investors CHRONICLE alpha

4 December 2020

Phil Oakley's Weekly Round-Up

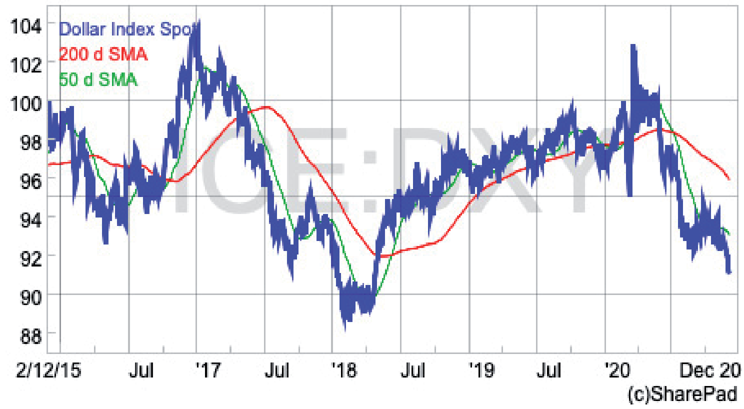
However Brexit negotiations unfold, I dislike the fundamental picture for the UK economy

The UK stock market's muted response to the news that the UK had approved the use of Pfizer's Covid vaccine suggests that the rally we have seen in stocks over the past month has largely priced this news in.

Attention is now focused on the progress of trade talks with the EU to see if a deal can be done and ratified before the end of the year. There seems to be a growing consensus view that a deal will be done even if it is a fudged one.

This is despite the fact that according to those close to the discussions that the two sides are still arguing about fish and state aid rules. Other rumours abound that Michel Barnier has given away too much to the UK, which may lead Emmanuel Macron to do his best General De Gaulle impression and say "Non" to any proposed deal.

Investors often turn to the currency markets to get a feel for the likely direction of travel. They are not always right and anyone taking a signal from it on 23rd June 2016 would have been very badly misled.



As I write this, the pound continues to strengthen against the US dollar and buys $1.349. This is mainly a result of dollar weakness rather than sterling strength.

Alpha Editor: James Norrington

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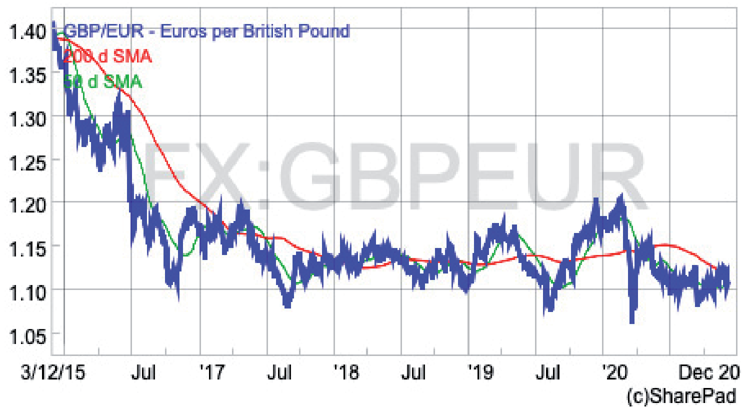
The dollar is at its weakest against a basket of currencies since mid-2018.

Against the euro, the pound's buying power still looks weak to me and has shown no noticeable signs of improvement.



An announcement of a trade deal may see a rally in sterling to $1.40 or thereabouts as a crude guess, but I continue to maintain that the long-term fundamentals of the UK economy remain poor. I therefore stick by my preference for overseas shares and UK-listed shares with plenty of overseas profits.

