RIVER AND MERCANTILE

RIVER AND MERCANTILE GLOBAL SUSTAINABLE OPPORTUNITIES FUND

Quarterly commentary to 30 September 2022

For unitholders only

Executive summary

- Global equity markets fell in Q3 2022 (MSCI ACWI -15.7% total return in USD) despite rallying hard in July and most of August. Losses were concentrated following Fed Chair Powell's speech at Jackson Hole on 26 August. Evidence of 'sticky' inflation measures increasing rather than declining sequentially have reinforced central bank commitment to fighting inflation, making summer considerations for a 'pivot' towards looser monetary policy a distant memory. Broad dollar strength is contributing to tightening financial conditions outside the US and brings to mind former US Treasury Secretary Connally's comment in the 1970s: "The dollar's our currency, but it's your problem."
- We initiated positions in three ingredients companies with pricing power: **IMCD**, **T Hasegawa** and **Tate & Lyle**. Another new purchase, **Industrie De Nora**, is the market leader in the electrode technology used for alkaline water electrolysis (AWE) – currently the predominant method of producing green hydrogen. **Elis** was sold as margin recovery had played out. Broken investment cases at **Valmet**, **Tadano** and **Avantor**, a larger downside risk scenario at **Subsea7**, and a new flag for a potential UNGC breach for **Baidu** let to exits in each.
- We are pleased to report on strong progress towards our engagement goals at **AGCO**, **Sprouts Farmers Market**, **Owens Corning**, and **Henry Schein**. **DBS** and **Hayward Holdings** have committed to improvements over the next 12-months on issues raised. **Verallia** remains committed to its decarbonisation investment programme but will see emissions increase in the short-term due measures put in place to manage through the European energy crisis.
- The portfolio in aggregate delivers ~13% cash return on capital and can grow sustainably at ~10% per annum, while valued at 9% earnings yield. The relative value opportunity is stark – the portfolio trades at two-thirds the benchmark's asset-based valuation despite similar fundamentals.
- This quarter we lay out the investment case for beneficiaries of capital investment ('capex'). Evidence currently points to capex being more resilient than earnings forecasts or current share prices imply. We also show scenario analysis to stress-test the portfolio's valuations to mean-reversion or recession and highlight one potential 'game changer' from the recent US Inflation Reduction Act regarding the economics for green hydrogen.

Investment background

Global equity markets fell in Q3 2022 (MSCI ACWI -15.7% total return in USD) despite rallying hard in July and most of August. Losses were concentrated following Fed Chair Powell's speech at Jackson Hole on 26 August. Evidence of 'sticky' inflation measures increasing rather than declining sequentially have reinforced central bank commitment to fighting inflation, making summer considerations for a 'pivot' towards looser monetary policy a distant memory. The US 10-year bond yield had an interesting journey from 3.0% at the end of June to 2.6% in early August, finishing at 3.8% at quarter end, having breached 4% for the first time since 2008. Longer duration equities significantly outperformed until mid-August but subsequently fell sharply as bond yields rose. UK gilts had an even wilder ride. The UK government's

'mini-budget' is aimed at boosting economic growth, but its unfunded nature spooked financial markets and saw the Bank of England step in with a temporary bond buying programme to stem losses in gilts. Sterling was initially weak, though this appears as much a feature of US dollar strength as anything (DXY +7% in Q3, +19% over 1 year). Broad dollar strength is contributing to tightening financial conditions outside the US – contributing to falling commodity prices (Brent oil -23%, copper -8%) – and brings to mind former US Treasury Secretary Connally's comment in the 1970s: "The dollar's our currency, but it's your problem."

Performance

Among our strongest contributors were banks **DBS** and **Bank of Ireland**, which were rose +17% and +16% respectively (in GBP). Both operate in consolidated markets which helps the pass-through of higher interest rates to improve net interest margins, while the market has started to recognise the shareholder return potential enabled by a strong capital base at each. In a weak market, **McKesson** again proved its defensive qualities. Its half-year results demonstrated a company executing well, on track to deliver +10-15% underlying EPS growth this year. **Carlisle**, which provides roofing and insulation for US commercial real estate, rose +21% aided by profit delivery ahead of expectations. Payments business **Fiserv** also delivered excellent interim results, justifying its recent upweighting in the portfolio. Life science tools company **Waters Corp**'s shares had performed well into its 2nd quarter results but fell following these. The company is delivering to the medium-term strategy and guidance laid out at the recent capital markets day, reinforcing our investment case. It expects to deliver 10% organic sales and earnings growth in 2022. We have increased our position into share price weakness. **Sony** fell -16%, which we attribute to concerns around consumer spending and the semiconductor cycle. Pharma giant **Sanofi** was hit by market concerns about litigation relating to a drug called Zantac. We have de-risked our position size based on our experience that these episodes are rarely resolved quickly and in recognition of a new element to the investment case on which we have little incremental insight. That said, most analysts size the potential liabilities – which would be shared between several parties including GlaxoSmithKline and its recent consumer spin-out Haleon – below $10 billion compared to $50 billion in market cap that has cumulatively been lost by the impacted companies. **Baker Hughes** fell -20% with the dual performance headwinds of a falling oil price and results which missed analyst expectations, predominantly due to lingering supply chain issues and its exit from Russia.

