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The Return of The Total Return Kings

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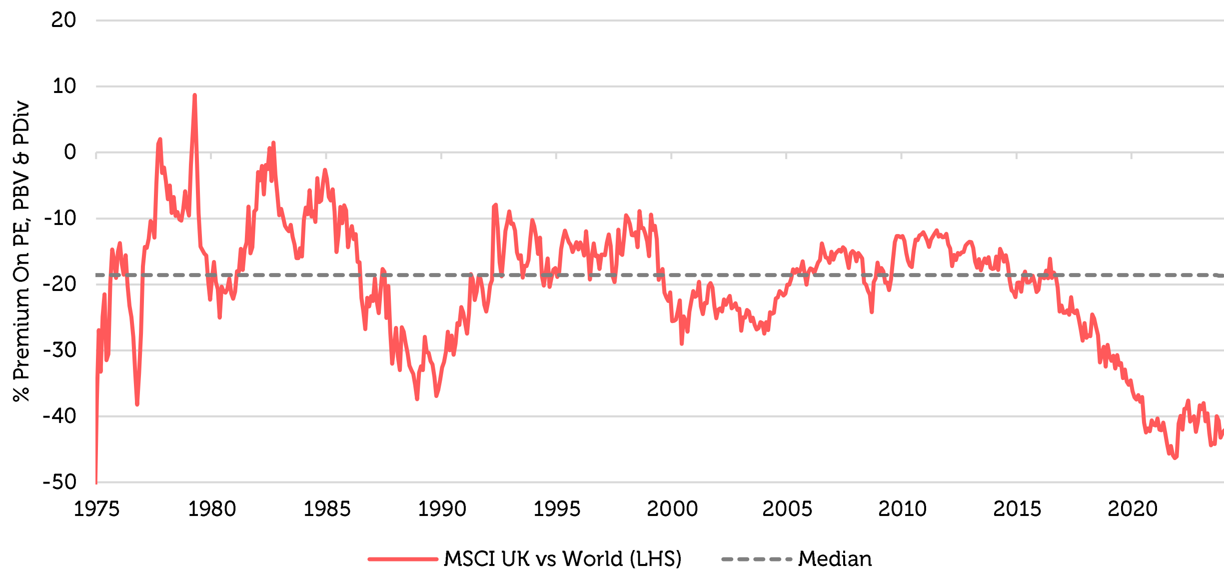
We, like most equity fund managers investing in the UK (I suspect), have spent the last few years trying to demonstrate how cheap the UK equity market is both in absolute terms but particularly when compared to the US equity market which is currently sporting one of the highest valuations ever observed.

Chart 1. MSCI UK Index vs MSCI World Index



Source. Morgan Stanley, 31 December 2023. Past performance is not a guide to future results. The prices of investments and income from them may fall as well as rise and an investor's investment is subject to potential loss, in whole or in part. No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

Despite this, UK equities have continued to lag their US peers rising by 7.9% in 2023 versus 26.3% for the S&P 500[1]. Whilst there have been many theories to explain the lacklustre returns of UK equities (sector composition, Brexit, political uncertainty), my own feeling is that it is mainly explained by money flows. As we have discussed before, we observe a number of UK pension funds spending decades not only selling equities to buy bonds but also reducing the UK as a percentage of their equity exposure. An additional factor has been the consolidation amongst the large wealth managers many of whom have moved away from allocating money on a regional basis to global investing. Since the UK currently has a 3% weight within MSCI World compared to the US weight of 70%[2], this has also led to switching from UK equities to US equities. These factors have led to relentless selling of UK equities irrespective of valuation and on the other side relentless buying of US equities regardless of valuation. When we highlight the very low valuations on offer in the UK equity market, however, the first question we are asked is "what is going to change this?" and that is a very fair question since I personally find it hard to see a scenario where all the money that has departed the UK suddenly comes back in this direction. We can now see, however, two mechanisms that can potentially realise this value in UK equities without the need for large money flows into the market.

