

Alpha shares analysis

6 November 2023

Balancing growth drivers and valuation

This week we revisit the investment case for Games Workshop – one of the darlings of the UK stock market during the Covid-19 pandemic. We also take a look at an important US infrastructure supply chain business that is still reasonably valued and well placed to continue growing thanks to exposure to America's need to upgrade its energy grid network.

Analyst: Phil Oakley

Games Workshop

Games Workshop (GAW) has been a fantastic long-term investment. Anyone who has possessed both the patience and good fortune to own the shares for the last decade has achieved a total return from their investment of 1,450 per cent.

Not one company currently listed on the FTSE All-Share index has performed better, whilst the index itself has returned 60 per cent over the same time period.

The last three years have not been as rosy despite the company's business continuing to perform well. The shares have returned just 12.5 per cent, whilst the All-Share has delivered 40 per cent.

Games Workshop is a great example of a company where its share price arguably disconnected from the underlying business performance.

Games Workshop total returns



Source: LSEG

Investors do have a tendency to chase high performing shares and expect the good times to keep on rolling. Games Workshop's phenomenal profit growth during the Covid-19 pandemic saw regular upgrades to profit forecasts which is something that the stock market rewards handsomely.

The thing is that such momentum eventually has to come to an end if the company cannot deliver the bullish outlook that is factored into its share price.

The company has continued to be very profitable, but it has had to cope with cost pressures and a slowdown in revenue growth. As a result the valuation attached to its shares has come down despite profits continuing to increase.

Is now a good time for investors to consider buying the shares?

Let's take a look at the business to try and answer this question, starting with explaining why the company has been so successful.

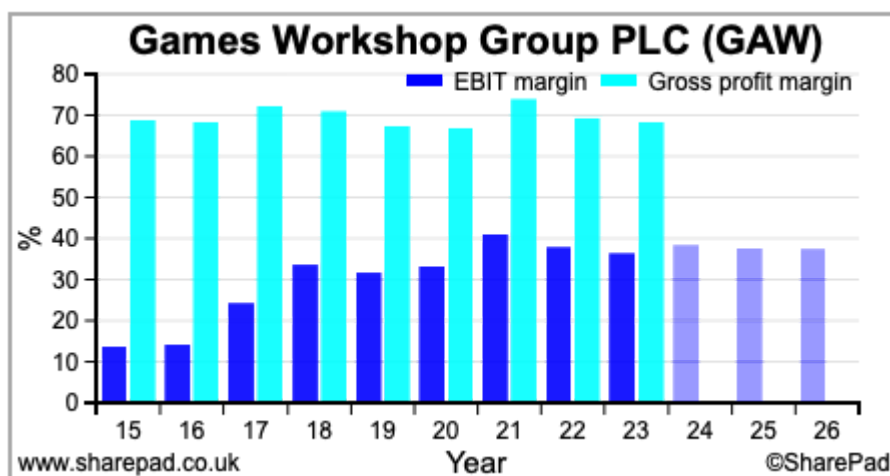
Fantastic business economics

There can be no doubt that Games Workshop's business model has some very attractive features to it.

The key to its success is that it is selling its high-quality fantasy miniatures and gaming products with very fat profit margins. The company believes that the quality of its plastic and resin miniatures is second to none and warrants a premium price to reflect this.

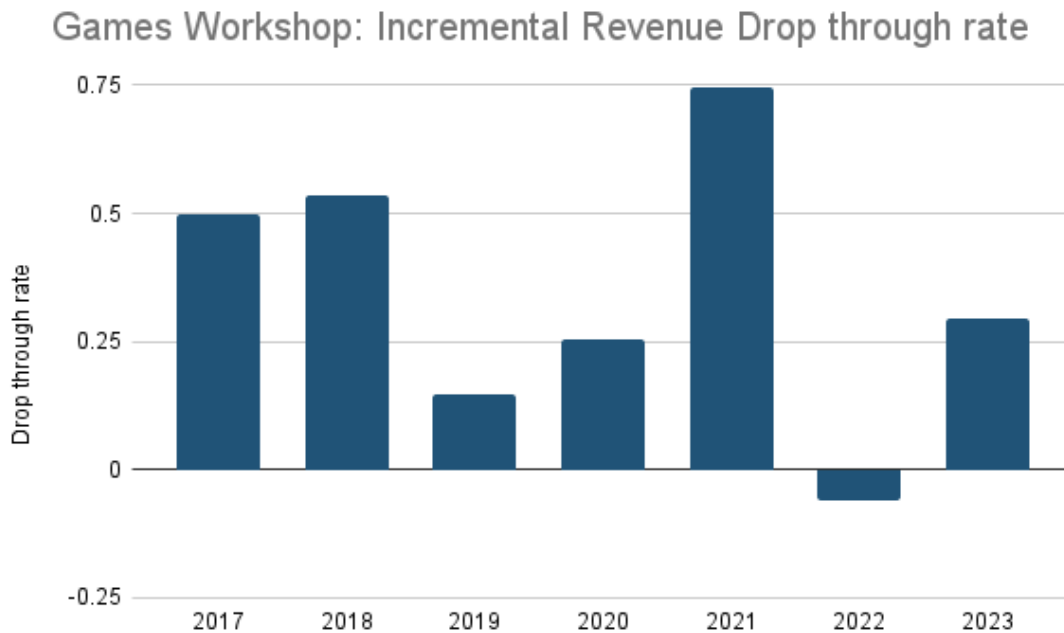
The company therefore has very high gross profit margins of close to 70 per cent. What this means in reality is the same as making something that costs 30 and selling it for 100.

By selling large volumes of products with big margins, the company can generate more than enough money to cover the large fixed costs that come with its manufacturing, design and selling operations with plenty left over.



This has given Games Workshop very high trading profit (or EBIT) margins, which is a hallmark of a very good business.

Its high fixed costs give the company considerable operating leverage. What this means is that its profits are very sensitive to changes in revenues. Once the profit contribution from revenues has paid for all the fixed costs in the business, a large proportion of additional revenues can drop through to additional operating profit and expand profit margins.



