Lancaster Absolute Return Focus Fund

Portfolio Manager Q4-23 Report

Introduction

We apologise for a disappointing year in which the fund lost 18.3%. It was particularly frustrating for us that in a year when we created stress for clients, with a costly de-grossing mid-year and a move to Lancaster Investment Management, this also dovetailed with subdued underlying performance. The fourth quarter was good for our long book yet this was more than offset by the losses on our shorts. We try to illustrate below how well-positioned both sides of the book are as we move into 2024 and in particular why we currently have such a different geographical weighting to the index.

Macro

The outstanding macro feature of the fourth quarter was the fall in the expected level of interest rates for 2024. At the start of the quarter the market was expecting two rate cuts from the FED in 2024 and by the end of the quarter it was pricing in six. This significant drop in the yield curve was driven by a near-perfect combination of inflation coming in lower than expected and other economic data cooling off by just the right amount to make a soft landing look more likely. This situation resulted in a near-three standard deviation move in 10-year yields – creating a goldilocks setup for long duration assets.

At this stage of the cycle central banks must be congratulated for navigating potentially treacherous economic waters without a major slip up. For our money however the market is getting ahead of itself. The rally in risk assets in the fourth quarter leaves little margin for error and whilst inflation has fallen significantly since the start of the year financial conditions have been eased dramatically by the market before central banks have even started cutting.

Exhibit 1: Goldman Sachs US Financial Conditions Index, 1-Jan-23 to 31-Dec-23

Source: Goldman Sachs, Bloomberg

We believe there is a narrow range of outcomes to justify what much of the equity market is pricing in at present; the economy turning out too weak or too strong could create problems.

Performance

1.2%	Monthly performance
-18.3%	Year-to-date performance
6.7%	CAGR since inception

These figures refer to the past. Past performance is not a reliable indicator of future results.

Fund details[1]

£ I Class	161.33
£ A Class	165.69
$ I Class	171.50
$ A Class	179.67
Fund Size	£90 million
Strategy AUM	£890 million
Fund Inception	30-Nov-2015
Class Inception	01-Apr-2016
Fund Type	Irish ICAV QIAIF

Portfolio Managers

James Hanbury

Jamie Grimston

Source: All sources, unless otherwise stated, are Lancaster IM internal unaudited data and refer to the £ A share class. All data shown as at 31 Dec 2023.

[1] U.S. Bank Global Fund Services (Ireland) Ltd and Bloomberg, calculation on a NAV basis with net income reinvested.

Gerard Minack's recent assessment of the state of play with markets and macro eloquently summarises some of our own views:

"US markets start 2024 expecting inflation to fall to target, GDP growth to slow but remain positive, EPS growth to accelerate, and the Fed to ease aggressively. Any one of those forecasts could be correct; perhaps two will be on the money – but it's almost impossible to think of a scenario where all these things happen in 2024. Which forecast is wrong will matter a lot. I think the market is under-estimating the risk that growth is weaker than forecast and that equities face a significant EPS miss. But if EPS growth accelerates, as expected, then the rate view will almost certainly be wrong."

On the downside a weaker than expected economy will see earnings revised lower for many companies which are starting on high multiples. The unprecedented circumstances of the COVID-induced recession may have distorted the market's view of how the 'Magnificent Seven' (Alphabet, Apple, Amazon, Meta, Microsoft, Nvidia and Tesla) will be impacted in a normal economic downturn.

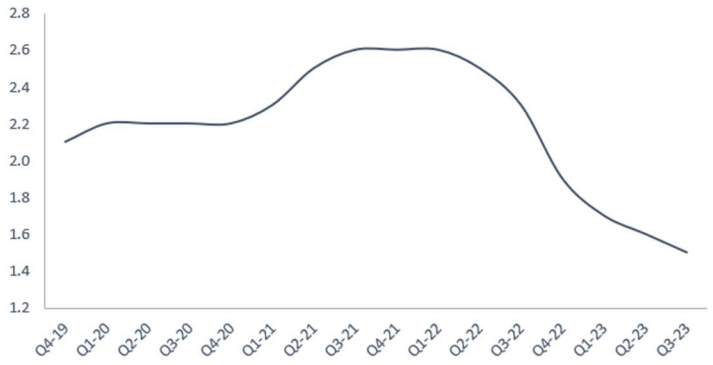
One reason the economy may turn out to be weaker than expected is the significantly greater amount of private credit in the system – where opacity makes it harder for central banks and the market to track the impact of higher rates. Since 2006 private credit has grown 13-fold and, according to the CEO of Apollo, only 20% of new debt in the US goes through the banking system, which is one of the side-effects of regulations brought in post the Great Financial Crisis. Some of the features of private credit, in its broader definition, are being covenant-light and having floating rate debt. Companies accessing private credit markets effectively only 'default' when they actually run out of cash, giving less warning compared to traditional debt with covenants. We feel there is not enough scrutiny of how these companies are handling borrowing costs that, according to Refinitiv and KBW Research, have gone from c.6% to c.12% over the last two years. The covenant-light profile of private credit is one of the reasons that default rates are still low in this asset class. H1 2024 should be a good indicator as it will see the first major wave of refinancings in the private credit and leveraged loans market start to bite. Certain US Senators share our concerns:

"Unlike the traditional banking industry, the private credit market is subject to minimal, indirect regulatory oversight. The lack of transparency in this market obscures its true size and risk. Troublingly, there is insufficient insight into the private credit market's key features, including loan terms, lenders' funding structures, and borrowers' financial health."

Letter dated 29th November 2023 to the Federal reserve from Sherrod Brown, Chairman of the Senate Committee on Banking, Housing and Urban Affairs.

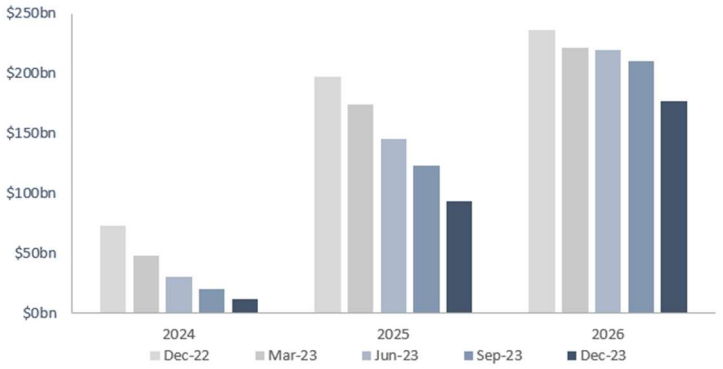
One of the ways we try to track the underlying health of the private credit market is by following the Business Development Companies, speciality finance companies that invest in private credit, where it is interesting how much their portfolio interest coverage ratios have fallen. FS KKR's portfolio interest coverage ratio in Exhibit 2 below is a prime example, down from 2.6 x in Q1-22 to 1.5 x in Q3-23. 1.5 x coverage when taken against EBITDA implies around 1x cash cover.

Exhibit 2: FS KKR Portfolio ICRs (EBITDA / Interest)



Source: Lancaster IM

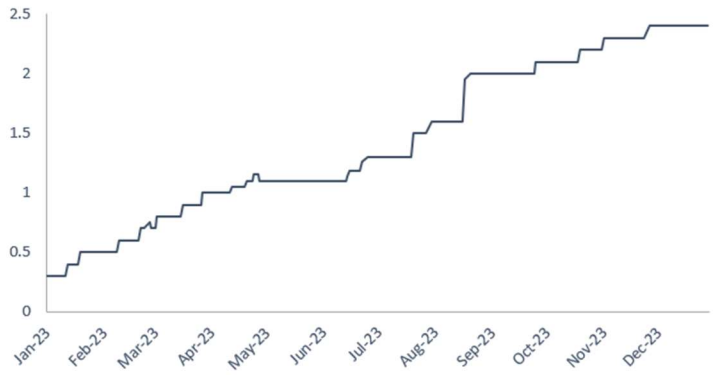
Exhibit 3: US leveraged loan refinance wall ($bn).



