Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

After Value comes Recovery

6 April 2020

Markets

News flow from companies has now accelerated to a deafening roar. Companies are telling us what they are doing while simultaneously withdrawing profit guidance and dividends, leaving us with many questions around the topic what will happen next?

Warren Buffett answered this question in 1966 "I am not in the business of predicting general stock market or business fluctuations. If you think you can do this, or it is essential to an investment program, you should not be in the partnership." All we can do is buy good companies at good prices. But that doesn't make us happy as investors. We want to know when it will bottom. Which raises the question of why we want to become predictors of the future? We have always had a need to know the future, despite the fact that it is unpredictable. Julius Caesar used Druids for astrological forecasts. Kings and Queens have for millennia employed the services of soothsayers. But it is this unmet need for knowledge that can render us vulnerable. Markets tap into our desires, becoming over bought and over sold which can destroy our power of logical thought.

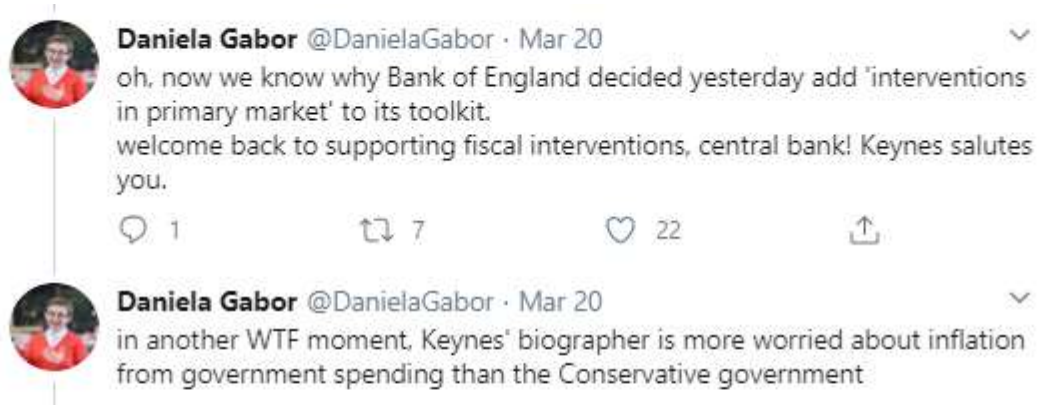
With food we know that we need to get our basic needs fulfilled, such as eating healthily and getting regular exercise. This is common sense. As we become more prosperous special diets start to appear and the publicity encourages us to suspend rational behaviour and hire a dietician or personal trainer to tell us what to eat and how to exercise. These dieticians and personal trainers have a conflict of interest and the more prosperous we become the more advice is supplied to us until elementary decisions are no longer straightforward.

As we sought growth in a low-growth world experts delivered us structural growth with unicorn valuations. Challenger banks didn't work out too well, so digital banks super-ceded them alongside peer 2 peer lending. And decisions became less straightforward until the fog enveloped us. Such have been the sins of a 50-year period of debt expansion. It is now time to stick to rational behaviour, which is to own good companies at cheap prices. As with every changing point the weak will perish while the strong will emerge in better shape in a healthier world.

Inflation

The financial crisis merely served to transfer the private sector debt onto government balance sheets and inevitably this results in the government effectively nationalising the economy in the current crisis. There remain only two ways of dealing with debt. One is to repay it and the other is to inflate the assets so the debt becomes smaller relative. The government has been trying this since 2009 by printing money, but now it is taking more drastic action.

If we stick to what we know and assess companies in that light our decision making can become more rational in this world of noise. I commend you to follow @DanielaGabor on twitter, not least because she is a professor of economics and microfinance that uses terms such as “WTF” and calls out Trump for “Bullshit” rather than the language that more theoretical economists can use. She has been increasingly conscious of inflation risk



The lower oil price will inevitably keep headline inflation down but “core” inflation, the prices of goods produced in the UK looks set to rise as consumers largely maintain pay, and capacity is cut. We are already seeing firms giving up rather than burden themselves with debt. When they re-start it will be in a smaller, less ambitious form which can fragment supply chains. The fall in the oil price itself is likely to result in a closing down of storage capacity enabling a supply chain restriction when demand eventually increases again.

