Brookfield | OAKTREE
WEALTH SOLUTIONS

Reasons for Real Estate Optimism, Finding Growth in Infrastructure, and Strength in Loans

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Overview

Financial markets are at an interesting juncture: public equities rebounded in 2023 (although most gains were from the *Magnificent Seven*[1] technology stocks), conflict persists in Ukraine, and a new conflict has flared in the Middle East. At the same time, some businesses are struggling while banks continue tightening lending standards. Still, most investors are upbeat about prospects for 2024, believing policymakers have contained inflation and that the U.S. economy can sidestep recession.

This issue offers insights from investment professionals throughout Brookfield and Oaktree on:

- **Real estate:** As 2024 gets underway, we are optimistic about real estate, where favorable supply-demand fundamentals should benefit the sector as central banks are expected to shift to cutting rates.
- **Infrastructure:** Investment opportunities remain robust as infrastructure continues to benefit from what many observers have called a super-cycle. This is creating favorable conditions for value investors as many businesses, particularly those with large growth pipelines, are available at more attractive entry points.
- **Credit:** Leveraged loans are coming off a historic year and, we believe, should continue to benefit from attractive yields as base rates remain above their 10-year average.

Our ***Alts Market Dashboard*** shares some data, market and investing insights that we find interesting from across the alternative investing universe. Notable numbers include:

- Despite a significant slowdown in mergers and acquisitions, private lenders continue capturing market share from traditional banks, helped by the resilient nature of the asset class. That strength is reflected in yields for direct lending of 11.76%, up 75 basis points from one year ago.[2]
- Real estate markets are showing signs of recovery with net income growth (at 4.7%) continuing to exceed historical averages.[3]

Finally, we offer some definitions that investors who might be relatively new to alternative investing may find useful, including an explanation of what is driving increased demand for industrial/logistics real estate. Investors who want to explore any of the investment themes in this publication in more detail should consult with their financial advisor.

Real Estate: Reasons for Optimism Ahead

We believe the real estate market is poised for a strong recovery as headwinds created by inflation and the recent rapid rise in interest rates gradually recede. Strong underlying fundamentals and healthy supply/demand drivers, coupled with lower valuations for high-quality properties should drive opportunities for outperformance in certain real estate subsectors.

We are closely monitoring three themes[4]:

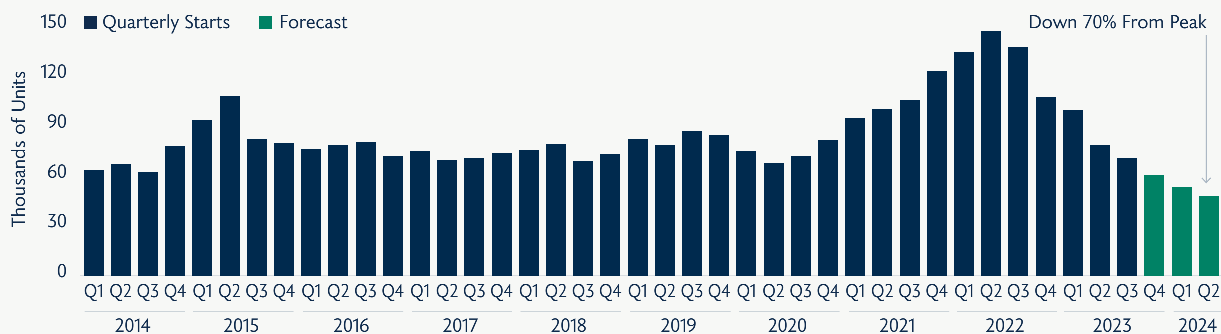
- **Demographics and affordability:** U.S. housing is in high demand, with household formations steadily increasing even as the cost of home ownership is at historically high levels and mortgage rates are significantly above recent historic lows. In addition, new homes are heavily undersupplied due to lagging new construction starts. The combination of these factors is driving many potential buyers to stay in rental housing for longer. Indeed, multifamily supply has failed to meet demand for the past decade and new starts are down 70% from their peak (**Figure 1**). These dynamics are creating attractive opportunities to meet rising demand by building new supply, renovating existing assets and optimizing operations.