Source: Exane, Pitchbook

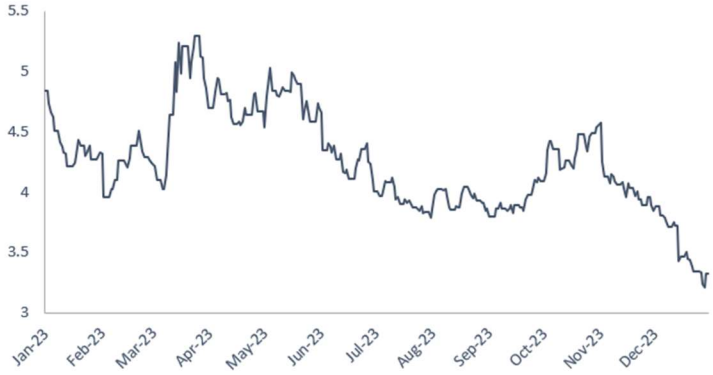
Given the current importance of discount rates to the valuation of the market we see a soft landing (or no landing) as also potentially creating a headwind for equities. Falling rates will stimulate an economy already in 'good health' which would then set up a new hiking cycle but from a higher base. Whilst there have been some weaker data points – in manufacturing and continuing job claims for example – overall the U.S. economy has been remarkably strong with an unemployment rate and credit spreads close to record lows.

Exhibit 4: 2023 US GDP Economic Forecast, 1-Jan-23 to 31-Dec-23



Source: Bloomberg

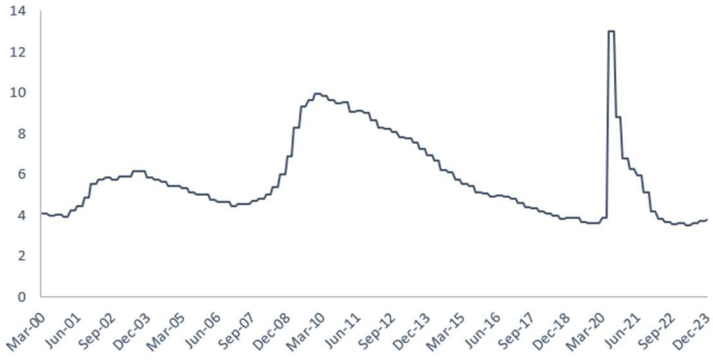
Exhibit 5: US High Yield ex Energy Average Option Adjusted Spread, 1-Jan-23 to 31-Dec-23 (%)



Source: Bloomberg

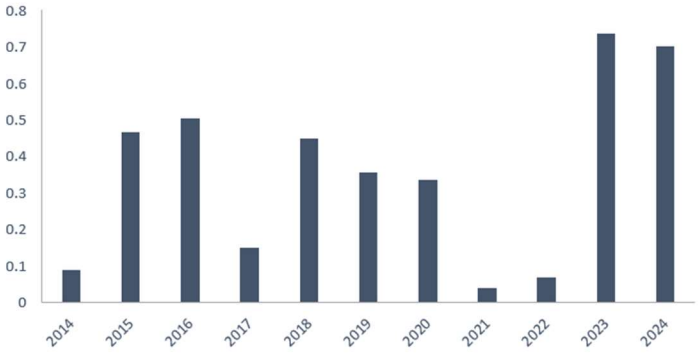
This may account for the unusually large gap between where the market sees rates in 12 months' time and where the FED sees them. With the above data taken into account it feels like an unlikely backdrop for an aggressive loosening cycle which may explain why the FED is diverging so much from consensus.

Exhibit 6: US unemployment (3 month average) 1-Mar-00 to 31-Dec-23



Source: Bloomberg

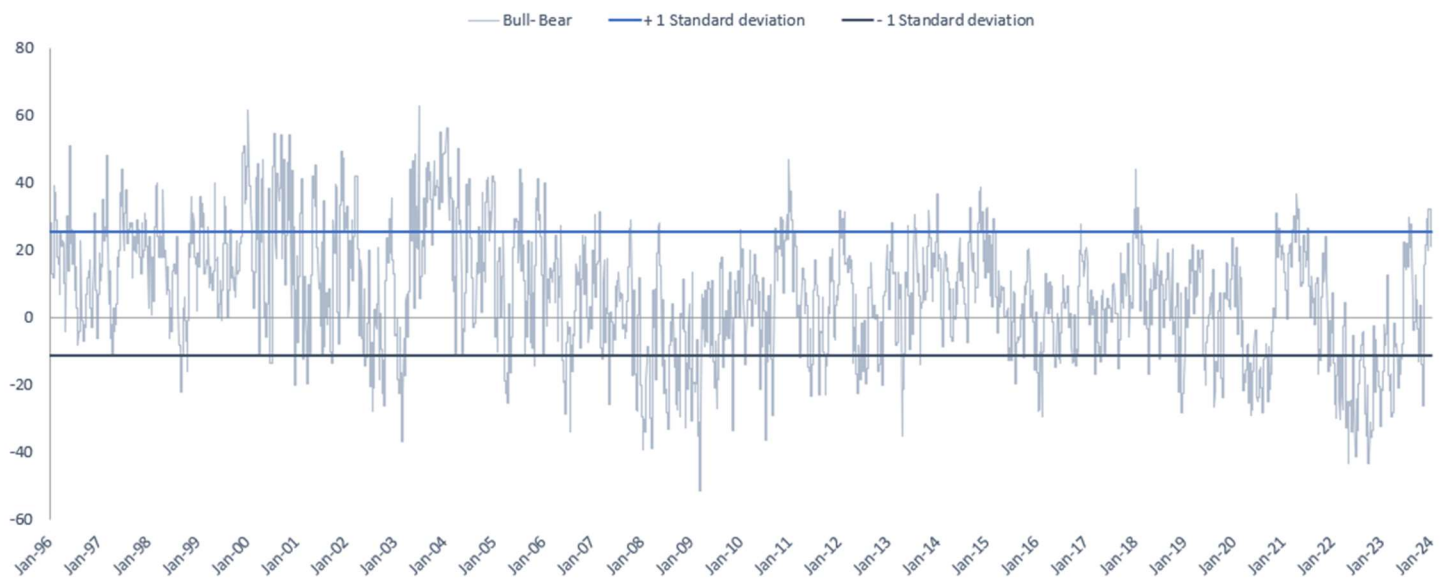
Exhibit 7: 1 year ahead FED Funds forecasts – gap between dots and market implied rates as at 31-Dec-23



Source: Bloomberg, Federal Reserve

Within the market we are still finding a number of high-quality companies which the market values as mediocre or even distressed assets, but these are the minority. Given the opportunity on the short side we are happy therefore being broadly market neutral particularly as sentiment in the US equity market approached euphoric at the year end.

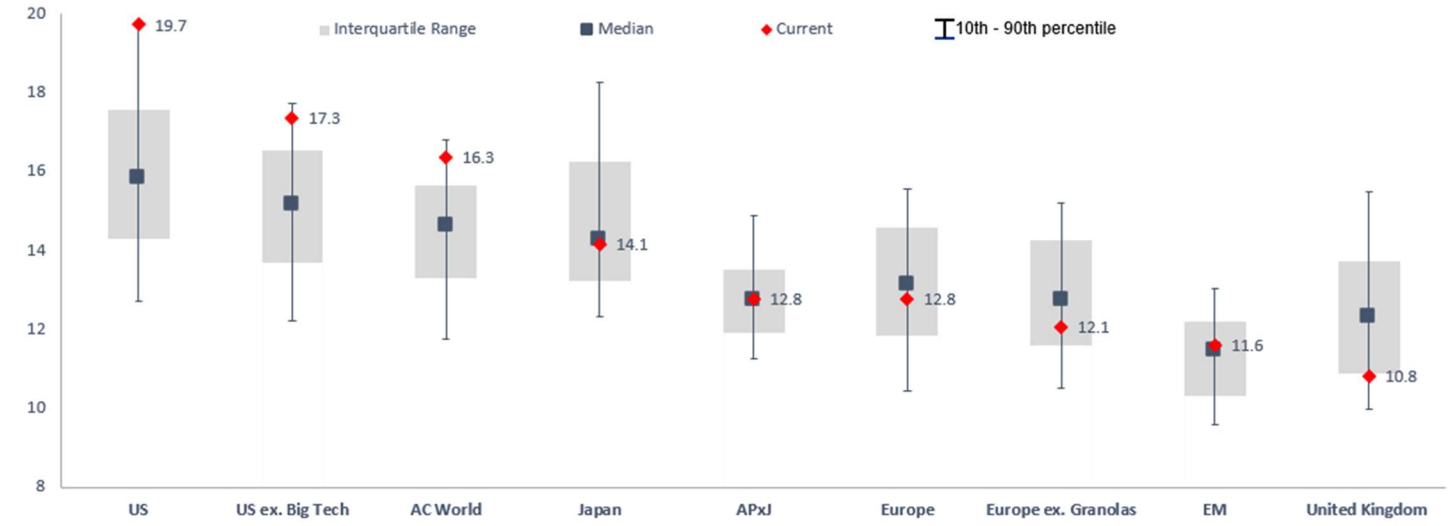
Exhibit 8: AAII US Investor Sentiment Bullish Readings Minus Bearish Readings 1996-2023



