



# The Cut

**Edition 14**

14th July 2017

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**IRF works with 105 Independent Research Providers covering multiple geographies, asset classes, industry sectors and methodologies.**

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## Researchers visiting London

- **Mithra Forensic Research** - Accounting red flags, short-biased, European and Australasian corporates. Melvin Galpion, Founder, **20-21 July**
- **Etalon Investment Research** - US Equities - Special Situations, Alex Gavrish, Founder & Senior Analyst, **20 July**
- **JL Warren Capital** - China Stocks, related Stocks and Macro, Junheng Li, Founder & Senior Analyst, **24-26 July**

- **Insight Investment Research** - Global Infrastructure sector research, Rob Crimes, Founder, **8-11 August**
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## **Macro Research**

1. **Asianomics** - Overweight China for the first time in a decade as economic momentum improves; other investment recommendations included
2. **Connolly Insight** - Italy's growth problem with sovereign debt to GDP > 150% a weak banking system and unemployment >12%
3. **FFTT** - Trump: 'Golden age of US energy now underway'...unlikely without a much weaker USD
4. **Heteronomics** - UK unemployment rate fall tightens hawkish pressure, despite this, no rate rise until May 2018
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### **Company & Sector Research Snippets:**

- **Deydun Markets** - **SELL Neste Oil** (NESTE FH) on declining revenues due to increased competition, uncertainty surrounding the US blenders' tax credit and palm oil price rising

- **Smart Insider** - **BUY JD Sports Fashion** (JD LN) as Peter Cowgill, Executive Chairman, purchases 30,000 shares
  - **Libra Investment Services** - **SELL Aryzta** (ARYN VX), Swiss Consumer Discretionary stock, as company screens as a five star red on Apollo Ratings System
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## Macro Research

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**1. Asianomics** – The Austrian Economics model influences and informs Asianomics Group’s strategic thinking and investment recommendations

**IRF Note** - *Dr Jim Walker created Asianomics to give investors an alternative perspective on Asian and global economies and markets and expose underlying economic realities ignored by other research firms. Current investment recommendations as follows:*

- For the first time in a decade Asianomics are overweight Chinese equities as economic momentum improves. The latest PMI shows an expanding manufacturing sector. Policies are generally appropriate rather than loose or tight. Fundamentals are supportive of growth as are money flows around the region as we are seeing an earnings upswing.
- Short Sterling against the US dollar and Euro - The British government is completely out of its depth with Brexit. Since the Brexit high of £1.5016 there has not been a decent prolonged recovery that reduces bearish sentiment.
- Long EM Asia/Short DM - South and SE Asia are “buy and hold” investment bets. Current account balances have contributed positively to annual foreign exchange reserve growth since late 2011, and have in the bulk of countries driven reserve accumulation.
- India Bull - Asianomics upgraded India in Nov 2013 as its experiencing a resilient multi-year upturn. Despite the short-term dangers, for example state governments providing farmer loan waivers, they remain long.
- Long Indian Financials/Short European Financials - The simplest pair trade to play superior demographics and growth in Asia relative to the region with the biggest problems.
- Commodity Bull - The CRB Spot Commodity Index bottomed in December 2015 and is now in a cyclical bull market. Copper is expected to make further gains in particular

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**2. Connolly Insight** - Italy’s growth problem

**IRF Note** – *Italy looms as the next fire for Draghi to manage and another potential trigger*

for a 'risk-off' event. With a sovereign debt-to-GDP ratio of 132.6%, a weak banking system and an unemployment rate of 11.6%, Italy is vulnerable to any type of shock, including a tapering of asset purchases by the ECB. In this 11-page report (part 1 of a 3-part series on Italy), Connolly Insight examines the causes of these problems and their implications for the future. Key points include:

- Italy's growth deficit and productivity stagnation is tied to a deterioration of Total Factor Productivity (TFP) growth. TFP growth disappeared in the late 1990s and then turned negative in the 2000s.
- Factors such as strict labour regulation and government ineffectiveness help explain why productivity is lower than the US, for example, but don't explain on their own why productivity growth slowed starting in the mid-90s.
- Government ineffectiveness and corruption has not only made the adoption of new technologies difficult, but has also influenced the ownership structure and management practices of Italian businesses. The need for trust has incentivised the need for small, family-managed firms focussed on the domestic market. Italy's growth and productivity problem is cronyism.
- Legislative reforms will have little or no effect in the near-term unless the culture of Italy changes so that the changes to legislation show up in the application of laws in the real world.
- Italy has one of the lowest enterprise-birth rates in the EU. Thus, even if changes are made at the Government level to incentivise distributed ownership and professional management, it will take a long time to cycle through the existing business population in Italy so that reforms begin to show up in actual business practices.
- Given the ongoing 'brain drain' and destructive effects of austerity on a nation with a competitiveness problem trapped in a currency union, Italy will be lucky just to maintain the productivity of its workers.

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**3. Forest For The Trees** – Trump: 'Golden age of US energy now underway'...unlikely without a much weaker USD (FFTT)

**IRF Note** - 'Exporting American energy all over the world' would represent a major shift from what has been by far the dominant US export of the past 15 years: USD's. It is highly unlikely to happen with the USD anywhere near current levels given that US shale remains one of the highest marginal cost sources of oil. The way the global monetary system has worked for the past 44 years (World ships stuff to US, US ships USD's to world) may be changing radically; this would likely be (and in fact must be) structurally negative for the USD. Key points include:

- Trump appears to be advocating using US energy exports to begin balancing the US' record Net International Investment Position (NIIP) deficit. This will require a meaningful weakening of the USD.
- With the rapidly emerging new 'Multi-Currency Oil Pricing System', the key to oil market share is no longer a nation's oil production cost purely in USD terms, but rather, a nation's currency relative to the USD.
- The ultimate oil reference point is therefore shifting away from the reference point of the past 44 years (the USD) and once again shifting back towards gold.
- Markets are beginning to sniff this out, as the Gold/Oil Ratio (GOR) has re-rated notably higher since China's SGEI opened in 3Q14. The GOR's 50-day SMA recently crossed above its 200-day SMA (only happened twice before in the past three years),

and led to 138% increase in the GOR on average (largely driven by oil price collapses rather than gold price increases).

- If Trump wants to begin balancing the US NIIP deficit on the back of US oil exports in this new oil pricing system, then the GOR must be allowed to rise via gold rising (USD devaluing) rather than via oil falling (USD strengthening).
- Result - weak USD, bullish gold, bullish energy/industrial shares, and bullish EM.

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#### 4. Heteronomics - UK unemployment rate fall tightens hawkish pressure

**IRF Note:** *The LFS unemployment rate declined another tenth to 4.5%, though contrary to the consensus, Heteronomics don't see the first BoE rate hike until May 2018. They also see this as the start of a slow hiking cycle rather than a one off expected by the consensus. Key points include:*

- The trend decline in the LFS unemployment rate extended to 4.5% in May, surprising consensus and the BoE. The BoE's current estimate of NAIRU, also 4.5%, indicates the unemployment gap may have closed. The previous fall to 4.6% prompted a significant strengthening of hawkish rhetoric.
- The dovish offset to recent unemployment developments is their reliance on changes in the sample. New joiners have had consistently lower unemployment than those they have replaced. With relatively high unemployment cohorts leaving the sample over the next two releases and the latest rate already close to rounding down, an additional decline to 4.4% seems likely soon. This would further raise the hawkish pressure in the trade-off the MPC is managing.
- With Kristin Forbes now gone. the question is what the others need to see before joining that hawkish vote. For Ben Broadbent, soft business confidence appears to be urging restraint.
- Stronger demand growth would make the MPC more confident that the Q1 weakness was not the start of a slide that a premature hike could turn into a recession.
- Risks to the BoE's forecast lie to the downside, which will encourage it to delay hiking until May-2018. A recovery in real incomes should assist with this pick up in q-o-q demand growth.
- Strong GDP growth is not a precondition for a rate hike. That mixture would be indicating that the Brexit-related devaluation was a supply shock and thus an inflationary encouragement to raise rates. If there isn't spare capacity in the economy, interest rates should theoretically be back at neutral, which means a hiking cycle, not just a one and done reversal of the hurried stimulus last August.

