August 2021

LET'S GO SHOPPING

I don't remember another time like this. Good businesses at bargain prices, delivering good returns while also getting cheaper thanks to a ferocious pace of earnings upgrades.

Things were not always so. While some investors recall March 2020 as a 'blink-and-you've-missed-it' bear market, the bear market for UK value had been going on for much longer. The 2010's was a difficult period for value, and the style's underperformance accelerated through the decade. From March 2018 to September 2020, for every pound of total return delivered to UK growth, UK value investors only received 62.4p. Or, flipping the numerator, over that 30-month period, growth outperformed value by 60.2%.[1]

High Conviction

With the help of Viking and Star Wars memes, I've been banging the drum about the risk/reward asymmetry in UK value. This optimism is bottom-up: the portfolio is a collection of individual bets (stacked with a careful eye on how the risks look in aggregate).

Our equity weighting reflects our conviction – unlike many strategies, cash is our default in the absence of good ideas. At times this year our equity weighting has been 100%. I see conviction as a combination of three factors: the potential return; the risks associated with that return (we want asymmetric bets); and the availability of catalysts to drive that return (via Narrative Shift or earnings momentum).

The table below tracks our conviction. Over 41 months from inception, the Fund's equity weighting averaged 66%. In March 2020 the share prices of our equity holdings collapsed. If we had sat on our hands our equity position would have dropped to 52%, but in fact it increased to 83%. Our willingness to hold cash meant that we were able to allocate 31% of the Fund into equities that month.

VT Cape Wrath Focus Fund	% Invested	
Inception to Feb-20 (41m average)	66%	Lower level of conviction
Feb-20	69%	
Mar-20 no trade scenario	52%	
Mar-20 actual	83%	Jump in conviction
Mar-20 net equity purchases	31%	
20-Aug-21	96%	Higher level of conviction

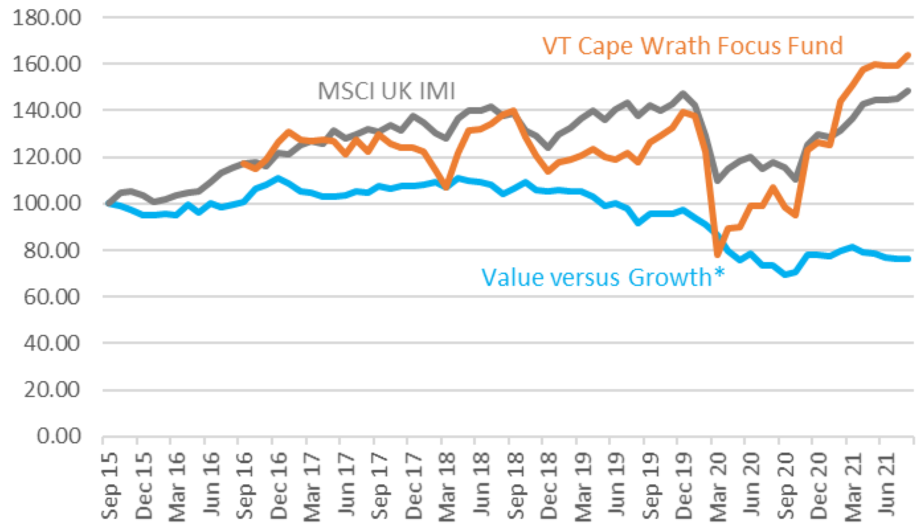
In terms of our three conviction factors – risk had increased, but so had potential return, while deeply depressed sentiment provided a behavioural catalyst.

Beyond the Factor

Research published by Trustnet has shown that the VT Cape Wrath Focus Fund has the strongest track record of outperformance when the market is being led by value stocks.

But the value 'factor' tells only part of the story. The following chart shows value versus growth, and also our benchmark (MSCI UK IMI GBP net dividends reinvested) since September 2015. From October 2016 we also see the performance of the Fund (start point rebased to the benchmark).

Fund has outperformed despite value headwinds



* (MSCI UK Value / MSCI UK Growth) x 100 *Refinitiv data 30/09/15 to 16/08/21*

Past performance is not a guide to future performance and the value of your investment can fall as well as rise

While value has been a headwind for the Fund, only a small component of performance is explained by this factor. Value indices are constructed on the basis of backward-looking valuation metrics (in the case of MSCI UK value, 3-year averages on sales, book value, earnings and cash earnings). By contrast, our assessment of value is forward-looking, and every case is different.

