Episode 117

Private markets outlook: Refilling the glass

[00:00:04] Andrew Korz: Welcome to FireSide, a podcast from FS Investments. I'm Andrew Korz, Executive Director of Investment Research here at FS, and today we're going to discuss private markets and the outlook for private equity, private credit and commercial real estate in 2025. Joining me for this discussion is my colleague, Alan Flanagan. Alan, welcome to the show. Good to have you.

[00:00:25] Alan Flannigan: Hey, great to be here, Andrew. Real buzz in these markets and exciting time to talk about them.

[00:00:29] Andrew Korz: For sure. No doubt about it. Excited for the discussion. I'd like to briefly plug the written version of our Outlook. It's actually our inaugural private markets outlook from our research team here at FS and this is available on fsinvestments.com and we'll link it in the show notes. I think Aaron, right, we can do that. It will be in the show notes.

So Alan, let me just level set some things here before we dive into the outlook. It's been a really interesting four years, just to put it mildly. I think it's important to briefly walk through what's gone on over that period—in the rates market and how that's impacted private markets, and where that leaves us today as we look toward 2025. So, if we go back to 2021, that was just a gangbusters year for market activity across markets.

If you recall, in the spring, we had the meme stock mania. We had a surge of IPOs, SPACs, you name it. People thought rates were going to be low forever. The economy was rebounding incredibly quickly after the dissemination of vaccines, and that fed into private markets as well, where you had deal activity surging in PE and in real estate.

You had valuations climbing ever higher and that was what I would call peak optimism in private markets. In 2022, I think inflation hit markets like a semitruck. Obviously, inflation started to accelerate. The Fed began to act at the end of Q1. They ended up raising rates by 425 basis points throughout the final nine months of that year.

I think of this as the year of shock and awe in markets. Nobody expected that level of tightening coming into the year. Public markets plunged. Everybody expected a recession, if you recall. And very quickly, private markets activity dried up. In PE, you had deal volume down more than 20% year on year. In real estate, it was closer to down 30%.

Fast forward to 2023, I think as a year of correction. Values across private markets were still too high for where rates had settled in. And until they adjusted, deals in these markets just were not going to get done. I think the saving grace was not only do we not have a recession, but the economy was actually remarkably strong.

Asset owners—because of this economic resilience—were able to take a wait-and-see approach instead of selling into a bad market like we normally see during typical recessionary down cycles. And then finally, this year has been a consolidation year. Asset values have largely adjusted. Rates have been volatile, but in the low- to mid-fours for most of the year, on the 10-year. Ultimately, I think investors across private markets do see the light at the end of the tunnel. Sentiment has certainly improved both quantitatively and through our observations of the market.

And folks are starting to think about what the rebound looks like, how to invest into that rebound in 2025. So, that's really where I want to kick it off here. Alan, I want to bring you into talk about this idea of sentiment. It sounds so abstract, but for those people who do follow these markets, it does feel like there's been a shift in inflection point here.

We have all these measures, surveys that tell us it's improving this year. What does that mean to you? How do you connect to this idea of sentiment and for lack of a better term, vibes, to what's actually going on in these markets?

[00:03:54] Alan Flannigan: And sentiment's probably more critical in private markets, I would suggest, than public. Folks think about the day-to-day volatility in publics, but the private markets, it's really deal-driven and folks have got to be willing to do those deals. That's really what sentiment is. It's that thing that makes you feel confident to do the thing that you know you should do. Maybe it's a fault of humans that we feel as though we need this confirmation. But really in private markets, when you've got to bring a buyer and seller together to arrive at a deal and put that capital to work and do it in a long-term fashion, you've got to have that confidence to do what you know is right to do.

And we're getting to that point. We see it across a variety of indicators. One of the things that we put out recently is just a short-term chart of M&A–focused banks post-election. Sentiment was improving leading into the election, absent the election and the results, and whichever candidate folks prefer.

But now that we do have the results, I think there is some feeling that there might be a little bit of a lighter touch from a regulatory front. It might be quicker to get approvals on capital-intensive projects and major investments, and the administration is indicating a focus on domestic industrial policy, which we'll talk a little bit more about. But all of that means that the people who deploy capital in a long-term committed fashion are arriving at a place where they feel more comfortable doing so.

