investors CHRONICLE alpha

10 July 2020

Phil Oakley's Weekly Round-Up

It is becoming crystal clear how reliant the UK economy is on the consumer, and that should worry investors

When will reality bite?

I've always found reading company results releases and their outlook statements far more useful than listening to the predictions of economists. This is due to the fact that companies operate in the real world and tend to have their fingers on the pulse of what is going on.

Based on what I've read this week, it's difficult to come away with any other view that life is very tough out there for businesses. The easing of the lockdown in the UK is seeing the economy pick up, but it's going to take a long time before things get back to where they were before coronavirus hit.

The announcement of job losses from companies such as John Lewis and Boots along with Chancellor Rishi Sunak's attempts to prop up the jobs market should leave no one in any doubt how fragile the UK economy is. I don't mind admitting that I find the lack of well-paid jobs and productive capacity deeply worrying for our future prospects.

We have relied too long on stoking the property market and credit-fuelled consumption to create an illusion of prosperity. Mr Sunak this week was very open about the fact that the UK is a consumption economy. The trouble is that you can only consume what has been produced and the country does not produce enough valued-added stuff to create the necessary wealth to pay for the kind of society that people have become accustomed to.

The fact that there are economists and authors out there who think we can pay for what we want with printed money is deeply insulting to the intelligence of ordinary folk who will quickly come to understand the reduced purchasing power that more money without more goods entails.

Yet, somehow the value of the pound holds up. Sterling bulls may point to a palatable trade agreement with the European Union as a path to better days ahead. This is of

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course possible, but it does not get round the fact that the UK economy is badly wounded and needs radical action to put it on the right path again. This view explains my continued preference for foreign stocks or those with plenty of overseas earnings.

In short, I think there's a lot to be concerned about but the stock markets of the world seem relatively untroubled for now. That said, further upside momentum is finding it hard to gain a foothold and it would not surprise me if markets keep trading in their recent ranges.

The next few months are going to be crucial for the outlook for company earnings. A second wave of coronavirus is a real risk and I'm not sure that economies could cope very well with one. The thing is, there's nothing you or I can do about it and so I will be mindful of the risks rather than lose any sleep over it.

The bull case is that we get through this and the virus goes away or becomes sufficiently subdued. With all the money that has been thrown at the problem, a substantial recovery in economic activity could see markets move higher again.

We really are flying blind. I am finding it hard to identify attractively-valued good quality businesses, but so is everyone else. Investors with no alternative income-producing investments continue to flock to high quality businesses, as they feel safer with them rather than speculating on bombed-out recovery plays.

I am mindful of complacency at times like this, but doing nothing again seems the best course of action. Sticking with quality even if you think the price may be a little too high has been the right thing to do rather than attempting to time the market. My view has simplified somewhat: if you are in the stock market stick with the good stuff or stay out.

In terms of portfolio performance, it is worth noting the stunning performance of Scottish Mortgage Trust during the past month where it has gained more than 20 per cent and is now up by more than 55 per cent year to date.

The trust has benefited from the stunning performance of its two largest holdings of Amazon and Tesla, as well as its exposure to the innovative parts of the Chinese economy.

This is a fund that is not managed like a traditional portfolio where valuation is seen as important. The managers take a long-term visionary approach to stock selection and make big bets on disruptive companies they see as benefiting from a changing world. They don't worry about the economy too much and are long-term optimists. We can all learn from this kind of thinking.

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Some might say they are speculators, but I can only admire what they have achieved for their shareholders. The fact that they are providing this with a total expense ratio of just 0.36 per cent per year is even more commendable and other fund managers could do with following this example.

