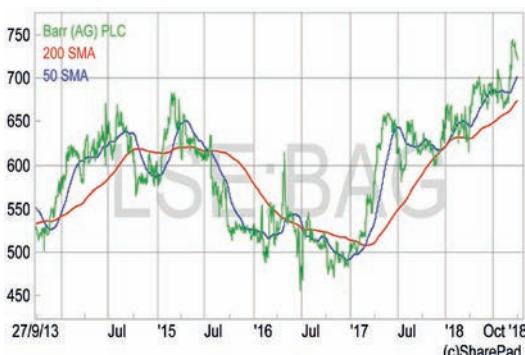




Phil Oakley's Weekly Round-Up

Every week I'll be producing a newsletter for subscribers. It will look at companies in the news and identify interesting analysis points from them with the aim of learning something new or different that perhaps hasn't been mentioned elsewhere



The companies mentioned this week are:

- AG Barr
- McCarthy & Stone
- James Halstead
- Hotel Chocolat

AG Barr

Soft drinks maker **AG Barr (LSE:BAG)** has long been regarded as a very good business by long-term investors in quality companies. The steady and predictable profits and cash flows that come from the frequent purchases of its iconic IRN-BRU drink have shown a remarkable tendency to keep on growing over the years and have made Barr shares a reliable if not spectacular investment.

As well as IRN-BRU, Barr's branded soft drinks portfolio includes Funkin fruit cocktail mixers, Rubicon juice drinks, Strathmore water and Tizer. It also makes and distributes the brands of other companies in the UK, including Rockstar energy drinks, Snapple, San Benedetto and Bundaberg ginger beer.

Barr displays many of the financial performance hallmarks sought after by quality investors. It has high profit margins (over 15 per cent last year) and a very decent return on capital employed (ROCE) of more than 18 per cent. It has also proved to be reasonably good at turning its profits into cash.

As with many quality companies, though, these characteristics are not worth much unless it can continue to grow and compound the value of its high returns on investment. The main concern with Barr is that it is too reliant on IRN-BRU for its profits and that it is something of a one-trick pony and that sooner or later it will stop growing.

This week's half-year results suggest that this is not some-

Alpha Production Editor: Sameera Hai Baig

'The company's strategy is to focus on selling more drinks (volume) rather than increasing prices too much. This seems to be working'

thing to worry about at the moment. Despite having to put up with changeable weather, the introduction of a sugar tax in the UK and a shortage of carbon dioxide, Barr is enjoying a reasonable 2018 so far, with revenues increasing by 5.5 per cent to £136.9m. Higher costs – such as investments in brands – resulted in lower profit margins, with operating profits only increasing by 2.2 per cent to £18.4m.

All Barr's revenue growth came from fizzy drinks (carbonates) which account for just under 75 per cent of total sales, with revenues increasing by 8.9 per cent. Stills and water saw revenues decline by 7.9 per cent.

As far as fizzy drinks are concerned, the company is doing well and taking a bigger slice of a market that is growing. The company's strategy is to focus on selling more drinks (volume) rather than increasing prices too much. This seems to be working, with Barr's volume share of the UK soft drinks market growing by 15 per cent in the first six months of 2018, as the company is selling more IRN-BRU in England and Wales and adds more distribution points. Funkin has also seem some decent growth. The company is putting more money behind marketing IRN-BRU, Funkin and Strathmore and seems happy to sacrifice a small amount of profit margin in order to sell more of these products.

Apart from the small reduction in profit margins, the other notable item of financial performance was the relatively weak operating cash flow, which fell from £20.1m a year ago to £15.9m in the first six months of 2018.

The reconciliation of profits into operating cash flow is my go-to check on whether a company's profits are believable or not. Changes in working capital, which

	Unaudited 6 months ended 28 July 2018	Unaudited Restated* 6 months ended 29 July 2017	Audited Restated* Year ended 27 January 2018
	£m	£m	£m
Operating activities			
Profit for the period before tax	18.2	19.4	44.9
Adjustments for:			
Interest payable	0.2	0.5	1.0
Depreciation of property, plant and equipment	3.7	3.4	6.7
Amortisation of intangible assets	0.7	0.7	1.5
Share-based payment costs	0.5	0.5	1.0
Gain on sale of property, plant and equipment	-	(2.5)	(2.5)
Operating cash flows before movements in working capital			
	23.3	22.0	52.6
Increase in inventories	(3.2)	-	(0.5)
Increase in receivables	(13.7)	(12.2)	(5.2)
Increase in payables	11.1	11.9	4.0
Difference between employer pension contributions and amounts recognised in the income statement	(1.6)	(1.6)	(2.1)
Cash generated by operations			
	15.9	20.1	48.8

'It would not surprise me if Barr eventually approached Britvic (LSE:BVIC) again about getting together'

often account for differences between the two, can be very revealing about what is going on in a business.

