investors CHRONICLE alpha

29 June 2020

Phil Oakley's Weekly Round-Up

The resilience of big tech shares continues unabated and with good reason, in my view

Should we just buy tech shares and leave it at that?
Despite what seems to be a growing risk of a second wave of coronavirus, stock markets are holding up well albeit with a bit more volatility.

The resilience of big tech shares continues unabated and with good reason, in my view. The economic lockdown has given these companies another fundamental leg up, in my view, as remote working and a focus on productivity are only likely to increase. Many shares are highly valued, but this is not like the late 1990s or early 2000s, as the companies involved today have profits and cash flows and, importantly, a visible path to growing rather than blind hope.

It is no surprise to see investment funds such as Scottish Mortgage Investment Trust and Blue Whale, which have heavy tech exposure perform so well in this environment.

That said, an investor buying a Nasdaq 100 ETF or iShares S&P 500 Technology sector ETF would have smashed most global equity funds out of the park for the past couple of years.

It certainly seems that concentrated tech share investing has a lot going for it right now. Those investors – including the Fantasy Sipp – which are adopting a more balanced sector and company approach are fairing less well, but are still doing so much better than the average investor in UK equities.

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Fantasy Sipp & UK Quality shares performance

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	10.4	39.1	51.3	50.0
LF Blue Whale Growth Fund	6.0	16.1	17.8	40.9
Smithson Investment Trust	3.3	13.2	18.9	–
Fundsmith Equity T Acc	2.9	8.0	9.0	29.1
Mid Wynd International Inv Trust	2.8	5.3	13.9	23.8
Martin Currie Global Portfolio Trust	6.3	4.1	9.6	28.4
Lindsell Train Global Funds	3.6	3.3	1.3	21.8
Vanguard S&P 500 ETF	3.1	2.5	9.1	23.7
Phil Oakley Fantasy Sipp	**1.5**	**1.2**	**6.4**	**26.9**
Finsbury Growth & Income Trust	3.3	-6.2	-5.8	7.2
Phil Oakley UK Quality Shares	**2.3**	**-9.9**	**–**	**–**
Castlefield CFP SDL UK Buffettology	4.6	-11.0	-3.2	5.1
FTSE All-Share - Total Return	3.8	-17.3	-12.5	-12.7
Vanguard FTSE 100 ETF	3.0	-17.3	-13.3	-12.6
Vanguard FTSE 250 UCITS ETF	6.0	-20.9	-8.1	-13.4
Tech ETFs:				
iShares Nasdaq 100 ETF	4.9	22.2	34.3	53.0
iShares S&P 500 Technolgy Sector ETF	4.7	19.4	35.9	60.9

Source: SharePad

I continue to worry about the fate of the UK economy and discussed this topic with *Investors Chronicle's* editor John Hughman in this week's podcast. The UK consumer is in a very weak state, while government finances look perilously strained.

I'm not sure how the leisure and hospitality industry can prosper in a prolonged period of social distancing and am concerned that lots of jobs – and therefore purchasing power in the economy – will be lost here.

With this in mind I have sold out of Hollywood Bowl and Forterra in the UK Quality Shares portfolio, as I see the growth outlook for the foreseeable future as being very poor. I have also sold out of National Express in both the UK Quality Shares and Fantasy Sipp portfolio.

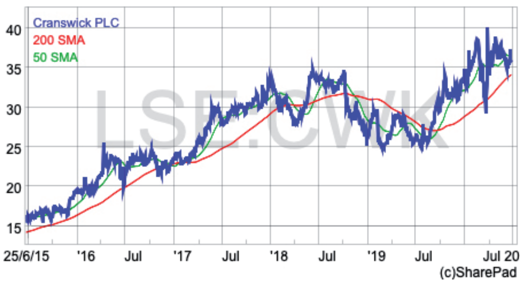
The decision to buy in a few months ago has been a bad mistake where I let the potential cheapness of the business take precedence over the business's prospects. In normal times, this is a business I like a lot, as it can grow its fleet of buses with good returns on capital. In a world of prolonged social distancing I'm not sure that remains the case.

This week, the chief executive announcing his departure to join Persimmon – I can't work out what a person who has run bus and train companies brings to a housebuilder – was the final straw.

YouGov – see last week's *Investors Chronicle* for an analysis of this business – comes into both portfolios. The shares are very expensive, but it is a unique business with very good growth prospects. RWS, which I wrote about a couple of weeks ago, joins the UK Quality Shares as I like its growth prospects for its languages and intellectual property businesses.

