J O Hambro Capital Management Group

# JOHCM UK Dynamic

FOR PROFESSIONAL INVESTORS ONLY

## Under the Bonnet

May 2017

### Investment background

Politics dominated the UK market in April following the surprise decision by the Conservative party to call a snap general election in June. Sterling strengthened on the news, driven higher by the expectation of a stronger mandate and negotiating position for Theresa May in the article 50 discussions and also on the hope of a slower and less economically disruptive path to an EU exit. The recovery in sterling began in earnest in mid-March, around the time that the UK OBR upgraded its forecast of GDP growth to 2.0% for 2017 (from 1.4%) with the UK budget. The OBR also highlighted improving public finances by reducing the expected public deficit for 2016-2017 by £16.4bn to £51.7bn. Sterling's recovery was extended with the triggering of Article 50 (on 29th March) and then again in April on the calling of the June election.

**Bank of England GBP Broad Trade Weighted Index (May 2015 = 100)**

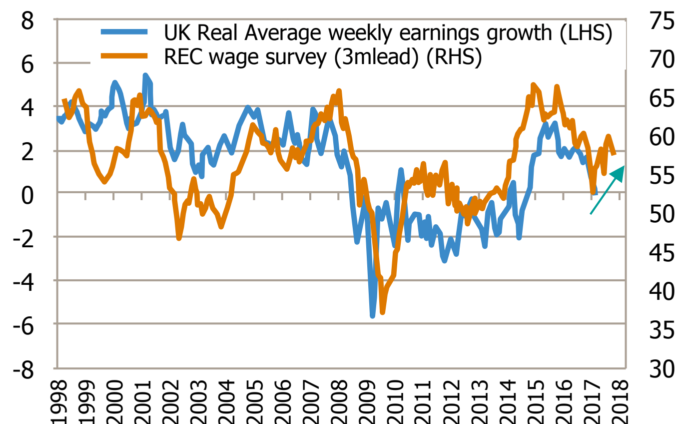
Source: Bloomberg JOHCM

This strengthening, if sustained, is highly significant for inflation expectations and therefore for the UK consumer and the UK economy. The ramifications of sterling weakness in the period since Brexit remain in evidence for now, with ONS inflation data for March staying at a fairly elevated +2.3%, albeit flat month-on-month as petrol costs begin to unwind. Rising prices have clearly had an effect on consumer behaviour so far in 2017, with ONS retail volumes for the quarter to the end of March showing a decline of 1.4%, with average store prices up 3.3% and petrol up 16.8% year-on-year. British Retail Consortium (BRC) data was similarly weak in showing a 1.0% decline in March, with non-food expenditure down by 1.1% over three months, the lowest three-month average since 2011.

Employment data in the UK remains extremely healthy. The April ONS release reported a 74.6% employment rate in the quarter to February, the highest since records began, and at 4.7%, unemployment was the lowest since the summer of 1975 (only months after this writer was born, i.e. the lowest in my lifetime). The recent inflation issue has, however, coincided with a period of continued weakness in wage data in the UK, with ONS average weekly earnings remaining stubbornly low at +2.3% year-on-year (including bonuses) for the three months to the end of February. It is no wonder that with subdued wage growth, weak sterling and a subsequent rise in living costs, the Markit Household Finance Index in April saw the sharpest fall in cash available to spend since August 2014 while at the end of April the ONS preliminary estimate of Q1 GDP came in lower than expected at just 0.3%.

Nonetheless, this highlights the folly of relying on historic data. On inflation, the trends look okay. The Brent crude oil price fell by 2.1% (to US$52/bbl) in April and is now down 7.1% over the last three months. Petrol prices were up c.17% year-on-year, but fell month on month in March and the April data will likely show a further fall. This will have a dampening effect on inflation and give consumers some respite. Indeed, when looking at consumer spending, while volumes showed some weakness on average in the Q1 BRC and ONS surveys (although March data was better), when we include price and look at the value of spending growth, it was running at a healthy 4.3% in the UK, as was seen in the Barclaycard Q1 2017 consumer spending report. If sterling does carry on its recent strengthening path, pressures on importers and retailers to increase prices or suffer margin pressures will abate. Prices may come down, but volumes will rise.

Ultimately consumers' propensity to spend is not just based on prices but on real wages and whether recent pressure abates. When looking deeper at the wage data, whilst average three-month earnings were low at 2.3%, earnings in March rose by 3.2% year-on-year in the private sector (and by 3.7% in finance and business services), confirming the KPMG REC employment survey for April, which showed demand for staff close to the strongest for 18 months and permanent starting salaries continue to rise sharply. It's worth remembering also that the national living wage increased to £7.50/hour from £7.20 in April and has yet to be captured in the data.




Source: Barclays Strategy Team

When digging deeper into household finance trends again there is encouragement. Mortgage rates in April hit new lows, a delayed reaction to declining UK bond yields and also due to increased competition in the market. Mortgage affordability ratios have recently hit 15-year highs[1]. It is also worth remembering the increase in the income tax threshold from April, announced in the last budget, which enlarges the subset of the population that will pay no income tax. Finally, the Conservative party have suggested energy price caps as part of their election manifesto, which again should be a good dividend to the lowest quartile of earners.

Looking forward, and taking all of the above into account, the outlook for real wages, consumer spending and the UK consumer space might be better than current data shows.

[1]Darren Winder, Lazarus Economics & Strategy, UK Economy Briefing May 2017 p.195, housing affordability arithmetic, first-time buyers.

