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Phil Oakley's Weekly Round-Up

I'm closely watching the pound to dollar exchange rate, as if sterling rises on No Deal being taken off the table, it could seriously affect share prices

The companies mentioned this week are:

- Dunelm Group
- Somero Enterprises
- Barratt Developments
- Michelmersh Brick Holdings
- Restaurant Group
- STV Group

Fantasy Sipp performance

	Portfolio returns (%)		
	1 month	Year to date	1 year
Fundsmith Equity T Acc	3.2	31.3	18.5
LF Blue Whale Growth Fund	0.8	30.4	14.5
Lindsell Train Global Funds	2.6	29.9	20.1
Phil Oakley Fantasy Sipp	**3.8**	**28.6**	**23.0**
Mid Wynd International Inv Trust	1.7	28.6	12.5
Martin Currie Global Portfolio Trust	0.2	28.5	13.3
Finsbury Growth & Income Trust	4.9	28.2	16.5
Smithson Investment Trust	4.1	26.4	
Vanguard S&P 500 ETF	2.0	22.9	7.6
Castlefield CFP SDL UK Buffettology Fund	1.1	13.8	3.4
FTSE All-Share – Total Return	2.4	12.6	2.6
Scottish Mortgage Investment Trust	-0.4	11.4	-4.3

Source: SharePad

The quality shares approach continues to perform very well in 2019, especially if a portfolio has heavy exposure to global and US shares. The Fantasy Sipp portfolio continues to do reasonably well by doing better than the UK market and a cheap S&P 500 ETF, while comparing well with most of the highly-regarded managed funds in the blue-chip quality and growth space. Time will tell whether it can continue to do so.

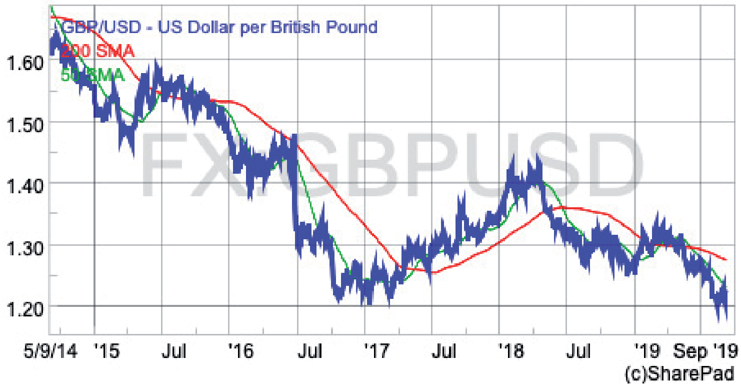
I remain very cautious on the outlook for shares in

Alpha Production Editor: Sameera Hai Baig

www.investorschronicle.co.uk
telephone: +44 (0)20 7873 3000 email: icalpha.editorial@ft.com

general given a weakening outlook for global economic growth and the high valuations of very good companies.

The one thing I am watching closely at the moment is the value of the pound against the US dollar, as this has provided a significant boost to UK investors and funds owning US shares in 2019. If this process was to reverse and the pound was to increase in value, many of the currently top-performing funds would face a very significant headwind.



Predicting the future direction of exchange rates is difficult and somewhat futile, but I'll share my thoughts nonetheless.

The value of the pound against the dollar in the short term is going to be heavily influenced by when – or perhaps more importantly if – the UK leaves the European Union. In very simple terms, leaving the EU without a deal is seen as being bad for the value of the pound. Staying in the EU is seen as being good for it.

This week the pound started by falling in value below \$1.20, as people bet on the UK leaving without a deal. On Thursday morning it was rising to \$1.227, as there was a shift in opinion that perhaps the UK was staying in the EU for longer than people previously thought and may not even leave at all.

A general election on 15 October now looks very likely, but it is far from certain it will change anything. We could see a shuffling of constituencies between the main parties and still end up with a hung parliament in deadlock.

Despite the ongoing political storm, I am beginning to think the end result is that the UK will not leave and that there could well be considerable upside in the pound from here. If I am right then \$1.35-\$1.40 is not stretching things too much.

This would be bad news for the FTSE 100 where the translated value of its foreign profits would take a big hit, as would the values of global and US listed shares held in the Fantasy Sipp and many of the best-performing funds today.

So what should equity investors do?

Nothing is my view. I could be wrong in my thinking, but I think it is wise to be aware of the risks the portfolios are exposed to.

If you are exposed to the current favourable trend in US shares then you will just have to take the ups and downs that come with any currency movements. Shifting your portfolio to inferior UK-listed stocks would be a bad move, as the underlying performance of the businesses you would be invested in would probably offset any move in exchange rates.

