Ocean Wall

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SUM OF THE PARTS – HIDDEN IN PLAIN SIGHT

Over the past decade, UK equities have consistently underperformed other major developed markets in terms of total shareholder returns; between 2010 and 1H 2021, S&P 500 delivered 379% return, DAX delivered 111% whilst the FTSE 100 delivered only 69% (and only 9% excluding dividends) in dollar terms.

These differences can be attributed partially to structural and fundamental factors. FTSE 100 has a greater leaning towards value and traditional sectors with less growth vs new economy sectors such as technology and healthcare which heavily weight the S&P 500. In addition, in this dovish central bank environment, markets have consistently favoured growth over value.

The UK has also had to contend with the pressures of Brexit and has seen a sluggish recovery post-Covid – mainly due to its high exposure to physical business models.

Currently, the S&P 500 trades at a 2022 P/E multiple of c. 20.5x vs FTSE100 2022 P/E of c.12.6x and FTSE250 2022 P/E of c. 16.0x. And whilst the bear argument and structural issues do exist for many UK companies – there are many ‘hidden gems’, or ‘gem components’ of those larger UK companies, that should be worth on par – and in some cases, more – than their US or global counterparts. Often these valuable parts can be lost or overlooked when valued together with other parts of a business at a conglomerate multiple.

With some hedge funds and investors (Elliott’s stake in GSK, Altice’s stake in BT and Cevian’s interest in Aviva) moving towards the UK market, we believe that now is a good time to look again at some SoTP opportunities.

Here are the 5 hidden gems that we think warrant further consideration:

Rolls Royce (RR LN)

Rolls-Royce is well known as the world's second-largest maker of aircraft engines (after GE) but also owns defence and diesel businesses. Its civil aerospace business is solely focused on wide-body aircraft 'Trent series' engines (i.e. mostly long-haul) and was hit hard by the pandemic. However, its defence and diesel engine businesses have not been directly affected and has seen those revenue streams relatively untouched.

Before Covid, due to poor management, engineering issues on one of RR's key engine products (Trent 1000) and opaque financial disclosure particularly on aftermarket sales, Rolls Royce was one of the least liked stocks in the industrials space and its share price has lagged behind comparables since 2015 – current market cap is c. 1/10 GE's and 1/5 Safran's.

The market seems to have forgotten about Rolls Royce's monopolistic nature (alongside GE and P&W), high-visibility economics, and a compelling growth story. Air travel is still a long term structural growing sector with many people in developing countries still never having flown on an airplane. Rolls Royce is the leader in wide-body aircraft engines and is enjoying a very strong market position thanks to its involvement in the Boeing 787 Dreamliner and the Airbus A350XWB.

Engines are typically sold at or below cost as long as they are paired with a lifetime long-term service agreement ("LTSA"). These LTSA agreements generally charge for service on a per flight hour basis ("power by the hour"). Rolls Royce do not make money selling engines but make very high margin on its LTSAs – it gets paid service revenue whenever a plane flies. And since Rolls Royce gets paid a set amount on flight hours, it does not matter if a plane is half full or completely full. So, as long as long-haul flights resume, Rolls Royce's cash flow situation will improve.

By the end of 2001, a total of 595 Trent engines had been delivered. By the end of 2020, a total of 5,613 Trent engines had been delivered. Of that installed base (actual number of units in use), only c. 25% are 15 years old or more and most are significantly newer. Furthermore, Rolls Royce's current order book is c. £60bn which will keep growing the installed base gradually over the next decade. The revenue to be generated from the LTSAs on these engines will be, not only significantly profitable, but also guaranteed and recurring.

Over the last few years, due to Covid and high capex required for fixing the problem on Trent 1000 and developing its next gen products, financials for Rolls Royce have appeared unattractive.

In addition, the company announced plans to sell non-core assets for c. £2bn in August 2020, of which c. £1.5bn are nearly secured as of August 2021.

