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Phil Oakley's Weekly Round-Up

Owning shares of growing businesses at reasonable valuations remains key to decent returns. I remain happy with my Fantasy Sipp portfolio, which is still performing well

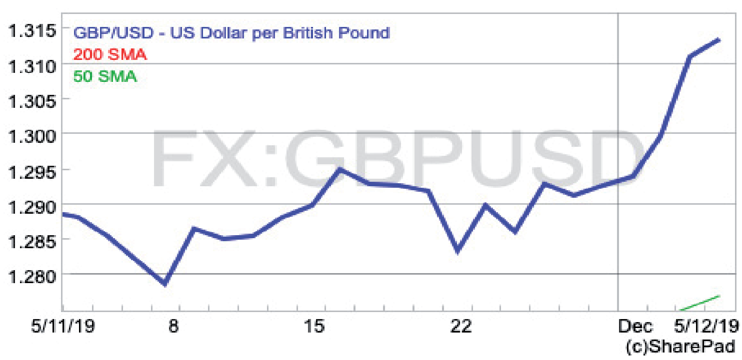
The companies mentioned this week are:

- Stock Spirits
- Cineworld
- Ramsdens
- Loungers
- Ocado

This time next week, the result of the general election will be known. What will it mean for UK shares?

It's not really sticking one's neck out to say that a Labour government, with a plan to take 10 per cent of company shares for employees and help itself to surplus dividends, as well as hiking corporation tax, would see share prices fall – perhaps significantly.

At the moment, this looks unlikely, but a Labour/SNP partnership of some sort cannot be completely ruled out. If the Conservatives win a majority then I see this as positive for the share prices of UK earning businesses. It may lead to a more muted response from the FTSE 100 – which earns the bulk of its profits overseas – if the value of the pound builds on this week's rally and reduces the value of overseas profits.



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Elsewhere, stock markets have been volatile on the back of mixed economic news and the almost daily changing views on the US-China trade dispute.

I have no idea where stock markets are heading, but I retain the view that UK shares are cheap and could rally.

What is undeniably true is that 2019 has been a good year to own shares, which up until now have posted decent gains. I certainly did not expect returns to have been as good as they have, but with interest rates so low or even negative on bonds, the support for share prices is still there.

I do think that expecting share prices to continue rising in the absence of genuine profits growth is dangerous. Price to earnings (PE) multiples ultimately have limits and in the long run share prices should track profit and free cash-flow growth.

This is why being able to own the shares of growing businesses at reasonable valuations remains the key to decent returns from a share portfolio. In that context, I remain quite happy with the shares in my Fantasy Sipp portfolio, which is still performing reasonably well.

Fantasy Sipp performance

	Portfolio returns (%)		
	1-month	Yeat-to-date	1-year
Mid Wynd International Inv Trust	2.4	29.0	21.4
Smithson Investment Trust	4.6	27.0	21.6
Martin Currie Global Portfolio Trust	-0.7	26.7	18.8
Phil Oakley Fantasy Sipp	**2.3**	**25.7**	**23.3**
LF Blue Whale Growth Fund	2.5	25.4	18.2
Fundsmith Equity T	0.9	23.3	16.2
Vanguard S&P 500 ETF	-0.4	21.6	12.0
Castlefield CFP SDL UK Buffettology Fund	3.8	20.1	15.3
Lindsell Train Global Funds plc	0.5	18.4	14.6
Finsbury Growth & Income Trust	-1.7	17.7	15.4
FTSE All-Share – Total Return	-1.4	13.2	9.9
Scottish Mortgage Investment Trust	0.9	11.7	6.3
Vanguard FTSE 100 ETF	-2.3	11.7	8.6

Source: SharePad

Stock Spirits

While Diageo is the quality play on premium spirits, **Stock Spirits (STCK)** is playing in different markets. The business is dominated by its operations in Poland, where it has a near 30 per cent share of the spirits market, and in the Czech Republic. It has smaller businesses in Italy, Bosnia Herzegovina, Serbia and Slovakia.

Its product sales are heavily skewed towards vodkas, with the company building up its whisky business in partnership with Diageo and Suntory.

