J O Hambro
Capital Management Group

News

A Shrinking Market Brings Short-term Gains But Longer-term Pain

As buybacks, M&A and transfers to the US slowly but surely reduce the UK equity market, short-term benefits will turn into long-term costs

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14 Apr 2024

The UK stock market is currently analogous to a melting ice-lolly – the number of stocks and the aggregate market cap is falling. There's a triangle of factors at play here, including mergers and acquisitions (M&A), share buybacks and companies leaving the UK market.

All of these factors are material and accelerating. Can anything be done to reverse this trend?

2023 was a sluggish year for M&A impacted by a rise in interest rates and 'risk off' sentiment (e.g. the reaction to the liquidation of Silicon Valley Bank). In 2023 around 1% of the market exited via M&A. This has turned into a feeding frenzy at the start of 2024.

In the first quarter of the year we have already seen 13 bids, including seven FTSE 350 stocks. Two of these bids affected our JOHCM UK Equity Income Fund (the 'Fund'), with International Paper confirming its £5 billion-plus bid for **DS Smith**, the FTSE 100 paper and packaging group. The US investment group Elliott's bid for electrical goods retailer **Currys** dropped away after we and other shareholders held firm for a higher valuation. At the mid-point of our publicly communicated range, the premia would have been c100%. This just shows how cheap the UK market is. It is this cheapness that is driving the trend towards 'de-equitization'.

The first quarter bids already add up to a total of £17 billion, around 0.75% of the UK market. We would expect this trend to continue, resulting in a material increase in M&A during 2024 compared to 2023, annualizing at 3% of the market by the end of the year, if the current pace persists. A sobering report from Peel Hunt predicted that at this rate the UK's small cap market, which is where M&A has been rife, would disappear by 2028.

Alongside the acceleration in M&A, we have seen a material increase in buyback programmes. It often feels as though the daily RNS regulatory newsflow feed is dominated by 'transaction in own shares' announcements. Some of these buybacks have been astonishing in magnitude. Barclays, for example, aims to buy back up to a third of its shares in issue over the next 3 years.

15% of the UK equity market could disappear

In 2023, 5% of our total share count in the Fund was retired via buybacks. Currently around half the companies in our Fund are buying back their shares, driven by a combination of boardroom frustration with multi-decade low valuations, a backdrop of strong balance sheets and robust trading. We think the proportion of the Fund retired via buybacks will reach a similar number again in 2024. That's 10% of the market cap of the Funds' holdings disappearing in two years through buybacks alone.

Meanwhile, companies are leaving our shores - mainly for the US, where they anticipate enjoying a higher valuation, higher remuneration for top management and a more liberal governance regime. Shell's former chief executive, Ben van Beurden, recently fuelled fears the company could quit London for New York, saying it is undervalued in the UK and that US investors are 'more positive' about fossil fuels.

Betting company Flutter, one of the more highly rated UK stocks, plans to leave the London Stock Exchange in June. Flutter makes up 1.2% of the FSTE All Share Index. When that moves to America, it on its own, will take a meaningful bite out of the lollipop.

Unfortunately, when we start adding this triangle of M&A, buybacks and exits together, we find they could add up to 15% of the UK equity market disappearing in just two years.

In normal times you'd have new companies coming to the market which would offset some of this, but the Initial Public Offering (IPO) market is currently as good as dead. We're seeing some IPOs diverted to the US and what would be IPOs being sold from one private equity fund to another. The reason is they can't achieve the valuation they would desire via an IPO in the UK. Why would we sell one of the 60 holdings in the Fund that have 50-300% upside to buy an IPO where the price is fair to full? IPO's tend to come with higher financial leverage and full earnings forecast agendas too, which compare negatively to what we own.

In the short term the melting lollipop trend highlighted above has some merits because of the earnings, dividend and value accretion driven by buybacks and the sort of premiums we might expect on M&A deals. But on a five-year view, it's bad for the UK as it narrows the market and it is likely the better companies that are succumbing to M&A. It is also bad for GDP growth because we're losing companies that have headquarters here, create jobs here and pay taxes here.

As the table below shows, UK institutions have a materially lower home bias than all other major economies. The need for strong policy action is clear.

Pension Fund Equity Allocations

	Domestic Equity Allocation	MSCI Weighting	% Relative Weighting
Australia	37.7	1.3	2,800
Italy	41	0.6	6,733
Japan	49.4	4.4	1,023
France	26	2.7	863
USA	63.5	43.2	47
UK	2.8	4.5	-38

Source: Capital Markets Industry Taskforce, as at 31 December 2023.

The Treasury has been trying to make it easier to list in the UK. But that's a red herring. The main issue is the valuation differentials discussed above not how hard logistically it is to list in the UK.

Some commentators think the British ISA proposed by Jeremy Hunt will help solve the problem. It is a positive move – a step in the right direction - but relatively small. The maximum investment is £5,000 and it is only allowed once the standard £20,000 allowance has been used up. The incremental investment is likely to be less than BP's annual buyback.

We need much more substantive change.

One effective measure would be cutting stamp duty on UK shares, which several stockbrokers and investment platforms are campaigning for. Investors pay 0.5% in stamp duty on the price of UK-listed shares they buy – but the tax does not apply to the purchase of shares in foreign companies. This is a bizarre anomaly.

Other effective measures would be more substantive rollback of tax such as taking capital gains tax off UK-quoted assets or reversing Gordon Brown's infamous removal of dividend tax credits.

In the Budget, Hunt announced new requirements for Defined Contribution (DC) pension funds to publicly disclose their level of investment in the UK by 2027. This again is a step in the right direction but it is hard to see what practical difference it will make. We can tell you that we hold two UK-listed retail stocks, but the requirement to tell you doesn't motivate us to buy a third.

We also need to address the various prudential requirements for Defined Benefit (DB) pension funds that drive them to hold fixed income, removing large asset pools from the equity market altogether. Data from the Pension Protection Fund shows that UK DB pension plans invested only 7.6% of their equity allocations into domestic listed companies in 2023, down from 48% in 2008.

We don't just want disclosure, we need a step beyond that to a policy that says all UK pension funds have to hold a certain percentage, perhaps at least 10%, in listed UK assets. Although Hunt said if he doesn't see action from the additional disclosure requirements, he'd introduce this type of requirement for DC pensions, we think action needs to apply to all pension funds. It also needs implementation earlier than the current timeline suggests. Otherwise, investors in UK shares could be left with very little lollipop left on the stick.

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