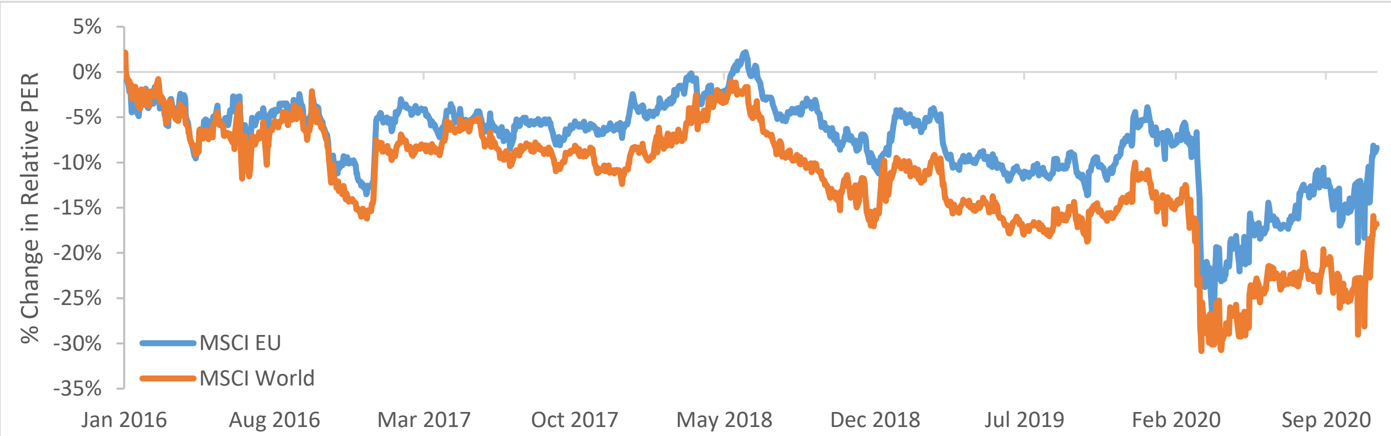
Barbarians at the Gate

November 2020

One of the emerging themes in the UK stock market over the last month has been the return of M&A. Whilst M&A activity has been on the rise globally, there has been a marked pick up in the amount of deals announced in the UK in the last few months. There are currently six bids progressing in the FTSE 350, with £22bn of proposed and announced acquisitions since August. This does not even include the two bids announced this week! It is interesting that in most cases the acquirers are overseas - both trade and financial buyers. We feel that this increase in deal activity is indicative of some of the opportunities that we currently see and offers an interesting alternative view about current Brexit & COVID-19 uncertainties and the valuation of UK PLC.

It has been discussed in previous ‘Bugles’ and the wider investment press about just how cheap the UK Equity market has become, especially relative to other global stock markets. Whilst the large cap index has some distorting sector weightings that make it look consistently cheap versus other geographies, we find that the more domestic focussed UK Mid-Cap Index (see chart) is also trading at comparatively low valuations versus global equities. What has been particularly interesting to note is how persistent this trend has been since the beginning of Brexit in 2016. This has been the case for some period of time and can primarily be attributed to the investor sentiment overhang created by almost five years of Brexit uncertainty, and the associated capital flight from UK stock markets to overseas - an amount estimated at the not-so-small sum of £11.5bn. Despite the recent rally on the back of three positive COVID-19 vaccine announcements, the FTSE 250 is still at a 10-15% discount to Global & European markets. However, if you were to adjust for the dispersion in stock markets over that period between growth and value, then the discount for some sectors is even more extreme. We estimate that the bottom quartile of the FTSE 250 is trading at a 60% discount to the index’s average, suggesting an even greater discount versus international markets. What is additionally striking is within this subset of companies, the common theme being that they are generally more balance sheet and capital-intensive businesses - including sectors such as housebuilding, property, financial services, and certain industrials.

UK Mid Cap PER Relative to Global & EU Markets[1]



[1]Source: Bloomberg, MSCI, Tellworth Investments, as at 24 November 2020

It is worth emphasising at this point that at Tellworth we take a balanced view on the ‘growth versus value’ debate - finding equal conviction in value situations, or those companies which we feel can more than grow into their valuations. However, in parts of the UK market there appears to be a very different view of risk, and the cost of capital priced into some stocks versus others. It is largely logical that high growth and high margin companies with low invested capital should trade on very high multiples - especially when the global cost of capital is low. However, it is less logical to us that this low cost of capital is applied to some companies and not to others, especially those that are still generating healthy returns and have bright outlooks. We find this often to be the case in these more capital-intensive businesses even if they are generating returns well in excess of even traditional views of the cost of equity. The conclusion might be that Brexit and COVID-19 uncertainty is the extra risk hurdle that investors need to jump to bid up the valuations of these companies.

It is interesting therefore that M&A has returned in these more ‘stressed’ and capital-intensive parts of the market. Of the eight significant deals that have been agreed in the past few months over half of them fall into this category. Two have been in the housebuilding sector, one in mining, and one in financial services. The other areas of M&A are broad, including gaming, leisure, and healthcare. Tellworth have been fortunate to be involved in two of them; *McCarthy & Stone* and *Codemasters*. In the housebuilding sector private investors were able to buy out two developers at just 1x tangible asset value; *McCarthy & Stone*, the retirement home developer, agreed to a buyout offer from *Lonestar*, and *Urban & Civic* have agreed to an approach from *Wellcome Trust*. In both cases, the shares were trading at c.60% of tangible book value prior to the bids. The interesting theme running through both deals is that both had long land banks, with decent visibility on their future income streams. In financial services, *RSA,* the insurance conglomerate, has been bought by two overseas buyers: *Intact* and *Tryg*. *RSA* has had its problems over the years, and some had argued that its pension deficit was almost an insurmountable poison pill, yet the valuation and quality of some of its businesses were still sufficiently attractive to justify a 45% premium to the prevailing share price. Finally, on a different thread, *Codemasters*, a UK based game developer, attracted a bid from *Take-Two Interactive*, an $18bn US gaming software company. We have been shareholders in *Codemasters* for a number of years, believing that their stable of driving games would deliver more growth than the market had priced in, but also recognised that the company traded at a significant discount to international equivalents. In all cases, other investors, either with longer time horizons, different views of Brexit risks or lower costs of capital have bid material premiums to the valuations the UK stock market was ascribing to these companies.

Of course, each buyer has slightly different rationales behind each deal with different levels of strategic or financial reasoning, but it is noteworthy that three of these deals have happened at both the ‘value’ and smaller cap end of the market. To us, this confirms that there are some material opportunities that have been presented by this confluence of Brexit and COVID-19 and leaves us excited about our portfolios and our current opportunity set.

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