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Phil Oakley's Weekly Round-Up

This week I ask whether M&S can recapture past glories. I also discuss Purplebricks' business model, assess Persimmon's prospects now that Help to Buy has been extended, and evaluate ITV, Morrisons and Wetherspoon

The companies mentioned this week are:
- Morrisons
- JD Wetherspoon
- Purplebricks
- ITV
- Marks & Spencer
- Persimmon

Morrisons

The business performance of **WM Morrison (MRW)** has been on the up for the past few years. Chief executive David Potts has tidied up the business and got the company back to focus on the basics of good food retailing. By this I mean selling good products at good prices with well-stocked shelves and no big queues at checkouts. I can see plenty of evidence of this on my visits to local Morrisons stores.

The strategy has worked with 12 quarters of like-for-like (LFL) sales growth. What seems to have disappointed analysts this week is that LFL sales growth from its supermarkets has slowed down to 1.3 per cent, which was lower than had been expected. LFL sales from wholesaling – a much smaller but growing part of the business – accelerated to 4.3 per cent, compared with 3.8 per cent during the second quarter. Consequently, Morrisons remains on track to meet analysts' forecast for the full year.

It's difficult to see how Morrisons' supermarkets can be expected to grow much faster than they currently are. Food retail is a fiercely competitive market with every scrap of market share hard fought for. There are arguably still too many supermarkets chasing too few shoppers which has created an industry with low profit margins and low returns on capital. Selling groceries online is barely profitable and

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often loss-making. This begs the question: why should investors buy and own the shares of food retailers?

I think the case for doing so is rather weak given the muted outlook for growth. Morrisons is one of the better operators out there and looks to be a fairly stable and cash-generative business. This should allow it to keep paying a rising dividend to shareholders over the next few years.

Morrison (Wm) Supermarkets PLC (MRW)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	17,870.5	+3.5%	18,385.9	+2.9%	18,885.4	+2.7%
EBITDA	911.7	+7.3%	959.0	+5.2%	997.7	+4.0%
EBIT	474.1	+9.8%	503.8	+6.3%	531.6	+5.5%
Pre-tax profit	411.9	+11.9%	458.0	+11.2%	491.3	+7.3%
Post-tax profit	316.2	+10.9%	344.8	+9.1%	377.0	+9.3%
EPS (p)	13.3	+11.8%	14.4	+8.3%	15.6	+8.3%
Dividend (p)	8.9	+46.1%	9.2	+3.4%	10.4	+13.0%
CAPEX	482.4	-3.5%	472.9	-2.0%	483.3	+2.2%
Free cash flow	302.1	+18.0%	403.8	+33.7%	433.6	+7.4%
Net borrowing	916.5	-8.3%	769.8	-16.0%	660.6	-14.2%

Source: SharePad

The forecast free cash flow yield of 5 per cent is not desperately expensive given that free cash flow is expected to keep on growing and underpins the forecast dividend yield of 3.6 per cent. On the other hand, it's difficult to see the shares as a bargain either.

It would not surprise me if Morrisons became a takeover target for Amazon, if the online behemoth wished to become a significant food retailer in the UK. Failing that, the shares look a reasonable safe home for investors seeking a reliable source of dividend income.

JD Wetherspoon

To me, pubs are very similar to supermarkets from an investor's perspective. There are too many of them operating in an industry that has to operate under very challenging conditions. The key problems pubs face is being able to grow their revenues enough to offset rising costs – particularly wages and business rates.

JD Wetherspoon (JDW) has many detractors who wouldn't darken the doors of its pubs, but it has been the best in the sector at growing its LFL sales in recent years. It has done this by wooing customers with cheap drinks and food in well maintained pubs.

Yet Wetherspoons has been closing more pubs than it has been opening. It has been spending most of its strong underlying free cash flows on buying the freeholds of its pubs and shrinking its share count. Its shareholders have fared a lot better than those of many other quoted pub groups.

