J O Hambro
Capital Management Group

News

Market liposuction

As we exit the extended lockdown period of stimulus super-binge, 2022 is likely to bring a dose of central bank liposuction treatment...

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Market liposuction

As we exit the extended lockdown period of stimulus super-binge, 2022 is likely to bring a dose of central bank liposuction treatment. The US Federal Reserve in particular is aiming for balance sheet reduction and interest rate rises at a faster pace than the actions it took in 2018. Meanwhile the longer term themes of de-globalisation, the need to re-shore supply chains and politically-driven wage increases are helping to drive more sustained inflation. Periods of policy change typically bring with them market banana-skins. The fund is in a healthy and resilient position and we look forward to 2022 well-prepared with good drivers of structural growth, companies which are investing and able to offset the effects of inflation and overall attractive levels of upside. It is in periods of rising volatility that our investment process has typically come to the fore and in recent years our work on 'watch list' stocks has left us well prepared for when the opportunities come along.

Here are 3 ways we're positioning the portfolio for success in 2022:

1) Growth and valuation

We have always been believers that valuation matters and that measures of valuation should be absolute, not relative. The bubbles created by the pursuit of 'growth at any price' in recent years have posed a challenge to our investment approach, but we have maintained the discipline of building a portfolio well-run companies exposed to thematic growth 'tailwinds'.

The current portfolio strikes a healthy balance between growth, quality, and valuation. Our conservative estimates for the fund include 3-year revenue growth of 7% per annum, an average ROCE of 15.2% and an average valuation of a 7% free cash flow yield (which equates to around a 14.5x Price/ Earnings ratio).

The drivers of structural and cyclical growth within the fund are strong. The position of many of our 'industry-leaders' has become stronger through the pandemic as their leading investment in areas such as data and systems has helped to ward off rising input costs and has increased the gulf between them and weaker competitors. Examples of companies where recent trading updates have demonstrated meaningful market share gains include SSP, Whitbread, Next and Bodycote.

In spite of inflationary headwinds and potentially rising interest costs, in most markets the consumer is still benefiting from elevated levels of savings and for the first time in a long time, are receiving pay rises. To put this in numbers, the 20% fall in household discretionary spending in 2020, was followed by a 12% rise in 2021*, and this level of increase could be superseded in 2022 as pent-up demand for events and travel are unleashed.

2) Borrowers beware

Years of quantitative easing have given markets a distorted price of risk, and with it over-leverage at the government and corporate level. According to Morgan Stanley data, UK plc (excluding financials) remains on average geared 2.5x in Net Debt: EBITDA terms. Not only is this a high level of debt when the outlook for growth remains uncertain and political risks are elevated but will result in a growing interest bill if rates start to rise. This will act as a double-whammy to the margins of companies suffering from rising inflation in their cost base, when they face increased interests bills too. The market will not look kindly on companies trading on peak valuation multiples when their margins start to fade.

We continue to favour lower overall levels of leverage, with an average of 1x Net Debt: EBITDA in the fund. Certain companies in the fund do hold leverage, such as the utility businesses National Grid and SSE, but both of these benefit from a regulatory structure and a high level of fixed, inflation-linked assets. We continue to avoid cyclical companies which hold inappropriate levels of debt, favouring the upside a company like Hays can give us, with significant growth in recruitment and wages which we're experiencing, and net cash on the balance sheet for when times get tough.

3) Inflation protection

For any company with an inflating cost base, the need to grow sales organically is becoming critical. Our focus is on finding companies with strong growth tailwinds and levels of investment in areas such as data and systems where they can eek out productivity gains and offset rising inflation.

The fund is full of companies with leading market positions where the ability to pass on price remains strong. Where possible we look for companies where there is inflation-linking in contracts, for example in utility companies, or where they can directly benefit from inflation in prices such as the mining companies Anglo American and Glencore, or for Hays through rising wages.