[00:05:21] Andrew Korz: I think of it as the first leg of what turns into a more robust rebound. It's a precondition if you're in a dry spell in a market or you're in a correction environment. It's the first thing that you need before you get the pull-through of the activity coming back, the pricing improving, all of that.

[00:05:41] Alan Flannigan: Absolutely, yeah, and the reason again why sentiment is so important. This isn't a market where you can just show up and buy whatever it is that you want to buy.

[00:05:49] Andrew Korz: There's no clearing price.

[00:05:50] Alan Flannigan: There's no clearing price. I make the analogy sometimes that public markets are like showing up at the deli and you can have anything that's on the menu as long as you're willing to pay the price that they're selling it to you. But private markets and private equity in particular, it's much more like running a big manufacturing plant.

You've got to go out and source your inputs. You've got to bring in skilled labor to add value in the production process. And at the end of it, when you've assembled your raw inputs, your materials, your resources, your knowledge and sophistication to add value to that, now you return that product to the marketplace as a more valuable finished good. That's really the difference in what we're talking about.

[00:06:28] Andrew Korz: So maybe we can pull this through to the specific markets and maybe I'll start because I think nowhere has sentiment born been more negative in the past than in commercial real estate, right. It's been the poster child for potential stress in the financial markets, in the capital markets since the Fed started raising rates. And I think you some folks, if you're passively paying attention, you've maybe seen fewer and fewer negative headlines about commercial real estate.

But I think if you look under the hood, the shift in sentiment really has been pretty tremendous. And I track a few of these sentiment indicators, which are really just surveys. You're just asking investors, market participants: How are you feeling today? And what do you expect the market to look like in a year compared to today?

And if you look at some of those, I mean, 88% of people expect the market to improve in the next year, broadly. Eighty percent expect values to increase. Eighty percent expect activity to improve the next year relative to the past year. The outlook for fundamentals is the best that it's been in three years.

So, those are just asking some people who are actually out there doing deals, how they feel about the market. And then there's the public markets. So, equity REITs, traded-equity REITs have performed a lot better. Even office REITs have performed a lot better, especially the second half of this year. In the CMBS market where we have regular trading, CMBS spreads have really tightened almost all the way back to pre-COVID levels. So you're seeing it in terms of people actually putting their money where their mouth is. Then eventually, they say in real estate, public markets tend to lead private markets. We're seeing that here. The hard data isn't quite there yet in real estate. Transaction volume, it's not going down anymore, but it hasn't quite inflected upward yet. It's been kind of flat for really two years straight.

And then on pricing, values are down 10%–20% across sectors. If you leave office off to its own, that's down by about 50% in central business districts. But they've mostly stopped falling. So it looks like we're forming a trough.

But again, I don't think we've seen this robust pull-through from sentiment to the hard data yet. So all of this suggests to me, ultimately, we're in this very early cycle environment. Nothing is certain here. Rates are still a big driver of this. There's still a lot of rate volatility. The health of the economy is going to continue to be pivotal in terms of investors stepping back into the market.

But all the early signs that we look for in terms of the sentiment are folks out there looking to do deals. I think those are all there, it's just a question of pull-through now. Maybe I'll kick it to you and see if it's similar on the PE side.

[00:09:03] Alan Flannigan: I was going to plug a little bit of your real estate work.

[00:09:06] Andrew Korz: No, I appreciate that.

[00:09:07] Alan Flannigan: Any chance to jump in and talk. So, Andrew, you've guided our investor base through this real estate correction with a ton of precision. And this is a great plug for some of the research that Andrew does in real estate. He writes extensively on the subject, chart books, outlooks, CRE correction. "Anatomy of a CRE correction" has been one of our top viewed research pieces here at the firm. Andrew's observations about the market improving and some of the forward indicators from equity REITs in the market doesn't necessarily align with what we see from a relative value perspective, thinking about it from a credit investor versus an equity investor perspective. Could you talk a little bit about your process looking at that?

[00:09:50] Andrew Korz: Yeah, absolutely. When we look at the real estate market, a lot of it comes down to number one, what are rates going to do, and number two, what's the starting point. So for a bit, there was this expectation that rates were going to come to the rescue. And as a result, it was going to restart this flywheel. Activity is going to improve, property values will start going up again. We don't necessarily see that on the rate side; and we can get into this a bit later when we talk about rates.

