On June 23, 2016, Britain voted to leave the European Union (“EU”). The drama that ensued could easily have been lifted from an episode of *House of Cards*. Meanwhile in continental Europe political and economic prognosticators were forced to consider the worst. To date, an uneasy tension prevails and the worst has not come to pass. Central banks quickly eased or maintained dovish monetary policy, and the UK government has established a timeline for negotiating its separation from the EU.¹ But, the election results across the US and Europe during 2016 and 2017 could change the political landscape, with significant consequences for Britain’s exit (“Brexit”) discussions and Europe at large. The only thing that can be said with certainty is that we must be prepared for a prolonged period of uncertainty.

The current atmosphere in Europe is particularly pertinent to Private Markets, which tend to benefit from market inefficiencies, including those created by volatility. However, credit markets have behaved orderly, public equity markets are up (with the exception of certain areas of the listed Real Estate market) and large amounts of equity dry powder have led to deployment pressure.² The combined result has been a continuation of frothy valuations for completed transactions, which has further supported existing portfolio valuations. The largest impact experienced by Private Markets to date has been reduced transaction volumes across the UK and Europe, as managers find their footing in today’s uncertain

¹ Conservative Party Conference, October 2, 2016.
environment. In response, and with the benefit of hindsight following the global financial crisis ("GFC"), StepStone recommends investing in European Private Markets opportunistically, and with a bias towards best-in-class managers and assets and strategies that are well-suited to volatility while high levels of uncertainty persist.

Immediate Political Aftermath in the UK
The UK’s decision to exit the EU surprised political observers and public equity markets alike, as seen in Figure 1. The UK now represents the first country to potentially withdraw from the 28-member political and economic bloc. In the referendum’s wake, the UK’s political establishment devolved into chaos. Immediately after the result was announced, Britain’s prime minister, David Cameron, declared that he would resign, and former mayor of London, and prominent Brexiteer, Boris Johnson, fell from grace almost as quickly as he had emerged as the odds-on favorite to replace Mr. Cameron. Amidst other resignations, machinations, name-calling, and a series of ballots, Theresa May became prime minister ahead of the anticipated October timeframe.

Mrs. May quickly appointed her cabinet. She named David Davis Secretary of State for Exiting the European Union and Mr. Johnson Foreign Secretary, making Brexiteers responsible for ensuring that the UK’s exit from the EU leaves the UK in the strongest possible position.

The prime minister is responsible for invoking Article 50 under the Lisbon Treaty, which will set in motion a two-year negotiation period for the UK’s departure from the EU. Though Mrs. May would like to trigger Article 50 by March 2017, Britain’s High Court ruled that she cannot without Parliament’s approval. The May Administration’s appeal is sitting with the Supreme Court, which will hear the case in early December and make its ruling early next year. StepStone expects that detailed negotiations on the UK’s future relationship with the EU may last several years.

ECONOMIC CONSIDERATIONS
Figure 1 highlights how the public equity markets fell overnight. Notably, the FTSE 250, which covers domestic UK companies that

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2 Ropes & Gray, November 2016.
Un-United Kingdom

Almost everyone projected that the UK would vote to stay in the EU. On the day before the referendum opinion polls forecast the likelihood of a “Remain” vote at 55%. Even the bookies got involved, placing the odds Britain would vote to remain at “1/4 on,” which implied an 80% probability of Remain winning; yet “Leave” won 52% of the vote.

Leave won a majority of votes in England and Wales, but the majority of Northern Ireland voted to remain, as did every council in Scotland. The majority of 18-to-45 year olds voted to remain, while the majority of those over the age of 45 voted to leave.

These inconsistent results have led to claims that Scotland and Northern Ireland could seek independence from the UK.

In 2014, Scotland held a referendum on independence. In an odd twist, the people of Scotland voted to remain part of the UK, as leaving meant they would no longer belong to the EU. While there appears to be support within the electorate for a second independence referendum, leaving the UK would place tremendous pressure on the country’s finances, given that Scotland would have to rely heavily on oil sales to fund its operations. With oil selling at about US$50 per barrel, now would not appear to be an ideal time to undertake such an effort.

While Northern Ireland has not tried to leave the UK, doing so has become a topic of discussion since the Brexit vote. As members of the EU, Northern Ireland and Ireland have historically elected not to erect borders between their two countries. The Brexit vote could lead both countries to do so. Alternatively, as promoted by Sinn Fein, a political party, Northern Ireland and Ireland could reunite.
when it devalued further as a result of Mrs. May’s stated expectation that Article 50 be triggered early next year, resulting in fears of a “hard Brexit” that could potentially sacrifice the UK’s access to the single EU market.

