Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Irrational or True?

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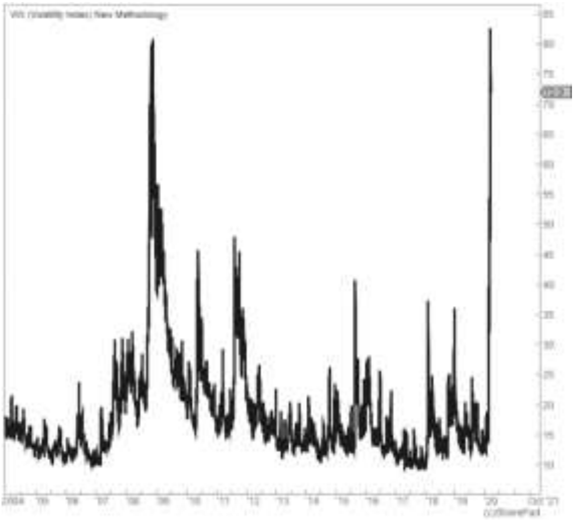
We like to queue under stress. Once we queued outside banks and now we queue outside supermarkets. I suspect somewhere there is a herding instinct involved. Which may help explain why markets can over-react. It good to be in company sometimes. The VIX index (The Chicago Board Options Exchange (CBOE) Volatility Index) was invented in 1992 and has never been this high.



Which may help explain the huge risk aversion that started last week resulting in the FTSE 100 falling 2.8% while the FTSE Small Cap (ex-investment companies) index fell 19.8%. In 2008 the stock market bottomed in March 2009 by which time the VIX index had fallen from its peak of 80 back to 50. Today it is off its high of 83, down to 72. If history repeats itself, we may well be able to use the VIX index as a lead indicator to time the market. Apart from what the VIX index is telling us no one has a scooby doo what is going to happen in the next 30 days. Companies have now largely put up the white flag by saying they can't predict the profits for this year and in that environment balance sheet is all that matters for downside protection.

The government is doing "whatever it takes" which involves spending large amounts of money propping up the economy while shops and bars close and stores run out of food. As oil, gold and equities all fall together the triumph of socialism with its central control is completed, having started in 2009 with the government printing money. Stock markets central purpose of efficiently allocating capital to productive areas of the economy has no purpose in that environment, and so capitalism is dead.

"Capitalism is dead" are words I recall my grandfather, a stockbroker in the 1970's, saying as I tucked into my eggy dippers. In 1974 the FTSE 100 fell 54%, having already fallen 31% in 1973. This triumph of socialism is entirely natural in a market dislocation. In 1974, without a whiff of warning, the bear market ended with an explosive rise in stock prices. Today the only certainty appears to be that this is not a time to be selling.

Changes

Winners and losers are binary in the current crisis. Supermarkets and CFD providers are booming while their share prices continue to fall. When this is over, some things will revert to normal, but some things will change forever. Analysts meetings, which used to be events where analysts asked searching questions on behalf of their investor clients have now become events where sponsored research providers ask questions to impress management teams in the hope of being awarded a research mandate. The current phase of doing these meetings by video conference is far more efficient and enables a wider audience to participate. This could well be a change that becomes permanent. I find myself wondering whether universities may also go online, which wouldn't be great for all those investors in Unite, the investor in student accommodation.

But for most companies the world has a good chance of returning to normal at some point if their balance sheet is strong enough to withstand the disruption. We don't know what this year's earnings will be, we don't know how long the disruption will last, we don't know if it will turn into a systemic melt down of credit markets and currencies. But what we do know is that at times of market stress, markets can become both inefficient and irrational.

Inefficient

There are signs that markets are becoming inefficient in more esoteric corners of the market. There are examples in retail bonds and the merger arbitrage market.

Retail Bonds

- paragon is an authorised bank which issues retail bonds as part of its financing structure and I was surprised to see these trading at 91p for the 6% bond redeemable in December 2020. So, for lending money to them over the 8 months to December investors get 16.5% on their 91p investment for the risk. This implies the company has a good chance of defaulting before December on the back of the rent holidays the government announced. This could cause a problem for equity holders, but the liabilities are effectively underwritten by the government as lender of last resort. So, investors are being offered what would seem to be government underwritten debt at 17% yields while base rates are 0.25%.

