ARCAPITA

Investment Outlook 2023: Navigating Troubled Waters

December 2022

Foreword

As 2022 draws to a close, we find ourselves cautiously optimistic about the new year. As we look back over the events of 2022, the challenges that emerged felt as if we had gone back to the 1970s – Cold War era rivalries took center stage in geopolitics, inflation and high interest rates racked the markets, and high energy prices returned, further straining many economies.

For Arcapita, we predicate our investment strategies on downside protection, particularly given the current economic environment, which is why we focus on sectors with long-term fundamental support and avoid opportunistic investing. We were also reminded this year of the importance of a diversified portfolio: the energy price increase that was a macroeconomic headwind for some of our investments was a tailwind for many others; the pace of inflation created an opportunity for many of our investments to pass through price increases to customers, while other investments retrenched; and high interest rates are creating value dislocations in the market that we expect will allow us to secure investments at more attractive valuations.

The current interest rate cycle continues to create pockets of distress and value dislocations, presenting an opportunity to invest at cyclically attractive valuations

This approach gives us optimism heading into 2023. In terms of the macroeconomic environment, sentiments have now become more upbeat. The most recent data from the US and the Eurozone points to slowing inflation, which has allowed central banks to indicate that we may be near the end of this cycle of monetary policy tightening. This news has been received as something of an early Holidays gift to investors, as public markets have now exited the bear market that began in June of 2022, although volatility continues to persist. Additionally, the energy shortage and crisis that was expected to materialize in Europe as a result of the conflict in Ukraine has not yet materialized. Warm temperatures and consumer discipline have reduced consumption, and energy prices in some markets are 70% off their one-year highs.

At the same time, these developments have led to uneven markets, creating areas of opportunity on both the buy- and sell-sides. The current interest rate cycle continues to create pockets of distress and value dislocations, presenting an opportunity to invest at cyclically attractive valuations. Meanwhile, the market has proved rewarding for well-managed, resilient assets, as demand and valuations for these assets have proven more durable, and we may look for realizations of select investments. We will continue to build scale globally within industrial real estate, which has once again proven its position as a resilient asset class, as economies continue to migrate towards e-commerce and digital consumption, but remains fragmented, enabling us to benefit from aggregating portfolios. We will aim to grow our private equity portfolio while retaining a focus on asset-light, scalable businesses with compelling growth opportunities. We are approaching 2023 with cautious optimism for the challenges and opportunities that lie ahead, and we look forward to working together with our investors to deliver a successful year.

We will continue to build scale globally within industrial real estate, which has once again proven its position as a resilient asset class

We are approaching 2023 with cautious optimism for the challenges and opportunities that lie ahead

Divergent Exits from Global Trends

Andrew Scott
Professor of Economics
London Business School

2022 ushered in major changes in the investment climate. If 2020 and 2021 saw the markets roiled by the rare event of a pandemic, in 2022 a more familiar but long absent foe returned – inflation. The 'temporary' inflation surge of 2021 turned into something far more stubborn and persistent, and the resulting monetary tightening brought about major market adjustments. After more than a decade of historically low interest rates, we were reminded that interest rates can rise quickly and that new eras don't last forever. That lesson was hammered home by significant declines in bond and equity markets and, as liquidity receded, repeated signs of financial instability, nowhere more prominent than in crypto markets.

Investors were also shaken by a range of concerns around future growth. The war in Ukraine renewed dormant global geopolitical risks and resulted in huge increases in energy and food prices. The magnitude of this cost of living squeeze is felt particularly sharply in Europe, threatening significant falls in demand and risks of a recession. In China, the fallout in the property market and the economic consequences of Covid lockdowns have also been damaging. In the US, expansionary monetary and fiscal policy had produced rapid demand growth, requiring multiple large hikes in interest rates to control inflation, which created the risk of an economic slowdown. The interest rate hikes strengthened the dollar, putting upward pressure on cost of living and creating other challenges for emerging market economies.

What is striking is how these distinct forces in different major regions are all coming together at the same time to lower growth. The IMF forecasts that global growth in 2022 will be 3.2%, down from a heady 6% in 2021.

In looking for clues as to what 2023 will bring, the natural inclination is to look back at the 1970s. That is

