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Phil Oakley's Weekly Round-Up

Listening to central bankers is generally a waste of time. But sometimes it is worth heeding the warning signs hidden within their announcements and investors in high quality, but highly rated, stocks should be wary of inflation coming down the line

I think listening to central bankers is a waste of time. The adulation of them in the mainstream financial media is cringeworthy. They have no more insight as to what is going on than any diligent investor who listens to what companies are saying, walks the streets and looks around and talks to people who run their own businesses.

The comments coming from Jerome Powell out of Jackson Hole are nothing new. We already know that the Federal Reserve has no intention of putting up interest rates any time soon and will print as much money as it takes to prop up the stock market and stop bond yields going through the roof.

On Thursday, Jerome Powell just said this in a different way – that there is too much debt out there and we are going to take the easier way out to deal with this by inflating it away. US inflation will be targeted to an average 2 per cent over time and will be allowed to go higher than this from time to time.

This is what has been going on anyway and the market knows this, likes this and wants this as long as it doesn't get out of hand. US 10-year treasury yields and the dollar index went up slightly and so did the S&P 500 and the Nasdaq. Gold and silver sold off, which surprised me a little.

I've gone on a lot – perhaps too much – about the valuation of quality growth shares in recent weeks and months, but with good reason. I totally get the points about them being scarce businesses with great pricing power and that low interest rates and predictable growth can justify very high valuations for these stocks.

One thing that I don't go on about as much as I probably should is inflation. For me, the whole point of investing is to preserve and grow the buying power of your savings. You sacrifice spending the money you have today and invest with the aim that your savings will buy more stuff

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in the future than they do today. The only way to achieve this is for the return on your portfolio to be greater than the rate of inflation. This means that you need to earn a real return on your investments – the nominal return must be more than the inflation.

What you must look at is the real yield on investments. Bonds in many countries have negative real yields. At the moment, the US 10-year treasury bond has a yield to maturity of 0.7 per cent. US inflation is currently 1 per cent giving a real yield of minus 0.3 per cent. In the UK, a 10-year gilt currently yields 0.3 per cent to maturity, with inflation also at 1 per cent giving a real yield of minus 0.7 per cent.

Given this backdrop, quality growth stocks with free cash flow yields of 1.5 to 3 per cent have positive real yields and the prospect of growing on top. This succinctly sums up the bull case for them.

But if inflation increases to 2 per cent, some of these stocks will have negative real free cash flow yields. They will have to grow more than expected to get back into positive territory.

The issue I have with central bankers allowing inflation to go higher is that once you let the genie out of the bottle it can be difficult to get back in. You can't control it with interest rates as that will hurt those with high debts.

If inflation takes off and earnings and cash flows do not keep up in real terms, then share prices which are high (even taking low interest rates into account) will look vulnerable. I'm not saying that we are heading for 1970's style inflation, which was driven by higher oil prices and unionised labour creating a wage-price spiral, but I don't think we need to be for share prices to fall. Inflation of 5 per cent could do real damage to share prices.

We have yet to find out how much pricing power some companies will have in a higher inflationary environment. It's all very well believing that they can increase prices, but their customers have to be able to afford to pay them. Inflation is a tax that eats away disposable income. If workers' pay does not keep pace with rising prices, then they may not be able to afford to buy a product or service at a higher price. If wages go up in line with inflation, will company profits grow as fast as people expect?

The stock market and share prices always face some wall of worry of varying heights. At the moment, it just seems to me that the margin of safety for some sections of the market is getting lower and lower as valuations increase.

For some time now we have seen more and more money flock to quality growth stocks. There are good reasons for this, but there is a danger of thinking that because the momentum drives their prices up, they are a buy at any price. That does not mean they won't keep on going up for a while yet.

I've always believed that investing is just as much about controlling risk as chasing returns. I also accept that you can be too risk-averse and miss out on money making opportunities.

At the end of the day, I think if you are investing rather than speculating you have to give yourself some protection when you buy a share. You do this in two ways. First and foremost with the quality of the business that you invest in and its likely growth prospects. The second is done through the price that you pay.

