Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

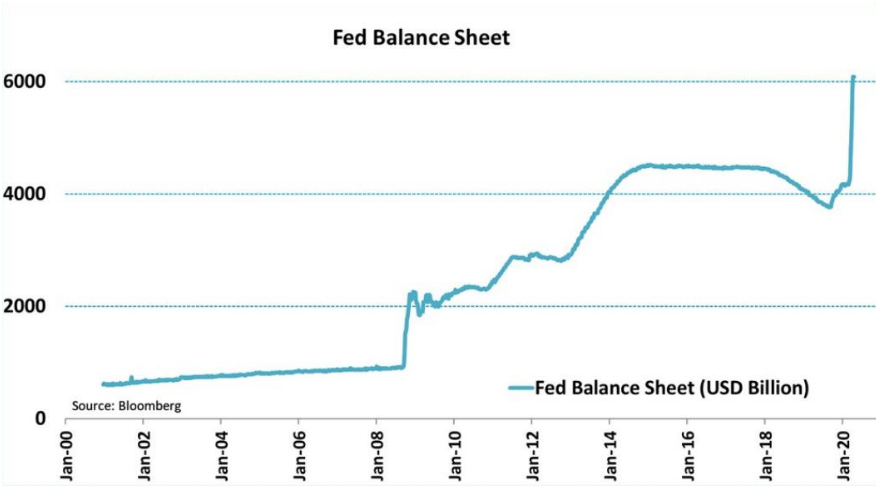
Depression in a Wall of Money

20 April 2020

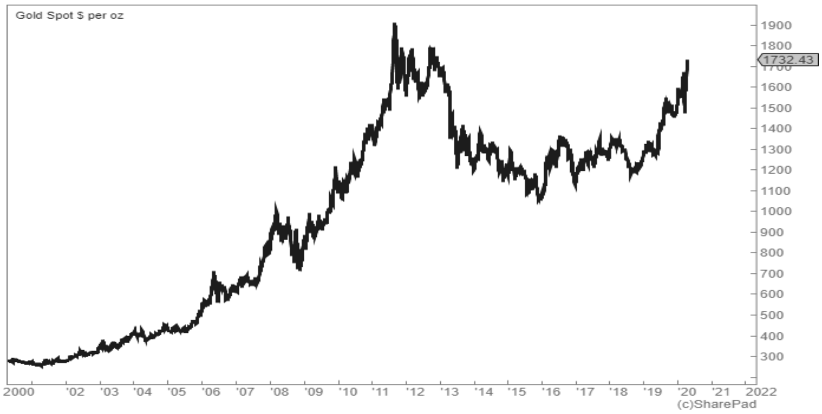
Markets

The speed of change is unprecedented. While the FTSE fell 35% it has now recovered 10% but the effect is more extreme in small cap world where the fall was 43% followed by a 21% recovery technically putting us back in a bull market for small caps. This bi-polar world may be coming from the conflicting forces of a looming economic depression in the face of the biggest wall of money the planet has ever experienced.

Governments all over the world are inventing trillions of new "currency units" and taking on vast amounts of debt whether in dollars, pounds euro's or yen. This supply of currency has been exploding upwards for years, but it the current pandemic means it is now going to accelerate a lot. The federal reserve not content with just issuing money is now buying more than the total issuance of all investment grade bonds in the US. This Bloomberg chart illustrates the US balance sheet



Let us take a look at what this does to the laws of supply and demand. If there is a relatively fixed supply of tangible "stuff" in the world and the amount of money chasing the "stuff" doubles it wouldn't be surprising to see the price of the "stuff" increase. These things take time, which is why inflation lags money printing, but we have centuries of evidence to confirm the relationship. Gold is a good example of "stuff" with a relatively fixed supply. The total amount ever mined is only enough to fill two olympic swimming pools. The price of gold has a strikingly similar shape to the fed balance sheet over the last 20 years with a time lag.