The UK now faces an uncertain economic environment, with businesses bracing for a downturn. After cutting its GDP growth forecasts for 2017 and 2018, the Bank of England (“BoE”) announced a stimulus package meant to buoy the UK economy.¹

The BoE Monetary Policy Committee’s measures included a base rate reduction from 0.5% to 0.25% (to stimulate borrowing), the lowest level in the BoE’s 322-year history; a plan to buy £60 billion of government bonds over a six-month period (to put downward pressure on Gilt yields and encourage investors to buy riskier assets); a £100 billion loan program for banks (to encourage banks to lend cheaply to UK companies); and a pledge to purchase up to £10 billion of corporate bonds over the next 18 months.² These measures, and the BoE’s declaration that all elements of the stimulus package can be intensified, signaled that it is more focused on supporting consumer sentiment and business activity than on devaluation of the GBP.

While the UK has braced for the worst, consumer confidence improved in August and September, returning to pre-Brexit levels. As seen in Figure 3, the UK services sector, which accounts for approximately 80% of Britain’s economy, rose by a record 5.5 points from July to August, stirring hopes that the UK would avoid a recession. Growth in the services sector was also complemented by signs of a recovery in manufacturing and construction in August. However, StepStone believes that monthly surveys should not be relied upon in isolation; they often exaggerate broader economic trends that should be considered for longer.

In late-September, the BoE’s Financial Policy Committee acknowledged that public markets have quieted since the referendum, but warned that the risk to the UK real economy of a “sharp adjustment” remains elevated, particularly as it relates to the commercial Real Estate market and the potential for foreign investors to divert money flows away from the UK.³

While there is no telling the ultimate impact of this historic event on the UK economy, consensus is that the damage caused by Brexit will be much less than the hit to UK GDP that was experienced during the aftermath of the GFC, as shown in Figure 4.

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² Ibid.
³ Record of the Financial Policy Committee Meeting, September 20, 2016.
Over the medium- to long-term, we believe real GDP growth will depend on the nature of new trade agreements with the EU and other sovereign nations, who hesitate to negotiate with the UK until its relationship with the EU is defined. Concerning is that the UK has not negotiated a trade agreement in over 40 years. As long as Britain is part of the EU, existing trade agreements will remain in place.

Meanwhile, in the EU, the president of the European Central Bank (“ECB”), Mario Draghi, proclaimed that “the economic recovery in the euro area is expected to be dampened by still-subdued foreign demand, partly related to the uncertainties following the UK referendum outcome.” However, economic data have not shown a major negative impact from Brexit concerns on the EU economy to date. As illustrated in Figure 5, the EU remains in a state of slow economic growth, despite unprecedented levels of monetary stimulus pre-referendum. Post-referendum, the ECB has maintained key interest rates at previous levels as it monitors Brexit’s impact. However, Mr. Draghi has stated that those EU countries that can spend more should, to complement monetary policy. This concern is particularly acute in the context of ongoing political uncertainty in certain EU members.

POLITICAL CONSIDERATIONS

The referendum was the first step in a long and complicated process of the UK extricating itself from the EU. The Leave vote has triggered a period of economic and political uncertainty, while the UK’s relationship with Europe is recast and the political landscape adjusts to new realities.

In parallel, as detailed in Figure 6, several events could affect the political landscape. The US election results, the Italian

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7 Introductory Statement to the Press Conference, September 8, 2016.
8 European Central Bank.
constitutional referendum in December (which could result in the fall of the Renzi government), the presidential election in France (2Q17), and the parliamentary election in Germany (3Q17) all demand close attention, as they have the potential to change the political landscape with very significant consequences on Brexit discussions. If we’ve learned anything in recent months (aside from the inaccuracy of current polling techniques), it is that electorates in many nations are divided, with broad discontent among working class families in non-urban areas who support populist movements. The world is watching to see if this trend toward populism continues in upcoming elections across Europe.

As these events unfold, the UK government must consider a range of alternatives to EU membership. While formal negotiations haven’t begun, and EU member state leaders have expressed that such negotiations will not occur until the UK invokes Article 50, informal discussions have commenced. StepStone believes it is in all parties’ interests to informally discuss as many elements of a broader framework as possible before triggering Article 50, as this will initiate a fixed two-year period within which all negotiations must be finalized.

The UK government will likely seek to secure a bespoke deal with the EU that addresses the sensitivities of Leave voters, while at the same time ensuring that Brexit leaves the UK in the strongest possible position, as seen in Figure 7.

The EU will likely seek to set precedents during its negotiations with the UK that will discourage other disillusioned EU member states from pursuing a similar path to that of the UK, while also exploring creative concessions to address critical UK considerations.

In any event, both parties may be required to make difficult concessions that fall short of their respective aspirations in order to reach an agreement.

**Impact on Private Markets Asset Classes**

As the world has digested the results of the referendum, StepStone has levered its unique vantage point, enabled by its privileged relationships with a wide range of Private Market managers, to objectively measure and evaluate the immediate and potential longer-term impact of Brexit on Private Markets.

