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Phil Oakley's Weekly Round-Up

High conviction fund managers face an uphill struggle picking winners in a difficult UK stock market

The difficulties facing UK fund managers

Investing is difficult. I think the task of a UK fund manager being asked to put forward a diversified portfolio of 25-30 shares that can beat the market and importantly grow the buying power of its investors' savings is extremely difficult.

There are talented managers out there that have done this for a sustained period of time, but there are not that many of them.

In my view, this is down to the simple fact that the UK market faces a dearth of high-quality businesses that have sustainable growth prospects. I have written before that the FTSE 100 offers a menu of shares that I'd rather pass on with very few exceptions.

To beat the market you have to have a portfolio that doesn't look like it. This is where many professional fund managers go wrong. The thing is, it's not their fault. They are told not to stray too far from the market benchmark because if their judgement is wrong they will underperform the market and customers will withdraw their money and destroy the very profitable economics of fund management companies.

This puts the managers in an uncomfortable straightjacket on the road to mediocrity because they have to own so many mediocre companies. Even those who are given the freedom to follow the courage of their convictions and have a truly differentiated portfolio are only given the support to do so if they are winning. Short-term underperformance with a high conviction portfolio needs the support of your employers and sometimes plenty of patience.

It is no coincidence in my view that some of the best performing UK fund managers in recent years such as Mark Slater, Nick Train and Keith Ashworth Lord are essentially their own bosses. Managers such as Giles

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Hargreave and Richard Watts have done a great job working for someone else.

If you are a UK value investor then life has been very difficult. This is because many shares that are seen as being value aren't – they are bad or average businesses which deserve to have inexpensive shares attached to them.

At the moment, the cheap shares of businesses whose frailties have been exposed by Covid-19 are rallying strongly, while many expensive shares of better quality companies are selling off.

Hopefully, a vaccine will allow many businesses and people to get back to normal sooner rather than later, but I think investors need to tread carefully when it comes to cheap, battered shares.

I definitely see this current reflation trade continuing. Profits should improve and share prices will reflect this as it becomes more likely. Yet, what happens when a recovery is largely completed?

Many businesses that are currently seeing their share prices rising faced challenging business conditions before Covid-19 or have cyclical earnings. This presents a problem for value investors and the investors in UK shares in general.

The problem is that many of the shares are not long-term compounders of wealth. They do not have sustainable and growing earnings and cash flows. You can own the shares for a while and make good money from them if you are lucky, but you have to get out before the tide turns and then find another share to invest in and take the trading costs and efforts that go with this.

If you have the personal characteristics to do this, then all well and good but many of us don't. Buying and holding either passively through a good index or ETF such as the S&P 500 or selective good businesses as advocated over the years by investors such as Philip Fisher, Warren Buffett and Terry Smith has arguably been a better route to wealth building.

The problem with this approach as I have been banging on about for some time now is that the shares of good businesses are very expensive and offer very low starting rates of return on investment, even though interest rates are low. That said, I still see what they offer in the form of high profitability, consistent growth and low earnings volatility. This still make them a more comfortable and better long-term investment choice than a short-term recovery trade in value stocks.

That said, I have been taken aback by how strong the rotation trade from quality into value has been. A few

weeks ago, my UK Quality shares portfolio was almost back to breakeven for the year, while the FTSE All Share index was down by nearly 20 per cent.

Now, my portfolio is down by 8.8 per cent year to date and the All Share is down by 11.6 per cent. I am down by 4.3 per cent in a month and the All Share is up by 9.3 per cent. That is a significant relative underperformance.

It may also be a sign that this writer is not very good at picking stocks. Being an analyst or a commentator is a lot easier than being a manager. The same issue that explains why so many ex-football players seek the comfort of being a pundit rather than managing a team can be applied to analysts and financial journalists.

That said, my Fantasy Sipp, which is based on my actual Sipp that I used to run, has many of the shares that it had before I joined the Investors Chronicle. In 2017, I reconfigured it along the lines of the approach I outlined in my book. It has not done badly and been close to matching some very good managers.

I think one of the reasons it has been okay is because I took the decision to invest a large chunk of it in US shares where better businesses with better growth prospects can be found in abundance compared with the UK. However, I also have to say that despite the effort I have put into it, I would have been slightly better off buying Vanguard's S&P 500 ETF. Investing and stock-picking is hard.