- **Changing consumer preferences:** As post-pandemic consumers adapt to changing work lifestyles and place more importance on leisure time and high-quality experiences, the hospitality and entertainment sectors are enjoying a strong recovery. We see opportunities to target undermanaged and undercapitalized assets as well as platforms with exposure to markets where demand is increasing. The pandemic also accelerated e-commerce and online shopping, increasing the need for more logistics warehouse space, where vacancies have been at record lows, creating an opportunity to drive rents as tenant demand increases.

- **Deglobalization:** Evolving global trade trends have spurred sharp growth in logistics and advanced manufacturing factories as firms focus on securing supply chains, adding inventory, and onshoring. Deglobalization has also become necessary for national security reasons, particularly in critical industries, such as semiconductors and pharmaceuticals, that are also being supported by industrial policies. This increased demand has created opportunities for real estate development of purpose-built space.

Figure 1: New Multifamily Starts Are Down 70% From Peak

Historical and Forecast Multifamily Construction Starts



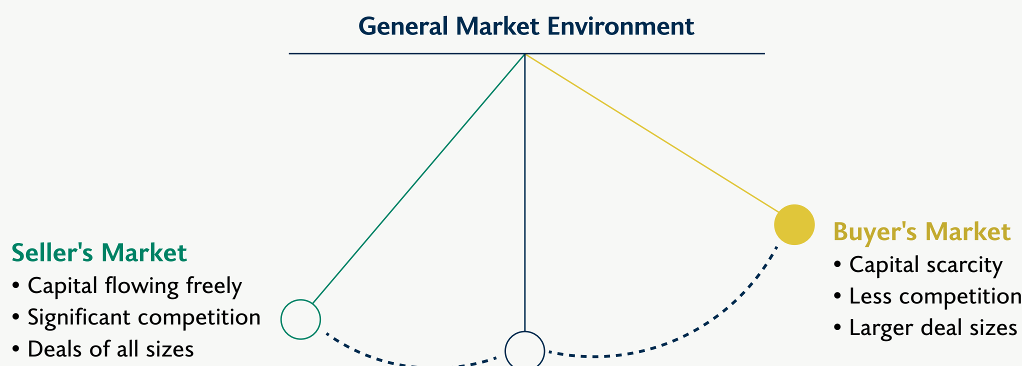
Source: CBRE Research; data as of September 30, 2023. Historical analysis does not guarantee future results.

We are at a rare inflection point in the real estate market cycle. Capital markets have been challenged by the high cost of capital, and low transaction volumes creating downward pressure on valuations. At the same time, underlying real estate fundamentals are strong, bolstered by strong demand and limited supply across several sectors. We believe these dynamics can create a meaningful opportunity to deploy capital over the next few years, investing in high-quality real estate on a value basis.

Infrastructure: Acquiring Growth Assets for Value

The infrastructure sector faces very different circumstances than at any time in recent years: interest rates are high, inflation has been elevated in many markets, and economic growth is expected to slow. As a result, access to capital is no longer easy and many investors are on the sidelines, potentially creating a buyer's market (**Figure 2**) for attractive infrastructure assets.

Figure 2: A Capital-Scarce Environment Often Creates a Buyer's Market



Source: Brookfield. For illustrative purposes only.

Infrastructure opportunities are typically classified into two main categories: brownfield and greenfield. (At Brookfield, "greenfield" investments are also called "platform" investments because they offer the potential to grow a platform.) A significant portion of the opportunity set is concentrated in brownfield investments—existing, operational assets that seek to offer high current income with modest growth potential, such as a utility.

We see potential in both types of investment, but given today's environment, we are finding significant opportunities in platform assets. These assets are less-established operationally and tend to provide lower current income but with potentially significant growth. Given the lack of available buyers, these businesses are available at attractive entry points.

