Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Clearing up the debris

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Humans, and markets, can behave badly. A property company CEO was venting his anger to me last week over the 30% of the rent roll that had actually been paid for the June quarter, now that the legal contract of property rental has become an optional payment. He was looking forward to October when he can either evict the tenants or wind them up. Both lenders and property companies have payments moratoriums which could potentially last until October and the results for the payments from their customers have largely been reported to the stock market. The receipts have been largely around 70% - 80% of expectations from those that have reported.

REITs	**Quarter/June receipts**
B. Land	88%
Derwent	70%
Hammerson	16%
Helical	76%
Land Secs	60%
London Metric	95%
Town Centre	79%
Workspace	65%

Lenders	**Quarter/June receipts**
OnePM	80%
Arbuthnot	75%
Int'l Personal Fin	88%
Morses Club	80%
Non-Standard Finance	89%
PCF Group	66%
PFG - Vanquis	97%
PFG -Moneybarn	78%
PFG - CCD	80%
S&U	80%

Note: These figures should be used as a rough guide only as companies disclose different metrics.Eg:% payment holidays

In the US Chapter 11 bankruptcies were up 26% in H1 to June and month on month up 43% during June. Yet despite the doom and gloom we read daily there has been a reduction in the oil price, government guarantees on wages, free loans, savings on travel costs which means that a large number of consumers are quietly comfortable. Unemployment came in last week better than expected remaining constant at 3.9% while GDP remains 24.5% down from February. The brunt of the GDP decline is being taken by corporates in specific sectors such as hospitality and property while the consumer is decidedly OK. I suspect that the gloomy headlines are missing the point that we are in a period of the most rapid structural change in our lifetime. Some of that will be permanent and some temporary. The shape of the change won't be clear until the payment holidays end in October.

The structural change from internet connectivity is causing over exuberance in stock markets. An article from 1873 suggests that the wisdom of pouring new money into railroads is infinite, much as the share prices of Tesla and Amazon now imply their business models are unassailable. "*Our new railroads increase the value of farms and open new markets for their products. They lessen the time and cost of travel. They give a value to commodities otherwise almost worthless. They concentrate population, stimulate production and raise wages by making labor more efficient. Our existing railroads are computed to create more wealth every year than is absorbed for the construction of new railroads."* And yet later in 1873 there was a major panic that led to default rates rising to 14.3%.

What happens next?

The somewhat enraged property company CEO was looking forward to October, November and December when he could either take possession of the property and redevelop it or receive the rent. Loan contracts and lease contracts remain valid in law and it may be reasonable to anticipate significant cash receipts towards the end of the year for the corporates that have been impacted. I can't help but ponder what the combination of cash rich property companies and distressed assets available on the market will provide for those forever hungry M&A brokers.

For lenders, the moment could arrive sooner, as many have withheld lending such that collections are shrinking their balance sheet. Non-Standard Finance reported £72m cash last week while MorsesClub, the home collected credit operator, has reduced its banking facilities as its loans get repaid and new lending is withheld. The combination of growing cash balances, low valuations and distressed companies is a feast beyond the wildest dreams of the average investment banking bonus grabber. It may just be that mergers and acquisitions are already being plotted in the east wing of the country residence by the previous inhabitants of One Canada Square in Canary Wharf.

The likely outcome of this disruption seems likely to be a number of company failures, such as the administration of Intu that we have already recently seen, alongside a frenzy of mergers and acquisitions, unless share prices increase significantly, putting acquisitions out of reach. Which is a good prospect for investors. The difficulty is whether to own the distressed company risking further downside before the wave of M&A activity arrives or whether to simply own the acquirer that will benefit, a lower risk situation, but potentially lower reward too.