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#### 5. Longview Economics - The UK productivity puzzle - The lost decade

**IRF Note:** *With UK productivity levels posting the worst 10-year streak since 1794, a fascinating article from Longview Economics asks if this is the worst quality global economic expansion in our lifetimes? Despite structural deterioration of the global economy they remain OW equities in longer term strategic portfolios. Key points include:*

- Further evidence this week suggests that this is probably the worst quality global economic expansion in our lifetimes. The ONS (UK) reported productivity levels unchanged since 2007 which is the worst 10-year streak since 1794 and the worst phase of real wealth creation in over 200 years. It's also the key cause of low real wage growth and a key driver of income inequality.
- The enormity of the length of that time highlights the unique nature of the last 40 years of Western economic growth. It's been a phase of financialisation facilitated by a trifecta of factors including i) an unanchored monetary system; ii) central bank inflation targeting; & iii) financial regulation in the form of various phases of Basel (which facilitated commercial banks to create and grow large mortgage books and drive house prices to unparalleled levels).
- Deregulation, ever cheaper (fiat) money and growing over-indebtedness have resulted in an increasingly poor allocation of capital (classic hall mark of credit booms).
- In the past 4 decades in which Western indebtedness has been building, capital has been funnelled into housing. Equally, ultra-cheap money has held back the forces of creative destruction. 'Zombie' businesses, which are unable to invest in new/productive capacity, have not only been kept alive, but grown as a share of total companies.
- The implication of excess liquidity, indebtedness, poor productivity and extreme asset valuations is discussed in more detail in Longview's quarterly Asset Allocation. This outlines the structural deterioration of the global economy in more detail and explains why Longview remain OW equities in longer term strategic portfolios (especially DM equities)

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**6. Macro Intelligence 2 Partners** – Latest investment recommendations at end of Q1 saw MI2 exit their US fixed income short recommendation and enter the “Trump gap” trade.

**IRF Note** – *MI2's product offerings focus on interpreting market movements. They utilise a combination of quantitative and qualitative models to monitor debt, equity, foreign exchange and commodity markets across the globe looking at momentum and price levels. Key recent findings and recommendations:*

- Economic surprise indicators after materially correcting are now at levels that are far more commensurate with the risk of upside surprise.
- Recent data, including a print above 55 for the ISM Non-Manufacturing suggest in the next couple of months a NFP print of +200K.
- That's potentially bad news for bond markets. The real problem is Europe where irresponsible ECB policies have created what could be the biggest bond bubble in history.
- Numerous European markets are now uncomfortably close to MI2 inflection points. These are levels from which they expect prices to either accelerate to the downside or bounce aggressively.
- The recommended trade is to buy 2-3 month delta hedged downside, leaving one long volatility and gamma.
- After such an extreme manipulation of asset prices, the fear is the process of normalisation will be extremely volatile.
- A tailwind of solid growth and especially European inflation data, which the MI2 models suggest is set to materially accelerate, will strengthen the resolve of the bond

bears.

- The MI2 recommended trade is to short the Bund and Buxl with some ambitious targets, a good 75bps above current levels. Given the increased volatility likely to ensue, position sizing is critical.

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### Macro Research Snippets:

**CrossBorder Capital** - Two reasons why the Euro is jumping – Improving economic data and less dovish statements from policy makers. Euro could be a key beneficiary of USD weakness in the coming months. The bottom line is that global capital is leaving the US; the Eurozone will harbour these inflows, while keeping domestic monetary conditions in-check; while Asia, for its part, will more likely monetise its inflows. Asian stocks hedged into Euros may be an interesting trade for the second half of 2017, but CBC's overall message for the year remains that 'the Missing US\$3 trillion of flight capital into the US is coming home.

