Equity Research; 2017 Brexit Focus List

COLLINS SARRI STATHAM INVESTMENTS

Research Report

Report Date

12th March 2017

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"Brexit" rolls on…

The Article 50 "trigger" has been and gone. But the "Brexit" environment is in place until March 2019 at least; what are the implications of this environment?

i) Prolonged sterling weakness; which improves the value of overseas earnings.

ii) A "dovish" Bank of England keeping 0.25% Base rates to support UK GDP growth.

iii) Sector divergence; "Brexit" impacts some sectors far more than others, creating longer term opportunities.

iv) Geopolitical events will feature, with forthcoming elections in France and Germany, a novice US administration and the potential for surprises as UK/ EU negotiations get underway.

The global context since the US Presidential election has been called the "Trump reflation" trade i.e. amounts to a series of assumptions about US corporate and personal tax cuts, defence/ infrastructure spending that will boost US GDP growth in 2017/ 2018.

The context has been helped by accelerating GDP data in the US, EU, most of Asia (excluding Japan). Trump reflation has provided an overlay to the "Brexit" environment but runs various risks:-

i) Dow Jones is up 15.2% since the November election lows (DJ 17,888) pricing in US GDP acceleration and earnings growth from lower corporate taxes. Equity valuations are elevated and sensitive to narrative change.

ii) A political impasse. The "Freedom Caucus" and splinter groups within the Congressional Republicans could delay or water down Trump's substantial new deficit funded spending plans. Failure to achieve legislation would hit Trump sensitive defence, infrastructure, and consumer stocks quite hard.

iii) US bond price reversal. Bonds have been strong despite Federal Reserve guidance suggesting two further 2017 hikes to money market rates and talk of Federal Reserve balance sheet reduction. Around $4trn of fixed income assets were added to the Fed's balance sheet since 2008.

iv) Tech re-think. Apple, Microsoft, IBM, Cisco are top beneficiaries of plans to offer a tax holiday on funds repatriated from abroad. This is a Trump promise that may be delayed, diminished or broken.

v) President Trump's declining "credibility"; possible geopolitical tensions would damage confidence.

The context suggests companies i) that might have oversold due to "Brexit" or sector issues ii) Revenues in USD/ EUR but costs in sterling iii) "special situations" where Brexit is of limited relevance.

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Our first two recommendations draw on i) oversold, whilst the last would be iii) a special situation.

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Gem Diamonds– LSE – BUY

Gem Diamonds is a leading Botswana (the Ghaghoo mine/ full ownership) and Lesotho (the Letseng mine/ 70% owned) gem producer with significant manufacturing and marketing operations in Antwerp.

Owing to the depressed state of the diamond market, the board made a decision to put the Ghaghoo mine on "care & maintenance" at an annual cost of c.$3m Rough diamond prices declined from $210/ carat in Q1 2015 to $142 per carat in December 2016. The Ghaghoo mine is ready to go into full production when diamond prices recover. Whilst this closure sounds bad, the Ghaghoo mine in 2016 earned revenues of only $7.2m (less than 4% of group revenues in 2016) and pricing in its diamond category had been particularly weak. The mine had been loss making. Gem Diamonds recognized an impairment of $170.8m relating to the Ghaghoo mine in the 2016 results.

2016 results were hurt by the Ghaghoo non cash impairment ($176.5m) with an attributable loss of $158.8m. Excluding these one off items, Gem Diamonds earned $17.7m or 12.8 cents per share.

The Letseng mine at Lesotho (108.2k carats at an average $1,695 /carat) earned $183.4m in revenues during 2016, its production has been relatively static. However its very high quality diamonds should see a significant price recovery. In 2015, Gem Diamonds had about 4.48m carats contained in 144.7m tons with an average price of $1220/ carat according to independent mining surveyors, Venmyn Deloitte.