Fantasy Sipp & UK Quality shares performance

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	21.9	55.6	64.9	70.5
LF Blue Whale Growth Fund	4.8	17.6	15.6	42.8
Smithson Investment Trust	2.0	16.6	20.5	
Mid Wynd International Inv Trust	5.5	9.1	13.9	34.1
Fundsmith Equity T Acc	1.5	8.9	7.0	30.1
Martin Currie Global Portfolio Trust	5.1	6.7	7.5	31.7
Vanguard S&P 500 ETF	-0.5	3.9	7.7	25.6
Lindsell Train Global Funds	0.6	3.3	-0.6	21.5
Phil Oakley Fantasy Sipp	**0.5**	**2.5**	**6.9**	**30.0**
Finsbury Growth & Income Trust	-1.4	-6.1	-8.0	6.8
Phil Oakley UK Quality Shares	**-2.5**	**-9.6**	**–**	**–**
Castlefield CFP SDL UK Buffettology Fund	-0.6	-10.3	-0.7	4.6
Vanguard FTSE 100 ETF	-4.3	-17.0	-14.8	-11.5
FTSE All-Share – Total Return	-4.2	-17.1	-13.9	-11.8
Vanguard FTSE 250 UCITS ETF	-4.9	-21.4	-10.3	-12.4

Source: SharePad

JD Sports

JD Sports (JD.) has proven itself to be one of the best retailers out there. It has developed a network of stores and online presence that resonates with young people who want to buy trainers and sports fashion clothes.

Its ability to generate impressive rates of like-for-like (LFL) sales growth in recent years has not been matched by many retailers out there. When this has been combined with a well-executed store opening strategy in the UK, Europe and Asia along with an acquisition in the US, its profits and share price have soared.

Its full-year results to 1 February 2020 released this week showed another good year for the company. UK LFL sales continued to grow at more than 10 per cent in the second half of the year and increased by double-digit percentages in Europe.

Its acquisition of Finish Line in the US has gone exceedingly well. This business has been sorted out with better buying, changes to ranges, formats and getting out of poorly performing concessions in stores such as Macy's. The financial results have been impressive with an operating profit of £97.9m last year.

I haven't taken the time to work out how much extra investment the company has ploughed into this business,

but it initially paid £400m back in 2018 and so current profits seem to show that JD may have made a very healthy return on its investment in very short order. At the time I thought it was a very risky buy given how poorly the business was performing with its wafer-thin margins and the competition it faced from the likes of Amazon. I have been proven wrong and the company deserves a lot of credit for what it has done.

The only blot on JD's performance has been its outdoors business. Losses were just over £16m last year and its Go Outdoors stores have since been put into administration. It remains to be seen whether Blacks can make decent profits going forward.

Unsurprisingly, JD Sports has suffered from closing its shops during the economic lockdown, but had some compensation from internet sales.

In a normal world I'd say the company has a winning formula that will continue to do well. Its overseas expansion in Europe and Asia looks well measured and is capable of delivering good results, in my view. It will have to sell Footasylum in the UK after its purchase was blocked by the competition authorities and my guess is that it will get back less than it paid for it, but this will be something the company will be able to cope with quite comfortably.

The big unknown for all retailers is how quickly customers come back to their shops. In its results press release, the company talks about the need for realistic rents and flexible contract lengths, which goes to highlight a degree of nervousness about the economics of its business going forward.

The shares are down just over 20 per cent year to date, but have more than doubled since their March low.

JD Sports: current forecasts

	Year (£m)		
	2020	2021	2022
Turnover	5,967.90	4,869.60	5,949.90
Ebitda	951.7	650.1	975.4
Ebit	500.9	231.6	496.5
Pre-tax profit	432.8	179.3	416
Post-tax profit	333.2	108.7	329.4
EPS (p)	34.4	12.8	33.2
Dividend (p)	0.9	0.7	1.8
Capex	196.8	139.6	220.1
Free cash flow	248.7	8.3	328.7
Net borrowing	-294.9	-301.2	-607.3

Source: SharePad

This year is clearly going to be difficult and is under the cloud of a potential second wave of the coronavirus. City analysts currently forecast it to be making just a little bit

