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Phil Oakley's Weekly Round-Up

Risks facing investors from political developments are rising fast

Political risk is rising

I don't usually discuss politics openly, but I will this week as I think the risks facing investors from political developments are rising fast.

The resurgence of coronavirus across Europe is deeply troubling. As I write this, Agence France Presse has said that France may go to maximum virus alert from 5 October. Meanwhile, in the UK, the government seems to be behaving like a rabbit in the headlights and confusing people at the same time. It says it does not want a second lockdown, but the risks of one seem to be increasing by the day.

If this happens then I fear for how the UK economy will cope with it and whether the general public will be as compliant as it was back in March. The risks that this brings to the economy, company profits, government borrowing and the value of the pound cannot be ignored. The ongoing trade talks with the EU add another source of anxiety.

In the US, millions of people watched or listened to the most unedifying presidential debate in history in which both participants showed their electorate the dire choice facing them on 3 November.

Most experts think that Biden will win, but I never underestimate the "it's the economy stupid" argument and that many voters will choose the candidate who they see as being best for their wallet. If the experts are right then there is a good chance that Trump may not accept the result and this has the potential to cause chaos. A Biden government may also raise taxes on consumers and businesses and it's hard to see this as being good for the fortunes of the US stock market or other stock markets around the world.

We are getting a lot of company results to look at right now and there seem to be three common themes to take

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from them. Firstly, there are companies that were expected to deliver good results and they did. Secondly, companies that are recovering – and there are quite a few – and raising profit forecasts. Thirdly, there are companies that have been hit hard and are saying they can't see a clear path to better days ahead.

Quality growth stocks are holding up pretty well, while the enthusiasm for tech seems as strong as ever. I also think that the scope for nimble traders to make quick big gains in some companies is quite good. Forecasts on some companies are so conservative because the impact of coronavirus made it hard to predict the future with any accuracy. Therefore an improvement in trading conditions can see profit forecast upgrades and a nice move upwards in share prices. Diageo is a case in point this week, while Halfords shocked the market in a good way on Thursday with a very strong trading update as the cycling boom continues.

Elsewhere, things still look very grim. British Airways is rumoured to be fighting for its very existence, while Rolls-Royce has announced a £2bn rights issue to keep it alive. These shares contain a lot of risks.

What is interesting is the beginnings of some takeover activity which might support the UK market or sections of it. Both William Hill and G4S are high-profile bid targets and more could follow as money is so cheap right now.

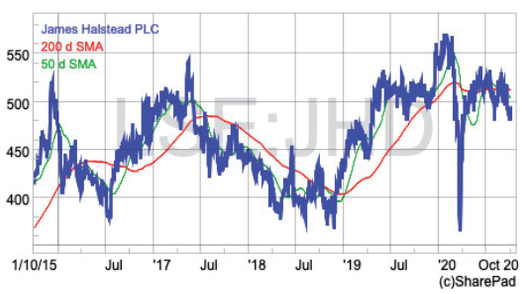
We are three-quarters of the way through the year and both fantasy portfolios have performed fairly well over the summer. At the end of June, the Fantasy Sipp was up 1.2 per cent year to date with UK portfolio down 9.9 per cent. The FTSE All-Share was down 17.3 per cent.

Three months later, the Fantasy Sipp year to date is up 8.7 per cent, the UK portfolio is down 5.6 per cent, while the All-Share Index is down 19.8 per cent. I am much happier with the make-up of both portfolios and am pleased that the Fantasy Sipp has now edged ahead of the S&P 500 ETF as well.