But if your view is that rates are going to be higher for longer, which I think is our core view, it doesn't mean the Fed's not going to cut more. But long-term rates…it seems like this is around the right level. If that's your view, financing costs are going to stay high. And that means the spread you're getting by investing in equity real estate—we think of as the cap rate—the spread you're getting over Treasury yields just is still really, really tight.

So, there's not a ton of room for valuations to continue to go up. Now we do think you're going to talk about this coil of activity. The need for more deal volume to happen in the markets. We do see that happening, and that's crucial, but we don't necessarily see the pull-through to property values in terms of the 10%–15% property value increases we saw in 2020 and 2021. So, I think we can get into a little bit of why that is, later, but I think ultimately if your view is that rates are going to stay higher for longer…I think, the credit side—the way it's priced relative to the way equity is priced today—looks a lot more attractive in real estate.

[00:11:27] Alan Flannigan: Yeah, and that higher-for-longer rate view is penetrating across the markets. In private equity, we've seen—since the Fed started raising rates—a very clear dispersion in terms of what types of private equity are outperforming. And it's the less rate-sensitive sectors, obviously. When debt's part of the capital structure, particularly in leveraged buyouts, borrowing costs are higher. There's less money left over for the residual claim holders, the equity investors. In smaller cap, private equity buyouts, we see this time and time again. Leverage is a lower part of the overall return proposition.

[00:12:05] Andrew Korz: There's more leverage in the large and mega cap deals than there is in the core middle market, lower middle market deals.

[00:12:11] Alan Flannigan: That's right. And we have business operations on both the equity and the debt side. And one of the things that we observe on the debt side is larger firms typically can sustain more leverage on the balance sheet. They're more diverse in terms of their operations. So there's a reason why larger firms tend to be more highly levered.

But when you're thinking about it from an investor's perspective, part of the main reason you're going into private equity is you want to get growth and you want to get growth that's uncorrelated with other things in your investment portfolio. This is where the challenge with public equities comes in, in terms of elevated stock-bond correlation and concentration with the Mag Seven; and the number of negative earnings, publicly traded companies. There's a lot of mess there, but then in private equity, you go in and you say, okay, let me get an uncorrelated source of growth or lower correlated source of growth.

And so we see within the smaller cap segment of private equity, we publish this value creation bridge and we see it's organic revenue growth. It's margin expansion at the lower end of the market that's driving that value increase. Relative to the upper end of the market where that higher borrowing cost has been punishing to investors from a return standpoint, where again, since the Feds raised rates, we've seen the smaller middle market type deals outperform relative to the large caps.

[00:13:27] Andrew Korz: I think this is such an interesting point because actually when one of the things I want to discuss is the dispersive—and that is a word—effect of higher interest rates on asset classes; really every risky asset class that you can think of. One of the things that I've observed during my time analyzing markets is that interest rates have this dispersive effect within markets. When rates are ultra-low, there's this powerful hunt for return; then the TINA, there's no alternative. So you have folks buying even low quality or speculative assets. Companies can survive by just financing themselves with cheaper and cheaper debt.

When rates rise, it has this effect of separating out the winners and the losers. It highlights what returns were driven by durable factors, i.e., margin expansion, revenue growth, and which were more a product of easy monetary policy. And I think it's interesting.

Because you talked about—on the private equity side—core middle market, lower middle market, outperforming upper middle market. In private credit, it's the opposite, where we've seen more resilient credit metrics performance in the upper middle market. And I think, intuitively, that sounds contradictory, but I want to walk through that a bit. Because when you're thinking about private credit and private equity, it's two very different, investment theses.

[00:14:57] Alan Flannigan: Absolutely.

[00:14:58] Andrew Korz: On the private equity side—you're investing in smaller companies—there's more volatility there. Maybe you've got a management team that's not quite as seasoned.

[00:15:06] Alan Flannigan: Sure. Right.

