AozoraStep

Q1 2024: How macroeconomic uncertainty can turn into opportunity

Quarterly Performance	Turnaround Portfolio	FTSE All Share TR
Q1 17	0%	0%
Q2 17	-8%	1%
Q3 17	-5%	2%
Q4 17	-1%	5%
Q1 18	9%	-7%
Q2 18	19%	9%
Q3 18	-16%	-1%
Q4 18	-30%	-10%
Q1 19	45%	9%
Q2 19	39%	3%
Q3 19	0%	1%
Q4 19	8%	4%
Q1 20	-43%	-25%
Q2 20	42%	10%
Q3 20	-3%	-3%
Q4 20	76%	13%
Q1 21	32%	5%
Q2 21	-3%	6%
Q3 21	5%	2%
Q4 21	1%	4%
Q1 22	37%	1%
Q2 22	-3%	-6%
Q3 22	17%	-3%
Q4 22	20%	9%
Q1 23	0%	3%
Q2 23	-13%	0%
Q3 23	40%	2%
Q4 23	3%	3%
Q1 24	1%	4%

Annual Performance	Turnaround Portfolio	FTSE All Share TR
2017	-9%	9%
2018	-31%	-9%
2019	113%	19%
2020	52%	-10%
2021	37%	18%
2022	99%	0%
2023	26%	8%
2024 Q1	1%	4%

Overall Performance	Turnaround Portfolio	FTSE All Share TR
CAGR	**29.2%**	**4.8%**
2017 - Q1 24 Return	**541%**	**40%**

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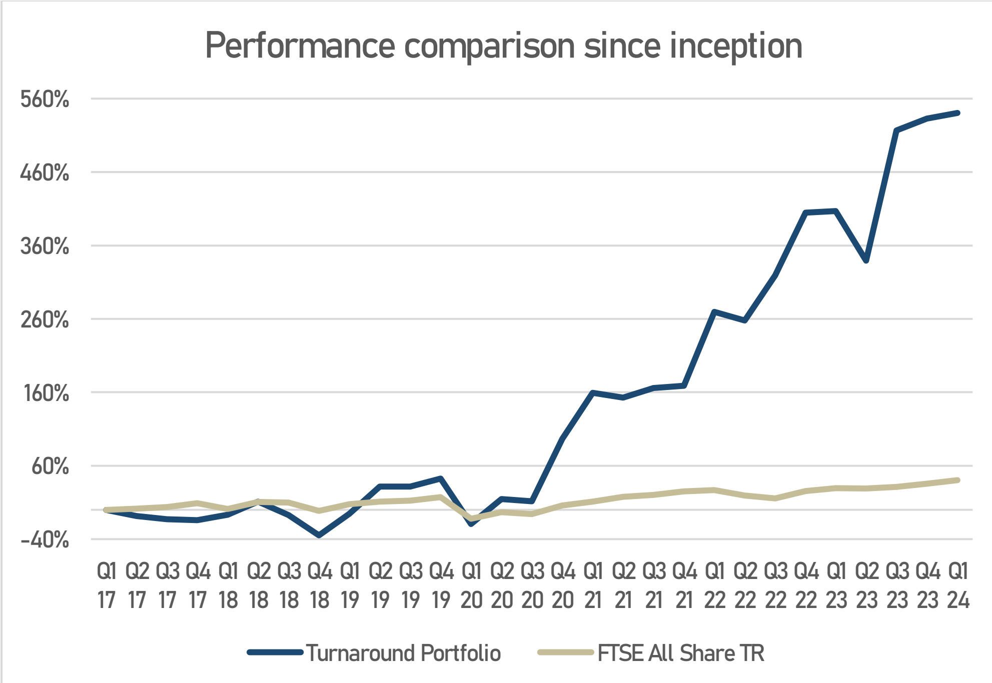

1st April 2024

Dear fellow investor,

It's been a somewhat frustrating quarter for me, as our performance with +1.2% was far below the market performance, with the S&P 500 up 11% year-to-date, while the FTSE All Share TR is up 4%. In the end, I concentrated the portfolio in the wrong names, but more on the details further below. Overall, the UK market offers an opportunity set that I have never seen before, and I could easily invest in over 20 UK listed companies right now. This is partly due to the uncertain macro environment, which has been lingering with the market for more than a year now. You can read trading updates from companies in nearly every sector of the economy – each update will mention this uncertain macro environment. So, what exactly is this uncertain macro environment that everybody is talking about?

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What exactly is the "uncertain macro environment"?

If I were to describe the uncertain macro environment in a nutshell, I would point out two main factors, which were both influenced by the pandemic induced lockdowns: Energy & Travel. According to the World Travel & Tourism Council, Travel & Tourism accounted for 1 in 5 new jobs created during the 2014-2019 period (including direct, indirect and induced impacts), 10.3% of all jobs (334mio) and 10.4% of global GDP in 2019 ($10trn). International visitor spending amounted to $1.9trn in 2019[1]. Then the pandemic hit, governments around the world panicked and locked down entire countries. People stopped travelling and energy demand declined. While not the entire industry collapsed, as people still travelled locally, suddenly people had say $1 trillion more in their pockets, which were mostly used to improve life at home and/or invested. People who have worked in the tourism sector looked for alternatives and the tourism labour force reduced. After the vaccine was rolled out and travel restrictions eased, we saw a reversal of what happened, more money was spent on travelling again, causing more energy demand, causing more tourism labour demand. Yet, due to "ESG" and a tough energy market in 2020, less was invested in energy, and with sanctions on Russia energy, prices spiked, while at the same time, it was hard to move the labour force back into tourism so quickly. In the end, the rise in energy prices, the shifts in labour & consumer demand across industries, and the resulting inflation and wage negotiations have led to where we are today: A rise in demand for travel & tourism at the cost of all other industries. However, by March 2023, tourism amounted to over 9% of global GDP (over 1% less than in 2019) and a total of 300.9mio people were employed in the travel & tourism sector (10% less than in 2019). At the same time, central banks have raised interest rates, which increases the costs for mortgages, auto loans and all other credit, further reducing the consumer's wallet size.