Yet this is not the point of my weekly round-up. It is not intended to be a tip sheet or a fund to be copied. It is to align me, the writer, with some of the practical issues that face many of you, the readers. Combined with a weekly commentary and analysis of companies, I hope that many of you continue to find this approach useful.

The key event this week was the government's spending review. My short conclusion on it is this: If the country did not have the ability to print its own money, then the government would be bust now.

The level of borrowing over the next five years is expected to increase by around £850bn and even some experts reckon this projection is too low. How gilt yields and the value of sterling will cope with this is anyone's guess, but I find it deeply troubling.

Taxes will have to rise significantly and some uncomfortable questions on government spending on pensions, public sector employment and welfare need to be made, but probably won't be.

The simple truth as I see it is that you cannot have low rates of personal and company taxation with ever increasing levels of government spending. Sooner or later investors will not lend to you to plug the ever growing

fiscal deficits and you will not be able to print money to pay for it without destroying the currency in the process.

This is not meant to be alarmist rather it is a sober reflection on how I see things. I think that the country has been papering over the cracks for the past 50 years. Since the late 1960s, the productive, wealth-creating sectors of the economy with well paid blue-collar jobs have been whittled away. At the same time, the liabilities of the country on healthcare, pensions and welfare have gone up.

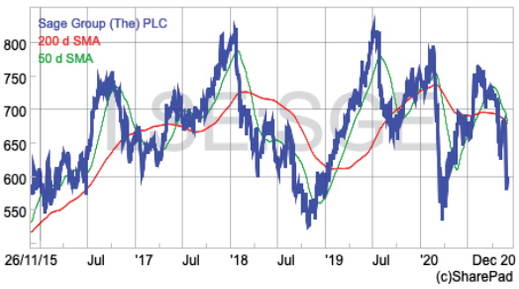
North Sea oil and gas revenues, selling of state-owned industries and a series of credit driven housing booms have kept the ship afloat. But if UK plc was a company, it would be one of falling profit margins, declining returns on capital employed (ROCE) and rising levels of debt. It will soon ask its shareholders – also known as taxpayers – for more money. Shareholders can insist on reform in return for their support; taxpayers only have this power every four or five years at the ballot box.

This dire state of affairs is why I continue to dislike the prospects of UK shares with mainly UK revenues, regardless of how cheap their shares might be and how much they might go up in the short run.

Fantasy Sipp & UK Quality shares performance

	Portfolio total returns (%)				
	1 month	Year to date	1 year	2 years	3 years
Scottish Mortgage Investment Trust	4.5	86.4	105.0	130.0	134.0
Smithson Investment Trust PLC	0.4	21.3	23.4	53.7	–
LF Blue Whale Growth Fund	-1.8	20.8	21.6	53.0	64.4
Martin Currie Global Portfolio Trust	2.1	19.9	24.4	50.7	52.9
Mid Wynd International Inv Trust	5.3	15.8	20.6	46.1	46.4
Fundsmith Equity T Acc	-0.4	14.5	15.8	39.0	47.8
Vanguard S&P 500 ETF	3.1	13.3	14.3	36.5	46.7
iShares MSCI World Acc	4.6	10.7	11.2	30.4	33.1
Phil Oakley Fantasy Sipp	**-1.7**	**6.7**	**9.6**	**39.1**	**45.4**
Lindsell Train Global Funds	2.4	5.7	5.8	24.7	41.3
Castlefield CFP SDL UK Buffettology	3.4	-1.4	1.6	18.8	28.0
Finsbury Growth & Income Trust	2.4	-4.3	-3.0	14.0	16.9
Phil Oakley UK Quality Shares	**-4.3**	**-8.8**	**–**	**–**	**–**
iShares FTSE 250	8.3	-9.3	-3.7	10.1	4.8
Vanguard FTSE 250 UCITS ETF	8.8	-9.7	-3.9	10.1	5.3
FTSE All-Share – Total Return	9.3	-11.6	-9.0	1.7	-1.0
Vanguard FTSE 100 ETF	9.3	-13.2	-11.1	-0.9	-2.7

Source: SharePad



Sage

I expressed my concerns about **Sage (SGE)** in last week's round-up when I replaced it with Intuit in the Fantasy Sipp. Sadly, I did not get rid of it from the UK portfolio, as last Friday's full-year results were very underwhelming. However, it was the outlook statement that did the damage.

