

## *'The Stock Market is Filled with People Who Know the Price of Everything, but the Value of Nothing' – Philip Fisher*

*This week's commentary is a follow up to our last note on the strength of outperformance by quality, growth and momentum stocks over the last decade or so, with a look at a couple of specific examples in the UK market to illustrate the issue more granularly.*

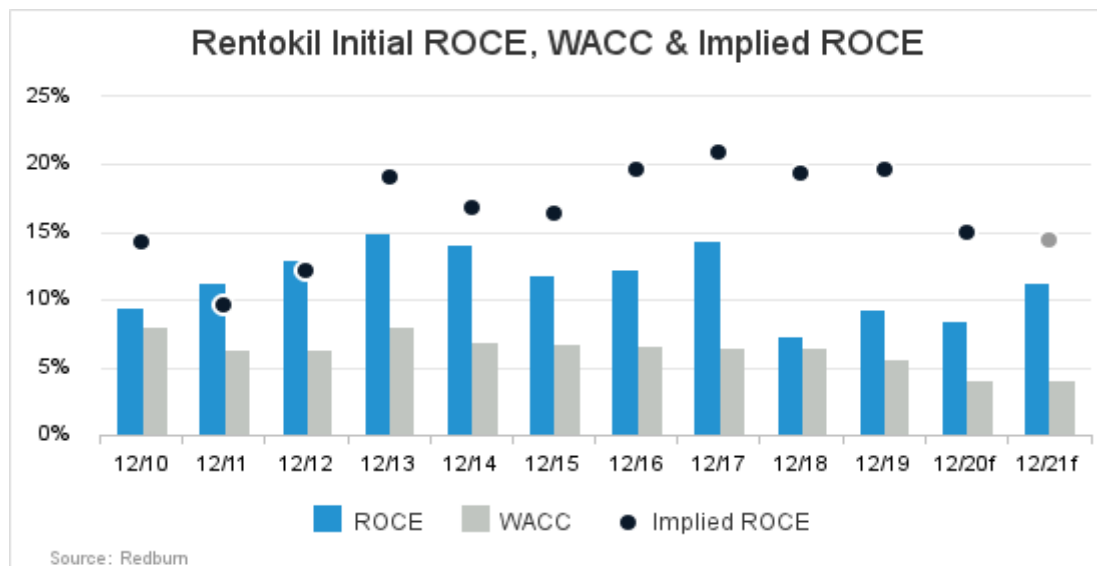
### **Rentokil Initial:**

In the blue corner, fighting out of the 'quality' stable we have Rentokil Initial a global leader in pest control and hygiene services. A truly fabulous performer (relative chart below) since Andy Ransom was appointed CEO in October 2013. We doubt that many people remember what a troubled business Rentokil was for over a decade prior to Andy's arrival. Several management teams had tried and failed to revitalise a sprawling business that had lost its way post the demise of the colourful Sir Clive Thompson – or 'Mr 20 percent' as he was known.



Now please don't misinterpret us here. We have tremendous respect for the job Andy and Jeremy Townsend (CFO) have done in streamlining the business, refocussing on customer service, scaling up to critical mass in key areas and delivering a much, much improved financial performance from the business. We did, indeed, own Rentokil for much of this period.

However, during the process of delivering this much improved business performance guess what – the market has noticed too! That's obvious from the relative performance chart above but you can also see it in a forward **P/E ratio of 34.8x** and a **dividend yield of c.1%**. Memory fails us exactly, but the P/E ratio was around 12x when we first invested in the 'recovery'. Indeed, the chart below illustrates the implied Return on Capital Employed (black dots) built into the current valuation of the company according to the Redburn Ideas system (the blue bars are the actual ROCEs achieved and forecast).



One of the more interesting things about the above chart is the relative lack of improvement in ROCE over the last 7 years despite the enormous rerating of the company’s prospects by the wider market.

