

## Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers



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### The Narrative of Growth

I suspect I am not alone in being trained as a value investor in the 1980's. That was an era when straws were made of plastic, burgers were made of meat and bonds paid an income. No longer. Today in an era when bonds don't pay income the trophies go to the high ROIC stocks rather than the cheap stocks. Terry Smith is an example of one of the winners from this trend while Woodford made his name from buying out of fashion large cap stocks at value prices. The world has changed.

Which is the reason that Muddy Waters research on litigation funder Burford was so effective last week. It was a high ROIC stock and doubting the reality of their returns is powerful. The returns of these litigation funders are truly remarkable:

	Yr End	Reported	Concluded Cases
Burford	Dec-18	98%	51%
LCM	Dec-18	138%	138%
Manolete	Mar-19	180%	180%

Source: Company presentations, Liberum research

Confidence in Burford's returns was shaken last week when Muddy Waters published its critical report. Gotham City joined the conversation over the weekend and this morning Burford have instructed no less than 3 sets of lawyers to investigate evidence of market manipulation. The original report criticises Burford's valuations of cases reported as concluded. Burford's audit report states that the valuation of investments is "highly subjective". Which raises an interesting point around valuations.

### Today's Environment

In a world of low interest rates, valuations become more sensitive to changes in investor assumptions. Share prices are by definition the sum of investors' expectations of future benefits to be derived from owning a share.

Mathematically this could be depicted as the future benefits divided by the cost of money which gives the value of the share. When bond yields are low, companies that can demonstrate sustainably high ROIC therefore have high share prices.

But with a low number for the denominator a small shift in the cost of money can make a large difference to the share price. This is particularly relevant when we have money as cheap as it is today. When bonds are undergoing a dot-com like mania, illustrated by the Austrian 100 year treasury bond below. This makes these highly valued high ROIC stocks risky.



Source: Bloomberg

## Risk

At the same time the investment industry defines risk in terms of past share price volatility. Much time has been spent inventing scientific measures to measure volatility which are all measures of share price volatility thus serving to confuse customers and create a perceived value for professional advice. Examples are below:

Measure	Meaning
Standard Deviation	How much the shares go up and down
R Squared	Correlation with market
Beta	Similar to R squared
Sharpe Ratio	Return relative to how much it goes up and down
Sortino Ratio	Return relative to how much it goes down
Value at Risk	Probability of losing money
Drawdown	Maximum it goes down

There is a problem here. The well-known phrase used in most disclaimers “the past is not a guide to the future” seems to contradict the use of risk measures based on historic data. These measures are generally of little use in predicting the future. They wouldn’t have helped investors in Burbord, Provident Financial, Kier, Carillion, ASOS, Aston Martin etc. All of these were originally supposed to be “quality” stocks.

Because risk is measured by historic share price volatility companies are incentivised to continue to deliver growth in a straight line and in the real-world business goes up and down. So narrative is used to smooth investors’ expectations.

## Power of Narrative

With such rich rewards available in this low rate environment to companies that can persuade investors that high ROE can continue the public relations industry has a more vital role than ever to fulfil at this moment in time. The result is that company announcements are increasingly wordy while accounting standards encourage this by relying on management estimates of the future returns. Share option charges are calculated using a Monte Carlo simulation which uses the volatility of the share price to estimate the likely value transfer and lenders estimate their future impairments to calculate this year’s impairment charge. Software can be capitalised if future benefits can be expected, while acquisition costs are exceptional but cross selling benefits from acquisitions are treated as organic growth.

This makes it hard for analysts to decipher the reality without disclosure of underlying customer contracts. The Muddy Waters research on Burford was only put out because the company started to disclose individual cases this year on its website. In such an environment where narrative can differ substantially from numbers it can be useful to use the following translator, which I once produced for a new recruit while working as an analyst:

<b>Wording in RNS</b>	<b>Analyst Interpretation</b>
State of the Art Systems	We are in shock at what the latest software upgrade cost
Record Revenue	1% growth
Successful acquisition	Unlike all the previous acquisitions
Strategic acquisition	We overpaid
Complimentary acquisition	the existing business is ex growth
Investment in business	Haemorrhaging cash
Data management	Putting mailing lists together
Momentum maintained	<u>Its</u> about to slow
Focus on margin	Because there is no growth
Solid	We arrested the implosion
Rigorous cost discipline	Last one out turn the lights off
Remains on target	We can leave the downgrade till next quarter
These are strong results	even though you can't tell from the numbers
Well positioned	no growth environment
Parachute	Landing comfortably after being thrown from HQ by angry investors
Unseasonal weather	Sales are plummeting
Model	Designed to handle everything except what is about to happen
Profit jump	A one off gain
Moderately above	The cupboard is bare
Negative growth	Terminal decline
Inflection point	when we are reporting huge losses
Poised to benefit	No upside currently
Pure play	Concentration risk
Multi Product	Lack of focus
Pleased	This time <u>its</u> not a profit warning
Cautious approach	Everyone is going bust