Tim Congdon, one of Britain’s monetarists argued in his recent newsletter the sort of maximum inflation rate to expect in the next few years would be in the 5% to 10% band, which is hugely different from what we have got used to. As inflation returns the government can repeat the trick used after the second world war when interest rates were kept below the rate of inflation thereby repairing balance sheets for all owners of assets, including governments.

To illustrate how that may work on the ground let’s imagine how it would work for Jet2, the main operating business of Dart Group.

After weary months of working from home with rare outings, for essential purposes only, it is conceivable that at some point we will be allowed out and may feel the need to have a holiday. With all holiday bookings on hold at the moment it is possible that a lot of people have the same thought, and so start to search for holidays online. With a number of airlines having ceased to operate and planes having been retired it is just possible that Jet 2 may not be inclined to offer huge discounts to late travellers and the ensuing higher prices create a rather unique profit opportunity.

The same principle applies to chemical companies, media companies and perhaps engineers that may well experience inflation driven by a lack of supply in the face of a resumption of demand. Conversely the gaming sector, on-line retailers, healthcare companies, and utilities are unlikely to enjoy the same benefits from inflation. In other words, this is when we should be taking a look at cyclical business that will be survivors. A look at the highly cyclical Media and Speciality Chemicals sectors reveals a number of cyclical businesses below.

Balance Sheets

Just now we need bullet proof Balance Sheets as we are approaching a cash crunch as the lack of revenues is likely to cause cash flow to eliminate the weaker players. Inevitably the stronger players will emerge with less competition and be able to enjoy the wonderful inflation wave ahead. In the media agencies FTSE sector incredibly only 3 out of 28 companies have net cash. This could be messy. While only 3 out of the 10 companies in the speciality chemicals FTSE sector are profitable.

Media

A SharePad search of the Media Agency sector reveals a list of 28 companies in the FTSE All Share index or the AIM index. If we add a filter for balance sheet strength setting a maximum debt to free cash flow of 2X and market cap above £10m the list of 28 companies reduces to 5, which may evidence the amount of destruction lying ahead in this sector.

Name	Price (p)	Market Cap. £m	Price/ NTAV (X)	CAPE (X)	fc PE (X)	fc Yield (%)	%chg 3m	Net debt/FCF (X)
4imprint	1834	515	10.5	27.2	14.8	3.4	-46.4	-1
Next Fifteen	297.5	258	-17.5	16.3	7.9	2.4	-44.1	0.5
The Mission Group	54.5	47	-5.8	8.8	5.9	4	-31	0.8
Tremor International	140	187	2.4	9	3.9		-17.6	-1.4
YouGov	623	675	24.6	78.2	38.4	0.7	-7.01	-2

Source: SharePad

Of these only The Mission Group and Tremor International trade at under 10X the cyclically adjusted PE.

The Mission Group

Share Price 54.5p

Mkt Cap £47m

Business

Mission Group earns 60% of its revenue from Advertising and digital, 22% from media buying, with 11% in events and 6% from public relations. Last Thursday it reported results, in itself remarkable, delivering its 9th consecutive year of growth. Operating profit increased 8% to £10.8m and free cash flow was £7.2m which compares to net bank debt of £4.9m. The company says it expects an acute downturn in the current quarter so is withholding the final dividend and board members have reduced salaries, while capex has been reduced, while bank facilities have been increased to £20m.

View

The company is yet to experience the downturn and the business is hugely cyclical. However, there are likely to be rich picking for the survivors with strong balance sheets that will pick up the business of the failures. This looks like a strong business with a strong shareholder base including Katie Potts of Herald Investment Management, Rob Gurner's Polar Forager fund and BGF, alongside significant management shareholdings. This looks like a potential winner but timing is important.