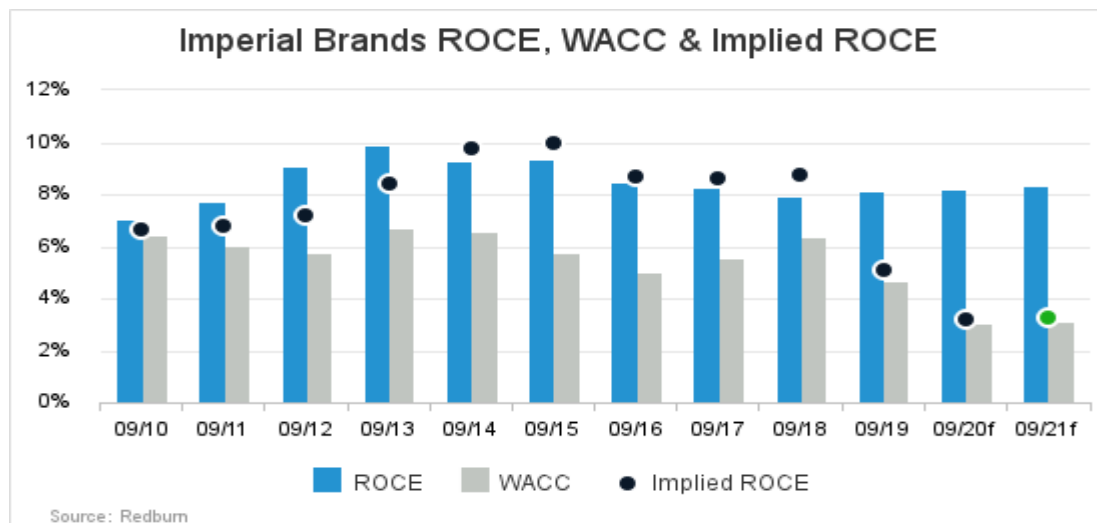
### Imperial Brands

In the red corner, fighting out of the ‘value’ stable we have Imperial Brands a global tobacco and related products company. A really dreadful performer (relative chart below) over the last 5 years or so, with the absolute share price falling -40% over the same period.



The market has struggled with tobacco stocks generally in recent years, particularly with the uncertainty of next generation product markets and what that might mean for the durability of the traditional cigarette business. Imperial have certainly not helped themselves either with a lack of clarity on their next generation strategy, concerns over certain accounting practices and a lack of enthusiasm for the long-standing management team, which has culminated in the appointment of a new CEO - Stefan Bomhard - who starts in July 2020.

However, to say that these concerns are already reflected in the share price is perhaps an understatement given a forward **P/E ratio of 6.1x** and a **dividend yield of 12.7%**. Even if, as widely expected, the new CEO cuts the dividend somewhat the yield is still likely to remain extremely healthy. The Redburn Ideas chart of Imperial (below) provides an interesting contrast to the Rentokil one not only for the level of implied ROCE (compared to what the company is currently delivering) but also the relative stability of ROCE over the last few years despite the very negative derating of the company's prospects by the wider market.



We have no doubt it feels extremely comfortable to own Rentokil Initial in portfolios currently and it definitely feels uncomfortable owning Imperial Brands - the market is, after all, a voting machine in the short term. However, precisely because trends do not persist indefinitely and market perception of the worth of a business franchise can change so dramatically, it is usually the case that the best investment returns come from outside the 'comfort zone'. We cannot tell you for sure that Imperial Brands on 6x P/E is a better investment opportunity for the next 5 years than Rentokil Initial on 35x but we have a strong suspicion it will be, even though we're sure Andy and Jeremy will continue to do an excellent job at Rentokil.

Who knows, perhaps Mr Bomhard will emulate their success and rehabilitate Imperial Brands in the fickle eyes of 'Mr Market'. Starting from 6x P/E how hard can it be.....

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Sources for data and charts (unless otherwise stated): Bloomberg

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