



# THE VALUE PUZZLE



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At the start of June we wrote a paper, '*Positioned for Recovery*', which highlighted that the performance gap between growth and value styles, which were already at record levels pre-Covid-19, had widened further in March and April. We also showed in that paper how cheap this had left value stocks and how cheap the Fund was on various metrics. We will publish a third paper in this series at the end of the month that will provide an update on the dividend outlook for the Fund for 2021. In that paper we expect to reaffirm, with detail, our previous comment that the 2021 Fund dividend will be closer to the 2019 level than the 2020 level.

Jigsaw puzzles have proved a popular distraction during lockdown, and in this second paper we have broken the Fund 'jigsaw' down into its different sector pieces. This should help investors understand our positioning. It also places in context our exposure to banks and oil, unloved parts of the market which we are understandably often asked about. We show in this paper the solid investment cases for those sectors, but also highlight we have more exposure to mining and insurance than oil and UK banks respectively.

We have written a few paragraphs on each sector to highlight which stocks we own and give a feel for the changes we have made since Covid-19 started. These changes have pivoted the Fund to better quality stocks but still with a value bias and with a clear capability to recover. The stocks discussed below, including the logos, represent 98.5% of the Fund excluding cash which is currently 2.2% (all data as at 15 June 2020).

Finally, for each sector, we highlight some valuation metrics which show how cheap stocks are across the Fund. Collectively, this cheapness at an individual stock level aggregates to paint a compelling picture that ties into the main themes we laid out in the first paper: the attractiveness of value versus growth and the overall cheapness of the Fund (its price-to-book value being the cheapest it has ever been in the Fund's 14-year history).

## Mining (13.0% of the Fund)



We start our sector tour with the beaten up mining sector. China has clearly recovered sharply from its Covid-19 crisis, with forward-looking PMI surveys now back above the 50 reading, the level which marks the start of expansionary conditions. There is clear evidence that the Chinese government has pumped up infrastructure spending to ensure that the recovery is entrenched. Feedback from our mining stocks suggests demand is running higher year on year, particularly for iron ore. Its price has moved to a multi-year high, partly as a result of China's rebound and partly owing to supply disruptions in Brazil. The copper price is also back to pre-crisis levels.

Both the demand and supply dynamics for certain commodities are favourable. The long-term outlook for certain commodities is also heavily underpinned by the switch towards green energy and electric vehicles, which use large amounts of copper, cobalt and nickel. The industry has also cut capex significantly in recent years, which means there is little new supply coming on stream in future years, which should lead to higher prices.

All our mining stocks have robust balance sheets. **Rio Tinto**, **Kenmare** and **Anglo American** continue to pay dividends, while **Glencore** (slightly more indebted than the others) is taking what is likely to be a one-year dividend holiday. **Central Asia Metals** is deferring its dividend whilst it assesses the impact of Covid-19 on the countries it operates in.

Valuations of mining stocks are close to lows when compared to the previous 30-40 years. Rio Tinto is the most expensive of the group on a 10% underlying free cash flow yield. The others have free cash flow yields of 10-25%. These compelling valuations are before any moves higher in commodity prices.

## Oil (12.7% of the Fund)



The oil sector continues to have strong valuation attractions despite the obvious need for the large integrated companies to progressively transition their businesses towards low-carbon operations.

Our biggest holding here is **BP**. It has been an industry leader in the adoption of new technology to drive down operating costs in its core operations. The new CEO, Bernard Looney, will increase the group's exposure to renewable opportunities, particularly in solar and hydrogen where it already has expertise. This change of capital allocation may include a reduction in the annual dividend. However, this could still leave the stock yielding around 6.5%, which would be highly attractive given BP's low costs of production. Over time, we would expect oil and gas prices to rise from here as demand recovers from the Covid-19 shutdown and due to global supply reductions. Making assumptions about the downstream operations and the gas price, BP's pre-dividend breakeven oil price is very low at c. \$10/bbl.

Elsewhere, **Diversified Gas & Oil** is a smaller company specialising in the efficient production of onshore gas in north-eastern America. It has acquired a series of operations at modest multiples and generates an annual free cash flow yield of well over 20%.

## Banks (11.5% of the Fund, of which 9.5% is UK domestic banks)



'Uninvestible', 'publicly-owned utilities' and 'an extension of the civil service' are some of the comments that have been levelled at UK banks by professional investors of late. Similar to the old economy/new economy narrative around the TMT bubble, when such views become the received wisdom it is normally the time to take the opposite stance.