[1] FTSE All Share Index TR, S&P 500 Index TR, Bloomberg, 31 December 2022 to 31 December 2023
[2] MSCI World, 5 April 2024

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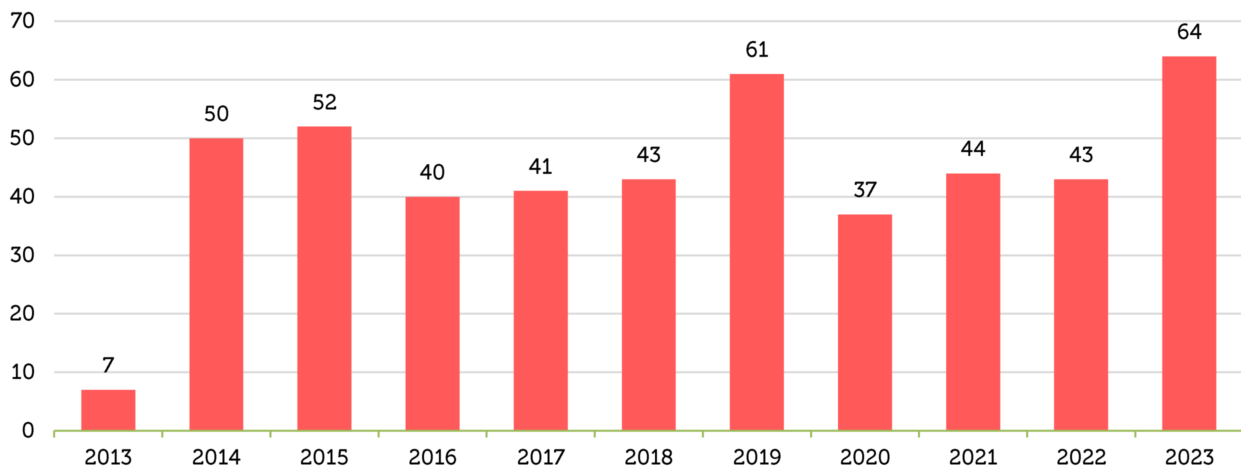
Catalysts for realisation of value in UK equities

1. Corporate takeovers

The relentless selling of UK equities has driven valuations to such low levels that overseas corporates have spotted an opportunity to acquire UK assets at prices that offer serious potential to achieve an attractive return. The chart below shows the numbers of takeovers in the UK market and the fact that this picked up significantly in 2023. This momentum has accelerated in 2024 as by the end of February, we had already seen offers for Currys, Direct Line, Wincanton, Redrow, LXI REIT and Spirent. UK investors have to accept that if they are going to drive valuations down to such low levels, overseas corporates are going to take advantage of them, and they mustn't complain when large numbers of UK companies are swallowed up by their international rivals.

