

A VIEW FROM THE BRIDGE

Edition 9 February 2007

A year ago, we shared with you news that Taylor Young Investment Management had been short-listed for two of the eleven PAM Awards, the “Oscars” of the Private Asset Management industry. This year we have been short-listed for three awards: two are performance related, with nominations for both “Growth” and “Income”, and the third is again for Image and Reputation - HNW (High Net Worth - previously called ‘Boutiques’). We are delighted with this achievement.

Turning from “news” to “views”, the first two articles focus on two of our current themes. The first looks at one of the drivers behind our “De-equitisation” theme. Twenty years ago publicly quoted conglomerates were the major predators in the market: today Private Equity occupies this space. The second is a follow-up to the previous edition’s article on “Investment In Real Estate Companies”.

The third article is a reminder to private investors not to pass on either an ISA for 2006/07 or the utilisation of their 2006/07 £8,800 Capital Gains Tax Allowance, without due consideration.

Budget Day is Wednesday 21 March 2007 with the Chancellor due to speak at 12.30pm.

*Philip Todd
Director, Private Client and Charities*

*Peter Thomson
Chief Executive Officer*

The Predators of Yesteryear

It is almost impossible these days to open a financial newspaper without reading of possible takeover interest from private equity houses or overseas companies for a number of our larger quoted stocks. Since the beginning of last year, Sainsbury has been the most prominent potential target for these buyout funds, although only a few weeks ago Pearson, the diversified media group, was also the subject of such attention. In the past year, there have been actual takeovers of a number of well-known companies in the UK, most notably BAA, BOC, P&O and Corus, formerly British Steel. **The common feature of all these takeovers is that the predators have been from overseas, and that the bids have been in the form of cash.**

Looking back some 20 years or so, though, the parties involved were very different. Instead of Blackstone or KKR, the major takeover specialists were publicly quoted UK companies such as Hanson Trust, BTR, Williams Holdings and Tomkins. Yet today these companies have themselves either been broken up and sold on, as in the case of Williams Holdings, or are, at best, a shadow of their previous incarnations. **Having done so well for investors during the 1980s and early 1990s, it is interesting to ask why such quoted conglomerate structures no longer dominate capital markets in the way they once did.**

There were indeed considerable advantages for

investors in the success of these companies. Their targets were often asset rich and relatively poorly run quoted firms, where a refocused management team and ruthless attention to cash generation and cost control could markedly improve overall performance. This was important in two ways: shareholders in companies that were targeted by these conglomerate predators found themselves in the happy position of experiencing an immediate capital uplift in the value of their shares, and, were a takeover bid to succeed, could usually exchange their existing shares for a mixture of cash and paper in the predator itself. For those who were unwilling to accept paper, there were often provisions for loan notes, which could help defer any liability for capital gains tax on the behalf of the investor. At present, this is not a feature of the current round of takeover bids by private equity interests or from foreign companies. Investors have been compelled to surrender their interests in companies which they may well have held for many years without being able to participate in any future growth. Additionally, if the shares were held in a taxable environment, despite indexation allowances and taper relief, longstanding holders could face involuntary and unwelcome capital gains tax liabilities. For such well-established companies as Allied Domecq, BOC and P&O, this was a particularly important issue for a number of patient and supportive private investors.