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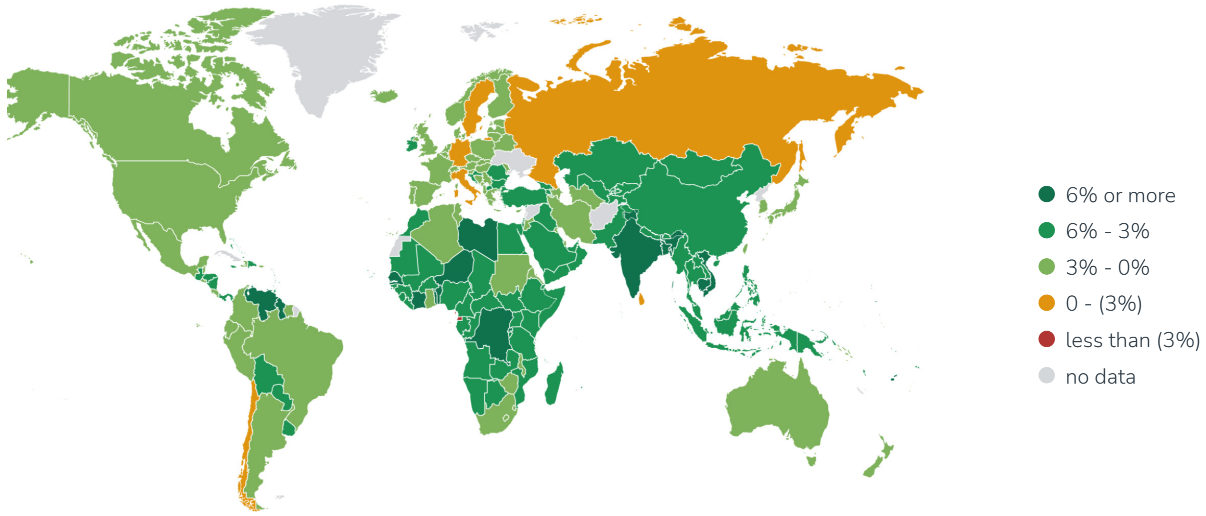
Green Shoots

Global projected GDP growth, 2023



Source: IMF

the last time that a long period of easy global liquidity came to an end with stagflation – rising inflation and recessions. How good a guide the 1970s will prove hinges around what happens next to inflation.

As 2022 draws to a close, a growing number of voices can be heard arguing that the recent rapid tightening of monetary policy, in combination with a cost of living income squeeze, has done enough to bring inflation under control. In response, monetary policy will soon need to become growth accommodating – a combination high on the investor wish list for 2023.

The opposite danger is that inflation becomes more firmly entrenched and, whilst likely to fall from its current highs, will prove stubbornly resistant to declining to or below target levels. Even with the prospect of slower growth, the IMF does not expect global inflation to get below its 2021 level until 2024. Aware of how stubborn inflation can be, central banks may risk keeping tight for longer, drawing their own lessons from the 1970s.

Another lesson to draw from the 1970s is the risk of policy mistakes. Monetary policy is ill-suited to deal with supply shocks, which are a natural blind spot in the intellectual frameworks of central banks. Further, a cost of living crisis and a recession require the right mix and coordination of fiscal and monetary policy. That makes achieving an 'immaculate disinflation' difficult, pointing to the risk of either higher inflation for longer or a worse economy for longer.

With so many turning points occurring at the same time – economic and non-economic, short and long run, the investor horizon is unusually uncertain. Another form of uncertainty to be aware of in 2023 is the risk of diverging cyclical trends. Whilst all countries are wrestling with the risk of a downturn, the factors at work are different in each. Add to that the scope for individual errors in how monetary and fiscal policy are coordinated, and the likelihood is of divergent trends in major markets.

In the US, the risk is of inflation being far more embedded than is hoped and an economy showing much greater strength than anticipated. This will be the story of the first half of 2023 and the issue will be how committed the Fed is to raising interest rates to counter its strength. All this pushes recession risks and interest rate cuts back into 2024.

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In Europe, the risks are skewed in the opposite direction. Given the weakness of growth and demand and the size of the cost of living hit, inflation is likely to be short lived and a deepening recession the theme of the early months of 2023. That will lead to debate as to when the ECB will cut rates.

Perhaps the greatest uncertainty revolves around China now that 'dynamic clearing' COVID policy has come to an end. Inevitably, COVID cases and fatalities will rise, but it also seems likely after so long in lockdown that the Chinese consumer will boost demand at the same time as the government has been supporting the property market. The likelihood is turbulence and a faster rebound to Chinese growth than was expected a few months back. That should help support commodity and energy prices, providing further strength to the Middle East.

Different shocks, different policies, different mistakes, and a fragmenting global economic and political environment all point to 2023 seeing divergent market performance. The lack of coordination that comes with these developments is a theme that investors will need to prepare for well beyond 2023.

Global Inflation & Interest Rates

Professor Sergio Rebelo
Kellogg School of Management
at Northwestern University

For decades, central banks in Japan, Europe, and the United States struggled with persistently low inflation (lower than their 2 percent target). Suddenly, most of the world is now experiencing inflation rates in the high single digits. What happened?

During the global financial crisis, many central banks used quantitative easing (QE) to stimulate the economy. QE consists of buying mortgages, corporate bonds, and long-term bonds to lower yields on these securities, thereby reducing interest rates.

Using these tools honed during the financial crisis, central banks in the developed world responded swiftly to the Covid-19 crisis, avoiding financial distress. During this period, the Federal Reserve in the United States doubled its balance sheet from roughly $4.5 trillion to $9 trillion.

There were also significant increases in government spending in many countries to provide disaster relief for households and businesses and to foster a faster economic recovery. The US increased government spending by a total of $5 trillion.

