

Jeremy Grime's Weekly Commentary

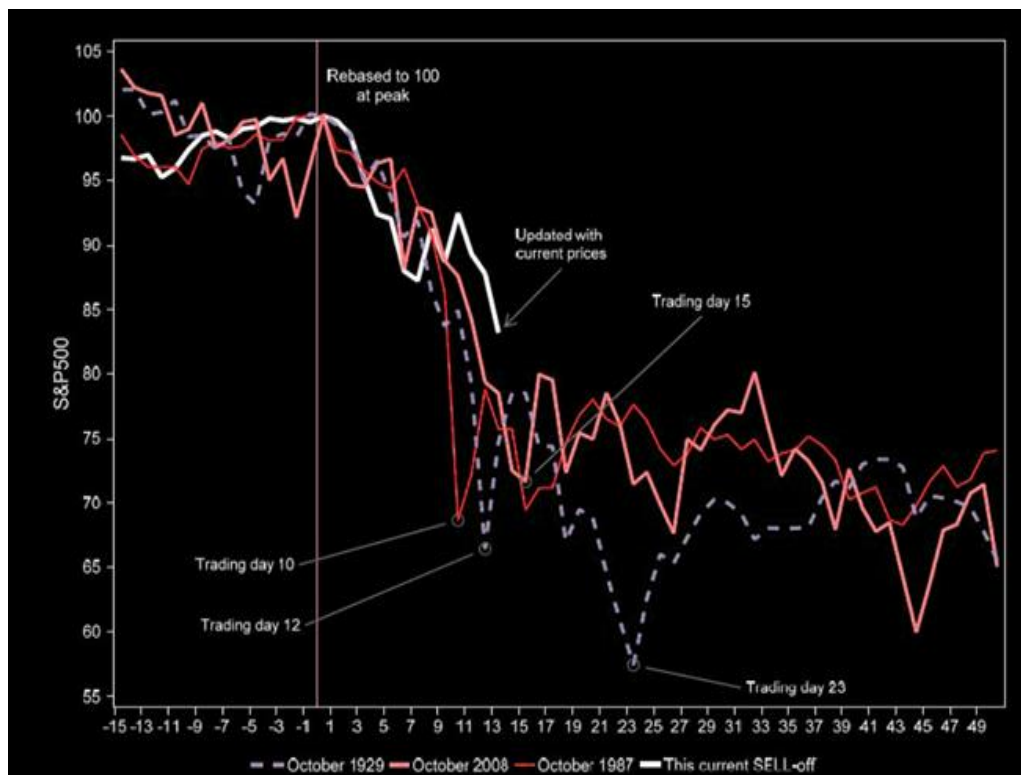
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Lessons

3 August 2020

In the spirit of reflection, I took a look through some past notes during what has been a year of extremes. It is so easy to forget the levels of uncertainty we have experienced. History is often a comfort when we are at market extremes but, as we know, the past is not a guide to the future. The fear in bear markets is easy to fuel. This chart from Longview economics that I used on 16 March is testament to the past not being a guide to the future. At that time few were expecting the 15% recovery in the FTSE 100 we have experienced.



Humans natural confirmation bias leads us to seek out information that confirms our fear, while the opposite reaction is natural in bull markets. Which is why an investors greatest enemy is themselves. Had we stood back and appreciated that the biggest influence on markets at that time was the vast amount of government money we may, possibly, have imagined a sharp recovery. But instead it is sometimes easier to rely on the evidence of history even though "it's different this time". Facts change, but human nature doesn't.

A review of mistakes is a good way to learn about our tendency for error, so below is a list of 2020 stock thoughts from my weekly note and the results. The biggest mistake was being negative on the US Unicorn

“Lemonade” on 15 June. A mere 6 weeks later the shares have risen 124% from the IPO price of \$29. It is silly to fight the wall of money seeking out the bubble stocks and a training in fundamental analysis can at times like this prove destructive to portfolio performance.