We see plenty of positives in this unloved corner of the market. For a start, this recession is different from the global financial crisis. Unlike 2008, banks have enough capital, which means they are unlikely to need to resort to damaging and dilutive rights issues. Because of this (and also new accounting standards) they made bigger provisions earlier, getting ahead of the curve rather than being behind it, as they were in the GFC. They have ample liquidity and are working with the government to be part of the solution this time, not part of the problem. Furthermore, the government's fiscal response (e.g. the furlough scheme, 'bounce back loans', etc.) should underpin the economy and its recovery and therefore lower the delinquency rate. Record levels of market volatility have also been a boon for their trading divisions. Lastly, the banks are more professionally managed now.

These factors have been dismissed by the market, which values the sector at close to a 20-year low, with individual valuations in some cases even eclipsing lows seen in the darkest days of the financial crisis.

In the first two weeks of the Covid crisis in the UK, we exited HSBC when it was trading at a six-year relative high after investors scrambled to the perceived safety of size. In its place we added to **Standard Chartered**. It has the best GDP footprint of all the UK-quoted banks and trades on a lowly 0.4x book value. We have also continued to run **Barclays** at an elevated level on a similarly low valuation. On a medium-term basis both these shares should be able to trade at tangible book value. **Paragon Bank** is well placed, with the scope for underlying income to increase due to positive mix changes and growth in its franchises. We also own **Lloyds Banking Group**. It has c. 40-50% upside potential, in our view, but our other banks have better growth prospects and higher upside opportunities given their starting valuations. We expect all our banks to return to the dividend list in 2021, with Paragon and Standard Chartered likely to come back earlier by posting final dividends for 2020.

## Insurance (11.1% of the Fund)



The insurance sector has been harshly treated by markets during the Covid-19 crisis. Our largest two stocks in the sector, **Phoenix** and **Legal & General**, are both predominantly life and pension companies, with little or no exposure to areas affected by Covid-19, such as business continuity Insurance. They have both managed their corporate credit book exposures relatively conservatively and as such have continued to pay their highly attractive dividends (both stocks yield over 7%). We view Phoenix in particular as being one of our most defensive and dependable businesses in the whole portfolio, with the vast majority of the group's value in its closed life book, where it has hedged out most asset risk. This book will generate cash equivalent to the current market capitalisation over the next 6-7 years, even though the duration of that book extends for decades.

**Randall & Quilter** is a little known, entrepreneurial insurance company with an exciting future. Part of the business generates cash from buying legacy insurance books in run-off at discounted prices. It also acts as an insurance broker in the reinsurance market in the US and Europe, where it is developing a fast growing and highly valuable recurring fee business. If the businesses were separately valued or better known, we could easily see a valuation around twice the current share price.

## Building & Construction (9.5% of the Fund)



We expect the government to extend the help-to-buy scheme and detail further infrastructure spending in an early July fiscal announcement. It is already clear that infrastructure spending has accelerated, with HS2 confirmed and a series of road contracts announced since the Covid-19 outbreak started in the UK. It is also clear after the Carillion and Kier corporate debacles that the terms of trade for government contractors have improved in both margin and cash flow terms.

On the housing front, indications from estate agents, trading updates from house builders and other sources suggest housing activity has restarted strongly as lockdown has eased, with enquiries and exchanges moving back to pre-Covid levels.

This could be a golden decade for UK construction. **Costain** and **Eurocell**, two of our 10 stocks in this subsector, have raised money to take advantage of the attractive market backdrop and, in the case of Eurocell, competitor failures. Based on cautious assumptions and an exit multiple of just 10x EPS, we believe Costain's share price could double; if management meet their margin targets, based on the same multiple, it could treble. We have materially added to both positions across the last three months as well as **Countryside**, **Tyman** and **Vistry**. This sector is extremely well placed.

## Retail (7.5% of the Fund)



The Fund's retail exposure is dominated by UK food retail (6% of the 7.5% sector position), which has had a good crisis given its essential nature and the shift from eating out to eating at home during the lockdown phase. The latter is likely to be an enduring tailwind. Even when the lockdown is completely lifted the recovery in demand in the restaurant and pub sectors (where the Fund has zero exposure) is likely to be slow due to social distancing rules and customer caution. As some consumers remain reluctant to dine out or head to the pub, like-for-like sales in the food retail sector could be boosted by a few percentage points, which is a material uptick in this mature sector.

