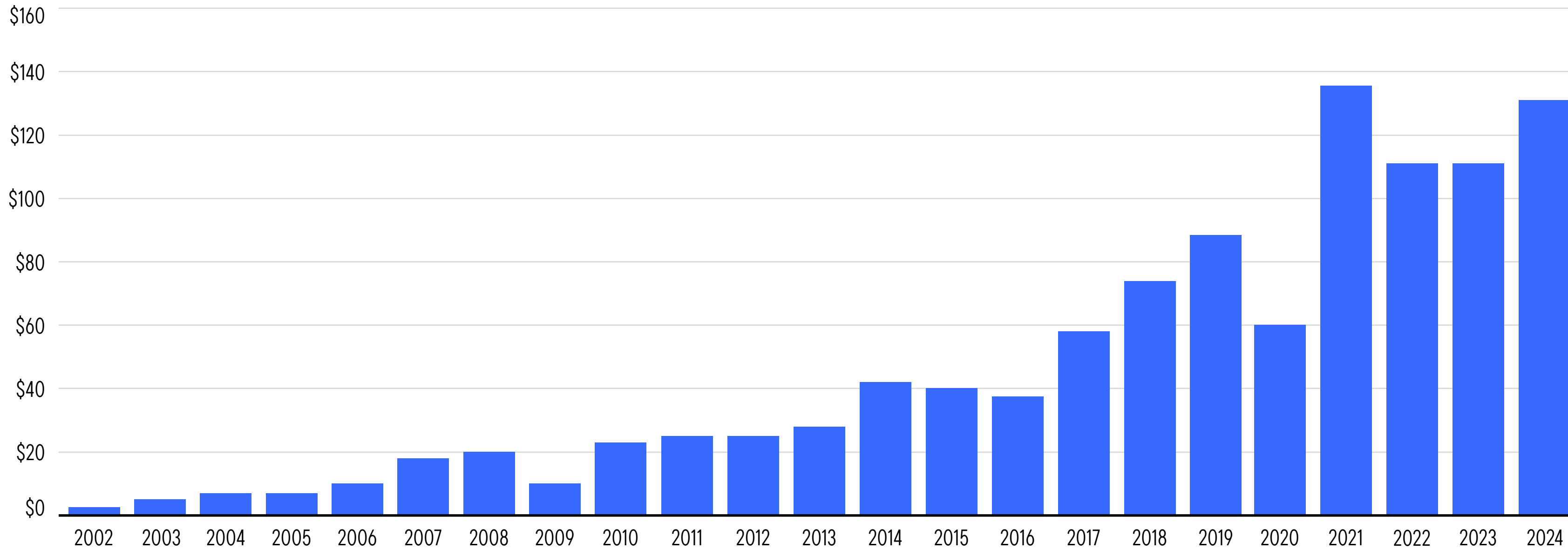
In fact, many institutions have put in place secondary programs to diversify their holdings and free up capital for new vintages. Secondaries have emerged as a vital cog in the private equity ecosystem, providing needed liquidity and diversification.

Even if exit activity picks up amid lower capital costs, it is likely that the demand for secondaries will continue to be strong. Secondary market transactions have increased dramatically over the past decade, rising from US$42 billion in 2014 to a projected US$130 billion in 2024 (See Exhibit 10).

Exhibit 10: Secondary Market has Grown Rapidly and Offers More Opportunities

Secondary Market Transaction Volume (in USD Billions)

As of June 30, 2024



Source: Greenhill Global Secondary Market Review Data.
The projected transaction volume for 2024 is US$130 billion, comprising US$69 billion from the first half and an estimated US$61 billion from the second half of the year.

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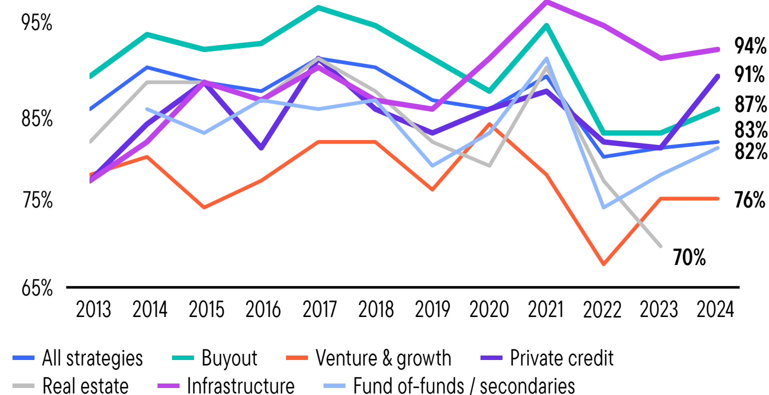
Given the strong demand for secondary liquidity, managers have been selective in deploying capital, and can diversify across stages of development (venture, growth equity, and buyout), geography, industry and vintage. By purchasing assets closer to their harvest stage, secondaries managers can also mitigate the effects of the J-Curve, and investors may receive distributions sooner because managers are buying seasoned assets.

While the market has grown significantly over the past decade, the opportunity to pick up assets at attractive valuations has remained. The average discount has decreased from the lows of 2022 but remains healthy, with the average historical secondary pricing across all strategies at 83% (see Exhibit 11).[9]

Exhibit 11: Global Secondary Discounts

Historical Secondary Pricing (% of Net Asset Value)

As of June 30, 2024



Source: Greenhill Global Secondary Market Review Data.

Summary

The overall private equity market remains strong and should benefit from improving exits in the years to come. After resetting valuations from their 2021 peak, venture capital looks more attractive for patient capital. Over the long run, there will be opportunities in artificial intelligence, sustainable energy, and digital finance, among other areas.

Secondaries have become a vital cog in the growing private equity ecosystem, providing investors with access to liquidity. Secondaries provide diversification and the market provides the broader ecosystem with additional scale and liquidity during periods of stalled exits.

Secondary funds provide a number of built-in advantages for individual investors, including shortening the J-Curve, providing distributions sooner, and diversification (GP, vintage, geography and industry).

