J O Hambro Capital Management Group

Under the Bonnet

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Investment background

Global equity markets were broadly unchanged in June, consolidating the significant bounce back in April and May from the tough market conditions seen in the first quarter. Signs of further tightening in central bank policy and heightening trade tensions weighed on global risk appetite, negating continued strong economic data.

The May global services PMI showed output expanding at its second highest rate in three years, led by the US, where survey data showed a sharp increase in business activity. The US labour market continued to strengthen, with non-farm payrolls rising to 223,000 in May (against estimates of 188,000), whilst the unemployment rate fell to an 18-year low of 3.8%. Faced with clear signs of a strengthening domestic economy, the US Federal Reserve raised the fed funds rate by a further 25bps, as anticipated – the second rate increase this year and the sixth since President Trump's election.

It was US international trade policy, though, rather than monetary policy which continued to dominate markets in June. Tariffs on US steel and aluminium imports were broadened to include additional countries and additional goods, in particular capital and intermediate goods from China. This led to retaliatory action. Whilst the impact of these current tariffs on global growth is likely to be only modest, a major increase in protectionism worldwide could have more significant effects.

There are already some early signs, with the recent strong run of growth in Europe beginning to show signs of waning. The flash European manufacturing PMI survey data for June indicated a further slowdown since May to an 18-month low, with companies citing trade worries and political uncertainty as their biggest concerns. Despite this, the European Central Bank concluded it would announce the end of its historic €2.4tn QE scheme by the end of December 2018, with the pace of net asset purchases being halved up until that point.

UK equities completed their best quarter in over three years in June and were the best performing asset class globally in Q2. In common with equity markets globally, however, the UK market experienced a loss of momentum in June. Economic data releases continued to be buffeted by Brexit uncertainty, with both the manufacturing and construction PMI surveys remaining subdued. Whilst the services PMI continued to show a recovery from March's low, rises in new business volumes remained lacklustre. Survey respondents noted Brexit uncertainty as a key factor. Likewise, the GfK consumer confidence index fell two points to the same level as in April, with the most marked deteriorations being levels of optimism about the general state of the economy.

Despite this uncertainty, the labour market continued to go from strength to strength. The ONS reported April's employment rate as 75.6%, the joint highest level since comparable records began in 1971. Growth in demand for staff strengthened to a six-month high in May, according to the IHS/REC report, whilst a sharp decline in candidate availability meant that salaries awarded rose at their steepest rate for three years. The most recent ONS data recorded UK weekly nominal earnings excluding bonuses increasing 2.8% year-on-year in April (2.5% including bonuses). This compared to a CPIH (consumer price inflation including housing costs) reading of 2.2% in April (and 2.3% in May), implying real wages continue to grow.

The Monetary Policy Committee voted against an increase in UK interest rates on 20 June, on the grounds that global growth had weakened since the MPC's last meeting. Interestingly, though, three committee members favoured an immediate increase (including the Bank of England's chief economist, Andy Haldane), as they believed there to be "some upside risks to the expected pickup in average weekly earnings." Surprisingly, despite this news, UK government bond yields remain little changed on the year.

Strategy update

The Fund outperformed in Q2, returning 10.17%, net of fees. This represented outperformance against its benchmark, the FTSE All-Share TR index (adjusted), which rose by 9.47%.

The outperformance came from a mix of allocation and stock selection, with three of the Fund's top four active positions (**Electrocomponents, QinetiQ** and **Morrisons**) providing a significant proportion of the added value. Not owning British American Tobacco, which underperformed the market, was a further significant positive.

Looking at June in isolation, the Fund performed broadly in line, returning -0.11% against the benchmark's -0.14%. A significant positive contributor to the Fund's performance was a continued rally in **Electrocomponents** (the Fund's largest position). This was driven by continued earnings upgrades associated with strong results and a bolt-on acquisition in the previous month. However, this outperformance was offset by further share price weakness at **ITE**, following its proposed acquisition of Ascential's exhibition business (see 'Under the Bonnet', June 2018). **Elementis** was also weak after it, too, announced it would be undertaking a rights issue, in this case in order to acquire Mondo Minerals, a leading producer of industrial talc additives. In what can only be described as an extraordinary period of corporate activity for the Fund, **DS Smith** also announced that it would be undertaking a rights issue, in order to acquire Europac, a leading Western European integrated packaging business.

The initial deal metrics perhaps look questionable in terms of valuation in all three transactions. Nonetheless, in each case the target business looks to be a genuinely good one with a solid market position and reasonably strong and sustainable competitive advantages. These types of businesses do not come cheap in the current environment. But it must be noted that these transactions are asking fundamental questions of the Fund and its role as an investor in these companies. Questions of patience, of the nature of the investment (recovery or growth), and the depth of support for and trust in the management teams. Is the Fund investing for today or for the duration of management's tenure? Does the Fund fully back management to make good decisions for the business? Are the individual boards sufficiently challenging management's thesis that the acquisition is right for the company across a range of measures. Specifically, will the high price paid today make more sense in time? For a Fund with a process so focused on investing with a margin of safety, these are important answers to find.