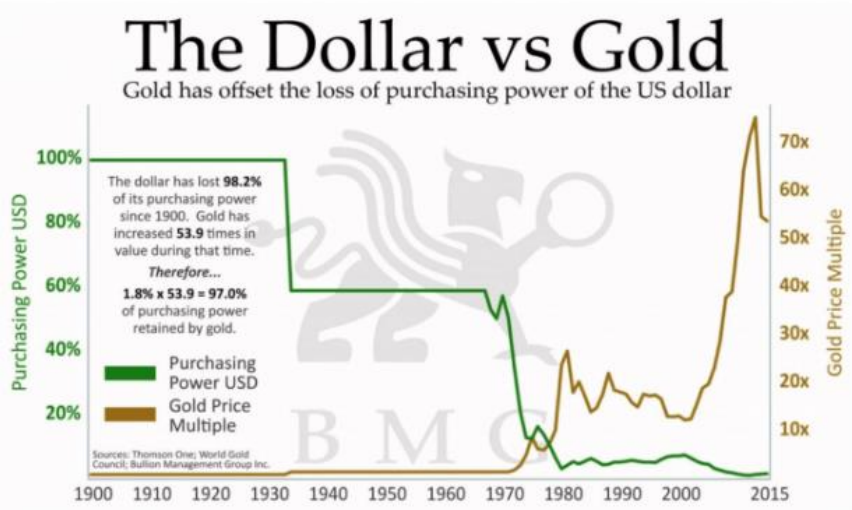


Source: SharePad

The same applies to all assets with a limited supply, such as high-quality companies. Anything unique will have an increasingly high value attached to it. Such as a unicorn. The top 5 companies in the S&P 500 index are Microsoft, Apple, Amazon, Google and Facebook. If we had owned an equally weighted basket of these stocks only our portfolio would be down 3.3% over the last 3 months which compares to the FTSE 100 index which is down 26% over 3 months. So while the contraction in GDP coming towards us is affecting real businesses those unique assets continue to appreciate in this bi-polar world. If we owned only these 5 stocks we would also own a portfolio trading at a forward PE ratio on average of 36X.

Sometimes I wonder why we spend our lives as analysts attempting to predict companies trading outcomes and place valuations on them when the key appears to simply find a unique asset and ignore valuation.

This money expansion has been happening for more than 50 years and our currencies have been depreciating while assets haven't. Since Gordon Brown sold the Bank of England's gold and president Nixon took the dollar off the gold standard in 1971 the currencies have devalued and there is enough history to suggest that all paper currencies eventually devalue to zero. The Chinese were the first to try it in the seventh century. France has tried it three times, post war Germany, Venezuela, Argentina etc. We may be witnessing the final years of our currencies, which is a time to own assets rather than the popular current asset called "cash". This chart is a little old but illustrates what happened to the dollar after it became a paper currency in 1971.



Source: ResourceWorld

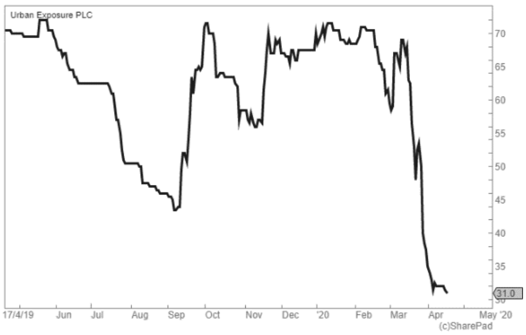
We are living in a world where the vastly increasing supply of money is forcing the valuation of unique assets ever upwards while impaired assets are incredibly cheap. The problem with impaired assets is that they have generally withdrawn guidance from the market. Uncertainty is the worst of prospects for markets, and gives rise to the expression “travelling is worse than arriving”. A good example is Urban Exposure.

Impaired Assets

Urban Exposure

Share Price 31p

Mkt Cap £49m



History

The company lends money to property developers for new home building and is fully secured on the underlying assets. It operated as a broker until IPO when it raised £150m at £1/share, valuing the broking business as £15m in May 18. Soon after IPO it was required to account for its profits over the period of the development rather than up front and so in the initial years the company is forced to report a loss and the profits come through over time as the loan book builds up. This had a catastrophic effect on the shares until Robert Tchenguiz tabled a proposal that the management team should be externalised and the company turned into an investment company. This announcement brought further proposals and eventually the solution was agreed to sell the assets to Honeycomb investment trust and de list the remaining management company returning 71p to shareholders. Then COVID 19 struck and Honeycomb reneged on the agreement leaving the company to pursue legal remedies. Hence the shares are 31p against a tangible book value of 84p announced on Friday.