It is also increasingly clear we are past the peak of the threat from the discounters (e.g. Aldi and Lidl) to the 'Big 4's' market share, as the latter have mitigated this with more competitive pricing over the last three years. **Tesco**, our largest exposure, is trading on a free cash flow yield of c. 10% and significantly strengthened its balance sheet after it recently sold its Asian business. The main risk to the supermarkets is a tax on perceived Covid-19 'winners' to help pay for the massive fiscal costs of the crisis.

In general retail, our main holding is **DFS** (c. 1.5% of Fund). It raised money during the crisis, which puts it in a strong position to assert its dominance as certain competitors have failed and others look vulnerable. We expect DFS's market share to increase from 34% to c. 40%. There will also be a degree of pent up demand for its product, as Britons get off their sofas and head out to buy new ones, amongst other hopefully economically productive activities. The stock has 50% upside, in our view, assuming a prudent exit multiple of 12.5x of recovered earnings.

## Telecoms / Utilities / Defensives (7.0% of the Fund)



The two large active weights in this defensives bucket are **Vodafone** and music rights investment fund **Hipgnosis**.

Vodafone is performing well under CEO Nick Read. It is reducing capital employed by network sharing agreements, cutting costs by digitalising its business and has lowered debt through an increased geographic focus and the upcoming part IPO of the Towers business. The epidemic has also reminded government of the importance of telecoms networks. This may prompt a change in Ofcom's (and the EU regulator's) mindset, where the telcos are also rewarded for investing in their networks rather than purely on the basis of price competition. Vodafone cut its dividend in 2019, so should have the strength to come through the Covid crisis relatively unscathed, although lockdown has seen roaming

fees fall sharply.

As well as the value versus growth dynamic in the stock market, one of the other major current anomalies is between the debt and equity markets. Vodafone's 30-year debt trades at a yield of 2.5%; its equity yields 6.5%. This does not make sense.

Hipgnosis plays into our tradition of finding differentiated small cap exposure with material upside. This is a £700m market cap investment company focused on music intellectual property rights. Drawing on the extensive industry contacts of Merck Mercuriadis, the company's founder and former manager of artists such as Guns N' Roses and Beyoncé, the fund has assembled a high quality catalogue that includes tracks from the likes of Nile Rodgers and Dave Stewart of Eurythmics fame.

The structural tailwinds here are appealing. Legal music streaming is rapidly replacing illegal downloading as consumers subscribe to quality aggregated content, e.g. iTunes and Spotify. The pandemic lockdown has only helped accelerate this switch. Growing smartphone usage in emerging markets and more proactive rights management will expand the addressable market significantly, while recent changes to US copyright legislation mean royalty rates for songwriters will increase by c. 50% over the next five years.

Historic acquisition multiples of 12.6x net income (i.e. a P/E of c. 12x) do not reflect the dramatic improvement in the monetisation prospects of songs or the longevity of these income streams. The net asset value, which is up c. 14% year to date, is based on a discount rate of 9%, which we think is too high versus other assets. Applying a more appropriate 7% discount rate would add c. 35% to the NAV.

**SSE** and **Drax Group** (1% aggregated position) are focused on clean energy generation, e.g. wind and biomass, and are well placed for the green energy revolution. We have kept SSE's weight low while waiting for clarity over its dividend policy and its balance sheet. Our modest weighting also reflects the stock's relatively high valuation created by demand for ESG assets.

We are steadily building up our position in Drax, which is much cheaper than SSE. Drax, which supplies 5% of the UK's electricity, has converted four of the power station's six generating units to use sustainable biomass instead of coal. This has transformed it into the UK's largest renewable power generator and the biggest decarbonisation project in Europe.

## Global Cyclical (7.0% of the Fund)



The average share price of the four stocks (**Page Group**, **National Express**, **WPP** and **S3**) that make up this group fell 50% in the initial phase of the pandemic. This was one of the main areas of the Fund which we added to during the market sell-off. We moved WPP to a top five active position, materially increased our recently introduced position in Page Group and brought National Express back into the Fund.

Recruitment groups Page and SThree are global businesses, earning less than c. 15% of their revenues in the UK. They have seen a shallower 'V' than initially expected and more signs of recovery thereafter. SThree is particularly interesting as its end use market focus is STEM, with technology and life sciences both



being high exposures. These areas should be substantial growth drivers after Covid-19 given likely structural changes. Countries that suffered early in the pandemic spread, e.g. China in the case of Page Group, are already showing robust recoveries. Both stocks have net cash on their balance sheets.