Many of these platform investments are driven by digitalization and decarbonization, megatrends focused on the build-out of digital infrastructure and the net-zero transition. Everything from artificial intelligence to streaming has made data increasingly important, driving demand for data centers, cell towers and fiber networks. Decarbonization opportunities are wide-ranging, including some often-overlooked opportunities focused on enhancing energy efficiency. For example, smart metering services for utilities that provide more accurate energy readings.

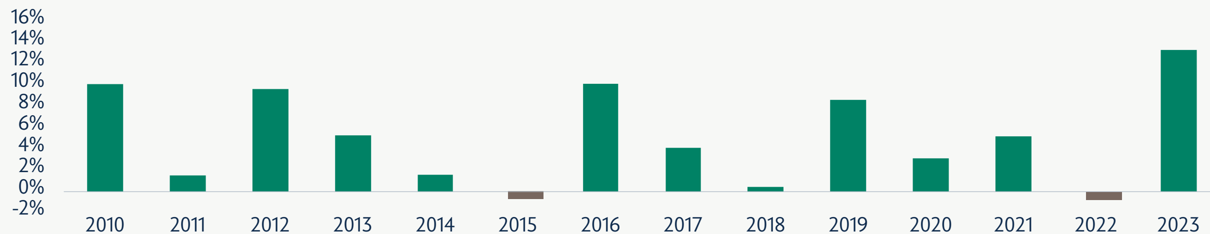
These investments share similar characteristics: strong demand for the services they provide, the ability to attract a strong customer base, and the ability to scale operations to meet incremental needs. As a result, we believe many of these projects have low execution risk. Large projects can be contracted out before construction, and contracts are often tied to inflation. This helps to provide stable cash flows, mitigating downside risk. In 2024, we are focused on building out these platforms. We are also open to engaging in similar opportunities, at the right price, in what could prove to be a strong year for infrastructure investing.

Credit: After Stellar 2023, Solid Outlook for Senior Loans

U.S. senior loan prices rose in the fourth quarter, supported by limited new loan issuance, moderating recession fears and expectations of lower interest rates ahead. Indeed, 2023 was an exceptionally strong year with U.S. senior loans gaining 13.32%, their best annual return in more than a decade (**Figure 3)**.

Figure 3: U.S. Senior Loans Posted Their Best Annual Performance in More Than a Decade

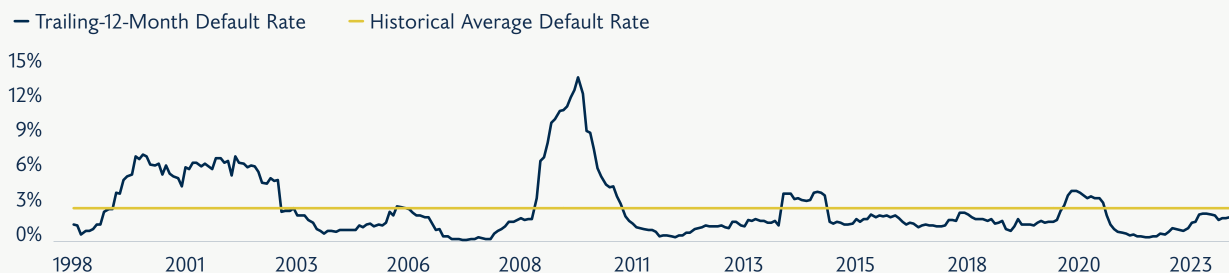
U.S. Leveraged Loan Returns, Annual



Source: Pitchbook, LCD, Morningstar LSTA US Leveraged Loan Index; data as of December 31, 2023.

Notwithstanding fading recession fears, many strategists continue forecasting higher defaults in the coming months among U.S. and European leveraged loans, driven by higher borrowing costs. Still, we expect defaults should remain manageable (**Figure 4**) even if the U.S. and European economies contract. Our view is supported by the limited number of maturities coming due and the strength of issuers' balance sheets (especially in Europe).

Figure 4: Default Activity in the Loan Market Remains Below the Historical Average



Source: J.P. Morgan; data as of December 31, 2023.

