AozoraStep

Our Performance vs. FTSE All Share Total Return

Quarterly Performance	Our Performance	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%

Annual Performance	Our Performance	FTSE All Share TR
2017	-9%	9%
2018	-31%	-9%
2019	113%	19%
2020	52%	-10%
2021	37%	18%

Overall Performance	Our Performance	FTSE All Share TR
CAGR	**21.9%**	**4.6%**
2017-21 Return	**169%**	**25%**

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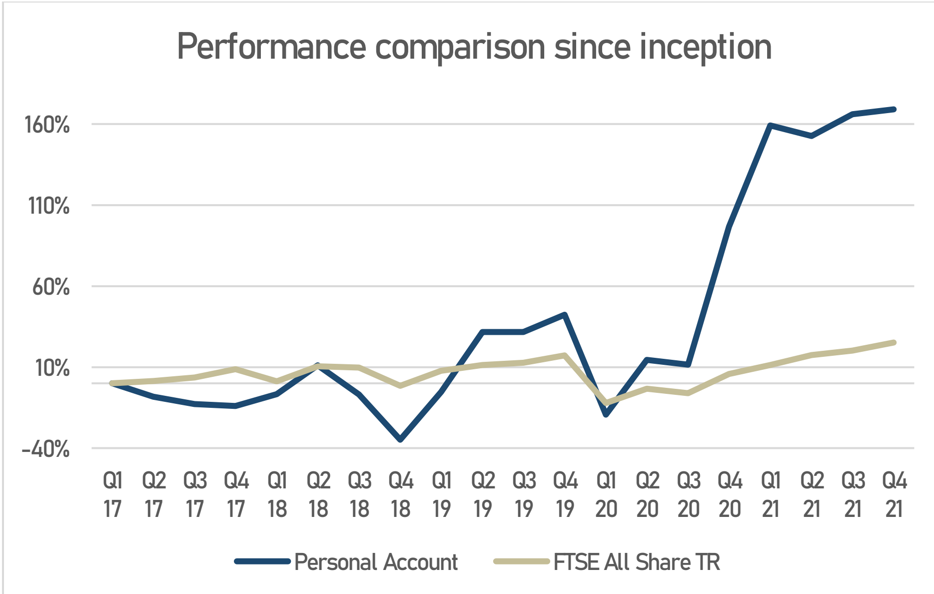

6th January, 2022

Dear Investor,

Before I kick off this quarterly letter, it is time to review the year: I registered AozoraStep Capital LLP on 13th April 2021, and since then I have created over 40 compliance policies, engaged with more than a dozen of compliance advisors, created a website, put out research and social media content, got in touch with investors and got everything in place from Accountants, Auditors, Banking, Brokerage and Insurance and Legal. But when the FCA got in touch with me at the end of November, I have not looked at compliance for over two months. I realized that the FCA was not happy with my application and they suggested to me to withdraw my application.

Since then I have given my very best in convincing the FCA to proceed and have yet to hear back from them. This came at a price: It drained an incredible amount of energy from me. I have revisited all relevant pages of the FCA handbook (a book probably 5x thicker than the bible!!) and updated all my policies. My compliance manual alone is 82 pages long with 25,ooo words, the Investment Management Agreement is another 41 pages and 12,000 words, the Anti-Money Laundering handbook 31 pages and 6,500 words, just to name a few. Having completed all this, I am truly exhausted.

However, you will realise that things have changed… For example, I am not calling my track record AozoraStep, but instead "Personal Account" to make it clear that I'm not investing on behalf of AozoraStep or anybody else rather than myself without authorization. More changes will follow. The FCA is not allowed to advise me or even point out my mistakes. This has been frustrating, as they argued in a very vague matter without any legal basis behind. Having understood all this now, it was the necessary evil to get off the ground. Meanwhile, another opportunity arose to become an Appointed Representative of Finex LLP, which is actually financially more attractive than a direct authorization with the FCA. Although I was hopeful of getting directly authorized with the FCA, I am now considering the Appointed Representative route. In either case, I would expect to get authorized by the end of Q1 22 now…

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A historic analogy

Over the year I have continuously referred to the forgotten depression of 1920/21 as a possible scenario of where we are headed in 2022 (table below). As we progress, the parallels are more and more striking, the influenza waves were similar to the Covid-19 waves, lockdowns and labour shortages occurred, while inflation, especially in commodity prices, was rampant. In addition, the Fed's tapering in November and likely speed up of tapering in January 2022 (this month), is in line with Fed rate hikes during 1919/20. Moreover, the fundamentals are also eerily similar, as back in 1918-20s we moved from horses to the combustion engine, moved from coal to oil, had high inequality, high speculation in stock markets and were about to introduce wide tax increases – just as it is all happening now with electric vehicles (EVs) replacing the combustion engine and the move away from oil to renewables.

