Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Flight to Quality

13 July 2020

The temptation to throw in the towel which has "fundamental investing" written on it is sometimes unbearable. I suspect the amount of valuation added to market valuations on the back of a cure for COVID runs into the £100's of billions. Certainly, according to Evaluate's COVID 19 analyser they estimate $26bn has been added to Gilead's market cap on the back of its potential COVID treatment Remdesivir. The comparable figure for Johnson and Johnson is also $26bn, Roche is $19bn, Sanofi $14bn, BioNTech $11bn etc. Just these 5 companies apparently account for an extra $100bn of valuation for potential COVID 19 treatments.

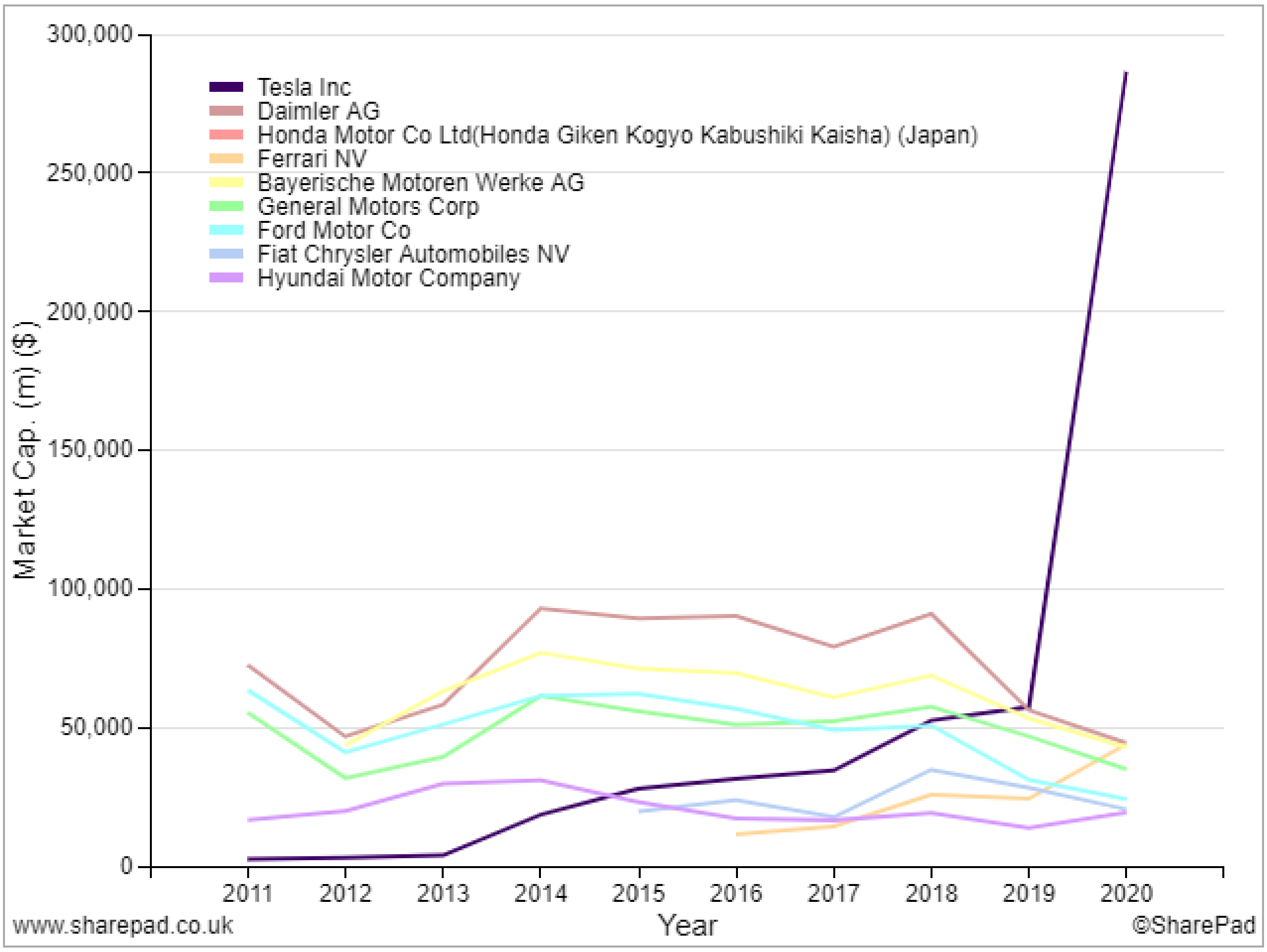
To put these figures into context it is worth remembering the global population is 7.8bn so if the valuation implied in the stock market is perhaps £200bn for all the potential treatments that would equate to £25 for every person inhabiting the planet. But it could be considerably more. This brings to mind James Goldsmith's line "when you see a bubble it's too late".