Why, then, did the conglomerate company

structures become effectively obsolete? There are a number of reasons which become obvious in hindsight. Firstly, an enduring argument for a conglomerate structure was that during most stages of the business cycle at least part of the business franchise should be doing well and thus earnings and also dividends would be protected to some extent by a company with a broad business base. However, as institutional fund management has become more specialised over the past 15 years, fund managers now contend that they are themselves able to identify trends within a business cycle and prefer more specialist companies in which to invest. Indeed, in a conglomerate structure, whilst some businesses may be performing relatively well during an up cycle, there would also invariably be some that would be lagging and, as the predator companies themselves grew, they would need larger and larger targets to prey on in order to make meaningful additions to earnings growth in the future. Inevitably, this would mean that the risks attached to any acquisition would become higher and that misjudgements would be punished accordingly. This was probably the case both for BTR in its bids for both Hawker Siddeley and Siebe and also for Tomkins in its poorly regarded takeover of Ranks Hovis McDougall. These acquisitions changed the perception of investors towards the predator companies and neither, in truth, could be said to have particularly prospered in the years following. In the case of Hanson Trust, as it was then known, similar arguments regarding the size of potential acquisition targets were a factor, as also was the increasing length of tenure at the top of the company of the two key individuals responsible for its original success, Lord Hanson and Lord White. Eventually, Hanson was effectively compelled to break itself up, and, although the name still lives on as a FTSE 100 constituent, it is now a much more focused USA-dominated aggregates and building business. Similarly, Williams Holdings, having successfully weathered the recession of the early 1990s through an astute sale of its paints business, latterly was unable to continue its acquisition-based strategy for growth and, for the benefit of its shareholders, unbundled itself into two more focused constituent businesses.

One other important factor which may have contributed to the decline of conglomerate companies has been the allegedly greater emphasis on short-term performance by institutional investors. Nowadays, large companies are moving ever closer to quarterly performance updates, but, in the case of companies motivated by an aggressive merger and acquisition culture, tangible signs of corporate change often necessitate a lengthier timescale. In a private equity structure, away from the prying eyes of demanding shareholders, longer term strategic views can more

easily be taken. One other profound advantage that private equity enjoys at the moment over quoted companies is that the cost of corporate debt is historically low and thus predominantly debt-financed vehicles will tend to enjoy an advantage in terms of the price they can offer for assets over quoted companies, who are often more equity financed and also have obligations to pay out dividends. This is only a benefit insofar as global interest rates remain at current levels and liquidity is plentiful. A salutary lesson was learned in the late 1980s when the food retailer Dee Corporation was taken private by Isosceles, a debt-financed private equity company. Sharp rises in interest rates, particularly in the UK, from 1989 onwards caused considerable problems.

It is thus unlikely that we will see a return to the 1980s and the dominance of aggressive conglomerate companies. More likely, quoted companies will continue to refocus their activities and demerge or sell off subsidiary businesses deemed non core. This is the path currently being followed by Smiths Group, Man Group, Reed Elsevier and BBA, and there is pressure on firms such as Pearson to follow suit. **As long as global interest rates remain at current levels, private equity interests will continue to dominate the merger and acquisition headlines, but if rates begin to rise, the lessons of the early 1990s are a salutary reminder that leverage can work both ways.**

The Post-REIT Environment

At our Investment Conference at the Whitbread Brewery in November last year, we predicted that the key change in the quoted real estate market for 2007 - the introduction of REIT (Real Estate Investment Trust) structures, which we anticipated would be adopted by most of the major quoted companies - would provide a focus for substantial additional investment interest. As we anticipated, most of the major companies did indeed convert to REITs in January of this year and the real estate sector in general has, over the past three months, continued to outperform the overall market. **Having had the opportunity of meeting a number of key figures within the real estate arena over the past week or two, it may be useful to reiterate our views on the future of this sector.**

Firstly, the unexpected rate rise on 11 January unsettled sentiment towards the real estate sector and elicited a number of pessimistic notes from analysts, convinced that we had arrived at the peak of the cycle. The quoted sector experienced a setback, although quoted real estate stocks in other major world markets continued to gain ground. And the announcement of a possible consortium bid for Sainsbury by a

combination of private equity firms, focusing on the inherent value of its property portfolio, served to inspire some interest in the sector once again. Secondly, a recent trading update from British Land revealed, for the first time in five years, a small drop in the valuation of its shopping-centre portfolio, together with a more cautious view on the prospects for investment yields and hence upward capital revaluations.