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[1] https://wttc.org/research/economic-impact#:~:text=Meanwhile%2C%20international%20visitor%20spending%20amounted,only%2023%25%20below%202019%20levels.

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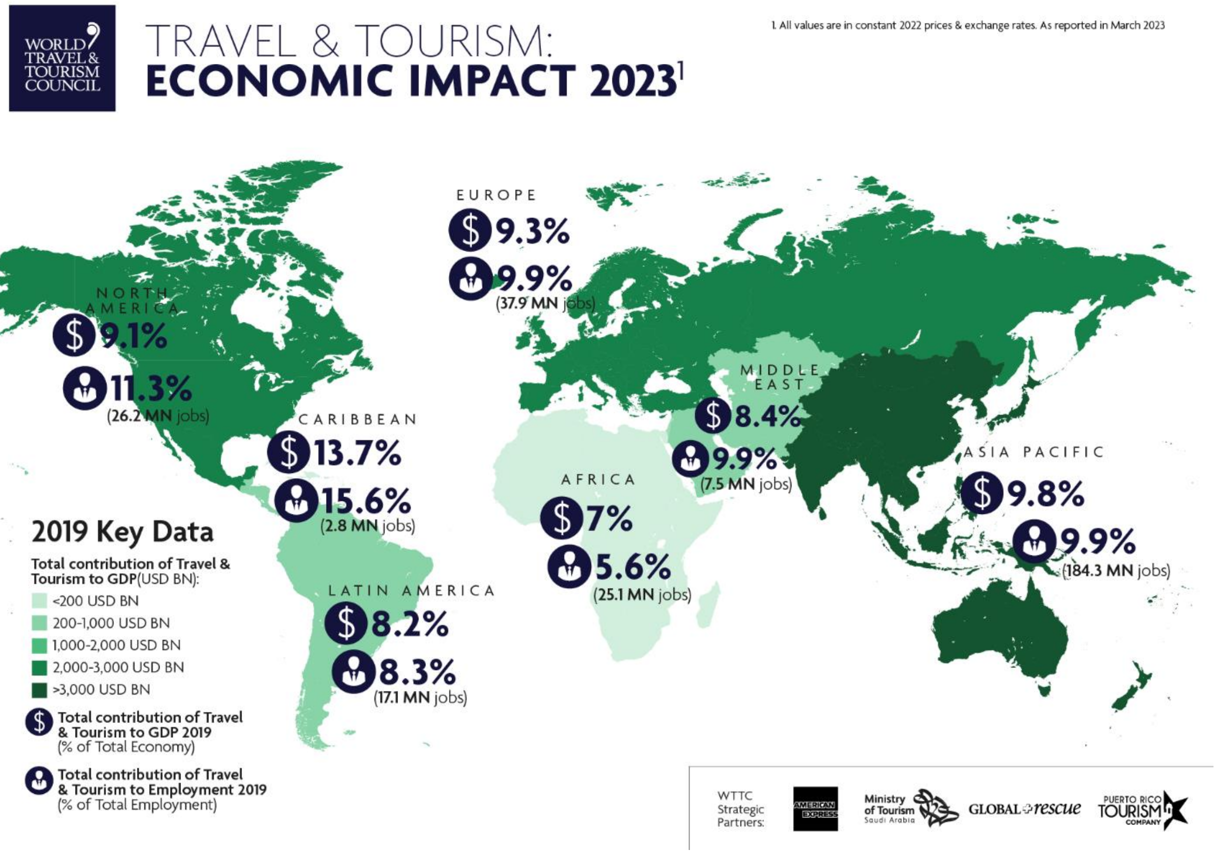


Source: World Travel & Tourism Council

Where the next opportunity might lie

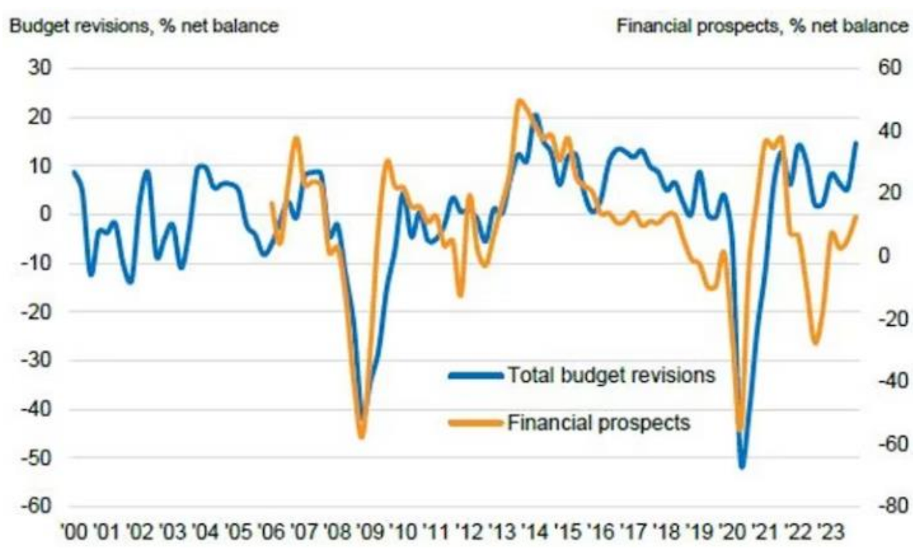
By March 2024, I believe that the tourism & travel sector is pretty much back at 2019 levels (no data out yet, but given that in 2022 Travel & Tourism amounted to 7.6% of global GDP and over 9% in 2023[2], one can assume this growth rate has continued and is now back to over 10%). The last leg of travel is likely coming from corporate travel. According to US Travel, business travel is expected to reach 95% of 2019 in 2024, up from 89% in 2023[3]. IAG with the most profitable business jet route on the planet (LHR-JFK) would be a natural beneficiary. But there are more trends behind this whole cycle… The cost-of-living crisis has caused consumers to down trade to non-branded products. The likes of McBride or Greencore have

