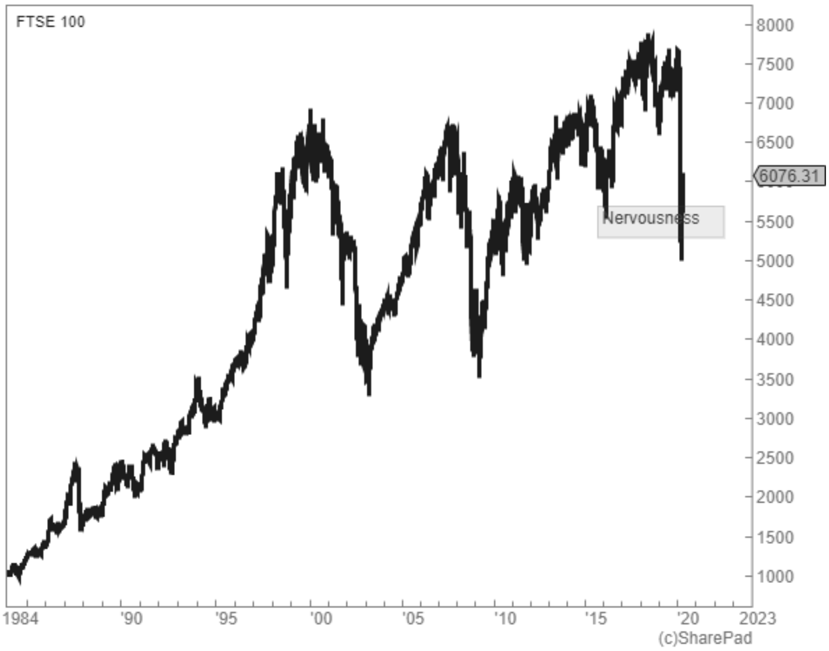
Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

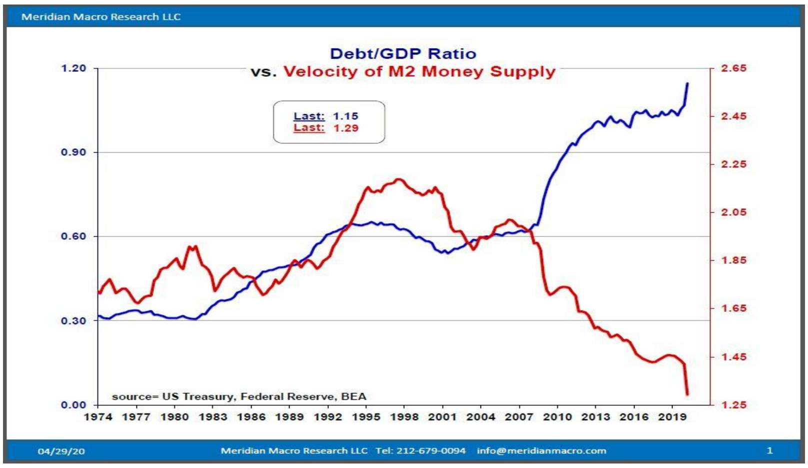
The Small Cap Opportunity

4 May 2020

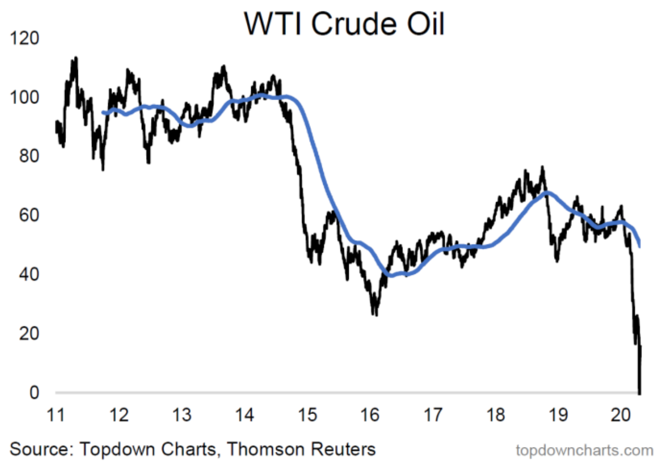
A Rising tide lifts all boats. With markets squeezing up last week it is tempting to turn negative, but in the long run that would be a mistake. This 36-year chart would suggest we are undergoing an exciting opportunity.

