Canaccord Genuity
Wealth Management

# INTELLIGENT INVESTING
**June 2023**

## Market review

Equity markets today seem to want to grind higher despite a darkening economic environment, with inflation at still elevated levels (albeit on a downward trajectory) and plenty of geopolitical worries, now made worse by the budget impasse in the US.

So why is optimism winning at the moment? Firstly, market participants are forecasting a peak in interest rates in the near future, and then quick declines from those levels. Secondly, company earnings have been coming through in reasonable fettle. Thirdly, many companies have well-financed balance sheets, which means the impact of higher interest rates has been less keenly felt on profits than consumers' household cash flows. Fourthly, many companies have managed to pass on the initial impact of inflation by raising prices.

Finally, for many of the world's largest technology companies, rapid advances in artificial intelligence (AI) – most notably ChatGPT – have engendered a surge of excitement that's driven large share price movements. At the time of writing, Apple Inc. (Apple), the world's largest company, is up 39% year-to-date; Microsoft Corporation (Microsoft), the second largest, by 34%; Alphabet Inc., the third, by 40%; and Amazon.com, Inc., the fourth largest, by 34%.

Even more notable are the moves in the fifth and sixth largest companies' share prices: Meta Platforms, Inc., the owner of Facebook, was up 99%, and NVIDIA Corporation (NVIDIA), the foremost supplier of complex chips that can facilitate the rapid data crunching needed for AI, was up by just shy of 120% year-to-date. When some of these companies make up 2%, 3% or 4% of the global index, these huge share price increases make a big impact.

We have to be careful about all this optimism. In our view, markets are too optimistic about the timing of cuts in interest rates. Company earnings may come under pressure if we see the widely forecast recession in the US later in 2023 – especially as the one-off initial impact of higher inflation actually boosts profits as companies sell products at new, higher prices, despite having made them using materials and inventory bought at previously lower prices. Higher interest rates will inevitably prove a headwind to profits over time. Pushing through price increases may become harder when the economy is weaker. Finally, the hype around ChatGPT and AI is becoming frothy and a little like the initial frenzy over cryptocurrencies. Consequently, valuations now look extended. Apple is on a 28x 12-month forward price earnings ratio (P/E)*, Microsoft on 30x, and NVIDIA on 81x (and, in the latter case, on over 20 times expected sales to the year ended January 2025).

It's hard to make good money when you buy expensive things that have gone up so much already. So perhaps it would be wise to follow the old adage: to sell in May and come back on St Leger Day – which this year is on 16 September.

**Richard Champion**
Deputy Chief Investment Officer, UK

*See glossary for definition.

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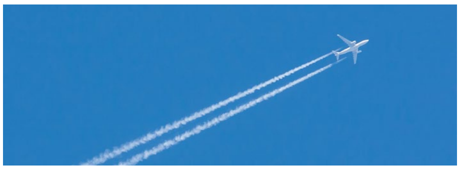
**Past performance is not a reliable indicator of future returns.**



UK LARGE CAPS

## Flying high

Melrose Industries plc (Melrose) has a successful 'buy, improve, sell' model whereby it acquires manufacturing businesses with strong fundamentals, whose performance can be improved through investment and better management. After three to five years, it sells these businesses, returning the proceeds to shareholders.

In March 2018, Melrose completed a hostile takeover of GKN Ltd, an aerospace and automotive company, for £8.1bn – its biggest-ever deal. Five years on, the automotive business has been spun out as Dowlais Group plc, a FTSE 250 company with a £1.6bn market cap. Since this spin off, Melrose is a pure-play aerospace business with 95% of revenue coming from industry-leading positions across engine systems, aerostructures and electrical distribution.

Melrose is integral to the global aerospace supply chain, with its engine or airframe products in over 90% of larger commercial aircraft. After five years of intense restructuring (33 factories down from 50), it is well placed to capitalise on a period of secular growth within global civil aerospace.

**Growth:** End markets are expected to grow over 15% this year, and by more than 10% annually until 2030. With Melrose well-positioned on a number of growth and next-generation programmes, we expect it to grow revenues faster than the markets in which it operates.

