AozoraStep

UK Equity Turnarounds & Special Situations

Love the business we invest in, but don't fall in love with the business

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AGENDA

WHY UK EQUITIES

WHY UK EQUITIES?

AN UNLOVED MARKET WITH OPPORTUNITIES

Attractive Valuations	**GS in December 2024: "UK equity markets trade at a 50% discount to the US and a 40% discount on a sector-adjusted basis. Even compared to Japan, UK has roughly twice the ROE of Japan but a similar Price-to-Book value"**
Brexit Opportunities	Low point of Brexit might have passed, and certain domestically focused businesses benefit from lower competition. Flexibility of trade deals is beginning to shine through.
Reversal of High Regulation	25% of UK government debt is inflation linked. To reduce inflation, the Bank of England reduces demand with higher interest rates, and regulators, such as the FCA, OFWAT, OFCOM and OFGEM increase supply and target excess profits with regulation. The government is now seeking to reverse some regulation for growth
Dynamic Tax Regime	UK has the 2nd lowest corporate tax rate of 25% in G7, but changes taxes frequently, such as business rates, VAT, and product specific taxes, such as on oil and gas producers. This poses both, risks and opportunities.
Declining Liabilities & Investment Refocus on UK	Over 5,000 corporate pension plans see the funding ratio reach a record high of 125% in December 2024. Higher interest rates/higher discount factor reduce or eliminate annual pension payments by corporates, leading to improved free cash flow & insurance buyouts. The government now pushes pensions to invest at home
PE Buyouts	The UK has one of the most active PE markets with as many as 1,800 PE buyouts annually. PE buyouts are attractive as it can enable returns of +40% in a short time frame
Diverse Listings	UK listed equities are highly composed of cyclical industries, which offer many turnaround opportunities

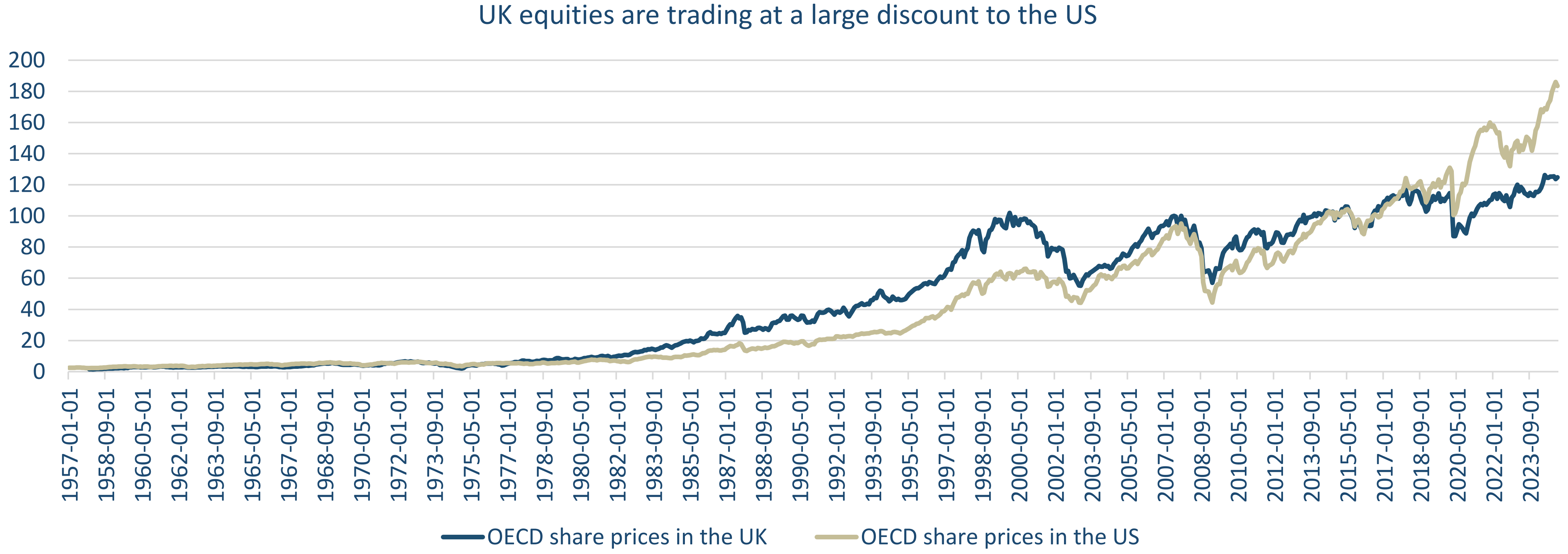
Source: https://www.gspublishing.com/content/research/en/reports/2024/12/13/bcb99822-b919-47e7-99d3-755181123bc2.html

WHY UK EQUITIES?

ATTRACTIVE VALUATIONS ON A SECTOR-ADJUSTED BASIS

1 Attractive Valuations

> **√ GS in December 2024: "UK equity markets trade at a 50% discount to the US and a 40% discount on a sector-adjusted basis. Even compared to Japan, UK has roughly twice the ROE of Japan but a similar Price-to-Book value"**

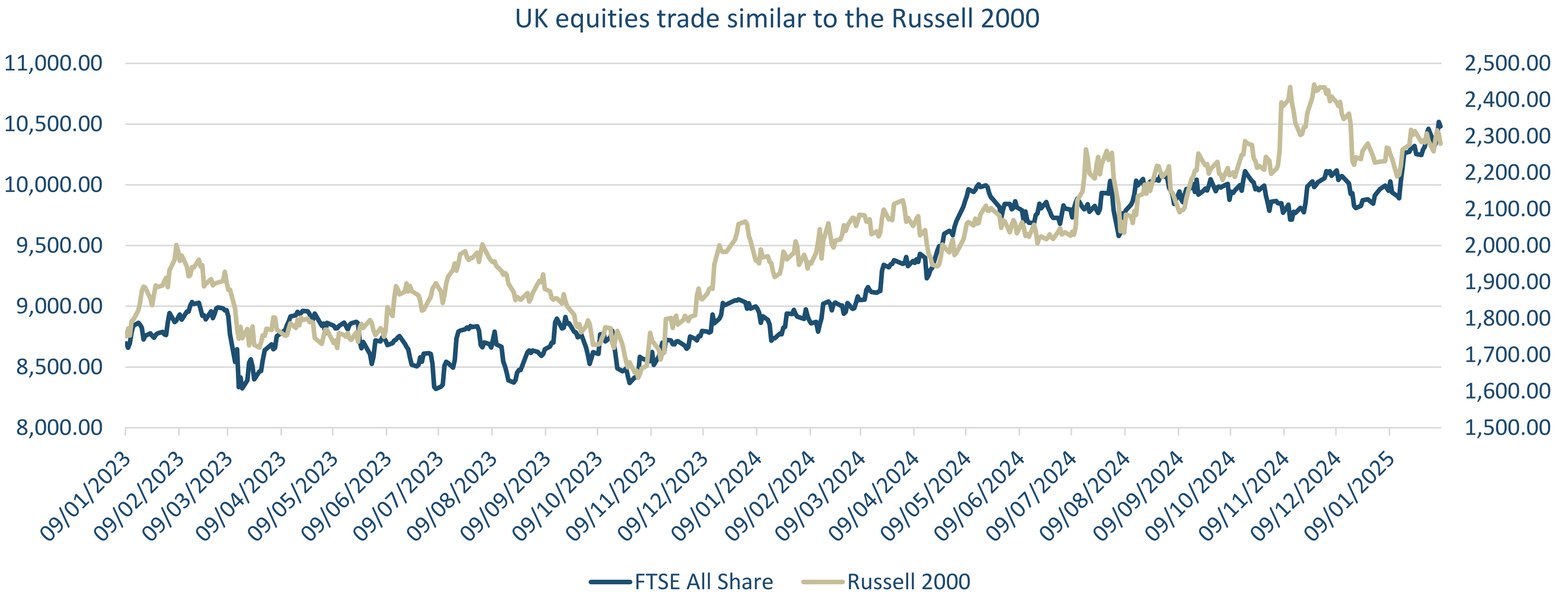


WHY UK EQUITIES?

ATTRACTIVE VALUATIONS ON A SECTOR-ADJUSTED BASIS

1 Attractive Valuations

√ UK markets are trading in line with US small cap markets in recent years. Lower UK valuations are partly down due to liquidity



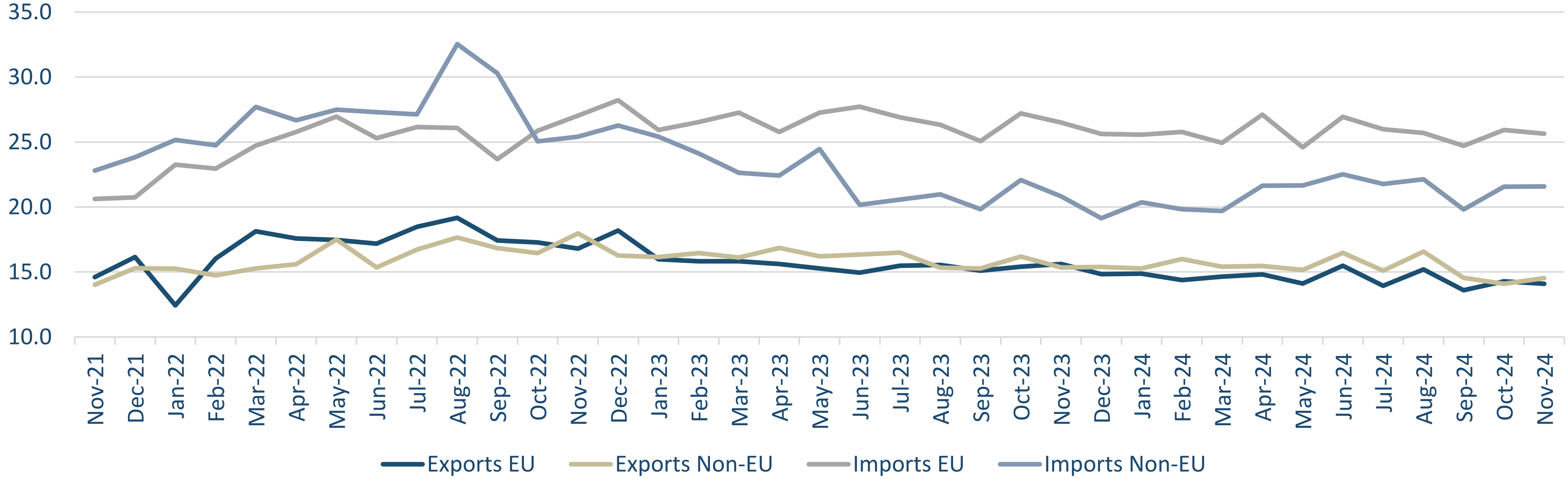
WHY UK EQUITIES?

BREXIT OPENS UP NEW OPPORTUNITIES

2 Brexit Opportunities

√ Trade balance with EU has deteriorated, partly impacted by the energy crisis. While this is overall negative, new trade agreements are only coming into effect now (New Zealand, Australia, CPTPP, Korea, China, India, USA) → Low point of Brexit might have passed & domestically focused businesses benefit

Despite Brexit, trade with the EU remains solid (£bn)



WHY UK EQUITIES?

