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MIRABAUD - UK EQUITY HIGH ALPHA MARCH 2020 REVIEW AND OUTLOOK

Jeremy Hewlett - Senior Portfolio Manager, UK Equities

Part 1: Background

"If something cannot go on forever it will stop" (Herbert Stein, economist)

Impermanence. It's innate to life, so it's definitionally true that "this too will pass", whatever 'this' is. Obviously, it's extremely alarming and scary that 'this' primarily happens to be a respiratory virus pandemic, but Coronavirus 'too will pass' (as too will concomitant share price hysteria – more of this later). To say that the current threat to life and dislocation to daily routine will pass isn't to underestimate the severity of the health threat or indeed the seriousness of the consequences for the global and national economy, on the contrary, without a policy response Imperial College's COVID-19 Response Team predicted 500,000 deaths in the UK (2.2m in the US). The 'medicine' ('lock-down') is itself a death sentence for investment capital broadly and some equity capital specifically; in our world, threats don't come more serious than this. What matters most for our investors (their health and the health of their loved ones aside) is first that their capital survives intact and, second, that with it we take advantage of rich pickings amongst unparalleled opportunity to generate superior returns through to 'the other side'. This is our focus, as we maintain our investment disciplines with the certainty that coronavirus and the stock market's hysterical response will pass.

Sitting down to write this, the aim was to talk about the Fund's holdings not as share prices but as strongly capitalised businesses, focusing on their 'see you on the other side' credentials and undoubtedly improved competitive prospects when they emerge, bathed in a new sunshine, but it's impossible not first to discuss the background context of Coronavirus, which is all pervading in current decision making.

Covid-19

Stating that coronavirus will pass eventually is hardly insightful, as to how long will be the wait is evidently crucial, but it's our belief that the current lock-down can only be administered for a couple of months, perhaps a quarter, but not quarters or the better part of a year. This is a highly contentious statement, given that the government is likely following advice that models suppression strategies in place for five months or longer (where 'longer' is defined as 18 months or more, dependent on the length of time taken until large stocks of vaccines are available to immunise the population). In fact, outsiders can't know precisely what the government is thinking given decisions in emergency are informed in secrecy. However, we set out in the appendix the thoughts and understandings that lead us to believe that lock-down restrictions will be lifted earlier than publicly indicated and widely accepted, conclusions which, of course, inform our investment perspective.

Part 2: The stock market

Had someone told us, a month ago, that the country, and most of the world, would be in total lock-down, we would have struggled to believe it. Centrally imposed lock-down and zero-revenue for businesses is, blindingly obviously, a shock to the system. Few, if any, businesses are capitalised to survive a prolonged period without revenue. Most will simply go bust notwithstanding government intervention. Businesses rarely hold, or have access to, cash resources sufficient to meet fixed costs against an environment of zero revenues. Hence market weakness is entirely consistent first-order thinking (company prospects have fundamentally worsened, so 'sell'). Obviously, our arguments in *Part 1* indulge a little in second-order thinking, i.e. unless scientists have mis-understood infection fatality rates, then a prolonged lock-down period is unsustainable given that the economic cost will outweigh the utility. Hence, 'strong-hand' businesses with the structure and the resources to survive may leave owners' interests less impaired than popularly feared, and quite possibly even enhanced as weaker competitors are, in cases, forced to shrink to fit. Therefore, our thinking mode is also 'second-order', of buying opportunity.

Certainly, lock-down's the equivalent of a dramatic, sudden low tide that reveals who's swimming naked, which for over-indebted corporates is always an ugly sight. To mix my metaphors, companies with high fixed operating costs and leverage that suffer a revenue heart-attack will likely need immediate resuscitation in the form of new equity capital to survive. In this crisis 'liquidity' is of paramount importance, in the absence of revenue even highly solvent businesses will need new equity funding without access to cash sufficient to meet fixed costs. Moreover, an 'inter-play' is that those drawing on 'liquidity' in the form of access to bank borrowings will cause debt levels proportionate to cash-flow to rise, inevitably stressing bond covenants. Hence, without a cash injection from new equity, owners of weak-hand business risk part, or all, of their claim on future profits passing to bond holders and banks given that zero revenue, even for a very short period, will inevitably cause a breach of net debt to 'cash-flow' covenants, enabling creditors to seize the company's assets. Whilst we are confident that in practice bond holders of investment grade credit will waive their covenants, fears that they may not are real. In other words, should new equity capital be raised the per share value of businesses thus exposed will inevitably fall and shareholders who don't, or can't, commit proportionally to their existing capital will also end with their interests diluted. These mechanics certainly help explain the market rout. It behoves investors to be 'alive' to realities; for us, Carnival Corporation serves as an example. We could not have envisaged, a couple of years ago, a 90% share price collapse, the business is ostensibly highly solvent (net tangible assets, i.e. approximately 105 ships valued at circa $380m each on average are around 4.0x greater than total liabilities) but in this crisis the company has insufficient liquidity to fund its running costs, hence the need to raise additional capital which has come at a significant cost to owners.

