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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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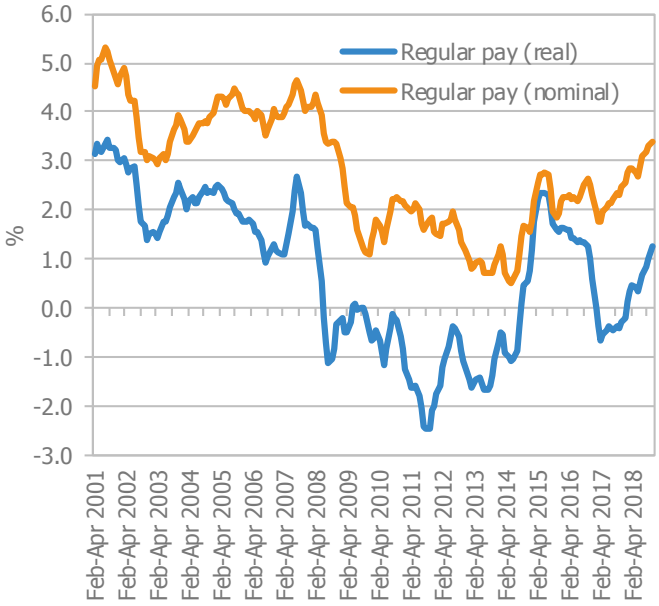
Investment background

Global equity markets continued to recover in February. US indices again led the rally (the S&P 500 index had its strongest start to a year since 1987), as market hopes of an end to the US-China trade war grew after President Trump delayed his deadline for raising tariffs and minutes released from January's Federal Reserve meeting showed that more accommodative monetary policy would be used if future economic conditions warranted it.

The ongoing trade war uncertainty continued to take its toll on global manufacturing, however. The JP Morgan Global Manufacturing PMI survey sunk to a near two-and-a-half year low of 50.7, or, if one excludes the US from this calculation, 50.0, thereby signalling stagnation in manufacturing outside America. China's manufacturing PMI fell deeper into contraction at 48.3, a 35-month low, whilst Japan's manufacturing PMI fell to 50.3, its lowest level since August 2016, with the first decline in production in two and a half years (ending the longest sequence of growth since the financial crisis). In the eurozone, manufacturing moved closer to stagnation at 50.5, as Germany entered contraction territory with a reading of 49.7, a 50-month low, and stocks of finished goods rose for a fourth successive month to the greatest degree since the survey began over 20 years ago. This provided a weak base for the eurozone flash manufacturing PMI, which subsequently showed contraction at 49.2, a 68-month low, as new orders continued to fall. Likewise, Japan's flash manufacturing PMI fell to 48.5, signalling contraction for the first time in two-and-a-half years.

The repercussions of the trade war on global services were more muted. Whilst the JP Morgan Global Services PMI fell to 28-month low of 52.6, it remained firmly in expansionary territory and subsequent flash updates from the US and the eurozone recorded encouraging 8-month and 3-month highs, respectively. In the UK, uncertainty continued to come predominantly from the Brexit negotiations rather than global trade. The UK services PMI for January showed a renewed loss of momentum, falling to a two-and-a-half year low of 51.2. It was accompanied by reports of more cautious staff hiring, leading to a reduction in staff numbers as companies chose not to replace voluntary leavers. Although only marginal, this is the first reduction since the end of 2012 and may be a sign that even the UK labour market is beginning to feel the strain of Brexit uncertainty, having previously been a source of unequivocal strength since the referendum. The KPMG and REC report on UK jobs showed growth in demand for staff softening to its lowest level in over two years. However, candidate availability continued to be the more limiting factor on job creation, worsened by rising hesitancy among potential candidates to move given the uncertain economic backdrop. That both nominal and real wage growth continued to rise (see chart) despite these pressures suggests that there could be scope for continued wage growth if and when Brexit uncertainty passes.

UK average weekly earnings excluding bonuses
(annual growth rates)



Source: ONS.