COMPETITIVE REGULATION THAT BACKFIRES

3 Reversal of High Regulation

√ UK government has world's highest share of 25% inflation linked debt → Goal is to increase supply/competition to reduce inflation. This is achieved by regulators such as Ofcom, Ofgem, Ofwat and FCA, which put rules in place to increase competition that often backfire a few years later.

For example, in 2016 the UK energy regulator Ofgem allowed any man and dog operation to set up an energy supply business in the UK. In 2019, Ofgem then introduced a price cap on default energy tariffs. From the 86 suppliers in 2016, more than 49 defaulted since then and over 27 defaulted since August 2021 leaving 37 suppliers and a larger customer base amongst the top 6 suppliers

Venture Capital funded challengers now face funding hurdles amid a lack of profitability and high interest rates, which benefits the larger incumbents

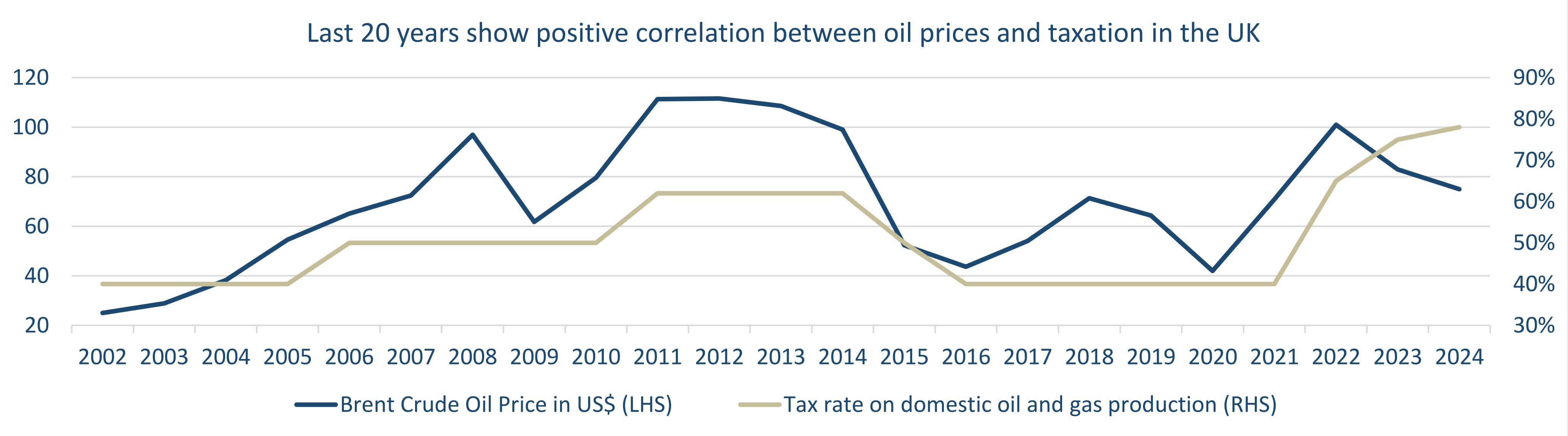
→ Amidst no growth, de-regulation is the only path forward & the UK government is actively pursuing it

WHY UK EQUITIES?
DYNAMIC TAX REGIME THAT CAN ALSO GO DOWN

4 Dynamic Tax Regime

√ UK has the 2nd lowest corporate tax of all G7 nations at 25%, but has a few "stealth taxes"

A dynamic tax regime is overall negative. However, higher implemented taxes often get reversed, such as in the oil and gas industry, business rates, VAT etc. Key is to integrate potential tax changes into valuations and to invest accordingly. Positioning for constant tax changes can offer high returns



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Sources: Gov.uk, Fred St. Louis

WHY UK EQUITIES?

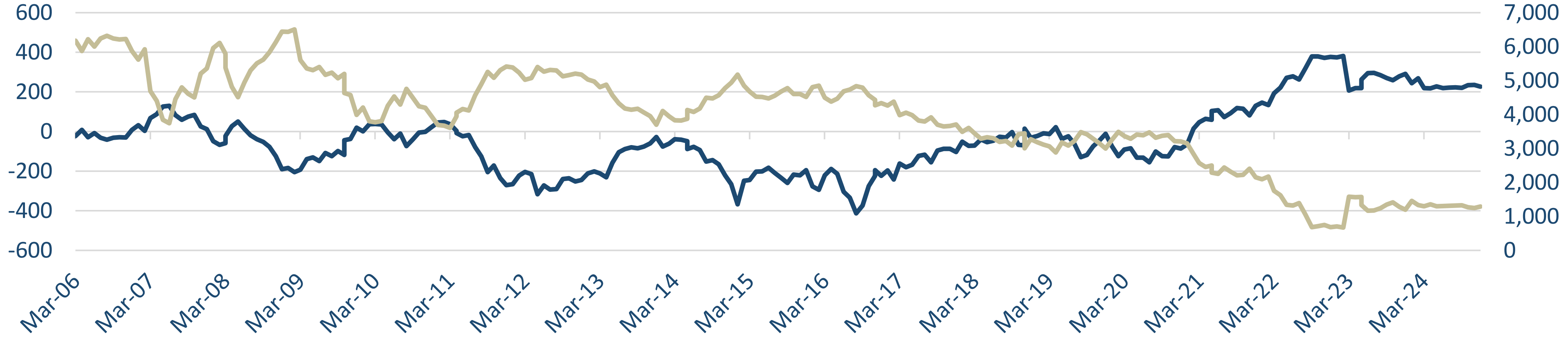
DECLINING LIABILITIES AMIDST PENSION SURPLUSES

5 Declining Liabilities & Investment Refocus on UK

√ The UK's Pension Protection Fund that rescues pension plans whose sponsor can no longer fund them and monitors over 5,000 corporate pension plans sees the funding ratio reach 125% in December 2024

Positive real interest rates reduce pension deficits and annual pension payments by corporates, leading to increased insurance buyouts. The UK government now pushes pensions to invest more in UK Equities

PPF 7800 Index



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Source: Pension Protection Fund

WHY UK EQUITIES?

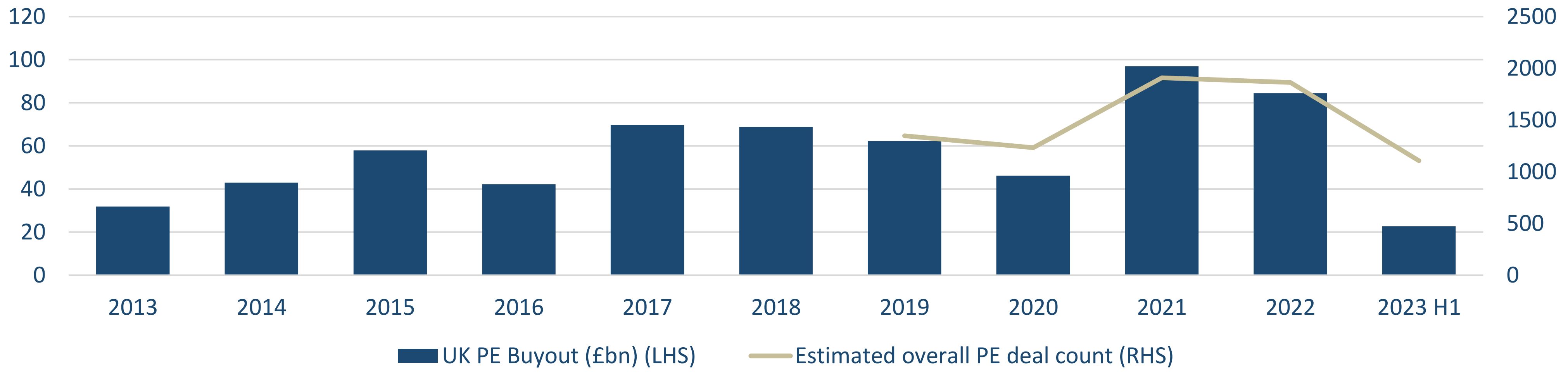
PE BUYOUTS DUE TO ATTRACTIVE VALUATIONS

6 PE buyouts

√ In 2007 there were 3,273 UK listed companies, now there are less than 1,700 (<1/3 of US stock market) according to Quoted Companies Alliance. Some of this decline is due to Private Equity buyouts, which achieved a record value in 2021.

PE buyouts are attractive as it can enable fast returns of +40% in a short time frame

UK PE Buyouts are at prior lows, but overall deal count is rising



WHY UK EQUITIES?

DIVERSE LISTINGS, INCLUDING MANY CYCLICAL INDUSTRIES

7 Diverse Listings

√ Cyclical industries offer many turnaround opportunities

Rank	Top 10 FTSE and AIM Industries	Number of companies
1	Oil, Gas and Coal	152
2	Investment Banking and Brokerage Services	127
3	Software and Computer Services	125
4	Industrial Support Services	113
5	Industrial Metals and Mining	112
6	Travel and Leisure	84
7	Pharmaceuticals, Biotechnology and Marijuana Producers	74
8	Precious Metals and Mining	62
9	Media	59
=10	Real Estate Investment and Services	54
=10	Retailers	54

WHY UK EQUITIES?
AN UNLOVED MARKET WITH OPPORTUNITIES

Attractive Valuations

Brexit Opportunities

Reversal of High Regulation

Dynamic Tax Regime

Declining Liabilities & Investment Refocus on UK

PE Buyouts

Diverse Listings

In Summary:

→ UK equities are cheap, diverse and both, domestic (25% of revenues) and global (75% of revenues)

→ High domestic profits are often temporary due to regulatory changes and tax adjustments; hence a short investment horizon needs to be applied

→ At the same time, high regulations and taxes often get reversed, offering opportunities, especially right now

→ Structural shifts in defined pension liabilities, low point of Brexit and fiscal budget clarity begin to turn into UK's favour. Deregulation and new trade deals start to emerge, pensions begin to focus on UK equities

UK: FACTS & FIGURES

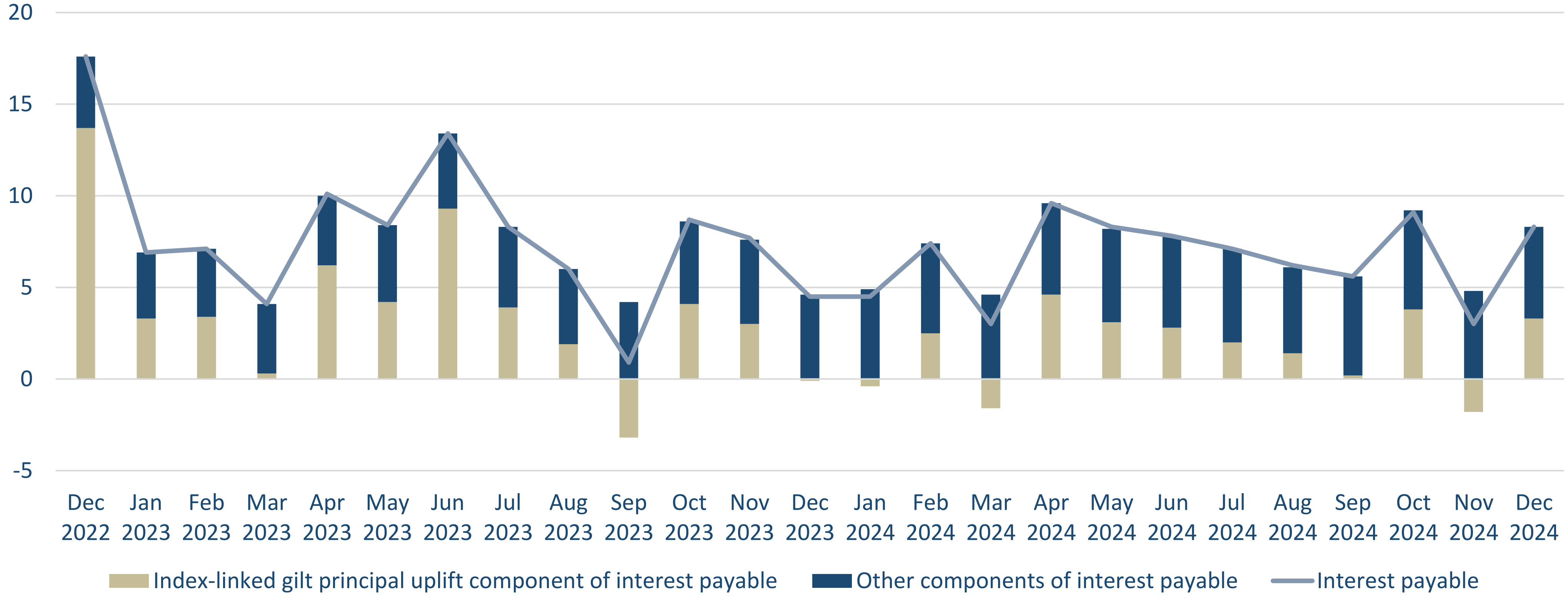
UK: FACTS & FIGURES

UK GOVERNMENT DEBT

1 UK Government Debt

- 25% of UK government debt is inflation-linked
- Over the last 12 months, 38% of interest expense was due to inflation-linked government bonds

