investors CHRONICLE alpha

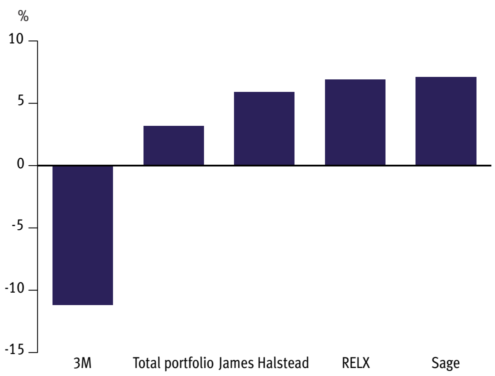
7 June 2019

Phil Oakley's Weekly Round-Up

The Fantasy Sipp portfolio is doing well, against peers and its benchmarks. Quality shares are doing well, but attractive entry points are getting harder to come by

The companies mentioned this week are:
- Hargreaves Lansdown
- Card Factory
- Applegreen
- AO World
- Auto Trader

Highlights from the Fantasy Sipp one-month total returns



Source: Investors Chronicle

Fantasy Sipp performance

	Portfolio returns(%)		
	1 month	Year to date	1 year
Phil Oakley Fantasy Sipp	**3.2**	**19.9**	**16.1**
Finsbury Growth & Income Trust	0.915	18.2	10.5
Lindsell Train Global Funds plc	0.927	17.4	16.8
Fundsmith Equity T Acc	-0.407	16.6	12.5
Castlefield CFP SDL UK Buffettology Fund	-1.15	14	8.77
Vanguard S&P 500 ETF	-0.619	13.2	7.72
FTSE All-Share – Total Return	-1.84	9.78	-2.72
Scottish Mortgage Investment Trust	-5.28	7.61	-2.87

Source: SharePad

The Fantasy Sipp seems to be doing quite well so far this year. It is beating the FTSE All-Share index and an S&P 500 index tracker, while holding its own against some of the best quality investors out there.

Fifteen out of the 21 stocks in the portfolio have delivered total returns over the past month of 1.2 per cent or better, while 16 have delivered positive returns. The star performer has been Sage (+7.1 per cent), closely followed by RELX (+6.9 per cent) and James Halstead (+5.9 per cent). 3M has been the biggest loser.

The performance breakdown of the stocks in the portfolio over one month, year to date and one year, are shown in the table on the next page.

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	1 month	Total returns(%) Year to date	1 year
Spirax-Sarco Engineering	4.15	37.9	36.6
Mastercard	3	35.8	28.6
Halma	2.61	35.6	34.4
Paychex	2.67	34.2	32
Moody's	-4.69	34.1	7.1
London Stock Exchange	4.26	32.4	19.5
Sage Group (The)	7.07	28.6	15.8
James Halstead	5.93	25.5	33.1
Visa	1.83	25.2	24.1
Walt Disney Co (The)	1.2	23.9	37.7
Diageo	4.01	20.3	23.3
Pepsico	2.95	19.8	33.9
WH Smith	-1.77	18.5	3.95
InterContinental Hotels	1.52	18.5	3.29
RELX	6.92	16	13
British American Tobacco	-2.38	15.2	-19.1
McDonalds	1.89	13.9	28.3
Intertek Group	3.24	13.5	-3.02
Croda International	0.0984	9.4	8.11
Avon Rubber	-5.77	8.05	-4.17
3M	-11.2	-12.8	-16.1

Source: SharePad

Don't keep expecting the Federal Reserve to underwrite the stock market

I find the worshipping of the status of central bankers rather boring. Yes, their slashing of interest rates and creation of whopping amounts of money from fresh air did prevent a depression following the financial crisis and has boosted stock and bond markets to record highs in the process.

In recent weeks, signs of economic weakness across the world have been increasing. Yields on US treasuries have moved sharply downwards, while the yield curve has inverted – short-term bond yields are higher than long term-yields – and there has been no premium offered for inflation over the long term. In short, this is quite bearish stuff.

Yet stock markets have rallied on the over-analysing of comments from Federal Reserve governor Jerome Powell. In reality, the markets have only gone back to where they were a week ago. But talk continues to be of interest rates being cut maybe more than once this year.

Interest rate cuts have been good for stocks, as the yields on them – their earnings, dividend or free cash flow yields – have been higher than those offered by government bonds, with the added attraction of growth on top.

