Annual report 2021

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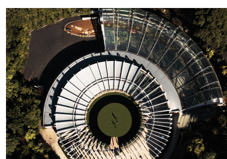

Today sees the release of Temple Bar's annual report and financial statements for the year ended 31 December 2021. You can read the Chairman's statement and investment manager's review below, and you can download the full report here.

Chairman's statement

"The UK market would appear still to be very cheap relative to its overseas counterparts. This valuation discount could well narrow."

Review

2021 was the first full year the Company was under the fund management of RWC Asset Management LLP ("Redwheel"). The year started extremely well as the post-vaccine bounce in value stocks continued into the new year. The first quarter brought a net asset value ("NAV") return of 17.0% versus the benchmark index return of 5.2%. However, this outperformance did not continue into the following three quarters in all of which the portfolio underperformed, albeit marginally in the fourth quarter. All this resulted in the full-year NAV return of 24.5% versus the index's 18.3% – a very pleasing result.

Less pleasing was the persistent discount at which the shares traded relative to their NAV. At times the discount was in double figures and for the year as a whole, it averaged about 7.1%. In reaction to this, and to accrete to shareholders' NAV, the Board instigated a buy-back programme. Shares to the value of nearly £10 million (excluding costs) were purchased during the period and placed in treasury. At 31 December 2021, the discount was 7.8%. Encouragingly, after the year end the discount narrowed to between 1% and 2%, but the terrible events in Ukraine have created such market volatility that it has recently widened again.

Portfolio

The change of Investment Manager in 2020, along with elevated market volatility, saw a period of increased trading. As detailed in the Investment Manager's Report below, by comparison there was very limited trading during the year under review.

Dividend

During the year the Company paid four interim dividends amounting to 39.5p. This compares to a dividend of 38.5p in the previous year (an increase of 2.6%). Although this did require a contribution from revenue reserves, it nonetheless represents a return to the previous pattern of annual dividend increases.

The Company saw a significant increase in income compared to 2020, receiving over £30.7 million, as investee companies resumed paying dividends following numerous suspensions and reductions in the early stages of the pandemic.

The Board does not intend to recommend a final dividend.

Gearing

At the year-end, gearing (net of cash and related liquid assets) was 6.5% and the level of gearing remained stable throughout the year.

Purpose and culture

The purpose of the Company is to deliver long-term returns for shareholders from a diversified portfolio of investments. These investments will primarily be UK listed.
As an investment trust, the Company has no employees, but the culture of the Board is to promote strong governance and a long-term investment outlook with an emphasis on investing in businesses that can deliver sustainable value to shareholders. Therefore, the Board asks the Company's Investment Manager to invest in stocks that fulfil the traditional metrics of the value style and possess a business model that is sustainable in the long term.

Environmental, Social & Governance ("ESG") and Stewardship Issues

The Board believes that ESG issues can be a material factor in determining the valuation of a company. Bad practice can have a negative impact on society which could in time threaten a company's social licence to operate and therefore detract from investors' capital.

The Board embraces the concept of active stewardship, asking the Investment Manager to monitor, evaluate and actively engage with investee companies with the aim of preserving or adding value to the portfolio. Further, conscious that on some issues, particularly globally catastrophic negative externalities, one manager acting alone can have limited effect, the Board asks the Investment Manager to collaborate with other investors in working with investee companies. The Investment Manager reports back to the Board regularly on engagement in these specific areas.

The Board

There were no changes to the Board during the year. However, the Board is pleased to welcome Charles Cade, as a new non-executive Director and member of the Audit and Risk, Management Engagement and Nomination Committees, with effect from 24 March 2022. He brings a wealth of experience and expertise, not just in investment trusts, but in investment generally. The Board continues to operate efficiently and demonstrates great diversity of gender, ethnicity, knowledge and experience. As stated in previous annual reports, this will be the last Annual General Meeting ("AGM") at which I will offer myself for re-election. In line with best practice, the Board's policy remains that Directors should serve a maximum of nine years. Only in exceptional circumstances will any Director serve more than this.

Share split

The Board has been advised that a share split would help liquidity in the market and be helpful to shareholders who invest on a regular basis or who re-invest their dividends. Accordingly, as described in Resolution 10, the Board is recommending a five for one division. This should have no effect on the overall value of your holding.

Directors' fees

As presaged in my statement in the half-year report for the six months ended 30 June 2021, in the autumn the Board reviewed the level of Directors' fees. A study was commissioned from Trust Associates, an independent investment trust advisory business, to establish the level of comparable investment trusts' directors' fees. Following this analysis, the Board concluded that it would be appropriate to set Directors' fees at the anticipated 2022 average of comparable vehicles. Full details of the new fees are given in the full Annual Report & Financial Statements.