In the case of **DS Smith**, the acquisition of Europac can be viewed as more business as usual, with the promise of substantial cost synergies, meaning that, if delivered, the deal is earnings-enhancing and returns would exceed WACC (weighted average cost of capital) in the first full year of ownership. However, this is an asset that is already performing well, which is reflected in the pre-synergy valuation of 10.7x EBITDA (8.4x post-synergies), and means the group balance sheet post-deal has had to stretch to greater than 2.5x net debt/EBITDA. This is the higher end of this Fund's comfort level for a cyclical business.

At **ITE**, the headline price being paid looks a little high, and, in our opinion, the structure of the deal could have been more skewed towards debt (c. 85% equity). However, the price paid is actually comparable to, if not slightly better, than the multiple paid for All World by UBM a few years ago. Furthermore, in ITE's case, the high price paid is compensated for to some degree by the lower execution risk associated, with the CEO having previously run the businesses being acquired (as outlined in 'Under the Bonnet', June 2018) and by the established nature of the acquired brands. New ITE will be, in the short run, a lower return business due to the dilutive financial nature of the transaction. But it will also be a higher quality and more diversified business across sectors and geographies. This will have cost-of-capital benefits, whilst also making the company attractive to a new and wider cohort of investors. These attractions are less visible today but absolutely worth it in the long run. The CEO bought c. £500k of stock during the recent share price weakness, having already declared he would take up his rights; this is clearly a management team who have conviction in the acquisition. The Fund will hold a look through position of c. 1.5% (active) after the rights issue, higher than the starting position pre-deal, but lower than its full rights entitlement.

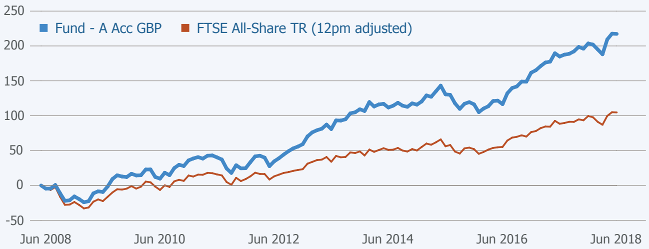
It will take longer for **Elementis's** deal to generate the return that financial theory says is a good one. The company has openly disclosed that returns will exceed WACC in year four. The market has decided that this is too far away and, given where we might be in the cycle, the risks to achieving that target look too high. As a result, the shares have fallen 15%. This situation has not been helped by management refusing to sugar-coat the acquisition with claims of major revenue or cost synergies. These are attributes that this Fund applauds in this management team, whilst having to accept that it is unhelpful in share price terms.

Elementis's CEO, Paul Waterman, has demonstrated, in his near two-and-a-half-year tenure, that he does not accept mediocrity. If he thinks this acquisition is a good idea, he has more than a fair chance of being right. By way of example, Elementis announced at the end of last year that it would sell its Surfactants unit, an unimpressive, loss-making legacy business. Having been unable to get the Surfactants management team to identify a solution to its underperformance, Mr Waterman undertook his own work and discovered that there was one major problem contract. After personally digging out the historic contract documents, he discovered there was scope within the wording to reprice the entire contract, turning losses into a quick $10m profit in six months ahead of the business eventually being sold. This is small but clear value creation from a detailed and obsessive CEO, the type of manager that this Fund wants to back.

Whilst management have said there are no major synergies that they want to disclose at this stage, it seems unlikely there will not be deeper revenue synergies, given the clear crossovers in sectors served and therefore client bases in both the industrial talc and hectorite markets (personal care, coatings, auto sector). And although the price being paid is high, of the three businesses being bought by DS Smith, ITE and Elementis, it is the latter's target, Mondo, which has the clearest attractions. It has high quality and long-lived assets, proprietary mid-stream processing technology and a global number two position. Whilst one could question whether the group needs to own the asset at all, at least management understand that if you pay peanuts, you get monkeys. So, whilst we are not happy by the short-term dilution, we like the business and are backing management.

Performance highlights (onshore Fund)

Return since launch (%):



Return history (% – data as at 30.06.2018):

	3m	1yr	3yr	5yr	10yr	SL	Annualised*
JOHCM UK Dynamic Fund	10.17	11.39	37.58	75.45	232.44	217.28	12.19
Benchmark	9.47	8.66	31.10	52.83	113.58	104.72	7.40
Quartile**	1	1	1	1	1	1	-

Discrete 12-month performance to:

	30.06.2018	30.06.2017	30.06.2016	30.06.2015	30.06.2014
JOHCM UK Dynamic Fund	11.39	31.53	-6.09	8.90	17.10
Benchmark	8.66	21.37	-0.60	3.39	12.75
Relative return	2.51	8.37	-5.53	5.33	3.85

Past performance is no guarantee of future performance.

Source: JOHCM/FTSE International/Bloomberg, NAV of Share Class A in GBP, net income reinvested, net of fees as at 30 June 2018. The A Acc GBP class was launched on 23 October 2009. During the period 16 June 2008 to 23 October 2009 the performance record is based on the pre-existing share class that had a higher management fee. Benchmark: FTSE All-Share TR (12pm adjusted). 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 the JOHCM UK Dynamic Fund. Performance of other share classes may vary and is available on request.

*Annualised since launch. **Sector quartile ranking: IA UK All Companies.