**Margins:** As the civil aerospace market continues to recover post-COVID-19, and with restructuring benefits flowing through to the bottom line, there's scope for significant margin improvements. In the first four months of 2023, adjusted operating margin was c.10% compared to 6.3% in 2022, with 14% expected for 2024 rising to 17-18% in 2025 – eclipsing the sub-5% delivered by GKN Aerospace in 2017 pre-acquisition.

Management has said it expects to generate over £1bn of EBITDA* in a few years – we estimate by 2026. There is huge upside potential if it decides to sell the business, given that sector peers Ultra Electronics Holdings plc and Meggitt plc were both taken over at higher valuations in 2021 and 2022 respectively.

### Melrose Industries plc

Share price 472p

Market cap £6.4bn

| | 2022A | 2023F | 2024F |
|---|---|---|---|
| Revenue (£bn) | 7.5 | 3.4 | 3.6 |
| Earnings per share (p) | 18.3 | 17.2 | 27.0 |
| Dividend per share (p) | 4.9 | 4.5 | 7.0 |
| Dividend yield | 1.7% | 0.9% | 1.5% |
| Free cash flow yield | 5.8% | 2.9% | 4.3% |
| Price earnings ratio | 15.5 | 27.5 | 17.5 |
| Return on capital employed | -0.9% | 7.1% | 9.5% |
| Financial year end* | | | 31 December |

Source: Quest®
Note: 2023 and 2024 are forecast years

Despite subdued equity markets, aerospace deals are alive and well, with Apollo Global Management Inc. and TransDigm Group Inc. recently acquiring Arconic Corp (US$5.2bn) and Calspan Corporation (US$725m) respectively.

To paint a picture of the potential upside, applying a 16x multiple to 2026e EBITDA* of £1bn arrives at £11.50 per share – 144% above the current share price.

**Simon McGarry**
Senior Equity Analyst

*See glossary for definition.

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UK SMALL CAPS

## Winning bid

Auction Technology Group (ATG) is a world-leading operator of marketplaces for curated online auctions.

Its technology connects bidders from around the world to trusted auctioneer partners, simplifying and integrating multiple parts of the online auction process. These include the cataloguing of items, marketing, auction hosting, bidding and, most recently, payment solutions. Its solutions are currently used on around 74,000 live and timed auctions a year.

Currently, ATG is a partner to over 3,800 auction houses (over half of which are in the US), giving auctioneers access to a global bidder base from 170 countries. Most of ATG's revenue comes from commission it charges on sales, with the balance largely from payments, event fees and digital marketing services.

The business has grown by moving into new industry verticals and new geographies, through launching new marketplaces and acquiring complementary platforms. Organic growth is benefitting from a structural shift online.

ATG's Industrial and Commercial division is market leader in manufacturing equipment in both the UK and US, and market leader in the US for construction and agriculture equipment. Meanwhile its Arts & Antiques division – also a leader in the US – covers several different categories including watches and jewellery, furniture, fine art, decorative art, collectables, vintage fashion and classic cars.

New merchandise verticals are being added and the platform has been upgraded to accept payments and other offers such as maintenance service contracts (e.g. on tractors) and referrals for art repair and restoration.

Management has set medium-term targets of achieving mid-teens revenue growth supplemented by potential M&A. Overall, ATG holds a leading position in a rapidly growing and fragmented market, with opportunities for organic growth, M&A, and margin improvements. The shares trade on a price earnings ratio (P/E)* to September 2023 of 25x, which we think is undemanding in the context of the growth opportunity.

### Auction Technology Group

Share price 770p

Market cap £928m

| | 2022A | 2023F | 2024F |
|---|---|---|---|
| Revenue (£m) | 120 | 140 | 164 |
| Earnings per share (p) | -5.2 | 30.4 | 35.6 |
| Dividend per share (p) | 0.0 | 0.0 | 0.0 |
| Dividend yield | 0.0% | 0.0% | 0.0% |
| Free cash flow yield | 1.3% | 6.2% | 6.9% |
| Price earnings ratio | -202.1 | 25.3 | 21.7 |
| Return on equity | 2.5% | 7.8% | 8.7% |
| Financial year end* | | | 30 September |

Source: Quest®
Note: 2023 and 2024 are forecast years

**Ian Berry**
UK Small Cap Equity Analyst

*See glossary for definition.

