CIO OUTLOOK

AUTUMN 2023

A glimpse into 2024

TIKEHAU CAPITAL

Foreword

The global economy is entering a new long term cycle. The last few decades have seen global growth driven by the ballooning of both financial and ecological debt. Both have reached a limit which will trigger deep changes in the current economic model: a transition towards a more sustainable, less optimised and globalised economic system is the only way to avoid significant value destruction.

This shift from seeking efficiency and optimisation to seeking resilience and sustainability will lead to increased dispersion, greater volatility, higher risk premiums and will restore a price for capital and liquidity. We welcome those developments as good news. Long-term investment discipline and culture, a robust platform with local deal sourcing and a strong alignment of interests will be necessary to generate superior returns in this new environment. For the investors that appreciate these features, significant investment opportunities are already emerging.

THOMAS FRIEDBERGER
Deputy CEO and Co-CIO
of Tikehau Capital

ASSESSING THE ECONOMIC LANDSCAPE:

18 months into the Ukraine conflict

1 Resilience substitutes efficiency in generating economic value

The economic consequences of COVID-19 and the crisis in Ukraine have highlighted signs of vulnerability in our economic system. Since the mid-1980s, three factors that were very favourable for the generation of corporate earnings were combined in an exceptional way: falling interest rates, the continued decline in corporate income tax rates, and globalisation. These tailwinds have allowed companies to over-optimise their production tools, taxation strategies and even the levels of equity with which they have operated, all aimed at maximising their profitability.

The tensions between the US and China, the COVID-19 pandemic, and the war in Ukraine have collectively reversed all three factors. As a result, headwinds to infinite economic growth are emerging. Global growth will slow down in the coming decades, which is not bad news, considering that the search for exponential growth in recent decades has had a negative impact on climate and biodiversity (E), inequality (S) and has resulted in the misallocation of capital induced by overly accommodative monetary policies (G).

In essence, lower growth, when factoring in extra-financial criteria will be more sustainable. The coming decades will prove that extra-financial criteria generate financial performance. This is excellent news since the orientation of capital towards virtuous investments can only materialise if these investments are financially profitable.

"The "relocation" and return of local ecosystems make it possible to move towards a more sustainable but less optimised growth model.

Faced with this new paradigm that combines globalisation with vulnerability, companies must generate resilience. This involves shifting production closer to the consumer instead of locating it in the countries with the lowest costs, paying taxes in the jurisdictions where they operate, and operating with larger equity buffers and less leverage to cope with uncertainty. The "relocation" and return of local ecosystems make it possible to move towards a more sustainable but less optimised growth model. To create this resilience, companies, public services and states must invest massively across several areas. These areas, due to their significant investment requirements, constitute megatrends with strong growth potential in a world characterised by low growth.

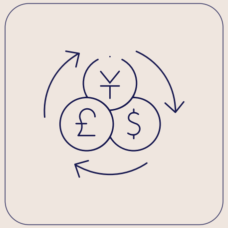
2

The growing policy rift between central banks and governments

Central banks need to fight inflation by raising interest rates and slowing money creation to levels that allow inflation to return to their official target. The return of inflation triggered the fastest rate hiking cycle in history by central banks in developed markets. This inflation is partly cyclical, but also partly structural and linked to demographic shifts, changes in the energy mix, the consequences of deglobalisation and China's effort to decouple from the US dollar by creating an alternative monetary area with its trade partners.

> **"The return of inflation triggered the fastest rate hiking cycle in history by central banks in developed markets.**

On the other hand, governments need to increase their debt issuance. After the second world war, the US budget has been dominated by military spending and less so by social security and healthcare spending. In contrast, Europe experienced the opposite: a significant welfare state and lower military spending, attributed to Europe's reliance on the military protection provided by the US.



But today in the US, spending needs are increasing significantly. **Even in 2023, the US debt ceiling has been welcomed by the market, despite occurring in a period of full employment for the US economy. The US government has recently made public the amount of bond issuance for the second half of 2023: a record $1.85 trillion worth of US Treasuries will be issued this semester.** This is one of the reasons why Fitch decided to cut the US sovereign credit rating. Compared with the downgrade by S&P in 2011, there are significant differences. In 2011, after the Global Financial Crisis (GFC), the US budget deficit stood at 8.4%, while the unemployment rate was 9% and interest rates stood at 0%. It made sense to issue debt and incur a budget deficit as a countercyclical measure to relaunch the economy. The cost of debt was cheap. In contrast, 2023 looks very different. The budget deficit will be around 6.5% this year, but unemployment is at all time low and interest rates are at 5%. As a result, not only is this deficit increasing, but it is also taking place at a time of full employment and the cost of issuing debt will have a significant impact on debt servicing in the coming years.

