investors CHRONICLE alpha

13 September 2019

Phil Oakley's Weekly Round-Up

This week I look at six companies and discuss the valuation being put on the London Stock Exchange

The companies mentioned this week are:
- Apple
- Bovis Homes
- Abcam
- JD Sports
- Ashtead
- Morrisons

The price of scarce assets
Investors in the shares of high-quality business such as Nick Train have often argued that the market undervalues them. I agree with this view, but the full price is often only realised in a takeover situation rather than as a quoted standalone business.

This week's takeover approach from the Hong Kong Stock Exchange for the **London Stock Exchange (LSE)** is a classic example. The bid of 8,361p a share values LSE at a staggering 42 times 2019 forecast earnings. Why is a bidder prepared to pay so much?

Alpha Production Editor: Sameera Hai Baig

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

Stock exchanges are scarce assets with limited competition and tremendous pricing power. LSE has dominant businesses such as LCH, which deals with all the clearing activities of derivatives on the London market. Its FTSE and Russell indices businesses are growing in value, as passive investing and index-tracking strategies become ever more popular.

Data is immensely valuable, which is why I think LSE's proposed acquisition of Refinitiv is a good long-term move and one that could stop the Hong Kong bid in its tracks, as it might not be able to afford to buy it.

At the moment, the big discount to the bid price suggests that the takeover will not go ahead. It may become embroiled in a political debate about China controlling western strategic assets.

I don't think this is a bad thing if it comes to pass, as it will allow UK investors to continue to own a business that can grow in value over the long haul.

LSE has been a significant contributor to the performance of the Fantasy Sipp portfolio (it's the biggest holding) and accounts for 6.5 per cent of the total portfolio. I will do a thorough review of the portfolio and its holdings at the end of the month.

Fantasy Sipp performance

	Portfolio returns (%)		
	1 month	Year to date	1 year
Mid Wynd International Inv Trust	0.7	27.3	11.4
LF Blue Whale Growth Fund	-2.4	27.3	13.8
Fundsmith Equity T Acc	-1.8	26.7	15.7
Phil Oakley Fantasy Sipp	**-0.6**	**26.4**	**20.8**
Smithson Investment Trust	1.1	25.8	
Martin Currie Global Portfolio	-2.5	25.7	13.4
Lindsell Train Global Funds plc	-0.4	25.6	17.3
Finsbury Growth & Income Trust	1.4	25.5	14.6
Vanguard S&P 500 ETF	1.4	23.9	9.1
FTSE All-Share – Total Return	2.7	13.5	4.1
Castlefield CFP SDL UK Buffettology	0.3	13.0	2.5
Scottish Mortgage Investment Trust	-0.9	12.6	-1.1

Source: SharePad

Apple

For some time now many people – including me – have pointed out that **Apple (NASDAQ:AAPL)** is too reliant on the iPhone for its profits. Every September, the company has an event where it launches its new products. They are eagerly awaited by fans and investors in the hope that it will unveil revolutionary blockbuster products.

This year it did not do so. Apple revealed a new iPhone, a new watch, an updated iPad and the price of its Apple TV+ streaming service. In my view, none of these are going to accelerate Apple's rate of profit growth.

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

Apple has created a fantastic brand backed by products that are simple and easy to use and it has succeeded in getting people to pay top prices. Its rate of profitability is nothing short of superb if you look at measures such as profit margins or return on capital employed (ROCE), yet growing profits has been more difficult.

The company made $71bn of operating income in 2015 and is expected to make $63bn in the year to September 2019. It has spent large chunks of its prodigious free cash flows on buying back its own stock – 1.2bn shares since then. As a result, earnings per share is expected to have increased from $9.22 to $11.65 – an increase of 26.4 per cent.

Its share price has almost doubled over the past four years, while its price/earnings ratio has increased from 12.4 times to 18.9 times. The shares are up 40 per cent in 2019 alone.

The point I am trying to make is that Apple's share price has been driven by shrinking the number of shares in issue and an upwards valuation rerating – not by profits growth.

The shares are not hideously expensive right now, but there's only so much gain that can be delivered to shareholders without profits going up.