Chart 2. Number of takeovers in the UK market

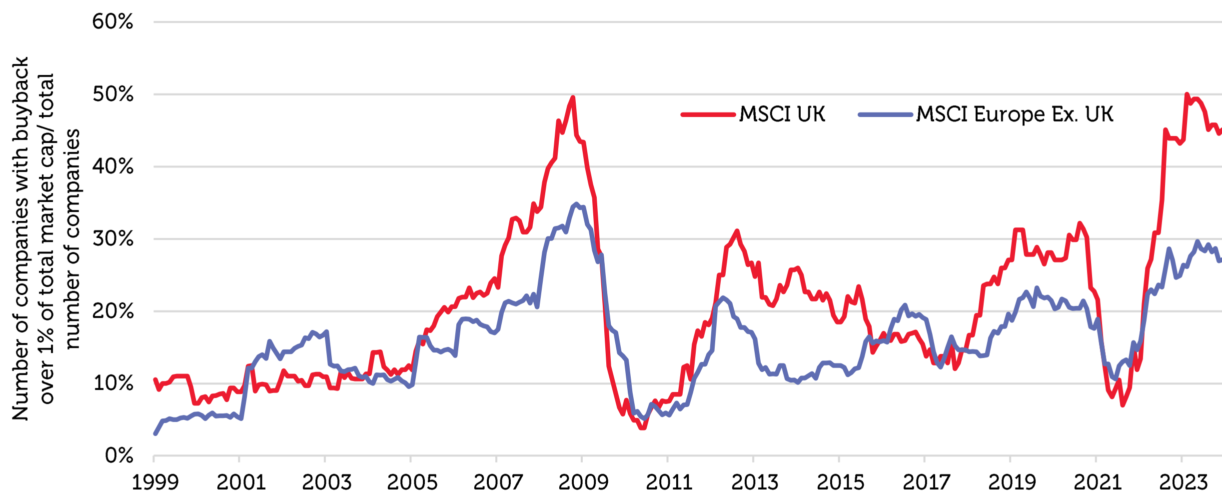


Source. Redwheel, Factset, 31 December 2023. The information show above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.

2. Share buybacks

Meeting the CEOs of the companies we invest in has been quite a depressing experience in recent years since many feel that they are doing a very good job of running their company and yet continue to watch their share prices fall. Our advice has been to not take the low share price personally but rather to use it to the advantage of the company's shareholders by buying shares back at lower valuations as this will be value accretive in most cases. The chart below suggests that this message is finally starting to hit home as 50% of UK companies within the MSCI UK Index have bought back shares in the last twelve months, the highest percentage of any market in the world.

Chart 3. Number of companies with buyback over 1% of total market cap/ total number of companies



Source. Morgan Stanley, 'The Land of Equity Yield', 31 December 2023. The information shown above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice.

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How share buybacks can add value: the theory

We believe that investors often overlook how accretive share buybacks can be which is surprising given that Warren Buffett opined on this subject in Berkshire Hathaway's 1984 letter to shareholders:
"When companies with outstanding business and comfortable financial positions find their shares selling far below intrinsic value in the marketplace, no alternative action can benefit shareholders as surely as repurchases."

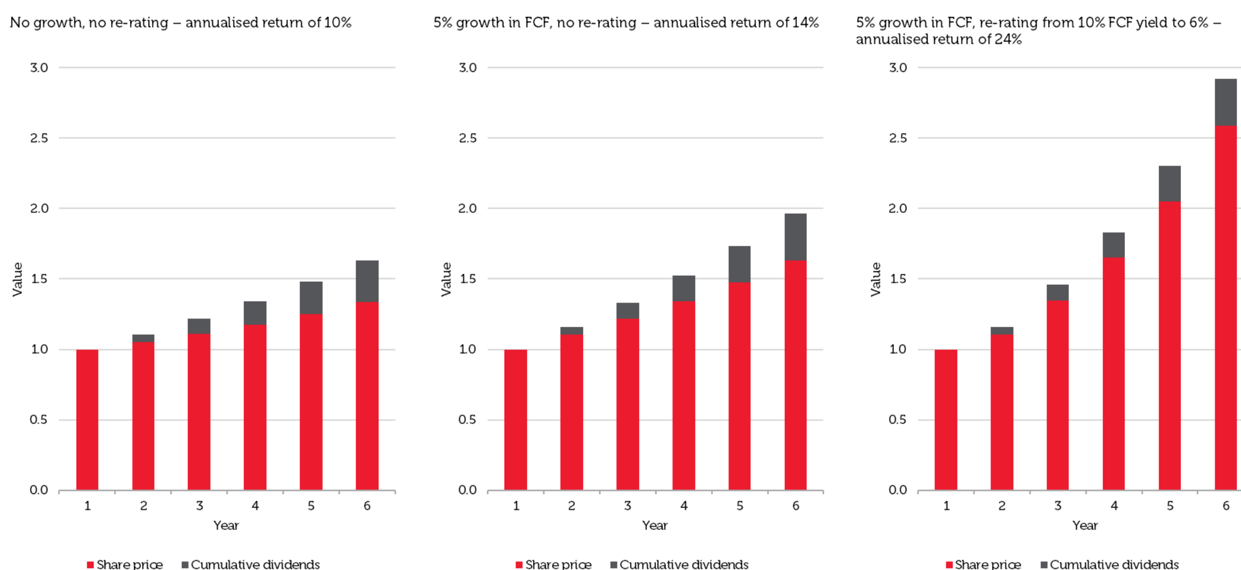
To show how share buybacks can add value we have created three scenarios below. To keep the maths simple, in all cases we are using a fictional company with a market capitalisation of £1bn that is generating £100m of free cash flow per annum i.e. cash generated after interest, tax and capital expenditure that is free to return to shareholders. This company would be valued on a 10% free cash flow yield (£100m/£1000m).