As we can see from its cash flow statement there was an outflow of cash from increased stock building (£3.2m) to meet the increased demand for soft drinks during the hot summer we have just had and a jump in receivables relating to unpaid invoices at the end of July. Note that the increase in receivables is not much bigger than last year and probably reflects some degree of seasonality in ordering and payment terms. There was also a £1.6m difference between the cash paid into pension schemes and the expense booked in the income statement.

Overall, there was a £7.4m cash outflow from working capital as the company offset its increased stocks and receivables by increasing its payables (invoices received but not paid). This compared with an outflow £1.9m last year.

I don't think there is anything to worry about here. Increased stocks can be a sign of weakening demand and be used to shift expenses but this is not the case here. Big jumps in receivables can be a sign of overtrading (offering generous credit terms to boost sales), but I very much doubt AG Barr could be accused of this. I would expect the bulk of the working capital outflow to reverse in the second half of the year.

AG Barr Forecasts (£m)	2019	%ch	2020	%ch	2021	%ch
Turnover	289.4	4.20%	297.5	2.80%	306	2.90%
EBITDA	55.5	6.70%	57.6	3.90%	60.4	4.80%
EBIT	46.3	5.80%	48.1	3.80%	50	4.00%
Pre-tax profit	45.5	4.30%	47.2	3.90%	48.9	3.50%
Post-tax profit	37.2	2.90%	38.8	4.30%	40.6	4.70%
EPS (p)	32	2.20%	34.9	9.10%	35.7	2.30%
Dividend (p)	16.8	8.00%	17.5	4.20%	18	2.90%
CAPEX	12.6	16.20%	13.4	6.90%	15	11.80%
Free cash flow	32.5	3.80%	32.6	0.40%	35.1	7.70%
Net borrowing	-18.9		-26.5		-41.3	

Barr says that it is on course to meet expectations for the whole of 2018, which implies operating profits of £46.3m according to the consensus of City analysts' forecasts. This compares with £45.1m made last year and £45.5m over the past 12 months.

I like this company and the way it is managed, but it does concern me that there is not much profit growth at the moment, nor is there any expectation of any. Yet the shares trade on a one-year forecast rolling PE of 21.4 times at a share price of 725p – slightly lower if you adjust for the expected net cash balance.

That looks quite expensive to me. Even with good profit visibility and good management, without meaningful growth the current valuation is beginning to look a little bit stretched in my opinion. It would not surprise me if Barr eventually approached **Britvic (LSE:BVIC)** again about getting together as the two businesses combined would probably be more prosperous than staying on their own.



James Halstead

In many ways I see **James Halstead (LSE:JHD)** as being in a very similar position to AG Barr. The manufacturer and distributor of high-quality flooring is an outstanding business and extremely profitable. In recent years it has been struggling to grow its profits and its share price has fallen back since peaking last year.

The last year saw this story continue. Revenues increased by 3.6 per cent to £249.5m (an increase of £8.7m), but operating profits increased by just £0.1m to £46.6m. Operating margins fell from 19.4 per cent to 18.7 per cent.

Despite some help to exports and the translation of overseas sales from the weaker pound, profits were held back by higher raw material costs, product development costs and a decision not to increase prices in the UK market.

Revenue growth was healthy in the UK, Scandinavia, Australia and Canada despite patchy markets. There are signs that the outlook for profitability could be better in 2019.

Firstly, the company has increased prices to offset raw material price increases and this has been accepted by customers. Secondly, new product launches and existing product relaunches could give a boost to sales. Thirdly, the company has spent some money improving the efficiency of its Radcliffe site, which should see it able to produce 25 per cent more output with the same man hours in the coming year.

James Halstead's profits are very cleanly stated with no exceptional items, which is always good to see, but its financial statements in its results press release could do with a bit more information.

Operating cash flow fell quite significantly from £47.5m to £38.2m, but there is no explanation as to why this happened in the cash flow statement or in the press release.

A look at the balance sheet shows that the culprit is a £10.6m reduction in trade and other payables. I see no reason why a supplier would be worried about James Halstead's ability to pay its bills and demand shorter payment terms and reckon that this move is just a question of timing – albeit a significant one.