Fantasy Sipp & UK Quality shares performance

	Portfolio total returns (%)				
	1 month	Year to date	1 year	2 years	3 years
Scottish Mortgage Inv. Trust	10.4	91.8	113.0	125.0	153.0
Smithson Investment Trust	7.7	23.8	24.6	55.6	–
LF Blue Whale Growth Fund	6.6	23.8	26.0	46.2	71.7
Martin Currie Global Portfolio Trust	6.5	20.1	23.1	48.1	52.0
Mid Wynd International Inv Trust	8.0	17.3	18.5	45.6	47.6
Fundsmith Equity T Acc	5.5	16.4	18.6	34.9	51.6
Vanguard S&P 500 ETF	6.9	13.9	15.8	32.2	48.6
iShares MSCI World Acc	8.7	11.4	13.0	27.5	35.7
Lindsell Train Global Funds	7.5	8.0	9.0	22.5	45.7
Phil Oakley Fantasy Sipp	**3.5**	**7.4**	**11.0**	**36.5**	**47.5**
Castlefield CFP SDL UK Buffettology Fund	5.5	-2.4	1.8	15.6	27.2
Finsbury Growth & Income Trust	9.8	-2.8	-0.4	15.1	21.1
Phil Oakley UK Quality Shares	**1.4**	**-7.2**	**–**	**–**	**–**
iShares FTSE 250	15.5	-8.4	-3.0	11.5	6.4
Vanguard FTSE 250 UCITS ETF	15.6	-8.7	-3.0	11.8	6.8
FTSE All-Share - Total Return	13.9	-11.3	-7.7	1.7	0.6
Vanguard FTSE 100 ETF	13.3	-13.0	-9.6	-0.9	-1.1

Source: SharePad

Avon Rubber

Avon Rubber (AVON) is an excellent business and has been a great investment for both my Fantasy portfolios. Its leading positions in the manufacture and supply of masks, filters, breathing apparatus, helmets and body armour have few competitors and make healthy profit margins. Revenues also have a high degree of visibility – albeit lumpy – given their contract backing.

Growth has been good in recent years as the company has won new contracts with the US Department of Defense (DoD) for new products and existing ones. It has a sizeable installed base of products which create a regular demand for spare parts and accessories that adds an extra source of high-margin products.

Recent acquisitions have widened the product offering of its military business, while the decision to sell its milk business has improved the quality of its earnings.

In short, there's a lot to like about this company.

But I sold the shares from both portfolios on the back of Wednesday's full-year results.

I did so because I am concerned about the capability of the business to grow organically and was taken aback by the weak organic growth in the second half of the year, as this is not a business that has been weakened by Covid-19.

It may well win new contracts and buy attractive companies, but I feel that a lot of the underlying momentum in the business has been lost for now and that the shares are consequently less attractive. Given the high valuation of the shares right now (32 times next 12 months' earnings per share), I feel the company needs forecast upgrades and I'm not sure we are going to get them any time soon. Without them the shares look very expensive and unattractive to new buyers.

I may be making a mistake as I still very much like the business. It will go onto the watchlist and I would not rule out buying it back sometime in the future. I sold out at £42.55, compared with the entry price in the UK portfolio at the start of the year of £20.90. With dividends it has given a total return of 104.7 per cent since the start of the year.

The performance for the Fantasy Sipp has been even better. I haven't worked out the total return yet as I sold the shares since its share price increased, but my buying price at the end of 2018 and the beginning of 2019 averaged around £13.

I used the proceeds to top up Games Workshop and added Associated British Foods to the UK portfolio. A few weeks ago, I wrote that I thought ABF shares looked cheap and the company was positioned well for a strong recovery in profits with a more stable sugar business. The shares have gone up a lot since then, but still look reasonable value to me on around 19 times rolling one-year forecast EPS.

I added Games Workshop to the Fantasy Sipp and view the recent sell-off in the shares as a good entry point. I also topped up the position in Frontier Developments.

Avon's full-year results met expectations, but I was disappointed in them. The slowdown in organic growth in the second half of the year was very significant. In the first half of the year, the business was growing at 10 per cent. The full-year growth was just 0.1 per cent. This was due to military revenues slowing significantly in the second half. First Responder revenues were very strong and this trend has continued into the start of the new financial year.

Avon Rubber: second-half revenues

£m	H2 2019	H2 2020	Change
Military	56.3	45.6	-19.0%
First Responder	22.8	26.7	17.1%

Source: Avon Rubber/Investors Chronicle

Management put a positive spin on things saying they were comfortable with the 2021 outlook and gave some guidance as to what the potential annual order intake could be for its three product lines over the next few years, which can be taken as a proxy for revenues.

