November 2017

FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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Investment background

Markets generally made good progress during October, a month that witnessed a remarkable amount of political and economic news flow around the globe. On the political front, China saw the conclusion of the 19th National Congress. This solidified and strengthened Xi Jinping's power within the country, with his name officially entering the Chinese constitution, the first living party ruler since Mao Zedong to be bestowed that honour. In Japan, Shinzo Abe won a decisive victory for his ruling Liberal Democratic Party, which opens the door to highly significant (for Japan and Asia) constitutional reform and drove the Nikkei 225 index 8.1% higher. In Spain, Mariano Rajoy exerted his authority over the want-away Catalonia region by dismissing calls for independence and dissolving the Catalonian parliament. In the UK, Theresa May's attempts to solidify her own position at the Conservative party conference were somewhat unsuccessful, with her keynote speech being widely derided after a generally poor performance in both content and delivery. Speculation lingers over a potential leadership challenge, although it seems unlikely for now. In the meantime, Brexit negotiations continue and although little of note was achieved by either side in October, there are signs that the impasse over first phase talks will be overcome, leading to a broader discussion soon over trade and a two-year transition period.

On the economic front, global trends continued on the same recent path, with strong output and jobs data being seen across the majority of developed nations with particular ongoing strength in eurozone data. The manufacturing PMI for September was particularly noteworthy, being the fastest pace of expansion for the region for six years and being a 77-month high for Germany, France and the Netherlands and the highest in Greece since 2011. The flash data for October released late in the month showed similar strength with new orders remaining strong, boding well for the short-term outlook. On the 26th October, the ECB announced a more dovish-than-expected tapering programme, with ECB president Draghi choosing to signal a much slower path to any future rate rises despite the rapidly recovering economic situation. This should ensure a continuation of the ongoing regional economic recovery. In the US, data generally remained positive, although there was a hurricane-affected lower-than-expected non-farm payroll print of -33,000 (revised up to +18,000 on 3rd November). The bigger news in the US in October related to the acceleration of Donald Trump's long-promised tax reform policies, with the Senate passing the required budget resolution on the 20th October which the House of Representatives then narrowly passed on the 26th October. This news and generally strong corporate results drove the Dow Jones index 4.3% higher over the month.

In the UK there was a solid picture. Manufacturing and Services PMI data were resilient, although did decline slightly in September, whilst the construction PMI recorded a surprisingly low figure of 48.1, with subdued risk appetite in some parts of the sector driven by Brexit uncertainty. The labour market remained strong however, in the form of the lowest unemployment rate since 1975 at 4.3%, although average weekly earnings data remained low at 2.1% excluding bonuses. Inflation data in the UK continued to overshoot the Bank of England's target, with the CPI for September being 2.8% (food and recreational goods were the main upward contributors). The chance of a rate rise in the UK, the first since 2010, therefore strengthened over the month and was then all but guaranteed after UK GDP for Q3 came in at 0.4%, slightly ahead of expectations. The Bank duly obliged on 2nd November with a 7-2 vote in favour of a 0.25% increase in the bank rate to 0.5%.

Strategy update

The Fund fared reasonably well in October, rising by 2.20% against its benchmark, the FTSE All-Share Total Return index (12pm adjusted), which rose by 1.88%. Technology (+8.5%) and oil & gas (+5.7%) were standout performers on a sector basis, with the former driven higher by very strong corporate results in the US sector (Alphabet and Amazon in particular) and the latter by the strengthening oil price (the Brent crude oil price rose by 6.2% over the month) and strong quarterly results from **BP**. Utilities (-3.1%) and healthcare (-2.7%) had tough months, with ongoing regulatory uncertainty affecting the energy utilities and a poor performance from **GlaxoSmithKline's** shares after comments on the Q3 results conference call led to the shares falling materially and closing the month 8.8% lower.

Focusing on GSK (the Fund has a 4.5% absolute position) first, the market decided there were dividend implications from comments on the Q3 call from the CEO that 2018 might see a slight margin decline due to extra investment and further comments that the company would look at the forthcoming sale of Pfizer's consumer unit (although not specifically commented on). We feel the market's concerns on the investment are overstated as the investment will help support strong new product launches and future growth.

On the dividend and capital allocation question, we feel that any acquisition-led change in the dividend, whilst not ideal, might be the right thing to do. However, we also recognise that the messaging from the company and the CEO, in particular, on the dividend since the strategy update with the interims has been mixed and needs to be cleared up. There were some clear priorities for future uses of free cash flow laid out which stated that business investment would come first, with investment prioritised on the pharmaceuticals pipeline, the realisation of the Novartis consumer put option and, lastly, capacity investment for the vaccines business. The second priority for free cash flow would then be the dividend, and then, thirdly, 'disciplined business investment'. Whilst we would not expect the CEO to dismiss outright the chance to have a deep look at a major competitor business when it comes up for sale, given there remains much work to be done with the existing Novartis consumer joint venture integration plus currently stalling growth plans, and given the above clearly laid out capital allocation priorities, we feel it is neither the right time to allocate more capital to this division nor does it fit within GSK's own capital allocation priorities. We would therefore be very surprised if GSK took part in an undisciplined competitive

auction for that asset and would need to be convinced if it were otherwise. Let us see how it plays out, but for now the market will remain highly sceptical. We should not expect an immediate share price recovery.

