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Private equity

Private credit

Private infrastructure

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PRIVATE MARKETS OUTLOOK

Northleaf Capital Partners' perspective on what is driving growing demand in private market investing

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Strong tailwinds propel private market investor demand

Private markets have long been a source of enhanced alpha potential, uncorrelated returns and diversification, and the space is now more accessible than ever. In our first private markets outlook, we explore many of the trends and tailwinds affecting each specific asset class, and present the key reasons why we're bullish on the space.

Still largely untapped opportunity

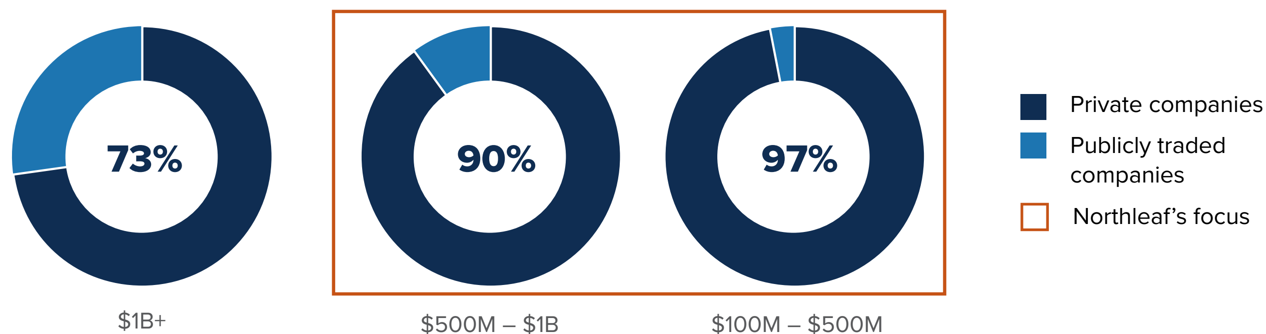
Pension funds, university endowments and family offices have been capitalizing on this part of the market for years. Historically, most individual investors were locked out of the market and therefore haven't considered private investment opportunities. In recent years, the market has evolved to create new fund structures more suitable to individual investors.

With more than 90% of companies in the US being privately owned, the opportunity set within private markets is significant (Figure 1).

In the past, businesses would favour listing on a public exchange to raise money and provide their investors liquidity, but many are now choosing to partner with private markets funds to access capital for growth or succession, and delaying going public – if at all. That's partly a result of increased regulation, but many are also benefiting from sophisticated partners who can bring expertise and capital to support the growth of their business. Remaining private allows the company to focus on its business, rather than dealing with short-term-focused shareholders or having their growth plans scrutinized by analysts on a quarterly basis. With more companies staying private, there are naturally more opportunities for private market investments (Figure 2).

FIGURE 1: >90% OF US COMPANIES ARE PRIVATELY OWNED

Number of companies, segmented by size of revenue



Source: Capital IQ/NAICS association data as of March 2024. Sample size of 185,000 largest US companies.

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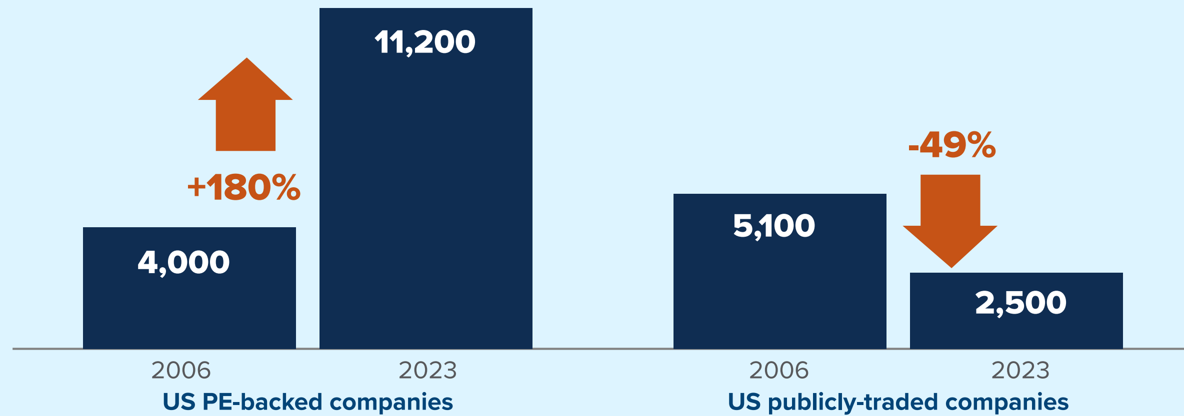
FIGURE 2: STAYING PRIVATE FOR LONGER

Number of US private and public companies 2006 - 2023



Source: Pitchbook/LCD; Capital IQ/NAICS association

The rise in private equity (PE) backed companies over the last decade is one example of the expansion of this market. Even with this growth, private markets, valued at $16 trillion (USD), represent just 5% of total capital globally, compared to just over $400 trillion (USD) in public equity and credit (Figure 3). Clearly, there is plenty of room for growth.

Activity will increase as the benefits are more widely known. Additionally, macroeconomic factors are driving interest in this space as well. While deal volumes in 2022 and 2023 declined from their peak in 2021 due to uncertainty in the broader macro environment, we are still seeing attractive investment opportunities. We expect that as interest rates and inflation show signs of easing, deals will further increase, spurring more private market growth. By the same token, we expect to see investments in private infrastructure rise as societal shifts, such as increased needs for powerful data centres, the move toward electrification and the repair of aging infrastructure, will require trillions of dollars of private investment to complete.

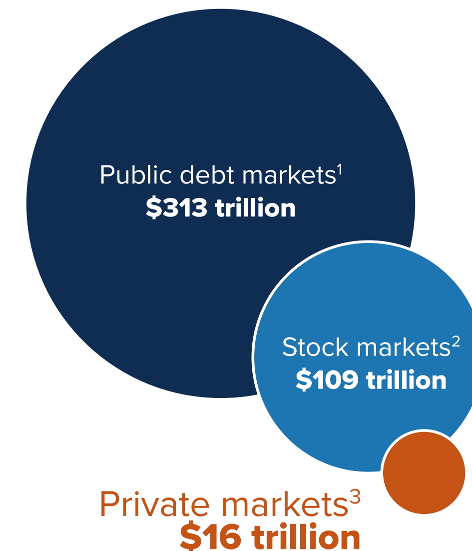
Strong, uncorrelated returns

Performance is another factor driving investor interest. While some public markets have been volatile over the last two years, private market performance has generally remained stable, proving that this space has been able to weather economic storms.

Going forward, we expect to see more investors complement their public market exposure with allocations to private markets. In this outlook, we explore the many trends in private markets and where we see opportunities unfolding.

FIGURE 3: PRIVATE MARKETS HAS ROOM TO GROW

Global market AUM (USD)



[1] Reuters, 2023

[2] World Federation of Exchanges (WFE) and the Securities Industry and Financial Markets Association (SIFMA) 2023.

