System Capital Long Short Strategy

Quarterly Report March 2025

The investment team is very pleased to present our March 2025 newsletter. Comments and suggestions are highly welcome.

STRATEGY PERFORMANCE OVERVIEW

The strategy returned 0.5% for the quarter, bringing 1-year performance to 17.2%.

Position Type	March 25
Short Positions	21
Long Positions	36
Index Positions	4
Total Positions	**57**

Region	Gross Long (%)	Gross Short (%)	Net Long (%)
Europe	60	-23	37
North America	38	-22	15
Asia	3	0	3
Australia/NZ	20	-3	17
Total	**120**	**-48**	**72**

	Month (%)	3M (%)	FYTD (%)	1 Year (%)	2 Year p.a.	Cumulative Since Inception p.a.	Since Inception p.a.
System Capital L/S	**-4.4**	**0.5**	**18.6**	**17.2**	**21.1**	**61.6**	**21.9**
MSCI World AUD Hedged	-5.0	-2.6	3.6	6.6	15.4	43.9	16.2
Stoxx 600	-3.8	5.8	5.7	6.9	10.9	39.2	14.6
ASX 200	-3.4	-2.8	3.9	2.8	8.5	26.8	10.3

Performance is in AUD (Hedged) and is before fees. Cumulative Returns and Annualised Returns from 26th Oct 2022 to 31st Dec 2024. Returns in AUD. Gross returns before management and performance fees. MSCI World 100% Hedged to AUD Index. ASX200 Accumulation Index Stoxx 600 Net Total Return.

SIGNIFICANT CONTRIBUTORS FOR THE QUARTER INCLUDED:

- **Safran (Industrial):** Increased 14% following strong FY24 results and raised FY25 financial guidance. Sentiment was also buoyed by the prospect of increased European defence spending and French government interest in Dassault Rafale purchases (powered by the Safran M88 engine).
- **Enel (Infrastructure):** Increased 6% on the back of a reassuring set of quarterly results at the top of the guidance range, and the announcement of a new buy-back program. Please see our detailed write up at the end of our report.
- **Visa (Payment Network):** Increased 11% after a strong set of CY24 results with accelerating volume trends. Visa also hosted an IR day where they outlined continued confidence in the company's strong organic growth rate and the potential of its value-added services portfolio.

DETRACTORS FOR THE QUARTER INCLUDED:

- **Flutter (Gaming):** Flutter shares decreased 18% due to unfavourable sports results during the NFL season and the March Madness basketball tournament along with concerns around an uncertain macro environment impacting discretionary spending.
- **Schibsted (Classifieds):** Schibsted decreased 19% due to earnings being below expectations in 4Q2024. This was driven by weaker advertising conditions, delays in rolling out a new advertising platform following the separation from the Schibsted Media (newspaper) business and cost dyssynergies from the separation. Listings trends in the job's vertical in Norway and the motors vertical in Sweden and Denmark remain under pressure in the short term.

QUARTERLY MACRO REVIEW

The new US Administration is in the process of implementing substantial trade, immigration, fiscal policy and regulatory policy changes.

The timing and size of trade tariffs have clear implications for growth. We discuss our view on tariffs later in this note. Change in immigration policy could put upward pressure on wages given the existing tight labour market, making it harder for the Fed to look through tariff induced inflation. Fiscal policy is likely to be material to the growth outlook over the next year with the Trump administration signalling a significant lowering of taxes, with only modest offsets through efficiency programs. Deregulation policy effects are likely to be ongoing throughout the year.

GROWTH

US growth continued to be robust in the quarter, with some softness in real spending but continued strength in labour compensation (0.5% m/m in March 2025) and a boost in real personal income growth (0.4% m/m in March 2025). Note that some items in the data may have seen a pull forward in demand due to anticipated tariffs e.g. auto sales.

INFLATION

In the US, core inflation, which excludes volatile food and energy prices, was 3.3% in January 2025, 3.1% in February 2025, and 2.8% in March 2025, coming in below expectations in both February and March. The March 2025 figure was driven by slower price increases in shelter, transportation services, medical care commodities and apparel. Food inflation, not captured in core inflation, was above expectations in March (3.0% versus 2.6% forecast), driven by a combination of factors, including rising egg prices due to a bird flu outbreak, increased costs for some meats and other food at home.