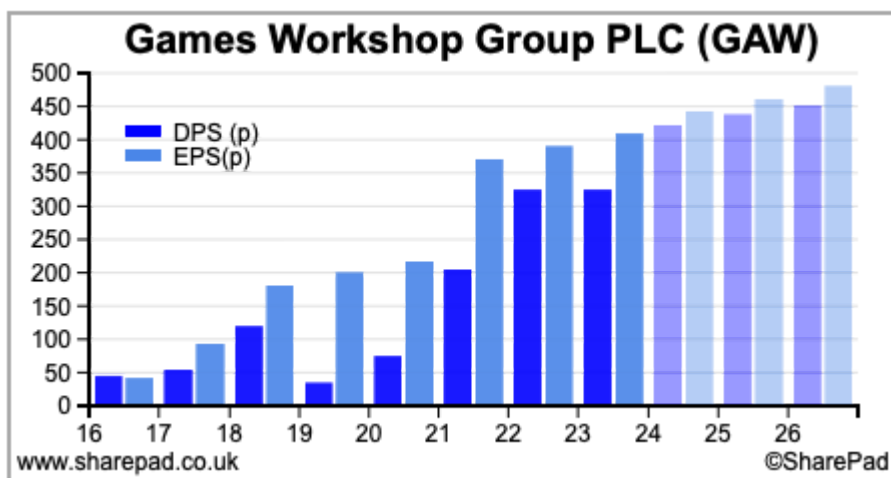
Source: Investors' Chronicle

Looking at the chart above you can see that Games Workshop has benefited from very high drop through rates in the last few years. During Covid-19 when sales boomed as people stayed at home, every £1 of additional revenues generated 75 pence of extra profit.

This gearing effect is great for investors when revenues are growing strongly as they have been in recent years. However, it should not be forgotten that the effect can work in reverse. If the company were to see a significant reduction in revenues then the impact on profits could be very messy.

This gearing effect has been weaker in the last couple of years as operating costs have increased.

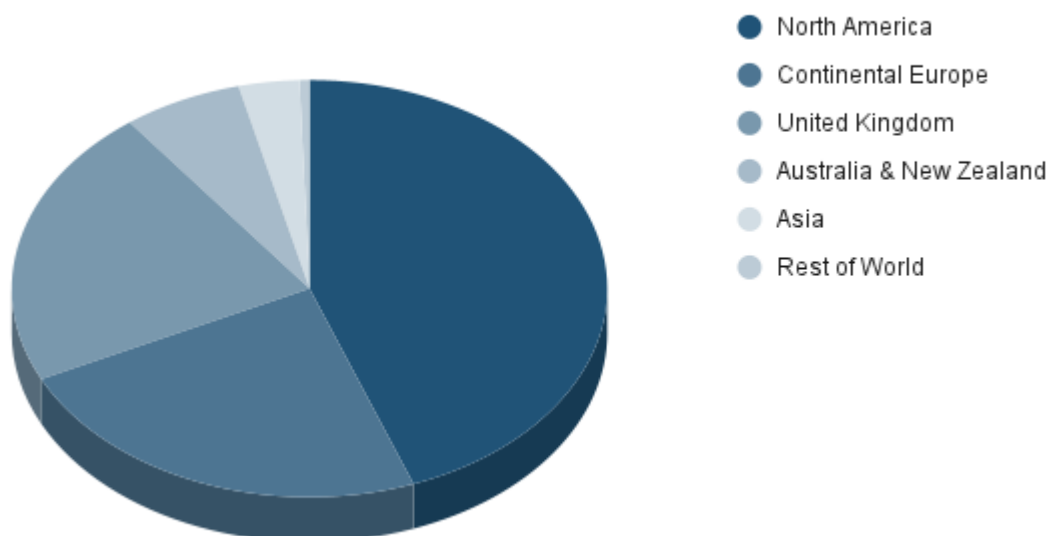
That said, shareholders have continued to experience growing profits and dividend payouts.



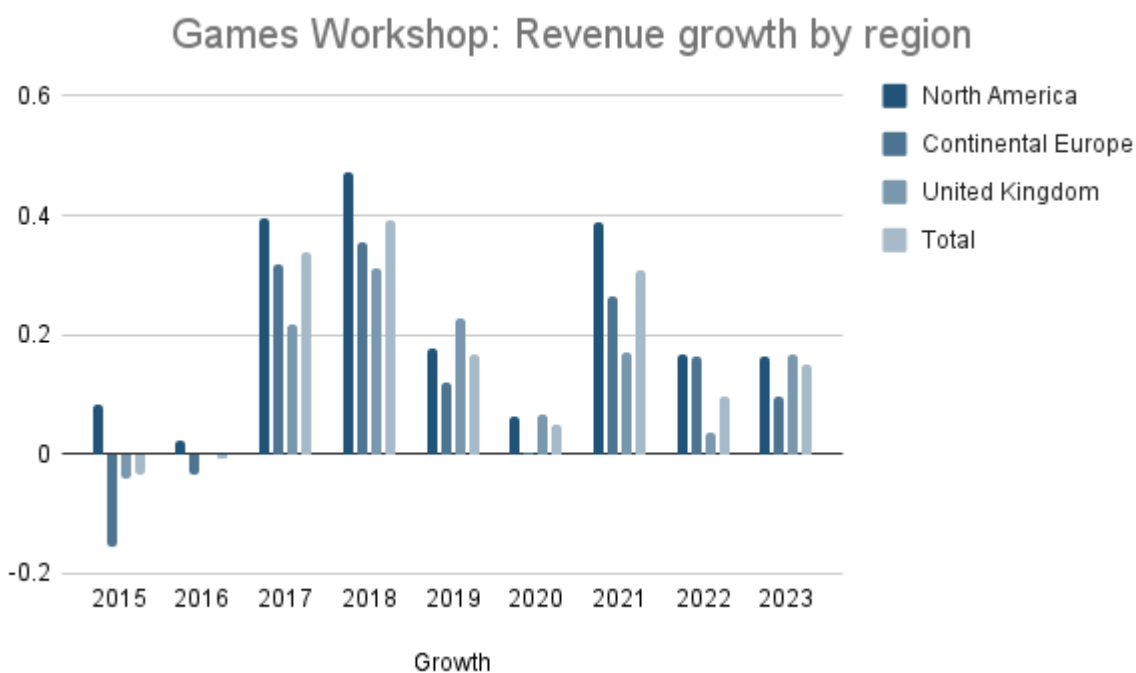
A global growth business

Whilst the company makes its products in or near its Nottingham base it sells them all over the world. 78 per cent of its revenues come from outside the UK.

