The Best Opportunity in a Generation for UK Equities?

As we end the first quarter of 2021, the UK equity market is increasingly drawing the attention of global allocators. At the beginning of the year, many had priced the UK stock market for long-term economic decline and were positioned for a period of flat-to-slow growth and structural retrenchment post-Brexit. We have always felt the opposite.

As we have said many times, post-Brexit, the UK should be viewed in the eyes of the international investing community as a larger Norway or Switzerland - a nice place to do business, slightly different rules, still in Europe, just not in the EU. On top of this, we have now seen the UK roll out a world-leading vaccine plan, which should allow the UK economy to be better positioned for a successful, permanent, and quicker reopening.

Given this positive focus on the UK, global allocators are increasingly questioning whether the UK equity discount to other developed markets is justified. Consequently, in February UK equities received their first net inflows after eight consecutive months of outflows, and we are seeing a significant uptick in acquisitions of UK listed companies, with many M&A bankers busier than ever. This has been picked up by mainstream media and reporting has switched from the doom and gloom of the preceding years to a largely positive one for UK equities.

In terms of new issuance, the importance to the City of the "Deliveroo moment" cannot be under-emphasized. Should it successfully list, this will be the largest IPO since 2011 and may lead to a Royal Mail-style IPO bonanza and a sustained IPO "deal window". This would see many private companies "dressing up" for their own beauty parade in a race to go public and may swing the pendulum of late-stage financing away from the prevailing dominance of private equity deals and more towards listing on the public markets.

Reflecting on broader market trends, it has certainly been an interesting start to 2021, with elevated US retail trading causing global hedge fund deleveraging, the emergence of a potential commodities supercycle, and what appear to be signs of a bubble across specific areas including green stocks, Special Purpose Acquisition Companies (SPACs), bitcoin and non-fungible tokens (NFTs).

In this macro piece we have attempted to pick out various themes from the zeitgeist and asked our usual questions: "what happens if?" and "why does it matter?"

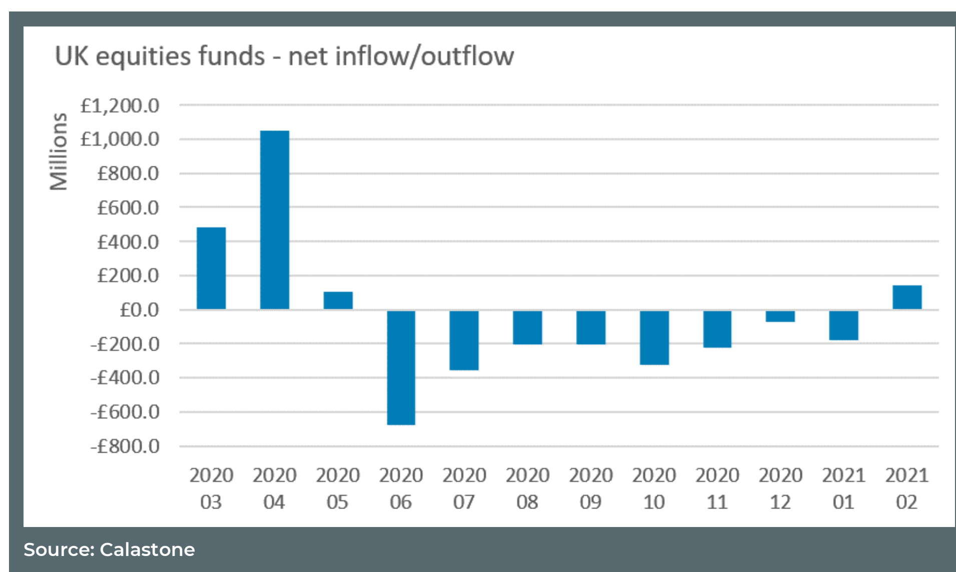
Thoughts welcome!

Alyx, Edward, Christina

What Happens If?... and Why Does it Matter?...

UK Equities Coming in From the Cold?

Having traded like an emerging market since the Brexit referendum in June 2016, the UK equities market is fast becoming talk of the town. In February Blackrock moved overweight UK equities and, anecdotally, from our discussions with global allocators we have found none that are increasing underweight positions in the UK. Contrarily many are looking to up their exposure.