**FIGURE 7 | LEAVER SENSITIVITIES / “STRONG POSITION”**

<table>
<thead>
<tr>
<th>Element</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Immigration</strong></td>
<td>Control immigration in order to reduce its strain on public services and employment of UK citizens (e.g., points-based system), while preserving the right for UK citizens to live / work in the EU.</td>
</tr>
<tr>
<td><strong>Sovereignty</strong></td>
<td>Maintain national sovereignty through self-government (e.g., legislation and regulation) without influence / control by the EU.</td>
</tr>
<tr>
<td><strong>Economy</strong></td>
<td>Stimulate economic growth by negotiating better trade deals with non-EU members (e.g., China), while maintaining the free flow of capital, goods and services with the EU on a tariff-free basis.</td>
</tr>
<tr>
<td><strong>Public Services</strong></td>
<td>Redirect EU contributions toward UK public services (e.g., NHS), while maintaining the benefits of access to the single EU market (cost- / tariff-free).</td>
</tr>
<tr>
<td><strong>Security</strong></td>
<td>Freedom to ensure homeland security at all times, particularly in the midst of migration crises.</td>
</tr>
<tr>
<td><strong>Foreign Criminals</strong></td>
<td>Ability to deport foreign criminals</td>
</tr>
</tbody>
</table>

**FIGURE 8 | IMPLICATIONS OF “DANGEROUS PRECEDENTS”**

<table>
<thead>
<tr>
<th>Element</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contagion Effect</strong></td>
<td>EU willingness to negotiate a preferential deal for the UK risks initiating a contagion effect. Populist leaders in the Netherlands, Denmark, France, and Italy have already called for referenda of their own. Short of other “exits,” certain EU member states may seek to renegotiate the terms of their EU memberships, which would further weaken the bloc.</td>
</tr>
<tr>
<td><strong>Survival of the Euro / EU</strong></td>
<td>While the UK has its own currency, most other EU countries use the euro. If one of the large EU countries that use the euro, such as France or Italy, elects to leave the EU, the implications for the euro and the EU could be dire. A disorderly euro / EU dissolution could trigger another banking crisis. StepStone believes that governments and central banks are ill-equipped to deal with such an outcome.</td>
</tr>
</tbody>
</table>
Possible Alternatives to EU Membership

The "Norwegian model" is the closest scenario to the status quo. Under this option, the UK would remain part of the European Economic Area and keep the four freedoms of capital, labor, goods and services, while remaining free to negotiate separate trade agreements with non-EU countries. Given that the UK will lose the right to influence EU laws and regulations, while being required to comply with them, this option appears to defeat certain of the main goals of the Leave campaign. To make matters worse, the UK would need to make a substantial contribution to the EU budget. Migrating to the right of the figure, the UK avoids the fiscal contributions and regulatory compliance required by the EU, but distances its economy from the benefits of “tariff-free” interaction with the EU.

<table>
<thead>
<tr>
<th>EU Member</th>
<th>EEA (Single Market Only)</th>
<th>ETFA (Free Trade Agreement)</th>
<th>Customs Union</th>
<th>MFN</th>
<th>&quot;Duty-Free&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>28 European Member Nations</td>
<td>Norway, Liechtenstein</td>
<td>Swiss</td>
<td>Turkey</td>
<td>Australia</td>
<td>Monaco, Singapore</td>
</tr>
<tr>
<td>Free movement of goods, services and capital</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Free movement of people</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Free to negotiate trade deals and set tariff levels with non-EU countries</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>EU laws and regulations</td>
<td>Influence</td>
<td>Yes</td>
<td>Very limited</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Compliance</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, but some opt-outs</td>
<td>Some</td>
<td>No</td>
</tr>
<tr>
<td>Fiscal contributions</td>
<td>Yes</td>
<td>Yes (83% of full rate)</td>
<td>Yes (52% of full rate)</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Common Agricultural Policy (CAP)</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: Deloitte, June 24, 2016 & StepStone analysis.
Note: Orange boxes indicate the UK’s “ideal” relationship with the EU.
The following commentary focuses on the impact of Brexit on credit markets, followed by a discussion of Brexit’s impact on existing Private Market portfolios and the new investment/exit environments across Private Equity, Real Estate, and Infrastructure and Real Assets.

**CREDIT MARKETS**

While the immediate impact of the referendum on public equity market valuations was swift and severe, it appears that public equity indices (with the exception of certain areas of the listed Real Estate market) have recovered and are generally trading above their pre-Brexit levels as of October 3, 2016, as shown in Figure 9. This rapid recovery in public equity markets, even for small-cap and mid-cap companies that have not benefited as greatly as their larger brethren from devaluation of the GBP and enhanced exports, was supported by an orderly functioning of the credit markets post-referendum.