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**Investments in smaller companies are not suitable for all investors as they are high risk and tend to be more volatile and illiquid. Selling may be difficult and they can fall further than the wider market. They are more exposed to fluctuations in the domestic economy and growth is not guaranteed. When we talk about investing in smaller companies, we typically mean companies listed on AIM or those with a market capitalisation of less than £1bn, which are not within the FTSE 100.**

UK EQUITY SCREEN

# Year of the buyback

Having come to the end of what has largely been a solid Q1 reporting season in the UK, one of our observations is that 2023 seems to mark the year that UK companies have decided to take a page out of the US corporate playbook by announcing a plethora of share buybacks.

Historically, UK corporates have tended to favour special dividends over share buybacks as the method to return excess capital to shareholders. But evidence would suggest this is rapidly changing after a host of buybacks being announced by UK corporates in recent months. These public limited companies (PLCs) include Barclays, Bellway, Balfour Beatty, Centrica, Compass Group, CRH, Essentra, Grafton Group, Harbour Energy, Informa, InterContinental Hotels Group, Lloyds Banking Group, OSB Group, RELX, Robert Walters, Spirent Communications, Standard Chartered, Tesco and Whitbread, to name just a few.

Only last month, Melrose, which features elsewhere in this publication, weighed into this debate, saying that going forward it would opt for buybacks over M&A – quite a U-turn for a company that has made its name over the last 18 years buying underperforming businesses and turning them around.

In our view, UK PLCs are materially undervalued versus their US peers, and as a result are increasingly being viewed as cheap acquisition targets by both private equity and overseas corporates. With their balance sheets mostly in good shape, several UK CEOs are now buying back their stock, which in effect increases earnings per share (EPS)* and therefore theoretically the share price. While Shakespeare said that 'you can't have too much of a good thing', when it comes to buybacks we are firmly of the view that there are good buybacks and bad buybacks. If the company is intrinsically cheap, then the buyback adds value. But if a company is buying back its own expensive stock, this only acts to destroy shareholder value.

To try and find companies that have a track record of buying back their stock and now look cheap, we have used Quest®, our proprietary equity valuation tool with 17,000 stocks under coverage. We looked to identify those UK companies where the shares in issue have decreased each year over the last three financial years, and by at least 9% in total over the last five years, and which also had 10%+ of their market value in cash at the end of the most recent financial year. This produced a list of 10 stocks which you can see below.

**Simon McGarry**
Senior Equity Analyst

*See glossary for definition.

| | | | Annual change in shares in issue | | | | | 12-month forward | | | Price change over | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Stocks** | **Industry** | **Market value (£m)** | **Cash/ Market Cap** | **FY-1** | **FY-2** | **FY-3** | **Changes in shares in issue over 5 years** | **Price earnings ratio** | **Dividend yield** | **EPS Growth** | **1mth** | **3mths** | **12mths** |
| Man Group | Capital Markets | 2,561 | 14% | -9% | -4% | -4% | -26% | 10.4 | 0.0% | -14% | -3% | -17% | -14% |
| Abrdn | Capital Markets | 3,853 | 31% | -8% | -1% | -7% | -22% | 16.7 | 7.3% | 41% | -7% | -12% | 2% |
| Plus500 | Diversified Financial Services | 1,301 | 46% | -6% | -3% | -5% | -21% | 6.9 | 2.9% | -18% | -13% | -20% | -8% |
| Balfour Beatty | Construction and Engineering | 2,064 | 59% | -7% | -7% | 0% | -18% | 10.9 | 4.9% | -5% | -4% | 1% | 41% |
| Shell | Oil Gas and Consumable Fuels | 150,758 | 21% | -9% | -2% | -1% | -17% | 6 | 0.0% | -11% | -9% | -12% | -7% |
| WPP | Media | 9,126 | 26% | -7% | -6% | -2% | -14% | 8.1 | 6.1% | 14% | -8% | -17% | -7% |
| Quilter plc | Capital Markets | 1,132 | 121% | -1% | -7% | -7% | -14% | 12.6 | 3.1% | -28% | -1% | -9% | -30% |
| Berkeley Group | Household Durables | 4,224 | 21% | -1% | -3% | -2% | -13% | 11.3 | 3.7% | -16% | -12% | -6% | -7% |
| CRH plc | Construction Materials | 27,751 | 20% | -3% | -2% | -1% | -11% | 11.2 | 4.1% | 10% | -1% | -3% | 16% |
| Vertu Motors | Specialty Retail | 209 | 38% | -3% | -2% | -2% | -9% | 6.5 | 4.5% | 9% | 6% | 1% | 5% |

Source: Quest®

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**Past performance and future forecast figures are not a reliable indicator of future results.**

US EQUITIES

## Amazon primed

Amazon.com, Inc. (Amazon) is one of the largest and most recognised brands worldwide, known for its leadership in ecommerce spending and cloud computing.