The company's balance sheet remains in rude health with £50.7m of cash and minimal debt. This gives the company plenty of firepower to invest or make acquisitions. The company has paid special dividends in 2007, 2010, 2013 and 2015 when its cash balances were lower than they are now, which makes it reasonable to wonder whether it will do so again.

I'm not so sure it will. The current dividend per share of 13.5p is only covered 1.3 times by current earnings per share and consumed all of last year's free cash flow. Given the lack of growth in profits at the moment, it would not

Audited Consolidated Cash Flow Statement
for the year ended 30 June 2018

	Year ended 30.06.18 £'000	Year ended 30.06.17 £'000
Cash inflow from operations	38,175	47,478
Interest received	150	134
Interest paid	(36)	(33)
Taxation paid	(9,642)	(10,682)
Cash inflow from operating activities	28,647	36,897
Purchase of property, plant and equipment	(3,567)	(4,234)
Proceeds from disposal of property, plant and equipment	232	234
Cash outflow from investing activities	(3,335)	(4,000)
Equity dividends paid	(27,245)	(25,438)
Shares issued	196	538
Cash outflow from financing activities	(27,049)	(24,900)
 Net (decrease)/increase in cash and cash equivalents	 (1,737)	 7,997
Effect of exchange differences	(116)	439
Cash and cash equivalents at start of year	52,532	44,096
Cash and cash equivalents at end of year	50,679	52,532

Audited Consolidated Balance Sheet
as at 30 June 2018

	As at 30.06.18 £'000	As at 30.06.17 £'000
Non-current assets		
Property, plant and equipment	36,324	36,103
Intangible assets	3,232	3,232
Deferred tax assets	2,674	4,151
	42,230	43,486
Current assets		
Inventories	71,096	72,936
Trade and other receivables	32,040	31,176
Derivative financial instruments	971	416
Cash and cash equivalents	50,679	52,532
	154,786	157,060
Total assets	197,016	200,546
 Current liabilities	 	
Trade and other payables	48,721	59,321
Derivative financial instruments	119	1,362
Current income tax liabilities	3,769	3,860
	52,609	64,543

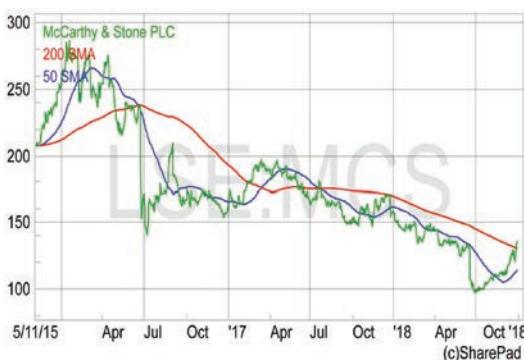
surprise me if the cash pile is used as a buffer to maintain the current regular dividend payout rather than being used to fund a special dividend.

I can see scope for profits to increase this year, but can't help thinking that the current consensus forecasts are a bit too optimistic. Analysts' forecasts are for operating profits to grow by just under 10 per cent and there to be

James Halstead Forecasts £m	2019	2020
Turnover	258.2	263.3
EBITDA	53.9	56.2
EBIT	51	53.4
Pre-tax profit	50.5	52.9
Post-tax profit	39.7	41.2
EPS (p)	18.9	19.8
Dividend (p)	14.7	15.3
CAPEX	3	3
Free cash flow	38.1	39.3
Net borrowing	-63.9	-57.2

a £13m cash inflow after dividend payments. This might happen, but it will require a step change from current growth rates in order to meet these estimates.

If we accept that the 2019 EPS forecast of 18.9p is realistic then the shares trade on a one-year forecast PE of 22.4 times. That's quite punchy and I wouldn't be surprised to see the shares continue to struggle to move much higher from here.



McCarthy & Stone

McCarthy & Stone (LSE:MCS) shares have had a torrid time over the past year. A big profit warning in June has led to serious questions about the sustainability of its business model. A further downgrade to forecasts in September has not helped matters.

Up until a few months ago, the company had big plans to build more retirement homes and was targeting in excess of 3,000 per year. When complemented with service income from managing its developments this was intended to generate a rising stream of profits.

Now everything has changed. Instead of building more homes, the focus will be on making more profits from fewer newbuilds. The company is targeting a ROCE of more than 15 per cent by 2021 and more than 20 per cent by 2023. This is intended to be achieved by reducing costs and getting more money from services.