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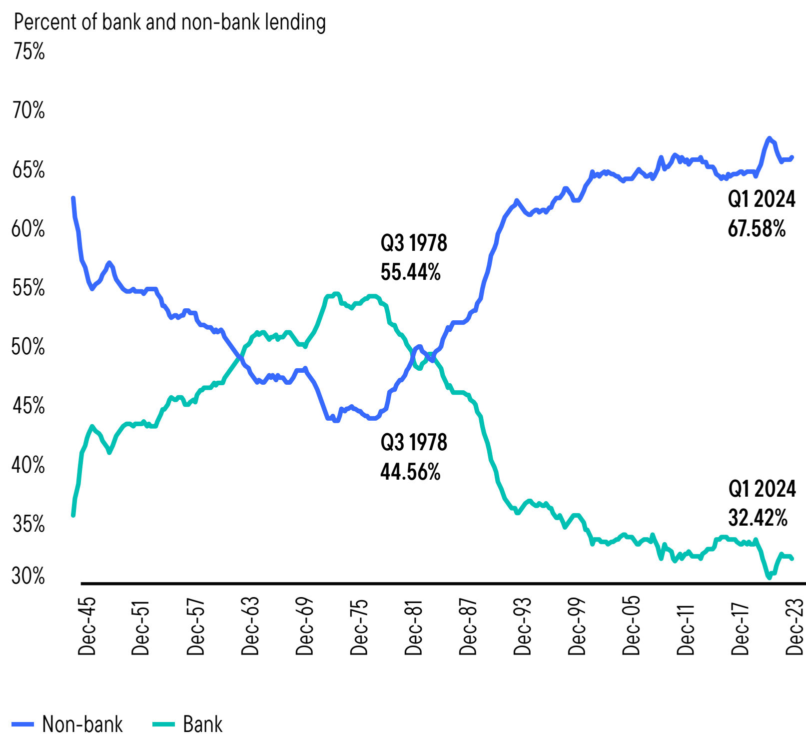
Private credit: New opportunities arise in real estate debt

Private credit has evolved meaningfully over the past few decades. Historically, banks were the primary originators and holders of loans to corporations. The expansion of credit markets has coincided with non-financial corporations (both private-owned and public) gaining an outsized share of the market. Exhibit 12 shows non-bank lenders hold the majority of debt.

Exhibit 12: Credit to the Private Non-Financial Sector (Core Debt)

From 1945Q4 until 2024Q1



Source: BIS. Analysis by Franklin Templeton Institute.

Private credit has stepped in to fill the void left by banks since the GFC, as banks retrenched from lending to small and middle-market companies. We expect this trend to continue and believe that seasoned private credit managers will have the upper hand in negotiating favorable pricing, terms and covenants.

Private credit has experienced significant growth from both institutions and individual investors seeking alternative sources of income over the last two decades. As seen in Exhibit 13, assets under management (AUM) in private credit has increased from US$300 billion in 2008 to US$1.65 trillion as of the end of 2023, according to Pitchbook. We expect this trend to continue, with investor demand increasing throughout this decade.

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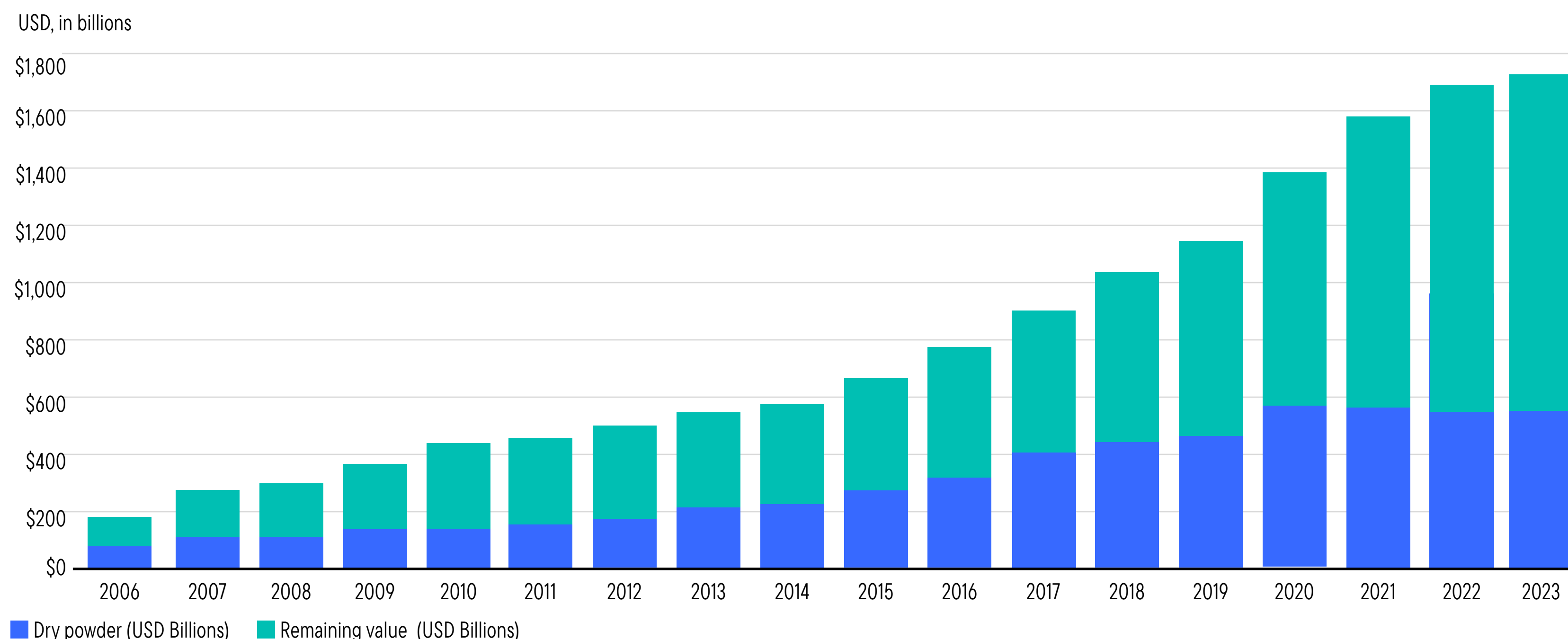
Exhibit 13: Private Credit Growth Since the GFC

Global Private Debt Assets Under Management

As of December 31, 2023



Source: PitchBook Q2 2024 Global Private Market Fundraising Report.

Private credit performance has been strong in recent years. As we began 2024, the key question was whether the Federal Reserve (Fed) could achieve a soft landing, or at least avoid recession, and how much it would cut interest rates. The Fed was very deliberate throughout the year, eventually beginning to cut interest rates in the fall, and it appears that a recession has been avoided, with real gross domestic product growth likely to eclipse 2% for the year. While the Fed has begun its cutting cycle, it appears for now that the pace will be slower than many forecasted entering 2024.

This environment has been supportive for private credit. A solid economy, strong corporate profits, and a steady consumer has helped both companies and individuals weather the impact of higher interest rates. This has resulted in relatively low default rates and strong returns across key areas of private credit. Returns in direct lending, real estate debt, and distressed debt each eclipsed 8% over the trailing one year, through June 2024 (See Exhibit 14).

