VT Lyndon Fund

Quarterly Commentary 30th June 2021

ContraCapital

2021 Q2 Lyndon Fund Commentary

The second quarter of 2021 was a relatively flat one for the fund, which appreciated by slightly less than 2%, leaving it up by +12% for the first half of this year (performance figures cited are for VT Lyndon Fund B Acc units). The “vaccine bounce” that commenced in November last year and had seen the more lowly valued and out-of-favour areas of the equity market rally hard, petered out towards the end of Q2, with more highly rated “growth” stocks once again in the ascendant by June.

The value rally lasted long enough to ensure that two of the fund’s best performing holdings during the quarter were “deep value” names, with these being SIG plc, a UK distributor of insulation and roofing materials to the construction industry in UK, France and Germany and SCS Group, a UK sofa and carpet retailer. In both cases, whilst the companies issued decent enough trading statements during the quarter, the large rises in their share prices were more to do with where they started the period – flat on their backs – than with anything especially exciting or surprising having been reported. In both cases the portfolio’s holdings were lightened following the share price rise.

Another notable performer during the quarter, but one where there was a very readily identifiable reason for the performance, was William Morrison Supermarkets. The UK grocer, seemingly utterly friendless in the market just a couple of months ago, is now suddenly the desideratum of multiple private equity houses and the recipient of several takeover bids at large premia to the undisturbed share price.

In Aggreko and now William Morrison the portfolio has held stakes in the two largest UK public companies to succumb to private equity offers so far this year. We remain confident that these will not be the last portfolio holdings to attract such interest, as we observed last quarter;

“Private equity, in particular, is awash with cash that it needs to spend in something of a hurry, so we would not be in the least surprised if our portfolio – composed as it is of lowly valued, lightly indebted and solid businesses – were to be in receipt of more takeover approaches over the next year or two.”

Overall, private equity bids for UK-listed companies totalled £21bn in the first six months of 2021 and there have been 345 bids for British companies altogether, which is the most since records began in 1984 (source: Refinitiv). UK plc having a “for sale” sign on it and the unusual prominence of private equity in the process is a theme that we strongly suspect we will be returning to in subsequent quarters.

At the other end of the table, some of the main drags on fund performance included TP ICAP, an inter-dealer broker of financial instruments, Foxtons, a UK estate agency and Capita, a business process outsourcing company. As with some of the portfolio’s better performers, there is little to point to in order to explain the relative weakness of these holdings over the period and, because nothing had changed other than the shares getting cheaper, we took the opportunity to add to the fund’s position in Capita.

A couple of positions were exited during the quarter, with easyJet plc, the UK budget airline, being one of these. The shares had rallied significantly from their lows and the market seemed to have become a little overexcited regarding this summer’s trading prospects. It appeared well-nigh inevitable to us that the dismally incompetent UK government would once again find a way to grasp defeat from the jaws of victory and miss the scheduled opening-up timetable, with this likely resulting in easyJet’s share price being down sharply again, with the possibility that yet more capital would be required before the sunlit uplands are finally attained.

The other position sold out of was Tenaris, an Italian manufacturer and distributor of high quality steel pipes to the global energy industry. Similarly to easyJet, the holding was exited after a decent rally in the share price left the valuation discounting a stronger operational recovery in the group’s underlying markets than seems warranted at this point.

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During the quarter we initiated two or arguably two and a half new positions. The two definitively new holdings were both Irish stocks, one a housebuilder, Cairn Homes, and the other a bank, AIB Group. Cairn Homes is a leading Irish housebuilder that currently trades at just 1.0x book value. This is a very different valuation to its UK peers, which trade at an average rating of more than 1.5x book value. Moreover, house prices in Ireland seem better underpinned than those in the UK as, unlike the UK, Irish house prices have still not recovered their pre-GFC peaks, being still c. -20% below those levels versus the UK at c. +30% above the 2007 peak.

In addition, Ireland's long-term economic fundamentals look far superior to those of the UK and there has been a marked lack of housebuilding over the last dozen or so years in Ireland. Cairn has a long land bank, with sufficient land for 10+ years at the current rate of construction, so the group should be very cash generative over the next few years and is expected to produce c. 50% of its current market cap in free cash flow over just the next three years. Cairn's current 1.0x P/BV valuation would appear to be a pricing anomaly.

AIB Group is Ireland's leading bank, with number one market shares in the mid-30s percent in retail loans and deposits and in the mid-40s for SME banking. The group's high market share looks sustainable over the medium to longer term, as it holds a 40%+ share of younger and less indebted 15-34 year olds. The group therefore holds a very strong market share in what should, longer-term, be an attractive market. Ireland has very favourable demographics (especially in a European context), with a young and still growing population. It can be noted that the Irish population (c. 6.9m for the island of Ireland) is still well below the level (of c. 8.2m) it reached in the mid-nineteenth century and population density is very low, so there's plenty of room to grow (the UK population is +150% over the same period, for example).

The structure of the Irish banking market is one that should, all equal, offer high returns to the incumbents, as it is exceptionally concentrated. Indeed, it is essentially a duopoly between AIB and Bank of Ireland, with Permanent TSB a pretty distant number three. The overseas banks that held significant presences in the Republic have all either departed or are in the process of doing so, with the largest of these, NatWest (through its Ulster Bank subsidiary) confirming its exit in February of this year. Ulster Bank has had a presence in Dublin since 1862. AIB has already agreed to buy some of Ulster's assets, as has Permanent TSB.

At below 0.5x P/BV, AIB appears absolutely cheap and is also cheap relative to UK peers, which typically trade on 0.6-0.7x P/BV. This is another valuation anomaly, given Ireland's recent economic performance, demographics and growth prospects are all more attractive than the UK's. To say nothing of the fact that Ireland has not just shredded relations with its main trading partners. AIB is just too cheap for a dominant operator in what is such a favourably structured market; in the longer term it does not seem likely that the largest Irish bank will be making the desperately poor return (<= 5% ROE) that is commensurate with the 0.5x P/BV at which it is currently trading.

Finally, the portfolio's "half new" position is in Wickes Group, which was spun-off from an existing holding, Travis Perkins, in April. At the time of Wickes' demerger it was a very small position on the fund, which we then added to, as we like the valuation and the group has strong operational momentum and should thrive as an independent entity. The group looks relatively well-placed vs DIY and materials distribution peers, possessing a well-invested and right-sized estate of stores and the balance sheet is strong, as Travis Perkins span it off with £130m of net cash. Wickes has historically been a 5-6% margin business, so the 0.33x sales that the group is valued at looks decidedly cheap, equating as it does to a normalised EV/EBIT of c. 6x. Finally, it seems unlikely that the group, with a market cap of just £600m, will remain independent in the longer term, with possible acquirers including one of the private equity houses that are currently active in the builder's merchanting space.

David Lynch, Fund Advisor, VT Lyndon Fund, July 2021

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