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Hosking Post
Taking on the 'blob'

December 2021

TAKING ON THE 'BLOB'[1]: A CASE STUDY IN ACTIVE ENGAGEMENT

Publicly-listed corporates are at a disadvantage. Unlike private firms, public companies face intense and increasing scrutiny from an array of observers, intermediaries and other helpers. Proxy advisors, institutional investors, environmental groups, politicians and NGOs are all now vocal in lobbying the public company. A consequence of this trend is that boards of public companies spend more time responding to the ever longer compliance agenda than in stewarding the core business. Whilst this might (or might not) be appropriate for an oil major, many small- and mid-cap public companies are increasingly disadvantaged. This is galling for practitioners of public equity investing such as ourselves because asset allocators appear, inconsistently, to accept differing standards of behaviour in the public and private spheres: in high-fee private equity investments all manner of ruthless, goal-orientated behaviours are not just permissioned but actively incentivised. Yet in the public equity bucket we see a relentless ratchet of compliance. The result is a pattern of 'lost' public companies where the original corporate purpose is obscured by a muddy Blob that has evolved in reaction to various external pressures.

Private equity has ruthlessly exploited this compliance arbitrage to take over these lost corporate souls. Once private, these companies are then re-invigorated by refocussing management on the core business, with incentives reset outside the harsh public glare. The public-to-private-merry-go-round often comes full circle when, often just a few years later, these same companies reappear, at higher valuations, to be re-sold to the good old public equity investors. Whilst this is not particularly 'new news' – and we abstain here from commenting on the societal level inequality driven by this low-to-high fee enrichment process – the opportunity for public market investors is to resist this patsy-at-the-table position through the practice of genuine active management. By joining forces with other shareholders it is possible to cut through the Blob and have a real impact.

Foxtons: a £1bn brand

Foxtons is an ongoing case study of this approach. As an exceptional, category-defining private company it ticked many of the lollapalooza boxes with a founder-led culture and win-win stakeholder incentive framework that led to industry dominance. With positive capital cycle tailwinds from a consolidating UK estate agency market (see quarterly report) and a leading deployment technology platform (the MyFoxtons portal has over 700,000 active users), Foxtons is well-positioned to

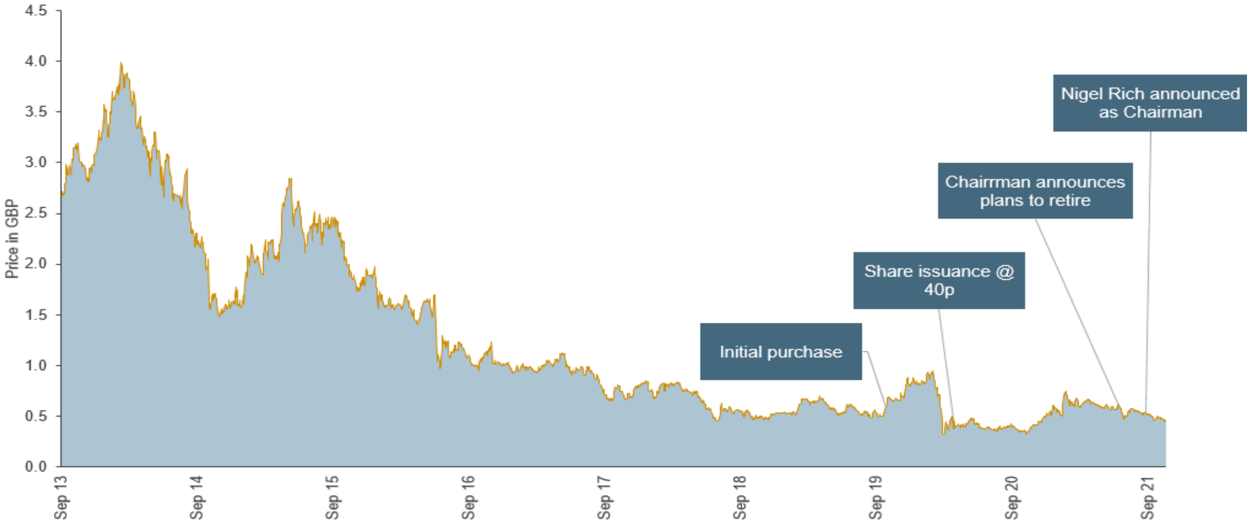
[1] Blob is a phrase made popular by UK politician Michael Gove

transition into a digital-first agent model. However, its 8-year history as a public company has seen the original sense of corporate purpose slowly calcify.

Founded in Notting Hill by Jon Hunt in 1981, Foxtons is one of the most recognised real estate brokers in London and the South-East of England. Built on a brash, high-energy, sales-led culture, the model historically generated c.2x the profitability of peers whilst simultaneously achieving c.8% higher average selling price for clients than what was achieved by traditional brokers: a client-centric, win-win business model. It achieved this result by putting the client – the house seller – first. Traditional agency models contain an inherent conflict between the competing interests of the vendor and purchaser. Although it is the vendor that pays the selling agent's fees, traditional agents often appear to act on behalf of the purchaser. In explaining the Foxtons' model, an early Foxtons pioneer relayed the following story:

"I used to go to dinner parties in Notting Hill where people would say to me 'I hate Foxtons. They are too pushy. I would never buy from them. But I would let them sell my house'. This was gold dust for me. All I wanted were listings as that is what you ultimately get paid for. And the people that give you listings are the people selling their house!".