INTEREST RATES

The Federal Reserve kept rates on hold at both of its January and March meetings. On the back of recent tariff uncertainty, the prospect of a cut in interest rates at the June Federal Reserve meeting is looking slightly less likely although the Fed has stated it will remain data dependent.

Due to heightening trade tensions globally, U.S. Treasurys have seen a selloff in recent weeks, which has sparked speculation surrounding the parties selling them. Investors are closely watching the benchmark 10-year Treasury yield, which fell as low as around 3.86% earlier this month (April 2025) before rising to 4.27% at the time of writing.

During April 2025 US 30-year mortgage rates have risen to approximately 6.9%, reaching the highest level since mid-February and further dampening the appetite to buy homes or refinance loans.

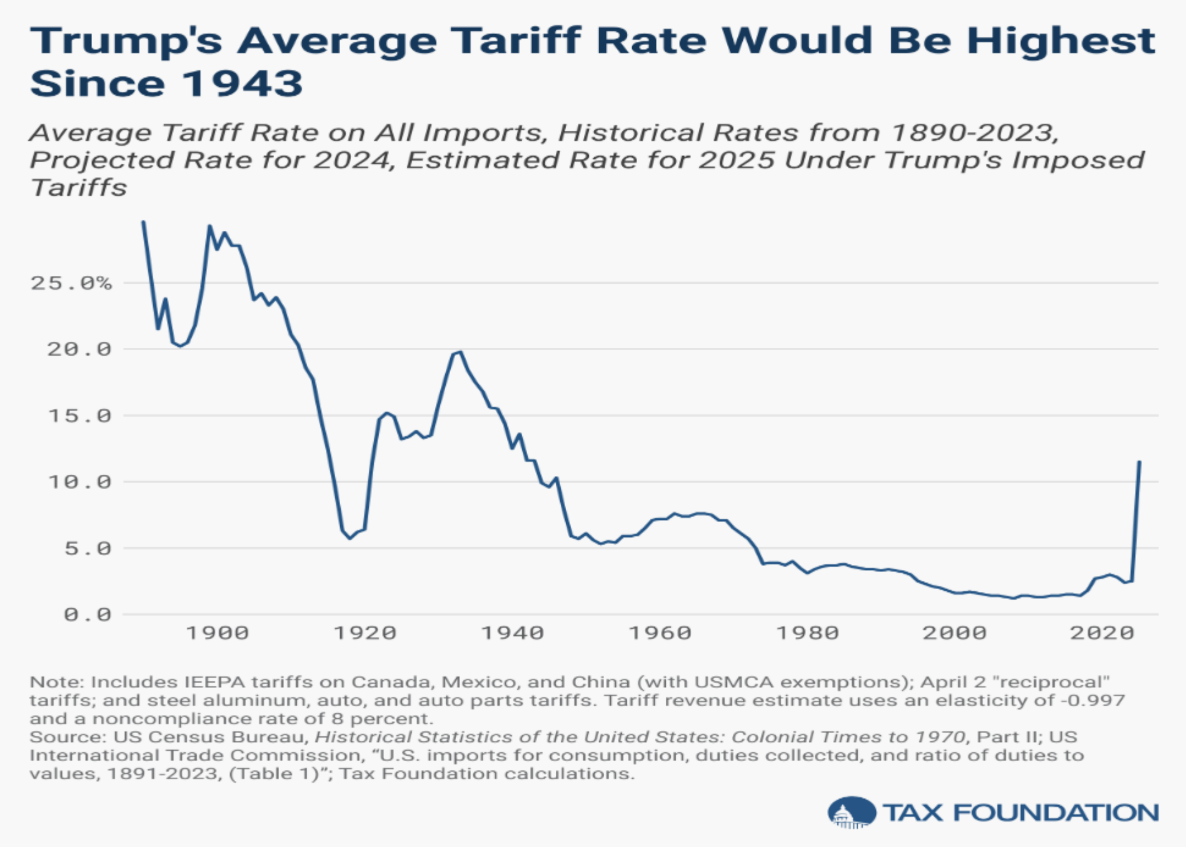
TARIFFS

The tariff announcements made by the Trump administration should be familiar to most of our readers. The following is an abbreviated timeline of the announcements and the current tariff rates.