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**Andrew Hunt Economics** - Japan Money watch - On a net basis, the BoJ has slowed its rate of acquisition of bonds quite appreciably over the last six months. Indeed, it is apparent that the BoJ has already begun to taper its level of net bond buying activity quite significantly while at the same time evidently succeeding in maintaining its Price Keeping Operation objectives in the bond markets. There has however been a welcome improvement in private sector credit trends. Nevertheless, in aggregate, the weaker public-sector stimulus is exerting the dominant effect and as a result overall monetary growth has cooled a little over recent weeks. [Click here](#) for a short overview of this researcher

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## Company Research

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**1. Badger Consultants** - SELL **Harley-Davidson** (HOG) given the downtrend in revenues (Motorcycles, Merchandising and Financial Services) and profitability as global motorcycle sales decline

**IRF Note** – *Tom Chanos, brother of the famous hedge fund manager Jim, who runs his own short focus research firm, has identified Harley-Davidson, Inc. as a Short recommendation.*

*Key points include:*

- 1Q17 Motorcycle revenues was down 15.7% year over year. Net income plunged 25.5%. Adjusted EPS down 22.8%. Gross margin was 35.9% down from 37.4%. Gross Profit down 9.1%. Operating margin 18% from 21.1%. Total operating income down almost \$100m Backdrop – Global motorcycle sales down 4.2% and US motorcycle sales down 5.7%.
- Touring motorcycles declined 24% year over year and cruiser motorcycles declined 7% year over year. These two motorcycles have higher margins than street bikes, so

the 24% decline in Touring bikes is problematic.

- Negative sales mix along with lower sales is. US registrations were down 5.9% and Europe was down 8.5%. And besides, 2017 will be the fifth year in a row of declining sales, yet the stock is up.
- This was the first time in the last four years that first quarter earnings per share was negative. Things are getting worse not better.
- While financial services revenue has been basically flat, operating income is declining. So, obviously retail credit losses from their loans to customers are increasing
- Harley keeps buying back stock, but earnings per share was still down 22%.
- The company trades at a forward EV-to-EBITDA of 12.3X, this is almost double the ratio that competitor motorcycle maker Honda trades at, 6.5X. The forward PE ratio for Harley is 14.4X, compared to 8.8X for Honda.

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**2. Entext** - Positive on **Baidu** (BIDU) since its autonomous driving platform, Apollo, has the ability to reshape the Auto Industry

**IRF Note** - Sean Maher, founder of Entext - a new provider for IRF, identifies macro themes and looks for investment to play these themes. Here they discuss autonomous driving and highlight Baidu and their platform Apollo which could be a huge market disruptor in the AI space when it comes to autonomous driving. Key points include:

- Last week saw a series of announcements underlining the seismic shifts underway in the auto industry value chain. As France announced plans to phase out combustion engine vehicles from sale by 2040. Chinese automaker Geely's Volvo subsidiary announced it is making all vehicles at least hybrid electric from 2019.
- Baidu to take advantage of these changes announced plans to freely offer an 'off the shelf' self-driving AI software package called Apollo. By making self-driving car technology available to any carmaker, the Apollo project could help China's car industry catch up with Silicon Valley, particularly as the electrification and autonomous trends converge as disruptive forces.
- It reflects China's ambition to establish itself as a leading Artificial Intelligence hub.
- Making the training data openly available looks an inspired move for Baidu, which has lagged the wider tech sector on the declining legacy PC search business.
- The goal is to begin testing Apollo vehicles on restricted areas later this month and to have fully autonomous driving on urban roads and highways by the end of 2020.
- A US startup called AutonomousStuff demonstrated a standard car that it turned into a rudimentary self-driving one using Apollo technology in three days.
- The Baidu package consists of a core software stack, cloud services and self-driving vehicle hardware such as GPS, cameras, and Lidar. Opening up the Apollo platform gives Baidu access to a vast amount of real-time data from its automaker partners as they launch autonomous test programs.
- "Apollo is an important milestone for the automotive industry. It is in essence the Android of the autonomous driving industry, but more open and more powerful." Qi Lu, vice chairman of Baidu speaking at the company's first AI conference in Beijing.

