MA Financial Group

2024
Investment Outlook

Asset Management

2024 Investment Outlook

Welcome to MA Financial Group's inaugural Investment Outlook.

Our investment professionals share their views and insights into the year that was and the year ahead across key asset classes including private credit, real estate, equities, private equity and venture capital.

2023 was an interesting time in global financial markets. Asset values held up reasonably well despite uncertainty around inflation and interest rates, while the bond market experienced significant volatility.

We witnessed an increasing trend towards investors seeking opportunity in defensive alternatives as they continue to become comfortable with the diversification benefits and risk/return and duration characteristics of private market assets.

We remain cautiously optimistic for Australia's economic outlook for 2024 and our investment teams will continue to seek opportunities based on sound market fundamentals, investing with discipline and rigour.

Regardless of market conditions, our focus remains on delivering attractive long-term risk-adjusted returns and co-investing in our strategies alongside our investors, aligning our interests with theirs.

We hope you enjoy reading our 2024 Investment Outlook.

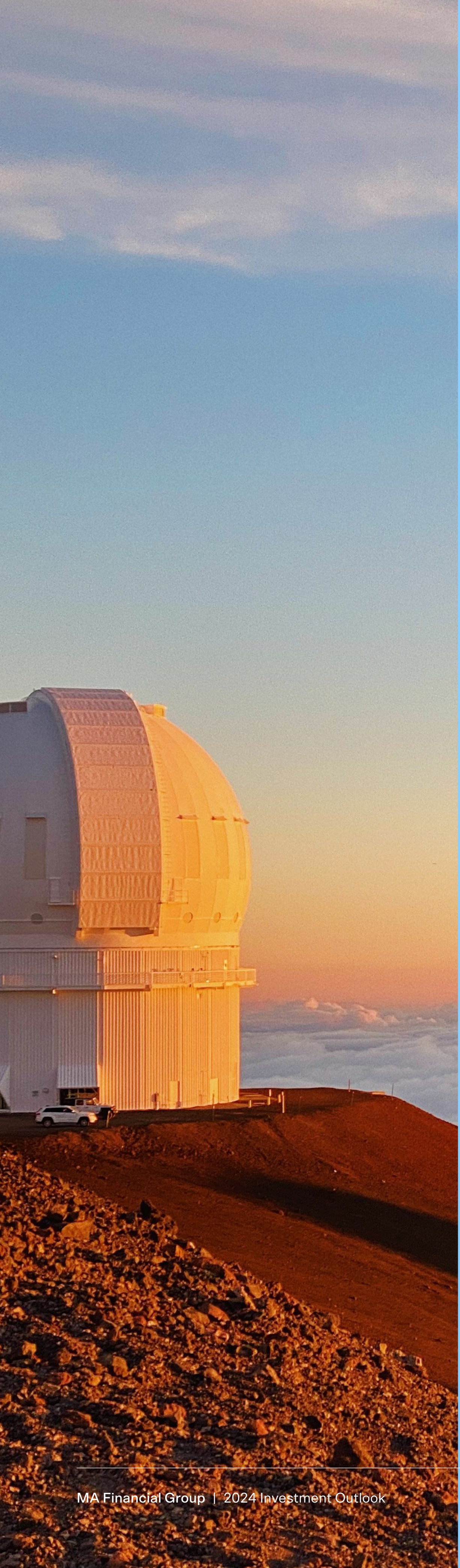
Sincerely,

Andrew Martin
Head of Asset Management
MA Financial Group

Andrew Martin

Head of Asset Management

Key themes



Economic growth defiant through rising interest rates and expected to continue as the rate cycle comes to an end

Investors seeking defensive assets, favouring resilient alternatives including private credit and alternative real estate

Private credit was the asset class of 2023. Opportunities in 2024 will be dominated by areas where banks have exited, earning investors outsized returns for the level of risk

Structural shift to private lenders continuing in 2024 for real estate credit. Cautious and patient deployment of capital, manager experience, platform strength and exit strategies are fundamental to success

Defensive buying opportunities in alternative real estate with favourable yields compared to core real estate. Increased opportunities to acquire quality real estate assets on attractive terms, and at meaningful discounts to replacement cost

Anticipate a continued shortage of private growth capital in 2024. This should result in a sustained flow of well-priced investment opportunities for private equity and growth credit investment

Long-term performance of equities set to continue as enhanced efficiency and strategic cost-cutting measures flow through

Macro overview

2023 was an interesting time in global financial markets. Asset values held up reasonably well despite uncertainty around inflation and interest rates, while the bond market experienced significant volatility.

