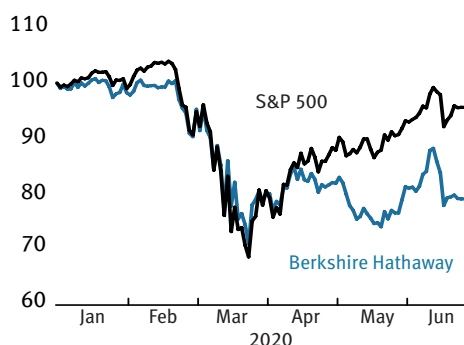




## Phil Oakley's Weekly Round-Up

*Warren Buffett has been an inspiration to investors, but his way of getting rich can't be copied by most people*

### In 2020, Buffett has underperformed the tech-heavy S&P 500



Source: FactSet & Investors Chronicle

### Why investors need to move on from Warren Buffett

Warren Buffett has been an inspiration to many investors. His annual reports have been a joy to read and have made complicated businesses such as insurance quite understandable to the layperson.

He is lauded for his accumulation of wealth from investing, but sadly I feel that Mr Buffett has little to offer to today's investors. I don't mean this to sound unkind, but more to point out that his way of getting rich can't be copied by most of us – namely by using the cheap leverage of insurance company float and owning companies outright – and that trying to buy good businesses for reasonable prices is not working for him or anyone else.

Many say that the absence of a major acquisition by Berkshire Hathaway in recent years is a sign that Buffett thinks that the market is overvalued. Others such as me might argue that this is a sign of someone who has failed to adapt to a changing world.

I look at Berkshire Hathaway's portfolio of listed shares and owned businesses and I'm not sure I'd want to own any of them. The reason is the pretty poor returns, high leverage and low growth that comes from banks, insurance, railroads and utilities.

However, it is Buffett's failure to embrace the businesses of today and tomorrow in areas such as technology that are clouding his legacy. He has known Microsoft founder Bill Gates for years, has never owned the shares, but bought Apple which remains over-reliant on the iPhone instead. I have much more faith in the ability of Microsoft's software and cloud computing services to grow in value over the next decade than I have in Apple's handsets.

There is no doubt that quality growth stocks are very highly priced right now, but at least quite a few of them

Alpha Production Editor: Sameera Hai Baig

have the all-important ability to grow their revenues and profits in the years ahead. Without the prospect of growth it is very difficult to generate big gains from owning shares by holding on to them for a long time.

More and more investors in recent years have woken up to the fact that buying shares that look statistically cheap relative to profits or assets can be a daft way to invest their money. This is because they are buying the shares of fundamentally poor or weakened businesses that will struggle to grow and more often than not become cheaper still.

Today's successful investors have to be bold and buy strong businesses with great products and services where growth can be scaled to become ever more valuable over the next five to 10 years or even longer. And they have to be prepared to pay very high valuations for the privilege.

Recognising this – as well as the need for an optimistic outlook – is the most important investing lesson I have learned in recent years. It is just another way of realising that with so many things in life you get what you pay for. Buy cheap, buy twice is true with so many tangible things. A £50 bottle of single malt whisky is likely to give the drinker more satisfaction than a bottom of the shelf supermarket own label offering that strips the enamel off your teeth.

There are of course limits to how much you should pay up for shares, but in a low interest rate and low inflation world that limit has increased, as future cash flows are more valuable in today's money.

A share with a free cash flow yield of 3 per cent that can grow at more than 10 per cent a year in a world where there are non-existent returns on cash and government bonds can make you a lot of money if you are patient.

Don't get me wrong, I fully get and sympathise with the views of those that point out that all is not well with the world economy and that the central bankers have rigged the world's financial markets in favour of its players.

It could all go wrong with a major currency crisis, the return of inflation and the collapse of company profits, or we might just get away with it.

The thing is, if these disastrous events come to pass, where do you want to have your money? Some might make a case for gold, but all you will ever own is the same amount of gold. It might preserve the amount of stuff you can buy with it, but who knows?

The reason I remain cautiously optimistic is because I believe that the investor will still be best served by owning high quality growth businesses that have the ability to defend what they have and continue to prosper.

