

Alpha shares analysis

10 March 2022

War, dogs and dividends

In turbulent times many investors will look more closely at the dividend, seeking security, scope for steady growth and as close to a real return as possible as inflation climbs. None of the companies analysed this week has a serious threat to paying a dividend, but yields are not high, may not rise and poor total returns often counteract income.

- **BAE Systems (BA.)** – there are few real winners in war, but defence contractor BAE System has seen its share price rise more than a quarter since Ukraine was invaded. The gains are not likely due to increased spending (it will happen away from BAE's core markets), but rather a revision of whether defence stocks are still pariah through the lens of ESG. However, not all investors agree and the extent of a fair re-rating is contentious. If trading is less affected, pressure on BAE's resources to fund interest, capital spending, expansion and dividends may only marginally improve. The dividend may become more affordable, but the yield has dropped from c. 5 per cent to nearer 3 per cent, losing a key reason for considering this stock.
- **Pets at Home (PETS)** – some businesses have performed really well in the pandemic and PETS has benefited from a large increase in pet ownership as large numbers continue to work from home. The risk the business faces is from the squeeze on household incomes with no useful precedent on how close pet spending sits to the tip of discretionary spending. While few are expected to abandon their pets outright, premium products and treats are at risk of being sidelined, potentially denting retail profits and dividends. Earnings from vet services feels more secure and of higher quality than the retail arm, but PETS does not fully own or control this side of the business.
- **Hargreaves Lansdown (HL.)** – HL sits as market leader in the large and growing UK wealth management market, but its shares have returned a negative total return over three years of 36 per cent. A series of shocks have beaten the shares down, most recently a 'redefining' strategy that seeks to accelerate growth, add material advice fees to revenue, materially upgrade the online/mobile/technology backbone, push harder on own-label funds and contain costs. Investors appear unconvinced that all the objectives will be achieved in only four years and deliver the promised uplifts. Although lower rated than its smaller, more nimble peers there are a lot of question marks and a chequered history. A modest yield and sub-inflationary dividend growth offer little comfort.

Analyst: **Robin Hardy**

BAE Systems – arming for peace



Source: FactSet

While this is primarily an income-oriented article, another issue looms (very) large when looking at a defence contractor such as BAE – environmental, social and governance (ESG) ratings. Defence companies have been pariahs in the investment world for some time, along with the likes of tobacco and oil, with many funds establishing and adopting policies that preclude investment. The war in Ukraine has created a maelstrom in this area for defence companies – voices are now arguing that those operating in this space should be seen as shifting from purveyors of absolute evils to ones providing necessary evils. A looser interpretation of the ‘S’ within ESG could suggest that arming for defence against a now proven aggressor is a social good. That is moot, but is really the issue when assessing the value of this stock as promises of increased defence spending across Europe (running to the tens of billions annually and for the foreseeable future) could bump profitability, free cash flow (by more than profits as capital expenditure need not increase) and the ability to pay dividends.

Financially, BAE (and the whole sector) unquestionably looks to be moving to a more positive place, and moving there from an already very stable trading position during the last decade. That said, ‘stable’ can also be a euphemism for a lack of a dynamic outlook and *ante bellum* that certainly was the outlook for BAE. While reasonable growth was forecast, it ran at c. 5 per cent CAGR, a dividend yield bumping along at towards 5 per

cent and a PE ratio of little more than 10x, the total return over the past five years was close to zero. Overall, this was not a great stock to own.

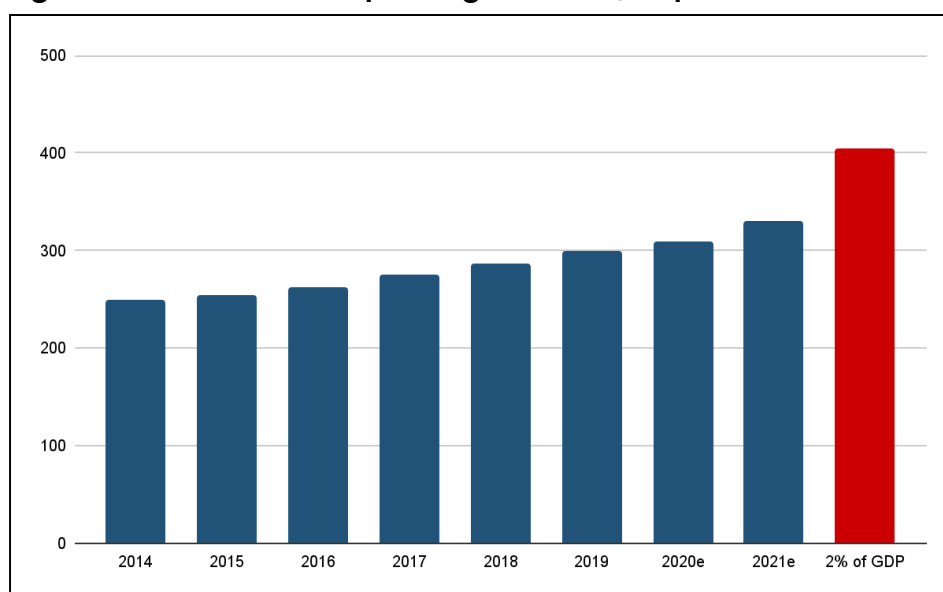
War dividend

The rapid change in the military and defence status quo across Europe has certainly been a strong kicker for BAE with its share price rising by over 27 per cent in the past month alone, almost all of which has come since day zero of the war on 24 February. Against its 2020 low of below 400p, the share price has almost doubled, but at the end of 2021 the share price was only 21p (or 4 per cent) higher than it was at the end of 2007.

