Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

The Recovery Trade

8 June 2020

The market is feeling like a well know Spanish festival, leaving those with cash on the side-lines feeling like vegetarians in Pamplona. Many of us expend our energies trying to pick stocks but the far more important factor is to be invested. Cash is frequently the largest holding in our portfolio but absorbs the least of our thinking time, which can cause anguish in a week when the FTSE small cap rose 5.8% despite rioting, lockdown and government bail outs as Brexit lurks over the horizon. And yet I find myself hugely bullish at a time when the disconnect between company news and markets is greater than I have ever experienced. The pain trade is to buy when markets have risen sharply but there are reasons this medicine could be the right one.

Weight of Money

It is easy to be gloomy about the high levels of government debt, but all that money must go somewhere. It is going to interest free loans for companies in trouble, it is paying furloughed staff and it is reducing borrowing costs for all. And that must create inflation. In an inflationary environment we don't want cash, we don't want low yielding bonds, we need assets. Gold, Wine, Equities, Classic cars, property will all do. But assets will re price, including equities. The correlation between the amount of issuance in the US and the valuation of the US market is striking.

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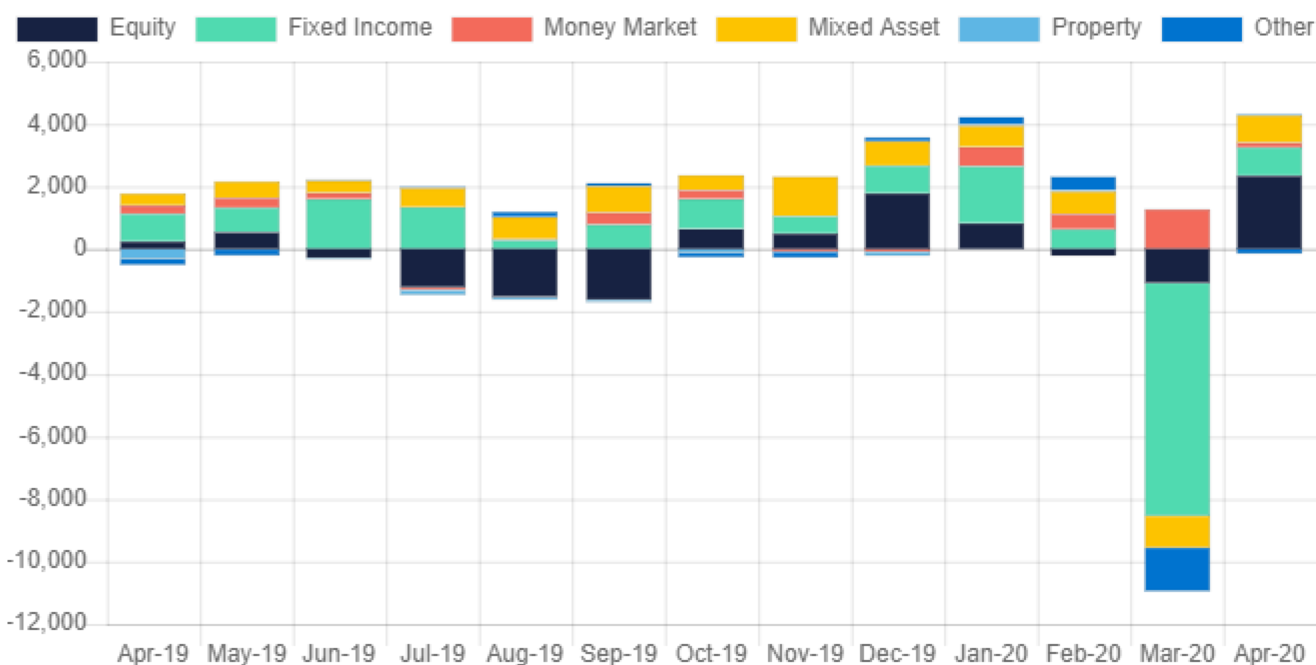
It is hard to see this ending anytime soon, particularly in a US election year. The US federal reserve has effectively nationalised stock markets. Europe is at it as well with the ECB announcing a further €600bn of bind buying last week.

