



Phil Oakley's Weekly Round-Up

Despite some upgrades to profit forecasts, the weak economic outlook is bad for shares

Good news seems to be rather thin on the ground right now.

As far as UK companies are concerned, there are plenty of cases where forecasts are being upgraded, but in many cases their expected profits are still a long way off from what they were making last year.

If I look at the share prices of many domestic-facing UK companies and those in the travel and leisure industries, I can only come to the conclusion that they look decidedly unwell.

Even on the other side of the Atlantic the blind faith that the Federal Reserve can keep share prices going up forever seems to be wearing off.

Sooner or later the direction of share prices always comes back to one key variable – profits and future profits, in particular.

The resurgence of Covid-19 infections across much of the world and the decisions taken by governments to try and slow them down is rightly worrying people who are concerned about the damage it will do to the economy.

It is often said that the stock market is not the economy. It isn't, but the economy has a big bearing on how much stuff the customers of businesses ultimately buy and therefore how much profit firms make.

The growing risk now is that the end of furlough schemes in the UK will see a big increase in unemployment in the months ahead, which means those who have lost their jobs will have less money to spend. This week has seen TUI, Whitbread and JD Wetherspoon announce significant job losses and sadly there's likely to be a lot more to come.

The threat of another lockdown is very real and I fear that the UK economy needs this like a hole in the head. Enough damage has been done and a lot of it is permanent as consumers may have changed their behaviour for good.

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While the financial commentariat repeatedly go on about money printing and the fear of inflation, the loss of jobs on a growing scale is actually very deflationary. The money printing that has gone on has inflated asset prices, but has not fed through to consumer prices in general, as it has not ended up in the pockets of households and created a situation of too much money chasing too few goods. If more households see a loss of a wage, then this is not likely to happen any time soon.

I am appalled by the brazen attitude of central bankers when they say that inflation is not high enough. Most of the gains in consumer welfare in history have come when prices have fallen and the money in people's pockets buys more things.

Deflation or falling prices is a nightmare if you have debts to pay off and incomes fall. The powers that be are also terrified of deflation becoming entrenched in the minds of consumers and businesses who might put off spending in the anticipation of prices falling further.

A debt-fuelled deflationary bust has long been the thing that central bankers have been most frightened of, but they have failed in their attempts to create inflation, while debt levels have continued to soar.

The financial markets continue to show few signs that there is a growing fear of inflation. Investors were happy to buy fresh issues of government bonds with low yields, while the prices of gold and silver – seen as key inflation hedges – have sold off.

Deflation can be very bad news for some, but falling prices increase the buying power of money – the ultimate aim of all long-term investors. The key is to find assets which produce cash flows that do not decline as much and hopefully can still grow.

Such a backdrop may well favour companies that produce and sell essential goods and services which consumers cannot do without and those with long-term growth potential on top.

As I wrote recently, the assumption that inflation is good for shares is a lazy one. Inflation reduces the value of money, especially money related to future profits growth. It is also assumed that companies and shares are good inflation hedges because they can raise prices. This is true for some, but not for all and is another reason for the investor to be extra diligent with their stock-picking and not buy index funds – a topic I will return to in the next few weeks.



Fantasy Sipp & UK Quality shares performance

	1 month	Portfolio total returns (%)		
		Year to date	1 year	2 years
Scottish Mortgage Investment Trust	5.3	69.6	92.2	82.4
LF Blue Whale Growth Fund	0.2	20.4	21.2	38.4
Smithson Investment Trust	0.9	16.2	20.4	
Martin Currie Global Portfolio Trust	4.1	14.0	19.6	32.5
Fundsmith Equity T Acc	-1.2	10.4	10.6	26.1
Mid Wynd International Inv Trust	1.2	9.1	12.8	22.3
Vanguard S&P 500 ETF	1.1	8.3	10.4	20.5
Phil Oakley Fantasy Sipp	2.4	8.1	12.0	34.3
Lindsell Train Global Funds	-1.0	3.4	-1.3	15.2
Phil Oakley UK Quality Shares	1.3	-6.2	-	-
Finsbury Growth & Income Trust	-0.2	-6.2	-8.7	5.4
Castlefield CFP SDL UK Buffettology Fund	-2.4	-9.7	-1.7	1.3
FTSE All-Share	-0.9	-19.0	-15.0	-13.4
Vanguard FTSE 100 ETF	-0.5	-19.0	-15.5	-13.2
Vanguard FTSE 250 ETF	-2.5	-21.6	-13.2	-13.0

Source: SharePad

Finsbury Foods

When it comes to some businesses, I question why they are listed on the stock exchange. **Finsbury Foods (FIF)** is one of them.