Inflation-linked interest expense was 50% higher than nominal interest expense on UK govt debt

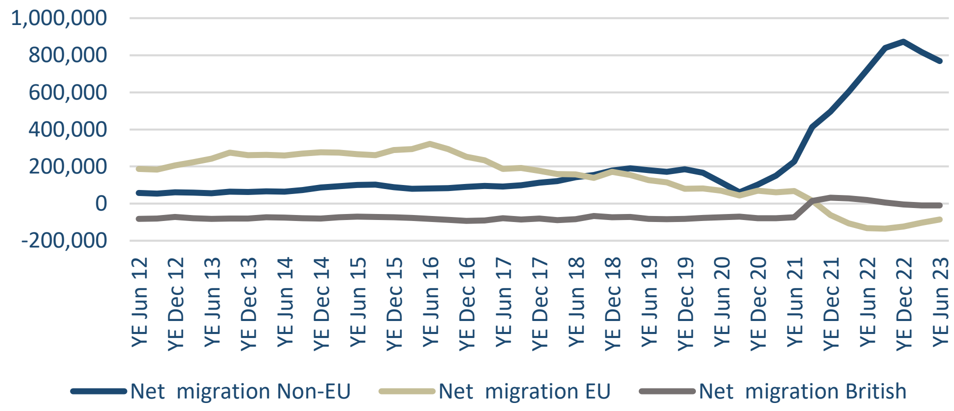


Source: Office for National Statistics

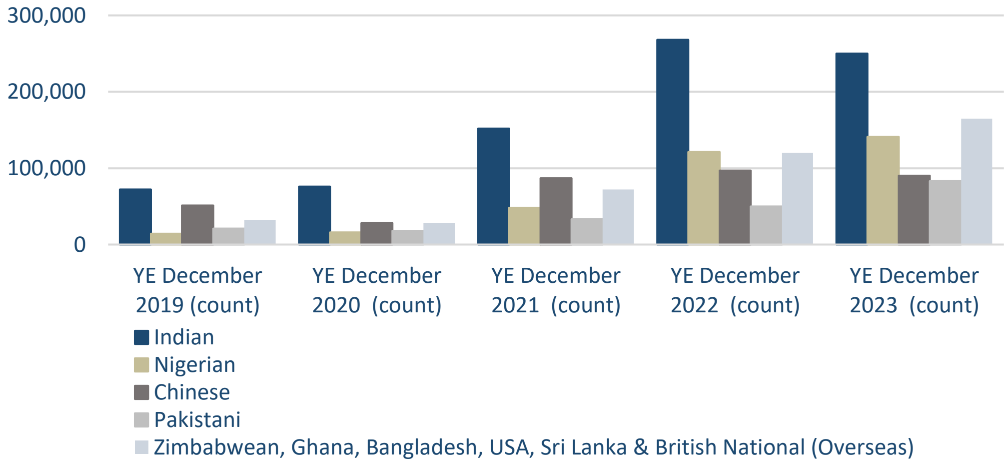
2 Migration

- 250k Indians came in 2022 and 2023 each. This figure doubled each year for a number of years
- 140k Nigerians came in 2023, more than half of them were independents from students. This figure also kept doubling
- Migration increases the UK population by 1% p.a. in recent years – many of them are from lower incomes
- Muslim prison population grew from 5k to 15k (200%) in 20 years, while Muslim population only grew 160%. Total prison population went from 75k to 85k. Muslims are 3x more likely to end up in prison

Net migration in recent years is mostly down to non-EU citizens



Non-EU migrants by nation arriving in the UK



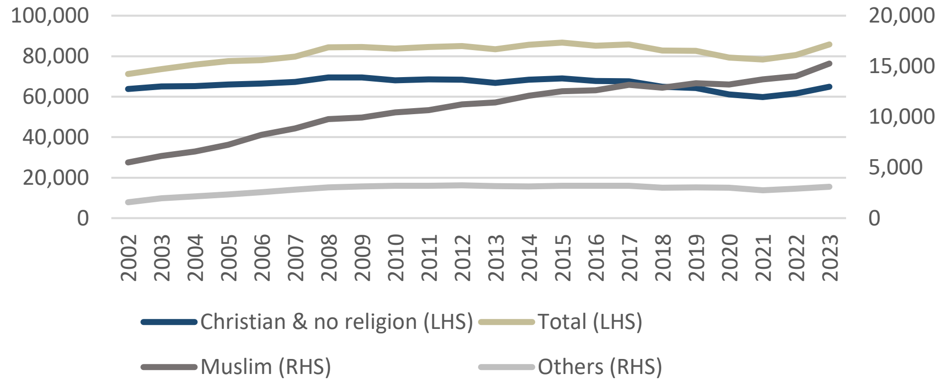
Source: UK Home Office

UK: FACTS & FIGURES

MIGRATION

2 Migration

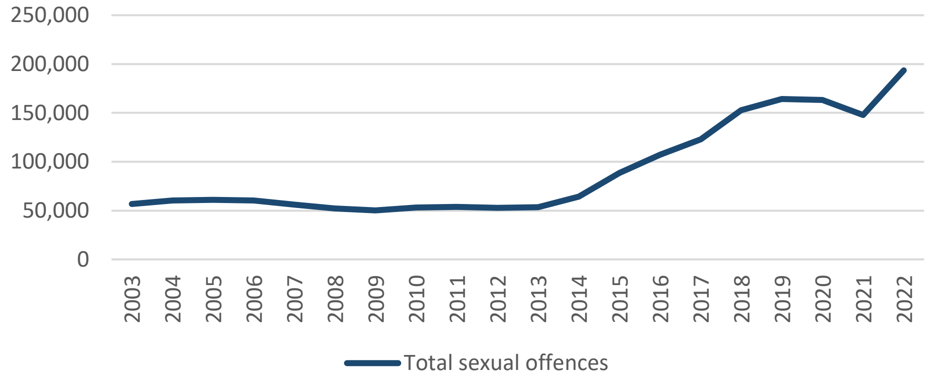
UK number of prisoners by religion over last 20 years show a large increase in Muslims



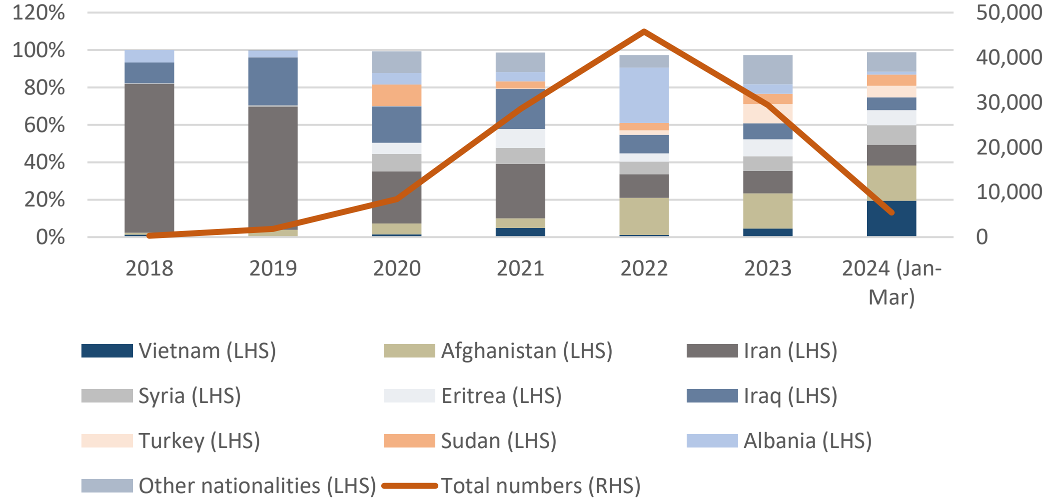
UK population by religion

Religion	2011	2021
Christian & no religion	84.5%	83.4%
Muslim	4.9%	6.5%
All others	10.7%	10.2%

Sexual offences in the UK have quadrupled over the last 10 years



Most illegal migrants come from countries which are either at war or have economic difficulties

