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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Under the Bonnet

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Investment background

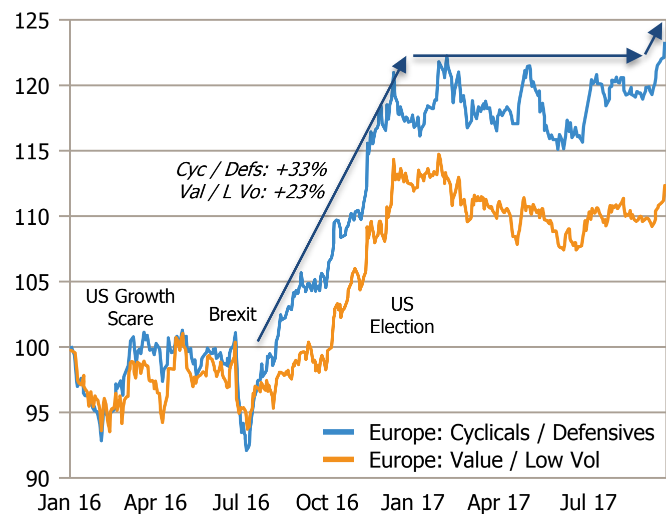
It was a strong quarter for global equities, with most indices rising as August's global services and manufacturing PMIs reached six- and two-year highs, respectively. The European manufacturing PMI equalled June's 74-month high and continued to lead global growth, while there was also strong growth in the UK, where the PMI reached its second-highest level in over three years. Whilst UK services and construction PMIs did not match the strength seen in manufacturing – both softened to near one-year lows – UK unemployment continued to create record lows at 4.3% in July, albeit wage inflation remained sluggish and below expectations at +2.1% (vs. +2.3% expected), comparing unfavourably to August's Consumer Price Inflation (CPI) number of +2.9%.

Despite sluggish UK wage growth, Gertjan Vlieghe, one of the Bank of England's more dovish Monetary Policy Committee (MPC) members, remarked at the annual conference of the Society of Business Economists: "the evolution of the data is increasingly suggesting that we are approaching the moment when the bank rate may need to rise". This came only a day after the MPC said a majority of its members thought it would be appropriate to increase rates "over the coming months". These events led UK-10 year gilt yields to rise sharply and end the quarter at eight-month highs, having previously been at levels in-line with 10-month lows. Consequently, sterling reached a new post-EU referendum high against the US dollar (further aided by Prime Minister Theresa May's speech in Florence signalling a softer negotiating stance with the EU), which put pressure of the share prices of the US dollar-earning members of the FTSE All-Share index, leading it to fall for the first time since June.

September marked a sharp reversal in bond yields, not just in the UK but globally. In the US the generic 10-year yield returned to the elevated levels seen at the beginning of the quarter as US consumer price inflation rose by 0.4% from the prior month and 1.9% year-on-year. The US services PMI reached a 21-month high and, notably, it was reported that firms were adding to their payrolls at the quickest rate in two years and that input cost and output charge inflation had reached 26- and 35-month highs respectively. Federal Reserve Chair Janet Yellen subsequently warned policymakers to be careful in "moving too gradually" on monetary policy despite "significant uncertainties" over inflation, whilst also announcing the Federal Reserve was to end its quantitative easing policy with the planned reversal of ten years of balance sheet growth which has seen it more than quadruple to US$4.5 trillion.

In light of the above commentary and as we draw close to the one-year anniversary of the US election, it is interesting to note the analysis below from the Strategy team at Barclays, who pose the question that after last year's dramatic moves "Is the reflation trade over?" after nearly a year of mixed performance… or is it not?

Is the reflation trade over?



Source: Barclays Research, Bloomberg, DataStream, MSCI.

Strategy update

The Fund performed strongly in September in returning 1.22%, net of fees, versus a -0.06% return for its benchmark, the FTSE All-Share Total Return index (12pm adjusted). The September performance also led the Fund to outperform for the quarter as a whole (by 111bps), although it was in reality a slightly tougher quarter given the documented issues with the share price of **QinetiQ** and the damaging profit warning from **SDL**, which we covered last month. So, whilst outperformance over the month and quarter was in the majority led by stock selection, the Fund also benefited from sector allocation tailwinds driven by the rising yield environment, due to its significant underweight position in sectors such as consumer goods and utilities (that are negatively correlated to rising bond yields).

In the Fund's top five positions, **Anglo American** was a standout performer over the quarter. Its share price responded to a positive commodity price environment but also to news that 'Volcan Investments Ltd', an investment holding company of the Agarwal family (Vedanta Resources Plc), intended to increase its current 12.4% stake in the company. We are unaware of Mr Agarwal's intentions but are minded to think that it merely highlights the value that still exists in this ongoing restructuring and recovery investment. **Electrocomponents** continued its recent trend of outperformance, although **Morrisons** had a tougher month and quarter after interim results showed continued revenue recovery but no margin progression. As a result, the shares saw some profit taking after a strong run. That profit taking may continue in the short term, but, with continued balance sheet improvement and strong strategic progression, we remain high conviction investors.

Most pleasing to note from the top five was the performance of **QinetiQ**. The shares responded to a positive pre-close trading update and began to recover from two-and-a-half months of fairly substantial price drops. As mentioned in the last few editions of 'Under the Bonnet', we have been baffled by the extent of the weakness in the share price. It is therefore pleasing to see management confirm their expectations for the full year and re-

iterate guidance for moderate growth in revenues, albeit the share price remains 20% off its May 2017 peak and the stock remained a negative relative contributor over the quarter.