The year to September 2019 looks to have been a good one for Stock Spirits. It sold 8 per cent more 9 litre cases to total 14.3 million on an underlying basis. This fuelled revenue growth of 9 per cent to €312.4m, with operating profit increasing by 11.9 per cent to €54.4m, giving a slightly improved profit margin of 17.4 per cent, which is a decent level of profitability.

On my preferred measure of return on capital employed (ROCE), Stock Spirits looks like a modestly profitable business with a return of 8.8 per cent. Cash generation last year was good and more than supported a 5.1 per cent increase in the total dividend for the year to 8.94¢ per share.

That said, from an operational perspective, the company looks to be doing reasonably well. The turnaround of its Polish business has been completed and has been buoyed by strong trading. The Polish economy has been getting stronger and disposable incomes have been increasing. This has led to consumers trading up to premium spirits and has seen Stock Spirits sell more of its flavoured and premium clear vodkas.

Its Czech Republic operations have also performed well for similar reasons. It is also encouraging that trading has been so robust in the face of strong competition from supermarkets' own-label spirits brands. The Italian business is stabilising, but is unlikely to drive a big increase in value for shareholders.

Current trading is solid, according to the company. New products are in the pipeline, while the company has a strategy in place to mitigate alcohol duty increases in some of its markets. Investment in new distillation capacity in Poland should also help to boost profit margins in the years ahead.

Given that the company made €54.4m of operating profit last year, forecasts for 2020 and 2021 look way too low, unless, of course, trading is affected by duty increases. The 10 per cent increase in the share price on Wednesday suggests that forecasts are moving up in a fairly significant way.

Stock Spirits forecasts

		Year (€m)	
	2019	2020	2021
Turnover	302.8	319	326
Ebitda	62.5	59	62
Ebit	52.1	48	51
Pre-tax profit	48.6	46	49
Post-tax profit	36	34	36
EPS (¢)	18.5	16.9	20.8
Dividend (¢)	9	9.2	10.2
Capex	7.8	10	9
Free cash flow	34.9	35	40
Net borrowing	40.1	36	16

Source: SharePad

I remain a big fan of Diageo for the sheer quality and breadth of its global spirits portfolio, but Stock Spirits may attract some bargain hunters. At 208p, the shares trade on a trailing PE of 17.4 times, which should be coming down as earnings will probably grow. The 3.6 per cent trailing dividend yield is not too shabby, either. The company's robust-free cash generation should see that yield grow over the next few years. I can think of worse homes for investors' money.

Cineworld

While cinemas remain popular leisure attractions, I struggle to see the long-term investment attractions of them. Streaming services continue to boom and remain very attractively-priced compared with the cost for a family going to the cinema.

Cineworld (CINE) has bet the future of its business with the acquisition of Regal in the US in 2017. It paid a rich price to do so and took on a large amount of debt in the process. It cannot afford for things to go wrong with this business.

	Actual ($)				Constant Currency[2] ($)			
	Group[1]	US[1]	UK & Ireland	ROW[3]	Group[1]	US[1]	UK & Ireland	ROW[3]
Total revenue	**(9.7%)**	**(10.9%)**	**(9.7%)**	**(0.5%)**	**(8.5%)**	**(10.9%)**	**(4.9%)**	**4.9%**
Box Office	(12.8%)	(13.9%)	(12.7%)	(4.2%)	(11.6%)	(13.9%)	(8.1%)	1.2%
Retail	(7.4%)	(8.3%)	(8.7%)	2.0%	(6.3%)	(8.3%)	(3.9%)	7.7%
Other Income	2.2%	(0.4%)	7.4%	9.9%	3.6%	(0.4%)	13.1%	14.8%

Source: Cineworld

This week's 11 months' trading update did not make for great reading, with sales down heavily due to weak box office sales that fed through to weak retail sales as people bought fewer snacks and drinks.

The US is the main source of weakness which makes for worrying reading. The company has tried to soften the blow by squeezing out more cost savings from the Regal acquisition. Savings are now expected to hit an annual run rate of $190m, compared with a previous expectation of $150m.

My chief concern with Cineworld is where the growth is going to come from. The company is somewhat of a hostage to fortune, as it is reliant on filmmakers making films that lots of people can't wait to watch. If they don't then people stay away from cinemas. Next year might be better with releases such as the new James Bond film, but only time will tell.

