September 6th 2024

Exit Oil States International: Too much uncertainty calls for caution

Company:	Oil States International (OIS)	**Market Cap:**	$340mio
Industry:	Oil and gas equipment	**Net Current Assets:**	$325mio (+$124mio debt)
Country:	US, worldwide	**Revenue:**	$782mio
Date:	4th September 2024	**Operating cash flow:**	$70mio
Dividend:	-	**Free cash flow:**	$40mio*
Entry:	$280mio	**Exit:**	$315mio (+12%)

*Estimated guidance as of Q2 24

Why exit Oil States International?

- A significant rise in VIX and drop in yields indicate a further market sell-off. In past market sell-offs (2007, 2008, 2014/15, 2018, 2020), Oil States International lost at least 35% in market cap
- US gas prices continue to decline, which hasn't happened during the month of August over the last 5 years
- Manufacturing PMIs point towards a worsening downturn, China oil demand remains lower than expected
- Despite a fraudulent election in Venezuela, the Biden administration continues to allow for oil to flow. This means they will likely allow Iran to sell oil no matter how they attack Israel

The outlook is just not improving

Despite a very positive Q2 report, in which Oil States International confirmed its outlook and bought back $11.5mio of their convertible bond and $2.4mio of their own stock, the oil field services industry overall displayed mixed results. Longer laterals (now up to 4 miles long) and consolidation in the industry has begun to put pressure on prices for equipment. Most operators have guided towards a muted 2nd half and

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

earliest upside from 2025. With an expected escalation in the Middle East and fraudulent elections in Venezuela, oil and gas production in the Gulf of Mexico & the US shale oil and gas industry could potentially benefit. However, after the Venezuelan election results were disputed by the U.S., the Biden administration has not reinstated sanctions on oil sales. This shows that Biden would not risk a rise in oil prices ahead of the U.S. election. In turn, it made any escalation in the Middle East less significant for oil & gas prices. When the latest manufacturing PMIs pointed towards further downside and the Fed kept its hawkish stance, a market sell-off of historic proportions began. The August Manufacturing PMI came in weak again and the comment from S&P Global Market Intelligence's Chief Business Economist pointed to further downside.

July 2024 ISM Manufacturing report USA

WHAT RESPONDENTS ARE SAYING

- "Business is relatively flat — the same volume, but smaller orders." [Chemical Products]
- "Demand continued to soften into the second half of the year. Supply chain pipelines and inventories remain full, reducing the need for overtime. Geopolitical issues between China and Taiwan as well as the election in November remain weighing concerns." [Transportation Equipment]
- "Even though we are used to a seasonal reduction in business over the summer, consumer behavior is changing more than normal. Sales are lighter, and customer orders are coming in under forecasts. It seems consumers are starting to pull back on spending." [Food, Beverage & Tobacco Products]
- "Availability of parts is good, with small exceptions of missing materials here and there. Ordering is still well below typical levels as we continue to burn down inventory of raw goods, with 'normal' ordering trends expected to return sometime in the second half of 2024." [Computer & Electronic Products]
- "It seems that the economy is slowing down significantly. The number of sales calls received from new suppliers is increasing significantly. Our own order backlog is also diminishing. We are hoping for an increase in customer demand, or we will possibly need to make organizational changes." [Machinery]
- "Unfortunately, our business is experiencing the sharpest decline in order levels in a year. We were well below our budget target in June; as a result, it was the first month this year that we had negative net income." [Fabricated Metal Products]
- "Business is slowing, and we are taking cost actions." [Electrical Equipment, Appliances & Components]
- "Some markets that are usually unwavering are showing weakness. Weather is the common factor, but only so much." [Nonmetallic Mineral Products]
- "Our sales forecast for July and August are slow, but we're making every attempt to remedy that situation. Our medical end-user customers continue to meet their forecasts, which is promising." [Textile Mills]
- "Elevated financing costs have dampened demand for residential investment. This has reduced our need for component products and inventory." [Wood Products]

Source: https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/july/

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

August 2024 S&P Global US Manufacturing PMI comment

Comment

Chris Williamson, Chief Business Economist at S&P Global Market Intelligence, said:

"A further downward lurch in the PMI points to the manufacturing sector acting as an increased drag on the economy midway through the third quarter. Forward-looking indicators suggest this drag could intensify in the coming months.

"Slower than expected sales are causing warehouses to fill with unsold stock, and a dearth of new orders has prompted factories to cut production for the first time since January. Producers are also reducing payroll numbers for the first time this year and buying fewer inputs amid concerns about excess capacity.

"The combination of falling orders and rising inventory sends the gloomiest forward-indication of production trends seen for one and a half years, and one of the most worrying signals witnessed since the global financial crisis.

"Although falling demand for raw materials has taken pressure off supply chains, rising wages and high shipping rates continue to be widely reported as factors pushing up input costs, which are now rising at the fastest pace since April of last year."