## Summary

Low interest rates give rise to high rewards for positive spin. This is exacerbated by accounting rules that allow for the use of management estimates and judgements. Burford appear to have used a lot of positive narrative which while Burford makes strong returns are not as good as those available at LCM and Manolete. XPS Pensions is another business I have always felt uses positive narrative that has been at odds with the underlying progress.

## XPS Pensions

Share Price 115p

Mkt Cap £234m



Source: SharePad

### History

This company provides consultancy to defined benefit pension schemes who each year require advice on matching the assets and liabilities in a pension scheme. It came to market in February 2017 and at the time of the IPO I was surprised that it was rated relatively highly at 5X revenue and 15X EBITDA given it operates in a declining market of defined benefit pension schemes and there was a Competition and Markets Authority (“CMA”) review pending at the time into their market. My concerns were enhanced when I found that there was no mention of the CMA review in the risk factors disclosed in the prospectus. Asking the company why this wasn’t disclosed they simply said they didn’t see it as a risk. The company came to market at a placing price of 139p per share.

## Regulation

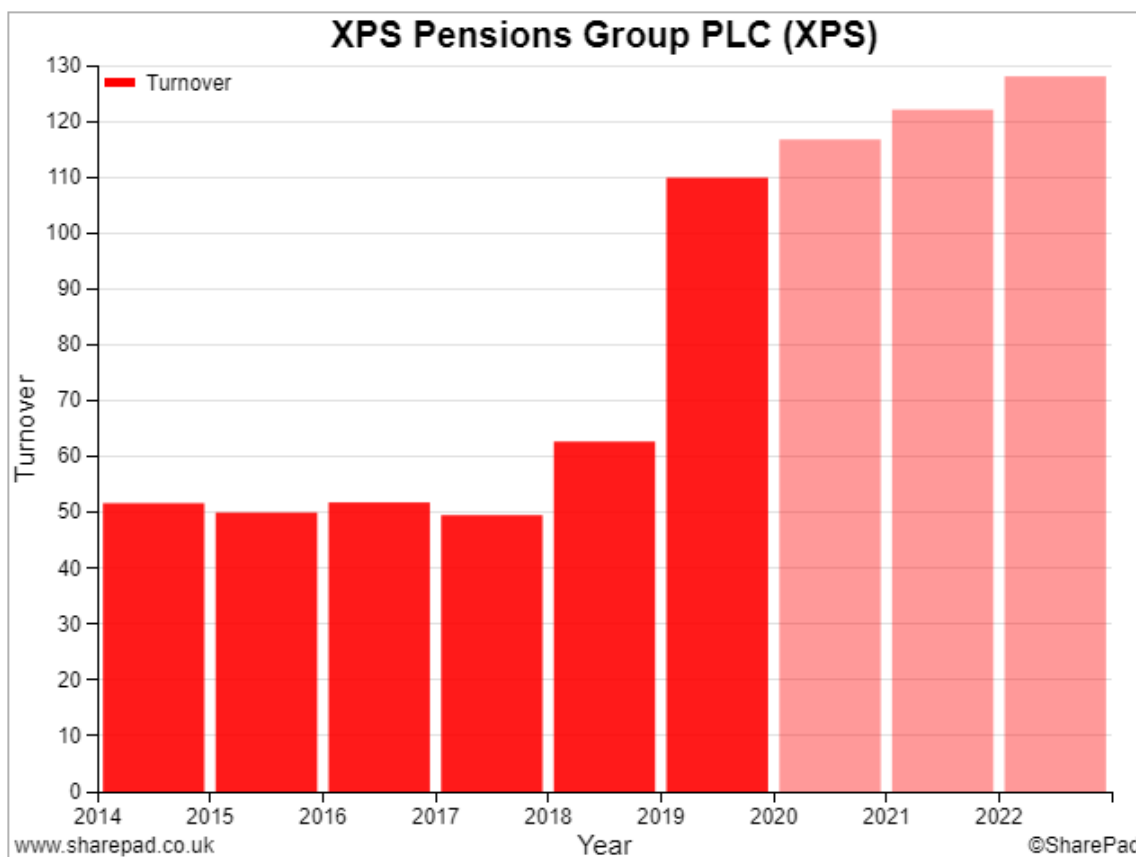
An FCA investigation of the pension consultants had found concerns over the conflicts between asset manager clients and pension fund clients. According to the FCA 38% of pension fund consultants revenues were from asset managers when frequently pension consultants can have influence over the awarding of fund management mandates to asset managers. Naturally the FCA was concerned over this apparent conflict and so had made a provisional decision to refer the market to the competition and markets authority.

