Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Correction or Bear Market?

2 March 2020

Buyers of the market were self-isolating last week. With the FTSE down 11%, European government bond yields retreating to below zero, and the oil price also falling sharply the Corona virus has a lot to answer for. The cries of "the stock market is down over 20 years" resounded across the twittersphere. Which happens to be the dot com bubble peak. Which suggests this may have more to do with the bubble rather than the virus. To know the answer to that may help us take a view as to whether this is the beginning of a bear market or just a brief contagion of fear.

I find the SharePad chart of the FTSE 100 gives a comforting sense of perspective. The chart adds the word "nervousness", which makes me wonder what it would look like when the narrative changes to "fear".

Fear theory

Franklin Roosevelt said "we have nothing to fear but fear itself". Fear of the virus is now impacting global economies. Guinness' warning last week sits alongside warnings from Apple, Walmart, HSBC, Standard Chartered, BHP, AB InBev, Imperial Brands, John Menzies, WPP, Aston Martin, Norcros, Topps Tiles to name but a few. We live in a globally connected world and the economic impact of the virus is slowing global trade. This picture of Frankfurt airport last Wednesday afternoon, which handles 70m passengers a year, illustrates the point.

Subscribers to the fear theory would take solace from previous epidemics. Over a 38-day trading period during the height of the SARS virus in 2003, the S&P index fell 12.8%. During the Zika virus at the end of 2015 and into 2016 the market fell by 12.9%. With our market now down 11% we may be through the worst. William Goetzman researched crashes using data from 101 global stock markets from 1692 to 2015, and concluded however that "*Declines on the order of -10% to -20% are more likely to be followed by another decline."*

Bubble theory

As Jesse Livermore said "Wall street never changes, the pockets change, the suckers change, the stocks change, but Wall Street never changes, because human nature never changes". On March 10th it will be exactly 20 years since the peak of the technology bubble, and the people running the money today are different from the people running money 20 years ago. And because human nature never changes, we have had another bubble caused by artificially low interest rates, as we did in 2000. The interest rate cuts on the back of the far east crisis in 1998 caused the dot com boom, and this time the Unicorn bubble has been caused by quantitative easing post the financial crisis.

Deflating a bubble needs fear. Perhaps the equity raise by Revolut, the digital bank, last week at a valuation of £5bn marked the top of this bubble rather like the IPO of Lastminute.com market the peak of the dotcom bubble. Certainly, a valuation of 95X the last published revenue has no fear imputed to the valuation, and a move from greed to fear shifts valuations from a uniqueness premium to a risk discount.

While the corona virus impacting global economies is causing some profit warnings the more significant impact may be to deflate the unicorn bubble. As fear stalked valuations will continue to go lower. Last time it took two and a half years for the market to find a floor in October 2002. This could take a while as prices aren't cheap yet. AB Dynamics was down 25% last week, but a forecast PE of 25X is not historically what we would call "cheap".

Personal view

I subscribe to the bubble theory that this may take a while. Certainly, quantitative easing remains, causing the high valuations, suggesting the market won't become cheap. However, high valuations cause human behaviour to become greedy, and greed always gets cleansed. Evidence of the start of the cleansing was evident last week at NMC with the suspension of its shares following allegations of secret off balance sheet financing, uncertainty as to who the shareholders are, and a boardroom clear out. Further evidence of human greed is evident at Amigo Holding where the CEO from October 2015 made a £106m gain on IPO in June 2018, stepped down in June 2019 and the 60% shareholder put his stake up for sale in January this year when the shares were 83% down on the IPO price. The Persimmon CEO finally stepped down last week after receiving his £110m bonus in 2018. In my view only when valuations are low, applying a risk discount, does human greed become cleansed. In March 2000 the PE of the UK market was 26X and by October 2002 this shrank to 17X, a fall of 32%, while the FTSE 100 actually fell 47%. The tech heavy Nasdaq fell by 80% over the same period.