I think Sage is doing the right thing with moving its customers towards subscriptions and the cloud, but it's something that it has to do rather than something that will transform its growth prospects or profitability.

Organic revenue growth for the year was 3.7 per cent and operating profits fell which, given that many of its customers have been struggling with lockdowns, is not too unexpected.

The problem is that its rivals Intuit and Xero have been growing much faster for a long period of time and are taking market share from Sage, which has seemed slow to adapt in comparison.

I feel people like me and some well-known fund managers have slipped up with Sage. I expressed my reservations about it with a detailed analysis of the company in the Investors Chronicle back in February and ignored it because of its very high profitability.

The uncomfortable truth is that you don't have to do too much digging around the internet to realise that Sage's products are not cutting the mustard with customers, especially new ones who are increasingly buying Intuit Quickbooks and Zero software instead.

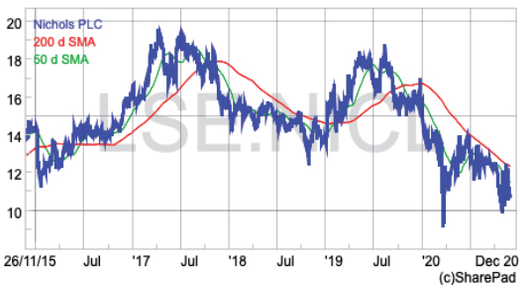
This very simple, but powerful, fact should be enough to keep most investors away from Sage shares, as it tells them that it has a weak competitive position relative to its peers.

Having dithered for too long, the shares left the UK portfolio on Friday. In a UK market where resilient, profitable and growing businesses are hard to come by, this left me with something of a problem.

Sage: current forecasts

	Year (£m)		
	2021	2022	2023
Turnover	1,874.70	1,974.40	2,102.00
Ebitda	419.7	457.5	474.2
Ebit	358.2	411.8	466.6
Pre-tax profit	350.7	400.1	420.4
Post-tax profit	256.1	296.1	649.8
EPS (p)	23.4	26.6	28.5
Dividend (p)	17.5	18.1	18.4
Capex	32.7	34.6	42.9
Free cash flow	289.4	336	427
Net borrowing	23	-90	-294.4

Source: SharePad



Nichols

I decided to replace Sage with **Nichols (NICL)**. It is a business that I have written favourably about in the past, but one where the valuation looked a bit too high relative to its modest growth outlook.

The company is going through a bit of a tough time along with the rest of the soft drinks sector right now, as revenues from pubs, clubs and hotels have dried up. This is reflected in the share price, which is down nearly 30 per cent year to date at around £11, compared with £19.50 in 2017.

Nichols is dominated by the Vimto brand, which has been a tremendous organic growth story for many years. Vimto has a unique recipe that is applied to fizzy, still and slush drinks and sweets. It has stood the test of time and, in my view, is capable of keeping up its growth in more normal times. A strong UK business is complemented with good sales of Vimto into Africa and the Middle East.

The company's other brands are Feel Good Drinks, which is based around premium health drinks. This business has not been doing as well as hoped and the value of its assets was written down recently. Noisy drinks specialises in frozen drinks such as slushes.

Nichols also makes US drinks Sunkist and Levi Roots Caribbean fruit drinks under licence.

The company adopted an outsourced production and distribution model some time ago and concentrates on recipes, ingredients and marketing. This makes it very profitable with high profit margins of over 20 per cent, high returns on capital and plenty of free cash flow. Even this year it has managed to grow its net cash balance.

I do like the fact that this is a business that is managed for the value rather than just the volume of sales. Unlike many peers, it hasn't entered into aggressive promotional pricing to gain market share, although Vimto has been successful in this regard nonetheless.

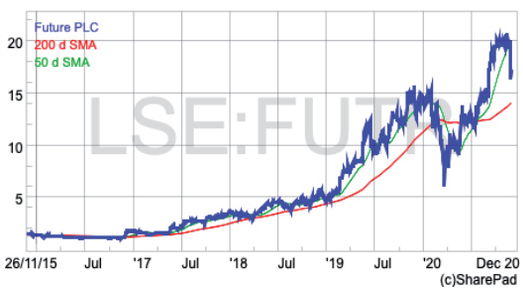
I think this is a business that will bounce back, but I am prepared for a tough winter and to wait a while for a recovery. If the company can get back to its 2019 profitability of 72.8p earnings per share (EPS), then at my in price of £11.125 that would equate to a PE of 15.3 times, which I think would be very good long-term value for a business like this.

