investors CHRONICLE alpha

10 May 2019

Phil Oakley's Weekly Round-Up

Stock markets have sold off in the past week as concerns over the US-China trade war have intensified. Some kind of a pull-back was overdue, however

The companies mentioned this week are:

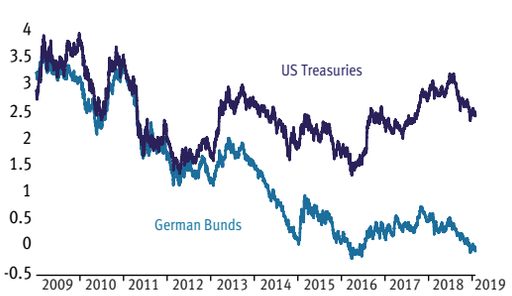
- JD Wetherspoon
- Domino's Pizza
- ITV
- Treatt
- Elegant Hotels
- Vertu Motors

Fantasy Sipp performance

	Portfolio returns(%)		
	1-month	Year-to-date	1-year
Finsbury Growth & Income Trust	4.6	17.9	14.3
Fundsmith Equity T Acc	-0.1	16.8	19
Lindsell Train Global Funds	3.3	16.4	22.1
Phil Oakley Fantasy Sipp	**2.7**	**16.0**	**18.1**
Castlefield CFP SDL UK Buffettology Fund	8.1	15.2	13.4
Vanguard S&P 500 ETF	0.3	13.3	12.3
Scottish Mortgage Investment Trust	-0.4	12.6	6.62
FTSE All-Share – total return	-1.6	10.3	-0.2

Source: SharePad

Yield on 10-year US and German government bonds



Source: Bloomberg

Stock markets have sold off during last week as concerns over the US-China trade war have intensified, while concerns about economic growth have resurfaced. Bond markets have been strong in the US as investors have bought into safe havens, while government bond yields in Germany have gone below zero.

I've written a lot about how I see high quality shares as being expensive and, in some cases, overpriced. I think share prices have run too far too fast and that some kind of pullback was overdue and indeed welcome.

Along with high valuations, my main concern is the

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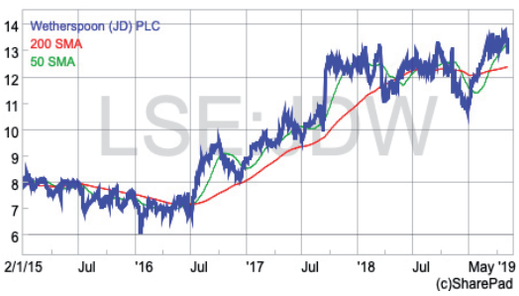
ability of companies to keep on growing their profits at a satisfactory rate. The Fantasy Sipp portfolio contains companies that have shown high degrees of earnings stability in difficult economic times and the hope is that they will do so again in the future, but at a higher level of profit.



JD Wetherspoon

JD Wetherspoon (JDW) continues to be the most effective pub operator in the country. I say this because it continues to generate vastly superior like-for-like (LFL) sales growth compared with its quoted peers. For the 13 weeks to 28 April, sales on this measure increased by an impressive 7.6 per cent. Year-to-date (YTD) LFL sales (nine months) are up by 6.8 per cent.

The problem is that this growth in sales is not feeding through into higher profits, as cost pressures – especially wages – continue to rise. Profit forecasts for the year to July 2019 are therefore unlikely to change on the back of this week's update.

I am a big fan of Wetherspoons' business model. It is very simple and based on offering great value for money in well-maintained pubs. It has a strategy that has served it well.

The company is also taking a very sensible approach to pub openings given the difficult state of the UK market where there are still arguably too many pubs chasing too few customers. Five pubs are due to open this year, while seven have been closed so far.

What seems clear to me given the sales performance is that the quality of the pub estate is improving. The company is also using the vast majority of its free cash flow to continue to buy out the freeholds of pubs where it was previously a tenant. It has spent just over £70m so far this year and this may explain why forecast net borrowings for the end of the year are £20m higher than expected.

Wetherspoons' estate is just over 60 per cent freehold now up from around 40 per cent a decade ago. I see the trend of freehold ownership continuing to increase as it makes sound business sense. It gives the company more asset backing and offers it more flexibility in getting rid of underperforming pubs.

The only issue with this is that it pushes up net debt levels which are approaching sensible limits of 3.5 times Ebitda (earnings before interest, tax, depreciation and amortisation). That said, as the business is producing around £100m of free cash flow annually, the ability to pay down debt quickly is there.