Both companies move the UK Quality Shares away from consumer-facing businesses and have the ability to grow, while generating excellent returns on capital and free cash flows.

The UK Quality Shares portfolio has just over a 2 per cent cash position following the sale of National Express, which will be deployed over the next few weeks.



Cranswick

Cranswick (CWK) can be crudely described as a meat processing business. It rears or buys in pigs and chickens and turns them into food. Many of the sausages, cuts of meat, cooked meats and sausage rolls that you buy in the supermarket will have been made by Cranswick.

This is a low margin, high volume business where nearly three-quarters of what you sell is going to supermarkets with tremendous buying power. Cranswick has done a very good job of keeping these customers happy in recent years and long-term shareholders have done very well from its shares. The company has a proud record of having increased its dividend every year for the last 30 years.

Financial results for the year to March 2020 were announced this week and they were very good. Like-for-like (LFL) revenues increased by 13 per cent with operating profits increasing by 13.9 per cent to £105.1m at a margin of 6.3 per cent.

Revenue growth came from a combination of new orders, new products and export growth to China. This led to sales volumes increasing by 3.4 per cent, while the recovery of cost inflation, better quality poultry products and higher export prices saw prices rise by 9.6 per cent.

While the same rate of price inflation is unlikely to be repeated this year, the outlook for the business is good. The demand for premium pork and convenience foods remains strong from its retail customer base, while export demand from China is also being maintained.

The company has invested a lot of money in new poultry processing facilities in Suffolk, which not only give it capacity to tap into a healthy end market, but to do so on a more efficient basis.

The acquisition of a plant-based Mediterranean food business – selling fine cheeses, cereals and olive oils – also give the company another avenue of growth.

After investing heavily in new production facilities and acquisitions in recent years, free cash flow has been weak and debt has gone up, but is still very modest at less than one times earnings before interest, taxes, depreciation, and amortisation (Ebitda). Capex should come down from £100m last year to around £60m this year and free cash generation should improve as a result.

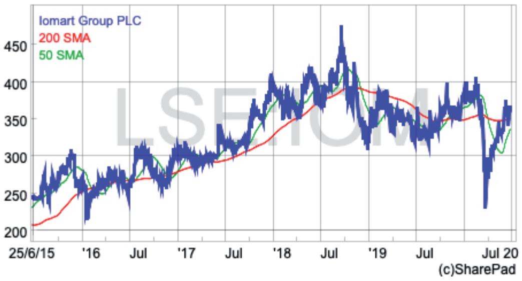
This is a business with many attractions and one that can grow. If you believe, as I do, that food security and provenance will only increase in importance in the years ahead, then Cranswick has assets that will probably continue to increase in value.

Cranswick: current forecasts

	Year (£m) 2021	2022	2023
Turnover	1,778.90	1,851.70	1,911.40
Ebitda	159.2	164.1	171.7
Ebit	109.3	115.4	118.3
Pre-tax profit	106.4	112.7	117.5
Post-tax profit	85.8	92.4	95.4
EPS (p)	163.3	176.2	180.5
Dividend (p)	63.3	64.6	69.3
Capex	60.8	62.5	66.8
Free cash flow	69.7	73.3	-
Net borrowing	114.1	50.5	39.2

Source: SharePad

At 3,525p, the shares trade on a 2021F PE of 21.6 times, which reflects its reputation as a very decent business. It will have its ups and downs in the future – especially in regards to its ability to cope with changes in pig prices – but I don't see why it won't continue to be a decent long-term investment.



Iomart

I am bullish on the outlook for cloud computing, as I think it makes sense for more companies to outsource their data storage and servers to third parties who can keep them well managed and safe.

If the current economic lockdown sees a rapid shift to more remote working and increased digitisation of processes, then this should give a further boost to the demand for cloud computing services.

Cloud computing is also moving beyond remote storage of data to value-added process and data analysis, which has become a key differentiator and growth driver.

You can invest in this growth market by buying shares of companies such as Microsoft, Amazon or Google, which dominate the industry and are generating lots of extra profits from it. Why then would you want to invest in the shares of UK cloud services provider **Iomart (IOM)**?

It thinks it has what it takes to co-exist with the giants by competing on service, advice and flexibility. In terms of bespoke cloud solutions for steady, low-growth businesses, it reckons it can compete with the likes of Microsoft on a whole project lifetime cost basis.