Games Workshop: Revenue split by geography 2023



Source: annual report



Source: annual report

The business has been powered by growth in overseas markets but particularly in North America where the popularity of Games Workshop's flagship Warhammer game has soared.

Back in 2016, revenues from North America accounted for just over a third of the company's total revenues. Today it accounts for nearly 45 per cent.

Over the same period, UK sales have gone from 28 per cent of total revenues to just under 22 per cent.

Fantastic customer engagement

None of this success would have been possible had Games Workshop not continued to make and develop products that its customers of gamers, collectors, painters, model builders and book lovers wanted to buy.

The development of the core Warhammer fantasy game has been driven by lots of investment in the company's design function in Nottingham.

More staff have been hired and this has been backed up by investment in tooling and moulding equipment to create a torrent of new Warhammer fantasy games and characters. It seems that each new edition of Warhammer has wooed more and more customers.

What has arguably been the most impressive feat over the last eight years – since the current chief executive took charge – is the manner in which the company has engaged with its customers and grown the customer base.

Customer engagement has traditionally been through the company's network of stores where customers can learn and immerse themselves in the Warhammer world.

The company has moved on from this to harness the power of the internet through social media and by demonstrating its products through online video sites such as YouTube.

The creation of a Warhammer community (at warhammer-community.com) has been a great success. This has been enhanced by the creation of a premium monthly subscription service, Warhammer +, which sits alongside other areas of engagement such as a monthly magazine and the Warhammer Alliance programme – a worldwide education programme to promote the Warhammer hobby – which has signed up more than 6,000 schools across the world.

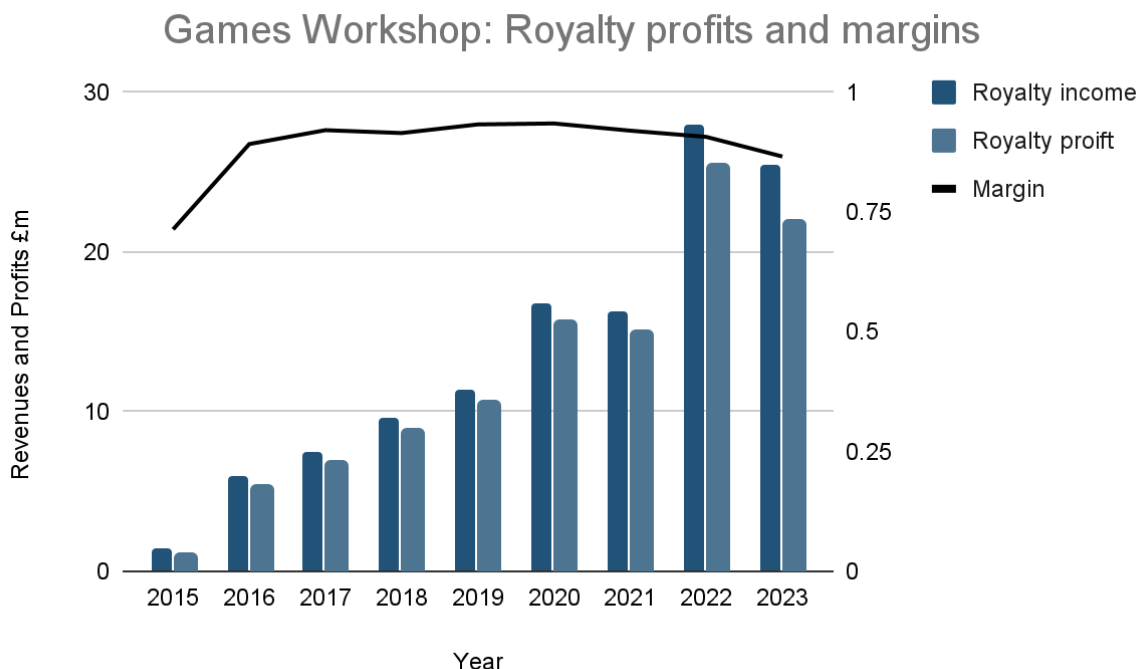
The leveraging of intellectual property

In addition to its core miniatures business, Games Workshop has been leveraging the intellectual property behind Warhammer to grant licences to third party video games and merchandise providers to use the brand in return for a royalty payment.

This is very lucrative for the company as there are virtually no costs associated with the royalty revenues. As a result most of the revenues convert into profit at a very high margin. Current levels of profits from this source are greater than the company's total profits as recently as 2016.

Growth in royalty profits has been strong in recent years and the company has plans to keep them growing.

However, the hopes of some investors in the recent past that royalties would become the company's biggest source of profits are probably a long way wide of the mark.



Source: annual reports/Investors' Chronicle

The company does not want to compromise the profitability and attractions of its core miniatures business and sees licensing and royalties as complementary to it.

One important point that investors need to be aware of is how Games Workshop accounts for its licensing and royalty income.

Essentially, the vast majority of income and profit from a licensing deal are recognised immediately when the contract is signed. These profits are based on guaranteed minimum levels of income.

This method of accounting may be above board and in line with accounting standards (IFRS 15), but could be considered to be quite aggressive.

In recent years, the company has accumulated a meaningful amount of longer-term (greater than one year) trade debtors relating to royalty income that has been booked as earned, but where the cash has not been received.

A great deal of excitement surrounds the company's ongoing talks with Amazon.com about creating a Warhammer TV series. Should these be successful, then it is very possible that Games Workshop will realise a very large profit on signing a deal.

