Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

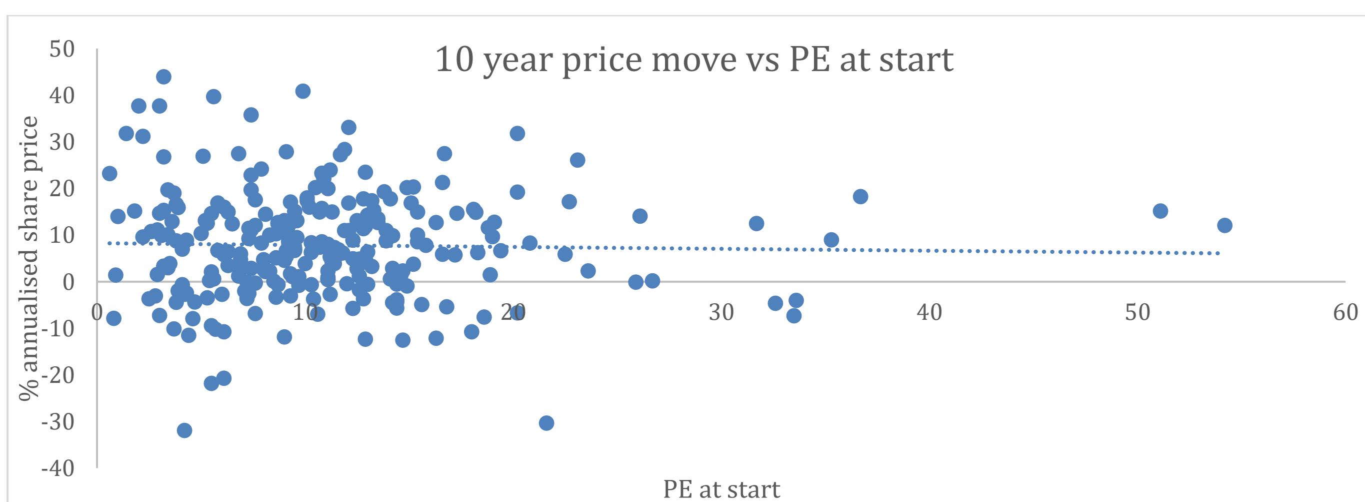
Purging Excess

9 March 2020

Bear markets come along in 10-15-year cycles. There is always a different trigger. In 2007 it was poor lending that blew out impairments and ultimately took down a number of banks. At the time impairments were becoming alarming we weren't aware of the extent of the connectivity between the banks. But the purpose of the financial crisis was to purge the bad lending. Capital, in the form of loans had been misallocated to high risks at too low a price. The FTSE 100 fell 50%
The bear market before that was 2001-2003 was a cleansing of the technology bubble. That time when interest rates were reduced in 1998 the cheap debt had leaked into equity markets causing a misallocation of capital to growth stocks. The FTSE 100 fell 45%.
This time a decade of easy money has brought about a new misallocation of capital to unicorns. The reward for growth has become too high in a world where growth is the rare resource rather than capital. And markets have an unpleasant way of cleansing the excesses of human nature. As I write the market is 20% off its highs, enabling this to officially be termed a bear market. The rule in a bear market is not to sell stocks. And the question of when to buy stocks is a tough one.

Valuations

Frequently it is tempting for a long-term investor to believe a stock is simply too cheap. But sadly, the PE ratio tells us nothing about how stocks will perform over the next 10 years. A chart of all the 254 quoted companies in London with 10 years of data from SharePad shows an inverse correlation between 10-year share price and PE at the start of the period. It certainly looks fairly random, but the line of best fit has a downward slope.