These kind of ROCE numbers are attractive – they are big enough to get analysts and fund managers interested in the investment case for the shares – if they can be achieved and sustained, but I am not sure they can.

I must admit to having lots of doubts about McCarthy & Stone's ability to make lots of money. I base this view on a general bearishness on the housing market in general and a recent visit to an existing McCarthy & Stone development in North Yorkshire. The company's ability to sell homes is based on customers being able to sell their homes. This is getting harder and is taking longer as the market for existing homes – especially in the affluent south and south-east of England – has become very sluggish as affordability remains a problem.

'In my opinion, asset values are only reliable indicators of value if the assets concerned can make acceptable levels of profits'

A few months ago, I visited a 10-year-old McCarthy & Stone development in North Yorkshire as a potential place for my mother to live. I was quite taken aback by how expensive these places are to live in due to the ground rent and especially the service charges. I did a bit more digging and found that a large number of the apartments in the development were empty and for sale. I then went on to Rightmove and looked at the history of selling prices and was horrified to see the losses made. This may be due to them being probate sales, but it left me with the feeling that these apartments were not very good value for money.

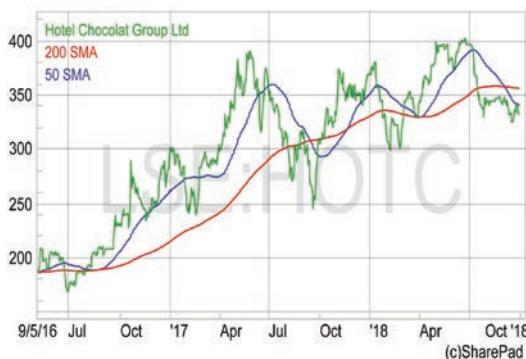
This leads me on to questioning the company's target of 20 per cent ROCE. This may be achievable, but only if selling prices on its land hold up. If there is an affordability and value for money issue with the homes then achieving the ROCE target may be difficult. The company is looking at improving affordability and different ownership options – including rental and smaller homes.

The shares have rallied hard since June's profit warning on the view that they represent a cheap strategic asset given the UK's ageing population. At 133p, the shares trade on a one-year forecast rolling PE of 13.7 times, which doesn't look particularly attractive unless you believe in a strong profit recovery which currently isn't being predicted by analysts.

FORECASTS			£ millions unless stated			
Year	2018	2019	2020			
Turnover	669.0	+1.2%	657.7	-1.7%	649.5	-1.2%
EBITDA	71.6	-26.4%	72.2	+0.8%	82.6	+14.4%
EBIT	70.5	-24.8%	66.0	-6.4%	76.4	+15.8%
Pre-tax profit	65.0	-28.3%	64.8	-0.3%	75.0	+15.7%
Post-tax profit	54.3	-25.6%	48.1	-11.4%	53.9	+12.1%
EPS (p)	9.8	-27.9%	9.7	-1.0%	10.7	+10.3%
Dividend (p)	4.4	-18.5%	4.4	0.0%	5.1	+15.9%
CAPEX	2.5	+127.3%	2.5	0.0%	2.5	0.0%
Free cash flow	9.0		66.0	+633.3%	66.0	0.0%
Net borrowing	5.4		11.7	+119.0%	-41.5	
NAV	759.0	+1.9%	793.0	+4.5%	833.0	+5.0%
Like for like sales growth %	-		-		-	

I would also caution on the use of asset values in measuring how cheap or expensive McCarthy & Stone's shares are. Back in June, the company guided towards a tangible net asset value of around £700m at the end of August 2018. This is slightly less than the current market capitalisation of £715m.

In my opinion, asset values are only reliable indicators of value if the assets concerned can make acceptable levels of profits. By this, I mean a return on assets of at least 10 per cent. Consensus post-tax profits for the year just ended are £54.3m, which equates to a return of just 7.7 per cent on tangible net assets of £700m. Profits need to be at least £70m to justify that value and it looks as if it will be a while before McCarthy & Stone is making that kind of money.



Hotel Chocolat

Shares in **Hotel Chocolat (LSE:HOTC)** have made very good money for anyone who bought them when they floated on the stock exchange just under two-and-a-half years ago. However, the shares have been very volatile over the past year or so.

In a very similar way to **Patisserie Holdings (LSE:CAKE)**, the company is a play on affordable treats. It makes and sells high-quality chocolates with a high cocoa content which it sells in high-street shops and over the internet as well as wholesaling its products to third-party sellers.