Source: American Association of Individual Investors, Bloomberg

Over the last 5 years or so we have had to rely on stock-picking to move the funds forward as our factor exposure has been poor; to generalise we have been overweight Europe vs America and overweight Value vs Growth. To be clear the fund is constructed on a bottom-up basis, playing to our greatest degree of edge and we then control the factor risks if they are getting too extreme. We continue to be overweight Europe and in particular the UK. Whilst the UK directionally has been through a similar journey to the US in 2023, in terms of higher GDP growth and lower inflation than expected, the market is far less influenced by discount rates due to a much higher equity risk premium. Whilst there are plenty of things not to like about the UK economy clearly what interests us is what is priced in – and the chart below shows how unpopular the UK market is at present in stark contrast to the US. The irony with our UK listed positions is that most of them are multinational companies with relatively little revenue derived from the UK. Several of them (e.g. Plus500, IWG) are talking about potentially relisting in the US.

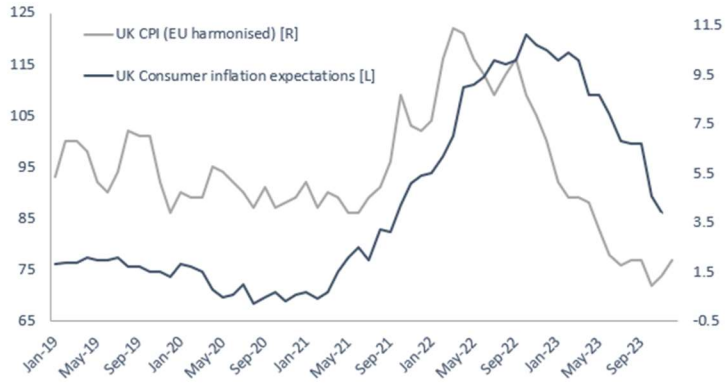
Exhibit 9: Geographical spread of valuations across regions - 12m fwd P/E multiple. MSCI Regions. Data for the last 20 years to 31-Dec-23



Source: Goldman Sachs, FactSet

Where we do have UK economic exposure we are comfortable with the margin of safety offered by current valuations. Compared to this time last year the economy finds itself in a quite different situation and consumers are now beginning to see decent real income growth. Despite well publicised public sector strikes consumer expectations for inflation, which can be a self-fulfilling driver, are now approaching 2019 levels.

Exhibit 10: UK inflation expectations



Source: Lazarus Economics

Exhibit 11: Real average UK earnings (% YoY)

Source: Lazarus Economics, ONS

As per our recent newsletters we are broadly on the fence with regards to the fundamentals of inflation with strong opposing forces hard to call. That said, from an equity and bond perspective, the market has become quite dovish in terms of how it is pricing inflation, so it is plausible that there will be a greater reaction in the event of an upside surprise.

Performance and positions

In the fourth quarter the fund lost 7.8%. Our long book had a good quarter, but this was more than outweighed by our short book. One of our largest factor risk exposures was that of falling bond yields in a healthy economic environment, this played out to an extreme extent during the quarter. We reduced losses in the short book by covering some positions near the trough but not enough in hindsight.

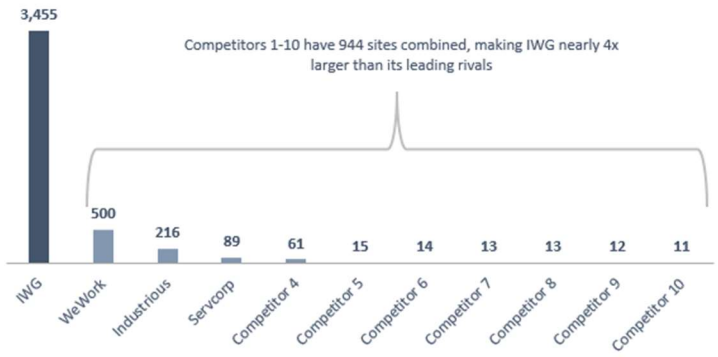
Overall it was a disappointing year in which the fund lost 18.3%. The fourth quarter was also the story for the year as we made good returns on the long book which were more than offset by our shorts. It was a perfect storm for the fund in terms of the exceptional disruption in the middle of the year, involving us being required to de-gross by nearly 80%, at the same time as delivering relatively poor performance. It is difficult to be precise, but our estimate is that the forced de-grossing during June and July cost the fund about 15% in total: c.12% came from the actual de-grossing and the timing of re-grossing dictated by counterparties and c.3% came in the fourth quarter as two of the illiquid names that we sold down in July, Restaurant Group and Shanta Gold, received cash offers. The 15% loss is still a loss, but it is important for us when assessing the year to discern what was 'normal' underperformance and what was a one-off exceptional. As large investors in the fund ourselves, we certainly felt the pain.

Long book

We were pleased with how our long book performed in the quarter and the year despite the hit we took from having to de-gross in the summer. The MSCI World also had a good year, delivering +19.4% in sterling, though with an extraordinary 41% of the return being driven by the Magnificent Seven. Without these stocks the same index would have returned 11.6% in sterling terms.

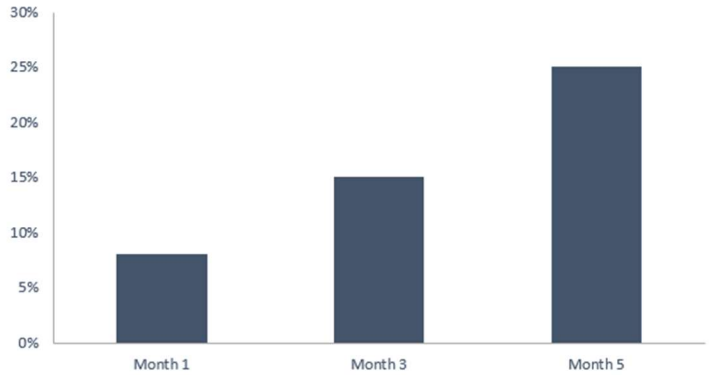
IWG was one of our top contributors in the quarter. This was no surprise after the December capital markets day which was possibly the most positive CMD we have seen relative to what is priced into a stock. It also helped that WeWork finally also went into Chapter 11 in the US and Canada and should return as a much smaller business with more rational pricing. The company made it clear how dominant its position now is, with nearly four times the number of centres compared to the next ten competitors combined. This creates a powerful network effect. The company also explained how its future expansion requires much less capital and that an uncertain office market is helpful in terms of boosting its growth with landlords becoming more likely to switch from a traditional office offering to a flexible one run by IWG. The company guided to $1bn of EBITDA from 2028. Although this looks conservative against the granular guidance management gave for each division it still offers high teens annual growth rates and would typically justify a high multiple – as per most growth franchise businesses. Putting the EBITDA guidance on a multiple of 15x would give an enterprise and market cap target value of $15bn versus the current market cap of c.$2bn. We like finding investments where the upside is large enough with basic assumptions that we have significant margin for error. We believe 2024 should be a big year for IWG in terms of providing proof points for its capital light growth and hopefully in getting more mainstream coverage from the sell-side. With over 60% of profits coming from the US a relisting is an option if the UK market does not rerate the business.