These are the businesses I am trying to own shares of in the Fantasy Sipp and while I admit I probably don't have enough tech shares or healthcare shares, I am reasonably confident that the businesses in there can do a good job of growing in value in most states of the world. This does not mean that this will stay that way and I am quite happy to change the holdings as I discover more attractive businesses.

I've heard that some of you want to see the current stock weightings of my two fantasy portfolios. They are shown below and will be added to the Alpha website for you to check on as you wish.

#### Fantasy Sipp weightings as of 18 June 2020

Company	%
Microsoft Corp	5.3%
Mastercard Inc	5.2%
Costco Wholesale Corp	5.0%
Pepsico Inc	4.9%
Amazon.com Inc	4.9%
Moody's Corp	4.7%
RELX	4.5%
Visa Inc	4.5%
Walt Disney Co (The)	4.4%
Avon Rubber	4.4%
Paychex Inc	4.3%
Croda International	4.3%
National Express	4.3%
McDonalds Corp	4.3%
James Halstead	4.2%
Diageo	4.0%
Unilever	4.0%
London Stock Exchange	4.0%
Spirax-Sarco Engineering	4.0%
Sage Group	4.0%
Reckitt Benckiser	3.9%
Intertek	3.5%
Smith & Nephew	3.2%
Cash	0.2%
Source:SharePad	

### UK Quality Shares weighting as of 18 June 2020

Company	%
Avon Rubber	5.0%
Experian	4.8%
Ashtead Group	4.8%
Spirax-Sarco Engineering	4.8%
Moneysupermarket.com	4.6%
London Stock Exchange	4.5%
Croda International	4.3%
RELX	4.3%
Bioventix	4.3%
Unilever	4.1%
James Halstead	4.1%
Reckitt Benckiser	4.1%
Auto Trader	4.0%
Rightmove	4.0%
Diploma	4.0%
Intertek	3.9%
Smith & Nephew	3.9%
Diageo	3.8%
Sage Group	3.8%
Howden Joinery	3.7%
Greggs	3.4%
JD Sports Fashion	3.3%
National Express	3.1%
Forterra	2.6%
Hollywood Bowl	2.5%
Cash	0.3%

Source: SharePad

### Fantasy Sipp & UK Quality shares performance

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	9.0	28.7	43.1	42.0
LF Blue Whale Growth Fund	4.2	13.5	15.4	37.3
Smithson Investment Trust	6.9	11.7	19.4	
Fundsmith Equity T Acc	3.3	6.8	7.7	27.2
Vanguard S&P 500 ETF	7.2	3.7	12.0	26.0
Mid Wynd International Inv Trust	6.0	3.5	14.4	22.2
Lindsell Train Global Funds	4.2	3.1	0.6	21.2
Martin Currie Global Portfolio Trust	5.7	1.8	8.9	26.1
<b>Phil Oakley Fantasy Sipp</b>	<b>5.9</b>	<b>1.4</b>	<b>7.6</b>	<b>25.4</b>
Finsbury Growth & Income Trust	6.4	-6.2	-4.9	7.3
<b>Phil Oakley UK Quality Shares</b>	<b>9.9</b>	<b>-8.3</b>	<b>-</b>	<b>-</b>
Castlefield CFP SDL UK Buffettology Fund	7.8	-10.4	-3.0	5.7
Vanguard FTSE 100 ETF	6.5	-15.2	-10.7	-10.5
FTSE All-Share - Total Return	7.3	-15.5	-10.1	-10.9
Vanguard FTSE 250 UCITS ETF	9.0	-19.5	-6.6	-12.2

Source: SharePad



The Fantasy Sipp is doing alright this year to date, but no more than that. It is suffering from its relative lack of tech exposure, but over the past two years is holding its own quite well with some of the best quality funds out. That said, I continue to note how well investors have done by owning a very cheap S&P 500 ETF.

The UK Quality Shares portfolio has had a strong month, but a rough year to date. As I have said in recent weeks, the economic hit from Covid-19 has exposed some of my stock-picks for their lack of resilience and some with hindsight can be seen as mistakes. I may make some changes over the next few weeks and will update you if I do.

### Cake Box

**Cake Box (CBOX)** is a franchiser of posh cake shops selling premium egg-free cakes. It has expanded rapidly and had 133 franchised stores owned by 70 franchisees at the end of March 2020.

