VT Lyndon Fund

Quarterly Commentary 30th June 2022

ContraCapital

Nowhere to run to, nowhere to hide

The second quarter of 2022 was a difficult one for investment markets globally. For example, the MSCI World Index – probably the most widely used global equity benchmark index – fell by -17% (price return in US dollars) and all major developed and emerging equity markets were down. Fixed income markets totally failed to offset this, with the weakness seen in Q1 continuing into Q2. The UK 10-year gilt yield has risen from 0.90% at the start of the year to 2.25% at the end of June, whilst the US 10-year treasury yield has doubled from 1.5% to 3.0%. The prices of fixed income securities are inversely related to their yields, so the S&P UK Gilt Index, a widely used benchmark for gilts, was down by -8% in Q2 and by -15% for the year-to-date.

With equity and bonds headed down in concert, there were not many places to hide for investors. Even commodities, which had been one of the few bright spots in the first quarter of the year, failed to provide much comfort in Q2. Broadly-based commodity indices, such as the S&P GSCI Index, peaked during March and but then slipped back a little in Q2. Within the commodity space, oil and the wider energy space have remained closer to March's peak levels than metals or agricultural commodities, due to the specific supply-side issues resulting from Russia's invasion of Ukraine, but even oil is now well off its highs.

Industrial metals have been considerably weaker, the S&P GSCI Industrial Metals Index was down -19% in Q2 and, perhaps most notably, the key industrial metal, copper, was down by more than -20% during the quarter (all commodity prices quoted in US dollars). The metal is nicknamed "Dr Copper", as it is reputed to have a PhD in economics due to its ability to predict turning points in the global economy. So, the recent sharp fall in the copper price is widely seen as portending a global recession, a message that is very much supported by the price action in most other commodities.

Precious metals have also been weak, surprisingly so. "Surprisingly", given that they are typically viewed as a good place to hide during periods of heightened geopolitical risk and also as a hedge against inflation, so right now very much "should" be their time to shine.

The Fund failed to buck the trend, falling by -4.1% during the quarter (figure cited is for VT Lyndon Fund B Acc units), as the portfolio's holdings in mid-cap UK domestic cyclicals continued to be a drag on performance. Against a backdrop of rising interest rates and falling real incomes, investors have fled from UK cyclical stocks as the odds on a severe economic downturn have shortened. In particular, stocks exposed to construction, home improvement and the housing market more generally, such as Grafton Group, Headlam Group, SIG, Travis Perkins and Foxtons were very weak.

In a rising interest rate environment this is perhaps not overly surprising, but the starting valuation of these stocks was *very* low. So, whilst we fully expected the "cost of living crisis" to be a theme in the UK this year, it seemed reasonable to conclude that a lot of bad news had already been priced in. Not enough was, clearly. We are naturally drawn to bad news, for as investing titan John Templeton advised: "don't look for the good news, but for where the bad news has been." However, the markets do tend to overreact and we believe that a surfeit of bad news is now priced into many of our holdings, with these being stocks where sentiment is currently very negative, but whose fundamental earnings power and fair value have not been impaired.

We observed last quarter how cheap some individual stocks had become and at what a low multiple of profits the Fund's equity portfolio was trading in aggregate. The figures are naturally now even more striking. All of the stocks listed above fell by -20% or more during the quarter and are trading at some pretty remarkable valuations. For example, Grafton Group, which we called out last time, now trades on less than 5x this year's forecast operating profits and below 4x EBITDA (both calculated on a pre-IFRS 16 basis). To recap, this is a notably well-run distributor of building materials in the UK, Ireland, the Netherlands and Finland, which at the last year-end held a net cash position of c. £600m, which currently accounts for a third of its market capitalisation.

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Similarly, Headlam Group, which is Europe's leading distributor of floorcoverings, is also now trading at less than 5x this year's forecast operating profits and holds a net cash position. Overall, the equity portfolio is now valued at below 7x this year's and less than 6x next year's operating profit (based on consensus estimates and on a pre-IFRS 16 basis). And, again, these are multiples that would be regarded as very low for a small private company, but these are positively peculiar multiples for the solid, robustly financed, growing and non-structurally threatened businesses that most of our portfolio holdings are.

We are continuing to see a lot of value, both within our existing portfolio positions – we added further to our holding in Grafton Group during the quarter, for example – and in the wider potential investment universe. The opportunity set remains rich.

One area where we are finding compelling value is in auto parts and, having built a position in Vitesco Technologies in Q1, we added another auto parts producer, Melrose Industries, to the portfolio in Q2. Melrose is an unusual entity in that it follows something akin to a private equity strategy, but does so whilst operating as a publicly listed vehicle, albeit one utilising relatively little leverage and seeking to turn around just one business at a time. The group's stated strategy, unchanged since inception in 2003, is "Buy, Improve, Sell", something it has practised very successfully. The business that Melrose is currently endeavouring to improve is GKN, which was acquired in 2018. Typically, Melrose seeks to move through the three stages of its process in 3-5 years, but Covid has significantly slowed things down this time.

GKN's two main business lines are Automotive and Aerospace and, with both of these markets hard hit by the pandemic, their revenues last year were down by a third versus the pre-pandemic levels of 2019. These are decent businesses with strong market positions, especially Automotive, which has c. 50% global market share in Constant Velocity Joints and sideshafts, and 30% in all-wheel drive systems. We see no good reason why all of the group's divisions will not recover in time, nor why management's targets for margin expansion will not ultimately be successfully realised.