Source: Calastone

As contrarians, it is always a bit awkward when things turn towards your favour, however, there is still a long road for consensus to catch up to our positioning. In terms of the vaccine roll-out, and hopefully permanent reopening of the UK economy, we still see more gains to be made from "the reopening trade".

The data suggest, unlike previous recessions, there has been considerable aggregate consumer saving during the pandemic, which means that any initial pent-up demand may give way to sustained higher spending, assuming job losses can continue to be sufficiently inoculated by Government support.

There were certainly positive signs last Summer when we exited the first UK lockdown, such as queues around the block for certain stores.

Many of the reopening stocks have now had their "reopening bounce" and there are only a few months left before we begin to see what the new normal looks like for them. Some will experience an immediate surge in demand, some a gradual increase back to pre-covid demand, and some will stay below pre-covid levels for many years, or perhaps forever.

- Office space is a big one. Although we think the third UK lockdown may have somewhat shifted worker preferences back towards office working, flexibility seems set to be the key theme. In fact, perhaps the most interesting thing to watch will be the flow of people and divergence in performance between those firms that offer flexibility and those that do not. This all supports our convictions that the share price for the likes of IWG looks wrong today – being either very cheap or very expensive, depending on your view on the direction of the above.
- Will cinema chain margins be a shadow of their former selves, mirroring the impact on banks of the great financial crisis, or will prices simply rise and promote exclusivity, with the consumer needing to book weeks in advance to get a seat (and a break from Netflix)?

- The move to online shopping and the extent of destruction on the high street is at the behest of government tax policy. They could just reduce local business rates or increase VAT for online sales versus physical stores. A national online revenue tax seems to be the preferred solution, but politics is unlikely to allow the UK to act on its own without tacit US approval and/or global co-ordination.
- Will business travel decline forever? Is there a pent-up demand that will return to pre-covid levels? Or will video conferencing permanently replace a significant portion of this demand? Again, we feel that consumer preferences may have moved on this as lockdowns have continued.
- What impact will be felt in supply chains? Will the move from "just in time and global" to "just in case and local" strengthen, or will economics win out and see a return to the cheapest available products and services wherever they may be?

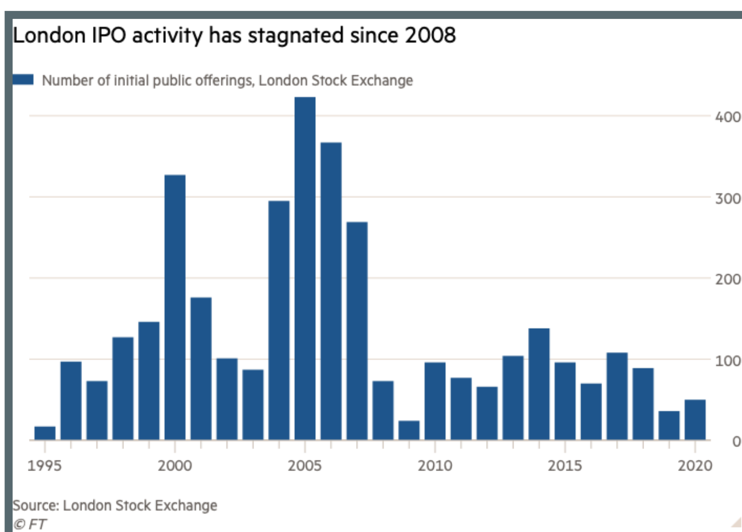
As the reality unfolds, the gap between the winners and losers of the "bounce-back trade" may have widened significantly by the end of the Summer.

London has a Long Overdue IPO Boom?

The UK IPO listings market has been in decline for several years. This can be attributed to several factors, the main one being that companies are simply waiting longer to go public, hence the VC/PE share of the economy has grown in line with their fundraising activity.

This mountain of private equity-funded companies needs to find exits at some point and the secondary market is just not deep enough to continue selling amongst themselves. If the IPO "window" opens and big companies can be floated at attractive valuations, this might kick off a structural trend where we see an increase, not decrease, in the number of IPOs.

The last decent, albeit modest, IPO window was when Royal Mail listed in 2013. The listing showed bankers that the market was hungry and would look past any negative macro monthly news flow for a year or two. This was just enough time for them to dress up a company and float it without losing face. Many did just that and the track record of this success is what partly led to the VC/PE fundraising boom over the following years. That dry powder has now been deployed and exits are due. The pressure to exit is real - if you do not exit, your track record suffers compared to peers who will likely take the lion's share during the next private equity fundraise season as a result.