Avon Rubber: potential order intake

Potential annual order intake ($m)	Low	High
Respiratory	105	150
Ballistic	115	185
First Responder	55	80
Total	**275**	**415**
Value in £ at £1=$1.34	205.2	309.7

Source: Avon Rubber/Investors Chronicle

If I look at analysts' consensus forecasts according to FactSet, then revenues are currently expected to be £289m, which tells me the top end guidance is almost already expected and arguably baked into the share price to a large extent.

Apart from the slowdown in organic growth, I thought the financial statements were messy. Companies often want you to ignore figures they treat as exceptional items, but Avon's £17m of acquisition costs and accounting adjustments looks high and perhaps excessive.

The cash flow was also horrible. The company adjusted net profit was £23.4m, but there was a free cash outflow of £15.6m. The chief culprit was a £21m top-up payment into the final salary pension scheme, which I was surprised was not even discussed in the press release as the pension liability increased, despite this injection. The other reason was a big increase in capitalised development costs and capex which I don't mind, as the company is investing in profitable new products and growth.

The other thing that needs watching is the tax rate, which increased from 8 per cent to 17 per cent on an adjusted basis, but remains low for a company that makes the bulk of its money from the US. This could continue to rise and represent a drag on earnings growth.

I am sad to part company with this very good business, but feel that having served the portfolios well it is perhaps less well placed to continue doing so.

Avon Rubber: current forecasts

	Year (£m) 2020	2021	2022
Turnover	212.2	281.8	297.8
Ebitda	47.3	64.2	68.9
Ebit	37.4	51.5	54.1
Pre-tax profit	35.3	50.6	55.4
Post-tax profit	27.6	40.7	44.5
EPS (p)	91.1	126.1	141.6
Dividend (p)	27.1	35.2	44.5
Capex	7.6	5.2	5.3
Free cash flow	16.3	34.1	42.4
Net borrowing	28.2	7.2	4.4

Source: SharePad

AJ Bell

The case for investing in the shares of **AJ Bell (AJB)** is very simple and straightforward: We need to save more as a nation and we need somewhere safe, reliable and cheap to do this. AJ Bell meets these criteria as does Hargreaves Lansdown, as long as you don't have a lot of money invested in open-ended managed funds, where in my opinion, the platform fees are very poor value for money and discriminate heavily against investors who choose to invest in them compared with shares, investment trusts and ETFs.

The other reason to invest is because it is a platform and platform businesses are very profitable once the business that is based on it has achieved sufficient scale. They have lots of fixed costs tied up in IT, staff and marketing. Once the profit contribution from revenues covers these costs, the additional sales are extremely profitable and quickly add up to a business capable of earning very chunky profit margins.

It is no surprise that some of the most profitable companies you will find listed on the London market are platform companies: Hargreaves Lansdown, Rightmove, AutoTrader, Moneysupermarket and AJ Bell are great examples.

When you have high profits and the prospect of growth that can maintain or even increase those profits, then you have the makings of a very profitable long-term investment. The high valuations that have been placed on the shares of platform companies is therefore unsurprising.

AJ Bell is managing the favourable economics of its business very well. It has grown its customer numbers by a healthy 52,070 to more than 295,000, which helped to bring in a net £3.4bn of money under management. It has been good at hanging on to its existing customers as well, with a 95.5 per cent customer retention rate.

This fed through to revenues growing by 21 per cent to £126.7m, with pre-tax profits growing by 29 per cent to £48.6m. The leveraging of fixed costs was shown in the pre-tax profit margin, increasing from 35.9 per cent to 38.4 per cent.