Activity

Due to elevated market volatility and a rapidly evolving backdrop, our activity was more elevated than normal during the past quarter.

We initiated positions in three ingredients companies.

Specialty chemicals distributor **IMCD** is an underappreciated compounder with multiple competitive advantages – based around its core competency of providing 'active ingredients', or in other words the chemical helping a producer of, for example, anti-wrinkle cream facilitate this trait – protecting its 20-25% return on capital and ~10% growth potential. We believe two aspects relating to its cash generation contribute to the mispricing today. Firstly, the accounting P&L does a poor job of reflecting the true economics of the business, by which we mean that cash capex is ~€10m versus ~€100m being expensed each year; in other words, the free cash flow yield is more attractive than anyone looking at P&L based valuation (e.g., P/E or EV/EBIT) might initially recognise. Second, its balance sheet is currently under-leveraged versus its normal (and sustainable) level, meaning it has significant firepower to deploy on M&A in a still fragmented market (top 4 players only 10% of the total market). We started to build our position following interims which set the business up to exceed consensus forecasts for the full year.

T Hasegawa is a top ten global flavour and fragrance (F&F) manufacturer. Management is focused on increasing profitability in the mature Japanese market and building overseas revenue in China, Southeast Asia, and the US. It has recently opened a new site in the US which doubles production capacity, is expanding capacity in Malaysia and investing Y2bn in R&D within China. This should deliver double-digit operating profit CAGR. Combining >40% gross margin with improving working capital efficiency implies strong free cash flow generation and value creation. On top of this, the balance sheet is inefficient – over 20% of the market cap in net cash plus 10% in long-term investments – which is recognised by the management, who have begun to sell down cross-shareholdings (and have set explicit targets on this). At **Tate & Lyle**, the divestment of the low-return, commoditised Primary Products division leaves a high returns ingredients business (FBS) with mid-single digit organic growth and 50-100bps per annum margin expansion potential. Growth is supported by sustainability tailwinds from healthy eating and with the passage of time we expect the gap to close between its current ~13x earnings multiple and the 20x-plus on which its specialty ingredients peers trade. A particularly opportune entry point was provided by some uncertainty over short-term earnings relating to energy cost inputs.

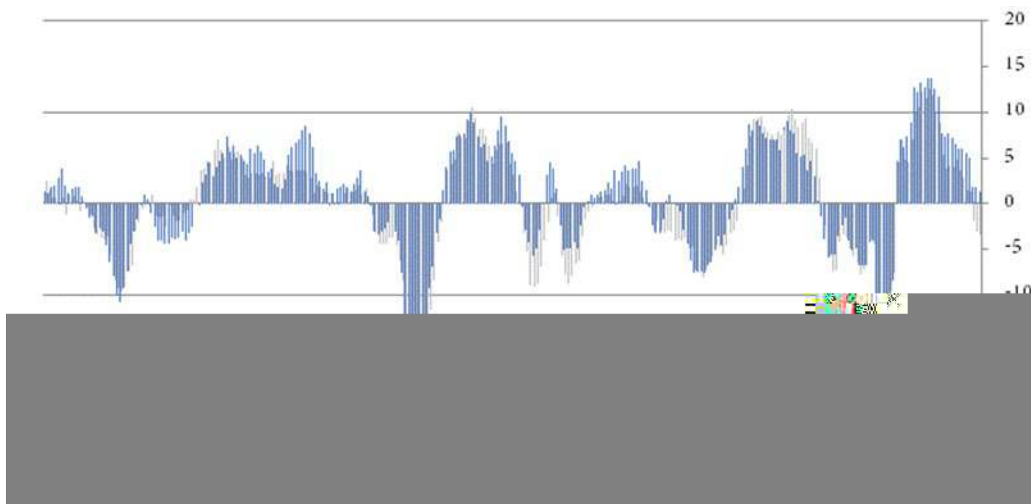
Industrie De Nora is a growth compounder investment case with strong 'sustainability enabler' credentials, particularly as it grows its nascent Energy Transition Technologies (hydrogen) division. De Nora is the market leader in the electrode technology used for alkaline water electrolysis (AWE)– currently the predominant method of producing green hydrogen. It also has growth options providing components into alternative methods which are less developed today: polymer electrolyte membrane (PEM) electrolysers and anode exchange membrane (AEM) electrolysers. Growth here is backed by cash generation from the more established divisions, Electrode Technologies and Water Technologies. Both hold leading market shares, with strong pricing power and resilient revenues.

