INSIGHTS:
PRIVATE EQUITY
JULY 2021

iCapital NETWORK

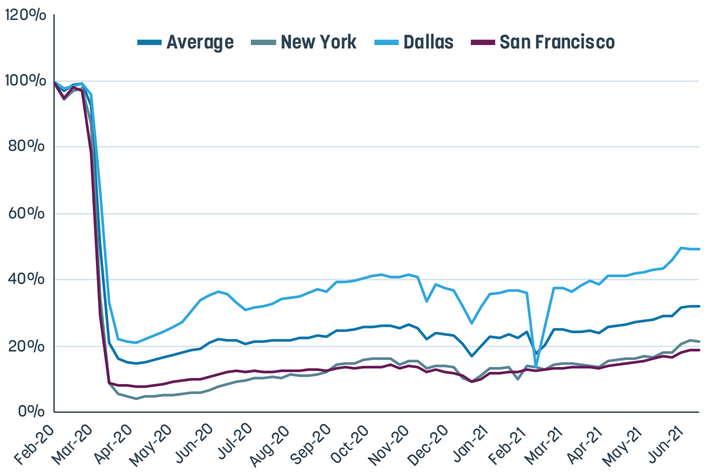
H2 2021 INVESTMENT OUTLOOK: RETURN TO (MUCH CLOSER TO) NORMAL

Amid a more modest equity market outlook, private equity and real estate are poised to thrive.

The third quarter in the United States should finally mark a return to a much more normal state of affairs as not only travel and dining resume, but also the daily commute for many office workers.

For markets, the third and fourth quarters are likely to bring a continuation of high growth and high inflation, but over the next few months it should become clear that growth is peaking. Estimates suggest GDP should grow 8.3% in the third quarter, less than the 9% expected in the second quarter.[1] Importantly, core inflation may remain at 3.5% and 3.7% in the third quarter and into the fourth quarter, respectively, and well above 2% in 2022.[2]

Exhibit 1: Workers are returning to offices
Average office occupancy rate



Source: Kastle, Bloomberg, as of June 23, 2021. For illustrative purposes only.

We see three major market implications of these economic developments:

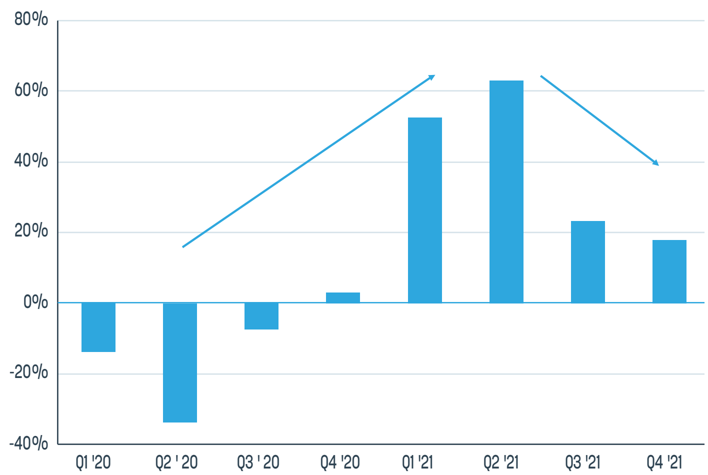
1. Public market returns are likely to be positive but more modest in H2 2021;
2. IPO markets should remain robust in H2 2021, benefitting private market investors; and
3. Inflation-protected assets like real estate will still be needed for above 2% inflation.

PUBLIC MARKET RETURNS ARE LIKELY TO BE POSITIVE BUT MORE MODEST IN H2 2021

The S&P 500 index rallied 14.5% in the first half of 2021,[3] but we expect more modest returns for the second half of the year. The reason: The best market returns typically happen when growth expectations are being marked up from low levels; that is unlikely to be the case in Q3. Instead, here are three factors that may lead to more muted market returns:

The markets should recognize that the pop in earnings will soon be behind us. Q2 earnings growth is already estimated to be 62.8%, the highest since Q4 2009.[4] But this should not come as much of a surprise to anyone. Slower earnings growth is likely in the second half, with a full-year 2021 earnings growth estimate of 35%. This will likely slow further to 11% in 2022 as most sectors that were hard-hit by COVID have largely normalized and the best of fiscal stimulus is behind us.[5]

Exhibit 2: Corporate earnings growth is likely to continue, at a slower pace
S&P 500 earnings growth by quarter



Source: Factset Earnings Insight, June 25, 2021. For illustrative purposes only.