Date	Event
20-January-2025	Executive order to review tariffs
3-February-2025	Mexico and Canada secure one-month delay after security concessions
10-February-2025	Announcement: Steel & Aluminium tariffs of 25%
14-February-2025	Announcement: 25% auto import tariffs
12-March-2025	Steel & aluminium 25% tariffs implemented
24-March-2025	25% tariffs on countries importing Venezuelan oil
02-April-2025	10% universal tariff and reciprocal tariffs (20%-50%) announced
05-April-2025	10% universal tariff implemented
09-April-2025	Reciprocal tariffs applied; China tariffs raised to effective 145%
09-April-2025	Reciprocal tariffs 90-day exemption announced
11-April-2025	Electronics exemptions announced
22-April-2025	Trump hints at potential reduction of 145% China tariffs
27-April-2025	IMF and World Bank meetings conclude with no new agreements

The table and chart below outline the proposed tariff schedule and the rates relative to history.

Product Category	Tariff Rate
Steel imports	25%
Aluminium imports	25%
Aluminium from Russia	200%
Autos & parts imports	25%
Semiconductors (planned)	25%+
Pharmaceuticals (planned)	25%+
All other imports	10% (universal tariff)
China imports overall	145% effective



WHAT ARE THE TARIFFS TRYING TO ACHIEVE?

The Trump administration has articulated a wide range of reasons for its aggressive tariff agenda.

1. **Stopping the flow of illicit drugs and enhancing border security:** Tariffs against China (fentanyl production) and Mexico and Canada (drug importation and illegal migration) are designed to strengthen border controls and lead to reduced drug importation.
2. **Bolstering national security:** Protecting critical industries like steel and aluminium is cited as vital for national defence. Tariffs on pharmaceuticals and semiconductors aim to rebuild domestic supply chains and incentivize US reshoring.
3. **Job creation:** Tariffs will revitalise domestic manufacturing and create jobs.
4. **Counter unfair trade practices:** Tariffs will aim to correct significant trade deficits and counter unfair trade practices, addressing the U.S. trade deficit which recently reached $1.2 trillion.
5. **Revenue generation:** Tariff revenues help fund tax cuts, supporting broader economic growth and reducing deficits.

OUR VIEW ON TARIFFS

We think it's important to work through these arguments, separating those that are likely to be a part of a negotiating position and can be significantly scaled back, and those which are core to the administration's thinking. This is particularly important as some of the goals are contradictory – i.e. onshoring of production will also reduce or eliminate tariff revenue. We would also highlight one very important consideration that the Trump administration is less keen to call out – the worsening budget deficit in the USA. We work through our conclusions below.

Stopping the flow of illicit drugs and enhancing border security: We think these can be addressed much more effectively without tariffs and are a negotiating position.

Bolstering national security: Traditionally support for critical industries has been done in a much more targeted way through public grants and tax concessions. Tariffs will not make a critical difference until there is confidence around the broader strategy of the administration and companies begin the multi-year process of onshoring. In that sense we think the Administration is looking for wins based on headline announcements. We expect tariff exemptions to be extended for multiple years to allow for the manufacturing base to be rebuilt, as well as a shift to more direct fiscal support for these industries from the US government.

Job creation: The onshoring of jobs lost to globalisation was a key plank of Trump's election platform and would seem to be a key aim of the administration.

However, it must be contrasted with:

- Very low unemployment rate and the low labour slack in the US economy,
- Impracticability of bringing many of these low value jobs without a heavy automation focus that would eliminate most of the roles (garment manufacturing, low level assembly etc.).
- Lack of an integrated supply chain (manufacturing relies on a long supply chain of component and sub-component suppliers which also have to onshore), which will take many years to rebuild.

Again, we think this is an area where the Trump administration will focus on big announcements and allow for long lags in implementation as it is not a core deliverable in the near term.