A lot has changed, primarily the expectation that across NATO the pledge to spend 2 per cent of GDP on defence, a figure that many nations today come nowhere near hitting, will finally be honoured in full. The biggest shift is seen as coming from Germany, a chronic under-investor in its armed forces under Schröder and Merkel and overall basic arithmetic suggests that if total defence spending within NATO increases to 2 per cent level, some \$70bn-\$80bn of additional spending per annum might be expected. And as the mood music has significantly changed, that expenditure might be expected to recur for many years to come.

However, the USA still dwarfs the rest of NATO with its spending total of \$754bn in the 2022 Budget, although not all of this is spent in the interests of NATO. Overall, the defence spending market globally (we exclude Russia's \$62bn budget from this as it is substantially internal) is worth in excess of \$1trillion each year.

Figure 1: NATO defence spending ex USA - \$bn per annum



Source: NATO

Table 1: Largest NATO defence spenders after the USA – \$bn per annum

UK	73
Germany	65
France	59
Italy	30
Canada	26
Spain	15
Netherlands	14
Poland	13
Turkey	13
Norway	8

Source: NATO

Interestingly, Germany is less of a slouch on defence spending than many might expect with current spending at around \$65bn – against 2022 forecast GDP of \$4.05tn, that is still around 1.6 per cent. The issue is perhaps that Germany is spending a lot on truly defensive, less/non-lethal items such as the boots, helmets, gas masks and chemical suits it had initially offered to send to Ukraine. So, it is less the scale of spending that will change here but its nature. A 20-25 per cent rise in the total spend would see a materially larger increase in lethal systems.

All good for BAE?

So, how much might BAE benefit from such spending?

The \$70bn-\$80bn is a large starting figure of total incremental spending, but is likely to prove too optimistic in practice as many nations are likely to drag their feet. Nonetheless, total defence spending globally is still likely to step up by at least 5 per cent, a positive but not dramatic change. We are assuming here that the US does not make any material, responsive change in its defence budget.

While it is Germany that has caused so much excitement there are reasons to expect that BAE would not benefit from any increase there. The German armed forces are primarily required to spend with German registered businesses and while there are few defence stocks in the US or UK sense, there are businesses through which money is spent and who will benefit most: Hensoldt, Leonardo (German-based subsidiaries of an Italian business) and Rheinmetall are seen as the most likely winners here. Thereafter, it is likely that Germany will look within the EU: so the likes of Thales, Dassault, MBDA and Airbus. BAE has an interest in the latter two enterprises here, but overall only around 2-3 per

cent of its revenues arise in Germany. The German promise of spending €100bn (\$109bn) in 2022 is a single 'catch-up' spend and is unlikely to be sustained after this year. Two per cent of German GDP (2022 estimates at \$4.05tn) would run out at \$81bn as a new baseline versus the estimated \$65bn spent in 2020.

If France (the next largest defence budget) decides to raise its defence spending, that money will also need to be spent with French contractors, so again BAE would see only marginal benefits through a couple of joint ventures. France accounts for an estimated 0.9 per cent of BAE's revenues (source: FactSet).

The greater part of BAE's revenues come from the US (48 per cent), the UK (19.5 per cent) and Saudi Arabia (13.5 per cent). Pre-existing plans for defence spending in these three markets are already above 2 per cent of GDP with steady growth in the US (in line with GDP), 6 per cent in the UK, but Saudi Arabia had planned to cut spending by 10 per cent in 2022. The US budgets may increase a little and the UK government is under pressure to step up more substantially, and most likely will, but does already spend its target 2 per cent on defence.

Overall, the outlook for BAE's revenues is likely to remain reasonably flat to moderately rising trend ahead of revised national budgets. Compound growth 2021 to 2025 is expected to be just 3 per cent in the consensus, with earnings before interest and taxes (EBIT) growth only a little better at just over 5 per cent compound. These growth rates are likely to improve to some extent, but the likely improvement is unlikely to be enough to have driven the share up 29 per cent in the past month and 54 per cent in the past year. So, other factors are at play: a re-rating exercise.

Coming in from the cold?

BAE had been a lowly-rated stock for some years as ESG issues and concerns have increased in prominence. Many funds, pension schemes and individuals have consciously avoided this stock and sector on ESG and other grounds. This has meant limited buyer interest in the stock and difficulties (if not a total barrier from) accessing the equity markets.

Almost in an instant, however, things have changed. Many observers are calling for a revision of ESG standards to allow defence stocks to be moved from their pariah status to become a tolerated necessity that might even be seen as a social good. This view is far from universal but in equity markets it only takes incremental shifts or changes in balance to drive significant changes in valuations. If only a few percentage points of the total money in the London stock market feels it can now justify investment in defence, the

weight of money that would be expected to hit BAE would be enough to cause the share price to shoot up.