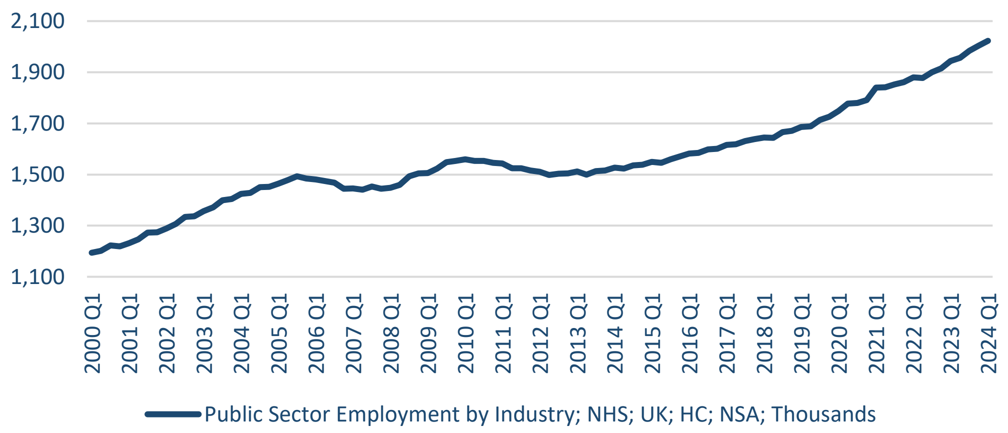


Sources: UK Home Office, Office for National Statistics, Ministry of Justice

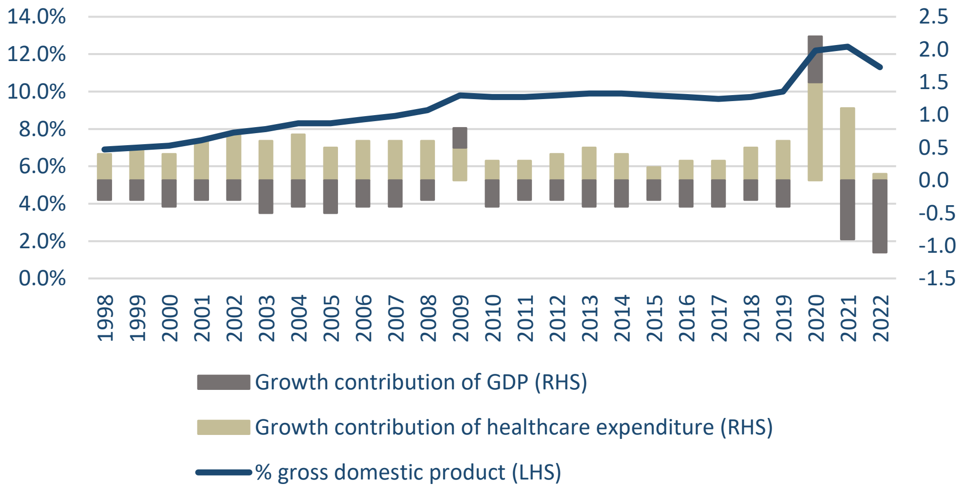
3 Health Care

- NHS's number of employees nearly doubled in the last 25 years, while the population grew only 15%
- Healthcare spending as share of GDP climbed from 6.9% in 1998 to 11.3% in 2022
- 1 in 4 people are disabled in the UK compared to less than 1 in 5 people being disabled 20 years ago. Disabled people can claim Universal Credit, Personal Independence Payment, Attendance Allowance, Employment and Support Allowance and Adult Disability Payment as well as exemptions from paying certain taxes

The number of NHS employees has nearly doubled in 25 years to just over 2mio workers in Q1 2024



UK healthcare spending requires continuously more funding than in the past



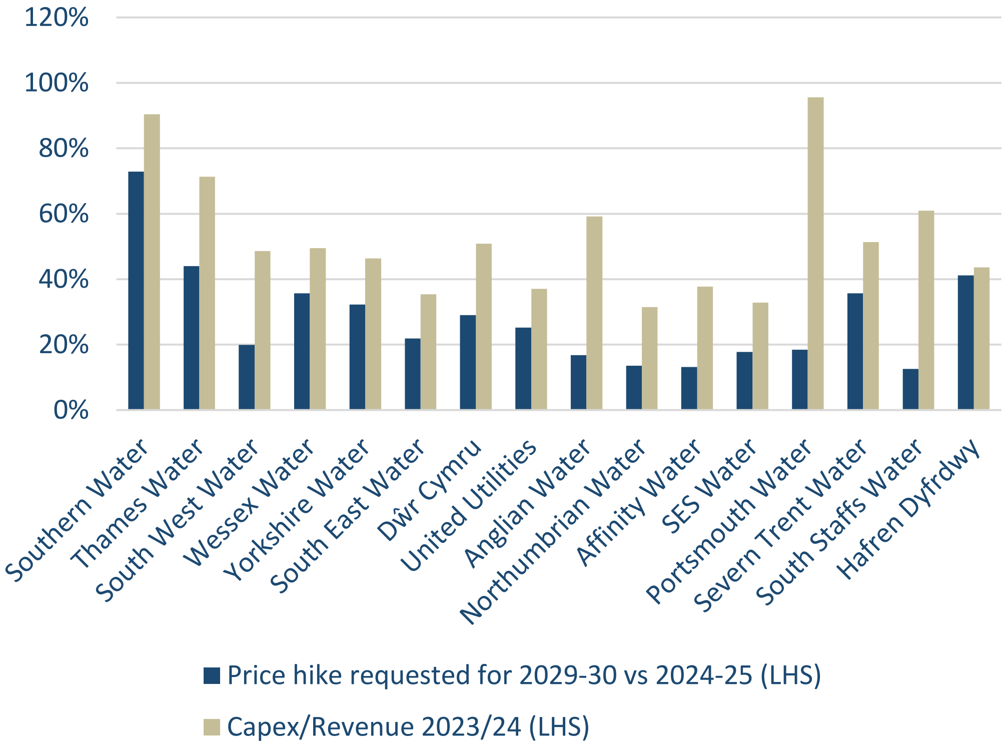
UK: FACTS & FIGURES

WATER

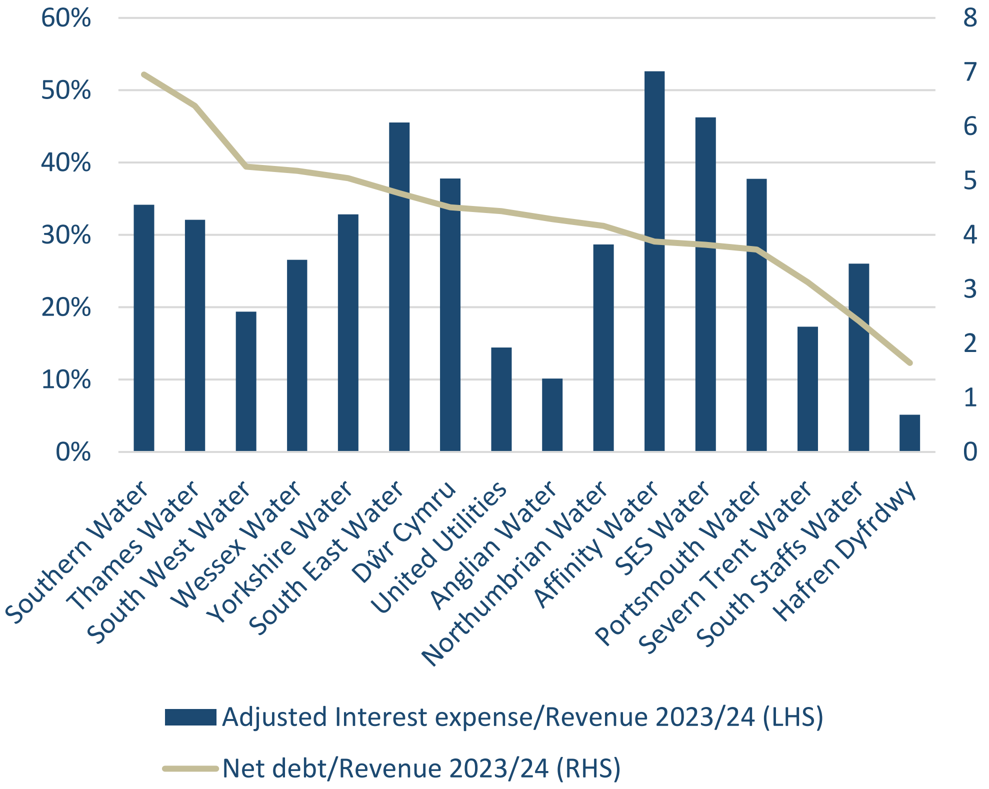
4 Water

- Over 50% of water companies have debt/revenue ratios of >4x and interest expense/revenue of over 30%

Requested price hikes over 5-yr period appear not outrageous given the amount of capital spending involved



UK water companies have massive debt burdens with large cash flows going towards interest expenses

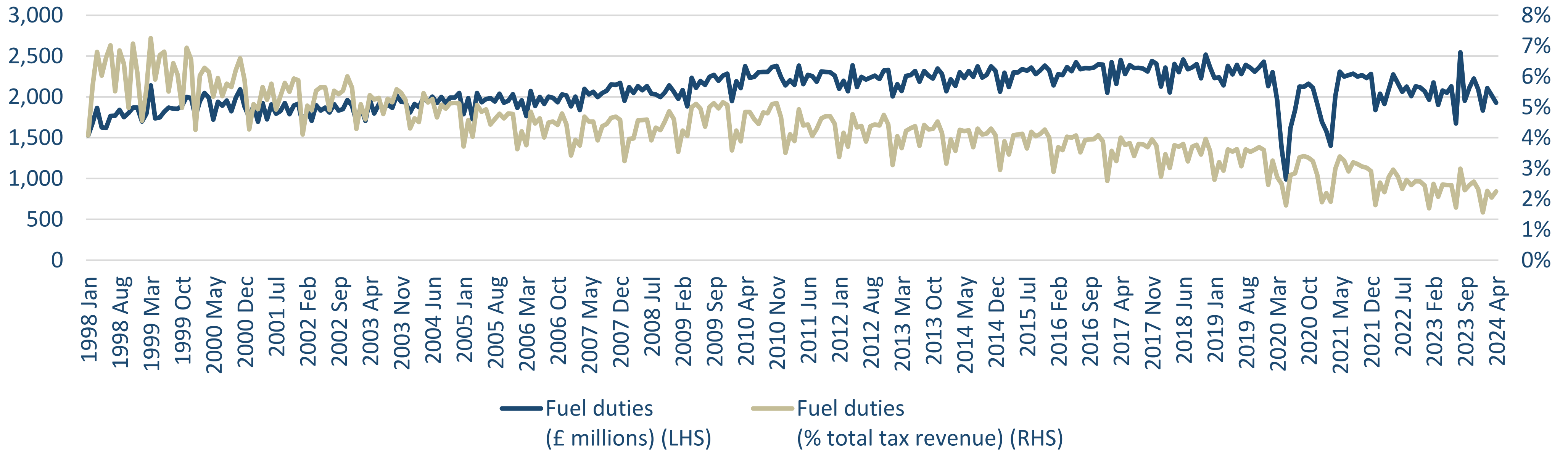


Source: Individual water companies' annual reports

5 Energy Transition

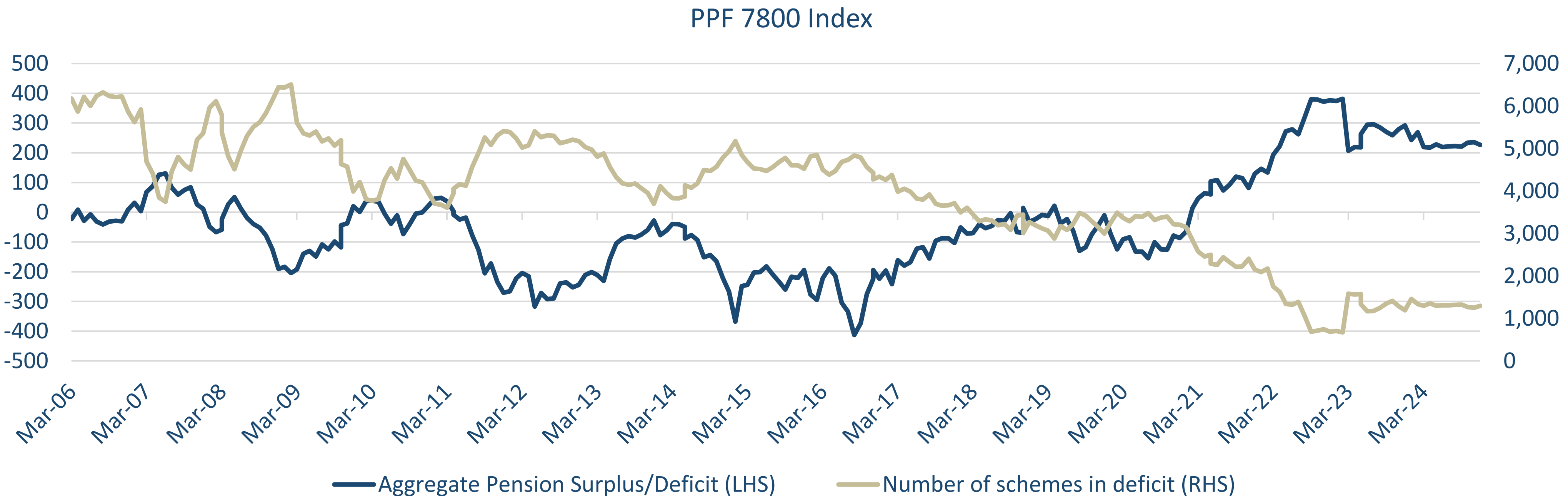
- Fuel duties generated 4-5% of tax revenue 10-20 years ago, now only 2% (£25bn), which will be a problem if UK moves towards EVs
- Only £2.6bn tax revenue was raised from oil and gas companies (before EPL (Energy Profits Levy)) in 2021/22 compared to nearly £10bn in 2022/23 after EPL was introduced

