Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

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Dinosaurs don't gallop

Jim Slater's "The Zulu Principle" was one of my formative investment reads which coined the term "elephants don't gallop". Back then, in 1992, the FTSE Small Index didn't exist; it took a further 3 years to be invented; but the facts appear to back up the theory with the FTSE Small Cap Index up 190% over the last 25 years vs the FTSE 100 up 142%. The annualised gain over the last 10 years is 7.7% for the FTSE small cap index against 3.8% for the FTSE 100 and in the last 4 months it is up 13% against the FTSE up 3.7%. On all these horizons small companies outperform large companies and yet fund liquidity constraints post Woodford dictate that funds are increasingly obliged to own more liquid (and consequently larger) investments, handing opportunity to those industrious investors doing it themselves on Sharepad.

Whilst Zulu championed small companies I suspect the consensus today would be to champion the scalability of technology. The title "Dinosaurs don't gallop" may be more apt today. It is puzzling that the US market is reaching new highs every day while the FTSE has been range bound over the last 12 months. The S&P 500 is up 23% over the last 12 months while the FTSE 100 is up 3.8% as I write. The S&P has a median PE ratio of 22.3 while the FTSE 100 by contrast has a median PE ratio of 17. The differential performance between the UK and the US may be down to the fact that the US index contains more of the tech companies. Microsoft, Apple, Amazon and Alphabet form the top 4 while the largest in the FTSE 100 are Royal Dutch, HSBC, BP and GlaxoSmithKline. And those tech companies do gallop faster than oils and banks.

Trade

This divergence in the indices across the Atlantic is mirrored in the increasing global tensions we are experiencing. Globalisation seems to be in reverse. Trade wars, middle East tensions and virus clampdowns are now restricting global trade. Which is generally bad for trade. Many companies with global supply chains are starting to warn on the back of the coronavirus disruption. Pernod Ricard cut their earnings last Thursday, the same day as the energy information administration cut its global oil demand growth forecast on the back of the china shutdown. In short global supply chains are getting disrupted which will impact global trade. The Baltic Dry Index is a reliable indicator of future global trade and it doesn't look very good, down over 80% from its peak last October.

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Baltic Dry Index

Source: Trading Economics

Conclusion

Generally, I have found the combination of buoyant stock markets and global slowdowns is a time to be cautious. But remembering that both dinosaurs and elephants don't gallop there are always small and agile companies that can make money for investors in the face of a global slow down. An on-line model is today's equivalent of what used to be called small companies.

Portfolio implications

Nervous about the outlook for trade and with the recent re-rating of stocks providing few anomalous valuations I am struggling to find stocks I want to buy. There are plenty of high-quality companies, but they seem to have been largely re-rated and buying opportunities are rare. So, I will hold core positions and this may be a time to trade rather than invest. I am generally not good at trading, so look for a high level of confidence to make a trade. And to avoid any pitfalls arising from the human tendency to become emotionally enamoured with stocks with rising share prices it is useful, I find, to set rules.

Looking for an agile company with an online model that avoids potential supply chain issues from Coronavirus there is one company that comes to mind, which reported earnings last week. Meeting the company post results I found myself undergoing one of those "high conviction" moments that only occur once or twice a year. It needs a few days to sense check whether I had eaten too many shredded wheats for breakfast that day but I still think it could be a trade a few days later. It fits the bill of being an online business and has had a torrid time over the last two years. With a high-quality business model delivering high operating margins, it is hugely cash generative. As its customers generally lose money it has suffered regulatory headwinds and it is Israeli. Therefore, it is a stock that can be loved and hated in equal measure.

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This is evidenced by the share price chart over the almost 7 years since it came to market which has been turbulent.

Plus 500

Share Price 915p
Mkt cap £991m

Source: SharePad

History

Coming to market in July 2013 the shares were placed at 115p providing a market cap of $200m, a little more than the profits they delivered last week. The extraordinary ride over recent years has led to the founders trading the shares successfully.

- July 2013 – IPO placing shares at 115p
- Feb 2014 – Founders sell 20m shares at £5 realising £100m
- Jan 2015 – FCA skilled person review commences
- May 2015 – FCA requires UK operation to close for business
- June 2015 – Playtech agreed acquisition
- Nov 2015 – Playtech acquisition fails to get regulatory approval
- Dec 2015 – UK operation resumes on boarding customers