But even Wetherspoons has now realised that it can't keep growing fast enough to offset rising costs given Wednesday's first quarter trading statement. Staff wages are increasing,

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and the company has decided not to pass this cost onto its customers by raising prices. As a result, it currently expects profits to be slightly below last year.

Wetherspoon (JD) PLC (JDW)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	1,767.6	+4.4%	1,831.1	+3.6%	1,897.7	+3.6%
EBITDA	222.2	+5.7%	229.1	+3.1%	237.6	+3.7%
EBIT	141.1	+7.9%	144.8	+2.6%	148.8	+2.8%
Pre-tax profit	107.5	+3.0%	111.7	+3.9%	117.4	+5.1%
Post-tax profit	83.2	+3.0%	86.3	+3.7%	91.2	+5.7%
EPS (p)	78.4	+2.5%	82.6	+5.4%	87.5	+5.9%
Dividend (p)	12.1	+0.8%	12.1	0.0%	12.2	+0.8%
CAPEX	109.0	+58.2%	93.0	-14.7%	109.9	+18.2%
Free cash flow	101.9	-5.2%	103.5	+1.6%	114.2	+10.3%
Net borrowing	684.1	-5.8%	636.2	-7.0%	589.2	-7.4%

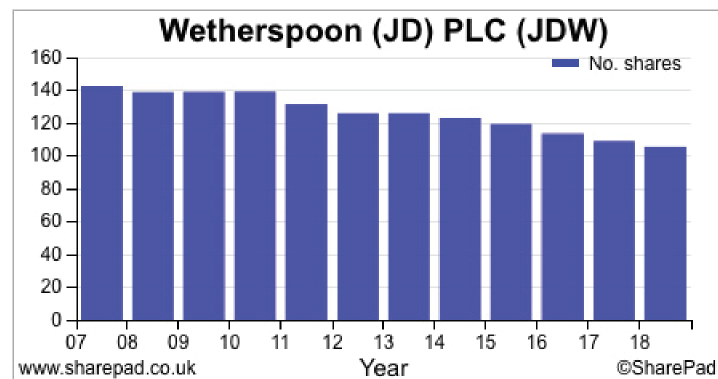
Source: SharePad

Given pre-tax profits last year of £107.2m, this statement does not imply a big forecast downgrade, but the market punished the shares which had fallen 11.5 per cent by early Wednesday afternoon.

This seems a bit of an overreaction to me. By not increasing prices, Wetherspoons may make itself more competitive and take customers from other pubs. The fall in the share price may also see it buying back shares again.

Given Tim Martin's dominance in this company, it's difficult not to think that it is run as if it is a private business. This is a good and a bad thing. Good because it can take long-term decisions at the expense of short-term profits – which may help the long term health of the company. Bad because shareholders have to take the hit in the form of a lower share price as a consequence.

I'm not a fan of investing in pubs, but if I had to then Wetherspoons is probably where I would put my money. The company generates £100m of free cash flow per year after maintaining its existing pubs and is well managed. This gives an underlying free cash flow yield of around 8.2 per cent at a share price of 1,162p.



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Using a chunk of that free cash flow to start buying back shares again looks a good idea to me. If Wetherspoons becomes more competitive against its peers, it may also be the case that its profit outlook is too cautious.

Purplebricks

Shares in online estate agency **Purplebricks (Aim:PURP)** have had a torrid 2018 and are down over 56 per cent so far this year. Despite having never made a profit at a group level – and not likely to for a while – the company still has a market capitalisation of £542m at a share price of 179p.

I have my doubts whether this company will make the kind of profits needed to justify its current stock market valuation. Estate agency is a cyclical business that typically doesn't command high valuations. Assuming a PE of 10 times implies sustainable post-tax profits of £54m, and it is a long way from that today.