The influence of the Nichols family on the board of directors in a non-executive capacity is a plus for me. I am also not put off by the imminent departure of the chief executive after seven years, as she is being replaced by the chief operating officer who has been with the business since 2013 and knows it well.

Nichols: current forecasts

	Year (£m) 2020	2021	2022
Turnover	121.8	137.9	145.2
Ebitda	20.6	29.8	33.9
Ebit	16.1	25	29.1
Pre-tax profit	14.2	24.3	29.5
Post-tax profit	13.1	20	24.1
EPS (p)	36.1	55.7	64.5
Dividend (p)	34.9	37.2	38.9
Capex	3	4.1	4.1
Free cash flow	13.7	21.6	23.9
Net borrowing	-45.3	-53.5	-61.9

Source: SharePad



Future

Future (FUTR) shares have been a fantastic investment in the past few years. Generally speaking, media and publishing is a very tough industry to be in, especially print titles. Future has been very successful in creating a scalable digital media business, largely by acquisition.

Investors are rightly suspicious of acquisitive companies, as they can mask weak organic growth and declining business and give no end of opportunities for creative accounting. Future has been the target of short-sellers who have pointed fingers at the integrity of its business model and accounts. I'll have more to say on this shortly.

The business is made up of two divisions. The media business is based around websites and engaging content. The company has some of the best known websites in areas such as technology, gaming (PC Gamer) and sports.

The aim here is simple: It is to create content that engages people and brings more traffic to the website in order to sell digital advertising. In addition, the company is trying – with some success – to create a profitable e-commerce business where it takes commissions from businesses that sell via their website. It has invested heavily in IT to develop price comparison services so that website visitors can get a better deal.

Future's media revenues largely come from the following sources:

- Advertising
- Paid content
- Ticket sales from Events
- E-commerce
- Email newsletters in the US

The magazines business is dominated by special interest magazines in the UK, with tiles such as *Classic Rock*, *FourFourTwo*, *What Hi-Fi*, *PC Gamer*, *Music Week* and *Procycling*. The business has been built by acquisition with TI Media being bought in 2019 for £140m. TI's profits are dominated by magazines such as *TV Times*, *What's on TV*, *Country Life* and *House & Hound*. TI is regarded in industry circles to have too much cost and it will not surprise them that Future has already found £20m of costs to cut.

Future is not just a business that is buying stuff to cut costs. There is a sound business strategy to grow digital advertising backed by heavy investment in IT to leverage the launch of new digital titles and websites.

Judging by this week's full-year results, the company is doing a good job. Revenues and profits were up sharply due to acquisitions, some impressive organic growth in media and the benefits of operating leverage.

£m	FY 2020	FY 2019	YoY Var	Organic YoY Var
Revenue				
Media	237.3	154.9	53%	23%
Magazines	102.3	66.6	54%	(29%)
Total	**339.6**	**221.5**	**53%**	**6%**
Gross contribution[1]				
Media	203.9	127.2	60%	31%
Magazines	62.8	41.4	52%	(32%)
Total	**266.7**	**168.6**	**58%**	**14%**
Total GC %	***79%***	***76%***	***+3ppt***	***+5ppt***
Gross profit[2]	**176.6**	**106.5**	**66%**	**24%**
Gross profit %	***52%***	***48%***	***+4ppt***	***+8ppt***

£m	FY 2020	FY 2019	YoY Var	Organic YoY Var
Revenue				
US Media	157.5	104.5	51%	27%
US Magazines	10.2	14.3	(29%)	(28%)
US Total	**167.7**	**118.8**	**41%**	**19%**
UK Media	79.8	50.4	58%	16%
UK Magazines	92.1	52.3	76%	(29%)
UK Total	**171.9**	**102.7**	**67%**	**(7%)**
Total	**339.6**	**221.5**	**53%**	**6%**

Source: Future

When you are looking at an acquisitive company you want to see some evidence of organic revenues growth, which is the lifeblood of any good business. Future's 6 per cent growth last year scrubs up pretty well on this metric.

It's not all rosy in the garden, though. Magazines have had a horrible year, with revenues down sharply and organic profit contribution down by nearly a third. This does make me wonder what the returns of the TI Media acquisition currently look like if cost savings are excluded.

