Jeremy Grime's Weekly Commentary

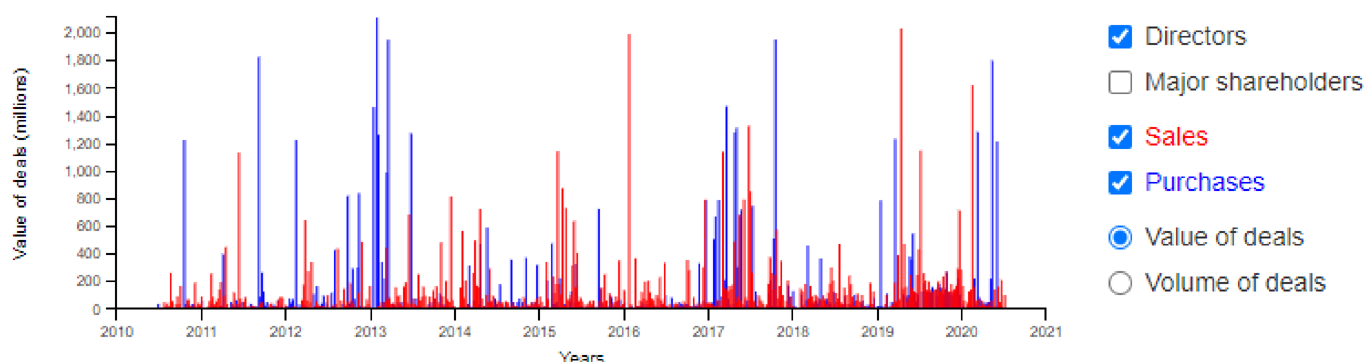
Exclusively for SharePad & ShareScope subscribers

Director Dealing

29 June 2020

By some measures we have had the fastest stock market rally in history after a 35% decline in March. This provides opportunities both to make, and lose, fortunes. But the speed of the change has meant that largely the opportunities have been available for the fleet of foot trader rather than the long-term investor. For the long-term investor, the challenge has been to sit tight as previously deemed quality stocks whipsaw frequently by as much as 50%. Directors are long term investors for the three reasons that they are restricted in their ability to trade their stock during closed periods, they have compulsory disclosure, and they will generally have a large proportion of their wealth invested in the company. Markets have been going sideways over recent weeks, with the FTSE 100 now roughly where it was at the end of May and with markets consolidating it may be useful to review what directors have been up to during the pandemonium, and perhaps spot the odd company whose share price hasn't recovered yet.

The Sharepad chart of all directors dealings across all UK shares in the last 10 years, show there was quite a lot of blue buying in March and April this year which has since quietened down.



Source: SharePad [You can find this chart feature in Directors Dealings > All UK. You can also view this chart for an individual UK & US share by selecting 'Dealings chart' from the chart drop down. NOTE: Not available for 'Current list' or 'All EU'. 'All US' is currently under re-development]

I find it useful to remind myself that there are many reasons for a director selling a stock, but only one reason for buying a stock and therefore the buy indicator can often be the more reliable indicator. Examples on the sell side are Mark Coombs, the CEO and founder of Ashmore who recently raised £44m by selling shares. Andy Bell sold £1.9m of shares on 21 May which is unlikely to be for the sole reason that the shares are over-valued. But no director will buy stock because he has excess savings, or for inheritance tax reasons. They have plenty of exposure to the company they already are employed by. The only reason to buy will be that they believe the shares to be mispriced.

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Recent Director Purchases

Reviewing a selection of recent purchases reveals a77% win rate. 14 out of 18 of the director buys are in the money, with Intermediate Capital being up 163% and Playtech up as much as 123%.

Date	Company	Value £000	Price (p)	Price now (p)	Change (%)
21-May	Dart	230	576	848	47%
13-May	Photo Me	86	41	56	37%
05-May	Sigma Capital	655	86	89	3%
01-May	Mind & Machines	517	6	5.85	-3%
23-Apr	Xaar	49	39	55	41%
21-Apr	Arbuthnot	50	1010	832	-18%
01-Apr	K3 Bus. Tech.	203	75	73	-3%
01-Apr	Photo Me	400	55	56	2%
30-Mar	Photo Me	227	35	56	60%
27-Mar	DWF	988	84	57	-32%
26-Mar	Microfocus	871	368	429	17%
26-Mar	Bellway	150	2026	2564	27%
25-Mar	Greggs	178	1625	1646	1%
20-Mar	Plus500	1,392	797	1291	62%
19-Mar	AB Dynamics	105	950	1630	72%
19-Mar	Intermediate Capital	252	503	1324	163%
19-Mar	Playtech	179	134	299	123%
18-Mar	Argentex	41	112	140	25%
18-Mar	Intermediate Capital	365	849	1324	56%