During the COVID-19 pandemic, Amazon's e-commerce business benefitted materially from the broader shift to online shopping. Despite this, there is still a significant potential for further online sales growth as 80% of global retail spending still occurs in physical stores.

One of Amazon's key targets to grow online sales is through capturing a larger market share of the US$800bn US grocery market, the majority of which is still completed in-store. With a selection of three million items for sale (compared with a typical supermarket's 30,000 items) and an efficient logistics network, Amazon is in a prime position to grow grocery sales over time.

Furthermore, while Amazon is a well-established player in online sales in the US and UK, its market share in other geographies is much smaller. It has invested heavily in recent years to expand its presence in key markets including India, Brazil, the Middle East and parts of Africa.

Aside from market share gains, Amazon's management team is committed to continually improving operational efficiency, including reorganising its US fulfilment network from a single national network into eight interconnected regional models. This strategic move is expected to drive efficiency improvements and enhance operating margins in its retail business, further solidifying Amazon's position as a leader in the e-commerce industry.

Amazon is also a market leader in cloud computing through Amazon Web Services, Inc. (AWS). Despite generating over US$80bn in revenue in 2022, AWS has ample room for growth with the majority (90%) of global IT spending still on-premise and yet to migrate to the cloud.

In addition, Amazon boasts a strong leadership team that is dedicated to making long-term investments and diversifying the company's revenue streams beyond its primary online and cloud-based services. One notable example of this strategy is the expansion of its healthcare business in the US through the acquisition of One Medical.

### Amazon.com, Inc.

Share price US$121
Market cap US$1,237bn

| | 2022A | 2023F | 2024F |
|---|---|---|---|
| Revenue (US$bn) | 514 | 561 | 627 |
| Earnings per share (US$) | 1.3 | 1.6 | 2.5 |
| Dividend per share (US$) | 0.0 | 0.0 | 0.0 |
| Dividend yield | 0.0% | 0.0% | 0.0% |
| Free cash flow yield | -1.8% | 0.8% | 1.9% |
| Price earnings ratio | 94.9 | 77.5 | 47.5 |
| Return on capital employed | 4.8% | 8.9% | 13.2% |
| Financial year end* | | | 31 December |

Source: Quest®
Note: 2023 and 2024 are forecast years

In summary, Amazon represents an attractive investment for investors with a long-term horizon. The company's strength in core online sales and cloud computing allows it to expand and diversify its revenue streams through investments in new areas like healthcare, while its strong leadership team is focused on driving growth and improving operational efficiency across all aspects of the business.

**Dan Smith** CFA
International Equity Analyst

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**These figures above are shown in US dollars (US$). These returns may differ significantly when converted to other currencies at the prevailing exchange rates.**

INVESTMENT FUNDS

## Rise of the East

In 2012, the McKinsey Global Institute reported that the world's economic centre of gravity is shifting east, based on the rise of the middle classes and rapid urbanisation in developing countries. It predicted that one billion people will enter the global consuming class by 2025, and more than a decade later we continue to witness this incredible growth – most notably across Asia, and in particular China and India.

The Stewart Investors Asia Pacific Leaders Sustainability Fund aims to capitalise on this progress by investing in shares of large and mid-sized companies either based in, or conducting the majority of their business across, the Asia Pacific region, excluding Japan.

The strategy is concentrated and invests in 30-60 high-quality companies which contribute to and benefit from sustainable development. 'Quality' is defined by the investment team as strong franchises, exceptional cultures and resilient financials, while avoiding companies linked to harmful activities. The rigorous focus on these factors, as well as transparency and sustainability, has historically led to a bias towards countries such as India and Australia, and sectors such as consumer staples, technology and healthcare.