Note	Company	Price when	Price when	Price Now (p)	Positive calls (%)	Negative Calls (%)	Theme
		Positive (p)	Negative (p)				
27-Jul-20	LoopUp	190		196	3.2%		Relative Valuations
20-Jul-20	RBG Holdings	78		74	-5.1%		Changing Points
13-Jul-20	Judges Scientific	5120		4900	-4.3%		Niche acquisitions
13-Jul-20	SDI	54		55	1.9%		Niche acquisitions
29-Jun-20	Arbuthnot	832		735	-11.7%		Directors deals
29-Jun-20	Minds & Machines	5.75		6	4.3%		Directors deals
22-Jun-20	Tatton A.Management	287		284	-1.0%		Conviction
15-Jun-20	Lemonade		\$29	\$65		-124.1%	Quality
15-Jun-20	Boo Hoo	370		263	-28.9%		Quality
15-Jun-20	ASOS		2998	3315		-10.6%	Quality
08-Jun-20	Victoria	221		267	20.8%		Recovery
08-Jun-20	Headlam		315	276		12.4%	Recovery
01-Jun-20	Lloyds	3179		2620	-17.6%		Credit recovery
01-Jun-20	Barclays	124		100	-19.4%		Credit recovery
24-May-20	Anglo Pacific Group	158		117	-25.9%		Intangibles
24-May-20	Trident Resources	17.5		22.6	29.1%		Intangibles
18-May-20	Ideagen		162	176		-8.6%	Acquisitive Tech
18-May-20	Tracsis		575	575		0.0%	Acquisitive Tech
11-May-20	City of London IG	311		412	32.5%		Long term
04-May-20	FBD Holdings	€ 6.55		€ 6.40	-2.3%		Overlooked
27-Apr-20	Grencore	173		126	-27.2%		Inflation
20-Apr-20	Aquis Exchange	350		345	-1.4%		Barbell
20-Apr-20	Urban Exposure	31		56	80.6%		Barbell
13-Apr-20	Numis	232		280	20.7%		Refinancing
13-Apr-20	Cenkos	47		48	2.1%		Refinancing
30-Mar-20	Airea	23		27	17.4%		Graham Value
	Portmeirion	245		367	49.8%		Graham Value
	Griffin Mining	38		37	-2.6%		Graham Value
	Walker Greenbank	33.5		48	43.3%		Graham Value
	Cenkos	35		48	37.1%		Graham Value
23-Mar-20	Plus 500	892		1207	35.3%		Irrational valuations
09-Mar-20	IMI Mobile		367	335		8.7%	Adjusting numbers
02-Mar-20	Andrew Sykes	557		600	7.7%		Quality
24-Feb-20	Non Standard Finance	31		5.04	-83.7%		Barbell
17-Feb-20	Plus 500	915		1207	31.9%		On Line
10-Feb-20	Applegreen		457	330		27.8%	Employee Culture
03-Feb-20	Ideagen		201	176		12.4%	Buy and Build
27-Jan-20	Trifast	191		102	-46.6%		Coffe Can stock
20-Jan-20	Adyen	€ 778		€ 1,378	77.1%		Payments
13-Jan-20	Tatton A. Management	246		284	15.4%		Culture
13-Jan-20	Liontrust	1195		1230	2.9%		Culture
06-Jan-20	Castings	424		350	-17.5%		Economic Expansion
					6.4%	-10.3%	

There are three lessons I can draw from the table:

1. The importance of a top down view

The most accretive note in terms of performance was the Ben Graham value investing note of 30 March where most of the stocks have made significant gains since. But the accretion here was actually due to the recognition that at that point in time it was a time to focus on value. With the market having recovered it may now be a time to focus on growth. Certainly, the performance of Lemonade suggests the unicorns are back frolicking in the field. Adyen, the highly rated payment processor has also performed well.