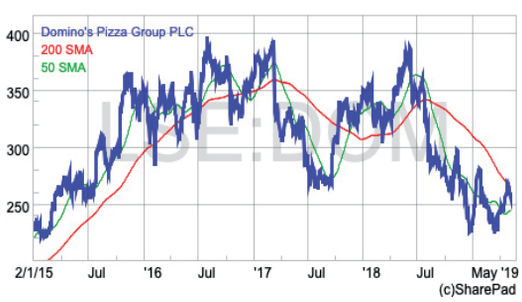
JD Wetherspoon forecasts

	Year (£m) 2019	2020	2021
Turnover	1,793.20	1,855.30	1,923.00
Ebitda	217.3	223.3	230.8
Ebit	134.8	137.6	141.5
Pre-tax profit	102	104.1	108.8
Post-tax profit	79.6	81.1	84.4
EPS (p)	75.8	78.1	82.5
Dividend (p)	12	12	12
Capex	121.2	98	90.8
Free cash flow	105.7	89.2	93.3
Net borrowing	725.2	681.2	648.5
Like-for-like sales growth (%)	5.7	3.6	3.2

Source: SharePad

I've written many times that I don't really like the pub sector too much. Profit margins are fairly thin and return on capital employed (ROCE) is pretty modest. However, if I was going to invest in the sector, Wetherspoons would probably be the one I would go for.

Without profit upgrades the shares look up with events to me, on a one-year forecast rolling PE of just over 16.5 times, at a share price of 1,285p.



Domino's Pizza

I've always believed that **Domino's Pizza (DOM)** is a very good and very profitable business. Over the past couple of years, I've become increasingly concerned as to whether it can sustainably grow profits in its core UK market.

My fear is that Domino's cannot do this without cannibalising the sales and profits of its existing store base. The strategy of growing the number of stores by splitting territories – in simple terms adding more stores to an area where one already exists – is dangerous and has pushed Domino's into conflict with its franchisees, whom it relies on to deliver growth.

Franchisees are also unhappy about the passing on of changes in food inflation from Domino's – particularly the cheese price – with the implicit view that it transfers too much profit from them back to Domino's. It's always worth remembering that Domino's makes the bulk of its profits from selling pizza ingredients to its franchisees not from the royalties they pay it.

Cannibalisation is not a new risk. It is exactly what brought the progress of Restaurant Group to a halt and then a decline. Investors are right to worry about it.

Understandably, Domino's does not want to draw attention to this issue. It continues to report its UK LFL sales excluding the impact of split territories – presumably because they would be lower – and this only increases suspicion among outside investors that this is a bad and damaging strategy.

UK LFL sales increased by 3.1 per cent in the first quarter of 2019, but order volumes decreased by 2.7 per cent and prices rose by a significant 5.1 per cent. The price and volume elements attracted a fair amount of scrutiny of the company's conference call with analysts, as some were rightly interested in the value perception of the price and the volume trade-off that it was creating.

Raising prices is not a good strategy in a competitive market and falling volumes could be seen as a sign of a customer backlash. The company played this down and said that the effects were mainly down to the impact of a promotion at the same time last year. It said underlying price inflation was running at the same level as cost inflation – about 3 per cent. It then confused matters slightly by hinting that some franchisees had increased prices by more than this amount.

"Raising prices is not a good strategy in a competitive market"

The problem with franchisees is not just about the effect on their profits, it is about store openings as well. Franchisees are dragging their heels and not opening as many stores so far this year. This is a major source of downside risk to profit forecasts.

Only four new stores were opened in the first quarter. Based on current firm plans, only 15 are in place so far for 2019. This compares with net store openings of 58 in 2018. I think profit forecasts in the UK could well be coming down because of this.

The international business continues to underperform. Iceland and the joint venture in Germany are profitable, but trading in Switzerland, Norway and Sweden is not going as well as expected. The company lost £4.1m last year from its international business and expected to break even this year a few months ago. It doesn't now. In fact, it doesn't really seem to know how much money the business would lose, but it did not rule out that the losses could be bigger than last year.