Counter unfair trade practices: We believe that the current administration intensely believes the trade system is deeply unfair to the USA. These positions on trade are deep rooted and go back decades for many people in the administration. As an anecdote, Donald Trump appeared on Oprah in **1988**, as a NY property developer to talk about tariffs. His views in that interview seem to very much mirror his views today. If anything, we believe that views of the administration have hardened to include non-tariff issues such as local sales tax, food standards, and government price controls on US products. This makes a trade deal harder to achieve given complex set of laws that will need to be rewritten.

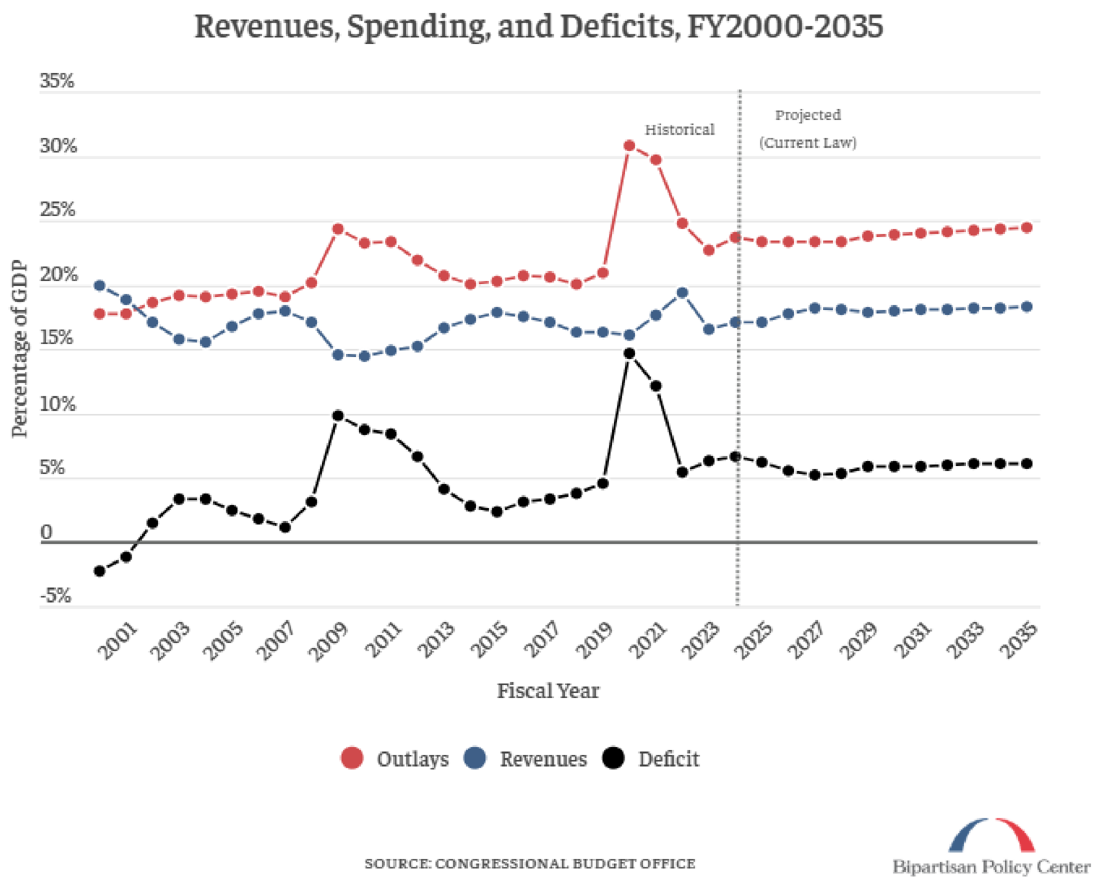
However crucially, even if some broad accommodation could be reached with trading partners, a trade surplus is not the only goal of the administration. Rather continued tariffs may be necessary to address the worsening fiscal deficit the USA faces and to fund the election promises made. We discuss this below.

Revenue generation: We believe revenue generation from tariffs is essential for the Trump administration to meet its promises around tax relief and to attempt to stabilise the budget deficit.

Prior to Covid, US taxation revenue was 16% of GDP, whilst spending was ~21% of GDP – leading to a fiscal deficit of close to 5% of GDP. By 2024, whilst tax revenue was still at ~16%, spending increased to ~23% of GDP – leading to an expanded fiscal deficit of close to 7% of GDP.