[2] https://wttc.org/research/economic-impact#:~:text=Meanwhile%2C%20international%20visitor%20spending%20amounted,only%2023%25%20below%202019%20levels.

[3] https://www.ustravel.org/research/travel-forecasts#:~:text=Business%20travel%20is%20still%20expected,volume%20not%20expected%20until%202026.

already benefitted from this, with the latter probably having more room to adjust the valuation higher, as the decline of working from home accelerates. This in turn has led major brands to see the need for more marketing spend or M&A to boost revenues, as prices started to ease towards the end of 2023[4]. Diageo, Nestle, Unilever, Dr. Martens are some companies that have announced higher marketing spend, and Nestle is already seeing the benefits[5]. According to IPA Bellwether, UK companies that made a net upward revision to their marketing budget climbed to 14.7% in Q4 2023, the highest in over a decade[6], with the financial year 2024/25 reporting a net balance of 29.4% of companies[7]. However, this does not take inflation into account. Ultimately though, when considering valuations in the advertising space, this sector is ripe for a revaluation if you ask me, even though the recovery has not fully taken place – but might begin with the Olympics and US election ahead. Always remember that "diamonds are forever", and that without this De Beers commercial, we might not spend $ billions on jewelry, and this is true for every other industry. Hence, as a major brand you can only do one thing when consumers start trading to non-branded, cheaper products: Increase advertising spending.

Businesses marketing budget revisions and views of their own financial prospects



Source: IPA Bellwether

[4] https://www.ft.com/content/29c1654c-0c9e-4c58-945d-106b0aa7d0da
[5] https://www.marketingweek.com/nestle-marketing-investment/
[6] https://www.marketingweek.com/marketing-budgets-get-unexpected-boost-despite-economic-uncertainty/
[7] https://ipa.co.uk/news/bellwether-report-q4-2023#:~:text=Latest%20survey%20results%20showed%20budget,robust%20outlook%20for%20UK%20marketing.

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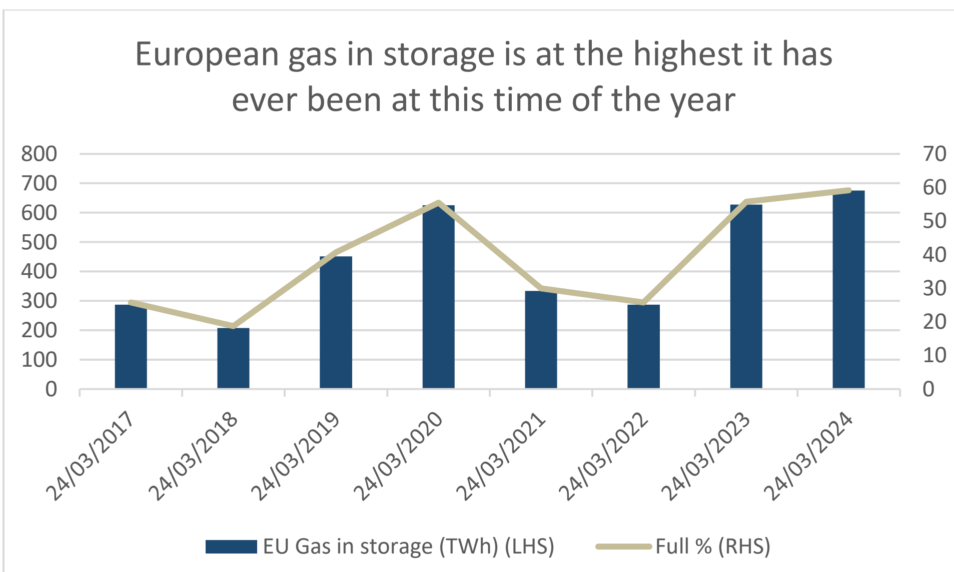
But wait, there is more…

2023 has seen one of the most dramatic shifts from manufacturing towards services, exactly for the reasons described above. Natural gas prices have meanwhile come down towards multi-year lows, especially when adjusted for inflation. This trend has now upended with the US ISM Manufacturing Index reporting growth at 50.3%, for the first time in 16 months! Specifically, new orders, production, imports and new exports orders are all in growth territory as of the March 2024 report[8]. The nine manufacturing industries reporting growth in March were: Textile Mills; Nonmetallic Mineral Products; Paper Products; Petroleum & Coal Products; Primary Metals; Food, Beverage & Tobacco Products; Fabricated Metal Products; Chemical Products; and Transportation Equipment. Specifically, chemicals appear to me the most attractive sector with a return to manufacturing growth, as this sector has been hit the most due to the rise in energy prices. This is also supported by the ongoing "shrinkflation", which requires more packaging for the same amount of goods. Europe's gas storage tanks are also at the highest they have ever been at this time of the year – even without Ukraine gas storage in the case of Russia destroying it[9] (which has swung by around 80 TWh during refill times, or 7% of European gas storage), Europe should have no problem getting through the winter.



