LIONTRUST
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GLOBAL FUNDAMENTAL

INCOME FUND | MONTHLY SUMMARY | JULY 2023

Summary

The Liontrust Income Fund seeks to offer attractive total returns to its investors while delivering dividend income to investors above the FTSE All Share Index.

June was a muted month for the Fund (-4bps), bringing a disappointing quarter (-93bps) to a close. Performance year-to-date (YTD) has been satisfactory both in absolute terms, delivering a total return of 3.16%, and relative to its benchmark (+55bps). YTD the Fund remains in the top quartile of the IA UK Equity Income Sector (C Acc share class, net of fees, GBP).

Notable trading activity in the quarter saw us initiate positions in **Telecom Plus** – a cost-advantaged provider of home utility services via unique multiservice contracts, operating under the Utility Warehouse brand in the UK; **MAN Group** – a rare example of competitive power in the asset management industry, thanks to the accumulated knowledge and knowhow in its systematic quant business; and **LondonMetric** – a UK REIT with one of the savviest management teams in the sector, adding value through active portfolio management. With dividend yields ranging from 5%-6.5% for their current financial years, these stocks largely sit on the Repeatable Cashflow side of the portfolio, though we believe each has good potential for capital appreciation too. We exited Aviva and easyJet in the quarter, two stocks offering very different levels of income but with the common theme that we find more opportunity in the stocks discussed above and in top-ups in other existing positions.

The top contributor to performance in June was **Kitwave** +36bps closely followed by **Ashtead** +35bps. While these are on the face of it two very different businesses – small-drop grocery and food service distribution in the UK and then rental equipment, largely in the US – they share the trait of exploiting density in a network to drive differential growth and margin versus the competition (an example of scale economies). Discount retailer **B&M** +22bps was also a strong contributor, following a strong update resulting from its compelling value offering for the UK and French consumer, which saw consensus move numbers higher once more.

The biggest detractor from June's performance was insurance company **Admiral** -44bps, which saw a heavy reset through the month due to concerns around persistently high claims inflation. The other side of the profit equation, as anyone facing a car insurance renewal will testify, is that we are seeing strong positive momentum on industry pricing. Ultimately, we are confident industry returns will mean revert and see Admiral as the high quality, market share winner in the sector. New position **LondonMetric** -20bps got off to a disappointing start due to fresh concerns around UK inflation and interest rates, a factor to which real estate stocks are highly sensitive, but we have taken the opportunity to add gently to the position on weakness.

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

Dividend paying companies with Competitive Power: **Morgan Sindall**

MORGAN SINDALL GROUP

Over the last couple of months, we have established a position in Morgan Sindall, a UK-focused building and construction contractor. Some of our partners might feel instinctively leery at this news, with history showing the sector to have a chequered track record and Carillion's high-profile bankruptcy perhaps lingering in the memory. Indeed, despite various quant screens having highlighted the company as having the quality characteristics we look for, we approached our due diligence with a higher-than-usual degree of scepticism, given this history and our sense being of construction as cyclical, competitive, low margin and with operational risks which are hard to monitor externally. While certainly not anticipating a Damascus Road moment, our process actually led to the inescapable conclusion that Morgan Sindall is a resilient, well-run and best-in-class contractor; indeed, a quality dividend paying company with Competitive Power.

Let's dig into what it does. Morgan Sindall delivers construction and regeneration projects to a customer base formed primarily (i.e. c.70%) of local authorities or quasi-public bodies (e.g. Highways England or Network Rail) as well as in the commercial sector. Examples of work it undertakes might include building a school or hospital; upgrading motorways or the rail network; constructing social housing and mixed-use urban regeneration schemes; or, fitting out office space. Operating across these diverse end-markets helps mitigate the inherent cyclicality of its various segments, with each operating within their own sub-climates. For instance, whereas its Partnership Housing division is likely to have a soft year in 2023 with first-time buyer affordability crimped by rising mortgage rates, this looks set to be offset by its market-leading office Fit Out unit which is on track to produce record results. On this note, the company issued a positive trading update at the end of June which saw mid-high single digit percentage upgrades to consensus earnings estimates.

Our investment philosophy is that 'quality dividend investing works best' and we apply a systematic framework to understand and identify quality.