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**3. GARP Research** – BUY **SeaWorld Entertainment** (SEAS) as a turnaround in the works since the board began to clean out nearly the whole management team in 2015

**IRF Note** – *SeaWorld's stock has lost well over half its value since the airing of the documentary "Blackfish" in 2013 which recounted the drowning of a senior trainer. GARP Research sees value and growth in shares of SeaWorld, but the opportunity is conditioned upon the company's relatively new management team restoring its namesake brand. Key points include:*

- A new management team led by CEO Joel Manby has been working for two years to restore SeaWorld's reputation. A major milestone was struck with the agreement in March 2016 with the Humane Society to stop Orca whale breeding and fund US\$50m of animal rescue efforts.
- The business is capital intensive, but the industry is known for enjoying fat operating margins with attendance being pure profit. If SeaWorld can stop attrition and restore moderate growth amid achieving savings from restructuring, operating margins could hit 15%.
- New shows and rides are designed to attract visitors. This June SeaWorld began to refresh all three of its namesake parks. Most interesting to GARP is the positive reaction greeting the arrival of a virtual reality retrofit to the Orlando park's Kraken roller coaster. Over half a million have viewed a YouTube video of the ride in just a few weeks.
- With water simulation and temperature variation supplemented by roller coaster G force, SeaWorld might well return to the top of things to do in Orlando, San Diego and Texas.
- Busch Gardens is a solid performer more akin to major amusement park operators, which are known to have operating margins north of 30% and recent agreements to open parks overseas indicates an interest in taking possession of a shrinking supply of trained killer whales.
- US theme parks have been victims of dollar strength. International visitors from Brazil and the UK are material to SeaWorld. While no one would forecast an immediate rebound, reversal of strong dollar policy could rekindle demand.

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**4. Insight Investment Research** – **Atlantia** (ATL IM)-**Abertis** (ABE SM) deal offers attractive FCF and dividends within the Infrastructure space

**IRF Note** - *Insight believes the high FCF estimated from a combined ATL-ABE entity would be very attractive to investors with a particularly appealing near term FCF yield and dividend yield. They also think the combined entity could have significant re-leverage potential. Key points include:*

- Highly attractive ATL-ABE FCF - estimate a post maintenance capex FCF yield of 18% in 2018E and 16-19% in 2019-23E, which is high as ATL would gain ABE's FCF at a low estimated post tax cost of debt financing of 1.3%.
- Most of the capex at both ATL and ABE is expansionary and estimate combined maintenance capex of €470m, only equating to 0.17x depreciation.
- High dividend would be very attractive to investors and be comfortably above all other companies in Insight's global infrastructure sector - expect a dividend of €1.49 and a

dividend yield of 5.8% in 2018E vs. 4.5% for ATL stand alone, which would be covered 2.4x by 2018E FCF.

- ND/EBITDA of 5.2x in 2017E reducing to 3.0x in 2025E. With forecast combined 2025E EBITDA of €8.8bn, this allows significantly more net debt to be supported (€13.2bn additional).
- Expect the deal to be approved by Spanish authorities - Spain will be a relatively small part of ABE after end 2021 when Acesa expires. Spain, excluding Hispasat that Insight expect to be sold, will reduce from 31% in 2017E to 13% in 2022E of proportional EBITDA with most of EBITDA in 2022E deriving from France (56%) and S. America (25%).
- TP of €33 – with value accretion from ATL-ABE deal of €1.7bn/€2 per ATL share. ATL stand-alone IRR of 8.6%, above cost of equity of 6.5% and an ATL New Co (ATL & ABE) IRR of 9.4%. ATL remains 5th of 19 on Insight's Stock Ranking System.

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**5. Spin-Off Research** – BUY **ALD SA** (ALD FP); recent IPO offers ~40% upside, valuing the company in-line relative to peers, given value-accretive deals, strong profitability and favourable market environment

**IRF Note** – *Joe Cornell, founder of Spin-Off Research believes spin-off situations often provide great opportunities to unlock significant value and ALD is no exception. The full service vehicle leasing and fleet management subsidiary of Societe Generale SA (GLE FP) started trading on the Euronext Paris last month. The company intends to use the IPO proceeds to accelerate its development and to seize new growth opportunities in both the corporate and B2C markets. Key points include:*

