Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Investing in Intangibles

25 May 2020

Moore's law states that the processing power per pound or dollar spent doubles every 18 months. The practical application of this is that in 1919 the average American had to work 1,800 hours to earn enough to buy a fridge, but by 2014 it took less than 24 hours' labour and the product would be far superior. That is real wealth creation. As human beings unable to see the future with clarity we are inclined to allow fear to impact our investment decisions.

Our obsession with GDP as our measure of economic health is born out of an era when survival of the species was the priority. I asked my father in law on his 60th wedding anniversary what had surprised him most over the 60 years and his reply was the huge increase in wealth. In 1929 the GDP of the USA was c $60bn which increased by 2019 to $21,200 billion, a 336-fold increase. Despite two world wars and a few pandemics it seems that capitalism has triumphed.

The concept of GDP was first developed in 1934, during the great depression. Simon Kuznets, in authoring a US congress report at the time, warned against its use as a measure of welfare. GDP catches less of the things that with our new-found wealth we care about. It does not measure the degradation of the world's natural, human, physical, or social resources. Nor does it value the intangible growth in intellectual property value such as the value of research and development of assets such as Silicon Valley itself.

Today we stand at the start of a new revolution, where our digital economy fuels responsible transformations. GDP measures tangible outcomes but ignores intangible benefits such as brand values or the extensive R&D that does into developing software, design values and know how. As we use Facebook, You tube and Whatsapp for free GDP fails to capture this value. Driven by our changing world of wealth the OECD introduced the Better Life Index in 2011 which has 11 components: housing, income, wealth, jobs, community, education, environment, civic engagement, health, life satisfaction, safety and work-life balance. The current investment focus on ESG and impact investing, it seems to me, is a symptom of our great wealth and the move to a more intangible economy and is here to stay.

Against the backdrop of these changes markets adapt. Tangible assets depreciate but intangibles have a longer term pay back. Optimal capital allocation is devoting capital to returns driven by long term intellectual property, while machinery may be depreciated over four or five years and then be worthless while the value of a brand or other resource can yield returns over a much longer period. It could even appreciate over time. The strong performance of Lindsell Train, Fundsmith and Liontrust economic advantage funds over recent years is noteworthy. All focus on intangible strengths. The growth of franchise

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

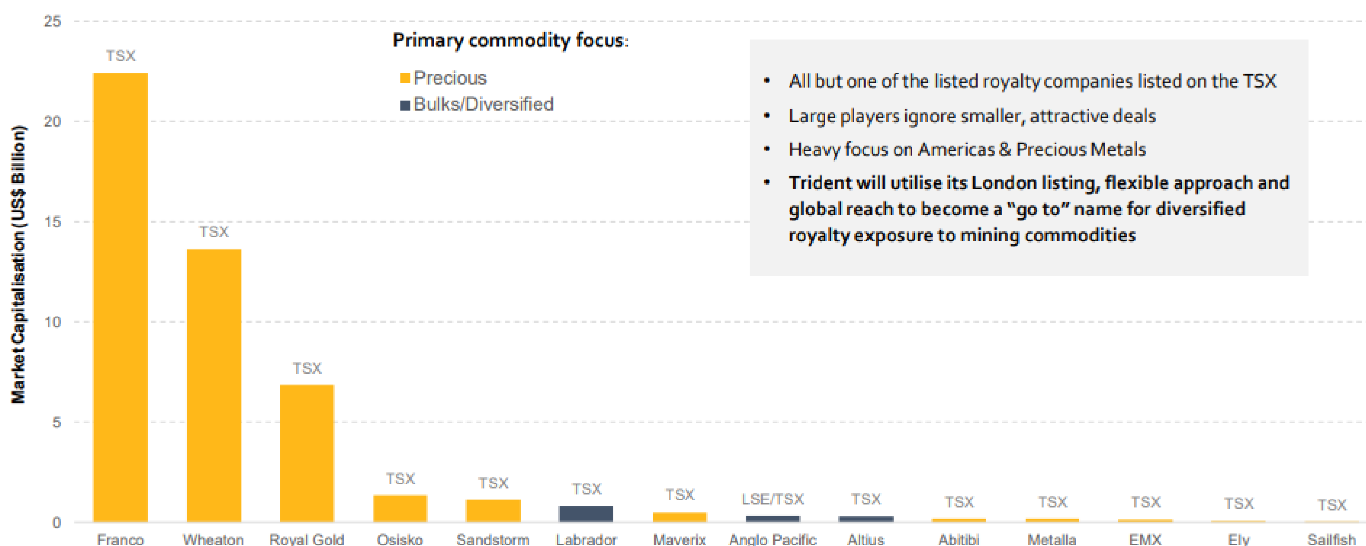
models over the last twenty years is a model which capitalises on a company's know how and brand value. And more recently royalty companies have come to the UK market as a way of monetising intellectual property. Duke Royalty came to market in March 2017 and Trident Resources is expected to list on AIM on 2 June, which will make one of two mining royalty companies listed on AIM, alongside Anglo Pacific.