Domino's Pizza forecasts

	Year (£m)		
	2019	2020	2021
Turnover	580.1	616.5	664.5
Ebitda	113.8	121.8	131.1
Ebit	99.9	107.3	116.2
Pre-tax profit	96.1	104.2	113.5
Post-tax profit	77.5	83.4	89.8
EPS (p)	16.8	18.1	19.7
Dividend (p)	10.7	11.4	12.4
Capex	28.8	27.5	27.7
Free cash flow	70.2	75.2	82.7
Net borrowing	207.4	186.3	169.6
Like-for-like sales growth (%)	3.5	4	4.1

Source: SharePad

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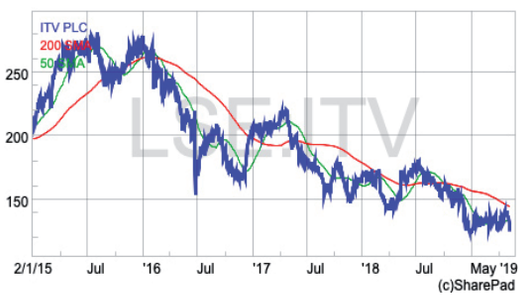
At 263p, the shares trade on 15.2 times one-year forecast rolling EPS. Yet those forecasts look too high to me, especially 2021 forecasts. The shares are not desperately expensive, while the prospective dividend yield of 4.2 per cent looks to be relatively safe.

That said, this looks like a company that has lost its way a little bit and has big problems with its franchisees. It is also lagging its competitors in terms of innovation. For example, Papa John's is selling vegan pizzas which tap into one of the biggest food trends of the moment, as has been evidenced by the success of Greggs' vegan sausage rolls.

I remain very cautious on the long-term growth potential of this business.



ITV

ITV (ITV) has long been touted as a takeover target, but this event has yet to occur despite the company's cheap stock market valuation (just over nine times its next year's earnings at 125p).

The reason for this is that despite its best efforts, ITV remains a very cyclical business and is still very dependent on advertising revenue. It also has a lot of fixed costs, which means that its profits are very sensitive to changes in revenues. The risk remains that its profits will be hammered in the next recession.

Despite this, it does have some reasonably attractive assets. It is the biggest free to air commercial broadcaster and therefore remains very relevant to advertisers. ITV Studios has some great drama content, while its extensive back catalogue – soon to be launched on a subscription streaming service called BritBox – has significant value.

Revenue for 3 months ended 31 March (£m)	2019	2018	%
ITV Broadcast & Online	489	526	(7)
ITV Studios	385	382	1
Total revenue	**874**	**908**	**(4)**
Internal supply	(131)	(136)	(4)
Total external revenue	**743**	**772**	**(4)**

Revenue for 3 months ended 31 March (£m)	2019	2018	%
Total advertising revenue	417	448	(7)
Non-advertising revenue	457	460	(1)
Internal supply	(131)	(136)	(4)
Total external revenue	**743**	**772**	**(4)**

Source: ITV

Current trading is soft with first-quarter advertising revenue down by 7 per cent. First-half advertising revenue is expected to be down by 6 per cent. ITV Studios is growing, but looks on course to pick up during the year.

The ITV Hub is doing well with a 16 per cent increase in viewing and nearly 29 million registered users. A new deal for targeted advertising should increase revenues going forward.

ITV forecasts

	Year (£m) 2019	2020	2021
Turnover	3,266.00	3,376.20	3,510.30
Ebitda	751	791	836.3
Ebit	706.5	731.1	799.7
Pre-tax profit	671.8	711.5	762
Post-tax profit	540.7	556.1	576.4
EPS (p)	13.4	13.9	14.4
Dividend (p)	8.3	8.9	8.9
Capex	59.5	60.2	59.6
Free cash flow	452	474.1	535.1
Net borrowing	909.2	876.5	786.2

Source: SharePad

However, it seems that a bleak outlook has been factored into the share price. Short of a takeover, what is going to cause ITV's share price to go up? It seems that investors are waiting for the worst to happen and assume a steep fall in profits is not too far away.

From time to time, people suggest that ITV should turn itself into a subscription business, but it is by no means sure that consumers would warm to it. Britbox has the potential to give a useful boost to revenues and profits and increase the quality of earnings.

Around 5m subscribers paying £5 per month would produce £150m of extra revenues (its 50 per cent share) for ITV, which given it owns its own content could see a lot of this drop through to profits. It would also reduce its dependence on advertising a little bit.