  For those that are happy to take a view on the 2024 bonds the upside is more as these trade at 62p. So, an investor will receive 38p capital appreciation when the bonds are redeemed at par in August

2024 and four 6% coupons over the next four years giving a cash return of 100% over the 4-year term. That could come sooner if markets recover and the bonds trade closer to par.

Merger arbitrage

- URBAN exposure is a lender to residential property developers which has agreed to sell its loan book to Pollen Street capital for £113.8m. The management company will be sold to the management team for £1.6m and the proceeds will be distributed to shareholders on 24 April resulting in an expected pay out of 72p plus a 1p dividend. The transaction requires shareholder approval on 30 March which in current market looks increasingly likely despite the net asset value of the company being 83p. And yet the shares trade at 53p. That is a 38% return in one month.

- Low& Bonar received an agreed bid from a German company FV Beteiligungs on September 20th last year for 15.5p/share. Trading has deteriorated since the bid and the banks have waived covenant tests. Shareholders approved the takeover in November and the only barrier remaining between shareholders and the 15.5p in cash is the European Competition Commission approval. It would seem unlikely that two companies consolidating as their markets are struggling would be vetoed but the share price seems to suggest this with the shares trading at 4.75p. There is a risk, but there is 226% upside in the event of the merger being approved and 100% downside if it is blocked as the company would be likely to breach its banking covenants. This mismatch of risk vs reward suggests that markets are dislocated at the moment.

- GAIN | CAPITAL **Holdings Inc,** a US listed spread betting company, agreed a $6 takeover from NASDAQ listed FC Stone Inc. on 27 February. This deal is highly likely to go through in the light of the fact that both companies are experiencing high volumes of trading in these volatile market conditions, as well as the fact that 44% of the shareholders have undertaken to accept the offer. Yet the shares trade at $4.85. So there is 24% available for what appears to be little risk. In normal markets highly leveraged “risk arbitrage” funds come in and buy the equity of the target reducing the spread to a modest “cash return” discount. But it seems these funds are not participating at the moment.

Irrational

- **Index** announced last week its third quarter update to February. Revenue was up 29% year on year driven by the spread betting business which was up 35%. Over 9 months to date the company has now delivered 77% of the full year consensus revenue number implying that unless revenue will decline analysts would be required to upgrade their estimates. The statement then went on to say that in the 12 trading days on March the company had delivered revenue of £52m, a quarterly run rate of £260m. This is approximately double the annual run rate. And on the day of the news the shares fell 10%. This is irrational unless there was some other macro news that made future expected returns more likely to decline.

What if markets are right?

This is a time when fortunes are made and lost. It appears to me that markets may be becoming inefficient as capital is restricted from flowing freely through markets, which presents investors with huge opportunities. The problem is I am scared. If markets are right, then the shortage of capital in merger arbitrage is the tip of the iceberg and the entire capital market will freeze up. If markets are right no takeover will be possible and generating increasing cash earnings has no purpose because the value of money itself declines faster. In that environment we are right to be hoarding food and may as well stay away from the office for a very long time.

This is a time to stick to what we know in the face of extreme uncertainty. Either the investing rules are being re written or when opportunities arrive, we should take them. For me, I will be sticking to the second bit. As a simple long only medium-term investor, I am searching for the mispriced equity, which isn't subject to the uncertainties of a takeover situation, or is at risk from other debt instruments being priced against it. And as the market appears to be behaving irrationally over IG Group, I am inclined to take a look at the more operationally geared spread better Plus 500.