Fantasy Sipp & UK Quality shares performance

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	1.38	68.7	94.2	81.3
LF Blue Whale Growth Fund	0.4	23.1	24.2	39.2
Smithson Investment Trust	2.14	17.9	22.6	
Fundsmith Equity T Acc	1.4	13.7	13.4	28.9
Martin Currie Global Portfolio	3.1	12.8	18.4	32.2
Mid Wynd International Inv Trust	0.769	9.3	14.5	24.8
Phil Oakley Fantasy Sipp	**1.2**	**8.7**	**13**	**35.2**
Vanguard S&P 500 ETF	-0.652	7.7	9.09	20.2
Lindsell Train Global Funds	3.1	5.6	1.4	16.1
Phil Oakley UK Quality Shares	**2**	**-5.6**	**–**	**–**
Finsbury Growth & Income Trust	1.14	-5.61	-8.91	6.87
Castlefield CFP SDL UK Buffettology	-0.1	-8.4	-0.2	3
FTSE All-Share – Total Return	-1.6	-19.8	-16.5	-14.3
Vanguard FTSE 100 ETF	-1.3	-20.2	-17.7	-14.5
Vanguard FTSE 250 UCITS ETF	-3.28	-21.1	-12.3	-11.5

Source: SharePad



James Halstead

James Halstead's (JHD) results for the year to June were fairly solid. They were affected by economic lockdowns for three months, which took the shine off a very strong performance up until March.

Sales were down 5.7 per cent to £238.6m, with profits before tax down by 9.2 per cent to £43.9m. The final dividend was maintained at 10p per share, giving a total of 14.25p (14.0p in 2019) for the year.

The company estimated that if its business had continued with the same strong trading performance it had experienced up until March, then sales would have been £25m higher, with profits around £7m higher.

This is a very well-managed business. Its main commercial brand is its Polyflor vinyl flooring product, which is used extensively in buildings such as schools, hospitals, airports, shops, leisure facilities, public buildings and factories. It is known for its hard-wearing and safety properties.

Amongst the company's other brands is Karndean, an upmarket vinyl flooring tile used in homes. In overseas markets, the company sells other branded flooring under the names of Objectflor and Expona. I've just had some Karndean vinyl tiles fitted in a bathroom and I can only say that the quality is top notch.

As well as the quality of its products, the company places a strong emphasis on after-sales and service quality as a way of giving it a competitive edge. James Halstead is operating in a business where a large chunk of its sales comes from refurbishment and repairs. By looking after its customers it is able to secure a significant amount of repeat business and therefore

recurring revenues, with the aim of generating significant customer goodwill that enhances the value of the company over time. Evidence suggests that it has been very good at doing this.

Customer engagement has become my main focus when weighing up a company these days. The repeat revenues and brand building that come from it are immensely valuable and can give companies a significant competitive edge. It's a key reason why companies such as Spirax-Sarco, Games Workshop, Frontier Developments and Costco have done so well. Looking after your customers seems like common sense, but so many companies – big and small – just fail to get this right.

Sales were down across most markets last year but held up quite well in Europe, while the Canadian business continued its excellent track record of sales growth. Nordic markets and India were the main areas of soft demand.

Profits actually went up in Asia due to a more profitable sales mix and good cost control. Stock levels and debt collection were well controlled, but there was a squeeze on payables due to lower sales levels. The swing in payables cash flows saw overall cash flow take a big hit, but there was just about enough money to pay the dividend. The company remains in rude financial health with net cash balances of £67.4m – down around £1m from a year ago – and is still making a return on capital employed of more than 26 per cent.

The company's competitive positioning seems to be very good and may get better when we eventually come out of the Covid crisis. A couple of years ago I was slightly concerned about the increase in competition in European markets, but this does not seem to be a problem at the moment.

The Polyflor brand is doing well and the company has introduced new products such as Polyflor Quicklay (tiles that don't need glue). Loose laying tiles are a growth area for the company and it is good to see that it has the products to exploit this trend.

Current trading is good and on a par with the record trading performance at the same time last year. Refurbishment demand (repeat sales are a key reason to like this business) is buoyant in places like hospitals, but is weaker in areas such as catering and hospitality. Looking further out, I do think there is a possibility that demand from retail outlets may fall as consumers continue their shift to online shopping.

With a bit of good fortune –no second lockdown in the UK – the company should be able to grow its revenues and profits in the coming year and years ahead.