Assets under administration

Year ended 30 September 2020

	Advised platform £bn	D2C platform £bn	**Total platform £bn**	Non-platform £bn	**Total £bn**
As at 1 October 2019	33.8	11.1	**44.9**	7.4	**52.3**
Underlying inflows	3.6	3.0	**6.6**	0.1	**6.7**
Outflows	(1.6)	(0.9)	**(2.5)**	(0.8)	**(3.3)**
Underlying net inflows/(outflows)	2.0	2.1	**4.1**	(0.7)	**3.4**
Defined benefit inflows	0.8	-	**0.8**	-	**0.8**
Total net inflows/(outflows)	2.8	2.1	**4.9**	(0.7)	**4.2**
Market and other movements	(0.3)	0.2	**(0.1)**	0.1	**-**
As at 30 September 2020	36.3	13.4	**49.7**	6.8	**56.5**

Source: AJ Bell

It used some of its extra profits to invest more in IT and staff, which it needs to do to keep service levels high and keep customers happy.

Revenue

	Year ended 30 September 2020 £000	Year ended 30 September 2019 £000
Recurring fixed	26,618	25,395
Recurring ad valorem	72,422	63,095
Transactional	27,709	16,412
Total	**126,749**	**104,902**

Source: AJ Bell

Where I become uncomfortable with investment platforms is in how they make their money. For years platform companies pocketed trail commissions from fund managers for selling their funds on their platform (typically 25 basis points of the value of the customer's fund holding) and also received fees for advice (50 basis points), which in many cases they had not given. The advice fees were often used to cut overall management fees to bring more investors onto the platform and create a virtuous circle of revenue growth. Hargreaves Lansdown, in particular, did this brilliantly.

Trail commissions were banned some years ago, but the platforms somehow got around this by charging platform fees for managed funds based on a percentage of their value (ad valorem) and it continues to make them a lot of money. It is different for DIY investors owning shares, investment trusts and exchange traded funds (ETFs) who pay a modest fixed fee (which is increasing quite substantially next year).

The platform fee income from mutual funds accounts for 57 per cent of AJ Bell's revenue and while it looks safe for now, a regulator or competition authority could – and arguably should – look at it because to me there is no justification as to why customers should pay much higher fees for choosing an open-ended investment company (Oeic) or unit trust. It remains the reason why I will not own any as I refuse to pay the fees.

Trading revenues have surged this year and you have to think that they will fall back, which could make it hard for AJ Bell to grow its profits. Compared with Hargreaves Lansdown, which makes a revenue margin of 54.7 basis points, AJ Bell is making a margin of 23.9 basis points highlighting its cheaper fees overall.

It is encouraging to see that over half of new customers are coming from younger savers and is testament to the marketing and educational efforts that the company is putting in to woo them. This bodes well for future growth in customers and assets under management.

The long-term investment story here is a good one and explains to a large extent why AJ Bell's shares have held up well this year. At 444p, the shares trade on a 2021F PE of 51.6 times, despite the expectation of no profit growth for the next couple of years. As good a business as AJ Bell is, the shares look a little too expensive.

AJ Bell: current forecasts

		Year (£m)	
	2020	2021	2022
Turnover	120.1	124	133.9
Ebitda	56.8	49.2	52.4
Ebit	50.2	45.2	49.2
Pre-tax profit	46	44.1	46.9
Post-tax profit	35.9	34.4	38.1
EPS (p)	9	8.6	9.3
Dividend (p)	5.6	6.1	6.1
Capex	1.6	2	3
Free cash flow	33	36.1	40
Net borrowing	-85.1	-85.8	-96.2
NAV	96.9	108.1	120.9

Source: SharePad

Countryside Properties

As I've written recently, things look good for housebuilders at least until the end of next March. Then I think things will become more difficult. The end of Help to Buy in its current form along with a reduction in the availability of high loan to value mortgages and the end of the stamp duty holiday suggests that builders should make hay while they can.

The last year has been a difficult one for all companies in the sector and their results reflect this. I think they are best forgotten as a gauge as to what will happen in the future, but they contain useful lessons as to what can happen when an economy tanks.

Countryside Properties (CSP) has also been dealing with an activist shareholder, who has been asking for the chairman to be removed and the housebuilding business to be sold off in order to concentrate on the partnerships business. It looks as if they have got their wish with the release of the company's full-year results on Thursday.

By its own admission, Countryside believes it will struggle to grow the profitability of the house building division, but that its partnerships business – which focuses on affordable homes and the private rental sector on brownfield land – has much better prospects.