Exhibit 12: IWG's dominant industry position



Source: Lancaster IM

Exhibit 13: Encouraging signs of cross fascia spend: 25% of customers shopping cross fascia within 5 months of onboarding on Frasers Plus



Source: Frasers Group

Frasers Group was also a top contributor for the fund in the quarter as it continues to deliver robust results whilst taking high-quality long-term investment decisions. With its high cash conversion and backing from the major sports and fashion brands Frasers can keep making acquisitions that should see its market share grow meaningfully across Europe in a value-accretive manner. We will discuss the challenger sports brands in more detail below but with the likes of On Running, Lululemon and Hoka taking share from Nike and Adidas in key categories in recent years this has given more power to the key wholesalers. Meanwhile Frasers is rolling out its credit and personalisation offering, Frasers Plus, across all its brands. The early indications here are encouraging and this should offer organic growth for many years ahead as well as providing white labelling opportunities.

A new and meaningful position for the fund in the quarter was Liberty Global. This is a fascinating John Malone company of which he is chairman and a major shareholder. Liberty Global offers converged broadband, video and mobile communications in Europe; its main brands are Virgin Media and O2 in the UK, VodafoneZiggo in Holland, Telenet in Belgium, and Sunrise in Switzerland. It also has investments in content, technology and infrastructure. There are five main reasons as we see it that this is an orphaned asset on a highly distressed valuation:

1. It is listed in America yet owns European cable and telecom assets.
   This makes no difference to the intrinsic value but provides an opportunity for us to acquire shares at a decent price and for management to arbitrage the market by buying back shares. The company recently upgraded its buyback to 18-19% of the share count for its current financial year. It has bought back c.60% of its shares in the past 4 years. Effectively the company is being taken private by management who own more than $700m of shares and have voting control.

2. It is complicated to understand
   There are four main assets held in separate companies, sometimes JVs or even JVs within the JVs! Whilst it is true this is a complex structure there is method behind the madness. It offers Liberty Global upside from each operating asset, as all free cash flow is upstreamed to the parent company whilst protecting it from having any recourse from the operating company liabilities. The structure also avoids any risk of cross-default, in the event (unlikely in our view) that one asset becomes distressed. All op-co debt silos are also fully 'portable' which insulates equity holders from any change-of-control ramifications.

3. The market feels the company is too highly leveraged
   Liberty Global, the parent company, effectively has cash of $3.5bn, equal to roughly half its market value with essentially no debt – assuming the bridging loan of c.$850m at the parent company gets repaid by Telenet in the next few months as guided. At this point the debt will then be held at the operating asset level with no recourse to the listed parent company. Whilst targeted debt levels at the operating companies of 4-5x EBITDA are high by European standards, those balance sheets are almost fully hedged at favourable fixed interest rates and with currency exposure also hedged. The average maturity of the debt is c.6 years. One can argue that if you marked to market the rates on Liberty's operating entity debt then much of the free cash flow coming back to the parent company would disappear. However we take the view that, if interest rates remained at these levels for the next 5/6 years, then the sector would be forced to 'price up' and there would be significant creative destruction to the benefit of Liberty Global. We also note that a number of Liberty's assets (UK, Belgium, Ireland) are each in the midst of a major, once-in-a-generation, investment phase as their networks are upgraded from cable to fibre. Even if, in contrast to market expectations, interest rates remain elevated for the next decade, this capex 'spike' should fall sharply at the same time as interest costs would rise helping to absorb a large part of the impact.

4. **From a technology perspective cable is an inferior offering to fibre when it comes to energy efficiency and fault rates.**
   Again there is some truth here but, as alluded to above, by the end of the decade Liberty Global is planning to have upgraded around 70% of its c.30m current footprint to fibre to the home. Where this is not happening, it will upgrade to Docsis 4.0, a technology being used in America by Comcast and Charter.

5. **Lastly the market does not believe the $3.2bn valuation of Liberty Global Ventures (LGV) – the portfolio of investments that sits on the balance sheet and makes up close to 100% of Liberty Global's Enterprise Value excluding non-recourse debt.**
   We are inclined to be sceptical of private market values at present but some of the stakes are in listed shares like Vodafone and ITV. One large position, All3Media (of which Liberty Global owns 50%), is reportedly close to being sold at a c.$1.3bn EV to Redbird IMI, consistent with the equity value within the $3.2bn valuation. Other meaningful stakes held are in Atlasedge, a datacentre business, Formula E and other content and technology businesses. Given the rumoured transaction of All3media and the listed stakes this materially reduces the potential mark-to-market downside of the LGV valuation.

As well as being comfortable with the bear points we also see several standalone bull points. The UK entity is in an almost unique position to buy distressed alternative network providers at below the cost of building the fibre. Separately regulators in Europe seem to be becoming more sympathetic towards allowing 4 to 3 consolidations within countries and allowing the industry to generate higher returns. Although regulators like consumers having low prices it has become apparent that retaining sovereignty of infrastructure is also important. Liberty Global management has guided that for its Q4-23 results it will provide an update on how it will accelerate value accretion for shareholders with capital allocation decisions. This may involve selling or IPOing some operating assets or accelerating the buyback with cash proceeds from investment sales.

With a market cap of c.$7bn (as of 3rd Jan), Liberty Global has an EV of $3.5bn when you consider the debt is non-recourse and the cash sits at the parent company. After subtracting the value of LGV its EV falls to c.$300m. The next few years are those of heavy investment spend in fibre. Even after this impact the proportionate free cash flow for Liberty Global from its operating entities after central costs is forecast by Redburn to be $973m for 2024 and $1060m for 2025 – FCF yields to the EV of around 300%. If we say LGV is only worth 80% of the stated value, this still puts Liberty Global on a FCF yield of 99% for 2024 and 108% for 2025. It is no surprise management is buying back shares at such a rate. History suggests that when John Malone allocates capital aggressively it is worth taking note.

Exhibit 14: Liberty Global FCF yield to EV post the investment stakes

Discount applied to Liberty Global Ventuires	2024 FCF yield to EV	2025 FCF yield to EV
0%	288%	314%
-20%	99%	108%
-40%	60%	66%
-60%	43%	47%
-80%	34%	37%
-100%	28%	30%

Source: Lancaster IM, Redburn

Exhibit 15: Liberty Global share price vs quarterly diluted weighted average share count – 1-Jan-19 to 1-Jan-24

Source: Bloomberg

On the topic of buybacks at present in the equity long book over 53% of our exposure has been to companies buying back their shares. When we look at who could potentially implement a new programme in the next 12 months this rises to 88%. Of course, we do not expect this to all play out, but it gives a sense of the capital allocation opportunities for our long book management teams, linked to the fact that these companies are on average less leveraged than the market. This is powerful when the median P/E for the long book is 10x for 2024.

One of our poor contributors in the quarter was **Ubisoft Entertainment**. There was some technical selling due to the company rolling forward a convertible bond and pessimism on Avatar sales may also have been a factor. We do track the estimated sales of individual games and, whilst we can see that Avatar has been subdued in the quarter, we are comfortable that the broader portfolio is heading in the right direction. Similarly, we are happy that Ubisoft is executing on its strategy of focusing on its core franchises and we believe that the IP in the third largest independent Western video gaming company in the world is worth significantly more than its current EV of c.$4bn. During the quarter there were more stringent gaming measures announced in China. Given Ubisoft's marginal current direct exposure to China, we believe this could increase its strategic value to Tencent. For March 2024, Ubisoft trades on <2x EV/sales despite this year still representing a relatively modest level of pipeline monetisation. The Guillemot family (in collaboration with Tencent) bought shares during the quarter and we also added to our position.