It's a fairly solid business that makes cakes and upmarket breads and pastries for supermarkets and food service companies. It's reasonably profitable, generates cash and is not stuffed full of debt. As with many businesses such as this, there is often one vital missing ingredient – growth.

The company had nine months of decent trading for its financial year to June 2020 before the lockdown hit. Even taking this into account, the business has not grown its revenues for more than four years. An attempt to grow by opening bakeries overseas in places such as Poland is a good idea, but it is not really moving the business forward.

The other thing which puts me off businesses like this is that their customers are supermarkets and food service customers with a lot of buying power, which hampers the ability to earn good profit margins.

Given a difficult backdrop, Finsbury's full-year results weren't too bad. Revenues fell from £315m to £306m, with adjusted operating profits down by £2m to £14.8m.

Demand for cakes and artisan breads has been solid, but the celebration cakes business saw weaker sales due to fewer celebrations caused by lockdowns. Food service and food-to-go sales collapsed in March, which is no small issue given that it accounts for around 20 per cent of Finsbury's business. Given the new Covid-19 prevention measures that have just been introduced, it is difficult to see this side of the business improving any time soon.

Finsbury is trying to position itself to exploit changing consumer tastes and bought Ultrapharm last year to make and supply gluten-free products. However, that business is not going to make as much money as was expected when it was bought and the goodwill associated with it has been partly written off.

There's nothing particularly bad about Finsbury Foods, but I'm not sure what it offers investors right now without meaningful growth.

The one attraction is that the shares look very cheap. At 56p, they trade on less than seven times forecast earnings. It's not beyond the realms of possibility that this company could be taken private as the current profits could support the current enterprise value of just over £100m if financed mainly by borrowings. Whether there are interested parties out there prepared to do this with the current economic outlook is another matter.

Finsbury Foods: current forecasts

	2020	Year (£m) 2021	2022
Turnover	324.4	320.1	327.2
Ebitda	27.8	26.6	27.4
Ebit	17.9	16.8	17.3
Pre-tax profit	16.9	15.8	16.4
Post-tax profit	13.2	11.9	12.3
EPS (p)	8.4	8.8	9.2
Dividend (p)	3.7	3.4	3.6
Free cash flow	-	12.9	13.6
Net borrowing	31.5	21.2	12.2

Source: SharePad



SSP

A year ago, I could see a lot of attractions for owning a slice of a business such as **SSP (SSPG)**. Its shops at railway station forecourts and at airports had lots of captive customers to sell to, which allowed it to make decent profits and returns on investments. Covid -19 has decimated air travel whereas working from home has done the same to commuting by rail.

Just how much damage has been done was revealed in a trading update this week. Sales are down 86 per cent for the year to September and only one-third of the company's units are currently trading.

The carnage has cost the business a whopping £1.3bn in lost revenues and, while losses are going to be less than previously expected, they are still going to be in the region of £210m, compared with an operating profit of £219m made last year.

The company has controlled its cash flow and debt levels very well. While it has been helped by a chunk of



new money from shareholders earlier in the year, it has also done a good job with controlling its working capital, reducing its rents, cutting investment spending and getting some help from governments.

Even so, the net cash outflow for the year to September is still expected to be in the region of £250-£270m. This is much better than the £340-£440m guided back in June, but is still pretty bad. The company is still burning cash every month and is a long way from being out of the woods.

The problem for investors is how on earth can they forecast the profits and put a value on a business like this? Air travel is not expected to get back to 2019 level until 2024, while working from home looks likely to become a permanent habit – for at least some days of the week anyway – which suggests permanent damage has been done to the rail business concessions.

Let's assume for a moment that analysts' forecasts for 2020 are in the right ballpark with a projection of 14.9p earnings per share (EPS). At 193p, that puts the shares on a price-to-earnings (PE) of 13 times. That doesn't look too racy, but how much confidence do you have in forecasts for two years' time?

I don't have much. If I thought that the current crisis could be resolved quickly, I might suggest that the shares are worth a punt. But I don't think they are yet.

SSP: current forecasts

	2020	Year (£m) 2021	2022
Turnover	1,505.90	2,052.40	2,575.00
Ebitda	-68.5	143.7	290.6
Ebit	-200.7	22.9	155.2
Pre-tax profit	-221.8	-28.2	131.4
Post-tax profit	-192.8	-17.8	82.4
EPS (p)	-39.9	-4.9	14.9
Dividend (p)	1.4	1.8	6.4
Capex	133	102	123.8
Free cash flow	-444	165.6	170.4
Net borrowing	2,277.00	2,245.00	1,032.00

Source: SharePad

Whitbread

Whitbread (WTB) is another company that has been hammered by the fallout from Covid-19, which forced most of its Premier Inn hotels to close.