Source: SharePad

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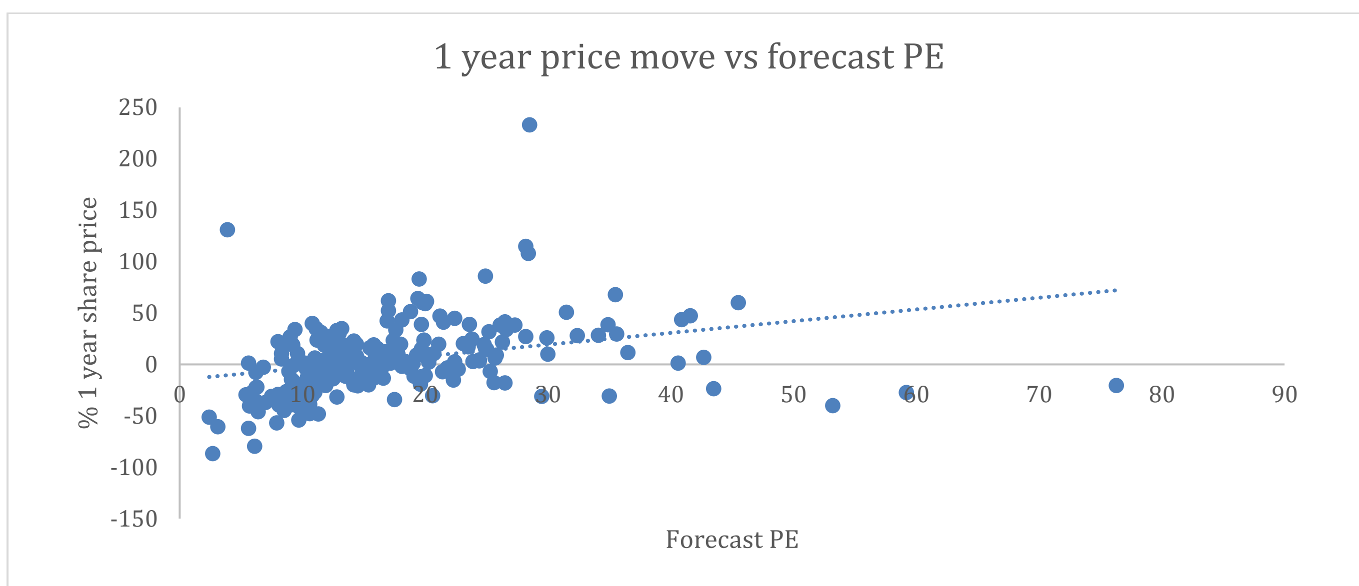
In fact, the PE tells us far more about what has happened in the last 12 months.



Source: SharePad

Rather than looking at valuations therefore it may be more helpful to take a look at the market behaviours the bear market is intended to cleanse. This may help to get closer to the answer to the question of whether the market will fall 40-50% as it did in the last two bear markets?

Excesses

The job of the analyst has changed from one who was on high alert for traditional manipulation of numbers to one on high alert around the measurement of "hot signals" such as organic growth numbers. No accounting standard has yet been devised for how this is to be calculated. Today we have a shortage of growth, rather than growth capital, which encourages companies to reach for the dressing up cupboard, emerging adorned in the finery of a growth company, resplendent in high PE's and low yields using heavily adjusted numbers. These are the excesses of this cycle.

For companies that adjust and dress their numbers, eventually the company runs out of road, perhaps because the finance dries up or they run short of cash. And bear markets serve this purpose of cleansing. Only when the tide goes out do we learn who has been swimming naked. (Warren Buffet).

Schroders – Growth Spin

One example of the invention of growth through spin was evident last week at Schroders results. The 216-year-old blue blooded pillar of the fund management industry announced after the numbers commentary that they "remain focussed on responsible, sustainable investing, and have continued to integrate ESG processes across our product range". Having broken more corporate governance rules than most of us

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broke school rules I wonder if someone has explained to the board what the “G” stands for in “ESG”. “Governance” disapproves of CEO’s moving to the chairman slot, as Michael Dobson has done at Schroders, and electing family members with little city experience to the board. The CEO is paid 34.5X the pay of the average member of staff, which is a healthy £195k. Lauding themselves as ESG managers devalues the ESG purpose and the fund manager community overall. There could be a shortage of soap boxes in the UK if the large players in the industry carry on in this way. Schroders disclosed their results in 5 segments last week for the first time, which enabled them to show net inflows of 33.6% in wealth management (Rathbone Investment Management reported net outflows of 1.5% over the same period), thus overlooking the fact that profits were down 8%. The £75m exceptional costs included a cost reduction charge of £29m, yet costs rose 5% with flat revenues. The growth narrative is evident. While Schroders is not growing its profits, a situation that will be worse today than last week. At the bottom of a bear market the narrative is typically more reflective.