Turning to WPP, it boasted a solid balance sheet entering the crisis after the timely part sale of Kantar. The new management team has reinvigorated the business to focus on technology, while the recent appointment of Sainsbury's well-respected former finance director is likely to see a re-engineering of the cost base. As with the recruitment companies, recent news flow from the advertising sector suggests the trends are better than current expectations. And WPP's valuation looks compelling. Conservatively assuming that the advertising markets only recover half of the ground lost during the pandemic next year, the shares would sit on an 11-12% free cash flow yield.

We sold National Express from the Fund in H1 2019 at 450p on valuation grounds. But we got back on the bus in May when we bought into the stock again at half that price. Its operations have obviously been affected by Covid-19, but certain elements of its business, like the US school bus division (which accounts for a third of group earnings), should recover quickly. Furthermore, governments are part funding public transport in its two other main markets (UK and Spain), given public transport is a vital element in the post-Covid recovery. Management expect earnings to recover to 2019 levels by 2021, helped by market share gains. This would put the stock on a P/E of just 8x.

## Other Financials (6.4% of the Fund)



Our other financials exposure is dominated by three stocks: **Standard Life Aberdeen**, **TP ICAP** and **Polar Capital**.

Standard Life Aberdeen is the largest holding in this sub-sector. It has started to see the historic net outflow of funds switch around in recent months, which is a major positive change. The majority of the value in the stock resides in its two quoted stakes in HDFC's life insurance and asset management businesses in India. It continues to sell down these holdings, which means cash at the group level is high and the share buyback continues. Stripping out the Indian stakes and excess liquidity, SLA's rump asset management business currently trades on a paltry c. 5x earnings.

TP ICAP, the world's largest broker/dealer, is benefiting from a dramatic increase in market volatility and volumes, with revenues up strongly year to date. Underneath that the new management team has repositioned the business to streamline costs, enhance growth and increase the size of the separate data business. The stock is on a P/E of 9x and has net cash.

Polar Capital's share price is back towards its previous relative highs, helped by its fund mix including tech, healthcare and US equities and the growth bias of its fund stable. It also has a strong net cash position.

## Other UK Domestic (5.1% of the Fund)



In the short term, TV advertising has been severely affected by the lockdown as categories such as travel and retail have moved to

survival mode. As such, we expect **ITV** to report an almost halving of advertising revenue in Q2 2020, despite higher audiences. However, revenues should progressively improve in the latter phase of the year as the lockdown is eased. Assuming that growth in 2021 recovers half of the lost ground from this year would leave the group valued on a 12-13% free cash flow yield and around a 7x P/E. Given the inherent value in its studio production business and its back catalogue, this assumes very little value at all for the broadcast operation, despite strong audience figures over the last three years.

We expect relatively resilient trading at **Redde Northgate** during the economic downturn as demand for van rental has been supported by the need for more home deliveries. The benefits of the merger will also prove to be a useful offset as well as potentially opening up new business verticals in the medium term. With the net asset value currently substantially above the current share price and second-hand van prices holding up well, the shares look very modestly priced, trading on around 5x pre-Covid-19 earnings.

**Headlam's** robust balance sheet should enable it to grow market share in the UK floorcoverings market during the downturn and emerge as an even more dominant operator.

## Paper / Packaging (3.9% of the Fund)



This is one of the Fund's defensive buckets, where we have used Covid-19-based share price weakness to materially add to **Mondi**, a recent Fund addition, and longstanding holding **DS Smith**. Their end-use markets are FMCG-dominated, which, along with increased need for packaging for online fulfilment, led to resilient demand during the crisis. Both companies are also benefiting from the structural shift from single-use plastics to sustainable packaging. This could be a game-changer for this sector. The move away from plastics could accelerate as governments are likely to increase taxes on plastics to speed up the transition to a greener economy whilst also looking for tax targets to fund the hit to public finances caused by Covid-19. On our normalised earnings estimates, both stocks trade on a P/E of 10x, with a reasonable expectation of 30-40% upside to their current share prices. This would leave them on earnings multiples of 13.5x, in line with recent share price highs ahead of the Covid-19 sell-off. They would re-rate further if the switch away from single-use plastic leads to sustainably higher growth rates.

## Other (1.6% of the Fund)



Two stocks that do not fit into the other buckets are **EasyJet** and **Raven Group**. The former has plenty of liquidity and should be a long-term winner, both within the broad airline sector and more narrowly within the low-cost flyer segment as the legacy airlines continue to retrench. It has a new management team that was starting to deliver multiple new growth drivers ahead of the pandemic (e.g. EasyJet Holidays, the use of AI to drive up flight yields and cost reduction via process re-engineering), while the stock is trading below the value of the company's tangible assets.