Demand

While we have been on lockdown British bank accounts have according to the bank of England increased by £30bn. We have been unable to spend our usual budget on rail fares, pubs, restaurants etc and the money is piling up in bank accounts. Some of that may be moved into an ISA, which may be good for equity markets and wealth managers, and some will likely be spent. Visa announced last week that payments volumes fell 5% in May compared to 18% in April as lockdown started to be lifted. The popularity of the Ikea re-opening evidenced we are keen to spend money on homewares. In financial services bear markets are generally accompanied by fund outflows but anecdotally the companies are reporting healthy inflows. The chart below from the investment association shows very strong inflows to equities (dark blue) in April after modest outflows in March.



Source: Investment association

The US has now resorted to "helicopter money" to stimulate demand. The CARES Act was passed in April whereby every American couple earning less that the lowly sum of $150kp.a gets $2,400 of totally free money, plus another $500 per child. Free money in my view is the best kind of money, and that type of money often gets spent. There seems little doubt in my mind that when we look back in a year's time, we may feel that COVID 19 spawned a new boom.

Supply

COVID 19 has restricted supply chains. Factories have been shut down effecting the availability of laptops, cars, and other products while a number of firms are likely to fail. Anecdotally having spilt coffee over my laptop, I ended up buying a replacement two weeks ago at a 20% premium to the coffee-soaked version I had acquired six months previously. Aircraft seats seem unlikely to go on sale while my local pub is having a refurb during lockdown and I suspect the newly refurbished country pub will not have lower prices than when it closed as the local boozer. I find myself wondering what will happen to rental prices of holiday homes. It seems unlikely they will go on sale. The forces of inflation have never been stronger. Even the oil price is now increasing.

Estimates

Companies have taken the opportunity to withdraw earnings guidance, effectively obtaining a blame free downgrade. This opportunity to rebase forecasts should ensure many happy periods of reporting when management can pull a succession of white rabbits out of the hat as they beat expectations. Mattioli Woods was a good example last week reporting their pre close statement that due to cost savings they had beaten forecasts to May 20 by close to 20% but then cautioned about the future so forecasts were downgraded for 2021 by 11% and 6% the following year.

Conclusion

With free money driving demand and constraints on the supply side we can expect inflation to start to surface as the deflationary impact of the oil price decline works through over time. Initially inflation helps company profits and is good. Until it gets out of control. Today, with the world worrying about deflation, I sense the worries may be misplaced. Companies have no rebased forecasts and with the benefit of lower cost bases any increase in demand will have an immediate and sharp impact on profits. I think the market may well be right to be on such a tear. If this scenario does play out the market should be higher than where it was in February, when it is in fact down 17%.

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Consumer Cyclical

The violence of the snap back has been extreme in some cyclical stocks, particularly if they have financial gearing.

	Low (p)	Price today (p)	Change (%)
Air Partner	17	84	394%
Dart Group	300	980	227%
Marstons	22	70	218%
AO World	50	153	206%
Hammerson	44	123	180%
Intu	3.9	9.4	141%
Mothercare	3.9	9	131%
Revolution	15	27	80%

Source: SharePad

Mere unicorns in the US such as Amazon are up only 8% in the last month. Without a strong recovery many companies with weak balance sheets will fail. But in the vent of a strong economic rebound these companies will rip. As I have a view that the rebound will be strong, I am keen to find some good highly geared companies struggling for survival in the consumer space.