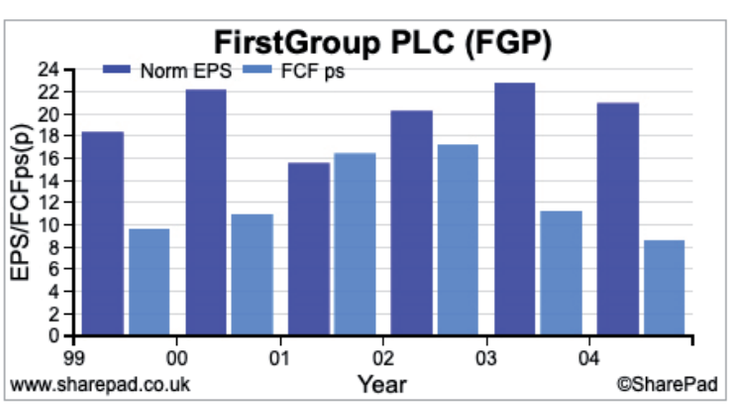
more than the £472m of operating profit that it made last year in the year to February 2022. On that basis, at 661p, the shares would trade on a 2022F PE of 19.9 times. That's not cheap, but JD has proven itself as a quality business with a decent growth strategy, although I think the shares may pause for breath for a while.

The shares are part of my UK Quality Shares portfolio and while there's a lot I like about it, exposure to the retail consumer economy is something that concerns me. If I could find a decent candidate to replace it in the portfolio, I would.

First Group

Many years ago when I was a City transport analyst, **FirstGroup (FGP)** and I fell out with each other. I'd always held the view that it had some very good bus assets in the UK and US, but they had not been managed as well as they could have been.

My chief gripe with the company was that I thought its accounting was aggressive. Every year, the income statement seemed to be littered with lots of exceptional costs – many of which were also cash outflows – and this was shown by its very poor track record of turning profits into free cash flow. I analysed the company between 1999 and 2004 and this was the company's record on cash conversion back then.



One year the company changed the depreciation on its school buses to the basis of school bus days, which meant that they weren't depreciated during the school holidays and that its first-half profits could be higher than the previous year's. I was the only analyst at the time to pick this up and talk about and I got a lot of grief from the company for doing so. I look back now on this time with great sadness, but it makes me happy that I no longer work in the City.

In the intervening years I have kept an eye on the

company's progress and nothing has changed my view about the quality of its reporting. I wrote an article in the *Investors Chronicle* back in November 2018 where I queried whether the company's profits were overstated by its self-insurance provision on its US buses, as the cash paid out always seemed to be more than what was expensed in the income statement.

I take no pleasure from this, but I have been proven right as for the past two years the company has significantly increased the provision with a big exceptional item, which is an admission that previous costs were understated in my book.

The table below shows how FirstGroup has gone from losing money – or making next to nothing – on a statutory or reported basis over the past two years and tells investors that it really is quite profitable. The scale of adjustments is staggering.

Reconciliation of operating (loss)/profit to adjusted operating profit	**Year to 31 March 2020 £m**	Year to 31 March 2019 £m
Operating (loss)/profit	**(152.7)**	9.8
Adjustments for:		
Greyhound impairment charges	**186.9**	–
North America insurance provisions	**141.3**	94.8
Restructuring and reorganisation costs	**58.2**	24.1
Other intangible asset amortisation charges	**4.9**	11.8
Gain on disposal of properties	**(9.3)**	(9.3)
Fuel over hedge	**7.4**	–
Legacy pension settlement	**4.9**	–
First Student onerous contract provision	**14.1**	–
Increase in SWR performance bond	**1.1**	–
SWR onerous contract provision	**–**	145.9
Guaranteed minimum pensions charge	**–**	21.5
Loss on disposal/impairment charges	**–**	16.2
Total operating profit adjustments	**409.5**	305.0
Adjusted operating profit (note 3)	**256.8**	314.8

Source: FirstGroup

Impairments are non-cash and reflect already weak profitability, but items such as restructuring, increased provisions and onerous contracts will sooner or later relate to cash flowing out of the company. I'll leave you to make up your own mind as to whether you think it's reasonable to ignore these items, especially when they have a tendency to crop up year after year.

FirstGroup currently has more to worry about, such as whether it will still be in business in the future. Its results include a detailed note on its status as a going concern and there seems no doubt that without government help this company would probably be insolvent now.