[3] Preqin, December 2023

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Private equity

Private credit

Private infrastructure

Portfolio construction

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Investor appetite for mid-market secondaries continues to grow

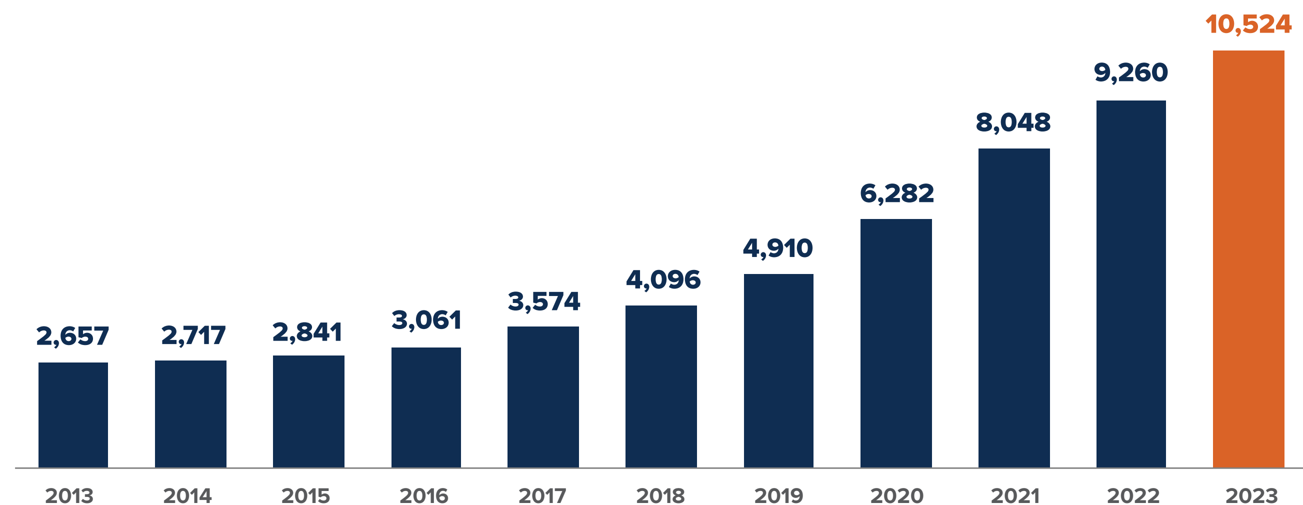
Private equity assets under management (AUM) have seen considerable growth over the last several years. Today, about $10 trillion (USD) globally is allocated to private equity, up from approximately $2.6 trillion (USD) in 2013 (Figure 4).

With many institutional investors now allocating between 10% and 30% of their portfolios to private equity – up from between 5% and 10% only a few years ago – and many more looking for alternative, uncorrelated investments to reduce risk and increase growth potential in their portfolios, we expect to see solid industry growth to continue for some time.

Private equity has produced attractive long-term returns and despite broader economic challenges in recent years, we expect the industry to continue delivering sustainable long-term outperformance to public market equivalents.[4]

High inflation and rising interest rates through 2022 and 2023 created more uncertainty in the deal markets, which slowed transaction volumes from a 2021 peak of approximately $1.7 billion (USD)[5], leading to longer holding periods for private assets and lower velocity of buyout and venture investment.

FIGURE 4: GROWING DEMAND FOR PRIVATE EQUITY
Private equity AUM, in billions (USD)[5]



[4] Private equity excess return: 5.4%. Private equity excess return is calculated as the average difference between the rolling 10-year returns of the Cambridge US Private Equity (legacy definition) Index and the MSCI World TR Index between December 2013 and December 2023. Quarterly returns in CAD.
[5] Source: Preqin, as of December 31, 2023

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Private equity

Private credit

Private infrastructure

Portfolio construction

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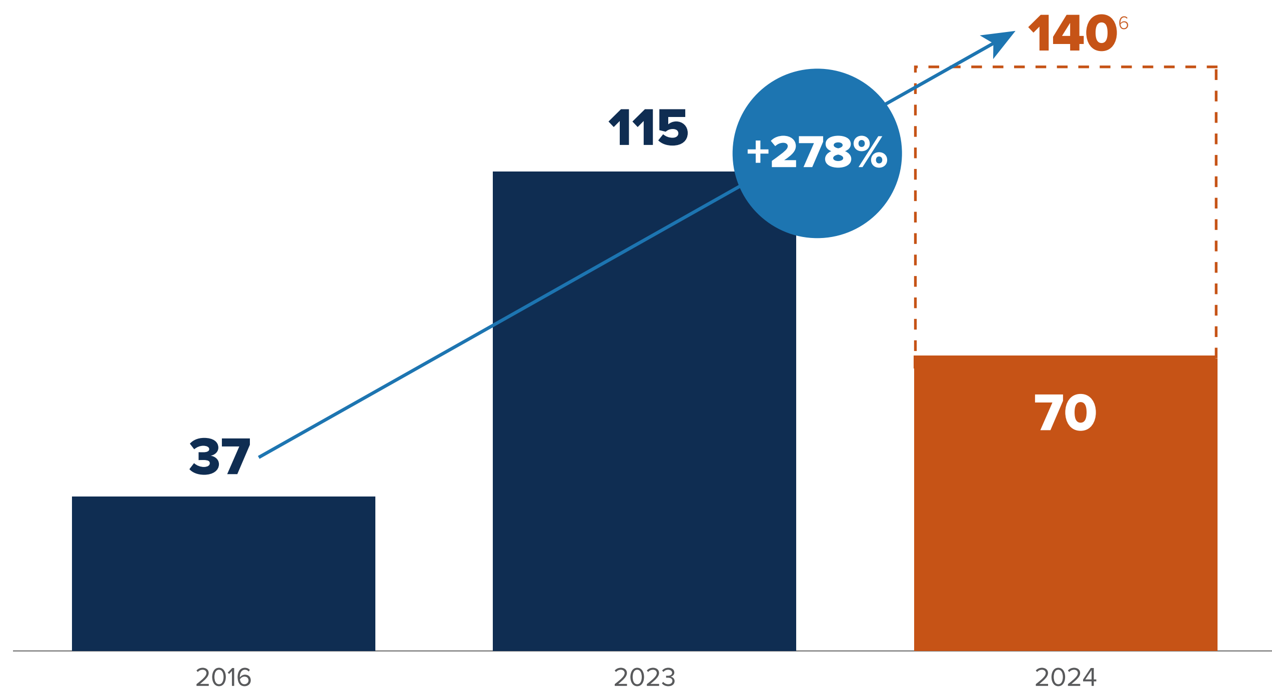
However, deal activity is expected to increase as rates decline and inflation moderates over time, resulting in renewed activity in the space. We are already seeing signs of this in the first half of 2024.

While buyout and venture deal activity saw reduced activity, the private equity secondary market saw continued growth in transaction volumes in 2023 and in the first half of 2024 compared to historical levels, despite these economic challenges. The secondary market is where private equity limited partners (LPs) can sell portfolios before the underlying assets are sold.

Notwithstanding this growth, secondaries currently account for less than 5% of the overall private equity market, suggesting plenty of runway ahead.

As overall private markets AUM has been climbing by ~15% annually over the last decade, secondary transaction volumes have also trended positively. Indeed, between 2016 and 2023, annual secondary transaction volume increased by nearly 211% to $115 billion (USD) in deal value in 2023. With strong deal activity in the first half of 2024 at over $70B (USD), many are now forecasting the secondary market to reach over $140B (USD) by the end of the year[6] (Figure 5).

FIGURE 5: ANNUAL SECONDARY TRANSACTION VOLUME
in billions (USD)



[6] Source: Evercore H1 2024 Secondary Market Review. Estimated FY 2024 transaction volume annualized based on H1 2024 stated volume.

Key trends driving growth in secondaries

In addition to overall private equity market growth, several other secular and cyclical trends are driving secondary activity. The slowdown of M&A and exit activity in 2023 has led to reduced liquidity in the private equity space. This has led LPs in the asset class to pursue secondary sales to help create liquidity solutions within their portfolios as they look to free up cash flow to pursue new investment opportunities, rebalance exposures or manage risks. While IPO and deal activity could increase when rates decline, there is still a long way to go before markets approach peak levels again.