However, such fears have given rise to stark anomalies in an indiscriminate uniformity of price falls; the market has made little effort to distinguish between companies that will, and those that won't, require new equity capital, and even between those that are more and those that are less exposed to the business cycle.

As stated, businesses that have the right share count may survive the current period with shareholders' claim on profits relatively unscathed. The value of any business that has a future lies in that future, in the cumulative profits of that future and not in any single year's profit or in the immediate year's profit. To lose the current year's profit is a misfortune, but on a 10 - 20-year time-frame the loss of the nearest years' profit is perhaps 5-10% of the value of all the future profits (depending on speeds of recovery, growth rates over the ensuing years and the business' longevity). The diminution in value from the loss of the current year's profits is even less if the value of those profits is then set against the much lower cost of money that now prevails following significant cuts to interest rates, and this says nothing of an improved competitive environment for future years as weaker operators curtail their growth ambitions.

Whilst the market has fallen by ~35% in aggregate (the market's recent low) plenty of individual share prices have fallen by ~50 - 75% with little, to no, appreciation of strong-hand and weak-hand differences as stated above. For example, whilst starting from similar valuations, TUI Travel, the travel operator (not owned) and On The Beach (OTB), an online travel agent (owned) fell 64% and 65% respectively in March. TUI is a substantially indebted business with very significant fixed operating costs, plus the cost of servicing debt. The business operates 150 aircraft, 440 hotels and 18 cruise ships, employs around 71,000 people and cash burn on administrative expenses alone is over £100m/month (excluding finance leases on aircraft, ships and hotels, etc). At the same time, the Group has ~£2.5bn net debt (or ~£4.5bn if leases on aircraft, hotels and ships are considered debt) and conventional debt covenants of 3x ND/EBITDA. We therefore see the stock as a weak-hand. Meanwhile, OTB has fixed costs of ~£10m and over £50m of net cash in January (a chunk of which will have been spent on increased marketing post Thomas Cook's failure), so we believe OTB can theoretically keep going for at least a couple of years without need of additional capital, making it a strong-hand in our view. It is anomalous that the market should treat the two share prices the same.

Indeed, the anomaly gap between price and value is extreme; so extreme that we believe investors have been presented with one of the great buying opportunities in recent history, alongside the 1987 crash, the bottoming in 2003 of the TMT bust and the aftermath in 2009 of the 2007/8 global financial crisis. To substantiate this, the starting point is something of a rhetorical question, when looking at the share prices of businesses we know well (with share price falls at intra-month lows between 50% and 75% for half the portfolios' holdings), we have had to ask, "who on earth is selling?" By implication, no one is selling, on valuation concerns, strong-hand companies already down by over half, hence selling is irrespective of price which is consistent with the point of capitulation. Ex post we can rationalise either general or specific explanations for distressed selling, the former most likely being Exchange Traded Funds selling baskets of stocks for investors, irrespective of a stock's discrete valuation, and the latter either credit investors 'hedging' their positions by shorting the underlying equity or most likely individual holders reaching the psychological point of capitulation. Indeed, red ink – and lots of it – does strange things to the mind even for those who know their companies well. Moreover, it's worth putting ~ 50% - ~75% share price falls into a valuation context; in essence buyers of strong hand companies now have, on a 'look through' basis, fantastically truncated waiting times to double their money whilst being paid handsomely to wait (investors will do well to remind themselves that a price-to-earnings ratio effectively measure the time it takes to double invested capital, all equal); PE ratios and dividend yields are, in many instances, near equivalent (e.g. ~8.0x earnings, ~6.0% yields), this against a global background of unprecedented central bank stimulus whilst interest rates and bond yields are prevalently negative in real terms. 'Through to the other side', half-priced, UK quoted growth businesses are compellingly valued and share price reaction has been somewhat hysterical in our opinion.