Alongside this growth narrative has been the tendency to adjust reported numbers such that adjusted EPS and ROE is open to interpretation and can frequently be manipulated for management purposes. The acquisitive technology companies’ reports make for good examples.

IMImobile

Share Price 367p
Mkt Cap £275m

Naturally we may expect a healthy PE as this is a backward-looking indicator, which weighs in at 23X.

Story

The company has a good story. It provides cloud communication software, enabling enterprises to automate digital customer interactions which it integrates with third party suppliers. It has 17 years or organic revenue growth, owns and is a market leader in the UK, South Africa and Canada. The model of selling the product as a service enables high levels of recurring revenues (90%). And has reported 21%

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adjusted EBITDA compound growth over 5 years. The company reports growth in all regions in the half year to September 2019.

Remuneration

The first stop in the report and accounts (once I have fought through the upward sloping charts) is the remuneration report which tells us, unusually, that the share schemes are in note 23 while directors awards are in the Directors Report. The CEO doesn't appear highly paid with total emoluments of £310k, but 1.5m options were awarded in March 2019 with an exercise price of 250p, suggesting the management will be more motivated by the share price than pay. Note 23 tells us that 4 share option schemes were established in 2014 with a 4-year vesting period with hurdles of an undisclosed amount of EPS growth. A total of 12.35m share options had vested by March 2019 which amounts to 19% of the issued shares at March 19.

Adjustments

The diluted EPS to March 19 was 1.3p but the adjusted number was 11.2p. To reconcile the difference a table is needed:

	(p)
Statutory EPS	**1.3**
Share- based payments	6.4
Acquisition costs	1.1
Amortisation	1.8
Defined benefit pension change	0.2
Nigerian exchange losses	0.5
Non-controlling interests	-0.1
Adjusted EPS	**11.2**

Taking each in turn:

- **Share-based payments** The share based payment charge in the income statement is £8.9m. The statement says that share based payments relating to deferred consideration and the company's IPO should be considered one-off. That is sensible with contingent consideration where accountants treat deferred consideration as remuneration because it is subject to continuing employment. This seems reasonable to strip genuine deferred consideration out of the P&L, but of course it should be added to the consideration paid in the balance sheet for return on investment calculations. It is a cost paid by shareholders. However, the company strips out all the deferred consideration including what is termed "on-going employee incentive share schemes", which I imagine is hard to suggest is a one-off cost. There are also put and call options on vendors residual stake where changes in the value are accounted for as share based payments.

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- **Acquisition costs** These should be added to the cost of the acquisition rather than exceptional item as shareholders have had to bear this cost.

- **Amortisation** This is excluded from the income statement which seems reasonable, but it represents shareholder capital invested so should be added back to the balance sheet capital in calculating return on investment.

- **Change in defined benefit pension.** This is a cost that many companies have to deal with and don't strip it out. It appears there was a legislative change that increased the value of liabilities, but that happens occasionally.

- **Exchange losses** on Nigerian Naira. This has been stripped out because of the loss when the Naira was unpegged from the US dollar. That would seem to me one of the ongoing risks when trading in Nigeria so in my view should be included in normal business.

- **Capitalisation** In 2019 the company capitalised £5.3m of development costs and £800k of software costs. The amortisation of this was £1.5m and £798m, so with the amortisation equating to the capex in software that may be representative of the ongoing cost, but the large amount of capitalised development costs is concerning. In 2018 this was £4.9m, £1.52m in 2017 and £975k in 2016. There is no description of this in the report and accounts.

Effect

If we ignore the arguable capitalisation of development spend, we get the following adjustments which increase net assets to close to cost by £35.5m and reduce profits by £1.6m.