Cineworld forecasts

	2019	Year($m) 2020	2021
Turnover	4,729.40	4,856.10	4,995.20
Ebitda	1,654.30	1,676.80	1,724.70
Ebit	907.4	914.2	945.4
Pre-tax profit	395.5	414.9	453.6
Post-tax profit	337.8	344.3	374.3
EPS (¢)	24.3	25.3	27.7
Dividend (p)	12.7	14.1	14.8
Capex	307.6	319.8	322.5
Free cash flow	586.3	622.3	661.5
Net borrowing	3,439.50	3,579.20	3,203.20

Source: SharePad

Despite a pick-up in box office sales in recent weeks, management confirmed this week that its trading performance will be a little bit below its previous expectations.

Even before forecast downgrades, growth in revenues and profits was expected to be quite modest and likely to be mainly driven by cost savings. For me, this is not the basis of a successful investment performance.

That said, the share price has recovered all its losses from this week, at the time of writing. The tone of the trading statement suggests to me that any downgrades to 2019 forecasts are likely to be quite small. Based on an EPS of 23¢, the shares are trading at just under 12 times revised forecasts. The 6 per cent dividend yield is sure to tempt some investors, but I see this as something of a red flag rather than a sign of compelling cheapness.

I think investors are right to question the sustainability of Cineworld's business model and therefore its profits and dividend payments. I don't see the dividend in any imminent danger of being cut, but I'm not sure I'd sleep soundly owning Cineworld shares.

Ramsdens

Ramsdens (RFX) is a very simple business. It makes its money from foreign exchange, pawnbroking, buying and selling precious metals and selling used jewellery. The last time I looked at it in June – at the time of its full-year results – it was doing just fine, and I thought the shares were quite attractively valued at nine times earnings, while offering a forecast dividend yield of 4.6 per cent at a share price of 175p.

Half-year results announced this week were very encouraging, with underlying pre-tax profits up by 12 per cent to £5.7m and the half-year dividend increased by 13 per cent to 2.7p a share.

All areas of the business performed well. Despite a weak pound making foreign holidays more expensive, foreign exchange volumes increased by 8 per cent, with Ramsdens' income increasing by 15 per cent to £8.4m.

Pawnbroking remained very profitable with a 16 per cent increase in interest income to £4.3m, which gave a 55 per cent yield on the average pledge book. The total loan book was up by 14 per cent in the half year to £7.7m.

Jewellery sales were buoyant and up by 22 per cent to £5.5m, but the gross profit margin was lower due to a higher proportion of new jewellery and pre-owned watches, which have lower margins than second-hand jewellery. Gross profit increased by 11 per cent to £2.6m.

The higher gold price has been very kind to the precious metals business, with gross profits up by 57 per cent to £4.1m. The company took advantage of the gold price to scrap some of its slow-moving second-hand jewellery stock, which brought in an extra £0.6m of profits.

Cash generation was very good with a big positive swing in working capital – there was a big outflow in the first half of last year – which led to net cash balances increasing from £8.2m in March to £12.3m at the end of September.

I have to say that I continue to like this business. It's not the highest quality out there, but it is good at what it does and is pretty simple for investors to understand. Its businesses will have their ups and downs depending on the health of the economy and what's going on with precious metal prices, but they are in a good place right now.

The company seems to be a beneficiary from the general high street malaise having picked up some shops from The Money Shop and integrated them into its business. Ramsdens is also using a favourable rent environment to renegotiate more favourable terms and relocate stores. All its 123 shops are profitable on a standalone basis.

Ramsdens forecasts

	Year(£m) 2020	2021
Turnover	53.6	56.9
Ebitda	9.4	9.8
Ebit	8.1	8.4
Pre-tax profit	8	8.2
Post-tax profit	6.3	6.4
EPS (p)	20.5	21.1
Dividend (p)	7.2	7.6
Capex	2.2	2.4
Free cash flow	5.3	6.5
Net borrowing	-12.1	-14.4

Source: SharePad

I think current forecasts are very doable and could end up being quite conservative. The share price has performed well during the past six months and now stands at 210p at the time of writing. This puts the shares on a March 2020 forecast PE of 10.2 times, while offering a prospective dividend yield of 3.4 per cent with scope for reasonable dividend growth going forward.