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James Halstead: current forecasts

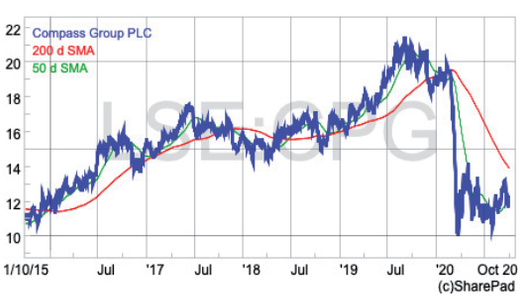
	Year (£m) 2020	2021	2022
Turnover	248.8	256.2	252.6
Ebitda	50.5	54.3	54.1
Ebit	47.3	50.6	49.6
Pre-tax profit	46.4	49.7	49.2
Post-tax profit	39.4	41.3	-
EPS (p)	17.4	18.6	18.4
Dividend (p)	9.6	12.6	9.4
Capex	8.5	8.5	-
Free cash flow	27	32.8	-
Net borrowing	-68.4	-95.4	-114.1

Source: SharePad

At 495p, the shares are not cheap and trade on 30 times trailing EPS, falling to 26.6 times if 2021 forecasts are achievable (given they are around 2019 EPS then that's not an unreasonable assumption at the moment). This is the going rate for very good businesses right now and I don't see that changing while bond yields and inflation stay low. The key risk is that company profits have to keep growing.

This is a business that I like for so many reasons. It has strong brands, market positions and a customer-focused culture. It also has very clean accounts as I've never seen them report adjusted profits. It is in both fantasy portfolios, but if I'm being brutally honest then it hasn't done them much good from a performance point of view.

It has been in the Fantasy Sipp since January 2018. The average cost price is 437p and with dividends it has delivered a return of 15 per cent, which is steady but not great. That said, it's a company that I can sleep soundly with and I see no reason why it cannot grow in value over the next five to 10 years.



Compass Group

In a world without Covid-19 and the problems for businesses that come with it, **Compass (CPG)** is a company that can potentially offer a lot for long-term investors.

It has become a global powerhouse in contract catering providing meals in places such as schools, hospitals, staff canteens and sports and leisure facilities. By building up a growing portfolio of contracts and managing them well it has been able to deliver respectable results to investors.

Right now, the company is in a bad place. With many people working from home and schools and universities having been shut for months, 2020 is going to be a very bad year for it. Sales in the third quarter between March and June fell by 44 per cent and then fell by 36 per cent in the last quarter between June and September. Sales for the

year to September 2020 are expected to be down by 19 per cent.

In more normal times, this is a business that makes operating margins of 6-7 per cent. It also has a lot of revenue visibility from its contracts, which makes it a business that people can understand and feel relatively comfortable.

Margins for the year that has just ended will be around 3 per cent. At the moment, the business has got itself back to a position of breakeven after suffering losses over the summer. The problem is that it has very little visibility as to when things will get better and is the kind of business that must be having sleepless nights over the potential of another lockdown.

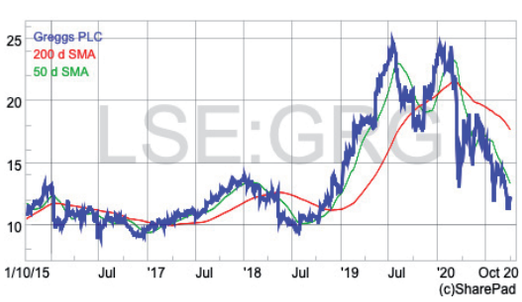
The unpredictable outlook has seen the company write down the value of some of its contracts to the tune of £100m. This is not unexpected but it shows how hard things are for it right now. Further right offs are very possible.

If further lockdowns are avoided and the world starts to see a decent economic recovery, then Compass is a share that could offer some decent upside from here. It will take a brave and patient investor to buy in right now, but the shares have fallen a very long way – down 37 per cent this year – and while forecasting future profits is hard, I can see a path to a much higher share price over the next couple of years.