Normal recessions are periods of low demand. Central banks usually respond by lowering interest rates to stimulate demand and help the economy recover. In persistent recessions or if interest rates are already at zero, governments might increase spending to boost economic recovery.

The Covid-19 recession was abnormal because it was a period of both low demand and low supply. The lockdowns imposed to control the pandemic, and the precautions people took to protect themselves from the virus reduced the labor supply, which in many sectors hurt the performance of supply chains designed for efficiency, not robustness. When demand recovered, supply did not respond sufficiently quickly. Then, the Ukraine war created havoc in commodity markets, raising the prices of oil, natural gas, wheat, and many other commodities. The result was inflation.

Initially, inflation was concentrated in sectors such as food, energy, and automobiles (a sector affected by semiconductor shortages). But then inflation spread to other categories of the CPI, creating the risk of an upward spiral: firms index their contracts to inflation, workers demand wage hikes, then firms raise prices to compensate for wage increases, and the upward spiral in prices continues.

Central banks raised interest rates to contain inflation and switched from quantitative easing to quantitative tightening. The problem is that, as the famous economist, Milton Friedman, noted, monetary policy affects the economy with long and variable lags. This means that most of the effects of the current interest rate hikes will only be felt in the future. Central banks have no alternative but to raise interest rates to maintain credibility. But they might cause a recession down the road.

We have seen significant corrections in asset prices. The tech sector has been particularly hard hit. As a growth sector, it is more vulnerable to rises in interest rates. Much of their earnings will come in the more distant future, and higher interest rates mean that their future income is

> Using forecasts for unemployment and inflation, this rule indicates that the size of interest rate hikes will likely shrink in 2023 and that the Federal Funds rate will peak at 5%

discounted at a higher rate. Another critical factor in tech valuations was the behavior of e-commerce and other sectors of the digital economy. A widely held view was that the pandemic would accelerate digital transformation, rapidly increasing the share of e-commerce, fintech, and other parts of the digital economy. Surprisingly, as soon as COVID-19 subsided, the share of e-commerce went back to trend. The expected permanent acceleration of digital transformation did not materialize, causing a revaluation of the valuation of tech companies.

One silver lining is that the burst of inflation has reduced debt/GDP ratios of countries experiencing inflation, reducing the weight of public debt and making it somewhat easier for governments to pay higher interest rates on their debt. Still, as the recent turbulence in the UK demonstrated, the times for unfunded fiscal policy are over.

John Taylor, a Stanford economist, suggested in 1993 a formula to guide monetary policy that became known as the Taylor rule. The Taylor rule suggests that the Fed should raise rates when unemployment is low and inflation is high. A version of this rule, where the Federal Reserve implements gradual changes in interest rates, has proven an accurate predictor in the changes made to the Federal Funds rate implemented thus far. Using forecasts for unemployment and inflation, this

rule indicates that the size of interest rate hikes will likely shrink in 2023 and that the Federal Funds rate will peak at 5%, notwithstanding shocks to the world economy that could alter the economic outlook. A slowing pace of interest rate hikes may lend more confidence and stability in the markets to the year ahead.

Without further shocks, US interest rates are likely to renormalize early in 2023. But quantitative tightening will continue, potentially affecting spreads between treasuries and other debt instruments.

In Europe, the course of monetary policy is less clear since the ECB has to weigh inflation pressures against the negative supply shock caused by the hikes in natural gas prices. The

> A slowing pace of interest rate increases may lend more confidence and stability in the markets in the year ahead

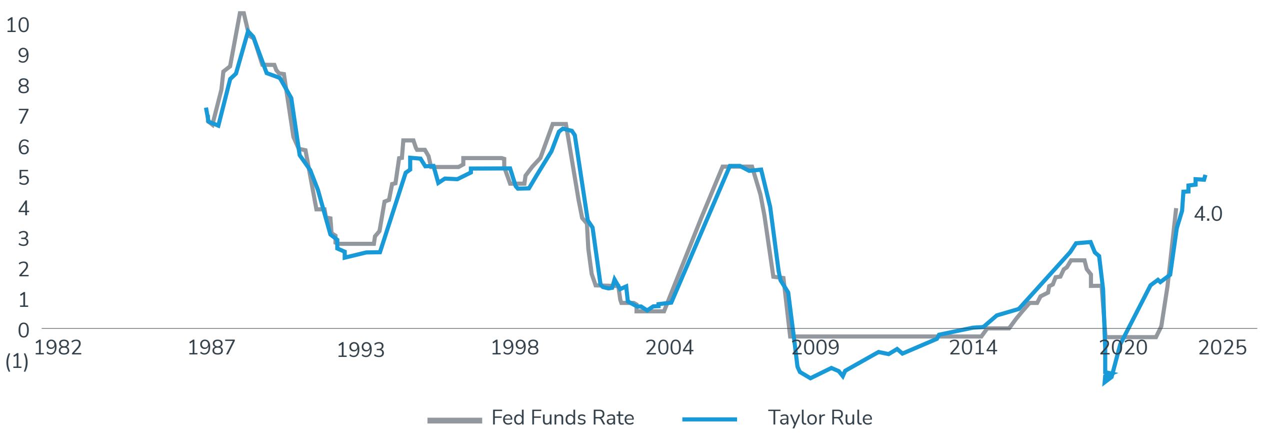
Bank of England is fighting inflation while keeping an eye on supply shocks and the turbulence caused by Brexit.