In the UK, Avacta has been one of the stocks that has ridden this wave. A glance through the SharePad income statements back to 2002 shows it has never made a profit but the shares have risen from 20p to 200p on the back of their potential COVID test, before settling back to 119p, valuing the company at £297m. Biotech companies normally partner with large pharmaceutical companies as their product near approval as these companies have the distribution to deal with the large scale roll out of a new drug which frequently results in the biotechnology company being bought out.

In Avacta's case the exclusive distribution rights for consumer distribution have been granted to a new company formed by the founder of Zeus, the company's broker, and Mahmud Kahmani, the founder of BooHoo, who don't as I am aware have the look of a large pharmaceutical company. The company then raised £48m on the 4 June in new equity at 120p/share. A few days post the fund raise it emerges that the large new investors were a US institution Conifer Management LLC, and Baillie Gifford. That will be the same Baillie Gifford that manages The Scottish Mortgage Trust which is full of Tesla, Amazon, Alibaba, Netfix etc, confirming my suspicions that this is a bubble stock.

In 2000 as a fund manager I owned a large holding in Kewill Systems which rose 20% the day before a capital markets day. So, I sold a few. The following day the shares rose another 20% and at the capital markets day my mobile phone in my pocket buzzed constantly inundated with calls asking for more stock. The shares rose further during the presentation to 40% up on the day. Reflecting that the other fund managers at the event didn't have the mobile phone buzzing constantly I rationalised that the share price move was a function of liquidity rather than fundamentals. For the next six months it was a question of finding stocks that were likely to experience a liquidity squeeze. All the models were quietly archived, and analysis became a question of monitoring news flow calendars.

When share prices become determined by supply and demand for shares rather than fundamentals the price moves can be acute. We are seeing this in healthcare now alongside the large US technology stocks, as well as some motor stocks amply illustrated in this chart. But liquidity driven prices cannot be sustained forever.



When bubbles burst moving large stakes in companies is difficult. For that reason, bubbles take time to unwind as many wait to sell when the shares bounce. And when they don't bounce the drifting share prices continues until the fund manager's superiors finally instruct a sale and capitulation is finally reached. It took 18 months in 2001 and many fund managers were unceremoniously marched off the premises in the process.

Good luck to those that want to play the calendar investing trade. What I learned in 2001 was that the sell decision is far harder than the buy decision. I suspect that is where efforts should be directed for Avacta, Tesla, and the large US tech stocks. When it is time to sell it may be necessary to sell below the price on the screen on a red day, rather than waiting for a bounce.

Extremities

At the same time as we have the bubble stocks, we have the disliked stocks, of which Plus 500 is a good example. It is trading on a current year PE of 4.8X. New customers usually produce more revenue in the second year than the first year due to the simple maths that they are a customer for more months in the year. So next year's revenues looks likely to exceed the current year's but forecasts from analysts remain downward sloping. So, on a PE of 4.8X and pregnant with forecast upgrades every bone in my body wants to buy it. But one thing is holding me back.

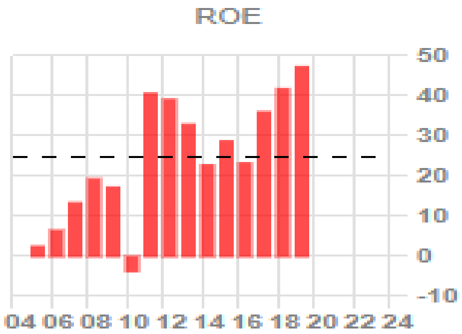
When the bubble bursts investors lack the courage to buy cheap stocks. Instead there is generally a flight to quality. In the coming crisis, when we are running round to shouts of "what were you thinking", quality stocks can look very attractive places to be. We experienced this in March as should heed the lesson. Investing can be uncomfortable, and I am wondering if the uncomfortable trade of buying expensive quality is the right trade today. And one of the surest indicators of quality is a high ROCE over an extended period of time, often the result of a wide "moat".
One high quality situation is in my view Judges Scientific which achieves an ROE's of 47%, while its smaller look alike, Scientific Digital Imaging achieves only 15%. It may be worth a comparison of these two in the light of the far stronger post COVID share price recovery at Judges than SDI Group.