Despite concerns that overall quality of the market has declined, loans remain supported by attractive yields and rates above their 10-year average, which should continue to make floating-rate assets compelling. As of year-end, the implied federal funds rate was 3.8%, down from 4.6% in the U.S. Federal Reserve's November projections. Even at a reference rate of 3.8%, the implied yield of leveraged loans should remain attractive, suggesting investors who stay invested will continue benefiting from high coupons for the foreseeable future. In addition, since collateralized loan obligations (CLOs) are the main holders of leveraged loans and are considered stable buyers of the asset class, there should also be limited selling pressure, making leveraged loans potentially less volatile than many other asset classes.

Despite the broad consensus that the U.S. might achieve a soft landing, we are only cautiously optimistic about this outcome. Against this backdrop, we believe credit selection will be as crucial as ever to successfully navigate the current market.

Alts Market Dashboard

Metrics to help investors interpret market conditions within various sectors of alternatives, both in public and private markets. Brookfield and Oaktree believe the addition of both public and private alternatives can play an important role in an investor's portfolio.

Credit

	1-Year	5-Year	10-Year
Private Credit	11.15%	8.64%	8.86%
High Yield	10.19%	2.8%	4.16%

$12B	11.76%	7.69%	$449B
Deal volume Q4 2023	Direct lending yield[5] Q3 2023	High-Yield yield[6] Q3 2023	Dry powder Q4 2023
-76% 1-year change	+75 bps YTD change	-48 bps YTD change	+8.1% YTD change

- Performance suggests private credit resilience
- Spread between private/public yield continues widening

Infrastructure

	1-Year	5-Year	10-Year
Private Infra.	12.09%	12.3%	11.24%
Public Infra.	1.36%	4.14%	5.98%

$25B	3.69%	9.66x	$346B
Deal volume Q4 2023	Public infra. yield[7] Q4 2023	Public infra. average EV/EBITDA multiple[8] Q4 2023	Dry powder Q4 2023
-49% 1-year change	+18 bps YTD change	-0.5x YTD change	4% YTD change

- Recent performance suggests resilience relative to many other asset classes
- Public yields and valuations remained steady, despite rising interest rates

Private Equity

	1-Year	5-Year	10-Year
Private Equity	9.17%	15.95%	15.07%
Public Equity	22.58%	7.8%	8.84%

$369B	15.2x	43%	$2,693B
Deal volume Q4 2023	Buyout median EV/EBITDA multiple[9] Q2 2023	Average deal LTV[10] Q3 2023	Dry powder Q4 2023
-1.7% 1-year change	+2x 1-year change	-7.1% 1-year change	+18.9% 1-year change

- Private equity sponsors are injecting more equity into deals to compensate for tighter lending conditions
- Deal making continues to be resilient

Real Estate

	1-Year	5-Year	10-Year
Private Real Estate	-1.79%	8.33%	10.2%
Public Real Estate	2.72%	-0.3%	2.97%

$90B	6.9%	4.7%	$401B
Deal volume Q4 2023	Average cap rates[11] Q4 2023	1-year net operating income growth[12] Q3 2023	Dry powder Q4 2023
-24% 1-year change	+94 bps 1-year change	+2% vs. historical average	-14.9% YTD change

- Cap rates continue to expand as valuations adjust to reflect higher interest rates
- Net income growth continues to exceed historical averages