Digging into the results statement, we can see that the actual cost of TI was higher than stated at the time when £140m consideration also included £83m of net debt. TI is currently making annualised operating profits of £23.8m, giving a return on investment of 10.6 per cent, which is not too bad, but far below the return on underlying operating assets.

Given my general – but not total – lack of enthusiasm for UK-focused businesses, the fact that the US business now accounts for 43 per cent of total revenues is another plus for investors, in my view.

It's also good to see that the company is investing money in writers to maintain and improve the content that it offers, as the business cannot survive and prosper without them.

If you look at some of the key financial performance metrics of Future, it seems there's a lot to like. I don't like the fact that the company thinks share-based payments are not a real cost and this flatters its profits slightly. However, its impact on profits is much smaller in 2020, with £5.5m against £9m last year.

Future: Financial performance

(£m)	2020	2019
Revenues	339.6	218.7
Op Profit	93.4	52.2
Net profit	72.9	41.2
Free cash flow	73.4	45.1
Invested Capital	489	318
Operating Capital	129.3	99.3
Ratios		
Op margin	27.5%	23.9%
FCF margin	21.6%	20.6%
FCF Conversion	100.7%	109.5%
ROCE	19.1%	16.4%
ROOCE	72.2%	52.6%

Source: SharePad

A quick calculation of some key financial ratios paints a good picture of Future. It is highly profitable and converts its profits into free cash flow. The cash flow performance is also not boosted by any significant working capital

inflows, which are often wrongly perceived as a source of permanent free cash flow and value.

For an acquisitive business, ROCE of 19.1 per cent is very good and return on operating capital employed (ROOCE) is very impressive. I've not yet had a deep dive into Future's accounts, but apart from lots of acquisitions – and the one-off cost savings that boost profits – I am not getting a lot of red lights flashing in my face, but that doesn't mean there aren't any.

I fully understand why some people might be worried about this week's proposal to buy GoCo – the owner of the Go Compare price comparison website for an EV of around £663m (£594m in shares plus £69m of forecast net debt). The new shares being issued would account for 37 per cent of Future's current market capitalisation, which gives some feel as to how big this deal is relative to the value of the existing business.

There seemed to be a view expressed on Twitter that the premium offered on GoCo's share price was small and that this was Future getting the business on the cheap. I don't think it is at all. Goco is expected to make £35m in operating profit in 2021, which will increase to £45m with £10m of cost savings. This gives a return on investment of 6.8 per cent. Of course, with growth this return can increase.

That said, price comparison websites are a fairly mature market and while GoCo's motor insurance business has done well with its auto switching service, AutoSave, this deal looks like a lot of money being spent for not a lot in return. Future is also proposing to give away 19 per cent of its business to GoCo's shareholders for the privilege which would annoy me if I were a shareholder.

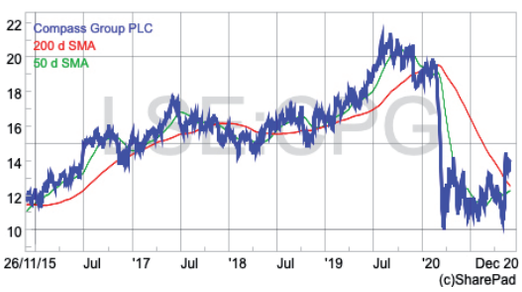
I struggle to be really critical of this business as it has some good assets and a decent strategy. That said, it operates in tough markets and digital advertising has some fierce competition. My concern with this company is that acquisitions make it hard to find out what's really going on underneath and that makes me feel slightly uncomfortable about it.

The size of the Go-Co acquisition and the amount of new shares being issued makes Wednesday's share price sell-off quite understandable. Ignoring the financial impact of the deal for now, at 1,675p, the shares trade on 20.3 times the next year's earnings. That does not look expensive for a highly profitable business that is growing, but the quality and sources of growth is all important and Future's latest deal has muddied the waters somewhat here.