It is, of course, vital to take note of comments from a company as important as British Land in the quoted real estate sector. **Nevertheless, our overall views on the prospects for commercial property in the short term remain reasonably positive.**

Liquidity conditions in global capital markets remain very buoyant and there is still evidence of increased allocations to this sector. Trophy assets such as the London “Gherkin” are still realising high valuations compared with estimates of only a year ago. Additionally, the heightened transparency of the new capital structures employed by the large quoted property stocks allows investors to focus more closely on the inherent value of development portfolios and outsourcing subsidiaries. This is particularly important in the case of a company such as Land Securities, where its Trillium subsidiary has been outstandingly successful in winning a significant number of Government outsourcing contracts over the past few months. This profit stream will now be more clearly visible within the overall Land Securities revenue and profits mix.

Another supportive factor for the sector is that overseas investors continue to focus upon the asset-backed strength of the major companies. The expectation is for a considerable amount of liquidity to be released in the American REIT market through the recent agreed bid by Blackstone for Equity Office Properties, the total value of which is \$39bn, financed entirely in cash. Over time, as the major companies are now in REIT form, we would expect a larger percentage of shareholders to come from overseas, which would result in a considerable re-orientation of existing shareholder bases. This has been the experience of some smaller real estate companies such as Capital & Regional, the retail park management company, where it appears that a majority of its shareholders are non-UK based. As shareholder registers change, we would expect some re-rating of the existing companies to continue.

Turning to the current commercial property market, recent contact with market professionals leads us to believe that the London market is still remaining strong overall through a combination of continued rental growth and stable or slightly hardening yields. We expect this to remain the case for at least the next

18 months or so; beyond 2009 the market may move a little more into equilibrium but at this stage our feeling is that rents would remain stable rather than decline.

Two factors that may derail this somewhat rosy outlook would be a sharp rise in interest rates or a sharp increase in construction inflation. However, in the light of recent inflation data, neither scenario appears particularly likely at the current time. Whilst the outlook for the office market remains relatively robust, the retail market is perhaps a little softer as rising tax rates make an impact on total discretionary expenditure for the UK consumer, and it is here that we may look to lighten our exposure a little to the sector.

Another factor to be considered is that of the increase in retail sales over the Internet which was most notable over the recent Christmas period. For less than prime sites, it may well be the case that developers have to provide additional incentives for anchor tenants to take up space and this factor may well have an impact on margins and profitability during the rest of the year and into 2008. For this reason, our focus on stock selection is very much towards companies with exposure towards the firmer markets of the West End, key City developments and other out-of-town trophy assets. Merger acquisition activity, too, remains a distinct possibility in the sector and, indeed, one smaller company, Halladale, agreed recently to be taken private at a 30% premium to its existing share price at the end of January.

Overall, therefore, we remain happy with our relatively positive stance towards the real estate sector, although naturally mindful of the risks that rising interest rates could pose to development and financing programmes. Inflows to specialist real estate funds also remain strong as retail investors attempt to diversify their portfolios away from conventional equities and fixed-interest securities. This has been highlighted as a potential problem area for the future, and we would tread very warily indeed in more peripheral real estate markets such as Eastern Europe, but for the time being our confidence in some further progress from the quoted real estate sector throughout 2007 remains intact.

“Don’t let the Tax Tail wag the Investment Dog”

Perhaps a rather clumsy expression often used by Investment Managers and Accountants at this time of year (as we run up to 5 April). The principle is sound as all too often tax incentives tempt investors to put too much into the wrong investment. But there are two tax-related issues which all tax-paying private

client investors should be discussing with their Investment Manager or Broker - ISAs and Capital Gains Tax allowances.

Have you subscribed to a 2006/07 ISA?

For individuals where it is appropriate to invest £7,000 in a Stocks and Shares ISA, you should think carefully before passing on the opportunity. It is true that for a basic rate tax payer there are no income tax benefits to be gained from a fully invested ISA compared to investing the same £7,000 in a taxable environment and whilst 40% tax payers are not required to pay additional income tax on investments inside an ISA wrapper, some 40% tax payers may feel the potential saving is minimal.