For this reason, I expect the combination of stagflation due to high commodity prices and tightening monetary policy to lead to a similar slowdown where consumers reduce spending and business' inventories to start climbing, order books start declining. As order books are still strong, it will take time to feed through the economy. Consumers will realise that the charging infrastructure and battery technology in existing EVs is not sufficiently built out yet and will start flying rather than driving again amid fewer restrictions due to less deadly Covid variants. This is my base case and makes it hard to find suitable companies to invest in at this point…

Influenza vs. Covid-19 waves

Influenza	**Covid-19**
1st wave: Early 1918	1st wave: Early 2020
2nd wave: Late 1918	2nd wave: Late 2020 (Alpha)
3rd wave: Early to mid-1919	3rd wave: Early & mid 2021 (Delta)
4th wave: Spring 2020	4th wave: Winter 2021/22

1918-20s vs. 2020-22s timeline

1918-1920 and beyond	**2020-2022**
1918: Lockdowns were introduced to curb the virus	2020/21: Lockdowns were introduced to curb the virus
1919: 1 in 5 American was striking to achieve higher wages	2021: Record number of people left their jobs, resulting in labour shortages
1919/early 1920: Inflationary boom with commodity prices reaching all-time highs	2021: Inflationary boom with commodity prices reaching all-time highs
November 1919: Stock market peak, just as the Federal Reserve hiked rates from 4% to 4.75% to fight inflation and speculators, stocks slumped 12.8%	November 2021: Fed announced tapering. Central banks around the world turn hawkish. NASDAQ peaked
January 1920: Fed raises rates to 6%, stock market didn't react	January 2021: Fed expected to speed up tapering asset purchases

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April 1920: A Tokyo bank defaulted, prices of rice, cotton and silk dropped quickly, GM shares dropped 8%	
1920: Consumers changed to non-inflationary living, buying used clothes	
Spring 1920: Consumers stopped buying cars, strong demand disappeared. GM sold 52,000 vehicles a month in early summer, 13,000 in November and only 6,150 in January 1921	
April 1920: Weather was cold, wet and caused wheat and other agricultural goods to spike in price, farmers started borrowing more, but then were facing huge losses in 1921	
April 1920: Steel Corporation had luxury of 10.4mio tons of unfilled orders. This backlog dwindled to 5.8mio tons from April 1920 to March 1921	
June 1920: Fed raises rates to 7%	
April 1922: Accumulated inventories were sold off for extremely low prices	

Similarities between the two time periods

1918-20s	**2020-22s**
High inequality, with top 1% owning 12-19% of the total share of income	High inequality, with top 1% owning 30% of all household wealth
Combustion engine replaces horses	Electric vehicles set to replace combustion engine
High speculation with businesses borrowing excessively and individuals borrowing to buy stocks	High speculation with individuals investing in "no return" cryptocurrencies
Large backlogs	Large backlogs
Income tax and other taxes were set to be introduced	Global corporation tax is set to be introduced, taxes are increasing
World was in globalization mode, but faced headwinds with WW I	Globalization continues, but faces headwinds with China desiring to become a world power
World leader had excessive debt/GDP of over 130% (England)	World leader had excessive debt/GDP of over 120% (USA)
"*On the way up, inventory accumulation had contributed to the panicky sense that the world was running out of everything. On the way down, inventory destocking helped to enflame the fear that the world was oversupplied with everything*	We have high inventory accumulation right now, and while inventory/sales ratio are extremely low (automobile industry), some industries are stocking up in expectation of high Christmas sales and due to supply chain issues