[00:15:07] Andrew Korz: Maybe you've got a younger company that has more uncertainty, but more opportunity as well. So you've got more losers where those smaller companies, those younger companies just don't make it, but you've also got more winners. And the ability to pick those winners can allow you to overcome the higher interest rates, the higher financing costs. On the credit side, you're just trying to avoid losers. You don't care if a company 3x's its revenue.

[00:15:30] Alan Flannigan: You don't capture the upside.

[00:15:31] Andrew Korz: You don't capture the upside. You don't, right. So you're hoping to get your principal and your interest back. If that's the case, you'd rather have the larger balance sheet, the more mature business plan, the more seasoned management team. That's how I square this circle, where it's the larger companies can withstand this, these higher interest rates. That's why we've seen lower default rates for larger, for loans to larger companies. But there's much more ability to drive outsized growth on the lower end of the middle market, and that's why we think that part of the market is so attractive in private equity.

[00:16:07] Alan Flannigan: This concept of interest rate sensitivity—it doesn't just flow through in terms of returns and relative attractiveness of the assets in a portfolio context. It's also where the deal is getting done. What you're seeing with some of the larger end of the private equity market is still some difficulty getting dollars deployed.

[00:16:28] Andrew Korz: I think this dovetails nicely into the next topic I wanted to get into, Alan, which is the shape of the rebound. We've talked a lot about…there's going to be an uptick in activity. Even if rates don't fall a lot. I think we're both pretty confident that there's this backlog of deals. There's a lot of dry powder out there. We're confident that more deals are going to get done. There's this lighter touch regulatory regime that's likely coming. I think we're confident that across these markets, there's going to be more activity and more opportunity.

This has been a really unique two-, two-and-a-half years. We haven't had a recession, but we have had this dry spell correction, whatever you want to call it, in private markets. In thinking about a rebound in 2025 and beyond, I want to talk about the shape of that rebound. Because I think the shape of it will be critical in deciding what are the investment opportunities as we go forward into next year and beyond.

So I want to start with you on the PE side. When you think about…we just talked about the rate sensitivity, how that had a dispersive effect on performance. We think rates will probably stay high. What does that mean for the shape of the private equity rebound in 2025?

[00:17:40] Alan Flannigan: Well, I think the rate picture…it's difficult to predict how that'll go. There's a view that the Fed will continue gradually lowering rates which, which will be helpful…

[00:17:50] Andrew Korz: So, right now, I would say just, not to cut you off, but right now there's about a 60% chance the market's putting on a cut in December. And we're recording this on November 21. The market's only pricing just over two cuts in 2025. We were pricing six cuts in September.

[00:18:07] Alan Flannigan: Right.

[00:18:08] Andrew Korz: Two months ago. So it's been a sea change in terms of the rate outlook. And part of that's the election. Part of that's inflation data coming in a little hotter. Part of that's the really strong growth data we're getting. But I think it's important to remember as you're talking about this, that the market's default setting is that we're still going to be around 4% Fed funds at the end of next year.

[00:18:27] Alan Flannigan: And the other factor in private equity is simply time. Let's not forget most of private equity assets are held in vehicles that are term limited in terms of the fund term. And there's a certain amount of time—they'll go through a fundraising period—for them to deploy those dollars that they've raised. They build, grow the companies and then they exit, and there's a certain amount of time before they're supposed to exit those companies and distribute proceeds back to investors. What we're seeing is really that frigid two-year period that we've had coming through in terms of how many companies are getting exited. And so what we see from an exit perspective, the share of unrealized value in buyout funds continues to skew toward the larger funds. We look back at the data and in 2018, the split between funds over four-and-a-half billion and under four-and-a-half billion in terms of the composition of the unrealized value within private equity funds…

[00:19:25] Andrew Korz: Where are the companies that private equity owns sitting?

[00:19:30] Alan Flannigan: That's right. Are they in large funds or are they in smaller funds? That gives you a picture in terms of what are these companies. Are they large cap companies, are they more middle market? And so in 2018, 57% of the unrealized value in private equity was in funds under four-and-a-half billion in size.

[00:19:48] Andrew Korz: You said 57%?

[00:19:50] Alan Flannigan: Fifty-seven percent; 43% over. Now it's completely reversed. Forty-four percent is under 4.5 billion, 56% is over that 4.5 billion. The composition of the companies that are in private equity funds are getting larger, they're getting bigger, they're in bigger funds. And so what does that mean from an exit perspective?