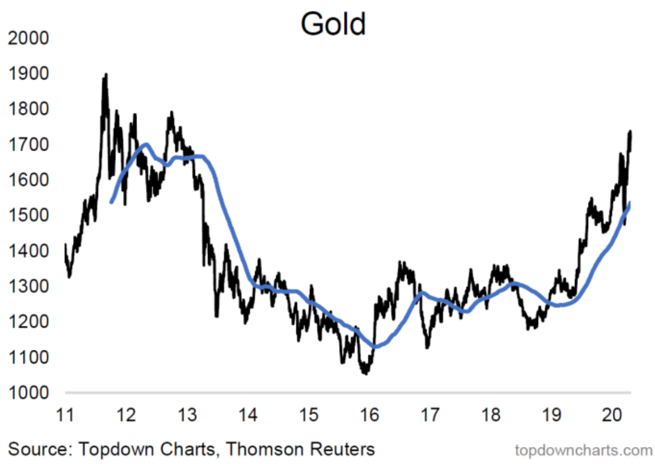


Except we are in a world where stocks are going up and earnings are going down. Stocks are being driven by a vast weight of money while economies are not benefitting from the money printing presses.



The slowing down of money velocity implies that banks are not lending. Back in my university days we were taught that banks acted as a useful "multiplier" to translate government lending into economic prosperity, but it is many years since I have heard economists talk of the multiplier effect. Since the credit crunch we have increased banks capital requirements, introduced a higher bank tax and increased their regulatory burden while printing money. The result is the money is low economic growth and buoyant investment markets. Illustrated here.

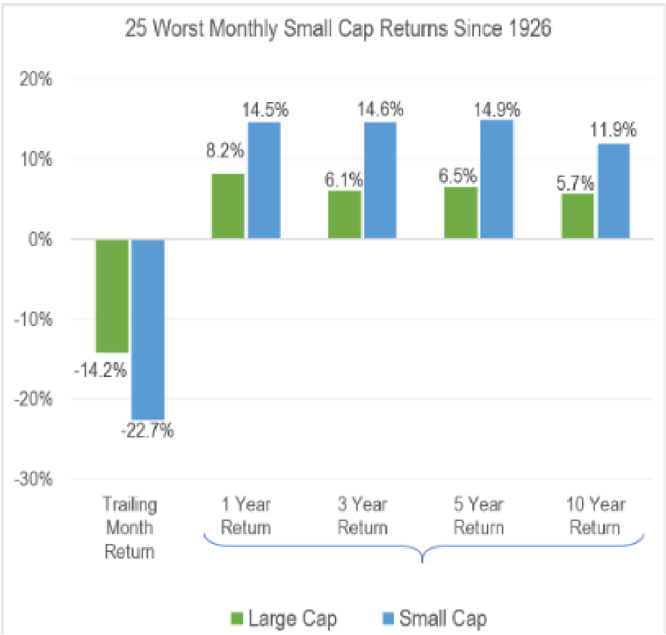




Markets

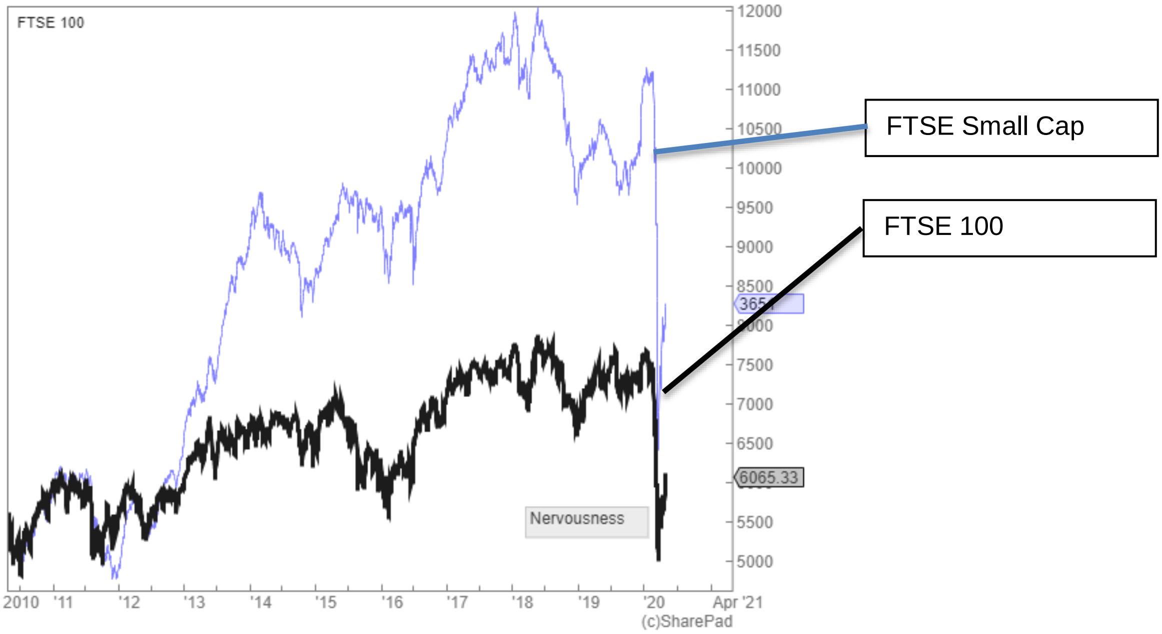
With equity markets squeezing upwards, much as they have been since 2010, investors are climbing a wall of worry. We hear "the market is crazy" frequently. But the market is set to remain crazy on account of our strange economic policy. With a rising tide lifting all boats stock selection has never been more important.