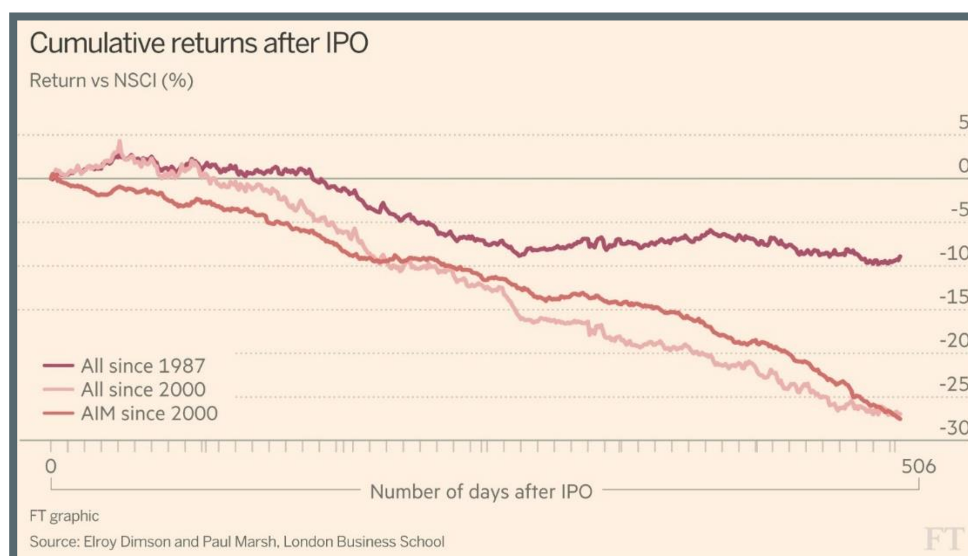


Perhaps the spark that ignites the next IPO boom, will be the upcoming IPO of Deliveroo (the largest since 2011), which follows hot on the heels of THG, Moonpig and Dr. Martens. If the IPO pops 10-30% on the first day, attracts significant US investor interest and trades strongly in subsequent days, the City will cheer and the IPO window will be officially open.

The confidence of getting it away will be infectious and all bankers will have a "London is open" slide in their decks when pitching to new IPO prospects. This might see private companies such as Graphcore, Darktrace, BenevolentAI, Behavox, Babylon and others listing in the next 12 to 18 months, assuming they are not eaten by a US SPAC first.

Or this might not happen, and nothing will change, and no-one in the press will have noticed this was a thing… But if it does happen, the "heartbeat" of the market story will change dramatically, although no doubt some of the last Brexit nonsense will be woven in. The point is that the potential for this has a skewed odds profile, and we like skewed odds. If we are wrong, nothing changes and we lose a pittance. If we are right, we make an asymmetric gain akin to a small fortune. To be clear, we are not macro traders and have not bid for any Deliveroo allocation in the Kernow strategy, it is just an interesting inflection point and an example of our investment philosophy shown in a different setting.

Having said that, we do look carefully at IPOs because they often make great short candidates, second only to frauds. Most IPO shares make money initially, then lose money reliably after year one. All the good news has been spent, insiders have mostly sold out and the company has to ask itself "now what"? The five-year underperformance is significant and prevalent in all geographies.