A, we've not had a lot of exits, so we see the number of companies that historically would have exited by now ticking up. We also see the companies that haven't exited are larger. So what does this mean in terms of getting that activity through the market? Well, from an interest-rate sensitivity perspective, that's exactly why it's the large companies. Because they're the ones where that's a more critical factor in that underwriting process to get to a target rate of return than what you have in your core lower middle market companies.

[00:20:40] Andrew Korz: So, as activity starts to come through, as we get this flywheel going again, what ultimately, how do you see this? You have all this unrealized value sitting in these large funds, they've raised a ton of money. As deal value starts to rev up again, how do you see that playing out? What are the exit avenues that you see those companies exiting by? Is it the IPO window? Is it sales to strategic acquirers? Do we still see significant secondary market activity coming? What do you see there?

[00:21:19] Alan Flannigan: There's a lot of companies waiting in the queue and we track this pretty closely, the number of actual exits versus expected exits. There's some really good data that we track back to 2000 that shows the number of private equity-owned companies invested in a given year and you can see how many exits in each subsequent year and period after that. So it gets a pretty good estimate of what should you expect in terms of activity.

To put some numbers around this, if we had a normal rate of exits, because we've had an accumulation of the number of private equity-owned companies; so if you just had an average rate in line with history, you do roughly 1,500 exits next year. That's pretty close to the all-time high in 2021. We're talking about a significant amount of volume there if we just did an average year.

Right now, we estimate we're roughly 1,100 exits behind schedule. So if you caught up even just marginally in the coming year, you're talking about all-time highs in terms of volume. So the question is: How do you get that volume processed? First of all, it's going to be a difficult couple of years to be an M&A analyst.

You might be able to retire shortly thereafter, but you're going to be working long hours in the years ahead. We track very closely the 2018 to 2022 cohort of PE-owned companies. And the reason why we track that cohort specifically is, they're right in the midst of like elevated rates, lower deal activity. And the vintages before that, we don't see the decline in exit rate as much because they benefited from like the 2021 year where there are a lot of exits being done. So for that cohort specifically, they're getting into that five-, six-year age range. Well, that's right about the time when LPs are starting to look for some liquidity, they might utilize the secondary market to do that.

And increasingly, we're seeing GPs set up continuation vehicles to be able to give existing investors liquidity, bring in fresh investors, to double down on those companies that they're setting up the CVs for. And I think the question is: How much capacity is in that market relative to the deal flow that we see coming? Because we do see an immense amount of deal flow in the coming years. And so I think, when you put that against the backdrop of the IPO window being sometimes open, sometimes closed, maybe you see a revitalization there. But in terms of the size of these companies, there may not be other PE buyers that have funds large enough to buy these larger companies. So you're really thinking IPO or continuation vehicle, secondary market. And so I think it's unique solutions that help process this additional volume that we're seeing.

[00:24:02] Andrew Korz: It sounds like there's no one answer there. You're going to have exits that need to get done, liquidity that needs to be had. And that's going to be done via some combination of public markets, maybe some corporate acquirers. Certainly, it sounds like secondary volume is going to do nothing but go up because it's just the sheer volume of liquidity that we're going to need. And as those exits occur, those large cap funds are going to need to redeploy capital into the market; all that dry powder they have right now is going to need to be deployed. They're going to need to probably get some of these middle market funds and buy up some of those assets. Because that's really the most fertile ground for investments there.

[00:24:43] Alan Flannigan: Yeah. And so this is the second leg of what we call the large cap dilemma. They've raised a ton of money in a very short amount of time. Over the past three years, nearly 50% of all U.S. PE dollars were raised by funds over 5 billion in size. If you go back, and conversely, funds under 1 billion in size have raised less than 20% of dollars in U.S. PE over that same period.