It's worth highlighting here just how volatile share prices have been. It's impossible for share prices to be even vaguely reflective of franchise values in volatility that changes pricing by ~50% one day to the next. Intra-day moves have rarely ever been so extreme. The Fund's holding in Intermediate Capital serves as an example, with an intra-day move on the 19th March of ~100%, i.e. the share price was, from the previous close, +10% in the morning, -25% by mid-afternoon and +35% at the end of the day. Whilst we consider every holding a strong-hand, wild swings in pricing are currently par for the course and we think investors need to be stoic, understanding that prices prevalently bear no resemblance to underlying business's intrinsic values.

Part 3: Fund positioning and activity

March has been a busy month, to say the least. In round terms, position changes sum to ~50% of the Fund (new holdings, exits, increases and decreases), albeit we generally view proactive decision making to be better represented by half the figure. Nevertheless, change has been meaningful to the point that we are confident the Fund is of higher quality and higher value than at any previous time we can remember. We continue to monitor each and every holding's liquidity position; all holdings must remain strong-hand companies able to see their owners through to 'the other side' without recourse to new share capital. Once such strength is better recognised, we expect that price differentiation and recovery should be highly satisfactory.

New Holdings

- **Berkeley Group:** the London centric house builder holds ~£1bn of net cash, with forward sales of ~£2bn. In lock-down the Group won't be able to generate cash from the order book, but nonetheless we expect that the £1bn cash balance should cover operating expenses (~£160m a year) for the foreseeable future.
- **Diageo**: the global alcoholic beverages brand has an exceptionally strong liquidity position in our view. The Group has no financial covenants on corporate debt and bank facilities are subject to a covenant of two times interest cover (versus 8x cover achieved in the last financial year). Moreover, the Group has an undrawn bank facility

of over a £2.75bn, equal to over eight months operating expenses whilst operating expenses in the last financial year were under half gross profit. Even should cash generation be significantly depressed by weak on-trade activity through clubs, pubs, bars and restaurant closures (notwithstanding reports that consumers are stockpiling alcohol in the lock-down!) we expect the Group to continue to generate cash from presence in ~180 countries globally.

- **Next:** the apparel and home-ware retailer has modelled mitigating action, in a worst-case trading scenario, that maintains headroom between rising debt and Group cash resources which, by year-end would represent headroom of over £1bn. This neither includes extending bank liquidity by ~£200m (in discussion, with their banks already having agreed to waive covenants) nor using the government's loan facility. Once through to the 'other side', owners would have a free option on Platform Plus and Total Platform, the former being sales of third party brands on Next's platform (incremental revenues but at lower margin than own brand sales) and the latter being a new venture as the solutions provider to a 3rd party online apparel businesses, in return for commission on sales.
- **London Metric:** A real estate investment trust (REIT) with a portfolio 70% comprised of last mile urban and regional distribution warehouses, critical to the growth of e-commerce, and 25% comprised of 'convenience' retail 'sheds' with the balance of the estate a mix of retail park and offices. Occupier covenants across the Group are strong, with Amazon, Tesco, M&S, TNT, FedEx, DHL, and Primark among the anchor tenants in distribution, and Aldi, Costco, Lidl, Dunelm, Safestore among the key tenants in convenience retail 'sheds'. Overall, rental income is secured on a weighted unexpired average lease term (WAULT) of over 11 years. The Group's financial position is solid in our view, with rental income of over ~£55m, administrative expenses of less than £14m and undrawn bank facilities of ~£75m, alongside Group debt that is less than 40% of the property value with interest more than 4.0x covered.
- **Compass Group:** we purchased this global contracted catering company in early March, following a positive outlook statement, prior to lock-down in the UK and USA and ahead of the Company's mid-March COVID-19 statement. We now model a 54% drop in revenue for the 2nd half of the financial year, which we calculate to be equivalent to a 30% drop in revenue for the full year. On these assumptions the Company will likely cancel the interim dividend albeit it doesn't follow that the Group will raise new equity capital, given both a strong liquidity position (£1.5bn undrawn of a £2bn syndicated revolving credit facility which contains no financial covenants) and what we consider to be a bright future as leisure, entertainment and education activities resume.