If we consider the business disposals and apply market multiple to the defence and diesel businesses, current market cap appears to include little value, if anything, for Rolls Royce's huge civil aerospace business. In fact, the market may have valued it close to zero.

SoTP Valuation over page:

SoTP Valuation:

£bn	EBITDA	MULTIPLE	VALUATION	DEBT
POWER SYSTEMS	0.45	11x	5.00	
DEFENCE	0.60	10x	6.00	
NON-CORE ASSET DISPOSAL			2.00	
DEBT				4.50
SoTP ex-CIVIL AEROSPACE			8.50	
MARKET CAP			9.00	

Implied valuation for civil aerospace c. £0.5bn

Upside will depend on how much FCF Civil Aerospace can generate -> Rolls Royce's "high quality" peer Safran historically trades on 3-4% FCF yield and every £100mm FCF generated from Civil Aerospace would imply £2.5-3.3bn uplift in Rolls Royce's equity valuation, or c. 30%.

BT (BT LN)

The European telecom sector is a tough business environment to be operating in. In the US and Chinese telecom market, there are only 3-4 operators and competition is generally more benign. In Europe there are over 20 operators and competition is fierce. Regulation and labour / pension deficits (particularly onerous in a declining rates environment) are further drags. As a result, most investments in European telecoms yield negative results. BT is no exception. It has been amongst the worst performing stocks in the European telecom sector, which in turn has materially underperformed the wider European stock market. Reflecting these issues, the share price has dropped c. 80% from the 500p level in late 2015 to 100p in 2020.

Compared to other European telcos, BT is more focused on a single market – it is the only fixed and mobile integrated infrastructure telco operating nationally in the UK. BT generates c. 52% from Consumer and Enterprise businesses, c. 40% of its EBITDA from Openreach and the remaining 8% from Global Services. Apart from Global Services, BT's other business lines are essentially a pure-play on the UK market.

Despite a turbulent history, we now have clarity on capex for the next 5 years and the pension valuation is set for 3 years with the pension deficit largely closed. BT's fibre business Openreach has a dominant position in in the UK. A simplification story is emerging. BT has attracted the attention of French telecom operator Altice owned by billionaire Patrick Drahi to build a 12% stake. BT's CEO Philip Jansen himself purchased £2mm of shares at 163p following May results bringing his total stake to £10mm, which is quite significant skin-in-the-game for a corporate executive.

For the past year, Openreach has built FTTP at a speed of 2mm premises per year and intend to ramp this up to c. 4mm premises per year. Currently, c. 5mm of Openreach premises have FTTP and it will reach 25mm or 81% of the Openreach network by end of 2026 according to BT. The ARPU uplift from fibre services is an attractive £10-15/month with a low-teens pre-tax IRR on the investment project. There is also regulatory clarity (to at least 2031) following Ofcom's final statement on fibre regulation and tax advantages. With increased working from home, broadband could, over time, be perceived as the fourth utility alongside water, gas and electricity. BT, Virgin Media, Vodafone and 3 have all raised prices by approximately 4%. Precedent market transactions would give Openreach a valuation multiple of at least 8-10x EBITDA which almost cover the market cap of the entire business.

Altice said, following its acquisition of a 12% stake in BT in June, that it was supportive of the current BT strategy and did not intend to make a takeover offer for the company (in the next 6 months, as per UK takeover rules). However, unconfirmed media reports have speculated about an increase in stake, push for a spin-off of Openreach and finding a partner for its fibre roll-out. These could be positive catalysts for BT to crystalize value for equity shareholders.

SoTP Valuation:

£bn	EBITDA	MULTIPLE	VALUATION	DEBT
OPENREACH	3.2	9x	28.8	
CONSUMER	2.1	6x	12.6	
ENTERPRISE	1.8	5x	9.0	
GLOBAL SERVICES	0.66	5x	3.0	
LESS				18.2
TOTAL			35.2	

Compared to a current market cap of c. £17bn

<u>Royal Mail (RMG LN)</u>

Royal Mail has two businesses: i) UKPIL division that focuses on domestic / international letters and parcels (it is the largest parcel operator in the UK with c.51% market share by volume) and ii) GLS division that focuses on deferred parcels (cheaper option for parcels to be delivered together with other parcels) and logistics in Europe and North America.