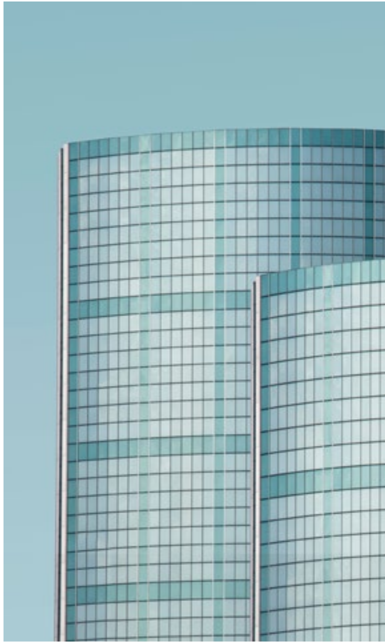
Private Credit reflects Cliffwater Direct Lending Index; High Yield reflects ICE BofA US High Yield Index; Private Infrastructure reflects Preqin Infrastructure Index; Public Infrastructure reflects FTSE Global Core Infrastructure 50/50 Index; Private Equity reflects Preqin Private Equity Index; Public Equity reflects MSCI World Index; Private Real Estate reflects Preqin Real Estate Index; Public Real Estate reflects FTSE EPRA Nareit Developed Index. Indexes are unmanaged and cannot be purchased directly by investors. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment.

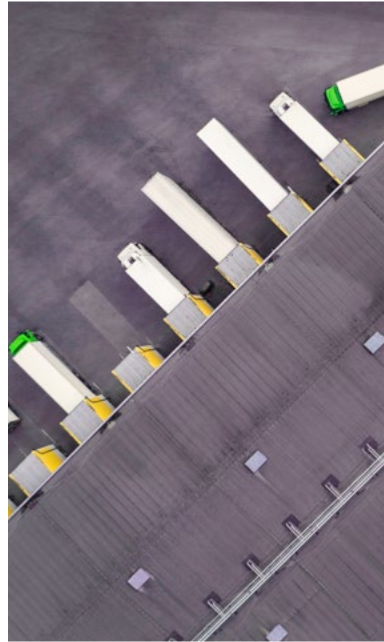
Deal Volume and Dry Powder data from Preqin, as of December 31, 2023, reflecting the Preqin Private Credit, Infrastructure, Private Equity, and Real Estate indices, respectively.

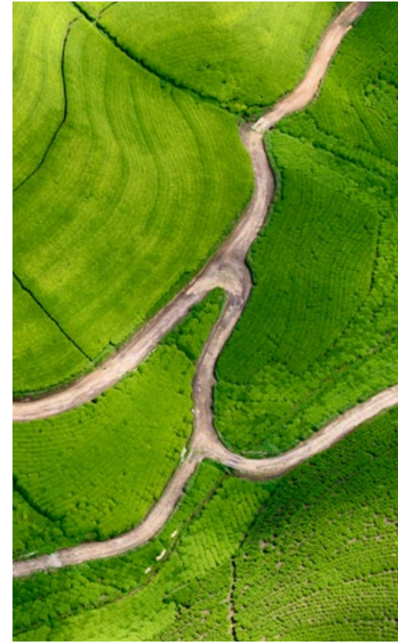
Net operating income (NOI) is a calculation used to analyze the profitability of income-generating real estate investments. NOI equals all revenue from the property, minus all reasonably necessary operating expenses.

Source: Bloomberg, Cliffwater, Preqin data (unless otherwise noted) as of September 30, 2023, the latest available for private market indices shown.

Alts Terminology Explained







Credit

Floating Rate

Floating interest rates change periodically, reflecting changes in overnight borrowing rates and prevailing market conditions. Floating rates are typically priced as a combination of a reference rate, such as the Secured Overnight Financing Rate (SOFR), and an added premium, or spread, reflecting perceived risk. For example, a loan priced at SOFR+150 would have an interest rate of SOFR plus 150 basis points (or SOFR plus 1.5%).

Real Estate

Industrial/Logistics

The growth of e-commerce, coupled with consumer expectations for fast delivery, has created strong demand for industrial/logistics real estate; properties specifically designed to support efficient supply chains with purpose-built structures for storage, order fulfillment and distribution. These facilities range from general warehouses to specialized buildings designed for temperature-controlled storage for perishable foods, or properties licensed for handling hazardous materials.

Infrastructure

Greenfield/Brownfield

Greenfield investments generally require development and construction. These investments are less-established operationally and tend to provide lower current income but offer significant growth potential. At Brookfield, we also call these platform investments because our goal with these assets is to build a platform and successfully grow a new business.