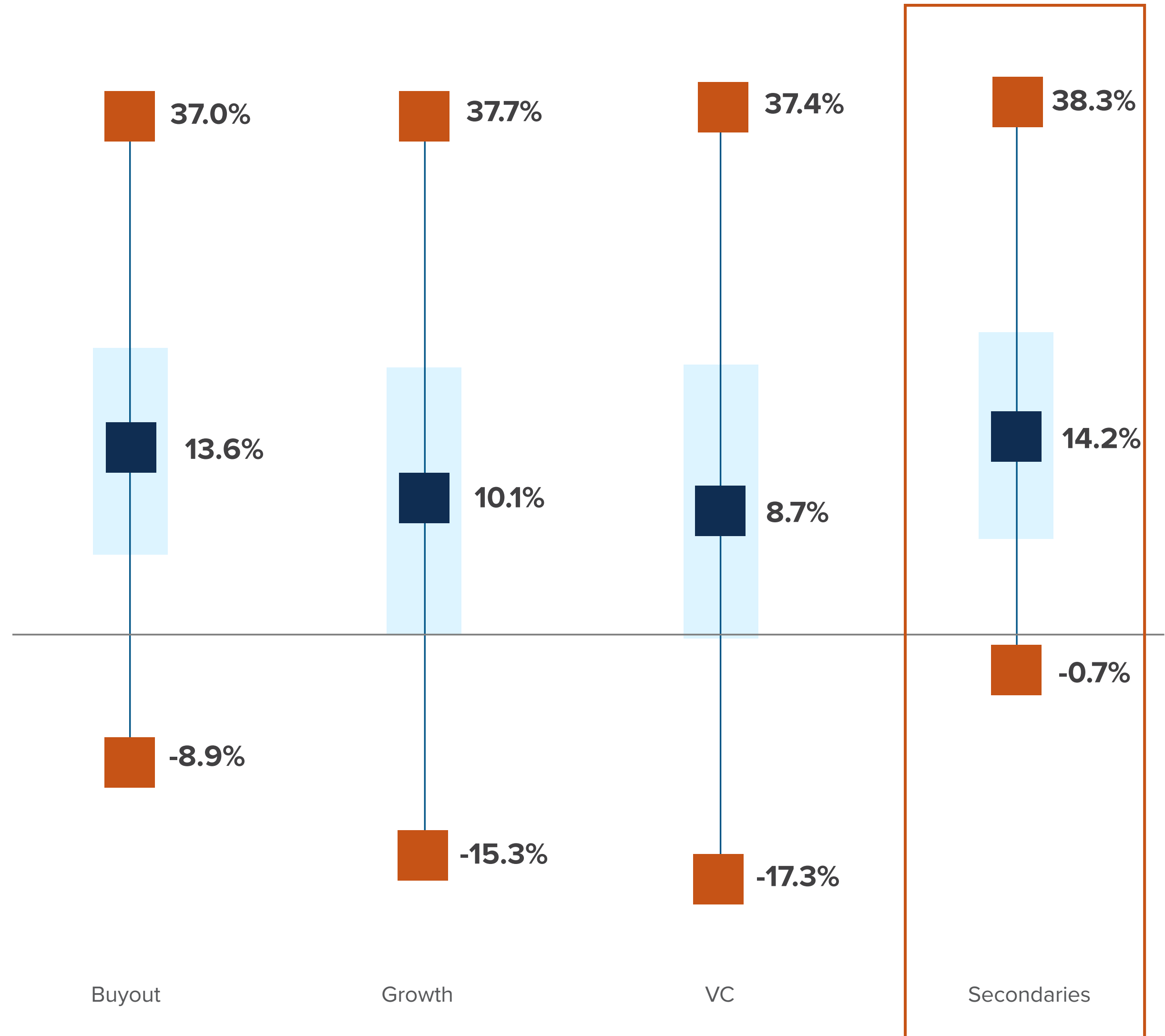
Further, many LPs are also becoming increasingly more comfortable using the secondary market as a portfolio management tool and are programmatically using secondaries to manage liquidity. At the same time, many general partners (GPs) are not as keen to exit an investment after the usual three-to-five-year holding period. Rather than sell, they are creating special-purpose vehicles to hold their investments for longer. To do that, however, GPs need to raise capital from the secondaries market to both provide liquidity for their LPs, and to buy more shares in new and existing operations. All that adds up to more opportunities in the secondary market.

PE secondaries: Strong performance, lower historical risk for investors

Amidst continued concerns about inflation and general economic and geopolitical uncertainty, investors continue to look beyond the public markets for portfolio-boosting assets and diversification. More will turn to vehicles that hold secondary assets, as this part of the market has historically provided top quartile returns with lower downside risk compared to other private market investment strategies (Figure 6).

This risk/return dynamic is driven by the ability to invest in secondary transactions at a discount to net asset value and the diversification that is inherent in portfolios that secondary funds are buying.

FIGURE 6: DISPERSION OF NET IRRS BY PRIVATE CAPITAL STRATEGY



Source: Cambridge Associates; since 2001 net IRRs of all fund vintages globally included in the Cambridge Associates database across each respective asset class as of December 31, 2023. The Cambridge information provided is not transparent and cannot be independently verified. The funds included in the private capital data shown report their performance voluntarily, and therefore, the data can reflect a bias towards funds with track records of success.

Private markets

Private equity

Private credit

Private infrastructure

Portfolio construction

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Private credit to benefit from attractive yields

Following the Great Financial Crisis (GFC) of 2007-08, many banks began pulling back from lending to private borrowers as they repaired their balance sheets to comply with stricter regulatory requirements.

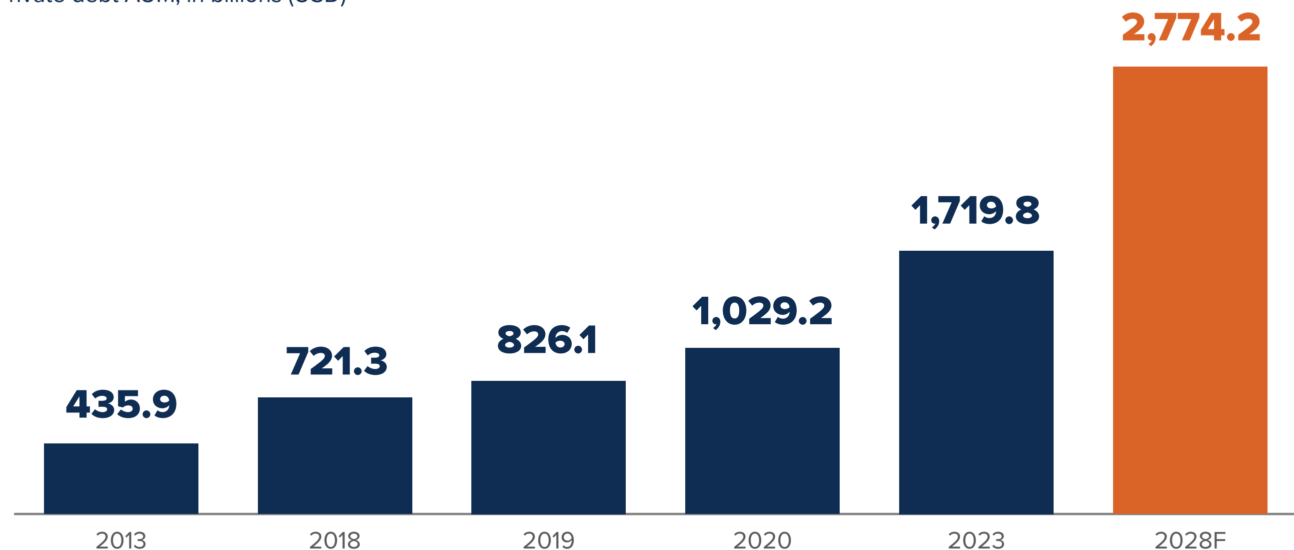
This created opportunities for private lenders, allowing them to gain significant market share as borrowers still needed capital to expand their businesses.

We are once again seeing a spotlight on bank lending practices with the recent regional banking challenges in the US. This has caused further bank retrenchment and is driving more demand for private credit, particularly in the mid-market.

We expect interest in private credit will increase significantly over the next few years, with assets under management (AUM) topping $2.7 trillion (USD) by 2028, up from $1.7 trillion (USD) today[7] (Figure 7).

We believe several dynamics will contribute to the increase in AUM, including continued bank retrenchment, a growing number of private equity-backed companies and strong demand for private credit from both borrowers and investors.