Share Price 17.5p
Mkt Cap £3.8m

Business

Trident Resources is currently listed on the main market and was suspended in March with a market capitalisation of £3.8m. It is proposed to change the name to Trident Royalties and conduct an equity raise concurrent with the move to AIM scheduled for 2 June. For investors this could represent an effective way of getting exposure to commodity prices while avoiding direct exposure to the operating risks of mining. Diversification is intended as the company states it has a strong pipeline of royalty acquisitions although at the outset the only royalty is over an iron ore operation in Western Australia.

The experience of mining royalty companies listed in Toronto is encouraging where there are 14 listed mining royalty companies.



Source: Trident Resources

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

Valuation

To date the company has had an unfortunate start to life having listed on the main market at 20p/share in October 2018 backed by some mining focussed institutional investors and having failed to execute on its acquisition target has now changed strategy to the Royalty strategy when it is suspended at 17.5p. The valuation of £3.8m is a modest premium to the £3.3m cash it held at 31 October 2019.

Investment Case

This is an early stage opportunity but investors in the placing at 20p/share will be getting in at cash value. If the company can acquire effectively the shares could trade at a premium. Further as the royalty streams become more diversified over time the shares may be expected to experience a valuation uplift.

Returns

The only hard information we have to go on to estimate the returns is the one Royalty the company has acquired to date. The company has paid A$7m for a 1.5% royalty on shipments from the Koolyanobbing Iron Ore mine is Western Australia. The most recent quarterly payment was A$731,733 and production is set to grow. If we simply annualise the most recent payment we get a return of 40% p.a but the reserves are expected to last only 4-5 years. Using the formula for a 4-year annuity discounted cash flow calculation that equates to a compound return in excess of 25%. If we take the overheads off perhaps this will reduce to an expected return in the mid-teens.

Conclusion

Companies that return 15% generally trade at significant premiums to book value, though on the other hand I have frequently been surprised at the propensity on mining assets to surprise negatively. There is risk in the company deploying the proceeds of the current fund raise at similarly high rates of returns in a timely manner, but if they can do that this company has the potential to perhaps have 50% valuation upside. With debt available to leverage returns in time the company could provide higher returns and so trade at 1.5X to 2X net asset value suggesting ultimately potential for 100% upside. For those of a more risk averse mindset the more mature Anglo Pacific may be worth looking at.

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

Anglo Pacific Group Plc

Share Price 158p
Mkt Cap £287m

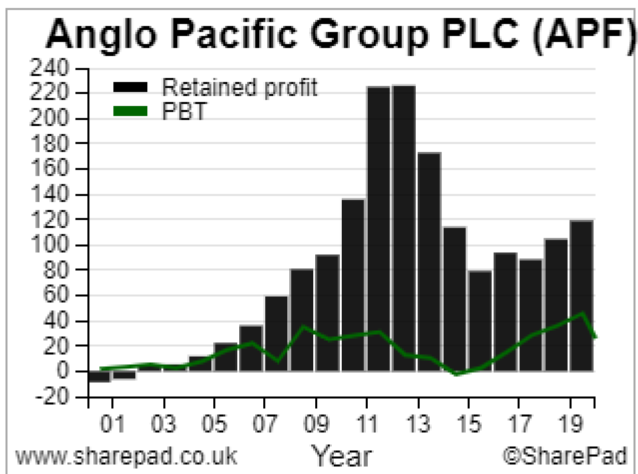
History

The company was founded as "Diversified Bank Shares Limited in 1967 and listed on the unlisted securities market in 1984, acquiring oil gas and mining assets since 1989.

Accounting

I am tempted to look at this stock more as an investment vehicle investing in high yielding assets. In that way we could derive a fair value by comparing the return on cash invested to the premium to asset value. However, accounting standards require companies to hold investments at fair value, making the return on cash outlay difficult to decipher by reference to the balance sheet. In the case of Anglo Pacific changes in the valuations are taken through the statement of changes in equity while the associated revenues are taken to the income statement. This gives concern that the company may be showing high profits while writing down the value of its investments through the reserves. However, a check of retained profit versus PBT using the below SharePad financial chart gives some comfort that the two are correlated. This makes sense because when royalty revenues decline, we may expect valuations to decline also. It therefore confirms that this is a play on commodity prices.