Sadly, for Foxtons, the Jon Hunt culture has started to wilt. Post-listing, a top heavy and expensive C-suite has overseen a continuous ceding of market share to more nimble private players. Where Foxtons used to be the number one agent by a large margin, it has started to lose ground in key central London postcodes, despite having some of the best branch locations. This has led to falling sales and profits. Shortly after its IPO in 2013 the share price peaked at 376p, representing an enterprise value of £1 billion – a multiple of around 20x the £45m of pre-tax earnings. Fast forward to today and the business is on track to earn £15-20m of pre-tax profits with the enterprise value shrinking to c. £100m. We are cognisant of the challenges facing the group but see the £900m of value erosion post-IPO as an opportunity. Over the past two years we have acquired c.13% of the company, doubling our stake during a Covid-related share issue at 40p in May 2020.



Source: Hosking Partners, FactSet. Share price from 20 Sep 2013 to 09 Nov 2021. The portfolio holds this security. Not all purchases have been included. This does not represent all the securities purchased or sold. Further details of the calculation methodology and a list showing every holding's contribution to overall performance during the period is available upon request. Past Performance is not a reliable guide to future performance.

Driving Board change

The market share losses, profitability declines and £900m of equity shrink post-IPO appear to have had little impact on the board of Foxtons or the executives it oversees. The Board actually increased CEO Nic Budden's pay over this period, and in 2020 Mr Budden (in situ since 2014) earned £1.6 million in total compensation – an extraordinary perverse reward structure that has been overseen by a complicit board which collectively own less than 1% of the outstanding shares. The incentive alignment issues are clear as day and we venture that no private equity firm would have permissioned such rewards for failure.

Motivated by the inequity of management compensation, Hosking Partners engaged with the board of Foxtons; the aim being to re-set the incentive framework. In early 2021 we started a robust campaign of board lobbying. Initially this took the form of discussions with the (then) chairman. An underwhelming response led us to write to the board in its entirety on three separate occasions, setting out our view of the unacceptable nature of the CEO rewards and questionable capital allocation. These letters are available upon request. Concurrent with this board pressure, we reached out to other shareholders and encouraged them to censure management. At the AGM over 40% of shareholders voted against the CEO's remuneration report. In a letter of 17 May 2021, we called for the chairman to conduct a full review of Mr Budden's tenure as CEO. This was closely followed by a letter on 4 June where we expressed our disappointment at a Foxtons capital markets event which failed to address our concerns over market share and profitability erosion.

Having been frustrated by the lack of board responsiveness, we entered into a full-scale collaboration with a group of other large shareholders accounting for around one third of the share capital.[2] This was notified to and discussed with the UK Takeover Panel to avoid so-called concert party rules – rules that put off most public equity investor engagement in such dialogue. In this letter, dated 30 June, we requested an opportunity to discuss replacements for the chairman and non-executive appointments. On 7 July, chairman Ian Barlow announced his decision to resign and two months later it was announced that veteran property executive Nigel Rich would take over as the new chairman.


Hosking Partners believe the time has come for radical board-level change at Foxtons.

The Times, 07 June 2021

Foxtons chair quits after largest shareholder's call for changes

Foxtons chairman quits following investor rebellions

The Telegraph, 08 July 2021

A new chapter

As a former CEO of Hong Kong Land, chair of Hamptons International and also Segro PLC, Mr Rich brings vast experience and a value creation mindset. He has already moved to appoint a new non-executive in the form of Peter Rollings, a former Foxtons executive from the Jon Hunt heyday, who joined on 1 December. This appointment should lead to an aggressive focus on regaining market share. There are encouraging signs Mr Rich sees value in the business. He has bought 500,000 shares in the past 6 weeks alone, whilst Mr Rollings has also recently bought shares. Should Mr Rich succeed in reinvigorating Foxtons, the return on his investment could be substantial. Pruning of the excessive central costs (a major feature of the Blob) together with a return to historic transaction levels in the sales and rental sector could see the business achieve pre-tax earnings north of £60 million. With a net cash balance sheet and current enterprise value of just £100m the upside is clear. Not least, given the huge digital customer acquisition costs required to replicate over 700,000 MyFoxtons portal users; conservatively we believe the embedded value of the customer base alone accounts for more than the current equity value. We think the value of this customer set will not be lost on potential acquirors of the business, representing probably the best digital footprint in UK residential real estate. Whilst it is unlikely the business would return to its prior peak multiple of 20x, an 8x multiple of the recovered earnings would see the investment return near fivefold.

Victory is not assured. But without robust and concerted engagement, the value present in Foxtons, and many mid- and small-cap equities, will continue to pass into the private equity sphere. With the

[2] Platinum Asset Management, 3G Capital Management, Catalyst Partners.

private equity boom showing no sign of slowing, public equity investors will be required to be ever more active. We stand ready for that task, motivated by the prospect of retaining for our clients the significant upside rewards.

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December 2021

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