Weight of money is not the only factor – sentiment and relative valuations also come into play. BAE has long stood on a sizable PE discount to its US peers (such as Boeing, Northrop Grumman, Lockheed Martin and General Dynamics) – these stocks traded on mid-to-high teens PE ratios, while BAE struggled to get above 10x despite many offering little or no growth.

The attitude of US investors to defence stocks is 180° different from that of those in the UK and Europe, but is it right that suddenly BAE should match their US ratings and jump to a premium over the UK market average? There are many better and more dynamic businesses listed in London that are cheaper than BAE and that do not have the lingering and unresolved issues surrounding whether ESG standards could or should be flexed.

It is easy to understand why a re-rating of BAE would occur but the extent may be too disconnected with hard numbers and too related to more ethereal issues that can prove harder to sustain. The share price has been strong but it feels too much like sentiment over substance and like one of its fighters climbing to too great an altitude, it could easily run out of lift.

Also are the market's memories perhaps looking a little short when looking to 'forgive' a stock for its past? Consider the case of Tate & Lyle. Castigated (and rightly so) for involvement in the slave trade, but those sins were committed over 200 years ago, yet many investors still refuse to invest in the stock.

Still suffering from a lack of resource

We wrote on BAE in Alpha [back in June 2021](#) and remarked that while the business and its income were long-term stable, there was a lack of free cash flow to fund everything that the group either needed or wanted to do. Paying tax, interest, replacement capex, dividends, pensions deficit funding and working capital expansion consumed all of the available funding. And as an unloved stock in an unloved sector, it would struggle to raise fresh equity to fund expansion or acquisitions. Long-term poor total shareholder return (TSR) also dampened any potential appetite for share issues.

That may change on two fronts. Firstly, there could be a little more free cash flow as defence spending raises revenue that can be used to lower debt, make some self-funded expansion possible and raise dividend cover. Second, and more important, the change of ESG perspective and potentially above rather than below market TSR might allow equity to be issued. A share price up by more than a half can only help. The window to do this

might be narrow as views on the stock and sector could easily fade plus all potential targets will have become more expensive, but BAe does appear to have re-rated more strongly than many others. So there is perhaps some scope for the long standing financial constraints to be eased.

But does the outlook for the dividend improve? It feels more likely that BAE would like to use any change in the market's attitude to improve its financial position and to expand rather than pay a higher dividend. While dividend cover is improving it is still less than two times and any improvements in trading would more likely be used to push back up the headroom and allow the balance sheet to strengthen after too many years of over-distribution. The yield has dropped sharply from over 5 per cent a year ago to now just 3.5 per cent, so the yield case (BAE has been a very reliable dividend-payer, increasing its payment every year since 2003 – even when it couldn't really afford it) on the stock has largely evaporated.

That was a core reason to buy the stock and had solid foundations. The focus has now shifted to the share price valuation and a re-rating: here the danger is that that process may have happened in full in barely a week. If the income attraction and the capital upside are both now low, despite a seemingly positive industry backdrop there do not seem to be strong grounds for buying and there may even be grounds for cashing out: after five years of a low to no total return, suddenly the five-year TSR has jumped to almost 40 per cent.

Better ways to play the defence spending game?

If investors remain unhappy with investment in a traditional defence stock like BAE, but do see that defence spending will be a positive driver, there are stocks that trade in less lethal products that also stand to benefit. Perhaps consider **Avon Protection (AVON)** – gas masks, chem suits/hoods), **Chemring (CHG)** – counter measure, detection equipment) or **Cohort (CHRT)** – specialist military cybersecurity software).

Continued below

Pets at Home – how much is that doggy in the window?



Source: FactSet

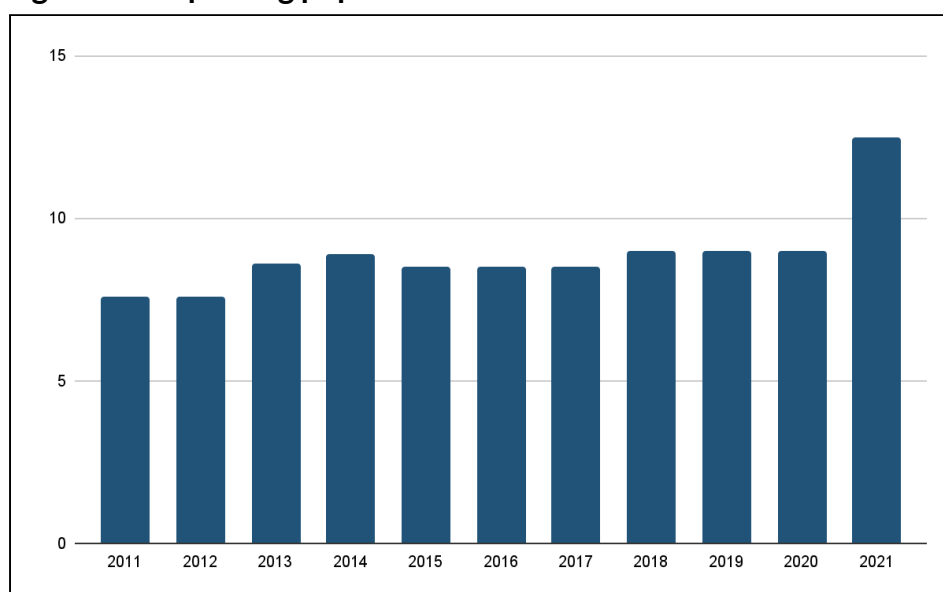
Pets at Homes has been a clear Covid winner. As more people stayed at home after the lockdowns started in the spring of 2020, so more households acquired a pet. The purchase of a pet is just the start of the journey as owners embark on potentially a decade of steady expenditure on food, treats, toys, bedding, grooming, medicines & treatments, insurance and vets' bills. While there has been some concern that new owners would abandon or put their pets up for rescue, largely this seems to have been avoided and the overall level of household spending on pets has increased in the past two years.