Fuel duties still make up £25bn of annual government tax income



6 Pensions

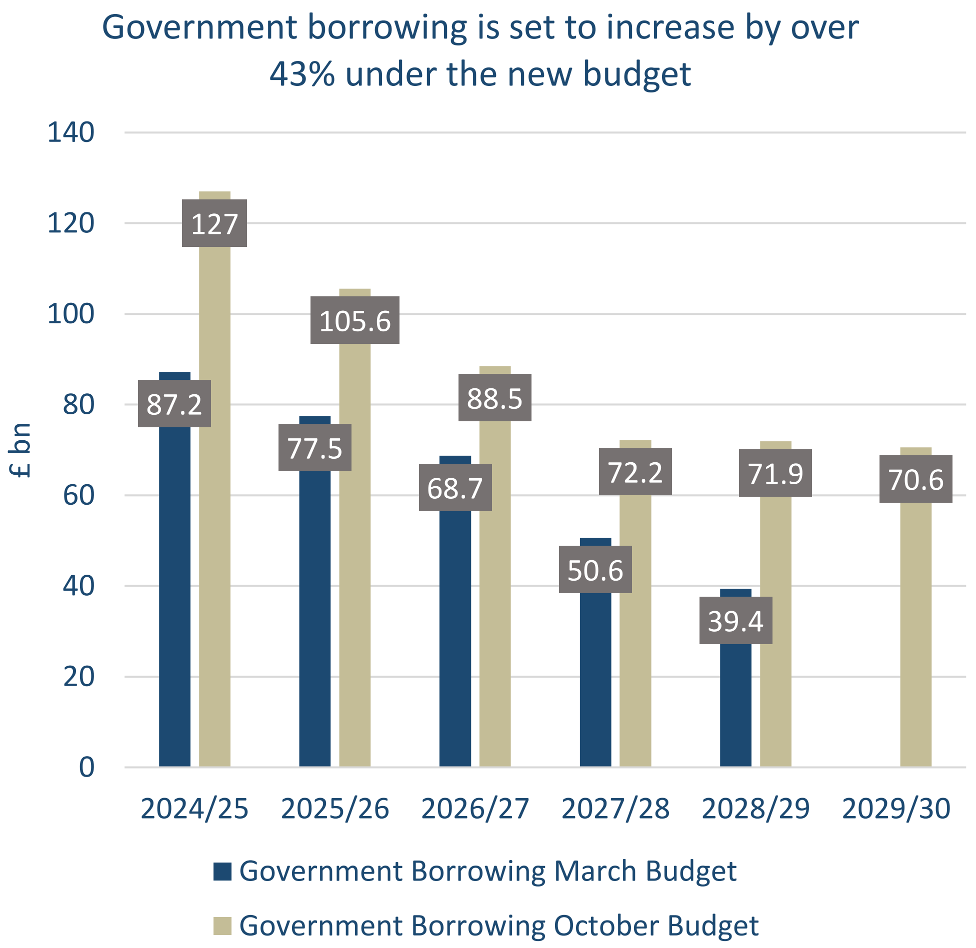
- £1.2trn is in defined benefit pensions, most of which is invested in bonds and equities abroad. 18% of this is allocated in equities in 2024 vs. 61% in 2006. Furthermore, 11.7% of Bond Portfolio and 80% of equity portfolio is invested abroad (£276bn or 23% of total DB pension pot or 11% of GDP). Defined Contributions Pensions and Local Government Pension Scheme together make up another £1trn.

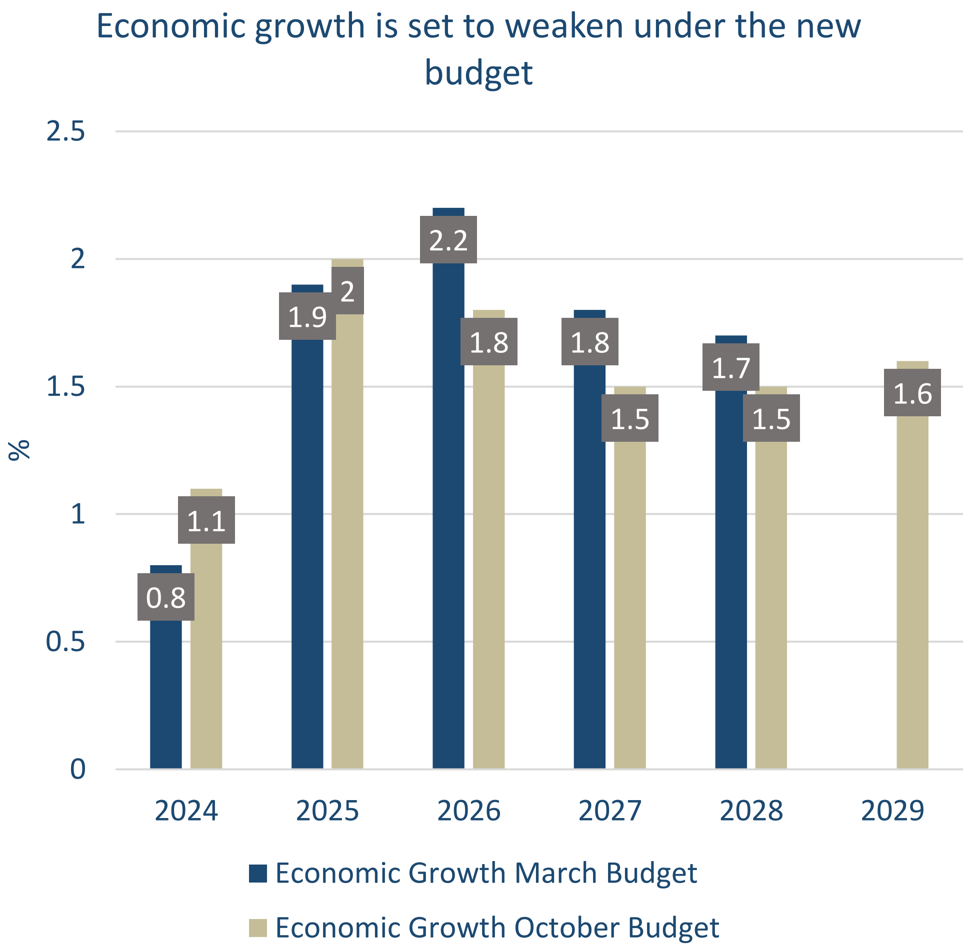


7 UK Budget

- Stability rule (day to day expenditures meet revenues) & investment rule: This reduces net financial debt (Public Sector Net Financial Debt (PSNFD)), because it includes student debt and other illiquid assets —> provides additional £53bn headroom due to maturing student debt (1.6% of GDP)
- £142bn extra spending via investments, which will not count as debt (but funded via debt issuance)
- Higher gilt yields will make the investments unfeasible
- £22bn black hole: Over £16bn was needed to pay for public sector wage hikes
- OBR forecast by end 2026: BOE bank rate at 3.5%, 5yr gilts just above 4%
- UK has a 4.4% fiscal deficit vs. 6-7% fiscal deficit in the US or France
- Due to fiscal rules, UK government can only stimulate growth through deregulation

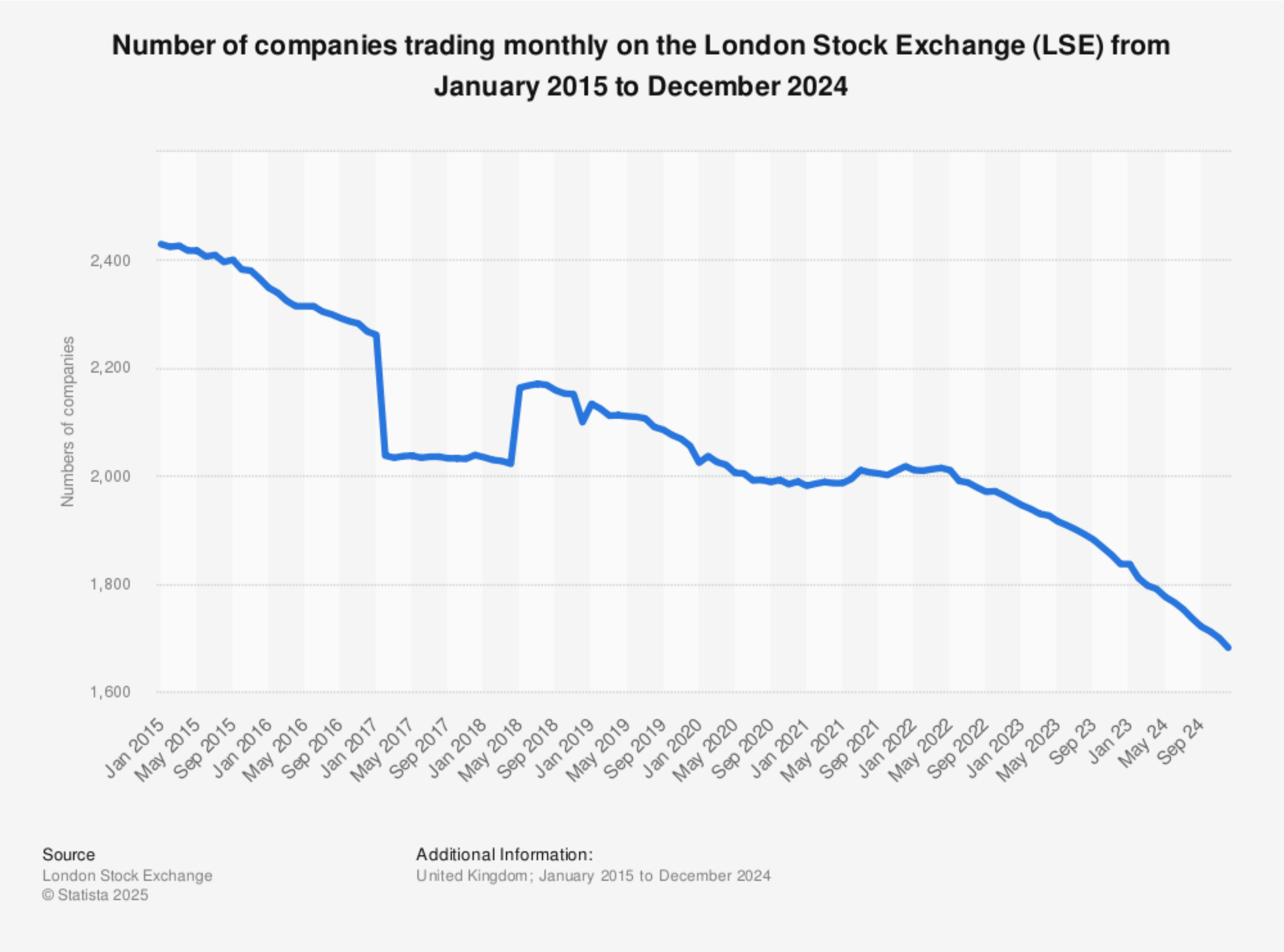
7 UK Budget


Government borrowing is set to increase by over 43% under the new budget
140
120
100
80
60
40
20
0
£ bn
127
87.2
105.6
77.5
88.5
68.7
72.2
50.6
71.9
39.4
70.6
2024/25
2025/26
2026/27
2027/28
2028/29
2029/30
Government Borrowing March Budget
Government Borrowing October Budget