AGM

The AGM this year will be held at Verde 8th Floor, 10 Bressenden Place, London SW1E 5DH on Tuesday, 10 May 2022 at 12.30pm. Unlike last year, shareholders are welcome to attend in person where you will be able to hear a presentation from the Portfolio Managers Nick Purves and Ian Lance. Shareholders unable to attend are invited to submit their form of proxy in advance by 12.30pm on Friday, 6 May 2022 at the latest. Should circumstances or Government guidance change, including the introduction of regulations to prohibit or restrict public gatherings, the Company reserves the right to take further steps in respect of AGM attendance. To the extent this is necessary, we will provide an update via a Regulatory Information Service announcement and our website as soon as practicable.

Outlook

The last two years have taught us how dangerous it is to make any prediction about future events. The dreadful events unfolding in Ukraine painfully underline this point. Nevertheless, the UK market would appear still to be very cheap relative to its overseas counterparts. This valuation discount could well narrow.

Arthur Copple
Chairman

Investment manager's review

"Our investment approach has always been to seek out fundamentally sound businesses which by virtue of their market positions can grow their profits over the long term, but where for one reason or another the shares are modestly valued as a low starting valuation ensures that shareholders benefit fully from improved profit growth, whilst often in the meantime drawing an attractive income."

Equity markets delivered strong returns in 2021, driven higher by a sharp rebound in economic growth, a corresponding recovery in corporate profitability, and large quantities of both fiscal and monetary stimulus. Whilst the reflation narrative was challenged by the emergence of both the Delta and Omicron COVID-19 variants, investors came firmly to the view that the worst of the adverse economic effects of COVID-19 were behind us. The recovery was sufficiently vigorous that corporate earnings made up the ground lost in 2020 with the result that those earnings returned to record levels. Unsurprisingly perhaps, commodity prices were also strong in 2021, with Brent Oil rising around 50% and copper around 30%.

The Company's portfolio performed well in 2021, continuing the sharp rebound that started at the end of 2020, when it was announced that vaccines would be largely successful in reducing severe illness from the virus. Top contributors to the Company's portfolio return in the year included: Royal Mail (+3.3%), Marks & Spencer Group (+2.8%), Shell (+2.1%) and NatWest Group (+1.7%); from a total absolute return on net assets of +24.5%.

After several years of sluggish sales, declining productivity, and falling profits, Royal Mail looks to have turned a corner. The company was a beneficiary of the pandemic, seeing a meaningful increase in parcel volumes. This, coupled with improved labour relations, has resulted in a sharp rebound in earnings. We continue to see significant unrealised profit potential in the company's UK business, which combined with continued growth in the company's overseas operations should result in meaningful profit growth from here. Despite the strong recovery in the share price in 2021, the stock market still applies little or no value to the company's UK operations.

At Marks & Spencer Group, there are signs that the recent overhaul of the business is really starting to bear fruit. In online food, the Ocado joint venture has been a significant success, whilst in store-based food the company is taking advantage of its niche to grow market share. Even in the troubled clothing business, performance has started to improve. In online clothing, the company is outgrowing its competitors and is now number two in the UK by market share. The company has a target that 40% of its clothing sales will be online within three years. The improved operating performance has led to significant upgrades to profit expectations and yet, despite the strong share price performance, the stock market continues to ascribe no value to the company's clothing operations.

The Company holds three energy names: Shell, BP and TotalEnergies, which collectively added over 5% to the Company's portfolio investment return in 2021. All benefitted from the sharp upward move in oil and gas prices, coupled with low starting valuations. Whilst we don't attempt to predict oil or gas prices, we were not surprised by the upward move in 2021 given that demand for fossil fuels bounced back strongly after a period in

which industry investment had been significantly curtailed. Some of this reduction in investment was no doubt an ongoing response to the weakness in energy prices in 2015/2016 and 2020, and some will have resulted from the sector's desire to fund increased investment in green energy; however, the upshot is that when strong demand meets restricted supply, prices normally increase.

Again, despite the recent strength in share prices, sector valuations continue to be attractive. Shell is the world's largest privately owned gas producer. Nevertheless, its enterprise value is around $250 billion at the end of 2021, the entirety of which can be accounted for by the company's so-called transition assets (Gas Production, Marketing and Renewables), even though these assets currently account for less than 50% of group profits. Assigning even a modest valuation to the remaining assets (Upstream, Refining and Chemicals) suggests significant upside to the share price. Meanwhile, BP is valued at around 9x shareholder free cash flow (after all investment but before dividends) assuming Brent oil prices of just $60 per barrel, significantly below where oil prices sit today. All three companies have set out ambitious but credible plans to get to net zero carbon emissions by 2050 and, whilst it will no doubt be a challenge, we believe that these companies can therefore play a significant part in the forthcoming energy transition.

In the banking sector, the Company has exposure to four names: NatWest Group, Barclays, Citigroup and Standard Chartered. These companies collectively added over 4% to the portfolio's return in 2021. We have for some time believed that the stock market is not giving enough credit to the banks for the very profound changes that the companies have made over the last few years. Their capital strength is much improved on where it was even a few years ago and lending standards are much better than they were. Whilst ultra-low interest rates have suppressed interest margins and have therefore been unhelpful, the banks have been using the benefits of technology to engineer cost out of their businesses. As a result, even assuming no pick up in interest rates, the companies are confident that they can deliver a 10% return on shareholder equity, as stated in their investor presentations. Nevertheless, the stock market has remained sceptical and many in the sector have continued to be valued at meaningful discounts to the value of that shareholder equity. Whilst the continued low level of loan losses and the spectre of rising interest rates were helpful for share prices in 2021, the companies continue to be valued at just mid-to-high single-digit multiples of earnings. In our view, therefore, the sector continues to be undervalued.