Source: AGSI

[8] https://www.ismworld.org/globalassets/pub/research-and-surveys/rob/pmi/rob202403pmi.pdf
[9] https://www.reuters.com/business/energy/ukraine-boosts-power-imports-after-russian-attack-losing-generation-capacities-2024-03-24/

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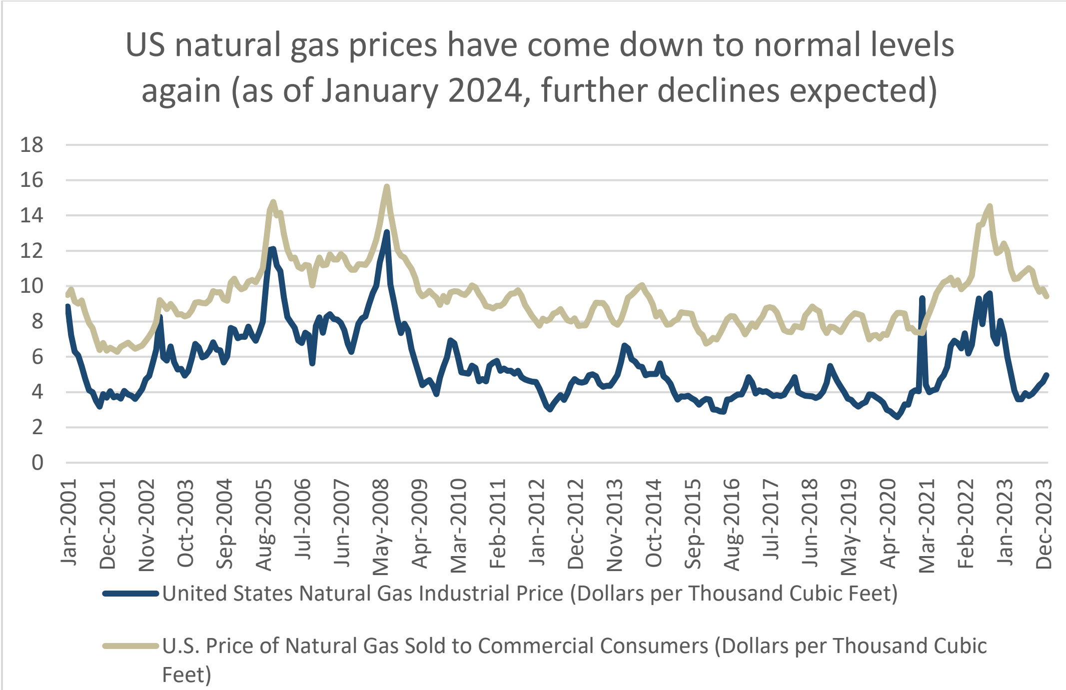

Source: US EIA

What about AI?

AI is often cited as the biggest opportunity, yet also the biggest risk. A recent report suggests that the UK could lose up to 8mio jobs in a worst-case scenario[10]. From what I have tested and seen; AI is of course amazingly helpful. I loved Jensen Huang's example of asking AI to read this 500-page book, and then asking AI to talk about this book a second later. Or that you don't need to learn coding, as AI will do it for you[11]. S4 Capital has shown on their Q4 2023 analyst webcast an interesting example of how AI is used for a marketing campaign with Burger King, where consumers can create their own burgers and win a prize. This is all great, but ultimately, in most cases you can still tell what is AI generated and what not. I mostly use ChatGPT these days for legal email or complaints, as I don't want to spend time on it and don't necessarily know the laws. However, even there I still need to edit the text and delete certain parts. I have also recently tested AI video translations/dubbing, which again, is great, but the quality is really not that high[12]. In the end, AI is nothing new, it's just machine learning, which has existed since the invention of

[10] https://www.ippr.org/media-office/up-to-8-million-uk-jobs-at-risk-from-ai-unless-government-acts-finds-ippr
[11] https://www.youtube.com/watch?v=BA25pQWds6Q
[12] https://elevenlabs.io/dubbing

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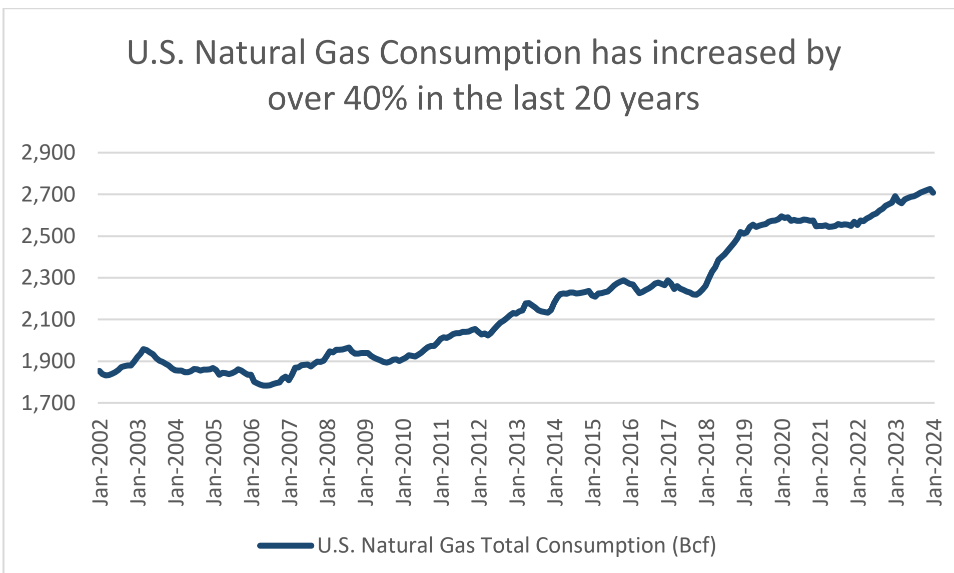
the computer. The only thing that really changed recently is the speed at which AI can operate, which enables new applications. Hence, what we might learn in a lifetime, is possible for AI to learn in a few hours. But ultimately, you still need a human to specify AI's output, and it depends on the knowledge of that human what AI can provide you. By that I mean, imagine you meet the smartest (human) person on the planet with the most diverse knowledge and ask him a question. As a general rule, the more knowledge this person has, the more specific the question you ask that person needs to be (unless it's a very basic question). Therefore, I believe that AI is neutral to employment. Yes, AI reduces demand for certain low-level services, but AI also needs human knowledge input and consumes energy, for which data centers, electricity, land and construction materials are needed. While Nvidia's latest chip is cutting its energy demand, it is estimated that as much as 1-1.5% of global electricity use could account for data centres[13].