If we go back to basics and see investing as about growing the buying power of your money, then lower free cash flow yields on some stocks and the prospect of higher inflation makes this more difficult to achieve. The more growth you need to make an investment stack up, the more risk you are exposing yourself to if that growth fails to come through, and that is where we have been with some stocks for a while now. This can persist for very long periods of time, but you ignore the risks of it at your own peril.

Fantasy Sipp & UK Quality shares performance

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	9.5	66.2	89.7	74.1
LF Blue Whale Growth Fund	4.1	20.8	20.7	38.8
Smithson Investment Trust	-0.1	16.2	22.2	
Fundsmith Equity T Acc	3.2	12.5	11.2	28.1
Martin Currie Global Portfolio Trust	1.8	11.2	17.9	29.6
Vanguard S&P 500 ETF	5.2	8.9	14.4	21.7
Mid Wynd International Inv Trust	-0.6	8.6	12.3	24.6
Phil Oakley Fantasy Sipp	3.7	7.2	11.0	31.9
Lindsell Train Global Funds	1.7	4.8	-0.3	17.6
Finsbury Growth & Income Trust PLC	1.1	-5.8	-7.2	3.2
Phil Oakley UK Quality Shares	3.2	-6.3		
Castlefield CFP SDL UK Buffettology	3.9	-7.5	3.4	6.0
FTSE All-Share - Total Return	0.1	-18.0	-10.8	-13.0
Vanguard FTSE 100 ETF	-0.9	-18.4	-11.8	-13.2
Vanguard FTSE 250 UCITS ETF	3.6	-18.7	-6.3	-9.9

Source: SharePad

JD Wetherspoon

JD Wetherspoon (JDW) and its founder Tim Martin are akin to marmite in the investing and wider world. While I find Mr Martin's political rants rather boring and unnecessary, I do think that he runs a very good business in a very difficult sector and his thoughts on it are well worth reading and listening to.

I also think that Wetherspoon is exemplary in terms of its financial disclosure. Its results presentations and accounts are packed with useful information that help the outside investor to understand what makes the business tick and use it as a benchmark for other pub groups to be measured against.

Throw in a simple business model based on great value food and drink in well-maintained pubs that has delivered sector-leading sales growth for many years, then there's a lot to like. Regular readers will know that I don't really like the pub sector as a place to invest, but if I was forced to put my money in one stock it would be JD Wetherspoon.

Having had to close all its pubs for many weeks, it said this week that 844 of its 873 pubs have reopened, but unsurprisingly trading is much subdued compared with last year. Like-for-like (LFL) sales for the 44 days to the 16 August were down by 16.9 per cent. This was better than some analysts had feared, but is evidence of the stark reality facing the pubs right now.

The lockdown and social distancing measures that are in place has changed the economics of running pubs and not in a good way. The government's Eat Out to Help Out scheme and VAT reduction on food is easing some of the pain as is the summer weather which is allowing more outdoor seating. What happens when the scheme ends and the days get darker and cooler is anyone's guess, but it's unlikely to be favourable.

It's difficult not to agree with Tim Martin's views on VAT on pub food and how the supermarkets have used their VAT-free status to sell cheap booze at the expense of pubs. However, the government's finances are stretched to the limit and the current favourable VAT treatment for pubs is likely to be temporary.

Unsurprisingly, the company will make a loss for the year to July 2020, but it has not given guidance on how big it will be. It made £57.9m of pre-tax profit in the six months to January and £102.5m in the year to July 2019.

Unless social distancing ends, I'm not sure how any pub can get back to making the same amount of profit it was in 2019, yet current consensus forecasts have Wetherspoon getting quite close to that in 2022. This view needs to be taken with a big pinch of salt, but would obviously be

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welcomed by all stakeholders if it materialised.

Earnings per share (EPS) of 68.2p in 2020 would put the shares on a price to earnings (PE) of 14.4 times at a share price of 982p. If you could have some confidence in that being achievable, then the shares might possibly be attractive right now. But I don't.