Linen and workwear rental provider **Elis** was sold as its margin recovery had largely played out, supported by improved volumes in key end market hospitality. Investment requirements are somewhat higher than our expectations which reduces fair value. This smaller margin of safety, combined with similar end market exposures within other holdings where we see a larger value gap, led to an exit. Similarly, upon review of each investment case, pulp & paper machinery provider **Valmet** and crane manufacturer **Tadano** were no longer considered strong enough ideas and were sold. We retain exposure to companies with similar earnings drivers elsewhere in the portfolio. Offshore energy contrac153(si)p 0 Tc 9.36016 0 Td 05(e829121-3.88762(i)-7.88aT 2 Tr (P)Tj(p)TJ 0.03984dc 9.36016 0 4(e de)-10.187s

Source: Bloomberg Finance LP, River and Mercantile Asset Management.

This is important context for the dynamics we are witnessing today. Forecast revisions for cyclical sectors have weakened relative to defensive sectors, notably since the middle of 2022, leading to broad-based share price underperformance for economically sensitive companies.

Forecast revisions for cyclical sectors relative to defensive sectors



Source: Redburn

Despite this, unlike 2009, capex forecasts are proving more resilient than earnings forecasts. We have aggregated the bottom-up analyst forecasts for capex in 2022, 2023 and 2024 for every company in the MSCI ACWI index to look at how these have moved over the past year. For 2023, for example, the aggregate level is +7% higher versus a year ago and the levels for all have hardly budged in US dollar terms since the end of Q1 2022 despite softening macro and the strong dollar. 2024 spend is expected to be higher than 2023, which in turn is higher than 2022.

MSCI ACWI Aggregate CAPEX forecasts 2023e (L) and 2024e (R) since 31 March 2022

Source: MSCI, Bloomberg Finance LP, River and Mercantile Asset Management LLP. Data to 21 September 2022.

When we drill down to a handful of key sectors and sub-sectors (below), the growth figures are like previous capex cycles while there is also a clear logic and narrative behind the current spend. The inflationary pressures we're experiencing today are a symptom of last cycle's underspend – the requirement to upgrade manufacturing bases ('smart industrial') and infrastructure is joined by decarbonisation, supply chain resilience or 'near-shoring', and energy security as critical investment priorities for the near, medium, and long term. Returning to the Rio Tinto CEO's quotation at the top of this section, "this is actually really fundamental" – rapid payback investments[5], helping build business resilience, or giving companies a licence to do business for the decades to come if we consider energy transition investments for oil & gas companies or investment in electric vehicle platforms for autos. Or as Morgan Stanley puts it, "Even if we were to dip into a recession, we are of the view that these investments still need to take place as the problems do not get resolved with a moderating demand environment. In other words, the capex investments we envision and believe are necessary are incremental and largely cycle/capacity addition agnostic."

Source: MSCI, Bloomberg Finance LP, River and Mercantile Asset Management LLP. Data to 21 September 2022.

The numbers involved are large. Morgan Stanley forecasts the following:

- ~7.5% manufacturing capex CAGR over the next 3-5 years vs historical levels ~4%, and within this automation growing at ~10%

[5] According to surveys, the key factors limiting Eurozone production currently are equipment followed by labour; until 2021 this was demand.

- Retrofit to enable EV infrastructure, onsite power generation and storage, and grid modernisation providing a 20-year runway of ~6% growth in electrical markets, incremental to industrial production growth and accelerating from 2025-30 (~$45bn opportunity between now and 2030)
- $350bn spending over the next 15 years to modernise the commercial building installed base, an additional $140bn over status quo investment requirements
- ~$39bn from the CHIPS Act to bolster domestic US semiconductor manufacturing (plus $13bn for R&D) versus a current ~$200bn manufacturing capex base
- ~$370bn earmarked for Energy Security and Climate Change investments within the US government's Inflation Reduction Act to incentivise the transition to greener energy sources
- ~€200 billion by 2026 from the German government for investments in decarbonisation and energy dependence.

