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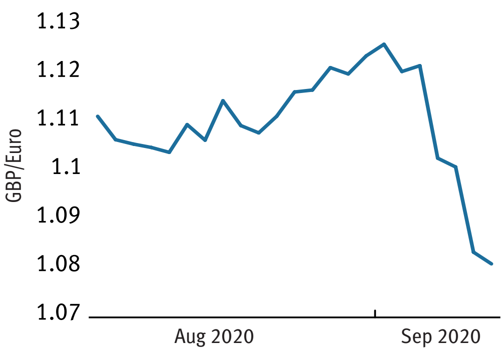
Phil Oakley's Weekly Round-Up

The key issues for the rest of this year will be the performance of the UK economy and the value of the pound

The pound has sold off sharply against the euro on Brexit tensions



Source: FactSet

Alpha Editor: James Norrington

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Having had a week off pretty much ignoring what was going on in the stock market, I have returned to find that not much has changed. Tech shares are still flavour of the month, despite a bit of a wobble, while the market does seem to move up and down depending on whether there might be a Covid-19 vaccine any time soon.

Personally, I think we are going to have to learn to live with this virus for a good while yet and that enough damage has been done to economies despite the best of intentions for public health.

For me, the key issue for the rest of the year will be the performance of the UK economy and the value of the pound. Putting to one side the continued troubles of the travel and leisure sectors, I think there are signs that the UK economy is recovering quite well.

I base this view largely on what I see locally and talking to people who run their own businesses. There seems to be a lot of pent-up demand with plenty of home improvement activity going on and a noticeable uptick in housing market activity as evidenced by lots of houses for sale. Tradespeople seem to be very busy and have lots of work. Traffic levels look almost normal again.

In stark contrast, town centres remain very quiet.

We are beginning to get a clearer view about what's going on from company results and trading updates, which I continue to see as being a much better way to gain a view than listening to economists. We are seeing signs of pent-up demand for some retailers such as Dunelm and Primark, while Travis Perkins and Forterra are cautiously indicating that construction activity is on the up.

How long this lasts remains to be seen. The big fear is that with the winding down of the government's furlough scheme unemployment could rise significantly. At the moment, furlough is putting money in people's pockets that may not be the case in a few weeks' time. If a lot of

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these workers are made redundant then the economy is likely to dip down again.

The UK economy cannot cope with another lockdown, but a further one cannot be ruled out.

The other area of concern is the near breakdown status of the government's trade talks with the EU. This is a toxic subject, but I'll say this. Regardless of how you voted in the referendum, the current situation is a terrible mess and being handled appallingly. This could have significant negative repercussions for the value of the pound.

Sadly, I am a long-term bear on the value of the pound. This is simply because I see the UK economy as a fundamentally weak one which does not produce enough and consumes too much with borrowed money. The reliance on the housing market as a source of wealth is a weak one that has persisted for a long time, but surely cannot last given house price affordability and high debt levels.

It needs radical actions to get it back on track. Looking further out, I do not discount the pound trading at parity with both the US dollar and the euro.

Despite seemingly every major trading country wanting a weak currency, I see dark days ahead for the pound and continue to believe that UK investors should own companies with lots of foreign earnings and foreign stocks.

This is not easy given high valuations and also the spectre of rising inflation which I talked about a couple of weeks ago. I note with interest a recent article by Terry Smith where he was very candid about the damage rising inflation could do to the valuation of highly-rated quality growth stocks as it reduces the real value of their future earnings. I agree with most things Terry says and do so again on this subject.

There could be stormy days ahead. I can't help feeling that the monetary juice that has driven stock markets is unlikely to keep propping them up and that easy gains in highly-rated stocks, while possible, are likely to be fewer.

There is nothing that we as investors can do to change what is going on in the outside world. It's boring and not particularly insightful, but doing nothing and holding on is probably the best course of action, as it often is.

Both fantasy portfolios are stuffed full of highly-rated shares which are hopefully backed by good companies. I am still on the lookout for new stocks and have added a new position in the UK portfolio this week. I am prepared to top-slice some highly-rated shares in the Fantasy Sipp to add new positions, but have yet to find anything to tempt me at the moment.

