# Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

## Inflation

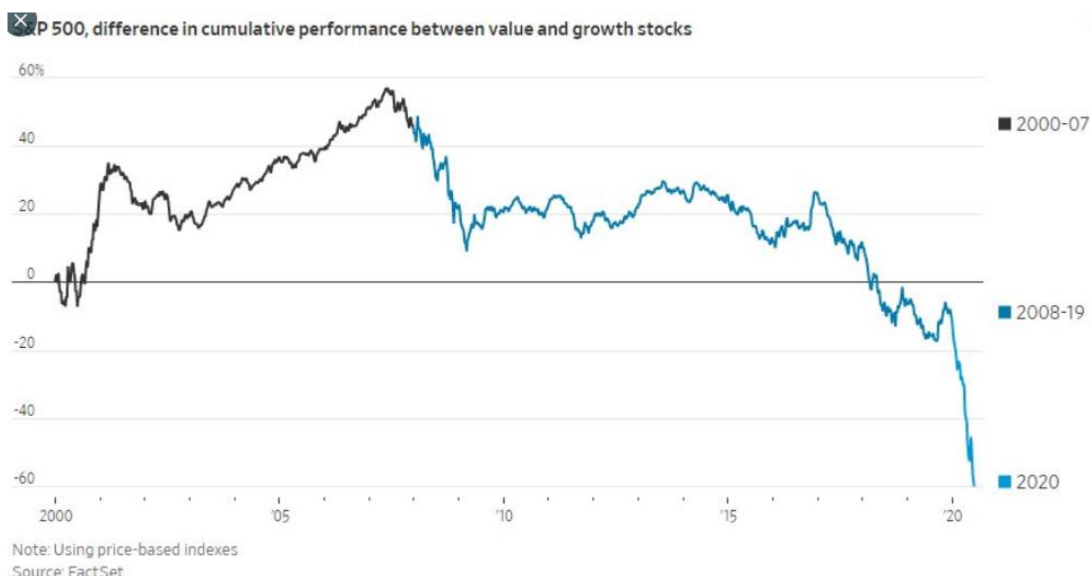
**6 July 2020**

Markets constantly remind us we get it wrong. I was wrong a few weeks ago when I became excited about the outperformance of value stocks. The week when value stocks outperformed was a brief uptick in the long-term outperformance of growth and perhaps it was wishful thinking or a personal bias that made me anticipate the return to value too early.

Mistakes are an opportunity to learn, rather than failure. I recall broking a stock to Woodford Investment Management and coming out of an hour-long meeting thinking I had only gained the benefit of the Woodford view rather than the constructive exchange of information I was expecting. When we stop listening and learning we make mistakes. Most fund managers are humble, which is what made broking an enjoyable past-time, forming relationships with well informed and humble people.

The high price of mistakes makes investing emotionally difficult and consequently requires self-knowledge. Accepting our personal weaknesses is not usually enjoyable, but it is important if we are not going to fall victim to the prowling emotional predators of Mr Fear and Mr Greed. Mr Fear will scream at us to sell a stock and jump to the green and pleasant land marked "safety" just at the time it is the wrong thing to do, while Mr Greed will fill our dreams with visions of endless prosperity as the storm clouds are gathering behind the sunny uplands of the mountainside.

The mistake of being a value investor is an expensive one and sometimes we need to change our view in the light of new facts. This chart shows the effect over the last 20 years of getting the call wrong. Value did in fact outperform until 2007 when the quantitative easing printing presses lumbered into action. The wall of cheap money is feeding the growth bubble.

