Market commentary

Investment outlook

Partners Group's mid-term outlook and investment preferences for all private markets asset classes.

Private markets outlook

While maintaining its rather modest pace in historic terms, the global economy picked up some speed in H2 2017, partially supported by improving fundamentals and partially due to cyclical factors. Inflation and wage pressures remain benign across developed markets and have allowed central banks to maintain or just gradually reverse unprecedented loose monetary policies. This smooth sailing has manifested itself in improving earnings growth, which in turn has supported strong equity returns in 2017 (rather than these being supported simply by multiple expansion as in most previous years). Whether this strong earnings growth is sustainable remains to be seen: following flattish developments over the past three years, earnings are growing from a relatively low base and much of the improving top-line growth and the support from the US tax reform are embedded in expectations.

According to our base case macroeconomic projection, continued low but steady growth – most likely at a slightly slower pace going forward – and gently rising inflation set the conditions for further tightening in certain regions (US), although policy is likely to remain accommodative in others (Eurozone, Japan). We continue to believe that markets are lenient about the pace of Fed rate hikes and while we do not project a more material correction of capital markets in the near future, higher rates are likely to temper rich equity valuations.

As the cycle is entering its ninth year, however, the chances of a deviation from our base case are rising. In particular, the combination of Fed balance sheet reduction and the rising US budget deficit in light of tax cuts raise uncertainty about the future path of longer-dated US rates. The following table lays out our base case and three potential test scenarios, showing how these could impact capital markets and valuations. The test scenarios are used to assess the robustness of an asset, sector or portfolio of assets to different economic and market outcomes.

Economic and market scenarios: main parameters

	Base case	Test scenarios		
	Low but steady growth	**Stock market rally**	**Faster rate hike cycle**	**Mild recession**
GDP growth* (5-year average)	2-3%	2-3%	3-4%	1-2%
Inflation* (5-year average)	~2%	~1%	2-3%	~1%
Change in Fed funds rate (in 5 years' time)	+200-250bps	+50-100bps	+300-500bps	unchanged
Market valuations (in 5 years' time)	10% lower	20% higher	20% lower	10-15% lower

*Capital (NAV)-weighted as per the Partners Group asset split across US, Europe, other advanced and emerging markets.
Note: market valuations refer to price-to-earnings ratio for public equities, enterprise value to earnings before interest, tax, depreciation and amortization for private equity, capitalization rates for private real estate and underwriting internal rate of return for private infrastructure.
Source: Partners Group, H1 2018. For illustrative purposes only.

Given the more uncertain outlook, we screen the market for assets that are or can become leaders in their field and operate in more defensive sub-segments of the market, yet experience better growth on the back of both traditional structural change as well as transformative trends. In particular, we focus on sectors benefiting from the global megatrends that we believe will continue to generate attractive investment opportunities in the long term. These include digital transformation, new generation living and consumption, and the energy revolution.

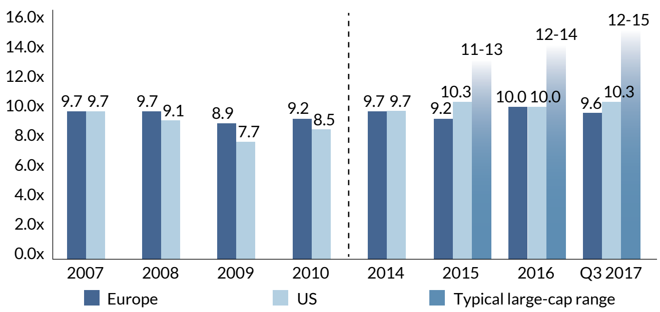
Finally, implementing value-accretive strategies, like enhancing tenant experience in real estate or building scale and promoting organic and inorganic growth in the corporate and infrastructure space, makes these assets more robust and strengthens valuations, even against challenging macroeconomic backdrops.