> **The US government has recently made public the amount of bond issuance for the second half of 2023: a record $1.85 trillion of US treasuries will be issued this semester.**

Why is this trend structural? The US needs to maintain its military spending due to ongoing tensions with China. When considering demography, by 2100 there will be 5 billion people in Asia and 4 billion in Africa out of a total of 11 billion humans. The Indian Ocean will probably become the economic centre of the world. For the first time since World War II, the economic centre will be at the antipodes of the US territory (in the latter half of the last century, it was centred around the Atlantic Ocean and in the first part of this century, it shifted to the Pacific Ocean, with the US having coastlines along both). The only way for the US to maintain their position is to bet on military and technological domination, enabling the country to project their power everywhere around the globe. At the same time, the health situation of the country is deteriorating.

For the first time in modern history, life expectancy has declined during peace time in a developed country, the US. The costs associated with obesity, cancer, diabetes, opioids are increasing, and the government will need to contribute to these efforts, on top of subsidising the energy transition (IRA). The US will need to issue more and more debt. Budget deficit will reach $1.5 trillion.

Europe faces the same challenge. **European countries will have to continue to fund a welfare state due to the ageing European population. Moreover, countries like Germany will need to increase military spending significantly, in response to the resurgence of war on the European continent. In parallel, they must fund their energy transition to cope with the sudden breakdown in Russian gas supplies, a very cheap source of energy**. Cumulated budget deficit for the eurozone will reach €650 billion, an all-time high.

Who will buy all the bonds issued by Western governments?

It won't be **central banks** who are **ending their QE programs**. **China will buy less of them** as it is seeking to establish its own monetary system, encouraging trade partners to trade and borrow in RMB.

Countries which needed USD reserves to buy commodities (including oil) in USD will soon be able **to buy those commodities** in other currencies, including their own (China and India buy Russian oil in non-USD currencies). As a consequence, those countries **need less USD reserves and will buy less US treasuries**. Finally, various emerging powers are now focusing on reinvesting their capital in their own economy. For example, they are using Sovereign Wealth Funds to invest capital with asset managers who commit to encouraging their portfolio companies to develop business within the country of the investor. This is the case in China, but also GCC countries. This probably means that **less money from those countries will fund Western government bonds, real estate, or minority stakes in Western listed companies**.

What does it mean?

Most likely, it implies that the only marginal buyers of Western government bonds will be Western institutional investors, such as pension funds, insurances companies and banks. **However, these private investors will have to absorb government debt worth 7.7% of developed economies' GDP in 2023 and 9.2% in 2024 (double the 4.3% recorded in 2011).**

What is the right price for these bonds?

Currently, the equity and credit bull market can be explained by the anticipation that short-term interest rates are too high, and the belief that waning inflation will allow central banks to cut rates. This rationale has led to the inversion of yield curves in the US and Europe. But, what if, due to the aforementioned factors, it is the long-term rates that are too low compared to the appropriate level of short-term rates?

Currently, T-bills at 5% offer the same yield as US investment-grade bonds and the yield of S&P 500 (the inversion of P/E i.e., E/P). Furthermore, US treasuries 10-year real yield (nominal – inflation expectations) is 1.7% versus 0% in 2011, meaning that the actual cost of debt for the issuer is already much higher.

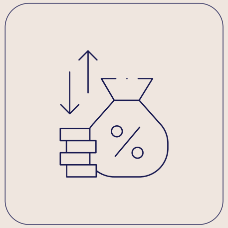
3

Capital has a cost and liquidity has a cost

Negative interest rates and abundant liquidity provided by monetary and fiscal policies over the last 15 years, with an even swifter acceleration during the COVID pandemic, have generated both an unsustainable amount of global debt ($305 trillion in 2022, more than three times the global GDP) and misallocation of capital. The cost of capital and liquidity was low in this period. However, this trend is now reversing.

There still might be signs of abundant liquidity:

- In July 2023, a single-day movement in NVIDIA's stock led to an increase of $185 billion in market capitalisation. This single-day gain exceeded the firm's cumulated revenues over a span of more than 20 years.
- In August 2023, Vinfast (Vietnamese EV manufacturer), went public via a SPAC on Nasdaq. On its first day of listing, the company was valued at $85 billion, despite $2.1 billion of losses in 2022. The company's market capitalisation is higher than both Ford and GM.