### Stewart Investors Asia Pacific Leaders Sustainability Fund

Price £9.8072
Market cap £6.5bn

The fund's ethos also naturally results in a long-term approach, as well as a focus on capital preservation alongside capital growth. We continue to maintain conviction in the highly experienced team, and recommend the fund as a core part of Asian equity exposure.

**Kamal Warraich**
Head of Equity Fund Research

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# Profit takers

In addition to providing insight and analysis of particular investment opportunities each month, we also review stocks that have shown strong performance in recent months and as a result investors might consider taking profits. Please do contact your Investment Manager to discuss any of these ideas or any other aspect of your portfolio held at Canaccord Genuity Wealth Management.

| | | | | | | | Performance over previous | | |
|---|---|---|---|---|---|---|---|---|---|
| Company name | Market cap (£m) | Share price (p) | Prior FY dividend per share (p) | Current FY dividend per share (p) | Prior FY price earnings ratio | Current FY price earnings ratio | 1 mth | 3 mths | 6 mths |
| Aston Martin Lagonda | 2,068 | 284 | 0.0 | 0.0 | -3.1 | -9.9 | 17% | 41% | 117% |
| Verona Pharma | 1,710 | 22 | 0.0 | 0.0 | -8.2 | -22.0 | 3% | 0% | 67% |
| JD Wetherspoon | 930 | 734 | 0.0 | 1.0 | -34.8 | 31.1 | 3% | 30% | 65% |
| Rolls-Royce | 11,974 | 143 | 0.0 | 0.2 | 7.9 | 28.1 | -6% | -1% | 58% |
| Marks & Spencer | 3,509 | 179 | 2.5 | 5.4 | 6.0 | 11.1 | 9% | 12% | 48% |
| Mitchells & Butlers | 1,214 | 205 | 0.0 | 0.0 | 12.2 | 18.4 | 17% | 26% | 47% |
| 3i Group plc | 18,828 | 1,956 | 53.0 | 58.2 | 2.8 | 6.1 | 11% | 20% | 45% |
| Burford Capital | 2,354 | 1,077 | 10.4 | 10.1 | 43.9 | 1.6 | 3% | 60% | 44% |
| Pets at Home | 1,792 | 375 | 12.8 | 12.1 | 13.8 | 18.8 | -3% | -3% | 42% |
| Senior | 685 | 167 | 1.3 | 1.9 | 30.6 | 24.8 | 2% | 0% | 36% |
| SIG | 458 | 40 | 0.0 | 1.1 | 12.5 | 16.2 | -10% | -6% | 35% |
| Hilton Food | 653 | 729 | 29.7 | 29.4 | 30.5 | 14.1 | 8% | 2% | 35% |
| Moneysupermarket.com | 1,348 | 251 | 11.7 | 12.0 | 14.2 | 16.5 | -8% | 9% | 32% |
| ME Group International | 520 | 138 | 5.6 | 6.1 | 8.0 | 11.3 | 7% | 9% | 31% |
| Seplat Energy | 678 | 116 | 8.3 | 11.5 | 10.3 | 3.1 | 10% | 1% | 31% |
| Flutter Entertainment | 27,511 | 15,735 | 0.0 | 10.0 | -64.0 | 40.3 | -1% | 18% | 29% |
| Volution | 884 | 447 | 7.3 | 7.7 | 19.2 | 18.2 | 3% | 22% | 29% |
| AB Dynamics | 465 | 2,030 | 5.3 | 5.8 | 75.6 | 39.8 | 17% | 13% | 29% |
| FD Technologies | 511 | 1,820 | 0.0 | 0.0 | -1156.2 | 51.2 | -3% | -3% | 29% |
| Games Workshop | 3,114 | 9,460 | 165.0 | 415.0 | 24.1 | 20.4 | -5% | 2% | 28% |
| Oxford Instruments | 1,596 | 2,765 | 18.1 | 19.1 | 28.2 | 20.4 | 0% | 11% | 28% |
| Premier Foods | 1,154 | 133 | 1.4 | 1.7 | 7.7 | 11.0 | 6% | 17% | 28% |
| Hollywood Bowl | 470 | 274 | 11.5 | 9.9 | 9.1 | 14.3 | 14% | 12% | 27% |
| Whitbread | 6,553 | 3,286 | 74.2 | 76.8 | 18.2 | 20.2 | 1% | 6% | 27% |
| SSP | 2,143 | 269 | 0.0 | 2.7 | -82.8 | 38.6 | 4% | 4% | 26% |
| Mortgage Advice Bureau | 403 | 706 | 28.1 | 28.1 | 31.8 | 20.7 | -10% | 20% | 26% |
| Wizz Air | 2,867 | 2,776 | 0.0 | 0.0 | -8.9 | -6.1 | -8% | 8% | 25% |
| Centrica | 6,558 | 118 | 3.0 | 3.5 | 2.3 | 5.8 | 3% | 12% | 24% |
| Bytes Technology Group | 1,221 | 510 | 7.5 | 15.3 | 25.2 | 26.0 | 23% | 28% | 23% |
| Hill & Smith | 1,165 | 1,456 | 35.0 | 38.3 | 15.2 | 15.4 | 6% | 5% | 22% |