The shares rallied hard off their March lows and drifted back. There is scope for them to rally again if trading conditions improve, but I think this is unlikely while many people continue to work from home and the favourable summer conditions come to an end.

JD Wetherspoon: current forecasts

	Year (£m) 2020	2021	2022
Turnover	1,350.60	1,615.00	1,894.50
Ebitda	144	197.7	251.3
Ebit	33.1	87.1	136.4
Pre-tax profit	-21.9	33.5	97.2
Post-tax profit	-4.8	40.8	76.4
EPS (p)	-12.3	34.2	68.2
Dividend (p)	3	7.2	8.1
Capex	110.1	71.9	74.6
Free cash flow	-36.2	82.3	138.1
Net borrowing	777.8	717.4	626.3
NAV	369.1	362.5	365.5
Like-for-like sales growth (%)	-29	17	15

Source: SharePad

Bunzl

I can think of a lot of reasons not to invest in **Bunzl (BNZL)** shares. Its business is rather boring and essentially boils down to buying commoditised consumable products such as packaging, labels, cleaning materials, personal protection equipment (gloves, masks) and workwear, and selling and delivering them to grocery businesses, retailers, food service companies, construction and industrial businesses and hospitals.

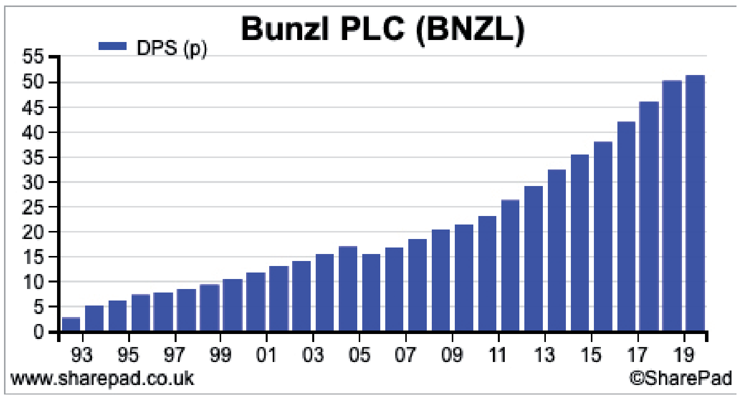
This is a low profit margin business with not a lot of underlying revenue growth, which the company tries to make up for by making lots of acquisitions.

Acquisitive companies rightly come with lots of health warnings attached to them given that an over-reliance on them often ends in tears, but there are a few exceptions to this general rule. Diploma is a good example and I think Bunzl is as well.

Bunzl's key selling point to its customers is simplicity and cost savings. It is offering to take away the hassle of buying stuff and the costs and investment that come with it. Bunzl uses its scale to buy things cheaper than a single company could do on its own.

It supplies a range of own-label and branded products to meet customers' just-in-time delivery needs without having an in-house buying team and tying up money in stocks, delivery trucks and warehousing. The customer saves money and can run its business with lower levels of capital employed.

This is a powerful pitch that Bunzl has done well for many years. It has created a business that throws off decent amounts of free cash flow, which has supported one of the most impressive dividend growth records on the London market and allowed what's left over to be reinvested in buying new businesses.



Acquisitive companies often have poor returns on capital employed (ROCE) because they pay too much to buy companies. Bunzl's is a respectable 14.8 per cent based on its last year's adjusted operating profit of £691.4m. Stripping out the goodwill on acquisitions, its ROCE is a very decent 21.6 per cent, which is a sign of a very good business.

I am also attracted to this business as it has a very low exposure to a weak UK economy – something I've been encouraging people to avoid – with half its profits coming from North America. Its markets are still very fragmented and therefore there's still an opportunity for it to keep on consolidating them, while making good returns on investment.

Half-year results released this week were good. Revenues increased by 6.7 per cent in constant currency with adjusted operating profit up by 13 per cent.