In a year where interest rates in Australia increased for the second consecutive year, inflation declined to 4.1% from its 2022 peak of 7.8%.[1] Australian and US housing markets remained elevated despite substantial interest rate increases.

The Australian and US economies proved more resilient to disruption and rate hikes than widely anticipated. Oil prices were contained despite geopolitical unrest in Ukraine and the Middle East and in the face of several US mid-tier banks failing in Q1 2023, financial markets reported a strong finish to a strong year with equities and bonds rallying on the back of falling inflation.[2]

Outlook for 2024

The 2024 outlook for the Australian economy is cautiously optimistic, with GDP (Gross Domestic Product) growth expected to remain positive as inflation comes off its peak and the economy continues to adjust to higher interest rates and cost of credit.

It appears central banks have navigated the challenge of utilising interest rate levers to manage inflation. A soft economic landing is now the base case for most investors, and the Reserve Bank of Australia (RBA) is indicating the same, although higher interest rates will be a feature of the investment landscape as inflation pressures remain elevated.

Consumer and corporate performance have been supported by the level of excess savings in the economy, although this has begun to deplete from its highs of the last few years.[3] Consumer and business confidence figures into Q1 2024 are keenly anticipated, as well as employment growth, as markers for the likelihood of an economic soft-landing eventuating.

Discretionary exposed segments of the economy and businesses with wage-driven margin pressure in competitive sectors (where higher costs cannot be easily passed on through higher prices or revenue) could face some genuine squeeze points by mid-2024. We do not anticipate any systemic issues.

Interest rates at or near their peak

The rate tightening cycle is probably not over everywhere, and history tells us market cycles often last longer than anticipated. More favourable inflation data suggests we are much closer to the end of the inflationary cycle than the beginning and further rate rises are unlikely in Australia.

In the US, where rates increased earlier and by far more than in Australia, the US Federal Reserve is also predicting a soft landing for the US economy in 2024. If there are signs of emerging stress, the central bank could certainly use their interest rate levers to support the economy. With more leeway to cut rates (compared to the RBA) there are reasonable prospects of a handful of rate cuts in the US by late 2024.

Bond yields in Australia and the US rose sharply throughout 2023, peaking at the end of October at just under 5% then declining (suddenly) over the final few months of the year to 3.9%.[4] The Australian stock market moved around, finishing the year strongly with the ASX200 up 12.4%.[5]

Investors are seeking pockets of opportunity and defensive alternatives as they become increasingly comfortable with the diversification benefits of private market assets and the different risk/return and duration characteristics they can deliver. We favour resilient and defensive sectors including private credit and alternative real estate.

1. Consumer Price Index, Australia, All groups CPI, annual movement (%), December 2023 quarter, Australian Bureau of Statistics, www.abs.gov.au. Peak inflation in Australia occurred in December 2022.
2. Consumer Price Index, Australia, All groups CPI, annual movement (%), ABS, www.abs.gov.au
3. Australian System of National Accounts, ABS, www.abs.gov.au/statistics/economy. The household saving ratio decreased to 4.3% in 2022/23, down from 15.2% in 2020/21.
4. Bloomberg, www.bloomberg.com
5. Australian Securities Exchange, www.asx.com.au

Private credit

The asset class of 2023

Private credit was the asset class of 2023. As interest rates rose rapidly, the returns on floating rate debt trended towards a range of 8%–12% (on a net basis). These are equity-like returns, in an asset class more senior in the capital structure, delivering investors with highly attractive returns relative to risk.

Significant credit market dislocation in a higher rate environment did not materialise with consumer and corporate borrowers performing resiliently in the wake of substantial shifts in the interest rate outlook.

The importance of being a fundamental-oriented, broad-based private credit investor was highlighted throughout 2023. In some areas, such as leveraged loans and sponsor-backed debt, there was a dearth of deal activity as higher rates made it harder for private equity to make acquisitions (and hence lower need for financing). For investors with a broader remit, there were significant opportunities to capitalise on a generational opportunity in private credit.