After an inevitably more challenging year to March 2021 when many stores experienced disruption, PETS only slipped back a little with earnings per share (EPS) dropping seven per cent and, in what was a rarity for the retail sector, it made a small increase to the dividend. Being classified as an essential service helped but Covid caution nonetheless slowed in-store footfall. The current year (ending this month) is expected to show the full extent of the UK's expansion on pet ownership with a rise in forecast EPS of more than 50 per cent.

While there have been a lot of headlines about the expansion of pet ownership since 2020, the trends prior to Covid were not especially strong. As figure 1 shows, dog ownership (the largest category with 22 per cent of households having a dog – there are materially more fish-owned, however, 30-40 million versus 12.5 million dogs) had a

relatively flat trend. Overall, fewer homes in 2020 owned a pet of any kind with 41 per cent of households being owners versus 47 per cent in 2011. So, 2021 and 2022 have had a sizable boost, but to what extent will this prove to have been not only an anomaly but also a potential robbing out of future new pet demand?

Figure 1: UK pet dog population



Source: UK Pet Food Manufacturers Association (PFMA)

Recent trading updates have highlighted that after very strong progress on a quarter by quarter basis, that momentum has slowed sharply in both the retail and vet service arms (see Table 1). The Q3 year-to-date figures for FY March 2022 runs out at +17.3 per cent for revenues but the consensus for full year revenues is +13.5 per cent suggesting that momentum in Q4 will again be slower although will stand against a weaker period in the prior year which may flatter it.

Table 1: Quarter sales momentum – versus same quarter in prior year

LFL Sales Growth	Apr - Jun 20	Jul - Sep 20	Oct - Dec 20	Jan - Mar 21	Apr - Jun 21	Jul - Sep 21	Oct - Dec 21
Retail	0.4%	12.5%	17.5%	6.1%	29.1%	13.8%	9.0%
Vet Group	-9.3%	14.2%	17.8%	16.3%	44.7%	8.4%	4.0%
Group	-0.7%	12.7%	17.6%	6.9%	30.2%	13.4%	8.7%

Source: Pets at Home

Digi-pets

One of the major drives of the business is its 'digitisation' initiative, which has recently been by far the largest slice of the group's capital spending. It was the 'omnichannel' offering (industry speak for selling online as well as in-store) that helped keep sales and profits so well intact during the pandemic but is PETS really doing anything so different

from a standard online sales model? Around 17 per cent of sales now come via the website rather than in-store shopping and while this can appear to lower the costs of each transaction, in this case those online sales are likely to be substantially from cannibalising store sales. The pandemic will have made it easier for shoppers to stick with PETS as their supplier without having to venture into the store. The danger is that store sales drop and make the recovery of overheads more difficult, plus there is the loss of impulse sales – from personal experience those can be fairly substantial.

There is doubtless value in mining its own data, but it does feel as though there is more value to be extracted from the vet side of the business rather than retailing. Vet services remain both significantly smaller than retail and largely in the form of joint ventures (PETS only owns part of the profit stream).

Vets push up the quality of the business

Vet income may appear fairly small in a group context with £56mn out of £677mn of total revenues in H1. At the pre-tax level, however, it is significantly more important accounting for £24mn out of £70mn of the first half profit. This is because the statutory revenue is in the form of 'fees' paid to the plc (which look to be around one quarter of the vets' gross income) by the joint venture vet practices and there are almost no additional costs attached.

This boosts the group margins with a c.10 per cent pre-tax return overall, but only 8.5 per cent from the core stores and online businesses. It is easy to see why PETS is keen to keep expanding the vet side of its operations although the number of practices has not increased (in fact there has been a small decrease since 2018) but PETS' network share of the UK vet service market has increased from 14 to 18 per cent in that time. At the same time the revenue per practice has also increased by 45 per cent.