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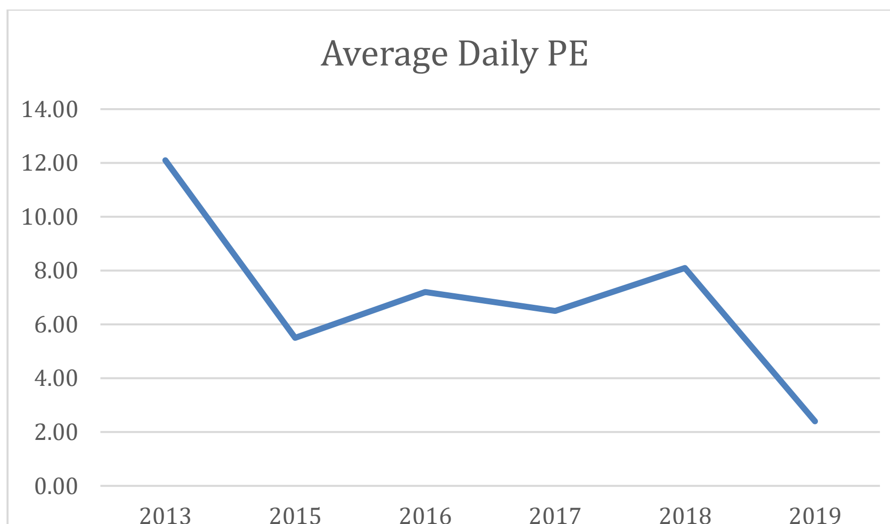
- Sept 2016 – Founders sell 15.5m shares at 650p realising £100m
- May 2017 – German regulator applies restrictions
- June 2017 – Company announces $10m buy back.
- Dec 2017 – European regulator consults on CFD trading
- 2 Mar 2018 – Founders sell 7.3m shares at £11 realising £80m
- 27 Mar 2018- ESMA sets leverage limits on trading
- June 2018 – Move to main market
- Sept 2018 – Founders sell 9.4m shares at 1550p realising £145m
- Feb 2018 – Profit warning following implementation of ESMA rules from Aug 18
- Apr 2019 – Profit warning
- Aug 2019 – Founders spend c £13m buying shares from 721p to 777p
- Aug 2019 - $50m share buy-back announced
- Feb 2020 – Further $30m share buyback with improving results but no forecast upgrades

Over this period the profits have risen from £23m in 2012 to £503m in 2018 before falling back to £186m in 2019. And the directors have traded the stock well buying back in around 720 with the shares standing at 912p today, so it looks like this is a stock to follow the founders' money in. Having sold stock to the value of $345m the first significant purchases were in August through to December last year. Following which the company has committed $80m to buying back shares.

Business

The company operates as a technology driven online CFD trading platform. Interestingly the shares have been de-rated over the period since IPO but investors that had stuck through the peaks and troughs would have made 9X their money excluding the significant dividends received over the 9-year period illustrating the powerful cash generation and earnings volatility of the company.



Source: SharePad

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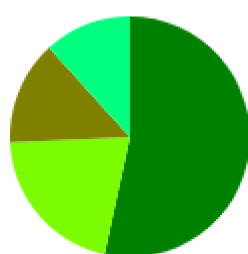
What I find attractive about the business model is the very high operating margins which is evidence of a technological advantage. In 2018 a 70% operating margin was achieved indicating that this really is a technology business. In businesses reliant on the staff the margins never usually get that high because the staff require some of the upside. IG Group reported 47% operating margin ion 2018 and CMC markets 29%. This high margin delivers a ROE of 149% while there is no leverage, rather $293m cash on balance sheet. Regulatory threats continue with the Australian regulator likely to follow the European regulatory rules sometime this year which accounts for 15% of the company's revenues. The geographic split of turnover is

ACTIVITY BREAKDOWN

By operating turnover

Last updated 31/12/18



Region	Turnover $	%
European Economic Area	384.7m	53.4%
Rest of the World	150.4m	20.9%
United Kingdom	100.5m	13.9%
Australia	84.8m	11.8%

Source: SharePad

Results

The leverage restriction came into force in August 2018 so 2019 was a year of two halves with a slow H1 but revenue grew 40% in H2 and EBITDA grew 93%. I was therefore surprised to see the 2020 estimate of flat revenues on 2019 unchanged from the house analysts. Until I noticed the announcement at 4.33pm the evening before results. Titled "notice of EGM" it is not an announcement that a reader rushes to open. But the EGM is to propose changes to the remuneration. The changes are to approve an annual bonus of 400% of base salary together with an LTIP which targets 12% EPS growth. There is also a $2.5m share appreciation scheme which has undisclosed targets. It would seem unseemly to upgrade numbers ahead of the EGM, I find myself supposing.

Estimates

Forecasts currently assume a flat 2020 at the revenue level. It is possible that 15% of the revenue in Australia could halve, post regulatory changes, presenting a 7% headwind, but CMC have guided to perhaps a 50% reduction while Plus believe it could be more. Against that H2 revenue grew 40%. Plus have reported a 20% tax rate last year but forecasts currently assume a 23% tax rate. The company also has some 23% of its market cap in cash on the balance sheet and will have bought back in the region of 10% of its shares, so there are numerous areas where upgrades can come from.