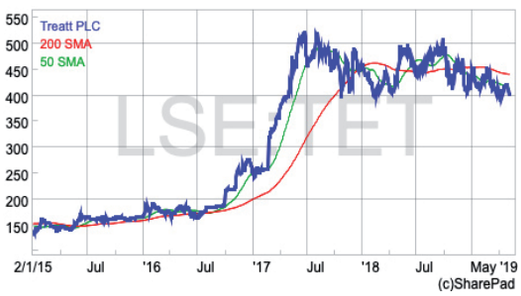
"The cyclical nature of ITV's profits refuses to go away"

But the nagging worry of advertising, the shift to streaming and the cyclical nature of ITV's profits refuses to go away. You can't help thinking that the core ITV channels will continue to have fewer viewers in the years ahead, which will make it less attractive to advertisers. ITV needs to do something radical to address this, and BritBox and the growing strength of ITV Studios looks to be the way forward.

The other main problem is the continued existence of the BBC licence fee, which creates a very uneven playing field in UK free to air broadcasting, as the BBC doesn't have to fish for its supper. If the licence fee was scrapped then it is possible that the BritBox joint venture could become something bigger. However, the current BBC charter runs until 2027, so this is not going to happen anytime soon.

ITV continues to look cheap, but a sharp fall in earn-

ings would blow a hole in this view. It seems that many investors are just scared to buy the shares because of what might happen to its profits. I understand this and can't see how anything changes this view in the short term.



Treatt

Treatt (TET) is a business that has plugged itself into some very favourable trends. The ingredients company specialises in flavours used in drinks, fragrances and consumer products. Most of its sales are from overseas, which gave it a big boost following the sharp devaluation of the pound in 2016. Since then the shares have been in something of a rut, as growth rates have been quite modest for the business as a whole.

The company's key revenue growth is from beverages in the form of tea (especially iced tea), low or no sugar drinks and citrus drinks. It does not split out individual revenue streams, but tea saw big growth (20.3 per cent), as did sugar reduction (37.7 per cent). Citrus sales – Treatt's largest product category – actually fell due to lower raw material prices, but a better mix saw profits increase. Natural fruit and vegetable flavours saw rapid growth in sales of 64.3 per cent.

In terms of geography, US sales – Treatt's biggest market at 38 per cent of sales – were up by 8.4 per cent (driven by premium drinks) and China by 8.6 per cent.

Underlying profits performed reasonably well, with gross profit margins up 140 basis points to 25 per cent, but operating margins fell slightly to 11.1 per cent, as staff costs increased with the company building up capacity in the UK and US.

Cash generation was better due to a much improved working capital performance, but capex was higher due to investment in new capacity. Going forward, capex will increase significantly due to investment in a new £35m facility in the UK.

Treatt forecasts

	Year (£m)		
	2019	2020	2021
Turnover	113.6	117	124
Ebitda	15.8	18.3	20.1
Ebit	13.4	14.4	15.4
Pre-tax profit	13.6	14.4	15.5
Post-tax profit	10.6	11.2	12.1
EPS (p)	17.7	18.6	20.2
Dividend (p)	5.2	5.8	6.1
Capex	23.1	14.7	2
Free cash flow	8.8	10.5	12
Net borrowing	-1	10.9	0.9

Source: SharePad

My main concern about Treatt is that I believe its profits and ROCE have been flattered by a very old asset base. I expect ROCE to be materially lower than the 15 per cent of 2018 once the new manufacturing capacity has been completed. I'm not convinced it will look that attractive then.

I do like the company's exposure to attractive end markets, but within this business the growth segments are not leading to big rates of revenue and profits growth overall. I remain wary that its big drinks company customers have a lot of pricing power and the ability to put pressure on profit margins and force Treatt to take on large chunks of additional working capital at the expense of its free cash flow.

The outlook for 2019 looks alright given that forward order books are healthy. I see this as a business that should be able to keep on chugging along, but am not yet confident that new facilities in the US and the UK will bring a step change in growth rates any time soon.

The shares have been derated since I last wrote about them back in November and have fallen from a one-year rolling forecast PE of over 25 times to just under 22. That looks fully priced to me.

Elegant Hotels

Elegant Hotels (EHG) is the owner and operator of a number of upmarket hotels on the Caribbean island of Barbados. Most of its hotels are on Barbados' very desirable western Caribbean Sea coast.

It is known as the 'Platinum Coast'. Speaking from personal experience, this is a very nice part of the world to spend your holiday and also very expensive.

The cost of staying in these four to five star hotels doesn't come cheaply. To sum it up, if you have to ask the price of the drinks or the meals you probably can't afford it. About 80 per cent of Elegant's customer base is made up of reasonably to very affluent Brits who want somewhere upmarket to soak up the sun during the British winter.