During the quarter we sold one of our smaller Russian positions, TCS, in an off-exchange transaction which contributed circa 1.5%. Whilst we are comfortable with how TCS is performing as a business, we sold at a valuation we would not normally have considered as the opportunity to trade in TCS is likely to disappear as it redomiciles from Cyprus to Russia at the end of this month. Given we have significant other Russian holdings valued at zero we felt it appropriate to take some money off the table for investors when the opportunity presented itself. If we could sell our other Russian positions at the local market price, which to be clear we cannot at present with the sanctions in place, then it would add circa 16% to the fund's NAV.

As things stand UK housing looks set for a rebound but this is not being priced in by assets we own. The next UK general election is likely going to be in the autumn of this year, and we see housing as a battleground for 'promises' where both contenders are vying to be the party of home ownership. Our exposure is through Vistry, Ibstock and Forterra which are all beneficiaries of increasing volume, and orderly pricing, of new build homes. It is odd therefore how the market got to near-trough multiples on trough earnings for these companies in the autumn – though somewhat recovered since. Falling borrowing costs and wage inflation vs sustained rental inflation, along with the structural needs for housing all point to a market where 2024 should see a path back towards more normal housing volumes.

Our airlines did very well in the year as Jet2 and Ryanair were both top contributors. We have been discussing this for some time but with demand bouncing back into a weaker capacity environment it will result in record profits for the year ended March 2024. We believe they both remain cheap for structural market share winners. Jet2 (excluding half customer cash) and Ryanair trade on 3.5x and 6.0x EV/EBIT for March 2025 respectively.

One of the push backs we get with our overweight exposure to Europe is 'we can see that companies are cheaper, but you get better growth in the US'. Whilst we accept this growth point in general it certainly does not mean there are not high quality growth businesses in Europe on low valuations. The table below shows our top five non-US holdings and how their growth rates and valuations compare to the US market.

Exhibit 16: Growth rates of top ex US listed holdings

	Last 10 years revenue CAGR	Next 3 years revenue CAGR	EV/EBIT 2024	P/E 2024
Frasers Group	8%	9%	7.9	8.2
IWG	7%	10%	9.5	12.6
Ubisoft Entertainment	7%	8%	10.3	14.3
Jet2	22%	14%	3.7	6.9
Plus500	20%	13%	3.8	5.5
Average	13%	11%	7.0	9.5
US market (S&P 500)	5%	5%	16.0	19.3

Source: Lancaster IM, Bloomberg.

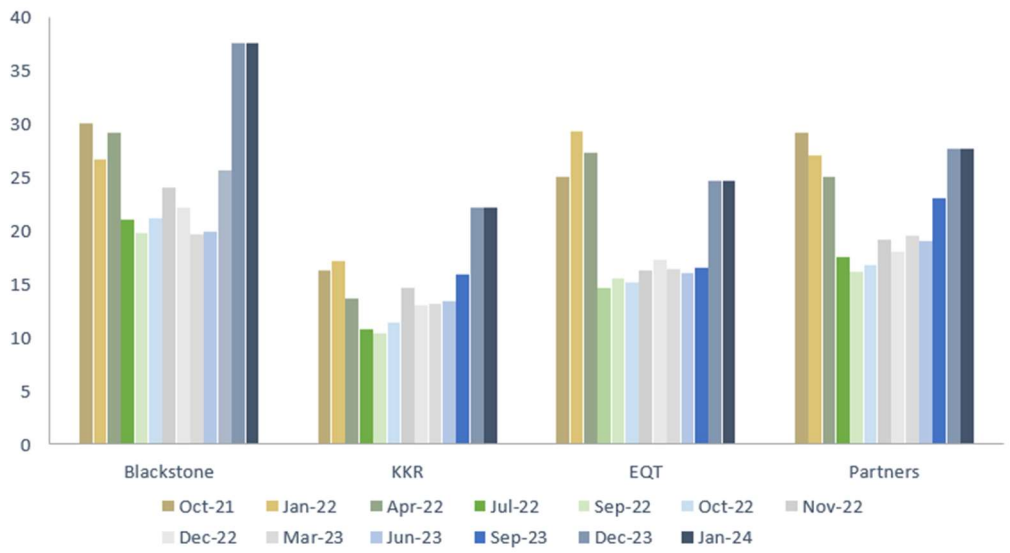
Short book

Our short book had a poor quarter and year. Since inception we have generated more alpha on our short book per annum than our long book, but this was a very disappointing year for the shorts which rallied hard as the goldilocks macro scenario emerged in Q4-23.

Our short in Ark Innovation was painful for the fund as it rallied over 30% in the quarter driven by falling rates.

Our private equity shorts like Partners Group, EQT and Blackstone rallied harder than the market as falling rates gave the market hope that 2024 can be a year of good exits. Our private credit focused shorts like Apollo and the Business Development Corporations (BDCs) rallied less than the market as a falling yield curve reduced expectations of these instruments' future returns. We think the market is looking at these assets in completely the wrong way. We believe that BDCs and private credit need falling short-term rates to give the underlying borrowers some breathing room – yet the market simply looks at the first level order impact. Until central banks rates do fall though spot funding remains very elevated and we are seeing a transfer of value in most leveraged private companies from the equity to the floating debt. Equally whilst lower rates are clearly helpful for private equity companies looking to exit an equity investment, we believe the market is underestimating the impact of excess supply and how falling rates might also be reflective of a weakening economy. The IPO pipeline is currently stacking up at the investment banks like planes at Heathrow. The first half of 2024 is going to be important for the private equity industry in two regards: firstly it needs to deliver sharply priced exits at an almost unprecedented cadence and secondly it sees the start of a wall of refinancing for their underlying companies. We believe the asymmetry of how the market is pricing this important phase for the private equity industry offers good risk/return on the short side. Most of the listed private equity companies where we have short positions are trading at close to record multiples of management fees and the BDCs are trading near book value implying a continuation of the current ultra-low default paradigm.

Exhibit 17: EV / Fee Related Earnings multiples at or above peak levels



Source: Exane

It was a case of when it rains it pours for us on our short book in Q4-23. Two of our shorts in the sporting goods space, Lululemon and Deckers, both re-rated significantly after rallying more than 30%.

Whilst Lululemon has been an unbelievable success story we believe that post the COVID windfall growth will become much harder. It looks to us that the company is becoming a hostage to the promised sales growth required to meet its plan and go some way towards justifying the market multiple. The company for example never used to wholesale as a principle of controlling stock and the experience of the brand. Wholesale and franchising are now seen as important growth drivers.

One of Lululemon's real strengths was its clarity about what the brand represented and to whom. It is now diversifying its offering to become more mainstream (e.g., men's polo shirts, swimwear and puffer jackets) which makes it much more vulnerable to competition and harder to justify its 'niche' multiple. The departed founder Chip Wilson agrees with this view:

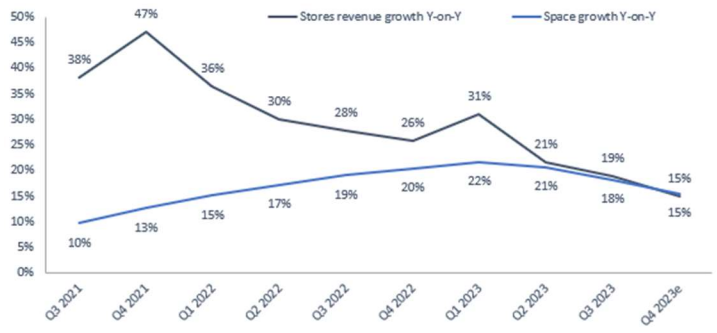
"They're trying to become like the Gap, everything to everybody. And I think the definition of a brand is that you're not everything to everybody…If you look at about 30% of their men's stuff, to me, it's appalling. They're making even dress shirts that have no style to them, but they're just making a dress shirt to put it in there. I'm sure they get the fabric for $2 a meter and they make it. It's in the Lululemon store so people are buying it because they think it's technical. They're buying it and wearing it, but it's not… What's happening is the margin on it is so huge that the merchandisers and everyone's getting a bonus on the profit and the margins of a bad streetwear fashion product, which is only selling at a high price because of the Lululemon technical product. It ends up being what I call bad profits. Bad profits in a company like that lead to the Gap and eventually you can see Lululemon is making more and more streetwear and less and less technical wear."
Chip Wilson (Jan 2024 Forbes)

We are also concerned at the degree to which Lululemon's stores business is becoming reliant on space growth to grow its revenue. This points towards declining returns on invested capital, particularly as the company is set to open more stores. One of the best characteristics of a good short is falling returns when its starting valuation is high.