Market commentary

Private equity

In H2 2017, we continued to see quality assets trade for near-record multiples. We have heard the refrain in the market that '15 is the new 12,' referencing that the hallmark EV/EBITDA exit multiple has moved from 12x to 15x. One factor that has precipitated this pricing shift is the entrance of new participants into the direct private equity investment market. Sovereign wealth funds, GP-like LPs (e.g. institutional LPs with an in-house direct investment practice) and long-dated core private equity funds have all recently emerged in the direct private equity market. The mandate of these new market participants is to identify and buy long-term category winners, for which they are often willing to accept lower expected returns compared to traditional private equity managers.

Average purchase price multiple of pro forma trailing EBITDA for LBOs



Source: Partners Group and S&P Global Leveraged Lending Review, Q3 2017.

In spite of the near-record pricing, we have found a number of instances of compelling value creation potential in the market. We continue to favor specialist category leaders in sectors with strong transformative growth trends and/or proven platforms in actively consolidating sectors. In addition, our approach is informed by our conviction that outperformance can only be achieved by having a value creation-focused investment process (i.e. focused on unlocking unrealized value), from sourcing through due diligence to ownership.

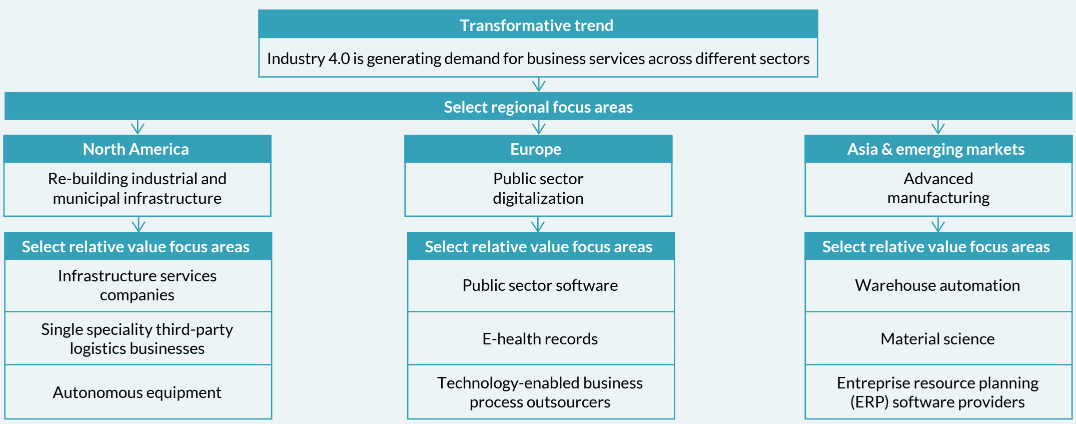
An overview of the transformative growth trends currently generating investment opportunities in each region is presented below.

In North America, we see a transformative trend towards the specialization and digitalization of services offered by companies in the business services, technology, media and telecommunications (TMT), and consumer segments of the market. This movement is happening in parallel to the Industry 4.0 trend we are witnessing in the industrial sector. Companies offering digitally-enabled manufacturing solutions are capturing specialized categories as they supplant companies that relied on labor-intensive manufacturing processes. Similarly, in the business services, TMT, and consumer sectors, we are seeing companies develop into category leaders by pairing their specialized expertise in a process or product with the development of digital solutions to address this process.

In Europe, one transformative trend we have seen is an increased focus on cost optimization. We have witnessed this in both the public and private sector. We believe the catalyst for this enhanced focus on cost optimization has been slow growth in the continent over the past five years paired with muted forward-growth projections. This has created a number of relative value opportunities in segments that target the delivery of cost optimization solutions, in particular companies in the business services outsourcing and software segments.

In emerging markets, we continue to see a compelling transformative trend in the emergence of a large middle class.

Spotlight on a transformative trend: Industry 4.0



Source: Partners Group.

