GRANT'S

INTEREST RATE OBSERVER®

Vol. 39, No. 2d 233 Broadway, New York, New York 10279 • www.grantspub.com FEBRUARY 5, 2021

Island of value

As the world gawks at GameStop Corp., we redirect our attention to the locked-down United Kingdom. A reprise of the theme of beckoning British investment value is the work in progress ("Merrie olde value," our opening installment, appeared in the issue of *Grant's* dated Dec. 11).

To be sure, you can hardly pick up a newspaper without reading why you should have nothing to do with the place. Yes, a Brexit deal was hammered out in the final hours of December, but now the liberated British economy is suffering from port congestion, supply-chain snarls and an unremitting stream of bad news.

A photograph of the bowed head of Boris Johnson filled the top half of the London *Daily Telegraph*'s front page of Jan. 27 alongside the prime minister's quoted words: "I am deeply sorry for every life that has been lost." This was on the occasion of British Covid-19-linked fatalities surpassing 100,000, indicating a population-adjusted mortality rate even higher than America's.

Then there's the economic toll of Brexit. French wine will cost more. London is losing €6.3 billion in daily stock trades to exchanges on the Continent; 7,500 London financial-service employees and more than £1.2 ($1.6) trillion's worth of formerly London-domiciled assets have likewise crossed the Channel.

As for the British GDP, it logged a year-over-year third-quarter contraction of 8.6%, which places it at the bottom of the G-7's performance rankings for 2020. According to the Bank of England, whose policy interest rate of 10 basis points is just 25 basis points below the yield on the 10-year gilt, full-year 2020 GDP contraction will be the most severe since John Law pumped up the South Sea Bubble some 300 years ago.

Perhaps, as Julian Jessop, former chief economist of the Institute of Economic Affairs, contends, statistical error exaggerates Britain's macroeconomic weakness. Still, we bulls acknowledge that things in England, Scotland, Northern Ireland and Wales are not so hot. Then, again, investment values, like mushrooms, grow in the dark.

British share prices have never cottoned to Brexit. Since the 2016 "Leave" verdict that shocked the world, the Financial Times Stock Exchange 100 index has returned a paltry 13% in dollar terms; excluding reinvested dividends, the FTSE is actually down by 5.3% over that span. In contrast, over the same period the S&P 500 and the MSCI World Index yielded 98% and 77.8%, respectively, also in dollar terms and including reinvested dividends.

"Ever since the [Brexit] referendum, we just had month after month after month of outflows," Matthew Tillett, a portfolio manager at Allianz Global Investors who manages a London-listed, UK-focused open-end fund, tells colleague Evan Lorenz. "In aggregate, money has been coming out of the market."

"England and America are two countries separated by a common language," said George Bernard Shaw, and the playwright was never so right as in the context of today's pandemic-cum-lockdowns-cum-everything bubble.

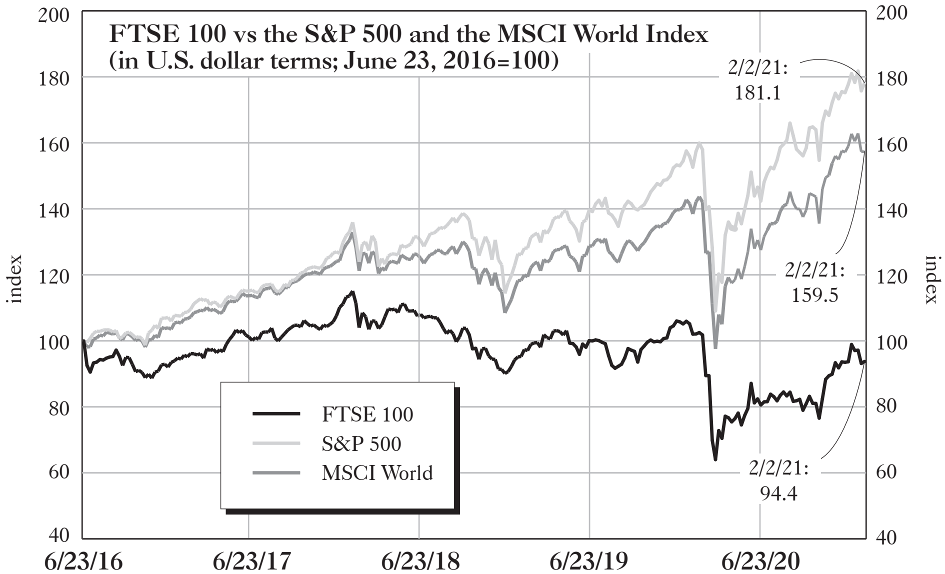
The FTSE 100, in which tech stocks command a weight of just 2%, is a very different index from the FAANG-heavy S&P 500. "So," Tillett notes, "we don't have these kinds of huge stocks that go up 30% every year."