Fantasy Sipp & UK Quality shares performance

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	-0.7	55.1	72.8	70.0
LF Blue Whale Growth Fund	2.4	21.3	21.6	38.8
Smithson Investment Trust	-2.1	13.9	16.4	
Fundsmith Equity T Acc	1.4	12.4	11.4	29.6
Martin Currie Global Portfolio Trust	3.1	9.5	13.2	28.9
Vanguard S&P 500 ETF	1.5	7.7	9.5	20.9
Mid Wynd International Inv Trust	0.5	7.0	8.7	22.2
Phil Oakley Fantasy Sipp	**1.5**	**5.9**	**8.9**	**32.9**
Lindsell Train Global Funds	1.3	3.7	-1.3	15.7
Finsbury Growth & Income Trust	0.8	-5.4	-8.6	6.0
Phil Oakley UK Quality Shares	**0.8**	**-7.5**	**–**	**–**
Castlefield CFP SDL UK Buffettology	-1.8	-8.8	1.1	3.9
FTSE All-Share - Total Return	-0.3	-18.6	-13.3	-10.6
Vanguard FTSE 100 ETF	-0.1	-18.9	-14.1	-10.1
Vanguard FTSE 250 UCITS ETF	-0.1	-19.7	-9.1	-8.9

Source: SharePad

Games Workshop

Thursday saw **Games Workshop (GAW)** announce a very impressive trading update that seemed to surprise even the most ardent bulls of the stock on how good it was.

Trading for the three months to 30 August saw revenues increase by just over 15 per cent to £90m, with operating profit increasing by 60.7 per cent to £45m. With royalty increasing by £1m to £3m, total operating profit including these was up by 60 per cent.

This is a tremendous result and is testament to how well this company has been managed, its continued launch of new products and its engagement with its customers. Covid-19 looks as if it has done little damage to the business and may even have helped it.

While its shops are still getting back up to speed, trading has been very healthy over the internet and trade channels and this has probably been a driver of improved margins. The company does not put any colour onto the nature of its revenues apart from its channel mix so it's difficult to know if an improved product mix had any effect.

Unsurprisingly, the share price went through the roof and is currently £103 as I write, having closed at £87.25 on Wednesday evening. The company's trailing 12-month (TTM) operating profit is currently £108m, compared with £90m for the year to May 2020 and current analyst forecasts of £90m for the year to May 2021. Clearly, these forecasts will be going up in a big way following this update.

That said, the company is not giving any further guidance for the rest of the year because it does not have enough visibility. This is a key point because it very rarely has. It seems that the company, city analysts and key investors cannot predict future profits with any accuracy or have any visibility as to what they might be.

The other key point to take on board, which I have made many times before when writing about this company, is that it has very high operational gearing that is highlighted very well in the trading update. Therefore, when revenues surprise on the upside, profits do so by even more and the share price unsurprisingly reacts well.

Experienced investors will also know that operational gearing works both ways. If this company sees a dent to its revenues – as was the case with Covid-19 initially – then profits fall a lot as well.

I have a high admiration for this business and how it is run, but the visibility of earnings and high operational gearing make this a very risky one as well, especially given that the shares were trading on a forecast PE of 40.7 times at Wednesday night's closing price. Upgrades and strong sustainable growth are a given with a valuation like this.

I also have to admit that I may be underestimating the long-term potential and sustainability of the Warhammer brand and its earnings power. The scope for increased royalty revenues –from things such as video games – is significant, but I don't know enough about the nature of them. They are highly lucrative and a source of almost pure profit, but I understand little as to how they are earned (on what basis the royalties are earned), how long they will last and their magnitude.

These shares have a strong following wind behind them right now and could keep on heading for the stars. Being aware of some of the risks is no bad thing though, in my view. A grasp of operational gearing is crucial in investing and the ability to know how it can reward you and hurt you is a lesson that all investors should take the time to learn.

The fact that management sold a lot of their remaining shareholdings at around £73 earlier this year continues to intrigue me. Hindsight is a wonderful thing, but had they had the visibility that trading was going to turn out as good as it has and possibly keep on getting better, then surely they would have been loading up on them instead. In my opinion, the CEO and finance director should probably own more shares of their own company than they currently do.

I sold Games Workshop shares out of the fantasy portfolios after the directors sold shares. This now looks to be a mistake, but I felt uncomfortable with the risk-reward trade-off with shares at £73, and would feel even more uncomfortable now. I accept that it could go on to great things, but it is not a share for me at the current valuation.