The following candidates that have only had modest rebounds in share prices over the last month. All are down over 3 months, albeit Vertu Motors only slightly. Walker Greenbank has a disappointingly low amount of debt while Applegreen looks like a strong contender with the enormous gearing. Though the question of whether we will spend as much time at petrol stations in future is debatable. Victoria Carpets has more debt than its market cap which makes it a strong contender to be a whipsaw recovery stock, while Headlam may be a more conservative way to play the carpets recovery.

Name	%chg 1m	%chg 3m	Debt to mkt cap.	CAPE	Return on Equity
Headlam Group PLC	2.77	-37.4	18.8	9.6	13.6
Victoria PLC	7.62	-39.2	146	16.1	14.8
Walker Greenbank PLC	-9.09	-40.3	6.8	4	12.7
Applegreen PLC	27.3	-19	302.7	17.4	12.7
Cambria Automobiles PLC	21.4	-22.1	59	8.2	16
Vertu Motors PLC	23.1	-1.61	59.7	6.1	7.1

Source: SharePad

I suspect residential carpets may be taking some extra wear during lockdown while in offices and shops we are going to see a lot of changes over coming years. I have heard of several companies in the city now introducing working from home as the norm which is likely to result in a need for smaller offices in the city. The great thing about the flooring market is any change is good since there is no second-hand market for flooring. Each change involves new flooring.

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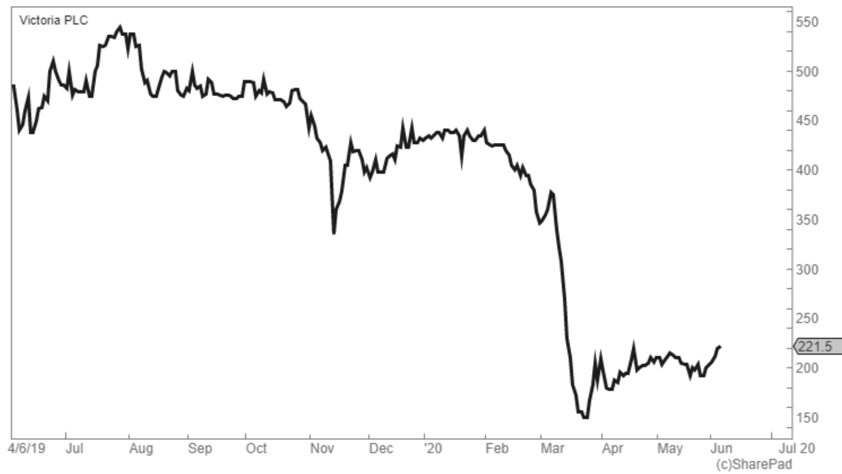
Victoria Plc

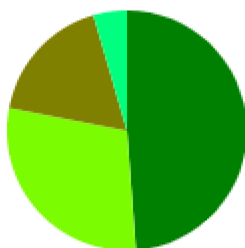
Share Price 221p
Mkt Cap £278m



Business

As a floorings manufacturer and distributor the company has a long history having been formed in 1895 and listed since 1963 the company has successfully grown by acquisition as well as organically. I am attracted by the wording of the trading update on 25 March which reassured that their modelling of scenarios meant there was no existential threat while reminding us that these are models rather than "divine revelations". The beauty of their business model is that 54% of their costs are wholly variable with revenue while a further 36% of the costs are capable of being cut within 60 days. That leaves a fixed cost base of only 10%, which in pounds is a little over £50m.
The company has built through acquisition and as well as carpet also supplies ceramic flooring and turf.