## Results

In December 2018 the CMA announced the results of their review which required a competitive tender for asset management mandates when more that 20% of a schemes assets were being affected which if anything was a benefit for the consultants. So, the company had been right that there was no risk.

## Growth

The prospectus stated that XPS Pensions, then called Xaffinity was “well placed in a growing market for DB (defined benefit) services”. While according to the most recent survey from the Pension Protection Fund the number of active members in DB schemes has declined from 3.6m in 2006 to 1.3m in 2018, while the number of schemes has declines from 7,800 to 5,450 over the same period. Perhaps XPS can claim growth in fees but that was driven by increasing fees from a fewer number of customers - which is a finite trend. As this SharePad chart shows the revenue growth prior to the 2017 IPO was minimal in any event.



## Post IPO

XPS has a March year end so in December 2017 it announced 2% EBITDA growth in the half year to September and then acquired the consulting business of Punter Southall in January 2018 for £153m, raising £70m in equity at 170p per share. This acquisition was described as “complimentary” and a “strategic” acquisition. See the table above for the analyst interpretation of these terms. The acquisition price was 14X EBITDA. Results to March 2018 then reported 27% with underlying pure Xaffinity growth of 4.4%. Debt was £55.1m and deferred consideration payable was £8.3m, while the outlook was described as “promising”.

H1 results subsequently reported 113% revenue growth, although underlying “pro forma” revenue growth was 3.3%. This was said to be subdued because of the focus on integration of the significant acquisition. The outlook statement was confident while H1 was deemed “successful”. 1 small acquisition and a small disposal had also been completed in the period.

## Other events:

- **November 2018** the company announced it had “reached an agreement with the CFO” who stepped down.
- **January 2019** Macquarie and RBC were appointed as joint brokers to replace Zeuss
- **April 2019** New CFP appointed
- **May 2019** £4.8m acquisition from Royal London
- **June 2019** FY Results  
Showed 75% revenue growth and 51% EBITDA growth driven by the acquisition as well as organic growth. On a “pro forma” basis revenue growth was up 5% with pensions down 2%. The outlook statement guided to “mid-single digit” revenue growth in the year ahead with pensions flat and growth from other areas. Increased costs of £2m and a changing business means there will be a “temporary” impact on profit growth in the next 12 months. The statement concluded they had traded “*in line*” with this. The shares fell 40%. Debt had risen to £57.1m over the year while exceptional costs stripped out were £3.8m and share based payments of £3.9m were also stripped out. The exceptional costs were restructuring costs relating to integrating the January 2018 acquisition of Punter Southall.

## Forecasts

Forecasts now anticipate flat profits this year and 5% revenue growth, 6% profit growth for the two subsequent years, and the shares trade at 11.6X PE and yield 5.8%, from a dividend which is covered 1.5X by earnings. my view the pensions business (22% of revenue) and the administration business (34% of revenue) are not growth businesses. The company may be able to invest in other areas that grow so this share should be looked at as an annuity rather than a growth business. The growth in forecasts may well be optimistic and with the natural human trait of denial meaning that profits warnings come in three’s this may well not be the last forecast downgrade for XPS.

ROE

## Valuation

ROE is a respectable 12.8% on equity of £156m. If we strip out the £208m of intangibles the equity is negative £52m. However, we need to adjust for two items. It is the amortisation of these intangibles that gives rise to a negative retained profit reserve on the balance sheet. If we are valuing pre amortisation profits we should value balance sheet intangibles at cost rather than amortised value in order to compare apples with apples. Also, companies generally state their earnings after share based payments as they are a cost to shareholders. Adjusting for these two items reduces the ROE from 12.8% to 9%.