Update

The company updated Friday that the loan book was robust. The company has never had any impairments in the past and being fully secured on the housing assets doesn't expect them. However, the rate of new lending will slow so, the company withdrew guidance. At the same time the company said it had received a number of enquiries and would pursue all credible proposals. It also reported that it had achieved a maiden profit in 2019 which de-risks the company in my view.

Prospects

It seems to me that the share price is implying the housing will halve in value and the housebuilders will all default. If this is the case, we should be short of all housebuilders. But possibly one of the proposals will give shareholders a return close to the 84p NAV in the next few years which is 170% above the current share price. But there is little visibility today, so these value situations offer opportunity for the value investor.

Unique Assets

Gold has no intrinsic value other than being relatively fixed in supply, but it certainly looks a good place to be invested while the money is increasing and GDP is doing a good impression of nose diving. In normal times an equity investor could get exposure through owning pawnbrokers but with their shops shut other factors may interrupt the investment journey.

Most quoted companies have their own uniqueness whether it be through know-how, brands, distribution networks or the scale that market leadership provides. For uniqueness to exist the barriers to entry must be extremely high which means that an increasing amount of money gets forced into the stock over time, guaranteeing a high and growing valuation, alongside repeat customers earnings.

Stock Exchanges

One market that has high barriers to entry is the quoted exchanges market. It is very difficult to disrupt the once monopolistic London Stock Exchange but **Aquis Exchange** results last week suggested the company is making significant progress. Sometimes monopolies can get a little too comfortable leaving cracks for new entrants.

Farm Genetics

Another company which came out of a once protected monopoly is **Genus**, which was originally demerged from the Milk Marketing Board. This was a company set up by an act of Parliament in 1933, which like many central bodies became the victim of bureaucracy such that it managed to fumble the launch of Lymeswold cheese just at the dawn of an era of artisan cheese exploding in popularity. But it did have close to a monopoly of the bulls used for inseminating the UK bovine herds which was ripe for exploiting. Because of the long lead times involved in developing optimal herds only very long-term capital enters the sector. One example is the Duke of Westminster who set up a Genus competitor in 1995 called Cogent Breeding Limited. A Companies House search of their accounts shows that 23 years after setting up the company remains loss making, despite their claim to offer twice as many sperm cells per straw than any other straw on the market.

AQUIS EXCHANGE

Share Price 350p

Mkt Cap £95m

Business

The CEO Alasdair Haynes, who has recently recovered from COVID 19, was preciously the CEO of Chi-X which was sold to BATS trading which in turn was sold to CBOE exchange in 2016. Consolidation is a constant theme in exchanges because of the “winner takes all” nature of markets. He came up with the idea of a subscription-based market when shopping for a mobile phone for his son in the Vodaphone shop in Tunbridge Wells. As the frequency of trades has increased exponentially over the years there is still no where you can pay a subscription and much in the way that as mobile phone usage accelerated the model moved from pay as you go to subscription. So Aquis was formed as the only subscription-based market.

The company now operates in 3 divisions, one is the subscription based trading revenue, one is licensing their technology to other operators for non-competing asset classes and the third division is the recently acquired NEX exchange which they hope will overtake the AIM market one day.

Results

Last week the company delivered on its promise to be close to break even by the end of 2019 delivering a £200k EBITDA loss for the year to December 2019 with a 73% revenue increase to £6.9m. Reassuringly the company still had £11m of the £12m it raised at IPO almost two years ago in June 2018 at 269p/share. The company reported last week that the exchange is being operated remotely and is coping with recent higher volumes while they also have an encouraging pipeline of new users so the impact of COVID 19 has been minimal for the business, if not the CEO who has recovered from COVID 19. With a strong balance sheet, solid growth prospects and close to break even this is a hugely de risked situation over the past 12 months.

