AozoraStep

Q2 2022:
How a lack of trust and a rising China has led to betrayal and division

Quarterly Performance	Personal Account	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%

Annual Performance	Personal Account	FTSE All Share TR
2017	-9%	9%
2018	-31%	-9%
2019	113%	19%
2020	52%	-10%
2021	37%	18%
2022 H1	35%	-5%

Overall Performance	Personal Account	FTSE All Share TR
CAGR	**26.1%**	**3.3%**
2017-22 H1 Return	**258%**	**19%**

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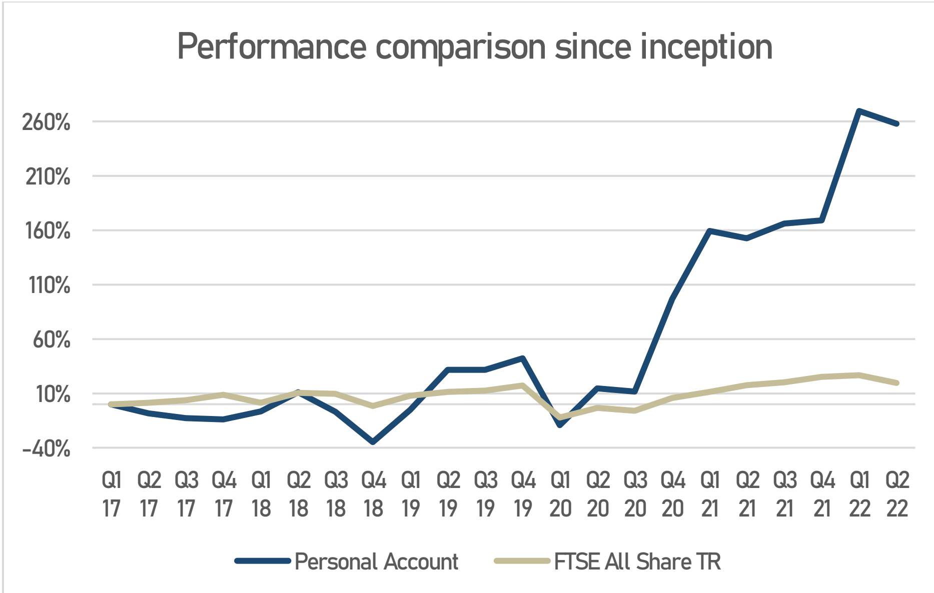

7th July, 2022

Dear Investor,

This quarterly report will mostly focus on gas and the European energy crisis. As I see this topic as the most urgent and important driver, I have positioned our portfolio accordingly. Higher gas prices and potential rationing will hurt everyone except the upstream sector. The war in Ukraine is unlikely to end, which will make this winter extremely hard. Countries like Germany will be particularly hard hit – it could perhaps lead to a suffering as bad as the Weimar Republic. A lasting blackout in today's world would mean no internet, no mobile phone, no computer, no heating. Farms wouldn't be able to work properly. A U-turn on the Ukraine strategy to appease Russia is impossible to imagine right now and would make the West appear as an unreliable partner. While this is "doomsday" writing, it could be a worst case scenario…

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The prisoner's dilemma

The prisoner's dilemma describes a situation where two counterparties choose a suboptimal outcome during a conflict in fear of a worse outcome, if they chose to cooperate, but the counterpart didn't[1]. John Gottman describes in his book "Trust and Betrayal" how marriages fail due to the most common failure of trust, whereas Caryl Rusbult describes betrayal as a "comparison level for alternatives", where one partner is trashing instead of cherishing the other partner due to better alternatives[2]. All of these theories describe very well what is happening with Russia & its allies and the West, where a lack of trust has developed and where alternatives (China & the Shanghai Cooperation Organisation[3]) have opened doors to betrayal, which now lead to worse outcomes for all: The prisoner's dilemma.