However, it surprises me that investors keep thinking that rate cuts or talk of them are akin to a free lunch. I don't blame them for thinking this, but cuts are a response to weakness or expected weakness in the economy. The faith put in central bankers to stop recessions borders on a religious cult. One day investors will be disappointed.

The bull case from interest rate cuts only holds as long as profits hold up. Peter Lynch was absolutely right when he said it was all about earnings, earnings, earnings. If company earnings start falling – and they aren't growing much now – then even if interest rates are zero or negative it's difficult to see how share prices stay as high as they are now.

Which brings me back to a topic I write about a lot – the high valuations of quality shares. More investors are flocking to quality and pursuing concentrated portfolios that cut out the rubbish shares. This, in turn, is driving the valuation multiples of such stocks ever higher, so much so that the outlook for future returns must ultimately be lower, as the profit expectations baked in become ever more difficult to meet. If they are not in a bubble, many are close to being so. If I am vaguely right in this assertion, I've no idea when it will go pop, but it will.

This begs the question: is there anything out there of decent quality that I like?

These weekly round-ups are essentially made up of comments on companies in the news, and quite often most of them fail to grab me. I find this occasionally depressing and do try my best to find good things to write about, but it feels like hard going at the moment.

But I do think there are a few businesses and shares out there that are worth a little bit of readers' further consideration. In this week's magazine I have done an analysis of Hollywood Bowl and like a lot of what I see. I also think its rival Ten Entertainment Group's shares could be very cheap.

On the weekly Companies and Markets podcast I've mentioned companies such as Britvic and WH Smith – for its travel business – as examples of decent quality at reasonable prices.

It's also worth remembering that the big advantage you have as a private investor is that you don't have to be fully invested all the time. You are your own boss and have the luxury of waiting for opportunities to arise.

Hargreaves Lansdown

A few weeks' ago all looked rosy in the garden of **Hargreaves Lansdown (HL.)**. Strong stock markets and more customers had driven its assets under management up to an impressive £97.8bn. Year-to-date revenues to the end of April – its year-end is June – were up by 8 per cent to £395.9m. It looked like all important analysts' forecasts would be met very comfortably.

Yet meeting short-term forecasts is not the be all and end all of being a good business and a good investment. How you make money and how sustainable that is is much more important.

On Monday this week, Neil Woodord's equity income fund, which has been struggling, announced that its investors could not redeem their holdings. This was apparently triggered by Kent County Council wanting to cash in its £250m stake. Given the illiquidity of many of the fund's holdings, this was not possible without selling them first and putting them into more liquid assets.

This is a big headache for Hargreaves Lansdown, who has been a big supporter of Neil Woodford and had £2bn of its clients' money invested with his funds as of the end of March 2019.

Hargreaves Lansdown biggest revenue and profit generator is the fees it charges its customers for owning funds on its platform. It charges 0.45 per cent per year for fund assets less than £250,000. Assuming that all the £2bn invested in Woodford earned that fee – holdings of more than £250,000 will pay a lower rate – HL would earn £9m from it.

This is a nice earner for just being a distributor. I've been very outspoken about platform fees on open-ended funds. I think that they are nothing short of a rip-off and represent money for old rope. They discriminate against customers who wish to own funds as those owning shares, investment trusts and exchange traded funds (ETFs) pay flat fees that don't go up once they have reached a threshold value. They are capped and fees on funds should be as well.

At the end of April, more than half of HL's assets under management – £52.7bn – were in open-ended funds and were providing the bulk of its profits.

Yet, the Woodford episode undoubtedly puts the company's business model under a cloud, in my opinion. Given the lucrative nature of platform fees on funds, it is no surprise that HL promotes them heavily to its clients. Yet, the way it does this is going to be heavily scrutinised in the light of this week's events.

Its Wealth 50 list of preferred funds offers discounted management fees to its clients and works very well for fund managers looking for fresh inflows of money through the country's largest retail fund distributor. All this money accrues lucrative platform fees for HL. Up until Monday, Woodford Funds were on the Wealth 50 list. High performing funds such as Fundsmith Equity were absent and most people in the industry know the reason why – it won't give HL customers a discounted management fee.

The support for the long underperforming Woodford funds will again raise questions as to the integrity and quality of the Wealth 50. Do funds get on the list because they are good investments or because they offer a fee discount which drives platform fee income for HL?