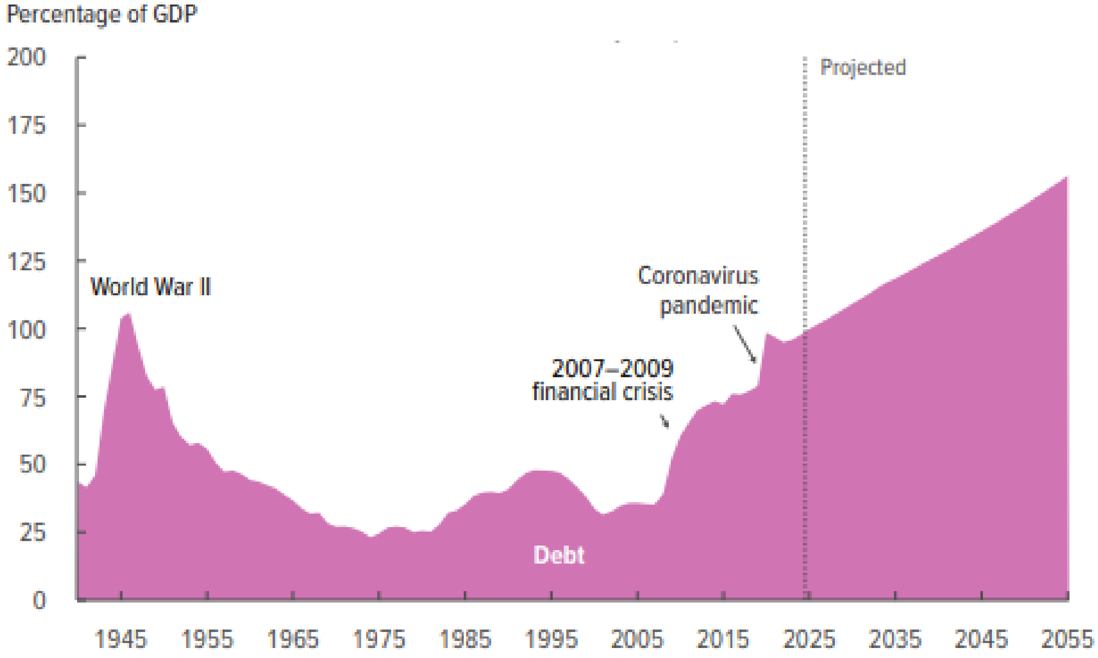
Reducing the fiscal deficit has been outlined as an administration goal. However, a substantial tax cut agenda, increasing core government spending and potentially higher interest rates all threaten to increase the deficit. Tariffs will need to play a key role to fund Trump's election agenda and stabilise the worsening fiscal outlook.

The charts below show the state of the US fiscal deficit according to the Congressional Budget Office (CBO) **before allowing for Trump policies.** It shows large, consistent budget deficits and rising federal debt.



Federal Debt Held by the Public

Debt increases in relation to GDP, exceeding any previously recorded level in 2029 and continuing to soar through 2055. It is on track to increase even more thereafter.



Source: CBO

EFFECT OF TRUMP ADMINISTRATION'S POLICIES ON DEBT AND SPENDING

The new administration's tax policies, if implemented, will significantly impact the budget. The tables below are based on estimates derived from the US Tax Foundation, Even including DOGE efficiency benefits and current estimated tariff revenues of approximately $200bln p.a., the deficit would expand over the CBO baseline. Without tariffs, the deficits would rise significantly faster.