You go back to 2016, the difference in market share, there was 1%. So it's taken off in the direction of large caps. And now they sit on a mountain of dry powder that we estimate is roughly equivalent to three-and-a-half years of deal activity. So how do you get that deployed, especially in a higher rate environment where you've also got investors? The other half of the dilemma, which is, you've got folks that are wanting liquidity on the back end of funds, you've not been able to really provide it. That's the polar ends of this dilemma that they're in. And so that deployment, I think you're absolutely right. They're going to be looking to middle market funds who can sell up the market to those GPs. Those companies have been diligent, they've had good ownership and stewardship before, and that is a dynamic in the marketplace in terms of buyers and sellers that really skews in favor toward the mid market GP.

[00:25:57] Andrew Korz: Yeah, that makes a lot of sense. I do want to touch real quick because it's so related on private credit and our outlook's impact on private credit. I think it's interesting. Private credit certainly has sensitivity to obviously M&A, volume, LBO volume; a significant portion of private credit is financing these sponsor buyouts.

But it's interesting to me because it seems like the sentiment shift hasn't necessarily been there in private credit. Private credit's been the whipping boy of the financial media for a couple years now. There's not enough deals to get done. There's too much capital being raised. That's been the sentiment in private credit. And despite the decline in M&A activity that we've talked about, private credit has continued to ramp up activity. Instead of relying on overall market activity improving, they've just been taking share from banks and taking share from public markets. I think it's interesting to see the sentiment hasn't shifted in private credit in the way that it has in private equity and in real estate. But actually, my view is that the sentiment in private credit should probably be higher than anywhere else.

[00:27:11] Alan Flannigan: There's a lot of deals that need to be financed.

[00:27:12] Andrew Korz: There's a lot of deals that need to be financed. As we see M&A, LBO volumes tick up. That will, almost by definition, increase the origination volume of private credit significantly. You've still got challenges with the banks. Private credit, if you take what we think about its TAM—its addressable market—it's totally about 16% of that market.

So there's this secular tailwind, this eating away at the bank's lunch, if you will. And then you have private credit also pushing into areas like ABF, commercial real estate finance, even parts of banks, investment grade books. So I think there are more tailwinds and actually if you look at dry powder and private credit, you extrapolate out current deal volume per month; we have less than a year's worth of deal value in private credit dry powder right now.

Folks are saying there's too much money that's been raised. I would almost argue, there's too little money that's been raised there. I do want to talk about how private credit is impacted by our outlook for PE. But I do want to get to our final topic here. We've talked a lot about, broadly, what does 2025 look like? What does the rebound look like? Who are the winners? Who are the losers?

I want to throw it to you, and maybe you can start us off with private equity. One important item or theme that we haven't touched on in this conversation that you think is important to the outlook in '25, maybe beyond '25. Something that maybe folks aren't talking as much about, sure what do you got.

[00:28:45] Alan Flannigan: Yeah, I think something I'm very interested to follow is the Trump administration's plans for domestic reindustrialization. The tariff talk, I think there's obviously things to be concerned about from a macro perspective with that. But it seems, from the context and resources that we have on the Hill, in D.C., familiar with plans from the administration, they would say that the tariff is to really reindustrialize the U.S. It's not as much a leverage negotiating tool as it was before. This is really about bringing back high quality manufacturing to the U.S., getting capital invested here domestically and building up those strategic industries over the long term. And so what does that mean for private equity?

Well, every time that you do a major capital intensive projects…my wife's a project manager for an engineering firm. It involves a lot of moving parts and a lot of companies, family-owned businesses, smaller, lower middle market type companies to make those projects come to fruition. And so, one of the things that we really emphasize for investors—when you're in a market where public equities are expensive overseas, the opportunity set doesn't appear to be very attractive, get closer to your growth. Your growth is here in the U.S. And this would be a significant tailwind to that in this market. And again, in that kind of lower core middle market.

[00:30:15] Andrew Korz: I think it's a great point. And as we point out in our outlook, middle market companies are growing revenues at 13% year on year. That's the highest we've seen in the history of this dataset that we track.

[00:30:42] Alan Flannigan: Absolutely.

[00:30:42] Andrew Korz: And it's higher than it was when inflation was 8%, 9%. A lot of that's probably because of the demand side industrial policy from the Biden administration; where you had the Chips Act, infrastructure, IRA, you're probably going to get something more of a supply side. Where Trump's going to try to put tariffs on, incentivize companies to invest here. But the impact may be the same where you, to your point, get all of these secondary…and the picks and the axes basically coming in and benefiting from all this spending that's happening in the U.S. economy. So maybe I'll just bring us home with one for private credit and one for commercial real estate.