Apple forecasts

	Year ($m) 2019	2020	2021
Turnover	258,709.70	270,371.70	285,489.70
Ebitda	75,451.30	78,253.50	82,953.50
Ebit	63,325.80	65,379.60	69,323.90
Pre-tax profit	64,582.90	66,626.80	70,953.70
Post-tax profit	54,440.40	55,707.10	59,035.70
EPS (¢)	1,165.90	1,280.20	1,439.90
Dividend (¢)	299.7	313.9	336
Capex	11,783.20	13,339.20	13,976.70
Free cash flow	60,848.10	63,447.10	66,808.10
Net borrowing	-102,095.80	-88,550.40	-92,772.40

Source: SharePad

Analysts seem to think that profits will start growing again in 2020 and 2021 and my guess is that a 5G enabled iPhone will be launched and lead to lots of people upgrading their handsets.

The bull case is that Services will contribute a bigger slice of profits. I think they probably will, but it's hard to get excited about Apple's new initiatives here. The TV+ service is very competitively priced at $4.99 per month (one year free if you buy some Apple hardware such as a new iPhone), but so it should be given its very thin content and non-existent back catalogue, when compared with offerings from Netflix and Disney. Dependency on the iPhone remains the key problem.

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

Demand for Apple's phones is not going to collapse, but the prices it can charge are going to have to come down given product improvements are unlikely to be revolutionary. I expect a temporary 5G recovery, but what happens after that?

I've been a big fan and owner of Apple's products for a long time, but it still has to prove it can deliver meaningful and sustainable profit growth in the years ahead. Buybacks have done a good job up until now, but can't be expected to keep on sustaining Apple's share price forever.

Bovis Homes

Bovis Homes (BVS) has delivered a steady set of half-year results. Despite market conditions getting tougher across most of the sector, selling prices are holding up well, while Bovis is selling more homes at higher profit margins. This should be comfortably good enough to keep most shareholders happy.

	H1 2019	H1 2018	Change
Total completions(1)	1,647	1,580	+4%
Total average selling price	GBP269.2k	GBP262.7k	+2%
Group revenue	GBP472.3m	GBP432.2m	+9%
Operating margin	16.0%	14.6%	140bps
Profit before tax	GBP72.4m	GBP60.2m	+20%
Earnings per share	43.7p	36.1p	+21%
Ordinary dividend per share	20.5p	19.0p	+8%
Net cash	GBP102.4m	GBP42.8m	+139%
Return on capital employed(2)	19.8%	14.5%	530bps

Source: Bovis Homes

The company is doing what lots of its peers are doing by carefully controlling the amount of homes they sell in order to avoid flooding the market and driving down prices. This is reflected by the fact that Bovis saw no growth in private completions during the half year, with all of its growth coming from its partnerships with housing associations and the useful margin kicker that comes with utilising its strategic and cheaper landbank.

Unlike some of its peers, Bovis is less reliant on the Help to Buy scheme, which accounted for 25 per cent of completions in the half year. It has been offering more part-exchange deals, which accounted for 9 per cent of sales. This is often a sign of trading conditions getting tougher and I read it as such. What I don't know is how much profit or loss Bovis made on the part-exchange properties. What is encouraging is that no part-exchange properties were held for more than three months before they were turned into cash.

As with others in the sector, Bovis is operating a short-

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

owned land bank of just 3.7 years at current rates of production. This is backed up by a strategic landbank of over 19,000 plots.

	H1 2019	H1 2018
Consented plots added	1,004	505
Sites added	8	4
Sites owned at period end	115	107
Total consented land bank	16,215	16,107
Joint venture plots	3,054	-
Owned land bank plots	13,161	16,107
Average consented land plot ASP	GBP316,000	GBP294,000
Average consented land plot cost	GBP58,000	GBP51,000

Source: Bovis Homes

The company looks well placed to eventually get to its target of more than 4,000 completions (3,759 in 2018). It seems quite bullish on the outlook for its social housing partnerships and is confident it can achieve a ROCE of 25 per cent by 2022 – if the market holds up, of course.

In addition to these solid results, Bovis has come back with a new offer for Galliford Try's Linden Homes and Partnerships business. It is offering just over £1bn in the form of around £600m of new Bovis shares, £300m in cash and £100m of assumed debt for a business that made £195m of trading profits in the year to June 2019.

This is slightly more than the £950m offered back in May and could be a good deal for Bovis if it goes through. It will significantly increase the size of the business to one capable of more than 7,000 completions a year, which should give it more buying power to enhance profit margins.