A recovered group, with revenues back at 2019 levels and generating management's targeted margins would likely be worth c. 250p and the shares were trading above this level in the months immediately preceding Covid. Since then the balance sheet has been strengthened, with debt paid down from £3.4bn to below £1bn (1.3x EBITDA), GKN's defined benefit pension position has improved from a deficit of -£983m to a net surplus of +£179m, £1.2bn has been paid out to shareholders and the share count reduced from 4.86bn to 4.37bn. This speaks to something else we like about Melrose, which is that this is a notably conservative group, that uses leverage lightly, has a good record in taking care of group pension schemes and does not use complicated tax structures or planning.

We also initiated a position in HeidelbergCement, which is one of the world's largest cement producers and is headquartered in Germany. The group has a sprawling global reach and a product portfolio primarily consisting of cement, aggregates, and ready-mix-concrete. The valuation is bargain basement stuff, with the group trading at below 6x this year's EBIT, a price to earnings ratio also of 6x and the shares have performed horribly, being down -50% from their 5-year high of €96. The all-time high was as long ago as 2007 and the shares would have to appreciate by +150% to regain the €120 they attained back then.

On a basic reading of the objective facts such a valuation is more than a little hard to understand, as HeidelbergCement is one of the world leaders in a massively important industry that should be able to sustain growth broadly in line GDP. In the group's largest, home market of Europe, the cement industry endured a dire post-GFC decade, but this has resulted in a more consolidated and rational industry, which should bode well for profitability and there is much potential recovery still to come, as industry volumes remain well below their pre-GFC highs. At the stock specific level, HeidelbergCement has a strong balance sheet (Debt:EBITDA of c. 1.5x), management really does look to have got the message on capital allocation and is far more focused on returns. Cash generation is good and the dividend yield healthy at 5%.

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So why are the shares down here in the bargain bin? The group's chequered history may have something to do with it, albeit the share price was very much higher than its current level only last year, so perhaps not (and the whole sector looks pretty cheap). Fears of an imminent recession are, not unreasonably, being factored into valuations by some. However, the best explanation for the deeply out-of-favour status of HeidelbergCement and its consequently paltry valuation is the growing prevalence of ESG considerations, with an emphasis on the 'E'. Cement production is, after all, one of the largest emitters of Co2, accounting for 4-8% of the global total of emissions when all stages of production are taken into consideration. Among materials, only coal, oil and gas are a greater source of greenhouse gases. However, whilst it is one of the largest contributors to carbon emissions, concrete is also the second most used material in the world after…water. And, for good or ill, there really is no commercially viable alternative available nor even one on the horizon. Nevertheless, in the current market obsession with all things green and sustainable Heidelberg (and its peers) seem to have been cast into the uninvestable bucket by too many investors; there is surely some baby in that bathwater.

Finally, we initiated a position in Rank Group, a UK-based gaming group. Rank operates 52 land-based casinos in the UK (Grosvenor), 72 land-based bingo halls in the UK (Mecca) and 10 in Spain (Enracha). In addition, it operates more than 100 digital gaming brands including Mecca and Grosvenor for the UK market and Enracha and Yo for the Spanish market. Rank also operates online rummy in India through a JV (Passion Gaming). This makes Rank the largest operator of casinos (by number) and second largest of bingo halls in the UK. Bingo is in gentle or perhaps not so gentle long-term decline, but the larger casino business (49% of revenues pre-pandemic, vs Bingo 28% Online 17% and the International business 6%) should have decent longer term growth prospects. The casino market is tightly regulated, with exceedingly high barriers to entry and Rank's assets here are at least potentially very valuable, possibly more so to others than the current holders.

The last couple of years have naturally been awful for the group, with venues having to be closed for much of the period and this also hit the online business, which relies considerably on cross-sell to in-person players. The timing of the pandemic was more than a little unfortunate for the group, as in 2019 and early 2020 Rank was performing very strongly operationally, with its transformation plan seemingly working. The share price hit a multi-year high above 320p on the eve of the Covid pandemic; they are now more than -70% lower. This means that Rank is one of few "reopening plays" that hasn't recovered. At all.

We acquired our position after the shares took another leg down in response to a poor trading update at the end of April, with the key contributor to the disappointing trading being a lack of non-UK visitors to London. However, this is surely an ephemeral headwind and a full recovery is still to be expected over the next couple of years. In addition to a cyclical recovery, it is at least possible that Rank could be one of the few potential beneficiaries of the current on-going gambling review. Firstly, if tighter limits are placed on online gambling, specifically limits upon staking or deposits at online casinos, then Rank could benefit from any substitution away from what would then be more constrained online gaming to less constrained bricks and mortar venues. In addition, there's at least an outside chance that bricks and mortar casino regulation could actually be eased, with an increase in the number of gaming machines permitted. It is estimated that such a change would boost group operating income by +40%. This is clearly not in anyone's numbers.

One of the reasons that the UK market is so rich in opportunities at the moment, is that the clown car politics (and economics) of recent years are clearly set to continue, just with a slightly different driver. It is therefore easy to understand the distaste that many investors feel for the UK market, we feel it too. However, the valuations that are currently on offer in many areas of the UK equity market do not allow for undue pessimism. Valuations this low and sentiment this negative generally portends good subsequent medium-term returns and consequently dictate a more bullish approach.

That beaten-down value stocks should be set to outperform is supported by research from Sanford Bernstein, a leading sell-side research and brokerage firm. They observe that a strategy investing in lowly valued and high cash flow yielding stocks has "outperformed historically during slowdowns and recessions, and is inherently short duration, which is attractive in an environment of rising interest rates." So, if we can buy equities in non-structurally threatened companies that offer a double digit free cash flow yield and possess strong balance sheets (and we currently very much can) then we should be well set.

(Source: for all share price and index movements is S&P CapitalIQ and are quoted in local currency unless otherwise noted).

David Lynch, Fund Advisor, VT Lyndon Fund, 25th July 2022

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