Business area highlights:

	Revenue (£m)		Growth at constant exchange	Adjusted operating profit* (£m)		Growth at constant exchange	Operating margin*	
	H1 20	H1 19		**H1 20**	H1 19		**H1 20**	H1 19
North America	**2,728.4**	2,634.5	1.5%	**154.2**	157.1	(3.7)%	**5.7%**	6.0%
Continental Europe	**1,088.7**	906.4	20.0%	**123.9**	91.1	36.3 %	**11.4%**	10.1%
UK & Ireland	**626.1**	602.5	3.8%	**29.4**	37.4	(21.4)%	**4.7%**	6.2%
Rest of the World	**403.1**	385.0	17.6%	**47.3**	28.7	90.0 %	**11.7%**	7.5%

Source: Bunzl

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The company has benefited from strong demand for Covid-19-related products such as masks, gloves and cleaning products, especially in Europe and Asia. In North America and the UK, which have a higher exposure to food service and grocery sectors, the performance has been more muted.

Bunzl has also benefited from supply of its own-label hygiene and medical products from its hub in Shanghai which earn better margins. This effect will wear off in the second half of the year as many orders in Europe were pulled forward, while food service and retail markets are expected to recover, albeit quite slowly.

What this means is that the profit and margin boost seen in the first half of the year from the positive sales mix will reverse in the second half, but the business overall looks in very good shape and has shown off its defensive qualities with flying colours.

Free cash generation has been good, which has allowed the company to reinstate the 2019 final dividend of 35.8p per share, while nudging up its half-year dividend slightly to 15.8p (15.5p) per share.

Bunzl: current forecasts

		Year (£m)	
	2020	2021	2022
Turnover	9,516.10	9,575.70	9,713.90
Ebitda	827.9	805.5	831.5
Ebit	665.8	628	649.8
Pre-tax profit	591	569.2	599.5
Post-tax profit	458.2	442	461.2
EPS (p)	132	129	134
Dividend (p)	66	52.2	54.6
Capex	33.4	35.6	36
Free cash flow	443.9	430.3	466.4
Net borrowing	1,638.00	1,263.60	970.5

Source: SharePad

I'm not expecting any forecast upgrades any time soon, but think current forecasts are very doable even if sales of hygiene products fall back. Further acquisitions could see forecasts move up.

This is a very decent business even if it is a little bit dull. Its ROCE is excellent and there is scope for some modest organic growth. The shares trade at 2,498p on a trailing 12-month (TTM) free cash flow yield of 6.1 per cent and 18.9 times forecast EPS. In a market where high quality growth shares are very expensive, this high quality, modest growth business looks reasonably priced with dependable profits and cash flows.

Having struggled to find attractive shares for the UK Quality portfolio, I've decided I'm happy to add some

Bunzl to it. It won't shoot the lights out any time soon, but if it turns out to be a steady long-term chugger it will have done a good job.

Henry Boot

Regular readers will know that I think **Henry Boot (BOOT)** is a very well-managed business. For a company that makes the bulk of its money from exposure to the very economically-sensitive sectors of housebuilding, property development and construction, it is also very conservatively-managed as well. An example of this is its current net cash balance sheet.

Half-year results released this week saw an expected sharp fall in pre-tax profits from £24.1m a year ago to just £7.2m. Land development profits were well down and the property development and construction businesses made a loss. The A69 road link, which Boot helps to manage, saw lower traffic volumes which will see reduced cash flows next year.

At 262p, the shares trade on 13 per cent premium to its June net asset value (NAV) per share of 232p. Whether you think the shares are worth more than this largely comes down to your view on the outlook for the UK housebuilding sector.

Boot has just under £174m of land assets on its balance sheet which are treated as inventories and valued at cost. The good news here is that these assets have to be valued at every balance sheet date at the lower of their cost or net realisable (selling) value and they have not been written down and highlight resilient values.