	Yr to March 19 £'000
<b>Profit after tax</b>	<b>20,061</b>
Reverse:	
Share based payments stripped out	-3,987
Tax on share-based payments	456
<b>Revised Profit</b>	<b>16,530</b>
<b>Equity</b>	<b>156,400</b>
Reverse amortised intangibles	27,263
<b>Invested Equity</b>	<b>183,663</b>
Add net debt	51,286
<b>Invested Capital</b>	<b>234,949</b>
ROE	12.8%
ROIE	9.0%
ROIC	7.0%

If we are valuing an annuity, we would expect a fixed return. For quoted investments I like to use the 115 year average total return on UK equities, which according to Professors Dimson Marsh and Staunton, who spend a lot of time crunching numbers is 9.4%. The last 115 years of history appears a reasonable number to use for the return I would expect.

The problem here is that the company is providing a 12.8% return on equity which is after excluding the writing down of the assets they have acquired. They have actually over-paid for acquisitions which provide a 7% return on their acquisition price. Then by using some cheap debt they leverage that return to 9%. If I wanted a 9% return, I would pay £183m for an annuity that gives £16,530 per year (see above table). Of this 9% I get 5.8% in dividends. The return will reduce as the retained profits would likely be used to repay cheap debt down towards the 7% return on the total cost the company has paid for the business. If my cost of capital is 9% then I value the business at c 20% lower.

It appears – if I am right that this is an annuity rather than a growth business - it should be valued at £140-£180m or 69p-99p per share against the current price of 115p. It seems to me that while the market has reduced its appraisal of the business on the downgrade in June it is still appraising it as a growth business. Which in my view it isn't.

## Litigation Funds

Frankly the returns available from XPS are simply so unattractive due to their very poor capital allocation I am tempted back to the Litigation funds. The problem is they are expensive. There are two ways of looking at them: Either as a current over/undervaluation and then to take a look at what the current share price is anticipating. The table below gives the following conclusions:

- **Burford** Either the shares are close to half their fair value or the profits are too high such that the ROE is going to decline to 13%. Both of these statements can't be correct.
- **LCM** Either the shares are circa 53% overvalued or the ROE will grow to 24%. Forecasts don't suggest the improved return but with the underlying portfolio achieving 138% ROIC this may not be difficult to achieve.
- **Manolete** Either the shares are 135% overvalued or the ROE will increase to 92%. With 180% ROIC on underlying cases this is possible.

Company	Burford	LCM	Manolete
Yr end	Dec	June	Mar
Year	2018	2018	2019
Currency	USD	A\$	£
ROIC	51%	138%	180%
ROE	29.9%	15.4%	31.9%
Assume cost of equity	10%	10%	10%
Valuation Multiple	3.0	1.5	3.2
Equity	1,363	77	28
Valuation	4,075	119	89
Exchange rate	0.82	0.56	1
£ Valuation	3,342	66	89
<b>Implied share price</b>	<b>1528.0</b>	<b>58.8</b>	<b>204.9</b>
<b>Current share Price (p)</b>	<b>830.0</b>	<b>90.0</b>	<b>481.0</b>
<b>Actual vs Implied Price</b>	<b>54%</b>	<b>153%</b>	<b>235%</b>
Market Cap	1,811	102	257
Implied Earnings	181	10	26
<b>Implied ROE</b>	<b>13%</b>	<b>24%</b>	<b>92%</b>
<b>Current ROE</b>	<b>30%</b>	<b>15%</b>	<b>32%</b>

## Personal View

I am very much more comfortable with LCM using historic cost accounting rather than fair value accounting for their cases. Manolete could well achieve the high ROE but I haven't before known a business able to sustain that level of return. In my view Burford returns are good but if they are now going to invest in their own litigation rather than third party litigation where their objectivity is diminished, particularly having bought shares heavily last week that renders the shares uninvestable.

## Summary

The Burford shorting note last week highlights the power of spin. This is a new world enabled by accounting rules that provide flexibility. The result is that narrative can differ from underlying reality. An example of this is XPS Pensions Group. Investors must be guided by numbers rather than narrative. For that reason, in order to benefit from the high returns these litigation funds offer Litigation Capital Management would be my personal pick.

## Forthcoming Events

Company	Date	Event
XPS Pensions	28-Nov-19	H1 Results
Manolete	20-Sep-19	AGM
LCM	Sep-19	FY Results
Burford	Mar-20	FY Results

Source: Websites, Estimate based on prior year