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## Growth

It seems the technology heavy NASDAQ has now broken decisively above the 10,000 level to close at a new all time high on 10,154 which chartists will tell us is a crucial level. At the same time Lemonade, the US IPO with a "playful onboarding bot", $108m of losses, and $67m revenue, exceeded the high end of its expected price range, valuing it at $1.6bn.  It rose 140% on day 1 of trading last Thursday. For now the growth party is in full swing but as always there will be storm clouds gathering, and as investors it is our duty to keep a weather eye on when to grab our coat and head for the door, despite our obviously very impressive moves on the dance floor. 83% of the June return from the S&P 500 index in June came from the IT sector, with Apple up 14.7%, Amazon up 13% and Microsoft up 11.1%.  Such concentration of returns is never healthy, but frankly, these businesses have strong positions, good business models and all looks set fair. The only issue is valuation.

## What could possibly go wrong?

Russell Napier, author of "Anatomy of the Bear" and former global equity strategist at CLSA Asia Pacific Markets recently published an article titled "The dawn of the age of inflation" where he argued that he expects inflation to exceed 4% in the developed world next year. He argues that since the 1990's we have been in an era when China has depressed returns for asset heavy companies and so US equities have increasingly become dominated by asset light companies. He cited ostracising China from global trade as a key catalyst to reverse the deflationary forces of the last 30 years. Which is a neat way for the US to inflate away its debt problem, while replacing China supply with domestic supply at higher prices.

Domestically we can see other factors that may help create inflation. The supply restrictions created by the COVID cost cuts could potentially create bottle necks in supply while the demand side could well be fuelled by cash rich consumers. The oil price has served to depress underlying inflation this year and it has the potential to stimulate demand and when last year's comparator oil price included in the inflation starts is a low one we may be surprised how quickly inflation starts to tick up.

Inflation may be OK for the economy, but it isn't for stock markets. The problem is that lifting interest rates to match inflation can decimate valuations.  We can see plenty of precedents of what happens when an era of cheap money ends. The newspaper article below is from 1896, when journalism was far richer. I don't think today we would read about the nerves of the City being "rudely upset".



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THE PANIC IN THE CITY.

THE nerves of the City were rudely upset last week by the Directors of the Bank of England, who exploded a veritable bomb-shell by suddenly raising the official minimum rate of discount. The advance in the rate was small enough, from 2 to 2½ per cent., and in former days when the course of the Money Market was more or less regular, would have been accepted as part of the established order of things. In the autumn gold used to be regularly withdrawn from London for shipment to the United States to meet the movement of cereals and cotton, and for the purposes of the internal circulation which has always been wont to expand from August until November. Dearer money and a rising Bank-rate were expected and allowed for in Lombard Street during these months as a matter of course, just as if they had been put down beforehand in the calendar like the changes of the moon, and if any accident had prevented their arrival, bankers and bill-brokers would have wondered what could be amiss. Nevertheless, so ready are even the keen-witted men who work the great machine of our credit system to accept an artificial state of things as normal if it only lasts long enough, and to forget in a couple of years the mental habits of a lifetime, that an upward movement in the Bank-rate came upon them like a thunderbolt, altogether disorganising the discount market for several days, and causing a very severe fall in prices on the Stock Exchange.

*Source: Investoramnesia.com*

## Timing is everything

The inflationary storm clouds are clearly in view, but the market is clearly taking a different view that rates will remain low for a long time. Which is highly credible because a rise in rates could be calamitous for an indebted consumer and even more indebted governments. Potentially we could have inflation picking up and governments leaving rates too low for too long ensuring the inflationary spiral runs out of control; not a pleasant prospect. These things can take a long time for the markets to anticipate but if they do it would be good to be standing at a safe distance at that point in time. The market, after all, took a long time to respond to the COVID threat.

Until that time the weight of money can drive valuations to ever higher levels. And the price of missing out on these new highs is a significant cost for investors to miss out on, such as the 140% day one premium on Lemonade’s IPO. I stupidly said I would put any desire to invest in it in the blender when writing this article two weeks ago and now have egg dripping off my face.

Of course, I have no clue as to how long this will last. But I am inclined to agree with Russell Napier that inflation will start to appear during next year and that represents an opportunity for the market to worry, perhaps early next year.