The company has set out some targets for completions, profit margins and return on capital employed (ROCE) until 2023. These margins look realistic given that they are very similar to what was achieved in 2019. Given that land costs are largely known, the ROCE figures will be possible as well.

	Partnerships		Housebuilding	
	2020	2023 target	2020	2023 target
Completions	3,213	c. 8,000	840	c.1,500
Adjusted operating margin	5.2%	15%	7.0%	18%
ROCE	13.0%	>40%	4.9%	>25%

Source: Countryside Properties

The only uncertainty is volumes where a lot depends on the economic climate. That said, given the challenging economic backdrop, the decision to focus on affordable and rented homes looks like a very sensible long-term strategy.

Countryside Properties: current forecasts

	Year (£m)		
	2020	2021	2022
Turnover	981.3	1,410.10	1,692.70
Ebitda	63.4	154.9	216.2
Ebit	54.4	152.9	223.7
Pre-tax profit	38.2	141.2	212
Post-tax profit	31.2	115.6	173.9
EPS (p)	6.4	21.6	32
Dividend (p)	-	6.4	11
Capex	5.1	7.9	6.8
Free cash flow	-175.9	-109.6	38.9
Net borrowing	-118	26.1	30.9
NAV	1,012.70	1,110.30	1,243.60

Source: SharePad

Given the disruption caused by the spring lockdown, it is not really surprising that Countryside has a record forward order book of £1,432m and is 70 per cent forward sold. This has given the company the confidence to say that it is on track to hit the upper end of consensus operating profit forecasts for 2021.

At 454p, the shares trade on a 2021F PE of 21 times and 2.2 times forecast net asset value (NAV). This looks pricey to me even in a good market – which it isn't.

At the moment, I have been slightly surprised that we have not seen any big impairments of land by housebuilders. This is telling us they are confident that current average selling prices are broadly sustainable. I'm not so sure about this, but have held this view for years. What might be different this time around is that the following winds from Help to Buy and cheap available

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mortgage finance becomes a headwind.

If that proves to be the case then Countryside's partnership business should prove to be one of the more resilient in the sector.

MJ Gleeson

Staying with affordable housing, **MJ Gleeson (GLE)** released a very bullish trading statement on Thursday morning. I am an admirer of this company's business model as it has very strong local footprints in the North and the North Midlands, where its affordable homes have plenty of buyers and limited competition from the bigger building companies.

I also like the company's ambitious building targets and how – Covid-19 aside – it has been very good at meeting them. It complements this well by buying and selling land.

The housebuilding business is doing very well. Building and sales activity is back to pre-Covid levels. It currently has 80 building sites in operation, compared with 64 this time last year and plans to add another 14 before the end of June next year. It is currently selling out of 65 sites, but will increase this as build rates on its new sites ramp up.

Demand for its houses is buoyant with average selling prices up by 9 per cent, compared with a year ago. The land business should meet profit expectations for the year.

The strength of home sales means that revenues for the half year to the end of December are expected to be up by 15 per cent and that profits for the year to June 2021 are now expected to be ahead of current analysts' expectations. Gleeson also reiterated its confidence that it will be delivering 2,000 homes per year by June 2022 (it did 1,072 last year and 1,529 in 2019). As a result, the reinstatement of the dividend sometime in 2021 is very likely.

This is very encouraging, especially given that most of Gleeson's customers are first-time buyers and so won't be impacted by the change in Help to Buy until March 2023.

Unsurprisingly, the market liked this update and pushed the shares 12 per cent higher on Thursday. At 784p and on pre-upgraded forecasts, the shares trade on 16.9 times the next 12 months' forecast EPS.

Regular readers will know my thoughts about this sector, but if you forced me to consider one share to own in it, Gleeson would probably be at the top of the list.