It will also get its hands on a landbank of 13,249 plots, and a strategic landbank, while increasing its geographic reach and adding to its existing partnership business.

The concern is that Bovis is doing this at the top of the current market cycle and increasing shareholder risk at the wrong time. However, social housing tends to be less cyclical and does give it some added resilience, which is a good thing.

Bovis will be effectively handing over just under 30 per cent of its business to Galliford Try shareholders. Existing shareholders will also get their expected £60m special dividend in shares (via a bonus issue) rather than in cash.

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

Bovis Homes forecasts

	Year (£m)		
	2019	2020	2021
Turnover	1,089.40	1,125.70	1,155.80
Ebitda	189.1	204.7	214.4
Ebit	188.5	204.3	213.8
Pre-tax profit	181.6	198.1	208.4
Post-tax profit	149.3	162.3	171.1
EPS (p)	109.2	120.2	126.6
Dividend (p)	104	105.8	95
Capex	2.1	2.1	2.5
Free cash flow	159.5	125.3	133.4
Net borrowing	-179.3	-188.4	-236.7
NAV	1,124.50	1,157.00	1,303.00

Source: SharePad

As I've written in recent weeks, I think housebuilding shares can still be decent investments with very good income returns if house prices and sales volumes hold up. The risk is that they might not. That said, Bovis' land-bank is not overly exposed to expensive houses. Ninety six per cent of it has an average selling price below £600,000, with 39 per cent below £300,000. A focus on smaller, more affordable homes looks to be well-timed.

Abcam

Abcam (ABC) is a leading maker and seller of research antibodies to scientists across the world. Its products aim to make life easier for its customers by allowing them to understand the causes of diseases so they can develop new treatments.

The company makes the bulk of its money from selling from a catalogue of its antibodies. It also sells licenses to companies so they can use its antibodies in diagnostic and therapeutic applications. In recent years, the company has invested a lot of money in digital technology and websites to make it easier for them to find the product they need.

From humble beginnings in 1998, the company now sells over 100,000 antibody products across the world. Over half of its revenues come from products it has developed in-house rather than acquired.

Most of its products are sold to academic and biotechnology laboratories for basic research tasks. In addition to this, the company has moved into the diagnostic market supplying hospitals and specialist medical laboratories where antibodies are used on blood and urine samples to track the progress of a disease or condition. Abcam tries to make things easier for its customers by supplying kits with everything that is needed to perform an experiment.

More sophisticated products look into how proteins change within cells and help with more complicated

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

experiments and investigations. It's clever stuff, albeit quite difficult for a non-scientist to understand, but it's not too difficult to understand what the products are trying to do.

There's a lot to like about this business. At its heart, Abcam is a problem-solving business that uses its knowledge and products to make things easier for its customers. These kinds of businesses are often difficult to copy and are often very profitable, as their prices cannot easily be forced down by competition.

When you have a business with attractive economics that is capable of delivering meaningful revenue growth then you have all the ingredients of a very successful investment opportunity. This is essentially what has happened with Abcam, which up until a year ago had seen its share price move higher and higher and the business commanded a very rich valuation.

Revenue growth does not seem to be a problem for this business, but turning that into profit growth seems to have become more difficult as the company invests to grow. Abcam believes that it is operating in an addressable market with $8bn of potential annual revenues and is scaling up its business to capture a bigger slice of it.

Revenues for the year to June 2019 increased by 11.4 per cent to £259.9m, with good rates of growth in the US and China – its two biggest markets accounting for 45 per cent and 15 per cent of revenues – and Germany. There was no growth in the UK and growth in Japan was only 3 per cent. The rest of the business saw no growth.

Gross margins improved by 60 basis points to 70.5 per cent, but higher costs saw operating margins fall from 34.9 per cent to 32.1 per cent, as adjusted operating profits increased slightly from £81.3m to £83.6m.

To be frank, I'm not sure if there was any growth in profit at all. As much as £8m of adjusted items due to investment costs and company headquarters might be one-offs, but they are a cost of doing business nonetheless that unfortunately reduce profits. Research and development (R&D) expenses came down by around £1m and capitalised R&D costs increased by £3.7m and boosted profits.

The company continues to invest heavily in its IT systems and laboratories to enable it to grow. It spent £40m(£37.4m) last year compared with a depreciation and amortisation expense of £15.4m (£12.9m last year), and this explains why Abcam's free cash flow is significantly less than its post tax profits.