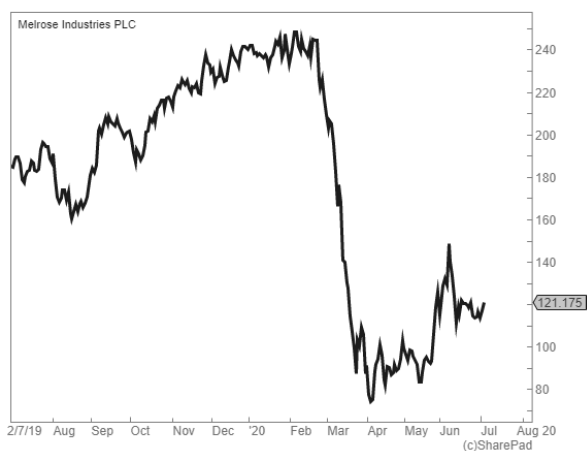
### Asset Allocation

If this scenario does start to play out in global economies inflation will favour the asset heavy industries that have been unfashionable for the last 30 years and hurt the expensive asset light companies that make up so much of the US equity market. As a long term investor I am happy to miss out on some of the gains to be had from these highly rated unicorn stocks but that doesn't mean there isn't money to be made for the fleet of foot trader.

The third choice we may have is to simply hoist the white flag and buy gold. For me, I am feeling I need some good old school manufacturing businesses that compete with China. There are few of these left in the quoted market today and those manufacturers that remain tend to be higher up the value chain, manufacturing patent protected products at high prices. One of the few that remains as an unashamed manufacturer is Melrose Industries. Though even Melrose makes an attempt at adding further value in buying good manufacturing businesses using low levels of leverage, improving them, and then selling them on.  In a new world of inflation, they could well find their manufacturing businesses in high demand and find themselves selling them at higher prices.

## Melrose Industries

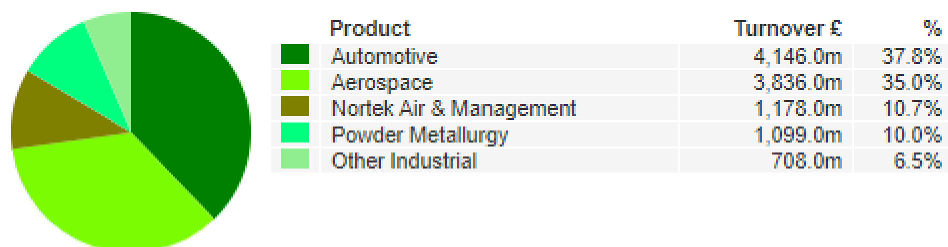
**Share Price** 121p
**Mkt Cap** £5,911m




### Business

The share price move and lack of recovery over COVID indicates the business may be impacted by the lockdown. Certainly the 38% of revenue derives from manufacturing "driveline" products for cars, which I think of as prop shafts and electric drive systems, may have been impacted by the reduced new car sales

while the outlook for selling new airframes can't be great with planes grounded. The trading statement issued on 7 May stated that for the four months to the end of April group sales were down 20% year on year. Aerospace was down 8% with the outlook for civil aircraft being poor but the 30% of production for the defence sector is relatively stable. Automotive was down 31% but by early May factories were starting to reopen. Nortek and other industrial was down 12% in the first four months.



| Product | Turnover £ | % |
|---|---|---|
| Automotive | 4,146.0m | 37.8% |
| Aerospace | 3,836.0m | 35.0% |
| Nortek Air & Management | 1,178.0m | 10.7% |
| Powder Metallurgy | 1,099.0m | 10.0% |
| Other Industrial | 708.0m | 6.5% |

## Balance Sheet

Last year Melrose delivered £11.6bn revenues and £1.1bn operating profit. At Dec 2019 net debt was £3.28bn. One of the problems with old fashioned industries is they tend to come with defined benefit pension scheme liabilities and in Melrose's case this is £1.1bn. Lower interest rates tend to magnify pension deficits so there is a risk this deficit could increase. The debt consists of multi-currency term loans of £100m and USD960m which mature in 3 years' time in April 2024 and the balance is a revolving credit facility which matures in January 2023. There remains c £1bn of headroom on the revolving credit facility at the end of April. There are also 2 bonds in issue.
There is £450m of 5.375% bonds due in September 2022 and £300m of 4.635% bonds due in May 2032. The bonds are guaranteed by the company and the subsidiaries but there is no security over the underlying assets.