In the UK and the rest of Europe, the impact of Brexit in the immediate aftermath of the vote led to only a moderate price correction in syndicated loans. Their recovery was swift, driven by market expectations for additional supportive measures from central banks. As discussed, the BoE did not disappoint, announcing rate cuts and corporate bond purchase programs, which provided strong technical support to corporate credit markets.9

A number of direct lending primary transactions in the UK were delayed and postponed.10 However, the situation in the rest of Europe was relatively stable.11 US corporate credit markets were largely unaffected throughout.12

Over the medium-term, StepStone expects that any fundamental Brexit impact within corporate credit markets will be idiosyncratic and industry-specific in nature (e.g., financial services, domestic vs. international tourism, export vs. domestic-oriented production, etc.) as opposed to being widespread. These potential impacts have been largely neglected by credit market participants to date and the direction of certain Brexit negotiation topics will drive a substantial amount of these effects.

In general, companies seek stable lenders. In the UK specifically, StepStone expects that companies will increasingly work with alternative lenders as opposed to potentially less stable traditional banks whose willingness/ability to lend can change rapidly. StepStone does not anticipate a material impact on pricing, as the UK’s well-developed non-bank lending market should have the capacity to replace a slow, but ongoing, decline in bank lending. In Europe, banks remain strong lenders in their respective home markets, although, unrelated to Brexit, competition is expected to become fierce with increased presence and use of alternative lenders. Pricing is expected to remain flat to slightly more attractive for borrowers.13

Against this background, StepStone recommends that investors focus on quality to address an uncertain medium-term fundamental outlook for corporates. This conclusion is partially driven by potential Brexit implications, but is also due to a maturing credit cycle. For Private Debt investors with moderate but stable return expectations, StepStone recommends investing in first lien transactions and, depending on client risk appetites, “stretched senior” and unitranche

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9 See supra note 4.
10 Credit Suisse Leveraged Loan Index, Credit Suisse High Yield Index, StepStone market observations, June/July 2016.
11 Ibid.
12 Ibid.
13 Ibid.
transactions. StepStone also recommends limiting exposure to higher risk second lien and mezzanine opportunities or restrict such exposure to portfolios with the necessary risk appetites.

Given that the impact of Brexit is likely to be idiosyncratic and industry-specific, StepStone believes that investors should seek high levels of diversification within their credit portfolios. StepStone believes that Private Debt portfolios should be invested into both high quality syndicated loans (providing liquidity and rapid deployment) and direct lending (providing liquidity premium), with direct lending representing a significant proportion over time.

Implications for Private Market Activities

Private Equity, Real Estate, and Infrastructure and Real Assets activities all depend, to some extent, on the availability of reasonably priced debt financing. Therefore, we believe an increase in financing costs due to spreads widening or a temporary shutdown of credit markets, or both could have negative implications for Private Market valuations and vice versa. However, growth in the alternative lending space in recent years has made the financing market less reliant on banks. In times of stress, alternative lenders—unlike traditional banks—will provide financing, but at a price.

Therefore, while the availability of financing through the direct lending market may be more reliable, even in a severe negative scenario, unattractive pricing may impact other Private Market valuations and/or slow activity levels.

EXISTING PRIVATE MARKET PORTFOLIOS

Despite the orderly functioning of credit markets and a speedy recovery in public equity market valuations, the impact of Brexit on existing portfolio assets was felt almost immediately, as the second quarter of 2016 came to a close only days after the Leave vote, when European public equity markets experienced material volatility with a downward bias. Given that best practice valuation policies dictate that managers revalue their portfolios based on fair value, the largely illiquid nature of Private Market assets generally requires managers to mark-to-market based on publicly-listed comparable companies.

As illustrated in Figure 10, the FTSE 250 and MSCI Europe Small Cap Index fell 4.2% and 7.5%, respectively, from March 31, 2016 (when public equity markets were “pricing in” a Remain vote) to June 30, 2016 (following the unanticipated Leave vote). However, StepStone observed that, during the same period by its calculations, Private Equity valuations in the UK decreased by 1.9%, while Private Market valuations in Europe increased by 0.9%.

We believe the fact that Private Market portfolios in the UK and Europe responded less severely than relevant public equity market indices reflects (i) the diversification of Private Market portfolios across asset classes that have varied risk profiles; (ii) Private Market managers’ focus on a sub-set of industries with characteristics appropriate for Private Market investors (e.g., Private Equity is less exposed to highly levered

<table>
<thead>
<tr>
<th>FIGURE 10</th>
<th>MARKET MOVEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q2 2016</td>
</tr>
<tr>
<td>FTSE 250</td>
<td>(4.2%)</td>
</tr>
<tr>
<td>MSCI Europe</td>
<td>(7.5%)</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>1.7%</td>
</tr>
<tr>
<td>UK Private Markets</td>
<td>(1.5%)</td>
</tr>
<tr>
<td>EUR Private Markets</td>
<td>1.5%</td>
</tr>
<tr>
<td>N.A. Private Markets</td>
<td>3.4%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>2.7%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>3.9%</td>
</tr>
<tr>
<td>Infra &amp; Real Assets</td>
<td>4.9%</td>
</tr>
<tr>
<td>Total Private Markets</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

Source: Burgiss Private iQ.
Note: “Since Vote” represents June 23, 2016 to October 3, 2016.

