Active Voice: Turnaround stories

Companies that have seen their share price depreciate sharply in the face of self-inflicted wounds, structural challenges, or cyclical headwinds, represent potential 'turnaround stories'. In this article we look at the attraction of investing in these businesses, and evaluate the risks or opportunities they present.

Low cost model	✓
Turnaround story	✓
Event driven strategy	
Wide economic moat	
Self-funded growth	
Deep value	

'Recovery stocks' are those which may be suffering from an emotionally-battered share price or look oversold on the back of a profit warning or disappointing newsflow. Alternatively, there may of course be deeper-rooted problems around leadership quality, financial resources or the rise of competition where barriers to entry are low.

For any investment consideration, it's important to fully understand the underlying issues. Deep-dive analysis allows us to assess if the process of restructuring will result in the ability of the company to redefine the business model. Strengthening the balance sheet is critical, predominantly because improvement here can create valuable strategic options. Failure to keep up with market trends or weak operations can be improved through deal flow, new product launches or better allocation of capital. Decision-making is likewise crucial. Investors need to ensure they are comfortable that any strategic change has the potential to bring a positive transformation.

Investing early in the restructuring phase may be considered a risky strategy. We are mindful that some companies may languish in the mire for years - becoming a 'value trap' - while others may find it difficult to respond effectively to competitive or financial challenges. Inevitably there will be periods of highs and lows along the road for most of these companies and we must acknowledge that not every investment decision has a successful outcome. However, while the market turns a blind eye, we will consider researching those out-of-favour shares should we believe the opportunity for a business turnaround becomes more evident. Below are some examples in our actively managed equity funds which we consider to be strong turnaround stories.

ARCELORMITTAL

A slowdown in growth of China's economy led to excess steel capacity, dragging spot prices to multi-year lows and putting unprecedented pressure on the steel sector. As the world's largest steel producer, ArcelorMittal reported its largest financial loss in its history and the shares underperformed significantly from 2014 to early 2016. The announcement of a large rights issue and the disposal of its stake in Spanish company Gestamp was part of an effort to reduce debt and improve the balance sheet. For most investors this was considered a classic value trap as they couldn't see a turning point for earnings.

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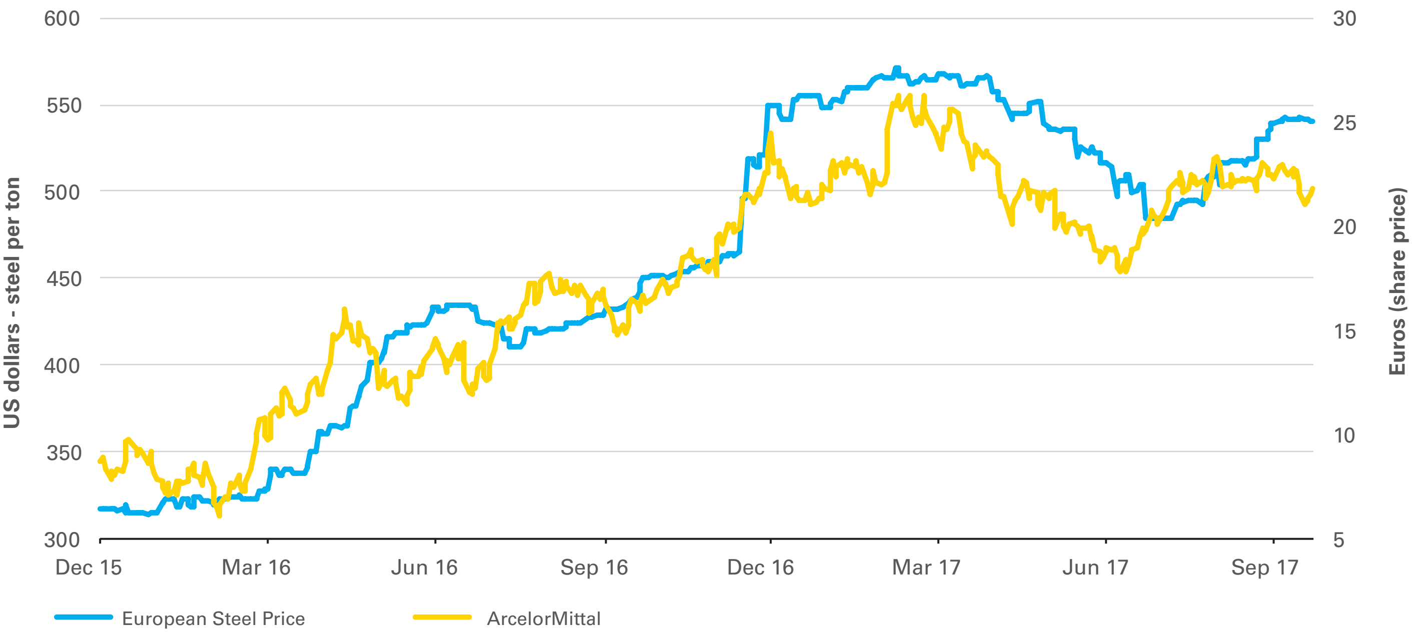
Figure 1. Steel recovery boosts ArcelorMittal