The vet side does look like a stable backbone of the group making more than one third of the profit and a greater share of the free cash flow. Numbers of pets registered at the various practices may not rise materially from here, but those extra pets will age and older animals incur higher vet bills (either directly or via higher pet insurance premiums). This side of the business looks to be of higher quality than basic retail (even if it is specialist in nature) as it is vulnerable to competition from supermarkets and other online retailers (ie Amazon). The problem is that as the vet side is mostly owned in joint-venture, it is not controlled by the plc. So, while a vet business would be worth a lot more than a shed retailer, that dilution of ownership and control will pull that premium valuation back down.

Strong trading but a weaker share price

If the trading climate looks to be so strong, why has the share price been in steep decline since hitting its all-time high of 500p in late September 2021? Normalisation. The step changes in business levels came at an extraordinary time for the British public, but risks largely being that – a single step change rather than a pattern of accelerating growth. Indeed the risk must be one of degrading growth. While households are likely to keep their pets, it is unclear how many will replace them and the strong acquisition of customers to premium services also risks being a facet of the group's stores and services being open when others (pet shops and poodle parlours) were not.

We only have to look at the consensus forecasts to see that after a great performance during Covid, the momentum afterwards is less impressive. Average EPS growth may look okay (but not spectacular) through to 2024 (noting that corporation tax jumps up from 19 to 25 per cent in April 2023), but the consensus does contain a couple of significantly more bullish outliers. Trim these out and the core of growth expectations in 2023 and 2024 drops from 9.5 per cent followed by 6.25 per cent to 7.5 and then 5 per cent. A year 1 PE ratio of 25x as the price peak looks in hindsight to have been a valuation bridge too far against these rates of growth. Even after falling back the forward PE is still almost 17x. The strength of the vet business does argue for a premium, however at this sort of PE every part of the business still feels pretty fully valued.

Household squeeze

The retail sector has been under pressure more broadly since the back end of 2021 as the scale of the squeeze on households' cost of living has become clearer. As inflation is set to tip the scales at perhaps 8 per cent by Easter (even without the additional burdens from the war in Ukraine) and with home energy bills in many cases to more than double, the more discretionary end of spending is going to come under pressure. There has to be a risk that pet owners purchase more basic food (and potentially buy that from the supermarket rather than a specialist store), buy fewer treats and less grooming visits. There is likely even to be pressure on the veterinary side – no suggestion of an increase in animal cruelty, but some pet owners could think twice about the need for a visit that previously would have been made without a second thought.

Is there a good income case here?

PETS' dividend record is hardly one of growth. Between 2016 and 2020 the dividend was flat at 7.5p, but at the last half-year results (December 2021) it posted a 72 per cent increase in the half-year distribution. This was part of a policy decision to move to a progressive dividend policy and to move forwards on a payout ratio of 2:1 or 50 per cent

of post-tax profits. Special dividends may also be on the table where there is surplus free cash flow in any one year.

This should mean that the full-year dividend increases from 7.5p to around 11p (so a 36 per cent increase in the final payment), which would leave investors with a yield of c.2.9 per cent at a 370p share price. While better than the trailing 2 per cent yield, this remains below the average for the FTSE All-Share of 3.5 per cent.

The income outlook should be okay but nothing to blow investors away, with EPS having gone through a step change in the past year rather than moving into a period of accelerating growth. Consensus still points to reasonable EPS growth and with a mechanical dividend calculation, DPS would follow suit. However, not all forecasts see that level of growth outlined earlier – broker Numis sees only 6 per cent growth next year and then flat earnings in FY2024. As discussed above, this is entirely possible if spending patterns change as household income pressures mount. Sure, PETS is looking to take market share and drive a stronger online proposition, but that is all new territory without great certainty of success.

It is also disappointing to see special dividends creeping into the mix and as we frequently discuss it would be far better for businesses with surplus capital to execute buybacks rather than fund special cash payments. Specials typically create a net zero position for investors, while buybacks create a permanent boost for earnings and make future dividends less expensive to pay.

So, the income case here is not a strong one and would not alone make a case for buying the shares which, as above, still trade on a chunky PE. The trading model exhibits a fair amount of risk, not from volume but from value of sales and with selling and admin expenses having risen in line with revenues in H1, any loss in the top line from shifts in buying patterns could begin to hurt margins. Profit could easily stall and dividends with that.

Continued below

Hargreaves Lansdown – changing, but for the better?



Source: FactSet

A big fish in a growing pond

Hargreaves Lansdown (HL.) is the UK's market leader in wealth management both in terms of client count and assets under management (AUM). Wealth management is the catch-all term for fee-based oversight of an individual's savings, investment and pension assets primarily focused on equity and bond-based investments (both direct and via collective funds). It is one of the few trillion pound markets in the UK (along with managed pensions, housing and commercial real estate) with a total estimated value of assets under management of around £1.3tn to £1.5tn: uninvested cash savings potentially double this. This figure has been growing in recent years at a high single to low double-digit percentage rate.