Source: US EIA

[13] https://www.scientificamerican.com/article/the-ai-boom-could-use-a-shocking-amount-of-electricity/

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Recovery ahead?!

In summary, a lot of data points suggest an attractive recovery in advertising, chemicals and energy, specifically oil due to low inventories. But there is reason to be cautious. As I began to lay out in Q4 2023, the number of weeks between the last hike and the first cut is 35 weeks currently. If the Fed would cut in mid-June, the number would be 46 weeks (currently priced 50% chance). While this would be the longest period of holding rates at elevated levels, only outpaced by the period ahead of the Global Financial Crisis (GFC), it would go to 53 weeks (vs. 58 weeks before GFC), if the Fed would cut only by end of July. To me it is increasingly likely that the Fed does not cut in June, as it would increase oil prices too much. Ultimately, the Fed will be forced to cut by ructions in the market, but the longer they wait, the higher the risk for turmoil. At the same time, one could argue that the pandemic stimulus (we even created a new term: Modern Monetary Theorem or MMT) justifies higher rates for longer, especially as the manufacturing sector begins to recover. But let's be realistic, US GDP only grows amidst a 7% fiscal deficit spending – without that the US would have been in a recession, similar to Europe. As yields and oil prices begin to rise again, 30-50yr inflation linked government debt could become very attractive towards the end of Q2 2024…

US weeks of yield curve inversions and rate hikes/cuts

Period	# of weeks UST 10yr - Fed Funds inversion	Weeks between last hike and first cut	Weeks between last hike and end of inversion
1973-74	99	1	26
1978-80	92	1	7
1982	17	1	16
1989	52	9	39
1998	29	12	16
2000-01	46	33	46
2006-09	81	58	77
2019	23	32	44
2020 Covid	4	-	-
Now	72 (so far)	35 (so far)	35 (so far)

Source: FRED St. Louis

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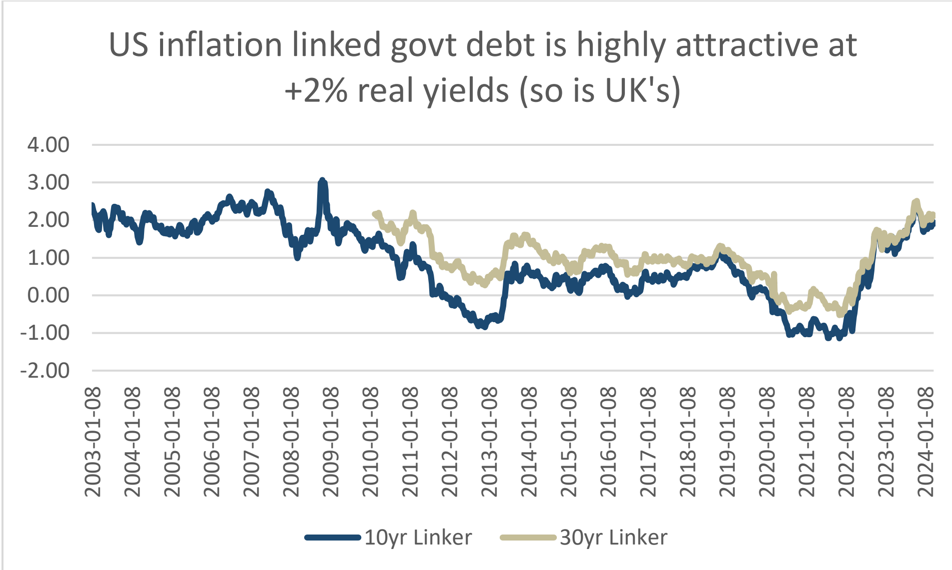

Source: FRED St. Louis

One last point on rates and oil prices…

Back in 2022, it became apparent to me that we are facing a multitude of crises. The 2000/01 Dotcom bubble was similar to the bitcoin and meme craze, the 1920 pandemic and resulting forgotten depression had many similarities, especially in terms of the state of globalization, innovation and inequality, the 1970s were similar to the current state of geopolitics, and finally the 2007/08 real estate crisis appears similar to the real estate crisis we see in China. Most of the historic comparisons have been very useful to analyse the current state of economic affairs. The only thing that hasn't materialized yet is financial problems that leads the Fed to cut interest rates, ignoring an uptick in inflation caused by oil prices. I believe that the recent rise in oil prices could be the starting point of this historic comparison/repeat. Below are two charts, which compare the Fed Funds rate and $/bbl of WTI oil in 2007/08 with 2024/25. The first chart aligns the start date of 1st January 2007 with 1st January 2024, whereas the second chart adjusts to bring the first rate cut to mid-June, instead of mid-September as was the case in 2007. I believe there is a chance to see a repeat of the 2007 developments, where the Fed kept its rate unchanged at the beginning of August 2007[14], which in turn caused markets to go into turmoil and the Fed needing to step in to provide liquidity[15], and then ultimately cut rates by 50bps in the September meeting[16]. If this was to repeat and