Attractive deal flow in specialty credit arose following the US regional banking crisis and ongoing bank streamlining occurring in Australia (and globally) shifting all types of lending outside the banking system. There were also attractive opportunities to partner with banks in co-lending models.

Avoiding losers in 2024

Private credit in 2024 will be about avoiding the losers, not picking the winners. This will require a sharp focus on strong fundamentals with robust security, asset coverage and downside protection and the rights and controls lenders need to safeguard capital if required.

The best opportunities in private credit over 2024 will likely be in areas where banks have exited for structural or regulatory reasons, or where market forces more generally mean there isn't a flood of money chasing the same transaction. In larger, more highly contested deals, and large syndicated loans, debt terms are likely to continue to progressively weaken further over time.

Smaller, mid-market transactions (lending on a direct or club-basis with real influence over terms and pricing) are likely to be negotiated on attractive terms, earning outsized returns for the level of risk.

In asset-backed and specialty credit, highly diversified portfolios of loans with substantial asset over-collateralisation gives a high degree of downside protection if stress starts to emerge at the underlying borrower level.

When lending to companies, the best opportunities in 2024 will be borrowers with a strong market position in non-cyclical industries, and which are 'price makers' and not 'price takers' ensuring they can deal with the impact of higher input or wage costs or a period of sustained inflation and supply-chain disruption.

There are also opportunities to partner with banks as they continue to pursue capital optimisation initiatives or partner, rather than compete with private credit funds.

Strong growth for real estate credit, but a careful approach necessary

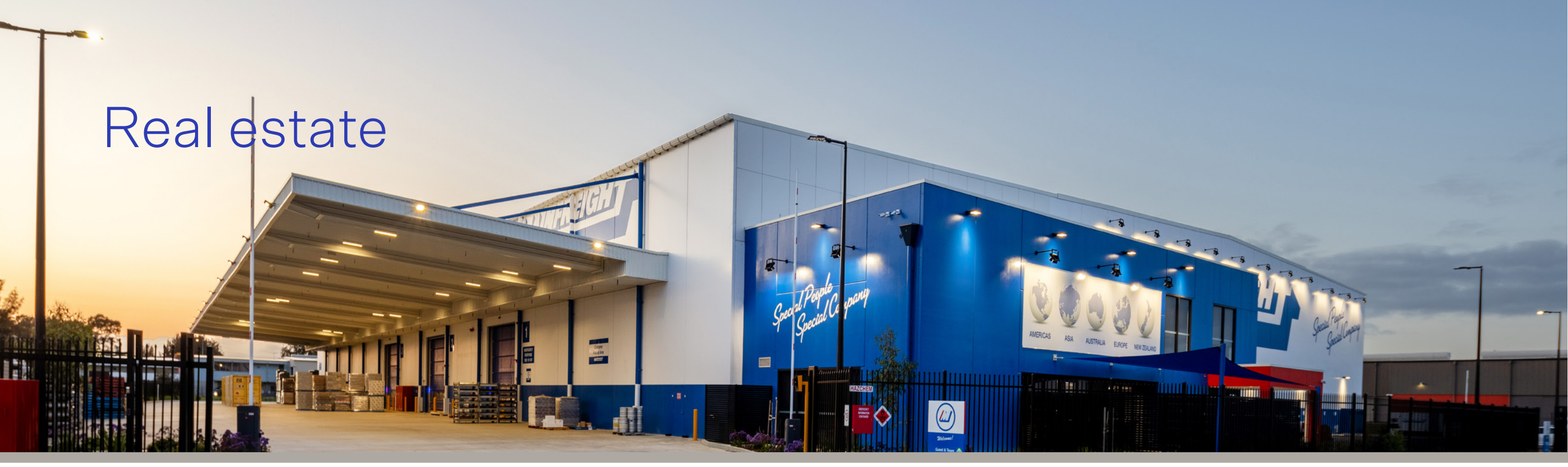
Australia's vast and highly diverse residential market continues to grapple with acute undersupply in the face of soaring demand. Despite the market imbalance, the forecast for residential prices over 2024 remains relatively benign as several key variables are in play.