Central banks are doing what is necessary to bring inflation under control. We might have some more financial turbulence as a result, but that is unavoidable if we want to navigate towards a stable inflation environment.

Don't Rule it Out

The Taylor Rule signals rate rise relief

Federal Funds Rate versus version of Taylor Rule



Source: The Federal Reserve Bank; Sergio Rebelo proprietary research

The GCC: A Port in the Storm

Yousif Al Abdulla
Managing Director
MENA Investment

In a year fraught with turbulence, the GCC provided a bright spot in the otherwise grim global economic landscape. This is evidenced by forecasted real GDP growth for 2022 of 7.5% in the Kingdom of Saudi Arabia and 5.9% in the UAE, the largest and second largest GCC economies, respectively. These figures are even more impressive when compared to the global macroeconomic environment: the IMF is forecasting 3.2% real GDP growth globally.

The GCC has benefited from secular economic realities and utilized several tools to successfully navigate global macroeconomic events, including abundant natural resources of regional economies, structural idiosyncrasies, and government policy. Where rising energy prices have become a global economic headwind, the GCC's status as an energy exporter resulted in high energy prices creating a net tailwind. Inflation, which has soared in much of the global economy, primarily due to rising energy costs, supply chain disruptions, and labor shortages, is only slightly above target in the GCC. In the GCC, government price caps on energy and essential food items have muted consumer inflation. Varied import partners have allowed for dynamic trade, limiting the rise of input costs and the impact of supply chain disruptions. Openness of the GCC labor market to migrant workers has helped the region sidestep labor shortages. Comparatively lower interest rates in the region, which are enabled by lower inflation, have promoted liquidity in the capital markets. Lastly, while both foreign and domestic geopolitical concerns have created uncertainty globally, the GCC has offered political stability.

While there may be some uncertainty about the longevity of some of these developments, primarily the durability of high energy prices, we see the majority of these factors as resilient and, coupled with a rapidly growing population, as the foundation for future economic growth in the GCC.

Despite the positive performance of GCC economies, valuations in the region have remained unchanged. Part of the explanation for these stubborn valuations seems to be the difficulty in attracting global capital via foreign direct investment (FDI) to asset classes other than oil

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7.5%

Forecasted real GDP growth in Saudi Arabia

5.9%

Forecasted real GDP growth in the UAE

3.2%

The IMF forecasted real GDP growth globally in recent years, as the chart nearby illustrates. As capital markets, structural reforms, and investment opportunities in the region continue to grow and mature and as the fundamentals and countercyclical performance of the GCC economies become better appreciated by the global investor base, foreign capital may begin to flow into the region, redirecting FDI flows into the wider economies. Government emphasis on deregulation, special economic zones, and public-private partnerships will certainly help promote FDI. This increased international demand for GCC assets should then put upward pressure on valuations, causing valuations in the region to converge with global asset valuations, to the benefit of asset owners.

As the economies within the region continue their rapid growth and modernization, we see opportunities for investment in the infrastructure that will support this growth. As such, industrial real estate, with its function as an enabler of distribution for modern economies and demonstrated cyclical resilience, will continue to be at the center of our strategy. We may also expand into additional property types, as we identify other segments that will benefit from growth and modernization. Private companies will also provide vital infrastructure support to the modern GCC economies. We view scalable companies offering mission-critical services to both government and private customers as particularly attractive in this environment, and will continue to deploy our disciplined, selective approach in this sector.

