# Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

## To the Future

**27 April 2020**

### Markets

It felt like a gentle week for equities after the gut-wrenching ride of recent weeks. The FTSE 100 was down 1% in line with the FTSE Small Cap ex IT down 0.4%. While it was oil that was the shocker with the WTI (West Texas International) price going negative and Brent Crude falling 17%, while Gold reached a new high.

FY 19 results have now started to be delivered after the FCA moratorium analysts have been taking chainsaws to forecasts or putting them "under review" when they have no idea. Forecast movement has become less correlated with share prices than any other period I can recall. The market is happy to look through the downgrades in the current year, as it should. What is clear is that some companies will emerge stronger from this and some will be weakened by the battering.

An example of this in practise is the fact that analysts meeting are working rather well by video conference and in fact without the need to traipse from the City to the west end for meetings it is possible to use time (the stock for many city firms) more efficiently. Equals Group in its COVID-19 update last week said "*the success of home working is also enabling the board to review the Group's office space requirements, especially in London*". Much progress comes from hardship, and this crisis will no doubt be the same.

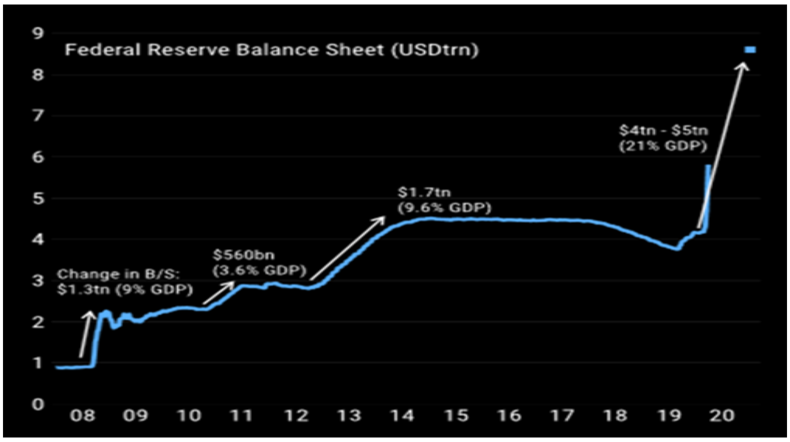
### Going Forwards

As we look to future with a smaller number of leaner companies, I can see only two futures.

- One where the debt burden continues hinders the economy while with low corporate earnings and tax revenues for governments there is no possibility of repaying the debt. Ultimately if the nation does not earn its way out of lock down the government will collapse. If we cannot earn our way out of debt the currency devalues and eventually disappears as it did in post war Germany. Which leads to inflation, but only after more corporate pain.
- The second option is that the huge amount of printed money leaks into the economy, the furloughed staff who have mortgage holidays, no travel costs and less spending in pubs find they are quite well off while the low oil price gives a boost to the economy. And spending starts to happen. As we get to a year from now and the inflation figures which have been previously depressed by the low oil price start to come up against low oil price comparators the headline inflation rate starts to quickly accelerate in a year's time. Fairly quickly after that staff start asking for higher pay in the face of increasing inflation and as now lean companies can afford it they give

a bit more to the staff, who are now feeling very confident in a recovery, and so spend more. And we have an inflationary spiral that makes debt levels start to look manageable.

My own thoughts are the second option is the more likely outcome. Perhaps it is a natural belief in human progress (look at how much wealthier our nation is than 100 years ago. We have nearly eradicated poverty in the UK despite the nay-sayers complaining that the rich have got richer). Or perhaps it is false optimism. But it seems to me there are greater inflationary forces in the system than there have been in my investing lifetime. By way of a reminder this chart shows the amount of US money being printed.




*Source: The marketear.com*

## Stocks

If the second option is the case, we are looking at a very attractively priced equity market. It is cash savings that is overpriced. But it is not clear today what the next hot sector is. What I do know is that companies that hold stock benefit from inflation, which are often manufacturers. With a rapidly changing world the product risk is higher in packaging manufacturers (such as Macfarlane) and other manufacturers such as Volex, I find myself contemplating food manufacturing as a more reliable product sector. Sausages seem unlikely to go out of fashion post lockdown to me. A look at the food producers from the SharePad table below highlights:

| Name | Price | Mkt Cap | Price/NTAV | CAPE | fc PE | fc Yield | %chg 1w | %chg 3m | %chg 10y | ROE % |
|---|---|---|---|---|---|---|---|---|---|---|
| Viscofan SA | 5725¢ | € 2,652.5 | 3.3 | 18.8 | 22.7 | 3.0 | 9.92 | 15.5 | | 12 |
| Cranswick PLC | 3826p | £2,003.1 | 5.1 | 35.3 | 25.0 | 1.5 | 4.04 | 9.15 | 372 | 14.6 |
| Devro PLC | 149.9p | £250.3 | 3.8 | 8.2 | 9.4 | 6.3 | 3.52 | -10.8 | -12.8 | 22.9 |
| Greencore Group PLC | 172.2p | £773.2 | -4.1 | 12.7 | 11.0 | 2.6 | 2.45 | -30.3 | 141 | 14.7 |
| Hilton Food PLC | 1081p | £886.7 | 7.5 | 32.5 | 21.6 | 2.3 | 3.33 | 4.73 | 357 | 20.8 |
| Tate & Lyle PLC | 696.4p | £3,254.0 | 2.8 | 13.5 | 12.8 | 4.4 | 0.95 | -11.0 | 57.2 | 17.1 |

*Source: Sharepad*

The following is apparent:

- **First** Devro appears to be the highest ROE stock while having the lowest PE, together with a 6.3% yield.

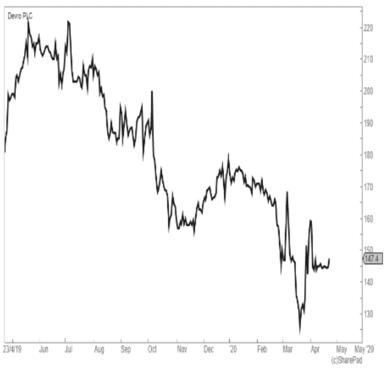
- **Second** In the last 3 months, 3 of these food producers have actually increased their share prices, only Devro, Greencore and Tate & Lyle have suffered share price declines.
- **Third** only four companies have a PE below its cyclically adjusted 10-year average PE ("CAPE"). Viscofan and Devro are both trading at a higher PE than CAPE.
- **Fourth** Devro has a shocking track record with the shares being down 11.7% over 10 years while Cranswick has performed rather well which is surprising given that Devro reports the highest ROE of the peer group.

The cheapest two are Devro and Greencore. They are the cheapest in PE terms, they are the two that have fallen most in the last 3 months and they are the smallest two. I was once told that elephants don't run so it may be worth taking a further look at those two.

## Devro

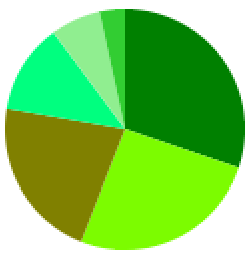
**Share Price** 150p

**Mkt Cap** £250m



### Business

Devro is a global business manufacturing collagen products (think sausage skins) for the food industry.

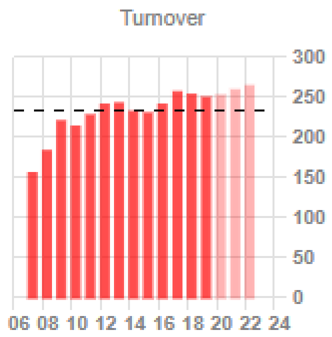


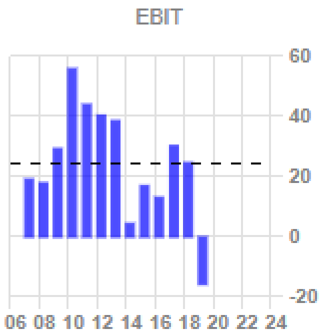
| Region | Turnover £ | % |
|---|---|---|
| Other EMEA | 75.5m | 30.2% |
| Other Asia-Pacific | 64.4m | 25.8% |
| USA | 54.4m | 21.8% |
| UK & Ireland | 30.3m | 12.1% |
| Australia | 16.9m | 6.8% |
| Other Americas | 8.5m | 3.4% |

I find it useful to start with the numbers and then check if the narrative fits.

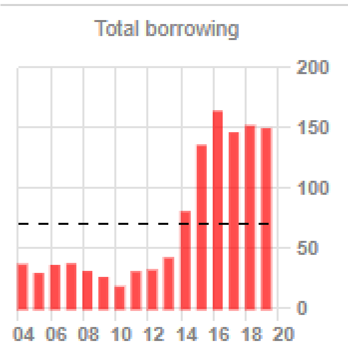
## Numbers

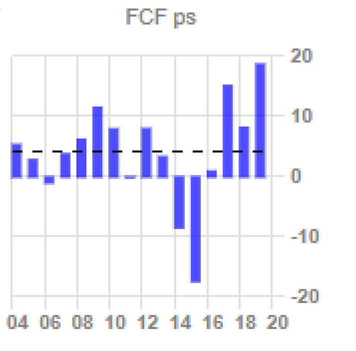
Turnover growth has been modest since the credit crunch but it appears to have a pattern of 3 year declines followed by 3 years of increases that could be called an investment cycle. EBIT however has declined consistently over 10 years.



