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Gilt by association

Shopping last month at the Brexit bargain counter, Hong Kong-based CK Asset Holdings Ltd. carried away Britain's top brewer and pub owner, Greene King plc, for a price of £4.6 billion, down 5% in sterling terms and 23% in dollars, from the June 2016 Leave referendum. For any who would follow CK's plunge into the market that most seem to want no part of, an investment primer follows. Skipping down to the bottom line, *Grant's* observes that value is returning to Britain.

You can argue with the merits of the pro-Brexit investment thesis—certainly, you can question its timeliness—but no one will call it mainstream. The August global-fund-manager survey by Bank of America Merrill Lynch crowns the United Kingdom as the least favored place in the world to invest (the votes were tallied before Argentina made its table-running bid for that unwanted distinction). At last count, major speculators were short a near-record quantity of sterling futures contracts. "According to Eurostat," reports the London consulting economist Peter Warburton,

> a comparable indicator of economic sentiment has fallen (since last August) by 2 points in France, 5 points in Italy, 12 points in Germany but 15 points in the UK. In terms of the index level, the UK sits second to last in the EU28 table, beating only Slovenia. I approach the task of analysing the UK economy with the least enthusiasm I can recall in 44 years on the job.
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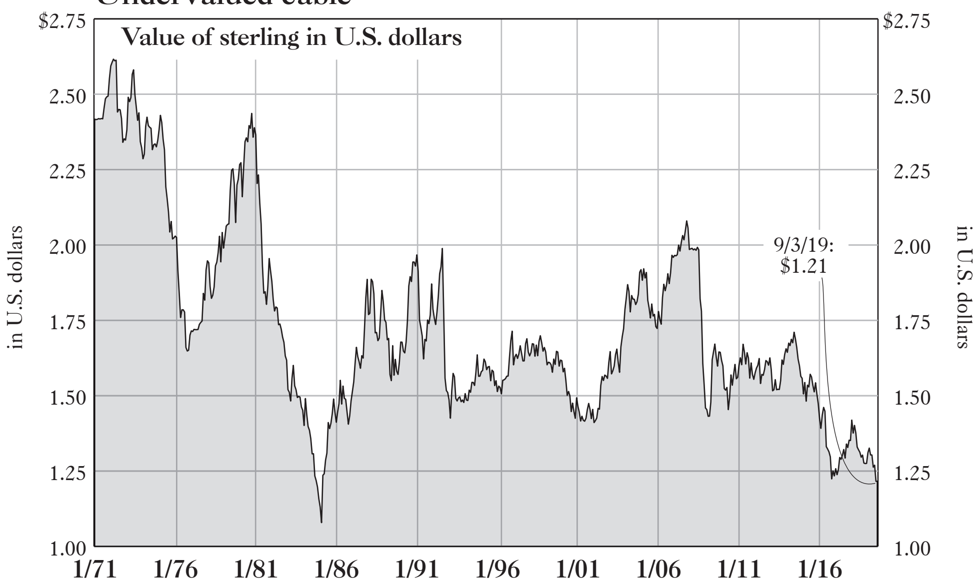
> If the UK were a patient, its condition would aptly be described as heavily medicated, verging upon comatose. What are the patient's symptoms? Lethargy, listlessness, disengagement, passivity, complacency, unproductiveness, wastefulness, hopelessness. . . . Labor productivity is falling; corporate profitability is declining; investment in equipment is falling in real terms and nominal GDP growth is a paltry 3.2%, which becomes 2.6% on a per capita basis despite a monetary policy stance that is as loose as cooked spaghetti.

"The UK fund-management community is in pieces," a professional investor tells colleague Evan Lorenz (our informant asks to go nameless). "If you were a value investor in the UK over the last 10 years, you are now borderline losing your job and you are certainly suffering from redemptions. There is technical selling pressure on anything that is not Diageo, Experian, Unilever."

Since the voters said "yea" to Brexit a little more than three years ago, the FTSE 100 has risen by 15% in sterling terms but slipped by 7% in dollars, while (likewise computed in dollars) the S&P 500 has gained 38%, the Nikkei 27% and the FTSE MIB index—that's Italy—15%.

