Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Value Time

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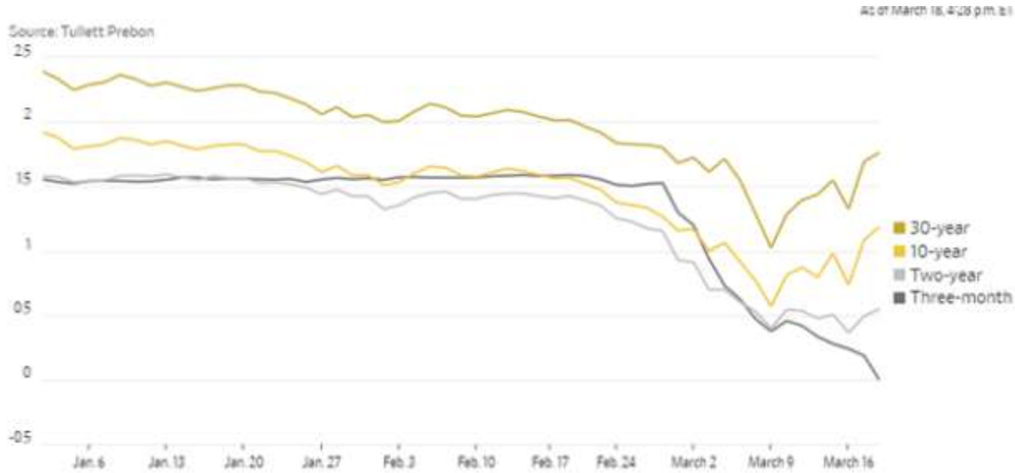
Markets

Allocating resources is an issue. Both labour and capital. Some, such as Dyson, have switched to making ventilators. Pubs have furloughed labour while supermarkets and fruit farmers are desperately short of labour. On the capital side dividends are cancelled and valuation considerations are replaced by balance sheet concerns. The recession will be deep but, as always, we will recover after reallocating resources. As we gloomily ponder the destruction of our portfolios let's remember we will look back one day and call this an "opportunity".

Contagion Possible - As yet we don't appear to have contagion into broader financial markets which is what caused the lengthy downturn in 2008, as the dominoes fell one by one. It is possible this lies ahead as balance sheets become increasingly stretched. But the unprecedented financial stimulus being applied by governments suggests the possibility of avoiding financial contagion. ETF's had been mooted as a potential area of financial contagion as for the first time ETF prices started to diverge from the value of the underlying assets. The US Federal reserve is alleged to be contemplating including ETF's in its purchasing programme. Meanwhile in Europe the issue of Corona bonds is currently under discussion to finance the downturn. We don't know the outcome yet but there appears still to be a chance of avoiding financial contagion.

Yield Curve now Upward Sloping - What provides hope is the yield curve has become upward sloping. The cross over was on March 9th. While governments have reduced short term rates the longer-term rates may now be anticipating a pick-up in inflation. With all the stimulus being provided it may well be that we get government induced inflation. Which would be good for companies at least initially. And would sort out the large debt problem.



It looks like while we have a deep recession ahead and potential contagion remains a risk but there are also the green shoots appearing a little way over the horizon.

Equities

1929 and the great depression heralded the birth of value investing. Benjamin Graham and David Dodd published the book "Security Analysis" in 1934 where they scolded Wall Street for its focus on a company's reported earnings per share, and were particularly harsh on the favoured "earnings trends." They encouraged investors to take an entirely different approach by gauging the rough value of the operating business that lay behind the security. They documented multiple examples of the market's tendency to irrationally under-value certain out-of-favour shares.

In the book they distinguished investment from what was deemed speculation. "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

Those principles are prescient now more than ever. With most companies withdrawing guidance and dividends while there is no clarity over how long the lock down will last, investment has been reduced to speculation. Airlines is a good example. With fleets of aircraft grounded for indefinite periods rendering airlines loss making the chancellor last week urged airlines to raise money from shareholders. The government would only step in as a last resort when the companies had "exhausted other options". Valuing these companies is relegated to the realms of speculation. It is time to change our valuation methods to intrinsic value.