Source: https://www.pmi.spglobal.com/Public/Home/PressRelease/78070699cd654baeb61c7a6dca339f58

This is different to the 2022 Ukraine invasion sell-off

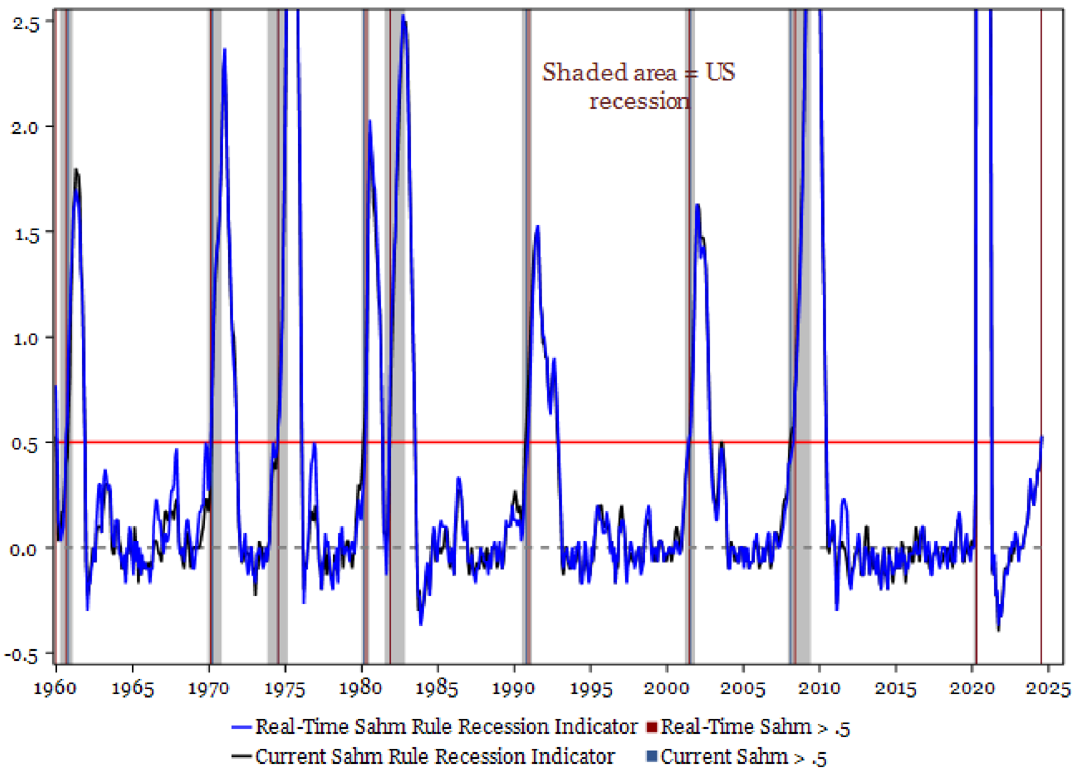
My thesis of escalation in the Middle East, while correct, has so far played out differently than expected. Before Russia invaded Ukraine, oil prices began rising to already $90/bbl. When Russia then began its invasion of Ukraine, sanctions quickly followed. While oil prices rose by 4% on 31st July in anticipation of a retaliatory response by Iran against Israel after Israel assassinated Haniyeh in Iran, oil and gas prices have since collapsed further. This was a sign for me that the market outweighs economic concerns over escalation in the Middle East. There are more interesting statistics that call for caution:

- The Japanese equity market had its worst 5-day decline on record and largest single day decline since 1987's Black Monday → different to 1987, the central banks are not stepping in today
- The VIX has never closed above 38 for a single day except on 24th August 2015 (flash crash). A level of this high volatility always lasted for at least 1 week and the effective federal funds rate over the last 25 years was never higher than 3.11% when it occured compared to 5.33% today. There was only one other period during the month of August when the VIX breached 38, which was in August 2011

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

- Sahm's rule has been triggered, which has been a reliable forecaster for a recession
- Oil prices dropped over 4%, while 2yr UST yields declined by over 20bps, which only occurred on 7 other occasions in the last

<u>Sahm's rule has been a reliable recession indicator historically</u>



Source: Longview Economics, Macrobond, Federal Reserve Bank of St. Louis

<u>Days on which oil was down over 4% and 2yr UST yields down by over 20bps</u>

Date	WTI $/bbl	Change in %	UST 2yr yield in %	Change in bps
1991-12-20	18.28	-4.4%	4.80	-25
2001-11-29	18.55	-4.2%	2.87	-25
2008-09-15	95.52	-5.6%	1.78	-45
2008-09-29	96.29	-9.8%	1.70	-41
2008-10-02	93.84	-4.5%	1.62	-20
2020-02-28	44.83	-5.0%	0.86	-25
2023-03-15	67.38	-5.3%	3.93	-27
2024-08-02	74.30	-4.0%	3.87	-28

Source: FRED St. Louis

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

Legal Disclaimer

The contents of this publication have been prepared solely for the purpose of providing information about AozoraStep Capital LLP and the services and products it is intending to offer, which are targeted for professional investors only. The opinions and views expressed are those of AozoraStep Capital LLP, may change without notice and should not be construed as investment, tax, legal or other advice. AozoraStep Capital LLP does not guarantee the completeness and accuracy of the information provided and all content can become out of date. Products or services mentioned in this publication are subject to legal and regulatory requirements in applicable jurisdictions and may not be available in all jurisdictions. Accordingly, persons are required to inform themselves and observe any such restrictions. In respect to investments described in this document, past performance is not a guide to future performance. The value of investments and the income of any financial instruments mentioned in this document may fall as well as rise and may have tax consequences. The performance of the investment strategy of AozoraStep Capital LLP is based on a personal track record of its managing partner and approved by Sedulo for the time period Q1 2019 - Q1 2021 and by HiCloud Accounting for the time period 2020 - 2023, only with further examinations being done on an occasional basis. AozoraStep Capital LLP is currently not authorized and regulated by the FCA, and therefore, is not allowed to provide financial products and services. AozoraStep Capital LLP is registered in England and Wales with registered number OC436835. Registered Office: 21 Knightsbridge, London SW1X 7LY, United Kingdom. Reproduction or distribution of any materials obtained in this publication or linking to this publication without written permission is prohibited.

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com