The acquisition of NEX exchange, a junior market to AIM, may put some off as it has been loss making for many years under the ownership of ICAP and CBOE, but Haynes is excited about it. With shareholders such as Rich Ricci, the colourful new CEO of Panmure Gordon, Miton and Axa he may have some support for the new consultation paper to improve the NEX market. Personally, I suspect the time is right as AIM continues to shrink on the back of increasing costs and reducing credibility. His aim is to position Nex (now renamed Aquis Stock Exchange) as a high integrity low cost alternative.

Valuation

With unique assets the valuation can typically be high, and this is no exception. With no profits we need to look at revenue multiples. The £6.9m revenue reported last year compares to a £95m market cap, which equates to an EV/Revenue multiple of 12.2X. Forecasts, which Haynes said he was comfortable with last week assume a 60% revenue increase to £11.2m, reducing the EV/Revenue to 7.5X. BATS trading, a predecessor alternative exchange was taken over by CBOE in 2016 at 7X revenues so it looks as if the valuation fully values last year's reported revenues but not future growth.

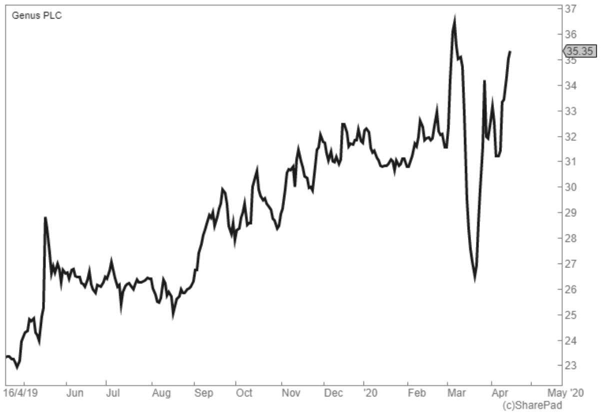
Conclusion

If this company gains traction that takes its market share higher than its current 4.6% it is inevitable that the company will be acquired as exchanges need to maintain their market share. With the break-even situation de risking the company significantly and a strong growth trajectory it would seem likely this unique asset could prove tempting for a predator in a couple of years' time. Perhaps a similar rating would be a reasonable expectation but over two years revenues could double implying 100% upside.

Genus

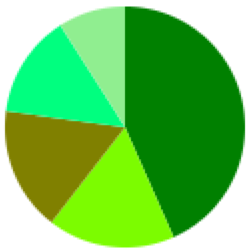
Share Price £35.35

Mkt Cap £2,300m



Business

In my view there is not purer intellectual property than a near monopoly of the genes of the UK farming stock. Couple that with competitors who are private companies, or worse, co-operatives, and the company has a strong position. It has been very acquisitive over the years acquiring PIC (Pig Improvement Company) to add pig genetics to its cattle genetics franchise and acquiring overseas distribution into 75 countries that it now distributes to. The global diversity is evident from this SharePad chart.



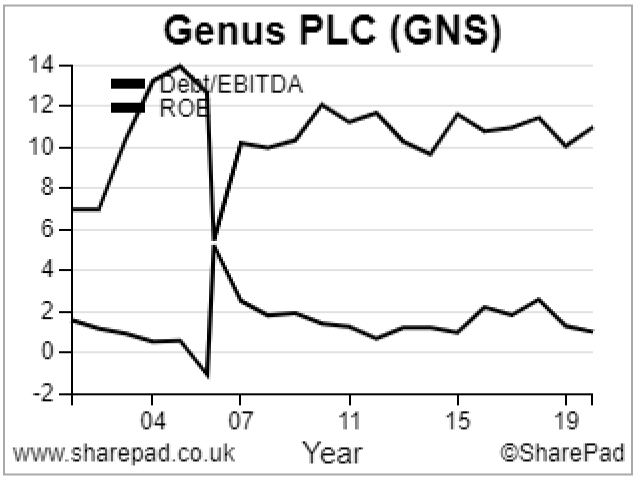
Region	Turnover £	%
North America	211.8m	43.4%
UK	83.7m	17.1%
Latin America	81.1m	16.6%
Rest of Europe, Middle East, Russia and Africa	67.7m	13.9%
Asia	44.2m	9.1%

As it distributes to food producers it has the benefit of being less cyclical, a factor that the market seemed to overlook briefly when the share fell for a short period in March before recovering.