FIGURE 7: RISING DEMAND FOR PRIVATE CREDIT
Private debt AUM, in billions (USD)



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Private equity

Private credit

Private infrastructure

Portfolio construction

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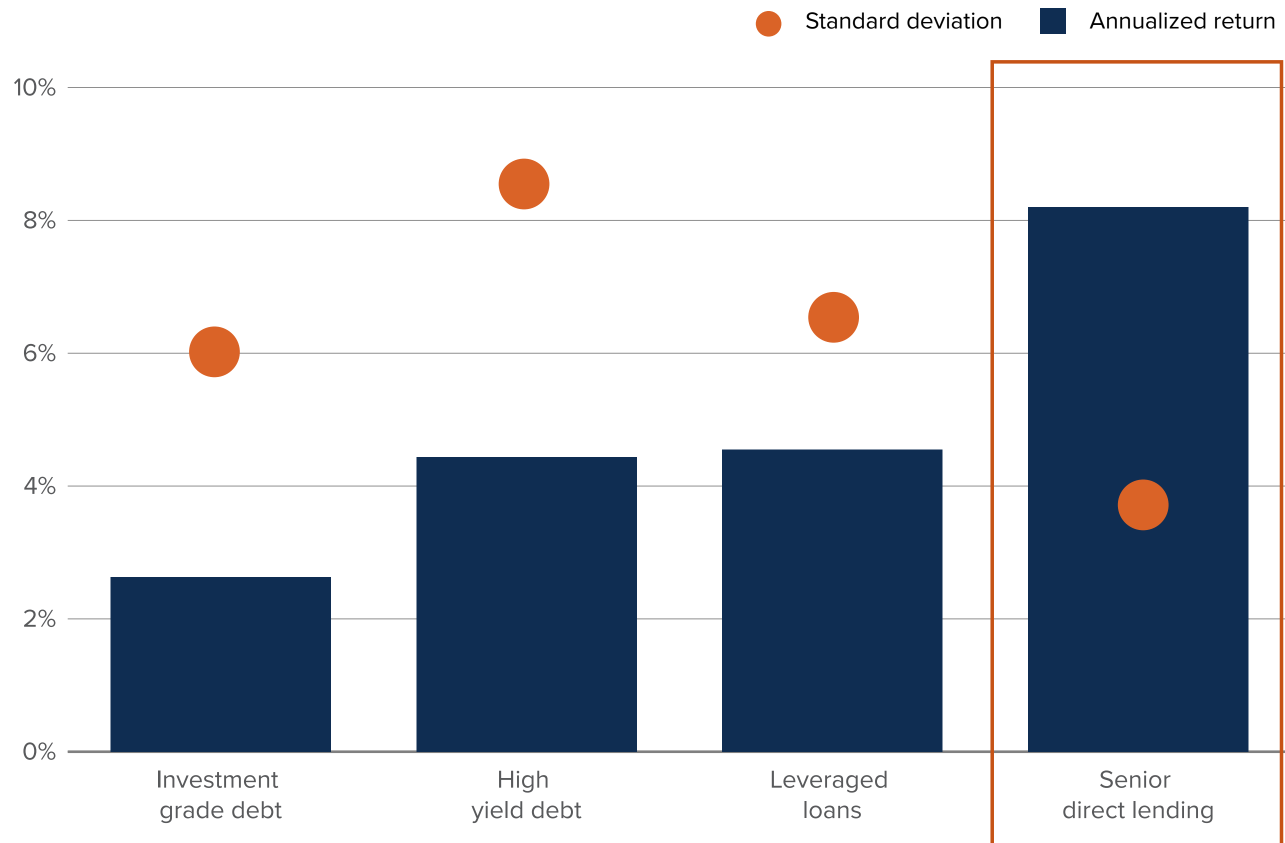

Source: Investment grade debt (equal-weighted portfolio of the Bloomberg Canada Corp IG Index and Bloomberg US Corp IG index), leveraged loans (Morningstar LSTA US Leveraged Loan Index), high yield debt (Bloomberg US Corp. High Yield Index), senior direct lending (Cliffwater Direct Lending (Senior) Index), Data is for the 10-year trailing period as of March 31, 2024. Returns in USD.

The investible universe is growing. According to Preqin, the value of businesses owned by private equity sponsors has more than doubled over the past decade to $10.5 trillion (USD) in AUM. Many of these businesses prefer to work with private lenders who can provide more flexible terms and act as a source of long-term capital to support their growth trajectory.

We also expect investor demand for this asset class to continue expanding. Institutional investors have long understood the benefits of investing in private credit, and we are seeing an increase in demand from family offices and individual investors. This rise in interest recognizes that private credit has historically held many advantages over public fixed income, including a return premium, strong rates of capital preservation and lower volatility (Figure 8). Its resilience has also been demonstrated through prior market cycles.

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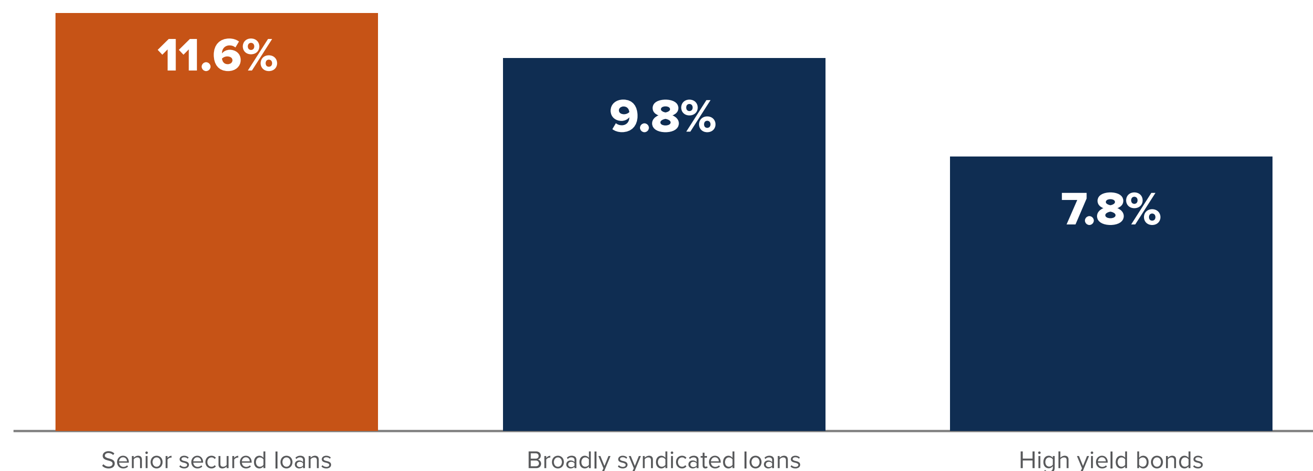
Attractive absolute and relative risk-adjusted returns

Private credit is predominantly a floating-rate asset class, meaning borrowers pay an amount above the base rate. With base rates in the US currently above 5%, senior secured loans to high-quality mid-market companies are generating low double-digit returns for investors (Figure 9) with strong downside protection due to substantial equity cushions and strong lender protections.

As capital flows across the market increase, we have seen some downward pressure on credit spreads and fees, though overall private credit returns remain highly attractive on an absolute and relative basis. While the Federal Reserve is expected to lower interest rates at some point, there is a growing expectation by market participants of a higher-for-longer interest rate environment with the current forward curve showing that rates will remain above 4% throughout 2024 and above 3% over the long-term (Figure 10).

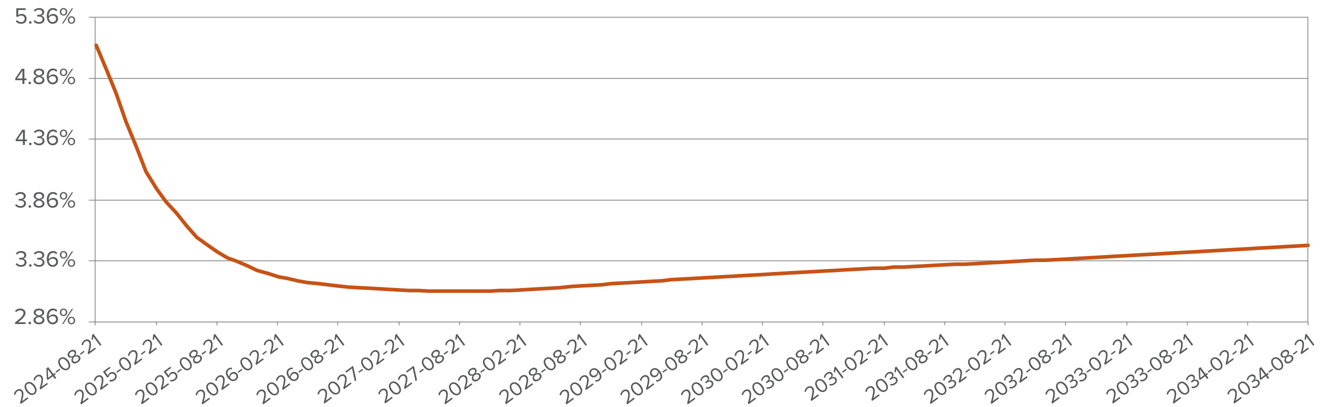
FIGURE 9: ANNUALIZED GROSS ASSET YIELD AS OF MARCH 31, 2024



Source: Cliffwater Direct Lending Index: Senior Only (CDLI-S); Pitchbook/LCD. USD. Senior secured loans: Cliffwater Senior Direct Lending Loan Index, Broadly syndicated loans index: Morningstar LSTA US Leveraged Loan Index, High yield bonds index: S&P U.S. High Yield Corporate Bond Index