The business is very seasonal and makes the bulk of its money between September and March, with peak revenues in the UK winter months.

The shares have been a very disappointing investment since listing on the stock exchange in 2015. The devaluation of the pound against the US dollar has made it more expensive for British holidaymakers, while the condition of some of the hotels has needed upgrading. The company has also had to compete against a growing trend for private villas and all-inclusive hotels. Shareholders have already experienced one dividend cut.

This week's half-year results covered the company's

"My issue with this company is, where is the growth going to come from?"

peak earnings season. They look reasonably solid but no more than that. Occupancy rates increased from 67 to 68 per cent, but average room rates came down slightly from $539 to $532. The closely watched revenue per available room (RevPAR) nudged up slightly from $362 to $364.

The results benefited from a full six months of contribution from Treasure Beach, where refurbishment finished in December 2017. This helped revenues increase from $42.5m to $43.7m and pre-tax profits from $11.4m to $12.0m. Cash generation improved with higher operating cash flows and lower capex, which meant that debt levels have come down. They still remain pretty high at 3.3 times Ebitda (4.0 times a year ago) though.

My issue with this company is where is the growth going to come from? It is selling a very expensive product that means its addressable market is quite small. Its occupancy rate of 68 per cent is not great during the peak season and shows how hard it is to sweat the hotel assets and perhaps the limited appeal of its offer. As a comparator, European hotels in southern Europe will average well over 70 per cent between March and September. Growing by increasing room rates is likely to be difficult.

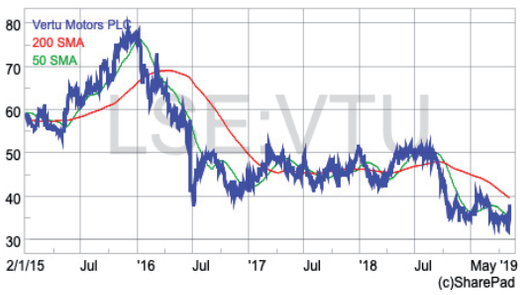
It is quite clear that the market has little faith in the valuation of $249.5m placed on Elegant's hotels by CBRE last year, which would equate to around 156p per share. This compares with a current share price of 70p, which equates to a forward PE of just seven times.

Elegant Hotels forecasts

	Year ($m)		
	2019	2020	2021
Turnover	65.3	66.9	68.2
Ebitda	20.6	21.2	21.7
Ebit	15.8	16.3	16.8
Pre-tax profit	12.1	12.8	13.6
Post-tax profit	11.3	11.9	12.5
EPS (¢)	12.5	13.2	14.1
Dividend (p)	4	4	4
Capex	4.1	3.2	3.3
Free cash flow	11.7	12.6	13.3
Net borrowing	64.7	56.3	47.2
NAV	123	131.1	139.8

Source: SharePad

The shares do look very cheap and offer a dividend yield of nearly 5.6 per cent, which looks safe as long as profits hold up. Despite this, it is not a business that I can get excited about.



Vertu Motors

It's tough out there for car dealership companies. The PCP credit-fuelled buying boom of new cars seems to have peaked, while buyer indecision caused by changing technologies and manufacturer teething troubles over new emissions standards have seen the UK new car market shrink.

Thankfully, new cars is not where dealerships make most of their money. That comes from selling used cars and on charging very high prices for servicing where gross profit margins are very high. **Vertu Motors (VTU)** is doing reasonably well in both businesses and managed to keep overall sales and gross profits growing last year. Operating profit fell due to higher costs.

	FY19 £'000	Mix %	FY18 £'000	Mix %	% change	Like for like Change %
Revenue						
New	862,824	28.9	836,370	29.9	3.2	2.9
Fleet & Commercial	644,643	21.6	662,520	23.7	(2.7)	(3.9)
Used	1,217,596	40.9	1,068,931	38.2	13.9	11.6
Aftersales	257,137	8.6	228,247	8.2	12.7	8.8
Total Group Revenue	**2,982,200**	**100.0**	**2,796,068**	**100.0**	**6.7**	**5.1**

	FY19 £'000	Margin[4] %	FY18 £'000	Margin[4] %	Gross Profit Change £'000	Like for like Gross Profit change %
Gross profit						
New	63,832	7.4	64,068	7.7	(236)	(0.6)
Fleet & Commercial	20,217	3.1	21,429	3.2	(1,212)	(8.4)
Used	102,043	8.4	98,680	9.2	3,363	2.5
Aftersales	136,013	43.9	123,531	44.0	12,482	6.4
Total Gross profit	**322,105**	**10.8**	**307,708**	**11.0**	**14,397**	**2.7**
Operating expenses	(294,714)	9.9	(277,257)	9.9		
Operating Profit	**27,391**		**30,451**			

Source: Vertu Motors

The key test for used car sellers is managing their stock levels and turning them into cash quickly. A look at Vertu's operating cash flow shows a £32m positive swing in working capital that seems to suggest that all is well.