Prisoner's dilemma

Europe / Russia	Russia supplies normal gas volumes to Europe	Russia reduces gas volumes to Europe
Europe does not sanction Russia	-1 / -1	-3 / 0
Europe sanctions Russia	0 / -3	**-2/ -2**

Source: Game Theory

The energy game

We are now facing the prisoner's dilemma where Europe sanctions Russia and supplies weapons Ukraine, while Russia continues its invasion of Ukraine and reducing gas supplies to Europe. As it stands, there is a chance of almost 1,300 TWh reduction of Russian gas to Europe (60%), as the Yamal pipeline is shut since the invasion, the Ukraine pipelines run at around 20% of usual flows, no Russian LNG imports and Nordstream at 40% capacity. On the other hand, there is an increase of nearly 800 TWh in supplies mostly from Norway, Algeria and US LNG compared to 2019, which leaves Europe around 500 TWh short. As laid out previously (here), the reduction in nuclear power more than offsets the increase in renewables in 2022, and coal power could only increase marginally, as there is also a decline in supply from Russian coal. However, German economy minister has sought to reduce demand from industries by 8% and from households by 15%, which, if implemented in whole of Europe (including UK, Ukraine) could roughly lead to a 10% decline in consumption, which is around 500 TWh.

1 https://issuu.com/johnsonnick895/docs/game_theory_paper
2 https://greatergood.berkeley.edu/article/item/john_gottman_on_trust_and_betrayal
3 https://www.aozorastep.com/The%20New%20Battleground%20-%20NATO%20vs.%20SCO.pdf

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Europe gas imports from Russia

Pipeline/LNG carrier	EU imports 2019 (in TWh)	Currently importing (annualised in TWh)
Russia Yamal Pipeline	358	0
Russia Nord Stream Pipeline	596	238
Russia Ukraine Pipeline	433	87
Russia TurkStream Pipeline	347	347
Russia Blue Stream Pipeline	173	173
Russia LNG Carrier	228	0
Total	2134	845
Difference	-1289	

Source: Reuters, https://mondediplo.com/maps/gas-pipelines#&gid=1&pid=1

Europe gas imports from non-Russia

Pipeline/LNG carrier	EU imports 2019 (in TWh)	Currently importing (annualised in TWh)
Norway pipelines	1065	1200
Norway LNG Carrier	59	59
Qatar LNG Carrier	293	293
Algeria Pipeline	205	300
Algeria LNG Carrier	98	98
Libya Pipeline	49	49
US LNG Carrier	166	661
Nigeria LNG carrier	127	127
Trinidad and Tobago LNG carrier	59	59
Other LNG carrier	49	100
Total	2170	2946
Difference	776	

Source: Reuters, https://mondediplo.com/maps/gas-pipelines#&gid=1&pid=1

Gas shortages in Europe

While EU gas storage levels have increased rapidly over the last few months, there are a number of headwinds coming towards Europe. Firstly, the Nordstream pipeline will go into a mandatory shutdown from 11th-21st July. Then, the Freeport explosion has reduced US LNG imports by around 1/3 (included in the numbers above). And thirdly (although resolved now), Equinor's offshore oil & gas employees are looking to strike to demand higher pay, which could cut up to 56% of Norway's gas exports (618 TWh pa). In order to achieve the newly regulated minimum 80% gas storage levels by 1st November, Europe needs around 251 TWh more gas between 1st July and 1st November than it currently receives (this is a rough calculation and given the vast amount of variables is a good estimate at best). This leads me to believe

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that Europe will need to cut their gas demand and enter into a deal with Iran to alleviate the supply shortage – but make no mistake, Russia will adjust their exports to Europe accordingly.

Europe gas shortage by 1st November 2022 (numbers from 1st Jul-1st Nov)

80% gas storage full by 1st Nov	TWh
Consumption Jul-Nov	1099
Non-Russia imports	993
Russian imports	285
Net gas injection	179
Storage to fill	430
Net short gas	**-251**

Source: AGSI, Reuters

The Joker

Iran is planning to boost gas output by a whopping 463 TWh in 2022[4]. This increase in supply would largely make up for the net shortages Europe faces, and hence the urgency of an Iran deal is logical for the Europeans. At the same time, Iran could add 1mio barrels of oil per day to supply, which is exactly equivalent to the current SPR release, hence logical for the US to agree on. My calculations are very rough, but the numbers would certainly perfectly make up for the shortages of both, oil and gas, which makes a deal very attractive for the West. The Iranians, of course, know this and therefore will be tough to negotiate with. As tempting as it is to get the Iran deal done, this could also lead to a more dramatic shift of powers from the West (NATO) to the East (Shanghai Cooperation Organisation – SCO, of which Iran is set to become a member), which, in my opinion, would be a fatal mistake. In fact, yesterday, Iran, Russia and China as well as 10 other nations announced to hold their fourth joint naval drills in Latin America mid-August after previous drills in the Indian Ocean and the Persian Gulf[5].