**Disclosure** of the covenants is excellent. Only the bank funding has covenants. The net debt to EBITDA covenant test is set at 3.5X measured at each half year, which was 2.25X at December 2019. The interest cover covenant is set at 4X and was 10.8X at December 2019. The average cost of the debt is 3.7%.

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**Sensitivity** Forecasts for the current year assume a 17% reduction in revenue and a 41% reduction in EBITDA, which looks reasonable given the company states revenue was down 20% in the first four months of the year to April.

FORECASTS £ millions unless stated

| Year | 2020 | | 2021 | | 2022 | |
|---|---|---|---|---|---|---|
| Turnover | 9,056.3 | -17.4% | 10,103.9 | +11.6% | 10,435.3 | +3.3% |
| EBITDA | 883.6 | -41.3% | 1,258.0 | +42.4% | 1,469.2 | +16.8% |
| EBIT | 428.6 | +38.7% | 811.1 | +89.2% | 1,009.2 | +24.4% |
| Pre-tax profit | 201.4 | +91.8% | 569.0 | +182.5% | 779.9 | +37.1% |
| Post-tax profit | 183.7 | -73.5% | 476.5 | +159.3% | 616.5 | +29.4% |
| EPS (p) | 3.6 | -74.8% | 9.2 | +155.6% | 12.4 | +34.8% |
| Dividend (p) | 0.6 | -64.7% | 3.5 | +483.3% | 4.8 | +37.1% |
| Capex | 308.9 | -40.5% | 446.3 | +44.5% | 427.3 | -4.2% |
| Free cash flow | 325.1 | +1.6% | 244.9 | -24.7% | 418.5 | +70.9% |
| Net borrowing | 3,396.5 | -11.0% | 3,295.1 | -3.0% | 2,905.0 | -11.8% |

If the net debt/EBITDA stood at 2.25X and the debt stayed the same while the EBITDA fell 40% that would move the ratio to 4X, enough to break the 3.5X bank covenants. However, on 30 March the company announced it has obtained a waiver from the banks of the covenant tests for June 2020 and December 2020, which appears to be a general trend with banks being helpful. The 7 May announcement stated that the company has maintained it £1bn headroom on facilities over the first 4 months of the year which could imply the company is operating at break even in cash terms.

## Valuation

At the current share price the equity is valued at £5.88bn. This is a PE of 8.2X using last year's reported numbers and going forwards the company is currently unable to provide guidance, but on the basis of current forecasts the shares trade at a PE of 33X. I am sure this year's depressed earnings is not the correct year to value the shares against so if we look at the anticipated recovery year in 2021 we get a PE of 12.8X. The shares have halved since the onset of COVID 19.

For a company with debt it is sometimes useful to look at the enterprise valuation. The EV is the market cap plus the debt which in this case is £8.97bn, and last year's EBITDA was £1.5bn, putting the shares on 6X EV/EBITDA which is at the lower end of companies typical valuation ranges. But that is using the EBITDA number from a strong year, which may take a couple of years to fully recover. It would appear to me that if it is possible to anticipate a full recovery the shares could trade at an EV/EBITDA of 10X recovered EBITDA, which would be an EV of £15bn. Subtracting the debt gives us a potential equity value of £11-£12bn, which is roughly double the current £5.77bn. The big assumption here is that it assumes a full recovery and aircraft frames may take a few years for demand to fully recover.

