J O Hambro Capital Management Group

Under the Bonnet

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Investment background

Global equity markets generally stabilised in November, closing at price levels broadly similar to those at the beginning of the month. However, levels of economic and political uncertainty remained heightened and asset markets remained skittish, with the Chicago Board Options Exchange Volatility Index (VIX) monthly average for November little changed on October at 19.4.

Economic data continued to slow. The only bright spot was the JP Morgan Global Services PMI, which accelerated for the first time in four months – up from September's two-year low – led by strengthening growth in the US. Even this proved to be short-lived, with the subsequent flash US services business activity index falling to a two-month low. Ongoing trade tensions continue to weigh on global manufacturing, with JP Morgan's Global Manufacturing PMI falling to its lowest level in almost two years.

China and the eurozone remained the geographies most affected by trade tensions. The Caixin China composite PMI fell from 52.1 in September to a 28-month low of 50.5, as manufacturing production slowed and softer services activity coincided with the first stagnation of new business for nearly 10 years. In the eurozone, the flash PMI recorded business activity growing at its weakest rate in nearly four years as slower order book growth and falling exports were accompanied by deteriorating optimism about the outlook, rising costs and rising prices. This resulted in employment growth falling to a 22-month low. German manufacturing slowed to a near standstill, the weakest performance since April 2013, whilst Italy registered a fall in business activity for the first time since 2014 as budget tensions continued.

US manufacturing remained relatively resilient despite trade tensions (the flash PMI reached just a three-month low). However, there were signs that slowing global growth may be beginning to affect the thinking of the Federal Reserve, with Chairman Powell commenting that US interest rates are closing in on "neutral" levels. These remarks were viewed by the market as an indication that policymakers may soon be open to a pause in the programme of rate rises. Global bond yields subsequently fell, with the yield on the US generic 10-year Treasury reaching a two-and-a-half-month low.

In the UK, it was once again domestic affairs that dominated markets. Brexit negotiation uncertainty quickly turned to political uncertainty following the resignation of Dominic Raab, the Brexit Secretary, in protest of the Cabinet backing the draft text of the EU withdrawal agreement. Sterling immediately lost all its gains against the euro for the month as markets focused on the threat of a vote of no confidence in Theresa May (since overcome) following further cabinet resignations (a total of seven MPs in the month) and the possibility of even a general election. For all the headlines, no leadership challenge emerged. EU leaders went on to approve the withdrawal agreement alongside a political declaration on future trade which, although not binding, sets out some ambitions for the next round of negotiations. Despite all the political uncertainty in the UK and a consensus view that Parliament would not vote through the agreement in its current form, sterling ended the month down just 0.2% against the euro and 0.1% down against the US dollar.

The reaction in the real economy to this heightened uncertainty has been mixed. The UK services PMI showed the weakest upturn in new work since July 2016. Meanwhile, the IHS Markit Household Finance Index painted a confused picture. UK households cast their most upbeat expectation of future financial conditions for almost four years, given a rise in real incomes (0.9%, excluding bonuses, year-on-year), but, on the other hand, spending growth and job security perceptions remained negative for the fourth successive month. This picture of domestic uncertainty was reflected in the FTSE 250's 50bp underperformance versus the FTSE 100 over the month.

Finally, global markets were dealt the additional uncertainty of a falling oil price. The price of crude collapsed 22% in the month after market concerns about oversupply were exacerbated by Saudi Arabia heeding President Trump's wishes and refraining from cutting production targets. This weighed on the oil heavy FTSE All-Share Total Return index, which fell 1.6%. In comparison, the FTSE World ex-UK equities index was up 1.8%, in sterling terms, over the month.

Strategy update

The Fund underperformed in November, returning -2.40% against a -1.68% return by its benchmark, the FTSE All-Share Total Return (12pm adjusted) index, representing a total underperformance of 73bps. This underperformance mainly came from declines in the share prices of the Fund's holdings in UK financials **Barclays, Lloyds Banking Group** and **Aviva** following the political uncertainty outlined above. On top of this, performance was also hurt by the marked impact of technical selling of **The Restaurant Group's** (TRG) shares following the approval of the Wagamama acquisition by shareholders.