Economic growth is set to weaken under the new budget
2.5
2
1.5
1
0.5
0
%
0.8
1.1
1.9
2
2.2
1.8
1.8
1.5
1.7
1.5
1.6
2024
2025
2026
2027
2028
2029
Economic Growth March Budget
Economic Growth October Budget

8 UK Listings

- 1,720 listings at LSE as of Q3 2024 (minus 45 compared to prior quarter) vs. 3,300 in 2007



9 Summary

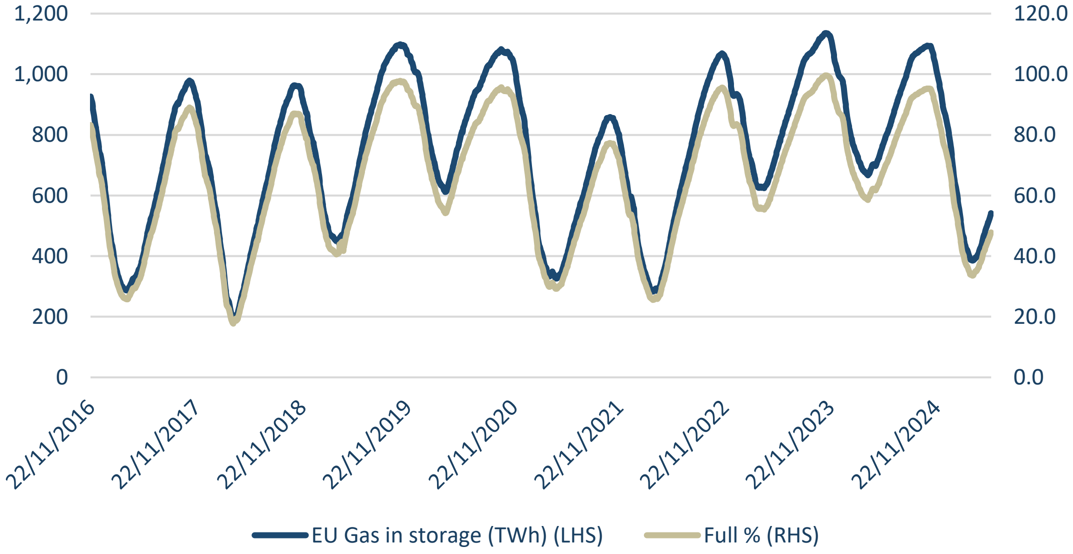
- Inflation-linked interest rate payments of UK government are set to decline on a 12-month rolling basis
- Migration of some of the least developed nations is spurring demand for affordable housing
- Health care cost as % of GDP keeps rising. Hence, the UK government strives to implement healthy living
- Water infrastructure is receiving a large boost, which will come along with higher bills for consumers
- Energy transition is at risk of stalling and taxes need to be implemented for EVs in futures
- Pension surpluses are improving the cash flows of companies and insurance buyouts are continuing. The government is now pushing to invest more of the pension pots at home
- UK Budget puts a ceiling on bond yields. If this ceiling is breached, higher taxes or lower spending will be the result. Either would lead to lower yields
- UK stock market faces risk of domestication. UK government could put rules in play to shift pension assets into UK equities. PE buyouts could also continue
- In summary, whilst the UK is facing multiple problems, each problem also creates opportunity. Goal is to capture these special situations and with that generating excellent returns

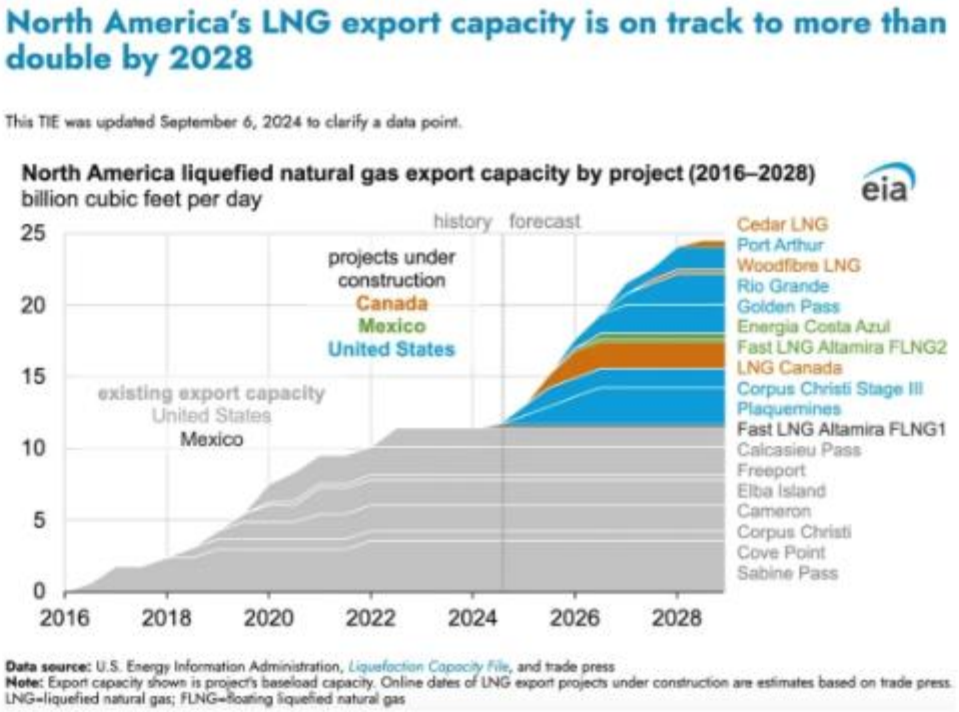
UK & WORLD MACRO

1 Natural Gas Prices

- Europe needs 90TWh of gas equivalent per month until November to achieve 88% storage levels
- In 2025, 895TWh LNG export capacity is supposed to come online in the US & 2,283TWh by 2030
- Growing US LNG export capacity could limit any natural gas price spikes in Europe in another cold winter

European gas in storage will end up at 88% full if injection pace continues at current pace till November



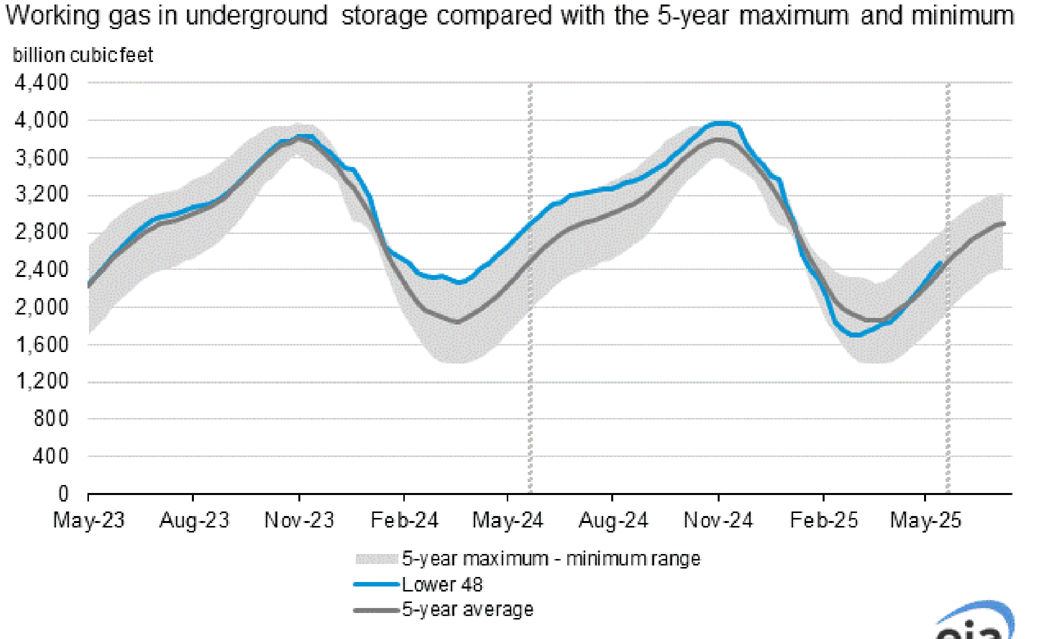


UK & WORLD MACRO
NATURAL GAS PRICES

1 Natural Gas Prices

➢ US natural gas prices could see downward pressure amidst strong inventory build up

US gas in storage



Data source: U.S. Energy Information Administration

Note: The shaded area indicates the range between the historical minimum and maximum values for the weekly series from 2020 through 2024. The dashed vertical lines indicate current and year-ago weekly periods.