Smarter selling reduces risks

Whilst Games Workshop continues to sell through its stores, a large chunk of its growth in revenue in recent years has come from expanding the number of trade selling accounts.



Source: annual reports/Investors' Chronicle

Not only have the number of trade accounts grown strongly but each account has also doubled its revenues on average since 2017.

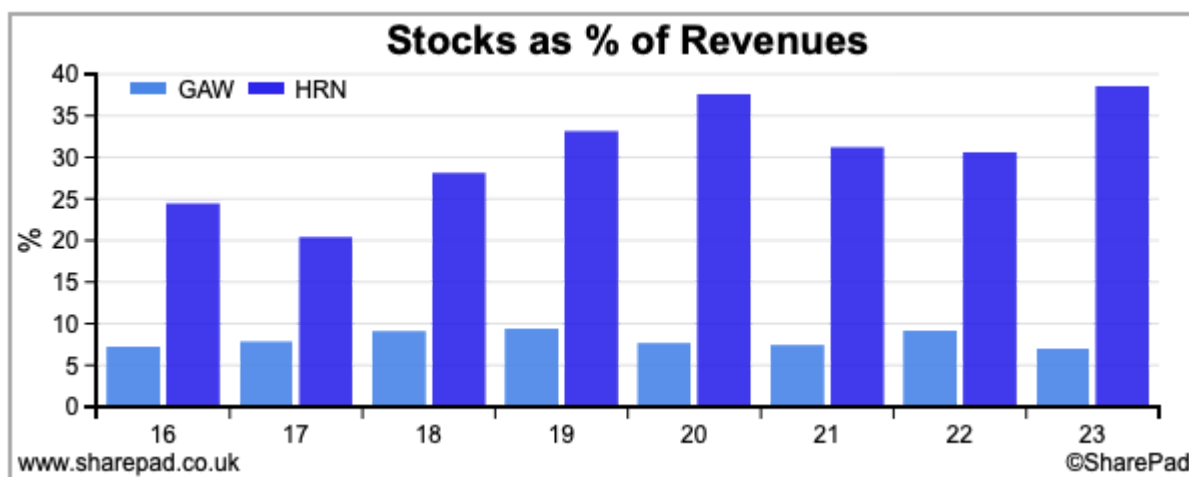
The trade route accounts for 56 per cent of Games Workshop's total revenues and brings with it a number of advantages to the company and the end customer.

Games Workshop has its own online store to sell directly to its customers. However, it tends to give its trade sellers more stock so that its own stock always sells out. It also does not give discounts on the recommended retail price but the trade sellers often do.

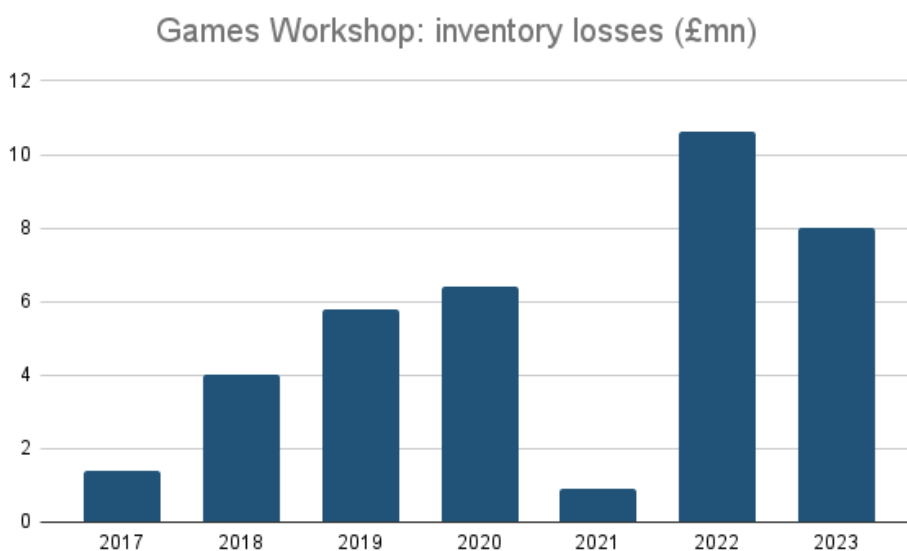
This means that Games Workshop reduces its stock holding risk and passes a lot of that risk to the trade sellers who will pay the company an agreed price and margin for it.

As a result, Games Workshop has a very low stock to revenue (turnover ratio) which is very encouraging. This compares starkly with a business such as **Hornby (HRN)** and

perhaps is one of the many reasons why the two companies have had such contrasting fortunes in recent years.



This is not to say that inventory has not created issues for Games Workshop. Stock losses in 2022 and 2023 have been higher than pre-Covid levels. This can be explained by the higher level of revenues but this trend will need to be watched closely by its investors.



Source: annual reports

The company has made significant new investments in its stock forecasting capability, which should help it keep a nice balance between having too little inventory – and losing revenue – and having too much – and risking stock losses.

Can the growth continue?

As with any company that has been successful, the key question is whether this can continue. The good news is that Games Workshop has plenty of spare capacity to accommodate future growth having invested heavily in land, warehousing, tooling and marketing over the last few years.

For an outsider looking at Warhammer it is not especially easy to understand the attraction and growth potential of it.

A newcomer to the game could quite easily be overwhelmed by the extent and complexity of the rules and permutations of it.

The price point of getting started might also seem to be a little on the high side. That said, Games Workshop tries to address this by offering a range of starter sets at different price points.



