

# INVESTMENT

## WEEK

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## A Deep Dive Into... UK Equities

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“When the facts change, I change my mind” is a quote commonly attributed to the legendary economist John Maynard Keynes. This is sound investment advice at a time when we are experiencing events that none of us have witnessed before.

The changing ways in which consumers, companies and governments operate requires the mental agility to challenge long-held convictions. The outlook for some sectors and companies, such as airlines or office property companies, has become bleak or at best, unknowable. Being able to admit where the facts have changed for the worse and implement a sell decision is vital for protecting client capital. Calmer periods will eventually come after this storm, but it is important to avoid the boats that sink while the storm is blowing.

On the positive side we know that for every loser in life, there is often a winner, and we believe there are some fantastic UK large-cap businesses that are positioned to benefit from the new environment.

Here are five factors we think investors should consider as we move forward in the ‘new normal’ and try to find those companies that will deliver long-term capital growth:

### The strong get stronger

The UK has plenty of best-in-class businesses with large market shares, levers to pull (thanks to characteristics such as high margins and strong cash flows), solid balance sheets and the ability to take market share on the other side of this crisis. Homeserve is on track to double its profitability in the next five years due to investment in new geographies and in building the leading trade search platform, Checktrade.com. Sage has invested heavily in cloud technology and as an enabler of remote working practices, meaning its double-digit revenue growth should accelerate. After years of investment in technology and distribution capabilities, Next has transformed itself into

the UK’s leading online clothes retailer, with 88% of profit now coming from online. We expect the trend of smaller retailers migrating onto Next’s online platform to continue in the coming years as they struggle with higher operational costs.

### Seek out structural shifts

When the near term is so volatile and uncertain, identifying sustainable structural change is key to protecting and growing capital. One of the largest changes in recent months has been the enormous role the government has taken in dealing with our economy and lives. Years of austerity have hollowed out western governments and this is now being reversed with capabilities being rebuilt and governments turning to the private sector to find solutions.

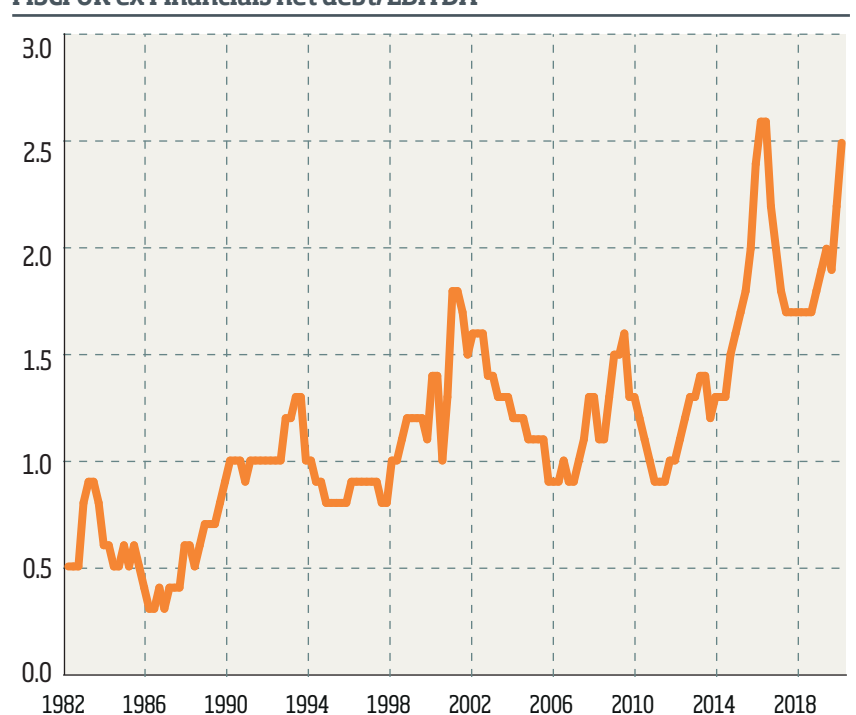
Serco is a company at the heart of this trend, where organic growth has accelerated from 6% last year to a current rate of 14%, in part due to Covid-related projects. Intertek now runs the world’s largest network of testing and certification for businesses that need to prove they are compliant with Covid-19 prevention measures. It also plays a key role in supply chain audit, which is an increased focus for governments and consumers. Meanwhile, in the utilities sector, SSE will benefit from fiscal policy initiatives that governments are using to deliver growth and a greener economy. Britain can generate more energy from offshore wind than Saudi Arabia can generate from its entire oil reserves, and SSE is the UK market leader.

### Diversity of cashflow

Investors should consider larger conglomerates over smaller, domestic companies that rely on one product or geography. A diverse set of cashflows means that if one product or region hits the rocks, the business can rely on other unaffected divisions for its survival.

Companies such as RELX can cope with a downturn in its exhibitions business because

### MSCI UK ex Financials net debt/EBITDA



Source: MSCI, FactSet Fundamentals, Morgan Stanley Research

its three other divisions, largely based on recurring subscriptions, have remained resilient. GlaxoSmithKline stands out with its leading position in the global vaccine market, already vaccinating some 40% of the world’s children. However, this is just one capability in a portfolio of hundreds of individual drugs that create resilient cashflows for investors. Unilever sells 400 brands across 190 countries and can therefore withstand a change in regulation in one country or weakness in a product line.

### Debt is more toxic than ever

Corporate debt has risen to extreme levels (see chart above). Many companies that look cheap on short-term ‘value’ metrics have balance sheets that will not withstand another downturn. Balance sheets must be repaired and those companies whose cashflow will be absorbed by debt repayments will not be able to invest for growth.

### ESG matters

Reputation matters, and those who have behaved responsibly before and during the Covid-19

crisis are likely to be rewarded. Companies that did not treat customers, suppliers or employees fairly during the pandemic may suffer the consequences for years to come. Governance and incentives need to be focused on long-term strategy rather than short-term outputs. Too many UK companies reward short-term outcomes where results can be manipulated, such as growth in earnings per share or where management have no control, for example, with short-term relative share price performance. We continue to argue for and back those companies with more balanced measures such as organic growth, return on capital, stakeholder satisfaction and balance sheet strength.

*Rachel Reutter is co-manager of the JOHCM UK Opportunities fund*