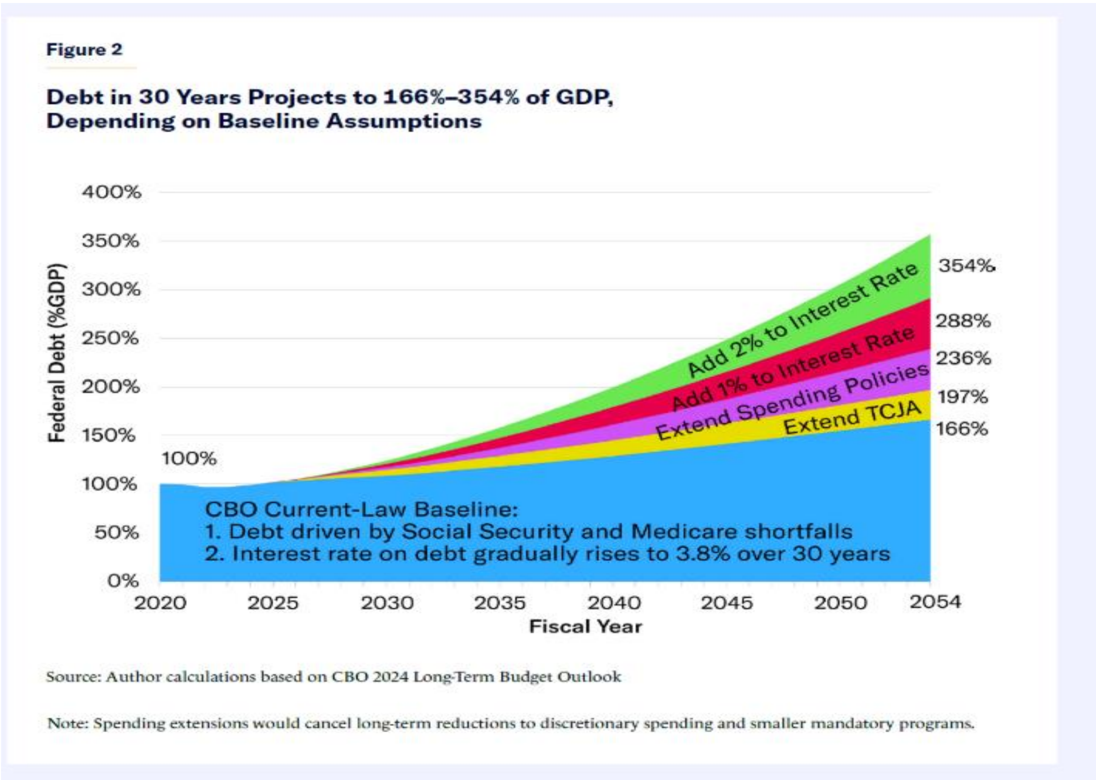
Trump Administration: Currently Announced Policies

Donald Trump Tax Plan 2024/2025 ($bn): Details & Analysis	2025 ($)	2026 ($)	2027 ($)	2028 ($)	2029 ($)	2030 ($)	2031 ($)	2032 ($)	2033 ($)	2034 ($)	2025–2034 ($)
Individual TCJA Permanence	0	-319	-343	-353	-363	-376	-391	-407	-411	-430	-3,392
Restore Full Deduction for SALT	0	-98	-106	-109	-112	-116	-118	-122	-127	-132	-1,041
TCJA Estate Tax	0	-14	-20	-21	-22	-23	-24	-26	-28	-29	-206
TCJA Business	0	-138	-121	-95	-73	-55	-45	-40	-39	-37	-643
Exempt Social Security Benefits from Income Tax	-95	-96	-106	-111	-117	-123	-129	-135	-136	-143	-1,189
Exempt Overtime Pay from Income Tax	-65	-64	-69	-71	-74	-76	-78	-81	-83	-87	-748
Exempt Tips from Income Tax	-10	-11	-11	-12	-12	-12	-12	-13	-13	-14	-118
Create an Itemized Deduction for Auto Loan Interest	-5	-6	-6	-6	-6	-6	-6	-7	-7	-7	-61
Lower Corporate Rate to 15% for Domestic Production Activities	-48	-26	-29	-31	-31	-35	-37	-39	-41	-45	-361
Repeal IRA Green Energy Tax Credits	69	81	$97	108	109	115	105	95	77	66	921
Tariff Revenue	**167**	**191**	**197**	**207**	**211**	**216**	**222**	**227**	**233**	**253**	**2,122**
DOGE	50	156	162	169	175	182	190	197	205	213	1,701
Total	62	-344	-354	-325	-315	-308	-325	-349	-369	-389	-3,015