Source: The Forgotten Depression by James Grant

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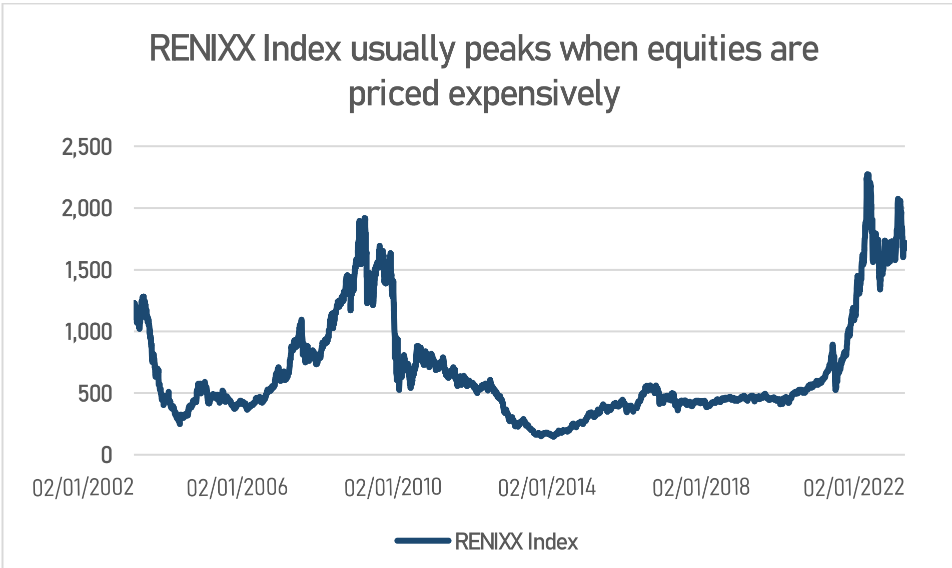
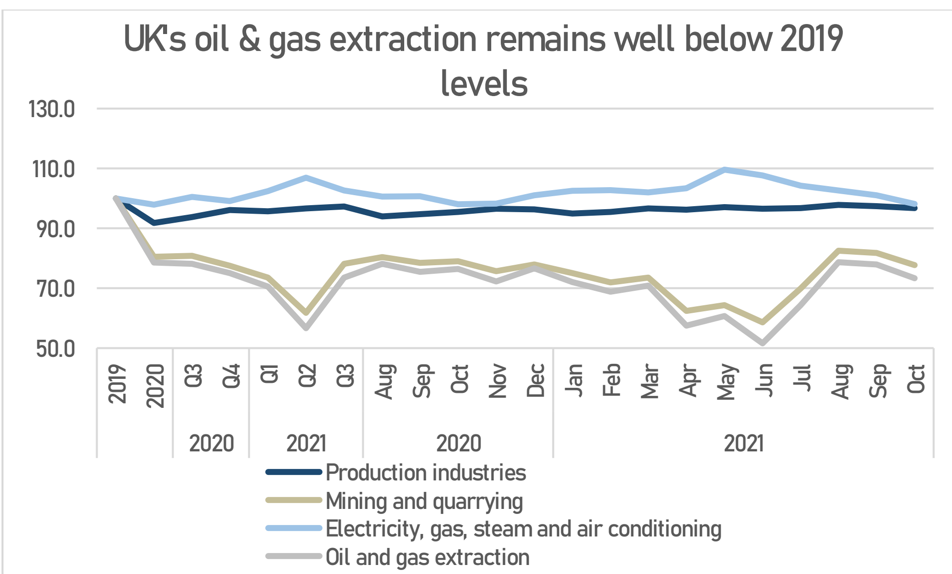
<u>The energy crisis that everyone ignores</u>

If I were a politician and want to fight climate change by promoting renewable energy, how would I do that? It is not the first time that we are trying to move away from fossil fuels and shift towards renewable energy and electric vehicles. It has always failed, just take a look at the RENIXX Index (Renewable Energy Industrial Index). Interestingly, the support for renewable was highest when the market was generally expensively priced, such as in 2000 or in 2008. This time the chances of success are higher than before amid the strong political support by incentivizing the renewable industry financially and depressing the fossil fuel industry. In the UK, for instance, oil & gas extraction is only at 70% of 2019 levels, two years into the pandemic. This, however, comes at a cost: Higher energy prices