MJ Gleeson: current forecasts

		Year (£m)	
	2021	2022	2023
Turnover	237	313.60	353.6
Ebitda	30.2	44.7	52.4
Ebit	28	42.3	50.2
Pre-tax profit	27.5	41.6	49.4
Post-tax profit	21.7	33.9	39.9
EPS (p)	38	57.9	68.5
Dividend (p)	8.3	13.4	16.7
Capex	2.6	2.6	2.9
Free cash flow	1.3	4	18.2
Net borrowing	-16.9	-14	-23.7
NAV	228.70	255.80	287.1

Source: SharePad

London Stock Exchange

I first bought shares in **London Stock Exchange (LSE)** for my Sipp (now Fantasy Sipp) in February 2018 at just below £41 each. I did so not just for its dominant position as the operator of the London Stock exchange and with LCH for euro-denominated swaps trades, but also for its FTSE-Russell index and analytics business.

I like data businesses as data and the ability to analyse it and turn it into something is very valuable. Financial data is a growth business and one where there is very high pricing power for the providers because its customers cannot do their jobs without it.

This week's announcement that S&P is buying IHS Markit for $44bn demonstrates this value and the consolidation of the market that comes with it only strengthens the hands of the industry leaders. Wednesday saw LSE's share price surge as news reports suggested that the EU is minded to approve its $27bn acquisition of Refinitiv – a trading and financial data business which includes the very popular Refinitiv data terminals and services which used to trade under the name of Thomson Reuters. LSE has apparently done enough to allay the concerns of EU regulators that the deal is anti-competitive.

This is great news for LSE and its shareholders. The deal transforms the business and creates a company with revenues of over £6bn and profits of around £2.7bn. Throw in some decent cost savings and continued steady growth and this looks like a fantastic deal to me.

LSE shares at £86.72 look very expensive on 37.4 times 2021F EPS, but these forecasts don't include anything for the Refinitiv deal. Lots of new shares will be issued to pay for it, but back in November last year the company said it would deliver 30 per cent adjusted EPS accretion and cover its cost of capital after three years.

When all this gets reflected into the numbers, I feel confident that investors will see a unique, scarce business with compelling economics that is reassuringly expensive.

London Stock Exchange: current forecasts

	Year (£m) 2020	2021	2022
Turnover	2,418.20	2,522.10	2,685.90
Ebitda	1,321.70	1,373.80	1,455.40
Ebit	1,084.30	1,158.40	1,257.70
Pre-tax profit	1,057.70	1,028.20	1,119.80
Post-tax profit	723.8	873.1	871.7
EPS (p)	213.3	232.7	256.7
Dividend (p)	73.4	83.3	94.2
Capex	160.3	119.8	125.9
Free cash flow	774.5	968.8	1,234.00
Net borrowing	520.2	-267.6	-509.7

Source: SharePad

JD Sports

For me, **JD Sports (JD.)** has been one of the best retailers in the UK over the past few years. It has succeeded in finding a sales pitch that resonates with fashion conscious young people who want expensive trendy trainers and athleisure wear. Pre-Covid, the company was delivering very impressive rates of like-for-like sales growth in the UK and rolling out stores successively in Europe and Asia.

Its acquisition of Finish Line in the US has gone better than most expected and is making good returns for shareholders. Its purchase of Footasylum was blocked, but has now been cleared on appeal and should stack up well if JD puts its footprint on it. The CMA is appealing, but I think JD will still be able to own this business as the argument that Covid has changed the retail landscape towards direct selling online is hard to argue against.

JD Sports shareholders should be very relieved to hear that it did not end up buying Debenhams. I find it slightly concerning that it was even interested given that Debenhams has never recovered from one of the best examples of private equity sponsored corporate vandalism in recent times. Why anyone would want to take on its horrible rented store estate is beyond me, as a business such as JD will surely be able to pick up vacated stores in good locations and with favourable rents fairly easily elsewhere right now.

JD Sports: current forecasts

	Year (£m) 2021	2022	2023
Turnover	5,769.80	6,521.40	7,073.10
Ebitda	852	1,055.00	1,174.40
Ebit	367.2	545.6	635.1
Pre-tax profit	294.3	473.3	562.5
Post-tax profit	230.2	360.7	427.9
EPS (p)	23.2	37	44
Dividend (p)	0.6	1.9	2.6
Capex	168.2	248.8	278.2
Free cash flow	266	324.8	394.7
Net borrowing	156.6	-63.2	-174.9

Source: SharePad

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