[14] https://www.federalreserve.gov/newsevents/pressreleases/monetary20070807a.htm
[15] https://www.federalreserve.gov/newsevents/pressreleases/monetary20070817b.htm
[16] https://www.federalreserve.gov/newsevents/pressreleases/monetary20070918a.htm

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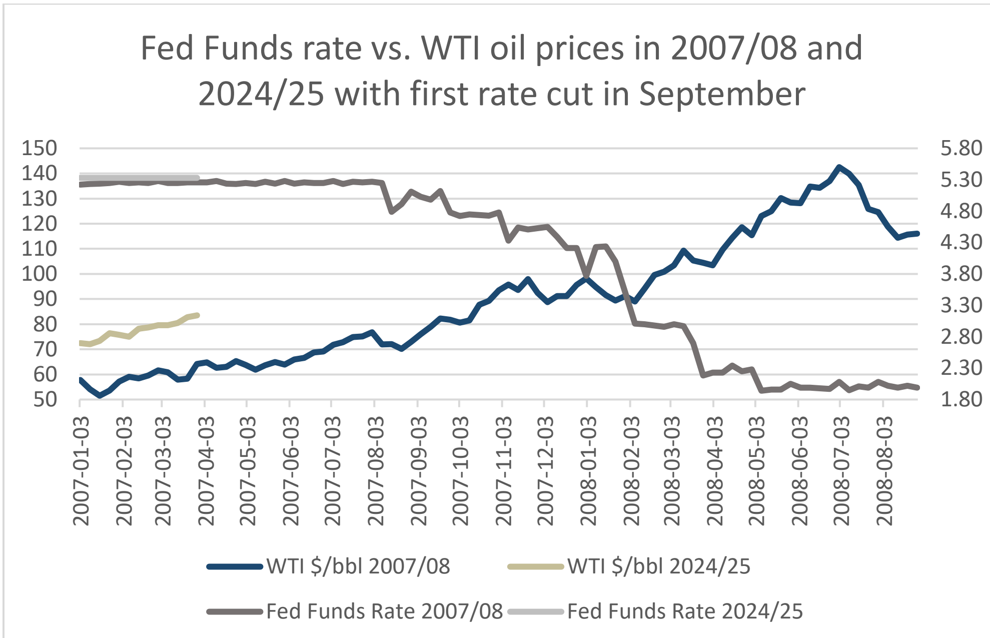
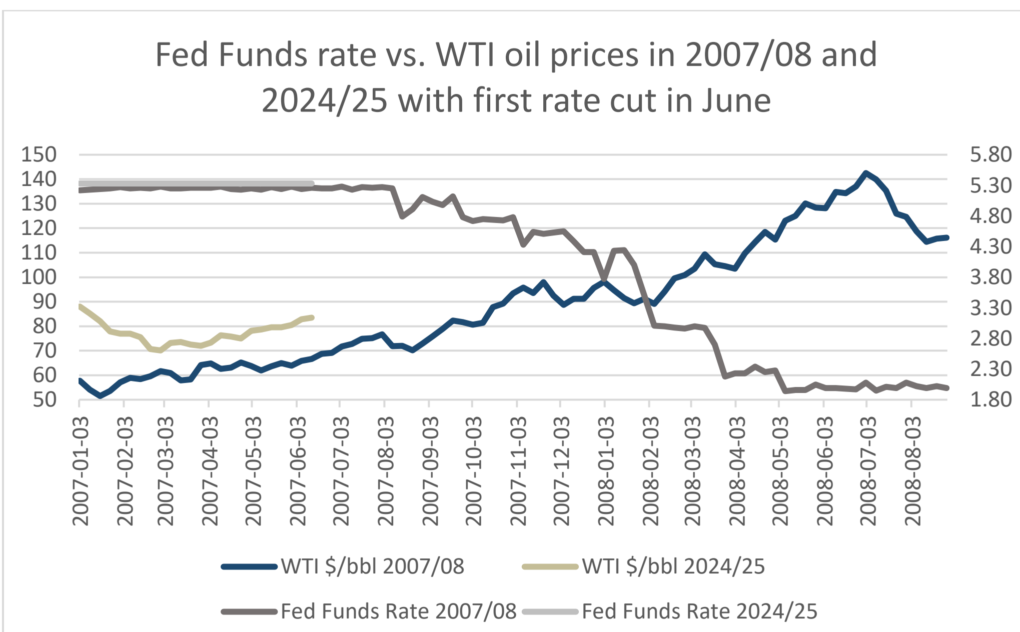
OPEC+ stays its current course, while the US government continues to fill its SPR (just like in 2007/08!), we should see a gradual and then spiking rise in oil prices in 2024/25. The third chart also shows how 30yr UST behaved, as yields began to fall in July, into August, while the Fed did not deliver on rate cuts then.