Q4 2021 performance and portfolio changes

Performance

The fund returned 0.49% in Q4 which was behind the FTSE All-Share total return index (12pm adjusted) which was up 3.62%. In absolute terms National Grid, Anglo American and WPP led the best performers. The barrage of Q3 results in the period saw the vast majority of the companies in the fund delivering positive updates.

CRH reported record profits and ongoing margin expansion in November. They expect both demand and pricing to be strong in 2022 and will be positively impacted by the passing of the $1.2 trillion US infrastructure package.

IMI which in recent years has focused heavily on new product innovation reported encouraging results from its growth acceleration programme in its Q3 results. Its businesses in both industrial automation and heating efficiency saw double-digit revenue growth.

WPP reported organic revenue growth of 16% for the third quarter of 2021 as it continues to win mandates in digital media and e-commerce services. New clients included Sainsbury's, L'Oreal and Beiersdorf.

Ashtead, SSP and Bodycote all reported growing market shares thanks to their balance sheets and willingness to invest ahead of their competition.

We had two disappointing updates, from QinetiQ and Johnson Matthey. After the issues QinetiQ faced in the US, and our questions around their M&A strategy mounted, our conviction in the long term upside for the company diminished and we took the decision to sell.

Johnson Matthey took the hard but ultimately positive decision to exit its battery technologies business as it was failing to reach scale in a highly competitive end market. Whilst the market reaction was severe, capital is now being re-allocated to better-positioned and higher returns parts of the group, including hydrogen technologies and its catalyst business Efficient Natural Resources where it has clear competitive advantages. The company has a strong balance sheet, healthy cash generation from its Clean Air division and good future growth in sustainable energy. At a 9% free cash flow yield, roughly 10x Price/ Earnings we think the risk and reward outlook remains in our favour so we continue to hold the position.

Portfolio changes
In October we started a new position in CRH which is a diversified building materials and solutions provider. It is asset-rich and in recent years capital allocation has improved, along with balance sheet leverage. We see good levels of upside in the company as it benefits from government fiscal spend on infrastructure assets in the coming years. In its largest market, the US, the recent $1trn infrastructure bill represents the largest increase in spend on physical assets in the US since 1959 and for roads, where CRH already provides 25% of asphalt surfaces, spend will increase by 30% per year for the next 5 years.

During the quarter we sold to zero Wood Group and PZ Cussons. We bought Wood Group in 2020 based on its ability to capture recovery in upstream activity and its leading position in green infrastructure design. The ongoing cancellation of upstream oil and gas capex has continued to weigh on the company's cash flows, and as a result of this and the drag of historic liabilities, the balance sheet had geared up towards 3x Net Debt : EBITDA. This level of leverage forced us to sell the position to zero as the level of potential downside was no longer acceptable and the company's ability to de-gear had become impaired.

We have been on a long journey with our holding in PZ Cussons, seeing it bring its Nigerian business back into profitability and the huge strides it has made in sustainability. With a large proportion of its products in fairly commoditised areas, upside was being hindered by competition and inflation where the outlook for passing on price increases in its major markets of Nigeria and Indonesia looked challenged. Based on a full valuation and limited growth, we took the decision to sell the position. We do remain engaged with the management team and will continue to be a part of their journey in sustainability.

Engagements

Q4 was a busy period for engaging with companies. We met with the management of Bodycote where we encouraging the company to set more challenging carbon emission targets and improve disclosure under the TCFD framework. We are awaiting the publication of disclosures in the group's annual report, due in February/ March and look forward to working with them to ensure their role as a solution to reduce emissions by consolidating volumes for OEM's and in the technologies they employ to deliver lighter metals is correctly recognised.

We also made a trip to see Next at their headquarters in Leicester to discuss the group's policies for reducing the use of plastic. We have been frustrated by the group's lack of disclosure and the heavy use of plastic packaging in its online division which we believe is not only damaging for the environment but also the group's brand as its competitors steal a lead with plastic-free solutions. We are urging them to become part of the New Plastics Economy Global Commitment which gives a leading level of disclosure and to explore the more sustainable packaging solutions supplied by companies, including portfolio holding Mondi.

*Source –Lazarus Economics, January 2022

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