Compass Group: current forecasts

	Year (£m) 2020	2021	2022
Turnover	20,316.50	21,569.10	24,181.30
Ebitda	1,230.70	1,746.90	2,266.60
Ebit	581	1,079.50	1,568.90
Pre-tax profit	528.8	962.9	1,515.30
Post-tax profit	381.1	749.6	1,120.30
EPS (p)	22.2	41.4	64.6
Dividend (p)	0.6	18	32
Capex	610.9	712.6	793.7
Free cash flow	-331.3	1,018.50	1,198.30
Net borrowing	2,879.10	2,233.00	1,730.50

Source: SharePad



Greggs

2019 was the year of the vegan sausage roll and soaring sales and profits at **Greggs (GRG)**. Just like Compass, it's business has been hammered by the chaos caused by Covid-19 and it might not get back to where it was before if working from home becomes the norm for lots of people.

Greggs has always been a well managed and adaptable business. In recent years it has successfully relocated

many of its shops away from high streets where footfall has been falling for years to places where it has been growing – bus and railway stations, airports and university campuses – but these locations have now been hammered by lockdowns, too.

While Greggs has opened up its shops again and will add around 20 more to its estate this year, sales are still down by a quarter, compared with a year ago. This means that some shops are not going to make enough profit to keep them viable, and sadly this means that some Greggs employees are likely to lose their jobs.

The main worry is that Greggs' business has suffered a permanent loss of value because of Covid and the changes that people are likely to make to their working and leisure habits.

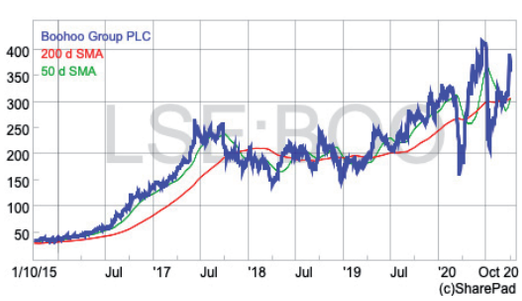
The company is looking for other ways to drive sales such as selling its products through Just Eat for home delivery as well as launching a click-and-collect service. I think these could pay off in time, but I struggle to find Greggs shares compelling right now.

I put them in a similar camp to Compass. A return to normality could see a big rise in the share price, but the risks are high.

Greggs: current forecasts

	Year (£m) 2020	2021	2022
Turnover	781.80	1,057.90	1,185.50
Ebitda	59.70	184.90	231.9
Ebit	-54.9	70.70	116
Pre-tax profit	-61.6	60.60	107.4
Post-tax profit	-50.8	49.70	87.5
EPS (p)	-48.6	47.7	84.4
Dividend (p)	2	17	39.6
Capex	54	81.8	85.2
Free cash flow	-71.3	51.60	85.9
Net borrowing	183.90	204.70	150.7

Source: SharePad



Boohoo.com

On the face of things, **boohoo (BOO)** has the hallmarks of an outstanding business. It has developed a portfolio of fashion brands that clearly connect with its target customer base of 16-40 year olds. It has been particularly successful in targeting different segments of the market at different price points and can arguably keep on doing so, With £345m of cash sitting on its balance sheet, it's a question of when, not if it makes more acquisitions to add to its stable of brands.

Half-year results announced this week were very good, with sales up 45 per cent and operating profit up by 49.6 per cent when share-based payments are counted as a real cost of doing business (which boohoo and many

businesses clearly don't, but I and many others do).

UK sales were up by a very impressive 37 per cent, but its overseas growth is where the real gains are being made with this business. US sales were up by 83 per cent. Overseas sales now account for 47 per cent of total sales, compared with 38 per cent three years ago.

Delivering this growth costs money, but the company is generating loads of cash flow to pay for new warehouses and automated warehouses and beefing up its logistics capability.