The economics of public transport in a world of prolonged social distancing are very difficult. Trains, planes and buses cost pretty much the same to run whether they are full or empty and need to be fairly full to start making a profit.

FirstGroup's problems are compounded by the fact that it has a lot of debt and a sizeable pension fund deficit. Interest cover on its adjusted operating profits is down to just two times, while it has £348m and £323m of bonds maturing in 2021 and 2022, respectively.

It should be able to release a decent slug of cash by selling its North American operations, which are up for sale. That said, the current backdrop probably means that the asking price has dropped in recent months.

I wouldn't rule out a big rights issue with this company, which adds another layer of risk to anyone considering the shares as a distressed value investment.

FirstGroup: current forecasts

	Year (£m) 2020	2021	2022
Turnover	7,663.90	7,487.20	8,688.20
Ebitda	942.3	742	938.7
Ebit	316.4	149	348.8
Pre-tax profit	193.9	27.4	236.6
Post-tax profit	136.7	9.5	156.4
EPS (p)	12	0.6	13.5
Dividend (p)	-	-	0.9
Capex	414	310.7	379.8
Free cash flow	-103.8	-103.8	22.1
Net borrowing	1,039.80	1,003.30	882.4

Source: SharePad

Reach

Reach (RCH) owns some very prominent newspaper titles in the *Daily Mirror*, *Daily Express*, *Daily Star* and *Daily Record*, regional titles such as the *Manchester Evening News* and *Liverpool Echo*, as well as *OK* magazine.

This is a business that is still very profitable (21.8 per cent profit margins last year), thanks to acquisitions and cost-cutting in recent years which have offset the decline in print circulation and advertising revenues.

The business is still dominated by print revenues which aren't growing (cover price increases are offsetting lower circulation), with digital revenues still only 15 per cent of the total revenues.

The company's pitch to investors is that it has the fifth biggest digital platform in the UK and can grow its revenues with value-added content that attracts lots of subscribers that advertisers want to reach. It currently has 2.5m people signed up to its websites and wants to have 10m by 2022.

This is a laudable aim, but the company faces very stiff competition. The reputation of the newspaper industry with the general public is not in a good place right now and it is no surprise that more people get their news fix from places such as Facebook and Google these days, with giants such as Amazon and Microsoft looking to get a bigger slice of advertising budgets. How does a business like Reach compete against these giants?

My view is that it probably can't and that it faces a long period of steady decline without acquisitions papering over the cracks. The pension fund deficit of £243m is still a major issue and will probably still have a claim on company cash flows for some time to come.

I think this business is well managed and a good job has been done getting rid of its other debts, but it has challenging economics which have been cruelly exposed by the current lockdown. Advertising revenues (which accounted for a quarter of print revenue last year) have fallen off a cliff and are extremely important to the company's bottom line profits.

As they are not expected to bounce back quickly, it sadly looks as if 12 per cent of the company's workforce will lose their jobs. Making them redundant is set to cost £20m, but will give £35m in annual cost savings that will preserve the company's profits for a while longer.

Reach: current forecasts

	Year (£m) 2020	2021	2022
Turnover	585.7	578	580.3
Ebitda	132.2	135.3	138
Ebit	107.6	111.3	112.4
Pre-tax profit	105.9	109.6	111.5
Post-tax profit	86.8	90.2	92
EPS (p)	28.8	32	33.3
Dividend (p)	5	6.9	7.1
Capex	9	9	10
Free cash flow	24.9	31.2	35.1
Net borrowing	-20.4	-21.1	–

Source: SharePad

Reach shares have looked very cheap for a long time and reflected its challenging business model, high debts and pension fund deficit. At 76p, the shares trade on just 2.6 times forecast EPS, but given the claims on its cash

flows such as the pension fund which aren't factored into profits adequately, investors should look at free cash flow per share instead. Forecasts for 2020 are for around 8.3p of free cash flow per share, which gives the shares a prospective free cash flow yield of 10.9 per cent – this looks attractive, but could also be seen as about right given the growth outlook.