Source: Renewable-Energy-Industry.com



Source: Office for National Statistics

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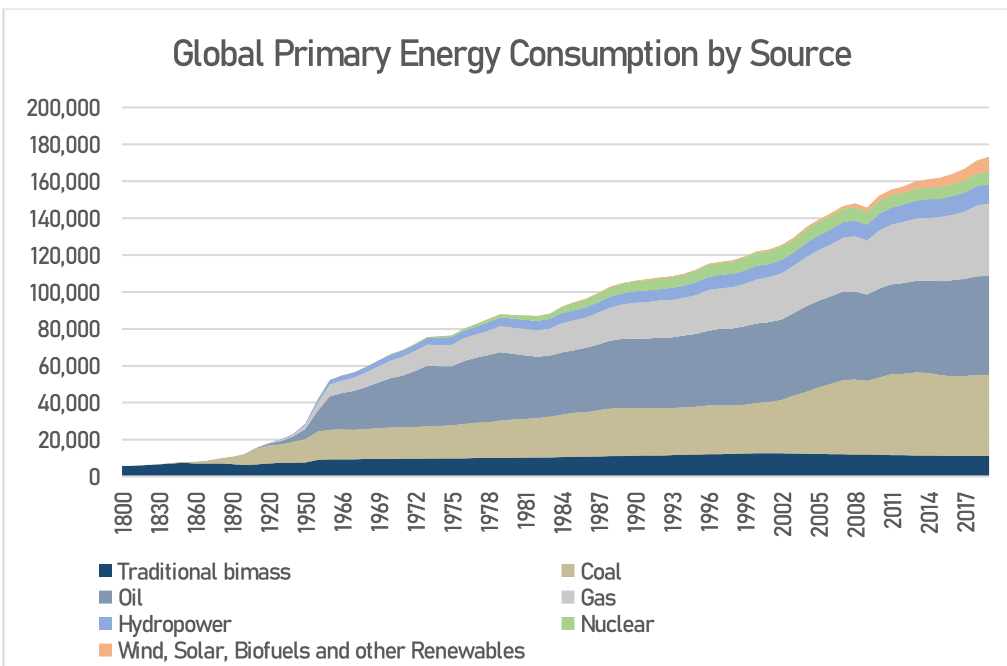
While out of this energy crisis there are already first conflicts emerging, such as in Kazakhstan or indirectly in Ukraine, you have to ask yourself whether this dramatic shift towards net zero is really the right path and how realistic it really is? I'm seeing 3 problems:

1. Coal emits around double the amount of CO_2 compared to natural gas and around 1/3 more than oil[1]. Natural gas on the other hand, is often a by-product of crude oil exploration. Both, coal and natural gas can be used for electricity generation. If we shift from the combustion engine towards electric vehicles, we would need to replace the oil consumption either by renewables, nuclear, natural gas or coal. Net effect will likely be a rise in all, renewables, nuclear, natural gas and coal consumption

2. Related to 1., by prohibiting oil, gas & coal production, developed nations ultimately face energy shortages, as we not only want to replace fossil fuel electricity consumption, but need a lot more electricity to shift away from the combustion engine towards EVs. This will make EV charging costs more expensive relative to oil fueled combustion engines

3. Not a single energy source saw a decline in consumption over the last 70 years. Not only is the world's population growing by around 80mio a year, but also energy consumption per capita is increasing, leading to higher energy demand



Source: Our World in Data

[1] https://www.americangeosciences.org/critical-issues/faq/how-much-carbon-dioxide-produced-when-different-fuels-are-burned