Hargreaves Lansdown forecasts

	Year (£m) 2019	2020	2021
Turnover	484.5	539.9	601.7
Ebitda	316.6	357.3	402
Ebit	305.6	343.1	383.2
Pre-tax profit	309	348.3	394.7
Post-tax profit	249.8	284.6	328.2
EPS (p)	52.4	59.5	67.4
Dividend (p)	41.4	46.8	52.7
Capex	6	8.7	8.7
Free cash flow	243.9	290.6	321
Net borrowing	-288.9	-346.3	-343.7

Source: SharePad

I think the fund platform fee levels charged by HL and others aren't justified and ultimately unsustainable. They are effectively a replacement for trail commission, which has been banned. The fund platforms cannot justify this price discrimination, and sooner or later I expect the industry to come under closer scrutiny for this practice. If and when it does, investors may wake up to the big threat to HL's business model, its long-term sustainable profitability and the right valuation for its shares. I continue to be bearish on all three.

As for the fate of Neil Woodford, it seems that his funds now face an uncertain future. There are lots of people putting the boot into him on Twitter, but I think this is a little unkind. He is a conviction investor, which is what you want in an active manager. Unfortunately, his conviction in unloved, lowly-valued stocks has not paid off recently, but I have yet to meet a fund manager who set out to lose his customers' money.

Where criticism is warranted is the inclusion of unlisted and illiquid investments in an open-ended fund. This is a very bad mix and hurts customers at times of distress, as we saw with commercial property funds during the last recession. These type of investments belong in closed-end funds such as investment trusts and their inclusion in open-ended funds needs to be stopped.

Card Factory

Card Factory's (CARD) business and its share price is stuck in something of a rut. I quite like how this business is set up with its vertically-integrated structure and its value for money for ethos. I also like its decent profit margins and good free cash flow generation, but I remain uncertain as to whether there remains any long-term growth potential in this business.

Trading in 2019 has got off to a good start with like-for-like (LFL) sales growing by 2.3 per cent and 14 new stores being opened. The company expects to open up 50 stores this year – net of closures.

Comments that it is on track to meet expectations are a little bit meaningless at the moment given that it makes most of its money at Christmas, but it seems a case of so far so good.

The company has 979 stores and its roll-out is still quite impressive, which means that LFL sales need to be treated with a little bit of caution. They could be capturing a maturation effect of stores more than a year old – which are included in LFL figures – that are still to reach their potential level of sales.

The main attraction of this share continues to be its dividend yield, which currently stands at 7.8 per cent on a forecast basis, at a share price of 194p. The company is essentially paying out all its free cash flow to shareholders having previously taken on debt to fund special dividends. While net debt is not overly excessive at 1.6 times for many businesses, it is quite high for a retail business with a lot of operational gearing.

The company says it expects LFL sales for the year as a whole to be marginally positive, which backs up the view that this is now essentially a low-growth business. New stores will add a bit of growth, but at 11.1 times rolling forecast earnings I don't see why these shares should be more expensive.

Card Factory forecasts

		Year (£m)	
	2020	2021	2022
Turnover	452.9	470.5	489.7
Ebitda	88.5	90.2	92.6
Ebit	76.9	77.9	79.4
Pre-tax profit	73.4	74.6	76.4
Post-tax profit	58.9	60.1	61.5
EPS (p)	17.3	17.6	18
Dividend (p)	15.1	14.3	15.8
Capex	18	15.5	15
Free cash flow	53.1	58.4	60.3
Net borrowing	140.1	133.6	129.6

Source: SharePad

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Applegreen

Applegreen (APGN) makes most of its money selling fuel from petrol station forecourts in Ireland, the UK and the US. It is the biggest operator of motorway service stations in Ireland and the second biggest in the UK after buying a majority stake in Welcome Break last year.

Its petrol stations are also mini-convenience stores where the company attempts to entice customers in with cheap fuel and hope that they pick up a few extra bits and bobs on the way. It is a popular strategy that has been replicated by major supermarkets in the UK, and by convenience store operators such as Budgens who often sell from branded petrol stations such as Shell.

Selling fuel and being a convenience store retailer have to be two of the most unattractive businesses to try and make money out of. Competition is beyond fierce and consequently the profit margins are wafer-thin, and you need to sell lots of products to make acceptable levels of absolute profits. Return on capital employed (ROCE) is fairly poor at around 5 per cent adjusted for leases last year.

Motorway service stations are a little bit more attractive. Their captive customer base gives the opportunity for retailers to charge premium prices and for owners to receive stable and potentially growing cash flows from concessions from fast food operators and the likes of WH Smith.