ACTIVITY BREAKDOWN — Last updated 31/3/19
By operating turnover

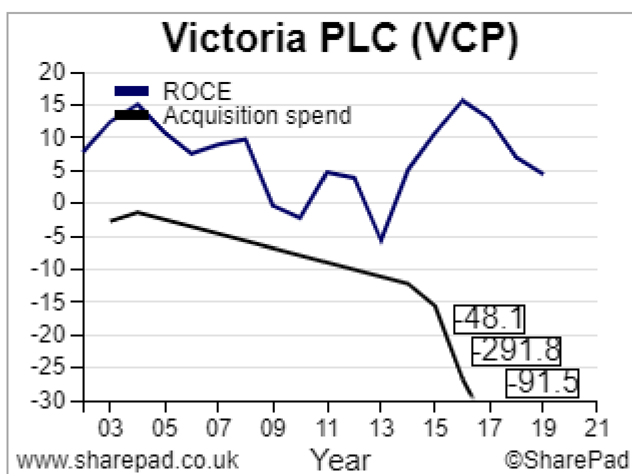


Region	Turnover £	%
UK & Europe	280.5m	48.8%
Spain	167.9m	29.2%
Australia	100.0m	17.4%
Italy	26.0m	4.5%

Source: SharePad

Financial

The company has been increasingly acquisitive over recent years, spending £292m in 2018 and the declining return on capital indicates the company has not yet earned the same return on its investment as it did historically, which is cause for concern. However, it appears that the company has experienced raw material price inflation which it has absorbed in order to gain some market share. I imagine that the current market shock will make them well placed to lift prices in a post COVID world where there may be fewer competitors.



In the 25 March update the company states that should revenue decline 50% for an extended period the company is able to withstand such a scenario. The company has not updated since 25 March which may be the reason the shares haven't yet recovered, so we don't know how far below budget current trading is.

Balance Sheet

Spending this money on acquisitions is responsible for the large amount of debt. Reassuringly the debt (at September) is in the form of €289m of senior secured bonds which have no covenants due in 2024 alongside a term loan of £143m. Since then a further €175m of 5.25% senior notes have been issued taking the bond issuance to c. €500m which was used to repay the term loans. Thus, assuming the company recovers by 2024 and is able to refinance the bonds before then the finance risk looks relatively small.

Valuation

The 10 year cyclically adjusted PE is 16 ("CAPE") and on the year to March 20 estimates, which are expected to be "broadly" in line the company trades at a PE of 6.4X. While there is no earnings guidance for the current year if the market gets to a point where it can anticipate similar earnings to previous years there look like the potential for these shares to double its valuation.

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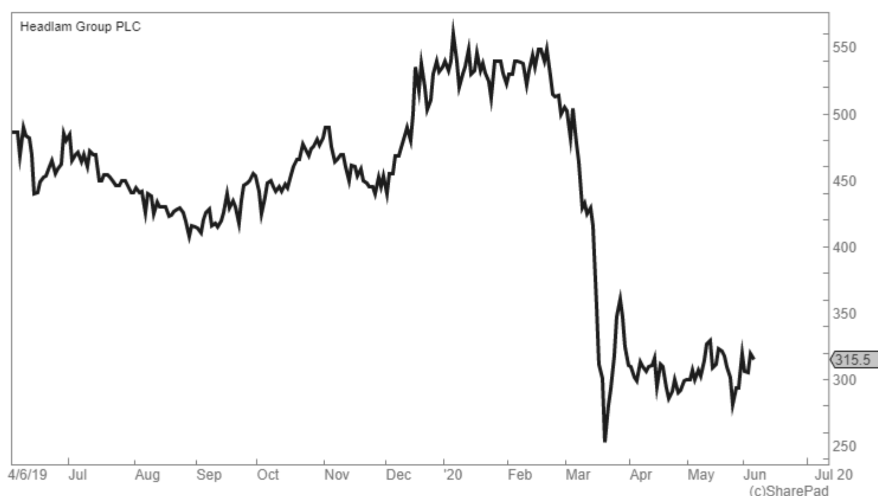
Conclusion

Results to March are usually announced in July by which time the company may well be able to shed some more light on re opening. This looks exciting to me. But those who prefer more conservative balance sheets may prefer Headlam. With all the gearing this company looks ideally placed to benefit significantly from a strong recovery. The shares are down 50% this year and have only recovered 11% in the last month.