Despite the well-publicised challenges facing high-street retailers, Hotel Chocolat is doing reasonably well on the basis of its full-year results published this week. Revenues were up 10.5 per cent to £116.3m with growth from existing stores as well as a contribution from new ones. Operating profits increased by 10.9 per cent to £13.2m, which was a good result in the face of higher costs.

The key thing to bear in mind with Hotel Chocolat is that it is a highly seasonal business. It makes all its profits between July and December, with the bulk of them coming at Christmas. Despite lots of chocolate buying occasions such as Valentines' Day, Mothers' Day and Easter coming in the second half of its financial year it does not make any profit from them.

If you are looking at profit forecasts for this company then its ability to meet them essentially boils down to how much it sells at Christmas. If it does well and controls costs in the second half of the year it will not disappoint. This is a business that has a lot of seasonal risk.

As you can see from the table below, the company actually lost a little bit of money during the second half of the year. Overall, the company did progress and improved its profit margins slightly. ROCE when adjusted for the fact that it rents its high-street shops (the assets are not on its balance sheet but will be next year when

Hotel Chocolat £m	H1 16	H216	FY 16	H1 17	H217	FY17	H118	H218	FY18
Revenue	54.9	36.2	91.1	62.5	42.7	105.2	71.7	44.6	116.3
Cost of sales	-	17.9	-12.3	-30.2	-20.0	-13.8	-33.8	-22.6	-14.1
Gross profit	37.0	23.9	60.9	42.5	28.9	71.5	49.1	30.5	79.6
Admin expenses	-27.8	-26.7	-54.5	-30.9	-28.7	-59.6	-35.9	-30.5	-66.4
Operating profit	9.2	-2.8	6.4	11.7	0.3	11.9	13.2	0.0	13.2
Net interest	-0.4	-0.3	-0.8	-0.4	-0.3	-0.7	-0.3	-556.4	-556.6
Profit before tax	8.8	-3.2	5.6	11.2	0.0	11.2	12.9	-0.2	12.7
Taxation	-1.8	0.3	-1.5	-2.4	0.0	-2.4	-2.8	0.1	-2.7
Profit after tax	7.0	-2.9	4.1	8.8	0.0	8.8	10.1	-0.1	10.0
Ratios:									
Gross margin	67.4%	65.9%	66.8%	68.0%	67.8%	67.9%	68.5%	68.3%	68.4%
Operating margin	16.8%	-7.9%	7.0%	18.7%	0.6%	11.3%	18.4%	0.0%	11.4%
Net profit margin	12.7%	-8.0%	4.5%	14.1%	-0.1%	8.3%	14.1%	-0.3%	8.6%

FORECASTS

£ millions unless stated

Year	2019	2020	2021			
Turnover	128.4	+10.3%	141.6	+10.4%	152.2	+7.5%
EBITDA	20.6	+17.4%	23.2	+12.5%	25.1	+8.0%
EBIT	15.4	+20.5%	17.7	+14.5%	19.2	+8.6%
Pre-tax profit	15.3	+20.8%	17.8	+16.0%	-	
Post-tax profit	12.2	+22.7%	14.1	+15.2%	15.1	+6.9%
EPS (p)	10.4	+18.2%	11.8	+13.5%	13.0	+10.2%
Dividend (p)	2.4	+41.2%	2.8	+16.7%	3.0	+7.1%
CAPEX	9.3	-20.2%	10.0	+8.1%	-	
Free cash flow	6.3	+924.9%	8.4	+33.4%	9.3	+10.9%
Net borrowing	-5.5		-9.9		-18.2	

a new accounting standard will be adopted) was a very respectable 15.6 per cent up from 15.5 per cent last year. The company has a very small net cash position (£0.2m) at the end of the year after investing in new shops and repaying its £6.5m of chocolate bonds.

The company will keep on investing in the UK, but has announced plans to expand abroad with shops in Scandinavia, Japan and the US. This will be done in a low-risk way with franchising in Scandinavia and a joint venture in Japan. If successful, it will provide a source of future growth, but having said that growth rates for 2019 look quite challenging.

I think Hotel Chocolat is a very decent business that seems to be coping well with the pressures facing bricks and mortar retailing. Future growth from internet sales, wholesaling and moving into new overseas markets suggests that profits can keep growing.

A one-year rolling forecast PE of 31 times means that the shares – like its chocolates – have a high price tag. This has been coming down over the past year, but personally I'd like to see the shares trade at less than 25 times earnings at the very most before I'd be tempted to buy them.

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Registered office: Number One, Southwark Bridge,
London SE1 9HL. ISSN 0261-3115.