At a time when industry growth is already slowing (see Exhibit 20) competition is heating up. Nike made it clear on their last earnings call that it now has a particular focus on women's fitness apparel, and smaller competitor brands like Vuori and Skims are seemingly looking to IPO this year, presumably to raise capital in an attempt to grow their share of the category.

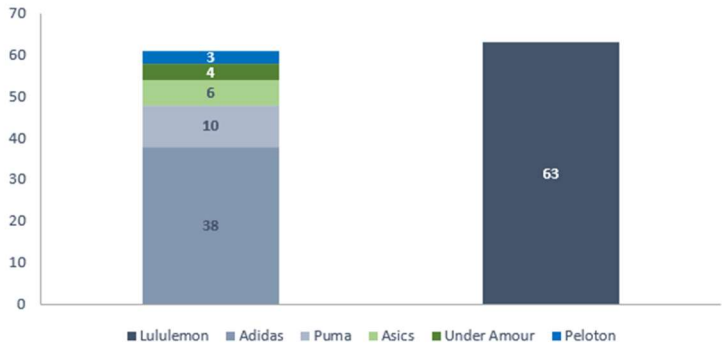
Currently Lululemon is delivering an industry-high EBIT margin of 23% and trades on a Jan 2024 EV/EBIT multiple of 28x and a P/E multiple of 40x. It is always interesting having a sense check on absolute value in these kinds of situations. Lululemon's enterprise value at the close of 2023 was c. $63bn and Exhibit 19 shows how many other branded companies you could own for less money.

Exhibit 18: Lululemon global stores revenue vs. space growth YoY



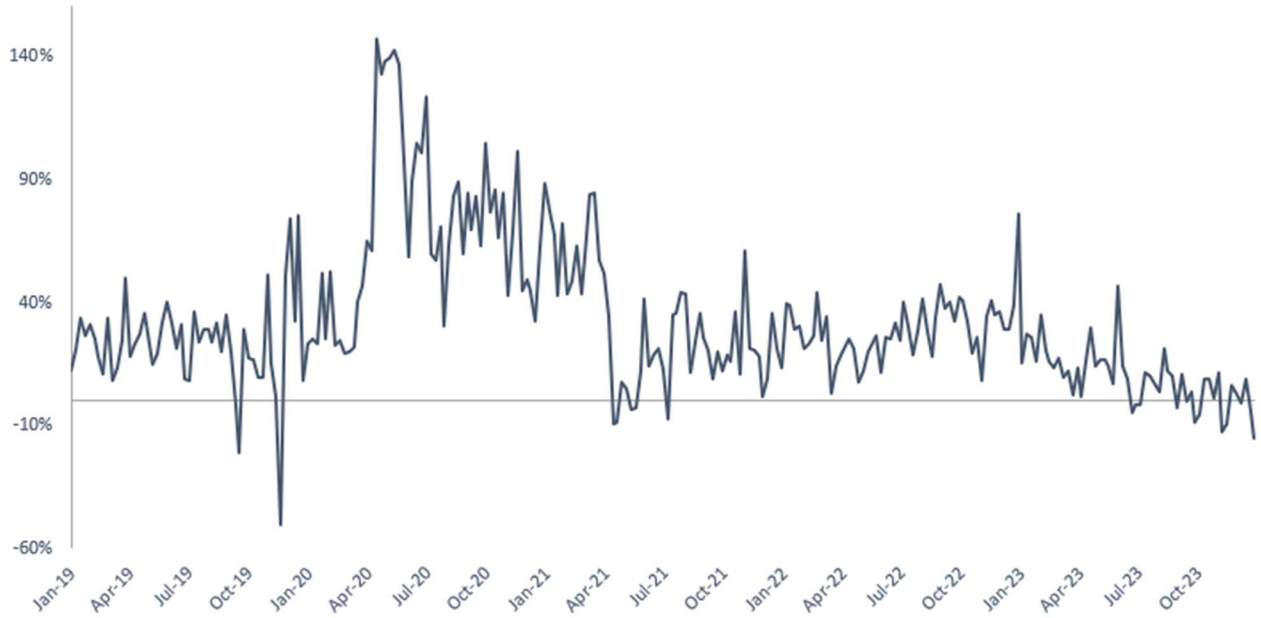
Source: Company reporting, Lancaster IM

Exhibit 19: Relative valuations of select global sportswear and equipment suppliers (Enterprise Value in $bn)



Source: Bloomberg

Exhibit 20: Estimated Y-on-Y spending growth in US sporting footwear & apparel



Source: MScience US digital spend data

Deckers and **On Running** also admirably made the most of the COVID boost to running. Hoka has been the key growth brand for Deckers and in particular its Clifton and Bondi shoes. What has been particularly striking about the running space is the share loss by the larger brands to On Running, Brooks and Hoka. Whilst it is difficult in this industry to sustain a true technology advantage, the shares of Deckers and On Running seem to us priced as if their slice of the pie is only going up and that the category will continue to grow at the same rates as the past few years. What has become noticeable in the past few months however is the increasing appetite of the larger brands to fight back. Nike, whose roots are in running shoes, see it as imperative to regain share. It is potentially putting a third of its freshly announced $2bn savings back into driving growth in the running category and are looking to use this summer's Olympics as a platform for product launches and marketing activity. When we go through the recent commentary of the 'other' top brands in running (Asics, Puma, Adidas, Nike and Under Armour) without exception they are all investing in and targeting to win back share in the category, and we also hear within the industry that New Balance and Salomon have equal ambitions. The short case is not about demand (despite the possible demand pull-forward over the past couple of years) but we can see there being a significant increase in competitive tension in 2024 as the space becomes a battleground. With Deckers and On Running trading on consensus calendar 2023 P/E multiples of 28x and 47x respectively we feel the setup for the short is very attractive.

Positioning

Given our high conviction level on both the long and short book we are currently broadly market neutral and do not have any index future shorts (which is normally default). The fund has an overweight to Europe and an underweight to the US. We continue to be hedged on our dollar positions. The long book continues to be cheaper than the market and is de-equitising at an unusual rate with our short book being materially more expensive. It is compelling that we do not feel this valuation discrepancy is representative of the relative prospects, as we have discussed above. Our factor risks are shown below.

Exhibit 21: Lancaster Absolute Return Focus Fund | Long & Short Book valuation multiples

	Forward P/E	Forward EV/EBIT	Forward EV/Sales
LARFF Long Book	7.7	6.2	0.7
LARFF Short Book	19.6	19.6	4.4
MSCI World Index	17.6	14.9	2.4