Sticking with the best businesses at reasonable valuations is the right long-term strategy for equity investing. This has served investors well over the long run, but that doesn't mean it won't have a bad patch over the next few years. If you want to protect your portfolio from turbulence in equity markets then sacrificing business quality is a mistake. Parking some of your money in other assets such as cash, bonds and precious metals is a much better way.

Dunelm Group

As expected, **Dunelm's (DNLM)** full-year results were good. Like-for-like (LFL) revenues were up by a very impressive 10.7 per cent during the year – against weak sales comparatives a year ago – and were boosted by a stonking last quarter. Gross margins were up by 160 basis points and other costs were controlled well, which led to an increase in trading profits of 21.2 per cent to £126.9m.

The company has also been helped by getting rid of the very poor-performing Worldstores business. As a result, operating margins increased from 10 per cent to 11.5 per cent. It is almost certainly true that Dunelm has also benefited from the woes at Debenhams and Homebase cutting back. As a result, its share of the UK homewares market has increased from 8.1 to 8.7 per cent.

Dunelm has also been doing a lot of things right with its product range and pricing which has brought in more customers. It has made significant progress with its online business with sales growing by 35 per cent in the year. There is clearly further to go from here as online is still only 14 per cent of its business. The decision to offer online-only products should help this part of the business to keep on growing.

Free cash flow increased substantially during the year. The improvement was driven by higher profits, a working capital inflow (there was a significant increase in the VAT creditors after a strong fourth quarter) and much lower investment spending as store openings were cut back. As a result, the business is almost debt-free (net debt of £25m) and has enough reserves to pay a 32p per share special dividend.

Dunelm shares have been on a fantastic run this year, but they needed a profit forecast upgrade to keep the momentum going and the results statement did not bring one. The company is being cautious about Brexit and thinks there is a risk that consumers will keep their hands in their pockets because of it and lead to lower profits in the peak Christmas trading period. Unsurprisingly, the shares fell sharply on the day of the results.

Dunelm Group forecasts

	Year (£m) 2019	2020	2021
Turnover	1,095.90	1,156.40	1,199.00
Ebitda	163.7	171.4	179.9
Ebit	126.9	132.7	139
Pre-tax profit	125.7	131.2	138.5
Post-tax profit	99	105	111.1
EPS (p)	48.9	51.9	54.9
Dividend (p)	28.5	29.7	36.3
Capex	28.4	34.5	36
Free cash flow	150.4	92.6	116.8
Net borrowing	44.8	61.8	-16
NAV	177.2	203.1	236.1
Like-for-like sales growth (%)	9.2	5.7	5

Source: SharePad

The business is in a good place, but I can't help thinking that it will find it tougher to grow going forward. The housing market is lukewarm at best which is not helpful, but further gains online should help.

I see the shares as neither cheap nor expensive at a share price of 800p. They trade on a forecast PE of 15.4 times, while the forecast dividend yield of 3.7 per cent looks attractive given that it is reasonably covered by profits and free cash flow. That said, I do see a reasonable degree of downside forecast risk for this company if the UK economy weakens.

Somero Enterprises

A few weeks ago I wrote that **Somero (SOM)** was a classic example of a quality trap. By this, I meant that its excellent levels of profitability were temporary, but were being mistaken as permanent. The stocks' cheap valuation was not a case of looking a gift horse in the mouth but a warning that a free lunch was not on offer.

A profit warning earlier in the summer due to bad weather in America saw the shares plunge, while this week's half-year results sowed more seeds of doubt when it said that its financials were "tracking broadly in line with guidance" given back in June. Furthermore, it broadened its revenue guidance to between \$83m-\$87m, with the lower bound of that range less than it had been previously.

Selling machines that level concrete in the building industry is a cyclical business. When you combine this with a business that has significant operational gearing, you have a risky business that is unlikely to command a very high stock market valuation – despite impressive levels of profitability when end-markets are strong.

Evidence of that operational gearing was clear in this week's results. Revenues were down by 13.3 per cent, with pre-tax profits down by 22.8 per cent. A dividend increase of 4.5 per cent is a small comfort to shareholders.

To be fair to Somero, its revenue decline is not of its own doing but it reflects an inherent risk in the business that shareholders need to be aware of. Within the business, levels of order activity are good, especially in the key US market but weak European sales are a concern and may get worse before they get better.

Somero Enterprises forecasts

	Year ($m) 2019	2020
Turnover	87	89.5
Ebitda	27.1	28.1
Ebit	25.5	26.3
Pre-tax profit	25.5	26.4
Post-tax profit	19.6	20.1
EPS (¢)	34.4	35.5
Dividend (¢)	18.2	21.8
Capex	5	2.4
Free cash flow	9.9	18.4
Net borrowing	-18	-24.9

Source: SharePad

I can't help thinking that this business is close to or is at its cyclical peak. This is reflected in the cheap valuation of its shares on a trailing forecast one-year PE of 7.6 times and a forecast yield of 6.8 per cent.