Brownfield investments are enhancements to infrastructure assets that are already operational and generating revenues but require upgrades to make them more efficient and profitable.

In general, greenfield investments have a higher risk/reward proposition vs. brownfield investments.

ENDNOTES

[1] The *Magnificent Seven* refers to Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft and Tesla.

[2] Source: Cliffwater Report on U.S. Direct Lending, reflecting CDLI 3-year takeout yield.

[3] Source: FactSet. Reflects FTSE Global Core Infrastructure 50/50 Index average EV/EBITDA multiple, a ratio used to determine the value of a company, which is enterprise value (EV) divided by earnings before interest, taxes, depreciation and amortization (EBITDA).

[4] Brookfield, *Three Themes Creating Opportunities in Global Real Estate*, May 10, 2023.

[5] Source: Cliffwater Report on U.S. Direct Lending, reflecting CDLI 3-year takeout yield.

[6] Source: Bloomberg. Reflects ICE BofA US High Yield Index yield to worst. Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.

[7] Source: Bloomberg. Reflects FTSE Global Core Infrastructure 50/50 Index dividend yield.

[8] Source: FactSet. Reflects FTSE Global Core Infrastructure 50/50 Index average EV/EBITDA multiple, a ratio used to determine the value of a company, which is enterprise value (EV) divided by earnings before interest, taxes, depreciation and amortization (EBITDA).

[9] Source: Preqin.

[10] Source: Pitchbook Q3 US PE Breakdown, reflecting the size of a loan used to finance an asset relative to the value of that asset.

[11] Source: Greenstreet. Reflects the simple average of cap rates for U.S. property types.

[12] Source: NCREIF. Reflects the net operating income (NOI) growth for properties included in the NCREIF Fund Index – Open End Diversified Core.

A WORD ABOUT RISK

Investments in real estate-related instruments may be affected by economic, legal or environmental factors that affect property values, rents or occupancies of real estate. Infrastructure companies may be subject to a variety of factors that may adversely affect their business, including high interest costs, high leverage, regulation costs, economic slowdown, surplus capacity, increased competition, lack of fuel availability and energy conservation policies.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment.

High-yield bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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The Preqin Infrastructure Index captures in an index the return earned by investors on average in their private infrastructure portfolios, based on the actual amount of money invested in private capital partnerships. Each data point is individually calculated from the pool of closed-end funds for which comprehensive performance data is held, as of both the start and end of the quarter.

The Preqin Real Estate Index captures in an index the return earned by investors on average in their private real estate portfolios, based on the actual amount of money invested in private capital partnerships. Each data point is individually calculated from the pool of closed-end funds for which comprehensive performance data is held, as of both the start and end of the quarter.

The Preqin Private Equity Index captures in an index the return earned by investors on average in their private equity portfolios, based on the actual amount of money invested in private capital partnerships. Each data point is individually calculated from the pool of closed-end funds for which comprehensive performance data is held, as of both the start and end of the quarter.

The Cliffwater Direct Lending Index (CDLI) seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.

The FTSE EPRA Nareit Developed Real Estate Index is an unmanaged market-capitalization-weighted total-return index that consists of publicly traded equity REITs and listed property companies from developed markets.

The FTSE Global Core Infrastructure 50/50 Index gives participants an industry-defined interpretation of infrastructure and adjusts the exposure to certain infrastructure subsectors. The constituent weights are adjusted as part of the semi-annual review according to three broad industry sectors: 50% Utilities; 30% Transportation, including capping of 7.5% for railroads/railways; and a 20% mix of other sectors including pipelines, satellites and telecommunication towers. Company weights within each group are adjusted in proportion to their investable market capitalization.

The ICE BofA US High Yield Index tracks the performance of U.S.-dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market.

The ICE BofA Merrill Lynch Global High Yield European Issuers Non-Financial 3% Constrained Ex Russia Index is a sub-index that contains all securities in the broader index except those from financial issuers or with Russia as their country of risk but caps issuer exposure at 3%. The index is rebalanced monthly. The index is USD hedged.

The MSCI World Index is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed markets.

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