Whilst February saw the UK Parliament come no closer to an agreed deal with the EU, importantly it did see the elimination of some of the more economically uncertain potential outcomes. Notably the passing of the Cooper amendment meant that a 'no-deal' Brexit on 29th March is now impossible against the will of Parliament, thereby reducing the risk of a disorderly exit. Likewise, the formation of a new political party, The Independent Group, following the defection of eight Labour MPs (subsequently joined by three Conservative MPs), may have set in motion the creation of a centrist party, thereby reducing the potency of the less business-friendly Left and Right extremes within the existing two dominant parties. The confluence of these developments led sterling to rally to a near two-year high against the euro and eight-month high against the US dollar.

Strategy update

The Fund underperformed in February, rising 0.49% versus a 1.65% return by its benchmark, the FTSE All-Share Total Return index (12pm adjusted), representing (geometric) underperformance of 114bps. Year-to-date the Fund has risen 6.62% versus a 6.32% rise by the index, outperformance of 29bps. Underperformance in February was disappointing given it was predominantly driven by stock selection and given that 30% of the portfolio's capital is in stocks that derive more than 70% of their revenues from the UK, meaning the Fund should have performed better in view of sterling's strength. The Fund not owning AstraZeneca cost it 36bp of performance, as the shares reacted well to strong Q4 sales growth in a number of its new drugs. However, it was the surprising announcement that Andy McCue, CEO of **The Restaurant Group**, would be leaving due to personal circumstances that provided the greatest headwind to the Fund's performance.

The news of the CEO's intended departure so soon after the highly contentious deal to acquire Wagamama (which only closed in December) was understandably met with uncertainty and disappointment. This was despite a trading statement stating that trading remained in line. The share price fell 13% over the month, costing the Fund 66bps of negative relative performance in a month when the shares should have been up given sterling's strength and Brexit de-risking. We cannot help but feel aggrieved and uncertain given the support we offered the company and CEO throughout the transaction in what was a challenging period given the increase in leverage and the size of the equity raise. However, we also believe that this would not have been a decision taken lightly by Andy McCue given his determination and conviction in driving the Wagamama deal to completion.

Looking forward, remaining unemotional and absent any material changes other than the CEO's circumstances (which would be pure speculation), the shares are now simply cheaper than they were previously: 10x forward P/E, 6x EV/EBITDA, 2x vanilla net debt/EBITDA. The concessions and pubs businesses are worth, in our view, at least c. £400m (including c. £150m of pub freeholds and long leaseholds). If these were sold and the cash used to pay down debt, then the remaining leisure business (Wagamama, Frankie & Benny's, Chiquitos, Garfunkels, Firejacks) unlevered enterprise value (excluding leases) would be £500m and on just c.4-5x EV/EBITDA. It could easily be worth double this, in our view, demanding an 8-12x EV/EBITDA if operated well. It is worth recalling that Wagamama alone was bought for an EV of £559m.

In summary, there is more than enough raw material within The Restaurant Group to attract a strong calibre of individual as the next CEO. There is a much improved platform, now oriented 70% towards growth businesses, from which to continue, accelerate or indeed tweak strategy where necessary. Further there is a low valuation and scope to protect the balance sheet if necessary (and in extreme circumstances) through either asset sales, or a dividend holiday. The odds of being able to create value from here are firmly stacked in a new CEO's favour.

Another of the Fund's UK-centric stocks, **Marks & Spencer**, ceded gains following the announcement of a £600m rights issue and 40% cut in the dividend in order to finance an acquisition of a 50% stake in Ocado's online food retail business. Whilst a bold and necessary move that will likely be a success in time, the terms of the transaction are dilutive to current earnings whilst the growth on offer is not near enough or large enough to change the P/E rating of the combined group sufficiently to support the share price. The Fund halved its position immediately from 120bps to 60bps. Much of the capital was reallocated to **ITV**, where full-year results showed signs that the turnaround strategy introduced by the new CEO, Dame Carolyn McCall, is gathering pace. We will reflect further and meet Marks & Spencer management before deciding the next move.

The worsening global manufacturing backdrop put pressure on the share prices of the Fund's industrial holdings, collectively delivering a 39bp headwind over the month. **TT Electronics** accounted for 19bps of this headwind, with its shares falling 13% as the market reflected on the short-cycle nature of c. 60% of group profits whilst also digesting the technical effect of an institutional shareholder placing 5% of outstanding shares at the end of January. Industrials remains the Fund's second largest overweight, but this has more than halved, from +639bps of active capital in Q2 2018 to just +301bps in February 2019. As we concluded in our 2018 Q4 investor call, the global macro remains difficult to read and hence we have been selective with our exposures.