Market commentary

Between 2010 and 2020, more than 1 billion individuals will acquire middle class status, with the vast majority of this growth expected to take place in emerging markets. We anticipate that this new middle class will initially direct its discretionary income towards personal health, education, and select consumer goods, largely mirroring the consumer spending patterns witnessed across developed markets.[3] As many emerging markets are still maturing, it is often challenging to find specialized market leaders in these segments. However, those select institutionalized companies that have been able to capture market leadership present compelling investment opportunities.

3 PwC, 2014.

Our key investment strategies

Build out platform companies

We acquire platform companies with a strong management team and infrastructure, and then purchase add-on companies to further grow the platform. This allows us to bring small or lower mid-market businesses into the platform and benefit from the lower acquisition multiples of these segments compared with upper mid-market and large-cap companies.

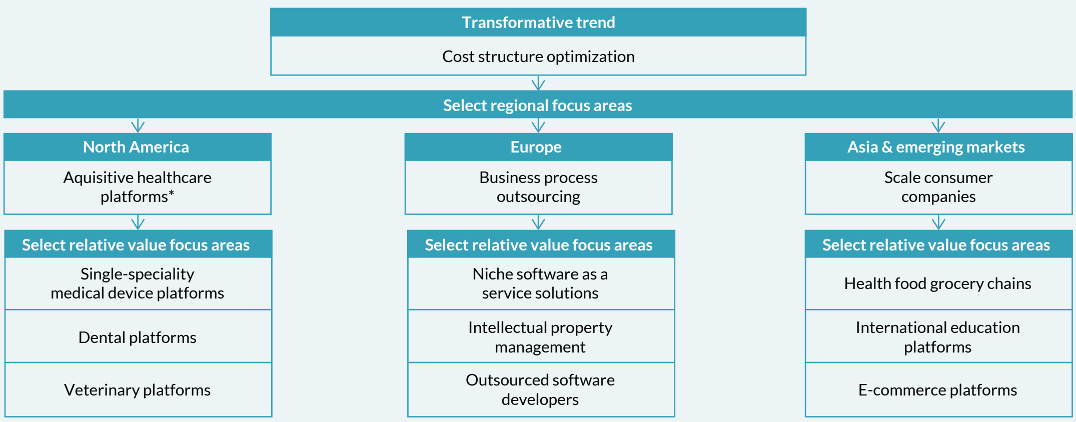
Capture category winners

We actively screen sub-segments of specific industries benefiting from trend-based tailwinds and focus on finding 'category winners' that are leaders in the sub-segment in terms of market share or growth potential. Our Industry Value Creation team then works with the companies' management teams to further develop growth and increase profitability via effective value chain improvements.

Seek out defensive leaders

We search for 'niche leaders', not only with value creation potential, but also with strong defensive capabilities, high cash flow generation and the ability to quickly de-leverage in an uncertain economic context.

Spotlight on a transformative trend: cost structure optimization



Source: Partners Group.
* Platforms are able to spread selling, general and administrative expenses over a larger base via M&A.

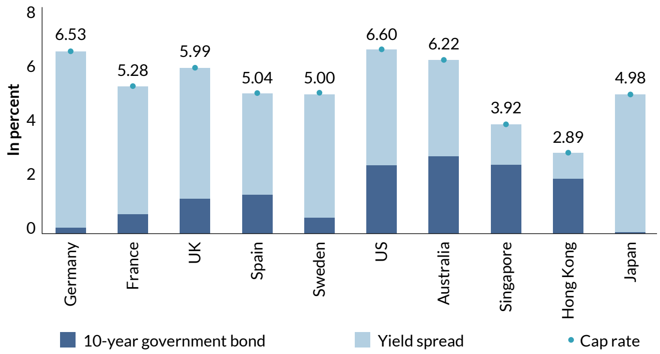
Market commentary

Private real estate

The real estate market continues to exhibit high levels of liquidity. Global real estate transaction volumes have maintained their positive momentum and further increased in H2 2017, mainly driven by activity in Europe and the Asia-Pacific region.

