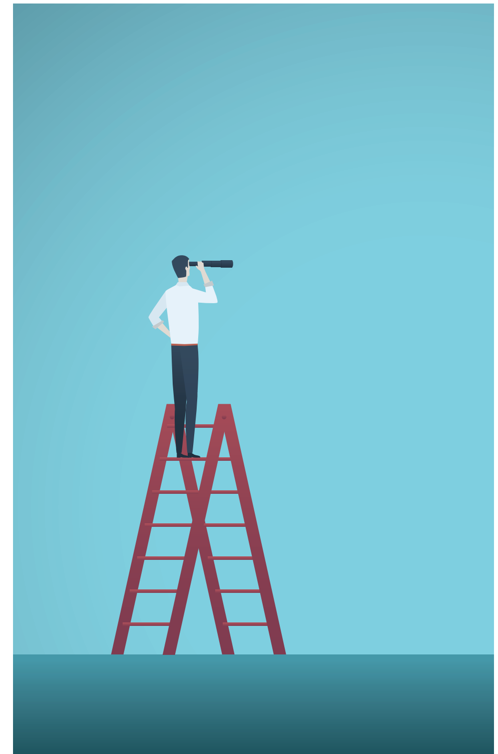
A glimpse into 2024

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 less globalised economic system is the only way to avoid significant value destruction, according to Tikehau Capital's Deputy CEO and Co-CIO Thomas Friedberger. He sees that significant investment opportunities are already emerging for investors who appreciate these developments.



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By *our editorial team*

How would you assess the current economic landscape?

'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. However, 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 isn't bad news, considering that the search for exponential growth in recent decades has had a negative impact on climate and biodiversity (E), has increased inequality (S), and has resulted in the misallocation of capital induced by overly accommodative monetary policies (G).'

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What does that mean for investors?

'The coming decades will prove that extra-financial criteria generate financial performance. This is excellent news since the much-needed orientation of capital towards virtuous investments can only materialise if these investments are financially profitable.

Faced with a 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.

But growth levels will not be enough to support the volume of debt within the system. Therefore, the shift from seeking

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efficiency and optimisation to seeking resilience and sustainability will lead to increased dispersion, greater volatility, and higher risk premiums. It will also restore a price for capital and liquidity.’

You say ‘excellent news’, why is that?
‘Our investment enthusiasm has three main drivers. Firstly, we are moving towards more sustainable growth. Ignoring extra-financial criteria will not only destroy financial value, but also generate considerable financial risks. Companies that don’t 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 in capital (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.

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. Also, 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.’

Besides extra-financial criteria, what else is critical?
‘The growth opportunities offered by all of this. Thus the second driver is that 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.

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 license 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.

Finally, the third reason for optimism is that 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. Deglobalisation and the rise in interest rates 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.’ ■

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Thomas Friedberger
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SUMMARY

The global economy is entering a new long-term cycle with lower growth, increased dispersion, greater volatility and higher risk premiums.

The coming decades will prove that extra-financial criteria generate financial performance. This is excellent news since the much-needed orientation of capital towards virtuous investments can only materialise if these investments are financially profitable.

There are three reasons for investment enthusiasm: the move towards more sustainable growth, megatrends driving growth in a slow economy, and value creation switching from asset allocation towards asset picking.

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