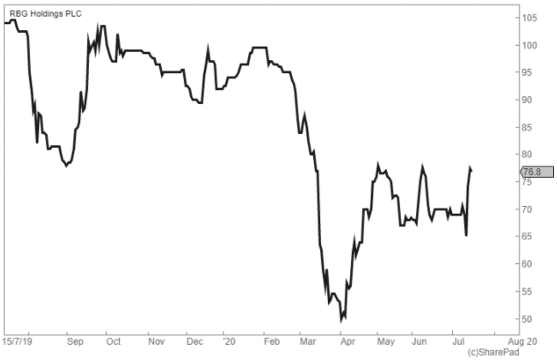
My preferred way of playing this would be to own the companies that benefit from the transactions. A look at Non-Standard Finance is a useful reminder where the advisory fees incurred in connection with the failed bid for Provident Financial came to £12.8m which was higher than the market cap of the company last week. If it costs £12.8m for a failed bid I can only wonder what a successful bid would have cost. The intermediaries can often make more than the companies themselves. I covered Numis and Cenkos on 13

April this year where I concluded that Cenkos was a higher risk potential multi-bagger while Numis' CEOs were incentivised to a 509p share price by September 2021. At the time Numis' share price was 232p and Cenkos' 47p. Today, Cenkos remains at 47p while Numis has risen 33% to 308p.

The other side of the disruption is the insolvency exposed companies which will benefit from clearing up the debris. With FRP advisory coming to market in March, shortly ahead of lockdown, the shares have risen over 50% from an IPO price of 80p to 121p today. Begbies Traynor have risen 15% over the same period. There is also the insolvency litigation funder Manolete which has done very well, and last week RBG Holdings, previously called Rosenblatt Law announced its entry into the insolvency litigation funding space.

RBG Holdings

Share Price 78p
Mkt Cap £68m



Business

The business came to market just over 2 years ago as Rosenblatt Group in May 2018 at 95p/share valuing the company at £76m. At the time of IPO the ex-partners took £41m out by selling shares. Before the first set of results were announced, the CFP resigned "for personal reasons" which was a red flag. Ian Rosenblatt himself owns 19.8% of the company but doesn't sit on the board. It was the January 2020 announcement that really worried me. The company said it had extended and broadened the restrictive covenants of Mr Rosenblatt put in place at IPO in consideration for £1m. I have to confess I would never have thought it feasible that a founder and 19.8% shareholder in a business bearing his name would need paying not to compete with it. So we must bear in mind the risk that Ian Rosenblatt leaves the group. Questioning the CEO over this unusual move unearthed that the covenants at IPO didn't include all clients post IPO and now these are included in the restrictions. The reality may just be that Ian Rosenblatt has an expensive lifestyle. However, it does leave significant questions.

Acquisition

The first acquisition the company made was in September 2019 when they acquired a Manchester based corporate finance boutique called Convex Capital for an upfront consideration of £13.6m and deferred consideration of £8.4m which is only payable if Convex delivers £6m EBITDA in the year to September 20. With many transactions currently on hold it may be unlikely that the deferred consideration becomes payable. Convex delivered £8.7m revenue and £4.3m EBITDA in the year to June 2019 so the initial consideration was only 3X the historic EBITDA, but corporate transactions are very lumpy and unpredictable so the business doesn't merit a high multiple. While Rosenblatt believes they can cross sell legal services I viewed the diversification as a reduction in business quality so remained sceptical.

Litigation

Of the £35m of new money raised at IPO initially £2m was put aside to fund litigation claims. The H1 results to June 2019 showed the first profit from this division when a sale was completed of a participation right creating £2m of revenue. By December 2019 the company had invested £2.2m in litigation cases having realised a profit of £3.8m over the course of 2019. Such strong returns underline the attractiveness of this space and the reason that the litigation funders can be highly valued.

Last week the company announced the launch of its new insolvency litigation financing solution. A gauntlet was thrown down squarely when the statement referred to a dominant provider in the space claiming this solution was both cheaper and more flexible than the dominant provider. The direction of their competitive launch is further underlined by naming the division ISLERO which happens also to be the name of the Spanish bull which was famed for killing the bullfighter Manolete in 1947.

Valuation

The company issued a pre close update on 9 July 2020 when they withdrew market guidance making forecasts on SharePad unreliable. However, this stated that in H1 law firm fees were up 38% while no revenues had been realised by the litigation funding business and nearly all of Convex's transactions had been deferred. This would imply £12m revenue from the law firm assuming it is the only revenue. This will enable the business overall to report a 18% revenue increase year on year to June 20. Should this carry on the company could well be in a position to achieve the 9.2p EPS originally expected this year, but with significant uncertainty it is perhaps better to value the company off historic EPS of 7.5p

COMPANY ADJUSTED	2018	2019	2020E	2021
Operating profit	-	-	-	-
Post-tax profit	3.3	6.2	7.9	8.3
EBIT	-	-	-	-
EBITDA	4.3	9.4	11.9	12.4
EPS (basic) (p)	5.4	7.6	-	-
EPS (diluted) (p)	5.4	7.5	9.2	9.7

The PE on historic earnings is 10.4X and 8.5X prospective EPS, so it looks to be in the value bucket. But with three different division it may be worth checking a sum of the parts valuation.