In any case, the Footsie trades at a cyclically adjusted price-to-earnings ratio of 13.7 times (calculated by dividing the index by its average 10-year inflation-adjusted trailing earnings), down from 16.4 times at year-end 2017, according to Siblis Research Ltd. Now compare and contrast the S&P 500: Its CAPE towers at 34.9, a level seen during only the dot-com boom and in 1929.

We were about to say that "good things happen to cheap stocks," but we will instead revise that epigram in concession to the long drought in value-investing returns. Thus, "good things happen to cheap stocks, except during times of zero-percent funding costs or in the midst of technological leaps that threaten the existence of potentially obsolete business models, no matter how statistically cheap those models may appear in the stock market."

Anyway, investors are beginning to reappraise British securities. As recorded in the January BofA Global Fund Manager Survey, while the net 15% of respondents who admit that underweighting British stocks is the biggest allocation shortfall of any market, it's a 3 percentage-point gain from the December poll. Since the end of June, sterling has appreciated against the dollar by 10.5%, and British bargains are starting to attract

Britain on sale



source: The Bloomberg

foreign money. Inbound mergers and acquisitions rose 30.3% year-over-year, to $253.6 billion, in 2020, the highest yearly total since 2017, according to the Institute for Mergers, Acquisitions and Alliances.

The Leave side of the Brexit debate promised that emancipation from the slow-motion statism of the European Union would pay dividends, and maybe there's something to it. As we go to press, 12.5% of Britons have received at least their first inoculation against Covid-19, compared with 8.8% of Americans and only 2.6% of the citizens of the EU. If it sustains this pace, Britain could find itself on the inside track to a blessed return to what we Yanks call normalcy.

For now, though, it's America that gets the benefit of the post-coronavirus doubt while Britain's stock market is (figuratively speaking) from Missouri. Only consider the kid-gloves treatment meted out to Live Nation Entertainment, Inc., the U.S.-listed concert-promotion and ticket-selling enterprise whose business model anticipated everything but a global pandemic. So confident are investors of the timely return of reopening prosperity that the shares are within 1.5% of their 2019 closing price (*Grant's*, Dec. 11, 2020).

"In the UK it is sort of like, 'Show me,'" Brian Feltzin, the managing partner and portfolio manager of Chicago-based Sheffield Asset Management, tells Lorenz. "You have to deliver, and there is a lot of skepticism embedded in valuations."

. . .

Not every British asset price is dormant—in December, house prices registered a 7.3% year-over-year gain. But scant traces of that fact are stamped on the valuations of Britain's home builders. Thus, while Lennar Corp., the American housing behemoth and a *Grant's* pick-to-click (see the issue dated April 3, 2020), trades 52.4% above its 2019 closing price, Redrow plc. (RDW on the London Stock Exchange), the eighth-largest British builder by market cap, languishes 28% below its 2019 close.

True to form, bust followed boom in the UK's mid-aughts housing market. "In 2019, roughly speaking, the top builders finished 170,000 houses, and household formation, depending on how you cut it, was roughly speaking 230,000," says Kartik Kumar, a portfolio manager at Artemis Investment Management. "So, you're getting a deficit of building each year. There's . . . a deficit of about 1 million houses built up from a decade of undersupply. And I would argue that that is why you see this anomaly, that UK house prices rarely fall when people predict them to."

Maybe the People's Republic will lend Redrow a hand. Reacting to the Chinese Communist Party's assault on the liberties of Hong Kong, the Johnson government opened a new visa program for residents of that so-called Special Administrative Region starting Jan. 31. Some 300,000 people, according to speculation last week, may take advantage of the opportunity to exchange Xi Jinping for Boris Johnson.

In the fiscal year ended June 30, 2020, Redrow built 4,032 houses, a 37% drop from the prior year resulting in an identical percentage decline in revenue, or, in money terms, a fall to £1.3 billion. Nevertheless, Redrow was profitable even in 2020, generating £113 million in net income. It currently commands a £1.9 billion market cap.

"There's demand for Redrow and, in particular, their type of product, which is higher-end, higher-quality family homes in good commuter areas with outside space, the kind of things that people want to buy even more so now, after Covid," says Tillett, who counts the builder as his fourth-largest position. "It has all the benefits of being the kind of larger player that allows it to make good returns [on capital]. But it's also small enough that it can, unlike some of the bigger peers in the UK which are already quite large relative to the market, grow its business over the next five years."

While Redrow's 6.8% return on capital in fiscal 2020 did not quite meet the company's cost of capital, the builder has generated high and consistent net returns—an average of 19.2%, in fact, on combined debt and equity in the five fiscal years ended June 30, 2019. That enviable record notwithstanding, Redrow trades at 1.2 times book value and 8.8 times the estimate for fiscal 2021 earnings.