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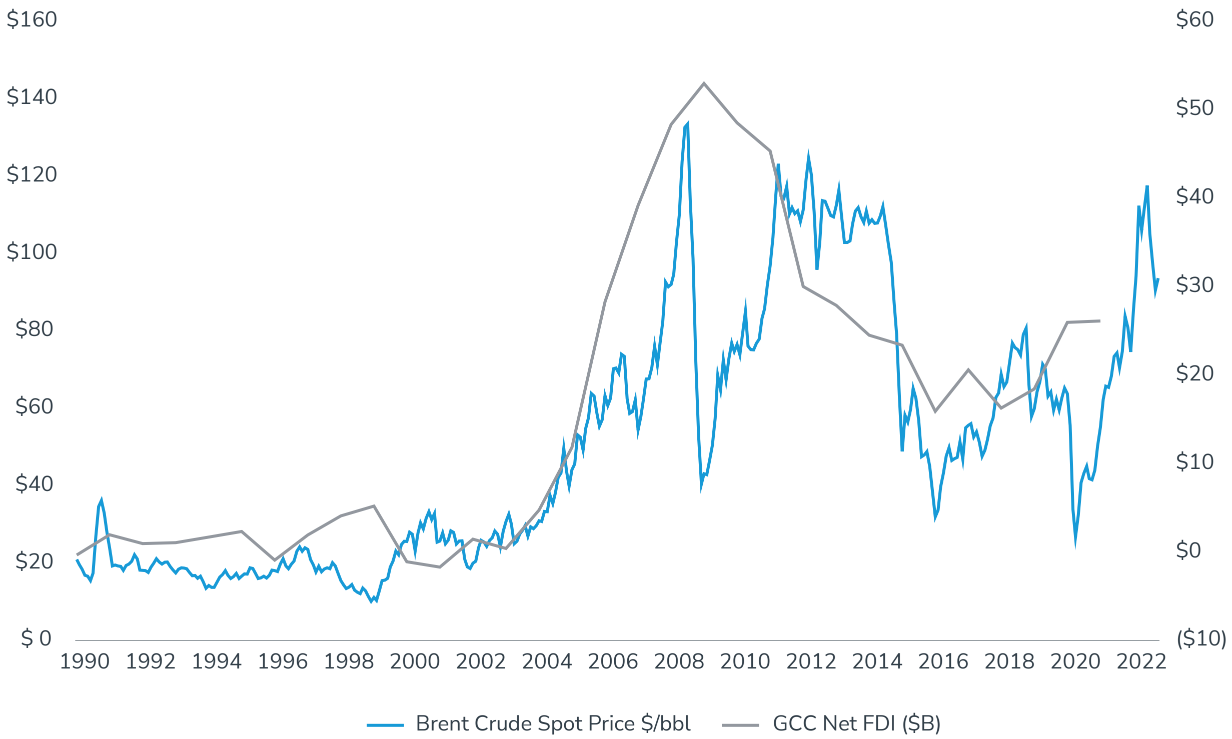
These are exciting times for the GCC region, and we want to position our investors to be at the forefront so that they can benefit from the current growth and stability provided by the regional environment as well as the coming demand from global investors for GCC assets.

Crude Awakening

Correlation of foreign direct investment and Brent crude oil price



Source: The Federal Reserve Bank; The World Bank

The US: Weathering the High Inflation Storm

Brian Hebb
Managing Director
US Real Estate

Neil Carter
Managing Director
US Private Equity

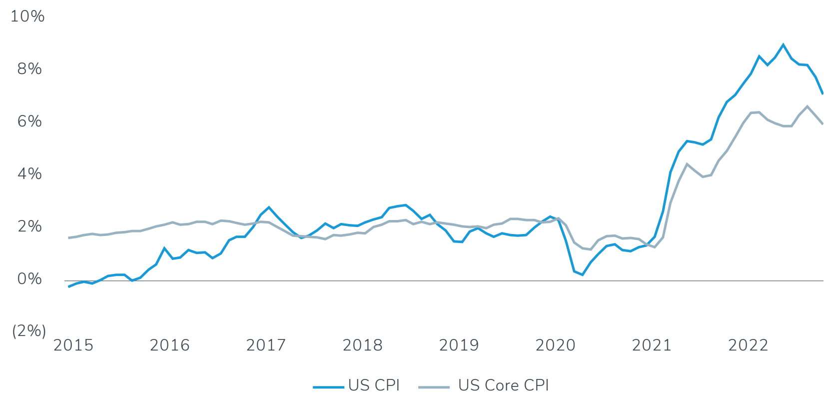
In 2021, economies roared back to life after emerging from a COVID-induced hibernation. By the beginning of 2022, it was evident that continued, isolated pandemic shocks, coupled with unleashed pent-up consumer demand, would create supply-demand imbalances, leading to strained supply chains and price inflation. The additional disruption and resulting surge in global energy prices caused by the conflict in Ukraine accelerated inflation.

In an effort to rein in inflation, the US Federal Reserve Bank embarked on its most aggressive tightening program, via both interest rate increases and quantitative tightening, in over 40 years. The effects of the tightening program were felt throughout capital markets, with certain parts, such as the technology sector, feeling more acute pain. Many financers also paused activity as they attempted to digest higher interest rates and their impact on valuations, which took liquidity out of the market.

The pace of interest rate increases has also changed the dynamic of capital markets. Would-be sellers, who have had their assets repriced in the market in this new, higher interest rate environment, are largely deciding to hold and wait out the storm, if possible. Meanwhile, would-be buyers are less aggressive, as their cost of capital continues to increase with each interest rate hike. The result is a market with less liquidity and markedly lower transaction volume as compared to 2021.

