Under the Bonnet

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Investment background

UK equities were the best performing asset class globally in May, courtesy of a 4.9% gain in the FTSE 100 Total Return Index. The FTSE 100's strength was in part due to a 2.2% weakening in trade-weighted sterling, as hopes of Brexit negotiations being led by a strengthened Conservative majority government quickly diminished after opinion polls showed the gap with the Labour party narrowing ahead of the general election on 8 June. Correspondingly, the yield on the generic UK 10-year gilt fell to a near eight-month low as the probability of a UK interest rate rise in 2017 dropped to 11%, having peaked at 56% at the end of January.

Economic data continues to suggest the UK economy entered polling day in relatively good health; April's PMI surveys recorded the sharpest rises in services and construction year-to-date, whilst the Markit/REC Report on jobs continues to show a rise in both permanent and temporary staff. As we wrote in last month's 'Under the Bonnet', strong employment data, falling petrol prices and increasing mortgage affordability ratios suggest that the UK consumer has reason to feel confident after the election, all things being equal. *(N.B. as we write this, we face the prospect of a hung parliament and a period of coalition government, which inevitably runs the risk of creating further political uncertainty and potentially a toughening short-term economic outlook).*

Outside the UK, European manufacturing expanded at its fastest pace in six years, more than offsetting a mild deceleration in the US and a slowdown in Chinese manufacturing and services. All seven of the eight nations covered by the eurozone PMIs (Greece being the exception) recorded an improvement in operating conditions, led by Germany where output has risen continuously since May 2013, the second longest sequence since records began in 1998. Backlogs of work continued to rise across the eurozone and, in turn, staffing levels increased at one of the fastest rates seen since early 2000.

Strategy update

The Fund performed broadly in line with its benchmark in May, returning 4.39%, net of fees, versus a 4.58% return for the FTSE All-Share Total Return Index (12pm adjusted). It was a good month for the Fund in terms of stock selection, albeit gains were more than offset by sector allocation effects. Defensive sectors such as consumer goods and utilities, in which the Fund continues to hold maximum underweights, performed well as bond proxies rallied with gilts.

We mentioned in our last quarterly call that we expected Q2 to be an important period for the Fund, with a number of the Fund's largest active positions reporting annual results in May. These results were generally very robust and well received, led in particular again by three of the Fund's top active positions, **Electrocomponents**, **3i Group** and **QinetiQ**.

Electrocomponents' full-year numbers provided further detail on the previous month's encouraging trading statement, with free cash flow significantly ahead of consensus expectations and the final dividend being raised for the first time in five years. Forward guidance has risen again but remains realistically struck and offers scope for further material outperformance.

Shares in 3i continued their recent upward move, benefiting from a further positive appraisal of the value of Action, 3i's largest investment, following an investor day which highlighted the significant European rollout opportunity. Only 363 of Action's 852 stores are currently outside the Benelux region, and with pay-back periods on new stores running at less than a year, like-for-like sales in new territories currently in excess of the group's FY16 6.9% average, and with plentiful funding options, there are very clear building blocks for further value creation. As the shares re-rate, we are mindful of valuation but suggest this remains more of an opportunity than a risk at this stage. This is not the 3i of old. Management state that their expected hurdle rate for investments is at least 2x money multiple over cost (cash proceeds over cash invested), which, if achieved and consistently applied, would suggest that 3i's shares could trade on a multiple to net book value in excess of 2x, rather than the current c1.3x FY18.

Lastly from the top five active positions, QinetiQ delivered steady results, slightly above expectations but with another strong cash performance and evidence that the new growth focus is starting to take root and therefore could deliver substantial upside optionality.

The Fund also continued to enjoy strong performances from positions outside of the top five actives. **AstraZeneca** surprised the market with an early read out on its PACIFIC trial, which showed high efficacy for its PD-L1 inhibitor, Imfinzi (previously known by its chemical name durvalumab), in non-small cell lung cancer (NSCLC). This is a major breakthrough for AstraZeneca's immuno-oncology (IO) platform, as it is the first company to file for approval in this setting - several years ahead of the competition - with potential for US$1.75bn to US$3.5bn peak sales. Management at AstraZeneca refer to 2017 as having the "potential to be a defining year", as revenues from new growth platforms offset declines in legacy products and a number of key pipeline drugs will have their final trial read outs, including some potential blockbusters in IO. MYSTIC is the largest of these blockbuster trials, with a potential market opportunity of up to US$15bn if the combination of Imfinzi plus tremelimumab is proven to have superior efficacy to chemotherapy in NSCLC. The market has become fixated on MYSTIC, with consensus valuing AstraZeneca shares at around 7000p (vs. 5293p currently) if the trial is successful, but closer to 3600p if it fails. PACIFIC was an important milestone for the market as it gave credibility to Imfinzi and AstraZenca's IO approach, albeit it does not chemically mean there is an improved chance of MYSTIC working, thus the trial readout remains a binary risk. Although we believe that the current share price undervalues AstraZeneca on a probability-weighted valuation ahead of the MYSTIC read out, the binary nature of the outcome means that we currently carry a c.100bp active position.