Source: Quest®

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**Past performance and future forecast figures are not a reliable indicator of future results.**

## Glossary

**The glossary is not intended as a technical definition as most of these metrics can be calculated in a number of different ways.**

| | |
|---|---|
| **Compound annual growth rate (CAGR)** | Compound annual growth rate (CAGR) is the rate of return that would be required for an investment to grow from its beginning balance to its ending balance, assuming the profits were reinvested at the end of each year of the investment's lifespan. |
| **Dividend per share (DPS)** | Dividend per share (DPS) is the sum of declared dividends issued by a company for every ordinary share outstanding. The figure is calculated by dividing the total dividends paid out by a business, including interim dividends, over a period of time by the number of outstanding ordinary shares issued. |
| **Dividend yield** | Dividend per share divided by the share price, often expressed as a percentage. For historic periods the average share price for the year is used, for forecasts the current share price is used. |
| **Earnings per share (EPS)** | An indicator of a company's profitability, it is the portion of profit after tax allocated to each outstanding share in issue. |
| **EBITDA** | Earnings before interest, taxes, depreciation, and amortisation (EBITDA) gives an indication of a company's financial performance. |
| **Enterprise value** | Enterprise value is defined as equity market capitalisation plus net debt. This metric may be used to value a company for a potential takeover. |
| **Financial year end** | Financial year end refers to the completion of a 12-month accounting period that may differ from the calendar year. If a company's financial year ends 31 March, H1 refers to the period between April and September, and H2 refers to the period between October and March. |
| **Gross margin** | Gross margin is net sales less the cost of goods sold. It's the amount of money a company retains after incurring the direct costs associated with producing the goods it sells and the services it provides. |
| **Growth stocks** | A company that is expected to deliver better than average organic revenue and earnings growth over the medium term. |
| **Net asset value (NAV)** | The net asset value (NAV) represents the net value of an entity and is calculated as the total value of the entity's assets minus the total value of its liabilities. Most commonly used in the context of a mutual fund or an exchange-traded fund (ETF), the NAV represents the per share/unit price of the fund on a specific date or time. |
| **Next twelve months (NTM)** | Next twelve months (NTM) refers to any financial measure that is forecast for the immediate next twelve months from the current date. |
| **Price earnings ratio (P/E)** | Share price divided by EPS. For historic periods the average share price for the year is used; for forecast years, the current share price is used. It shows how much investors are willing to pay per pound of earnings. |
| **Quest®** | Canaccord Genuity's proprietary online valuation and analytical tool which combines consensus market figures with the Quest® Discounted Cash Flow (DCF) Valuation Model. |
| **Tables** | F – forecast results, figures based on the combined estimates of analysts covering the company.<br>A – actual results, figures based on the company's published results. |
| **Value stocks** | Investors looking for 'value' seek out stocks which they believe have been undervalued by the market and are trading for less than their intrinsic worth. They are viewed as trading at a lower price than justified when measured against metrics such as earnings, profit margins or sales. |

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**Investment Recommendation:**

Date and time of first dissemination: 05.06.23 - 10AM BST
Date and time of production: 05.06.23 - 10AM BST

**Buy:**

Unless otherwise stated, at the time of the recommendation we consider there is a material upside to the current share price.

**Price:**

Prices are as at market close on 31.05.23

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