Games Workshop: current forecasts

	Year (£m)		
	2021	2022	2023
Turnover	276.5	303.8	325.1
Ebitda	110.5	124.2	141.3
Ebit	90.2	101.6	116.1
Pre-tax profit	88.1	99.4	115.5
Post-tax profit	67.3	79.7	-
EPS (p)	214.3	242.3	282.5
Dividend (p)	126.7	155.3	161.4
Capex	22.9	19.9	25.5
Free cash flow	68.5	84	90.8
Net borrowing	-60.8	-94.7	-129

Source: SharePad

Avon Rubber

Avon Rubber (AVON) is enjoying a purple patch right now. Its core defence business is trading well and has seen some good contract wins for its M50 masks and M61 filters, which has strengthened its position with the US Department of Defense (DoD) and broadened its customer base to other countries' military budgets.

The quality of its earnings will also improve now that it has managed to sell its InterPuls milking products business for a very good price.

Following the acquisition of 3M's ballistic protection business last year, the company announced this week that it was buying Team Wendy, a manufacturer of helmets and helmet liners for military and first responders. The price is $130m on a cash free and debt free basis and equates to 9.7 times 2019 Ebitda (earnings with interest, taxes, depreciation, and amortisation) added back which looks to have satisfied most people that Avon has not overpaid.

The business is a very good complementary fit with its existing defence businesses and operates with one manufacturing facility in Cleveland, Ohio. The management of Team Wendy will also be staying with the business, which I usually view positively.

The business had revenues of $44.2m in 2019 with Ebitda of $13.4m at a margin of 30.3 per cent, which compares favourably with Avon's Protection business in total that had Ebitda margins of just over 24 per cent in 2019.

I like the fact that Team Wendy is not overly dependent on one particular customer or contract and has customers in over 50 countries. The deal will enhance EPS (not that difficult in a low interest rate environment) even before cost savings and synergies are realised.

Avon is now building up a very impressive portfolio of defence and protection businesses, which give the opportunity for cross-selling and possibly to improve the loading of its manufacturing plants. This bodes well for the company to continue to grow its revenues and profits in the years ahead, while making good returns on investment.

Avon's shares have been a stellar performer this year delivering total returns of 91 per cent so far. Its shares are very expensive and trade on a forecast PE of 41.7 times and a one-year rolling forecast PE of 32.6 times at a share price of 3,978p. It is the largest holding in both fantasy portfolios.

I've top-sliced Avon in the Fantasy Sipp as a source of funds for new investments and may do so again. That said, it is a business that I feel I understand, and has more revenue visibility (albeit not perfect) than say Games Workshop, and therefore one I am happy to keep hold of.

Avon: current forecasts

	Year (£m) 2020	2021	2022
Turnover	231.6	290	307.6
Ebitda	48.8	60.1	68.1
Ebit	37.9	48.2	53.5
Pre-tax profit	36.5	47.4	55.9
Post-tax profit	29.6	41.3	45.5
EPS (p)	94.7	122.5	142.8
Dividend (p)	27.1	34.7	44.1
Capex	7.6	5	5
Free cash flow	20.3	33.6	41.4
Net borrowing	26.6	6.2	-12.8

Source: SharePad

Frontier Developments

Frontier Development's (FDEV) shares have had a great 2020 so far and have doubled in value. This week's full-year results was the first time I have ever looked at the business and I have to say I like a lot of what I see.

For those of you who are unfamiliar with the company, it is a developer and publisher of video games and is based in Cambridge. Its games are played on PCs, and gaming consoles such as Sony Playstation, Microsoft XBox and Nintendo Switch. It does not sell into the more crowded mobile gaming market.

I like the look of the company's strategy and how it has been building its business up over the years. At the moment, the business is based around four main games:

■ **Elite Dangerous (2014)** – where players control a starship in a galaxy

■ **Planet Coaster (2016)** – building rides and sceneries in an amusement park

■ **Jurassic World Evolution (2018)** – build your own Jurassic World

■ **Planet Zoo (2019)** – players create habitats for their chosen animals and then control and manage their lifestyles in it.

The company develops its games with its own proprietary technology called Cobra. It also publishes games for third parties and is developing this further through its Frontier Foundry business. Ninety seven per cent of its games are sold through digital downloads.

This business looks as if it is very well managed. The games are very involved and take a long time to master, which means they have a lot of long-term and loyal players. Free content is used to introduce new players to the games, while they are constantly evolved and developed with subsequent pre-downloadable content.