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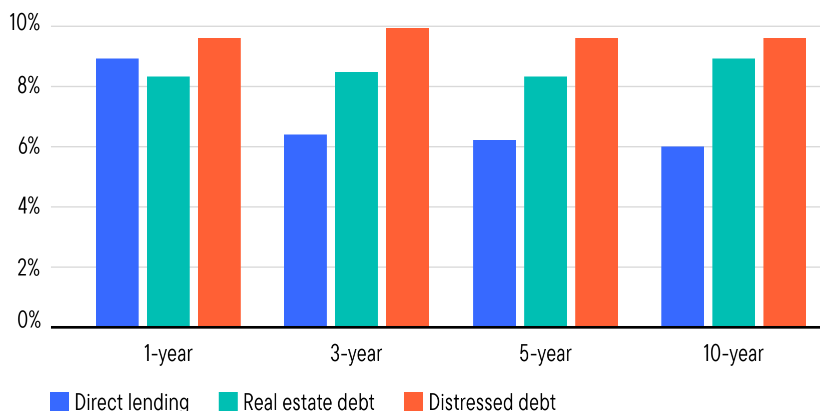
Exhibit 14: Returns within the Private Credit Market

As of June 30, 2024



Sources: Cliffwater, PitchBook. Analysis by Franklin Templeton Institute.

Returns for periods exceeding one year are annualized. Net of fees returns for Direct Lending have been calculated considering a fee of 1.342% p.a. is subtracted from the quarterly returns. Additionally, a carried interest percentage of 16.844% is charged on positive returns. This fee and carried interest is average for private credit funds during 2014 to 2022 (data from PitchBook). In case of a negative quarterly return, carried interest is not charged until losses are reversed. The hurdle rate to charge the carried interest is 6% p.a., based on data provided in iCapital's article titled "Understanding Private Market Fund Distribution Waterfalls," dated January 20, 2023. Indexes used: Real Estate Debt and Distressed Debt: PitchBook fund search results for US Private Real Estate Debt funds and US Private Distressed Debt funds; Direct Lending: Cliffwater Direct Lending Index.

Indexes are unmanaged and one cannot directly invest in them. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Proskauer recently noted in a research report that default rates for broadly syndicated loans and private credit had risen slightly.[10] However, the report contrasted the differences between the two types of loans. "We believe that there are structural differences between the products that explain the difference in default rates—stricter underwriting standards, tighter documentation (including financial maintenance covenants), regular access to information/management, and loans that are typically held to maturity and not distributed."

The Fed's interest-rate cuts should be supportive of the economy, but that does not mean that higher-risk companies will be immune from still decades-high interest rates. In our view, it is unlikely that rates will retreat to the near-zero levels of the post-GFC era. Companies that took out debt at low interest rates will need to refinance at higher rates, and this will create opportunities for seasoned lenders across private credit who have capital to deploy. At the same time, investors should continue to benefit from relatively high income levels.

Direct lending

Direct lending represents a unique risk and return profile relatively to broadly syndicated loans (BSLs) and high-yield bonds. Direct lending focuses on small and middle-market opportunities, while BSL and high yield tend to focus on larger companies. This market tends to be less liquid than traditional fixed income, and loans are typically held to maturity rather than traded. We believe experienced managers, especially in the middle-market space, have the ability to take advantage of higher spreads in resilient sectors of the economy.

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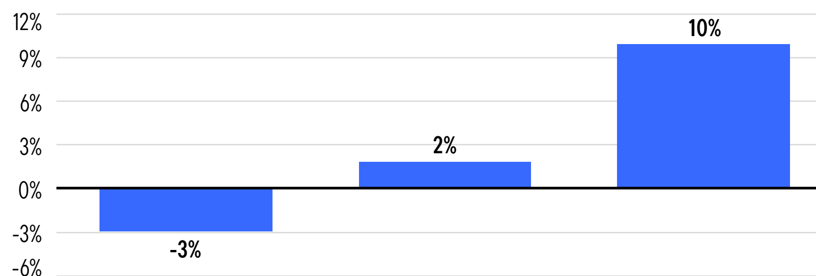
Private credit has historically delivered an illiquidity premium relative to core bond and high yield bond categories. Exhibit 15 shows the three and 10-year annualized returns. The rise in interest rates over the previous three years has had an outsized impact on the Bloomberg US Aggregate Bond Index, where the vast majority of the index is fixed-rate and the index as a whole has a longer duration. Direct lending tends to be floating rate, and thus coupons adjusted during the rising interest rates of 2022 and 2023. Falling rates could provide a bit of a headwind, but we believe there will be other offsetting factors.

Even with rates moving lower in the coming years, direct lending—and private credit broadly—and should continue to benefit from attractive yields to maturity, and increasing demand from institutions and individual investors.

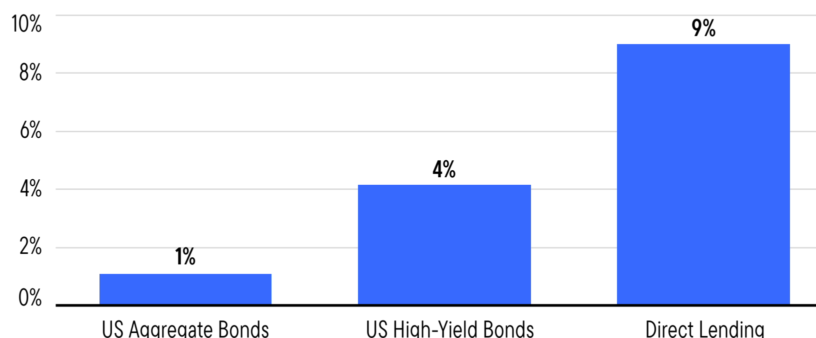
Exhibit 15: Illiquidity Premium (Public vs Private Markets)

As of June 30, 2024

Three-Year Annualized Returns



Ten-Year Annualized Returns



Sources: Bloomberg, ICE BofA Indexes, Clilffwater, Macrobond. Analysis by Franklin Templeton Institute.

Indexes used: Bloomberg US Aggregate Total Return Value Unhedged USD, ICE BofA US High Yield Index, and Cliffwater Direct Lending Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