Franchises can be very profitable for the franchisor. The franchisee takes on most of the costs of running the business and pays a royalty fee to the franchisor which is usually based on its revenues.

Cake Box is set up in a very similar way to Domino's Pizza. Not only does it get paid royalties from the franchisee's sales, but the franchisee also has to buy the cake ingredients from Cake Box. As with Domino's, the key driver of Cake Box's profits will be the margin it earns on ingredients sales rather than royalty revenues.

The key thing to understanding the investment proposition of a franchising operation is whether the economics stack up for the franchisee. If they can't make a decent living from running a cake shop or the franchisor gets too greedy with its profit margins then the business model can unravel.

When I first looked at this business back in 2018, I thought that the returns on investment for a franchisee looked very attractive. The average store that had been open for over a year was making an annual earnings before interest, taxes, depreciation and amortization (Ebitda) of £97,000, compared with an initial outlay of £125,000 to set up the franchise. Pardon the pun, but with economics like this you can see why people who could afford it would want a slice of it. The return on investment looks better than an average Domino's Pizza store in the UK.

### Estimated returns for mature franchised stores

£000's	Cake Box	Domino's Pizza
Sales	297	1050
Ebitda	82	149
Margin	27.6%	14.2%
Investment Cost	125	300
ROI	65.6%	49.7%

Source: Companies/Investors Chronicle

I note with interest from the latest Cake Box annual results presentation that the average annual Ebitda is now quoted at £82,000. That's quite a sharp fall in such a short time. Are franchisees seeing their profits squeezed or is it a sign that the newer sites have less attractive store economics?

The franchisees seem to be doing okay. Like-for-like (LFL) sales increased by just over 5 per cent for the period up to 8 March 2020, the final three trading weeks of the year, so the impact of Covid-19 kicked in and LFL sales growth for the year was 2 per cent, compared with 6.5 per cent the year before.

Internet sales have been going very well and a new trial of cake kiosks in 12 locations is seeing similar average weekly sales to stores, but with a much lower capital outlay. Since the year-end, the company's internet offer has been beefed up as it has teamed up with Uber Eats, Just Eat and Deliveroo.

Given the LFL sales growth and 20 new openings, franchisee sales in the past year have been good and have increased by 19 per cent to £35.5m. This has fed through to 10.8 per cent sales growth for Cake Box to £18.7m. Gross profit margins were also higher as it sold more cake sponges to its franchisees, which come with higher profit margins than other ingredients.

Despite this, the company blamed higher costs from being a listed company for a full year for there being no growth in profits. Earnings per share (EPS) was down by 1.3 per cent to 7.8p and no final dividend was declared due to the uncertainties caused by Covid-19. Its annual operating profits of £3.8m are no higher than they were 18 months ago, which is a little bit disappointing.

The company has invested in the business with a new warehouse in Bradford and another one to open in Coventry in the second half of 2020. This should bring down the cost of delivering ingredients to franchisees and help profit margins, which are still above 20 per cent.

Shareholders will hope that profits can start growing again. In the past, the company has talked about targeting 250 stores in the UK, while the success of the kiosk trial suggests that there is further growth potential from new formats.

It is encouraging to read that 75 per cent of its stores are now trading at pre-Covid-19 levels and that LFL sales in the first week of June were higher than a year ago.

Cake Box looks a fairly decent business to me and is making high returns on capital of 32.7 per cent, but it needs to show that it can grow its profits. Granted, the lockdown has not helped, but with modest LFL sales growth, new store openings and the efficiencies from its new distribution investments, it looks like there is a platform to get profits growing.

### Cake Box: current forecasts

	Year (£m) 2021	2022
Turnover	23.4	26.6
Ebitda	6.2	6.9
Ebit	5.6	6.4
Pre-tax profit	5.8	-
Post-tax profit	4.6	-
EPS (p)	11.3	12.6
Dividend (p)	5.7	6.3
Capex	0.7	-
Free cash flow	4.3	5
Net borrowing	-5.4	-8.2

Source: SharePad

At 172p, the valuation of the shares suggests that growth needs to come through. The shares trade on 22.1 times March 2020 EPS, falling to 15.3 times on March 2021 estimates. The jump from 7.8p EPS last year to 11.3p next – 44.9 per cent – looks a bit too big to me and I expect forecasts will need to be revised downwards.