The evidence is clear that while small cap stocks underperform in a bear market, they outperform after bear markets. This chart from Ibbotson Associates evidences their study of large and small cap returns since 1926



Source: Ibbotson Associates

To translate this to todays' equivalent over the last 3 months the FTSE is down 22.5% while the FTSE small cap (ex-investment trusts) is down 27.8% thus underperforming the FTSE 100 in a bear market. In the last month, the FTSE small cap is up 12%, outperforming the FTSE by 5.6%. If 94 years of stock market history repeats, we are in for a good year for small cap stocks. And 3 years, and 5 years, and 10 years. The aftermath of the 2008/9 bear market underlines this thesis.



Stocks

This small cap effect has been evident last week as strong gains have been experienced by overlooked small stocks.

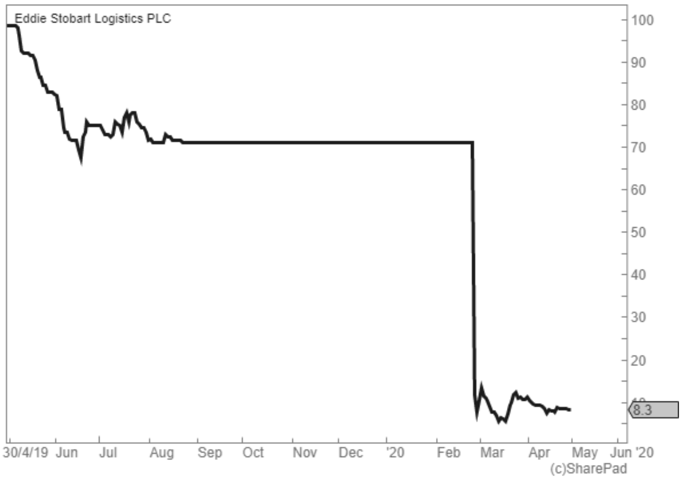
If we screen out companies above £100m and below £20m where the spreads can make investment expensive the AIM small cap universe is 278 companies. Of these 236, or 85% have experienced share price increases in the last month. The chart above tells us this is likely to be a multi-year phenomenon after a bear market. There are rewards to be had from finding those with earnings resilience. This was evidenced with several companies last week. STM shares rose 26%, Universe Group 32% and Proactis 36% on "in line" updates.

Two companies that should be resilient and are small and overlooked due to complexity are Eddie Stobart Logistics and FBD Holdings, the Irish agricultural insurer.

Eddie Stobart Logistics

Share Price 8.3p

Mkt Cap £31.5m



History

After an IPO in 2017 at a valuation of £570m with £115m of debt the CEO since 2007, Andrew Tinkler, stepped down in June 2018 and launched a court action to rule his sacking was invalid. Stobart Group, a 12.5% shareholder and licensor of the name claimed that Tinkler breached his duties as a director by conspiring with Woodford and others to oust the Chairman. Interims announced in August 18 and the revenue growth to November 2018 was 35% of which 18% was organic. A new CFO was appointed in April 2019. Net debt on 31 May 2019 was £154m and in July 2019 a series of prior year adjustments were announced following the arrival of the new CFO.

In August 2019, a new CEO change was announced with Alex Laffey, who had been at Eddie Stobart since 2018 taking up the position of CEO. At the same time revenue recognition accounting rules were changed, receivable write offs announced and the dividend withheld. Trading in the shares was suspended. Takeover approaches were then received from the previous CEO, DBAY advisers and Wincanton. An update in November 2019 revealed that debt was in fact £200m and EBIT was lower than expected which ensured the Wincanton bid fell away and left the door open for Tinkler and DBAY advisers to trade blows over refinancing proposals, while Woodford, the largest shareholder sold stock. In December 2019 the DBAY Advisers proposal was overwhelmingly approved by shareholders and post the restructure the shares resumed trading on 26 February 2020.