The balance sheet is blameless. As of June 30, 2020, the builder owed £126 million in net debt, an amount equal to 0.8 times fiscal 2020 Ebitda, or 0.3 times fiscal 2019 Ebitda. Beyond contractual debt obligations, as of last report Redrow also carried £302 million in liabilities relating to land development. Adding these to net debt boosts leverage to 2.8 times fiscal 2020 Ebitda and just 1 times the 2019 figure.

"We . . . emerged from the lockdown in a position of strength with a record order book and high levels of work in progress," said Redrow chairman John Tutte on the Sept. 16, 2020 earnings call. "We've also seen resilient post-lockdown demand fueled by the learning changes to the Help to Buy scheme and the stamp duty holiday. As a result, in the first 11 weeks of the financial year, reservations by value are 12% ahead of last year and reservations per outlet are particularly strong."

Of the 17 analysts on the case, 15 say buy to the one who says sell (the 17th appears noncommittal). Over the past 12 months, insiders have net sold 52,526 shares for net proceeds of £280,981.

"Some investors like to make it more complicated than it needs to be," says Kumar. "But that's not easy when it comes to house builders, because the case for investing is as simple as it is clear. I like Redrow. It's one of my largest positions."

. . .

By British lights, Redrow is a cheap mid-range stock. And by the same lights, Norcros plc (NXR on the London Stock Exchange), a leading British manufacturer of bathroom and kitchen fittings, tiles and enclosures, is a cheap small-cap stock. Quoted at 10.2 times estimated earnings for the fiscal year ending March 31 and 8.3 times the fiscal 2022 forecast, Norcros trades at a £169 million market cap, a little less than one-tenth of Redrow's. Each marches to the beat of residential investment.

In the six months ended Sept. 30, 2020, Norcros suffered a 25.3% drop in year-over-year revenue, to £135.3 million, and a 75.5% plunge in net income, which was burdened with virus-related restructuring and acquisition-related expenses. Exclusion of such one-time charges narrows the drop in net income to 30.1% year-over-year, more or less in line with the decline in revenue. In the first half of fiscal 2021, Norcros generated 80% of operating income from the UK and the rest from South Africa.

Before the bug bit, Norcros had boosted revenue every year since fiscal 2009. And in the five years ended March 31, 2019, it had compounded its top and bottom lines by 8.6% and 9.9% per annum, respectively. "Norcros is an example of one of these small caps in the UK that is actually a perfectly decent company that has performed pretty well over many years," says Tillett, who owns it in his portfolio. "Its management team has been there for a long time. It's just a bit boring."

As of Sept. 30, Norcros's balance sheet showed £7.3 million in net debt and £48.9 million in underfunded pension liabilities, which combined sum amounts to 1.6 times estimated fiscal 2021 Ebitda. In the first half of fiscal 2021, operating income covered interest expense by 10.2 times.

All three analysts who follow the company rate the shares a buy. Yet, whatever management may think, here's what it does: Over the past 12 months, insiders have sold a net 203,309 shares for proceeds of £696,969.

. . .

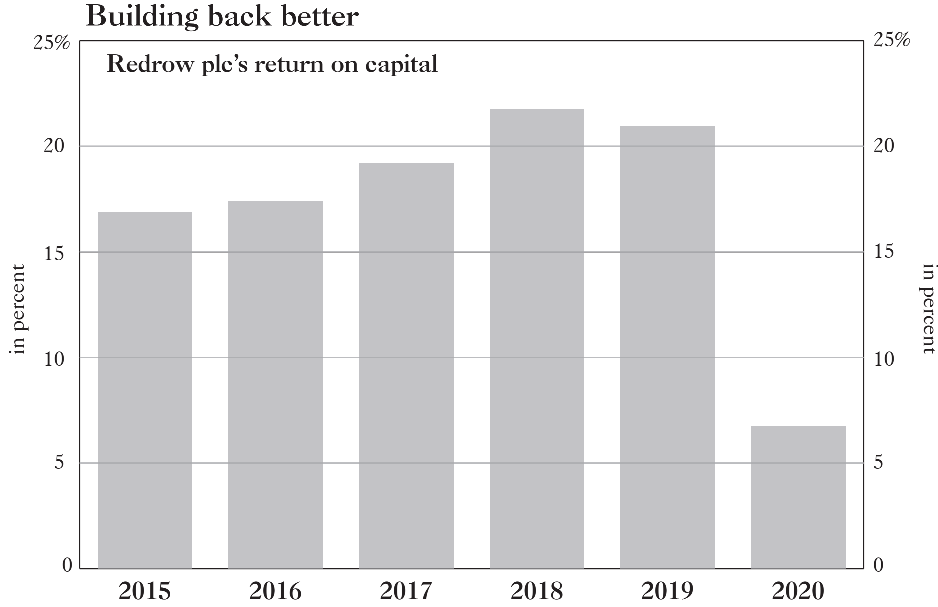
Greencore Group plc (GNC on the London Stock Exchange), a product of the 1991 privatization of Irish Sugar, claims to be the largest maker of sandwiches in the world. Its fans see it as a logistics company that happens to make prepackaged foods for sale in grocery markets, convenience stores and coffee shops, and its business is more complex than it first appears. Delivering quick-to-spoil food requires a top-notch transportation network, and it's that corporate infrastructure that keeps the competition at bay.