However, we saw a strong chance that anti-dumping tariffs would be raised in the US and Europe against Chinese imports, while we also expected environmental issues to result in Chinese capacity closures. Accordingly, this should lead to rising steel prices and a recovery in profits, so we bought shares in ArcelorMittal, and increased our position through the rights issue.

The shares have since yielded an impressive triple digit return. Tariffs were levied, Chinese plants have closed and, as the steel price rose, earnings have recovered. Fund manager of the L&G European Income Fund, Andrew Koch, believes the company is well positioned. "It benefits from economies of scale, its cost structure has improved and the group significantly lowered capex commitments so is improving cash generation."

This is a turnaround story with an improving balance sheet, with margin and volume growth on the table. ArcelorMittal could also regain investment grade status (lost in 2011) and there is potential to resume dividend payments next year.

QANTAS

Australian airline Qantas faced major structural challenges at the beginning of the decade. They were hit by a long running dispute with unions around pay and had to tackle a domestic capacity war with Virgin Australia. On top of this, fierce international competition and increasing fuel prices culminated in record losses in 2014. The company launched a bold turnaround effort in response, with management focused on cutting capacity, shedding staff costs and reducing flights (to maintain ticket prices). This transformation was supported by an improved operating environment and a timely slump in oil prices.

Qantas appears to have since recovered well. This has been driven by an improved cost base and a pivot to the profitable domestic market, according to Veeral Gandhi, analyst for the L&G Asian Income Trust. "The business transformation has led to a strong competitive position, significantly more predictable earnings and opportunities for growth by providing direct flights from Australia to Europe."

The company delivered a record annual profit last year, which reflected the return of attractive market dynamics; strong passenger yields and small increases in capacity growth. Qantas Loyalty, the frequent flyer reward program, continues to grow and now makes a significant contribution to earnings. Qantas also declared its first final dividend in eight years. Veeral believes its past problems are now behind it and there is renewed confidence in the airline's strategic position.

BURBERRY

Since luxury goods company Gucci conducted a complete overhaul of the brand in 2015, this has led to market share gains and impeccable strategic execution on margin progression and top-line performance.

The company has gone on to defy cynics and deliver impressive earnings growth. Parent company Kering has seen its share price more than double in just fifteen months and appears to now be firing on all cylinders.

Today, the luxury goods sector is awash with companies attempting to follow the successful transformation story of Gucci. At the beginning of their journey is British institution Burberry. Burberry has seen growth fall behind luxury goods peers in recent years, suffering from a lack of 'newness' and limited strategic creativity. Investor positioning remains very negative, which in part is understandable.

However, the company has now undergone the biggest management reshuffle since its IPO in 2002. New CEO, Marco Gobbetti, recently announced a complete brand elevation strategy aimed at reinventing brand perception. The group will look to capitalise on the need for innovation across the product portfolio, rationalise distribution in the US and focus on strengthening its brand equity. The company is also embarking on significant change in creative direction, with long-standing creative director Christopher Bailey stepping down next year. The appointment of a new creative mind will be required to introduce a new aesthetic and products.

While we accept there is execution risk along the way, L&G Growth Trust fund manager Gavin Launder believes resetting financial targets for the next two years is sensible. Gavin believes "re-ignition must come first, followed by brand elevation. Addressing product positioning is crucial to long-term value creation, but much of this success will hinge on the timely appointment of a new creative driver and adopting an improved pricing structure."

THE STRENGTH OF PATIENCE

There is a degree of satisfaction for investors that comes from finding value where others did not. Providing any hurdles can be overcome, we see great value in buying shares at depressed levels if a turnaround of growth is in sight. Ultimately, we are looking for a company to charter a course for a more effective long-term strategy. The strategy will likely result in organisational change, a stabilisation of operations and an ability to adapt to a changing technological or competitive landscape. Patience and commitment to the investment outcome is required, but these measures are crucial to the creation of substantial shareholder value.

Given the potential for significant upward revisions to market earnings expectations, while these stocks always carry a measure of additional risk we believe turnaround stories offer the potential for considerable alpha generation.