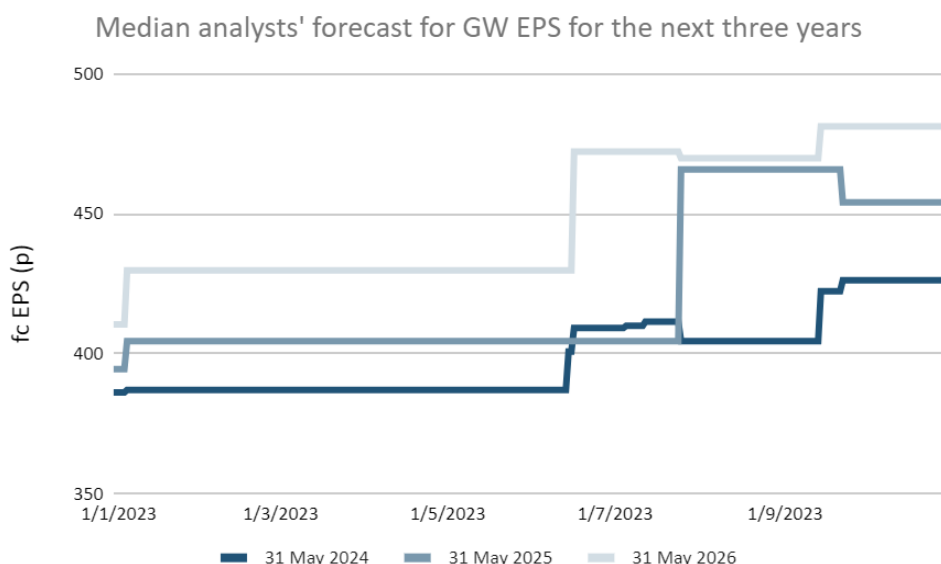
Source: annual reports/Investors' Chronicle

However, the company's track record in growing its customer base provides a lot of comfort that it can continue doing so.

The latest version of Warhammer 40,000 – Leviathan – seems to have been well received by customers whilst products such as Warhammer Age of Sigmar continue to grow steadily.

Growth is always important but even more so now as the core business is not as profitable as it was. Profit margins have come down and are not expected to expand as they have done in the past.

What is encouraging is that the momentum in profit forecasts has been strong during 2023 with City analysts upgrading their estimates significantly since the start of the year.



Source: FactSet

One of the great uncertainties for an investor in Games Workshop is how much revenue visibility the company has. It is now in its key pre-Christmas selling period which will have a big say on its financial outcome for the year to May 2024.

The outcome in North America will be very important. There are signs that higher mortgage rates and a rising cost of living are hitting consumers' purchasing power. A recent profit warning from US toys and games company **Hasbro (US:HAS)** cited consumer weakness whilst **Mattel (US:MAT)** issued some cautious guidance for its holiday selling period for similar reasons.

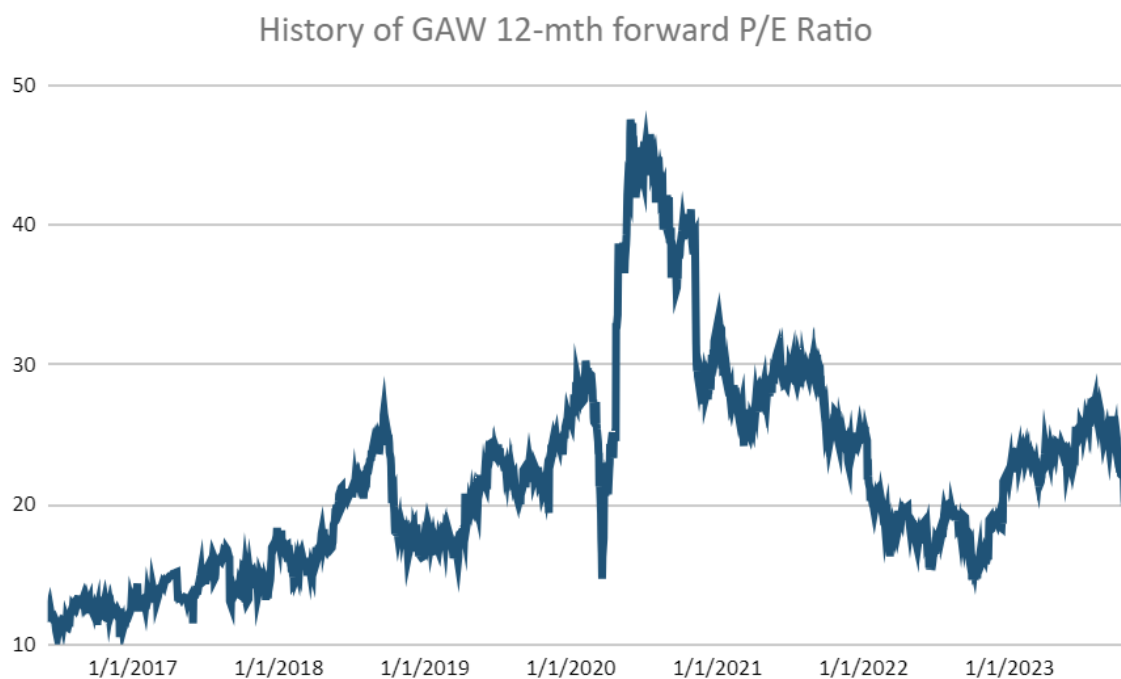
Games Workshop's last trading update in September saw profit guidance revised upwards. Trailing 12-month (TTM) pre-tax profits to the end of the August first quarter were running at £188.6mn, compared with the current full-year estimate of £190.2mn.

If trading momentum remains positive then this estimate looks too conservative, but navigating the Christmas selling season unscathed is the next hurdle for the company to clear.

Valuation still high but becoming more reasonable

Games Workshop is a unique, high-quality business that deserves a high stock market valuation.