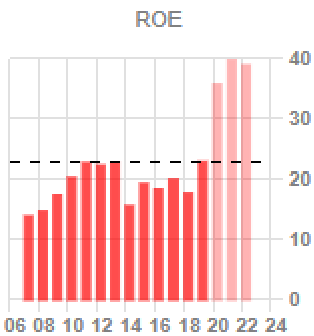




Borrowings have increased from the credit crunch to 2016 since when they have been maintained or decreased. Free cash flow however has started to be delivered indicating the company may be starting to reap the benefit of previous investment.




The result is an ROE forecast to increase significantly going forward. If a company delivers a 30% plus ROE it is unlikely to trade on its current 9.3X PE.




## Narrative

**Last week** The COVID 19 update last week said that Q1 volumes increased 2% driven by growth initiatives. Hardly exciting. Emerging markets grew 13% and mature markets declined 3%. They have experienced some supply chain disruption but to secure supply they have experienced some raw material inflation. This supply chain disruption could be one of the real-world factors that fuels the beginning of underlying inflation in the economy. Discretionary Capex and operating expenditure have been cut. Revenue and profit guidance for the year was maintained which anticipates a 1% growth in revenue and a c 3% increase in profit.

**Results in March** The strategy is focussed on aligning resources with growth markets, which means investing in emerging markets, while improving efficiency in mature markets. The company reported a respectable 26% operating margin which should produce a strong ROE. The company has historically reported equity of £146m which almost halved to £75m as the company closed historic sites and rationalised its manufacturing footprint resulting in balance sheet write downs. I enjoy the way companies that headline the write downs as “Non-Cash” write downs. I once called a fund manager on behalf of a company to explain an IT write off and called it “noncash”. The dry clipped Scottish fund manager politely asked how the number got into the balance sheet in the first place. For Devro it seems the ROE growth shown in the chart above is achieved by shrinking the “E” rather than growing the “R”.

**Balance sheet** The company had net debt of £130m on 17 April 2020 comprising gross debt of £156m and cash of £26m. There are available facilities £33m on top of the cash balance of £26m. The debt consists of a £105m revolving credit facility expiring 2023, a $100m private placement expiring in 2021 ($25m), 2024 ($50m) and 2026 ($25m). In the context of a £35m consensus PBT for 2020 this looks manageable assuming capital markets remain open for refinancing. But were debt markets to close, which seems unlikely today, there could be a need for an equity issue.

**View** I am finding it hard to get excited, but maybe that’s good. The balance sheet is getting tidied up and the business rationalised but the results statement gives no confidence that this is complete with capex set to be maintained at c £20m in forecasts going forward, compared to depreciation of £25m. It looks like a reliable annuity. According to Warren Buffet ex growth annuities could be valued at 8.5X PER and 2% growth companies at 12.5X. This trades at 9.4X which doesn’t look out of kilter, so perhaps it’s a good home for money, but there must be better things for the more excitable investor. However, note the reference to price inflation in the trading update. Underlying inflation pressures are building, and this could become a more exciting stock as they start to put prices up in a year’s time.

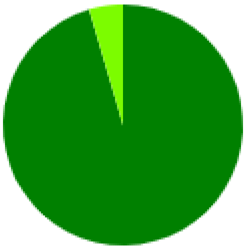
## Greencore

**Share Price** 173p

**Mkt Cap** £772m


### Business

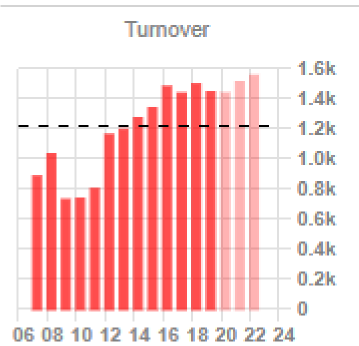
Greencore is a Dublin based manufacturer of frozen and chilled convenience foods from its Chesterfield premises selling sushi, salads, ready meals etc to large chains in the UK and Ireland.