Royal Mail's shares had a turbulent history mainly due to poor execution and inefficient labour force. Coupled with macro headwinds on traditional mail volume, the company issued two profit warnings in 2018, failing to meet both top-line and margin consensus – share price fell from its peak of ~630p in May 2018 to ~200p in mid-2019, and further reaching a historical low of ~130p in 2020 due to the impact of Covid. Ex-CEO Rico Back left in May 2020.

Royal Mail's UK business is significantly behind European peers on parcel automation – today it operates around 33% automation vs. 90% for European peers. The new CEO Simon Thompson is very clear on its strategic plan to focus on growth in the parcel market, and currently the company is aggressively investing in parcel infrastructure. The target is to achieve c. 50% automation this year and 90% by 2024. Despite strong competition, Royal Mail remains the undisputed leader in UK parcels in terms of volume. The company is now in a much stronger position having agreed on a wage-deal until 2022, de-risked the pension, and has the Designated Universal Service Obligation for mail (as governed by the Postal Services Act 2011 and regulated by Ofcom) on which it is guaranteed a reasonable return.

GLS is an attractive business – it is asset-light, has high single digit growth and stable margins (6%-7% EBIT). GLS operates in 41 European countries and has one of the largest ground-based deferred parcel delivery networks in Europe. More than 60% of its business is B2B and no customer accounts for more than 1% of revenues. GLS also operates in North America with a focus on B2B segment.

Covid has evidently changed the trajectory on e-commerce penetration across European countries. With 47% UK e-commerce penetration forecasted by 2030 (vs. 19% in 2019), the size of the UK parcel market can still triple from here. Royal Mail's UK business will benefit from new management team with clearer focus, increased

automation and favourable parcel volume / pricing trends due to e-commerce boom. This should be able to offset the decline in traditional mail. Similarly, the GLS business will also benefit from e-commerce tailwinds in Europe and North America.

Share price has already rebounded sharply since last April. Despite this, RMG is still the cheapest European transport logistics stock. There are simply no other transport logistics stocks that trade on a single-digit P/E multiple for 2022E. Of course, we still need to tick a few checkboxes in the coming quarters - particularly on execution and new management's ability to deliver margin targets. With Covid restrictions easing, we also need to watch the normalized growth rate for the parcel business.

SoTP Valuation:

£bn	EBIT	MULTIPLE	VALUATION	DEBT
UKPIL	0.60	5x	3.00	
GLS	0.35	12x	4.2	
LESS				0.50
TOTAL			6.70	

Equity value £6.7bn vs. current market cap of c. £4.9bn

GlaxoSmithKline (GSK LN)

GSK is one of the world's largest pharmaceutical companies, established in 2000 by merger of Glaxo Wellcome and SmithKline Beecham. There are three main business lines: i) pharma: prescription drugs (treating asthma, cancer, infections, diabetes, etc.); ii) vaccines (treating hepatitis, influenza, HPV, etc.) and iii) consumer health (toothpastes, vitamins, OTC drugs such as Panadol, etc).

On the pharma and vaccines side, GSK has been lagging on investment and R&D spend compared to peers. It has been historically conservative in pursuing M&As, with a negative net-spend if we factor in the divestments (sale of Oncology to Novartis). GSK has now made some progress on its new drug innovations pipeline over the last 18-24 months (e.g. bone marrow cancer medicine Blenrep, HIV/AIDS treatment cabotegravir). Given GSK's firepower it has optionality to add to its organic biopharma growth via sourcing inorganic growth opportunities. Meaning, they should (with right opportunities) be able to get mid-single-digit top line growth.