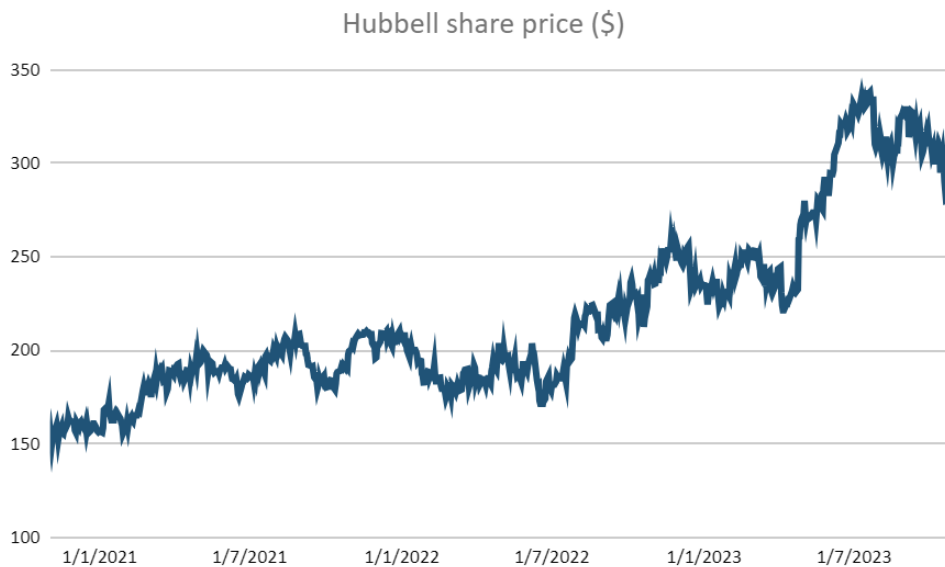
The valuation of the shares has been derated significantly since peaking in 2020, but still stands at a demanding 22 times based on the next year's forecast earnings per share (EPS).



Source: FactSet

However, this still looks quite high for a company which is currently expected to grow its EPS in the mid-single-digit percentages over the next few years. It looks as if chunky profit forecast upgrades are still needed to move the shares higher.

Hubbell



Source: LSEG

To make money from investing over the long haul it usually helps to own the shares of growing businesses. Growth is what helps the value of share investments to compound in value over time.

Looking for growth industries is therefore the first point of call for the growth-oriented investor. However, there are often many different ways to play a growth theme and the investment results can be very different depending on which route you choose to go down.

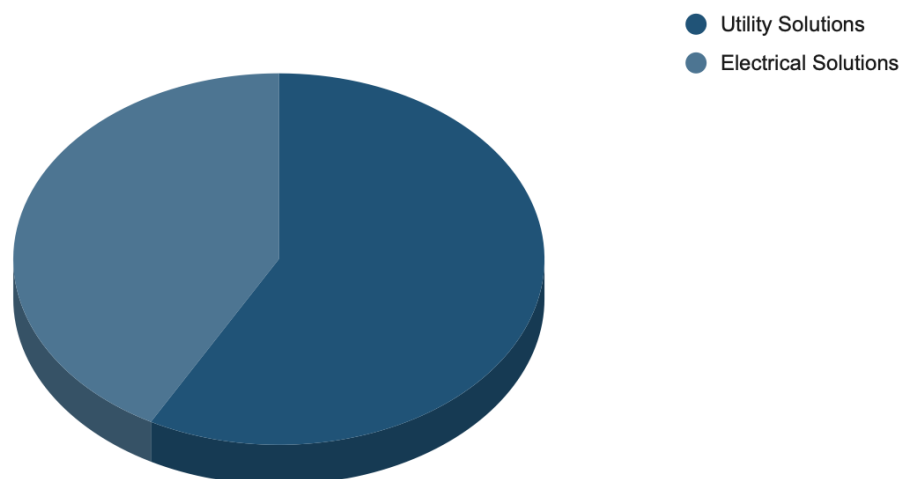
Two of the biggest growth themes in the US right now – and many other parts of the world – are the electrification of products in order to cut carbon dioxide emissions and the replacement and upgrade of ageing infrastructure.

An obvious investing strategy is to buy the shares of electric vehicle and battery makers or construction companies.

The alternative is to go a little deeper and invest in companies within the supply chain who are exposed to these growth themes.

This is where US company **Hubbell (US:HUBB)** may be of interest to investors.

Hubbell Inc:Revenue Split



Source: annual report

The company has two businesses that are well placed to tap into the electrification and infrastructure megatrends.

Sustainable growth potential as US electricity grids are old and need upgrading

Its Utility Solutions business designs and manufactures products that are used in the transmission and distribution of electricity. It also sells products into the water, gas distribution, solar and wind farm and telecom industries.

Its products include: arrestors, insulators, connectors, bushings, enclosures and switches that are critical to the safe and efficient movement of electricity from power stations and across the transmission and distribution grids.

Hubbell also sells products such as smart meters, communications systems and protection and control devices.

The company has built a market leading position in its sectors by competing primarily on the basis of product performance, quality and service as well as price. Its aim is to

produce the highest quality products at the lowest possible cost rather than be the cheapest supplier.

The business is benefiting from the strong growth in electrification and the demands that this is putting on the ageing electricity grid in the US. Huge amounts of renewable electricity projects have to be connected to the grid whilst the rapid growth in energy intensive data centres and electric vehicle chargers are stressing its ability to cope.

Without big investments by electricity transmission and distribution utilities, the US will not be able to drive its economy forward. Their spending plans have been increasing in order to meet this challenge.

Hubbell is very well placed to profit for many years to come by selling connections, wiring and grounding products to renewable energy and grid companies. The critical nature of its products to the ongoing reliability of the grids means that Hubbell can charge high prices for them and improve its margins.

It can do this because its selling prices are a very small part of the capital expenditure budgets of its customers. Hubbell has been able to push up its prices to recover rising material costs in recent months without any push back from its customers.

