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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

Alex Savvides, JOHCM UK Dynamic Fund

Investment background

Global equity markets suffered another poor month with nearly all major indices posting negative total returns as trade tensions between the US and China escalated. Following US President Donald Trump imposing tariffs on steel, aluminium and US$50bn of Chinese goods, equity valuations, already shaken by rising inflation concerns last month, were forced to adjust further for potential earnings headwinds implied by the tariffs and any retaliatory actions by China.

Conversely, rising trade tensions have come at a time of continued strong economic growth globally, and particularly in the US. US non-farm payrolls increased by 313,000 in February, ahead of forecasts and the largest increase in 18 months, whilst the flash US manufacturing PMI reached a 36-month high. This strengthening in the economy led the US Federal Reserve to raise the target federal funds rate to 1.50-1.75%, just 25bps below the level it was at the time of Lehman Brothers' collapse. Economic growth also remained elevated in Europe, with both the manufacturing and service sector PMIs experiencing the best periods of expansion for seven years in February, albeit the subsequent flash estimates showed this slowing to the lowest level of growth in a year, with the loss in momentum potentially attributable to bad weather and growing pains. Despite record-breaking global growth equity markets were unable to sustain the high valuations with which they began the year, with nearly all major equity indices in the developed world ending the first quarter lower on a total return basis (the NASDAQ 100 Total Return index was the notable exception).

The FTSE-All Share Total Return index (12pm adjusted) fell 2.2% in March to complete its worst quarter in six years with a decline of 6.3%. Weakness in March was in part due to the index's large mining sector coming under pressure as basic material prices softened on global trade tension concerns. However, the most notable headwind came from sterling's strength following an agreement being reached on the terms of the transitional period of the UK's withdrawal from the EU, putting pressure on the index's predominantly overseas earnings base. Sterling strengthened not only against the US dollar (+1.9%) in March - continuing its trend for the quarter (+3.7% in Q1) - but also against most other currencies at +1.5% against the Bank of England's trade-weighted broad index compared to +2.0% for Q1 as a whole. Whilst trade negotiations are still yet to start between the EU and the UK, the likelihood of a 'no deal' scenario is quickly receding and the UK Government's stance is clearly softening, with at least a form of a mutual recognition regime and thereby some access to the Single Market now being sought. As we wrote last month, "confidence is the missing link" currently preventing the UK economy from enjoying the benefits of the broader global upswing ('Under the Bonnet', March 2018), so this transition deal should act to ease business fears of a 'hard Brexit'.

Confidence also remains the missing link for UK consumers. ONS data showed the UK unemployment rate for the three-months ended January edging back down to its 43-year low level of 4.3% (vs. 4.4% expected), helping year-on-year nominal wage growth to accelerate to a two-and-a-half year high of 2.6% (2.8% including bonuses), in line with forecasts. This compared to CPI inflation, which fell from 3.0% in January to 2.7% in February (vs. 2.8% expected), as the sharp weakening in sterling post the EU referendum continued to fall out of the data. Minutes from the Bank of England's Monetary Policy Committee (22 March 2018) suggest inflation is expected to "... ease further..." whilst "... pay growth will rise further in response to the tightening labour market." It seems the UK economy is at last set to enjoy a period of real earnings growth for the first time since the financial crisis. This message was echoed by the IHS Markit Household Finance Index, which reported one of the fastest rises in income from employment in the nine-year survey history as pay rises came through ahead of the changes to the National Living Wage Threshold. Additionally, the GfK Consumer Confidence Index reported a three point increase to -7, its best reading since May 2017. However, it was the constituent parts of this measure that were most enlightening. Survey respondents reported their most positive response in over 10 years with regards to their personal financial situation over the next 12 months, with a score of 10 (+5 month-on-month). But this was offset by the general economic situation over the next 12 months being scored at a lowly -22 (albeit a +4 improvement month-on-month). Once again, it seems confidence about the economy remains the missing link.