Even though 98 per cent of them are now open, the company is preparing for an existence that will not be as kind to it as it was in the recent past. Some 6,000 jobs are likely to be lost, while those employees that keep theirs may have to work less and be on more flexible hours.

From a customer's point of view, I think Premier Inn is a

very good business. For years, the company has been opening up lots of new hotels across the UK and extending many of its existing ones. With a good customer experience and offering good value for money it has continued to take market share from independent hotel operators.

I think it will continue to do this, but I'm not sure how the economics of its business stack up in a changed world. Hotels in tourist attractions have seen occupancy levels get back to a very respectable 80 per cent in recent weeks, but in places such as London its hotels have not been very full at all. For August, the average occupancy for the company's hotels as a whole was just over 50 per cent.

That's not enough to make good profits and even half decent returns on the huge amounts of money that has been invested in hundreds of Premier Inns.

With fewer business meetings taking place it is possible that more of them will be done over the internet going forward. This will reduce the demand for mid-week hotel stays from business people.

Whitbread had been investing a lot of money to beef up its presence in the London market. How this works out for it is uncertain. There's a lot of talk about how London is getting hammered by commuters staying at home and a growing realisation by many of them that they don't need to live within a short commuting distance anymore. It crossed my mind that if workers move further away from their London workplace, then demand for mid-week hotel stays may increase and Premier Inn could benefit from this. There is, however, a possibility that workers work remotely and put up with infrequent and long day trips without staying overnight.

What is not being discussed is what happens to hotel room rates going forward in order to fill up rooms. It is possible that some parts of the market such as big cities without a lot of tourist demand could be oversupplied and will be permanently less profitable than they were before.

This brings me to the valuation of Whitbread shares, which unsurprisingly have fallen a long way.

The current market capitalisation of £4.1bn is less than its forecast net asset value (NAV). I used to think that Whitbread could release substantial value by selling off its freehold property assets, but my guess is that the opportunity to do so has passed for now.

It's all very well looking at asset values, but ultimately assets are only worth the profits and cash flows that they can produce. This is when the outlook for Whitbread looks a bit grim. If I compare forecast post-tax profits with forecast NAVs, I can calculate the return on equity being

projected by analysts. For the three years between 2021 and 2023, this is currently -8.2 per cent, 3.8 per cent and 4.9 per cent, respectively.

As a rough rule of thumb, I think returns of 8-10 per cent are needed to justify the asset values in the accounts and Whitbread looks well short of this. I therefore don't rule out significant asset write-downs at its full-year results early next year.

Whitbread: current forecasts

	2021	Year (£m) 2022	2023
Turnover	1,016.20	1,783.90	2,026.20
Ebitda	-65.7	586.6	712.2
Ebit	-235.6	304.9	414.7
Pre-tax profit	-468.1	193.2	314.9
Post-tax profit	-357.8	168.4	225.9
EPS (p)	-151.2	89.3	114.1
Dividend (p)	13.7	25.8	54.6
Capex	259.3	417.3	454
Free cash flow	-503.9	35.4	88.8
Net borrowing	2,608.00	2,670.50	2,751.60
NAV	4,354.30	4,455.70	4,596.00

Source: SharePad

I don't happen to think that the shares look great value on a PE basis either. At 2,056p, they trade on 18 times 2023 forecast EPS with significant uncertainty on top.

AG Barr

AG Barr (BAG) has long been regarded as a very competent soft drinks maker and seller. It has the dominant soft drinks brand in Scotland in IRN-BRU and has tried with mixed success its own other brands and drinks it makes on licence for others.

The good news for the company is that people are still guzzling lots of fizzy drinks. Like Finsbury Foods, the closure of the hospitality and leisure sectors for many weeks earlier in the year has hit it hard.

Half-year results announced this week did not read too badly. Sales were down 7.6 per cent to £113m, but operating profits increased from £14.3m to £17.1m due to good cost control. IRN-BRU is still managing to grow – just – while Barr's own branded fizzy flavoured drinks have seen very strong growth of 13 per cent.

Weakness in the hospitality sector saw a very sharp fall in the sales of Funkin ready to drink cocktails and Strathmore Water. The latter has seen its assets written down in value and its manufacturing operations slimmed down.

Where Barr has lost its way is with the brands it used to make on licence for other brand owners for sale in the



UK market. It used to make Orangina, but doesn't any more and has had its contract to make and distribute the Rockstar energy drink terminated. It will stop making Snapple drink as well.