Staying with the pharmaceutical theme, we promised a further update on the Fund's remaining position in **AstraZeneca**. As a reminder, we had taken the position to a near neutral after many years of being overweight prior to the announcement of the much-anticipated Mystic immune-oncology trial results in July. The shares have since recovered their poise after a number of positive announcements from the company on other pipeline assets and now trade at a higher level than pre-Mystic. This is partly due to the relatively positive announcements and partly due to continuing speculation of a takeover. Either way, the shares trade on a headline P/E of 18x against c. 12x for GSK and a FCF yield of c. 3%. On a cash EPS basis, which adjusts for one-off divestments (the scale of which has been worrying us of late), restructuring and royalty obligations, the shares, using JP Morgan forecasts, are closer to 39x 2018 earnings. The dividend yield is c. 4% but the cash cover of that dividend is low at c. 0.6-0.7x. Net debt is c. 2.2x ebitda. The risk/reward profile therefore looks unattractive, and if the growth from immuno-oncology does not come through as fast or in the scale expected, the dividend and share price look vulnerable. And so, after nine years of successful ownership (AstraZeneca was a core holding when the Fund launched), we have sold the final position and moved on.

Electrocomponents had a strong month after a further positive trading statement covering the company's second quarter and half year to September 2017. Revenue growth accelerated in Q2 to 14% across the group from the already high 13% in Q1. Trends in Europe strengthened, perhaps unsurprisingly given the strong economic backdrop, and elsewhere across the globe remained very robust (+17% in Asia and +15% in North America). However, this is not just about global PMI growth, helpful as it is. It is about strong strategic progress. Own branded business RS saw an acceleration in its growth rate to +10% in H1, implying c. 12% in Q2 from 8% in Q1. This is highly important as it is a key strategic focus of this management and a high margin part of the group. Gross margins across the group were also indicated to be up year-on-year, proving that this growth is not just simply being bought. Given the strong trading, management took the decision to invest further in the business by increasing working capital and committing to more innovation and digital spend to support future growth. This is the right thing to do. Despite this extra investment, forecasts moved higher in the market by c. 5-7%, continuing the strong momentum that started c. 18 months ago. As a reminder, eps forecasts for April 2018 were around 15p 18 months ago but are currently 73% higher at 26p. A very impressive update.

Another successful investment for this Fund over the last few years has been **Robert Walters**. The company announced a very strong Q3 update in October. This again showed very strong revenue growth (+21%), with rising demand across the globe for core recruitment and in its recruitment process outsourcing business Resource Solutions, where the company have invested over the last few years. As a result, the board announced that results would be ahead of expectations.

Robert Walters is a good business that is well managed and invests counter-cyclically. Management continued to build a global platform throughout the post-financial crisis downturn and maintained investment in Europe through some tough years. As the global economy has recovered and the eurozone recovery has cemented, financial performance has been consistently ahead of market expectations from this company.

We first invested in the shares on 4th January 2013 at 196p (I still remember walking to the first meeting with management on that day) and the shares have never really been lower since then, a rare occurrence indeed! The thesis on the Fund's investment was fourfold. Firstly, that the business was likely to see recovering economic conditions in the UK first but then globally over the next few years. This would lead to a revenue recovery that analysts were not yet predicting. Secondly, that there would, in time, be a strong 'conversion margin' recovery (operating profit/net fee income) as the revenue recovery took hold and as the embedded investment to build both Resource Solutions and the global platform paid off – conversion margins peaked in 2017 at 20% but troughed nearer 2%. This would drive rapid earnings growth. Third, that the Resource Solutions business was a key differentiator of the company relative to the competition but was also still in its infancy and therefore might be undervalued and misunderstood by the market. Finally, that as a result of these things the brand Robert Walters and therefore the group was undervalued (at a market capitalisation of roughly £160m at that point) and indeed may well get taken over; we are still very surprised it hasn't been.

Having watched the business recover and grow and the thesis play out, we started to slowly sell the shares in 2017 as the share price climbed. The final position was exited in October at 601p after we took advantage of the strong liquidity after the trading statement (interestingly, unbeknown to us, management also sold a large amount of stock at that same time). Whilst we expect the business to continue to grow, EPS has gone from 6.2p to 33p (forecast for this year) and the market capitalisation is c. 3x larger than when we first invested. To us that feels like a job well done and an opportune time to sell what remains a highly cyclical asset. The next five years will perhaps not be as easy as the last, but either way it has been a good investment for the Fund and we wish management well.

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