## Strategy update

The Fund had a fairly flat month, rising by 0.42%. This represented outperformance against the benchmark FTSE All-Share Total Return (12pm adjusted) index which declined by -0.15%. The Fund's outperformance was driven in the main by sector allocation effects, with stock selection effects being fairly neutral. Indeed, it was an interesting month for sector movements, with political and macro-economic events being key market drivers.

Utilities, a sector where the Fund has no current exposure, fell by 3.4% following the Conservative party's proposed energy price caps. The basic materials and oil & gas sectors, which the Fund is currently marginally underweight, fell by 4.4% and 3.9% respectively in response to declining commodity prices more generally. Consumer services, where the Fund has a growing overweight position, rose by 1.7%, with the general retail and travel & leisure sub-sectors leading the gains, up 4.4% and 3.9% respectively. This rise was primarily in response to strengthening sterling, but we feel there are an increasing number of attractively valued, idiosyncratic and significant business transformation opportunities emerging in that sector. Lastly, the financials sector is worthy of mention, rising by 3.4%, but with a strong showing from the real estate sub-sector (+4.7%). Given a tricky sector backdrop, where macro was the predominant driver of market movements, marginal outperformance was a pleasing outcome, particularly given that the month started very poorly.

On the 3rd April, **Imagination Technologies,** an earlier stage investment made in August 2016, announced that Apple "…will no longer use the Group's intellectual property in its new products in the next 15 months". This was a major negative in the ongoing restructuring of this company and represented a crystallisation of a known but inadequately discounted (by us and by the market) tail risk in this particular investment case. Whilst it was early days for this investment in the Fund (sadly this is the first time we are reporting on it in 'Under the Bonnet'), this news marked a huge departure from the expected path from the management's, and crucially from our own, investment case. If Apple does indeed stop using the Imagination Technology core architecture for its Graphics GPU, then there will be a completely different set of revenue, profitability, cash flow and balance sheet metrics and none that could sustain dividend payments. With that in mind, we elected to crystallise the loss from the Fund's 75bps active position and sell the shares in full on the day of the announcement for a 51bps relative loss over the month.

On a more positive note, the Fund continued to benefit in April from the ongoing strong performance from some of the larger active positions. **Electrocomponents** had an extremely encouraging full-year trading update, reporting that both revenue growth and gross margins were ahead of expectations in the final few months of the underlying year. Of particular note was the fourth quarter performance in North America, which saw revenues grow 16% year-on-year and strengthen as the quarter went on.

Elsewhere, **3i Group** had a strong month as the market continued to appraise the strengths of its largest portfolio investment, Action, a European discount retailer. In March, Action reported strong results for the year to December 2016, which showed revenue growth of 34%, like-for-like revenue growth of 6.9% and EBITDA growth of 37%. As a result a number of 3i analysts have increased their valuation assumptions applied to the investment, with one analyst suggesting the investment could be worth double the existing book valuation.

**QinetiQ** is another stock benefiting from a positive reappraisal of the investment case as the company shifts from retrenchment to growth. This tighter growth focus has recently resulted in a number of contract renewals at favourable margins, an interesting acquisition and a commitment to increase investment in the group's core assets. One of these assets is the Empire Test Pilot's School (ETPS), where a direct consequence of a recent commitment to invest £85m into the ETPS (with the Ministry of Defence) was its accreditation by the European Aviation Safety Agency (EASA) as a certified trainer of test pilots to civil standards. This makes ETPS one of only three schools in the world and the only one in the UK with this accreditation. Under new rules all civilian test pilots in Europe must be trained in an accredited school. We look forward to full-year results from Electrocomponents, 3i Group and QinetiQ in May.

Following on from a strong end to 2016, **Robert Walters** reported Q1 2017 results which saw net fee income grow by 20% year-on-year in constant currency, the fastest growth rate since Q1 2011 and marking a new record for quarterly fees. All regions grew by double digits but there was particular strength in the UK, which grew by 27%, and Europe, which grew by 25%. The results bear witness to the continuing strength in the UK employment sector and particularly the more recent recovery in the financials sector but also the relatively nascent recovery being seen in Europe. Management continue to impress in the way they are growing the business globally and particularly their market leading outsourcing business, Resource Solutions. We continue to hold the shares, albeit at a recently reduced weighting.

In April, we saw continued evidence of performance broadening out amongst our holdings, whereas previously performance was driven by the largest active positions. One such example came from **Elementis**, a speciality chemical company with an increasing focus on the personal care market, which showed evidence of positive developments within its Q1 trading statement. Strategically in Q1, the company sold a non-core business in the US, closed a facility in Jersey City (which made sub-standard returns) and announced the acquisition for US$360m of SRLH Holdings, a high margin speciality chemicals platform selling chemical actives in the personal care market. This business has in excess of 40% market share in the 'AP actives' market – essentially the core base ingredients in anti-perspirant deodorants. The business brings with it intellectual property, customer relationships and a strong sales team that can help drive revenue synergies across a broader portfolio of personal care products within Elementis. Operationally, after a tough two years in its Chromium business, evidence in Q1 suggested a stabilisation and improvement in demand in the high margin international market, which has been a key source of earnings disappointments. Demand in the speciality products businesses – coatings, personal care and energy – was also up year-on-year in Q1, 'strongly' in the case of personal care and energy, whilst in the non-core surfactants business, short-term positive pricing effects give the company a clear window to sell the assets. These assets could be worth well in excess of book value. This new management team are moving at pace, undertaking a rapid business transformation and creating a cash-focused, higher quality and faster-growing business. Something missing here?

*Erratum: In April's edition of 'Under the Bonnet', in discussing Acacia Mining, we mistakenly stated that Tanzania accounted for 30% of the group's revenues. The correct figure is 100%. (Gold and copper concentrate amounted to approximately 30% of group revenues.)*

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