Strategy update

The Fund marginally underperformed in February, returning -2.38% versus a -2.18% showing by its benchmark, the FTSE All-Share Total Return index (12pm adjusted). This concluded the strongest Q1 relative performance for the Fund since 2014, with a return of -5.13% compared to the benchmark's -6.30%. Market allocation, which was a significant tailwind for the Fund over the quarter as a whole, was a headwind in March as the defensive sectors in which the portfolio is predominantly underweight outperformed after bond yields reversed some of their gains for the year

due to global growth concerns following the imposition of US tariffs. The announcement that the Japanese pharmaceutical company Takeda Pharmaceutical is considering making a possible offer for Shire, a stock that the Fund does not own, provided an additional 21bp headwind in the month.

It was another busy month for news flow for the Fund, which was predominantly positive with the only notable exception being **De La Rue**, discussed in full later.

GlaxoSmithKline (GSK) was one of largest positive contributors to the Fund's performance, not only in March but for the quarter as a whole, following news that it would not bid for Pfizer's health assets and instead would buy out Novartis' put option on its stake in the Consumer Healthcare joint venture. This was very much in line with what we had hoped to see from new management (see 'Under the Bonnet', November 2017). It represented a narrowing of outlined capital allocation priorities alongside a further streamlining of the legacy entity structure, with the accompanying news that there will be a strategic review of Horlicks and other consumer healthcare nutrition products, in addition to the non-core assets review that management has already initiated. Whilst the transaction is accretive to earnings in 2018 it is the cash flow accretion which is more important. Although net debt/EBITDA for FY19 will increase from 1.4x to c.2.3x (c. 2.2x post non-core asset disposals) after the deal, this is a reduction under the calculations previously used by the debt rating agencies, who fully accounted for the Novartis put option in their liability calculations despite not including the associated operating cash flows. After the deal GSK will now receive the operating cash flows from the 36.5% of the joint venture it did not previously own. As outlined in the Fund's 2017 review ('Under the Bonnet', January 2018), GSK's shares performed poorly for much of the second half of 2017 and had been a significant headwind to the Fund's performance following fears that the dividend was at risk, particularly if management chose to pay the rumoured US$20bn price tag for Pfizer's healthcare asset. These recent developments should allay these fears.

Full-year results at **Morrisons** saw it become the first UK food retailer to return to special dividends, with the announcement of 4.0p being distributed in addition to the 4.43p (+12.2%) FY2017 final dividend. Morrisons has been the top active holding in this Fund in large part due our belief in its strong cash generation potential, so this announcement, alongside net debt reaching £973m (below the full-year target of £1bn), marks a major milestone for the investment. Cash flow and balance sheet strength afford strategic optionality and this is exactly what management have done: prices have been further reduced, thereby matching Asda's recent moves and defusing the Asda 'price bomb' that so many analysts feared, whilst investment in systems and physical infrastructure has also been increased. Although this has inevitably led to margins remaining supressed, these are important actions towards building a sustainable competitive advantage in this fast moving market. Morrisons remains the Fund's largest active position.

Urban & Civic was one of the top contributors to the Fund's performance over the quarter and positive news flow continued in March after Huntingdonshire District Council approved the company's urban extension plans for St Neots. The extension will include up to 2,800 homes, two new schools and 63,000 square metres of commercial space, with first occupations due no later than November 2019 (within two years of the application submission compared to an industry average of seven). Urban & Civic acquired a 33% interest in the scheme in April 2017 at £13.3m, which equates to £14,285 per residential plot without placing a value on the commercial space. If we use historic analysis from management as a guide then, on average, these plots in their current form could be worth as much as £55,000 of an average house's £283,000 selling price, thereby representing significant value creation. The net asset value of this holding will be upgraded at the company's forthcoming interim results. The plots at St Neots represent the first to be completed under Urban & Civics new capital-light, licence model and thus an important step for this market leading strategy. Urban & Civic remains one of the Fund's highest conviction positions.

The Fund had a number of positive full-year statements in the month. Notable statements included **TT Electronics** reporting revenue and margin growth ahead of analyst expectations, although the share price reaction was muted as the optically high valuation demands further details on the Stadium acquisition (which will come post the deal completion) or news of further acquisitions.