- ALD has witnessed strong growth in recent years and is the largest company of its kind in Europe (third-largest worldwide). In 1Q17, they reported gross operating income of €328.4m (+8.3% YOY), making it one of the most profitable and fastest-growing units of GLE due to its efficient operating model and economies of scale.
- Being separately listed is expected to enable ALD to accelerate growth and provide new avenues of financing. The company can aim to become a leader in the mobility services space, which allows customers to use shared vehicles.
- ALD can also focus on its strategy of targeted and value-accretive bolt-on acquisitions to complement its organic growth as it pursues opportunities in both the corporate and B2C markets. As part of its strategy, in May 2017 ALD announced acquisitions of BBVA Autorenting, a Spanish full-service leasing (FSL) subsidiary and Merrion Fleet, Ireland's number 2 FSL services provider.
- Enables GLE to focus on its high-synergy businesses, while also monetising a profitable unit at good valuations. Since GLE continues to have ownership control in ALD, it should benefit from the unit's growth in an otherwise subdued interest rate environment.
- Spin-Off has a target price of €20 per share and a Buy rating on ALD, and €54 target price and a Buy rating on GLE - given its strong capital structure, lower 1Q17 provisioning and potential value unlocking from ALD IPO.

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## 6. Storm Research - Positive on **LAC** (3857) - sophisticated cybersecurity company

**IRF Note** - Storm Research, who focus on uncovered and undervalued Japanese equities, have recently initiated a positive recommendation on LAC as a play on cyber security

- LAC provides IT security services, including consulting, managed security monitoring & system development. It also sells IT system products & maintenance services.).
- LAC operates JSOC, the largest security monitoring center in Japan and deals with over 70% of the major domestic IT crime incidents reported in the media.
- The expectation is that the recent spate of global cyberattacks will fuel sustainable growth in cybersecurity demand.
- Demand for increasingly sophisticated cybersecurity is accelerating. Whilst LAC is responding via its new hiring program, it is also considering price increases for higher value added services.
- To supplement its cybersecurity focus LAC appointed new President Itsuro Nishimoto in April 2017, aiming to capitalise on his security background to drive medium term growth.
- LAC's earnings deteriorated following the 2008 Lehman shock due to weak corporate IT investment, but began to recover from FY 3/11.
- A new President and ambitious hiring scheme provide evidence LAC is refocusing its resources to fully capitalise on increasing cybersecurity demand strength. The expectation is that it results in a significant earnings acceleration that the stock has yet to discount.

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### Company & Sector Research Snippets:

**Deydun Markets** - Short **Neste Oil** (NESTE FH) which topped out over a year ago. Neste's revenues have declined from over Eur 17 billion in 2013 to just under Eur 12 billion in 2016. The company missed Q1 EPS estimates and competition from new plants from 2018 is expected to pressure margins further. The uncertainty surrounding the US blenders' tax-credit continues to pressure margins and with palm oil prices increasing, the pressure on earnings looks likely to persist into the foreseeable future. NESTE's implied volatility has made a multi year low. We are in a situation now where the realised volatility is slowly rising and due to the extremely low levels of implied volatility, the chance of a large, fat-tailed move is increasing. Consensus expectations for the name have been declining YTD. [Click here](#) for a short overview of this researcher

**Smart Insider** - Peter Cowgill (Executive Chairman, joined 2004) purchased 30,000 **JD Sports** (JD LN) shares on July 5 at GBP 3.52, spending GBP 106,000. His last two purchases were timely. He purchased 100,000 shares in September 2015 at GBP 1.86, and then 75,000 shares in June 2016 at GBP 2.31. Brian Small (CFO, joined 2004) purchased 10,000 shares on June 30 at GBP 3.61. Small's last purchase was also timely, 25,000 shares in July 2016 at GBP 2.18. These two insiders are buying the stock as it pulls back from a May 2017 high of 4.60, but still up from where it began 2017 at 3.17. Smart Insider are ranking the stock +1 (Positive Insider Pattern). [Click here](#) for a short overview of this researcher

**Libra Investment Services** - **Aryzta** (ARYN VX) is screening a 5-star red. FV is down 3% over the last month; IV is down 8% over the last three months. The current discount to FV is 5% vs. a median discount of 2%. The FV range is falling. Apollo's excess return to IV (the future growth trend) is -10%. [Click here](#) for a short overview on this researcher

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