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Loungers

Loungers (LGRS) listed on the stock exchange back in April. The business is based around two food and drink concepts.

Lounge is essentially a hybrid combining a British pub with a coffee shop. They serve the same menu from 9am to 10pm and are focused on providing a friendly atmosphere and value for money. The bars/shops are located in secondary locations (not big cities) and small market towns. There are currently 133 Lounges across the UK.

Cosy Club is more of a traditional bar based in city centres and large market towns offering restaurant food and table service. There are currently 28 of them open.

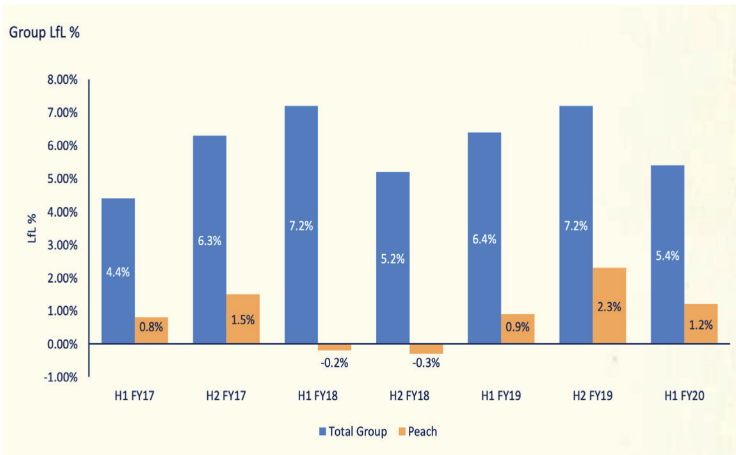
The company has been expanding rapidly over the past few years and has been opening 20 new sites per year for the past five years. The aim is to roll out 25 new sites per year with the company seeing potential for 400 Lounges and 100 Cosy Clubs.

The stock market tends to love a good retail/pub roll-out story. Analysts look at the potential for lots of new sites and make big predictions for rapid profit growth. This can often see a strong share price surge for the business involved for a while, but often reality bites and growing profits becomes tougher.

Pubs and restaurants is a very tough sector to make money. It is fiercely competitive and faces a lot of cost pressures. Many businesses have gone to the wall and many are struggling.

So how does Loungers stack up?

Mixed is my initial view. I am impressed by its like-for-like (LFL) sales performance, which is much better than most of the quoted pub sector, with the exception of JD Wetherspoon.



Source: Loungers

I also like the focus on value for money and that virtually all its sales growth has come from selling more food and drink (volume) rather than jacking up prices.

But I do have some concerns as well.

I see a few similarities with **Revolution Bars (RBG)**, which has not worked out well. Loungers operates a rented site business model. This gives it the opportunity roll out new sites quickly, but it gives very little flexibility when times get tough.

The average lease length of its estate is 16.1 years with 12.2 years remaining. If trading turns down, it could be left with rents it will struggle to pay. I much prefer the Wetherspoons business model, which is increasingly moving to freehold sites. The asset backing this provides allows the company to exit a site if it performs poorly and to raise cash from selling the freehold. You don't get that key safety buffer with renting.

I am also wary with Loungers' management focus on adjusted earnings before interest, tax, depreciation and amortization (Ebitda) given pubs and cafes – even leasehold ones – need to replace assets such as furniture, bar and kitchen equipment that Ebitda ignores. The company also ignores bar pre-opening costs and share-based payments when calculating it, which I see as genuine costs of doing business.

Loungers has struck a reassuring tone on its maintenance capex which currently stands at 1 per cent of revenue, and says that it maintains the pubs to a high standard where the costs are expensed against revenues (similar to JD Wetherspoon).

If we look at a proper measure of profit – operating profit – we see that Loungers is currently a low-margin business. Profit margins were 5.2 per cent in this week's half-year results, up from 4.9 per cent a year ago.

I am generally not a fan of low-margin businesses because they can quickly become loss-making when trading turns down. That said, low margins can be used as a source of competitive advantage by keeping selling prices low. This has been deployed with great success by businesses such as amazon.com, Costco and JD Wetherspoons in the UK. Loungers' impressive LFL sales performance does suggest that its value for money strategy is attracting more customers.