### Domino's Pizza

Pizza delivery is a business that is well suited to thrive in an economic lockdown when restaurants are closed. Therefore it was no surprise to see **Domino's Pizza (DOM)** report a fairly robust sales performance from its UK business this week.

LFL sales from 23 March to 14 June, which take into account the impact of split territories (where new stores have opened in an area with an outlet already), increased by 5.1 per cent, up from 2.3 per cent in the first quarter until the end of March.

The performance in Ireland – which is a relatively small part of the business – was not so good (perhaps due to harsher lockdown conditions) and saw LFL sales, which fell by 2.5 per cent in the first quarter, tumble by a further 9.2 per cent.

The problem for Domino's is that the reasonably good performance from its UK business is not going to help it grow its profits this year. Like most retailers that have kept





on trading during the lockdown, it has had to spend more money to do so and this is eating into profits.

There has also been a change in the make-up of its orders. It should not be forgotten that the vast majority of Domino's profits come from the sales of pizza ingredients to its franchisees. When people order more sides and desserts, these are often made and provided by others and so the profit margins are not as good.

These two factors mean that the company's adjusted Ebitda for the half year to June will be lower than it was in 2019.

### Domino's Pizza: current forecasts

	2020	Year (£m)	
		2021	2022
Turnover	531	588	565.5
Ebitda	116.7	119	124.9
Ebit	106	106.9	113.2
Pre-tax profit	100.8	102.3	109
Post-tax profit	83.7	84.9	91
EPS (p)	17.8	17.9	19.3
Dividend (p)	7.9	10.2	9.6
Capex	28.1	27.1	27.5
Free cash flow	80.5	71.7	76.5
Net borrowing	201.4	180.9	154.7

Source: SharePad

Domino's shares had been a decent performer so far this year but, as with supermarkets, defensive revenues have not led to higher profits for shareholders.

The problem with its franchisees has also not been resolved, while my concerns about its split territories strategy still remain. Getting out of Europe has cleaned up the business and improved the quality of earnings, but until investors can have renewed confidence in the resumption of a profitable roll-out of new stores that keep franchisees on side, the shares are unlikely to make much progress, in my view.

### MJ Gleeson

Regular readers will be aware that I am no fan of the housebuilding industry. However, if I was to consider owning one stock in it, then **MJ Gleeson (GLE)** would probably top the list.

This is because it really is the only listed builder with a business model based on affordable housing in the north of England and the Midlands. This is backed by a strategic land business that has done a good job in recent years of buying up land in the more expensive south and selling it on to its peers with a decent profit.

Covid-19 has dealt a hammer blow to the sector which has downed tools over the past few months. The good





news is that Gleeson's building sites and show houses are nearly all up and running again which should allow for some profit recovery next year.

The year to the end of June 2020 has been a rough one. Revenues are likely to be around £145m, compared with £249.9m last year, and profits will be well down.

The good news is that during the last two weeks, reservations are back to 70 per cent of pre-Covid-19 levels. What's even better is that price increases are being achieved with low levels of incentives (such as stamp duty paid or part-exchange schemes).

Mortgage lenders are also not valuing down properties, which is something they tend to do when the housing market or the economy has a wobble.

That's not to say they won't eventually do so and with new-build premiums at historic highs recently there's grounds for thinking they might. The Nationwide Building Society has tightened up mortgage lending to first-time buyers and now demands a 15 per cent deposit. This should not worry housebuilders like Gleeson selling a lot of homes through the Help to Buy scheme, in which the taxpayer puts in 20 per cent equity to make sure that lenders can rest relatively easily in their beds at night.

The company will enter the 2020-21 financial year with a much bigger order book due to delayed sales. It currently stands at £135.2m on 940 plots, compared with £87.6m on 677 plots a year ago. No strategic land sales are expected in the near future.

As with all housebuilders, it is going to take some time before the previous levels of selling activity return. Gleeson's market positioning at the cheaper end gives it more resilience, but further weakness in the UK economy could see margins fall heavily and significant land value write-offs.