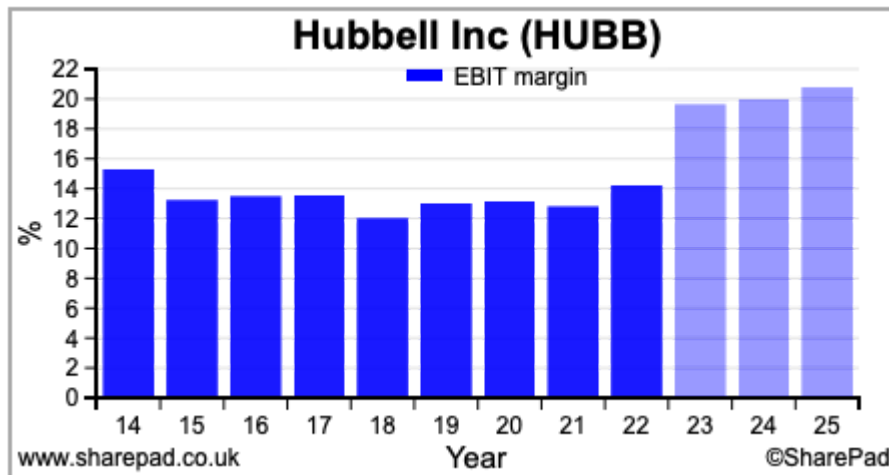
Hubbell has increased its exposure to electrification with its recent deal to buy Systems Control for \$1.1bn. This business is a market leading provider of substation control and relay panels (which control the flow of electricity) where demand from renewables companies is soaring and sales have been growing strongly for many years.

These products are critical to the upgrading and protection of grids whilst they also help with the integration of renewable power projects onto the grids.

This will bring \$400mn of additional revenues to Hubbell's utility solutions business. Around two-thirds of these sales will be from replacement and upgrading projects with the remaining third coming from new renewable and electrification projects.

Hubbell has also just made a smaller bolt on acquisition with a company called Balestro. It provides utility arrestors (which protect against power surges) and insulators whilst bringing the additional benefit of more manufacturing capacity to supply transmission and distribution customers.

The company is very optimistic that its utility business can grow revenues in the mid single-digit percentages for many years to come whilst improving its margins.



Electrical Solutions is more cyclical but should still grow

Hubbell's Electrical Solutions business sells wiring and electrical installation products such as boxes, switches, plugs and circuit breakers to industrial and commercial customers.

Its customers are typically electrical contractors, electricians, maintenance contractors, utilities and telecom companies.

It also sells industrial controls and communications systems products into the oil and gas and mining industries as some of its products are designed to cope with harsh operating environments.

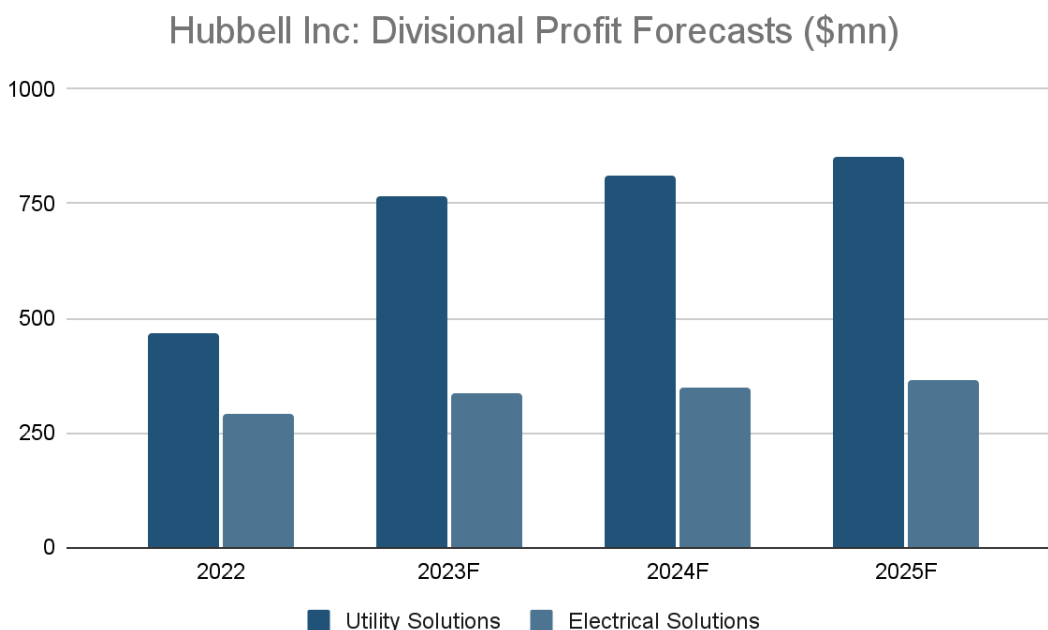
Lighting fixtures and wiring devices are sold to residential and utility customers and are used in residential products and internet connected devices.

The products are sold through distributors, DIY stores, lighting stores and over the internet.

The exposure to residential and commercial construction makes this business more cyclical than the utility business. However, the division also sells into the datacenter, renewables and transmission and distribution sectors where demand is strong.

Revenues are also benefiting from the reshoring of industrial manufacturing capacity to the US.

The mixed end market exposure of the business means that it is not expected to grow as fast as the utility business.



Source:FactSet

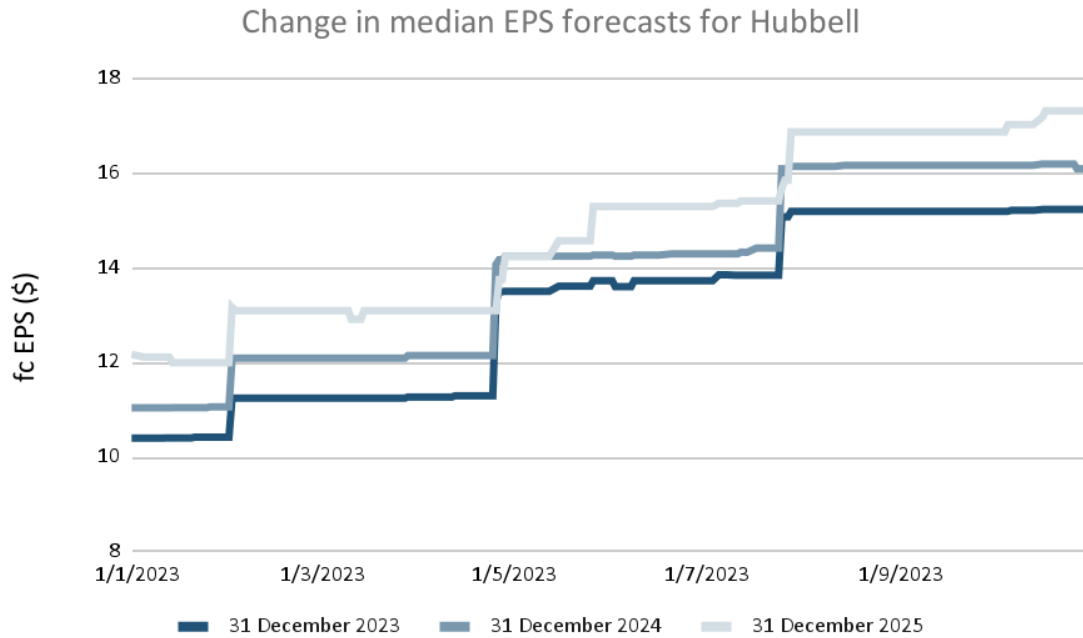
Stock normalisation and productivity improvements help future profit and margin growth