Generally, both the occupier and capital market seem stable, with institutional investors incrementally raising their target allocations to real estate, supported by the spreads between long-term government bond yields and cap rates. This leads us to conclude that the real estate market is currently fully priced but not consistently overpriced.

Office, industrial and retail cap rate spread over risk free rate



Source: Costar; Real Capital Analytics; Bloomberg, October 2017.

In terms of property types, retail cap rates continue to be under pressure due to the growth of e-commerce. We see cap rate expansion for fashion-anchored shopping centers, particularly in the US and UK, for instance. In contrast, we still maintain that the current environment offers a reasonable variety of investment opportunities in the office and residential segments. New office supply is generally under control, with many office market vacancy rates still trending down. Similarly, we see a supply and demand imbalance across many European cities where new housing demand exceeds supply.

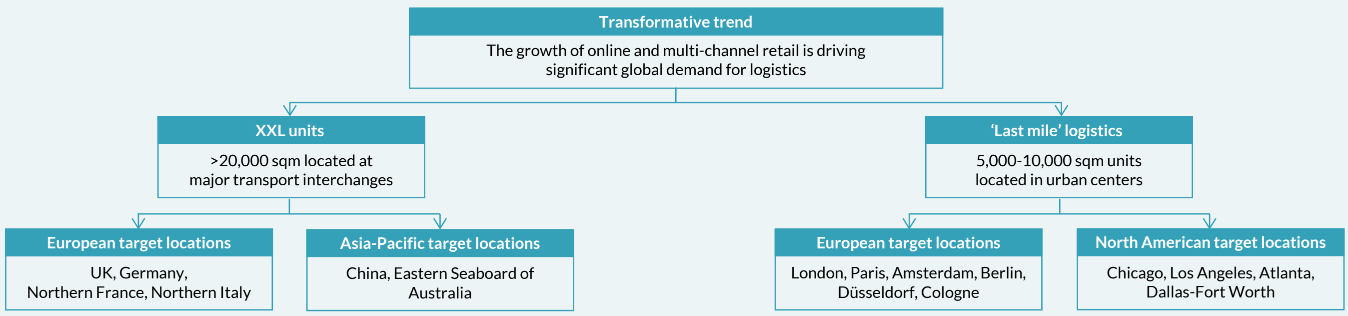
As markets are flush with capital, we feel that competitive processes should be avoided as a means of sourcing opportunities. Instead, we are further emphasizing our focus on special situations, which we define as situations that require bespoke solutions and that offer the potential to unlock hidden value. For these off-market situations, we typically seek the following characteristics:

- a bespoke structure, i.e. opportunities that others are dissuaded from pursuing given their global and complex nature;
- a trigger event, i.e. opportunities that are unlocked by a trigger event such as investor fatigue and/or discord;
- a unique angle, i.e. opportunities that are sourced off-market in an exclusive manner; and
- uplift potential, i.e. opportunities with clear value-added potential to generate outperformance.

In terms of specific investment themes, we focus on assets benefiting from the two main trends that are shaping the real estate market: technological improvements generating demand for logistics space and new urbanization generating demand for modern offices and apartments.

Global demand for **logistics facilities** is being driven by the growth of online and multi-channel retail. Companies around the globe are placing increased emphasis on their supply chain, as well-located and well-specified fulfillment centers and distribution facilities are key to efficient operations. In the US, logistics fundamentals continue to improve, with attractive vacancy rates in the main logistics hubs such as Inland Empire, Chicago, Atlanta and Dallas-Fort Worth – all target locations for our private real estate investment team. Chicago, for instance, has clearly benefited from the growth of e-commerce, especially

Spotlight on a transformative trend: e-commerce



Source: Partners Group.