#### Gleeson: current forecasts

	2020	Year (£m)	
		2021	2022
Turnover	145.3	252.3	294.9
Ebitda	9.4	37.2	46.5
Ebit	8.4	36.1	45.4
Pre-tax profit	8.9	37.1	47
Post-tax profit	8.4	30.4	38.6
EPS (p)	11.7	50.8	63.7
Dividend (p)	7.2	23.1	27.8
Capex	1	2	2
Free cash flow	-30	18	34
Net borrowing	-13.9	-17.2	-20.5
NAV	192	227	265

Source: SharePad



Current consensus forecasts suggest that in 2021 the company will be back to a similar level of revenues and profits as it was in 2019, and then continue with its strategy of growing annual sales volumes. This is quite a rosy outlook and would value the shares at 13.7 times 2021F EPS and 1.8 times forecast net asset value. That's no bargain which makes me think that the strong recovery seen in the shares since their March lows has run far enough for now.

### Ashtead

**Ashtead (AHT)** is one of my favourite UK-listed cyclical businesses. You know that it will take a bit of a battering when the economy goes into recession and chunks of its plant and equipment get returned to it, but it is exposed to favourable long-term trends that should add value for investors who hold on through the rough patches. It is part of my UK Quality Shares portfolio.

The company has a leading position in the US equipment market with only one significant national competitor in the form of **United Rentals (NYSE:URI)**. A healthy construction market along with investment in US utility and telecom infrastructure has seen good demand for Ashtead's equipment assets and good rates of organic revenue growth.

The market is also very fragmented with lots of smaller private operators that can be bought up and integrated into Ashtead's existing businesses. The company wants to try and replicate this business model in the Canadian market.

Ashtead makes its money by buying equipment and renting it out to construction companies, special events, facilities maintenance, local authorities and emergency services – things like aerial platforms, forklift trucks, tools, diggers, cranes, power generators, fencing, barriers and pumps. In the US, these assets can be rented out to generate returns on investment of more than 20 per cent and the hope is that Canada will get to this level of return in the next few years. The UK market is oversupplied and has low returns, and Ashtead is sensibly slimming down in this market.

I see Ashtead as a fantastic savings account where you can deposit new money (invest) and get a 20 per cent rate of interest. The caveat is that you won't always get returns like this every year as economies turn down from time to time.

One of those times is now, but Ashtead's full-year results this week were very reassuring. Its fourth-quarter profits from January to April took a big hit, but underlying rental

revenues in the US still increased by 6 per cent for the year and the ROI on assets was still 21 per cent, compared with 24 per cent the year before.

Pre-tax profits for the year were only down by 4 per cent and EPS was largely unchanged at 175p. Encouragingly, the company maintained its final dividend at 33.5p per share.

2020-21 is not going to be easy as US fleet revenues were still 14 per cent lower on a LFL basis in May than a year ago. The good news is that the fleet on rent has started to grow again. However, this is a business with lot of fixed costs and therefore a lot of operational leverage which can put a lot of downwards pressure on profits when revenues fall as they have been. The year 2021 is likely to see much lower profits from Ashtead because of this.

The great advantage that Ashtead has at a time like this is that it can cut back its investment capex, hold onto its existing assets for a little bit longer than it usually does (average fleet age has increased from 34 to 36 months), generate lots of free cash flow and pay down debt. This will put it in a good position to grow again when the economy recovers.

Capex is expected to be £500m this year before disposal proceeds, compared with £1.4bn last year and an annual depreciation expense of just over £1bn. Even with lower profits, free cash flow should increase and debt should come down nicely.

#### Ashtead: current forecasts

	2021	Year (£m) 2022	2023
Turnover	4,686.90	5,002.80	5,232.00
Ebitda	2,095.80	2,283.40	2,392.70
Ebit	1,001.20	1,196.00	1,292.10
Pre-tax profit	697.2	988.7	987.5
Post-tax profit	667.8	807.5	904.5
EPS (p)	121.2	166.3	189.5
Dividend (p)	40	45.4	57.2
Capex	405.9	1,070.60	1,453.70
Free cash flow	1,356.20	813.6	577.1
Net borrowing	3,705.00	3,024.80	3,405.10

Source: SharePad

The shares have rallied hard this week on the back of rumours of huge US infrastructure spending as a way of stimulating the economy. At 2,665p, the shares trade on 22 times forecast EPS, which will hopefully represent trough earnings. I remain optimistic on the long-term potential of the company and am happy to leave the shares in the UK Quality Shares portfolio for now.