Style

Each market reset involves a structural change, and at the turn a new theme will develop. The dotcom bubble was superseded by the housing bubble. It does appear to be the end of globalisation. Starting with political tensions, trade wars and now corona virus it is possible we may revert to more localised supply chains for a period. Which pushes us towards good old-fashioned UK centric businesses. Many of these have a long history, where intellectual property in the form of patents and reputation, has been built over time. Decisions are generally taken in the long-term interests of the business. As a result, the companies are durable; a factor which the market rarely pays attention to and so tends to undervalue. The following examples come to mind:

	Founded Year	**ROE %**	**PE %**
Andrew Sykes	1857	30.3	13.8
Dewhurst	1919	6.9	34.1
F W Thorpe	1936	13	24
Goodwin	1883	11.1	20.1
James Halstead	1914	28.9	29.1
S&U	1938	17.7	9.8

Source: SharePad

Sector

The government's policy response to the current problems will likely determine the specific sector to outperform. The last two crises have resulted in credit expansion driving assets that use leverage; housing post the dotcom bubble and private equity post the financial crisis. It seems likely this time the government is returning to a fiscal leaning, using direct spending to stimulate the economy rather than printing money which the banks are failing to lend. That may suggest construction or plant hire could be the next vibrant sector. A check on SharePad of those in the sector generally puts them on a rating of 10-16X PE, (with the exception of HSS which is priced for a profit recovery).

Name	Price	fc PE	PE	fc Yield	Mkt. Cap.	ROE	EV / turnover	EV / EBITDA	Price/NTAV	%chg 5y
	(p)	X	X	(%)	£'000	(%)	X	X	X	(%)
Aggreko	696	14.4	14.6	3.8	1,783	9.4	1.4	4.9	1.6	-59.3
Andrews Sykes Group	557		13.8		235	30.3	2.7	7.9	4	91.3
Ashtead Group	2472	13.2	14.9	1.7	11,151	31.4	3.4	7.3	8.7	108
HSS Hire Group	39	38.2	30		67	-7.4	0.9	4.8	-0.8	-79.4
Speedy Hire	76	14.1	16.2	2.8	400	12.4	1.3	6.4	2.4	0.132
Vp	1007	10.2	10.9	3.1	405	16	1.5	6.2	5.1	56.7

Source: SharePad

In a world becoming less global we can discount the larger ones which have significant overseas operations, such as Aggreko and Ashtead. The very high ROE that Andrew Sykes produces together with the impressive 5-year performance draws the eye. There are no forecasts out on Andrew Sykes which indicates to me the company has little interest in building its shareholder register, so there could be some market inefficiency in the share price. This may be one of those well-run family businesses that have a repeating tendency to run a good business simply and well. The 10-year chart suggests so.

Andrew Sykes

Share Price 557p

Mkt Cap £235m

Source: SharePad

History

The company was founded in 1857 at Upper Thames Street in the City of London by Henry Sykes, recently arrived from Sheffield. Some of the early pumps where vital to the development of London. When Henry Sykes died in 1879 his wife ran the business for 6 years until their son took over, which can't have been an easy task as a female in the Victorian engineering world. During the war years the company prospered producing winches and masts as well as providing pumps for the mulberry harbours. Expanding into heating, air conditioning and hire in the post war years it embarked on geographical expansion in the 70's. Chillers and air handling was added in 2000. Some of the early pumps were a thing of beauty.

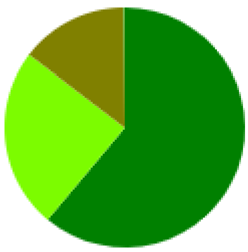
Business

Only 61% of the revenue is from the UK, so there is some cross-border trade risk.