Intrinsic Value

Defining intrinsic value is the topic of endless debate. Analysts have often referred to discounted cash flow to determine intrinsic value, but personally I find this close to useless when interest rates are at 0.1%. And then we have the problem that we don't know what the "E" is likely to be in the PE.

In such a world of uncertainty there are two metrics that may be of more use in valuing stocks:

1. **Price/net tangible assets.** Where the assets are tangible and the shares trade at a discount to this the implication is that there is no goodwill attached to putting the assets together to trade as a business. In other words, it costs less to buy the company today than the cash that has been invested in building it. Sometimes that may be fair if the assets are rapidly becoming devalued, but sometimes the assets do have more value as a business. Work is needed to make this judgement, but it may provide a starting point for research.

2. **CAPE ratio.** This stands for Cyclically Adjusted PE ratio. In Graham and Dodd's book "Security Analysis" they recommended one should use and average of earnings over preferable 7 or 10 years. This ratio is calculated as the Share Price divided by the 10-year average inflation adjusted EPS. In the current environment, when we don't know what future earnings are, this may give a guide as to what the price relative to the potential earnings is. Assuming of course that the environment does normalise again. Which it will, albeit possibly in a different shape.

Screen

Ben Graham's formula for finding the intrinsic value of a stock was:

Value = EPS * (8.5 +2g). Where 8.5 is deemed to be the PE ratio of a zero-growth stock and g is the long-term growth rate. In other words, a company that grows at 1% a year would be valued at a PER of 10.5X. In our search for intrinsically undervalued companies I have used the SharePad filter to apply a CAPE of less than 10 (I used the default settings - most recent / Value of 1yr / Preferred) and a Price to NTAV of below 1X to reveal the following list:

Name	CAPE	Price to NTAV	Debt to Free cash flow	EPS 10y %chg (ann)
Cenkos Securities	2.4	0.7	0	2.5
OPG Power Ventures	2.9	0.3	5.8	13.6
United Carpets Group	3	0.5		10.6
Walker Greenbank	3.3	0.8	0.2	13.7
Zytronic	4.1	0.6	0	3.9
Rotala	4.2	0.6	31.6	16.2
Portmeirion Group	4.2	0.9		8.6
Vertu Motors	4.4	0.5	3.9	3.1
Tandem Group	5	0.9	3.9	10.5
MS International	5.5	0.6	0	1.7
Arbuthnot Banking Group	5.6	0.6	13.5	27.7
Cambria Automobiles	5.6	0.8		19.9
Airea	5.9	0.6	0.7	16.1
Griffin Mining	5.9	0.3	0.5	17.2
First Property Group	6.2	0.6	16.9	2.9
Wynnstay Group	6.4	0.6	0.6	2.1
FIH Group	8.3	0.7		2.6

Source: SharePad

With a deep recession on its way debt is very dangerous at this point in the cycle. I would therefore ignore all the companies in the list above with debt to free cash flow above 1, which reduces the list further. If we then add the annualised 10-year growth rate in EPS according to Ben Graham's formula (the aforementioned, Value = EPS * (8.5 +2g)) we can manually calculate a "Graham Value" for the share and determine how much upside Ben Graham may see in the stock:

Name	CAPE	Price to NTAV	Debt/FCF	EPS 10y %chg (ann)	Graham Value	Share Price	Upside
Cenkos Securities	2.4	0.7	0	2.5	160	35	458%
United Carpets Group	3	0.5		10.6	20	3.1	637%
Walker Greenbank	3.3	0.8	0.2	13.7	225	33.5	673%
Zytronic	4.1	0.6	0	3.9	295	97.5	302%
Portmeirion Group	4.2	0.9		8.6	1055	259	407%
MS International	5.5	0.6	0	1.7	211	114	185%
Cambria Automobiles	5.6	0.8		19.9	170	33.5	507%
Airea	5.9	0.6	0.7	16.1	96	23	417%
Griffin Mining	5.9	0.3	0.5	17.2	157	36	436%
Wynnstay Group	6.4	0.6	0.6	2.1	373	225	166%
FIH Group	8.3	0.7		2.6	259	194	134%