My mother was a sales negotiator in an estate agency for 18 years. My wife's parents ran their own surveying, estate agency and lettings agency for over 30 years. This does not make me an expert by any means, but I have a little insight into the economics of the business and what goes on behind the scenes.

I think high-street estate agents have overcharged their customers for years. This is despite the barriers to entry in the business being relatively low. Commission rates received on the sale of large properties often bear no resemblance to the amount of work done by the agent. Yet, what is often ignored is the fees that are not received for homes that do not sell. In effect the sellers of properties are subsidising a free service to those that don't sell.

Purplebricks' fixed fee, of £849 outside London and £1199 in London, looks very attractive at first glance in comparison to the percentage of value commissions charged by traditional high street agents. Extra fees are charged by Purplebricks for viewings (£300 and £399 in London) and ancillary services such as conveyancing.

It is easy to tar estate agents with the same brush and think that they are making lots of money for doing very little. Good agents work very hard for their customers. Chasing solicitors and keeping abreast of complicated chains is easier said than done. They have to do this because they don't get paid unless the property is sold.

This is why I would never sell my house with Purplebricks where you pay a fixed fee regardless of whether your property is sold or not. Yes, you can save a lot of money versus a high street estate agent's commission if your house sells quickly but you could be paying a fee for nothing.

My view is that you should never pay in advance for a service because once the seller of that service has your

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money the incentive for them to do a good job – despite their best intentions – is reduced. If you have any problems with a traditional agent you can withhold their fee or take your business elsewhere after an initial lock in period without paying. That option doesn't exist with Purplebricks where you pay a fee upfront.

Purplebricks gets paid regardless of whether it sells a property or not. In a slowing housing market, I think that many sellers may wise up to this and recognise that the fixed fee may not be the best option. A commission-based agent has a strong incentive to sell a property and, with a lot of overheads to cover, might offer a very competitive deal. I see this as a significant risk to Purplebricks' business model.

This of course is just my opinion. As with most companies, I prefer to let the numbers do the talking. On a positive note, the UK business is profitable and increased its profits during the year to April 2018. It sold 81 per cent of its listings during the year which is a good result.

Purplebricks UK	2017	2018
Instructions	41211	64376
Average revenue per instruction	£1,088	£1,168
Cost per instruction	£349	£332
Gross profit	£739	£836
Gross margin	67.9%	71.6%
Total revenue (£m)	43.2	78.1
Operating profit (£m)	0.2	4.2
Margin	0.5%	5.4%
Incremental revenue (£m)	–	34.9
Incremental operating profit (£m)	–	4
Margin	–	11.5%

Source: Company report & Investors Chronicle

If you want to get bullish about this company then you need to look at the operational gearing that is in this business. The business has a lot of fixed overheads –although a lot lower in proportional terms than a chain of high street agents – and this allows the incremental profit margin on additional revenues to drive the overall profitability higher. If the business can keep adding more instructions, then this operational gearing can lead to a rapid growth in profits.

It's always worth remembering that operational gearing does work both ways. A downturn in the property market would likely see profits fall and could see a consumer shift back to commission based agents.

That said, UK profits should increase again in the year to April 2019 given that sales are up by 20 per cent during the first half of the year.

Apart from its cyclicality, my chief concern with Purplebricks is that it is trying to run before it can walk. It has entered the Australian and US markets where losses are significant and instructions are currently small. It has also recently entered the Canadian and German markets.

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Purplebricks Group PLC (PURP)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	172.3	+83.8%	253.8	+47.3%	350.0	+37.9%
EBITDA	-24.9		35.5		20.9	-41.1%
EBIT	-23.1		10.6		56.9	+437.6%
Pre-tax profit	-30.9		34.6		10.8	-68.8%
Post-tax profit	-27.4		6.3		8.1	+27.7%
EPS (p)	-10.8		2.3		2.5	+8.7%
Dividend (p)	-		-		-	
CAPEX	3.9	+4.2%	5.3	+37.3%	5.4	+2.2%
Free cash flow	-18.4		27.0		16.2	-40.0%
Net borrowing	-94.9		-77.8		-106.6	

Source: SharePad

The company has said it is on track to achieve revenues of between £165m-£185m for the year to April but losses are expected to be significant. Looking further out, estimating future profitability is difficult as consensus forecasts are all over the place. Stockbroker Peel Hunt said this week that it expects a profit in 2021.

