Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

High Conviction from here on

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Lessons from 20 years ago should have taught us that buying stocks that haven't made any revenue yet is generally a bad idea, but handing new money to companies that are bankrupt so they can hand it to creditors is a new one. Hertz' prospectus for its modest capital raise includes an unusual 'risk factor': "*We are in the process of Chapter 11 reorganisation cases under the Bankruptcy Code, which may cause our common stock to decrease in value, or may render our common stock worthless*". Giving money to creditors while in chapter 11 rather than the company is not a rational thing to do, but as the tempo of the party increases markets are rapidly finding ways to relieve investors of their free money. Easy money, it seems, means easy come, easy go.

The NASDAQ reached 10,000 on 10 June but rapidly fell back. The chartists are telling us that if it rebounds back above the crucial 10,000 level the bull market will resume but should the 10,000 level form a "double top" the bubble is likely to deflate quickly. On Friday the NASDAQ closed at 9,946, having reached 10,053 intraday as it makes a second attempt to breach the crucial level, making the next few days crucial for market confidence on double usual volumes.

Bubbles are usually formed around a change which is real. The internet bubble in 2000 was founded around a real change and I find myself contemplating that as Robin Hood comes to the UK with its commission free trading model it may bring the world of high speed trading to the retail investor, which traditionally has been the preserve of the hedge funds. Retail investors have been becoming a larger part of the UK market since c.2001. Change is slow but inevitable and I am sure there we will ultimately return to a world where retail investors cornerstone placings as they did 100 years ago. But it will take time, and today we have a bubble cause by the confluence of free money and real change.

I have no idea which way NASDAQ will go, but that doesn't matter. As investors, all we can deal with is the facts we know which is that animal spirits are determining market movements. Fundamentals, economic data, and monetary policy are only relevant for determining investor psychology and that is what is now driving share prices. With these animal spirits running wild, areas of the market are now looking suspiciously like a lunatic asylum, which, for most of us, may be unfamiliar territory.

It is time to tread carefully and I will be checking all my stocks for my levels of conviction because when the music ends I don't want to find myself losing faith when the FTSE has retraced to its March low of 4994. For the stocks I have less conviction in I will put the money into stocks that can perform, even when the enthusiasm of the animal spirits turns to a stampede of fear. Corporate bonds are generally safer than equities and in a downturn they can provide good insurance, as can special situations.

Rather than market levels, it is the psychology of market behaviour that is driving me to feel a more cautious approach may be appropriate. In fact I sense that the profit recovery may be sharper than most are assuming. The 17% recovery in consumer spending in the US last week was higher than forecasters expected and a lot of people have been saving money while on lockdown. Hence while I am feeling positive about profitability that matters less than psychology. So, for me, it will be high conviction equities with the insurance policy being special situations that can deliver returns, even in bear markets, from here on.

Insurance Policy Holdings

Corporate bonds and preference shares can be a good insurance policy which if markets fall can simply provide a strong return until they are redeemed. Examples of some of the companies I follow who have bonds or other instruments are:

No.	Name	Price	Gross redemption yield	Par value	Coupon date
1	AFH Financial Group PLC 4.00% Cov Unsec Loan SK 30/07/24	£4637.50			
2	Burford Capital PLC 6.50% GTD BDS 19/08/22	£96.90	8.08	£100.00	19/7/20
3	International Personal Finance PLC 7.75% NTS 14/12/23	£88.45	11.91	£100.00	14/12/20 e
4	Paragon Banking Group PLC 6.00% NTS 05/12/20	£100.00	5.99	£100.00	5/9/20
5	Provident Financial PLC 7.000% NTS 04/06/23	£102.375	6.11	£100.00	4/12/20 e

Gross redemption yields of 6% - 12% are available for short durations of 1-3 years. I am attracted by the almost 12% return available if International Personal Finance can repay the December 2023 bond. Home collected credit has traditionally been less cyclical than other forms of credit and while many of these companies have experienced difficulties in the past, it has generally been caused by funding difficulties, or company specific actions, not external economic difficulties. As a CEO once told me, their customers are always in recession.

International Personal Finance

Share Price 61p
Mkt Cap £137m

Distress We need to be certain IPF won't become insolvent within 18 months to get a 12% return. Certainly, the equity is trading at a 63% discount to tangible book value which indicates some financial distress. As a home collected credit operator in Eastern Europe and Mexico the company has been unable to make collection during lockdown which restricts its ability to generate cash to repay the bonds. The risk here is that the delayed payments turn into impairments when the company resumes collections.

Updates On June 10 the company updates that it had £223m of undrawn credit facilities available and is hoping to refinance its €406m Eurobond due in April 2021. It also said that collections were running at 80% of pre COVID 19 levels. The receivables were £987m at the end of 2019 and the fact that the loan book is short duration (c.8 months) should aid the company in collecting out its book.