14 Represents a Private Equity figure per StepStone’s Monitoring & Reporting database as a proxy for a Private Markets figure due to the limited scope of Burgiss Private iQ data (i.e., Burgiss Private iQ data is not available at a country level).
Financial Services businesses than are the public markets); and (iii) Private Market managers’ tendency not to fully recognize short-term volatility in public equity markets. We believe the rebound in public equity markets in the weeks following the vote validates, to some extent, the practice in (iii) above.

PRIVATE EQUITY

European Private Equity valuations increased by 2.4% in 2Q16 (in euro terms).\textsuperscript{15} However, UK Private Equity valuations decreased by 1.9% in 2Q16 (in GBP terms).\textsuperscript{16} We believe this dynamic suggests that the near-term impact of Brexit on existing portfolios has been felt most deeply by UK businesses, with diminishing impact on European and other businesses as UK market exposure is reduced. This conclusion comes as no surprise, as valuations have some correlation with trends in market confidence and GDP growth expectations.

While European Private Equity valuations increased by 2.4% in 2Q16 in terms, the same index increased by 7.6% in GBP terms, suggesting that movements in foreign exchange rates had a material impact on assets denominated in GBP, given the magnitude of GBP’s fall following the referendum.\textsuperscript{17} Those assets that are most heavily exposed to Brexit are UK businesses that generate revenue in GBP, but have international supply chains with associated costs denominated in other currencies. However, to the extent that businesses sell into international markets, earnings are partially protected by increased exports as a result of a weaker GBP.

StepStone also believes that assets’ maturities may influence the magnitude of Brexit’s impact on valuations and, ultimately, performance. Mature assets that have substantially completed their value creation phase are most exposed to Brexit-related risks, as their net asset values ("NAV") already reflect the value created under Private Equity ownership. These assets will have less time remaining in their financing packages and, therefore, a shorter period of time to preserve value and generate incremental returns. Companies in the middle of their value creation phase still have the opportunity to rise above the macro noise and may have enough runway to shift their value creation plans to reflect new market realities. New investments face some risk, in that they were bought at a high point in the cycle and probably have higher leverage than more mature assets. However, they also have the greatest flexibility to pivot their value creation plans to meet challenges and capture opportunities.

Overall, excluding the impact of foreign exchange rate movements, StepStone expects near-term valuation movements of existing Private Equity portfolios to generally reflect the underlying performance of assets, as public equity valuations and M&A activity currently provide support for a steady mark-to-market environment.

REAL ESTATE

European Real Estate valuations decreased by only 0.3% in 2Q16 (in euro terms).\textsuperscript{18} In USD terms, the same index decreased 3.5% and, in GBP terms, the index increased 5.3%.\textsuperscript{19} We believe this dynamic is due to two factors: (i) devaluation of the GBP; and (ii) the fact that UK investments were responsible for a decrease in capital values during the course of the year. StepStone has witnessed a fall in pricing in both the public and Private Markets, with the most vulnerable sectors in the UK being high-end residential and London offices.

Other major European cities, including Paris and Munich, have continued to experience Real Estate capital appreciation, despite Brexit.\textsuperscript{20} While it remains too early to determine which (if any) European financial centers could benefit from Brexit, it is clear that Brexit has increased uncertainty and volatility within European Real Estate markets and further dampened growth prospects across the continent.

We believe a consequence of lower growth prospects in Europe is the increased likelihood of lower interest rates for a longer period of time. Should such a result materialize, we believe Real Estate could become an attractive alternative to Fixed Income as a result of its higher cash yield generation. For example, UK prime properties offer a spread of approximately 300 basis points ("bp") over the 10-year Gilt, while, in Germany, prime offices in the country’s seven largest cities currently offer approximately a 400bp spread over the 10-year Bund.\textsuperscript{21}

\textsuperscript{15} Burgiss Private iQ, June 30, 2016.
\textsuperscript{16} StepStone’s Monitoring & Reporting database, June 30, 2016.
\textsuperscript{17} OANDA, October 3, 2016.
\textsuperscript{18} See supra note 15.
\textsuperscript{19} Ibid.
\textsuperscript{20} Jones Lang LaSalle, Q2-Q3 2016.
\textsuperscript{21} CBRE, Deutsche Bundesbank, Q3 2016.
Given that capital interest in Real Estate is driven by such technical factors, StepStone believes it to be all the more important to focus on identifying investments with differentiated drivers of demand, and selecting properties with healthy supply/demand characteristics.