Despite, a sharp reduction in its share price I still view Purplebricks' shares as a speculative punt on the unknown, especially with regard to its overseas businesses. I think the business is virtually impossible to value with any degree of confidence whilst the high cyclical risk of estate agency still remains.

ITV

Independent broadcaster **ITV (ITV)** has long been seen as a takeover candidate. It has a lot of desirable characteristics as a free to air broadcaster capable of delivering big audiences to advertisers – for now – and a decent quality and growing production business. The company is also very profitable with profit margins of 17 per cent last year and return on capital employed (ROCE) of 23 per cent.

Yet the company has not received a bid approach in years and in my opinion may not do so for a while yet. Despite growing the scale and profits of the production business, ITV remains far too reliant on advertising revenues (49 per cent of year-to-date total revenues) and remains a highly operationally geared business. This means that the profits of its broadcasting business tend to get hammered in a recession.

ITV's problem is that people's viewing habits are increasingly shifting away from live to on-demand TV. They also tend not to like adverts. Netflix, Amazon Prime and Now TV, have no adverts and more (and arguably better) content than ITV that many people are happy to pay for. The big unknown for me is: does ITV have the content to manage a decline in advertising revenue and create an on-demand product that lots of people are willing to pay for?

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The BBC is aware of the threat of Netflix and wants to expand its iPlayer service to offer more box sets free of additional charges (on top of the licence fee) and without adverts. Ofcom has stopped it from expanding for now because of the threat it would pose to commercial broadcasters such as ITV and Channel 4. This highlights the precarious competitive position that ITV is in despite its efforts to grow the use and advertising revenues from its ITV Hub.

This changing landscape probably explains why no-one has bid for ITV and why its shares have been a very disappointing investment of late.

The risks of the business were highlighted in this week's third quarter trading update with the company warning that net advertising revenues would be down by 3 per cent in the fourth quarter and flat for the year as a whole. The Studios business is expected to grow its organic revenues by 3 per cent for the full year.

ITV PLC (ITV)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	3,218.3	+2.8%	3,315.5	+3.0%	3,426.1	+3.3%
EBITDA	847.4	+26.1%	837.7	-1.1%	893.6	+6.7%
EBIT	803.4	+48.8%	767.6	-4.5%	829.7	+8.1%
Pre-tax profit	764.2	+52.5%	759.9	-0.6%	824.5	+8.5%
Post-tax profit	610.8	-4.9%	597.6	-2.2%	640.6	+7.2%
EPS (p)	15.3	-4.4%	15.0	-2.0%	16.3	+8.7%
Dividend (p)	8.0	+2.6%	8.1	+1.2%	8.7	+7.4%
CAPEX	95.5	+34.5%	58.7	-38.5%	59.2	+0.8%
Free cash flow	504.0	-17.9%	541.3	+7.4%	580.1	+7.2%
Net borrowing	866.0	-7.1%	682.9	-21.1%	651.7	-4.6%

Source: SharePad

The softness of advertising revenues will understandably lead to concerns that this is the start of a prolonged weakening trend that could lead to a reduction in profit forecasts, despite an ongoing cost-cutting plan.

ITV's shares do look cheap. At 150p they offer a forecast free cash flow yield of 8.1 per cent and a dividend yield of 5.1 per cent. Given an uncertain outlook, they may continue to stay cheap.