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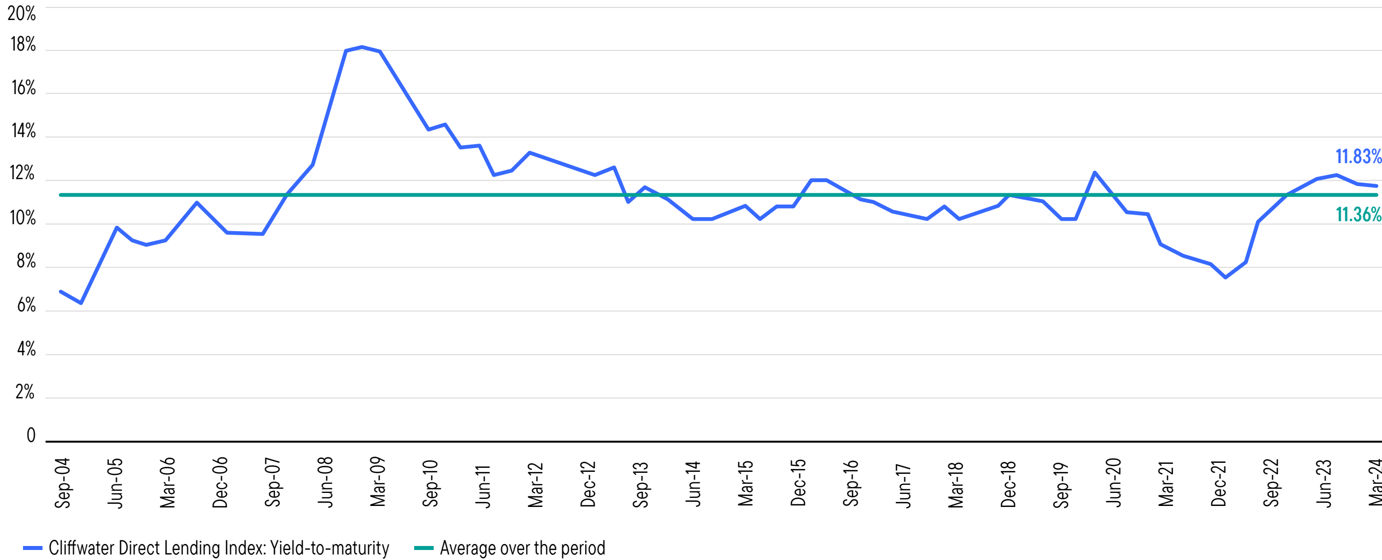
Exhibit 16: Direct Lending: Yield to Maturity

As of June 30, 2024



Source: Cliffwater. Analysis by Franklin Templeton Institute.

Indexes used: Cliffwater Direct Lending Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future results. Important data provider notices and terms available at www.franklintempletondatasources.com.

The slowdown in M&A activity over the last two years has created challenges for investors in both direct lending and leveraged loans. Activity has picked up in 2024 relative to 2023, and we expect this trend to continue into 2025, creating a tailwind for deal flow. Refinancing activity in the next 12-24 months should also provide a tailwind for deals. As Exhibit 17 shows, a significant percentage of credit will hit a maturity wall in the coming years.

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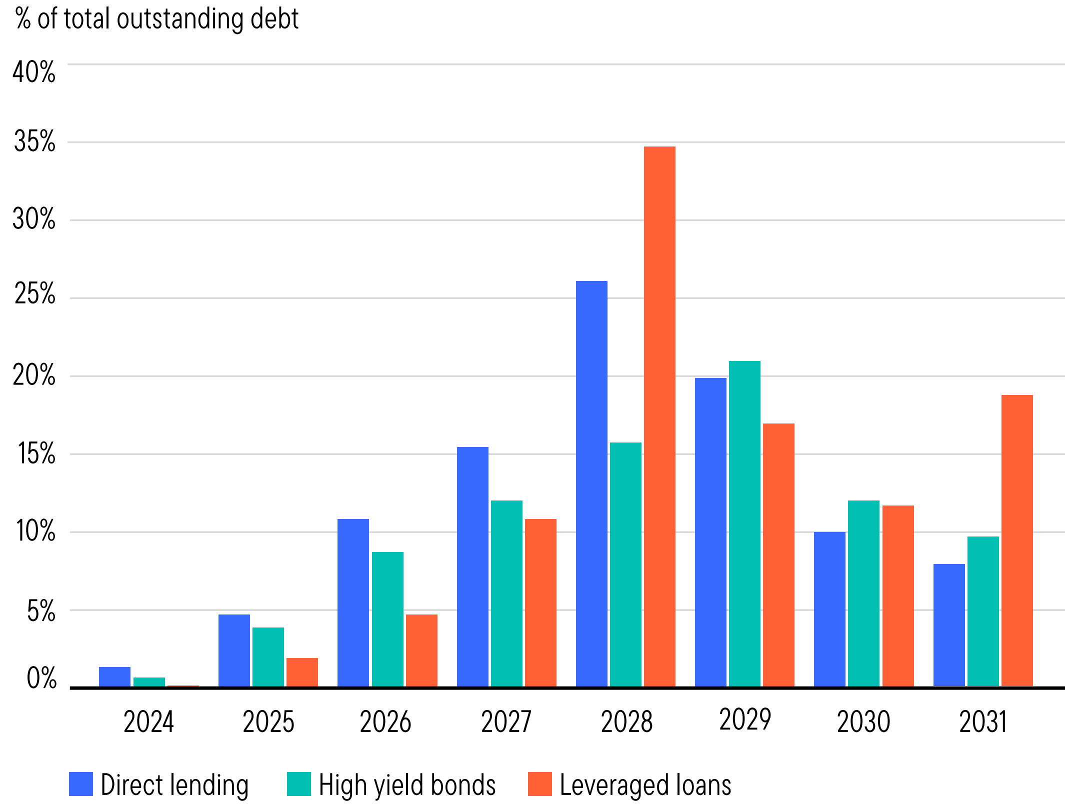
Exhibit 17: US Credit Maturity Wall

As of September 30, 2024



Source: PitchBook.

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Distressed and special situations

Despite tight financial conditions and the Fed's undertaking of the fastest monetary tightening in decades, default rates have remained in check. As the Fed embarks on its cutting cycle, it appears as if a soft landing has been achieved. As noted, we believe that interest rates are likely to stay higher for longer, at least in the context of the near-zero interest rate policy that followed the GFC. These higher rates, coupled with slow but positive economic growth, will create challenges for struggling companies.

While the current economic environment has been more supportive than many expected, there is a risk that complacency has entered the market. Spreads for B and B- rated new issues have compressed to multi year lows, per Pitchbook (H1 2025 Global Private Debt Report).

Further, the looming debt maturity wall shown in Exhibit 17 could increase the pressure on struggling indebted companies. This will create the opportunity for experienced managers to provide liquidity, work with companies to recapitalize their balance sheets at attractive valuations and take advantage of temporary dislocations in the secondary market.

Commercial real estate debt

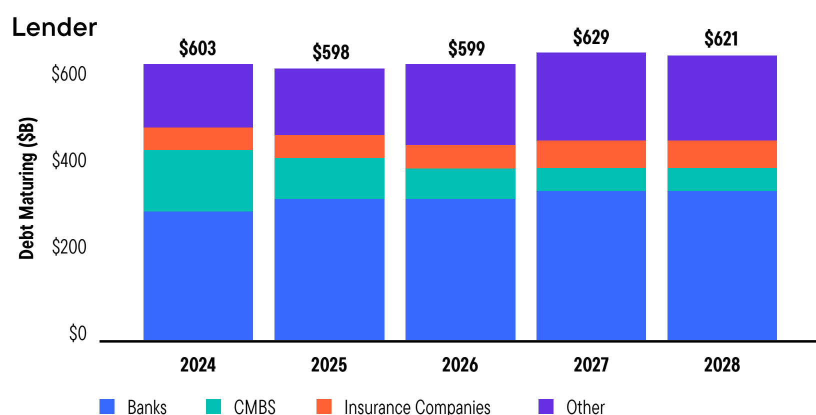
As we will discuss in the real estate section, the challenges facing the commercial real estate market are well publicized. Certain areas, most notably the office sector, have struggled post-COVID-19, with flexible work arrangements and higher interest rates. The capital markets have also retreated from the office space amid higher interest rates, wider cap-rate valuations, and the resulting pressure on property values. In our view, this disruption creates attractive prospects for seasoned managers who can implement more conservative lending standards at more realistic valuations.