Record levels of immigration, demographic changes, increasing average household size and acute affordability pressures are all impacting both the rental and owner-occupier market. A wide range of outcomes over 2024 is possible, depending on location and depth of the market. We believe values will remain strongest in markets with the most acute demand/supply imbalance, for example metropolitan Sydney.

The key questions for real estate credit investors will be the impact of the increasing affordability crisis on sales and prices, and which pockets of the market will continue to perform and offer opportunity.

Undoubtedly, the opportunities for private lenders to finance the growing demand for real estate credit will continue over 2024 as they work to complement the major lenders in addressing the critical housing shortage. Sound market fundamentals, security through first lien mortgages and an experienced manager to assess underlying value and exit strategies will remain critical to success.

Real estate



CORE

A complicated year for core real estate

2023 was a complicated year for Australian core real estate with uncertainty the prevailing theme.

Sharply rising interest rates, volatile bond yields, sticky inflation and the threat of an economic slowdown were major macro hurdles as core office real estate owners saw equity values soften. Transaction levels across all global core real estate were nearly 40% below pre-pandemic averages over the year with investors in unlisted funds queueing for redemption opportunities.[6]

The quantum of transactions in the office market reduced materially as investor demand was impacted not only by higher interest rates but also concerns around demand for office assets as work habits change. Office values remain under pressure due to enduring questions around the durability of long-term tenant demand, where Australia's national CBD office vacancy rate has reached just under 15% (the highest level since the mid-1990s).[7]

In the face of declining household savings and weaker spending on discretionary retail, Australian retail turnover remained relatively resilient.[8] Bolstered by record migration levels and the wealth effect of rising residential property prices, retailer demand held up, although the leasing market was generally flat across the nation throughout 2023. With new completions concentrated in the neighbourhood sub-sector, the total supply of retail space remained low compared to historical averages.

Occupier demand continued to outstrip supply in the prime industrial and logistics market where fundamentals and strong rental growth supported remarkably low capitalisation rates (prime yields in Sydney ~5%[9]) despite capital market hesitancy.

A shifting risk/return landscape in 2024

The 2024 outlook remains dominated by a shifting risk/return landscape. Real estate is especially susceptible to the direct impact of debt financing and indirect impact of increasing risk-free-rate benchmarking. Compounding this is the significant structural changes affecting all sectors of the core real estate market.

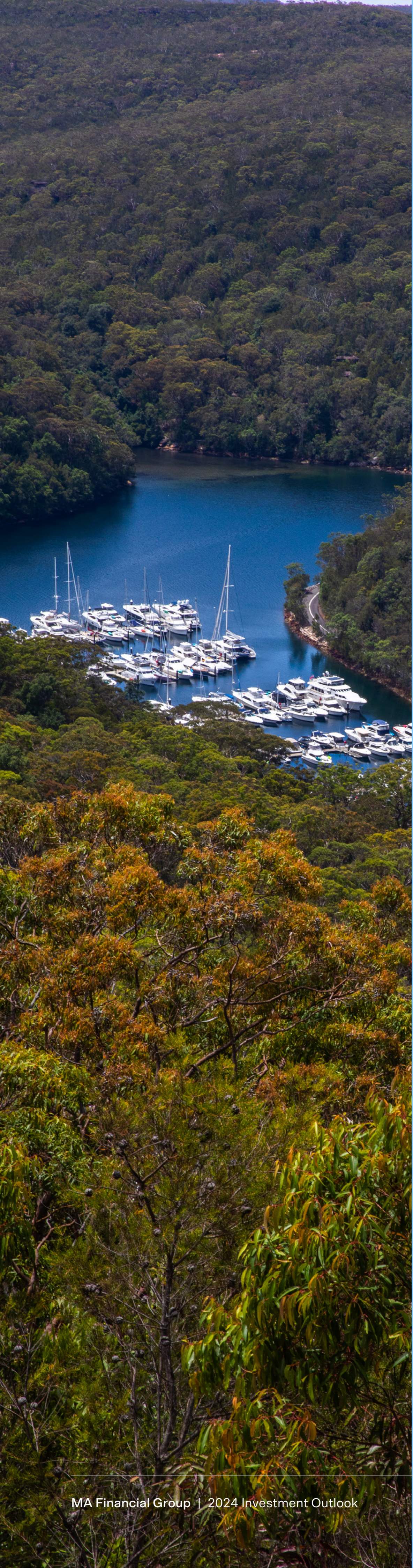
As credit conditions remain tight, refinancing existing assets and taking on new investment opportunities is challenging. The higher interest rate environment means investors require a higher yield for core real estate. We believe independent valuations for some real estate assets have further to fall and more vendors are likely to meet the market over 2024.