Plus 500

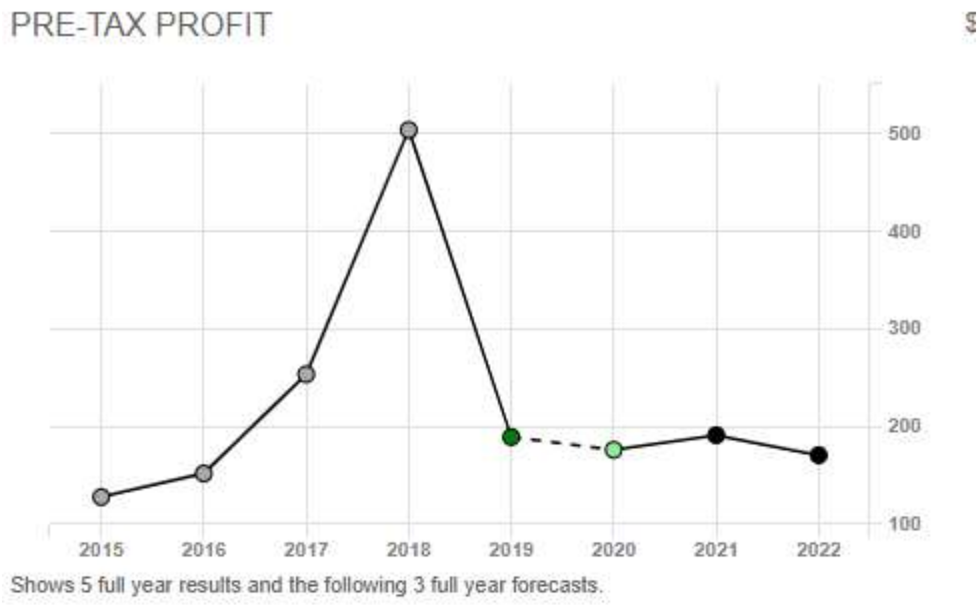
Share Price 892p
Mkt Cap £957m

I reviewed this company on 17the February in the “dinosaurs don’t gallop” note where I concluded the stock is an earnings play and not one to own in the hope of a valuation uplift.

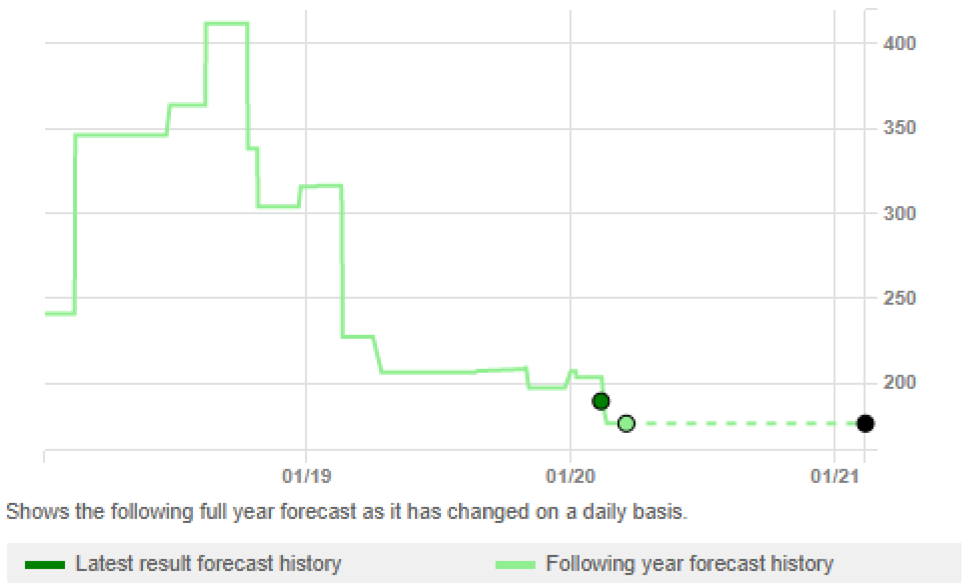
What has changed?

- **Valuation** The share price was 915p then. Today it is 3% lower at 891p. The PE was then 9.3X and the yield 5.8%. Today the PE is 7.7 and the forecast yield 5.1%.

- **Outlook** Two unscheduled trading updates were issued on 28 February and 16 March. The first said that trading had been “substantially ahead of expectations” and the second to say that expected revenue and profitability for the full year to December are again “substantially ahead of expectations”, but the analysts are slow to upgrade their forecasts.