Results

The H1 results to Dec 2019 were released on 27 February. A 13% revenue increase to £270.7m delivered a 27% PBT increase to £36.6m. The pig business "PIC" grew profits 29% which represented a huge 39% adjusted operating margin but this may not be sustainable as this was partly driven by Chinese buying post the outbreak of African Swine Fever in China. The bovine division grew profits 15% achieving a 12.4% adjusted operating margin. While cattle farming may not be a growth industry it is becoming more capital intensive as farms get larger and with that the demand for scientifically researched genetics is increasing over time.

Typically, with such strong companies we may expect a company to take on high leverage but the net debt/EBITDA is a conservative 1.3X while the ROE is consistently in double digits.



Valuation

This is another unique asset with a high valuation. On June 2020 estimates the PE is 43.4X and the yield 0.8%. The SharePad history is useful to tell me how that sits versus history

Average daily PE

From	To	Low	On	High	On	Average
1/7/19	Today	35.4	15/8/19	51.5	5/3/20	42.1
1/7/18	30/6/19	28.0	11/10/18	39.9	20/7/18	32.6
1/7/17	30/6/18	24.8	26/7/17	39.3	5/6/18	33.0
1/7/16	30/6/17	27.3	5/7/16	34.0	4/10/16	30.5
1/7/15	30/6/16	22.8	24/8/15	28.9	29/12/15	26.1
1/7/14	30/6/15	21.9	4/8/14	32.4	22/5/15	27.2
1/7/13	30/6/14	19.4	10/4/14	30.8	27/8/13	25.6
1/7/12	30/6/13	23.8	2/8/12	30.2	21/3/13	26.7
1/7/11	30/6/12	19.4	10/8/11	33.0	2/5/12	25.1
1/7/10	30/6/11	19.5	28/7/10	28.9	7/6/11	23.8
1/7/09	30/6/10	13.1	8/7/09	21.6	15/6/10	18.5
1/7/08	30/6/09	16.1	30/6/09	27.2	19/9/08	21.3
1/7/07	30/6/08	20.7	16/8/07	37.4	12/5/08	30.2
1/7/06	30/6/07	22.2	18/7/06	36.7	15/6/07	28.7
1/4/06	30/6/06	20.6	23/5/06	23.8	3/4/06	22.1
1/4/05	31/3/06	16.1	23/5/05	26.8	27/3/06	19.4
1/4/04	31/3/05	9.4	18/5/04	17.0	7/2/05	12.7
1/4/03	31/3/04	6.8	10/4/03	9.8	12/9/03	8.8
1/4/02	31/3/03	8.2	3/4/02	12.3	18/6/02	11.1
1/4/01	31/3/02	5.4	14/11/01	11.9	18/2/02	7.8
1/4/00	31/3/01	5.9	28/3/01	17.5	7/7/00	12.2

It seems the valuation is the highest it has been in the last 20 years. The theory is that with increasing money chasing these unique assets this can go higher but personally I find it hard to buy a share at a 20-year high rating. Perhaps the lucky ones are those that bought it when it fell 30% briefly in March.

Conclusion

This company is unique in having a less commercial customer base and owns the genetic codes for much of the global pig and cattle stock. It also has a strong 20-year record in the quoted markets but at a 20-year high rating irrationally I find myself struggling to rush to own it today.

Summary

Markets have now become becalmed as the profit warnings are yet to come while the pressure of money printing is exerting upward pressure on valuations. This is evident in the large stocks in the US and will arrive in due course more widely in markets. This money pressure may well be felt more in companies that represent unique assets, as well as in gold prices where the supply is almost fixed. The problem is that with 50 years of money expansion behind us many of these unique companies are already expensive. I find Genus valuation a little rich for me, but I suspect that Aquis exchange could reach higher valuations on very much higher profits and produce a pleasant investing experience. At the other end of the spectrum there is also money to be made for that rare and long-suffering breed of investor called a “value investor”. Urban Exposure may just be such a situation. Today we are in no-man’s land so it may be back to Bar-Bell time.

Forthcoming Events

Urban Exposure	April 2020	FY Results
Aquis Exchange	30 April 2020	AGM
Genus	8 Sept 2020	FY Results