Although the shareholder approval of the Wagamama acquisition was closely fought, it was not as close as headlines would imply: 39.57% of votes cast were against the transaction but only 80.77% of shareholders voted, implying the percentage of total shareholders against the transaction was closer to 31.96%. Even so, the highly dilutive terms of the rights issue, plus the size of the equity raise, will have meant many shareholders were forced to sell some of their TRG shares in order to raise capital to finance the take up of their rights. This is what likely led to the 15% share price fall on the day. The Fund has added to its position given the virtually complete removal of Wagamama from the valuation of the now expanded group.

QinetiQ – a reward for patience

We wrote at the beginning of the year that we hoped patience would be a virtue when it came to evaluating the performance of **QinetiQ** in 2018 ('Under the Bonnet' – January 2018). It is pleasing to report that this patience has been rewarded. New management's growth strategy has delivered earnings upgrades this year, greater geographic diversification, improved revenue visibility and a continuation of strong cash generation. A wider appreciation of these attractive characteristics has now also led to a re-rating of the company, with the shares outperforming the market by 42% since the beginning of the year. Whilst this Fund believed the seeds of this were evident in 2017, the tumultuous UK political environment that ensued after the snap election last year led the market to focus on the potential for a hiatus in UK defence spending rather than on the fundamental improvements that were underway at QinetiQ.

Although there is still no certainty that the UK political environment will improve, interim results last month illustrated quite how much work management has done to de-risk QinetiQ's business: 90% of FY19 revenue are under contract; international revenues have grown from 26% to 31% over the last year; and sufficient UK government work has been moved on to long-term contracts to drive efficiencies that will more than offset the anticipated headwind from changes in the Baseline Profit Rate (BPR) by FY20. And this has all been achieved whilst delivering 9% order growth, 8% organic revenue growth, leading the modernisation of defence test and evaluation in the UK, executing a number of strategically important bolt-on acquisitions and maintaining a net cash balance sheet equivalent to 15% of the current market capitalisation. Management have set the foundations for sustainable and profitable growth from here and stated their ambitions to grow international revenues to be 50% of group. We look forward to updating you on their progress. QinetiQ is currently the Fund's largest active position.

Daily Mail & General Trust – patience needed but extreme value on offer

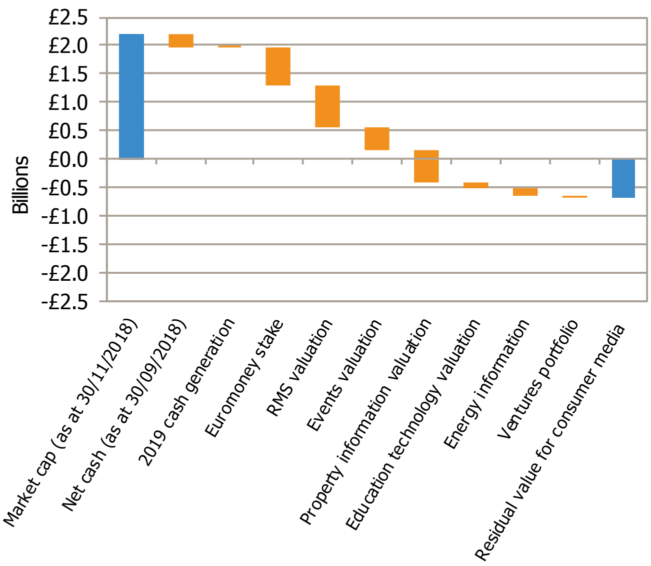
It seems patience will be required in waiting for the market to appreciate the good work being undertaken by new management at **Daily Mail & General Trust** (DMGT). Its share price fell 10% following the company's full-year results as, despite beating forecasts for FY18, analysts took issue with management's commentary on the divisional outlook. Given the conglomerate nature of the group, there are many moving parts to the outlook. However, in the round, to us they do not constitute a downgrade. Consumer Media margins, one area of concern for analysts, only reduced as DailyMail TV became a wholly-owned subsidiary. The associated operating costs therefore became fully consolidated, having previously been under joint venture accounting. Furthermore, whilst continued revenue declines in Print may be seen as a disappointment, this should not have come as a surprise given external conditions. The Consumer Media business, particularly the Print media business, is the lowest valued part of the group, and we feel the whole Consumer Media business, including Mailonline, is in for free anyway. Elsewhere, guidance around Risk Management Solutions (RMS), the second source of concern, we think was entirely consistent with previous commentary over the year.