Another theme is continued bifurcation in performance between the upper mid-market (defined as borrowers with EBITDA greater than $75 million) and the core mid-market (defined as borrowers with EBITDA between $20 million and $75 million). A greater share of capital has flowed to the upper mid-market, which is putting pressure on pricing and terms. The core mid-market has been more insulated from these competitive pressures, resulting in better pricing, lower leverage and continued strong lender protections.

FIGURE 10: HIGHER-FOR-LONGER INTEREST RATES
3-month term secured overnight financing rate (SOFR) forward curve



Source: Chatham Financial. 3-month secured overnight financing rate (SOFR) at August 19, 2024.

Manager selection is important

Despite the higher cost of debt, there have been far fewer defaults than many had expected. As of Q2 2024, the trailing 12-month default rate by issuer count in the Morningstar LSTA US Leveraged Loan Index was 1.6%, which is in line with the 10-year average.

Although most borrowers are performing well, those who are highly levered or within cyclical industries are facing challenges and it is important to understand the underlying loan portfolio construction. As long-term outperformance in credit is about making fewer mistakes, partnering with a manager that has access to high-quality deal flow and a disciplined investment philosophy is critical to long-term success. Portfolio construction is also key; managers must ensure they construct portfolios that are well diversified by borrower, sector and geography. These core competencies are what will enable managers to deliver continued strong risk-adjusted returns into the future.

We believe there is a significant opportunity within private credit for individual investors, particularly in the current economic environment, where we expect to see long-term interest rates remain at higher levels than seen over the past decade. It is a longer-term investment with less liquidity, though it has offered investors a return premium to public fixed income investments with strong rates of capital preservation and lower volatility.

Strong demand for private credit deals

With the continued trend of banks moving away from providing loans to private companies, as well as the growth in the underlying investment universe, private lenders will continue to see an abundance of attractive loan opportunities.

Choosing experienced managers with a track record of sustainable success will be paramount as this space continues to evolve.

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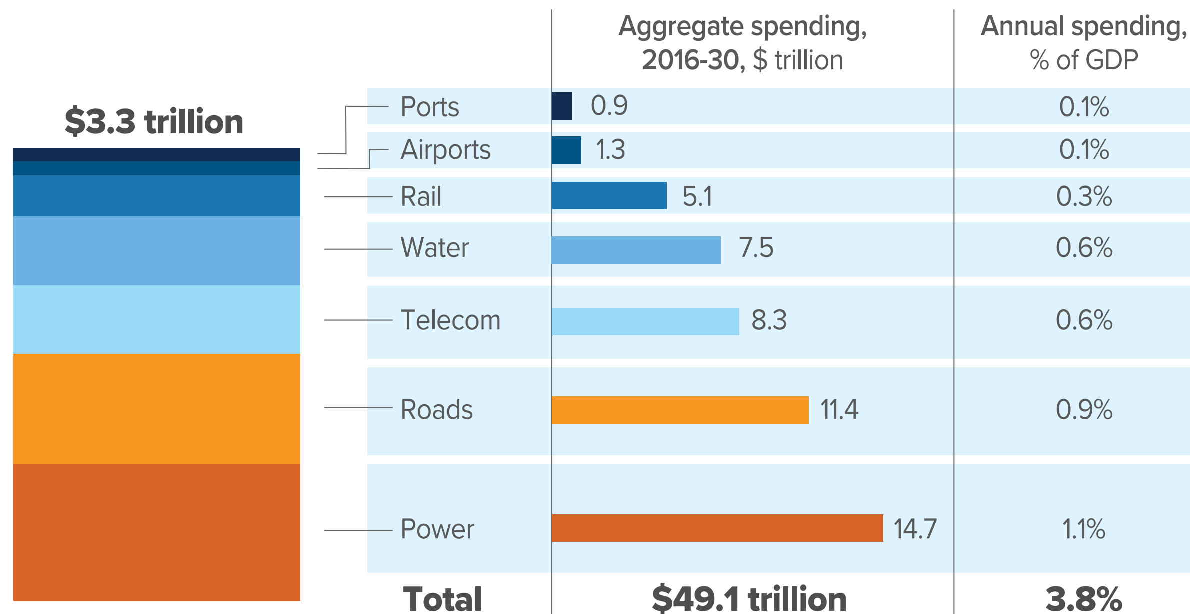
Demand for infrastructure assets set to soar

Economies are only as good as their infrastructure, with countries needing functioning bridges, roads, airports, power generation, communications and energy grids to operate efficiently and grow their GDP into the future.

Over the years, though, many of these critical assets have fallen into disrepair, and governments, struggling with increasing debt loads, do not have the budgets to make the necessary capital investments. Estimates peg the capital required to maintain and replace existing infrastructure at the current rate of global growth at roughly $3.3 trillion (USD)[8] per year through 2030 (Figure 11).

FIGURE 11: AVERAGE ANNUAL CAPITAL REQUIRED, 2016-30
In constant 2015 dollars, $ trillion (USD)



Source: McKinsey analysis; McKinsey Global Institute analysis

[8] https://www.mckinsey.com/capabilities/operations/our-insights/bridging-global-infrastructure-gaps

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Private equity

Private credit

Private infrastructure

Portfolio construction

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At the same time, there will be many new opportunities to invest in as society moves towards a more sustainable future. The G20 projects a $15 trillion (USD) infrastructure investment gap around sustainable infrastructure through 2040.[9] While a large portion of that is from emerging markets seeking to meet the basic needs of growing urban populations, the gap in developed nations is large, too – in the US it's estimated to be $3.8 trillion (USD) or 16% of GDP.

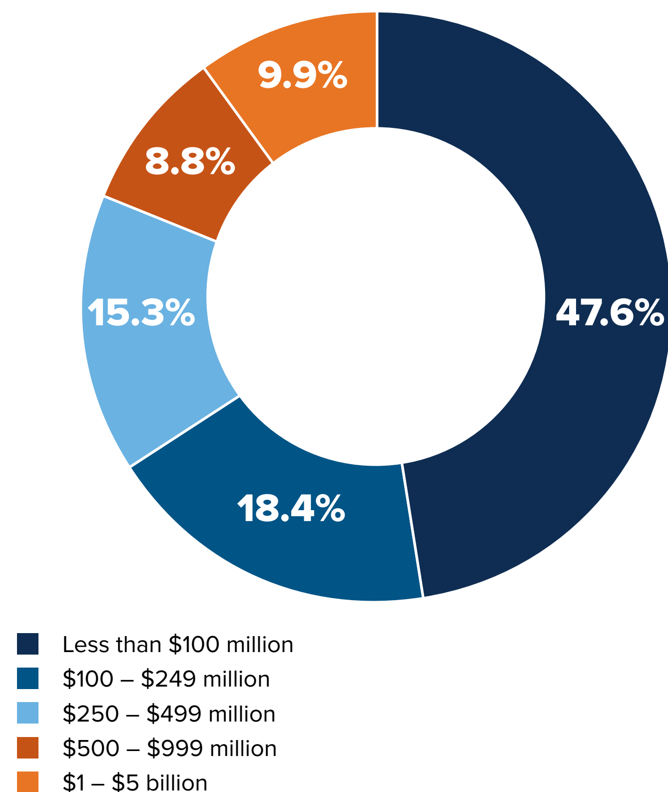
Taken together – replacing aging infrastructure and building the new infrastructure economies need to grow – these massive capital requirements represent an opportunity for investors to provide the funding, whether through private ownership or private-public partnerships of critical assets, and in turn share in the economic and societal returns these investments will generate over the coming decades.