Price Surprise

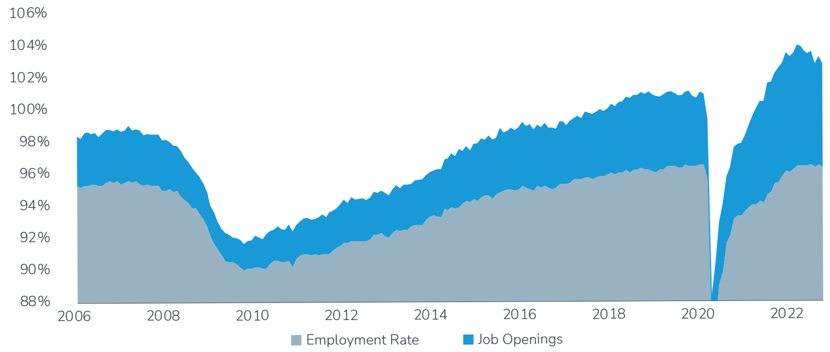
US CPI and Core CPI inflation



Source: Federal Reserve Bank

Hire and Higher

US Employment rate and job openings



Source: Federal Reserve Bank

Isolated pandemic shocks coupled with unleashed pent-up consumer demand created supply-demand imbalances, leading to strained supply chains and price inflation

As we stand on the threshold of 2023, we see reasons to be optimistic for the year ahead. The most recent inflation figures are down from their peaks as a result of multiple factors, including supply chain bottlenecks easing and the Fed's tightening program. This has allowed the Fed to see a light at the end of the tunnel for this tightening cycle and consider slowing the pace of interest rate increases, both of which will provide increased stability for capital markets. The November elections resulted in a divided Congress, which should promote political stability in the coming year. Additionally, most economists are now predicting either no growth or a mild recession in 2023. While this is less than ideal, it is an improvement over their prior expectations.

In 2023, we will maintain our disciplined, sector-driven, thematic approach to investing. We see buying opportunities at attractive valuations, given pricing dislocations created by higher interest rates. We will look for inorganic growth opportunities created by pockets of distress to strengthen the position of our investment portfolio and ready our portfolio and investors for growth in future economic expansion cycles.

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The UK: Finding Calmer Waters

Michael Riccomini
Director
European Investment

Matt Seston
Principal
European Investment

It has been quite a year in the UK: a new monarch and three Prime Ministers. Long-held and long-tested plans ensured a stately and emotional accession of King Charles III, while the UK's robust political system meant that when the Truss/Kwarteng administration's economic policies met a negative response from the markets, the leadership was swiftly replaced, with the incoming Sunak/Hunt administration recommitting to predictable fiscal orthodoxy. All the while, the Bank of England has progressively raised interest rates, albeit at a less aggressive pace than the US, in an attempt to rein in inflation.

The IMF predicts real GDP growth of 3.6% in 2022 for the UK, which compares favorably to the growth rates of other G7 economies

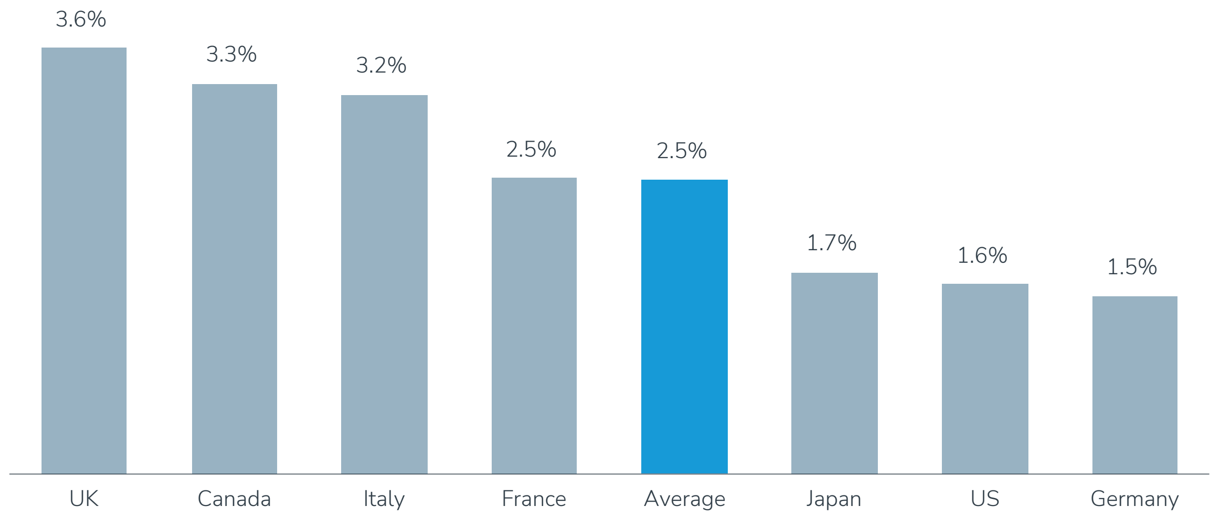
While these ingredients have not resulted in a banner economic year, growth has not been lackluster in 2022: the IMF predicts real GDP growth of 3.6% in 2022 for the UK, which compares favorably to the growth rates of other G7 economies.