I find it is helpful to have a top down view of markets as a backdrop against which to invest. Markets are actually quite good at recognising quality stocks and awarding high ratings to them. In my view to beat the market by selecting stocks that the market hasn't yet found to be high quality is very difficult. The only one of these I can think of is Tatton Asset Management where the current rating is 20X. This is still a high rating, but as the company gets larger there is still scope for the rating to go higher. Generally markets are quite efficient at stock picking.

But markets are more random in their overall movements and direction. Bull and Bear markets are impossible to predict, but having a top down view can help us to focus on value in market crashes and different flavours of growth in bull markets. It may also reduce the number of mistakes, such as being negative on Lemonade, in a market driven by a wall of money. With hindsight I should have known.

2. Extreme value investing in dangerous.

This particularly applies to the lenders. My worst performing stock positive call has been Non-Standard Finance which is down 83% since 24 February. At the time, the company had recently obtained a new £200m funding facility and so with plenty of headroom and reducing impairments the future looked rosy. It didn't take long for lockdown and government payment holidays to cause a breach of the covenants on this new facility. While the company says that a waiver has been granted and a more permanent solution is likely to be agreed the company has also said it is minded to raise some more equity. This potential equity raise presents the significant risk that shareholders will be diluted, thus ensuring a deep value share price.

This serves as a reminder of the precarious position that lenders occupy. They lend, taking default risk, while borrowing money from other funders which carries other risks; as we discovered in the credit crunch. Then we also have intense regulation which can interfere, such as the required payment holidays during the pandemic. For these reasons, lenders can often be cheap and attract the unwary value investor, such as myself. Note to self: Often with lenders it may be best to buy quality rather than value.

Returning the point on the top down view above lenders find it hard to make money at times of low and reducing interest rates. When base rates are 5% borrowers are happy to pay 8% to borrow money giving a

healthy 3% turn to the banks, but when base rates are 0.1% not many of us are happy to pay 3.1% for our mortgage. This squeeze on margin encourages banks to take higher lending risks to make the required profit, so low interest rates is not a good environment for lenders generally. A firmer top down discipline may have help to improve my poor performance here.

3. Acquisitive companies continue to dress up returns

My most consistent negative views have been around acquisitive technology companies. Ideagen, Tracsis and IMImobile have all been the subject of my criticism. While the share prices indicate the market doesn't agree I am wanting to dig my heels in here and say "I am sure I am right" like an intransigent child. Timing is important, so perhaps we won't find out until the next bear market.

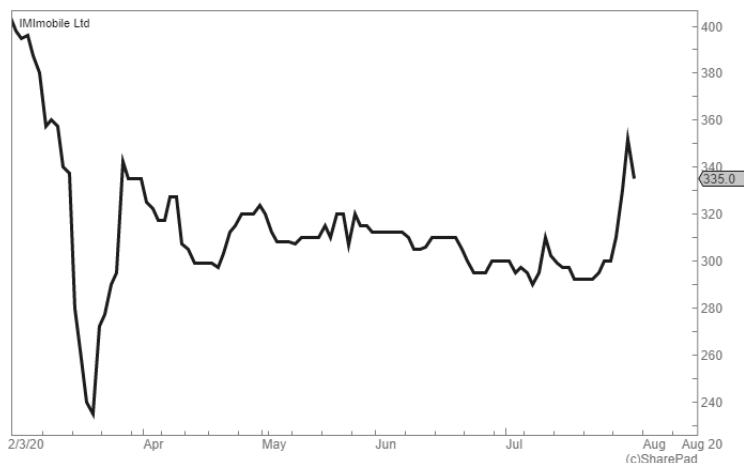
One of my formative investing books was Terry Smith's "Accounting for Growth, which I read in 1992. Terry Smith has the great ability to explain apparently complex issues in every day simple terms. An example is his description of investing in tobacco stocks, where he explains that the government measures to restrict advertising means that they become more profitable, and the packaging means you actually have to say the name of the brand when buying in a shop.