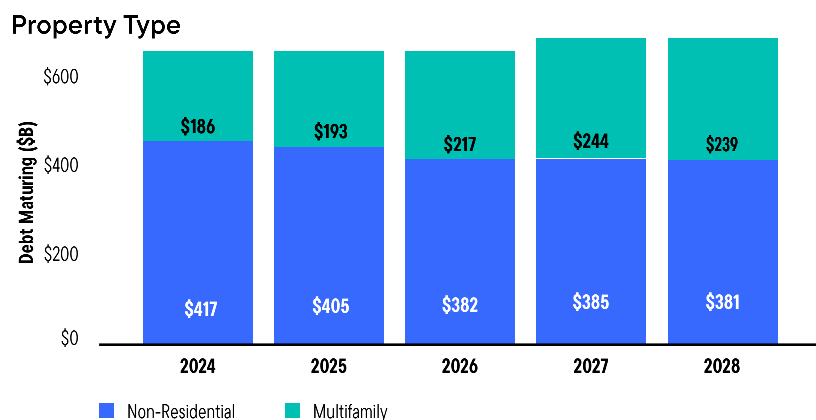
Despite this challenging environment, there is hope that things may be stabilizing in the real estate market. Valuations are starting to reset at more appropriate levels, and the Fed's easing cycle should help ease some of the pressure facing borrowers. At the same time, there is a wave of refinancing activity that will need to take place as private real estate debt faces its own maturity wall, as shown in Exhibit 18.

Exhibit 18: Wall of Debt Maturities for Commercial Real Estate Loans

Nearly US$2.5 Trillion in Real Estate Debt Needs to be Refinanced in the Next Four Years

As of Q1 2024





Source: Trepp.

Other category is primarily comprised of multifamily lending by Fannie Mae and Freddie Mac. This could also include finance companies (private debt funds, REITs, CLOs, etc.), pension funds, government or other sources.

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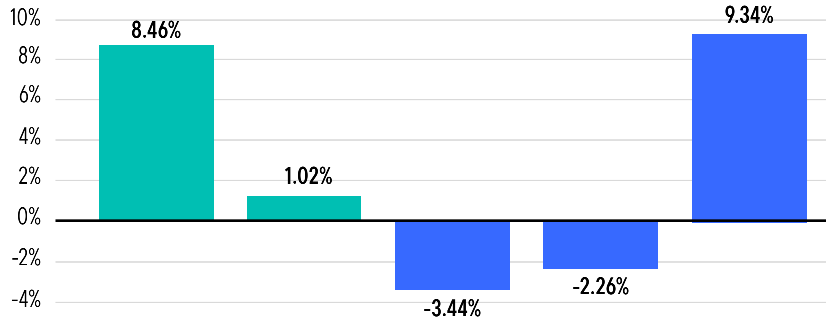
In this challenging environment, commercial real estate debt has produced strong absolute and relative returns over the trailing three- and 10-year periods, as shown in Exhibit 19.

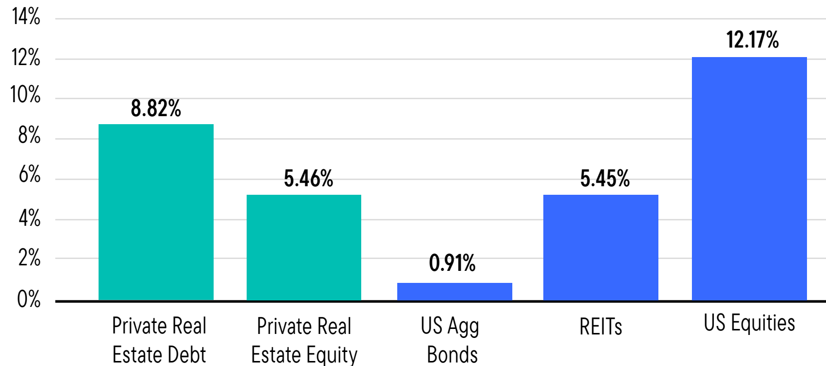
Exhibit 19: Annualized Returns

As of June 30, 2024

Three-Year Annualized Returns



Ten-Year Annualized Returns



Sources: PitchBook, NCREIF, Bloomberg, FTSE, SPDJI. Analysis by Franklin Templeton Institute. Location/Region: US The annualized returns are based on net of fees total returns. For US Aggregate Bonds, a fee of 0.43% p.a. is subtracted from the returns. For REITs and US Equities, a fee of 0.63% p.a. is subtracted from the returns. The Private Real Estate Debt and Private Real Estate Equity returns are net of fees. Indexes used: Private Real Estate Debt: PitchBook fund search results for US Real Estate Debt funds; Private Real Estate Equity: NCREIF Fund Index Open End Diversified Core Equity (ODCE) Index; US Aggregate Bonds: Bloomberg US Aggregate Index; REITs: FTSE NAREIT All Equity REITs Index, Gross Total Return; US Equities: S&P 500 Total Return Index. Indexes are unmanaged and one cannot directly invest in them. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Given the concerns of the real estate market, and the need for refinancing in the next several years, we believe that experienced managers should be able to negotiate favorable terms and covenants. Commercial real estate debt has historically exhibited low-to-negative correlations to traditional asset classes and other real estate options.[11]

We believe that commercial real estate debt can be a valuable addition to a diversified portfolio and can serve as a complement to existing real estate portfolios.

Asset-based lending

In recent years, there has been growing interest in asset-based lending (ABL) as private credit managers step in to fill the void banks have left. ABL are loans that are secured by collateral. They are also referred to as asset-based finance, or ABF.

According to Pitchbook,[12] with leveraged buyout and M&A activity down, private credit managers are expanding their footprint beyond direct lending and distressed. “We expect alternative asset managers’ share of this market will continue to increase as they build out their own origination capabilities, while banks remain capital constrained. But these instruments—with a focus squarely on maximizing yield—will also push leverage levels in financial markets higher.”

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Summary

Private credit has filled the void left by banks who have been reticent to lend to small and middle-market companies. After the GFC, there has been increased demand for alternative sources of income, and private credit has grown substantially.

Private credit represents a diverse set of opportunities, from direct lending to distressed and commercial real estate debt. Private credit has historically delivered an illiquidity premium and higher income than traditional fixed income.

We believe the looming "wall of debt" that will be maturing in the next couple of years creates an attractive opportunity to negotiate favorable terms. As noted in the executive summary, we believe that there will be a larger dispersion of returns between the seasoned, experienced managers and those who lack the resources and skill.