Judges Scientific

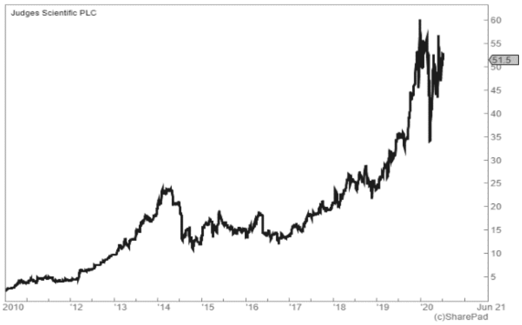
Share Price £51.20
Mkt Cap £321m

Business

The company was listed in 2002 since when it has made 14 acquisitions of scientific instrument companies. This sector is typified by a large number of privately owned company formed by entrepreneurial scientists and engineers whose strengths may not necessarily lie in the commercial side. The model is very clear in that they buy companies at 3-6X EBITDA and borrow up to 2.5X EBITDA and then set about creating additional opportunities. The debt costs the company in the region of 3% so if the company was to pay, say £1000 for a company making £200 of profit and borrowed half the money the implied equity return would be 30%. And this is before any additional opportunities are created. The result has achieved what the company intended to achieve:



With a rewarding impact on the share price.



The two questions that arise are whether the company is now too expensive and whether the model is sustainable.

Valuation

There is no doubt that the company trading on a PE of 31.3 is expensive, but the NAV of £32m only has £5.8m of debt despite 14 acquisitions, underlining the cash generative nature of these businesses. More acquisitions that generate a 30% ROE at inception could be hugely earnings enhancing and so the valuation could soon come down.

FORECASTS

£ millions unless stated

Year	2020		2021		2022	
Turnover	79.1	-4.2%	81.2	+2.7%	86.1	+6.0%
EBITDA	15.1	-19.6%	16.4	+8.5%	18.1	+10.5%
EBIT	12.3	-14.9%	15.0	+22.3%	16.7	+11.2%
Pre-tax profit	14.3	+2.7%	14.5	+1.8%	16.8	+15.9%
Post-tax profit	-		-		-	
EPS (p)	169.4	-22.4%	182.8	+7.9%	202.6	+10.8%
Dividend (p)	53.3	+6.6%	60.5	+13.5%	66.5	+9.9%
Capex	0.8	-38.6%	0.9	+12.5%	1.0	+11.1%
Free cash flow	9.6	-37.3%	9.8	+2.2%	11.8	+20.9%
Net borrowing	-5.8		-6.6		-14.8	
NAV	32.0	+14.8%	40.0	+25.0%	49.7	+24.3%
Like for like sales growth %	-		-		-	

Forecasts are compared to company adjusted, normalised or reported values as available. ?

RATIOS

Year	2020	2021	2022
PE	31.3	29.0	26.2
EV/EBIT	27.7	22.6	20.3
EV/EBITDA	22.5	20.7	18.8
Price to NAV	10.5	8.4	6.8
Price to free cash flow (equity)	35.1	34.3	28.4
EV/Turnover	4.3	4.2	4.0
FCF yield %	2.9	2.9	3.6

Sustainability

The availability of acquisitions at reasonable prices is a key sensitivity in this company's business model. With grants available for innovation and research and development tax credits it seems likely to me that innovation is likely to continue and the supply of companies that have reached the point that an entrepreneur is able to take it to looks relatively safe. Perhaps there is a risk that larger competitors may compete more aggressively for the acquisitions. Certainly, the arrival of SDI Group in this space indicates this is a risk.

The other threat to the business model is the availability of cheap debt. As I expect inflation to come through next year it is possible we may start to be facing the prospect of interest rate rises. In the pro forma illustration used above when the company acquires for £1,000 a company using £500 of debt when the company produces EBIT of £200 the effect of a rise in the interest cost from 3% to 5% would result in a decline in the ROE from 30% to 24%. Thus, there is some sensitivity to the interest rates but if base rates were to increase strongly I suspect we would have a lot of other things that are more worrying.

Conclusion

Ultimately all businesses mature and become more competitive but sometimes it can take a long time. With high levels of know how and knowledge the company has a wide moat and so my guess is it may take a while for larger competitors to push acquisition prices up. While the timing of acquisitions is hard to predict these shares look like they will do well as acquisitions are delivered.