Marks & Spencer

I'm not a fan of politics generally and tend to avoid mentioning it when discussing investments. However, I can't help thinking that **Marks & Spencer (MKS)** has many similarities with the current Conservative party: Both are very reliant on the support of wealthy older people and will probably face terminal decline unless they change their ways.

Half-year results released this week show that the company has much to do. LFL sales in clothing and homeware were down by 1 per cent and Food LFL sales were down by 2.9 per cent. The company is looking to put things right by closing stores, opening better stores,

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refreshing its clothing ranges, improving its online business and revamping its supply chain and cutting costs.

Can M&S become a successful and growing retailer again? I'm not so sure it can.

In clothing, I think it has a very tough task. Competitors such as Boohoo, Asos, Next and Primark offer a combination of better and cheaper ranges. With the exception of Primark – which doesn't sell online – all have good and established online businesses and fulfilment.

I think M&S food is very good quality but its prices are too expensive – with a few exceptions such as ready meals – given what can be bought elsewhere. I think it's going to be hard for it to woo more customers.

Marks & Spencer Group PLC (MKS)

FORECASTS — £ millions unless stated

Year	2019		2020		2021	
Turnover	10,584.7	-1.1%	10,628.3	+0.4%	10,647.7	+0.2%
EBITDA	1,171.8	-6.8%	1,146.3	-2.2%	1,108.9	-3.3%
EBIT	620.6	-7.5%	615.3	-0.9%	611.5	-0.6%
Pre-tax profit	544.8	-6.2%	547.2	+0.5%	546.4	-0.2%
Post-tax profit	426.6	-5.6%	425.9	-0.2%	423.8	-0.5%
EPS (p)	26.3	-5.4%	26.4	+0.4%	26.3	-0.4%
Dividend (p)	18.7	-0.0%	18.9	+1.1%	19.0	+0.5%
CAPEX	358.6	+2.7%	371.9	+3.7%	369.9	-0.5%
Free cash flow	456.6	-26.8%	433.9	-5.0%	458.6	+5.7%
Net borrowing	1,684.8	+6.1%	1,544.1	-8.4%	1,441.1	-6.7%

Source: SharePad

If it can prove doubters such as me wrong, then I would say that M&S shares look quite interesting just now. The business remains very good at generating cash flow, with free cash flows increasing due to a tight rein on capex spending. As a result, debt levels are coming down. But can M&S deliver meaningful growth in sales and free cash flow?

If it can, then the shares look cheap and offer a 2019 forecast free cash flow yield of 9.5 per cent at a share price of 297p. This suggests that the dividend yield of 6.2 per cent looks safe for the time being. One for contrarian investors to consider perhaps?

Persimmon

Those of you who used to follow me on Twitter (having spent far too much of my time on there, I decided to quit a couple of weeks ago) may be familiar with my rants about the failings of the government's Help to Buy scheme.

I won't go into the details, but for me this flawed policy of taxpayer subsidised mortgages has pushed up the premium of new home prices over existing ones (my view is based on what I see in my local housing market and industry studies) and created massive windfall profits for builders. **Persimmon (PSN)** – and its outgoing chief executive – have been major beneficiaries of this scheme with every other home that it sells currently bought with

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the assistance of a Help to Buy loan.

Persimmon has become extremely profitable on the back of Help to Buy and is expected to have operating margins of nearly 30 per cent in 2018 - the highest in the sector. Last week's budget extended Help to Buy out to 2023 – from 2021 – and whilst it is going to be limited to first time buyers, this is good news for Persimmon and its peers. They now have just over four years of visibility which should enable them to sell homes on their current land banks at attractive margins – as long as house prices hold up.