Morgan Sindall does not undertake building work itself, instead subcontracting out work and acting as project manager. Its ability to identify and manage commercial and operational risk is key to its success. Our discussions with management focused extensively on culture and risk management. The business operates a highly devolved, regionalised, structure so as to stay close to its projects and better manage customer and subcontractor relationships. When bidding for contracts it adopts a risk averse mindset, generally bidding on projects of relatively low value (average size is c.£10m in construction), so adverse outcomes are contained, and avoiding scenarios where extreme positive and negative tail risks could exist, actively eschewing high margin but high-risk opportunities. It does not participate in single stage tenders where costs are locked in early, instead working collaboratively with its clients and subcontractors on a multi-stage negotiated basis, to mitigate risks of inflation and cost slippage. Family style ownership, with founder and CEO John Morgan's name above the door, and long tenure of senior management underpin this risk-averse culture.

Our investment philosophy is that 'quality dividend investing works best' and we apply a systematic framework to understand and identify quality. Morgan Sindall demonstrates the five building blocks we look for across our portfolio holdings.

- It generates **attractive returns on invested capital** (ROIC), achieving c.22% (post-tax) in FY22a, in line with its 5-year average, creating distributable cashflows for reinvestment and shareholder returns. It has achieved a 5 and 10-year compound annual growth rate of earnings per share (EPS CAGR) of c.15% and c.12%, respectively.
- As dividend-focused investors we want **clean, cash generative financial models**. This was a key focus, given the complexities of contractor accounting, such as large working balances and percentage of completion revenue recognition. While free cashflow can be lumpy due to timing of receipts and payments, over three years cumulative FCF/net profits after tax (NPAT) conversion has been c.105%, suggesting revenues and costs are booked on a prudent basis. Adjustments to earnings have been largely non-existent.
- Morgan Sindall runs a deliberately **prudent balance sheet**, with an average daily net cash balance of >£250m (FY22a) and year-end of >£350m. While arguably bordering on 'inefficient' per the textbooks, we learned that publishing its daily net cash demonstrates financial resilience to both its sub-contractors and its customers (as well as offering reassurance to investors), a source of differentiation versus its peers when it bids for work. It has no material provisions or pension deficit.
- **Attractive underlying markets**. Although we do not see construction as a high-growth sector, Morgan Sindall is exposed to segments with above average potential, geared towards the UK's increased demand for affordable housing, urban regeneration and investment in public, commercial and social infrastructure. Energy efficiency and carbon regulations are also driving high demand in its Fit Out business. While on average industry returns are capped by competition, it is one with potential for highly differentiated returns and Morgan Sindall's strategy puts it firmly on the right side of the averages.
- John Morgan (CEO) founded Morgan Sindall in 1977 and alongside Steve Crummett (CFO) forms one of the longest tenured management teams in the UK public market. Morgan still owns c.7% of the company himself. They adopt a very long-term approach, with a focus on risk and sustainability and have adeptly navigated various market cycles. Morgan left the business once in this long history, but the combination of poor replacement, and a love for the job, saw him return successfully to the helm – having 'retired' once before we believe that Morgan will be around for the foreseeable. These are the **skilled, motivated management** we look for.

Operational excellence has translated into a smoother and, indeed, profitable journey for shareholders. Aside from a brief interruption due to the pandemic, earnings estimates have consistently been revised higher over the past decade

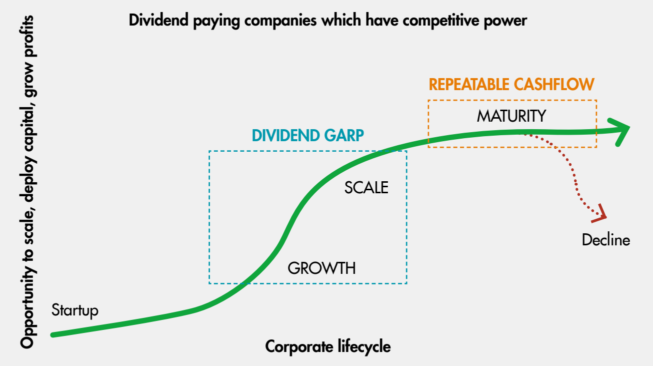
(Source for all metrics: company financials, 31.12.2022)

Operational excellence has translated into a smoother and, indeed, profitable journey for shareholders. Aside from a brief interruption due to the pandemic, earnings estimates have consistently been revised higher over the past decade. Over five years its shares have outperformed (total shareholder return) the FTSE ASX / FTSE Construction / FTSE Housebuilders by c.32% / c.18% / c.77%; over 10 years this increases to c.256% / c.165% / c.268%[1]. High inflation and supply chain challenges over the past year or so have subjected its processes, contractual protections and, perhaps most importantly, strength of relationships with clients and subcontractors to a very real world acid test, which it seems to have navigated adeptly.