Tariff Revenues ($bn)	2025 ($)	2026 ($)	2027 ($)	2028 ($)	2029 ($)	2030 ($)	2031 ($)	2032 ($)	2033 ($)	2034 ($)	Total
Fentanyl	16	16	17	17	18	19	19	20	21	22	184
Reciprocal Mexico	18	17	18	18	19	19	20	21	22	23	195
Reciprocal Canada	15	11	11	12	12	12	13	13	14	14	127
Reciprocal EU	20	29	30	31	32	33	34	36	37	53	335
Reciprocal ROW	48	68	69	74	74	74	74	74	74	74	701
Sec 232 Steel Aluminium	11	11	12	12	12	13	13	14	14	15	127
Sec 232 Auto	38	40	41	43	44	46	47	49	51	53	452
Total Revenue	**167**	**191**	**197**	**207**	**211**	**216**	**222**	**227**	**233**	**253**	**2,122**

These CBO projections assume an average 3.5% interest rate on debt through the period (compared to the current 3.3% rate). However, the entire Treasury yield curve is higher than this rate currently – meaning higher interest rates could be a further source of fiscal deficit pressure.

The chart below shows the significant impact on the deficit and debt outstanding further interest rate rises could cause.



Source: Manhattan Institute

OUR CONCLUSION

What is evident from the above charts is that any increase in interest rates will significantly offset the benefits derived from tariffs, exacerbating the fiscal strain caused by Trump's proposed tax cuts.

Therefore, the bond market—and the trajectory of interest rates —will likely be a key determinant in whether Trump maintains his tariff strategy and extensive tax cut agenda.

Tariff or tax policy which casts doubt on the reserve currency status of the US dollar, the willingness or ability of the US to repay its debt obligations or triggers a renewed bout of inflation will force US interest rates higher. The result will be trillions of dollars in additional interest expense, jeopardizing the US fiscal position and the ability to enact any further tax cuts.

Given the political importance of these tax cuts as election promises, Trump is likely to be very reluctant to scale back his key election commitments. In isolation, tariffs can help pay for his extensive tax agenda. We believe politically, the administration can force through the tax and tariff policies through Congress. But the behaviour of the bond market will act as the greatest constraint on the ambitions of the administration. We continue to watch developments in the bond market very closely.

OUR APPROACH TO SYSTEMIC RISK AND HOW WE ARE ADJUSTING THE PORTFOLIO IN THIS ENVIRONMENT

In our first quarterly newsletter we outlined our approach to systemic risk. We wanted to illustrate how we use this framework to deal with the current uncertain operating and macro environment.

We classify systemic risks in our portfolio into three areas.

RISKS WHICH THREATEN THE QUALITY OF THE BUSINESS

These are risks that impact the structural advantages our businesses enjoy. These includes tariffs. Tariffs can impact the how customers perceive the value of the products our companies sell by raising prices relative to competing products. Tariffs can also impact the structural position of the supply chains our companies rely on, forcing them to find new suppliers with higher costs, less integration with our manufacturing base or lower quality. To aid our understanding of quality risks we regularly meet with regulators, suppliers and customers of our portfolio companies and build our circle of competence in related industries over time. We have spent the last three months going through our portfolio companies, trying to understand the impact of tariffs on the prices they can charge, the costs they will bear and any limitation to market access. Importantly we have extended this analysis to key competitors in the space, with a focus on making sure our structural advantage is maintained. **In cases where the structural advantage is now less clear, we have exited or greatly reduced portfolio positions.**

RISKS THAT THREATEN THE SHORT-TERM EARNINGS OF THE BUSINESS

These include macro risks relating to lower consumer and business spending. It also includes inflation risks to the extent they can impact operating margins. Tariffs have introduced significant uncertainty around short term inflation expectations and raised the possibility of a slowdown in spending. We manage these risks by prioritising companies with high levels of revenue visibility, often paired with moderate to high degree of pricing power or clear structural cost advantages. **We have assessed our portfolio further and refined our assumptions to factor in a lower demand environment in the short to medium terms. Where this has led to lower potential returns for our portfolio companies, we have selectively reduced those exposures in favour of less macroeconomically sensitive names.**

RISKS THAT IMPACT RETURNS REQUIRED FOR THE STOCK MARKET AS WHOLE

These are risks related to the cost of capital more broadly and the real rate of return on assets. We tend to deal with these risks by making sure all investments meet a high IRR threshold that does not move with short-term interest rates. **In this environment we are exercising strict discipline in relation to required rates of return and prioritizing companies with the highest quality scores in the portfolio.**

STOCK REVIEW: ENEL (ENEL)

ABOUT THE COMPANY

Enel has been a core stock holding since the Fund's inception in October 2022.