However, there are many canaries in the coal mine indicating that liquidity is drying up and that its cost is increasing massively:

- **Real estate dynamics**
- **Crypto crisis**
- **China property developers' crisis**
- **Slowdown in M&A volumes, IPO volumes, corporate bond issuance**
- **Venture capital dynamics**

- **Governments need to increase sovereign debt issuance.** Institutional buyers will provide liquidity, but this will drain liquidity elsewhere in the private sector (public and private assets)
- **Cost of debt in LBO, real estate**
- **Discounts in secondary private equity and private debt markets**

Despite substantial support from the government and the FED, **US regional banks face challenges:**

80%

of CRE loans are granted by regional banks and CRE loans represent 40% of the balance sheet of regional banks.

In Q1 2023, the average deposit rate of US banks was 1.5%. With T-bills offering 5% yield, this deposit rate will need to increase massively. This adjustment will have a significant impact on banks' profitability and liquidity.

4 Risk premiums will be structurally higher

The high visibility provided by the extended downtrend in interest rates and the strong tailwind of globalisation have allowed risk premiums to remain compressed. In this environment, growth will have to slow, with the decline optimisation and the cost of building resilience: less leverage, less optimisation, greater capital constraints for banks and corporates. Growth won't be enough to support the volume of debt within the system. This shift will bring **volatility, dispersion and reduced long-term visibility, justifying higher risk premiums.**

In parallel, the **emergence of AI could have severe destabilising consequences for democracy**, with hostile countries or internal forces influencing voters, creating filter bubbles to encourage extreme voting behaviour. Risk premiums are compressed in democratic systems because the democratic regime ensures economic stability, monetary credibility, and the prevalence of the rule of law (where anybody can in theory benefit from the judgement of an impartial court of justice). **If democracies are destabilised by AI, uncertainty will grow and risk premiums will have to increase.**

During the long phase of globalisation, the global equilibrium between developed markets (DM) and emerging markets (EM) were founded on a division between cheap labour and expensive capital in EM, versus cheap capital and expensive labour in DM.

> **“During the long phase of globalisation, the global equilibrium between developed markets (DM) and emerging markets (EM) were founded on a division between cheap labour and expensive capital in EM, versus cheap capital and expensive labour in DM.**

AI has the potential to disrupt this equilibrium by allowing developed markets to reindustrialise and engage in local production. **If AI threatens this equilibrium, unless emerging markets can lower their cost of capital** (which is happening in countries like Indonesia, Mexico or in the Middle East) emerging markets will lose their competitive advantage of providing a more cost-effective labour force. This is currently taking place, with the US gaining competitiveness through initiatives like the Inflation Reduction Act for electrical vehicle (EV) car manufacturing, for example. Large immigration waves will follow towards North America, Europe and potentially China, if the country opens its doors to immigration to compensate for its ageing population. This could lead to the redistribution of the factors influencing value creation and political stability, again justifying higher risk premiums.

SUSTAINABLE GROWTH, KEY MEGATRENDS, STOCK SELECTION AND LIQUIDITY PROVISION:

Why we're optimistic: four key drivers of current investment enthusiasm

1

Moving towards more sustainable growth

Companies that do not perform well in extra-financial metrics have decreasing access to available capital. Both their financing costs and the cost of capital increase placing them at a huge competitive disadvantage compared to their peers who perform better on these metrics. We can see this happening in our investment activities in debt (private debt and debt traded on capital markets) and in capital (private equity and listed shares), as well as in real estate. This trend is on the rise.

The Glasgow Financial Alliance for Net Zero (GFANZ) initiative is an interesting example. On the sidelines of COP26, most of the world's major banks signed the GFANZ initiative with the aim of achieving net zero in two-thirds of their assets by 2050.

Given the current composition of the banks' balance sheets, this suggests that the cost of financing non-net zero assets through the banking system would need to rise very rapidly to have a chance of attaining such an objective. The equivalent for asset management is called the Net Zero Asset Managers initiative. It has more than 315 asset manager signatories, generating $59 trillion or approximately half of the world's managed assets.

Extra-financial criteria will predominate in the generation of financial performance, and this is excellent news since the orientation of capital towards virtuous investment can only be done significantly if these investments are financially profitable. **Ignoring extra-financial criteria will not only destroy financial value but also generate considerable financial risks.** Companies that do not perform on the basis of non-financial criteria already have access to smaller amounts of available capital. Their cost of financing and cost of capital are rising, creating a massive competitive disadvantage compared to their more successful competitors on these criteria. We observe this across our investment activities in debt (private debt and debt traded on capital markets) and capital (in private equity and listed equities), but also in real estate and infrastructure. Insurance premiums for bad performers are also rising rapidly, and the trend is accelerating.