Valuations aren't cheap, investor positioning is uber bullish, and we see little room for multiple expansion. At 22x, forward earnings are well above their 10-year average. Additionally, hedge fund net-long positioning is also close to the highest level on record (97th percentile over the past three years[6]). Meanwhile, investors have poured over $500 billion into global equity funds year-to-date.[7] All in, investors have less room to increase bullish bets than before.

A potential spike in rates during Q3 may challenge valuations. Tactically, we think the rally in bonds is overdone, and rates have some room to move higher, pending upcoming 3%+ core inflation prints and Fed taper talk. One caveat to this – investors are already very bearish on bonds, which could temper any move higher. As a result, public equity market returns are likely to be positive as earnings growth persists, but more modest in the second half of 2021, versus the first half of the year.

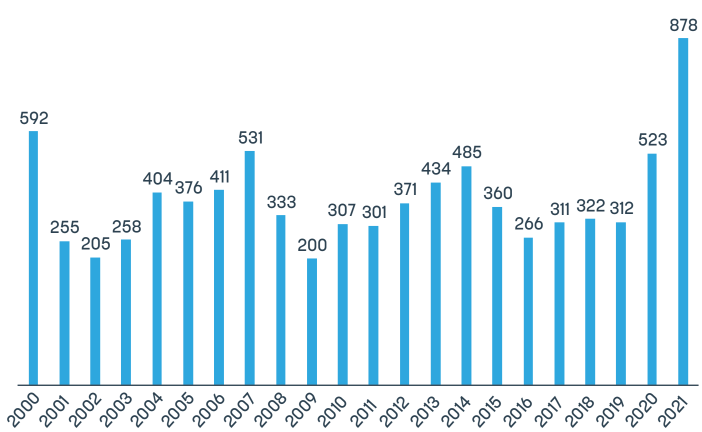
IPO MARKETS ARE SET TO KEEP BREAKING RECORDS, BENEFITTING PRIVATE MARKET INVESTORS

We think private market investors will continue to benefit from a supportive IPO environment in the second half of 2021. In the first six months of the year, U.S. IPOs proceeds reached $171 billion, surpassing the 2020 record of $168 billion.[8] We expect IPO activity to remain robust in the second half of the year and into 2022 as zero rates and fund flows into innovation drive premium public market valuations. Compare the 19x EV/EBITDA for the S&P 500 to the 14x for U.S. private equity.[9] This is incentivizing private companies to tap the public markets.

There is no shortage of companies waiting to go public. The average age for a private company today is 12 years and there are more than 500 unicorns.[10] Many of these companies are likely to take advantage of the attractive exit opportunity while the IPO window is wide open.

Exhibit 3: Already a record-breaking year for IPO activity

All U.S. public offerings 2000-2001



Source: Pitchbook, as of June 30, 2021. Includes all public offering types (IPO, direct listings, reverse mergers, dutch auctions, SPACs). For illustrative purposes only.

We believe the robust IPO market is likely to persist even if yields rise. Investors concerned about the impact of a potential Q3 increase in 10-year Treasury yields may take comfort in recent performance: IPO activity was undeterred during the first quarter when a rate increase prompted valuations of high growth stocks like renewables, SPACs, and electric vehicles to reset to lower levels. In fact, Q1 was a record quarter.

Continued strength in IPO activity stems from increased investor focus on innovation. With the pandemic recovery boost slowing down and global IT spending forecasted to pick up in the coming quarters, the search for growth and innovation should once again be top of mind. Indeed, amid blockbuster U.S. equity fund flows year to date, one category in particular stands out – thematic funds that invest in anything from gene therapy to space tourism to robotics have seen an explosion of fund flows.