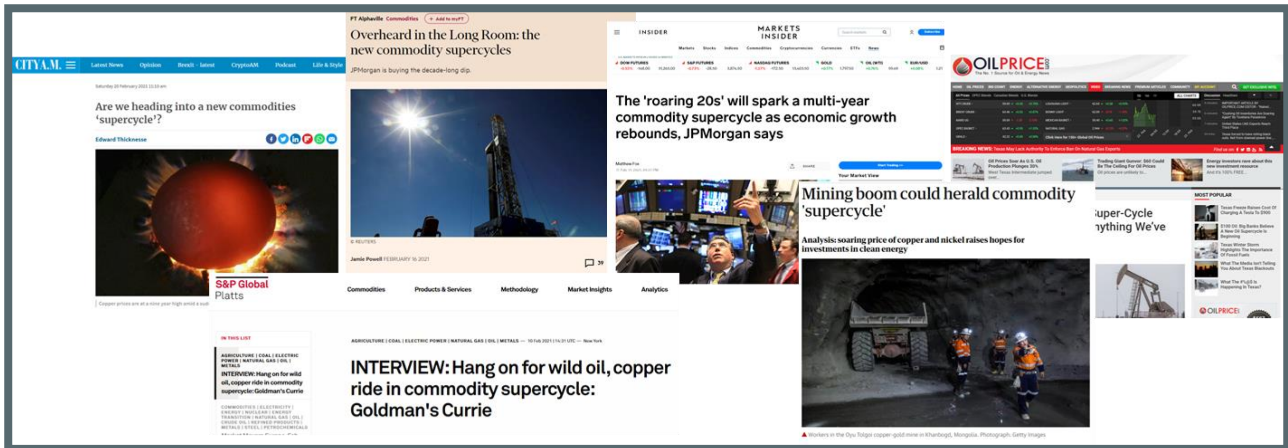


Now of course there are some outstanding IPO successes, with some turning into future market darlings while the underperformers drift away over time and are sold to consolidators or private equity. Survivorship bias means we remember these darlings and forget the others but their combined performance is not enough to reverse the overall trend. As a starting point we screen for companies that had an IPO one to five years ago and recently had a profit warning or large insider sell. Then the real work starts, with any identified candidates being put through our full investment process.

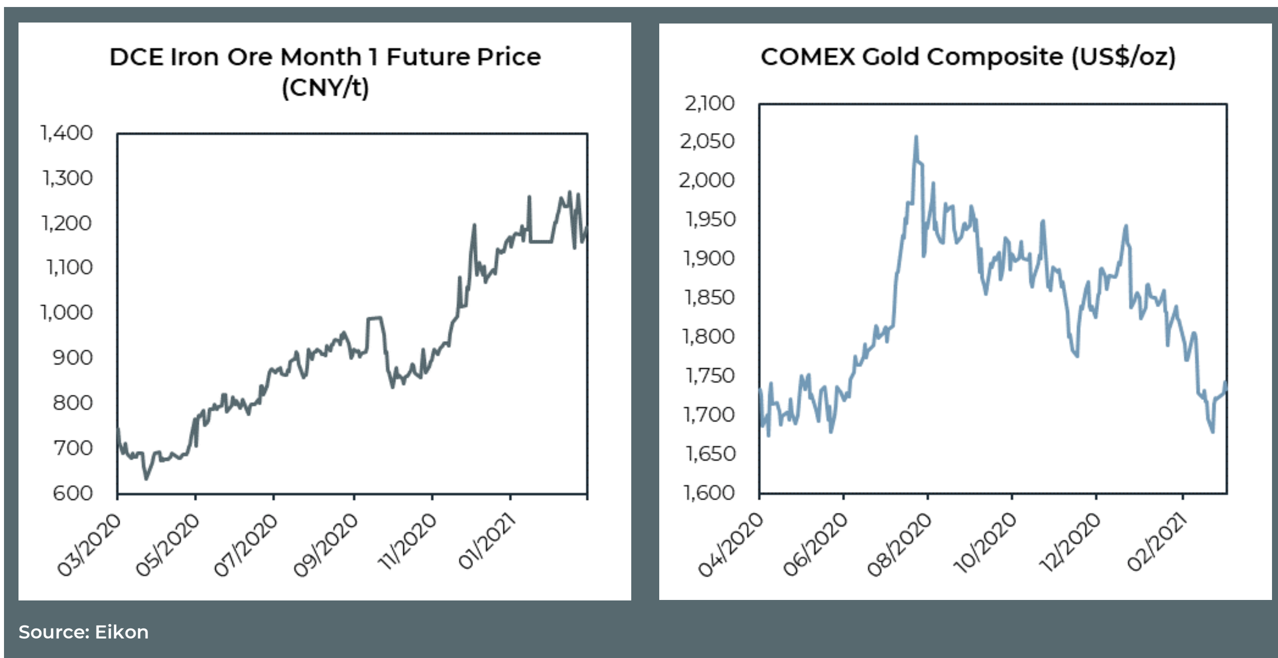
This means we must wait at least one year to initiate a short position on a newly IPO'd underperformer, however, our research efforts start much earlier than this, meeting management teams and looking for cues, inconsistencies, drift, or pivots later down the line. For example, management scrub old promises from their websites but RNS releases cannot be removed. For a challenge, pick any PLC company website and try to find the capital markets day slide deck they presented five years previously. It will be a rare find. We also hope to find one or two potential star performers on the long side, but that is much harder job and a discussion for another day.