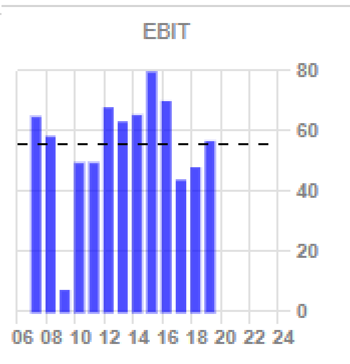


| Region | Turnover £ | % |
|---|---|---|
| United Kingdom | 1,380.2m | 95.4% |
| Ireland | 65.9m | 4.6% |

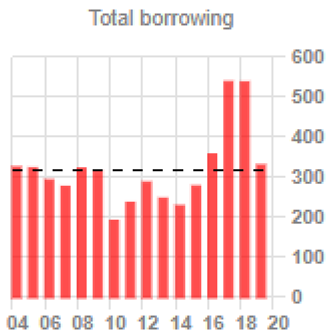
### Numbers

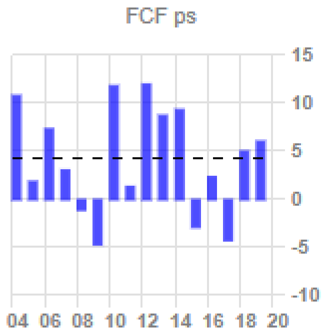
Revenue growth has been intermittent since 2015 and EBIT has declined though it now appears to be on a growth trend again.



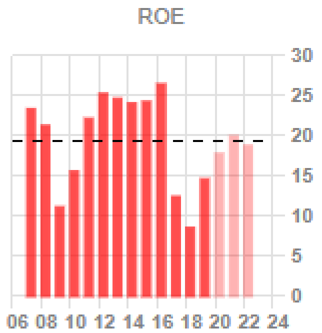




From the 2015 peak in revenues the company has been investing, depressing free cash flow, which has resulted in higher debt levels though this now appears to be coming down as cash generation has improved.




The ROE has tumbled with the profits since 2015 but is now increasing and is forecast to increase to high teen percentages.




## Narrative

**March 30th update –** The company has been impacted in the convenience "food to go" category as people are working from home, though other food outlet customers have mitigated the negative impact. The directors took pay cuts and staff furloughed. Financial guidance for 2020 has been withdrawn reducing the credibility of forecasts. Capex and dividends have been cut.

**Results to September 2019** – Revenue growth of 2.6% for the year to September was reported, which translated to EPS growth of 6%. The strategy is to expand the channels in the food to go market which, before COVID 19, was a growth market. Operating margins are a slimline 7.3% but notwithstanding this the company reported a 14% return on invested capital. The company is investing in its future with £95.8m spent on capex and acquisitions during the year, while depreciation was reported at £32.8m.

**Balance Sheet** At 27 March the company had cash and undrawn facilities of £265m including a newly agreed £75m committed debt facility in March. At September 2019 the net debt was £288m and there is a pension deficit of £92m. During 2019 the company restructured the balance sheet following the disposal of the US business returning £509m to shareholders. At the end of September the group had total facilities of £506m with an average maturity of 4 years. No maturities are due in the current year to September 2020. The risk could be that a profit hit could cause a covenant breach this year, although it seems banks are sympathetic in the current scenario. Or perhaps they don't have the bandwidth to deal with technical covenant breaches from all their loans.

**View** There may be more people working from home going forwards and we need to believe that those offices will remain occupied to own this play on food to go. My view is the empty desks will be replaced by meeting rooms and over time central offices change but I don't see people living from sandwich boxes in the future so I take the view that demand will return, but slowly. I am attracted by the ability of this company to invest its cash generation at 14-15% returns and so grow (in a normal world) in a less mature market than sausage skins. The ROE is forecast to reach 20% going forwards due to investment and growth though this could move to the right with COVID 19. When it reaches 20% the shares are unlikely to trade on a PE of 10.7X, lower than the historic inflation adjusted average. And inflation could in the future bolster returns.

## Summary

It is hard to know how long it will take but ultimately the result of the current currency issuance, supply restrictions, and low oil price is likely to be inflation. Food producers are well placed to benefit from this while being less volatile than most in terms of demand swings. Some have benefitted from COVID 19 as supermarkets prosper and others struggle as retail outlets close. A look at Devro and Greencore suggests that on the other side Greencore may have a strong future and the 33% share price fall over the past 3 months as retail outlets close could present an opportunity. While Devro could be one of those dull investments that provides a comfortable investor experience in an inflationary world. The signs are there. The coop warned of higher costs on Friday.

## Forthcoming Events

| Company | Date | Event |
|---|---|---|
| Devro PLC | 30-Apr | AGM |
| Cranswick PLC | 19-May-20 | FY Results |
| Greencore Group PLC | 19-May-20 | H1 Results |
| Hilton Food Group PLC | 21-May-20 | Trading Update |
| Tate & Lyle PLC | 21-May-20 | FY Results |
| Viscofan SA | Jul-19 | H1 Results |