I believe that these acquisitive technology companies are not generating the high returns they present to the market. IMI Mobile's results last week serve to underline my concerns, while the market clearly liked them:

IMI Mobile

Share Price 335p

Mkt Cap £275m



The numbers felt more like a fancy-dress contest than a financial report. The headlines showed a 13% EBITDA increase to £21.6m while profit after tax was £2m. The net bank debt of £22.2m at 31 March has since become net cash of £2m as the market continues to believe in the returns, and so provide fresh equity to fuel the acquisitions. A top down view is important here in that when money is easy, and

markets are buoyant, the market will be happy to invest in positive stories paying less attention to the numbers. It is only when the tide goes out that we see who is swimming naked. And the tide remains firmly in for these acquisitive technology companies.

I may be wrong, but for a technology business which employs 1,100 people across 21 offices around the world to deliver £2m of post-tax profit appears disappointing to me. While the market awards it a PE of 26.5X. It may be worth reconciling the adjusted EPS of 15.5p with the reported EPS of 2.5p

	EPS (p)
Adjusted EPS	15.5
Non-controlling interests	0.1
Amortisation	5.6
Acquisition costs	4.2
Share base payments	3.1
Reported EPS	2.5

Share based payments The reason for stripping out this charge from the income statement is strange. While the accounting calculation of it is arguable there is a cost to shareholders of awarding shares to management. In the case of IMImobile the share-based payment charge is in fact larger than the EPS. We wouldn't see Royal Dutch Shell stripping out share based payments. Perhaps the reason for IMImobile treat it differently may just be because it is such a large number. The notes state they are considered to be on off in nature, except they do recur every year.

Acquisition costs These costs include retention bonuses payable to key management agreed at the time of acquisition. The conversation with the vendors of the business could well go along the lines of "the headline price for your business is only £5m but we will give you a £1m retention bonus" enabling the company to effectively disguise the price paid for the business. These would be better included in the acquisition cost as it effectively amounts to deferred consideration.

Amortisation Unusually there is no intangible note in the results so we will have to wait for the report and accounts to be published. However, intangible amortisation during the year was £7.6m which is getting close to the £10.4m of amortisation that the company had accumulated over its life, as at March 2019, It has spent £42.3m on acquisitions during the year. In order to determine the return on investment the amortisation should added back to the cost. Gross profit increased 26%, or £16.5m of which 7% was deemed to be organic. The balance of £12.1m may be a reasonable return on a spend of £42m on acquisitions but this is at the gross profit level. Around 27% of this drops to profit implying £3-£4m profit from the £42m spent. And the £42m excludes retention bonuses and integration costs.

Capitalised costs The company capitalised costs of £6.25m during the year (2019 £6.57m). Under GAAP accounting rules internal costs can't be capitalised, but one of the luxuries of IFRS is that costs can be deemed to derive benefits in future periods, so can simply be capitalised in the balance sheet and carried

forward to future periods. Note however, that the company strips out amortisation of these costs from its underlying profits, which means that in fact these costs never actually get counted.

Cash flow While the company generated £20.8 from operations last year after capitalising costs and acquisitions it consumed £30.9m cash, requiring regular equity issues. This works well in a buoyant market when the share price is a good currency but in a bear market the company will be paying out deferred consideration without the ability to issue shares. There is net cash of £2m but deferred consideration due of £8.4m. When acquisitions can't be made investors may find that the organic growth is not what it seemed when cross selling benefits from acquisitions are no longer available. And then those capitalised costs still need amortising.....

Summary

Bear markets and bubbles have been alternating with exhausting frequency this year, which requires investors to handle with care those emotional human traits that can have negative outcomes. A review of some of my thoughts this year, with the benefit of a hindsight mirror, is a good teacher. I find it important to stick to a top down discipline and not invest into a howling macro headwind. Similarly, I must watch my tendency to choose for extreme value investing when the risks are high. The promise of the huge upside usually has the odds heavily stacked against it. And then there are times that I just want to say "but I am right" and stamp my foot like a stubborn child. I may be wrong for now, but one day I may be right. I think.

Future Events

IMI Mobile AGM is scheduled for 25 September. Though the report and accounts hopefully will be published before then.