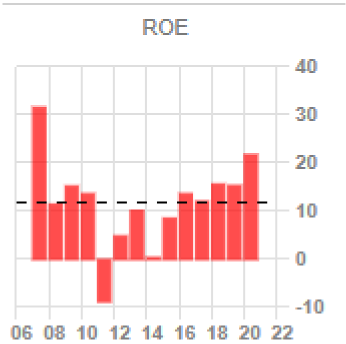
SDI Group

Share Price 54p
Mkt Cap £53m

Business

The company joined AIM in 2008 under the leadership of Harry Tee, who was the founder of Dialight plc. With a focus on developing internally for the science, healthcare, astronomy, consumer manufacturing, and art conservation markets. It didn't make its first acquisition until 2014 and it acquired one business per year until 2018 when 2 were completed and 4 in 2019.

The ROE is not as impressive as Judges Scientific but the full impact of 4 acquisitions in 2019 is not yet in the numbers, so perhaps it is worth taking a look at the acquisitions in 2019



Acquisitions

The acquisitions appear to be at prices in line with the 3-6X EBIT range that Judges use so the pricing looks very reasonable while the total spend was £10.1m while the interest cost of the debt used to finance the acquisitions but from the accounts appears to average a little above 3%, so a very similar model to Judges'.

		Price (£M)	PBT /EBIT (£m)	Multiple X
Nov-19	Chell	4.3	0.8	5.5
Apr-19	MPB Industries	1.6	0.3	5.1
Feb-19	Graticules	3.4	0.7	5.2
Feb-19	Thermal Exchange	0.8	0.2	4.0
Mean				5.0

It is these acquisitions that have resulted in bank debt increasing from £1.4m at December 2018 to £4.1m at December 2019 which should enhance the ROE usefully in 2020. Which appears to be the case on the ROE chart above but still only to a level a little above 20%.

The reason for the lower ROE is in part down to smaller scale where central costs at SDI account for 5.8% of revenue, almost double Judges 3% of revenue. The other area of inferior returns is in SDO' sensor division which makes margins of only 13.3% which compares to 20.7% in their digital imaging division and 21.9% at Judges Materials and science division and 25% at Judges vacuums division. The reason for this is not that clear, but it may be a question of scale as the 17% growth in revenue last year translated to 32% operating profit growth, implying that margins will grow as it scales.

Valuation

The PE of 15 is very reasonable for a company that grew its profits by 23% in 2019 and is set to grow them 65% in the current year to April 2020. The company confirmed in its COVID update on 23 April that it continues to expect to meet market expectations, despite COVID, as all 8 of its operating units remain open. There are no subsequent forecasts, but cost reductions have been made so it could be conceivable that the company grows it profits in the year to April 2021.

FORECASTS	£ millions unless stated	
Year	**2020**	
Turnover	24.0	+37.7%
EBITDA	5.8	+52.2%
EBIT	4.4	+68.6%
Pre-tax profit	4.2	+65.8%
Post-tax profit	3.7	+62.1%
EPS (p)	3.6	+50.0%
Dividend (p)	-	
Capex	0.9	-10.9%
Free cash flow	2.8	+26.5%
Net borrowing	4.3	+167.7%
NAV	-	
Like for like sales growth %	-	

Forecasts are compared to company adjusted, normalised or reported values as available.

RATIOS	
Year	**2020**
PE	15.0
EV/EBIT	12.3
EV/EBITDA	9.4
Price to NAV	-
Price to free cash flow (equity)	18.0
EV/Turnover	2.3
FCF yield %	5.3

Conclusion

This company has the look of a sub scale version of Judges Scientific. While Judges may have better access to acquisition opportunities by virtue of its scale, the rating uplift potential from SDI is very significant. Usually the rating increase as the ROE increases and it would appear that we may be able to expect SDI's margin, and hence ROE to increase from 20% to 30%, as it gains scale. With strong earnings growth combined with a potential re rating the upside is considerable. However, the smaller market cap could make this share price more vulnerable in a prolonged bear market should market liquidity get tight.

Summary

In these strange times the value of hope is over rated and has spread beyond the large technology companies to the healthcare companies such that the valuation of the profit coming from COVID to the healthcare companies may well be £25 for each person alive on the planet. Unwinding that is usually painful and in anticipation of a flight to quality the high ROE Judges Scientific and SDI Group look attractive. There is perhaps more upside in SDI Group by virtue of its faster profit growth and re-rating potential, but in a melt-down there are advantages to being invested in a £321m market cap company rather than a £53m market cap company. SDI reported it expects to report results in line with expectations next week and perhaps, if that makes pleasant reading, there could be a trade ahead of the flight to safety.

Future Events

Company	Date	Event
SDI Group	21-Jul-20	FY Results
Judges Scientific	22-Sep-20	H1 Results

Source: Sharepad, RNS