As we work through the tail end of the office market downcycle and supply is constrained over the next few years by increased construction and capital costs, there will be a reduced pipeline of new development. Nonetheless, a significant amount of capital is waiting to be deployed into core real estate by both institutional and private investors.

Despite the recent challenges and subdued outlook, Australian core real estate has historically played a critical role in portfolio allocation. Significant diversification benefits (low correlation to equities and bonds), strong institutional investor interest in the Asia-Pacific region and the consistent long-term average performance of core real estate is likely to underpin opportunistic buying. Transaction volumes are expected to increase over 2024 as interest rates peak and more vendors adjust their expectations.

We believe when a clear baseline for values is established as the cycle progresses and commercial real estate assets are transacting at meaningful discounts to replacement cost, attractive investment opportunities will emerge.

6. Core real estate refers to office, retail, industrial and logistics. Quantum of transactions in first three quarters of 2023 compared with average of first three quarters in 2015-2019, MSCI, www.msci.com
7. Australian Office Overview & Outlook Q4, 2023, JLL, www.jll.com.au
8. Australian Bureau of Statistics, Retail Trade, Australia, www.abs.gov.au. The ABS has reported the seasonality of retail turnover has changed since the COVID-19 pandemic and the increasing popularity of Black Friday sales in late November. An abrupt change in spending patterns has led to extreme movements in turnover impacting the seasonal adjustment process which requires the previous three-years of data to estimate seasonality and calculate seasonal factors.
9. Australian Industrial Overview & Outlook, Q4 2023, JLL, www.jll.com.au



ALTERNATIVE

Defensive buying opportunities

Significant structural and cyclical trends occurring concurrently with rapidly rising interest rates resulted in some investors reassessing their real estate allocation strategies in 2023 to take advantage of the great buying opportunities in alternative real estate assets.

The value of an asset is typically a function of its earnings potential. With alternative real estate, by effectively controlling the tenant and landlord relationship there is far greater ability to not only maximise the value of the land over time, but also drive and unlock earnings upside and value-add opportunities associated with the going concern interest.

Like all assets, alternative real estate is subject to macro challenges including higher inflation and rising interest rates, however, valuations tend to be less interest rate sensitive than traditional core real estate assets. Earnings also have greater protection from inflationary pressures as prices can be more readily reset and higher costs passed through to end users of the product or services provided.

As a number of alternative real estate sub-sectors mature in Australia, more sophisticated, corporatised operators draw deeper pools of capital away from traditional asset classes in search of less correlated and better risk-adjusted returns.

Strong fundamentals meet cyclically-low pricing for Australia's accommodation hotels

Buying opportunities not seen since the period following the 2008 global financial crisis are emerging in Australia's accommodation hotel market.

Market dislocation caused by substantial increases in construction costs and the disruption to the travel industry due to the global pandemic have resulted in the opportunity to acquire assets at a meaningful discount to replacement cost. Under the right operator, with the right expertise and active management strategies offering scalable growth potential, accommodation hotels are a compelling investment case.

We see significant buying opportunities in 2024. This is as some existing owners will struggle to rebalance their capital structures with higher interest rates and lower valuations (and without access to new equity) along with the convergence of surging population growth, strengthening tourism figures, broad-based demand drivers from corporate and leisure sectors and positive demand/supply market fundamentals.

Unique investment opportunities are also arising for specialised alternative real estate assets like marinas and pubs. Underpinned by positive supply/demand fundamentals, yields remain favourable relative to core real estate and the strength and recurring nature of revenue offers investors stable and durable income through a range of economic cycles.

Equities

Defying expectations

Despite a prevailing sense of scepticism entering 2023, financial markets and economies once again defied economists, commentators and investors' expectations.