This list of value stocks all have significant upside if Ben Graham's principles still apply today. All are trading significantly below tangible book value implying that if the company could be wound up and the assets distributed to shareholders a positive return may be possible. This suggests the market is taking a very dim view of the long-term prospects for the company. Let's consider what the market is worried about:

Share Price 35p

Mkt Cap £20m

- **Market concerns**: With a paucity of fund raising at the moment it is likely Cenkos is struggling for revenue at the same time as the institutional broking industry is highly competitive. But Cenkos is possibly unique in having never made a loss with it's "eat what you kill" culture. In February they completed the IPO of FRP advisory and carried out a placing for Brickability, following on from the IPO of MJ Hudson as well as placings for Creo Medical and Crorero in December. But that is the past.
- **Personal View** With most of the net assets consisting of cash the TNAV is real. While this isn't a growth company revenues are lumpy. They have c 135 corporate clients which over coming months one suspects will have their share of rescue placings and rights issues. This looks like the market is throwing the towel in when the company may just be enrobing their batman capes on for the rescue issuance which may bring significant fees for Cenkos.

Share Price 2.85p

Mkt Cap £2.3m

- **Market Concerns**: As a carpet retailer with its 58 stores closed the company is likely to be loss making. The company has lease liabilities of £20.5m and £5.3m of balance sheet equity. c £3.7m is in a debtor book and £2.1m in stock.

- **Personal View** With a market cap. of £2.5m, of which 47% is owned by the CEO liquidity is so low that the likely spread on these shares could make taking a position very expensive. There is the possibility of not being able to exit should things get worse.

Walker Greenbank

Share Price 33.5p

Mkt Cap £23.8m

- **Market Concerns:** The company has closed its two factories in the UK as well as its showrooms in Chelsea, New York and Paris. Capex and discretionary spend has been frozen while spring collection launches postponed. The company has recently moved from £1m net cash to a seasonal net debt position. Dividend cancelled.

- **Personal View** Prior to the lock down the company was forecast to make £7.2m in the year to January 2020. Shareholders equity was £66.8m at the interims which was largely made up of £28.8m of inventory and £21m of receivables. The disruption could cause inventory write downs and receivable impairments while there is also a £5.2m pension deficit which is likely to grow as interest rates reduce again. This could potentially make the company loss making but if the assets are close to real the company should be able to squeeze through the eye of the financial storm. Some risk and a lot of upside.

ZYTRONIC

Share Price 100p

Mkt Cap £16m

- **Market Concerns**: This capacitor technology company reported weak market conditions ahead of the December year end but a pick-up in January. That is likely to now have vaporised. Of the £26m of balance sheet equity £13m is held in cash. With a market cap of £16m this suggests the market is giving the company credit for its cash but has little hope that it will ever grow its profits.

- **Personal View** Last year's profit warning was partly due to a slow down in the gaming market and I find myself wondering if there could be some benefit with 67m people currently under house arrest. But I don't understand their markets well enough to have a view. Could be worth more research. The small market cap may make transaction costs high for investors, however.

PORTMEIRION

Share Price 245p

Mkt Cap £27m

- **Market View** Results 10 days ago where in line with expectation with revenue of £92.8m and PBT of £7.4m despite a like for like revenue decline of 5.1%. The 3 largest markets of UK, USA and South Korea all have significant pandemic outbreaks so there could be further disruption. Net tangible assets of £31m includes £26.6m of inventory and £19.3m of receivables financed by debt of £13.4m. There is also a modest pension deficit of £0.4m.

- **Personal View** This may be too early. With the impact of the pandemic on the US only just starting given the debt position investors may wish to take another look when there is more certainty. In Benjamin Graham's words this is closer to "speculation" than "investment."