	Note	2019 £'000	2018 £'000
Cash flows from operating activities			
Operating profit		29,013	32,345
Profit on sale of property, plant and equipment	6 & 8	(520)	(3,529)
Amortisation of other intangible assets	16	543	614
Depreciation of property, plant and equipment	18	10,722	9,714
Impairment charges	6	-	513
Movement in working capital	33	18,861	(13,332)
Share based payments charge		904	954
Cash generated from operations		**59,523**	**27,279**
Tax received		157	350
Tax paid		(4,860)	(6,468)
Finance income received		99	14
Finance costs paid		(3,953)	(2,321)
Net cash generated from operating activities		**50,966**	**18,854**

Source: Vertu Motors

A closer look tells a slightly different picture. Inventories increased substantially and were only offset by delaying payments to suppliers and an inflow of receivables from acquisitions. There's a good chance that this will reverse this year and cash flow will take a hit. Stocks as a percentage of sales increased from 20 per cent to 21 per cent. The fact that used car sales were flat in March and April might have raised concerns of lower profits, but margins at the start of the current year have been maintained, which is a good result.

2019	Inventories (Note 20) £'000	Current trade and other receivables (Note 22) £'000	Trade and other payables £'000	Total working capital movement £'000
Trade and other payables (Note 24)			(717,204)	
Deferred consideration (Note 17)			(4,100)	
Contract liabilities (Note 28)			(19,413)	
At 28 February 2019	618,675	62,940	(740,717)	
At 28 February 2018	558,386	66,272	(672,381)	
Balance sheet movement	**(60,289)**	**3,332**	**68,336**	
Acquisitions (Note 17)	27,651	8,398	(25,575)	
Deferred consideration on acquisitions (Note 17)	-	-	(4,000)	
Movement excluding business combinations	**(32,638)**	**11,730**	**38,761**	**17,853**

Source: Vertu Motors

Overall, Vertu's results were taken well by the market and beat analysts' forecasts quite comfortably at the operating profit level. A dividend hike of 6.7 per cent was slightly better than expected as well.

Vertu Motors forecasts

	Year (£m) 2019	2020	2021
Turnover	2,916.20	2,941.40	2,971.80
Ebitda	35.9	39.9	43.3
Ebit	25	28.8	31.7
Pre-tax profit	22.1	26.3	28
EPS (p)	4.5	5.4	6
Dividend (p)	1.5	1.6	1.8
Capex	30.7	18.9	15.5
Free cash flow	3.5	11.9	18
Net borrowing	12.4	7.4	-3.9
NAV	276.5	290.1	305.5

Source: SharePad

But what of the future?

I think this is the kind of business that will do alright over the next few years. Their servicing and used car business tends to hold up well in soft new car markets, and with 100,000 customers having bought service plans this high margin source of business looks to be secure for now.

Longer term, the outlook is much more uncertain. Where do car dealerships fit in a world of internet retailing and electric vehicles?

There are no signs that car buying will shift to the internet, as it is a relatively complex process that involves test drives, trade ins, finance, warranties and service plans which tend to be done face-to-face. Car dealerships still seem to be part of car manufacturers' plans to sell their vehicles, but I would never rule out them taking this back in house – maybe not yet.

Electric cars don't require oil changes and should be cheaper and easier to service. This could see a hit to lucrative service revenues where Vertu is currently earning gross margins of 75 per cent. The good news for Vertu is that electric vehicles are only 1 per cent of new car registrations and are not going to hit the fortunes of car dealing service businesses for many years.

That doesn't mean that making money is going to be easy for Vertu and its peers. This year is looking like another tough one for new car sales, as new emissions tests could delay the launch of new models again.

However, at 37p, a lot of bad news is priced in with the shares trading at just seven times forecast rolling EPS, offering a yield of 4 per cent and a discount to tangible net asset value of 43p per share.

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