## Kingfisher

In the late 1990s and early 2000s, B&Q was a highly respected retailer that could seemingly do no wrong. Then it got into a prolonged battle to buy out the 45 per cent stake in French DIY company Castorama in 2002, which it eventually coughed up £3.2bn for, and things have been tough ever since with a few false dawns.

It has been hit by recessions and a change in consumer habits that has seen them pass on DIY projects and get a tradesperson in to do jobs instead. In my view, it has one great asset in Screwfix where the company doesn't disclose its financial performance, but a quick look at Companies House accounts shows how good it is.

Screwfix (£m)	2019
Revenue	1684
Operating profit	178.1
Margin	10.6%
Capital employed	730.9
ROCE	24.4%

Source: Companies House

If we then compare this to **Kingfisher's (KGF)** business as a whole – (note I have not adjusted Screwfix's capital employed for rented stores whereas the whole business includes them) then you can see the difference in financial performance – in particular, its operating margins.

## Kingfisher: key numbers

£m	2020	2019
Revenues	11513	11685
Operating profit	717	747
Inv capital	8828	9267
Inv cap ex goodwill	6412	6831
FCF	46	286
Operating margin	6.2%	6.4%
ROCE	8.1%	8.1%
ROCE ex goodwill	11.2%	10.9%
FCF margin	0.4%	2.4%

Source: Annual report/Investors Chronicle

Various chief executives have had a go at fixing Kingfisher by trying to cut cost, cut inventory and buy better and not had much success at returning the business to sustainable sales growth.

Retailing is a complicated and fascinating industry and is hard for practitioners to get right. What seems to be working right now is a discounter model based on selling lots of products at low profit margins and running a very lean business.

Stores tend to be smaller rather than larger and the

number of products being offered to customers is cut right down to allow for much more concentrated buying (fewer shopkeeping units or SKUs), which means lower prices can be passed onto customers.

Kingfisher is a long way from this, which makes me doubt that it can be fixed. However, the potential value of Screwfix intrigues me and makes me wonder if there is any way this could be unlocked to make Kingfisher shares worth buying.

#### Kingfisher: main store characteristics

Trading business	Avg store size (sq m)	SKUs 000's	2019-20 LFL sales
B&Q UK & Ireland	7,500	20-40	-2.9
Screwfix	65	10-35	5
Castorama France	12,400	40-50	-3.3
Brico Depot France	6,900	10-15	-3.1

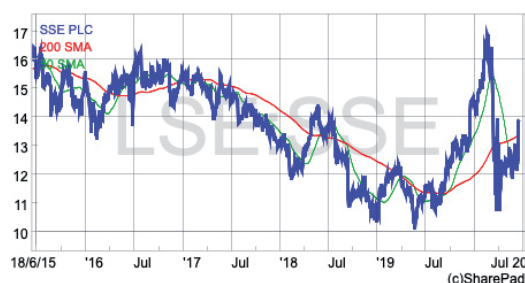
Source: Kingfisher

My big concern is that the big DIY sheds that characterise B&Q and Castorama in France are just millstones around the company's neck. Even though the Covid-19 lockdown has seen the general public embrace DIY again, it is unlikely to be sustainable to make these big DIY sheds earn their keep with decent returns on capital.

Screwfix is a different matter. It is my go to place for DIY tools and products as the service is so slick. The product range and quality is great and stock availability is generally very good. Ordering over the internet is easy and often I can complete the whole process from start to finish with a short drive, easy parking and no queuing in less than half an hour.

Yet Screwfix does this out of an average store size that is less than a tenth of the size of a B&Q store. It is also the only part of Kingfisher that has been capable of delivering sustainable organic revenue growth. If I look at other trade-focused businesses such as Howden Joinery, which currently trade on about 13 times historic operating profits, then putting Screwfix on a slight premium to this (say 14 times due to faster growth and more diverse end markets) could see it command an enterprise value (EV) of £2.5bn, compared with Kingfisher's current total EV of around £7.1bn.

Spinning off Screwfix could be a good thing to do, but may not be straightforward in practice. It will probably benefit from Kingfisher's combined buying power and could be less profitable on its own. This is a shame because I think it could be a great success and might prompt a more focused and radical restructuring of the rest of the group.