Its full-year results to March 2020 saw its cloud services division deliver organic sales growth of 6 per cent to generate revenues of just under £100m. It won new business, as well as buying up some smaller businesses.

The company has some well invested cloud assets in the form of data centres and fibre networks which connect servers, routers and firewalls. It also offers on-site self-managed server services, as well as supplying computer equipment.

The rump of the business – just under £13m of revenues – supplies website domain names and email servers, which is a commoditised market that requires huge amounts of marketing investment to grow. Iomart has chosen to focus on keeping hold of the customers it already has and running the business for cash.

The company is very profitable with profit margins of just under 24 per cent and a return on capital employed (ROCE) of 14 per cent. The ROCE has been dragged down by the goodwill paid on a lot of acquisitions in recent years. Excluding this, the ROCE on the operating assets is a very healthy 25.7 per cent.

Cash flow is good and backed by long contracts from big customers and many smaller customers who tend to pay in advance. Conversion of profits into free cash flow is pretty good and free cash flow margins last year of 11.6 per cent are again a sign of a good business.

Iomart: current forecasts

		Year (£m)	
	2020	2021	2022
Turnover	112	116.4	122
Ebitda	43	44	46.7
Ebit	24.4	25	26
Pre-tax profit	22.7	22.4	24.7
Post-tax profit	18.8	18.5	19.4
EPS (p)	16.7	16.5	18
Dividend (p)	7.5	6.5	7.7
Capex	18.9	19.4	20
Free cash flow	16.1	18.9	17.8
Net borrowing	54.6	49.3	39.9

Source: SharePad

My issue with Iomart is its ability to grow organically. Six per cent organic growth in a growing market is alright, but not a sign of a business that is really going to tap into a favourable trend, in my view.

It seems that City analysts share a similar view judging by their current profit forecasts where operating profit and

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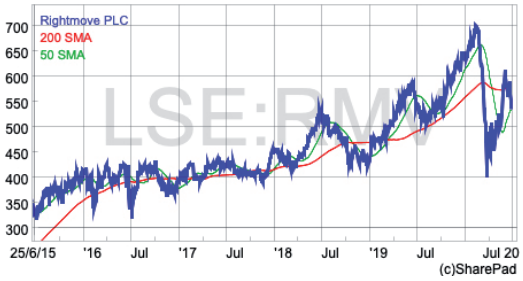
EPS growth are expected to be fairly uninspiring. At 357p, the shares trade on a trailing free cash flow yield of 3.3 per cent, compared with Microsoft on 2.9 per cent. The latter's shares look a better long-term bet to me.



Rightmove

Rightmove (RMV) is one of the most profitable companies listed on the UK stock exchange in normal times. It has a virtual monopoly (85 per cent share) of the online property listings market and is essentially a leveraged play on a fixed cost base.

As well as listing the properties of its estate agency customers, it does provide other value-added services such as local market intelligence and lead generation strategies. This has allowed it to keep on increasing its average monthly fees it charges them to over £1,000.

Times are tough right now as estate agents aren't selling houses and are short of cash to pay Rightmove. They were given a 75 per cent discount between April and July, and will now be given a 60 per cent discount for August and 40 per cent for September. This is going to cost Rightmove something between £82 and £95m of lost revenues, compared with £298.3m it made last year.

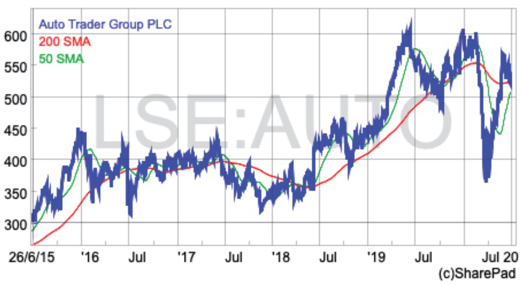
Given the huge operating leverage of this business, most of this is going to come off profits. It will not come anywhere close to making a loss for the year and has used taxpayers' cash to pay 80 per cent of the wages of one-third of its employees to offset some of it.

The property market is showing signs of getting back to normal, but Rightmove's membership is down by 3.8 per cent to 19,054 branches, as some have gone out of business. My guess is that unless the UK housing market enters a steep downturn – which is not impossible – then Rightmove will get back to making very healthy profits in 2021.