Source: RNS

The four that are not yet in the money, Mind & Machines, Arbuthnot, K3 Business Technology, and DWF may possibly be left behind so merit further investigation:

Deal Timing

- **DWF (down 32%)** On 27 March, shortly after releasing a COVID 19 update Vin Murria bought £988k of shares at a price of 84p. The shares had fallen from a pre COVID level of 140p. The 27 March statement concluded that the group is well placed and had a counter cyclical business model. On the 24 April, the company announced that it had obtained an extra £122m revolving credit facility and the covenants had been relaxed for the next four testing dates. Subsequently on 29 May a further deterioration in trading was announced together with the resignation of the CEO.

  View It seems in this case the facts have materially changed since the director purchase and serves as a reminder that not all director buying is inspired.

- **Arbuthnot (down 18%)** On 21 April Nigel Boardman, a NED, acquired £35k shares at prices up to 1010p. The shares had fallen from a pre COVID high of 1350p. Subsequently, on 14 May, the company released a trading update saying that payment holidays had been granted to 25% of their

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mortgage customers and 67% of the asset finance customers but that the group would have more surplus capital than originally planned at the end of 2020.

View While the surplus capital puts the company in a strong position payment holidays introduce uncertainty, and the market hates uncertainty. It seems to me that lenders are one of the most extreme groups where some will fail and strong ones will emerge stronger. While the market is worrying may be a good time to look at the stronger companies.

- **K3 Business Technology (down 3%).** Having announced a delay to results, cancelling the dividend and discussions with shareholders and banks to strengthen the balance sheet on 24 March it then announced a further £6m of loans secured from its 2 major shareholders and Barclays Bank. Oliver Scott acquired 600k shares at prices up to 75p on that day and 3 April. The shares have moved little since then and results have now been confirmed for 16 July.

  View This could be well worth previewing ahead of 16 July results.

- **Mind & Machines (down 3%)** The shares are down 36% from pre COVID highs and results were announced on 24 March. Dividend decisions were deferred in the light of uncertainty, but the company underlined its recurring revenues. Notably however, the company determined to continue with its pre-authorised share buy backs and a non-executive director, Henry Turcan acquired £517k of shares at 6p/share, where the shares continue to trade.

  View The £517k investment by the director is material and with no news flow since this could be an overlooked situation.

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ARBUTHNOT LATHAM
Private Bankers
Since 1833

Share Price 832p

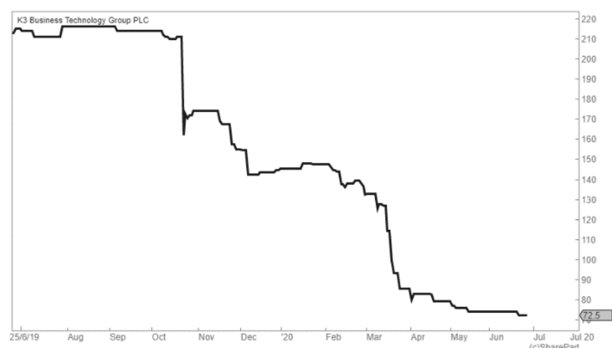
Mkt Cap £125m

Business This is a traditionally managed private bank 56% owned by Sir Henry Angest, from which Secure Trust was demerged in 2016. As such the loan book is unlikely to be risky in my mind, but with forbearance being granted on loans the market is clearly worrying about payment holidays turning into impairments. We do know that surplus capital is likely to be higher than expected so the capital base can be removed from the worry list. The company's strategy is to grow into its loan book, so it is more appropriate to its strong capital base and consequently improve the ROE from its current low of 6.6%. This will clearly take longer then hoped due to COVID 19.

Loan Book The company at December 2019 had £208m of equity supporting a loan book of £1.6bn. Within the loan book 65% is accounted for by mortgages, 17% by commercial loans and 10% by asset finance. 67% of the asset finance customers have requested forbearance and 25% of the mortgage customers. All the loans are secured and the normal loan to value requirement is 60% while in exceptional circumstances 70% loan to value will be allowed, though the company has reported loan to values of low 50%'s in recent years. This compares to typical high street bank lenders that provide mortgages at 75% loan to value frequently going up to 90% loan to value. This therefore looks like a lower risk book than most banks. While it is impossible to predict whether the forbearance will become impairments the market may well be misunderstanding the risk in the loan book, with all loans well secured on assets.