GSK has bought out Novartis' 36.5% stake in its consumer health business in March 2018 and subsequently set up a JV with Pfizer to combine both companies' consumer health businesses in December 2018. The combined consumer health JV has strong geographical presence of global brands with leading market positions in several categories including Oral Health, Pain Relief and Vitamins, Minerals and Supplements. Overall, consumer health is a stable business with low-single-digit top line growth and some expected margin progression (as GSK integrates the Pfizer business).

The overall GSK is set to deliver reasonable growth over the next few years. However, GSK is currently priced like a company with no growth. This is due to historically under investment in R&D / pipeline (GSK currently pays a 6% dividend yield which will be reduced to fund growth) and a complicated corporate structure making it difficult for investors to easily understand the underlying businesses.

After increasing pressure from activist investor Elliott Advisors (building a substantial stake and issuing a public letter demanding board changes and re-evaluation of the CEO) GSK has indicated that it proposes to make changes. In order to make the equity story clearer for investors, GSK plans to split itself into two by demerging the consumer health business by 2H22. New GSK will be a focused pharmaceuticals business that will be

structurally aligned with AstraZeneca, Merck, Pfizer and Sanofi. New consumer healthcare will be owned 68% by GSK in a JV with Pfizer and this is a stable business with low R&D requirements and high cash conversion.

SoTP Valuation:

£bn	EBITDA	MULTIPLE	VALUATION	DEBT
PHARMA	4.90	10x	49	
VACCINES	3.60	12x	43	
CONSUMER HEALTH	2.80	16x	45	
LESS				28
TOTAL			109	

Equity value £109bn vs. current market cap of £77bn.

Countryside Properties (CSP LN)

Countryside is a UK housebuilding and urban regeneration company, operating in London and the South East of England, and with a presence in the North West of England through its Partnerships division. Countryside used to be privately owned, was then purchased in 2013 by private equity firm Oaktree and finally IPO'd in 2016.

The company operates under two segments: (i) Partnerships, which accounts for c. 2/3 of the group profit and (ii) Housebuilding, which accounts for c. 1/3 of the group profit.

Under the Partnerships model, Countryside sources the land, secures the planning permission and is responsible for the design and build-out of the project. A private or public partner (e.g. local authority, housing association and local community) is brought in to complete the project. Typically, those projects have significant affordable housing and Private Rented Sector (PRS) components (c. 70% vs. c. 35% for standard Housebuilding projects, in the case of Countryside). The affordable housing and PRS units are generally forward funded by the buyers (on a percentage of build complete basis), therefore, requiring little or no upfront capital from Countryside.

As a result, although the gross margin on the Partnerships side is usually lower compared to Housebuilding (c. 19% vs. c. 24%), the ROCE is significantly higher (more than double) due to lower capital requirements and higher asset turnover. Countryside also takes lower risk as it only commits a small portion of the overall project yet it still takes majority of the profit pool. Additionally, Partnerships is a growth area of the UK housing market due to structural undersupply and is under government support. With strong profit contribution from Partnerships, Countryside is expected to grow its earnings by double digit in the coming years.

Despite Partnerships providing the majority of Countryside's profits, the market still values the whole business based on TNAV – a multiple used for traditional Housebuilding businesses with more capital required, higher risk and lower ROCE. Countryside currently only trades at low-teens P/E, which is low for a company with double-digit earnings growth.

In recent months, Countryside has come under increasing pressure from activist investors. They are keen to see Countryside unlock this 'value' by spinning off its Housebuilding division. If this happens, then this should provide much better clarity of the high growth, high ROCE nature of the remaining Partnerships business.

SoTP Valuation Over:

SoTP Valuation:

£bn	EARNINGS	TNAV	MULTIPLE	VALUATION	CASH
PARTNERSHIPS	0.15		20x	3.00	
HOUSEBUILDING		0.70	1.2x	0.80	
ADD					0.10
TOTAL				3.90	

Equity value £3.9bn vs. current market cap of £2.9bn

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