Rightmove: current forecasts

		Year (£m)	
	2020	2021	2022
Turnover	195.3	283.4	306.7
Ebitda	131	212.1	231.2
Ebit	127.3	207.8	226.6
Pre-tax profit	129.2	208.6	230.4
Post-tax profit	105.4	171.7	189.2
EPS (p)	12	19.4	21.6
Capex	1.1	1.7	1.8
Free cash flow	183.7	173.6	191.8
Net borrowing	-83.2	-99.8	-97.9

Source: SharePad



At 545p, the shares trade on 27.8 times current 2021F earnings per share (EPS). This company remains a rare example of outstanding quality on the UK market and I remain happy to keep it in the UK Quality Shares portfolio.

Auto Trader

Auto Trader (AUTO) is in the UK Quality Shares portfolio for the same reason. It's dominant market position is backed by a continued ability to add value to its customers, and with a similar business model to Rightmove it makes exceptionally high profits that show no sign of being competed away.

Its full-year results to the end of March 2020 saw revenues increase by 4 per cent to £368.9m, with operating profits increasing by 6 per cent to £258.9m – a profit margin of 70 per cent.

Like Rightmove, Auto Trader's customers have not been trading and have been receiving discounts on their monthly fees, which averaged £1,949 per forecourt per month last year.

Things have been so bad in the car market that Auto Trader actually lost £6.6m in April and £4.8m in May. It expects operating profits of £11.8m in June, which would be £45m less than it made for the same month in 2019.

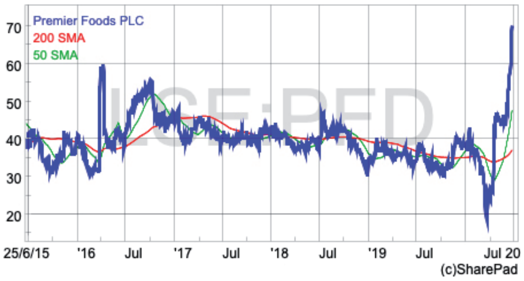
Its customers are going back to paying full rates from 1 July, but I think it's going to take a while for Auto Trader to recover its previous levels of profitability. Used car stock in the UK has come down and prices have stayed firm, which is good news for used car dealers as they can start making money again, but it will mean that Auto Trader's revenues will be lower as there will be fewer car adverts.

Looking further out, I remain happy enough with this company. If Covid-19 changes people's travelling habits, then it may turn out to be a positive for car dealers and Auto Trader, as additional demand for cars is likely to follow the trend of starting online.

Auto Trader: current forecasts

	Year (£m) 2020	2021	2022
Turnover	371.4	284.5	371.3
Ebitda	267.1	185.7	263.8
Ebit	259.2	178.7	257.5
Pre-tax profit	251.1	172	252.4
Post-tax profit	204.1	142	207.7
EPS (p)	21.9	14.9	21.6
Capex	3.3	2.3	2.9
Free cash flow	207.4	163.2	220.8
Net borrowing	266	47.2	-25.2

Source: SharePad



At 538p, Auto Trader shares are expensive at 24.3 times trailing diluted EPS, but reassuringly so, as I think this business will bounce back.

Premier Foods

It seems that Mr Kipling does still make “exceedingly good cakes”, as seen by **Premier Foods (PFD)** results this week. Sales were up 4 per cent in the year to March 2020 and have been very popular during the recent lockdown.

This is all very welcome news for this company which has a very attractive stable of grocery and sweet brands that has sadly been dented by appalling financial mismanagement in the past.

The shares have had a stellar 2020 – up 88 per cent so far – as it has done a deal that will reduce the size of its pension fund deficit and how much cash it has to plough into it. That said, this company still has huge amounts of financial leverage, as it paid £80m into its fund and to its lenders in interest, compared with the £62m of free cash flow it generated for shareholders last year.

While media attention is on Mr Kipling’s current levels of popularity, it is worth noting that the company’s cake business is far less profitable than its grocery brands such as Bisto, Loyd Grossman and the fast growing Nissin premium noodles brands. The latter makes contribution margins of 24 per cent, compared with just over 10 per cent for cakes, so cakes have to grow much faster to have a meaningful impact on operating profits, which grew by £4m to £133m last year.