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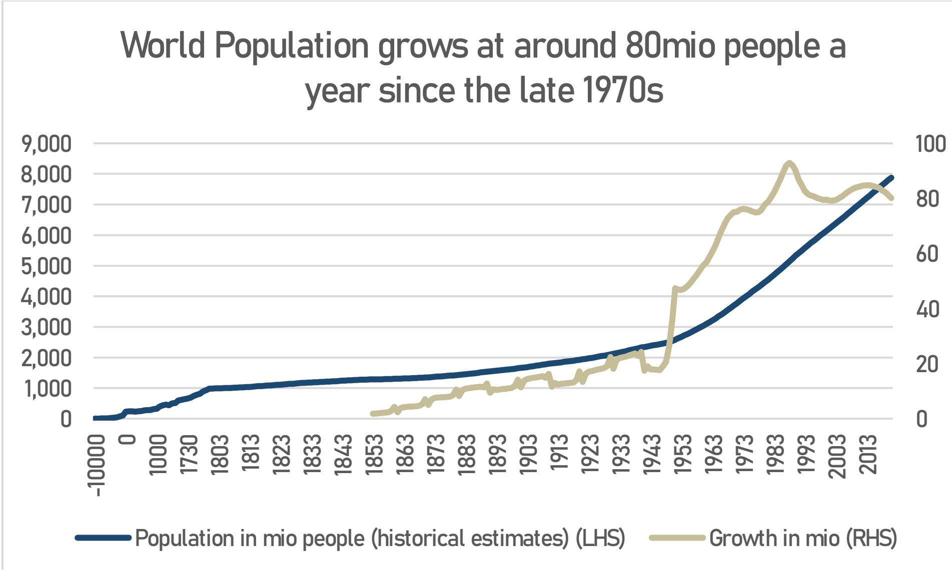
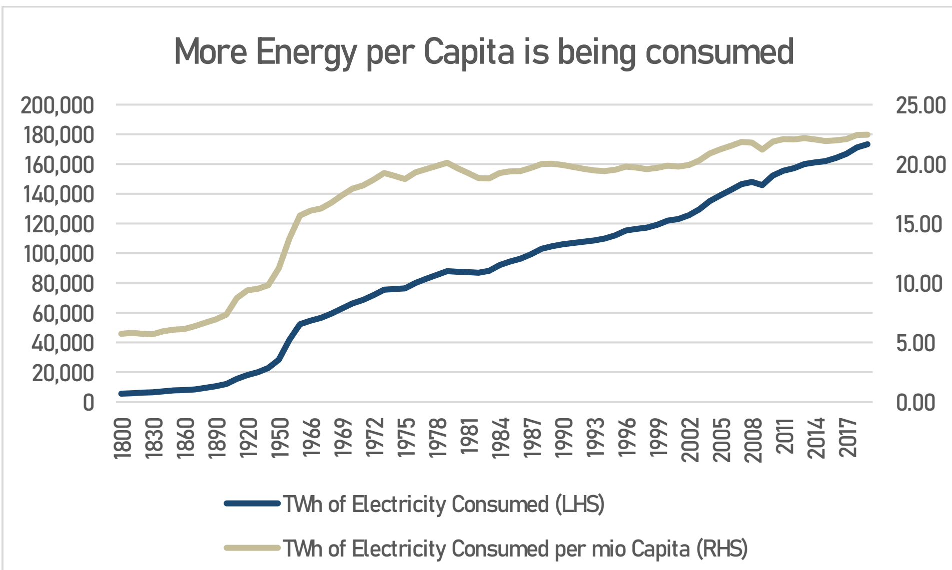


Source: Our World in Data



Source: Our World in Data

Performance

I close the year up another 1% in Q4, which is somewhat disappointing given the 4% climb in the FTSE All Share TR. However, on an annual basis the 37% performance is 19% higher than the FTSE All Share TR performed. As my portfolio is more concentrated, quarterly divergence is normal and hence the annual relative performance remains the key measure. While I exited the remaining Photo-Me shares, the turnaround of Centrica has taken shape, while Hunting was unfairly punished for a reduced full year profit guidance, which has led me add to the position.

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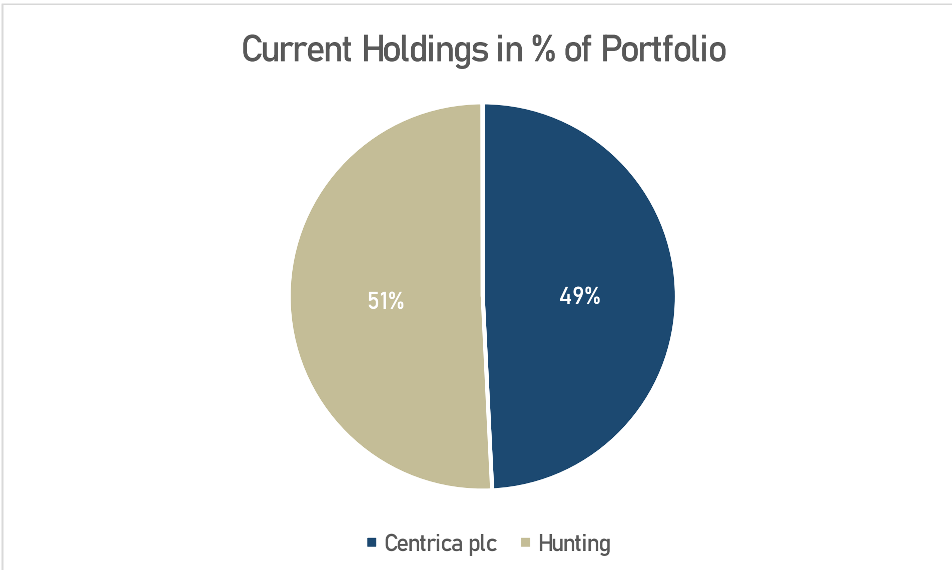
Current Holdings