Persimmon PLC (PSN)

FORECASTS — £ millions unless stated

Year	2018		2019		2020	
Turnover	3,644.1	+6.5%	3,783.4	+3.8%	3,926.7	+3.8%
EBITDA	1,078.0	+9.1%	1,110.7	+3.0%	1,155.4	+4.0%
EBIT	1,069.4	+9.2%	1,100.7	+2.9%	1,143.5	+3.9%
Pre-tax profit	1,080.7	+11.9%	1,119.2	+3.6%	1,162.0	+3.8%
Post-tax profit	878.2	+10.1%	908.3	+3.4%	950.7	+4.7%
EPS (p)	275.4	+11.7%	284.5	+3.3%	294.1	+3.4%
Dividend (p)	228.7	-2.7%	235.0	+2.8%	235.0	0.0%
CAPEX	16.4	-8.9%	14.8	-9.8%	14.4	-2.7%
Free cash flow	892.0	+10.7%	904.7	+1.4%	953.3	+5.4%
Net borrowing	-1,214.5		-1,263.2		-1,357.4	
NAV	3,144.7	-1.8%	3,313.9	+5.4%	3,517.6	+6.1%

Source: SharePad

This week's third-quarter update said that current forecasts for 2018 are in the bag, with forward sales for 2019 ahead of last year by 9 per cent. Private sales per outlet are down slightly, but there's nothing to suggest that this business isn't still in rude health.

TIDM	Name	Price	Market Cap(m)	fc EBIT margin	PE roll 1	Price to NAV	ROE	fc ROE	ROCE	fc Yield
BDEV	Barratt Developments PLC	533p	£5468.6	18.1	7.6	1.2	15.1	16.0	17.0	8.5
BWY	Bellway PLC	£30.12	£3735.1	22.0	6.7	1.4	21.9	20.2	26.3	4.9
BKG	Berkeley Group Holdings (The) PLC	£36.00	£4691.6	25.8	10.1	1.8	32.0	19.4	33.5	5.6
BVS	Bovis Homes Group PLC	£10.12	£1372.1	15.5	9.2	1.3	9.3	12.0	11.0	10.1
CRST	Crest Nicholson Holdings Ltd	362.8p	£940.4	16.9	6.2	1.1	21.9	17.7	20.6	8.9
MCS	McCarthy & Stone PLC	140p	£752.3	10.5	13.9	1.0	10.5	7.2	12.4	3.1
GLE	MJ Gleeson PLC	710p	£387.6	18.8	11.5	2.1	17.0	16.6	20.0	4.7
PSN	Persimmon PLC	£23.69	£7538.8	29.3	8.4	2.3	26.9	27.7	29.3	9.7
RDW	Redrow PLC	549p	£2030.2	19.9	5.9	1.4	22.7	20.7	23.8	5.5
TW.	Taylor Wimpey PLC	165.55p	£5450.9	21.3	7.5	1.7	21.9	21.4	18.6	9.5
TEF	Telford Homes PLC	334p	£252.8	13.9	6.0	1.1	17.2	17.1	15.7	5.6

Source: SharePad

My problem with Persimmon and most of the sector (except Telford Homes and Berkeley Group) is that they are hooked on Help to Buy. The danger, as I see it, is the size of new build premiums may have become too big and that new homes look increasingly poor value for money compared with equivalent existing homes.

Whilst early buyers of Help to Buy homes may be sitting on a gain, I think there is a risk that recent buyers could struggle to sell at the prices they have paid and risk negative equity if prices don't continue to increase.

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The other unknown is what happens to new home prices if Help to Buy ends in 2023?

I think current trading conditions could be as good as they get for Persimmon and that new build premiums cannot get much bigger without creating further controversy. Rising build cost inflation and moderating selling price increases suggest that profit margins are close to peaking. Whether it can offset this with materially higher volumes remains to be seen. Current forecasts suggest modest profit growth in 2019 and 2020.

That said, the security and predictability of profits that Help to Buy is underpinning means that shareholders should still expect capital returns of 235p per share in 2019 and 2020 and a further 110p per share in 2021. It would not surprise me if Persimmon promises further capital returns out to 2023 to coincide with the extension of Help to Buy.

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