**INFRASTRUCTURE & REAL ASSETS**

European Infrastructure valuations increased by 0.7% in 2Q16 (in euro terms). However, as was observed in other asset classes, significant currency fluctuations during the quarter had a material impact on returns. For example, in USD terms, the index decreased by 2.5% and, in GBP terms, the index increased by 5.9%. StepStone’s discussions with General Partners and industry participants indicate that Infrastructure valuations have remained largely unchanged, supported by the inherent stability of Infrastructure assets and the continued availability of inexpensive financing.

Infrastructure revenues are typically not exposed to market volatility or to volume and pricing risk, given that they are subject to regulation and/or long-term contracts. However, certain assets, such as airports or ports, are exposed to GDP risk. While GDP forecasts have been revised downward for the UK and Europe in the wake of the referendum, the meaningful downturn that was expected by many has not materialized.

In the pre-referendum world, modest economic growth in the UK and Europe led to speculation of central bank rate increases, with the discount rate applied to Infrastructure valuations reflecting these expectations. However, today, with clearer visibility into an extended period of low interest rates, discount rates may be adjusted downward in certain scenarios, potentially increasing Infrastructure asset valuations in the near- to medium-term.

**Private Markets Activity**

While existing Private Market portfolio valuations remained largely unchanged in 2Q16, a gap has developed in the near-term between what sellers expect to be paid (especially for high quality, growth-oriented and defensive assets) and what many investors are willing to underwrite (given current levels of uncertainty). However, there continues to be significant pressure to deploy capital across the UK and Europe due to record levels of equity dry powder. The result has been high prices for those assets that have transacted. While StepStone believes that Brexit could serve as a brake on responsible capital deployment by many Private Market managers, the fact that deals are still transacting at these high levels indicates that there are still managers with confidence to deploy capital in the current environment.

Given that valuations and debt availability are healthy in both Europe and North America, but that the level of risk is higher in Europe, StepStone believes that the relative risk/reward trade-off in developed markets currently favors North America. However, interesting European opportunities will undoubtedly materialize, from which smart investors with flexible capital can profit.

**PRIVATE EQUITY**

While Private Equity assets continue to be sold at lofty valuations, StepStone has observed that the pace of exit activity in the UK and Europe slowed, as seen in Figure 11. This empirical trend is consistent with qualitative feedback that StepStone has received from Private Equity managers pre- and post-referendum, many of whom actively managed-out significant portions of their UK portfolios ahead of the vote.

We believe the implication of reduced exit activity in the UK and Europe is that many high quality Private Equity assets may be held for longer until buyer and seller valuation expectations converge, particularly if assets can continue to generate attractive go-forward returns. Marginal assets, on the other hand, may come up for sale, but may struggle to achieve attractive exits. Therefore, StepStone continues to be pessimistic about the health of the Private Equity exit environment in the UK and Europe while uncertainty persists.

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22 See supra note 15.  
23 Ibid.  
24 See supra note 2.
As illustrated in Figure 12, Private Equity managers have taken a breather in recent months, with the pace of new investment activity in the UK and Europe also slowing during the quarters leading up to the referendum. While many Private Equity managers have reduced new investment activities in the UK as political processes throughout Europe play out, many managers have also observed sustained appetite from strategic buyers for high quality assets in the UK and Europe. Both of these factors have contributed to reduced new investment activity in the months following the referendum. StepStone expects continued downward pressure on new Private Equity investment volumes in the UK and Europe for at least the next twelve months as political events unfold.

However, while uncertainty abounds and investment-related Private Equity activities in the UK and Europe are subdued for now, StepStone advises clients not to attempt to time the market and, instead, to employ the discipline of “dollar cost averaging,” as Private Equity returns tend to be strongest in vintage years falling within periods of economic volatility or recession. The incremental benefit investors have today versus at the onset of the GFC is that the catalyst has been introduced, but the process of negotiating the UK’s exit from the EU will be a lengthy one. Should any recession ensue, Private Equity investors should prepare to proactively pivot deployment towards geographies, strategies, and best-in-class managers that are well-suited to volatile and uncertain market environments and, therefore, represent compelling relative risk/reward propositions.

Under normal circumstances, new Private Equity fund commitments benefit from careful manager selection with full knowledge of uncertain times ahead, meaning that capital can be deployed in an attractive risk-adjusted manner. However, in the current environment, StepStone believes this conclusion to be suspect as a result of pressure to deploy high levels of equity dry powder. Therefore, StepStone recommends investing in European Private Equity opportunistically while high levels of uncertainty persist.