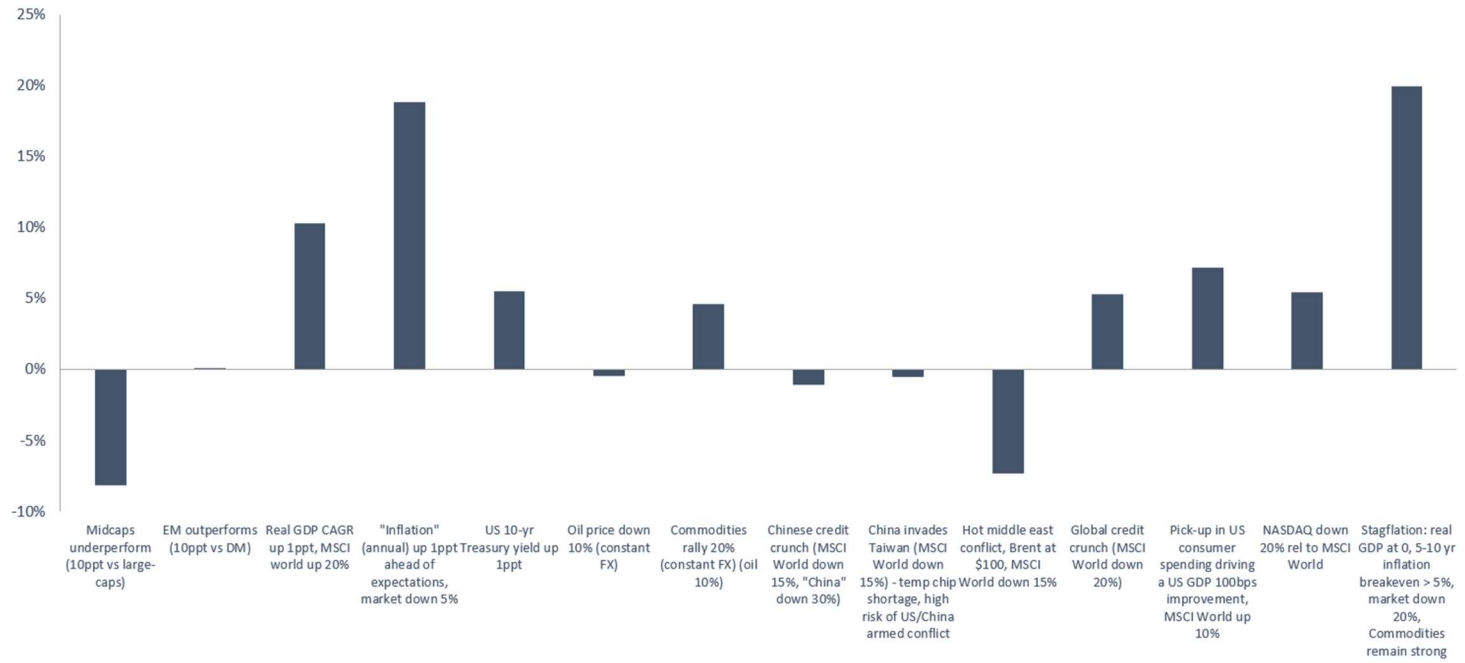
Source: Bloomberg, Lancaster IM, as at 12-Jan-24.

Conclusion

In summary we feel for large parts of the equity market the setup is quite precarious due to pricing in a continuation of a goldilocks scenario. Economic growth that is too strong or too weak could be unsettling for equities. Fortunately, we do not have to make a strong call either way as our long book offers very different characteristics to the market with a much higher equity risk premium and a stronger growth profile. After a poor 2023 we believe our short book has a huge amount of potential. It is no surprise therefore that we look forward to 2024 with much anticipation.

Once again we would like to apologise for a disappointing 2023 and to thank you for your support during the year, particularly as we moved from Brook to Lancaster. As more time has passed at Lancaster our conviction on it being the right home for us has only increased. We look forward to updating you further on our quarterly conference call.

Exhibit 22: Lancaster Absolute Return Focus Fund | Estimated factor return as at 12-Jan-24



Source: Lancaster IM unaudited internal data & Bloomberg, as at 12-Jan-24. Note: Assumes current currency hedging; The information above is an estimation of the expected factor return; Lancaster may make investment decisions that are inconsistent with these views expressed in this communication. The chart above presents projections of future performance. These projections are based on a number of assumptions that may or may not prove to be accurate. Future performance is subject to a wide range of significant risks. As a result, there can be no assurance that the projections in the chart above will prove to be accurate.

—

James Hanbury & Jamie Grimston

Lancaster Absolute Return Focus Fund

Net Performance (GBP)

	1-month	3-month	1-year	3-year	5-year	YTD	Inception	Inception CAGR
Fund	1.2	-7.9	-18.3	5.5	68.0	-18.3	65.7	6.7
MSCI Daily TR Net World	3.7	6.6	17.3	32.0	82.4	17.3	146.5	12.4
Relative	-2.5	-14.5	-35.6	-26.6	-14.4	-35.6	-80.1	-5.6

Monthly Performance (net)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2023	4.2	-0.2	-1.5	0.6	-10.5	-7.6	1.9	3.4	-1.1	-1.7	-7.5	1.2	-18.3
2022	9.9	-13.2	-9.7	15.7	5.5	-11.1	-0.6	1.4	-5.9	20.6	12.4	2.2	22.8
2021	-14.1	20.8	0.6	4.8	3.8	-9.2	-2.0	1.4	9.2	-9.5	-9.5	14.7	5.1
2020	-4.6	-4.4	-17.4	13.7	8.9	2.9	-6.0	17.9	-2.7	7.0	24.1	6.0	45.6
2019	8.5	-8.5	0.9	-5.0	3.3	-9.1	-5.1	1.5	0.6	8.0	4.0	12.4	9.4
2018	0.9	0.7	-1.0	7.4	4.9	0.3	2.1	-4.6	3.0	2.6	3.3	-9.2	9.7
2017	0.4	-3.8	-0.5	3.1	2.9	0.4	-1.4	9.9	-0.6	1.5	-3.0	-6.9	0.9
2016				-3.1	4.3	3.1	-1.4	-0.6	-1.2	-6.9	0.6	-5.8	-11.0

Fund details[1]

£ I Class	161.33
£ A Class	165.69
$ I Class	171.50
$ A Class	179.67
Fund Size	£90 million
Strategy AUM	£890 million
Fund Inception	30-Nov 2015
Class Inception	30-Nov 2015
Fund Type	Irish ICAV QIAIF
Comparators	Primary: Cash Secondary: MSCI Daily TR Net World GBP
Base Currency	GBP

Team & contact details

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Top 10 Long Equities

	% NAV
IWG	19.3%
Frasers Group	17.9%
Ubisoft Entertainment	14.1%
Plus500	11.1%
Jet2	8.7%
Glencore	5.2%
Natwest Group	5.1%
Shell	4.9%
BP	4.8%
Liberty Global	4.7%

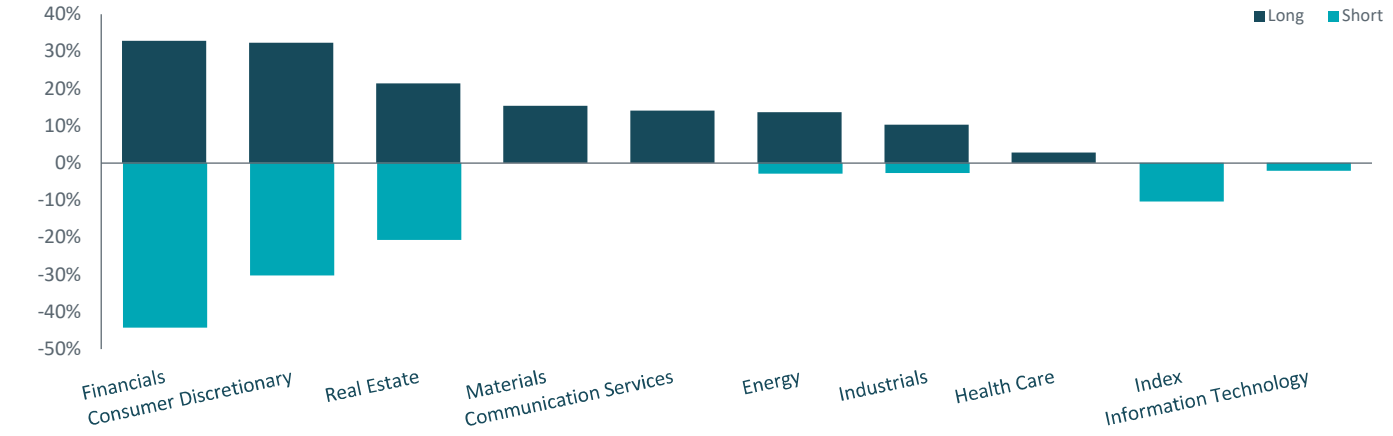
Portfolio Characteristics

Long position count	30
Short position count	33
Gross long exposure	143%
Gross short exposure	-116%
Total gross exposure	259%
Net exposure	27%
Beta adj. net exposure (2yr)	-46.4