[00:31:04] Alan Flannigan: Sounds great.

[00:31:04] Andrew Korz: On private credit, one thing we wrote about, it's a floating rate asset class. The yield is predicated in part on where the Fed goes. I think this idea, however, that the attractiveness of private credit is sensitized one to one with rate cuts, I think is a false premise. Just to reiterate, we're expecting maybe three cuts between now and the end of 2025 in terms of what the market's pricing.

Even if that happens, let's just play that through. Number one, I think real yields in private credit are going to remain really attractive. So, end of next year, you're looking at a Fed funds right now, market's pricing about 3.85 at the end of 2025. Private credit in that scenario probably yields around nine, nine-and-a-half.

If you assume inflation's 2.5% or so, that's a seven-ish percent real yield. That's incredibly attractive historically, and it's more attractive than when the nominal yield was 11.5, and inflation was six or seven. So, real yield's historically attractive even in that scenario, that the Fed cuts three times between now and the end of next year.

I think the second thing, we've talked a lot about this, you spur M&A activity, which obviously provides a lot more lending opportunities out there for private credit lenders. I think maybe what's not being talked about is that if there's a higher supply of potential deals, you could actually have a situation where you drive spreads a little bit wider. Because the supply of deals is higher, it drives pricing a bit wider. So I could see that being a scenario and maybe a surprise in 2025, is the economy stays strong, but spreads in private credit widen a little bit.

And then finally, I think modestly lower rates should help, obviously by definition, increase debt service coverage, which all else equal, should help reduce expected defaults and losses on loans. So I think it's one critical question we get all the time on private credit. And we do have an article on this in our outlook where we explain this in further detail. But I think it's important for folks to think beyond just, oh, the Fed's cutting rates, yields are going to fall. Now's not the time for private credit.

[00:33:08] Alan Flannigan: No. And I mentioned this at the beginning, there's a buzz around this place right now and it's because, in these markets it really is the sentiments change. Sentiments coalescing around, hey, there's going to be more activity. There's going to be more opportunities to do deals. There's going to be, from a portfolio manager perspective, more exciting and attractive opportunities that you can go out and pursue and bring into a fund and really drive a differentiated source of return for investors.

[00:33:32] Andrew Korz: Yeah, 100%. And I'll just end with commercial real estate, which I think I've talked about before and I talked about it a lot in our commercial real estate outlook.

Look, the supply side, I don't think people appreciate how significant this shift is where we started building a ton of new properties in 2021 when rates were really low. Those buildings, especially industrial and multifamily, which are the core secular growth stories in real estate; they've been delivered last year and this year.

As we go into the next couple of years, higher rates have just completely sapped the ability of developers to start new projects. So since the end of '22, we've started very few new construction projects in the U.S. So in these areas like industrial, multifamily, which have had a lot of new properties come online…when we look into '25, '26, '27, unfortunately for society and for people looking to rent apartments, there's going to be very few new apartments finished.

For investors, I think it's one of the biggest tailwinds we have for fundamentals. Because think about it. It's Econ 101. If demand for space remains strong and the growth in supply slows dramatically, that equals higher prices, i.e., higher rents in this case.

I think the outlook for fundamentals, assuming you believe the economy stays strong, demand remains strong, the construction is just not going to be there. So I think as we get into next year, we're going to start to realize that that's coming through and it's going to open up a lot of opportunities across real estate. Again, we think the debt side remains more attractive, but it's going to open opportunities on the equity side as well.

Alan, that was great. This was a lot to talk about in whatever 30, 40 minutes we just had. Again, we did write our inaugural Private Markets Outlook, where we cover this and a lot more. We cover the growth of private wealth in private alternatives. We cover middle market fundamentals, which I think is a really interesting and unique topic that we approach in our outlook. So, again, it'll be in the show notes, it'll be on fsinvestments.com. Give it a read. Feel free to reach out to us with any questions. But, with that, Alan, thank you for your time. This was fun.

[00:35:42] Alan Flannigan: Yeah, thank you. Enjoyed it.

[00:35:43] Andrew Korz: Awesome.

[00:36:00]