The share price has almost recovered from the trouncing it took back in July when a *Sunday Times* article claimed that boohoo was being supplied by workshops in Leicester paying people less than half the minimum wage in conditions with poor social distancing.

Boohoo has strenuously denied these claims, but is undertaking a review of its supply chain and went to great lengths this week to show investors what it has been doing with it.

I don't think it's unfair to say that the company has found some things it would rather not have found and has put its hands up and is setting about putting things right. It will be reducing the number of suppliers – hopefully without reducing the capacity of the business to grow – and banning the use of subcontracting by those that remain.

Whatever has gone on here, this situation just looks like bad management and I think it is stretching things a little to believe that senior management did not know what was going on.

I think you also have to ask what non-executive directors (NEDs) have been doing as well. Good and diligent NEDs get to know a company well and keep their fingers on the pulse. I can't help thinking that some are just there to nod, tick boxes and take the cash. Hopefully, the company will quickly put this issue to bed and move on.

It has been very candid in explaining to investors that it sells dresses for £5 and cannot make money on them if they are made in the UK. Customers love these products, though, for obvious reasons and usually don't even think about how they can be sold so cheaply. Primark is questioned regularly about this and boohoo is in the same camp for some of its products and that seems perfectly understandable.

The company remains very bullish in its outlook for growth and is guiding to 25 per cent sales growth at 10 per cent earnings before interest, taxes, depreciation and amortization (Ebitda) margins for the next few years. By the end of 2022, its investments will have created the

capacity for 46m stock units and net annual sales of £3.6bn. To put this into context, the company will probably do around £1.6bn of sales in the current financial year.

Location	Description	Completiton Date	Stockholding Capacity	Net Sales Capacity
Burnley	Extension & Automation	April-19	17m units	c. £1.4bn
Sheffield	Mezzanine fit-out and flooring	Aug-20	12m units	c. £0.9bn
Sheffield	Automation	CY 2022	12m units	c. £0.9bn
Burnley	Future Options	CY 2022	~5m units	c. £0.4bn
Total			**~46m units**	**c. £3.6bn**

Source: Boohoo

Current profit guidance for the company would see it make operating profits (before taking away share-based payments) of £138m in this year at the high end of the range. I expect it to do this and possibly beat these estimates.

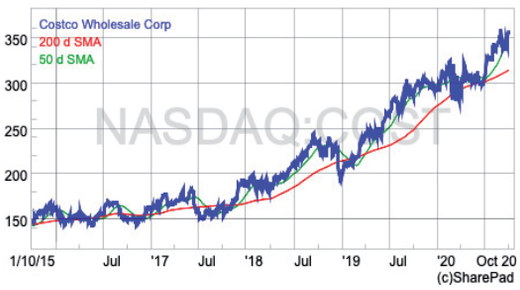
At 360p, the shares trade on a forecast PE of 45 times which, given its expected growth rate, is not that ridiculous in today's markets. This company has an ambitious and arguably aggressive strategy to become a major global player in fashion retail and I would not bet against it succeeding. How it goes about achieving this has become a little bit tarnished in recent times which will put some people off the shares, but it would not surprise me to see the share price materially higher than it is now in five years' time.

I won't be adding it to any of my fantasy portfolios as I find fashion businesses hard to fathom, and while I like businesses that offer great value to customers the recent goings-on means it is a share I would be happy to pass on.

Boohoo: current forecasts

	Year (£m) 2021	2022	2023
Turnover	1,623.20	1,997.30	2,481.20
Ebitda	156.6	192.5	239.3
Ebit	131	157.5	194.9
Pre-tax profit	132.1	160.8	199.7
Post-tax profit	101.6	128.9	159.1
EPS (p)	8	10	12.6
Dividend (p)	–	–	0.1
Capex	78.9	94.3	127.4
Free cash flow	67.4	80.1	114.8
Net borrowing	-330.1	-410.9	-518.7

Source: SharePad



Costco

I think **Costco (US:COST)** is probably the best retail business I have ever looked at. Its focus on offering value for money to customers, working with its suppliers and treating its employees well has created a great business model where all stakeholders can be better off.