> **“ Extra-financial criteria will predominate in the generation of financial performance, and this is excellent news**

The refusal to consider new measures is now overshadowed by reality: **the over-optimisation facilitated by the continuous fall in interest rates and globalisation increases margins but weakens the system and increases risk. Ultimately, it threatens to destroy more value than this system creates. The COVID crisis serves as an illustration of this and acts as a warning. Climate change and the social instability it generates will destroy even more value.** Finally, performance based on extra-financial criteria could, in the relatively short term, provide companies with a valuation premium. In addition to concentrating strong growth, sectors that contribute to economic resilience are likely to have higher multiple valuations.

2

Megatrends driving growth in a slow economy

The amount of investment needed to fund the transition to a sustainable model is so great that if these investments are well executed, they will trigger strong growth in a world characterised by increasingly weak growth. The example of the energy transition is particularly interesting. As well as addressing the climate issue, the energy transition offers a competitive advantage in a context of deglobalisation. The necessity to relocate industrial production to the countries where consumers are located, involves significant investments, as well as an increase in labour costs. **Investing in energy-efficient buildings, production methods, supply chains and vehicles will enable companies to stay competitive.**

> “The energy transition offers a competitive advantage in a context of deglobalisation

It is clear, therefore, that the energy transition is more than just a nice-to-have gimmick or a superficial attempt to “greenwash” communication. It is a crucial competitive advantage that grants a licence to operate. Without it, companies will lose their competitiveness and financial profitability. What's more, the energy transition creates jobs and is a factor in energy sovereignty for governments. **The energy transition will attract massive flows of investment, making it a strong growth megatrend.**

Several other megatrends aim to enhance resilience. Enablers of these megatrends should provide considerable investment opportunities. Tikehau Capital has been developing expertise across the following trends for many years:

European direct lending:

Acquisition financing in Europe is facilitating the creation of continental champions from mid-sized, fast growing national companies. European direct lending will create resilience by enabling consolidation within strategic sectors.

Cybersecurity:

The need to build resilience becomes evident in the context of cybersecurity. No technological revolution can be achieved without cybersecurity. Cybersecurity risks likely rank among the most universal concerns shared by humans worldwide, along with public health and climate change issues.

Value-add real estate:

The COVID crisis has permanently changed people's behaviour. Outlying shopping centres are struggling to attract customers, companies are opting for smaller offices in city centres combined with remote work instead of larger offices in peri-urban areas, e-commerce is changing logistics requirement and new modes of mobility are reshaping urban flows. The acquisition of assets not adapted to these new realities, located in prime locations and their subsequent transformation into new mixed-use zone solutions combining offices, residential spaces, retail establishments and public services makes all the more sense, given this transformation contributes to the creation of energy efficient buildings, green spaces and represents a solution for relieving traffic flows and preserving biodiversity in urban areas.

The energy efficiency of buildings, the redevelopment of urban spaces through flow optimisation, and the integration of biodiversity spaces for the temperature regulation of cities and resilience to climatic events, constitutes both an element of sovereignty for Europe and global expertise for leading companies to attract international talent. It represents a considerable investment opportunity for the investor. Europe is at the forefront of addressing these issues and is exporting its expertise on these matters.

Digitalising industry:

All over the world, the creation of resilience requires a relocation of the industrial production apparatus and supply chains. The concept of "reshoring" or "friend-shoring", involving the repatriation of production to "friendly countries", is a challenge for all economic powers. The widespread emergence of new technologies allows companies to digitise their production processes and supply chains. The digitalisation of processes related to the production of goods and services, distribution, relations with customers and suppliers, as well as supply chains, serves as an essential driver of competitiveness.

Regenerative agriculture:

40% of agricultural land globally is damaged by intensive agriculture. Agriculture is one of the largest contributors to greenhouse gas emissions although soils should in principle be the largest carbon sink on the planet. Regenerating soils through regenerative agriculture using less chemicals, less water and less agricultural equipment will not only give back purchasing power to farmers but also regenerate soils that will be able to compensate emissions from other sources (industry, transportation, power generation). Agri-tech, biofertilisers and soil regeneration techniques offer a massive investment opportunity worldwide.

