December 2017

FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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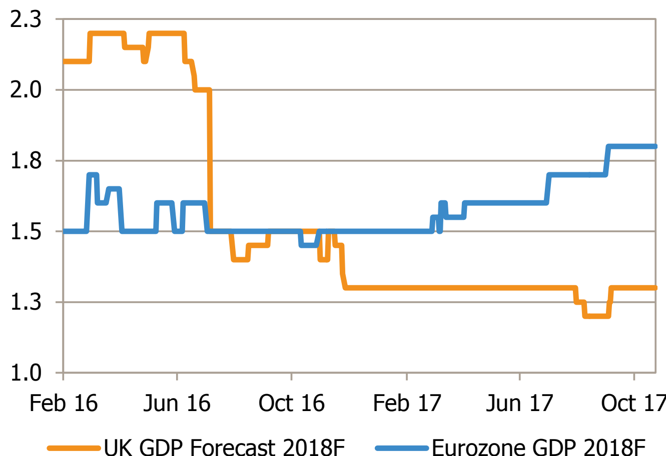
Investment background

The bull run in US equities continued, with the S&P 500, NASDAQ and Dow Jones Industrial Average indices all making new all-time highs, buoyed by investor optimism over potential Republican tax reforms and the effect of a weakening trade-weighted dollar; the S&P 500 finished the month with its 58th record close for the year and its eighth straight monthly gain, with only one down month in the last 13. Whilst the weaker dollar put pressure on eurozone and UK equity indices, economic indicators continued to reach multi-year highs in the former. The eurozone flash composite PMI showed the economy on track for its best quarter since April 2011, with business activity and prices rising at their steepest rate for over six years whilst the largest accumulation of uncompleted work for a decade led firms to take on staff at a rate not seen in 17 years.

In the UK, the back-and-forth of Brexit negotiations once again dominated headlines amid signs of progress emerging towards the end of the month following the news that the UK government would honour its £53-58bn share of EU liabilities. Given the uncertainty surrounding Brexit and the continued softness in sterling, it is maybe of little surprise that GfK's November Consumer Confidence Index was negative for the twentieth consecutive month. The autumn budget provided some respite for consumers, with an increase in the National Living Wage, further increases in personal income tax allowances and, most notably, the removal of stamp duty for first-time buyers on properties up to £300k. However, these changes were also accompanied by downgrades to UK GDP forecasts by the Office for Budget Responsibility (OBR) following productivity assumption changes (real GDP growth of 5.7% between 2017-18 and 2021-22, down from 7.5%). Counter to this, the October UK services PMI signalled a positive shift in momentum, with a rebound in new orders taking the survey reading to a six-month high. Whilst anecdotal evidence cited a range of factors underpinning the growth, including improved domestic demand and successful new product launches, the continued economic momentum in the eurozone is likely to be a significant factor given it is the UK's most material trade partner (accounting for 44% of all UK exports in 2015 according to Office for National Statistics). Despite the inherent linkage between the UK and EU economies, there has been a widening in the expectations gap between the GDP growth forecasts of the two ever since the EU referendum (see below).

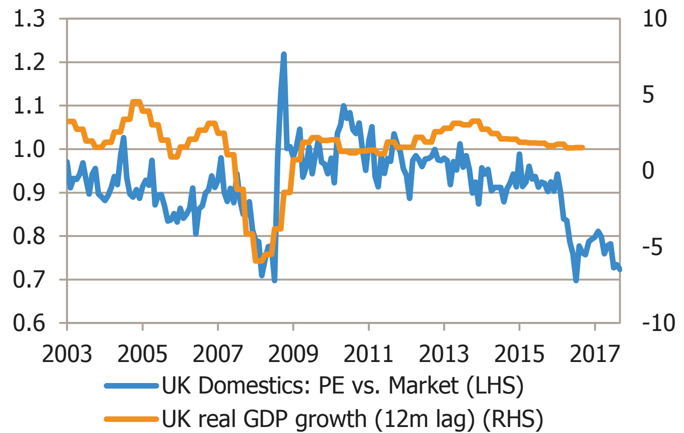
UK 2018 GDP expectations are seriously lagging the Eurozone



Source: Bloomberg as at November 2017.