Future: current forecasts

	Year (£m) 2020	2021	2022
Turnover	331.5	440	451.6
Ebitda	95.3	118.4	124.4
Ebit	82.3	100	106.5
Pre-tax profit	82	104.4	110
Post-tax profit	68.5	82.8	89.5
EPS (p)	67.3	82.7	88.1
Dividend (p)	1.5	1.9	2.6
Capex	6.2	6.9	8.9
Free cash flow	63.1	83.5	95.1
Net borrowing	72.4	-8.6	-100.5

Source: SharePad



Compass Group

In more normal times **Compass' (CPG)** contract catering business has proven to be very reliable. It doesn't have very high profit margins, but a growing number of contracts to provide catering services at hospitals, schools, universities, sporting events and workplaces across the world had served long-term investors well.

With over a third of revenues coming from workplace canteens, Covid-19 has been a disaster for this business. Full-year results saw revenues fall by nearly 20 per cent to £20.2bn, with profits falling by nearly two-thirds to £680m. Thanks to raising £2bn from shareholders during the year, the financial position of the company is not dangerously stretched with £3bn of net debt equating to 2.1 times annual earnings before interest, tax, depreciation and amortisation (Ebitda).

Compass shares have rallied 27 per cent in the past month in anticipation that a vaccine will allow it to get back to business as usual. This is not going to be easy or quick.

Despite some improvement in the last quarter of last year where good cost management has got the business back into profit again and at cash breakeven, Compass still faces major headwinds.

Organic revenue trends

By Sector	Q1 2020	Q2 2020	Q3 2020	Q4 2020	2020
Business & Industry	4.4%	(3.8)%	(50.7)%	(44.1)%	(23.9)%
Education	4.4%	(5.1)%	(60.2)%	(35.1)%	(21.7)%
Healthcare & Seniors	5.4%	5.5%	(5.1)%	0.2%	1.5%
Sports & Leisure	9.0%	(10.9)%	(89.9)%	(78.9)%	(45.1)%
DOR	4.3%	1.0%	(8.8)%	(7.6)%	(2.9)%
Group	**5.3%**	**(2.1)%**	**(44.3)%**	**(34.1)%**	**(18.8)%**

Source: Compass

Home working looks like it is here to stay, at least for some part of the working week. Online learning may also become more commonplace going forward. Sports venues will also take time to open again. Compass also faces competition from food delivery companies both to workers at home and in offices.

The company is adapting with its own delivery services and still has major competitive strengths in the form of its buying power, in-house food preparation and global reach.

Looking further out, just under half of the estimated $220bn global food services is still provided in-house, which means that the outsourcing opportunity is still there, especially in sectors such as healthcare and education.

The key uncertainty is how fast this will materialise in a world where working habits might not get back to being the same as they were before.

A bounce back in profitability is likely, but progress will probably be slow. First-quarter operating margins for the current financial year are expected to be around 2.5 per cent, compared with over 7 per cent last year. The company is not expected to get back to making £1.9bn of trading profits until at least 2024, but current analysts' consensus forecasts are for it to be fairly close to doing so by 2023.

Compass remains a very solid, well-managed business, despite its current difficulties. Whether the shares will command the same valuation on fully recovered profits as they did not so long ago has to be questioned. At 1,400p, they trade on 45 times 2021F EPS, falling to 23.5 times 2022F EPS. Without forecast upgrades, a further share price bounce should not be counted on.

Compass: current forecasts

	Year (£m)		
	2021	2022	2023
Turnover	20,536.80	23,591.50	24,756.50
Ebitda	1,588.90	2,191.90	2,539.60
Ebit	907.7	1,481.00	1,764.10
Pre-tax profit	638.7	1,416.00	1,585.80
Post-tax profit	549.1	1,053.70	1,199.20
EPS (p)	30.9	59.6	68.4
Dividend (p)	18.5	31.2	36.4
Capex	736.9	777.5	897.5
Free cash flow	591.6	1,121.60	1,247.50
Net borrowing	2,368.80	1,653.50	1,297.40

Source: SharePad

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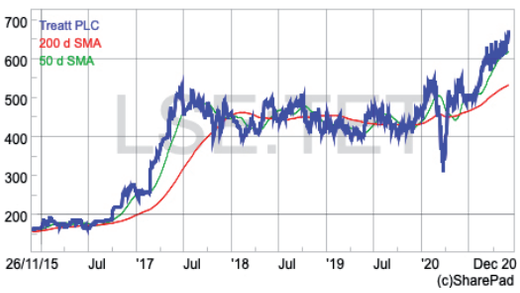


Treatt

Long-term readers of my weekly round-ups will know that I like **Treatt (TET)** as a business, but I don't think it will be as profitable or cash-generative as it used to be. I've also been a little unimpressed by its revenue growth rate in recent years.