ACTIVITY BREAKDOWN

By operating turnover

Last updated 31/12/18



Region	Turnover £	%
United Kingdom	48.0m	61.1%
Rest of Europe	19.1m	24.3%
Middle East and Africa	11.4m	14.6%
Rest of the World	0.1m	0.1%

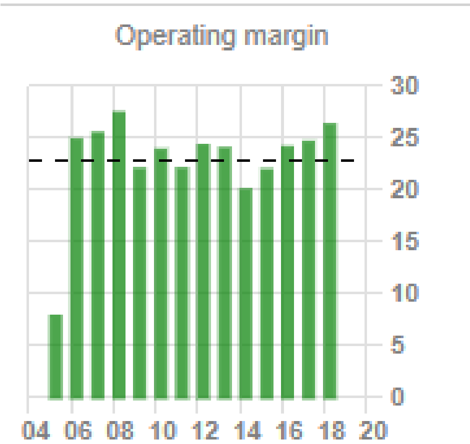
But it is involved in the hire of pumping equipment and climate control products, which in a world of fiscal spending and climate change could be a hot area. The business is 85% owned by overseas trusts so there is little by way of an institutional shareholder base, but the chairman and related parties own in excess of 3% of the company. Altium are the Nomad (Nominated Advisor) and there is no broker indicating the company sees little purpose in marketing itself to institutions, which I find encouraging. This may explain why, despite strong returns, the company is the lowest rated of the above peer group.

Results

The last published results were the interims to June 19. The segmental analysis tells us that 87% of the revenue is derived from hire, so it makes sense to start with taking a look at the balance sheet, which is striking. Normally hire companies have significant debt secured against the hire assets but this company has net cash of £17m. The company has £23.2m of property plant and equipment and £5.8m of stock from which in 6 months it generated £37.8m revenue. Which is an annualised revenue yield of 260%. From that revenue it generates an operating margin of 25% thus enabling it to deliver the 30% ROE. This looks like a cash machine with a conservative balance sheet. The question is whether these returns are sustainable.

Future

In H1 pumping was reported to be "in line with expectations" while heating increased revenue by 21% and ventilation by 14%. The UAE operations had a more challenging time so produced only £1m of revenue down from £1.2m, while in Europe, Italy grew revenue 39% and the recently established businesses in Benelux and Switzerland are said to be trading in line with expectations. The outlook is cautiously optimistic. Overall revenue was up 7% while the company was cash generative. £4m was invested in purchase of plant and equipment for expansion which compared to an operating profit of £9.3m. The capex of £4m is also in excess of the depreciation of £3.4m indicating the company is confident to expand. There is however, a defined benefit pension scheme but that is in surplus of £3.3m. It would appear the company believes it can grow by reinvesting its cash generation and is investing accordingly. The high operating margins would appear to be sustainable if history is a guide:



Conclusion

The Fundsmith equity fund owns companies that produce an average ROCE of 29%. I sense this company would be a typical Fundsmith holding where it not for the low liquidity. It makes a strong return on capital which is sustainable but also is able to reinvest that capital to earn a similarly strong return, which is a rare feature. Fundsmith companies trade on average at a free cash flow yield of 4%, while Andrew Sykes trades on a free cash flow yield of 5.5% on last year's numbers (which is after investing £7.1m to grow the hire fleet). Given it is set to benefit from construction as well as change in climate I am surprised it is valued at a lowly PE of 13.8X on historic profits. This looks like the sort of stock that will prosper through market gyrations. Sadly, it only fell 2% last week when the market fell 11% but I would be happy to own and forget this "coffee can" stock.

Summary

Perhaps the market wobble is a response to the Coronavirus. But my suspicion is its the excuse the market needed to unwind the unicorn bubble by re-introducing risk discounts, moving greed back to fear. If this is the case it may take a little while and we need to review sector exposures. The construction and infrastructure space appears well placed to benefit from a government now following a fiscal agenda rather than a monetary one. Within that space Andrew Sykes looks like a well-run cash generative high return business with unique intellectual property that is set to continue throwing off cash and dividends. The dividend yield is 4.3% and the dividend policy of paying "affordable dividends" may well mean the dividend increases. Increasingly I am seeing these well-run understated family-controlled businesses as the place to be invested, while the market cleanses itself.

Forthcoming Events

Company	Date	Event
Dewhurst	20-Mar-20	H1 Results
F W Thorpe	24-Mar-20	FY Results
Goodwin	31-Mar-20	H1 Results
Andrew Sykes	May-20	FY Results
James Halstead	Jun-20	H1 Results
S&U	Aug-20	FY Results

Source: SharePad estimates