There were positive updates from two of the Fund's more contrarian positions: **The Restaurant Group** and **Pearson**. The Restaurant Group was added to the Fund in August 2016 after major share price underperformance through much of 2016 (-63% relative to the FTSE All-Share index between

December and July 2016) following a number of material profit warnings. This resulted in a boardroom overhaul and a firm commitment to significant change from the new team.

Whilst the Leisure businesses, consisting of various ex growth or failing brands – Frankie & Benny's, Chiquito, Coast to Coast and Joe's Italian – were in need of a major overhaul, we were attracted to the fact that the group owned a concessions business and a pubs business which were both growing and provided a substantial valuation backstop, somewhere between 30-50% of the then market capitalisation. New management were given a clear remit to restructure, invest where necessary in price and quality and improve the customer offering and experience, which they set about doing straight away. The first few months of 2017 were again tough for The Restaurant Group's shares on a relative basis; full-year results in March showed a Q4 like-for-like (LFL) exit rate of -5.9% despite much being done to stabilise performance, and management guided the market for substantial price and menu changes, thereby implying a likely continuation of poor LFLs throughout 2017.

Additionally, in April, it was announced that the CFO, Barry Nightingale, only hired in June 2016, would be leaving the company with immediate effect. Whilst he was specifically hired to help stabilise the business and begin the turnaround, his short tenure still sparked murmurs of continued poor trading. This pessimistic market backdrop intensified further when some analysts aggressively cut their forecasts ahead of the company's AGM trading statement in May, believing that management's menu changes and price investment were not sufficient to stabilise LFLs. In the event the trading statement was a positive surprise, with earlier than expected evidence of the turnaround materialising. Whilst there were few explicit expectations for the reported 20-week period, the majority of analysts expected substantially worse than the reported -1.8% LFL, with some expecting a negative double-digit figure for year-to-date LFL. Whilst there were some shorter-term trading benefits which may unwind as the year progresses (e.g. good cinema attendances), there is no doubt that the company is now ahead of where it expected to be at this stage and certainly ahead of analyst expectations for the full year, many of whom had forecasts built on c.-3% to -5%. This is highly encouraging in what remains an extremely early stage recovery and (necessarily) intensive restructuring situation.

Likewise, **Pearson**, a very recent (and small) addition to the Fund, released Q1 numbers which saw a reiteration of full-year guidance, organic growth ahead of recently revised expectations, a new cost saving plan of £300m and a strategic review of the K-12 courseware business. This was in addition to the already-announced reviews (at year-end) of the 47% stake in Penguin Random House and two other divisions (Global Education and Wall Street English). The shares closed 12% higher on the day of the Q1 results, which perhaps shows the scale of scepticism towards this company.

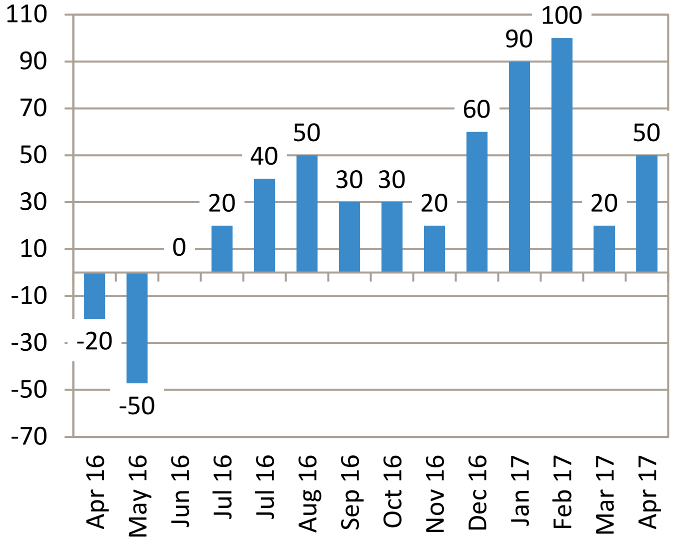
Pearson was added to the Fund on the day of full-year results in February (but after the January profit warning), with what we believed was a high short-term margin of safety: a low starting valuation; low expectations for the year ahead; certainty of forthcoming dividend payments; and optionality over cash returns and balance sheet security from asset sales. The margin of safety was important in providing time to properly assess the structural issues that surrounded the investment case.