US infrastructure:

Infrastructure requirements are significant in the US. But energy transition amplifies the significance of this opportunity even further. The Inflation Reduction Act highlights the willingness of the US to speed up its energy transition. Shale oil and gas provided a very strong competitive advantage to the US economy, but the only shale basin to have not reached peak production is Permian-West Texas. The US won't be able to maintain its fossil fuel independence for ever and needs to retain its global leadership by leading by example on transitioning to clean energy. The US infrastructure opportunity is even stronger with this new angle.

Listed equity high ROCE / quality stocks:

Buying shares of businesses with high return on capital employed, benefiting from a long track record of outperformance as listed companies. Those firms are usually good asset allocators and good at passing inflation to the end consumer as they sell small products and services to a large number of people across the world, giving then access to EM growth as well as providing them with a long track record in performing capital expenditure.

3

Value creation is switching from asset allocation to asset picking

Capital expenditures are often seen as the enemy by investors, because only the best companies, that are well managed and have strong governance efficiently invest their free cash flow. The rise in interest rates and deglobalisation create dispersion between the performance of companies in the same sector or geography. Across all asset classes, economic value creation for the investor shifts from asset allocation to value selection. When favourable conditions prevailed, positioning oneself in the right asset class was enough to generate performance. When the conditions become more challenging, only the best elements manage to stand out from the crowd. Identifying them requires in-depth fundamental analysis, both financial and extra-financial. In the long term, we are convinced that financial and extra-financial criteria are two sides of the same coin: to be profitable, growth must be sustainable.

4

Being a liquidity provider during a liquidity crisis brings significant value

Tikehau Capital has abundant dry powder, a solid balance sheet with strong shareholder equity and has refrained from using extensive leverage in its strategies[1]. Tikehau Capital has been a pioneer in the secondary private debt market, launching one of the first funds in this new asset class and executing the largest private debt secondary transaction on record.

Tikehau Capital is well positioned to provide liquidity selectively and benefit from substantial investment opportunities across various areas, including:

- Private debt secondary transactions
- Special situations: providing liquidity across the capital structure (senior debt, mezzanine, private convertible bonds, preferred capital) to strong businesses facing a liquidity gap.
- Real estate financing
- Liquid bonds acquired at a discount, facilitated by a strong credit research setup. This setup has consistently provided proprietary analysis on corporate bonds and leveraged loans issuers of smaller size, where no sell side research was available.
- External growth for Tikehau Capital's asset management platform: providing liquidity to GPs by integrating good businesses and expertise into the Tikehau Capital platform.

[1] Average debt/EBITDA ratio of 3x across its private equity portfolios and 4.5x across its private debt portfolio, which is much lower than industry standards.

READY TO SEIZE OPPORTUNITIES:

How Tikehau Capital is equipped for the current environment

- Only the most disciplined asset managers will outperform in this environment. Tikehau Capital has a strong investment culture, is highly selective (closing an average of 5% of transactions for which it has signed an NDA) and has a 20-year track record in deploying capital across both private and liquid asset classes.

- Because ecosystems will be more local in order to build resilience, local sourcing will make even more difference than before. Tikehau Capital has 15 offices spanning four continents. Most of the local teams have investment professionals on the ground, plugged into those local ecosystems. Tikehau Capital does not invest directly in countries where it has no local presence. This strong local setup is a solid entry barrier and will serve as a key differentiator in the coming years.

- Tikehau Capital has a strong capital base, with dry powder across its funds and a balance sheet of €5 billion, including €3.1 billion in shareholder equity, deployed both in the funds we manage and in third party funds and transactions. This amalgamation contributes to fostering a thriving and fertile ecosystem within the firm.

- Tikehau Capital funds do not use high leverage and are not dependent on leverage to generate strong returns.

- Tikehau Capital's credit expertise are now spread across the platform, allowing us to acquire or structure credit instruments spanning from senior secured debt to capital instruments in a wide range of areas: corporate bonds, loans, private credit, real estate financing, asset backed instruments, convertible bonds, and preferred equity. With higher interest rates and liquidity priced appropriately, expected returns in the credit space represent a unique risk-reward profile in the current environment. This is particularly relevant for large platforms like ours, capable of sourcing transactions across primary and secondary markets worldwide.

- Tikehau Capital's alignment of interest is second to none, with 80% of the invested portfolio of the balance sheet deployed in its own funds. This distinction positions Tikehau Capital as one of the largest LPs across all managed strategies. 56% of capital belongs to employees and partners, establishing a symmetrical and robust alignment of interests.

TIKEHAU CAPITAL

tikehaucapital.com