While there will always be opportunities in multi-billion-dollar projects, as urban centres have expanded and rural areas have become more developed, there is an increasing number of opportunities to deploy capital in smaller (mid-market) projects and existing assets around the world.

For instance, there are many more small wind farms, regional toll roads and communications networks than large-cap opportunities in these spaces.

We're already seeing a significant number of transactions in the mid-market, which typically focuses on projects with an enterprise value below $1 billion (USD). Between January and December 2023, whilst large-cap transactions accounted for 56% of deals by dollar value, mid-market transactions made up 90% of executed deals (Figure 12).

FIGURE 12: NUMBER OF DEALS BY DEAL SIZE (USD)



Source: Preqin, as at December 31, 2023. Trailing 12 months.

[9] https://www.ubs.com/microsites/wm-for-you/en/sustainability

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Private credit

Private infrastructure

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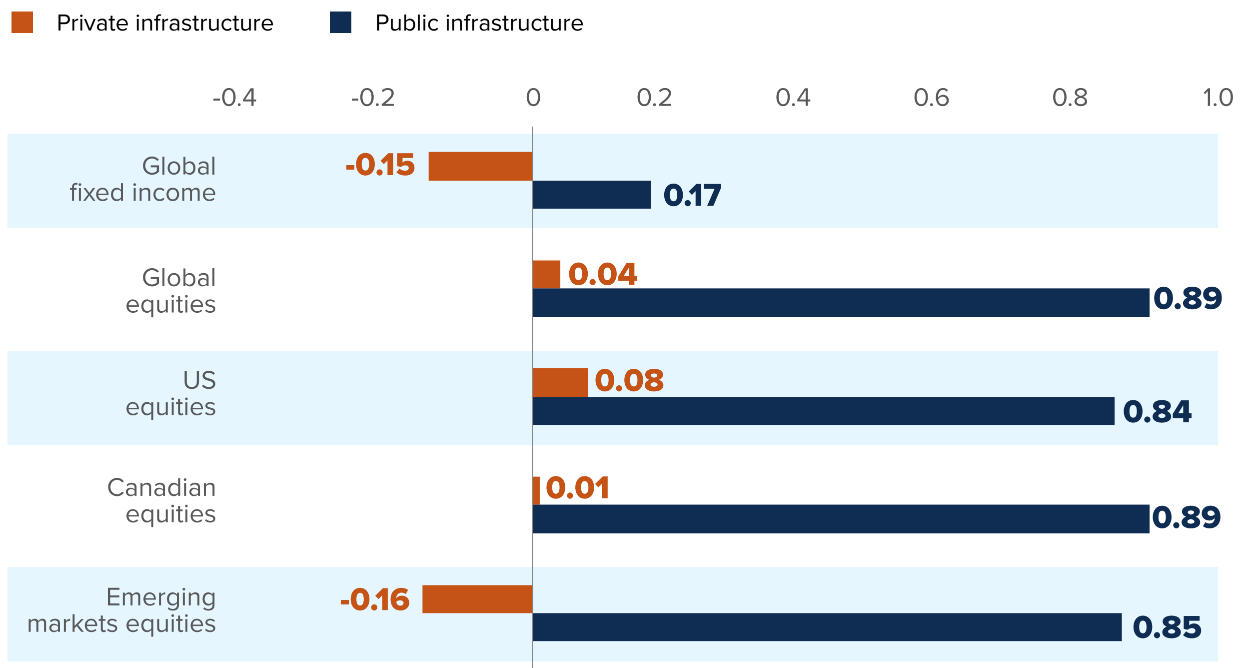
Private infrastructure's evolution

Investor demand is also driving opportunities in this space as more family offices and high-net-worth investors seek investments that have low correlation to the public markets (Figure 13) which also provide a high level of capital preservation, plus ongoing yield and capital gains.

Between 2010 and 2021, the amount of private capital from institutional – and increasingly retail – sources funnelled into this sector globally more than quadrupled to $129 billion (USD).[10] However, this amount pales in comparison to the required investment to meet the ever-growing demands for updated, modern infrastructure.

Private infrastructure, with equity-like capital gains characteristics alongside yield potential, remains an attractive investment because these are long-life assets that tend to generate reliable income streams. However, what constitutes an asset in the space has evolved. While traditional infrastructure assets, such as roads and bridges, are still an important part of this sector, infrastructure asset managers have identified and built-out entirely new sub-sectors within this space that did not exist a decade ago.

FIGURE 13: CORRELATION TO TRADITIONAL ASSET CLASSES, 2008-2023



Source: Private infrastructure: Preqin Quarterly Infrastructure Index, Public infrastructure: S&P Global Infrastructure TR, Global fixed income: Ice BofA Gbl Brd Mkt TR HUSD, Global equities: MSCI World GR, US equities: S&P 500 TR, Canadian equities: S&P/TSX Composite TR, Emerging markets equities: MSCI EM IMI GR USD.

[10] https://cdn.gihub.org/umbraco/media/5266/gih-infrastructure-monitor-2022-report-availability-of-private-capital-may-2023.pdf

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Private equity

Private credit

Private infrastructure

Portfolio construction

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For instance, the US Inflation Reduction Act (IRA), which laid out an ambitious infrastructure plan to support the transition to net-zero, includes projects such as carbon capture and sequestration, green hydrogen and electric vehicle charging. The IRA will provide some $400 billion (USD) in funding through tax incentives, federal loan guarantees and grants rather than direct investments.[11] The government will rely on private companies and investors to bring these projects to life.

It's a similar story within the development of internet infrastructure, where private infrastructure investors can help create more broadband access alongside government funding. In the US, the Rural Digital Opportunity Fund is injecting $20 billion (USD) over 10 years into companies that are developing and operating broadband in rural areas. Already, 180 companies, including satellite operators, fixed wireless providers and cable operators, have received $9.2 billion (USD).[12] As well, the Broadband Equity Access and Deployment Program will contribute more than $42 billion (USD) to close the digital divide between rural and urban locations.[13] These types of bipartisan government programs will provide the tailwinds for long-term capital projects that would otherwise not be feasible for the private sector alone. We see a significant opportunity going forward in programs such as these across almost all OECD countries.

There is a rapidly rising demand for data centres, too, as businesses increasingly explore and deploy artificial intelligence capabilities and other high-performance computing applications. Data centres provide a once-in-a-generation investment opportunity. An estimated $1 trillion (USD) is needed per year to build out this infrastructure,[13] which includes massive ventilation systems, backup generators, new power generation, upgrades to the energy grid and much more.

As stated previously, thinking about what might be considered an infrastructure asset has shifted. When we look for infrastructure assets or companies to acquire, we're not just seeking what many may think of as traditional infrastructure – we're also looking for new types of opportunities that are also essential to well-functioning economies, governments and companies. A security fencing company, for instance, may not seem like a typical infrastructure asset, but fencing is required to protect data centres, car dealerships, logistics centres, airports and shipping ports. It's an asset with very sticky revenues due to long-term customer contracts and the expense and inconvenience to internalize security services.

Infrastructure assets, including ones in emerging sectors, are attractive because of the quasi-monopolistic nature of these businesses, low demand elasticity, long-term contracts and operational lives, high barriers to entry, consistent long-term cash flows and overall low correlation to the broader market. As well, these assets should do well in any economic environment. In both recessionary and high inflation environments, society will still need to access the internet, have working roads and bridges, and require security fencing to keep projects secure. And in high inflation/interest rate environments, these assets can generally produce positive returns.

One of the fastest-growing segments

Infrastructure investment is ultimately expected to be one of the fastest-growing segments in private markets.

With cash-strapped governments unable to fund new infrastructure entirely themselves, more are providing incentives to bring new assets online and update existing ones through private investment.

Add to those new categories of infrastructure seeking private investment, and we believe there will be no shortage of exciting opportunities in the years ahead.