Some of the major investment opportunities come in what we might consider 'derivative spend'. For example, we know that spend on renewable energy generation is ramping fast (captured above in Energy's +23% increase in 2023 forecasts over the past year). A future grid with 20-30% solar is considered optimal, which requires a 3-5x acceleration in the pace of annual solar deployments. However less well known is that solar output typically flickers downwards by over 10% around 100 times per day[6] and building out power grids and inter-connectors is considered the best means of helping to resolve both short- and long-term variability in output. Thunder Said estimates that power network investment can rise from an average $280bn per annum in 2015-20[7] to $600bn by the end of the decade, equivalent to all upstream oil & gas capex in 2015[8]. Portfolio holding NKT is well placed to benefit from demand for its high-voltage cable solutions.

Global power network capex 2020-2050e

Source: Thunder Said Energy

Anticipation of a global recession has made accessing this long-term growth very cheap, with the prospect that for the select cyclicals that are beneficiaries, near-term earnings also look set to be more resilient than analysts are forecasting or share prices are embedding. Overleaf are the price/earnings multiples (based on consensus earnings 1 year ahead) for a handful of companies held in the portfolio which are positively exposed to the trends mentioned:

[6] Source: Thunder Said Energy

[7] Of which one-third was transmission, two-thirds distribution

[8] Thunder Said estimates $1 trillion annual spend by 2045 assuming wind and solar at just 20-25% of all global energy in 2050. 'Aggressive' renewables scenarios can require $2-3 trillion p.a. of power grid spending.

Source: Bloomberg Finance LP, River and Mercantile Asset Management LLP. Data to 4 October 2022.

And from a timing perspective, using the broad Capital Goods industry group as a proxy, capex beneficiaries have underperformed the bear market, but investors have nascently begun to differentiate their outlook versus other cyclical sectors. This suggests the idiosyncratic outperformance is in its early innings.

Capital Goods relative performance year-to-date (indexed to 31/12/2021 = 100)

Source: MSCI, Bloomberg Finance LP, River and Mercantile Asset Management LLP. Data to 30 September 2022.

This entry point offers a positively skewed risk-reward: "heads we win, tails we don't lose too much." Nonetheless, it's worth considering where we could be wrong. Firstly, and most obviously, monetary policy works with a lag – that's to say, the capex cuts are coming, we just haven't seen them yet. Do companies have the capacity to make the investments, even if they want to? Current analysis is relatively comforting on this point. Goldman Sachs "see the ability for public companies to spend $1.0 trillion in additional Green Capex without stretching balance sheets while still retaining 30%+ of operating cash flow." The impact of rising interest rates is nuanced. For an announced project already underway and financed, corporates will likely have visibility on cost of debt for the coming 3-5 years; preparation for this spend is no doubt partly behind the reduction of short-term borrowing in Europe from 30% to 20%. Long-term lending (over 5-years maturity) is holding up well – it picked up slightly in August and is still above the pre-pandemic average growth rate. The broad observation is that although the bond market has repriced up sharply, banks have been happy to step in and so the true price shock for corporate borrowing is more moderate than bond yields suggest. Governments are clearly also stepping in with tax benefits and other incentives which reduces the bill that corporates will foot and shortens the payback on the spend they do.

We certainly don't expect there to be no cuts, and indeed some have already emerged. Semiconductor company Micron recently cut its 2023 capex guidance by 30%, or $8 billion. Putting this in context, TSMC alone is still expected to spend $37 billion in each of the next 2 years and most of the semi capex cuts have so far been in memory, which was anticipated by many industry analysts given pricing trends there (logic and foundry are expected to be more resilient).

Eurozone credit growth (%, Year-on-Year)

Source: ECB, BNP Paribas Exane estimates

The long-term requirements for investment are relatively well -established by now, but we detect nervousness among investors about how a combination of tight ening financial conditions, demand weakness, inflation and earnings forecast reductions will fee d into an 'air pocket' and capex cuts during 2023 and 2024. We expect this is conditioned by the experience of the previous cycle, but the evidence is currently incontrovertible that we've entered a different regime. Many companies can't afford not to invest today. Cleansing capitalism's karma – or fixing the 'sins' of the last cycle – suggests casting off the s karma

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