However, wage costs remain a big concern for this company and the sector as a whole. Wage inflation has been running at 3-4 per cent and looks to stay at that kind of level given continued expected hikes in the national living wage. Companies therefore need a reasonable amount of LFL sales growth just to stand still. Loungers is hoping that it will reap some of the benefits of increasing scale to offset these cost pressures.

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Loungers forecasts

	Year(£m)		
	2020	2021	2022
Turnover	186.6	221.6	257.8
Ebitda	22.6	27.5	32.3
Ebit	12.5	15.8	19.1
Pre-tax profit	11.3	14.2	17.1
Post-tax profit	-	-	-
EPS (p)	9.9	12.5	15.2
Dividend (p)	-	-	-
Capex	23.8	21.8	-
Free cash flow	20.6	25.2	29.2
Net borrowing	28	21.8	13.2

Source: SharePad

I have to admit that I would be cautious about investing in this company, but I quite like the idea behind the Lounge concept. Whether it can deliver acceptable and growing returns on capital remains to be seen.

At 202p, the shares are priced for strong future profits growth and trade on a 2020F PE of 20.2 times. EPS growth is expected to be 53 per cent between 2020 and 2022. This would be impressive if it can be achieved and would bring the PE down to 13.3 times by 2022 at the current share price.

Ocado

One of the most reliable signs the management of a company thinks its shares are overvalued is the issue of a convertible bond.

By using a lofty share price and the promise of locking in an option to convert the bonds into shares at guaranteed price in the future, it is possible for a company to gain access to borrowed money at a very cheap price.

This is what I think **Ocado (OCDO)** has done this week. It has done a great deal for the company, but I think it sends a powerful signal to investors that its shares are wildly overpriced.

I have seen this kind of thing before. Early in my analyst career, the share price of Railtrack went to stratospheric levels, as highly paid City analysts wrongly claimed that the business was a property goldmine. It wasn't. The company's substantial property assets were to be used to fund the railway network with only a small surplus available to shareholders. Yet, management used the lofty share price to issue convertible bonds at a low interest rate, with an option to convert the bonds into shares at a premium to the then current share price. It did not end well.

I think Ocado is doing the same thing. What astonishes me is that investors are falling over themselves to buy it. This week, the company issued £600m of convertible bonds, with a coupon of just 0.87 per cent and a redemption date of 2025. The bonds will have an option to convert to shares at a price of £17.93 per share – a 45 per cent premium to the current share price of 1,233p.

Ocado is essentially getting almost free money to fund its business, which is a great deal for it. But, frankly, I just don't get the valuation of the business. I don't buy into the tech valuation argument, I just look at profits and cash flows and how much the current share price is implying in the future and struggle with it.

My issue with Ocado is that it operates in an industry with terrible economics. No one is making much money from selling groceries online and delivering them to people. I don't dispute that its software technology and automated warehouses are very good, but how are its customers going to get a return on it? After all, Ocado has been using this technology for some time in the UK and is making no money from it, yet it is selling it to customers who think they can.

Ocado forecasts

	Year(£m) 2019	2020	2021
Turnover	1,769.90	1,996.30	2,266.70
Ebitda	25.2	80.4	116.7
Ebit	-79.9	-61.7	-31.2
Pre-tax profit	-100.9	-71.7	-53.2
Post-tax profit	-120.3	-76.3	-41.1
EPS (p)	-16	-11.8	-10.7
Dividend (p)	–	–	–
Capex	347.1	363.8	369.8
Free cash flow	-268.7	-283	-84.5
Net borrowing	-184.2	4	142.2

Source: SharePad

The key issue is how much success with selling its wares to the world's grocers is being priced into the shares. At 1,233p per share, Ocado has a market capitalisation of £8.7bn. It is not expected to make a profit for the next three years according to analysts' forecasts.

I wrote about Ocado back in February in the Investors Chronicle and did a detailed study of its accounts. In it, there is an estimate of £1.34bn of the future profit that is expected to be made from its solutions contracts that were in place at the balance sheet. Note that this is total profit, not a present value of future profits which will be a lower number.

This is a business that I may ultimately be proven wrong and I can live with that. However, what I will say is that a current market capitalisation of £8.7bn looks like a blue-sky outcome for the business, while a conversion premium of 45 per cent above this is going to the moon.

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