However, the future is the only thing that matters in investing and, as with all our investments, we apply a *Competitive Powers* framework to assess whether Morgan Sindall's superior financial performance can sustain over time. As a reminder, Powers are strategic traits that underpin potential for a company to generate persistently attractive returns. They have dual attributes – benefits to the company, manifest through pricing power or lower costs; and, barriers to competitors, who would ordinarily attempt to arbitrage away supernormal financial returns (for further discussion see here). We believe Morgan Sindall has one of the seven Competitive Powers – Switching Costs, which we think will underpin several years of profitable growth.

- **Switching Costs:** Morgan Sindall has deep understanding of the built environment, developed over many years, and is recognised for excellence in project execution. Customer satisfaction levels are tracked through a 'Perfect Delivery' metric, with c.90% of its projects meeting all client expectations[2]. Operational excellence is not a power, in and of itself, but is a prerequisite to becoming a preferred bidder and establishing long-term client relationships. Morgan Sindall's clients are generally risk-averse and so incentivised to use it on a repeat basis rather than, for instance, taking a chance on lower priced competitors. This represents a type of procedural and relational switching cost. For instance, c.90% of Morgan Sindall's workload in construction and infrastructure is secured through multi-year frameworks and partnerships, while its £8.6bn secured order book provides revenue visibility beyond 2025e.

Morgan Sindall sits within the Repeatable Cashflow portion of our portfolio. With this silo we focus on more mature companies, directing a greater proportion of their cashflows to dividends. Our investment hypothesis with this group of stocks is that 'cashflows underpinned by Competitive Power are durable, yet sometimes undervalued'. A high yield (or 'cheap' valuation) is an implicit expression by 'the market' of scepticism around the sustainability and/or growth potential of that cashflow stream. Often this scepticism is appropriate; sometimes it is not. Our job is to find companies, such as Morgan Sindall, trading on attractive dividend yields, with better prospects than are currently 'priced-in'.



Dividend GARP: 'When underpinned by Competitive Power, value-added growth can persist for longer than may be priced in'.

Repeatable Cashflow: 'Cashflows underpinned by Competitive Power are durable, yet sometimes undervalued.'

GARP: growth at a reasonable price
Source: Liontrust

The stock trades on blended forward P/E of c.7.6x (FY1-2e) vs. its own 5-yr average of 10.1x and is on a prospective FCF yield of c.8.2%[3]. Whilst we think that on a justified multiples basis the stock could reasonably trade as high as 16x PE, we are pragmatic in our approach and believe we can make reasonable returns without a re-rating and strong returns if the shares were to become simply 'less cheap'. Hence we see material margin of safety at these prices. It has not traded below current multiples for any sustained period in the past decade, and in better times the market has been prepared to pay c.12-14x for this business. We see this as an attractive entry point into a company which has delivered a trailing 5/10yr EPS CAGR of c.15/12% and with management targeting 6-13% per annum growth going forward. The dividend yield is c.6% and this payout should grow in line with earnings. We note the management incentive scheme set in March 2023 targets 260-308p/sh of EPS in FY25e. If the company were to achieve 300p/sh and trade at a mid-cycle 10x P/E multiple we could see a mid-term pathway to c.£30/sh for the stock, or c.70% upside from today's level.

Fund performance year-to-date has been satisfactory. We are, though, focussed on the more substantial opportunity that exists to grow our investors' wealth and dividend income over the long-term (and indeed our own, as substantial investors in the strategy). We remain confident that our process, identifying dividend paying companies with Competitive Powers, gives us a framework to capture superior risk adjusted returns. As ever, we thank you for your interest and continued support.

[1]Source: Bloomberg, 30.06.2023
[2]Source: company accounts, 31.12.2022
[3]Source: company accounts, 31.12.2022

Key Risks and Disclaimer

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