Market commentary

from the resulting demand for 'last mile' distribution centers close to urban centers. The city's industrial market consists of around 110 million square meters, making it the second largest in the US behind Los Angeles/Inland Empire in California.[4]

In the office space, we are targeting pockets of growth globally. Major cities in Europe, Asia-Pacific and the US are exhibiting economic and population growth, often aligned with growth in the technology industry. The top global cities for venture capital investments include San Francisco and New York in the US, with a global share of around 20%, London and Berlin in Europe, with a global share of around 3%, and Beijing and Shanghai in Asia-Pacific, with a global share of around 3% as well.[5] These cities are among the most appealing for millennials, as they have adapted to combine life, work and play. Berlin, for instance, has embraced this combination and has, in our opinion, become an attractive market from both a short- and long-term perspective. In the short term, its real estate fundamentals are currently among the most attractive of any European capital city. Vacancy rates are below 2.5%, its development pipeline seems limited and despite strong historic growth, rents are still low for Europe and are forecast to continue to grow at 4% per annum[6] for the next few years on the back of strong tenant demand.[7] In the long term, Berlin's population is expected to continue to grow at around 0.5% per annum until 2030.[8]

In the US, we like cities experiencing population and technology growth such as San Diego and Austin. Our focus here lies in acquiring and generating income growth from substantially leased assets. In many markets we see good potential to improve the value of office properties by marking to market existing lease contracts to capture growth that has occurred since leases were signed earlier in the cycle, as well as by applying a lease-up strategy to improve net operating income via occupancy increases.

In the residential segment, our main focus is on developing affordable housing, especially in Europe. In 2016, an estimated 55% of the world's population lived in urban areas. By 2030, this is expected to rise to 60%.[9] While urbanization is nothing new for major cities across Asia, more and more young people are flocking to growing cities across Europe as well. Major cities like Berlin, Copenhagen and Stockholm are experiencing high regional migration, consisting mainly of millennials in search of affordable and convenient living in 'desirable' cities with high employment growth. This trend offers a number of attractive opportunities to develop new affordable residential units for rent or sale.

4 REIS, August 2017.

5 Martin Prosperity Institute, January 2016; Partners Group estimates, October 2017.

6 Knight Frank and Investment Property Forum, October 2017.

7 Angermann, November 2017.

8 Schroders and CBRE, October 2017.

9 United Nations, 2016.

Instead, our focus in Asia-Pacific and the US is on the active management of existing properties where capex investment can drive rental growth. For the US in particular, we overweight multifamily properties in defensive urban markets with solid demand drivers and focus on upgrading Class B houses in markets such as Atlanta, Denver, Nashville and Austin. In these markets, net absorption levels over the past 12 months have increased between 160-380%.[10] Similarly, rental growth rates for apartments in these markets are above the rate of GDP growth.

10 Costar, October 2017.

Our key investment strategies

We focus on providing solutions to operating or general partners that do not have the appetite, tenure or means to support asset-level business plans for their existing assets or portfolios. We continue to prefer asset strategies that fall into one or more of the following sub-strategies:

Buy below replacement cost

We target assets with low valuations located in rebounding markets that can be repositioned and then leased-up by under-cutting market rents.

Buy, fix, and sell

We seek older buildings in great locations that are in need of owner-oriented asset management initiatives.

Develop core

We target markets with strong long-term fundamentals and trends that support additional absorption to selectively develop properties through ground-up construction.

Market commentary

Private debt

Partners Group views the private debt market in three distinct categories:

- **Liquid loans:** senior loans broadly syndicated by banks, which typically offer relatively low returns but can be used as a cash management tool by fixed income investors because of their high liquidity. As part of our CLO and liquid loans business, we target smaller investments in large liquid loans, where tranches can be in excess of USD 1 billion and issued by stable companies.
- **Direct loans:** loans which are senior in the capital structure but privately originated by a single lender or small group of institutions and are thus generally illiquid. Direct loans remain our primary driver of outperformance. In this segment, we target companies with EBITDAs in excess of USD 20 million.
- **Subordinated loans:** debt tranches which are subordinated in the capital structure, including second lien, mezzanine, and holdco tranches. These investments tend to have very limited liquidity, but offer the highest return potential. In subordinated transactions, where tickets can be in excess of USD 100 million, we leverage our platform and scale to provide subordinated solutions to sponsors.