The two issues facing EasyJet are the short-term repair needed after lockdowns and the implementation of social distancing, and

its starting net debt position. The cash cost of operating during lockdown means its debt levels will be too high, in our view, at the end of lockdown. Whilst it has ample liquidity, we think the company should raise equity. It would be wrong not to hold a small amount of the Fund in franchises such as EasyJet that should deliver real structural growth once these issues are resolved. As we noted earlier, we have no holdings in the more structurally challenged restaurant and leisure sector and limited holdings in general retail.

Raven Group is Russia's equivalent of Segro, the latter being the leader in logistics warehouse space in the UK and which has generated significant value as retail's shift online has created increasing demand for big box warehouses. Raven Group trades on c. 35% of book value due to a shareholder overhang. And this NAV is based on the properties being valued on an 11% yield (versus c. 4% in the UK and Europe) – there is effectively a double discount being applied here. This is a remarkably cheap stock, in our opinion.

## UK Property (1.5% of the Fund)



Commercial property is one part of the economy that has been structurally impaired by Covid-19. The crisis has accelerated the transition to online shopping, led to numerous retailer insolvencies and seems highly likely to change society's requirements for office space. In the leisure and retail sector, as well as speeding up existing pressures and creating new longer-term ones (e.g. reduced demand for out-of-home dining), it has also hollowed out near-term income due to low rental collection percentages. This will likely continue for the next few quarters at least.

The second derivative impact is that the resultant fall in property values – which we think could be 25+% in certain sub-sectors – will lead to a rise in loan-to-value ratios. Commercial property is the sector that will likely see the most significant deterioration in debt metrics because of the Covid crisis; government support across many other sectors means most companies should be cash neutral across the 'V' of the economic contraction and recovery. The step change higher in loan-to-values could lead to dilutive rights issues. For all these reasons, we have therefore reduced our weighting to just 1.5% of the Fund.

We own three property stocks. Two, **Real Estate Investors** and **Palace Capital**, are nimble, vanilla names that have broad exposures and are focused on specific markets (e.g. the West Midlands). The other stock, **U&I**, is focused on urban redevelopment in partnership with local government, which is likely to be a major plank of central government policy. U&I moved quickly to sell assets in the initial stages of the crisis and raised £70m, which is 70% of the company's current market cap. This significantly strengthened the balance sheet. This stock trades at a mere 33% of its historic NAV.

## Conclusion

In recent months we have regularly pointed out how stretched the relationship between value and growth styles has become and that this should begin to normalise as economies stabilise. Hopefully the granular bottom-up detail that we have provided in this piece will highlight the substantial upside potential across our portfolio in a variety of sectors. We strongly believe that some of these stocks have the potential to rise 50+% from here, as many of them did in similar conditions in 2009.

## JOHCM UK Equity Income Fund

### 5 year discrete performance (%)

#### Discrete 12 month performance (%):

	31.05.20	31.05.19	31.05.18	31.05.17	31.05.16
A GBP Class	-20.99	-12.21	12.66	27.85	-11.12
Benchmark	-10.02	-3.52	6.41	24.51	-6.80
Relative return	-12.20	-9.01	5.87	2.68	-4.64

### Past performance is no guarantee of future performance.

Source: JOHCM / Lipper Hindsight. NAV per share calculated net of fees, net income reinvested, 'A' accumulation share class in GBP. Performance of other share classes may vary and is available on request. Inception date: 30 November 2004. Index return is net income reinvested, adjusted for 12pm.

Source: JOHCM/Bloomberg unless otherwise stated. Fund launch date 30 November 2004. Issued by J O Hambro Capital Management Limited authorised and regulated by the Financial Conduct Authority. The value of investments and the income from them may go down as well as up and you may not get back your original investment. Any forecasted dividend yield quoted is prospective and not guaranteed. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. The Fund's investment include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. Source: JOHCM/Bloomberg/FTSE International. Note for return history: NAV of share class A in GBP, net income reinvested. Benchmark: FTSE All-Share TR Index. Performance of other share classes may vary and is available on request. FTSE International Limited ("FTSE") © FTSE 2017. The Industry Classification Benchmark ("ICB") and all rights in it are owned by and vest in FTSE and/or its licensors. "FTSE"® is a trademark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. Neither FTSE or its licensors accept any liability for errors or omissions in the ICV. No further distribution of ICB is permitted without FTSE's express written consent. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Holdings Ltd. Registered in England and Wales under No: 2176004. Registered address: Level 3, 1 St James's Market, London SW1Y 4AH, United Kingdom.