[11] https://www.infrastructureinvestor.com/the-inflation-reduction-act-how-new-rules-fuel-new-financings/
[12] https://www.usac.org/high-cost/funds/rural-digital-opportunity-fund/
[13] https://broadbandusa.ntia.doc.gov/funding-programs/broadband-equity-access-and-deployment-bead-program

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Private equity

Private credit

Private infrastructure

Portfolio construction

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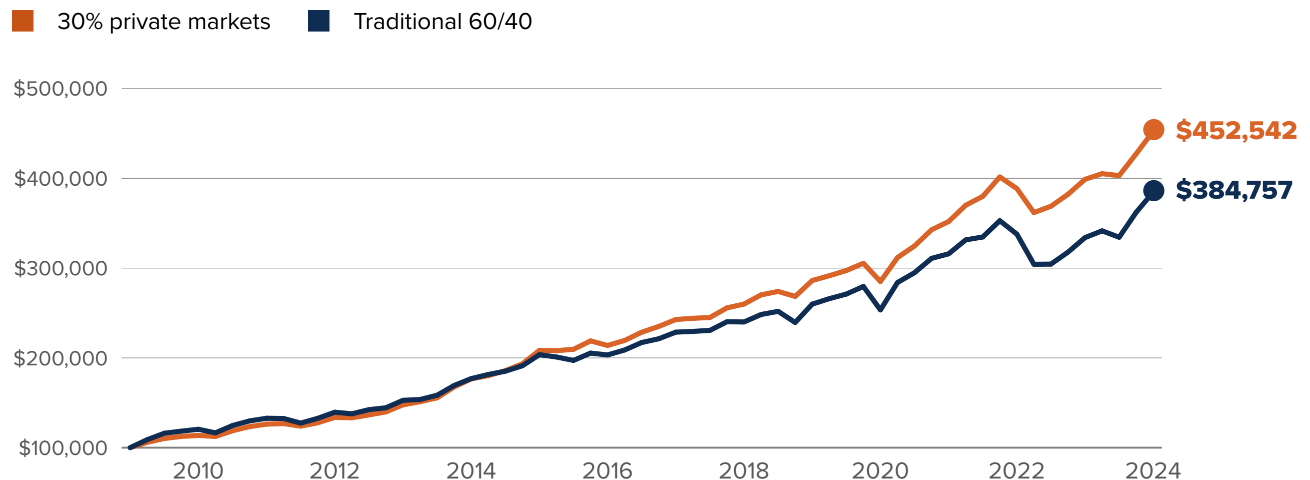
Considering the role of private markets in your portfolio

As market dynamics have evolved since the early 2000s, the classic 60/40 approach to portfolio construction may no longer provide the returns and stability investors need to achieve their long-term goals. Some of the world's largest institutional investors have been increasingly allocating to private markets for some time.

Adding private market assets to a portfolio may offer the potential for higher returns and reduced volatility, with low correlation to public markets. This is especially powerful for portfolio construction since, historically, reducing volatility in a traditional portfolio came with lower, not higher returns. Adding a 30% private markets allocation to a traditional 60/40 portfolio can have a substantial impact on returns (Figure 14).

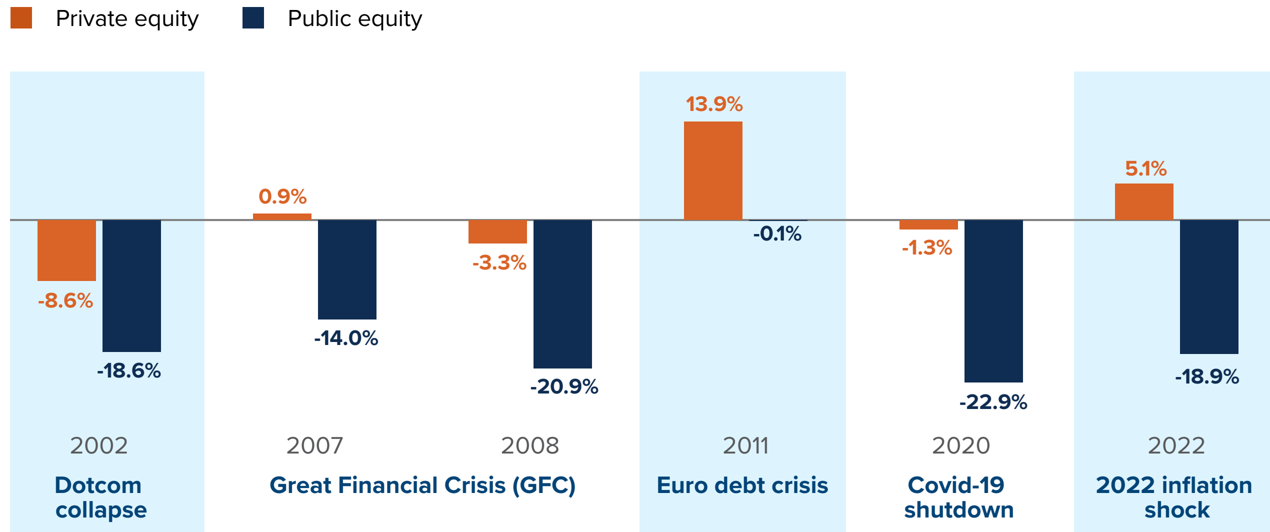
FIGURE 14: RETURN POTENTIAL OF PRIVATE MARKETS



Provided for illustrative purposes only. Hypothetical performance is theoretical, subject to risk and does not reflect actual client trading or the impact of material economic and market factors on the investment decision-making process for an actual account. Hypothetical performance is based on certain assumptions that could change without notice or prove to be incorrect. Different assumptions would produce different results. Fees and expenses applicable to investments in each asset class (not included within the assumptions described herein) would have reduced returns.
Source: Burgiss & MSCI as of March 31, 2024. Traditional 60/40 is comprised of MSCI World Index TR CAD (20%), S&P/TSX Composite Index TR CAD (20%), S&P 500 TR CAD (20%), Barclays Canada Aggregate TR CAD (20%), Barclays Canada Aggregate Bond (Corporate) TR CAD (20%). The 30% private markets portfolios is comprised of Burgiss Global Private Equity Funds Index (CAD) (10%), Burgiss Global Private Debt Funds Index (CAD) (10%), Burgiss Global Infrastructure Funds Index (CAD) (10%), MSCI World Index TR CAD (15%), S&P/TSX Composite Index TR CAD (15%), S&P 500 TR CAD (15%), Barclays Canada Aggregate TR CAD (12.5%), Barclays Canada Aggregate Bond (Corporate) TR CAD (12.5%)

The relative illiquidity of private market assets and longer-term perspective has historically helped insulate investors from the volatility of public market assets. Private equity, for example, has established a track record of resiliency in times of public equity shocks. (Figure 15).

FIGURE 15: MARKET RESILIENCE: PRIVATE EQUITY VS. TRADITIONAL EQUITY



Source: Private equity data provided by Cambridge Associates. Public market indices provided by Morningstar Direct. Private Equity: Cambridge U.S. Private Equity Index (Legacy), Public Equity: Russel 2500. Time period, 01/01/2004 – 12/31/2023. Data denominated in CAD. Private equity returns are shown net of fees, expenses and carried interest.

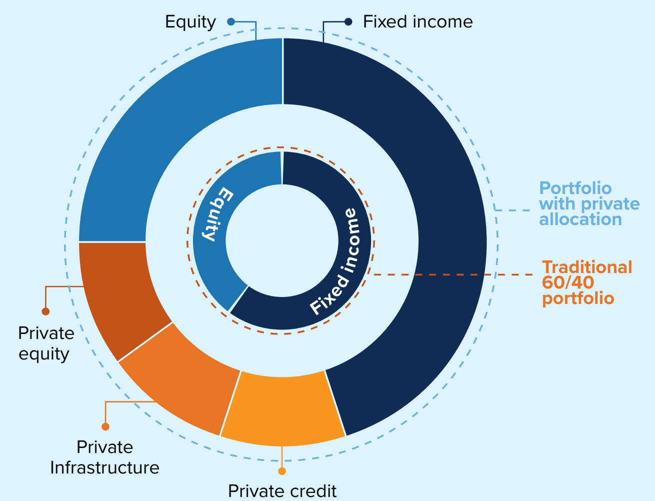
Major market drawdowns have demonstrated that in times of crisis, traditional equities and fixed income are more closely corelated than once believed. As a result of this increased correlation during sharp downturns, investors have tended to sell both stocks *and* bonds and seek safety in cash.