Applegreen has spent big on Welcome Break (£362m) in the hope of transforming the financial performance of the business. It has loaded the company up with barely comfortable amounts of debt – net debt to earnings before interest, tax, depreciation and amortisation (Ebitda) is forecast to be 3.4 times this year – and needs this acquisition to pay off.

The current evidence that it looks like doing so is a little bit lukewarm judging by Wednesday's AGM trading update. The business has been integrated well and remains on track to deliver the expected cost savings, but I find the comment that Welcome Break's trading has been affected by the uncertainty caused by Brexit a little hard to believe. I've been out on the motorways in the south and north of England quite a bit recently and they seem busier than ever.

I would never buy petrol at a service station unless I was desperate and my car was running on fumes – as the prices are horrendously expensive . Last week's announcement that the UK government was looking at service station fuel prices does not bode well for Welcome Break and its peers. A trip down the A1 from Yorkshire last weekend did strike me that prices may have been cut.

As for the softer-than-expected trading performance, perhaps Britain's drivers are keeping their hands in their

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pockets and using Welcome break for public conveniences and eating their homemade sandwiches.

The Irish business continues to perform well, which is reassuring.

If the one analyst forecast on this company is right then profits are set to grow nicely and debts are expected to come down quite quickly. Yet, on a forecast rolling PE of 14.7 times, a lot of this outlook looks priced in.

This business looks to be well-run given the tough competitive environment, but the low margins and ROCE would put me off. If the Welcome Break trading turns up, the acquisition could make decent returns. Cutting fuel prices on the back of political pressure could be a source of significant forecast risk in the UK.

Applegreen forecasts

	Year (€m)		
	2019	2020	2021
Turnover	2,770.20	3,102.00	3,313.40
Ebitda	140.8	154.1	160.9
Ebit	95.7	107.4	111.1
Pre-tax profit	70.9	84.9	90.7
Post-tax profit	39.6	47.1	50.7
EPS (¢)	32.7	38.7	42
Dividend (¢)	1.8	2.1	2.3
Capex	55.6	55.1	53
Free cash flow	30.7	53.8	–
Net borrowing	470.3	403.8	336.3

Source: SharePad

AO World

I have immense admiration for anyone who starts and runs a business. It is a very hard thing to do and even harder to be successful. Most analysts and journalists commenting on businesses could not do so – including this writer – and therefore I do try to make my criticisms constructive and from the viewpoint of a potential investor who has to be unsentimental and rational about their decisions.

AO World (AO.) is a business I struggle with. I'm not sure why anyone would want to own shares in it. A bit like Applegreen with its petrol stations (above), it is trying to make reasonable amounts of money from a very competitive market.

As with all businesses, you have to ask what is its competitive edge? It either has to be able to do something that others cannot or it has to be the lowest cost operator. When it comes to selling electrical goods, I don't think AO World has either of these characteristics.

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	31 March 2019			31 March 2018			Change		
	UK(3)	Europe(2)	Total	UK	Europe	Total	UK	Europe	Total
Income Statement									
Product revenue	628.4	151.1	779.5	600.2	114.4	714.6	4.7%	32.2%	9.1%
Service revenue	30.1	1.6	31.8	26.2	1.4	27.6	14.8%	20.2%	15.1%
Commission revenue	61.2	0.3	61.5	26.6	0.1	26.7	130.0%	180.9%	130.2%
Third party logistics revenue	15.3	0.0	15.3	16.0	0.0	16.0	(4.2)%	–	(4.2)%
Recycling revenue	14.3	0.1	14.5	11.7	0.1	11.8	22.2%	17.3%	22.2%
Revenue	749.3	153.2	902.5	680.8	116.0	796.8	10.1%	32.0%	13.3%
Adjusted EBITDA(4)	27.4	(27.8)	(0.4)	22.6	(26.0)	(3.4)	20.9%	(6.4)%	87.6%
Adjusted EBITDA margin(5)	3.7%	(18.1)%	0.0%	3.3%	(22.4)%	(0.4)%	0.4ppts	4.3ppts	0.4ppts
Adjusted operating profit/(loss)(6)	21.0	(28.9)	(7.9)	16.8	(27.7)	(10.9)	24.6%	−3.9%	27.8%

Source: Company report

Amazon, John Lewis, Dixons and Currys are four places to buy your electrical stuff and most of them price-match. How does AO World stand out in this market? Carphone Warehouse tried to create a meaningful big box electrical business with Best Buy from the US and gave up trying because it couldn't make it work. It merged its phone business with Dixons instead.