But it is the potential Capital Gains Tax benefits of investing in ISAs over a prolonged period which is the key benefit. Introduced in April 1999, investors have had the opportunity to invest £56,000 (8x£7,000) in a Capital Gains Tax free environment and the present government seems committed to making ISAs permanent, with an overall annual investment limit of at least £7,000. It is not too difficult to imagine a situation where you might have £100,000 invested in ISAs. This is a significant sum which could, in an emergency, be liquidated, transferred out of the ISA wrapper and spent without having to worry about any tax implications (although these monies would lose all their tax benefits for ever).

So think long-term and if you have not subscribed to an ISA before, do one now, as if you do not subscribe £7,000 before 5 April 2007, your chance to do an 2006/07 ISA is lost for ever. We would remind any Taylor Young clients, that if you have an ISA portfolio managed by us, you will have signed a continuous ISA application form and therefore no action is required but if for any reason you miss a year, you will have to sign a new form. Do remember that if Taylor Young has subscribed to an ISA, you must not do any other type of ISA anywhere else.

The second question is, have you used your Capital Gains Tax Allowance?

All too often one sees mature investment portfolios where investment decisions are constrained by Capital Gains Tax considerations. Whilst we would take the view that in most situations, clients or trustees should be prepared to pay some Capital Gains Tax each year, the very least that should be achieved, particularly on a mature portfolio, is utilising the Capital Gains Tax allowance. For the current tax year 2006/07, an individual has an £8,800 allowance and trusts generally have a £4,400 allowance. The principle of paying tax on a realised capital gain is easy enough to understand but in practice, potentially, one has to take

into account the March 1982 value, indexation, taper relief and whether or not the asset is a business asset.

If you have a spouse who is not making use of their Capital Gains Tax allowance, then remember assets can be transferred to the spouse and the asset retains its original book cost. The asset can then be sold in the spouse's name thereby utilising their allowance. It may be that you actually wish to realise the gain yourself but also keep exposure to this particular company and so do consider "bed and spousing". If you sell shares in your own name and then buy them back in your own name within 30 days then actually you are deemed to have sold the shares that you subsequently bought and not the shares you originally held. You can wait 30 days and then buy the shares back but clearly there is a risk of the shares rising in value during that time. If you wish to avoid taking that risk then consider "bed and spousing" which means you sell the shares in your name and buy the shares back in your spouse's name. The sale and purchases are executed at the same time and at the same price - you actually "cross" the shares at a mid price.

Capital Gains Tax calculations are not straightforward and there may be some costs involved in realising the gains but the 'do nothing' option generally just creates greater problems in the future. Private individuals with investment portfolios potentially subject to Capital Gains Tax should understand why it is they are not utilising their £8,800 allowance. Again, we would remind any Taylor Young clients that sharing information about the carried-forward loss position as at 6 April 2006; capital gains realised outwith the portfolio; and any intended chargeable disposal in the current tax year or in future tax years, is extremely helpful.

Please send your views and comments on any of the articles above to Nick Rundle at:

Taylor Young Investment Management Limited

Tower Bridge Court

224-226 Tower Bridge Road

London SE1 2UL

Tel 020 7378 4519

Fax 020 7378 4501

nick.rundle@tyim.co.uk

www.tayloryoung.com

Edited by Nick Rundle

Printed and published by Taylor Young Investment Management Limited. Authorised and Regulated by the Financial Services Authority. The information in these articles is based on research compiled by Taylor Young Investment Management Limited from a number of sources and reflects our current thinking. The information is believed to be accurate at the time of going to press but cannot be guaranteed. We cannot accept responsibility for any losses occasioned to persons by their taking action or refraining from action as a result of the information herein. Investments can fall in value as well as rise and past performance is no guarantee of future performance.

©Copyright Taylor Young Investment Management Limited. All rights reserved.