Private Equity primaries should focus on Buyout managers with established platforms that have track records of discipline and strong returns across the cycle. We believe proven operational capabilities that are accretive at the micro level are of incremental value in Europe’s low growth and currently uncertain macro environment. However, European Venture
Capital and Growth Equity managers should be considered only on a selective basis, given the limited scale and defensibility of target businesses. Deployment of capital into such opportunities should be concentrated on managers that have a proven ability to acquire assets that benefit from structural tailwinds, but where “growth at a reasonable price” can be achieved with confidence.

Private Equity co-Investment activities should focus on high quality assets at appropriate valuations, utilizing capital structures that are carefully tested by downside scenarios. This may limit European deployment in the near-term in favor of better risk-adjusted returns elsewhere. However, high quality, defensive UK assets with revenue and cost bases denominated predominantly in GBP may represent unique opportunities to capitalize on a potentially attractive entry point from a currency perspective (the value of the GBP remains near its 30-year low vs. the USD).25

Brexit may also catalyze a dislocation that leads to a “buyer’s market” in European Private Equity Secondaries. During the coming years, investors may be presented with a compelling opportunity to buy high quality assets at meaningful discounts. While such an event has not occurred in the immediate aftermath of the referendum, we believe Brexit has the potential to trigger a number of adverse outcomes that could result in a dislocation, including a recession, additional “exits” by other EU member states, etc. In StepStone’s view, the key to generating attractive risk-adjusted returns will be an ability to underwrite and acquire select high quality funds, rather than buying large portfolios of mixed quality funds.

REAL ESTATE

Brexit led to two material developments within the UK and European Real Estate markets. First, many investors adopted a “wait and see” position, particularly in the UK. In the run-up to the referendum, 1H16 transaction volumes declined significantly as investors avoided making “one way bets” on the outcome of the vote.26 Post-referendum, Real Estate activity in the UK has been limited, while investors continue to assess the implications of the vote on the local Real Estate market. In continental Europe, certain investors are exercising caution as they form views on which regions could benefit from Brexit and which regions could be adversely impacted by Brexit.

The second material Brexit-related development within the UK and European Real Estate markets is the emergence of a bid-ask spread. In the immediate aftermath of the vote, redemption queues formed for some of the large unit trusts, thereby forcing managers to close funds for redemptions and liquidate certain assets at discounts.27 Some of these funds have since reopened for new investments and redemptions, as investors’ apprehension has subsided.28

**FIGURE 13 | COMMITMENTS VS. VINTAGE YEAR RETURNS**

![Graph showing commitments vs. vintage year returns for private equity investments, with bars indicating different years and IRR percentages.](image)

Source: IRRs are based on the Burgiss Private iQ Global All Private Equity benchmark as of September 30, 2015. Post-2013 vintages are deemed to be too immature for the benchmark to provide meaningful results; Annual Commitments per Thomson One.

25 See supra note 17.
26 Real Capital Analytics, Q3 2016.
28 Ibid.
The feedback that StepStone has received from UK-focused market participants is that UK Real Estate asset values may experience a 5% to 10% downward repricing, with potentially greater value declines to be experienced by London office and high-end residential properties.

Real Capital Analytics (“RCA”) estimates that year to 3Q16 UK Real Estate transaction volumes decreased by 37% in GBP terms (42% in euro terms) when compared with the same period last year (see Figure 14). However, considering that the UK represents 34% of the total European Real Estate market, this implies that over half of the 25% decline in transaction European volume is the result of a reduction in UK transaction volumes. Despite this trend, quarterly transaction volumes in Europe are still above their average investment volumes during the last five years.

As seen in Figure 15, the most visible impact of Brexit has been on the UK Listed Real Estate market, which experienced a 22% drop in share price between June 23, 2016 and July 6, 2016, before subsequently recovering 15% by September 29, 2016. This sharp fall followed by a steep inflection highlights the “shock effect” of the UK referendum result on the broader UK Real Estate market.

In StepStone’s view, the current market environment for Real Estate in Europe demands a cautious and discerning approach to capital allocation and investment decisions. It is not only Brexit that is creating uncertainty—persistently low yields / interest rates that have brought Real Estate valuations to historical peaks, weak economic growth with further potential weakness due to the direct and indirect impact of Brexit, and a demography that is not growing and definitely aging, creates a challenging backdrop for Real Estate investing.

In this context, StepStone is focused on areas of the European Real Estate market that should demonstrate resilience during these uncertain times, including a bias towards major markets with liquidity and stronger-than-average population growth and Real Estate demand fundamentals; Real Estate Credit and Special Situation strategies; and sectors with long-term favorable supply / demand dynamics (e.g., housing, healthcare, etc.).

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29 See supra note 20.
INFRASTRUCTURE & REAL ASSETS

During 2Q16 and 3Q16, Infrastructure deal values declined dramatically across the UK and Europe, according to the InfraNews deal database. These data coincide with media reports that construction spending fell significantly following the referendum. This result is unsurprising, given the immediate uncertainty introduced to the broader market.