As a result, public market participants are welcoming innovative and tech-driven IPOs with open arms, driving very rich market valuations for these companies. The average one-day pop for an IPO this year is 40.5%, almost double what we witnessed in 2020 and 2019.[11] Further, consider that average unicorn IPOs that went public last year priced at 2.4x company valuations during the last private round of fundraising (which in many cases took place just months before the IPO) and 3.5x at the close of the first day of trading.[12] This bump in valuation accrues to the private market participants that invested in companies well before the IPO.

For more on the disparity in public versus private valuations and implications for investors, see Individual Investor Access to the New Economy Comes at a (Hefty) Price.

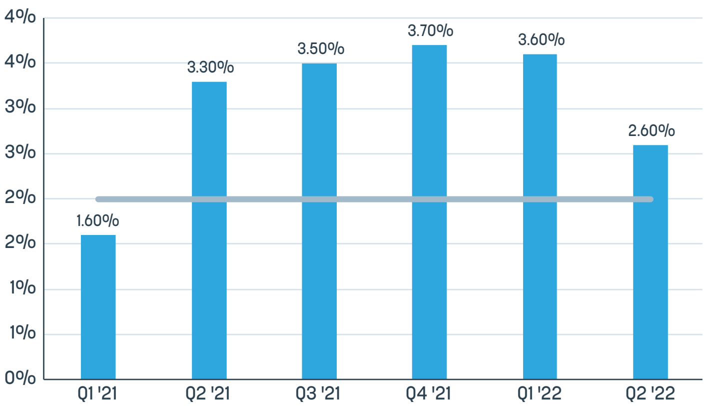
Finally, while SPAC IPOs slowed in Q2, there are 394 wielding $128 billion of equity capital that are currently searching for a private company to acquire.[13] These SPACs offer another exit route for owners of private companies.

INFLATION-PROTECTED ASSETS LIKE REAL ESTATE WILL STILL BE NEEDED FOR ABOVE 2% INFLATION

In recent weeks, the markets have been giving up on the inflation trade. The forward inflation breakeven fell from 2.4% to 2.17% as investors (and the Fed) concluded that inflation is transitory. But let's be clear about what this means. We are likely to come back down to earth from 5% CPI inflation as easy year-over-year comparisons fade away, bottlenecks are resolved, and mobility and travel fully recovers. However, we are unlikely to return to the pre-pandemic average of 1.7% core PCE inflation.[14]

Inflation should top 2% for the next year-plus, fueled by the economy returning closer to full employment at 4.9% by year-end 2021[15] and a continuation of negative real rates. These sustained inflation pressures are likely to remain in place through 2022. Against this backdrop, we recommend that advisors consider increasing exposure to inflation-protected real estate. Below are a few reasons why increased real estate exposure may benefit investors.

Exhibit 4: Inflation is likely to remain elevated through 2022
Core PCE inflation by quarter



Source: JPMorgan Economic Research, June 25, 2021. For illustrative purposes only.

Commercial real estate is a $16 trillion market,[16] with many sectors offering inflation protection for investors. For example, apartments with short-term leases benefit in times of inflation, and longer-term property types like offices, have built-in inflation escalator provisions.

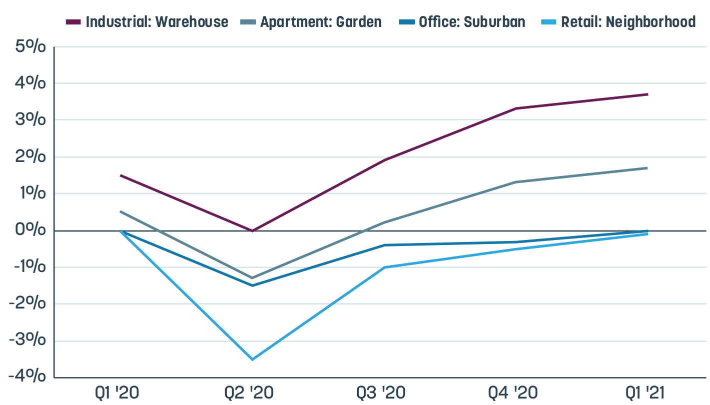
The fundamentals of commercial real estate are improving faster and more than expected as mobility and foot traffic returns. Consider these examples:

- Retail: Foot traffic in apparel retail is up 0.78% relative to two years ago and is down just -0.97% for hotels/casinos.[17]
- Hospitality: The current hotel occupancy rate of 66% is approaching pre-pandemic levels.[18]
- Office: With only 32% of workers back in the office,[19] this sector is lagging the rest of the real estate market. The majority of recently surveyed CEOs, however, expect a return to office in the fall,[20] and the percent of CEOs thinking about shrinking their office footprint has declined significantly to 17%, from 69% in mid-2020.[21]
- Apartments: As the value proposition for urban city life returns, apartment occupancy levels have rebounded quickly to 93%.

As a result of these improvements, we have a positive outlook for real estate for the second half of the year and beyond. With demand rising and leasing activity improving, we expect a resumption in net operating income growth and price appreciation to help real estate returns. Already in Q1 of 2021, we have seen the apartments and suburban office sectors return to price appreciation. The others are on the cusp of turning.

Read more about our perspective on the real estate market in [The Outlook for the Private Commercial Real Estate Market Is Positive](#).

Exhibit 5: Real estate returns are improving across sectors
Quarterly appreciation return by subsector (NPI – ODCE)



Source: NCREIF, as of June 3, 2021. For illustrative purposes only.

Finally, many investors are likely underweight the real estate asset class today. REITs represent less than 3% of the S&P 500 benchmark.[22] Investors focusing solely on the public equity markets likely don't have enough real estate exposure. We think this is an opportune time to add more.

Our day-to-day lives should move much closer to normal in the third quarter. And we should also see normalization in the markets. The sharp outperformance of pandemic recovery trades versus tech should narrow. Investors in public markets will likely see mid-single digit S&P 500 returns through year-end.

And investors should remember that average annual private equity returns are expected to be 370 basis points above U.S. large caps longer-term, while private real estate offers compelling yields of over 4% and optionality for inflation resets.[23] With that in mind, as we adjust our daily routines back to normal, we recommend positioning portfolios for this return as well.

Anastasia Amoroso
Managing Director,
Chief Investment Strategist

END NOTES

1. Source: JPMorgan Economic Research, June 25, 2021.
2. Source: JPMorgan Economic Research, June 25, 2021.
3. Source: Bloomberg, as of June 30, 2021.
4. Source: FactSet Earnings Insight, June 25, 2021.
5. Source: FactSet Earnings Insight, June 25, 2021.
6. Source: Goldman Sachs Portfolio Strategy Research, June 18, 2021.
7. Source: BofA Global Research, June 24, 2021.
8. Source: Dealogic, Reuters, U.S. IPOs hit annual record in less than six months, June 15, 2021.
9. Source: Pitchbook's 2020 US PE Breakdown, Partners Group, as of December 31, 2020.
10. Source: iCapital, "Individual Investor Access to the New Economy Comes at a Hefty Price," February 2021.
11. Source: Dealogic, Reuters, U.S. IPOs hit annual record in less than six months, June 15, 2021.
12. Source: iCapital, "Individual Investor Access to the New Economy Comes at a Hefty Price," February 2021.
13. Source: Goldman Sachs Portfolio Strategy Research, April 21, 2021.
14. Source: Bloomberg, as of July 2, 2021.
15. Source: JPMorgan Economic Research, June 25, 2021.
16. Source: NAREIT Research, July 2019.
17. Source: Placer.AI, week of June 21 – June 27, 2021.
18. Source: STR, week of June 12, 2021.
19. Source: Kastle, as of June 28, 2021.
20. Source: CNBC, LaSalle, 2021: Office Re-Entry Index, June 26, 2021.
21. Source: KPMG 2021 CEO Outlook Pulse Survey, March 4, 2021.
22. Source: Bloomberg, as of July 2, 2021.
23. Source: JP Morgan, "2021 Long-Term Capital Market Assumptions."

iCapital NETWORK

IMPORTANT INFORMATION / DISCLAIMER