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Private real estate: Follow the macro themes

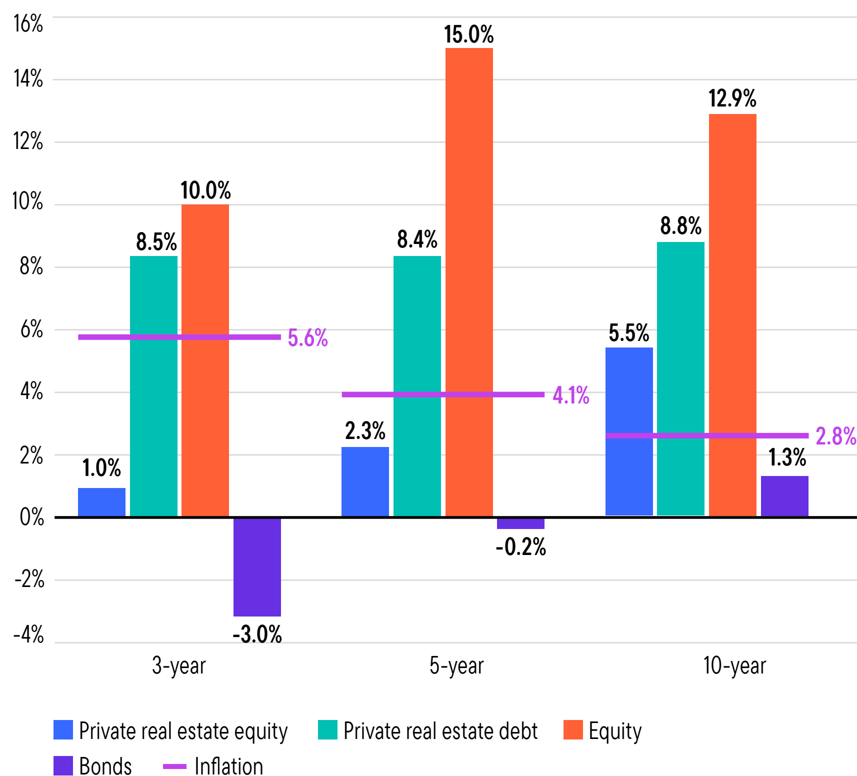
The real estate market has faced plenty of headwinds over the past few years, but we believe the market is stabilizing. The COVID-19 pandemic, and ensuing lockdowns, significantly affected the real estate market. The office sector has been in the spotlight, due in part to changing office work arrangements that many employers have instituted post-pandemic.

The Fed's move to increase interest rates in 2022 was a headwind as higher interest rates impact capitalization rates, and thus property values, and tighter lending conditions constrain deals and investment. Conversely, the Fed's change in policy to easing should be a tailwind.

As Exhibit 20 shows, private real estate equity results have struggled in recent years. However, we believe that valuations have come down to more realistic levels, the macro environment looks more constructive, and there are opportunities across select sectors.

Exhibit 20: Annualized Returns vs. Inflation

As of June 30, 2024



Sources: NCREIF, PitchBook, SPDJI, Bloomberg, US Bureau of Labor Statistics, Macrobond. Analysis by Franklin Templeton Institute.

The inflation data shows the average US Consumer Price Inflation for urban consumers across all items during the respective periods.

Private Real Estate Equity and Private Real Estate Debt are net of fee returns. Indexes used: Private Real Estate Equity: NCREIF Fund Index Open End Diversified Core (ODCE) Total Index; Private real Estate Debt: PitchBook search results for US Real Estate Debt funds; Equity: S&P 500 Total return Index; Bonds: Bloomberg US Aggregate Total Return Value Unhedged USD Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

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As much of the noise has focused on the office sector, we believe that there are opportunities in industrials, multi-family housing and life sciences. As noted in the executive summary, the office sector has been shrinking, and industrials have been growing due to long-term secular trends. As illustrated in Exhibit 21, not all sectors are created equally, and there has been a big shift in the underlying opportunity set.

Exhibit 21: Real Estate Sector Performance

As of September 30, 2024

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Retail 12.89%	Industrial 13.42%	Retail 15.27%	Industrial 9.22%	Industrial 12.77%	Industrial 14.30%	Industrial 13.37%	Industrial 11.77%	Industrial 43.34%	Industrial 14.54%	Hotels 10.32%	Hotels 5.62%
Industrial 12.32%	Retail 13.12%	Industrial 14.39%	Retail 9.04%	All Property 7.06%	Hotels 7.57%	Offices 6.60%	Apartments 1.82%	Apartments 19.91%	Hotels 9.96%	Retail -0.90%	Retail 3.41%
All Property 11.01%	All Property 11.97%	All Property 13.50%	All Property 8.00%	Offices 6.25%	Offices 6.85%	All Property 6.42%	All Property 1.61%	All Property 17.70%	Apartments 7.07%	Industrial -4.07%	Industrial 1.46%
Apartments 10.42%	Offices 11.91%	Hotels 13.22%	Apartments 7.32%	Apartments 6.17%	All Property 6.71%	Apartments 5.52%	Offices 1.57%	Offices 6.11%	All Property 5.52%	Apartments -7.33%	Apartments 0.30%
Offices 9.92%	Hotels 11.06%	Offices 12.92%	Offices 6.27%	Retail 5.67%	Apartments 6.07%	Hotels 3.51%	Retail -7.48%	Hotels 5.48%	Retail 2.70%	All Property -7.94%	All Property -0.47%
Hotels 7.69%	Apartments 10.36%	Apartments 11.98%	Hotels 4.72%	Hotels 4.93%	Retail 2.18%	Retail 1.90%	Hotels -25.57%	Retail 4.23%	Offices -3.36%	Offices -17.63%	Offices -7.08%

Sources: NCREIF, Macrobond. Analysis by Franklin Templeton Institute.

Indexes used: NCREIF National Property Index, NCREIF Office Property Index, NCREIF Apartment Property Index, NCREIF Industrial Property Index, NCREIF Retail Property Index, and NCREIF Hotel Property Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