Barratt Developments

Barratt Develpment's (BDEV) full-year results highlight that builders' profits are largely dependent on the cost of land. Despite lower sales volumes and flat average selling prices, a change in sales mix and changes in building styles helped offset rising build costs. Trading profits increased by 4.5 per cent and profit margins increased to 18.9 per cent from 17.7 per cent.

The company remains reasonably upbeat about its future profits based on the cost of its landbank. It is targeting 3 to 5 per cent volume growth over the next few years and currently expects to make gross margins of 23 per cent and ROCE of 25 per cent on its land.

These are excellent returns in anyone's book and remain significantly underpinned by the Help to Buy scheme, which has inflated new-build price premiums and boosted profits. Regular readers will know my views on this scheme and how it has led to a big transfer of wealth from the taxpayer to shareholders.

Despite what I think, this scheme is set to continue until 2023 and unless the UK enters a recession – not impossible by any means – which leads to falling house prices, Barratt shareholders should continue to expect healthy profits and chunky dividend payments.

Barratt Developments forecasts

	Year (£m) 2019	2020	2021
Turnover	4,833.70	4,891.10	5,038.90
Ebitda	905.3	908.1	949.8
Ebit	898.7	903.5	941.6
Pre-tax profit	904.9	886.6	916.1
Post-tax profit	721.7	727.2	756.7
EPS (p)	71	70.7	73.8
Dividend (p)	45.7	46.6	48.2
Capex	7.4	7.9	8.3
Free cash flow	411.4	593.9	639.3
Net borrowing	-758.7	-820.5	-953.4
NAV	4,287.30	4,591.30	5,063.50

Source: SharePad

Shareholders should take comfort from the fact that the company is holding a relatively short landbank consisting of 3.9 years of owned land and 0.8 years of controlled land. This is above its target of 3.5 years and 1.0 years, respectively. This should give its balance sheet some protection from land write-downs if the housing market does enter a downturn.

As with all housebuilders, I believe that in an environment of rising or stable selling prices they will earn very good profit margins of around or above 20 per cent, as this is what gets factored into land buying.

When and if Help to Buy ends, things could become more interesting. I think new-build premiums could fall substantially which will get reflected in lower land costs, but also a lower level of profits. Consequently, I believe that the current rates of profits are very close to their peak.

Michelmersh Brick Holdings

I have been very positive on the UK's three quoted brick makers. Demand is well supported by new house-building activity, while there is an undersupply of bricks in the UK market. This should be a positive backdrop to make decent profits.

So it has proven for **Michelmersh Brick Holdings (MBH)**. Half-year revenues increased by 17.4 per cent, which reflected the acquisition of a Belgian business in

February and a very strong performance from the UK business where LFL sales increased by 8.6 per cent.

Profit margins fell slightly from 20.3 per cent to 19.9 per cent, but remained very healthy. Operating profits increased by 15.5 per cent to £5.4m.

Going forward, the second half of the year is shaping up well. The order book is 7 per cent higher than a year ago, while the UK market fundamentals remain good. Industry stock levels remain at very low levels and imports are increasing – which should be good for Michelmersh's Belgian business.

Within the business, good progress is being made with the replacement of its Carlton Plant where efficiency improvements are being made. A new road at Telford will release a valuable source of minerals for its brick plant.

Michelmersh Brick Holdings forecasts

	Year (£m)		
	2019	2020	2021
Turnover	51.5	53.5	55.3
Ebitda	12.7	12.9	12.9
Ebit	9.7	9.8	9.8
Pre-tax profit	9.2	9.3	9.4
Post-tax profit	7.3	7.4	7.5
EPS (p)	7.8	7.9	8
Dividend (p)	3.4	3.6	3.6
Net borrowing	12	8	5

Source: SharePad

While accepting that brick making is a cyclical business, the shortage of housing and a sizeable repairs and maintenance element to the business makes me view it as an attractive and steady business.

What I like most about all the quoted brickmakers is that barriers to entry are high and there is an undersupply of the market. The key attraction is their clay assets which are used to make bricks. Without them, effective competition is impossible. Michelmersh has 6.4 million tonnes of clay reserves which is equivalent to 20 years' of supply at current production rate 9,125 million bricks per year). It also has land assets which have development value.

At 91p, the shares trade on a one-year rolling forecast PE of 12 times and offer a forecast dividend yield of 3.6 per cent. That's a fair valuation in my view but I'm not sure it fully reflects the strategic value of its assets to a possible acquirer.