### Kingfisher: current forecasts

	2020	Year (£m) 2021	2022
Turnover	11,452.90	11,061.30	11,262.20
Ebitda	1,206.00	1,004.80	1,187.40
Ebit	752.7	676.7	739.1
Pre-tax profit	588.9	501.2	571.5
Post-tax profit	427.4	327.5	398.9
EPS (p)	20.2	15.6	19.1
Dividend (p)	3.5	1.2	8.4
Capex	358.8	269	357.9
Free cash flow	397.3	284.7	362.9
Net borrowing	2,510.20	2,272.90	1,014.20

Source: SharePad

Sadly, I do not see this happening anytime soon, but I don't rule out a financial buyer trying to break this company up one day.

At 210p, Kingfisher shares trade on a 2021 forecast PE of 13.5 times, which looks about right to me.

### SSE

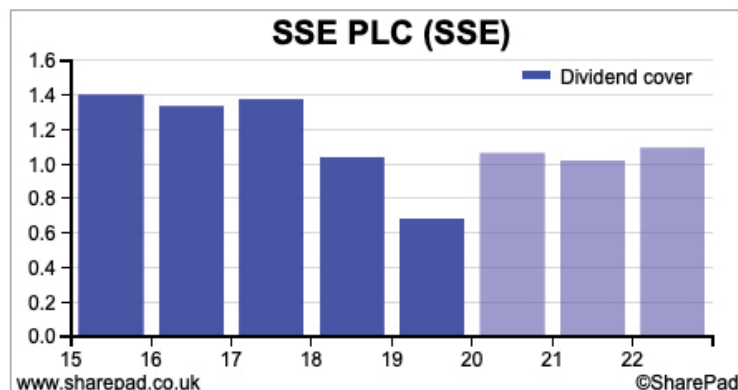
For many years, utility company **SSE (SSE)** was a slave to a dividend it could not really afford. It made hay on the back of buying cheap and old coal-fired power stations in the 2000s, pocketed the windfall from free carbon credits and used them to Hoover up lots of domestic energy customers and did quite well for a while.

When that game ended and making money from generating electricity got more difficult, it faced many years of stagnating profits and rising debts kept increasing its dividend. It finally cut it when it sold its domestic energy business to Ovo Energy in January this year. It is also getting out of the gas production business.

It has made good on its promise of declaring a total dividend of 80p per share for the year to March 2020, but this was barely covered by EPS of 83.6p. Despite a target to increase dividends by the RPI measure of inflation out to 2023, I think this is by no means certain.

The coming year's profits are going to be under pressure from the impact of the lockdown, which is reducing demand for electricity and seeing increased customer bad debts. This should be temporary, but then the company may see the electricity regulator take a big bite out of its profits when it reviews prices for its transmission business in 2021 and its distribution businesses in 2023.

I would not be surprised to see SSE pay an uncovered dividend this year based on where its profits are going. Dividend cover based on current forecasts looks pretty thin to say the least.



The bull case for the shares is that its transmission and distribution networks are part of a future world where we are likely to need more electricity connections. Its wind farms also play a big part in reducing carbon emissions.

SSE is forecasting that the regulatory asset value (RAV), which it is allowed to earn a return on, could grow from £9.1bn currently to £12bn by 2026. Combined with some big investments in wind farms, it will spend £7.5bn on new assets in total.

This will see already high debt levels climb further and this needs to be underpinned by acceptable returns on investment. If they are then SSE could become a steady dividend payer with some growth, but don't rule out it being from a lower payout than shareholders are receiving now.

#### SSE: current forecasts

	2020	Year (£m) 2021	2022
Turnover	7,508.00	7,214.40	7,402.00
Ebitda	2,030.50	2,371.40	2,120.60
Ebit	1,344.20	1,646.20	1,399.90
Pre-tax profit	1,036.50	1,112.60	1,089.10
Post-tax profit	856.5	888.1	886.6
EPS (p)	83.2	84.2	88.8
Dividend (p)	78.1	82.1	81
Capex	1,446.60	1,263.50	1,592.50
Free cash flow	87.2	1,047.00	271.7
Net borrowing	10,434.40	9,968.00	11,242.20

Source: SharePad



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