If I could own lots of shares in this business I would, but it is a proud holding in my Fantasy Sipp portfolio instead. I added the shares to the portfolio at the end of May this year at $303. At the time of writing it is $358, which equates to an 11.2 percent return in sterling terms, which I'm happy with so far.

Like Amazon, Costco is a company that is relentlessly focused on growing its sales and uses low profit margins as a source of competitive strength to do so. Efficiency gains are reinvested back into prices and when combined with a policy of concentrated buying this allows it to deliver great results for customers and shareholders. Despite having profit margins of just over 3 per cent, Costco made a return on capital employed (ROCE) of 17.6 per cent last year by selling lots of stuff on a very efficient business model.

Full-year sales to the end of August 2020 were up by 9.3 per cent to $163.2bn, with operating profit up by nearly 15 per cent to $5.4bn. This was despite extra costs to cope with Covid-19 (it is currently paying staff a premium of $2 per hour on top of their normal wages). Membership income – its main source of profit – increased by 5.6 per cent to $3.5bn.

Its core US business grew sales by 9.2 per cent, International sales were up by 11.2 per cent and e-commerce sales were up by 50 per cent.

It added 1.3m paying members to its membership base and ended the year with 58.1m members and 105.5m cardholders. Renewal rates in the US and Canada remained very high at 91 per cent and were 88.4 per cent overseas. It ended the year with 795 outlets, of which 552 were in the US.

I have recently become an online member in the UK and have been very impressed with the customer experience. The annual membership fee is £15, with a flat delivery fee of £5.99 per order. I got both of these back – and more – with the cost savings on my first order.

You have to be quite selective with what you buy and you have to spend quite a lot to make purchases stack up with the delivery fee. I find for buying bulky, non-perishable household goods I can make good savings with very high quality products, compared with Tesco, and it will be my go-to-place for these kinds of things.

I get the impression that Costco's UK internet sales are doing very well – at least in my part of Essex anyway. I base this view on the comments from a grumpy Parcelforce delivery driver who was complaining about the weight of Costco packages this week. I asked him if he was delivering a lot of them and he said he was. I'm not too surprised.

As well as good prices, the website and ordering process is very good. Returns have also been dealt with quickly and refunded back to my credit card. There's a lot to like.

Costco is just scratching the service with internet retailing and could do very well with it. Unlike some food retailers it is also determined to make money from doing so. It charges a fair delivery fee and uses third-party logistics who deliver stuff for others at the same time to keep costs down. A high percentage of sales are electricals, which have lower gross margins than food. The company is growing its website advertising to add extra sources of revenue to counter this.

Elsewhere, the company continues to pursue a strategy of vertical integration in areas such as bakery, meat, poultry and logistics to become more efficient and pass on the savings to customers.

This suggests to me that the company is well placed to keep on growing organically. It also should get a boost from the reopening of its optical and hearing aid outlets but Travel is expected to remain subdued.

Costco is still very upbeat on the potential for it to expand in its core US market, which accounts for around 70 per cent of its business at the moment. It sees the potential to open 20-25 new warehouses a year for the next five years, with half of them in the US.

At $358, the shares trade on a 2021F PE of 37.4 times, which I see as being reassuringly expensive.

Costco: current forecasts

	Year ($m)		
	2021	2022	2023
Turnover	177,662.90	191,096.50	204,495.00
Ebitda	7,609.80	8,252.60	9,236.30
Ebit	5,833.20	6,384.90	6,942.50
Pre-tax profit	5,830.80	6,511.40	7,516.20
Post-tax profit	4,229.80	4,633.30	5,013.60
EPS (¢)	957.8	1,048.30	1,191.40
Dividend (¢)	293.6	307.2	308.5
Capex	3,089.70	3,189.30	3,164.10
Free cash flow	3,494.50	5,005.30	5,145.10
Net borrowing	-4,204.00	-5,772.30	-7,592.70

Source: SharePad

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