Restructure

The quoted company, Eddie Stobart Logistics plc now owns a 49% interest in the trading businesses which are held in a company called Greenwhitestar Acquisitions Limited, with a fund managed by DBAY Advisors owning the other 51%. The operational directors all resigned to move across to Greenwhitestar Acquisitions and new board is being appointed for Eddie Stobart Logistics Limited. Moving from the main list to AIM is being contemplated which would enable the company to raise funds to co-invest alongside DBAY in private equity deals across Europe, which may imply the company becomes an investment company.

The 26 February 2020 announcement included the interim results for the period that ended 10 months earlier in May 19 which reported an underlying EBIT loss of £11.6m from £421.3m of revenue and warned of an expected loss for the year to November 2019. Importantly the company said no significant contracts had been lost since the interim period end 10 months earlier and several new customers, such as Tilda, Metsa and Lallemand had been won with contract extensions from Tesco, Aldi and Mayborn. The company claimed that customer service remained excellent.

Subsequent Events

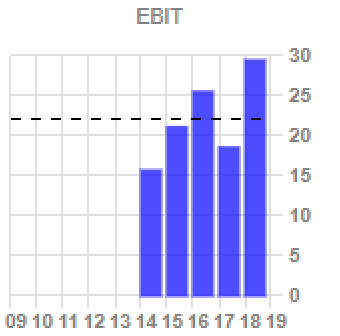
As the company is technically a cash shell owning 49% of the trading entity of Eddie Stobart trading updates are not to be expected but on 24 March the underlying trading entity reported that they were experiencing “exceptional volumes” that would only normally be expected around the festive period. On 3 April 2020 Adrian Collins was appointed as the new Chairman who previously had been Chairman of Liontrust, the highly successful fund manager for the previous 10 years, in a further sign of the progression towards becoming an investment company.

Estimates

Since the company returned from suspension Cenkos, the house broker, has not issued forecasts. It has indicated the possibility of raising money ahead of May, the deadline for posting results. Cenkos, reporting their results last week, referred to a “strong pipeline” of fund raising and it doesn’t take a rocket scientist to guess that Eddie Stobart could be one of those companies.

Eddie Stobart Logistics Plc is operating as a shell with the only income being the dividend from a 49% stake in the trading business and it is hard to know what the new dividend policy will be under the 51% ownership of funds managed by DBAY advisers.

DBAY advisers is an Isle of Man based fund manager which has been going for 15 years, is owned by the partners and claims to be a value investor managing money for institutions and family offices. As such they may be differentiated from traditional private equity where high cost debt is typically used to syphon the profits out of the company so it would seem likely a solid dividend stream may be possible, together with a growing value of the underlying business. However, DBAY have injected £55m into the trading company by way of 18% loan notes which will cost £10m p.a. Bearing in mind there is another c £200m debt outstanding within the trading company this could devour most of the EBIT of the trading company in a normal year. Historic EBIT has varied from £15m to close to £30m.



It would appear that this year could turn out to be exceptional on the back of the pandemic but most of the profits may still go to the debt holders.

Valuation

The current £30m market cap, values the equity of the trading business at c £60m. Given there are £55m of loan notes, £200m of historic debt and a further £20m facility negotiated by DBAY advisers the enterprise value of the company could be as much as £335m. This compares to £685m of enterprise value at IPO in 2017 so potentially the value of the stake could double.

Conclusion

Investors need to be careful. The benefits from Eddie Stobart Logistics strong trading will not flow to the holders of the quoted company quickly. On top of that there is likely to be an equity issue in coming months. I suspect when the equity issue is conducted this could prove a useful opportunity to benefit from the refinanced trading business of Eddie Stobart Logistics as well as those rather attractive 18% loan notes. But personally, I would hold fire until then.

FBD Holdings

Share Price €6.55

Mkt Cap €335

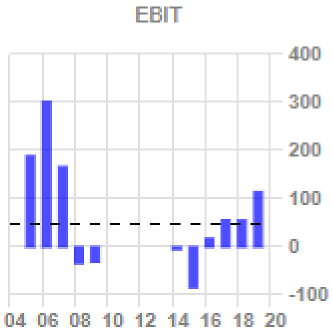
History

Originally formed as an Irish farmers co-operative and listed in 1988 the company, rather like the National Farmers Union in the UK, is an Irish agricultural insurer. It currently insures 70% of the farming community in Ireland and has many farmer shareholders. With its heritage it is conservatively run and today has a 35% shareholding by an agricultural investment company and a related charity trust, who appreciate dividend income. Alongside these shareholders are M&G, Invesco and Fidelity Management and Research.