Increased Positions

- **Intermediate Capital:** A private bond and credit fund management business with balance sheet capital (with some modest leverage) which is co-invested with client's monies into funds 'locked' for a six to twelve year life. Moreover, as private market investments are not readily discernible in value, management fees are levied against either invested capital (predominantly so) or committed capital (less so). In other words, Intermediate's basic fee income is not altered by financial market movements. In addition, not all of committed funds are currently invested; in certain strategies putting committed capital fully to work can take five years, with a further six or seven years until the funds are fully realised and money multiples crystallised. It follows that the current economic disarray is opportunity for around the half of Intermediate's funds by number that still have capital to invest. In total, Intermediate manages ~€43bn capital in 21 strategies lent to ~250 companies across 24 industries, with less than 10% lent to industries worst impacted by COVID-19, e.g. aviation and travel. Third party capital undermanagement has grown by four-fold over the last decade, with growth certainly due to the attractions of through-cycle performance (over 30 years the minimum gross money multiple on all realised funds is 1.8x) but also due to the secular tailwind of very low interest rates globally. Whilst rates remain low and capital in search for yield, investors may be well served by Intermediate, given the Company's ability globally to originate strategies and deploy capital, the low risk nature of fixed-incomes strategies and the track record of attractive investment returns. During March, Intermediate's share price collapsed by ~72% at the low point (a 75% fall from February) and during this fall we increased the holding to become the largest position at just over 9.0% of the portfolio.

- **St. James's Place:** As a wealth manager, the cash result will evidently be meaningfully, adversely affected by 'variance' (the market level's impact on fees and performance). However, client behaviours through previous financial crises have been consistent with long-term investing (buying the 'dip' where possible), significantly because clients themselves are 'strong-hands' (they are not leveraged and they are relatively long-term investors). Moreover, ~30% of assets under administration (AuA), i.e. ~£40bn, are not fee earning but in gestation, subject to a 'penalty fee' if withdrawn within six years of the initial investment. Hence gestation funds specifically are unlikely to be withdrawn in our view, despite investor's wider panic. All equal, over the next six years the gestation funds will release a further ~£350m of cash to the business, effectively doubling 'steady state' earnings and dividends, effectively placing the business on ~7.0x 'look-through' distributable profits and on a dividend yield of over 10% on current distribution policy, six years forward.
- **Hargreaves Lansdown:** We believe investors in Hargreaves will survive current times with their ownership intact, given that the company is unencumbered by debt, cash generative and one of the most profitable business in Britain (~65% pre-tax profit margin). Moreover, we are not concerned by the apparently demanding headline valuation (~25x profits) for a number of reasons. First, Hargreaves is still a robust growth company in our view (the addressable market is, itself, of secular growth whilst Hargreaves' is increasing its market share); second, with the collapse in interest rates, risk premia for the highest security equity (that on a par with genuine bond quality, as Hargreaves is) should now be much higher. Hence we see scope

for Hargreaves to trade at a lower risk-premium or higher price. Third, we think shares' transactional activity in the current period will be exceptional and, fourth, Hargreaves' active savings product brings cash as an asset class onto the platform, i.e. the product addresses an incremental £875bn of savings (albeit at low margin).

- **Fever-Tree:** Clearly, revenues for Fever-Tree are not as assured as those above, particularly as a meaningful percent of sales will likely be lost to lock-down (i.e. those to the on-trade, pubs, clubs, bars and restaurants). Nevertheless, Fever-Tree has £130m in cash, the business is highly cash generative, asset 'lite' and, in our view, a distinguished domestic brand with enormous global potential. We think there's little likelihood of owners being asked for further capital and at the current valuation, growth potential is attractive.