I took the view that it was a good example of how old assets can flatter profits and returns on investments. Back in May when the shares were trading at 508p, I thought they were too expensive on a trailing 12 months (TTM) PE of 28.9 times.

My caution seems to have been misplaced.

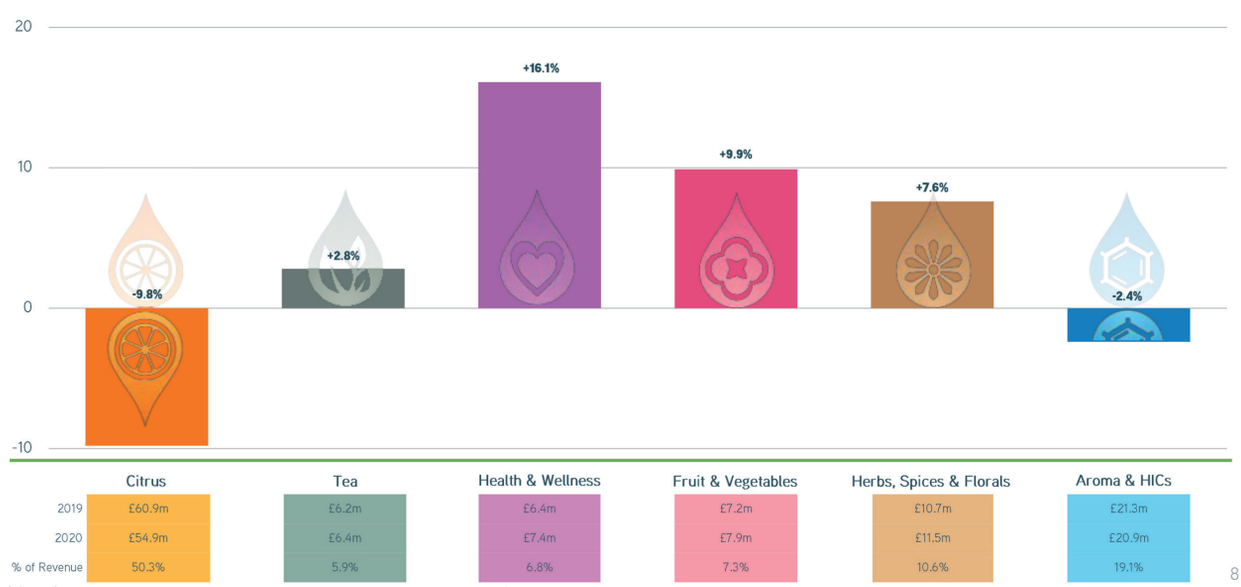
At the time of writing, the shares are 669p, which equates to 33.9 times trailing EPS. The reason being is that Treatt is doing very well and could continue to do so.

The company is reducing its reliance on commoditised citrus flavours and fragrances that go into drinks, beauty and household products. The business has been positioned to take advantage of changing consumer preferences such as natural flavours, reduced sugar, reduced alcohol and ready to drink products. The pace of new product innovation remains encouraging and should get a nice productivity boost from the new UK facility that should open some time next year and a new Chinese subsidiary.

While revenues declined by 3.3 per cent last year, their quality and profitability increased significantly.

PRODUCT CATEGORY PERFORMANCE

% Growth in Sales[1] - 2020 v 2019



Source: Treatt

Citrus revenues declined but premium flavoured products performed well. Other categories saw decent growth with health and wellness (sugar reduction products are a major part of this) the star performer. This improvement in revenue mix saw gross profit margins improve by 380 basis points. Despite investing in staff (a good thing), operating margins improved from 12 per cent to 13.8 per cent, which fed through to an operating profit of £15.1m and an 11.3 per cent increase in pre-tax profit to £14.8m. The total dividend for the year increased by a very healthy 9 per cent to 6p per share.

Treatt is very bullish on the capacity and efficiency gains that it will get when it relocates to its new premises in Bury St Edmunds. The cash spent on building it contributed to a free cash outflow of £11m last year, which all but eliminated the company's net cash position. There will be another free cash outflow next year, but net debt is expected to peak at around 0.5 times Ebitda, which suggests a figure in the region of £10m-£11m that is higher than current analysts' forecasts but nothing to worry about.