Private debt markets remain robust, both in terms of investment activity and fundraising levels. Demand for private debt financing remains strong on the back of significant amounts invested by private equity funds and a growing number of private equity transactions that require refinancing. On the supply side, fundraising continues at a strong pace, particularly for senior debt, with a large CLO volume differential in the US and Europe, as well as potentially diverging regulatory trends in the US vis-à-vis the rest of the world.

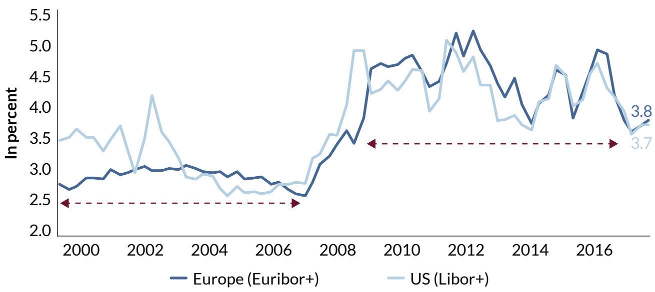
In the US, 2017 was a record year for senior leveraged loan volumes, with issuance surpassing USD 645 billion for the first time.[11] A large proportion of newly issued loans has been absorbed by a growing CLO market, which had already exceeded 2016 full-year new issue CLO volumes by the third quarter of 2017.[12]

11 S&P LCD Global Interactive Loan Volume Report, December 2017.

12 S&P LCD, Q3 2017.

In this record-setting environment, the risk-return profiles of liquid loans have developed sideways. While spreads remain at the lower end of the historic range dating back to 2008, they continue to be comfortably above the lower levels witnessed in pre-crisis years. Furthermore, the increasing base rate has had a positive effect on expected returns for private debt investments.

Weighted average new issue spreads for senior loans



Source: S&P LCD Leveraged Lending Report, Q3 2017.

The risk-return profiles of direct loans have largely followed these developments. Overall, however, given their bespoke nature, private direct loans continue to offer an additional premium over liquid loans and generally better downside protection through tighter documentation, including maintenance covenants that protect buy-and-hold credit investors until repayment.

Bespoke subordinated debt financing solutions continue to be employed in the market, with second lien remaining a prevalent component. Second lien volumes in the first three quarters of 2017 alone reached a level of more than twice full-year 2016 volumes. Return potential remains attractive in the second lien space, where spreads offer more than a 400bps return difference compared to new issue first lien liquid loan spreads.[13]

In Europe, liquid loans have seen a strong new issuance volume. While margins and leverage levels are similar to those witnessed in the US, differences remain in base rates and equity cushions: Euribor rates are still in negative territory and the European market standard 0%-floor continues to be valuable for private debt investors. Equity cushions remained more significant and roughly four percentage points higher than in the US on average (44.4% in Europe versus 40.5% in the US through Q3 2017). Liquidity has also been supported by an increase in new issue CLO volumes; although, unlike the US, third quarter year-to-date volumes remain below 2016 full-year volumes. Furthermore, overall CLO issuance in Europe represents approximately 20% of total CLO issuance in the US.[14]

13 S&P LCD, Q3 2017.

14 S&P LCD, Q3 2017.

Market commentary

Direct senior loans and subordinated debt can be very attractive in the current market environment given banks' ongoing lower market share and the overall risk-reward enhancement provided by original issue discounts, base rate floors and the option to participate in equity upside. Club transactions in particular are typically characterized by benign competitive dynamics and in our opinion offer attractive risk-return profiles.