Pearson, easyJet and Capita all marginally detracted from portfolio returns in the year. easyJet has continued to be disrupted by COVID-19 induced lockdowns and has continued to burn through its cash reserves, albeit at a much-reduced rate. Pre-COVID-19, the company had no net financial debt on its balance sheet; however, its

finances have since been undermined by cash losses that have accumulated over the last two years. Unsurprisingly therefore, last year the company took the decision to issue fresh equity and, whilst this restored the company's balance sheet to health, it was dilutive to existing shareholder returns. Pearson has continued to struggle with the transition from physical print textbooks to a digital offering in its North American Higher Education business and although this journey is proving to be protracted and damaging to group profitability, we continue to believe that educational publishing is an attractive business offering the prospect of healthy returns. Accordingly, during the year, we used share price weakness to add to Temple Bar's holding in the company. Likewise, the turnaround at Capita is proving more challenging than we had originally hoped. Nevertheless, we continue to believe that there is significant unrealised potential in the business, at a time when understandable scepticism in the stock market means that the shares are valued at a mid-single digit multiple of our conservative view of the company's medium-term profit potential. Although Capita has been a poor investment for the Company, we think that ultimately patience will be rewarded in this instance.

We are long-term investors, who recognise the importance of keeping transaction costs to a minimum. At times of major stock market dislocation, such as that seen in 2020, we will rotate portfolios more aggressively to try and take advantage of other investors' willingness to sell reasonable businesses at knock-down prices. More normally however, shareholders should expect that portfolio turnover will be low. This was the case in 2021, with just under £300 million of notional value trade. We established no new positions in the year although we did exit the Company's positions in GlaxoSmithKline and Tesco in order to take advantage of what we believed were better opportunities elsewhere.

For some time now, UK equities have traded at a significant discount to other stock markets, and this resulted in high levels of corporate activity as overseas buyers sought to take advantage of this disconnect. Consequently, during the year the Company benefitted from the takeover of Royal & Sun Alliance Insurance (by an overseas competitor) and WM Morrison (by private equity), both at large premiums to the previously prevailing share price.

Our investment approach has always been to seek out fundamentally sound businesses which by virtue of their market positions can grow their profits over the long term, but where for one reason or another the shares are modestly valued. This may be because the company is underperforming its longer-term potential (Marks & Spencer Group) or because of a lack of interest or neglect (Shell). Either way, a low starting valuation looks to ensure that shareholders benefit fully from improved profit growth, whilst often in the meantime drawing an attractive income. Companies with low valuations also have a greater potential to re-rate as investor perceptions improve, further adding to investment returns. We

believe investors should learn the lesson of stock market history which is that the starting valuation has proven to be the best predictor of investment return over time.

As we write, the economic outlook is particularly unclear. Following Russia's invasion of Ukraine, commodity prices have increased very dramatically and this will squeeze corporate profit margins whilst acting as a tax on consumers, thereby reducing their spending power. It is possible and maybe even likely that Europe and the US are on the verge of another recession, putting renewed short-term pressure on corporate profits. The direct effect of the Ukraine conflict on the holdings in the portfolio are largely limited to the holdings in the Energy companies. In response to the crisis, BP has announced that it will be selling its 20% holding in Rosneft, thereby ceasing its involvement with Russia.

We have assumed that the company will not receive anything in consideration for its stake and yet the company estimates that the annual hit to corporate cash flow is likely to be in the order of just 5%. Shell has announced it will exit its joint venture with Gazprom, including its stake in a liquefied natural gas facility. At the end of 2021, Shell had around $3 billion in non-current assets in these ventures in Russia and likewise will now cease its exposure to Russia. TotalEnergies has a 19% holding in NovaTek, a Russian producer of natural gas. The company has said that it will not supply capital to any new projects that NovaTek undertakes.

The stock market is a discounting mechanism and therefore some companies in the portfolio have already seen their share prices fall as investors attempt to price in increased risks in the short term. However, it is important to remember that a share represents a claim on a long-term stream of cash flows and therefore, a temporary reduction in those cash flows because of an economic downturn does very little to alter the long-run intrinsic value of a business.

In our minds, this serves to highlight the importance of investing for the long term (five years plus) in financially strong but lowly valued companies, where profits can grow, and any set back is likely to prove temporary. In this report we have attempted to highlight the undervaluation that exists in some of the Company's largest holdings. It is our belief that if we are roughly correct in our view of the potential of these businesses then, despite the inherent economic uncertainties of today, patient shareholders are likely to be rewarded with outsized investment returns over the coming years.

Ian Lance and Nick Purves
Redwheel