	2020 Half Year (£m)	2019 Full Year (£m)
Cash and cash equivalents	58.9	42.3
Borrowings	(13.0)	(10.7)
Lease liabilities	(3.4)	(4.6)
Net Cash/(Debt) Total	**42.3**	**27.0**
Completed investment property	59.2	61.8
Investment property under construction	11.0	8.2
Investment Properties Total	**70.2**	**70.0**
Developments in progress	29.5	31.7
House builder land and work in progress	36.2	36.3
Land held for development or sale	55.2	50.7
Options to purchase land	14.2	14.9
Planning promotion agreements	38.7	36.1
Inventories Total	**173.8**	**169.7**

Source: Henry Boot

I do note with interest that Boot's profit per plot is coming down over the past couple of years and was averaging £6,500 in the first half of the year. It was £10,000 last year and £14,700 in 2016.

This may be a reflection of location or end use, but may also be a sign that the margins on selling oven-ready land to housebuilders are getting squeezed. Nonetheless, profits are still being made, which underpins the balance sheet value of the 15,456 acres and 23, 450 plots, the bulk of which are in the South or Midlands.

The value of investment properties is also well underpinned with most pre-let, pre-sold or under offer, with only a small amount of speculative build. The company has projects ongoing with a gross development value of £296m and a pipeline of up to £1.4bn. This is mainly concentrated in industrial areas such as manufacturing, warehouses and distribution, as well as a decent chunk of lower risk, public sector projects.

Henry Boot: current forecasts

		Year (£m)	
	2020	2021	2022
Turnover	234	269.9	318.2
Ebitda	20.7	31.8	47.2
Ebit	13.2	25.1	40.5
Pre-tax profit	16	26.4	42.5
Post-tax profit	13.1	21.8	35.2
EPS (p)	9.1	15.5	26.4
Dividend (p)	5.2	5.7	8.5
Capex	2.9	2.9	3.8
Free cash flow	-7.3	-0.4	10.8
Net borrowing	-20	-13	-11
NAV	316.9	326.8	352.5

Source: SharePad

Despite my admiration for how this company is run, I'm fairly lukewarm on its short-term prospects. I'm not particularly bullish on the outlook for housebuilding and still take the view that the heavily subsidised market has peaked and looks vulnerable to price falls, especially if UK unemployment increases.

Residential land values are highly geared to changes in selling prices and there is a risk that the values on Boot's balance sheet could come under pressure. I continue to take the view – based on my observations in a few local markets where my family lives around the country – that new-build asking prices are too high relative to existing housing stock and there's only so much support that Help to Buy can continue to offer. If we (hopefully) avoid a sharp rise in unemployment when the current furlough support ends, then big damage may be avoided.

That said, I see more downside than upside risk in Henry Boot shares at the moment.

RWS

I added **RWS (RWS)** shares to the UK Quality shares portfolio back in June. I like the business of intellectual property based around patents and the technical and language translation services. The company is very profitable with a strong market position and the prospect of some reasonable organic growth. The shares have performed well and have returned 14 per cent so far.

On Thursday morning, the company announced what amounts to an all-share takeover of SDL, which specialises in translation technology services.

From a strategic point of view, this deal makes a lot of sense. There is very little overlap between the two companies' businesses and the combined business will be the world leader in its fields. Throw in the prospect of some cost-cutting and cross-selling and they should comfortably make more profit combined than apart.

RWS shareholders will own 70 per cent of the combined business, but its management looks like it has paid a very high price for the privilege. At the time of writing, the offer of 1.2246 RWS shares at 709p for each SDL share values it at 868p or £791m for all the equity. This equates to a forecast PE of 34.5 times.

Put another way, if we include SDL's £6m of net debt, RWS is paying £797m for a business that is currently making £31.2m of operating profit – a very low starting rate of return on investment of just 3.9 per cent. Add on £15m of cost savings and that return increases to 5.8 per cent.

RWS says EPS will increase by a double-digit percentage in the first year. This is largely due to financial engineering where RWS is using its more expensive shares (on 37 times EPS) to buy the cheaper rated SDL's (on 24 times). The rate of return on investment leads me to conclude that RWS is paying top price for SDL and may be paying too much. However, with growth it can still make this look like a reasonable deal given enough time.

Just to put this into perspective. RWS' existing business makes a ROCE of nearly 24 per cent and it is buying SDL for a starting rate of less than 4 per cent. Acquisitions usually dilute returns on capital because of the goodwill paid, but this is a big hit and one that I – and by the look of the share price reaction, the market – do not like too much at the moment.