In the half-year ended Sept. 25, 2020, Greencore's revenue fell by 26% against 2019 results, producing an operating loss of £22.7 million versus an operating profit of £58.5 million in the second half of fiscal-year 2019. However, according to a Jan. 26 trading update, business has stabilized. Thus, revenues in the quarter ended Dec. 25, 2020 were lower by 15% from the year before, and management says that the rate of decline in sales has diminished over the course of Britain's successive lockdowns. The first such cessation, last April, knocked "food-to-go" revenue for a 70% loop, while the latest lockdown, which began in January, is doing only half as much damage.

Covid may have ravaged Greencore's business (95% of which is sourced in the UK), but it also hurt the competition's. "They have two-thirds market share in the sandwich market," William Rice, an analyst at Sheffield Asset Management, which invests in Greencore, tells Lorenz. "As part of Covid, the third player in sandwich manufacturing, Adelie Foods, went bankrupt. So now it's basically a two-player market." A £90 million's worth accession of pre-virus business from Adelie's former customers is already in the bag, said Greencore last week.

"UK fund managers view the business as at risk of being impaired because they take their own experience, of going down to Marks & Spencer during lunchtime, and basically think with work-from-home that market is dead," Rice continues. He contends that that's wrong. Yes, ready-to-go food produces about two-thirds of the top line, but office workers account for only 30% of that amount. Even if

Building back better



source: The Bloomberg

Eating will resume

source: The Bloomberg

the work-from-home phenomenon becomes a permanent part of the fabric of British life, it would only sting, not mortally wound, Greencore's results.

. . .

Like Redrow and Norcros, Greencore is paying no dividend, the better to conserve cash and (as management puts it) to seize the opportunities afforded by a newly scrambled market. To the same end, on Nov. 24, 2020, Greencore sold 80.4 million shares to raise £90 million. The transaction saddled the shareholders with an 18% dilution, although management purchased 617,498 of the issuance itself. The collapse in earnings has caused Greencore's ratio of net debt to Ebitda to bulge to 4.4 times after the equity issuance, from 2 times at the end of fiscal 2019; lenders have waived a March covenant test and pushed off a subsequent test (to 5 times net debt to Ebitda, from 4.25 times) till June.

"We have given ourselves the space, the financial headroom and the organizational momentum to trade through Covid and, we believe, to emerge as a stronger player on the other side," Greencore CEO Patrick Coveney told listeners-in on a Jan. 26 call.

The autumn's dilution notwithstanding, Greencore trades at 5.4 times fiscal 2019 enterprise value to Ebitda and 6.3 times 2019 earnings per share. The current £1.19 share price is 56% below the 2019 year-end closing price.

Of the 10 analysts who rate the stock, five say buy and five say hold. Excluding the fall equity sale, insiders have purchased a net 757,066 shares at a cost of £837,227.

. . .

Individual stock selection may or may not be your cup of tea. The Allianz UK Opportunities Fund, of which the aforequoted Tillett is the lead portfolio manager, holds "a concentrated portfolio of 30–50 materially undervalued companies listed on the UK stock market," in the words of the front office. "Valuation-driven and downside-focused," and "benchmark unconstrained within the UK universe of companies typically above £50 million market capitalization," are additional management-penned descriptors. Because it's an onshore British fund, a would-be American investor must first open a British brokerage account. Annual management fees range as high as 75 basis points for modest commitments down to 40 basis points or so for institutions. Over the 10 years ended Dec. 31, 2020, Tillett et al. have produced an annual average compound return of 9.7%, besting the FTSE 100 by 400 basis points; the fund has £120 million under management.

Kartik Kumar's Artemis Alpha Trust (ATS on the London Stock Exchange) is a 22-year-old closed-end vehicle whose £171 million portfolio is 83% exposed to UK-listed securities. Kumar describes himself as a "long-term value investor." The management fee is 94 basis points per annum. Discount to net asset value stands at 8.6%, down from as much as 24% on Oct. 30, 2020. Since taking over the helm in late 2018, Kumar has notched a 28.5% gain in 2019 (versus 19.2% for the FTSE 100) and a 10.1% rise in 2020 (versus a 9.8% decline in the index). We asked Kumar if, on his side of the Atlantic, past performance is any guarantee of future results. "I generally don't like talking up performance because I can't control outcomes in the short term," he reasonably replied.

•