Accounts Adjusting

	£'000		£'000
Gross Assets on Balance sheet	**142,003**	**Adjusted Profit**	**13,981**
Net assets on Balance Sheet	**60,120**	**Finance Costs**	**-285**
Add share payment charge 2019	8,317	**Adjusted Profit**	**13,696**
Add share payment charge 2018	4,561	Ongoing employee incentive	-582
Add share payment charge 2017	2,572	DB pension plan	-96
Add share payment charge 2016	3,362	Nigerian Naira exch. Loss	-349
Add share payment charge 2015	7,294	**Realistic Profit**	**12,669**
Add Acquisition cost 2019	788	Finance Costs	-285
Add Acquisition cost 2018	863	**Realistic PBT**	**12,384**
Add Acquisition cost 2017	362		
Add Acquisition cost 2016	376		
Add Acquisition cost 2015	1,575		
Restate amortisation of acquisitions	5,503		
Gross Assets on Balance sheet	**177,576**		
Net assets on Balance Sheet	**95,693**		

Source: Report and accounts, tax assumed at 20%

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Impact

The ROE for 2019 shows on SharePad as 18.9% which is good. It uses the company adjusted profit after tax of £10.8m. However, by ignoring £9.5m of money spent on acquisitions and £17.7m of acquisition consideration the assets are understated. If we return them closer to cost, we obtain a ROE of c.11%. The company is geared, so if we look at the ROIC the return on total invested capital moves close to 7%. If someone said, we can get a return of 7% on money spent buying a business and lever it up to 11.4% I am not sure I would be excited by that.

Results	%
Adjusted ROE	**18.6%**
Realistic ROE	**11.4%**
Adjusted ROIC	**9.8%**
Realistic ROIC	**7.1%**

Source: Calculation from restatement table above.

Cash Flow

At March 2019 the company had bank loans of £20.7m at 1.5%-2% over LIBOR which is cheap when you can invest it at 7%. At September 2019 borrowings had increased to £38.2m from a new facility provided by a bank at 2.5% above LIBOR.

The interims showed a PBT of £1.3m but cash from operations of £10.8m because share-based payments are not cash, nor is amortisation, and the receivables were reduced. However, £4.2m of intangibles and other capex was spent which is close to the depreciation and amortisation charge, suggesting that just perhaps the depreciation and amortisation charge is roughly what they actually spend in cash. That may suggest that cash generated was a little above £6m. Then £6.7m was spent on deferred consideration. This is paying for what the company already owns. The balance sheet shows that there is another £7.7m to pay. There is no money left to pay a dividend.

It appears the company is reporting results from businesses they have acquired, stripping out a number of the costs, and by paying on deferred terms the reported ROE can be inflated. But when acquisitions slow the ROE will decline.

Deferred Consideration

In 2019 the company agreed to settle early the deferred consideration on the Healthcare Communications acquisition. This involved a cash payment of £1.75m and a share-based payment charge of £1.2m which is stripped out of the income statement and not included in the balance sheet.

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Put Options

This is an unusual feature of some of IMImobile's acquisitions. By leaving a holding of, perhaps 20% of the company with the vendor management, with the company having a call option to require management to sell it within 5 years the company can buy in the remainder later. A portion of this later consideration is accounted for as a share-based payment charge, which is stripped out of the income statement. In 2019 £2.4m of this kind of cost was accounted for as a share-based payment charge for the 2017 Sumotex acquisition.
This of course doesn't matter if the acquisitions continue and the bankers keep lending cheap money. But £10.76m needs to be repaid to the bank in July 2022 and £10m needs repaying in December 2021. Without a further re financing by a bank this would not be possible from cash flow. Given that a bank has lent them further money in H1 2020 it seems likely they may be able to keep refinancing without generating the cash to repay it.

Conclusion

By borrowing at 2% the company is investing in businesses that return 7%. This is the mechanism by which cheap money leaks into the economy causing returns to be out of step with the risks involved. There is no definition of how IMI Mobile calculated organic revenue growth of 14% in 2019, but it does say it excludes MTN in Middle East and Africa (MEA) region and is on a constant currency basis rather than what appeared in the accounts. The PE of 23X suggests the market believes the 14% organic growth. While this looks to me like misallocated capital which is under-estimating the risks. This may be cleansed by the cost of capital increasing, whether equity or debt and a bear market increases the cost of equity, which makes acquisition harder and the return will start to decline. It is this which leads me to believe this bear market may be a drawn out one.

Summary

Bear markets arrive to cleanse excesses of the cycle. There is plenty of excess in misallocated capital currently in terms of narratives and adjustment of numbers to present growth in a low growth world. Acquisitive technology companies have been using this to great effect to garner support. As the tide goes out, we will see who is swimming naked, which may take some time yet.

Forthcoming Events

IMImobile's full year results are expected c. 2 July. The auditor has changed in January ahead of the March year end.

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