The company reckons that once the relocation is complete, it should be capable of achieving operating margins of 15 per cent and a ROCE on the new facility of 20-25 per cent. Both are good numbers and if achieved would be a very good result.

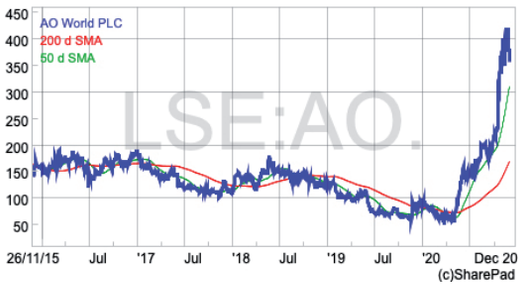
Despite being highly valued and with expectations for modest revenue growth of around 5 per cent per year going forward, Treatt shares have not sold off like many shares with similar characteristics. I think they could continue to serve long-term investors well and I might even reconsider them for the UK quality shares portfolio over the next few weeks.

This is a scarce, niche business that is performing well. We saw last week with Croda's acquisition of Iberchem that a flavours and fragrances business can sell for high valuations but Iberchem is growing a lot faster than Treatt right now.

Treatt: current forecasts

	Year (£m)		
	2021	2022	2023
Turnover	115.1	122.2	128.5
Ebitda	20.1	22.2	23.8
Ebit	15.8	16.8	18
Pre-tax profit	15.6	16.7	18.4
Post-tax profit	12.6	13.4	14.8
EPS (p)	20.9	22.3	24.5
Dividend (p)	6.2	6.6	7.5
Capex	8.6	2.4	2.9
Free cash flow	4	10.3	11.6
Net borrowing	4.6	-7.5	-17.5

Source: SharePad



AO World

Back in October last year when **AO World (AO.)** shares were relatively unloved and priced at 65p, I wrote that I could see a path to a higher share price if it ditched its loss-making European business. I never thought for a second that the share price would be 356p just over a year later.

AO has got out of Holland and has revitalised its German business, which is now on course to make a profit in 2022. However, it is in the UK where it is making hay.

One of the best ways to understand any business is to be a customer of it. My customer experience of AO was a good one. From price to delivery performance and all round customer service it has been so much better than John Lewis and it seems that I am not alone in this.

That said, AO was given a huge windfall with lockdowns in the spring. While many of its bricks and mortar rivals had to close, it picked up a large chunk of the revenues that would have gone to them.

With a surge in sales volumes and significant operating leverage (due to its fixed costs), the impact on profits has been impressive. Back in March, AO was making 60,000 deliveries per week; it is now making 150,000. With losses in Germany coming down sharply, half year pre-tax profits came in at £18.3m this week, compared with a loss of £5.9m last year.

Suppliers love businesses that can give them a source of volume growth and AO is now benefiting from improved terms from theirs. This is seen starkly in improved payment terms (it is being given a longer time to pay its suppliers) and a huge one off cash inflow during the first half of the year which along with improved profits saw the business generate free cash flow of £78.6m, compared with an outflow of £4.9m last year.

Despite bricks-and-mortar stores opening up again, AO has held on to its market share gains. The second half of the year has started well, with increased delivery capacity seeing an acceleration in the revenue growth rate. Business sales are also looking healthy with increased sales to housebuilders and an initial trial with Tesco.

AO is clearly a brand on the up and the company is investing heavily to keep the momentum in its business. The operational gearing in this business has the potential to see significant profit forecast upgrades as revenues keep on growing which could see the share price at least hold on to its stellar gains.

However, it's difficult to see the company's current valuation as being anything but very rich. Forecast post-tax profits of £35.8m for the year to March 2021 are

expected to increase to £60m in 2023. This equates to a 2023F PE of 28 times, based on current market capitalisation of £1.7bn, which looks like a lot of good news is priced in.

AO World: current forecasts

	Year (£m) 2021	2022	2023
Turnover	1,479.00	1,558.30	1,737.70
Ebitda	63.7	74.6	91.6
Ebit	45.5	59.1	76.1
Pre-tax profit	44.1	50.9	68.4
Post-tax profit	35.8	44.2	59.3
EPS (p)	7.5	8.6	11.4
Dividend (p)	-	-	-
Capex	7.5	8.1	5
Free cash flow	80.5	54.3	65.6
Net borrowing	-42.5	-83.7	-189

Source: SharePad

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