This expectations gap has become even more noticeable in the divergent performance of the UK domestic and non-domestic UK listed stocks. UK domestic stocks are currently trading on price-to-earnings (P/E) discounts to the market in line with those experienced at the depths of the 2008 financial crisis and have detached from their previous correlation to GDP growth (see below).

Are we heading for a 2008/9 style recession?



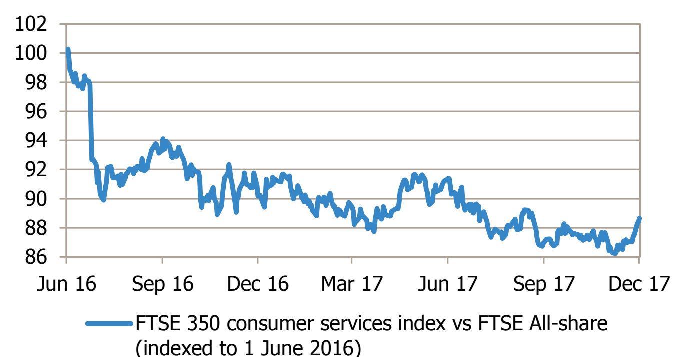
Source: Barclays as at 15 September 2017.

With news stories increasingly suggesting a narrowing of the difference between UK and EU demands in negotiations and the potential for clarity over some form of deal before the end of the year, the likelihood of a 'hard Brexit' is dissipating and thus so too are many of the arguments for such an expectations gap in forecasts.

Strategy update

The Fund slightly underperformed in November in returning -0.86%, net of fees, versus a -0.69% return for the FTSE All-Share Total Return Index (12pm adjusted). The month was marked by the v-shaped relative performance of UK domestic stocks versus the benchmark, which put pressure on the Fund's performance in the first two weeks due to its overweight in consumer services. The FTSE 350 consumer services index underperformed the All Share index by 131bps before rallying on Brexit negotiations and autumn budget headlines to end up outperforming for the month by 86bps (see below). Macro factors appeared to lead to some unusual share price reactions in what was a busy month for the Fund, with over a third of positions issuing trading updates. Results were generally positive with the exception of **Xaar**, an early stage holding which was exited.

FTSE 350 consumer services index vs FTSE All-share



Source: Bloomberg as at 6 December 2017.

Starting with the good news, interim results from **Majestic Wine** showed strong growth in the earnings of the online-only Naked Wines business and good operating margin control in the core retail business. Whilst there were no upgrades, investor confidence in the growth potential of Naked Wines in the US was partially restored, pushing the shares up 23% on the month, crucially above the level they had been immediately prior to the warning in September 2016, which had occurred in part due to the failure of Naked Wines' £2m direct mail campaign in the US (see 'Under the Bonnet', October 2016). Whilst this is still very early days with Naked Wines having only just turned profitable in all three of its geographies and the competitive pressures in the UK retail market showing little sign of abating, it is encouraging to note that the initial investment case we outlined nearly two years ago is beginning to show signs of progress.

Patience has been a virtue at **Britvic**. The last two years have seen free cash flow reduced as management have invested in their UK supply chain, which, in tandem with the announcement of a UK sugar levy in the August 2016 budget, put pressure on the share price in the second half of last year. Full-year results this month saw analysts upgrade earnings, having already upgraded following Q3 numbers four months before, as cost savings from UK supply chain efficiencies and synergies unlocked from the acquisitions in Brazil came in ahead of expectations. Free cash flow is set to improve significantly in FY19 when the £220-240m supply chain investment is completed and, whilst the UK sugar levy is due to come in to effect midway through FY18 (1st April), these new capabilities have allowed Britvic to re-position its product portfolio in order to take advantage of the market changes, with c.75% of its GB portfolio now below the sugar threshold and its innovative, low/no-sugar drinks offering making it the category partner of choice for retailers.

There was good news from **Urban & Civic** where the NAV grew 7% and should be on track to accelerate from here, with management guiding to 315 residential plots completions in FY18 and then 720 in FY19, compared to just 52 in FY17. This remains one of the Fund's highest conviction positions, with a residential land bank placed almost entirely within the arc covering Oxford, Milton Keynes, Northampton and Cambridge, an area within which Lord Adonis, Chairman of the National Infrastructure Commission, last month urged ministers and council leaders to "seize the opportunity" and deliver new and improved infrastructure in order to unlock one million new homes. This is an opportunity not to be missed by the management at Urban & Civic who believe they will have at least 17 agreements with housebuilders in place across their estate by March 2018 and, using the proceeds from their recent disposal of non-core commercial assets, will be building out for the first time their own new homes under the name Civic Living.