Since investing at an initial purchase price of c. 640p, the Fund has received the 34p final dividend (for FY16) and, although the dividend is guided to be lower, a further ordinary dividend of 23-30 pence per share is expected this year, plus a share of the disposal proceeds from the announced asset sales. At this stage it is too early to ascertain if the undoubted structural issues in the US higher education business, the cause of the recent profit warnings, have been fully addressed by management's new strategy or are fully encapsulated in market forecasts. What our early work does show is that there have been a number of idiosyncratic headwinds that the business has faced in the last few years that are likely to not recur: a major regulatory shift which affected the group's market leading assessments business; scandals in the for-profit college sector, where Pearson has high market share; and longer-term cyclical declines in university and higher education enrolments as the global economy recovered after the financial crisis.

There is no doubt that the cost of a good education became too high in the last decade, and textbook publishers have had their part to play in this. Forcing printed book prices ever higher has compounded existing enrolment weakness, resulting in the emergence of the book rental model, digital piracy and the increasing involvement of philanthropic learning organisations. Pearson's recent acceptance of its part to play in this is a good investing starting point. Management actions look encouraging at this early stage, too, given low market expectations: aggressively restructuring the cost and asset base, adopting its own rental model and accelerating the shift to a digital and online learning future that embraces student-specific learning outcomes using modern techniques including Artificial Intelligence. We will keep you updated on our work here.

Another new position for the Fund this year is **Marks & Spencer**, which we see as one of the more idiosyncratic business transformation stories in the deeply unloved UK retail sector. M&S has been of interest to the Fund since Steve Rowe took over as CEO just over a year ago. Despite Rowe being an M&S 'lifer', we found his new strategy in Clothing & Home refreshing, and it bore a number of similarities to the successful turnaround that is underway at Morrisons: a capital-light approach to a return to top line growth by getting the basics of retailing right including less promotions but lower opening price points and simplified ranges but greater availability. Additionally, we liked a stricter focus on returns in the business, with capital allocation decisions no longer based on discounted cash flow derived internal rates of return (IRR) but instead on cash payback metrics, thereby reducing exposure to the increasing tail risks that occur when using long-term forecasts in this fast moving sector. It is early days, but full-year numbers suggest there are signs that Rowe's Clothing & Home strategy may already be having an effect. Despite Q4 like-for-like sales being at the lower end of expectations, it is likely that much of this was self-inflicted given that 2,400 key lines were reduced by an average of 18%, full-price sales are no longer in decline (see chart below) and market share is stabilising after five years of declines (from 10.4% to 8.7%), as M&S is winning share off those retailers that are failing to adapt to the new environment e.g. BHS and New Look. Additionally, gross margins were significantly ahead (+105bps) despite currency headwinds, as the business benefited from continued improvements in direct sourcing and, most notably, reduced discounting. Although stabilisation in Clothing & Home is not the sole appeal of this story, it is certainly one of the most underappreciated aspects.

Marks & Spencer: increases in 'Clothing & Home' full-price market share



Source: Kantar Worldpanel – Clothing and Footwear market 12 w/e 9th Apr 17 data. Bps change versus prior year.

Arguably the clearer driver of future value at M&S is the roll-out of its Food business, where it is the leading innovator in the sector (25% of the range is new each year). Whilst the UK supermarket sector has by no means been an attractive sector in recent years, the food-to-go market has been a very different story: IDG, the grocery industry's research and training charity, forecasts the sector could grow up to 35% over the next five years. M&S is well placed, with over 40% of shoppers buying food 'for tonight', a new five year strategic roadmap to increase food floor space by over 30% (some of this replacing Clothing & Home space), plus the recent announcement that it will trial a very small online food shopping service this autumn. Food is already the largest contributor to M&S's revenues, and in two years' time it is likely to be the largest contributor to profits too, diluting the more cyclical Clothing & Home earnings.

Whilst we accept that the UK consumer faces uncertainty, we take comfort in the growing margin of safety around this turnaround story: the shares trade on an EV/EBITDA multiple near historic lows whilst offering a secure 5% yield, which is almost twice covered. Capex has more than halved from its peak in FY13 and continues to decline following completion of a number of major infrastructure projects, so net debt is reducing, while there is a pension surplus. The recent appointment of turnaround veteran Archie Norman, who made his name bringing Asda back from the brink of bankruptcy, as Chairman brings further strategic insight and focus to the ongoing recovery.