Source: FRED St. Louis



Source: FRED St. Louis

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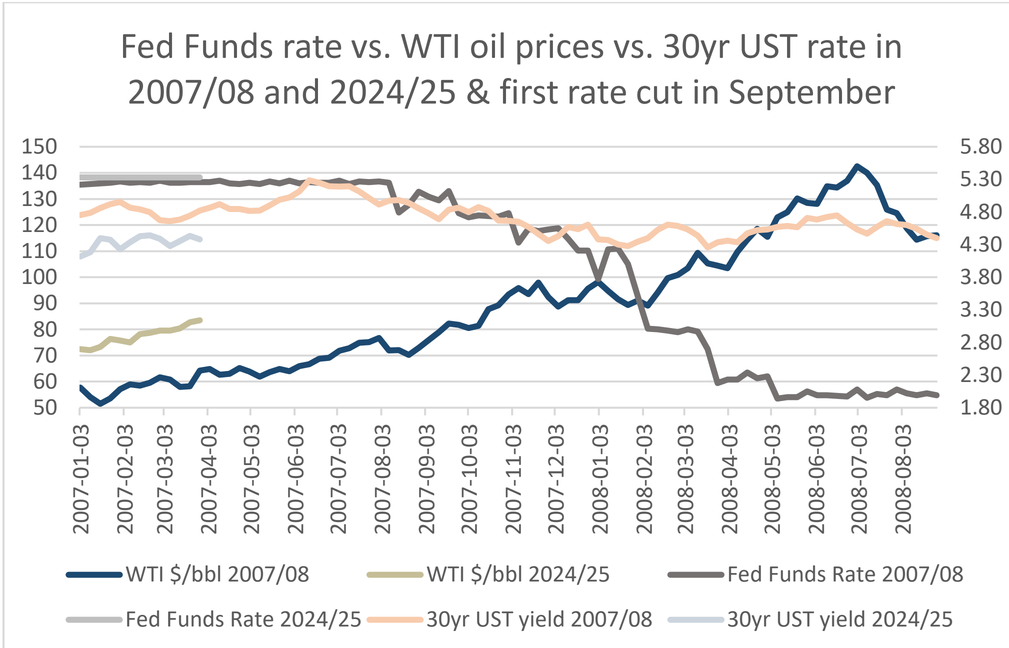

Source: FRED St. Louis

Performance

Q1 2024 has really been a poor performance, underperforming the FTSE All Share TR by 3% and the S&P 500 by 10%. Some of the performance is down to Mobico, which I sold with a 3% loss – although it was up by 15% before, hence it felt like a much bigger loss. The unusually high concentration of over 80% of the portfolio in Nexxen International of course does not look great for prospective investors (and I would never concentrate this much with a higher AUM). It was the third time I was only willing to invest more than 50% in a single holding, and the first time I actually acted on it. The first time was when Hunting was trading at 200p in the summer of 2023, the second time when Nexxen was trading below 150p in early winter 2023. In both prior cases it would have been the right decision to increase the concentration, and hence I felt this time I should risk it. More details on this below.

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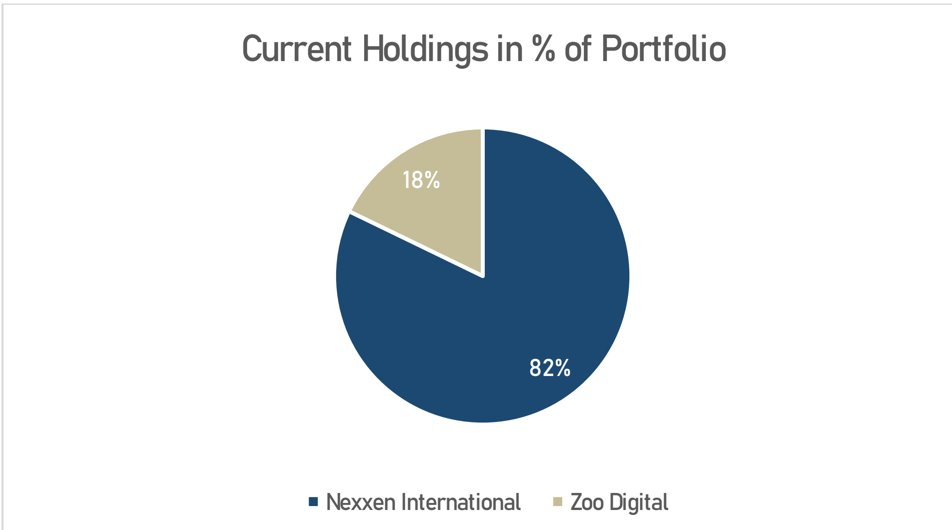
Current Holdings

Company	Average Purchase Price	Current Market Price	% change
Nexxen International	2.06	2.10	2%
Zoo Digital	0.32	0.36	11%

As of 29th March 2024



Exit Mobico

While Mobico's announcement on the German railway provision and the resulting delay of the results was surprising, it was my mistake not being aware of the details of the contract. In fact, I did reach out to Mobico's head of IR in the summer of 2023 to find out about these details, as already back then the parallels to what happened to National Express in 2008 were striking. However, the head of IR ignored me, despite having met him and the management team in person at the AGM. I sent follow up emails, suggesting to sell their North American school bus business to reduce debt – which they seem to have followed, as they announced their intentions in autumn 2023. The most recent update call on the delay of the results also raised more questions than answers, as it was a bit unclear to me what the total provision for the German contract is and how the earlier provision seems to be related to something different than new changes to the contract's energy indices. It was all quite confusing to me, and given the bad experience with their IR team, I did not follow up. A call with Synthomer's head of IR, who used to be the head of IR at First Group during their US exposal, showed me that there are high uncertainties

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to Mobico's plan to sell their North American School bus business. First Group took more than 10 years to sell their division. While the Cosmen family could ultimately take over Mobico, I would want to wait for a valuation of around £350-400mio before re-engaging, and even that is uncertain given the number of problems the firm still faces.