Frontier has also been very good at building a player community and produces huge amounts of content for them on places such as Youtube and Twitch TV. You only have to look at the positive effect Warhammer-Community.com has had on Games Workshop to know that this is a very good thing to do as far as brand building and repeat sales are concerned.

The longevity of the core games is there for all to see in the company's financial results. Sixty per cent of the £76m revenues generated by the company in the year to May 2020 have come from the first three titles. Elite Dangerous had its highest ever player numbers in 2020 – seven years after it was launched. The hope is that Frontier can replicate this with its other games.

Of the 10 million units sold last year, Elite Dangerous accounted for 3.5 million, Planet Coaster 2.5 million, Jurassic World Evolution 3 million and the recently released Planet Zoo 1 million. The latter has been Frontier's fastest selling game to date.

The company is pouring money into development of new games and hiring lots of new games developers. At the moment, this is depressing ROCE (around 12 per cent) and free cash flow (although free cash flow margins were still a pretty decent 14.5 per cent last year), but I see this as a very interesting play on scale where a long-term player base could see return on capital employed (ROCE) and free cash flow soar when some of the more recent games mature.

The outlook for this business looks very promising. The scaling up of the development team means that it should be able to move to a release schedule of one new game per year to two games from the May 2022 financial year.

The Frontier Foundry business should also be capable of five to six new releases per year from 2023 onwards.

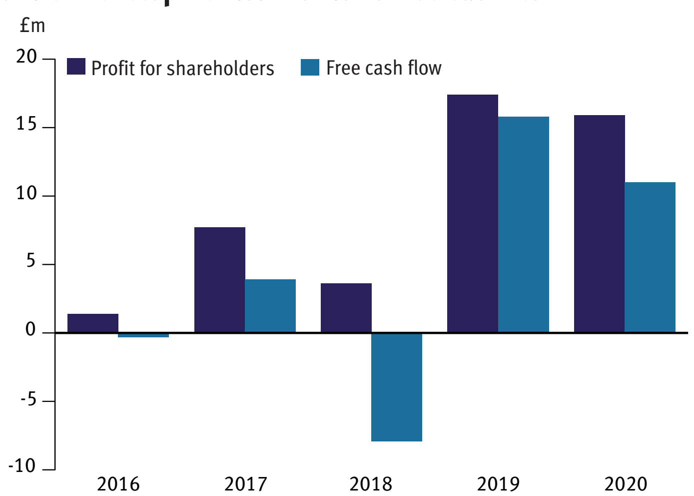
Frontier also has some very good prospects for developing games under licence. It has signed deals to make games under the Formula 1 brand as Games Workshops' Warhammer, as well as an unannounced licence. The payment of royalties will dilute gross margins (which were 68 per cent last year), but the likely volume of sales should see these licenced games become a significant driver of profits and value.

I think the foundations have been put in place for very strong revenue and profits growth over the next few years. 2020's profits were down a little as 2019 saw a full-year contribution from Jurassic World Evolution, but did not get the same boost from Planet Zoo which was released in December 2019. Profit margins were maintained at 22 per cent.

Two main things to note from its accounts is that most of its development costs (around 85 per cent in most years) are capitalised rather than directly expensed (but the amortisation of them is expensed against revenues in the income statement) and it also benefits from video games tax relief (VGTR) and research and development tax credits, which means that it pays very little tax right now. Investors should therefore expect that tax rate to eventually go up and take this into account when valuing the business.

The capitalisation of costs means that free cash flow is less than reported profits. I don't think this is a sign of aggressive accounting and cash flows should improve as the games portfolio matures (meaning development costs as a proportion of revenues will decrease).

Frontier Developments: Profits vs free cash flow



Source: Annual reports

The shares are very richly valued on a one-year rolling forecast PE of 51 times. Ordinarily, this is a share that I would not go near, but as with YouGov recently I think that paying up for growth could pay off. 2021 is said to be a year of record revenues of £90-£95m, with further growth likely in the years to come.

I also like the fact that the business is run by its founder who retains a 33 per cent stake in the business. I also note with interest that Tencent Holdings, the Chinese technology company, has an 8.7 per cent stake, which raises the possibility it might buy the company in the future.

Although I am very late to the party with this company, I have used the remaining cash balance in the UK Quality Shares portfolio to buy a 2.7 per cent position at 2460p.