The new Sunak/Hunt policies announced on November 17 provide the framework for 2023. These policies kept the pro-growth measures from Truss's package (for example, on labor force participation, high-skill immigration, and streamlined regulations on key sectors including green industries and life sciences), while cancelling Truss's tax cuts and making changes to personal taxes and windfall taxes on energy producers. In addition, the new policies reduce Government spending growth while targeting investment in health, social care, and education. They also continue the UK's commitment to net zero by 2050, including interim goals of reducing building and industry energy consumption by 15% by 2030 and decarbonizing power supply by 2035.

The policy package has been received by markets and domestic critics as sensible, pragmatic, and predictable. Not perfect, but presenting voters, companies, and investors with a familiar flightpath. Furthermore, recent commentary from the Bank of England suggests that we may be nearing the peak of the Bank's tightening cycle. This familiarity should be the backdrop for the UK's 2023: consolidation, resilience, predictability.

Method to the Madness

G7 projected GDP Growth, 2022



Source: IMF

With markets calming, the Pound at historically attractive levels, and real estate pricing still dislocated, 2023 may provide one of the most attractive investment windows into UK real estate for US Dollar-denominated investors since 2009, especially for occupationally resilient assets with shorter term leases that can more readily provide an inflation hedge.

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In terms of timing, it is impossible to predict the bottom of this economic cycle. We want to position our investors to benefit from cyclically attractive pricing levels via a programmatic approach that invests through the cycle, locking in an attractive basis and targeting resilient assets through a disciplined, focused strategy.

The policy package has been received by markets and domestic critics as sensible, pragmatic, and predictable. Not perfect, but presenting voters, companies, and investors with a familiar flightpath

Biographies

Andrew Scott
Professor of Economics
London Business School

Andrew J Scott is Professor of Economics, former Deputy Dean at London Business School and Research Fellow at the Centre for Economic Policy Research. His research focuses on longevity, an ageing society, and fiscal policy and debt management and has been published widely in leading journals. His book, The 100-Year Life, has been published in 15 languages, is an Amazon bestseller and was runner up in both the FT/McKinsey and Japanese Business Book of the Year Awards. He was Managing Editor for the Royal Economic Society's Economic Journal and Non-Executive Director for the UK's Financial Services Authority 2009-2013. He has been an advisor on policy to a range of governments. He is currently on the advisory board of the UK's Office for Budget Responsibility, the Cabinet Office Honours Committee (Science and Technology), co-founder of The Longevity Forum, a member of the National Academy of Medicine's International Commission on Health Longevity and the WEF council on Healthy Ageing and Longevity.

Sergio Rebelo
Professor of International Finance
Kellogg School of Management at Northwestern University

Professor Rebelo is the MUFG Distinguished Professor of International Finance at the Kellogg School of Management, where he has served as Chair of the Finance Department. He is the co-director of the Center for International Macroeconomics at Northwestern University. He is a fellow of the Econometric Society, the National Bureau of Economic Research, and the Center for Economic Policy Research. He has been a member of the editorial board of various academic journals, including the American Economic Review, the European Economic Review, the Journal of Monetary Economics, and the Journal of Economic Growth. Professor Rebelo has served as a consultant to the World Bank, the International Monetary Fund, the Board of Governors of the Federal Reserve System, the European Central Bank, the McKinsey Global Institute, the Global Markets Institute at Goldman Sachs, and other organizations.

Yousif Al Abdulla
Managing Director
MENA Investment

Yousif is a Managing Director and the Head of MENA Investment at Arcapita. He is responsible for the origination, structuring and management of private equity Investments in the region. Previously, he spent 15 years originating, structuring, analyzing, monitoring and closing transactions in the real estate, private equity and asset-backed security sectors at various financial institutions including Al Salam Bank – Bahrain, Capital Management House and Gulf Finance House. Yousif is a CFA charterholder and a Fulbright Grantee, obtaining his MBA from Fairleigh Dickinson University, USA and Bachelor's degree from the University of Ottawa, Canada.

Brian Hebb
Managing Director
US Real Estate

Brian is a Managing Director and the Head of the US Real Estate Investment team at Arcapita. Brian has 20 years of real estate and private equity experience, overseeing origination, negotiation and management of various investments. Previously, Brian has held investment positions with Goldman Sachs Group, NYL Investors and Colony NorthStar, covering all major sectors including industrial, multi-family and student housing. Brian holds an MBA from Columbia Business School, USA and a BA from the University of Western Ontario, Canada.

Neil Carter
Managing Director
US Private Equity

Neil is a Managing Director and the Head of the US Private Equity Investment team at Arcapita. Neil has over 18 years of private equity experience, including ten years at Fortress Investment Group where he was an investment professional in the Credit Funds. In this role, Neil oversaw origination, underwriting, negotiation, and management of middle market private equity and private credit transactions across multiple industries. Prior to Fortress, Neil worked at Goldman Sachs focused on M&A in the Consumer and Retail industries. Neil holds an MBA and Bachelor of Science in Commerce from the University of Virginia, USA.