[4] https://www.spglobal.com/commodityinsights/en/market-insights/latest-news/natural-gas/122121-iran-plans-to-boost-gas-output-in-2022-including-from-delayed-south-pars
[5] \ https://www.express.co.uk/news/science/1636808/iran-china-russia-joint-military-drill-venezuela-south-America-defence-news

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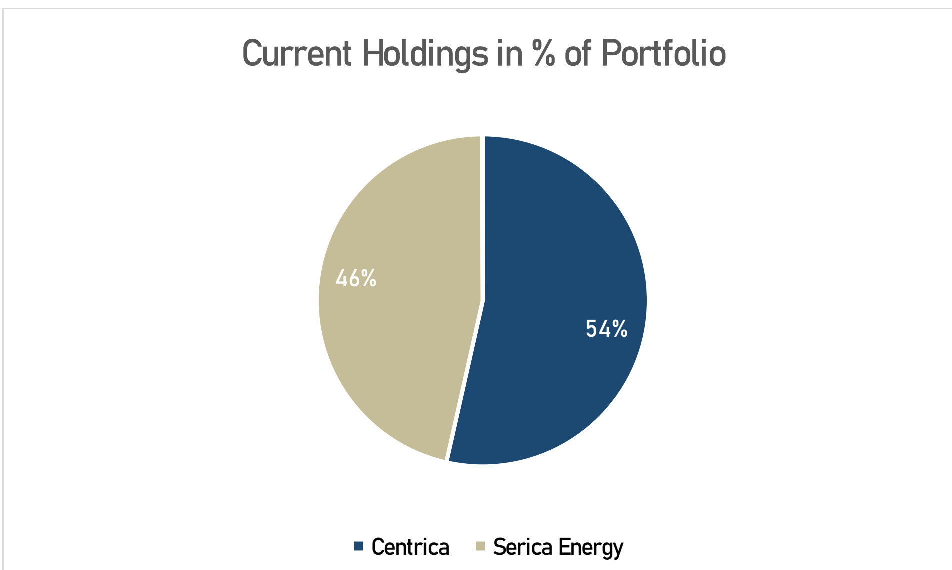
Performance

The 2nd quarter of this year was a challenging one. We have achieved a 13% return on greetings card producer IG Design Group and a 64% return on bus and railway operator Go-Ahead Group (which was subject to a takeover bid), while losing around -16% with the position in car dealership owner Vertu Motors. Despite the larger gains, the positions were smaller in IG Design and Go-Ahead Group and therefore roughly offset the loss in Vertu Motors. British Gas owner and utility Centrica was stable. I entered Serica Energy, a UK gas producer, with a view that higher gas prices are here to stay. We finished the quarter down -3.2% compared to -5.7% of the FTSE All Share TR.

Current Holdings

Company	Average Purchase Price	Current Market Price	Currency	% change
Centrica	0.82	0.81	GBP	-2%
Serica Energy	3.01	2.87	GBP	-5%

As of 30th June 2022



As of 30th June 2022

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Performance explanation: Exits

I sold greetings card manufacturer IG Design Group towards the end of April amid the prospect of worsening supply chains in light of Covid lockdowns in China. The group is having a large part of their production in China and the port congestion can therefore lead to delays and higher costs. Mid-June I also exited public transportation operator Go-Ahead Group after two takeover approaches were announced and the valuation of the company increased above the bid price. Both exits have been profit-making, but were rather small positions. The exit of Vertu Motors was a larger position and exited with a loss. While supply chain issues remain, consumer confidence dropped to a new record low and multiple firms reported a decline in consumer demand, which I did not anticipate to play out so early. While Vertu Motors remains extremely attractively valued, car dealerships in general suffer more than other sectors during a recession. The loss in Vertu Motors therefore largely offset the gains from IG Design and Go-Ahead.