RWS: current forecasts

		Year (£m)	
	2020	2021	2022
Turnover	359	386.1	405.4
Ebitda	83.2	92.7	98.9
Ebit	73.3	81.9	87.7
Pre-tax profit	69.5	78.9	86
Post-tax profit	54.8	61.8	67.6
EPS (p)	19.9	22.5	24.6
Dividend (p)	8.7	9.5	10.3
Capex	6.1	7.8	8
Free cash flow	58	59	65
Net borrowing	46.5	9.2	-29.9

Source: SharePad

I'm a bit disappointed by this, but don't rule out the deal making a reasonable return for shareholders in time and will hang on to the shares in the portfolio.

Rolls-Royce

For me, **Rolls-Royce (RR.)** shares are uninvestable. This is simply because I cannot work on what's going on in the business. Even before Covid-19, this business just looked very complicated with cash flows moving all over the place, large foreign exchange hedging exposure and pretty modest returns on capital.

This is a shame because I think this should be a very good business at the very least and perhaps even a great one.

With a market-leading position in aircraft engines with a large installed base, profits and cash flows from regular maintenance and spare parts sales should be creating a very valuable and growing business.

Instead, we have what can only be described as a big mess. Covid-19 has blown a huge hole in the foundations of the civil aerospace market. This is not Rolls-Royce's fault, but its business has been hurt very badly by it.

While defence profits have held up well in the first half of 2020, Civil Aerospace's have fallen off a cliff with engine deliveries halving and service revenues down by 46 per cent. Power Systems' profits were down by 28 per cent. The total operating loss for the company as a whole was a whopping £1.7bn.

If this wasn't bad enough, the company has taken a huge hit of £2.6bn on its US dollar hedging position. It hedges because most of its revenues are in US dollars, but most of its costs are in euros or pounds. The trouble is that the hedge was based on the assumption that business volumes would be much higher than they are now expected to be and therefore the hedge is too big and too expensive. The cost of closing it is eye-wateringly expensive.

The cash flow statement reads like a disaster with a free cash outflow of £2.8bn in the first half of the year. As well as the big trading loss, Rolls-Royce is usually a negative working capital business when volumes are increasing. This means that the trade payables increase by more than trade receivables, inventories and cash flows into the business. When volumes are shrinking, as they are now, the process works in reverse and cash flows out of the business. Another £1bn is expected to flow out of the business in the second half of the year and will send debt levels soaring. The business is still expected to be free cash flow negative in 2021.

The company is making 9,000 workers redundant and consolidating its manufacturing facilities to set the business up for lower levels of activity. It is also looking to sell £2bn of assets to raise cash.

The problem is that Rolls has £3.2bn of debt maturing in the next 18 months and this could not come at a worse time. My guess is that this company will need to have a fairly hefty rights issue in the next six months so that bankers will roll over the debt at a half reasonable interest rate.

The company is trying to find a path to generating £750m of free cash flow by 2022. I'm very wary of this and think investors should be as well. In a business when working capital inflows can make up a large chunk of free cash flow (not profit), this figure may or may not be meaningful. If this company could make £750m of steady state annual free cash flow (excluding working capital) then I'd say the shares at 230p would be screamingly cheap by offering a free cash flow yield of more than 16 per cent. Sadly, I don't think it can any time soon.

Rolls-Royce: current forecasts

	Year (£m) 2020	2021	2022
Turnover	11,819.10	12,527.40	13,514.20
Ebitda	1,315.20	1,661.20	2,033.70
Ebit	-151.1	527.9	917.5
Pre-tax profit	-451.1	273.9	725.3
Post-tax profit	-280	249.2	523.8
EPS (p)	-15.6	8.7	24
Dividend (p)	2.9	3.8	6.5
Capex	543.4	558.3	552.3
Free cash flow	-3,185.30	-8.4	658.1
Net borrowing	4,331.40	4,987.00	5,209.10

Source: SharePad

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