After navigating a challenging 2022, the US stock market rebounded impressively with solid gains predominantly realised in the latter part of 2023. Leading this resurgence were large-cap technology stocks, riding a wave of renewed excitement around artificial intelligence (AI), propelling the Nasdaq to its most successful year since 2003, notching an impressive 43% gain.[10]

The S&P500, with its substantial allocation to technology stocks, surged by 24%, while the Dow Jones index (representing the 'older-economy') posted a commendable 13.7% gain.[11] Smaller companies, although slower to follow suit, managed to wrap up the year with the Russell Micro showing a 7.7% gain after staging a notable 30% rally in the final two months of 2023.[12]

Australian equities lagged their US counterparts, reflecting a higher relative weighting to financials and resources versus technology. Notably, technology stocks comprise a mere 2.3% of the ASX200 index, significantly lower than the 29% in the S&P500.[13] The ASX200 posted a respectable 12.4% return, while the Small Companies index achieved 4.7%, and the Emerging Companies index ended at -2.4%.

The robust recovery in the stock markets mirrored a shift in sentiment as inflation eased throughout the year, juxtaposed against sustained economic growth. Bond markets exhibited high volatility, with the US 10-year bond yield initially rising sharply before an equally swift descent, ultimately concluding the year largely unchanged.

Despite the US Federal Reserve's interest rate hikes, the US economy side-stepped the anticipated recession. Federal Reserve Chairman Jeremy Powell, acknowledging tempered inflation, signalled a shift towards rate cuts in 2024, sparking renewed optimism among equity investors.

The recent years underscore the unpredictable nature of equity markets, yet their long-term track record highlights the ability to deliver appealing returns. As the late Charlie Munger wisely observed, "God knows where the world is headed. I just think that one way or another, the world muddles through."

Long-term equity performance to be sustained

Companies, having navigated a challenging environment, are poised for enhanced efficiency in 2024 through strategic cost-cutting measures. The integration of AI holds the exciting promise of even greater productivity and potential innovative breakthroughs.

With private equity flush with cash and numerous small companies yet to participate in the improved equity market performance, a surge in corporate activity (characterising the closing months of 2023) is likely to continue during 2024.

We anticipate a sustained favourable environment for equity returns over 2024. Embracing a long-term perspective and investing in high-quality companies with demonstrated resilience across various economic cycles should provide some protection against market volatility.

10. NASDAQ, www.nasdaq.com
11. S&P Dow Jones Indices, www.spglobal.com
12. The Russell Microcap Index measures the performance of the microcap segment of the US equity market. Microcap stocks make up less than 2% of the US equity market (by market cap) and consist of the smallest 1,000 securities in the small-cap Russell 2000 Index, plus the next 1,000 smallest eligible securities by market cap. FTSE Russell, www.ftserussell.com
13. Australian Securities Exchange, www.asx.com.au

Private equity and venture capital

Limited availability of growth capital

Valuation resets for private growth businesses continued during 2023 in line with public market declines, particularly over the first half.

Businesses in the private sphere continued to refocus on profitability at the expense of growth due to a limited availability of growth capital in 2023.

We saw a significant step-up in 'take-private' activity across technology companies on the Australian Securities Exchange (ASX), demonstrating significant inherent value in many growth-stage businesses. The lack of capital availability places significant strain on business solvency for those who need it.

Private investors with capital to hand, predominantly private equity (PE) funds and PE-backed corporates, are capitalising on the reset in valuations to become active acquirers in both public and private markets, consolidating with competitors through merger and acquisitions (M&A) activity.

Increasing M&A activity likely with some confidence returning in 2024

This year, we anticipate a continued shortage of private growth capital which should result in a sustained flow of well-priced investment opportunities for ventures, PE investment and growth credit.

Further M&A activity based on strategic consolidation is likely which in turn should drive private market pricing for exits.

Recovery in public market valuations during the second half of 2023 suggests some confidence returning and, while we are cautious around the economic outlook over 2024, the reactivation of initial public offerings (IPOs) would be a positive signal for growth-oriented businesses.

About MA Financial Group

We invest. We lend. We advise.

We are a global alternative asset manager specialising in private credit, core and operating real estate, hospitality, private equity and venture capital as well as traditional asset classes. We lend to property, corporate and specialty finance sectors and provide corporate advice.

Our investment teams have diverse skill sets and experience across a range of strategies and market conditions and are focused on delivering long-term growth. Our conviction runs deep and as testament to this we co-invest in many of our strategies alongside our clients, aligning our interests with theirs.

More information

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