Britain is plainly unloved. It is likewise charged with political risk, including Labor's threat to expropriate common stock and hand it over to the workers when Jeremy Corbyn moves into 10 Downing Street. But broadly and statistically speaking, Britain isn't cheap. A 10-year government bond yielding 40 basis points puts one prop under valuations; the nondomestic focus of many large UK businesses (i.e., their insulation from the full brunt of

Undervalued cable



source: The Bloomberg

Brexit) provides another. Thus, the FTSE 100 changes hands at 17.8 times earnings, a stone's throw from the 19 multiple of the S&P.

Cheap English stocks tend to be small, illiquid and hairy. They're the kind favored by Neil Woodford, the fallen money-management star, and the investors who ran on Woodford in June are queuing up to withdraw their money from funds that resemble his. "For a UK manager to go down the market-cap spectrum," our anonymous investor tells Lorenz, "is really making a big call. The first question any client will ask right now is about liquidity, because they are terrified."

The book on sterling is that it wants to trade lower. It's depreciated against gold for more than a century. It's even lost ground against the paper dollar, itself a century-long loser against gold. On the eve of the Brexit vote, the pound changed hands at $1.49. Today, it's quoted in the low $1.20s, destined, say some, to dollar parity.

There was betting on $1 for £1 in 1976, when Prime Minister James Callaghan went hat in hand to the International Monetary Fund for what was then the biggest bailout in the Fund's history, and again in early 1985. But innumerable office pound-parity pools have disbanded over the years with disappointment for the bearish punters (in 1976, the low was $1.59; in 1985, $1.05).

If the bulls again prevail, it probably won't be sterling interest rates that catalyze a sterling rally; more likely is a clean, final and non-apocalyptic break from the European Union. Anyway, as Bank of England Governor Mark Carney reminded his Jackson Hole audience last month, the pound is "highly competitive." The trusty Big Mac index of purchasing-power parity (calculated in June, before the latest Brexit sell-off) called cable 29% undervalued with respect to the dollar; a more recent calculation by Eurostat-OECD puts the fair-value deficit at 15%.

With all of that said, Tesco plc (TSCO), Dixons Carphone plc (DC), Capital & Counties Properties plc (CAPC) and Aurora Investment Trust plc (ARR; all on the London Stock Exchange) are the stocks on the *Grant's* analytical agenda.

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Five years ago, Britain's top grocer was reeling from margin-crushing competition from the deep-discount retailers Aldi and Lidl. Tesco's newly installed CEO, David Lewis, was on the job for three weeks when a £250 million earnings overstatement popped out of the accounting department. Down went the Tesco share price, to £1.89 at year-end 2014, from £3.88 in April 2013.

Lewis closed money-losing shops, sold non-core businesses, improved product quality and gave the discounters a taste of their own low-price medicine. But Tesco's margins, too, came under the ax, slumping to 0.7% in fiscal 2015 (ended Feb. 28) from 6.1% in 2012 before recovering to 3.3% in 2019. The company today commands a 27% market share in the UK and Ireland, a nose ahead of Walmart, Inc.'s 26% share in the United States.

"In some ways," Lorenz observes, "the UK market is better positioned—better adapted—than America's. While, for instance, Tesco has fought its battles with the German discounters, Aldi and Lidl have just begun to make inroads in the United States (*Grant's*, Feb. 23, 2018).

"In April, in the UK," Lorenz goes on, "trust-busters blocked a merger between Asda Stores Ltd., Walmart's British subsidiary, and J Sainsbury plc, each of which owns a 15%-plus market share. In 2017, in the United States, Amazon.com, Inc. acquired Whole Foods Market, Inc., and Jeff Bezos is still on the prowl. Then, too, Lewis continues to press, for instance, in June, with the announcement of cost-cutting projects in the sum of more than £2 billion vs. fiscal 2019's operating profit of £2.1 billion."

Tesco trades at 13.4 times the 2020 estimate and provides an 8% free cash-flow yield; Walmart is priced at 23.2 times the estimate and posts a 5% free cash-flow yield. Tesco's 2.6% dividend yield is more than five times the yield on the 10-year gilt. Net debt (including pension obligations) sums to 1.6 times estimated fiscal 2020 earnings before interest, taxes, depreciation and amortization. Of the 21 analysts who cover the UK grocer, 15 say buy, five say hold and one says sell. Over the past year, insiders have sold a net 112,332 shares for proceeds of £305,174; at last report, Lewis owned 103,346 shares.