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.



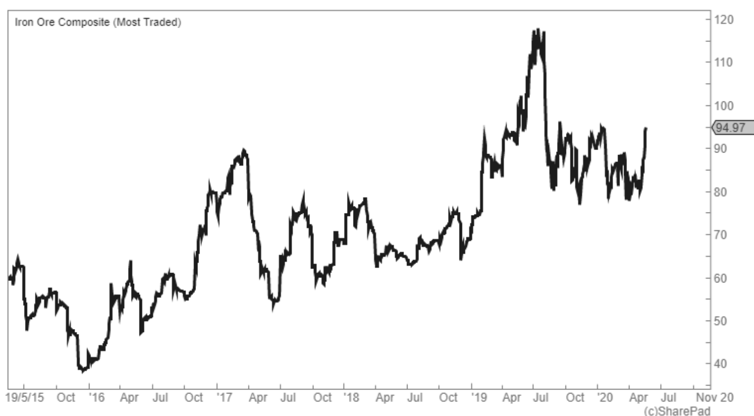
The ROE ,whilst cyclical, appears to generally around the 15% level which would fit with the 25% return achieved on Trident Resources investment, less costs, which brings it down, which suggests that the balance sheet values are close to market value.

Valuation

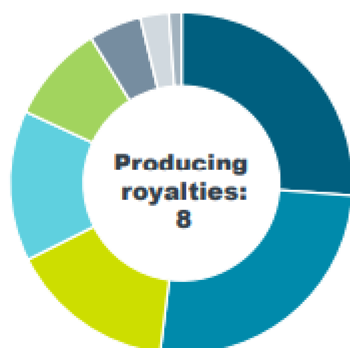
I sense this isn't a growth business in itself but rather more like a fund that invests in assets returning 15%. The price of equity in the stock market varies a little but I have found 10% is a reasonable rule of thumb. Small risky stocks may have a higher cost of equity and large reliable stocks may have a lower cost of equity but 10% is often a good starting point. If the cost of equity was 10%, we might expect this stock giving a 15% ROE to trade at 1.5X net asset value. With net assets of 124p/share that would derive a price of 187p, 22% ahead of the current price of 154p. This suggests the stock may be perhaps 20% cheap.

Other sensitivities

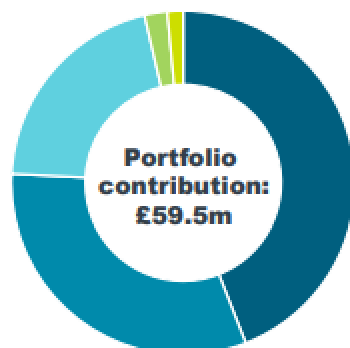
As a royalty lender these companies tend to be involved in more mature producing mines. Perhaps it is a function of the origins of these royalty businesses in Australia that they are weighted toward coal and iron, but the commodity exposure will affect investors views. Anglo Pacific is weighted towards iron ore and coking coal, which I have little experience of predicting. The sharepad chart of Iron Ore prices over the last 5 years appears encouraging, while coking coal has also increased in price over 5 years.



AS OF YEAR END 2019 (3)



COMMODITY EXPOSURE	
Coking coal (4)	26%
Iron ore	26%
Base metals	16%
Thermal coal (4)	14%
Uranium	9%
Vanadium	5%
Gold (4)	3%
Other	1%



GEOGRAPHIC EXPOSURE	
Australia	44%
Canada	32%
South America (5)	21%
Europe (5)	2%
Other	1%

Source: AnglePacific Group Plc

The company has net debt of £28.8m about which I am relaxed given the £225m of net assets across 15 different royalty assets and it is provided at rates of LIBOR +175 bps and LIBOR + 300bps which would appear to be very efficient and suggests the banks see this as low risk lending.

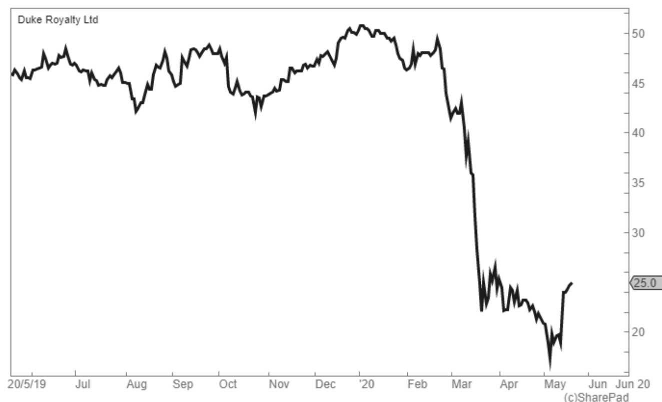
Conclusion

For those that have a view of commodity prices this appears to be a low risk way of playing the cycle with reduced operational risk. This could be useful portfolio diversifying stock.