Frontier Developments: current forecasts

	Year (£m) 2020	2021	2022
Turnover	75.9	93	139.4
Ebitda	28.2	35.1	52.6
Ebit	16	19	32.6
Pre-tax profit	16	18.3	31.7
Post-tax profit	13.6	15.5	28.1
EPS (p)	36.5	46.9	70.8
Dividend (p)	-	-	-
Capex	20.4	22.8	28.4
Free cash flow	5.3	10.9	21.5
Net borrowing	-41.7	-54.7	-74.2

Source: SharePad

Associated British Foods

If **Associated British Foods (ABF)** just had its grocery business – with strong brands such as Twinings, Jordans and Ryvita – and Primark, I'd be quite happy to own shares in it. The other stuff, especially the sugar business, puts me off.

This week's trading update was pretty upbeat. The sugar, grocery, ingredients and agriculture businesses will all make more money than last year. Primark, which was closed for months and has no internet business, will see its profits collapse from £913m last year to at least £350m this year.

The good news is that Primark is now trading very strongly, as its value for money offering has been sorely missed during the lockdown. Profits next year should hopefully be back to near or above 2019 levels, but trading in city centre locations has been decimated as many people continue to work from home. Thankfully, these locations now only account for 8 per cent of Primark sales and out-of-town locations are seeing very strong sales performances.

ABF is essentially a family business run by the Weston family. This is a good and bad thing. Good because it can take a long-term view on profits and investment, but bad because it owns businesses that offset the value being created in grocery and Primark.

The volatility of sugar profits is a major turn off for me and this year's rise is not going to be sustainable. The ingredients business has seen soaring demand for bread-making ingredients such as yeast, but problems with its bread business – Allied Bakeries has lost two significant contracts in the past two years – is also a drag on profits.

Primark remains the key attraction, but I do feel that it needs to embrace the 21st century and start selling online, even if it is just for click-and-collect orders. The business will also probably remain under close scrutiny as to how its clothes are sold so cheaply, but a recycling scheme could generate positive publicity.

My chief concern about ABF is that it will struggle to deliver consistent and steady profits growth from its current portfolio of businesses. A break-up of the company would seem to make a lot of sense, but under its current ownership structure, it is unlikely to happen.

Associated British Foods: current forecasts

	Year (£m) 2020	2021	2022
Turnover	14,245.40	15,933.10	16,699.20
Ebitda	1,767.20	2,193.10	2,409.00
Ebit	953.9	1,385.20	1,558.80
Pre-tax profit	841.7	1,291.40	1,452.80
Post-tax profit	606.5	963.4	1,096.10
EPS (p)	75.8	123.7	140.4
Dividend (p)	28.7	43.3	49.2
Capex	617	755.1	841.5
Free cash flow	189.3	938.6	1,063.60
Net borrowing	2,657.00	1,967.30	1,385.40

Source: SharePad

Fevertree

Regular readers will know that I am very lukewarm on **Fevertree (FEVR)** shares. I see the company as a magnificent triumph in marketing that has convinced many consumers to buy very expensive mixer drinks. When combined with a business model that outsources production and distribution of its products it has been able to produce the kind of profit margins, free cash flow and ROCE that many investors salivate over.

Premium products can make great long-term investments. Companies can charge higher prices for their products because they offer great value in terms of the consumer experience. I am very happy to pay up for quality in many things (including shares), but only if I think I can get a lot of value out of them. This is why I will happily pay £100s more for German domestic appliances, which have ended up costing me much less over 15 years of life than people I know who bought several cheaper appliances over the same period.

A 500 ml bottle of Fevertree tonic costs me £1.80 (£3.60 per litre) in my local Tesco. I am currently drinking Sodastream diet tonic which does not contain aspartame (which so many Fevertree lovers are very quick to criticise Schweppes for) and with filtered Essex tap water, carbon dioxide and concentrate costs me around 60p per litre and with more fizz.

I am perfectly aware that there are lots of people who will disagree with my opinion, but I think I am getting great value from Sodastream and not from Fevertree, despite all its exotic ingredients.

I've also been around long enough to see many drinks trends come and go and feel that the gin and tonic boom in the UK which has been a key driver of Fevertree sales has peaked. Even before the lockdown, the company was showing signs of stagnating in its core UK market.

This week's half-year results showed that UK sales had been hammered by the lockdown. On-trade sales to pubs and bars, which accounted for half of the UK business, fell by 66 per cent. Some of this lost business switched to the off-trade, which saw sales increase by 24 per cent. This was not enough to stop overall UK sales falling by slightly more than 20 per cent.