Company 1 pays a £50m dividend (5%) and buys back £50m of shares. The share buyback will reduce the share count by 5% meaning that for a constant level of earnings and dividends, the earnings per share and dividends per share will rise by 5%. This 5% dividend and 5% buyback will thus produce a total return of 10% per annum and will continue to do so even if the free cash flow remains unchanged.

Company 2 is identical with the exception that the free cashflow grows at 5% p.a. and this produces a total return of 14% p.a.[3]

Company 3 is the same as company 2 but in this case, we have assumed that investors warm to the company over the five-year period and place a higher valuation on the business. In this case we assume the shares re-rate from a 10% FCF yield to a 6% free cash flow yield. This produces a total return of 24% p.a. which I believe would be more than acceptable for most investors.

Chart 4. How share buybacks can add value



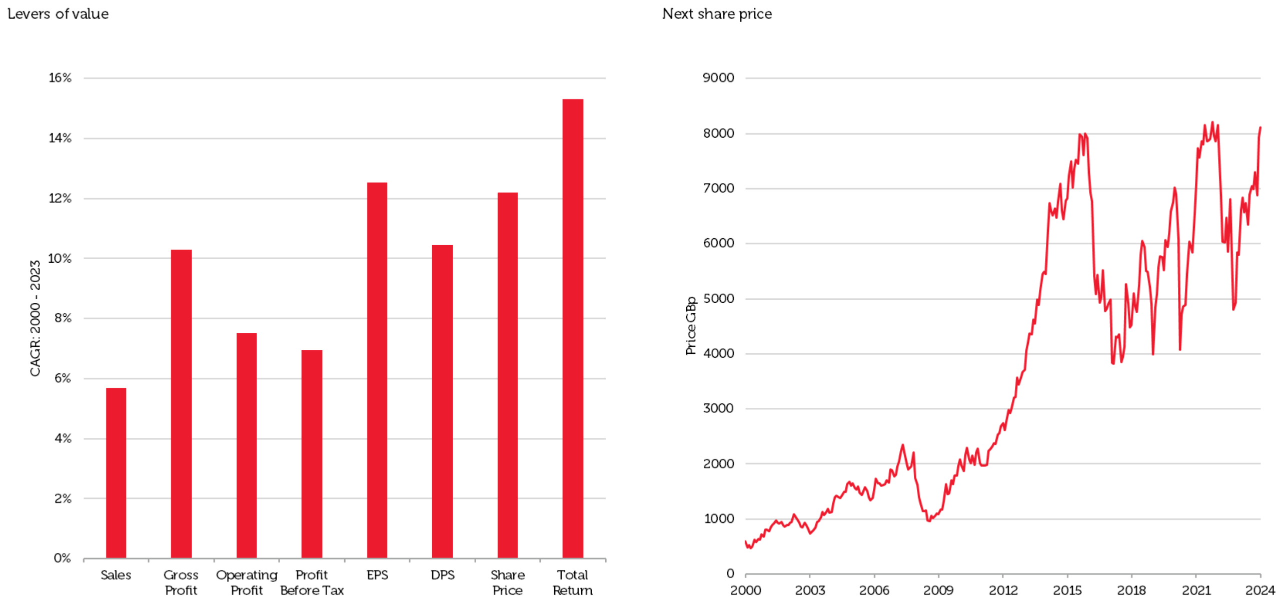
Source. Redwheel, 29 February 2024. The information shown above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice. No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

Share buybacks in practice

As we have highlighted before, the poster child for a successful capital allocation policy that uses share buybacks is Next plc which has bought back two-thirds of its shares in issue since 2000 and hence produced a total return for investors of 16% p.a. and seen its share price rise from £5 to £80 over that time despite only growing sales at 5% p.a.