Company	Average Purchase Price	Current Market Price	Currency	% change
Centrica plc	0.53	0.72	GBP	36%
Hunting	1.95	1.69	GBP	-13%
Cash	-	-	GBP	0%

As of 31st December 2021



As of 31st December 2021

Performance explanation: Exits

As mentioned in previous Q3 report, I have exited Photo-Me due to high shipping fees, which makes exchanging older with newer machines more expensive for the company and digitization of driving licenses in China and UK, which could make their Photo-booth business obsolete very quickly.

Performance explanation: Entrants

As the turnaround of Centrica is ongoing and the turnaround of Hunting is just starting to materialize from a lower base of where I invested, there are no new positions in the portfolio. Given my broad macro view of a potential repeat of the 1920 forgotten depression and a continuation of the energy crisis, I am positioned to see a recovery in oil & gas exploration, in particular in the US shale patch (Hunting), as well as a recovery in the UK downstream energy sector due to a doubling of utility bills from April 2022 (Centrica). More details to both positions can be found under turnarounds.

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Review

Although being down -13% with Hunting (at one point -25%), I do not consider the investment a mistake. Quite the opposite, as the company continues to trade below their current net assets and now has increased their stake in their UK business from 60% to 100% as well as entering the Indian OCTG market with the Jindal SAW joint venture, which will be highly lucrative. I continue to view 310 pence as fair value for Hunting's shares, i.e. $700mio market cap.

Centrica is now close to my first target price of 75 pence, i.e. £4.5bn market cap. I have reduced the position at the beginning of January 2022, as the danger remains that customers on fixed rate tariffs are rolling into the variable Ofgem tariff, which could leave Centrica ending up buying gas at GBp 200+ a therm, while selling it at GBp 61 a therm to its customers. Although this will be short-term, if natural gas prices were to collapse into the summer, all those on variable tariffs might switch to cheaper fixed tariffs, leaving Centrica with too much energy bought at expensive prices to be sold back to the market at lower prices. While this is not my base case, I have reduced this risk by cutting the position by 40%. Worth of note, I'm a customer of British Gas and they have sent me a letter proposing to fix my energy plan until July 2023 at an average of GBp 200 per therm, which indicates that they have already bought this energy and expect the energy crisis to last at least until then. Uniper, a German downstream energy supplier has meanwhile increased their credit lines to €12bn to manage higher margining requirements[2]. Given that Uniper is around 3.5x bigger than Centrica, comparable liquidity needs would translate into £3.5bn for Centrica. This is below their £4.5bn in cash, hence manageable.

I was eager to buy shares in James Fisher and Sons over the holiday period in December when the market cap dropped to £150mio vs. £30mio guided profits. Unfortunately, I could not get hold of their IR team to clear my questions and decided not to buy. When James Fisher and Sons released a statement regarding receipt of payments from an LNG project in Mozambique, the shares soared over 30%. This has not been a mistake, but was a bit unfortunate. I have spoken to their IR since and will receive answers shortly.

Outlook

Having reduced my position in Centrica at the beginning of January, I am now 20% in cash, which I'm looking to redeploy quickly. Studio Retail Group remains incredible cheap with a market cap of £142mio and £35-40mio guided pre-tax full year profit. James Fisher & Sons also remains attractive despite the 30% rise in recent days with a market cap of £185mio and £27-32mio guided operating income. Despite not being 100% happy having sold 40% of Centrica, I think it's right to act prudently in light of this energy crisis, as the price is more in line with my initial fair value estimate and the higher volatility is also a risk for energy suppliers…

Sincerely,

David Herrmann

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[2] http://irpages2.eqs.com/websites/uniperag/English/15/news-detail.html?newsID=2182982

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