Headlam

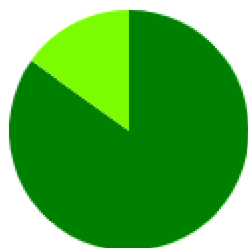
Share Price 315p
Mkt cap £268m



Headlam was established in 1992 by a series of acquisitions of flooring businesses. Today they have 66 business trading under their own unique brand. 62 of these are in the UK, 2 in the Netherlands, 1 in France and 1 in Switzerland.

ACTIVITY BREAKDOWN
By operating turnover

Last updated 31/12/19

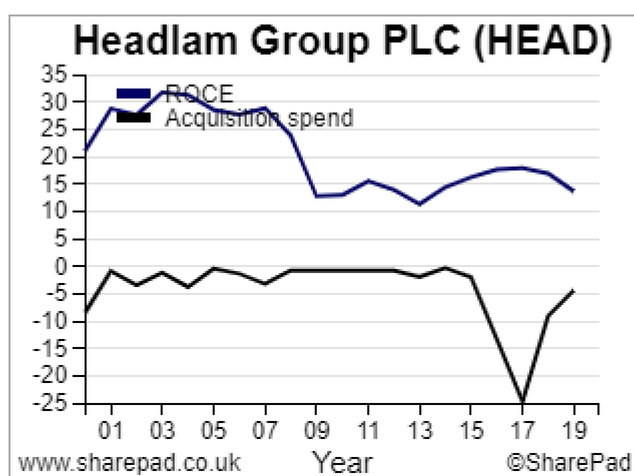


Region	Turnover £	%
United Kingdom	610.2m	84.8%
Continental Europe	109.0m	15.2%

COVID 19 Having closed all its UK sites on 24 March excepting its UK hub in Coleshill the company announced the re- opening of its principal distribution centres on 22 May. The trade counter network was also planned to open commencing the same week. During lockdown, the UK traded 89.6% below expected levels and Europe 33.2%.

Financial

The return on capital is healthy at around 15% though this has declined a little since the company made 3 acquisitions for £31.9m in 2017. However, the decline in the return is reported to be down to inflationary pressures on distribution costs coupled with weak residential flooring markets as the housing market slowed.



Balance Sheet

Debt facilities of £109.9m are available to the company from Barclays and HSBC who have recently revised the covenant tests so the company said on 22 May it was confident in its ability to manage within the facilities. There remained £70m headroom at that time.

Valuation

The company withdrew any guidance to the market, but forecasts are currently for a £16m loss in 2020 followed by a £24m profit in 2021. The current share price puts the shares on a 13.7X 2021 PE. This is ahead of the 10-year average CAPE of 9.5X. However, there is significant uncertainty over the forecasts and normal profitability is assumed only in 2022 when the profit is anticipated to reach £43m at which point the PE falls to 9.3X.

Conclusion

It is perhaps Headlam's reputation as a reliable dividend payer that is encouraging the market to give the company the benefit of the doubt. It is possible perhaps to see a 50% valuation uplift when profits have

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fully recovered, but the risks are also high. I am struggling to get excited by this. Unless we all have an IKEA style rush on carpets when I could very well be wrong.

Summary

There are reasons to be optimistic about the economy next year and it seems markets are taking the optimistic view. The noise from bears talking the market down can also be an encouraging sign. In this new bull market, the recovery trade can make significant gains for investors. While many airlines and pub companies have already doubled there could well be gains to be had from the carpet distributors who appear not to have yet participated significantly in the recovery optimism. Small operators may fail which could place them in a good position to raise prices post COVID. Victoria Plc looks exciting, particularly with the high leverage, while Headlam doesn't excite me but may appeal to those of a more risk averse disposition and a long-term view.

Company	Date	Event
Victoria Plc	10 July 20	FY Results
Headlam	28 August 20	H1 Results

Source: SharePad estimates