DMGT is going through a generational shift in strategy, probably one of the most marked and underappreciated strategic transformations that we have seen in 10 years of running this Fund. A key part of the strategy is to slim down the complex conglomerate structure and focus capital allocation on the group's leading scale and scalable businesses. There were simply too many businesses to manage effectively.

In just two years, material change has taken place, including the sale, partial sale or closure of a number of businesses. Some of these transactions have been material, including the partial sell-down of **Euromoney** in late 2016 – a statement of intent if ever we have seen one – and the sales of EDR, a US property business, and the remaining stake in Zoopla. These sales have revolutionised the balance sheet, taking it from net debt of £679m at FY 2016 to net cash of £233m at FY 2018. The pension deficit has gone from £246m then to a surplus of £244m now. A transformation indeed!

We use sum-of-the-parts to value this business, as it is a highly relevant approach. In the Fund's Q3 update, we suggested that, assuming market value for Euromoney (which accounts for c. 35% of DMGT and is itself a fascinating business transformation situation), 3x sales for RMS (the world's leading insurance risk modelling business), 3.5x sales for the events business, and 2x sales for Landmark (the UK's leading provider of land and property search information), investors were effectively getting for free the following businesses: Consumer Media (2018: revenue £654m, profit £64m), Energy (£80m revenue, although no profit today), and Education Technology (£68m revenue, £7m profit), plus all of the small stakes and start-up investments. Updating this for the recent share price fall, which, due to the net cash balance sheet and stake in Euromoney (results ahead of expectations in November), suggested a decline in the enterprise value of the remainder of the group of c. 20%, despite virtually no change to forecasts, means we can now add Property Information to the list of divisions that come for free. Yes, we believe that the valuations of Euromoney, RMS and the Events businesses alone account for the whole enterprise value of DMGT.

DMGT – extreme value on a sum-of-the-parts valuation



Source: DMGT.

Fleshing this out, in our opinion the market currently ascribes zero value to the following: Mailonline, one of the world's leading newspaper websites and probably worth 2-3x sales (> £300m of value?); the Daily Mail, The Mail on Sunday and Metro, three of the UK's pre-eminent newspapers; Landmark, the UK's leading provider of land and property search information; Hobsons, a fast-growing US education technology business; and Genscape, the world's largest network of energy market monitoring technologies. These businesses generated a combined profit of £130m in 2018. This is extreme value.

Such extreme value credentials are very attractive to this Fund, but particularly so when combined with a management team targeted with and focusing on outing that value. This isn't just about slimming down, it is about operationally improving the remaining businesses whilst increasing the revenue-generating capacity and operating cash flows of each division. And this is only done through investment, not just cost cutting. Each core division is currently under-earning due to above the linerestructuring charges and increased investment. That point is seemingly lost in the way the market currently thinks about this group. Add in our understanding of the transformation strategy and likely capital allocation at Euromoney – a share which this Fund also owns and which offers further value creation opportunity for DMGT via its 49% stake – and you have an attractive recipe for generating superior shareholder returns in time.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12 month performance to

	30.11.2018	30.11.2017	30.11.2016	30.11.2015	30.11.2014
JOHCM UK Dynamic Fund	-3.52	19.02	13.34	0.81	6.29
Benchmark	-2.33	13.70	10.32	1.35	3.88
Relative return	-1.22	4.68	2.74	-0.53	2.32

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 at 30 November 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.