[3] Whilst some may expect this figure to be 15% (5%+5%+5%), we have assumed the share prices rises over the five-year period and the buybacks at a higher price have a slightly lower impact

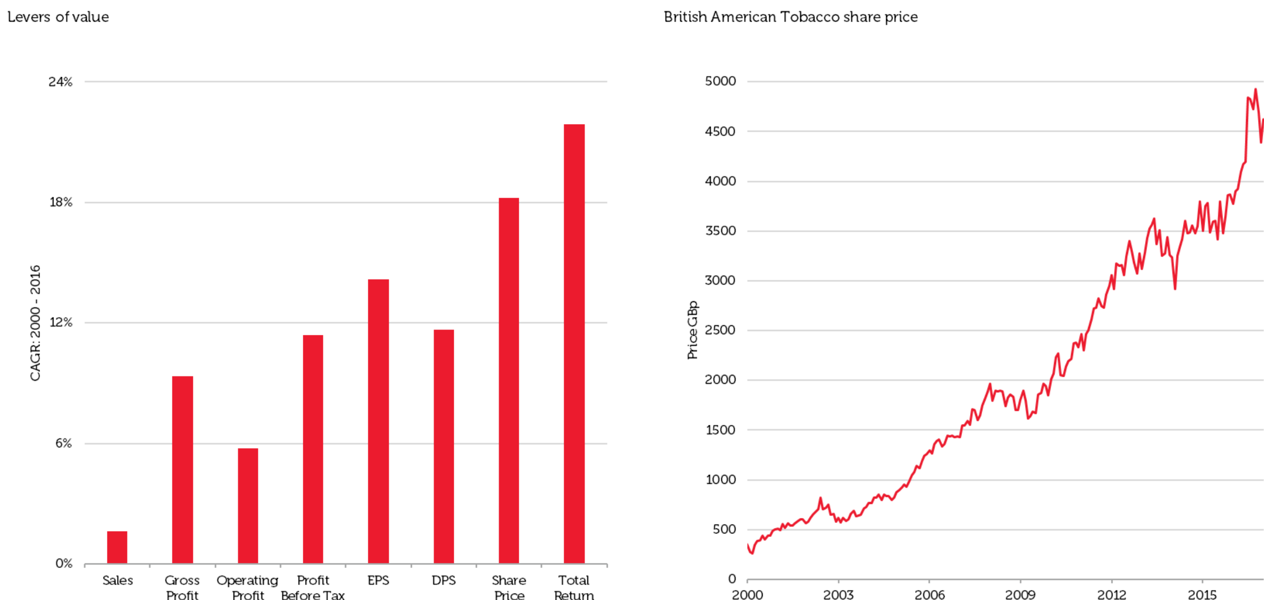
Chart 5. Share buybacks in practice – Next PLC



Source. Bloomberg, Redwheel, 01 January 2000 to 31 December 2023. The information shown above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice. Past performance is not a guide to future results. The prices of investments and income from them may fall as well as rise and an investor's investment is subject to potential loss, in whole or in part. No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

Perhaps an even more spectacular example of the power of share buybacks has been British American Tobacco because investors were right to identify in 2000 that it had poor growth prospects due to declining numbers of people smoking. Between 2000 and 2016, its sales only grew by 2% p.a. and yet it gave its shareholders a 22% p.a. total return and saw its share price rise from £3 to £50.

Chart 6. Share buybacks in practice – British American Tobacco



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The Return of the Total Return Kings?

We believe that the conditions today are reminiscent of those that existed in 2000; once more investors are focusing on the growth prospects of technology companies and are paying very high valuations for them in our view. Conversely, they have seemingly little interest in investing in old economy sectors such as energy, financials, and autos and have driven the valuations of these parts of the market to lower levels. So which companies today are in a similar situation to Next and BATS and thus have the potential to reward their investors with attractive total returns in the future?