As illustrated in Figure 16, across the UK and Europe, deal volumes by both value and number decreased significantly during 2Q16 during the run-up to the vote. Following the vote, 3Q16 Infrastructure deal values and volumes continued to fall. However, these declines came on the back of elevated transaction volume levels, with 4Q15 and 1Q16 representing a recent peak in deal activity.

However, StepStone does not expect decreased deal activity to be sustained for a long period of time. While investors may have considered it prudent to delay significant financial decisions, given immediate post-referendum market uncertainty, we believe today’s relatively benign macroeconomic backdrop should support a recovery in activity levels in the near-term. For example, in the UK, Angel Trains announced in early-October its acquisition of £900 million of new rolling stock. This transaction alone represents more than 30% of total deal value recorded by InfraNews during 3Q16. Other notable processes include the sale of the M6 Toll Road, the recently approved investment in Hinkley Point nuclear power plant, and the ongoing divestiture of National Grid’s gas distribution business (expected to be valued at about £11 billion). We believe each of these transactions demonstrates continued appetite for investment in UK Infrastructure assets.

StepStone’s expectation of a recovery in deal flow is further supported by the prime minister’s stated commitment to use Infrastructure spending to support Britain’s economy. Similarly, supportive rhetoric has been heard across Europe, which will continue to support an active Infrastructure deal environment. However, most significant is the EU’s commitment of more than €20 billion to European Infrastructure investment via the “Juncker Plan,” which could help catalyze additional Infrastructure investment in Europe.

Within Infrastructure and Real Assets, StepStone continues to focus on managers that are able to generate value for investors without relying on GDP growth or discount rate compression. In particular, StepStone focuses on the operational capabilities of managers to drive business efficiencies and enhance yield to investors, given today’s low interest rate environment. The expectation of an extended period of low interest rates and open credit markets will also likely allow prices to remain high, increasing the importance of selecting managers who have a proven ability to source deals on a proprietary basis and

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30 Angel Trains, September 30, 2016.
33 European Investment Bank, October 20, 2016.
avoid competitive auction processes. With expectations of a rate rise delayed, pricing may even increase, particularly for high quality, cash generative assets that can provide investors with an alternative source of yield.

Given the significant impact of the vote on GBP exchange rates, underlying currency exposures within funds and across client portfolios is an area that deserves considerable attention. Recent foreign exchange rate movements have highlighted the potential for erosion of value through currency risk, with this risk being particularly relevant for European or global funds that are expected to complete investments in the UK. Given these additional risk factors, StepStone recommends assessing concentration limits that managers propose in order to ensure that portfolios are not heavily skewed towards geographic or foreign exchange rate risk.

Consensus 2017 UK inflation (“CPI”) forecasts collected by HM Treasury (the UK treasury department) have increased from 1.8% in June, immediately prior to the referendum, to 2.5% today. This compares to a target inflation rate set by the UK Government of 2%. This increase is likely substantially driven by devaluation of the GBP, increasing the cost of imports. This is particularly relevant for the UK, which runs a significant trade deficit (£5.1 billion in June 2016 alone). Infrastructure is commonly used by investors as a hedge against inflation, given that infrastructure assets often have inflation-linked revenue models. As such, investors who fear rising inflation may seek to increase their Infrastructure allocations.

StepStone has also redoubled its focus on the regulatory risk associated with certain Infrastructure investments. It remains to be seen whether, during the medium- to long-term, regulators update their weighted average cost of capital-based remuneration models for any changes in the cost of financing or perceived equity risk. While there has been no noticeable change in pricing to date, investors may require additional compensation for perceived increased political / regulatory risk associated with UK and European assets as a result of the potential for market turmoil when the UK begins the process of exiting the EU.

**Conclusion**

The post-Brexit environment in Europe has, in many respects, benefitted Private Markets, which tend to capitalize on inefficiencies, including those created by volatility. However, in the context of high debt availability, equity deployment pressure, and a resulting frothy valuation market, StepStone recommends investing in European Private Markets opportunistically, and with a bias towards best-in-class managers and assets and strategies that are well-suited to volatility while high levels of uncertainty persist.

However, it is worth remembering that Private Market returns in Europe have never been, and are unlikely to be, predicated on GDP growth. As discussed in StepStone’s 2015 European research paper, *La Trahison des Prévisions*, while Europe’s volatile macroeconomic and political climate has given Private Markets investors cause for concern in recent years, the devil is in the detail. StepStone believes that Europe will continue to offer Private Markets investors ample attractive investment opportunities. The key to success will be flexible capital deployed through careful manager and asset selection. Best-in-class managers with appropriate investment strategies should allow Private Markets investors to avoid the treachery in Europe’s macroeconomic environment, driving value in their portfolio companies and outperformance for their investors.

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