Private market assets have behaved differently. Since they typically require long-term commitments, this reduces the risk of panic selling. The rewards for patient investors typically include lower portfolio risk, reduced drawdowns, higher returns and potentially enhanced yields.

Private equity aims to maximize growth and has historically displayed low to almost no correlation to public markets. Private credit provides floating rate exposure with higher yields than publicly traded fixed income and lender protections that provide strong rates of capital preservation. Private infrastructure provides a blend of capital growth and income and offers resilience against inflation and recessions, as these assets fulfill essential needs of society.

These three private asset classes can be used as partial substitutes for existing public equity and fixed income allocations (Figure 16). In doing so, looking back to the historical example in Figure 14, the positive portfolio results can be substantial over time.

FIGURE 16: TRADITIONAL 60/40 VS. PORTFOLIO WITH PRIVATE MARKETS



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Private credit

Private infrastructure

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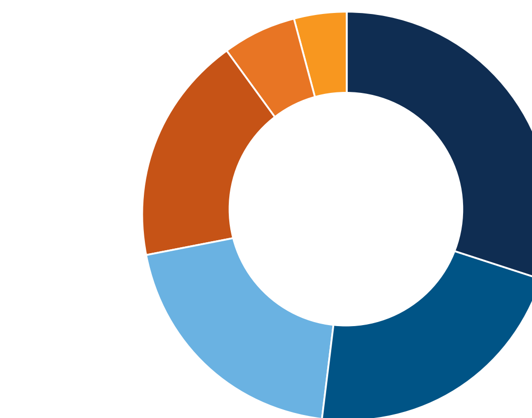
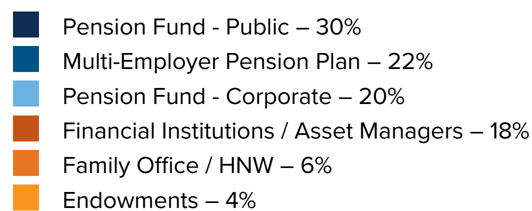
Seeking to achieve investors' portfolio objectives: Northleaf's differentiated approach

Northleaf Capital Partners is a global private markets specialist firm, focused on mid-market private equity, credit and infrastructure throughout developed markets. With a successful long-term track record, Northleaf serves more than 275 institutional investors and family offices globally, with more than $30 billion in commitments raised. Mackenzie is proud to partner with Northleaf to offer accessible private markets opportunities for you and your clients.

FIGURE 17: NORTHLEAF INVESTOR BASE BY TYPE





$30B+
Investor commitments raised

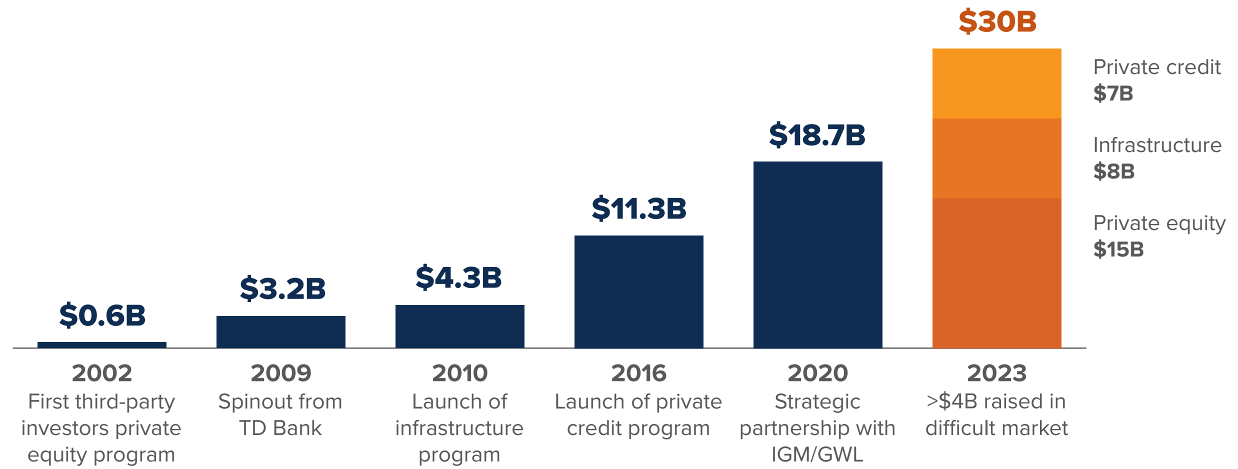
275+
Global investors

250+
Global professionals

10
Global offices

5*
PRI Assessment Score[14]

FIGURE 18: STRONG SUPPORT FROM A GROWING INSTITUTIONAL, FAMILY OFFICE AND INDIVIDUAL INVESTOR BASE



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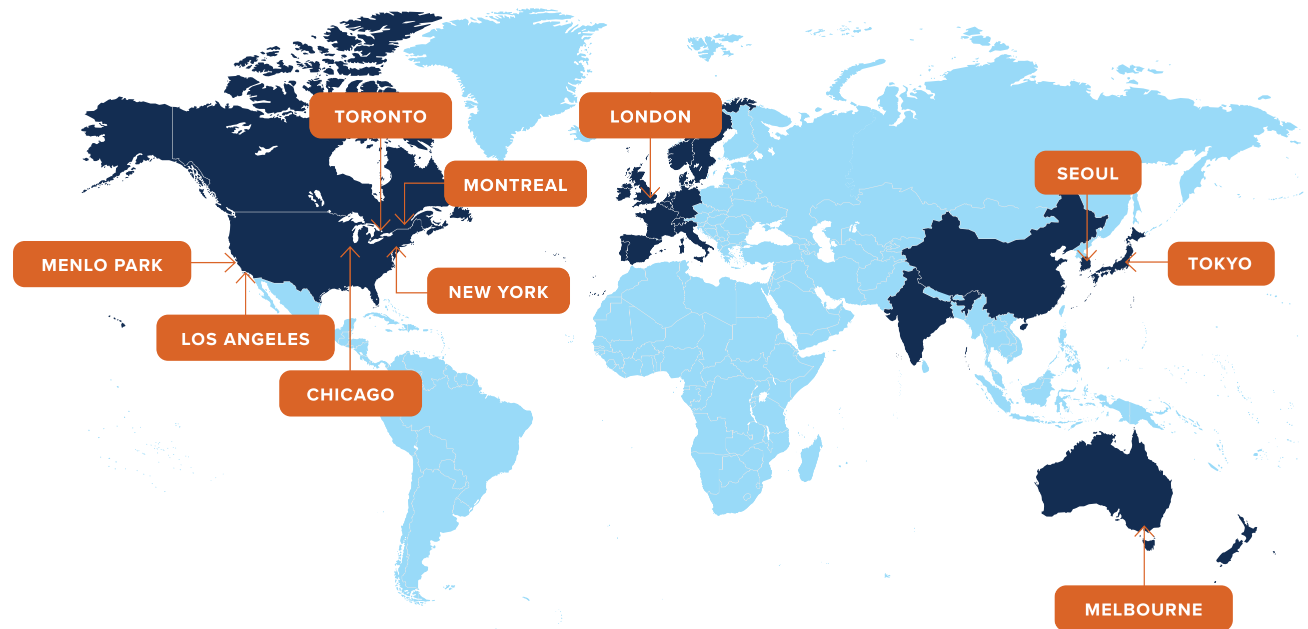
GLOBAL FOOTPRINT FOR ON-THE-GROUND SOURCING, DILIGENCE AND INVESTMENT OVERSIGHT



Private markets

Private equity

Private credit

Private infrastructure

Portfolio construction

Northleaf Capital Partners

Contributors

Danielle Charney
Vice President
Northleaf

Jessica Kennedy
Managing Director
Northleaf

Michael Bowman
Managing Director
Northleaf

Zaman Khan
Vice President
Northleaf

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