The strong run in the shares in 2019 shows that lots of money has been made from these shares recently from a trading perspective and I don't rule that out happening again. As a long-term investment I'd probably stay clear.

Halfords

Cycling has boomed since the start of the economic lockdown, as people have been getting out on their bikes for a source of exercise. This has been good news for **Halfords (HFD)**, as people have flocked there to buy a new bike or get an old one fixed. Halfords needs to keep these customers coming back if it is going to reap a sustainable benefit from this trend.

I would describe myself as a reasonably keen fitness cyclist and try and go out three times a week in the summer months. I have a reasonably good bike with good kit on it that I have been using for the last 16 years (would probably cost around £2,000 in today's money), but it would not be considered posh in any way by the increasing numbers of mamils (middle-aged men in lycra) found on the quiet country lanes of Essex.

I would not take my bike anywhere near Halfords to be worked on. I bought a nice Boardman Hybrid from them about five years ago for a great price, but the mechanic that built it for me clearly hadn't discovered the benefits of grease. Luckily there is a great independent bike mechanic near me who put it right, but I increasingly do a lot of stuff myself nowadays.

Most recreational cyclists buying bikes from Halfords will probably stretch to mending a puncture, but will need a bit more help with general maintenance and repairs. Halfords needs to show that it has the quality of staff and capacity to serve these customers well, and I see this as a key challenge.

Its Autocentres work in a highly competitive field where trust is paramount. My opinion of main dealer servicing is not great and, as with bikes, I look for a quality independent. That said, I was pleasantly surprised to see how many good reviews there are of Halfords Autocentres on websites such as Trustpilot. These should always be taken with a pinch of salt and can be gamed, but the internet is a great place for whingers and I found surprisingly few.

The key issue facing Halfords is growth. LFL sales in Autocentres was only 1.4 per cent in the year to April 2020, with retail sales down by 2.7 per cent. The current year has started better, with cycling LFL sales surging by 57 per cent and retail sales turning positive in the past nine weeks. Autocentres have opened up again and mobile servicing centres are seeing good demand from people who want their cars serviced at home.

I think this is a business that is trying hard to please its customers and is not doing too bad a job. From an investor's perspective it looks a bit stale, a jack of all trades and master of none where the customer has plenty of choice to shop elsewhere. It's going to struggle to grow and become more valuable, I think.

Halfords: current forecasts

	Year (£m) 2020	2021	2022
Turnover	1,126.70	1,019.50	1,192.60
Ebitda	93	92.6	109.7
Ebit	57.8	35.8	53.3
Pre-tax profit	53.9	21.3	50.3
Post-tax profit	44.5	26.6	46.1
EPS (p)	22	11.6	20.5
Dividend (p)	5	0.6	8.1
Capex	42	12.7	33.3
Free cash flow	38.7	22.3	20
Net borrowing	83.3	55.9	20.9

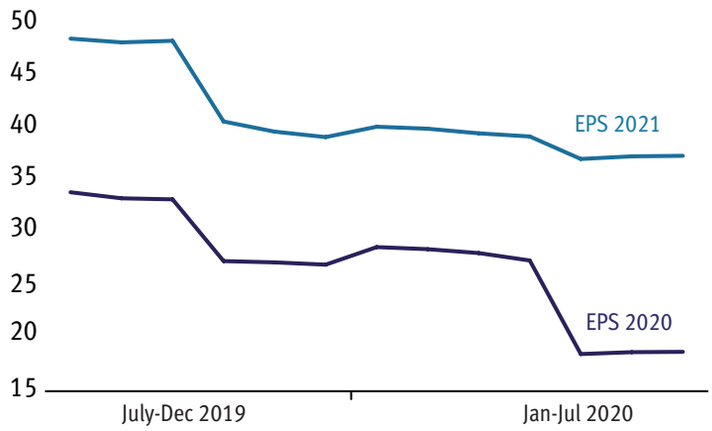
Source: SharePad

Amazon.com

Are **Amazon.com (Nasdaq:AMZN)** shares a bubble? I think that they could be, but I wouldn't sell any shares. The company has thrived in lockdown and kept delivering its mountainous amounts of cardboard packages to households. While bricks and mortar retailers have been closed, Amazon has just hoovered up consumer demand for most kinds of products that you can think of.