Conclusion It is possible that the delayed collections may result in impairments, but bond holders have a superior claim above equity holders and the £370m equity provides a substantial buffer for bondholders in terms of impairments on a £987m loan book. In return they will earn a 12% return while the return for equity holders would substantially higher when the shares trade at a 68% discount to book value.

Conviction Holdings

My highest conviction stock at the moment is Tatton Asset Management which seems strange given its revenues are largely market sensitive so if markets decline it will directly impact the company, but there are specific reasons I sense they will progress despite markets. Primarily because it has 3 drivers of growth while most growth stocks have only 1. Today one or two of those drivers are in their favour and the day that all three of their revenue drivers are providing a tailwind could be very powerful.

Tatton Asset Management

Share Price 287p
Mkt Cap £161m

The shares are at an all-time high, but rear-view mirrors aren't a useful guide to what is in front. Rather it reminds that a check of the valuation is necessary.

Business & History

The founder and CEO, Paul Hogarth is a well-known figure in the financial planning industry, and he still holds a 19% stake in the business. He originally founded Bankhall in 1987 which he sold to Skandia in 2001 at which point it serviced around 25% of the UK IFAs. He founded Paradigm Partners in 2007 to provide compliance services and mortgage products to the IFA sector. It wasn't until Lothar Mentel joined in 2012 when the Tatton Investment Management business was set up to provide portfolios to IFA's who were facing increased regulatory pressure to outsource their investing activities.

Model

While Paradigm Partners remains part of Tatton, the fact that Paradigm is reliant on stable annual fees means it is harder to grow than the investment management business. Investment managers can make high operating margins and are highly scalable but reaching scale is hard. In the case of Tatton there are 3 levels of growth drivers while most comparators in the quoted market would perhaps only have one or two of the three growth drivers.

1. Markets over time increase and as fees are charged as a % of AUM, fees also go up with markets
2. IFA's tend to harvest more client assets each year, so each IFA will be adding AUM to Tatton each year.
3. The company services a small proportion (c.11%) of the number of IFA firms in the UK and so can add more firms each year.

Estimates

The company reported a healthy operating margin of 42.5% at its results last week while also having net cash of £12.8m. Going forward estimates anticipate 24% growth in EBITDA for the year to March 2021. Given that markets went down in March a confident statement indicates the company is still confident in forecasts despite a lower market. Revenue is only expected to grow 7.5% this year which translates to 24% EBITDA growth, underlining the scalability of the model; as assets under management grows few extra costs are incurred.

FORECASTS — £ millions unless stated

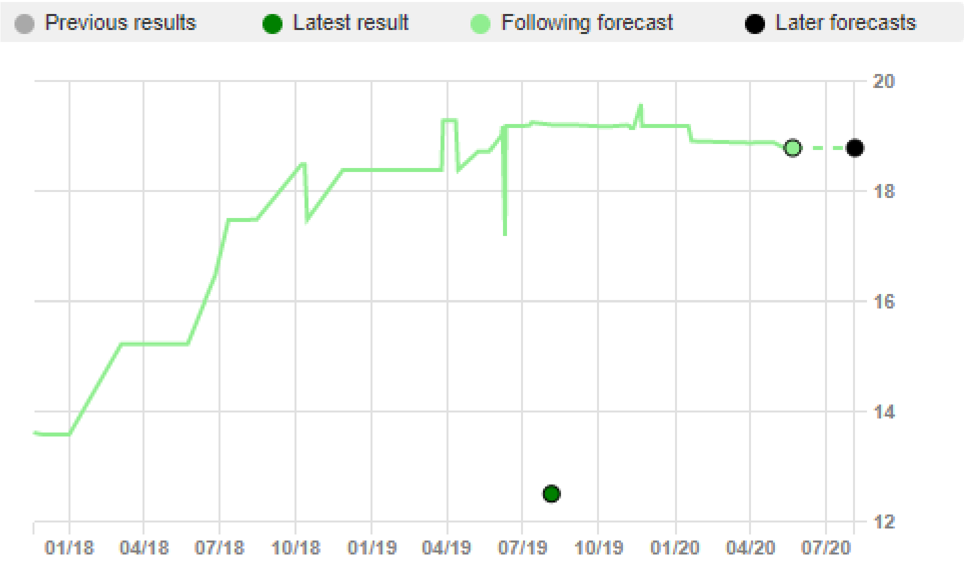
Year	2021		2022		2023	
Turnover	23.0	+7.5%	26.4	+15.1%	26.6	+0.6%
EBITDA	11.5	+24.3%	15.3	+33.4%	-	
EBIT	10.8	+23.6%	12.8	+18.8%	11.9	-7.2%
Pre-tax profit	11.0	+26.2%	14.8	+35.1%	-	
Post-tax profit	7.5	+2.2%	7.9	+5.5%	8.7	+10.1%
EPS (p)	14.0	+16.7%	17.1	+22.1%	-	

To test the drivers of this revenue growth we need to look at the three growth factors.