Intra-Period Entry/Exit of holdings

During the mid-month rout, we bought a position in Schroders (~40% below the share's month-start price) and a position in Brewin Dolphin respectively (~50% below the month-start level), with the intention of building larger, long-term holdings. However, the share prices rallied very significantly (~20%) the following day with extreme volatility coupled, in the case of Brewin Dolphin, with illiquidity and we preferred to exit the positions in favour of adding to existing holdings commented on above.

Eliminated Holdings

New holdings were funded by the sale of Ferguson, Reckitt Benckiser, Fidelity National Information Services, GBG and YouGov. Stock sales were effectively for grounds of relative opportunity.

Decreased Positions

We decreased Bellway, DS Smith, Trainline and Clinigen. We believe that Beltway (and all house builders held) has sufficient liquidity for their equity to remain intact through the crisis, however we switched 2% of Bellway to help fund the new position in Berkeley Group. We also reduced DS Smith; the shares had held up very well relatively, the Group has substantial liquidity ($400m cash recently received from the sale of the Group's plastic division together with a £1.5bn revolver credit facility) and the company's heavy dependence on food and drink packaging is of 'protected status', hence we expect all plants to remain running, with e-commerce a driver of volumes. Nevertheless, DS Smith is a 'GDP+' business (corrugated box volumes are directly correlated to economic activity) and with the shares having held up well and with economic activity inevitably going to be weaker we reduced the holding. We reduced Trainline relatively sharply, despite £50m net cash on the balance sheet, the business has no guaranteed revenues in our view. Finally, we also reduced Clinigen, a specialist in sourcing and distributing drugs, globally, on behalf of pharmaceutical companies and individuals. In a case of unfortunate timing the business is relatively indebted having recently completed an acquisition funded by debt that has performed well and triggered further earn-out payments, delaying the Group's ability to pay down debt.

Conclusion

We understand that the Fund is going through a tumultuous time, as investors struggle to distinguish between weak and strong hand businesses and to understand the changing values of their interests. However, we are confident that we know the value of the Fund's collective interests and that the value is significantly greater than implied in current pricing. The Fund doesn't own share prices, per se, but through them claims on future cash flows, the present values of which today are vastly greater than reflected in their share price levels. Bear markets and stock market corrections evidently have a real wealth impact, but ultimately, they do two things, they cause financial assets to move from weak-hands to strong-hands and they provide strong-hands with rich investment opportunity. We are confident that the Fund holds strong-hand companies which will not only withstand lock-downs' economic and financial stress, but which will also be able to benefit meaningfully from an improved competitive landscape, when bathed in the sunshine of the 'other side'.

Appendix: Covid-19, thoughts and findings informing our investment perspective

The government is advised by SAGE (the Scientific Advisory Group for Emergencies) normally chaired by the government's chief scientific officer and SAGE, in turn, draws on wider expertise. SAGE has drawn on the work of Imperial College's COVID-19 Response Team, whose 16th March paper 'Impact of non-pharmaceutical interventions (NPIs) to reduce COVID-19 mortality and healthcare demand' is publicly available. I am not an epidemiologist, and certainly no expert in pandemics but the Response Team's advice is made – and acknowledged as such – "without considering ethical or economic implications". The Team's priority is to model the strategies that minimise fatality rates which therefore keep requirements for intensive care unit (ICU) beds at a level with which the NHS can cope. Prior to latest capacity initiatives, the UK had only 4,000 ICU beds (with ~80% typically in use) for a population of 7m people over the age of 70 (with ~2.8m over 80s). Should beds be insufficient, then fatality rates will rise sharply. Clearly, this is an alarming possibility, made all the more real by the fact that it's going to take very little to overwhelm the NHS.

The only alternative to lock-down suppression is aggressive case identification, isolation and extensive contact tracing. To be effective this requires a very large number of tests be administered (leading epidemiologists, such as Prof Julian Peto, have suggested the entire UK population would need to be tested weekly). Establishing this kind of infrastructure will also take time. For now, government policy is 'beds and tests before the economy'.

The current policy response is laid out in the COVID-19 Response Team's paper, it's comprised of five suppressions or 'lock-downs' (case isolation, voluntary home quarantine, social distancing of over 70s, social distancing of the entire population, and closure of schools and universities). Such draconian measures are necessary given current projections of the rate at which the disease spreads. The measure of epidemic potential is the basic reproduction number (R0, or R-nought) – i.e. the average number of secondary infections produced by a single infected individual in an otherwise entirely susceptible population. The critical issue is whether R0 is greater than one, for example

R0 in coronavirus is thought to be 2.2, so one infected person infecting 2.2 others who each in turn infect 2.2 more. Left unchecked, the NHS would be over-run in no time. Obviously, the seriousness of infection is paramount in policy decisions.