We Are at The Start of a Commodity Supercycle?

In February, the market was full of bullish commodity commentary with the prospect of a "commodity supercycle" due to years of capex underinvestment and increasing demand.



Clearly those companies positively exposed to higher commodity prices have performed well, as the underlying prices have increased. One commodity that has not performed as well as we may have expected is gold but, with higher levels of inflation perhaps around the corner, this might soon have its day in the sun.



Source: Eikon

From previous experience working in a natural resources-focused investment bank, we have seen plenty of failed commodities bull cases, but perhaps this time it is different. Regardless, the lowest cost producers tend to be a good place to prospect for investment opportunities.

Hedge Funds Afraid of Retail Traders and Terrified of Being Seen as Anti-ESG

It has become common wisdom not to waste a good bubble - get in, add soap, and get out clean. Investors know they are in a bubble but are happy to trade on the "greater fool" theory of investing. The fall guy is often the average retail investor and it seems likely to be the same this time around. Previously you priced a stock to reflect your understanding of the present value of the future cash flows of the underlying company, but many see that as old hat now, with the proliferation of "meme stocks", ESG-anything stocks, bitcoin- and Covid-pivot stocks. The market does eventually reflect the long-term return of a specific stock, but there are certainly cycles of fear and greed that result in over- and under-valuation in the meantime (thankfully, because this is where we make money).

Clearly there are some ridiculous valuations in the ESG sector right now, which can only be justified by using an absurdly low discount rate sustained for 50 years and assuming no recessions (history's tune is not supportive of this). Despite these stretched valuations, with pension funds now having to invest in everything ESG (but effectively just the 'E') we may see further inflows into this sector. Unsurprisingly some of the best-performing UK stocks over the last six months have an 'E' element to them.

Company Name	6M Performance	Market Cap (£m)
EQTEC	298.9%	141
AFC Energy	165.8%	301
Ilika	154.6%	270
Powerhouse Energy Group	119.0%	243
Ceres Power Holdings	105.8%	2,017

Company Name	6M Performance	Market Cap (£m)
ITM Power	66.2%	2,184
Invinity Energy Systems	49.1%	124
Proton Motor Power Systems	36.5%	548
Impax Environmental Markets	30.2%	1,202
Smart Metering Systems	28.4%	888

This is where it gets thought provoking for two reasons.

Firstly, where are all the shorts? Hedge funds would typically take the other side of retail trades and slow pension funds from making these mistakes, but what if *hedge funds have become afraid of retail traders and do not want to be seen as anti-ESG by shorting stocks in this sector*? If this is a bubble, there may be little to stop it getting bigger.

The government assumes retail investors are financially illiterate and have been desperate to regulate them out of the market wherever possible, however, we can assure you that there are some exceptional retail investors out there. Easy to access sources of information and corporate access opportunities such as InvestEgate, Investor Meet Company, Primary Bid and Mello, to name a few, have democratised the investment process. The ability for the smartest retail investors to lead the others via platforms such as eToro, Stockopedia and Reddit forums, and operate in effect as a fund with meaningful aggregated flows as opposed to dispersed noise, has gained significant traction as a theme. Being on the wrong side of flow against an entity who does not care about price is a daunting place to be. Certainly, most risk managers will not entertain the idea.

Secondly, there is a lack of equity that actually meet the 'E' criterion, in which to invest this torrent of ESG-hungry cash. The market is desperate for new stories and, as such, bankers' IPO pipelines are full of companies in this area. We have no doubt the market will accommodate these for as long as the music keeps playing.

The elephant in the room is that our investment process may miss out on some of this ESG-frenzied upside but buying great businesses with catalysts and shorting zombie companies is a winning Kernow formula. It may not be as exciting as buying lottery ticket companies but we make no apology for this and exceptional success comes from an atypical approach. We created Kernow to focus our conviction, enthusiasm and talent on creating repeatable, superior, risk-adjusted returns. We thrive on sifting through the discarded, misunderstood and esoteric opportunities to find skewed risk reward situations, often finding "hidden gems" in unfashionable areas. We have a contrarian mindset, and it works.