1-year natural gas price change history: UK vs. US

= UK Natural Gas Price

= US Natural Gas Price

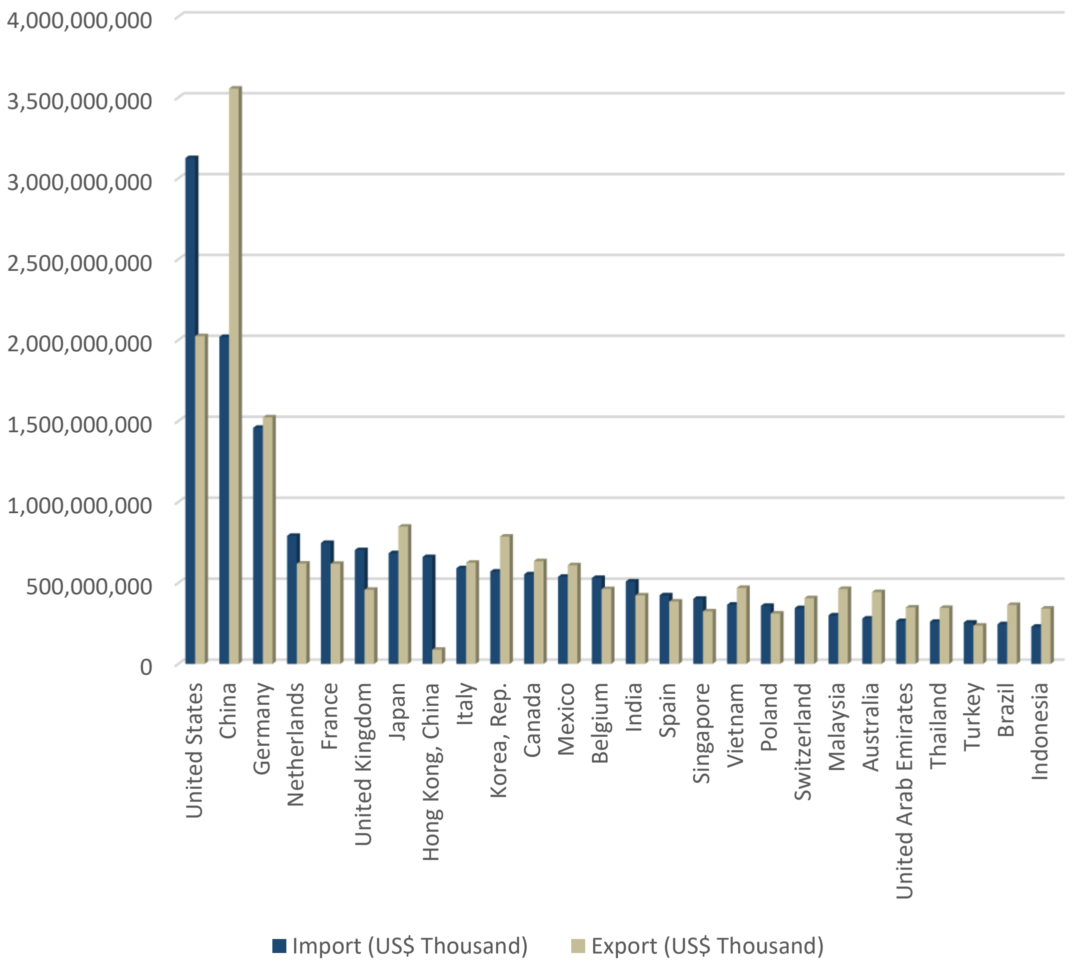
2 Tariffs

- The UK has a goods deficit with the US, hence will not be targeted in trade war
- Smoot-Hawley average tariffs were 60%, 50% higher than prior 40% average tariff
- Stocks dropped 2.5% when congress approved initial Smoot-Hawley tariff in May 1929. Then tariffs were rewritten, stocks rallied, as industrial tariffs were set to be lowered. On 21st Oct 1929, legislation was changed from lower tariffs to higher tariffs again and stocks crashed
- Global trade as % of GDP was 11% in 1929 and 5% in 1935. Today this figure is 25%
- US imports as % of GDP are now 14% vs. 5% in 1929.
- Biden tariffs were worth $18bn of Chinese imports vs. Over $500bn of total Chinese imports
- Trade makes up 38% of Chinese GDP compared to 27% of US GDP (2023)
- Trump's trade war is all about China but also targets areas such as cars, pharmaceuticals and chips. Some of these products also come from Europe, India and East Asia

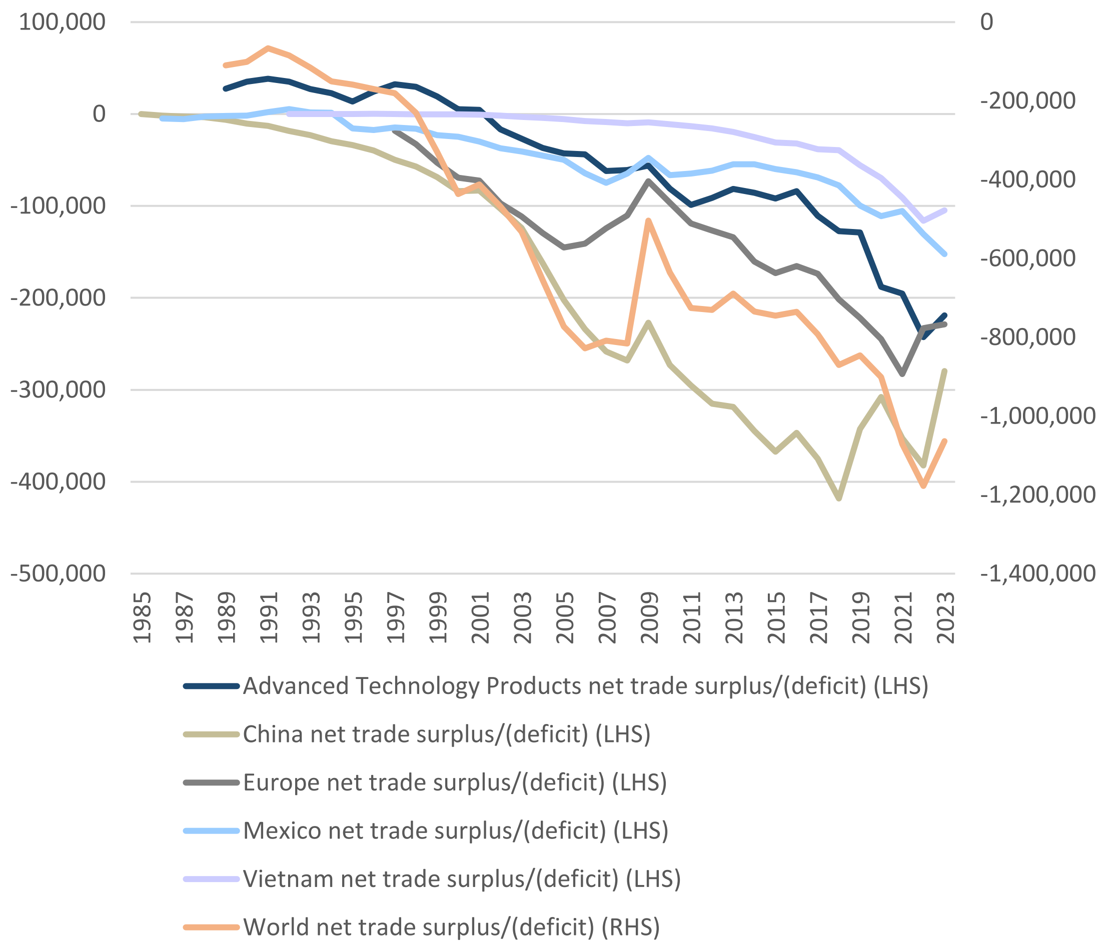
Source: World Bank, Bureau of Economic Analysis, https://www.aozorastep.com/Trade%20with%20the%20U.S.%20and%20tariffs.pdf

2 Tariffs

The US appears to be financing China's trade surplus



Largest US trade partners' trade deficits over time shows shifts to new countries (in $mln)



Source: World Integrated Trade Solution, US Bureau of Economic Analysis

2 Tariffs

US Imports by Category (2024)

Category	US$ million
Pharmaceutical preparations	246,849
Passenger cars	213,590
Crude oil	167,326
Other automotive parts and accessories	145,660
Computers	116,732
Cell phones and other household goods	111,879
Electric apparatus	102,684
Computer accessories	100,660
Other industrial machinery	84,921
Telecommunications equipment	84,611
Semiconductors	81,943
Trucks, buses, and special purpose vehicles	63,388
Medical equipment	62,706
Other textile apparel and household goods	53,731
Finished metal shapes	51,806

US Trade Balance by Country (2023)

Country	US's goods trade balance in $m
China	-278,716
Mexico	-161,382
Vietnam	-104,598
Germany	-83,234
Canada	-72,329
Japan	-71,878
Ireland	-65,507
South Korea	-50,996
Taiwan	-47,328
Italy	-44,451
India	-43,233
Malaysia	-26,920
Switzerland	-24,241
France	-14,143

Trade Deficit with China by Countries with Large Trade Surplus with the US

Country	Trade deficit with China in US$ million (2023)
Mexico	>$100bn
Vietnam	>$80bn
Canada	>$30bn

Source: US Bureau of Economic Analysis, OEC World, Tradingeconomics

2 Tariffs

Parameter	1920s	Now
Superpower has high debt/GDP	The UK had government debt/GDP of 150-190%, while the US had government debt/GDP of 30%	The US has government debt/GDP of over 130%, while China has 77% debt/GDP
New Superpower leads new technology	The US produced 26.5x as many cars as the UK in 1924	China produced over 6mio EVs in 2022, 8x more than the US
Globalisation	The world slowly moved from globalisation towards de-globalisation	It appears like we have reached peak globalisation
Technology	Energy transition from the horse and firewood towards the combustion engine and coal	Energy transition from ICE vehicle and oil and gas to BEV and renewables
Inequality	Top 1% owned 12-19% of total share of income	Top 1% owns 30% of all household wealth
High speculation	Businesses and private individuals were borrowing excessively and bought stocks	High speculation, cryptocurrencies were worth over $3trn
Low interest rates	Interest rates stayed between 4-5% before declining during the Great Depression	Interest rates moved to 4-5% after a long period of near 0%
Pandemic	The Spanish Flu had 4 major waves	Covid also had 4 major waves (Beta, Alpha, Delta, Omicron)
Conflict	WWI followed by WWII	Ukraine war, Israel/Gaza war and potentially Taiwan/China
Trade restrictions	The British insisted on free trade despite the US (& Germany) turning to high tariffs	China has high tariffs in place for many products, while the US insists on free trade (until Trump came along)

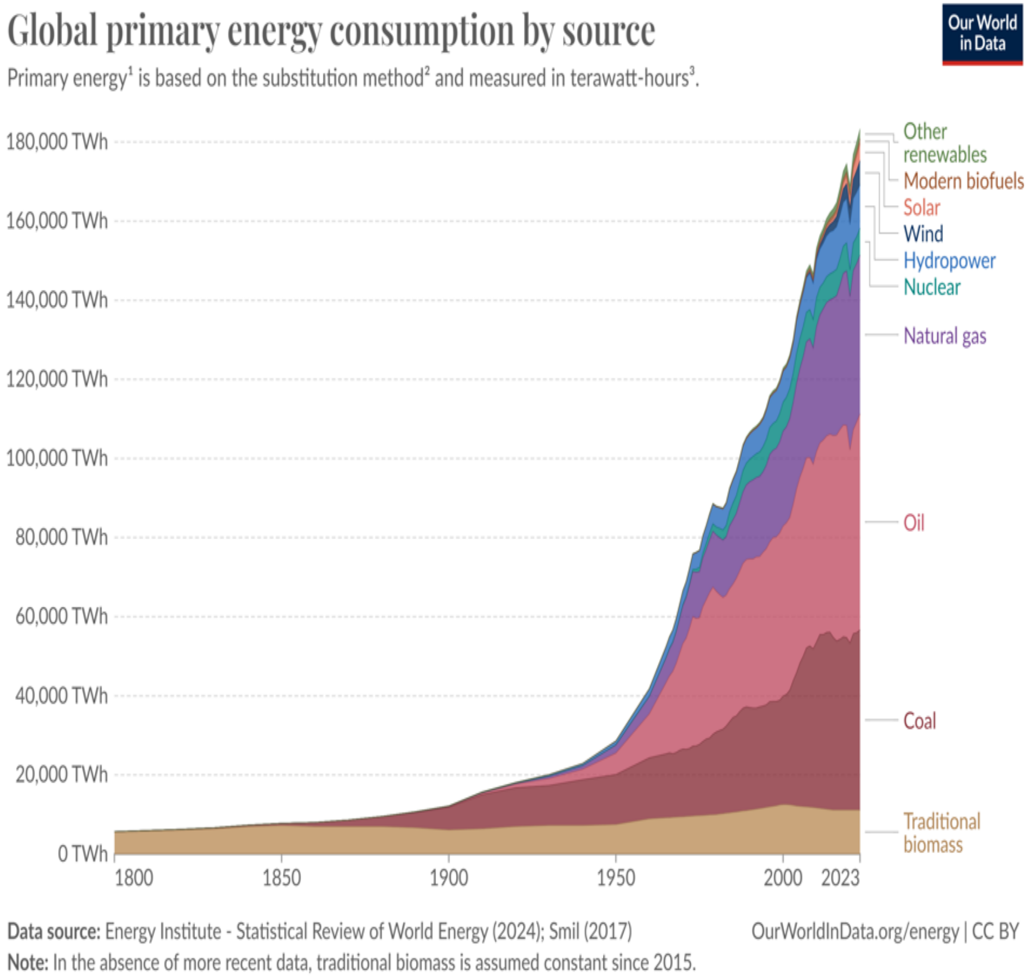
1918-1920 and beyond	2020-2024
1918: Lockdowns were introduced to curb the virus	2020/21: Lockdowns were introduced to curb the virus
1919: 1 in 5 American was striking to achieve higher wages	2021: Record number of people left their jobs, resulting in labour shortages
1919/early 1920: Inflationary boom 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 expected to announce tapering. Central banks around the world turn hawkish
January 1920: Fed raises rates to 6%, stock market didn't react	January 2022: Fed speeds up tapering and market starts pricing in 50bps rate hikes for March 22
April 1920: A Tokyo bank defaulted, prices of rice, cotton and silk dropped quickly, GM shares dropped 8%	March 2023: It took one year longer for first financial cracks to appear with SVB default
1920: Consumers changed to non-inflationary living, buying used clothes	2023: Non-branded products gained in popularity (e.g. McBride)
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	2024: Vehicle sales continue climbing, but the rate of growth begins to stall
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	Since the spike in 2022, wheat continues to decline
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	2024: Order books are being run down
June 1920: Fed raises rates to 7%	August 2023: Fed hikes rates to 5.33%
April 1922: Accumulated inventories were sold off for extremely low prices	Inventories have gradually been sold off