The table below contains some of the companies we hold in our portfolios which we think could produce attractive total returns for their investors. It's important to note that share buybacks are more powerful when valuations are low simply because for every £1 used, you are able to buyback more shares. We would argue that US technology companies who buyback highly valued shares are making a bad capital allocation decision.

Column 1 in the table below simply looks at the earnings that these companies have generated in the last two years as a percentage of the current market capitalisation. Remembering that in our theoretical examples above we used a 10% FCF yield, we would note that some of these companies have generated between 40-50% of their market cap or 20-25% p.a. This puts them in a favourable position to return cash to shareholders and the next columns look at whether they have been doing that. The second column across is the dividends that these companies have paid out as a percentage of today's market cap, and we can see that some of the companies have paid out between 10% and 14% (in the case of NatWest) in the last two years.

The next column shows the share buybacks as a percentage of market cap and again, some of these figures strike us a truly impressive. BP and Shell have bought back 17% of their market cap in two years whilst NatWest is again the winner having bought back nearly 30% of its market cap in just two years (remember that we earlier noted that Next PLC had retired two thirds of their shares in 23 years which puts the NatWest figure in context). The final column then adds together the dividends plus share buybacks to show the total cash return these companies have given their shareholders over the last two years as a percentage of today's market cap with a range of figures from 16% to 43%.

Table 1. Company earnings as a percentage of current market capitalisation

	2yr earnings per share yield	2yr dividend paid/accrued	Share buyback return 2yr	2yr cash shareholder yield
Energy				
BP	42%	9%	17%	26%
Shell	34%	8%	17%	25%
Total	39%	12%	8%	19%
Consumer Durables				
Stellantis	55%	12%	4%	16%

	2yr earnings per share yield	2yr dividend paid/accrued	Share buyback return 2yr	2yr shareholder yield
Banks				
Barclays	47%	10%	10%	21%
NatWest	39%	14%	29%	43%
Standard Chartered	33%	6%	16%	22%

	2yr operational capital generation yield	2yr dividend paid/accrued	Share buyback return 2yr	2yr shareholder yield
Insurance				
NN Group	35%	16%	12%	27%

Source. Redwheel, Company Report & Accounts, 29 February 2024. The information shown above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice. Past performance is not a guide to future results. The prices of investments and income from them may fall as well as rise and an investor's investment is subject to potential loss, in whole or in part. No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment.

We hope that it should be fairly obvious that if these companies continue to buy back shares at the rate of the last two years, it seems likely that their share prices will eventually respond since their earnings per share and dividends per share could increase significantly. If the share price does not rise, then the price to earnings ratios and dividend yields will eventually reach ridiculous levels. It is worth noting that share buy backs can sometimes have no impact for a while and then have a very marked impact when the market finally wakes up to what is going on. The chart below shows how US department store Dillard's Inc quietly bought back shares for a number of years with no real impact and then between Jan 2021 and Jan 2022 saw its share price rise from $50 to $400.

Chart 7. Dillard Inc's share price and shares outstanding

Source. Bloomberg, 11 March 2024. Past performance is not a guide to future results. The prices of investments and income from them may fall as well as rise and an investor's investment is subject to potential loss, in whole or in part.

Conclusion

We believe that the market is currently offering up some incredible opportunities for investors not because there is anything fundamentally wrong with these businesses but rather because of neglect.
As US fund manager David Einhorn has said, valuation has become almost irrelevant for most market participants.

"The market is still dominated by investors that either will not (index funds), cannot (untrained novice investors) or chose to not (valuation indifferent prof. investors) have valuation as a cornerstone of their investment process."

What we have hopefully demonstrated, however, is that companies have the ability to use this low valuation to change the fundamentals of their business i.e., increase their earnings per share and dividends per share and that eventually the market will take notice of this. Just as in 2000, investors are so entranced with the potential growth being offered by US technology companies, that they are ignoring some of the real bargains to be found in the New Total Return Kings.

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