Performance explanation: Entrants

As we have likely entered a recession, I have been seeking to find a recession-proof industry. This industry is UK natural gas. Since we are at war with Russia via Ukraine and Russia has close to absolute control over European gas prices, it is very unlikely for gas prices to decline and after the Energy Profit Levy was introduced, it led to a major sell-off in oil & gas North-Sea producers. However, Serica Energy only needs a gas price of GBp 240 and oil at $100 to achieve annual net profits that are equivalent to their enterprise value, including taking a 65% tax into consideration. The average forward gas price for 2023 is currently trading at GBp 300 per therm. We also remain long Centrica, because I expect their upstream profits after the new tax regime to reach £1bn net income (vs. £4.5bn enterprise value) with around 2/3 coming from gas and 1/3 from nuclear considering a conservative GBp 150 per therm. Regulator Ofgem has now also changed the rules that makes switching supplier extremely difficult, as the company acquiring any customer from a competitor needs to pay the previous company 85% of the costs the previous supplier faces by losing this customer. At the same time, Ofgem makes it harder for new firms to enter the market with larger capital requirements to secure client deposits. Both is positive for British Gas, owned by Centrica, which has lost customers every single year for a decade and in 2021 finally added customers due to the failure of private equity backed and growth-focused new entrants.

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Review

Perhaps the biggest learning lesson over this quarter is to size positions equally. If this would have been done, this quarter we could have achieved a +20% return in Q2 22. This was somewhat difficult to do, as my target valuation of my other investments has not shifted and was still out of reach at the time. In the future, I'll make sure that the positions are all sized at least roughly equally.

Outlook

The recent sell-off in commodities show that my fears might come true: Each time when Russia invaded another country, such as Georgia in 2008 and Crimea in 2014, it was when oil prices peaked and in subsequent months sold off heavily. I continue to view natural gas prices in Europe to be immune from such a sell-off given the lack of infrastructure to divert the flows. However, the Iran deal could solve part of the shortages in natural gas, as pointed out above. A deal seems unlikely though given that the US has just recently stiffened sanctions[6]. Therefore, for UK natural gas prices to decline, we would need to see European gas storage levels to fill up rapidly to achieve the 80% storage levels before 1st November and have a very mild winter. Again, I see this scenario as unlikely… On the other hand, if the energy crisis does intensify over the winter (or my thesis turns out to be wrong), I would be looking to exit Centrica and Serica Energy once my price target is met and buy stakes in the following businesses, which are all attractively valued, but face near term risks, which I am not comfortable at this point:

- **James Fisher & Sons** – they are looking for a buyer of their tankers division. Ship-to-ship transfers remain low due to Russian sanctions and their EBITDA might be too low and could breach their debt covenants
- **IG Design Group** – 2/3 of their supply contracts are contracted, rest floated. While contract rates are the same as last year, they have doubled compared to the years before. US inventories are high, hence likely lower sales this year, especially in light of a recession where consumers will spend less on greetings cards
- **Sylvania Platinum** – Most of their profits come from Rhodium, which is in higher demand to reduce ICE vehicle emissions. However, if EV sales accelerate, there might be a decline in demand

[6] https://edition.cnn.com/2022/07/06/politics/iran-sanctions-biden-administration/index.html

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for rhodium, palladium and platinum. A decline in car sales due to a recession could also reduce rhodium demand

- **Reach** – pulp prices and printing costs have increased and the war in Ukraine has led to fewer advertising demand in connection to war coverage. Would need to see a bottoming of advertising demand decline first
- **Vertu Motors** – attractively valued, well run and growing car dealership. I like the CEO, who is a capitalist and works 7 days a week. If cost of living crisis is averted, would buy a stake again. Their Bristol Street Motors brand sell mostly cheaper vehicles, which sales can be more volatile than premium
- **Hunting** – Oil service firm that lost 40% in its value in one month partly due to missing guidance for 2022. Very attractively priced now, but I can't figure out how the loss of Russian and Ukrainian steel might impact the business, as they source some of their steel for OCTG from Austrian firm Benteler. They are also slightly impacted by the chip shortage
- **Hostmore** – Owner of UK's TGIFs restaurants. Again fear of cost of living crisis and higher energy bills lets me hold off for now. Their cash flows are currently still very attractive at this valuation

Sincerely,

David Herrmann

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