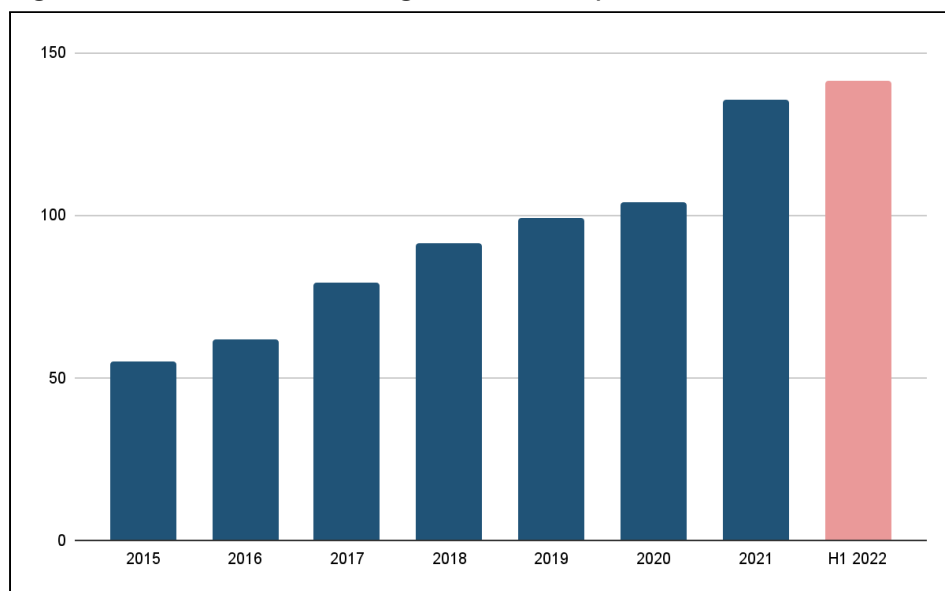
The wealth management industry makes its money by offering differing levels of active and passive management, dealing services and 'platforms' on which assets can be managed. Customers pay annual fees either as a percentage of their invested asset value or on a flat fee basis but manage their investment themselves; more active, discretionary and advised investment services are available at additional cost.

HL has around 10 per cent of the UK's AUM with £141bn of investors' funds held at the last count. This generates around £700mn of revenues on which margins of around 50-55 per cent are made. The AUM has been growing steadily in recent years and today

is almost triple the level reported at the end of 2015 (see Figure 1). The change in AUM is a blend of net new business inflows and the change in the value of the various instruments held by investors. Figure 2 shows that the more important net new inflows (more important as this is something that the group can control or influence) have been good averaging 10 per cent since 2015, but understandably slowing as market share grows – last year saw an 8 per cent expansion but H1 of 2022 saw just 3 per cent.

AUM is an important figure as this drives the core fee income – typically customers pay 0.45 per cent of their asset value per annum (lower as a portfolio gets larger) – and with £141bn held, these recurring fees are significant.

Figure 1: Assets under management – £bn period-end



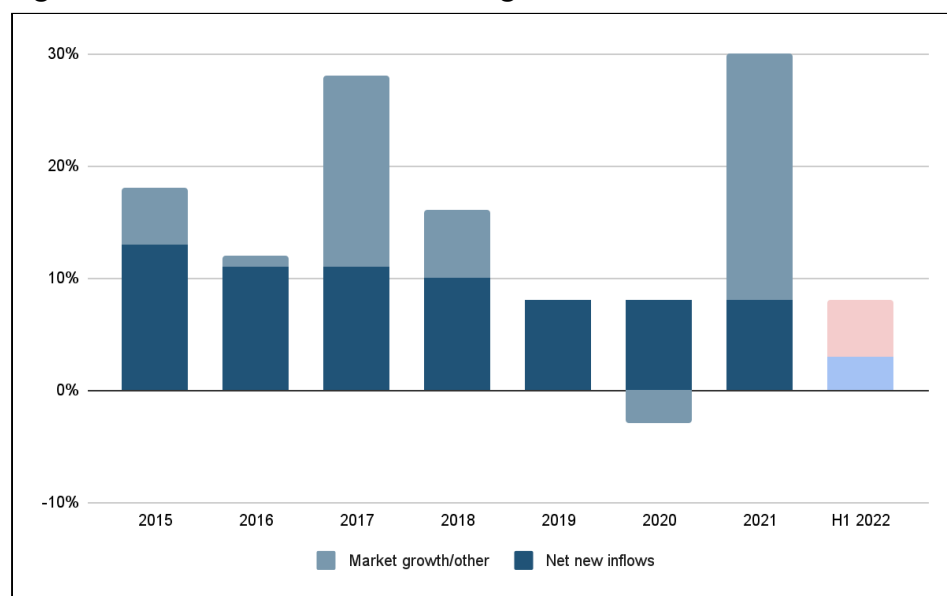
Source: Hargreaves Lansdown

Where does all that money come from?

The expansion of the available market has come primarily from: winning market share from smaller providers through heavy advertising and marketing; pension freedoms since 2015's rule changes; auto-enrolment in work pension schemes; growing awareness by 'Generation-X' (those born between 1965 and 1980) that their retirement is under-funded; rising inherited wealth passed down from the baby-boomer generation; growth in self-invested pensions as more final salary pension schemes are closed and members are 'persuaded' to move to direct contribution pension schemes; and people exiting buy-to-let housing investments as the tax regime has become more draconian. So the addressable market for HL is a healthy one plus there are many billions sitting in

savings accounts earning 0.01 per cent interest that inflation is rapidly rotting away that are increasingly likely to be more actively invested.