Valuation Net asset value is £208m, but £20m is intangible so net tangible asset value is £188m while the market cap is £125m, a 40% discount. Some may argue this is appropriate given the poor 6.6% return on the equity. But for those investors able to wait for a couple of years until the excess capital is utilised on a larger portfolio when the prospect of 10%-15% ROE is in view, the company could trade at perhaps 1.5X net asset value, providing the potential for 100% or more upside.

Share Price 72p
Mkt Cap £31m



Business The company supplies enterprise solutions, CRM software and e-commerce solutions for retail, manufacturing, and distribution customers. As such it is not easy to determine what the customer base will look like as we come out of COVID.

Sensitivity In the half year to May 2019 47% of the revenue was classified as recurring, 11% from licenses and 40% from services. It is inevitable there may be some disruption to the services business as retailers and their suppliers work out new strategies. The company reported losses of £1m but an adjusted profit of £800k in the first half to November 2019. The profit adjustments are typical of acquisitive software companies – amortisation of intangibles and reorganisation costs, which implies we should not place much weight on the ROE as it is manipulated by write offs of intangibles.

Balance Sheet A look at the balance sheet confirms the acquisitive nature of the company with £66m of equity largely provided by the issuance of shares rather than retained profit and £51m of goodwill accompanied by £17m of other intangible assets. It seems that to finance acquisitions, alongside equity the company has used bank debt, which is a dangerous thing when loss making. Total bank loans were £10.7m at May 19, which are secured. A check of note 16 in the report and accounts tells me that the company does not disclose the bank covenants. On 24 March 2020 the company agreed to extend it loan facilities by £6m by way of £3m unsecured loans from shareholders at 8% with warrants attached while Barclays has extended a further £3m facility on similar terms to its original loan, which is evidence that the company had become financially distressed.

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Valuation The company has negative net tangible equity so there is little security for shareholders other than the future profit stream, which is unclear. I have never been a fan of the plethora of acquisitive software companies that dress up companies in the hope of high technology valuations, and with no visibility on earnings, I can't see any justification for being brave with this one ahead of 16 July results. In fact, I may dust off the tin hat in case it is needed on the day.

(Mind & Machines)

Share Price 5.75p
Mkt Cap £52m

Business Mind and Machines operates as a registry for 32 top level domains such as: .work, .yoga or .fit. 62% of revenues are generated from renewals and so naturally recur, while the company aims to create relevant services that enhance the value of their assets. 91% of revenues are generated from online channels.

Sensitivities Results on 24 March noted that with their experience when China was undergoing lockdown showed no impact on its revenues. The company said there could be an impact on their brokered sales which account for less than 10% of turnover. The company did delay its dividend decision, but announced it would continue with share buy backs, which shows some confidence.

Balance Sheet The company reports in dollars and had $6.6m at December 2019. Net assets were $78.4m which includes $84m of goodwill and intangibles implying negative net tangible assets. This looks like a company with a strong balance sheet but has acquired domains at full prices, resulting in negative net tangible assets.

Valuation On the day of results (24 March) the house broker removed forecasts on the back of COVID uncertainty though such a business as this ought to be resilient and even potentially benefit from the shift to online working. It is therefore difficult to estimate the PE going forwards, but from profits of $6.9m last

year a PE of 11-12 would appear to be cheap. There are, however, a number of adjustments stripped out of the operating profit. One was a bad debt charge of $1.4m as credit had been extended over the usual 30 days to customers in China, Europe, and the US. There is also a release of a provision against an un-economic contract which the company had historically guaranteed minimum revenues to a partner. This reminds us that these contracts are highly competitive so perhaps the moat is not very deep. While credit risk is high so perhaps the company should not be highly valued, but it certainly appears that the 30% share price fall on the back of COVID 19 is unwarranted in the company and a directors' view.

Summary

With extreme market volatility agile investors have made money. It seems directors have also been surprisingly canny too with a surge in director buying of which 77% of my sample seem to be in the money already. A scan of recent director deals highlights 4 situations where the share price remains below the level where directors committed significant personal money. Of these Arbuthnot and Minds & Machines may well be situations where opportunity still exists.

Future Events

Company	Date	Event
K3 Business Technology	16 July 2020	FY Results to Nov 19
Arbuthnot	16 July 2020	H1 Results to June 20
DWF	31 July 2020	FY Results to April 20
Mind & Machines	24 Sept 2020	H1 Results to June 20

Source: SharePad

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