In Asia-Pacific, we had previously identified a number of emerging transactions which cater to non-bank institutional lenders in senior debt, particularly in the term loan B market. In the past half year, we have seen firm demand from private equity sponsors for institutional debt in Australia, in particular 'unitranche' debt structures, which combine elements of both senior and subordinated debt into a single stretched senior debt tranche. The increase in institutional unitranche has been driven by demand from sponsors as it can offer higher leverage to improve positioning in competitive situations, ease of execution and flexibility, and the ability to provide incremental or add-on acquisition debt capital to fund further growth. This provides a competitive and differentiated offering for sponsors as compared to traditional bank offerings, which remain conservative in this space.

Within our key investment strategies in the direct lending space (see box above), we continue to focus on companies with three defining characteristics: recession resilience, stable recurring cash flows and high cash conversion levels. Currently, we are finding such companies within specific sub-sectors of the information technology, healthcare and business and financial services sectors.

Our key investment strategies

We provide financing solutions that fill gaps in traditional debt market coverage and are often more attractive and flexible than those offered by the broader capital or syndicated loan markets, providing excess yields to our investors. We focus on three key strategies:

Offer creative structures

We offer flexible and tailor-made capital structures that support companies' specific cash flow profiles and working capital needs.

Target attractive sub-sectors

We target sub-sectors within industries where we have depth of experience and confidence in underlying growth fundamentals. We actively seek to invest into loan structures in these spaces in resilient companies growing both organically and via acquisitions.

Support buy-and-build strategies

We support successful sponsors and management teams in their buy-and-build strategies by providing add-on acquisition financing in a timely manner, particularly under strict time constraints.

Market commentary

Private infrastructure

The search for stable and strong risk-adjusted yield has been a near-constant theme over the past decade. It has brought many new investors into private infrastructure and led existing investors to increase their allocation to the asset class. As we head into 2018, we expect appetite for stable, brownfield infrastructure to remain extremely high.

The unprecedented volume of capital available for private infrastructure is fueling competition for investments and supporting high asset valuations, while also pushing down expected returns. While higher valuations can in part be justified by potential transaction synergies, we believe that in most cases, these are due to lowering return thresholds or more aggressive business assumptions in the underwriting.

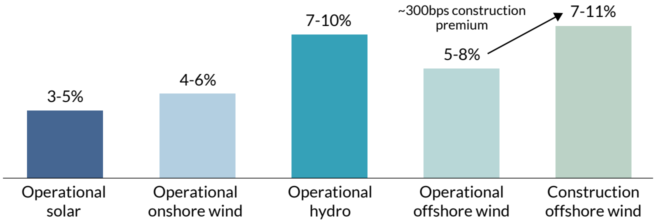
In general, we believe higher levels of assumed risk are not adequately reflected in current return expectations, especially at a time when interest rates in many economies appear to be increasing. Nonetheless, the record amounts of available capital and high prices for operating assets do make for a good exit environment. To benefit from the attractive selling conditions and to capture outsized returns, we have thus increased our focus on portfolio exits.

In terms of deal origination, our efforts over the next year will be guided by two key relative value convictions. Firstly, to create value, we prefer to build core assets or expand platforms over buying ready-built infrastructure. Secondly, we maintain our focus on sectors that are supported by transformative growth trends which drive demand for new and better infrastructure in that particular sector. Currently, we see such trends in the renewable energy, communications infrastructure, and energy infrastructure sectors.

In Europe, we see the best relative value in the communications and renewable energy sectors. In communications, we prefer terrestrial fiber infrastructure, as the segment offers strong inherent upside based on relatively low penetration levels and widespread government support for build-out initiatives. Demand for additional fiber capacity outweighs supply, creating tailwinds for new installations, particularly in rural parts of Europe. However, as the industry matures and the complexity of installing new networks decreases, prices for fiber capacity are declining, putting pressure on future expected revenues for network owners. We focus our efforts on more bespoke situations, such as building core and platform expansion projects across multiple jurisdictions.