Tremor International

Share Price 140p

Mkt Cap £47m

Business

Formerly known as Taptica this company sells technology which helps advertisers target and deliver a digital advertising story. Results on Tuesday were delivered by Webcast with no printed statement outside of the presentation. Revenues were $325m and EBITDA of $60.4m. The company is acquisitive and has $79m on balance sheet. Balance Sheet is $300m of equity which has largely been raised from issuing shares for acquisitions illustrated by the $210m of intangibles on the balance sheet. The market cap today is less than the value of the paper issued.

View

This is a supplier to the advertising industry so may be further down the supply chain than The Mission Group. While it has a strong balance sheet the added value is unproven from its acquisition trail and the lower cyclicality is evidenced by the modest 17% fall in share price over the last month. Too early to call this a recovery stock.

Speciality Chemicals

There are only 3 companies in the speciality Chemicals sector that are profitable; Treatt, Victrex and Zotefoams, all 3 of which are cyclical and may have an inflation opportunity with supply chain disruption.

Name	Price (p)	Market Cap (£M)	Price/NTAV (X)	CAPE (X)	fc PE (X)	fc Yield (%)	%chg 1m	Net debt/FCF (X)
Zotefoams PLC	163p	79	1	12.3	10.4	3.1	-47.2	
Treatt PLC	410p	247	2.8	32.4	21.3	1.5	-11.6	-2.1
Victrex PLC	1920p	1,662	3.8	18.2	17.8	3.1	-6.98	-1.3

Source: SharePad

Zotefoams

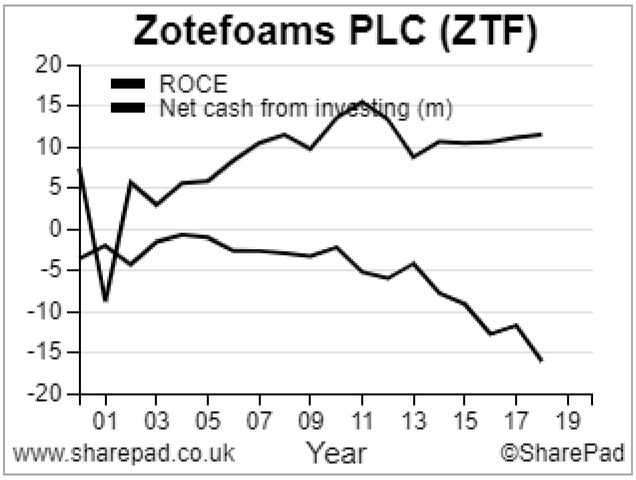
Share Price 163p

Mkt cap £79m

Business

The company's high performance polymer foam goes into many industries such as automotive, aerospace, packaging, industrial, marine, construction, military etc. Only 16% of revenue is derived from the UK, with Europe accounting for 36% and the US 26%. As a cyclical business the shares have fallen 47% in the last month. The results have been postponed but the year-end update expected profits to be in line with 2018 at £9.1m. A weak pound may benefit the results this year but the shut-downs look likely to hit profits. Net debt at the end of 2018 was £12.9m.

A check back to 1992 on the SharePad financials tells us the company has never made a loss since 1992 and the company has a strong franchise and consistently good returns on capital. Recent investment in capex has accelerated over recent years bring a net debt position which stood at £23.4m at June 2019. This brings an extra 40% capacity for Kentucky, extra capacity at Croydon, and a new plant in Poland expected in 2020.



View

It is looking like the extra capacity enabling the company to achieve its stated target of £100m revenue (2018 £81m) may come on stream just as demand is weakening. However, the lower all price is also set to help their gross margins as input costs reduce. This looks a very high quality situation where some time over the next 12 months there is likely to be a buying opportunity. Today there is little visibility, but sometimes the darkest moment can be before dawn.