Furthermore, with such high operating margins changes in revenue have a magnified impact on the bottom line, so it is generally fair to assume that forecasts are usually wrong, we just have to guess in

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which direction and trade accordingly. Following the company share buy backs and management purchases I am minded to guess that forecasts are too low.

Balance Sheet

With a highly cash generative business model the cash has built to $293m. Last year there was a story they had held discussions with US listed Gain Capital, a smaller peer which is lossmaking which has a market cap of $129m. The attraction of Gain Capital would be their Japanese licenses which would add a significant new territory for Plus 500. According to IG Group Japan represents a £1bn revenue market and Plus has shown that with its targeted online marketing it can quickly gain market share. In the UK Plus500 has a 23% market share, 14% in Germany and 13% in Spain. If we could envisage a 10% market share in Japan that could add £100m to Plus's revenue of £354m. With the high operating margin, it is possible to see at least 50% of this going to the bottom line, adding 25% to pre-tax profits.

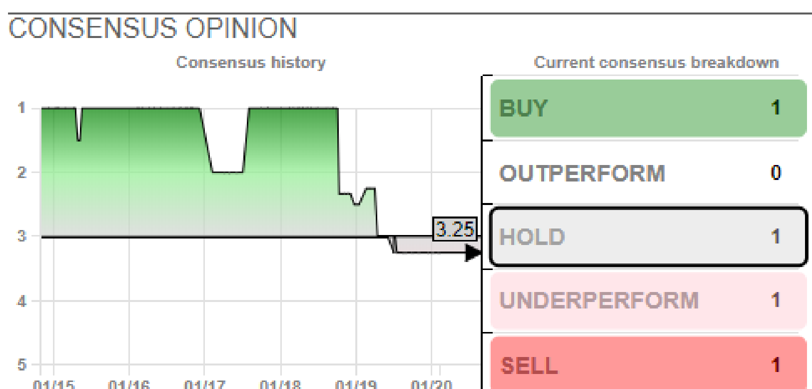
Whether or not the cash is used for M&A purposes the potential upside from both share buy backs and/or M&A activity provides very significant upside.

Valuation

The PE ratio on current forecasts is 9.3X and the yield is 5.8%. The dividend policy is to pay out at least 60% of post-tax profits with at least 50% by way of dividend. Forecasts currently assume a 56% dividend pay-out next year, but in 2019 following the announcement of share buy backs 100% of the profit has effectively been returned to shareholders. By contrast IG Group trades at 15.7X PE ratio to May 2020.

If we strip out the cash from the balance sheet the EV, which is a measure of the value of the business ex cash is 5.7X EBITDA. This is cheap by stock market standards but with the turbulent history it is hard to argue that the shares should be expensive. Furthermore, in the face of increased emphasis on sustainable investment it seems unlikely the pool of investors wishing to invest in a CFD trading business where around 80% of investors lose money is going to be met by a growing pool of investors.

I am, however, encouraged by a slightly negative analyst consensus on the stock



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Generally, when all analysts are positive seems to be the time that negative surprises occur. When consensus is negative the more likely surprise is frequently positive. And the earnings estimates look likely to provide positive surprise.

Conclusion

There is significant upside on this company which appears to have somewhat cautious analyst forecasts out at the moment. This is an earnings play rather than a valuation play and it is not a stock to hold forever. I could be tempted to own some but would make a note to sell at the earlier of management selling stock, a strong increase in the share price or 18 months. I find it is so easy to become emotionally involved with stocks that perform well. As in life there are some things it is best not to become emotionally involved with, so setting strict criteria at the outset is important.

Summary

The small company era that was my formative investment years has now been replaced by the tech era. Both gallop faster than elephants and dinosaurs. Searching for these companies when small company share prices and tech companies have run it is hard to find new long-term holdings. It may be time to take a short-term view on some recovery stocks where high conviction can be found. An online example of this is Plus500 where once again the remuneration scheme, slipped out at 4.33pm the day before results and headed “Notice of EGM” gives us a clue to the direction of earnings. I suspect there could be a useful trade here on a 12-18 month view.

Forthcoming Events

Plus500 provides detailed quarterly trading updates, as do IG Group and CMC markets.

Company	Date	Event
Plus500	20-Feb	EGM to approve remuneration
Plus500	12-Apr	Q1 Trading Statement
IG Group	21-Mar	Q3 Trading Statement
CMC Markets	03-Apr	FY Trading Update

Source: SharePad estimates, RNS