MSI™ MS INTERNATIONAL plc

Share Price 137p

Mkt Cap £23m

- **Market View** The company's three divisions of Defence, Petrol Stations and Forging reported subdued conditions in the interim period to September last year, resulting in the company reporting a small loss. No broker forecasts in place prior to the recession impacting doesn't imbue confidence. The company has tangible assets of £35m of which £19m was cash at September. Et cash was reported as £15.5m last week. It appears the market is giving the credit for the cash but very little for the business.
- **Personal View** I am attracted by the retained profit reserve of £25m evidencing that the company has been built through retained profits in the past rather than share issuance. Historically the company has paid strong dividends, but with this currently falls into the realms of speculation rather than investment. One to research.

Cambria
Automobiles plc

Share Price 34p

Mkt Cap £34m

- **Market View** All dealerships are now closed. Capex on hold and revolving credit facility fully drawn to ensure liquidity throughout the pandemic. The £44m of tangible equity is the net of a high stock and WIP amount of £113m, fixed assets of £85m, a trade creditors figure of £86m and debt of £30m at last August.

- **Personal View** The leverage of the balance sheet to not just debt but also creditor financed stock makes this a high-risk situation in the face of closure of all the show rooms. In a fire sale there would be likely to be write downs. Too speculative for me.

AIREA

Share Price 23p

Mkt Cap £9.5m

- **Market View** The recent update states the company expects a slow down in flooring carpet sales and has suspended the dividend. The net tangible assets of £13.9m include a property valued at £7m and £5.5m of inventory. Cash of £3m is accompanied by an overdraft facility of £1m. The company has had declining profits for two previous year so it looks like the market ascribes a negative value to the business.

- **Personal View** This manufacturer and distributor of floor tiles to the commercial sector has a strong record of profit growth over the last 5 years. There are high barriers to entry in this market and I have a feeling there could be good value here if the company can recover, which seems likely to me. The only thing is that the investors' transaction cost will be high because of the small market cap.

GRIFFIN MINING LTD

Share Price 38p

Market Cap £65m

- **Market View** The company has had multiple warnings over the past two years on the back of a lower zinc price, higher smelting charges and lower production. The Chinese mine ceased operation on the back of Corona virus on 22 January but resumed operations on 24 February. The company is expected to have £30m of cash and the market is attributing £35m valuation to the remaining £181m of net tangible assets which may arguably be appropriate given the assets are based in exotic locations. However, after a number of downgrades the assets are expected to deliver a profit of £7.7m in 2020.

- **Personal View** This looks like a value stock, but I don't understand the sensitivities of the commodity markets well enough to call this anything more than a speculation.

WYNNSTAY Group

Share Price 225p

Market Cap £45m

- **Market View** At the AGM last week the group announced subdued trading this year. The tangible net asset value largely consists of debtors of £68m, fixed assets of £20m and stock of £42m financed by trade creditors of £57m. Cash is £11m, but there is also £6.7m debt. The reason for the discount to TNAV is the company earns a low ROE of 6.9%. To return to NAV the company would have to increase the profit yield on its assets which makes this a play on profits.

- **Personal View** This looks like a value trap. If the business was closed the amount available for shareholders would be likely to be less than the current market cap, but running the business earns a poor return.

FIH group plc

Share Price 194p

Market Cap £24m

- **Market View** Since 2009 pre tax profits have varied between £1.9m and £5.7m. Operating art logistics and storage as well as trading and ferry services with a presence in the Falkland Islands this business may be expected to be less cyclical. With 57% of the share held by a non-executive director and a trust there is nothing likely to change the poor returns on the £30m of tangible net assets.

- **Personal View** The market may be right. This looks like a value trap.

Summary

There are far off signs of a recovery of inflation the other side of the coming recession. A deep recession was the catalyst that heralded the term value investing. Using Benjamin Garham's principles and a SharePad screen reveals 11 classic value stocks. Some may be high risk and some may be value traps, but six stocks, with varying degrees of risk, look worthy of further research. Those are Cenkos, Airea, Portmeirion, Griffin Mining, and Walker Greenbank.

Forthcoming Events

With most results now delayed at the behest of the FCA updates are not able to be forecast with any accuracy at the moment.