According to *De Beers*, the supply of world diamonds is expected to peak in 2017 with very little new supply until 2002. This is due to rough gems being located in deep mines and hence higher extraction unit costs which will limit new supply. The diamond market stabilized in 2016, according to the annual "*Diamond Insight*" report that highlighted increased Asian demand from millennials, particularly in India and China (demand has doubled to 14% of the global market since the 2008 crisis). The drop in supply is expected to boost depressed diamond prices.

Gem Diamonds' Letseng mine in Lesotho has a remarkable track record of finding large diamonds. It reported the recovery of a very large 114 carat diamond, D colour, Type 2 diamond on 7th April 2017. Since its acquisition in 2006, Letseng has produced four of the 20 largest white diamonds ever recorded.

Company	GEMD	**Key Catalysts**
Share Price	99p	Gem Diamonds revenue and profit recovery will be sensitive to diamond price recovery and Letseng's ability to find large high quality diamonds given the constraints on overall production. There is a positive currency effect
Target Price	140p	
52 Week Hi/Low	147.5p/ 89.2p	
5 YR Hi/ Low	240.8p/ 90p	

Shares O/S	138.37m	(revenues in USD, expenses in Lesotho loti, Botswana pula, South African Rand and sterling) that should continue in 2017. Gem has significant cash balances of \$31m (c.18p per share) alongside significant US\$348.3m in tax losses.
Market Capitalisation	£136.9m	
Avg. Daily Volume	323k	
Dividend Yield	0%	

Source: Bloomberg

Key Risks to Price Target

i) Recent improvement in rough uncut diamond prices is sensitive to EU consumer demand and continued demand from Asia
ii) Reliant on Letseng for production growth and revenues
iii) Proliferation of artificial diamonds might impact dealer market/ prices

NEXT plc – FTSE 100 – BUY

NEXT is a leading UK clothing/ homewares retailer via NEXT Retail, NEXT Directory and Lipsy.

Recent 2017 results, EPS 445p (-0.3%) provided comfort that cost pressures were being managed, and the team are taking steps to offset new cost increases. During 2017/2018 NEXT has identified £36m of new costs in the form of Apprenticeship levy, workplace pension, higher national living wage and higher wage inflation. Recent *Barclaycard* data suggested consumer spending on High Street clothing went ex-growth (-0.3%) in Q4 2016 suggesting lower revenues.

The 2017 results and accompanying presentation made clear the board is rethinking its UK property exposure in the light of shifting shopping preferences away from shop visits and more online/ mobile shopping. The plan is to reduce the footprint from 8m sq foot in 2017 (20% sales) to 7.1m sq ft in 2027 but NEXT has considerable flexibility in that 70% of its leases expire in the next 10 years enabling churn / cancellation opportunities.

The board have agreed to pay a 45p quarterly dividend (hence 180p for FY18) alongside the ordinary dividend of 158p. The decision comes alongside a cancellation of the share buyback employed in recent years. The board has pointed out that Next Directory receivables (c. £1bn) now exceed net debt (£861m) providing comfort over NEXT ability to maintain its investment grade rating.

Consensus profit estimates; NEXT							
Year End	Revenue (£m)	PBT (£m)	EPS (P)	DPS (P)	P/E (x)	Yield (%)	Share Price (p)
Jan-16	4176.9	836.1	443	218	9.05	5.44	4009
Jan-17	4097.3	790.2	432	338	9.28	8.43	

Jan-18	4100.0	715.0	390	338	9.97	8.43	

Source: Bloomberg

The consensus forecasts suggests an EPS decline due to board forecasts of a wide dispersion of sales expectations (from +1.5% to -4.5%).