Both of Hubbell's businesses have seen weaker revenues due to customers working off their high stock positions in response to supply disruptions over the last couple of years.

This has seen the company recently downgrade its 2023 revenue growth guidance from 8-10 per cent to 8 per cent at its third-quarter results announcement on 31 October.

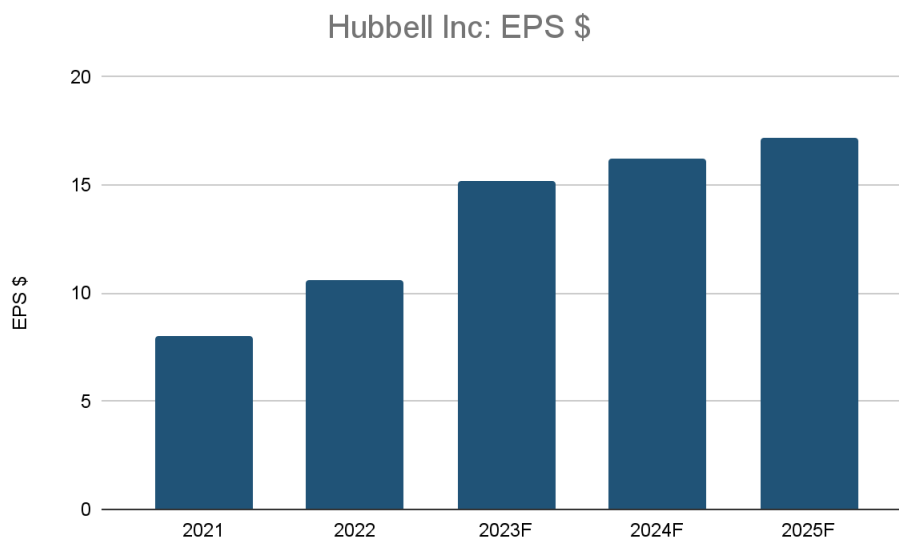
The good news for Hubbell's shareholders is that customer stock levels are showing some signs of normalising which should boost orders and revenues in 2024.

EPS forecasts for 2023 have not seen meaningful downgrades from the weaker sales guidance, whilst 2024 forecasts are yet to reflect the acquisition of Systems Control which is expected to increase EPS.



Source: FactSet

2023 is set to be a very good year for Hubbell with strong profit and margin growth. Its price increases are sticking with its customers and its higher margins should be preserved with business productivity improvements going forward.



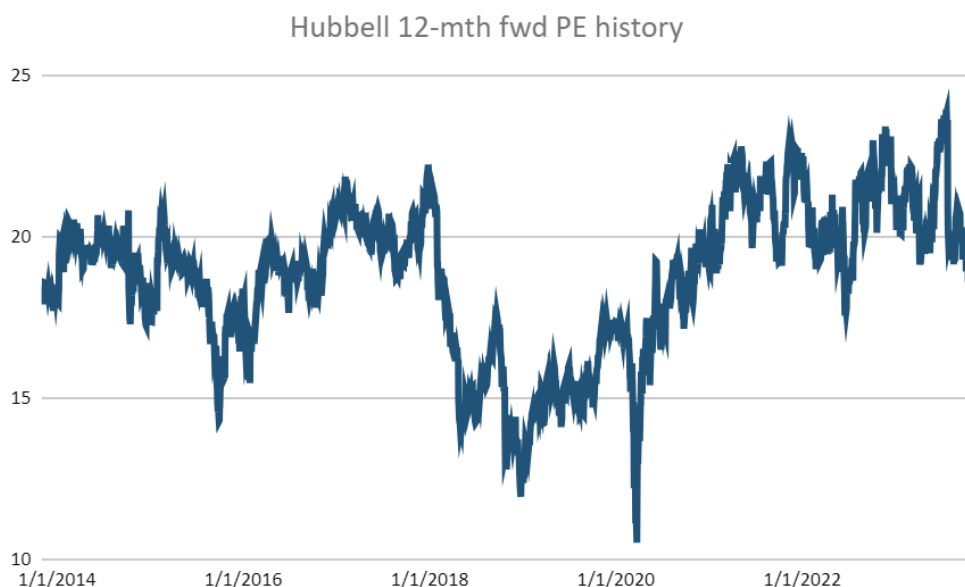
Source: FactSet

EPS growth for 2024 and 2025 is currently expected to be around 7 per cent, but should rise once the acquisition of System One is factored in.

Not expensive given favourable growth trends and the improving business mix

Hubbell's businesses look to be very well positioned to offer a reliable source of growth going forward. Over half the company's revenues are exposed to the megatrends of grid modernisation and renewables whilst the sales mix continues to shift towards more profitable and higher margin products.

The acquisition of System Control is big in relation to the size of Hubbell and does come with integration risks. However, it will not overly stretch the finances of the company with net debt to Ebitda expected to increase to 1.5 times which is not worrisome.



Source: FactSet

Hubbell shares have performed strongly in 2023 – up by just under 20 per cent – but still look reasonable value on a one year forecast PE of 17.4 times at a share price of \$278.

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