Whilst cognisant of the headwinds implied by recent economic data, this Fund's selection process is based upon choosing those stocks that can generate shareholder value through idiosyncratic, self-help characteristics rather than any reliance on prevailing macro trends. Although no company operates in a vacuum, share prices are dynamic and thus quick to reflect changes in economic reality. Our job is to identify those companies where share prices have been overly discounted and thereby under-price an attractive equity story.

In this context, it is worth noting that many of the Fund's industrial holdings have limited or no exposure to the global investment cycle: **QinetiQ** and **Chemring** are pure defence companies selling to international governments; **SIG** is a distributor to the construction industry; and c. 60% of **Essentra's** current revenues are derived from the non-cyclical healthcare and tobacco sectors. Those stocks that are exposed to investment cycles are undertaking significant restructurings including asset disposals and/or acquisitions in order to generate shareholder returns independent of the wider economy. Names here include **Melrose**, **TT Electronics** and **Elementis** (although Elementis is not technically classified as an industrial, 40% of its profits are derived from its industrials coatings division), or have been taking significant market share, thereby acting as an offset to prevailing market headwinds e.g. **Electrocomponents**. The scale of market share gains being achieved by Electrocomponents was evident in the recently issued trading update for the four months to 31 January. Group like-for-like revenues grew 6% whilst the company maintained flat gross margin guidance and continued to deliver cost savings.

In the context of discounted share prices, it is pleasing to report that **Moneysupermarket** had a strong set of full-year results that demonstrated traction in the new management team's strategy to re-establish growth by focusing on improved customer experience. The numbers for 2018 were slightly ahead of expectations, but importantly the cash generation was strong and the forward outlook statement encouraging. The company also announced an additional cash return of £40m. The Fund increased its position to 1.76% of absolute capital.

3i Group was the best performing share for the Fund in February, as the shares continued to react to the strong Q3 performance update at the end of January. Elsewhere, **McBride**, a small position within the Fund (c. 70bps), had a profit warning just over a month after having confirmed at the H1 stage that full-year earnings were on track with expectations (see 'Under the Bonnet', January 2019). Cost inflation in logistics costs and raw materials returned sharply, having previously thought to be under control by management. Cash flow and debt were slightly better but despite this the shares fell c. 30%, costing the Fund 19bps of relative performance. The Fund partially rebuilt the position, as the issues seem genuinely market related and the P/E is now at a 10-year low of c. 7 x (to June 2020). Finally, the Fund exited its residual (c. 27bps) position in **CMC Markets**.

JOHCM UK Dynamic Fund
5 year discrete performance (%)

Discrete 12-month performance to:

	28.02.2019	28.02.2018	28.02.2017	28.02.2016	28.02.2015
A GBP class	-1.59	8.81	28.97	-8.23	4.32
Benchmark	0.93	4.96	23.09	-7.53	5.70
Relative return	-2.49	3.67	4.78	-0.76	-1.30

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 28 February 2019. 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.

Source: JOHCM/Bloomberg unless otherwise stated. Issued by J O Hambro Capital Management Limited authorised and regulated by the Financial Conduct Authority. Past performance is no guarantee of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. The Fund's investment include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. Source: JOHCM/Bloomberg/FTSE International. Note for return history: NAV of share class A in GBP, net income reinvested. Benchmark: FTSE All-Share TR Index. Performance of other share classes may vary and is available on request. FTSE International Limited ("FTSE") © FTSE 2017. The Industry Classification Benchmark ("ICB") and all rights in it are owned by and vest in FTSE and/or its licensors. "FTSE" ® is a trademark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. Neither FTSE or its licensors accept any liability for errors or omissions in the ICV. No further distribution of ICB is permitted without FTSE's express written consent. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Holdings Ltd. Registered in England and Wales under No: 2176004. Registered address: Level 3, 1 St James's Market, London SW1Y 4AH, United Kingdom.