Elsewhere, the largest contribution to performance in the month came from **McBride**, Europe's largest private-label household and personal care manufacturer. This came after the announcement of the transformational acquisition of Danlind early in the month, followed by solid final results which delivered continued improvements in margins and returns on capital and positive commentary on its strengthening market position and growth strategy.

McBride has been a near top 10 position in the Fund for two years, having built the position not long after new management joined and outlined their 'Repair, Prepare, Grow' strategy. In September 2016, management communicated that the 'Repair' phase of the business was nearing completion and that they were intending to invest over £100m in order to grow over the next four years – equivalent to 26% of its market capitalisation. This was not only a significant sum but also a major departure from the strategies of previous management teams, with cost cutting now replaced with capital investment, albeit in very strict, well defined product category verticals, such as laundry, in order to gain scale advantages from the simplification of processes and improved quality.

Management's proven success in optimising asset performance and cash generation in the 'Repair' phase alongside their rationale on the market opportunities gave us the necessary confidence to back them in the next phase of company's life cycle. Management have already de-risked one third of this £100m investment following the announcement in September that they are to acquire Danlind, a Denmark-based supplier of auto dish-wash and laundry products, for a total enterprise value of £38.8m. Not only does this give management instant production capacity in the high-end, high-growth shrink wrap dishwasher tablet market (seven production lines compared to McBride's existing one, which would have taken them two to three years to build organically), it also gives McBride an additional 8-9% market share position and access to market-leading technologies and customer relationships.

This is an exciting step forward in the investment case and marks an acceleration in strategy. On a relative basis the shares had barely moved for two years, and thus provided little contribution to the Fund's performance, as the market grappled with the switch from recovery story to growth story. Since the acquisition and further strong results, the shares have increased by 25% relative to benchmark in just over a month and now sit at a new recovery high.

The Restaurant Group, one of the Fund's earlier stage and deeper restructuring stories, had a tough month in September despite reasonable interim results at the end of August which highlighted slow but real progress in the ongoing turnaround of the group's more challenged leisure restaurant brands (Frankie & Benny's, Chiquito's and Coast to Coast). The management team here are very much in repair mode, battling a legacy of self-inflicted wounds at a time of industry capacity issues and possibly consumer belt tightening (although recent spend data from the ONS and Barclaycard suggests that UK leisure spending has been holding up remarkably well all year). The historic wounds relate to service, pricing and a negative evolution in the customer offer, which combined to alienate core customers, particularly at Frankie & Benny's. Under this management, price reductions (on average of c. 7% at Frankie & Benny's) and menu changes that are more attractive to the family and kids market have helped to improve volumes. The industry capacity issues will not be fixed immediately but there are signs of the industry responding. Just in the last few months we have seen The Restaurant Group, Prezzo, Byron and Jamie's Italian commit to meaningful site closures, whilst Fulham Shore (owner of The Real Greek and Franco Manca brands) has recently announced a slowdown in rollout plans and Pizza Express, which is in private equity hands, looks highly dubiously financed (2022 maturity CCC-rated bonds yielding c. 12%). We expect a trend of more discipline around opening programmes from the major restaurant operators to continue for a while.

Whilst The Restaurant Group has lease exposures, it does not have material balance sheet debt. It also remains highly cash generative, with net cash from operations this year predicted to be c. £80m and free cash flow of between £40-50m after expansionary capex of c. £20m (set against a current market capitalisation of c. £600m). The rollout strategy under this team is much reduced and is focused not on the group's challenged leisure restaurant brands but on its more stable and much ignored pubs and concessions businesses. This is a major reason why we are interested in this investment.

The concessions business is the number one airport restaurant concession operator in the UK, operating concessions on behalf of themselves, third-party brand owners and airport owners. TRG Concessions is highly regarded as one of the better operators in the industry, but the business has been underinvested in over the last few years, stagnating at c. 59 sites. In 2010 (the last time its results were separately reported), the business had 52 sites and generated revenue of £92m, ebitda of £19m and ebit of £14m. If we conservatively assume that revenues have grown at 2% compound since then and we add in similar per site revenue for the seven extra concessions, we get to a revenue figure of close to £130m. Using a historic ebit margin of c. 15%, subtracting £5m of central cost and then taxing at 20%, gives net income of £12m. A P/E of 18-20x (or EV/Sales of 1.5x) for a market-leading business which management intend to nurture and grow seems fair – particularly as SSP, a global concessions operator, is currently trading at c. 28x historic earnings – and yields a valuation of c. £200m. More simplistically, looking at the pubs business, we value the 57 units at c. £2m per site (Brunning & Price Ltd is the heart of this business and was bought in 2007 at a price of £32m for 14 sites, of which c. 40% were freehold). So, in combination, we have two stable and growing parts of the group which combined may account for in excess of 50% of the current market capitalisation.

What does the other £300m of market capitalisation buy you? Well, it buys an estate of c. 370 sites generating revenue of c. £500m, which should produce between £70-100m of ebitda if run properly. Valued at a 10-year average ebitda multiple of 7x generates c. 50% upside to the group's share price. There have been times where these profits have been valued at 12x ebitda, however.

We are under no illusion that turning around the leisure brands will be easy. The prize for doing so whilst growing the concessions and pub businesses at a faster rate is, though, very clear. And at this early stage and despite a highly sceptical share price, we are willing to believe it can be done.

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