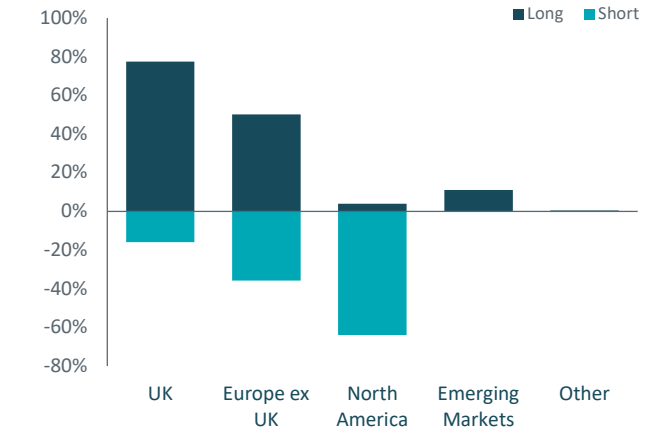
Important information
These figures refer to the past. Past performance is not a reliable indicator of future results.
This document is a marketing communication. Before subscribing please read the prospectus, available upon request from Lancaster IM. The performance calculation shown is based on the GBP A share class. If the past performance is shown in a currency which differs from the currency of the country in which you reside, then you should be aware that your performance may increase or decrease as a result of currency fluctuations.

Source: All sources, unless otherwise stated, are Lancaster IM internal unaudited data and refer to the £ A share class. All data shown as at 31 December 2023.
[1]US Global Fund Services and Bloomberg, calculation on a NAV basis with net income reinvested.

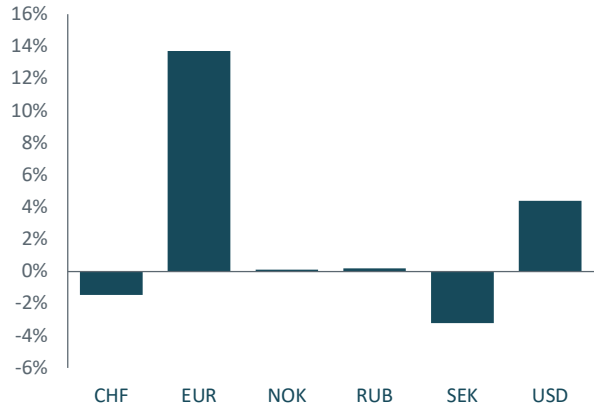
Equity exposure by sector



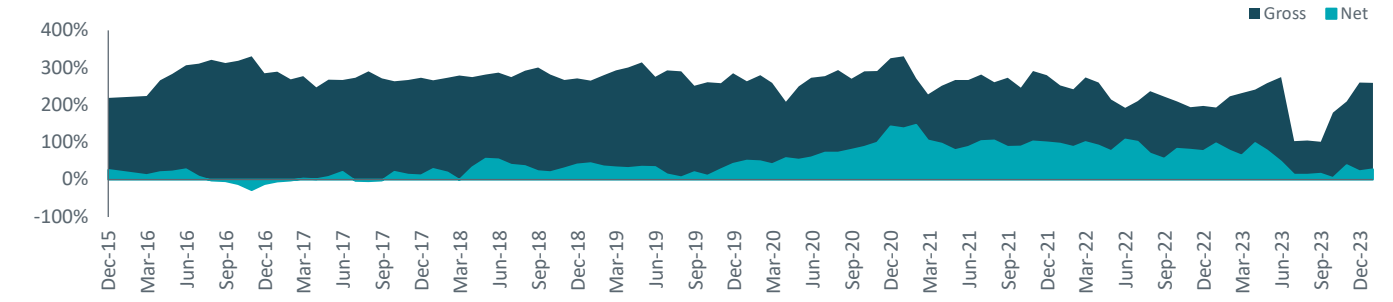
Equity exposure by geography



Non-base currency exposure



Equity exposure



Equity exposure includes all equity related instruments. Government Bond exposure can be provided on a ten-year adjusted basis. Currency exposure shows non-base currency through forward currency contracts and portfolio holdings. Commentary is provided on a quarterly basis. Equity exposure as classified by GICS. The fund was renamed from Brook Absolute Return Focus Fund to Lancaster Absolute Return Focus Fund in Q3-23 on the back of the Investment Management Agreement and the investment team transferring to Lancaster Investment Management LLP. All performance in GBP.
Source: All sources, unless otherwise stated, are Lancaster internal unaudited data and refer to the £ A share class. All data shown as at 31 Dec 2023. [1]US Bank Global Fund Services and Bloomberg, calculation on a NAV basis with net income reinvested – the share class prices refer to NAV per share.

LANCASTER
INVESTMENT MANAGEMENT

Investment objective and policy

The Lancaster Absolute Return Focus Fund ('The Fund') aims to achieve a positive absolute return on a 12 month rolling basis independent of market conditions. Capital is at risk and there is no guarantee that a positive return will be delivered over any one or a number of 12 month periods. The Investment Manager seeks to achieve this objective through managing a portfolio of securities, bonds and currencies and related financial instruments.

Approach

This is a fundamentally driven equity long short strategy. It is concentrated, global in scope and built around three core principles; investing in fundamentally sound companies, disciplined short selling, and diversification. On the long side, the approach is valuation driven with a particular focus on sustainable free cash flow generation. On the short side the portfolio is stock-specific. The strategy harnesses the experience and judgement of James Hanbury, his investment team and the wider equity research resource at Lancaster Investment Management. While the team invest for the medium to long term, position sizing is dynamic to ensure the portfolio remains focused on highest conviction ideas. The Fund is built without formal reference to an index and typically contains 20-30 positions long and 15-20 positions short with a high concentration in the top 10 positions on each side.

Risk Considerations

The Fund has considerable latitude over its allocation both long and short equities and it may employ leverage and own sophisticated instruments such as futures and options. The Fund may hold a large weighting in a small number of investments and may therefore be subject to larger than normal swings in its value. The performance stream is likely to be volatile and the Fund is suitable only for investors who have a long time horizon (>5 years) and can tolerate high risk. Investors may not get back all the money invested and an investment in this Fund should only form part of an investor's total portfolio. Investors should discuss the suitability of this Fund with their professional adviser.

Investor information

Share classes	I (€, £, $)2, A, B, C (€, £, $)	**Anti-dilution fee**	On all orders
Share class hedging	Non-base currency share classes are hedged	**Dividends**	Income accumulated and reinvested on behalf of shareholders
Trade date	1st of month	**Administrator**	U.S. Bank Global Fund Services (Ireland) Limited
Valuation	Close of business T-1	**Depositary**	U.S. Bank Depositary Services
Front end fee	Up to 5%	**Auditor**	Deloitte & Touche, Ireland
Annual management fee	I & C 0.75%, A 1.25%, B 1.00%	**Price reporting**	Available from Lancaster IM on request. Also available on Bloomberg and from other third party data providers
Performance fee basis	I & A 20%, B 18%, C 15% of the increase in the value per share of the Fund between the beginning and the end of the year or end of lock up period. Fees crystallise annually (31-Dec) or at the end of the lock up period. Losses carried forward.	**ISIN**	£I IE00BYQ96119[2], $ I IE00BYQ96226[2], €I IE00BYQ96002[2], £A IE00BD2MF988, €A IE00BD2MF871, $A IE00BD2MFB05, £B IE00BD2MFD29, €B IE00BD2MFC12, $B IE00BD2MFF43, £C IE00BD2MFH66, €C IE00BD2MFG59, $C IE00BD2MFJ80
Exit fee	Up to 5% if outside redemption period (A 1-month, B 1-year, C 3-year)	**SEDOL**	£I BYQ9611[2], $I BYQ96222[2], €I BYQ96002[2], £A BD2MF98, €A BD2MF87, $A BD2MFB0, £B BD2MFD2, €B BD2MFC1, $B BD2MFF4, £C BD2MFH6, €C B D2MFG5, $C BD2MFJ8

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