However, like lots of retailers, the cost to serve the customer has shot up. Sales may be surging, but profits and free cash flows most certainly are not. FactSet data shows the trend in earnings per share (EPS) forecasts for 2020 and 2021 over the past year. In short, they have come down a lot.

Amazon.com: Forecast EPS 2020 and 2021

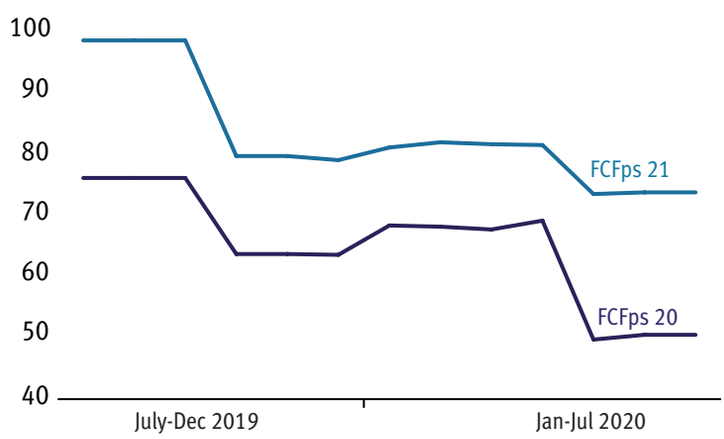


Source: FactSet

Since a year ago, EPS forecasts for the year to December 2020 and 2021 have come down by 45 per cent and 23 per cent, respectively. Yet, Amazon's share price has gone up by more than 50 per cent in the meantime. The December 2020 prospective PE of the shares has increased from 57 times to 161 times.

Many investors tend to look at free cash flow for Amazon and forecasts have also come down, but not by as much. The 2020 free cash flow yield has fallen from 3.9 per cent to 1.7 per cent. However, Amazon's free cash flow is not as good as it might appear. It is generally calculated by taking operating cash flow and subtracting capex, but this often ignores the cask kicker from share-based payments (which are a real cost in my book) and the repayment of lease finance. The truth is that there is not much free cash flow being generated from Amazon at all. The cash it generates is being reinvested for future growth.

Amazon.com: FCFps forecasts 2020 and 2021



Source: FactSet

The shares look insanely expensive on just about any measure you care to use, but this business is a phenomenon that short of political interference is hard to stop. Its laser-like focus on customers may not be perfect, but is extremely good and very hard to compete with.

I am fully aware that this is the kind of talk that used to go on 20 years ago during the tech bubble. You get companies where their value seems so detached from reality and what is likely to happen, and the share price is justified by its uniqueness and all-conquering potential. This can lead to dangerous complacency among investors.

Not so long ago, I would have dumped Amazon shares from the Fantasy Sipp on valuation grounds. Part of me still thinks I should, but these are strange times and I do believe that this company is doing a lot of things right. Does this make me a speculator? Possibly in this case, yes, but I struggle to find a better replacement for it right now.

Amazon.com: current forecasts

	Year (£m)		
	2020	2021	2022
Turnover	346,893.10	407,878.20	476,345.10
Ebitda	45,202.80	62,257.90	78,835.90
Ebit	13,100.10	24,544.00	36,273.40
Pre-tax profit	11,701.80	23,224.40	34,815.80
Post-tax profit	9,945.00	19,450.90	28,502.50
EPS (¢)	1,998.50	3,845.70	5,467.30
Dividend (¢)	-	-	-
Capex	20,893.40	22,545.20	23,365.70
Free cash flow	25,018.80	40,006.50	52,254.40
Net borrowing	-45,450.90	-76,678.70	-109,164.00

Source: SharePad

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ISSN 0261-3115.