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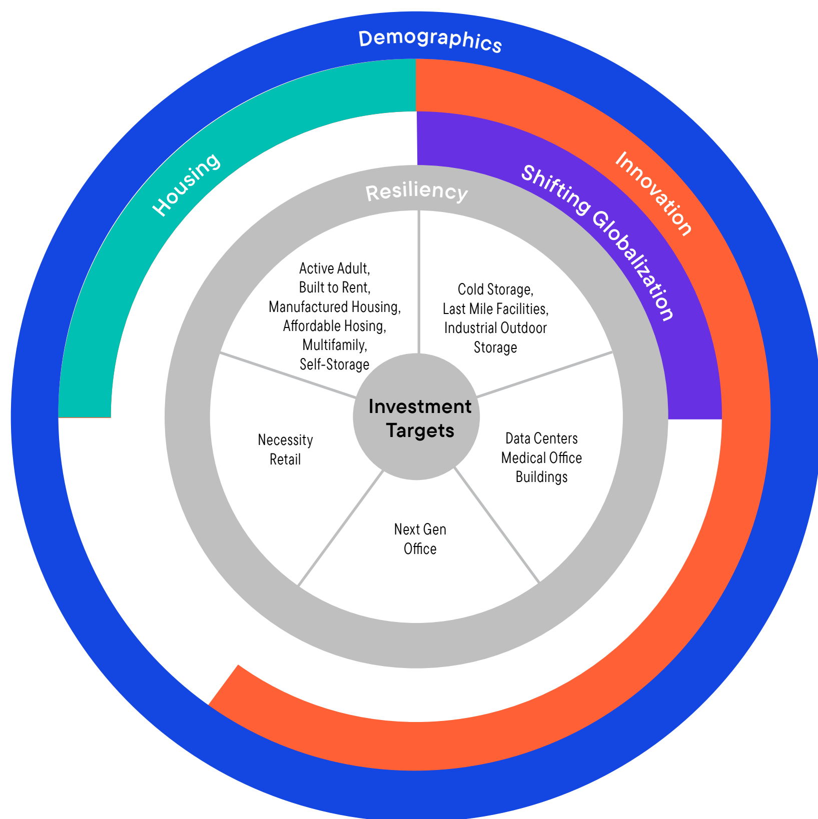
As noted in our 2024 Outlook, there are a number of macro themes that will drive performance across the sectors that we believe will persist for the foreseeable future: demographics, innovation, globalization, housing and resiliency.

Exhibit 22: Macro Themes Offer a Large and Diverse Investment Opportunity Set



Source: Clarion Partners Investment Research.

Macro themes

Demographics—Demographic cohorts will have significant impacts on property demand. Millennials are reaching their peak earning and spending years while Gen-Z has entered the workforce. Strong consumption benefits both the industrial and necessity retail sectors, while housing demand benefits rental apartments. US baby boomers will likely continue strong migration patterns to southern, tax-friendly states like Florida, Texas, Arizona, Tennessee and the Carolinas, as well as drive the need for life science and medical offices, and senior housing.

Technology and innovation—The surge in interest and spending around artificial intelligence serves as a reminder of the technological innovation happening in the United States. While the technology itself will drive spending in data centers, chip facilities and energy, it will also likely drive demand toward the “innovation” clusters that create, invest in and build innovative technology. E-commerce will continue to drive the growth of fulfillment centers and industrial parks. The ongoing boom in artificial intelligence, technology broadly, and innovation in health care will continue to benefit life sciences, health care, and supply-chain facilities.

Shifting globalization—Supply-chain failures during the pandemic, alongside growing geopolitical tensions, have increased focus and action on diversifying and bringing supply chains closer to home. This will impact distribution networks and lead to more robust and localized supply chains, creating new potential investment opportunities such as mission-critical manufacturing and research and development facilities. While increased export and manufacturing growth will drive the need for new industrial real estate space, properties serving last-mile delivery and e-fulfillment will continue to be in high demand.

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Housing—Housing affordability and inventory levels are near all-time lows, driven by underbuilding, strong demand, and high mortgage rates. Strong demographic tailwinds from Millennials and Gen-Z household formation are leading to fundamental strength in housing demand, while affordability challenges in the housing market are leading to a strong push into rental housing. These dynamic offers investors multiple opportunities to address the sector's challenges, including opportunities in traditional multifamily, single-family rentals (SFR) and affordable housing.

Resiliency—Severe weather events in the past several years in the United States has helped sharpen focus on the resilience of properties. Sustainable building processes are critical to providing repeatable cash flows through economic cycles and can lead to significant financial benefits. Sustainable buildings thus often command valuation and rent premiums, while updating obsolete buildings represents a large opportunity.

How does this translate into opportunities?

The current investment landscape and the above macro themes leads us to a few areas of opportunity: multi-family housing, industrial warehouse, life sciences, medical offices and neighborhood retail.

Multi-family housing—This sector sits at the center of the demographic change and need for housing. Millennials and Gen-Z have unique needs and tastes for housing. As baby boomers retire and downsize, this is driving demand for age-targeted housing. Historically low housing affordability, driven in part by high mortgage rates but structurally by low supply, is increasing demand for the rental market.

Industrial warehouse—The strong demand and performance of this sector is likely to continue, in our view. Steady consumption growth, buoyed by the higher earnings of the digitally native Millennial and Gen-Z cohorts, will drive e-commerce and thus warehouse demand. This sector will also benefit from the shifting trade patterns that have led to reshoring and onshoring of manufacturing.

Life science and medical office—Aging demographics and the resultant need for specialized care will drive growth and demand in medical office buildings and specialty outpatient health care facilities. The same trend, coupled with technological innovation, will drive the life sciences sector, which includes biotechnology, pharmaceuticals, medical devices and genome research, among other areas.

Neighborhood retail—As Millennials and Gen-Z enter their prime earning and spending years, neighborhood retail properties will likely benefit, alongside e-commerce. This will be a benefit to grocery and necessity formats. Technological advancements in omnichannel retail are driving demand near consumers, and we expect this trend to continue.

The appeal of private real estate

In addition to the macro themes above, private real estate has historically provided attractive growth and income, diversification, and inflation hedging.[13] Both private real estate equity and debt have historically exhibited low-to-negative correlation to traditional investments. Thus, they can provide potential diversification benefits when combined with traditional investments.

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Exhibit 23: Correlation, Based on One-Year Rolling Annual Returns Net of Fees

As of June 30, 2024

	Private real estate debt	Private real estate equity	US aggregate bonds	REITs	US equities
Private real estate debt	1.00				
Private real estate equity	0.34	1.00			
US aggregate bonds	-0.29	-0.32	1.00		
REITs	-0.38	0.23	0.21	1.00	
US equities	-0.15	0.11	0.07	0.76	1.00

Sources: PitchBook, NCREIF, Bloomberg, FTSE, SPDJI. Analysis by Franklin Templeton Institute.

Location/Region: US

Correlation is calculated over the period of March 2008 to June 2024 based on one-year rolling returns as of every quarter-end. The correlations are based on net of fees total returns. For US Aggregate Bonds, a fee of 0.43% p.a. is subtracted from the returns. For REITs and US Equities, a fee of 0.63% p.a. is subtracted from the returns. The Private Real Estate Debt and Private Real Estate Equity returns are net of fees. Indexes used: Private Real Estate Debt: PitchBook fund search results for US Real Estate Debt funds; Private Real Estate Equity: NCREIF Fund Index Open End Diversified Core Equity (ODCE) Index; US Aggregate Bonds: Bloomberg US Aggregate Index; REITs: FTSE NAREIT All Equity REITs Index, Gross Total Return; US Equities: S&P 500 Total Return Index. Indexes are unmanaged and one cannot directly invest in them. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Summary

Private real estate has faced headwinds since 2022, including rising interest rates and concerns about the office sector. This stress has brought down valuations from their lofty 2021 levels. There are several secular trends underway that have shaped the overall market.