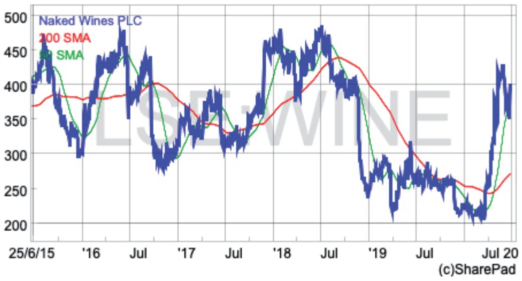
Going forward, the company is still going to be paying £38m into its pension fund along with another expected £34m of interest. Working capital, which had a nice cash inflow last year, will have a small outflow this year. I reckon this all adds up to free cash flow of around £40m for the year to March 2021.

Premier Foods: current forecasts

	Year (£m)		
	2020	2021	2022
Turnover	847.1	881.7	891.9
Ebitda	152.1	157.6	160.1
Ebit	132.1	135	137.1
Pre-tax profit	91.1	100.4	105
Post-tax profit	76.6	83.5	87.8
EPS (p)	8.7	9.6	10
Capex	25	25	25
Free cash flow	62.6	48	56.4
Net borrowing	432.6	379.6	327

Source: SharePad

This business is moving in the right direction. It is increasing its investment in brand marketing and this seems to be producing good results. At 71p, the shares trade on a forecast PE of just 7.4 times, but I'd argue that such a low rating is quite appropriate for a business that still will have combined debts and a pension fund deficit of around £550m in 2021, compared with a current market capitalisation of £590m. This leverage may continue to work in its favour if sales keep modestly growing, but I struggle to see the long-term potential in this business which must now deeply regret selling Quorn a few years back.



Naked Wines

Naked Wines (WINE) was bought by Majestic Wine back in 2015. It has now become the main business of the company as the Majestic stores have been sold off.

Naked is a subscription wine business that supports independent winemakers. Its main business is in the US and UK, with a smaller business in Australia.

By subscribing from £20 per month, members can fund the development of winemakers and in return get 33 per cent off exclusive wines. The company's plan is to become the leader in the direct-to-consumer wine subscription market by offering quality wines at value for money prices (typically in the £10-£20 range).

This is seen as a very young market with lots of potential to grow. Naked is the market leader in the US, but only has a 3.7 per cent value share of the market. It is investing heavily in marketing and distribution and looks to be producing some results.

The cost of acquiring new customers means that the company is making a small loss, but repeat business is proving to be very profitable and making respectable contribution margins.

Contribution from new and existing customers

£m	2020	2019
New customers		
Revenue	29.2	25.5
Contribution	-22.9	-19.1
Margin	-78.4%	-74.9%
Repeat customers		
Revenue	173.7	152.9
Contribution	45.7	39.8
Margin	26.3%	26.0%
Total revenue	202.9	178.4
Total contribution	22.8	20.7
Fixed costs	-24.2	-23.7
Operating profit	-1.4	-3

Source:SharePad

The company reckons its standstill operating profit – which would only take into account the cost of replacing lost customers – would be around £10m. If it can cling on to new customers and they keep buying wines, then this is a business that could be scaled into making a reasonable amount of profit, in my view.

The big doubt I have is just how popular it can be. It appeals to people who want to help the underdogs of the corporate world and feel that they are getting something back in return, but wine is a crowded space.

There's no shortage of websites selling the stuff. Supermarket wine is very good these days and I can't help wondering whether the novelty will eventually wear off after a few deliveries from Naked.

Naked Wines: current forecasts

	Year (£m)		
	2020	2021	2022
Turnover	203	241.3	272.3
Ebitda	1.8	6.2	9.7
Ebit	-1.6	2.2	5.4
Pre-tax profit	-2.1	2.6	5.9
Post-tax profit	1.2	2	4.4
EPS (p)	-	3.1	6.8
Dividend (p)	5.2	-	-
Capex	4.3	4.3	4.3
Free cash flow	-	-10.3	-8.4
Net borrowing	-51.5	-48.8	-48.3

Source: SharePad

Analysts reckon the business will make a small profit in the year to March 2021, but it needs to be making a lot more to justify the current £290m market capitalisation, in my view.

I also wonder if it will need to raise fresh equity to fund future growth. It did have £54.7m of cash on its balance sheet at the end of March, but I also note £43m of deferred income liabilities from subscribers who have paid cash into the business and have yet to buy wine with it. As long as subscribers keep growing this is not a problem as is a source of future profits (although the cash has already been received).

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