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Company	NEXT	**Key Catalysts**
Share Price	4009p	"Brexit" and the tough High Street environment has created a longer term opportunity in NEXT. The stock has halved in the last year, which is a rare event (only once since 1997).
Target Price	5100p	
52 Week Hi/Low	5680p/ 3791p	
5 YR Hi/ Low	7950p/ 2952p	We are confident NEXT mobile initiatives (nextpay launched in March, 12 new international mobile sites DUE in September) coupled with its willingness to slim down its property exposure is helpful in resolving investor concerns over High Street exposure.
Shares O/S	147.06m	
Market Capitalisation	£ 5.89bn	
Avg. Daily Volume	640k	
Dividend Yield	8.4%	NEXT covered dividend yield <8% provides considerable incentive to s/h.

Source: Fidessa plc

Key Risks to Price Target

i) Overall UK discretionary spending on clothing/ homewares could be pressured due to "Brexit" related uncertainty limited NEXT revenue growth

ii) Margins likely to be pressured when FX hedges expire over 2017

iii) Bad debt levels in the Next Directory receivables book could rise

NMC Healthcare plc – FTSE 250 – BUY

NMC Healthcare is a leading private healthcare provider in the United Arab Emirates and a leading global provider of fertility treatments via Clinica Eugin. In addition to its private hospitals business, NMC is a leading distributor of healthcare related consumable products. NMC reported revenues of $1.22bn in FY2016 up 38.6% with net profits of $151.4m up 76.5%, and earnings per share of $0.711.

NMC is acquisitive. It bought the 140 bed As Salama Hospital in Al Khobar in 2016 and the Al Zahra Hospital in Sharjah (UAE) in December 2016. Further hospital acquisitions are likely over 2017, possibly in Oman.

The UAE economy is expected to grow 2.3% in 2017 with demand growth

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expected from higher patient volumes and the completion of mandatory healthcare insurance by end Q1 2017. There is significant capacity within NMC, hospital bed occupancy rates were 74.3% in 2016.

The board expects to keep the dividend at a payout ratio of between 20%-30% of net profits as outlined in its 2012 IPO prospectus.

This is a special situation, a high growth business where Brexit is of little relevance.

Consensus profit estimates; NMC Healthcare							
Year End	Revenue ($m)	Net Profit ($m)	EPS (c)	DPS (P)	P/E (x)	Yield (%)	Share Price (p)
Dec-16	1220.8	151.4	71.1	10.6	31.5	0.59	1805
Dec-17	1510.0	158.7	97.0	15.5	23.1	0.86	
Dec-18	1580.0	203.6	121.0	20.0	18.5	1.11	

Source: Fidessa plc

The consensus forecasts suggest profit growth will continue over 2017-2018.

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Company	NMC
Share Price	1805p
Target Price	2200p
52 Week Hi/Low	1878p/ 1021p
5 YR Hi/ Low	1878p/ 169p
Shares O/S	204.29m
Market Capitalisation	£ 3.68bn
Avg. Daily Volume	114k
Dividend Yield	0.59%

Key Catalysts

New CEO Prasanth Manghat (appointed 8th March 2017) is likely to review NMC operations, acquisitions and dividend policy in the short term. It is possible further acquisitions will take place in 2017.

NMC's strategy of increasing licensed beds should ensure increases in average revenue per patient from $176.30.

The healthcare consumables distribution business (97.6k customers) is facing lower profit margins. Recent initiatives to boost efficiencies should help restore margin growth.

Source: Fidessa plc

Key Risks to Price Target

i) NMC Healthcare has financed acquisitions via new equity placings, this policy is expected to continue, presenting some risk of equity dilution.

ii) Increased competition in UAE healthcare markets specifically

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with Mediclinics International.

iii) Potential regulatory risk and slowdown in UAE given weak crude oil prices.

(NB. “PBT”- profit before tax, “EPS” earnings per share, “DPS” dividend per share, “P/E” price to earnings)

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Please be aware that the following disclosures of Material Interests are relevant to this research note:

Gem Diamonds	**Relevant disclosures: <2>**
NEXT	**Relevant disclosures: <1,2>**
NMC Healthcare	**Relevant disclosures: <2>**

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