Browsing the Middle Aisle

Every opportunity has its own idiosyncrasies, but here are three broad Special Buy baskets.

Turnaround

The turnaround at **Capita**, the business transformation and outsourcing business, has been a long time coming, with revenues in decline since 2014 and the share price topping 800p in 2015 (after adjusting for the 2018 rights issue). Consequently, expectations and valuations are low, with the shares trading on Next Twelve Months (NTM) consensus of 6.3x P/E and 3.3x EV/EBITDA. The shares could double without becoming expensive (we see c.80% upside); the catalyst is revenue growth, which will improve both margins (high operational leverage) and cash generation (negative working capital). The two divisions, Public sector and Private sector, are recovering at different speeds, but a key metric for us is the group Book to Bill ratio which has recovered from 0.78x at FY19a to 0.94x at FY20a and with management guidance for 1.3x at FY21e. Flat revenues reported in 1H21, and guidance for growth in FY21e all point to the business being through an inflection point.

Obscure, cheap quality

With a market cap of under £300m, **Somero Enterprises**, the US-based but UK-listed laser-screeding equipment manufacturer (for super-flat concrete floors) is below the radar of many investors. This is a high-quality business with 30% EBIT margins, 40% RoIC, and net cash on a balance sheet that includes virtually no goodwill or intangible assets. A 4.7% dividend yield is boosted by regular specials and ongoing buy-back programme. We bought the shares in late 2019 after a period when bad weather had impacted the concrete laying season in the US, creating a short-term earnings blip.

Although the shares are up 140% since purchase, the multiple is virtually unchanged (a NTM P/E of 13.2x at purchase, versus 13.9x today), in part thanks to a 35% increase in FY21e EBITDA guidance so far this year, helped by the boom in demand for e-commerce warehouses. There are many ways to play the structural growth of ecommerce, but I am aware of none with this combination of quality and value.

Structurally unfashionable - a diversion into ESG

Doing my bit to support the overuse of acronyms, I approach ESG/SRI with CSE ('Common-Sense Ethics'). We sold **Chemring**, the military countermeasure and energetics manufacturer, when their sale of ammunition to support Saudi military involvement in Yemen became morally untenable (the offending division has since been sold). Palm oil is almost ubiquitous in manufactured food; we don't eat it at home and the Fund will not invest in companies that produce it.

Oil is also on the wrong side of ESG, but here we are overweight. The energy transition is coming, but we will need hydrocarbons to get there, and supply and demand will not decline in lock-step. Capital investment in the sector is around half of its 2014 peak. Oil majors reserve replacement ratios are running at close to 50%, and many have dropped this metric as a KPI altogether. It is significantly cheaper for to buy producing assets than to make greenfield investments. All of this points to oil price risk on the upside.

We own **EnQuest**, the UK North-Sea focused E&P company. On less than 2x P/E and just over 1.5x FCFE (c.60% FCFE yield) it is too cheap. We are a top-ten holder of **Gulf Marine Services**, the UAE-based owner and operator of self-propelled, self-erecting, support vessels for the offshore oil (predominantly) and wind sectors. It has recently completed an equity refinancing, which saw the major UK institutional investor exit at a 98% loss from their initial purchase price (this is what I mean by looking for 'capitulation events'), while the principal local UAE-based investor significantly increased their holding. The stock trades at a fraction of the value of its vessels, and day rates and utilisation are rising sharply.

Sale Now On – Everything Must Go

During the first half of 2021 there were 124 private equity deals announced for UK companies, totalling £41.5bn, the largest half-year transaction value on record.[2] With money pouring into private assets, PE firms sitting on record levels of dry powder, and with the UK equity market looking cheap on any metric you care to crunch, I see this trend continuing. With two takeovers year-to-date (**RDI REIT** and **Equiniti**), private equity provides an extra catalyst. I would not be surprised to look back on 2021 as a year in which a quarter of the Portfolio was sold to private equity.

If this is the 'new normal', I'll take it.

Adam Rackley

Cape Wrath Capital

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1. MSCI UK Value GBP net dividends reinvested versus MSCI UK Growth GBP net dividends reinvested; data from Refintiv, calculations from CWC
2. www.theguardian.com/business/2021/jul/09/morrisons-private-equity-buying-spree-hits-new-record-as-british-firms-targeted

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