Sum of the Parts

The law firm looks set to deliver all of last year's 7.5p EPS on its own this year so perhaps the law firm is worth the market capitalisation on its own. Comparators are below. As Rosenblatt tends to operate on large and high profile cases the margins are higher than peers which makes an argument for the law firm being more valuable but they are valued in line with Gateley and DWF. Keystone Law. As a platform has a different valuation basis, while Knights Group simply looks expensive to me.

No.	Name	Price	PE	EBITDA margin
1	DWF Group Ltd	66p	9.7	10.4
2	Gateley (Holdings) PLC	140.5p	10.5	18.5
3	Ince Group (The) PLC	28p	1.6	32.5
4	Keystone Law Group PLC	495p	33.0	12.3
5	Knights Group Holdings PLC	407.5p	34.5	21.5
6	RBG Holdings PLC	76.8p	10.3	47.3

Convex

There are times when I would argue this business could be worthless. However, there are also times when it can produce a substantial profit. It is focussed on selling businesses in a similar way to K3Capital so has inevitably had its mandates deferred. The differentiator with K3Capital is that K3C has an online lead harvesting system and the teasers and prospectuses are systematic but perhaps Convex could justify a valuation of 1X previous year revenues which were £8.7m.

Litigation Funding

It is the potential from this business that I sense may have the ability to transform the business. Generally high returns can be made and as a rule of thumb a high ROE equates to a high Price/NAV. While Litigation Capital Management holds its cases at cost Burford and Manolete mark them to market making comparisons difficult. However, Manolete's high ROE does indeed result in a high valuation of 4.9X NAV. Burford's valuation of 0.9X NAV reflects the fact that the market doesn't believe the unrealised part of the NAV, which is largely the Peterson claim against the state of Argentina. There may be some logic to this given Argentina is in technical default on its liabilities at the moment.

No.	Name	Price	PE	Return on Equity	Price to NAV
1	Burford Capital Ltd	536.4p	6.8	14.6	0.9
2	Litigation Capital Management Ltd	59.4p	12.0	15.3	1.6
3	Manolete Partners PLC	415p	23.2	24.2	4.9

It would logical that a valuation of 1.5X – 2X NAV may be achievable for Rosenblatt's investment into litigation funding. The problem is that at the last reported date of Dec 2019 only £2.2m was held on the balance sheet in the litigation funding arm, making the potential valuation only £4m. The H1 update on 9 July stated that the company expects to execute four potentially significant litigation financing transactions imminently which could increase the potential valuation upside.

Conclusion

There remain some red flags with RBG Holdings, and my biggest concern is the risk of the founder leaving. But I suspect with a lavish lifestyle financial needs may in fact keep him in situ. Having been rather negative as their first acquisition hasn't been a value enhancing experience. But that is why the shares are cheap. Now the prospect of the high return litigation funding is increasing it could possibly have the ability to transform from a value stock to a growth stock. At times like this it is emotionally difficult to perform an investing U turn but the facts have changed and it is important to change our minds as the facts change. I am feeling a U turn here and feeling far more positive. Not enough though to suggest that their Islero insolvency financing will actually slay Manolete but it may compete in an attractive market.

Summary

Payment moratoriums for lenders and tenants continue until October this year so the real changes in our economy are likely to start to happen then as moratoriums are lifted. At that time both advisory businesses and insolvency businesses are likely to be busy with merger and acquisition activity as well as administrations. Many shares have started to reflect this potential but Cenkos is lagging. The new arrival of the RBG Holdings' ISLERO insolvency funding division on the scene could prove to be well timed and has the potential to move the stock from a value stock to a growth stock. As always it will take time but if it works the rewards could be significant.

Future Events

Company	Date	Event
RBG Holdings	16-Sep-20	H1 Results

Source: Sharepad, RNS