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Dixons Carphone, the product of the 2014 merger between electronics retailer Dixons Retail Group Ltd. and cell-phone vendor Carphone Warehouse Group plc, was value-laden one year ago (*Grant's*, Sept. 21, 2018). Following a share-price dip to £1.10 from £1.72, the stock is that much more so today.

"As you may now wish to forget," Lorenz relates, "DC's problems begin and end with the UK mobile market. With rising cell-phone costs and a falling exchange rate, British customers are opting for month-to-month SIM-only plans over traditional two-year contracts. This is a problem for Carphone, which signed contracts with minimum-volume commitments to the UK's big three telco providers: EE (BT Group plc's mobile-phone network), O2 and Vodafone. That, plus a penchant for overpromising, under-delivering and—in the case of CEO Sebastain James—for selling shares ahead of bad news, led to the April 2018 appointment of new-broom CEO Alex Baldock."

In the fiscal year ended April 27, the troubled mobile division generated sales of nearly £2 billion (19% of the company total) but only £9 million (3%) in operating profit before impairments and exceptional items. The electronic-retail businesses in the UK and Ireland (56% of operating income), the Nordic countries (35%) and Greece (7%) are thriving with market shares of 26%, 25.5% and 35%, respectively.

Not one quick fix featured in the turnaround plan that Baldock laid out on Dec. 12. It will take three years to resuscitate the mobile division, as losses in that unit jump to £90 million in fiscal 2020, he said. And it will be three years to reach the £200 million in cost savings that he aims to achieve. A 40% cut in the dividend is the cost of repairing a £597 million pension deficit, a deficit directly connected to the remarkable plunge in sterling interest rates (each 25 basis-point change in the discount rate applied to pension liabilities means £91 million to the shareholders).

However, CFO Jonny Mason told dialers-in on the June 20 earnings call, "This is the worst year of [mobile] losses; it will improve from here, and in this year of losses, cash flow will be better than [the] P&L." The company could have walked away from its mobile business, Baldock added, but in doing so it would have had to sacrifice about £500 million of the £797 million contract receivables held against the big three telco companies. Those minimum-volume requirements expire after fiscal 2020, management said, a good thing for competitive flexibility. Further to the constructive case, Dixons underwrites no customer credit, a line of business that can cost the careless underwriter dearly, as it did, for instance, with former *Grant's* pick-not-to-click Signet Jewelers Ltd.

Overall, says Baldock, Dixons expects to make £1 billion in free cash flow over the next five years; an average of £200 million per annum would give the shares a 16% free-cash flow yield. He says he's shooting for an operating margin of at least 3.5%, a level last obtained in 2018 (excluding Carphone, Dixons generated a 3.7% margin in fiscal 2019).

Dixons trades at 7.8 times 2020 estimated earnings, which, if management is correct, will be the trough in net income; the shares boast a 6.1% dividend yield. As of April 27, net debt, including pension obligations, of £844 million amounted to two times estimated fiscal 2020 Ebitda. The net-debt figure is just about equal to the £797 million in contract receivables that DC holds against the UK's big three telecom companies.

Of the 14 analysts who cover Dixons, seven rate the stock a buy, six a hold and one a sale. Insiders continue to buy, most recently 493,000 shares in June at a net cost of £560,623.

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"You would suppose," Lorenz notes, "that prime real estate might be the place to invest amid a falling exchange rate—i.e., a rising inflation rate—and declining bond yields. After all, over time, such forces ought to express themselves in lower capitalization rates and, therefore, higher land values. The performance of Capital & Counties (Capco to its few friends) would seem to argue to the contrary. In sterling terms, shares are down 11% since the start of the year and 43% since the UK electorate voted 'Leave.'"

Capco is a real-estate company with two main assets: leased-up properties around Covent Gardens in the West End of London and interests in 9.8 million square feet of land (the rough equivalent of 98 city blocks) permitted for development in central London. Covent Gardens is a trophy asset: Framed by the Royal Opera House, it's a collection of high-end retail, office and residential properties facing a central square. Capco's rents in the Gardens are broadly diversified: 51% retail, 23% food and beverage, 15% office, 4% leisure and 7% residential.

WeWork is among those office tenants, though in mitigation of that worrying exposure is the fact that contracted and pending rents in the Gardens are 25% below market rates, resulting, for instance, in a 10% year-over-year jump in rental income in the second quarter. The development parcels, collectively Earls Court, are primarily slated for residential construction.