To give it its due, AO's UK business did quite well last year. It added £28.2m of extra product sales, but got a big kicker from commission revenue, which helped it add £4.2m of extra operating profit to get to a total of £21m – equivalent to a profit margin of 2.8 per cent.

Europe added £37.2m of sales, but losses went up from £27.7m to £28.9m. The company's ambition to get this business to breakeven by 2021 looks a bit optimistic to me.

Analysts don't seem convinced given their current profit forecasts, which would be a lot higher if this was expected. These shares remain a punt and a risky one at that.

AO World forecasts

	Year (£m)		
	2019	2020	2021
Turnover	900.6	1,102.70	1,222.40
Ebitda	-0.4	8	18.1
Ebit	-8	-1.7	10.7
Pre-tax profit	-6	0.4	8.6
Post-tax profit	-5.7	-2.7	9.5
EPS (p)	-1.1	-0.3	2.3
Dividend (p)	-	-	-
Capex	6.8	5.5	5.9
Free cash flow	-31.9	18.7	15.7
Net borrowing	-10.1	-2.7	-29.6
NAV	65.8	89.9	99.7

Source: SharePad

Auto Trader

Along with Hargreaves Lansdown and Rightmove, **Auto Trader (AUTO)** is one of the most profitable businesses listed on the London Stock Exchange. The business has had another good performance in the year to March 2019, with revenues up by 8 per cent and operating profits up by 10 per cent. Operating margins increased from 67 per cent to nearly 69 per cent.

Auto Trader does what every good and outstanding company does by converting all of its post-tax profits into free cash flow. The capital expenditure requirements of this business are minimal, which allow it to generate free cash flow margins of over 58 per cent and ROCE of 63.3 per cent.

I think this is an outstanding business and I can fully understand why investors would want to own a slice of it. The company has successfully migrated from a physical publication to a dominant digital platform that remains highly relevant to car retailers and car buyers. Eighty per cent of UK automotive retailers advertise on Auto Trader.

Auto Trader has continued to launch innovative products and services to its customers, particularly in the area of new cars and car finance. While the number of car retailer forecourts is stable, the amount of money Auto Trader made from them last year went up by 9 per cent. About 49.1m visits were made to the website (up 1 per cent) with the share of time spent on the platform at a very high 76 per cent – nearly five times greater than its next biggest competitor.

The only slightly disappointing part of the results is that full page advert views fell by 3 per cent.

Key performance indicators

Average Revenue Per Retailer forecourt(4)	GBP per month	1,844	1,695	GBP149
Physical car stock on site(4,5)	number	461,000	453,000	2%
Number of retailer forecourts(4)	number	13,240	13,213	0%
Cross platform visits(,4,6)	million per month	49.1	48.7	1%
Share of time spent on site(4,7)	%	76%	75%	1% pt
Full page advert views(4,8)	million per month	239	246	(3%)
Full-time equivalent employees and contractors(1) (FTEs)	number	804	824	(2%)

Source: Company report

Auto Trader is a dominant player in its field and, contrary to the views of doom mongers, is as strong as it has ever been. The likes of Facebook and Google have failed to strike a blow to its business.

The new trading year has started well, with the company expecting average revenue per retailer forecourt to grow again and for the business to keep on growing overall.

Unsurprisingly, Auto Trader shares are not cheap and trade on a one-year rolling forecast PE of 26.3 times, at a share price of 587p. This compares with Rightmove on 27.1 times and Hargreaves Lansdown on 33 times. That said, I think the shares might still be worth paying up for.

I think I'd rather own Auto Trader shares than the other two. The company looks set to keep on growing and will use its prodigious free cash flow to buy back shares (I think that a special dividend and a share consolidation might be a better method of returning cash). In a UK market which has a shortage of high-quality businesses on offer, Auto Trader shares are still worth owning (or at the very least considering).

Auto Trader forecasts

	Year (£m)		
	2019	2020	2021
Turnover	351.8	374.9	400.5
Ebitda	251	271	290.8
Ebit	241.5	262.7	284.6
Pre-tax profit	230.1	252.4	273.7
Post-tax profit	186.6	205.9	224.6
EPS (p)	19.8	22.3	25.1
Dividend (p)	6.6	7.4	8.3
Capex	3.6	3.8	3.9
Free cash flow	204.7	223.9	244
Net borrowing	311.3	274.4	249.9

Source: SharePad

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