Enel is one of world's largest electricity and gas utility companies (€75bn EUR market capitalisation). Crucially, Enel is one of the few energy companies to be vertically integrated, with ownership in electricity generation, electricity transmission and electricity retailing across Spain, Italy and South America. It is also one of the largest investors in renewable projects with a focus on solar and onshore wind.

WHAT ATTRACTED US TO IT

Following the outbreak of the Ukraine war in 2022, European electricity and gas prices rose dramatically. In response, the Italian and French governments legislated price controls on electricity and payment holidays for consumers. This significantly impacted Enel's cashflows as it faced much higher power input prices and elevated working capital. Enel's heavy investment in renewables also resulted in elevated leverage, which together with the depressed cashflows led to fears of a cut in dividends and/or a capital raise. As a result, Enel's share price declined 40% in 2022 prior to our investment.

We focused our research on three key areas which highlighted the attractive underlying valuation and the structural advantages of the business.

Analysis of True Capex Requirements Highlighted a Very Attractive Valuation: Although ENEL's capital requirements were very significant (circa 75% to 85% of operating cashflows) most of them involved highly discretionary renewable projects with short lead times. These could be deferred and suspended at short notice. Based on our measure of free cash flow, which excludes these discretionary growth projects, we were purchasing ENEL on a FCF yield of 19% (5x multiple), which was extremely attractive given the depressed nature of the cashflows and the growth options in the portfolio.

Minority Positions and JV's Hid Underlying Asset Value: Enel's international investments were often structured through JV and minority positions and not consolidated on the balance sheet. Due to SPV structures, many did not stream dividends up to the parent company. As a result, sell side models failed to account for the true value of these positions, but through a careful analysis of historical capex and disclosures from national energy regulators, we were able to piece together a more accurate picture of these positions which highlighted significant value.

Integrated Position in Italy and Spain Underappreciated by the Market: Based on our work in Australia/NZ power generation we saw Enel's portfolio as very attractively positioned. Specifically, Enel's integrated position across transmission, generation and retail allows it to replace its highest cost thermal generation assets with renewables, connect them to its transmission assets, and capture the extra margin directly through its retail electricity network. This gives Enel the ability to capture very high returns on incremental investment in its core geographies. This contrasts with standalone renewable developers, who need to fund the cost of transmission access and to find commercial customers for power offtake at much lower prices, significantly impacting returns.

HOW ITS PLAYED OUT AND WHAT WE ARE LOOKING FOR

Following our investment, Enel announced a new strategic plan for the period covering 2023-2025.

The plan involves the sale of non-core development assets held in JV stakes, a reduction in renewable investment targeting the highest returning opportunities, a bigger focus on development of more predictable regulated transmission assets and a cost out program.

Enel's divestment program allowed for a significant de-gearing of the balance sheet with leverage moving from 3.1x to 2.4x, and with sale multiples significantly exceeding the trading multiples of Enel. The reduction in interest expense allowed for growth in operating cashflows, which together with cost outs and a normalisation of working capital allowed for operating cashflows to grow from $9bn in FY2022 to $16 bn in FY25. This was returned to investors in the form of higher dividend payments and a buyback program.

Enel's stock has appreciated from €4.22 to €7.5 euros during our ownership while also distributing €1.2 in dividends. The stock remains a core holding as we believe the benefits of its integrated portfolio and the upcoming reset of regulated returns for its transmission assets are still not sufficiently recognised by the market. Enel's stock trades at a 11x P/E multiple and an EV/EBITDA multiple of 6.6x, an attractive valuation for a business that can grow its free cash flow generation by 6%-8% for many years to come while becoming a structurally stronger business.