An in line pre-close statement from **QinetiQ**, which confirmed that the existing Long Term Partnership Agreement (LTPA) terms with the UK's Ministry of Defence (MoD) would be extended for another 12 months as renewal negotiations continued and that QinetiQ is now the sole bidder for the MoD's Engineering Delivery Partner programme, reaffirmed its importance to the UK Government.

Oil services company **Hunting**, a relatively new position for the Fund, announced that full-year EBITDA is likely to meet the higher end of consensus expectations due to operational momentum and strong market demand for its Titan products.

Whilst highlighting a challenging construction market in the UK due to macro uncertainty, management at insulation supplier **SIG** marginally increased the dividend and noted increasingly confident markets across Continental Europe plus the potential for significant improvements in operational and underlying performance across the group through continued self-help measures.

Essentra's new management confirmed their confidence in turning the business around following improved revenue trends in H2 compared to H1 and significant improvements in all aspects of business stability, albeit a stronger pound sterling and higher interest charges led to small downgrades.

3i's largest investment, Action, revealed full-year results that showed softer like-for-like revenue growth due to some operational issues in a French distribution centre and poor ranging. Management were, however, forthcoming about remedial actions and the potential impact on NAV was more than offset by growth from store opening plans and the significant cash released via the completed refinancing. Additionally, subsequent

news of the partial sale of 3i's third largest holding, Scanlines, at a 27% uplift to NAV, provided a further tailwind to the NAV.

Developments at **De La Rue** were less positive. Its share price fell c. 20% following two separate statements. The first announced that the CFO would be stepping down, albeit remaining with the business until September, and that full-year trading would be at the low end of the consensus range. The second, two days later, advised that the company had not re-won the contract with Her Majesty's Passport Office (HMPO) to design and produce the UK passport. With the range between analyst earnings forecasts being just 3%, the share price decline of 14% on the day of the first announcement looked to be an overreaction. Having said this, the loss of the HMPO contract to the Franco-Dutch company Gemalto NV (recently acquired by Thales SA) – although highly publicised for political reasons - is particularly disappointing for shareholders for strategic and financial reasons.

First, De La Rue was meant to have a world-leading Identity Solutions business having developed new material technologies such as their polycarbonate which won them the highly competitive Australian passport contract in July 2017. Second, it appears the previous 10-year HMPO contract was significantly more profitable than most had expected, with exact details never previously disclosed for commercially sensitive reasons. With what could now be near an £8m profit headwind per annum to be bridged from FY21 onwards, management have a significant task ahead of them, albeit the share price adjustment has already de-risked much of this. Questions will be asked as to how Gemalto was able to bid £120m lower than De La Rue and the implications this has for the Identity Solutions part of the business (one-sixth of the group's operating profits last year with the HMPO contract potentially c.70% of this). We await full-year results in May for a fuller picture of the situation, especially with regards to the group's growth strategy.

Finally, the **Melrose's** bid was accepted by **GKN** shareholders. As detailed last month, the Fund will recycle this cash in to Melrose shares.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12 month performance to

	31.03.2018	31.03.2017	31.03.2016	31.03.2015	31.03.2014
JOHCM UK Dynamic Fund	4.24	29.40	-5.98	6.54	18.95
Benchmark	1.36	21.88	-4.42	6.87	8.66
Relative return	2.84	6.17	-1.64	-0.31	9.47

Past performance is no guarantee of future performance.

Source: JOHCM/Bloomberg/FTSE International. NAV of share class A in GBP, net income reinvested, net of fees, as 31 March 2018. Inception date: 16 June 2008. Note: Performance data for the period 16 June 2008 to 22 October 2009 is for Ryder Court UK Dynamic Fund. From 23 October 2009 onwards, the Fund converted to JOHCM UK Dynamic Fund. All fund performance is shown against the FTSE All-Share TR Index (12pm adjusted). Performance of other share classes may vary and is available upon request.

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