In 2014 and 2015 the company ran into problems as increased solvency requirements loomed ("Solvency2) while the size of claim settlements was increasing. A new CEO, Fiona Muldoon, came in from the central bank of Ireland who sold off a joint venture, retrenched from broker distribution and closed the online distribution channel. Since then profits have recovered strongly and the company now maintains a 70% market share with the farming community distributing through its 34 branches while expanding into the SME sector, insuring small hairdressers, pubs etc.

Results

The 2014 and 2015 difficulties can clearly be seen on the Sharepad history



Last year to December 2019 the company reported €112m PBT which was described as "exceptional" having reported €50m in 2018. While premium income was flat on the prior year the operating margin increased from 13% to 30%. 10% increased margin was accounted for by reduced claims and 5% by a better investment return. The reduced claims weren't a feature of good weather, it was reserve releases from prior years where the company had been over conservative in providing for claims. It is this cyclicality of insurers that influences my investment view on insurers. The sector occasionally becomes despised and occasional becomes popular because when times are tough companies tend to over reserve. As these reserves are subsequently release the companies surprise positively and become popular until they start to under reserve a few years later when times are good, and the cycle reverts. Last year's reserve releases were delivered from all underwriting years back to 2015. It may be reasonable to assume that only now are underwriting reserves starting to be lightened with further releases possible from year going back to 2016.

Current Trading

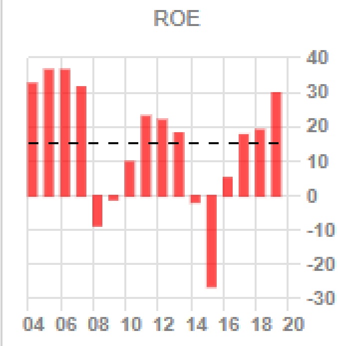
Insurance for both farmers and SME's continues through a pandemic but with pubs closed the claims incidence is hugely reduced. 50% of the current insurance book is in agricultural businesses and 50% in the Irish SME sector. 40% is motor insurance where during lockdown few miles are being travelled and potentially the company could experience an exceptionally positive year in terms of underwriting results. Though investment returns have declined this year which may mitigate the potential upside.

Estimates

The Balance Sheet is strong, (190% solvency ratio) and the company proposed a €1/share final dividend in February (15% yield at the current price). Since then regulators have put pressure on companies to withhold dividends so the company has deferred the AGM. I am assured the risk of business interruption claims from COVID 19 are not valid under their policies though there is some political pressure in this area. Prior to the onset of the pandemic the company was guiding for a normalisation of profits back towards the €50m Euros delivered in 2018 though it seems the pandemic has provided an embarrassment of riches.

Valuation

If we assume normalised 2018 earnings the company would trade on a PER of 5.4X but on last year's exceptional profit the PER is 2.3X. In ROE terms the company delivered 30% last year but in 2018 this was 18%.



A company that can normally deliver an 18% ROE would normally trade at 2X balance sheet equity value. In this case with an equity value of €1,068 per share, all of which are tangible assets, a share price of €6.55 is a 39% discount.

In terms of yield using the 2018 dividend a 6.1% yield was delivered but a potential 15% is available if the company proceeds with the proposed dividend for last year.

Interestingly since the onset of the pandemic the shares have fallen 25% while the pandemic has resulted in exceptional profitability.

Conclusion

This looks like a reliable business with modest growth that is woefully undervalued and misunderstood by markets. It has a strongly loyal customer base with limited growth, but the CEO has announced she will be stepping down and a replacement process is underway, which could be a catalyst for a new strategy. This could be one of those mispriced opportunities that come 2 or 3 times in an investing career.

Summary

Post bear markets small and overlooked companies significantly out-perform and this is a time when risk aversion may well prove to be the misguided herd view. There are returns to be gained from small cap risk. The outperformance of the last month is historically likely to continue for 1,3 and 5 years. Hunting for overlooked small caps Eddie Stobart Logistics may not be as exciting as the strong trading at the distribution business implies, while I am excited by the 25% decline in FBD Holdings share price in the face of embarrassing profitability resulting from the pandemic.

Forthcoming Events

Eddie Stobart Logistics: FY Results to November 2019 must be posted by the end of May. It would be unsurprising to see an equity issue before then.

FBD Holdings: have adjourned their AGM to confirm the dividend but it must be held within 15 months of the previous AGM which gives a deadline of 10 August. If approved there is a 15% yield on offer.