### Bonds

As this company has a bond in issue it is worth checking the valuation of the bond. Fortunately, we can look at the bond in SharePad by searching for GKN. You can quickly see all the key details for a bond by

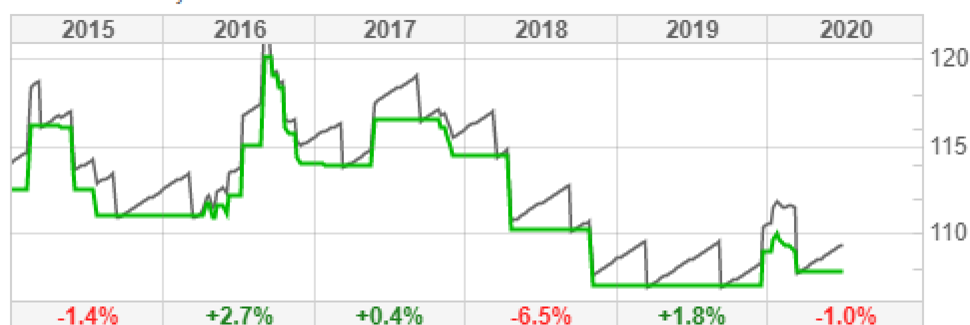
changing your blue list screen column setting to ‘Bonds’ in the bottom left hand corner. For GKN this gives you details below:

| TIDM | Name | Price | % | Coupon | Gross redemption yield | Coupons / year | Coupon date | Macaulay duration | Maturity | Par value |
|---|---|---|---|---|---|---|---|---|---|---|
| 16DW | Gkn Holdings PLC 5.375% Nts 19/09/22 | £107.875 | 0.00 | 5.375 | 1.74 | 2 | 19/9/20 e | 2.10 | 19/9/22 | £100.00 |

The Gross redemption yield is 1.74% which is an uninteresting return but tells us the market believes there is a very small chance of default on the debt ahead of the September 2022 repayment date. Interestingly the price of the bond hasn’t changed this year despite the company being forced to obtain a covenant waiver from its banks.

PERFORMANCE £107.875 0p 0.00%

16DW & Dirty Price




| Rolling | 2015 to 2016 | 2016 to 2017 | 2017 to 2018 | 2018 to 2019 | 2019 to 2020 |
|---|---|---|---|---|---|
| Bond | -0.3% | 3.8% | -5.4% | -2.9% | 0.8% |

| Rolling | 1Y | 3Y | 5Y | 7Y | 10Y |
|---|---|---|---|---|---|
| Bond | 0.8% | -7.4% | -4.2% | 3.2% | |
| Bond annualised | 0.8% | -2.5% | -0.8% | 0.5% | |

I suspect this is a function of low liquidity which tends to be prevalent in some bonds where holders tend to hold them to redemption.

## Conclusion

In a world of perfect liquidity I would be tempted to own the equity of Melrose and be short of the bonds, but there is probably insufficient liquidity to be short of the bonds. There could well be a possibility of another profit warning this year, but with covenant tests waived it is not clear that the market would punish the shares for further downgrades when the company has withdrawn its guidance anyway. This is a company that I would want to own sometime this year, but there may be harsher news to come on the H1 results.

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## Summary

As the bubble reflates post COVID the inflationary storm, clouds are gathering over the horizon. While there can be strong gains to made at the steeper end of the exponential growth curve of the valuation bubble, when it changes it won't be good for markets. With the spectre of inflation likely in my view to be the catalyst for the bubble burst, this may well favour asset heavy industries and hurt the highly valued asset light companies which many are invested in today.  Melrose is one of the few unashamed industrial engineering businesses which could be a beneficiary of such a change. While there is a risk of further bad news on June results over the current disruption it is going firmly on my watchlist.

## Future Events

Melrose Industries H1 results to June are expected on 5 September but having had trading updates on 30 March and 7 May we may have unscheduled updates ahead of then with the unfolding COVID disruption

*Source: SharePad*

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