At year-end 2015, Capco valued its Earls Court interests at £1.4 billion. A logy London housing market has weighed on the project. Last week, according to PropertyReporter.co.uk, 29% of London's residential-property sellers have slashed their offering price ahead of the Oct. 31 Brexit deadline. In a third of the cases, the decline was in excess of £37,800, an amount greater than "the average annual London salary," or 6.2% of the average house price in the city.

In Capco's favor, London is short of housing, especially low-priced units, and Earls Court is one of the few large-scale projects to have secured the necessary permitting. To Capco's detriment, the Labor Party-dominated council of the borough of Hammersmith and Fulham, in which some of the project is situated, opposes development. The borough, demanding more affordable housing than Capco plans to build, has threatened to invoke the British equivalent of eminent-domain law to repurchase parts of the development. Capco's defense is that a sale's a sale and that, anyway, it was the borough that approved the plan to develop it.

"Assuming," Lorenz speculates, "the continuity of property rights post-Brexit, it would seem that Capco has the stronger case (I write this from lower Manhattan), but a new government could change things. Under Prime Minister Corbyn, one could imagine Capco's Earls Court ownership rights being abrogated."

On June 30, management wrote down Earls Court by 56% from the 2015 mark, to £599 million. The accompanying emollient words—the new valuation, said the front office, does not "currently reflect the potential of our long-term investment"—failed to soothe the market, as the share price fell by 2.4%.

Capco trades at £2.05 per share, a 35% discount to the company-derived net asset value per share of £3.15, which includes the Earls Court write-down. The company is not unaware of this yawning gap. To close it, management is implementing a plan to spin off Earls Court to shareholders in a transaction that's expected to close by Christmas. A new Earls Court development company will be capitalized with a net cash position of £100 million; Covent Gardens will become a real-estate investment trust focused on the eponymous London district and will have a loan-to-value ratio of 27%.

According to local press reports, the Earls Court parcels have received expressions of interest from Canary Wharf Group plc, The Berkeley Group Holdings plc and CK Asset Holdings, among others. Of the 15 analysts who cover Capco, six rate the stock a buy, five a hold and four an outright sale. In the past year, there was but one insider transaction—a single sale for proceeds of £134,897.

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Aurora Investment Fund, a £118 million, London-listed closed-end fund, is one of the few such value-themed tickers in the UK. As of July 31, it held 17 positions, of which the top 10 accounted for 76% of assets. The average top 10 positions command an average market cap of £16 billion and trade at 11.6 times forward earnings. Gary Channon, co-founder of Phoenix Asset Management Partners Ltd., is the manager. "Great companies with good management, quoted at attractive prices," is his mantra (he was away when we called for elaboration).

Under the "capital preservation" section of the primer on Aurora's website, the fund has this to say: "We start out by trying not to lose it. We take a great deal of care to invest in businesses that we understand thoroughly. We only back managements that we trust. Most importantly, we pay a price that has a big margin of safety; in fact, we never pay more than half of what we think a business is worth. . . . We also don't pay more than what we think a business is worth in a downside scenario; in other words, if things go wrong we want to get our money back."

Aurora uses no leverage and assesses no fee unless returns beat the FTSE All-Share Index, including dividends. The fee, which is set at one-third of above-market returns, can be clawed back if Aurora's outperformance reverses over the succeeding three years. Channon says he holds cash when opportunities are scarce and puts that money to work when the market sells off—which words he put into practice in the fourth-quarter 2018 swoon by reducing Aurora's net cash position to 2.2% on Jan. 31, from 8.5% on Sept. 30, 2018.

Since January 2016, when Phoenix took control of Aurora, the fund has seen a cumulative 19.4% increase in net asset value vs. a 37.7% return in the All-Share Index. Thus, no fees to Phoenix. Long-term results are a different and happier story. The flagship Phoenix UK Fund generated an 11.2% compound annual return from inception in 1998 through July 31, twice the annualized return of the All-Share Index over the same interval.

The aforequoted Warburton, milking his well-drawn analogy between the British economy and a nearly comatose patient, adds this: "Further medication (e.g., lower interest rates) would be futile and dangerous. The most promising treatment would appear to be shock therapy. Indeed, perhaps the best way to think of impending Brexit is as a defibrillator, designed to rouse the patient from stupor to consciousness."

Better, though, if the physician in residence were Dr. Johnson. Even when not wielding defibrillator paddles, Dr. Corbyn cuts a scary figure.

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