Figure 2: Extent and drivers of change in AUM



Source: Hargreaves Lansdown

Reassuringly expensive?

A common comment about HL's basic fees for using its platform is that they are high, and they are. An annual fee of 45 bips (starting level) is above Fidelity's 35 bips, Integraftin's (Transact) 27 bips and AJ Bell's (YouInvest) 25 bips. Then there are a number of fixed fee platforms such as *interactive investor* which charge £10-£20 per month regardless of an investor's fund value. HL has been in this position for more than 10 years but this has not prevented a steady inflow of funds nor has it led to a large exodus to the flat fee platforms. Although I am not an HL customer, I have used both flat and floating fee platforms and, in my view, it is well worth paying the extra in terms of service quality and that is what customers get here – an information rich platform, no fees when trading funds, high service levels, quasi investment research, news and informed opinion. In any case, with an average portfolio of £62,000 annual fees would run out at £280, little more than a flat fee platform would charge. HL has no plans to lower its fees.

Surviving Woodford

HL in 2019 became a little unstuck due to an overly heavy bias towards the now closed Woodford portfolio of funds. In a number of areas, a material proportion of HL customers' funds in managed or advised portfolios and HL's own-label fund were invested in funds run by Woodford AM, in particular the infamous Income Fund. This fund's

collapse in value is well-documented but despite this uncomfortable episode there was little loss of customers and new clients continued to sign up. However, shadows and memories may yet prove to be longer than the company might like to think (see later).

New strategy

Two days before Russia invaded Ukraine, HL held a Capital Markets Day (CMD) and unveiled a new 'redefining' strategy aimed at accelerating both growth in client numbers, ways to extract more fees plus a drive to digitise the business (i.e. move more processes from human to automated handling) in order to save money. The core of the proposal is to materially increase the advisory side of the business and persuade customers to allow HL to examine, direct and manage more of their investments – this would generate a new slug of fees (advice typically costs many hundreds to a few thousand pounds) and with 1.7 million customers could add up to a lot of extra income.

However, this is a congested space, not only with many thousands of IFAs, but also other large financial institutions are well-established here. HL believes that many of its customers will embrace a vertically integrated offering but that is not assured. No indication of pricing has been given but with the average portfolio at just £62,000 (£92,000 for Sipp), there is a risk that normal industry fees will feel expensive for many of HL's customers.

Part of the transition to more advised business is the launch of 19 new HL branded, ready-made portfolios or open ended investment company (OEIC) funds structured to target people at different life stages. This too could provide a sizable new block of income – funds are likely to charge 75 to 150bps of management fee each year, which is on top of the 45bps platform fee. HL's customers pay these fees now but pay them to third parties through net pricing but HL aims to bring some of that in-house.

This may, however, not appeal too strongly. First, there is the spectre of memories of Woodford and losses incurred by HL investors following HL's guidance and second, some integrated/in-house funds do not perform that well - look at the rankings of St James's Place branded funds: many are deep in the bottom quartile.

Investing in technology

A large part of the 'redefining' process is investment in new technology but on examining the areas to be addressed, one is struck with the question: surely they are doing that already? An apparent lack of unified services across different access platforms, limited evidence of having mined its own data, very little tailoring/personalisation, limited transition thus far to cloud-based backend solutions, barely any mention of AI or machine learning and, most worrying, the need still to automate very basic functions like password

resets. The danger here could be that when the new systems are fully rolled out, too few people will notice, as what is meant to look like advancement here is already the norm in many other places.

The drive is going to cost £175mn through to 2026 and HL promises a run rate of £55mn of annual cost savings by that time: the generated savings will be used to largely fund/repay the investment. HL does need to cut costs because it has consistently failed to leverage its expansion in client numbers and AUM because operating costs have risen equally as fast - in this year's first half operating costs rose 14 per cent while revenues fell by 3 per cent. The problem has long been that more customers has always meant more staff and more manual processes.

The big push

HL also believes that it can accelerate customer acquisition thanks to the advice side and investment in automation. It is targeting a rise from today's 1.7mn customers to 2.6mn by 2026. Tracking the numbers from 2020 and 2021, that would appear deliverable, but the number of new customers in these two years might prove to have been exceptional: another Covid abnormality. The previous run rate for new clients was around 40 per cent lower and in H1 of FY2022, new client acquisitions were almost exactly half the level seen in FY2021. Reaching 2.6 million customers could actually take until 2028, which feels uncomfortably long. There is a lot of faith here that provision of advice and a more 'digital' platform will be a powerful draw: that is yet to be proven.

Table 2: New client additions

Period	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021
New clients added	100k	118k	137k	133k	188k	227k

Source: Hargreaves Lansdown

Through the customer base expansion, HL aims to grow AUM acquisition from around £8bn per annum up to £20bn again by 2026. This seems to assume that the majority of any customers added to its roster will be those with larger portfolios. That does rely on a large amount of market expansion (HL believes its addressable market will rise from £3tn to £4tn in just four years) and although there are factors like Pension Risk Transfer (pushing employees from DB into DC schemes) that feels ambitious. Also a lot more of the customers potentially coming in are likely to be younger and while offering scope for ultra-long relationships with HL, the portfolios they bring will be much smaller. The balance of customer acquisition costs relative to fees generated should swing unfavourably and drag on margins.