However, the likelihood of dying from being exposed to the virus is currently impossible to determine with precision; case fatality rates (deaths over known cases) aren't a meaningful measure of probabilities for those infected, they are understated from the perspective of those currently infected who will die shortly but overstated from the perspective of unreported and undiagnosed infections (and the suspicion here is that this number is many times known cases). The broadest fatality rate (the infection fatality rate) is deaths over everyone infected, which given that those infected but not seriously ill are highly prevalent in number and typically not included in official statistics given resource constraints on testing and those 'asymptomatic' aren't part of the statistics either. Hence it follows that the infection fatality rate will be meaningfully lower than the case fatality rate.

Moreover, the aggregate case fatality rate is of little predictive power as it is widely different to rates by age cohorts and to rates between those with pre-existing health conditions and those without. At the beginning of March, SAGE's best estimate for the infection fatality rate was 0.5% to 1%, ranging from 0.01% in the under 20s to 8% in the over 80s; the case fatality rate estimate was 0.25% – 4%, with expected mortality rates of 12% for hospitalised people, from 4% in the under 50s to 20% of over 80s, with 50% mortality in those hospitalised who require invasive ventilation (SPI-M-O consensus statement 2nd March 2020). These estimates were based on China's precedent and the broad spread within estimates is because of variance in findings between the World Health Organisation and the Chinese Centre for Disease Control and Prevention (CCDC). (Report of the WHO-China Joint Mission, 28th February and CCDC data 17th February).

Logically, the best available wide-scale laboratory test for death rates remains the involuntary testbed of the Diamond Princess (a cruise ship owned by Carnival) which was quarantined off the coast of Japan earlier in February. Almost all on aboard (3,711) were tested, 634, or 17%, had the virus whilst 328 had no symptoms at the time of diagnosis. Of the 306 with symptoms, the fatality ratio was 1.9% (with those 70 and older with an overall fatality ratio of ~7.3%). Hence the overall infection fatality rate was half again (i.e. below 1%) whilst fatalities (numerator) over all on board (denominator) was less than 0.2%.

Clearly deaths are very prevalently the elderly. Currently, the reported death rate globally is very low for those generally healthy and under 50 years old, with the corollary that the case fatality rate (~20% in aggregate, globally) is alarmingly high for the elderly with pre-existing health conditions. Indeed, the average age for deaths in Italy has been reported as 81 (LiveScience).

Finally, coronavirus deaths need to be put into the context of excess mortality rates (deaths incremental to those statistically expected in an average year). Again, this is hard to measure (e.g. some 340,000 over 80-year olds die in the UK each year and it's too early to tell whether coronavirus is distorting UK morbidity and mortality tables or, for example, that some of the ~13,000 a year who succumb to flu are instead succumbing to coronavirus).

Clearly the government's imperative is to do 'whatever it takes' to avoid deaths in undignified circumstances for want of intensive care treatment and a hospital bed. Once available intensive care bed numbers are sufficient, and there is numerous infrastructure available with which to increase capacity, then the government will prioritise the economy.

Moreover, we believe that another reason for lock-down ending earlier than not, lies in our countrymen's and women's character. Within a week, over 500,000 people have volunteered to help the NHS; the logistical battle will ultimately be won by the nation's character. Rule Britannia!

In short, once the government deems ICU capacity sufficient, then seemingly suppression policies must be relaxed in our view (particularly the social distancing of the entire population) and allow businesses oxygen. Obviously, the economy's well-being has also to be a policy priority. Indeed, the imperative to provide oxygen to the economy as early as possible will likely lead to the early implementation of an "on-trigger" / "off-trigger" suppressions policy, where suppression are lifted and re-initiated when weekly ICU patients fall and rise between desired thresholds (a scenario also modelled by Imperial College). It is therefore our view that lock-down will be lifted a lot earlier than indicated in the Response Team's initial central case estimate of five month and longer.