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telephone: +44 (0)20 7873 3000 email: icalpha.editorial@ft.com

Restaurant Group

I don't like **Restaurant Group (RTN)** as a business. It burned itself out by over expanding into a saturated market and has now bet its future on a very expensive and leveraged acquisition of Wagamama.

Wagamama is a good business in my view and has an attractive customer offer. The problem is that Restaurant Group paid a very high price for it which means I think it will struggle to make acceptable returns (return on capital employed of more than 10 per cent) any time soon.

The underlying Wagamama business continues to perform very well, with LFL sales growth in the first half of the year of 10.6 per cent. This has seen a healthy increase in its rolling one year adjusted earnings before interest, tax, depreciation and amortisation (Ebitda) from £42.3m to £51.4m. The company remains confident that it can deliver £15m of cost savings – from initiatives such as better purchasing – and site conversions.

Its pubs and concessions business continues to perform solidly, but its Leisure business – dominated by Frankie & Benny's continues to struggle. This business is frankly a mess and will require a lot of cleaning up. As much as £100m of value impairments and £10m of onerous lease provisions were recognised in the first half.

It is clear that the plan is to drastically reduce the size of this business. The average remaining lease length is currently six years, with the company looking to exit half of its sites when they come up for renewal. This is undoubtedly the right thing to do.

Restaurant Group forecasts

		Year (£m)	
	2019	2020	2021
Turnover	1,075.50	1,141.60	1,207.60
Ebitda	140.9	164.7	182.2
Ebit	92.4	109.1	124.1
Pre-tax profit	75.9	93.8	108.8
Post-tax profit	59.6	-	85.3
EPS (p)	12.2	15	17.6
Dividend (p)	6.3	7.8	8.7
Capex	88.5	88	87
Free cash flow	52.3	73.4	88.1
Net borrowing	312.5	308.3	289.2

Source: SharePad

Despite strong trading at Wagamama, there is still a lot to worry about with this business. For an operationally geared business, debt levels are far too high and don't look like they are coming down that quickly based on current analysts' forecasts.

The business is also slowing down. LFL sales increased by 3.7 per cent for the first 34 weeks of the year against

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very soft comparatives, but during the past six weeks growth was only 0.2 per cent.

The shares are lowly valued on a one year forecast rolling PE of nine times and a forecast dividend yield of 5 per cent, but the risks remain very high. My concern is that the Leisure business could dent much of the good things going on at Wagamama.

STV Group

Unlike ITV, **STV (TVG)** does not have a big and profitable production business to cushion the ups and downs of the TV advertising market. Just under 90 per cent of STV's revenues come from TV advertising which means that staying relevant in a world of fast changing viewing habits is a big challenge.

Judging by the look of this week's half-year results, the company is doing a fairly good job. Its advertising revenue was effectively unchanged. Whilst national advertising revenues fell, its digital and regional advertising revenues both increased by 19 per cent.

Most encouraging was the 10 per cent growth in operating profit and, in particular, the very string growth in digital profits that have come from the STV online streaming service (STV Player).

STV operating profit

STV (£m)	H1 2019	H1 2018
Broadcast	9.7	9.1
Digital	3.0	2.1
TV Productions	-1.7	-1.2
Total operating profit	11.0	10.0

Source:STV

The outlook for regional and digital advertising for the rest of the year is shaping up well, with national advertising expected to be down by 6-7 per cent. It looks as if the company should be able to meet current analysts' forecasts.

For me, the main attraction of this business is the strength of the STV Player service. As an increasing amount of TV viewing is done via catch up services rather than live, having a good product in this space is crucial.

STV has invested heavily in the STV Player by getting it on to all the main broadcast platforms and by offering new services which drive advertising revenues. It has just announced a partnership with sports pay-TV company, Premier Sports. This will see FreeSports incorporated into the STV Player and STV become the advertising agent for its two pay TV channels which have some attractive sporting rights such as Italian Serie A football, Pro 14 Rugby and Scottish Cup football.

STV forecasts

	Year (£m)		
	2019	2020	2021
Turnover	124.7	133.7	140
Ebitda	25.1	28	29.8
Ebit	21.9	24.8	27.2
Pre-tax profit	20.7	24	26.3
Post-tax profit	17.1	19.6	21.7
EPS (p)	43.9	50.9	55.5
Dividend (p)	21	22	23.2
Capex	2.5	2.8	2.9
Free cash flow	8.5	12.2	14.6
Net borrowing	36.2	31.4	26.4

Source: SharePad

Despite its heavy exposure to advertising, high operational gearing and cyclical risk, I quite like the look of what is going on at STV. In some ways, its regional niche makes it a more attractive asset than the much bigger ITV. At 346p, its shares trade on a one-year forecast rolling PE of just over seven times, while offering a forecast dividend yield of just over 6 per cent, which is currently well covered.

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