UK Equity Market - Three Month Snapshot

Top and Bottom Stocks in FTSE 100

Top Five - FTSE 100	3M Change
Ashtead Group PLC	25.3%
Johnson Matthey PLC	23.5%
Aviva PLC	23.1%
Kingfisher PLC	22.6%
DCC PLC	21.6%

Bottom Five - FTSE 100	3M Change
Fresnillo PLC	-20.5%
Polymetal International PLC	-15.8%
Just Eat Takeaway.com NV	-15.7%
Hikma Pharmaceuticals PLC	-12.6%
Avast PLC	-12.3%

Top and Bottom Stocks in FTSE 250

Top Five - FTSE 250	3M Change
Gamesys Group PLC	71.0%
Cineworld Group PLC	56.5%
Royal Mail PLC	53.3%
Mitchells & Butlers PLC	46.2%
Aggreko PLC	39.7%

Bottom Five - FTSE 250	3M Change
Petrofac Ltd	-33.2%
Provident Financial PLC	-33.2%
AO World PLC	-26.5%
Petropavlovsk PLC	-22.6%
Cairn Energy PLC	-17.2%

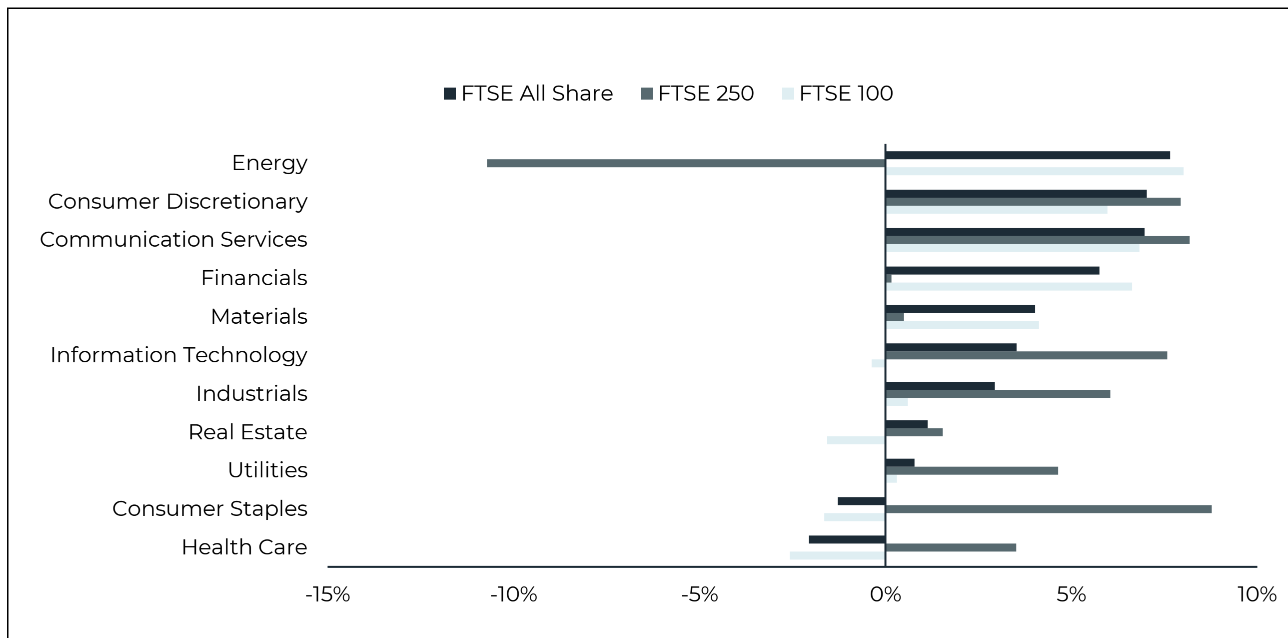
Top and Bottom Stocks in FTSE All Share

Top Five - FTSE All Share	3M Change
Lookers PLC	152.4%
Restaurant Group PLC	85.0%
Amigo Holdings PLC	76.5%
EnQuest PLC	71.2%
Funding Circle Holdings PLC	72.4%

Bottom Five - FTSE All Share	3M Change
Provident Financial PLC	-33.7%
Petrofac Ltd	-33.1%
AO World PLC	-26.5%
Petropavlovsk PLC	-22.6%
Fresnillo PLC	-20.5%

Index Performance

Best and Worst Sectors



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