In the European renewable energy sector, we focus on offshore wind, which we believe offers the most attractive opportunities based on a number of factors, including available investment sizes and expected returns.

Expected returns for European renewables projects



Note: showing lifetime buyer IRR, assuming stable regulatory regimes.
Source: Partners Group research, December 2017. For illustrative purposes only.

Although significant declines in capex have elevated offshore wind from a niche segment into renewable energy mainstream over the past 18 months, the sector is expected to grow globally at a 19% CAGR from 2017-2025[15] and capital demand for new projects is set to remain high. We see better relative value in late-stage development projects that offer us the opportunity to enter a project without taking development risk. Compared to operational wind farms, projects at this stage offer superior risk/return for investors like Partners Group that have the ability to add significant value in the pre-closing phase, for example by shaping the debt process or the final EPC (engineering, procurement, and construction) negotiations.

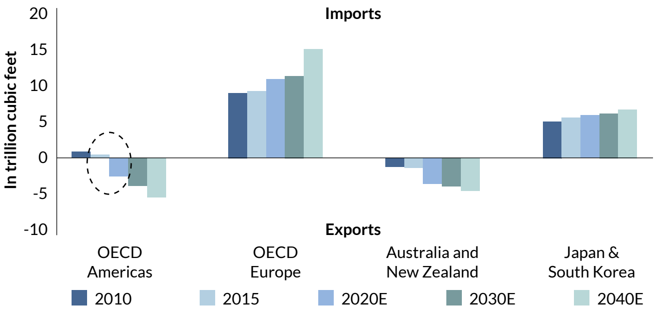
In North America, we see compelling relative value in the communications and energy infrastructure sectors. Within communications, we look at terrestrial fiber and data centers. Deal flow for the latter is robust and, similar to Asia-Pacific, opportunities arise from corporate owners disposing of their non-core communications assets.

Within energy infrastructure, our focus remains firmly on the midstream segment. The shale revolution has created a value chain of investment opportunities that ranges from upstream gathering and processing infrastructure, through intermediate transportation and storage assets, to downstream processing, logistics, and export infrastructure. Deal flow is relatively strong in all areas, but we believe the best relative value is currently found away from the wellhead, where there is a growing fundamental need for infrastructure that helps create pathways for the export of natural gas and its derivatives and where contractual underpinning is strong. Recent projections indicate that the US is on the verge of becoming a net exporter of gas for the first time in almost 60 years.

15 Bloomberg New Energy Finance, October 2017.

Market commentary

Net trade of natural gas



Source: EIA, September 2017.

In the Asia-Pacific region, we continue to focus on renewable power and communications infrastructure in select key markets such as Taiwan, Singapore, Japan and Australia. We have, to-date, developed close to 2GW of solar and wind energy capacity in the region, and relative value in these areas should persist throughout the first half of 2018. However, as competition from low cost-of-capital buyers for operating assets intensifies, we focus predominantly on capturing the premiums available for building core and select platform expansion opportunities.

Within communications, we see the most attractive opportunities in data centers and fiber infrastructure, particularly subsea fiber cables. We have substantial experience in communications infrastructure, having completed seven investments in the sector globally in the last ten years, and will continue to actively monitor the space.

Our key investment strategies

Capitalize on platform expansion opportunities

We look for investments that offer us the opportunity to build scale, for example through investing in fragmented markets that have the potential for consolidation and platform-building.

Proactively build core

We seek out opportunities where strong long-term fundamentals in a particular market support the demand for building a select type of infrastructure, for example due to evolving infrastructure needs or changing market fundamentals.

Focus on operational value creation

We focus on investment opportunities that offer us the potential to enhance operational value through growth and efficiency improvements. A key source of these opportunities is the ongoing trend for corporate owners of infrastructure to sell assets as part of a restructuring.