Michael Riccomini
Director
European Investment

Michael is a Director in the European Investment team. Prior to joining Arcapita, Michael was an equity partner at Cew Capital in London which is a boutique firm providing comprehensive real estate services with a client base principally covering MENA, European and UK investors. Prior to that he worked across real estate with various institutions in the UK, France and Italy including Barclays, Eurohypo and CBRE. Michael was a Queen's Scholar at Westminster School, and has a first-class master's degree in engineering science from the University of Oxford, UK.

Matt Seston
Principal
European Investment

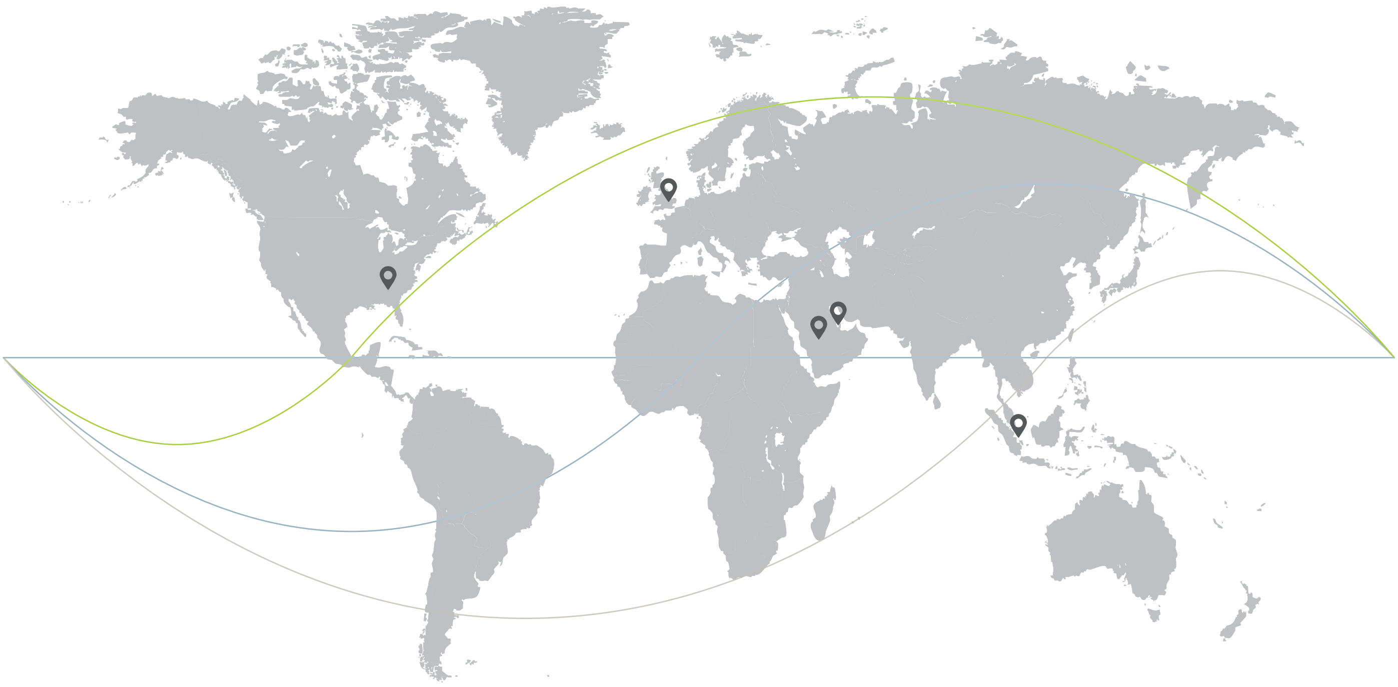
Matthew is a Principal in the European Investment team. Prior to joining Arcapita in 2015, Matt spent two years as an Associate in PriceWaterhouseCooper's Deals Advisory practice. Matt holds an MBA from The Kellogg School of Management at Northwestern University, where he graduated at the top of his class, and received his BS in Mechanical Engineering with high honors from the Georgia Institute of Technology.

ARCAPITA

Overview

Arcapita is a premier asset manager offering diverse investment opportunities, focusing on private equity and real estate. At the center of one of the fastest growing wealth markets in the world, Arcapita's management has been serving an exclusive group of investors in the GCC region over the past two decades. With offices in Bahrain, US, UK, Saudi Arabia, and Singapore. Arcapita's management team has completed over 100 transactions with a total value of approximately $30 billion and possesses a footprint to invest on a global scale. Arcapita focuses on defensive and counter-cyclical sectors supported by long-term macroeconomic and demographic trends.

With two decades of experience, Arcapita's management has built a global investment platform to access the opportunities that exist in our core markets of the US, Europe, Middle East and Asia.



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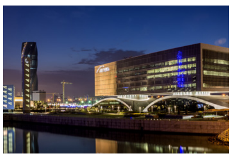

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