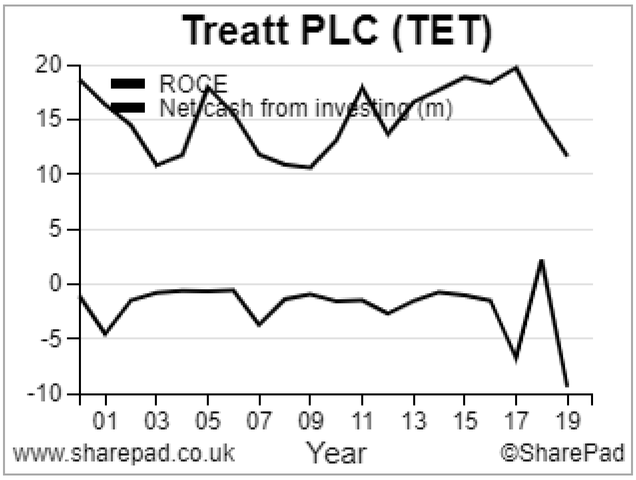
Treatt

Share Price 410p

Mkt Cap £247m

Business

Over the last 3 years diversification has to an extent decoupled profits from the weakening orange price. 40% of revenue is from the US with only 7% from the UK. Net cash on the balance sheet is £16m with shareholders' equity of £87m. ROCE is very healthy while despite an increase in investment the company continues to generate cash.



View

The shares remain geared to global commodity prices of orange oil, coffee and tea, but on a forecast PE of 21X and having fallen only 11% in the last month this is probably not a recovery stock.

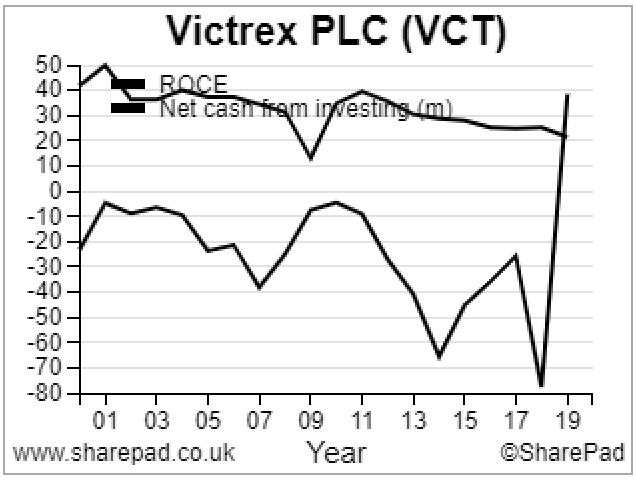
Victrex

Share Price 1920p

Mkt Cap £1,662m

Business

42% of revenue is to the EMEA, 30% to the US and 26% to Asia of it's high performance lightweight plastic "PEEK". The most recent update was the AGM on 6 February where some recent weakening of demand was noted. Q1 sales were up 7% to 877 tonnes but perhaps the more significant news in January was the creation of a China joint venture at a cost of £32m to be operational in 2022 to create a 1,500 tonne factory in China. At September 2019 the company had £72m of net cash and shareholders equity of £461m so it has a very strong balance sheet. It achieves extraordinarily high returns on capital which has built the cash pile despite consistent investment



View

Forecast anticipate 9% PBT growth in 2020 followed by 16% growth in 2021. Given the global shut down one could guess there are downgrades ahead. The shares are only down 7% in the last month. This looks like one for the watchlist to pick up when we get visibility on the downturn.

Summary

We don't know the future. All we can do is buy good companies at good prices. This is a time to get our watchlists tightened up ready for opportunity. With the likelihood of an inflationary squeeze it is possible there will be some fantastic opportunities in cyclical companies as part of the current disruption. Media and Speciality Chemical companies are two of the most cyclical sectors. Dangerously there is a lot of debt in the media companies at the moment but The Mission Group looks well placed to emerge strongly. In Speciality Chemicals Victrex, whilst not yet very cheap is in a very strong position while Zotefoams could be an earlier opportunity.

Forthcoming Events

Zotefoams infoms us that the FCA has "strongly requested" that all listed companies observe a moratorium on the publication of results. The company is observing this moratorium and awaits further guidance from the FCA. I find myself that when the FCA lifts the moratorium there could be a blockage in the newswires. Outside of that normal timetables would be:

Company	Date	Event
Zotefoams	TBC	FY 2019
Treatt	07-May-20	H1 Results
Victrex	29-May-20	H1 Results
Tremor International	12-Jun-20	AGM
The Mission Group	15-Jun-20	AGM