There was significant progress at **De La Rue**. Interim results showed a step up in revenue growth led by the currency division despite using two fewer print lines year-on-year. This lower capital intensity growth provided management the opportunity to increase R&D investment by 33% year-on-year to accelerate their 'Invest for growth' plan. Of greater note was the potential reduction in the company's large pension deficit. A change from RPI to CPI indexation in the calculation of the liabilities is expected to reduce the deficit by £70m on an accounting basis, which, in conjunction with a £40m lower valuation due to revisions in the long-term inflation rate and demographic assumptions, means the pension deficit is likely to fall from £237m at March 2017 to c.£127m, equating to a 17% increase in the value of the equity if we assume a constant pension-adjusted enterprise value (market capitalisation is £646m, so £110m/£646m). Disappointingly the share price has not yet responded and was down on the month. It may require confirmation of the reduced pension cash contributions and P&L charge before we see any movement given this is a little followed stock (only three analysts).

Unusual share price weakness elsewhere in the portfolio included **Electrocomponents**, which potentially suffered from trading update overexposure, with the Q218 trading update only a month earlier pre-announcing much of the strong trading at the interims. Profit taking ensued and the share price has now unwound all of the gains following the Q2 earnings upgrades despite an interims outlook statement of "continued strong underlying revenue growth in October" and additional moderate earnings upgrades. There was also profit taking in **3i Group** despite interims showing continued NAV progress, albeit a slowing trend in Q2, in part due to H1FY18 representing the first period of net investment for 3i in three years. Likewise, despite **QinetiQ's** management re-iterating in their interims that they are on track to meet expectations for FY18 with 89% of revenues already under contract, the QinetiQ share price continued to fall in reaction to a profit warning at UK defence peer Ultra Electronics the week before. **Morrisons'** Q3 update also found its critics, with analysts seemingly expecting much stronger retail like-for-like sales than the 2.1% reported (excluding fuel), despite this being in line with the previous quarter and only three of the 19 analysts having a 'buy' recommendation and the outcome being upgrades to FY18 consensus earnings estimates (albeit marginal). At **Marks & Spencer**, despite a strong performance in Clothing & Home and International resulting in H1 numbers being 9% ahead of consensus, shares weakened as the market processed the potential requirement for higher near term exceptional costs and margin investment implied by the accompanying strategy update: an acceleration of the store closure plan, slowing of the Simply Food roll-out and further investment in prices, particularly in Food, offset by operating cost reductions. Whilst we applaud such radical action being taken in this dynamic industry, there is no doubt that the shape of earnings in the short term have become more difficult to forecast. We continue to take comfort from the margin of safety that the 12% FCF yield affords us and the capital-light manner of the recovery plan.

Pressure on UK domestic stocks provided an opportunity for the Fund to build a small overweight position in **Tesco** following the Competition and Markets Authority's (CMA) approval of the merger with Booker. This is an early stage investment for the Fund, so we will provide a fuller update in due course. The clear attractions, though, are strong trading momentum (the best like-for-like sales of the 'big four' supermarkets) combined with a focus on rapid debt and pension pay-down (leverage had previously been a sticking point for us when compared to Morrisons), meaning that free cash and hence shareholder returns should grow substantially from here. A FY19 (February year-end) free cash flow yield of 7%, ahead of the inclusion of Booker and any related synergies, is attractive for this recovering, de-risked, market-leading business.

It is disappointing to report that Xaar, a global leader in industrial inkjet printhead production and a small, early stage position for the Fund (added April 2017), profit warned following a worsening of competitive pressures in its ceramics end market and slower ramp up of its new 1201 printhead for the graphic arts market. Our investment thesis was predicated on there being signs that the new management team had stabilised the declining ceramic revenues (there was period-on-period growth in H1 following a number of strategic partnerships with customers) and that returns in the business would improve as new products were being launched using existing intellectual property and capital. Whilst the new product launches may still go on to provide attractive growth characteristics, the significant decline in the ceramics revenue base has removed the accompanying margin of safety and reduced the absorption rate of operating costs. The subsequent share price reaction did not fully reflect this new reality, so the Fund exited its position with a total loss to the Fund's performance over the holding period of 4bps.

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