1. Markets on 1 April 2020. The FTSE stood at 5472 which is the beginning of Tatton's year. This is some 25% below the 7289 the FTSE stood at a year earlier so it would appear that as Tatton investment management charges 0.15% of AUM that the revenue line for investment management faces a 25% headwind. Of course markets have recovered somewhat since then and they may end the year higher or lower but at the start of the year markets look like they will be a revenue headwind.
2. IFA assets. In terms of AUM per IFA firm the average AUM per average number of advisers decreased in the year from £15.m to £12.7m. This may be a function of the high sign up rate of new advisers as it takes time to onboard clients of new firms signing up to Tatton's services
3. IFA numbers The number of firms using Tatton Investment Management grew 33% last year to 595 which compares to 30% growth in the previous year and 44% the year before that.

   We can rationalise from the above that with a 25% headwind from 1 above, a 30% tailwind from new IFA's and a slightly higher market than at 1 April the 7% revenue growth forecast looks comfortable. But if there was no market headwind this company could reach very much higher growth levels and it is that ability which makes this potentially a company with an excitable valuation.

What the market missed At the results call none of the analysts asked about the exceptional income of £1.7m last year which was received from the HMRC declaring Tatton Investment Management services were exempt from VAT. That meant that they had been taking 0.125% to revenue and giving the rest to HMRC. When this was refunded it was treated as exceptional income, which is fine except that going forwards the company will be taking all 0.15% to revenue, giving the company an automatic 20% uplift in revenue. No analysts changed their forecasts to reflect that this week as the SharePad forecast barometer shows:



Shows the following full year forecast as it has changed on a daily basis.

Competitive advantage The reason that Tatton is able to sign up so many of the 14,000 IFA firms is that it is the lowest cost in the market at 0.15%. The next nearest is AJ Bell at 0.18% while peers such as Brewin Dolphin charge double the price at 0.3%. This is very important as an adviser is able to charge for their advice if they are getting lower cost products for their client. While price is not the most enticing competitive advantage in a market I suspect in this market it isn't just a "race to the bottom" on fees as the assets tend to be very long term and no one wants to break their existing model. The fact that Tatton is a "pure play" offer for financial advisers is what gives it its ability to disrupt the market.

Valuation Tatton Asset Management trades on a PE of 20.5X March 2021 forecasts which is not cheap. It pays out 70% of its earnings typically so provides a dividend yield of 3.6%. But as the company also has the IFA consulting business a sum of the parts valuation may be more appropriate. The divisional spilt of profits is:

	Operating Profit
Tatton IM	£8.9m
Paradigm	£2.1m
Central	£-1.97m

For Tatton IM I would value the business at a similar multiple to the high growth fund managers which are currently Impax and Liontrust who trade at a market cap of 25X and 20X 2020 PBT. If we conservatively use 20X that means the investment management business is worth £178m, above the current £161m market cap.

Paradigm grew at a more modest 17% last year and now accounts for 25% of the revenue and 20% of the profits. As a consulting business it is worth less. Alpha Financial Markets Consulting trades at a market cap/PBT of 9.5X and this multiple would value Paradigm at £20m, though most of that would be negated by the central costs.

It looks that in fundamental terms the shares may be only 10-15% cheap to me.

Conclusion While the company is only 10%-15% cheap it seems to me that the company has a structural driver that will ensure sustained profit growth for an extended period of time. Over the long term share prices follow profits which are set to keep growing at 30% for a number of years, so I am happy to keep this in my high conviction basket despite market risks.

Summary

In a surprisingly swift transition from bear market to bubble market the increasing number of signs that we are in a global bubble starts to make my cautiousness hairs twitch. I have therefore reviewed my portfolio to ensure I have long term conviction in my holdings. When the bear market next arrives I don't want to be throwing the towel in then. This process has confirmed to me that I am happy with Tatton Asset Management as a large holding and I shall start to consider some corporate bonds and other lower risk special situations. When the world wakes up to the reality that printing money devalues it I certainly won't want to be holding cash when that particularly angry bear is roaming markets.

Future Events

Companies such as Provident and IPF can be expected to provide regular updates as restrictions ease but the next scheduled updates are below:

Company	Date	Event
Burford	24-Jul-20	H1 Results
Provident	28-Aug-20	H1 Results
IPF	04-Sep-20	H1 Results
Tatton AM	27-Nov-20	H1 Results
Paragon	03-Dec-20	FY Results
AFH	20-Jan-21	FY Results

Source: SharePad