The second half of 2020 should be better, but continued social distancing and a recent spike in Covid-19 infections means that a recovery in on-trade sales could be slow, but could also see a slowdown in off-trade growth. The European business is also dominated by on-trade sales and recovery here is also likely to be slow.

The bright spot is the performance in the US. Fevertree has done a lot of good work here and I think there's more to come from this business.

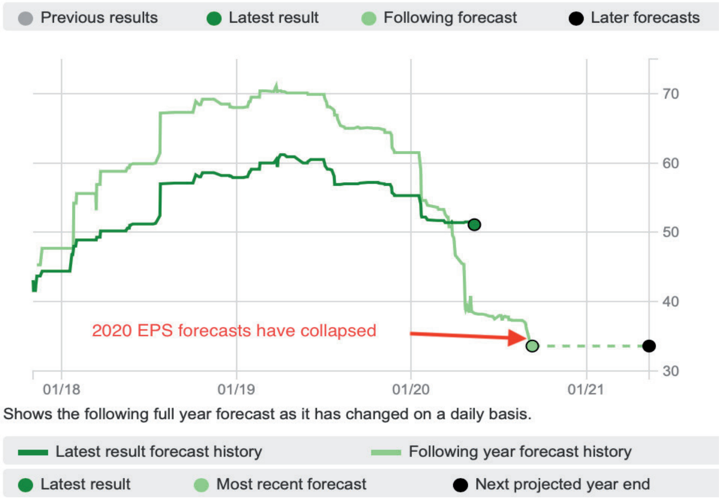
The company is learning fast in this market. The company credits its 38 per cent sales growth in the first half of the year to many things including what is calls "price optimisation". Reading between the lines, I think Fevertee went into this market with a price point that many US consumers rejected because it was seen as being too expensive. It has now cut prices and is seeing more of its bottles being put into supermarket trolleys and bought in liquor stores. These price cuts were responsible for taking 300 basis points of Fevertree's gross margin in H1.

I also think that Fevertree not only has a decent business opportunity in the US, but may also be capable of building one that is more balanced and not dominated by tonic water. Dark spirits are more popular in the US which give rise to more potential ginger beer sales, while the company seems to have begun to tap into the tequila market with its pink grapefruit soda drink.

A current issue for the US market is that it is still being supplied from the UK. This means there are a lot of extra costs in terms of shipping, storage and internal distribution in the US. The company will eventually have to link up with probably several US bottlers, but this should bring margin and customer service benefits.

Unsurprisingly, forecasts for 2020 have been hammered given the impact of Covid lockdowns and have pretty much halved in the last year.

Evolution of Fevertree 2020 EPS forecasts



Shows the following full year forecast as it has changed on a daily basis.

Looking further out to 2021, current consensus EPS forecasts are for EPS for 51.6p rising to just under 60p in 2022. This compares with the 53.2p of EPS made in 2018. In July last year, analysts thought that Fevertree would make EPS of 78p in 2021. Current forecasts may move up and even though Covid-19 was not even thought of a year ago, there can be no doubt that there has been a significant downwards revision in the market's estimate of Fevertree's earnings power, which has seen the share price fall back a long way from its peak.

The company is guiding to a recovery in the second half of 2020 subject to the usual caveats about things such as lockdowns. Full-year sales are now being guided to £235-£243m. At the top end of this range, this would imply a year-on-year reduction in second half sales of just under 3 per cent, which would be a very good result in my view.

If we take a view that 60p of EPS is achievable in 2022 then, at 2,087p, the shares trade are on a PE of 34.9 times, which still looks very rich to me. The US has been the key driver of this business for a while now and while I think it will show decent growth, whether it can move the business forward enough remains to be seen. The response of US drinks giants Coca-Cola and Pepsico – if any – will be interesting.

Fevertree: current forecasts

		Year (£m)	
	2020	2021	2022
Turnover	241	294	329.3
Ebitda	53.4	79	90.9
Ebit	48.5	73.6	84.9
Pre-tax profit	48.2	72.2	82.7
Post-tax profit	39	58.9	67.7
EPS (p)	33.6	51.6	59.4
Dividend (p)	15.7	18.8	21.1
Capex	2.5	2.5	2.6
Free cash flow	44.7	52.6	66.4
Net borrowing	-153.1	-186.5	-229.3

Source: SharePad

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