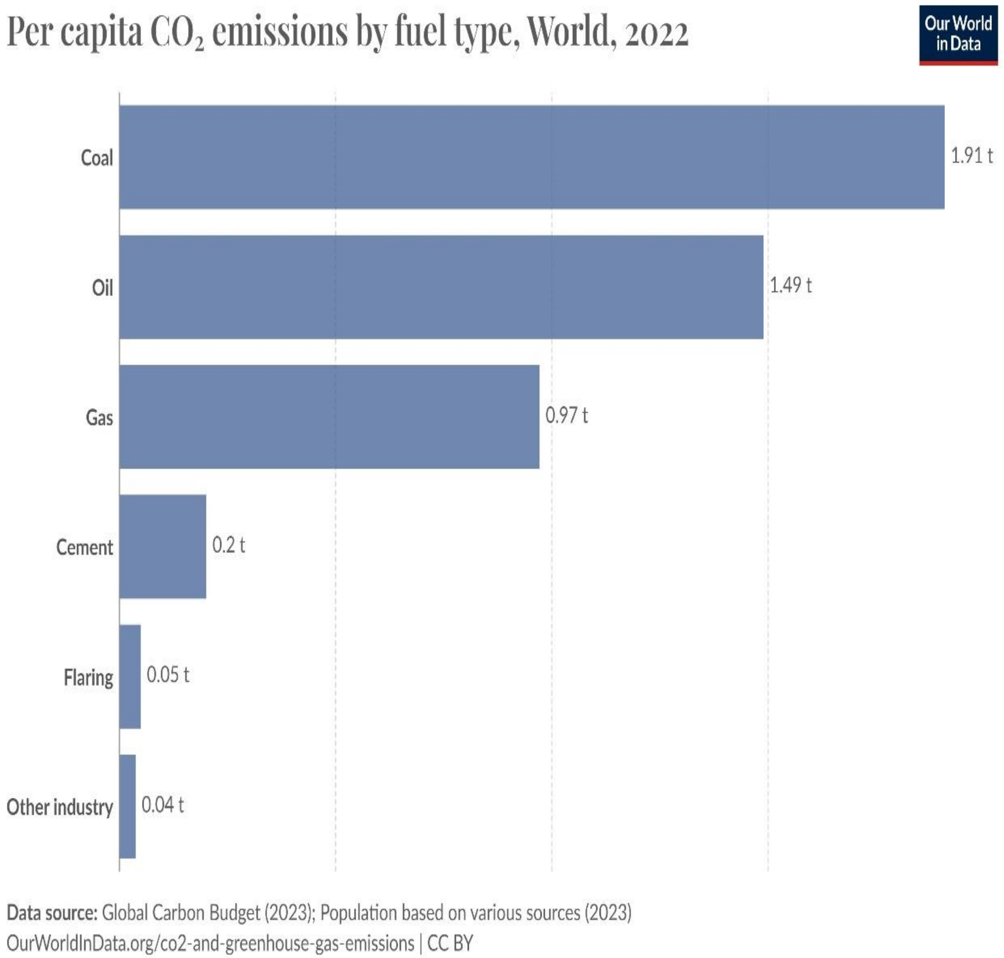
Source: James Grant's "The Forgotten Depression", CATO Institute

3 Climate & Energy

- We should end up in an ice age next (every 100k years)
- If emissions were the reason, we can stop climate change immediately by reducing thermal coal slowly while replacing it with natural gas
- Paris climate accord can lead to nasty lawsuits affecting only Western companies (hundreds of pending cases)
- Thermal coal emits 30% more emission than oil and double that of natural gas
- Electric vehicles only make sense in countries that don’t have thermal coal in their energy grid

3 Climate & Energy





4 US Yield Curve

➢ Historically, the end of a yield curve inversion was during an economic crisis, except in 1999, when the market rallied one more year before topping out

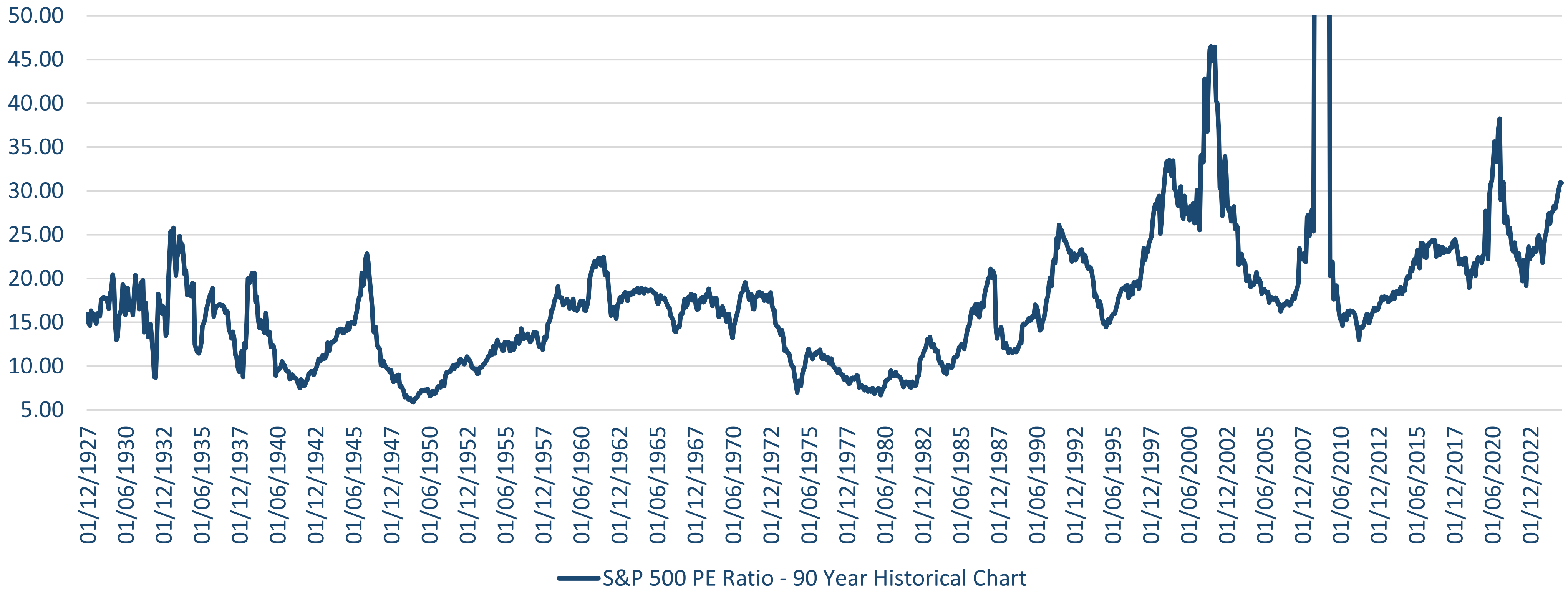
Date when yield curve ended inversion	Weeks of 10yr – Fed Funds inversion	Fed Funds rate	Reason	S&P 500 in weeks following	Oil in weeks following	Comment
1980-06-25	60	9.08	Fed cut rates by multiple % points, then hiked rapidly	Climbed steadily	Prices peaked end 1979 from Iranian Revolution, then steadied, declined slightly	Fed hiked because of 2nd round effects from 1979 oil price shock
1990-01-24	52	8.23	Fed cuts by 25bps, then stable for 10 months, then cut	Rose until Iraq invaded Kuwait	Fell until Iraq invaded Kuwait, then rose sharply	Fed did not hike because of oil price shock, but cut quickly when oil prices retreated
1998-12-30	29	4.48	Fed cut by 25bps and then began hiking afterwards again	Steady, then rose	Steady for 3 months, then doubled in <1 year	Fed hiked because economy was strong, Dotcom bubble formed
2001-04-25	46	4.42	Fed cut by 50bps, and continued cutting	Steady for a month, then declined	Steady for 5 months, then declined	Fed cut, because dotcom bubble burst, economic weakness
2008-03-26	81	2.18	Fed cut by 50bps, then 25bps, held stable before cutting more	Went up and down, after 3 months decisively down	Went up steadily and rapidly	Fed continued cutting because of mortgage crisis and financial instability
2019-11-08	23	1.56	Last 25bps cut	Climbed steadily	Climbed steadily	Fed cut under pressure from Trump, which saved the economy
2020-03-20	4	0.47	Fed cut to zero	Hit low, then climbed rapidly	Moved to all-time low and only months later recovered	Fed cut because of lockdowns and Treasury-bond future basis blow up, potential financial instability
2024-12-27	110	4.33	Fed cut rates by 25bps			"All hell might break out in Middle East", driving oil prices higher, but I'd expect it to be short-lived, no shock

UK & WORLD MACRO

5 US Valuations

- US equity valuations are at the highest since 1999 bar any recessions in 2000/01, 2008/09 and 2020 when earnings go negative, hence boosting P/E ratios

S&P 500 PE Ratio is at highest since 1999 (excl. recessions)



6 Summary

- Gas prices in Europe could become less volatile, but be subject to the speed of LNG projects in the U.S. coming online
- Trump tariffs appear very similar to the tariffs set in the 1920s/30s. Goods compared to services take a smaller proportion of GDP compared to the past, but global trade is now 25% of GDP vs. 11% in 1929, and US imports as % of GDP are now 14% vs. 5% in 1929.
- The Paris Climate Accord and net zero targets are unachievable and will shift power from NATO towards China, India and Indonesia. Sooner or later the Europeans will also realise this and change course. There should be no EVs as long as we use thermal coal in our energy grid
- Whenever the US yield curve comes out of inversion there is a crisis. This might not be different this time
- US valuations are near record highs driven by the magnificent 7. This will likely change, especially if AI demand lags AI supply
- In summary, UK equities are diversified, cheap and well placed in a changing macro economic world

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