Exit Just Group

Despite Just Group being up +25% since we bought it, we only made +5% on aggregate. The poor exit level was really down to a call with PIC, which warned me that they struggle to find attractive investments due to low credit spreads (which was ill judgement), and to increase the position in Nexxen, which turned out to be wrong. Overall, Just Group remains a highly attractive business and it just highlights the sheer number of other opportunities that exist and why I exited the position.

High concentration of Nexxen

The idea to buy back into Nexxen really came after their Supply Side Platform competitors Magnite and PubMatic showed strong results and a market cap revaluation of around 30%. Naturally, I expected Nexxen to follow suit. This did not happen, despite good results and record net cash position. As the valuation declined, I increased the position. Ultimately, the company has a net cash position of nearly $150mio, meaning their enterprise value (EV) is trading at 2x expected adjusted EBITDA, and at 6.6x on a very aggressive free cash flow to the shareholder including dilution. I suggested Perion Networks, a competitor and also Israeli based company with similarly low valuations, to buy Nexxen, as they could bid $500mio, which is over 40% above the current valuation, but only pay $250mio, given that Nexxen has $250mio cash on their balance sheet. I have also started an activist campaign to improve Nexxen's website and general marketing for their new brand. In the coming days, I will provide an update on Nexxen with more details on why the company is trading at such low valuation, and why it should be higher.

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Entering Zoo Digital

Zoo Digital is one of the top 5 leading video globalization firms in the world. The company enables localization and media services including dubbing, subtitling, scripting, interconnected cloud-based workflows and other services to ensure movies, series, shows and other video production reaches the international audience in the same high quality as the original. The investment is driven by the end of the Hollywood strikes and first signs of a return to business. Zoo Digital grew by 34% CAGR for seven years before the strikes lamed production. The company has now adjusted their cost base to cash break-even below $4.8mio revenue a month or $57.6mio per annum, while their order book suggests a current run rate of over $52mio. Although this is not that positive, we are still in the early days of the recovery, hence this can quickly grow further; and the international expansion of streaming firms like Paramount and Warner Brothers could accelerate this growth. The main risk lies with 74% of 2023 revenues concentrated with a single client (Disney). This client is seeking Netflix-like margins and will have an important board vote on 3rd April 2024[17]. The key is that all streamers want to become like Netflix, and Netflix has gone the farthest in localization of its shows to over 190 countries[18]. However, there remain risks of going concern for Zoo Digital, which makes this position highly risky.

[17] https://restorethemagic.com/wp-content/uploads/2024/03/Disney-Trian-White-Paper-2024.pdf
[18] https://www.getblend.com/blog/localization-strategies-for-international-streaming-success/

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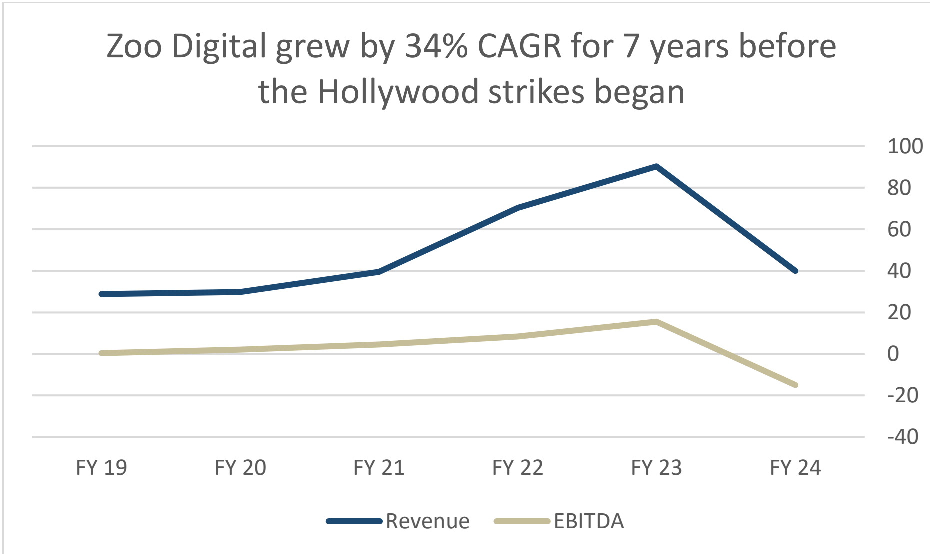

Source: Zoo Digital

Outlook

The outlook for UK equities has never been more attractive, at least from a valuation perspective. I could set up a £100mio+ portfolio mostly of around 20 UK mid-caps that are all turnaround candidates, and even add large caps UK banks and insurance companies, as well as UK government inflation linked debt to the mix. However, the rates market could still leave valuations at these very low levels, as rate cuts have been priced back again. Many companies have given guidance on the back of expectations of rate cuts. If these rate cuts don't materialize, there could be a few painful revisions in the months ahead. A recovery in commodity prices (especially oil), on the other hand, could become an opportunity in any outcome of rates meanwhile. This more diversified portfolio, however, should beat the market, in my opinion: Hunting, Greencore, Nexxen, Just Group, Future, Synthomer, Direct Line, S4 Capital, Endeavour Mining, Thungela Resources, Close Brothers Group, Mobico, JD Sports, Zoo Digital, EnQuest, IAG, Videndum, Kenmare Resources, Audioboom, Jupiter Fund Management, Reach

Sincerely,

David Herrmann

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