Source: Sharepad



Source: SharePad

- **The directors bought shares** £21.2m has been spent on shares at prices varying from £7.66p/share to £9.80/share.

- **The company buys back shares** £8.45m at prices varying from £7.58/share to £9.48/share.

All of these announcements have been made because they are meant to be price sensitive. In a normal world they would be positive, but the shares have continued to slide.

Forecasts

I concluded on 17 February that this was an earnings play rather than a valuation play and the valuation has gone down while the earnings outlook has improved. It may be worth therefore checking what the earnings could potentially be.

If the revenue of IG Group is running in the first 12 trading days of March at roughly double normal levels it may be that Plus 500 revenue is running at a similar level. CMC Markets also confirmed on Friday that their revenue was running at more than twice normalised levels. In fact, Plus 500 is likely to be taking market share as IG Group has recently experienced outages in its platform. When a customer is running exposed positions in volatile markets this can be costly for customers so cause them to swiftly switch platforms. But let us imagine that Plus 500's revenue could be double what is expected.

Because Plus 500 is essentially a technology business a large amount of this would fall to the bottom line. Let's assume 70%. Then we could suggest there is potential to add $275m to the $176m PBT shown here. If that was the case the shares would be trading on a "actual" PE of 3X. Given last year all the profit was returned to shareholders via dividend or share buy back this could also result in a very high yield for holders, rather than the 5.1% forecast.

FORECASTS — $ millions unless stated

Year	2020		2021		2022	
Turnover	393.1	+10.9%	386.5	-1.7%	358.2	-7.3%
EBITDA	207.6	+4.3%	195.4	-5.9%	171.8	-12.1%
EBIT	176.4	-10.4%	171.5	-2.8%	170.0	-0.9%
Pre-tax profit	176.2	-6.9%	191.2	+8.5%	170.7	-10.7%
Post-tax profit	136.9	-9.8%	133.6	-2.4%	132.7	-0.7%
EPS (¢)	124.9	-7.5%	137.3	+9.9%	125.9	-8.3%
Dividend (¢)	49.2	-24.3%	64.9	+31.9%	48.8	-24.8%
Capex	-		-		-	
Free cash flow	199.8	+57.1%	169.0	-15.4%	144.0	-14.8%
Net borrowing	-303.9		-357.6		-395.1	
NAV	-		-		-	
Like for like sales growth %	-		-		-	

Source: SharePad

Risks

This high level of trading will not be sustainable in the medium term. 15% of last year's revenue was derived from Australia where new legislation is likely to reduce the market size later this year. This has already been included in analysts' forecasts. Plus 500 guided to a 65% reduction in Australia, which is inconsistent with CMC markets guessing at to a 50% reduction. There are also unknowns. Such as how will the government make those that benefit from this crisis help those that aren't? Could the government restrict dividend payments?

Conclusion

If we ever return to a normal world this would be my high conviction situation. But I wouldn't hold it forever. The earnings upside is huge. While in the past there have been unhappy investors because managements sold stock ahead of a downturn, I suspect there could, by the end of this year, be unhappy investors because directors were able to buy stock when forecasts were unrealistically low. Let us remember that the company pays the house analyst and is able to influence the analysts view.

Summary

We are in extreme times. Volatility has never been this high in recorded history. Markets are starting to malfunction and there are signs of inefficiency and irrational pricing. The rational investor carries on, but I confess to being scared. If markets are right, we have nothing to look forward to. In an attempt to be rational, I am sharing (my personal view only) that Plus 500 is a liquid mispriced stock where a patient investor can wait for the price to correct. More agile investors may be able to make money from other mispriced situations. We are in the sweet shop called the stock market, and there are a lot of goodies choose from. This is either a time of opportunity, or we should be going back to working the fields as the shortage of farm machinery starts to threaten a famine. We have choices.

Forthcoming Events

Urban Exposure	Vote on proposals	30-Mar-20
Plus 500	Q1 Trading Update	07-Apr-20
Paragon	H1 Results	20-May-20
IG Index	FY Results	23-Jul-20
Low and Bonar	ECC approval	?
Gain Capital Inc.	Regulatory clearance	Mid 2020

Source: company documents, SharePad, estimates