Why have the shares been so weak, and for so long?

There have been a number of stages to the share price trending lower. First, in May 2019, HL reported weaker than expected net inflows and from an all-time high of 2,419p the share price quickly dropped by one quarter. Next, at the end of 2019 came the Woodford debacle and the shares came close to halving.

In August 2020, final results failed to impress leading to another drop of one quarter in the share price. Then in Q2 of 2021 HL announced that the Covid-related share trading boom was over. This should not have come as any surprise as the likes of CMC Markets, Plus500, Winterflood and a slew of stockbrokers had already indicated that this was the case. Nonetheless, the shares dropped less precipitously but still shed another quarter of their value up until the time of the CMD and its revised strategy on 22nd February this year. The market does not seem to like what is on offer in the revised 'redefining' strategy and following the presentation, HL saw its largest ever one day drop losing 15 per cent of its market value.

The final hit is from the Ukraine war with falling equity values cutting the AUM and the fee income base at a time when costs are still expected to rise by around 13 per cent. Overall, the share price has fallen back to where it was at the beginning of 2015 and since the May 2019 peak, the total return has been -36 per cent despite shareholders pocketing 149p in ordinary and special dividends in that time – the pure capital loss is 58 per cent.

Income perspective

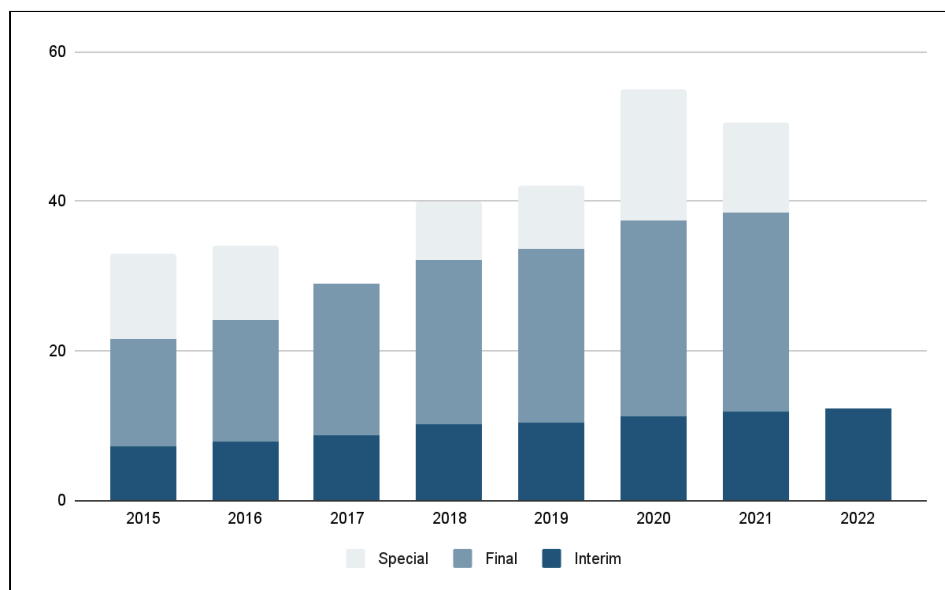
The dividend prognosis is not great, although there is every reason to expect that the promise to increase the total ordinary dividend in 2022 and 2023 by 3 per cent will be honoured. That should mean a total distribution in FY2023 of 40.8p and at the current share price (997p) the yield would be approximately four per cent. That said, the ordinary dividend payment would only be covered by EPS around 1.3x-1.4x, but this has long been the case. HL has no calls for heavy capex and can afford to make high ratio distributions. What has been dropped is the regular special dividend, the cherry on top of the dividend shown in Figure 3. For investors this should not be a major issue due to the give and take of special dividends – the company gives the payment and the market takes away an equivalent sum from the share price, making specials a zero-sum game.

As frequently discussed here, it would be more meaningful to see HL using its surpluses to execute buybacks allowing permanent value to be created for shareholders. Perhaps that could be considered when the additional distribution is promised to restart in 2024 but the board has shown no desire to use its surplus in this way before.

There is not a particularly strong income case here certainly for the next two years, perhaps right through until 2026. Any income received in the last few years has been more than erased by the capital losses and the market seemed to have a fair amount of disquiet about the new direction now to be followed, so there may be further pressure on the total return in future. Having created a long delivery timeline for its new structure, HL has created a large number of waypoints at which progress could potentially disappoint and as we have seen many times, the market is willing to hit hard when things are not on song.

HL perhaps should be rewarded for trying to shake things up, but there is a lot that will need to be proven here and there is too little reward on offer in the short-to-medium term while waiting. If the transformation does appear capable of propelling the business forward there is probably ample time to step in later without any material price disadvantage. Potential investors can probably afford to wait and see.

Figure 3: HL's dividend history



Source: Hargreaves Lansdown

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ISSN 0261-3115.