We believe that there are macro themes that are likely to drive future returns across private real estate. These macro themes will provide opportunities in certain key areas: multi-family housing, industrial warehouse, life science and medical office, and neighborhood retail.

As noted in our executive summary, we believe that there is a big difference in putting capital to work today versus 2021. For private real estate managers with dry powder, they can selectively deploy capital to the attractive sectors at reasonable valuations and avoid those sectors that face headwinds. This should lead to a larger dispersion of return between the top and bottom quartile managers.

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We have shared the short and long-term results, macro trends, and where we see the best opportunities to allocate capital today. We want to thank **Lexington Partners, Clarion Partners, Benefit Street Partners,** and **FT Ventures** for sharing their insights in developing this outlook.

As always, to learn more please visit Knowledge Hub | Alternatives by FT. And if you haven't already done so, please subscribe to the ***Alternative Allocations*** podcast series to hear from industry experts about allocating capital.

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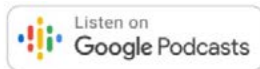

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Appendix 1: Methodology for Exhibit 1

Asset Class	Index	Methodology for Net Returns
Equity	MSCI ACWI Total Return Index	A fee of 1.46% p.a. is subtracted from the quarterly returns.
Fixed income	Bloomberg Global Aggregate Total Return Index Value Unhedged USD	A fee of 0.43% p.a. is subtracted from the quarterly returns.
Alternative investments		
Private equity*	MSCI Private Capital Solutions - US Private Equity (all categories)	The returns are based on private equity fund returns that are net of fees.
Private credit	Cliffwater Direct Lending Index	A fee of 1.342% p.a. is subtracted from the quarterly returns. Additionally, a carried interest percentage of 16.844% is charged on positive returns. This fee and carried interest is average for private credit funds during 2014 to 2022 (data from PitchBook). In case of a negative quarterly return, carried interest is not charged until losses are reversed. The hurdle rate to charge the carried interest is 6% p.a., based on data provided in iCapital's article titled "Understanding Private Market Fund Distribution Waterfalls," dated January 20, 2023.
Real estate equity	NCREIF Fund Index Open End Diversified Core (ODCE) Total Index	Net returns as reported by the index provider.
Real estate debt	PitchBook search results for US Real Estate Debt funds	Returns are net of fees.
Secondaries	MSCI Private Capital Solutions search results for global secondaries across all the strategies within the secondary market.	Based on fund returns, which are net of fees.

*Generic US PE return series for all equity categories (buyout/growth/VC etc.)

Sources: MSCI Indexes, MSCI Private Capital Solutions, Cliffwater, NCREIF, Bloomberg, Macrobond, PitchBook. Analysis by Franklin Templeton Institute. The indexes are total returns in US dollar terms. Indexes are unmanaged and one cannot directly invest in them. **Past performance is not an indicator or a guarantee of future results**. Important data provider notices and terms available at www.franklintempletondatasources.com.

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WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

To the extent the fund invests in alternative strategies, it may be exposed to potentially significant fluctuations in value.

Investments in many alternative investment strategies are complex and speculative, entail significant risk and should not be considered a complete investment program. Depending on the product invested in, an investment in alternative strategies may provide for only **limited liquidity** and is suitable only for persons who can afford to lose the entire amount of their investment. An investment strategy focused primarily on privately held companies presents certain challenges and involves incremental risks as opposed to investments in public companies, such as dealing with the lack of available information about these companies as well as their general lack of liquidity. Diversification does not guarantee a profit or protect against a loss.

Risks of investing in **real estate investments** include but are not limited to fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by local, state, national or international economic conditions. Such conditions may be impacted by the supply and demand for real estate properties, zoning laws, rent control laws, real property taxes, the availability and costs of financing, and environmental laws. Furthermore, investments in real estate are also impacted by market disruptions caused by regional concerns, political upheaval, sovereign debt crises, and uninsured losses (generally from catastrophic events such as earthquakes, floods and wars). Investments in real estate related securities, such as asset-backed or mortgage-backed securities are subject to prepayment and extension risks.

An investment in **private securities** (such as private equity or private credit) or vehicles which invest in them, should be viewed as illiquid and may require a long-term commitment with no certainty of return. The value of and return on such investments will vary due to, among other things, changes in market rates of interest, general economic conditions, economic conditions in particular industries, the condition of financial markets and the financial condition of the issuers of the investments. There also can be no assurance that companies will list their securities on a securities exchange, as such, the lack of an established, liquid secondary market for some investments may have an adverse effect on the market value of those investments and on an investor’s ability to dispose of them at a favorable time or price.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Changes in the credit rating of a bond, or in the **credit rating** or financial strength of a bond’s issuer, insurer or guarantor, may affect the bond’s value. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default.

Equity securities are subject to price fluctuation and possible loss of principal. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks.

Any companies and/or case studies referenced herein are used solely for illustrative purposes; any investment may or may not be currently held by any portfolio advised by Franklin Templeton. The information provided is not a recommendation or individual investment advice for any particular security, strategy, or investment product and is not an indication of the trading intent of any Franklin Templeton managed portfolio.

Endnotes

1. As of October 31, 2024. Sources: SPDJI, Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**
2. As of October 31, 2024. Sources: SPDJI, CBOE, Bloomberg. There is no assurance that any estimate, forecast or projection will be realized.
3. Source: "Private Market Investing: Staying Private Longer Leads to Opportunity." Hamilton Lane. April 14, 2022. 4.
4. The "J-curve" is the term commonly used to describe the trajectory of a private equity fund's cashflows and returns. An important liquidity implication of the J-curve is the need for investors to manage their own liquidity to ensure they can meet capital calls on the front-end of the J-curve..
5. Source: "A $1.5 Trillion Wall of Debt is Looming for US Commercial Properties." Bloomberg. September 1, 2024.
6. Source: Davidow, Tony, "Exploring the Merits of Private Equity. 2024.
7. Source: "Q3 2024 US Private Equity Breakdown Report." Pitchbook.
8. Source: Q3 2024 US Private Equity Breakdown. Pitchbook.
9. As of June 30, 2024. Source: Greenhill Global Secondary Market Review Data.
10. Source: "Private Credit Defaults Rise to 2.71% According to Latest Proskauer Index – Insights." Proskauer Rose LLP. July 22, 2024.
11. Source: Davidow, Tony. "Commercial Real Estate Debt: Another Way to Access Real Estate." 2024. Based on data from PitchBook, NCREIF, Bloomberg, FTSE, SPDJI, Analysis by Franklin Templeton Institute.
12. Source: "Asset-based finance cast as next act for evolving private credit market." Pitchbook. March 8, 2024.
13. Source: Davidow, Tony. "Private Real Estate: Unlocking Values Beyond Stocks and Bonds." 2024.

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