Rockstar accounted for 8 per cent of Barr's sales last year and its loss is a serious blow to the company's reputation as a partner for other drinks brands, in my view. Energy drinks are a very popular category and Barr no longer has a meaningful presence in this market.

Hospitality markets will hopefully come back, but I am left wondering how Barr is going to deliver meaningful sales and profits growth in the years ahead.

A net cash balance sheet gives it the firepower to make acquisitions, but I'm not sure where it can get these from in order to make a big difference to its shareholders. A tie-up with Britvic looked like a good deal a few years ago, but I'm not sure that is doable now given that Britvic looks to be in a much better place than it was in 2017. Fevertree is probably out of reach and, along with Nichols, adopts an asset-light business model (with outsourced manufacturing and distribution) that doesn't really fit.

At 444p, Barr shares trade on a 2021F PE of 21.3 times, falling to 18.8 times on 2022 forecast EPS. That's not desperately expensive in a very low interest rate world and the shares could prove to be a steady, but dull, investment going forward. The growing net cash balance could see special dividends paid in a more normal world.

AG Barr: current forecasts

	2021	Year (£m) 2022	2023
Turnover	219.6	228.9	237.7
Ebitda	43.7	46.6	48.8
Ebit	31	35.1	36.6
Pre-tax profit	29.6	34.1	35.8
Post-tax profit	23.8	27.1	28.3
EPS (p)	20.8	23.6	24.4
Dividend (p)	7.3	13.9	14.6
Capex	7	14.6	13.8
Free cash flow	29.5	22.5	27.6
Net borrowing	-36	-49.5	-60.8

Source: SharePad



Diploma

Normally, I am not particularly enthusiastic about distribution companies or ones that tend to make a lot of acquisitions in order to grow. I think Bunzl is an exception to this rule and so is **Diploma (DPLM)**. Both shares are part of my UK Quality shares portfolio.

Diploma has been very successful for a long time now. It strikes up long-term relationships with suppliers and

customers in niche problem-solving product markets in areas of the economy that can grow – such as medical devices, high performance seals and controls and fasteners. By focusing on products that are part of its customers' day-to-day operating activities rather than big investments means that it has much more stable revenues and profits.

The company has been good at being able to grow organically and has complemented this by making lots of acquisitions and turbo-charging its growth. It is a recipe that has delivered very good long-term returns to its shareholders.

This week Diploma announced that it was buying Windy City Wire & Cable, a distributor of low voltage wires and cables in the US, for £357m. It also raised £190m from a share placing to help pay for it.

Investors gave the deal a huge thumbs up, which I found a little bit surprising. Don't get me wrong, I think it looks a good deal, but I'm not sure it warranted a share price rise of nearly 27 per cent on Wednesday.

This is a deal that will make a big difference to the numbers that Diploma produces. It will add \$192m of sales and \$44.5m of earnings before interest, taxes, depreciation and amortisation (Ebitda), which at current exchange rates would account for a 28 per cent increase in sales and 39 per cent increase in Ebitda compared with 2019. The deal is expected to significantly increase EPS and cover Diploma's cost of capital in the first year of ownership – a sign that it has not overpaid.

Windy City comes with a solid reputation for growing revenues and profits. It strengthens Diploma's Controls business and its presence in the US market. The growth prospects look pretty good as well given the demand for cables to go into areas such as data centres for cloud computing and 5G mobile telecom networks.

In some ways this looks like a dream deal, as you would think that a business which is performing as well as Windy City combined with its growth prospects would command a much higher price tag. Hopefully, the warm reception given to the deal will be justified by the profits it delivers in the years ahead.

Diploma: current forecasts

	2020	Year (£m) 2021	2022
Turnover	529.9	596	636.8
Ebitda	97	114.3	125.2
Ebit	87.4	102	111.8
Pre-tax profit	85.3	95.8	105
Post-tax profit	64.3	73.2	81.2
EPS (p)	56.6	63.9	70.2
Dividend (p)	23.7	30.1	32.4
Capex	10.6	9.8	11.2
Free cash flow	59.2	75.9	81.8
Net borrowing	-25.5	17	-23.9

Source: SharePad

The financial impacts of the deal and the extra shares that have been issued have yet to find their way into consensus forecasts. At 2,171p, Diploma shares trade on a September 2021 forecast PE of 34 times, which will probably come down once this deal gets factored in. This is not cheap by any means, but is the current going rate for companies that have been good at keeping shareholders happy and are expected to keep on doing so.

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