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.

DUKE ROYALTY

Share Price 25p
Mkt Cap £60m



The share price fall in March of this year spikes my interest here. The concept of providing royalty-based funding to companies whereby a % of revenue is charged appears a more sustainable form of funding than typical private equity debt. It will also tend to bias towards companies with high intellectual property content which tends to be sustainable while not generally captured in financial metrics.

History

The company has invested in 12 businesses since IPO and has net debt of £13m provided by Honeycomb investment trust at LIBOR +7.25%. At IPO and in 3 subsequent fund raises it has issued £96.5m of equity at prices between 40p and 44p while today it trades at 25p implying some impairment risk. The recent 14 May update warns there may be write downs to come.

What is the share price implying?

The NAV at September was £72.8m which had been created from £102m share issuance and £30m of retained losses from the earlier legacy business before the company became a royalty business in 2017. This is largely represented by royalty assets of £71.1m, equity investments of £1.2m and loans of £11.1m less debt of £11.7m. The share price is now valuing this £72.8m NAV at £60m. Since then the company has raised a further £17.5m equity at 44p so perhaps the NAV is now close to £90m.

Results to March 2020 are said to be in line with expectations but COVID-19 has impacted their investments. The royalties and loans are invested in 12 investments which by piecing together RNS announcement look as follows:

1. Temarca - €12.3m yielding 13%. This is secured on 3 river cruise boats on the Rhine.
2. Lynx Equity - £13m yielding 13%. Highly geared acquisitive business investing in traditional industries.
3. Trimite Global Coatings - £11m yielding 13%. Industrial coatings business
4. Brownhill Investments - £7.5m yielding 14%. United Glass Group has used the facility for acquisitions.
5. Inter Health Canada Holding Corp - £10m yielding 13%. International healthcare consultant and facility operator.
6. Berkeley Recruitment - €1.3m. – Recruitment business
7. Welltel (Ireland) Limited - £8.1m yielding 13%. Telecom services
8. Xtremepush Limited - £2m – Technology services
9. Pearl & Dean -£2.75m yielding 18%. – Cinema advertising business
10. BHPC Limited - £4.6m – Insurance Broker
11. BIL - £9.4m – Recruitment business
12. Miriad - £10m yielding 13%. Funds provided for MBO of adventure/camping product business.

With the shares trading £30m below net asset value on the face of it the market is pricing in significant impairments. This looks realistic as river cruises are likely to have ceased and recruitment will be slow while cinemas are also closed. I am concerned that sometimes this company is providing funds for acquisitions and MBO's effectively providing private equity funding rather than funding long term lowly geared cash generative businesses.

Safety margin

On 14 May the company revealed it had received £600k in cash receipts in April, down from £1m in March. The company has a 30% loan to value covenant with Honeycomb Investment Trust and revealed it has £18m of headroom to invest further in its investee companies.
Currently we can estimate the net asset value is £90m with £13m net debt making a gross portfolio of £103m. It would take a 50% write down in assets to cause a covenant breach if no further funding is provided which looks relatively conservative.
However, the company says it is investing further to support its investee companies. If the company invested its stated £18m of headroom in its investee companies the debt would be £34m which would make the gross asset value perhaps £120m. A very modest write down on this would cause a covenant breach.

Conclusion

My concern is that this company while in principle having a sound purpose has provided private equity leverage at 13% returns rather than invested in long lasting cash generative brands. The 14 May statement that the company anticipates making further investments over coming months to support its portfolio is a

very dangerous and, in my view, flawed strategy. The company is upping the risks and effectively running the gauntlet.

Summary

As our world gets wealthier intangible assets play a larger part in the economy and markets adapt. Royalty companies are a relatively new innovation in London. I am tempted by the prospects offered by Trident Resources, soon to be renamed on 2 June as Trident Royalty while Anglo Pacific looks to be an efficient allocator of capital and provide useful returns potentially offering good diversification for portfolios to the commodity sector. While I hoped to spot a recovery situation in Duke Royalty I find myself concerned by the underlying leverage in some of their investee companies and their strategy of investing to keep their companies alive is dangerous.

Forthcoming Events

	Date	Event
Anglo Pacific Group	27-May-20	AGM
Trident Royalty	2 June-20	Relisting
Duke Royalty	Sept 20	FY Results

Source: SharePad estimates

This article is for educational purposes only. It is not a recommendation to buy or sell shares or other investments. Do your own research before buying or selling any investment or seek professional financial advice.