Free cash flow of £30.3m – on my calculation – compared with the company's adjusted post-tax profits of £67.4m, which equates to a free cash flow conversion ratio of 45 per cent, compared with 39 per cent last year.

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

This trend looks as if it is going to continue for the next five years, as the company expects to spend on average £45m per year on investment. The free cash conversion ratio should improve as profits do.

Higher capital employed saw ROCE fall from 22.2 per cent to 20.8 per cent, which is still a very healthy number.

Abcam forecasts

	Year (£m)		
	2020	2021	2022
Turnover	289	317.5	353.3
Ebitda	99.9	112.6	129.5
Ebit	81.2	92.7	107.5
Pre-tax profit	84.1	94.7	107.5
Post-tax profit	63	74.3	87.4
EPS (p)	32.5	36.1	40.7
Dividend (p)	12.7	13.8	14.7
Capex	21.6	21	11.3
Free cash flow	57.3	66.5	69.7
Net borrowing	-96.3	-161.2	-203.5

Source: SharePad

It looks as if profits could stagnate or shrink in 2020, as the company continues to invest in its business and incur higher costs. Based on the expectation of 11 per cent revenue growth and profit margins of between 25 per cent and 28 per cent, operating profit could be anything between £73.5m and £82.3m.

The company's medium-term outlook remains bullish. Its aim is to have a business with revenues of up to £500m, with profit margins in the low thirties by 2024 and a ROCE of around 18 per cent. This would imply a near doubling of operating profits.

By my estimation, this is also going to cost a lot of money. About £175m to £225m of capex is planned, but profits of £155m (31 per cent margin) and 18 per cent ROCE suggest capital invested of £860m, compared with just over £400m. The company has plenty of firepower to make acquisitions if it needs to.

I think Abcam is a very attractive business that is supported by good fundamental growth prospects. Its shares have been derated over the past year, as forecasts of future profits have been significantly downgraded. Yet the shares still trade on a one-year rolling forecast PE of 35 times at a share price of 1,164p. Given costs are holding back profits and could still lead to forecast downgrades, I'd be nervous about buying the shares just now, but they are definitely worth a place on most investors' watchlists, in my view.

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

JD Sports

JD Sports' (JD.) phenomenal trading performance seems to know no bounds. This week it delivered another excellent set of results, which were underpinned by its UK business producing another stonking sales performance. Like-for-like (LFL) sales increased by 10 per cent, which is quite remarkable given it has been growing at this rate or better for a few years now.

The only disappointment in these results was the higher losses at Go Outdoors. The decision to buy this business and Blacks has not really worked out and I do wonder if they will be sold off or closed down. For me, the most positive bit of the half-year results was the performance of Finish Line in the US.

When JD bought this business back in March last year, I was not entirely convinced it was a good thing to do. It paid $436m (£360m) for a business that was making annual operating profits of around $41m and really struggling against fierce competition.

In the first six months of 2019 it has made operating profits of £34.7m, driven by LFL sales growth of 5 per cent. The outlook for this business looks very encouraging and it seems profits can grow substantially through self-help initiatives. These include improving sales per square foot in stores, better buying of stock, closing underperforming stores and cutting central overheads. From what I can see, JD looks like it is going to make a very handsome return on its UK investment.

If it can do the same with Footasylum – which is still being reviewed by the Competition and Markets Authority – then JD has two excellent sources of profit growth to complement its existing businesses, which are still firing on all cylinders.

JD Sports forecasts

	2020	Year (£m) 2021	2022
Turnover	5,832.40	6,269.20	6,755.90
Ebitda	916.1	876.7	871.5
Ebit	473.6	571	622.9
Pre-tax profit	413.9	461.6	509.9
Post-tax profit	319.3	357.9	393.9
EPS (p)	32.8	36.5	40.4
Dividend (p)	1.9	2.3	2.4
Capex	201.2	215.7	211.8
Free cash flow	214.6	292.3	343.2
Net borrowing	-280.3	-531.6	-831.5
NAV	1,329.80	1,676.10	1,937.70
Like-for-like sales growth (%)	7	7.5	7.5

Source: SharePad

The shares have been a great investment, but I think there is still more upside in them. They look to be reassuring expensive even on their current rolling forecast PE of 20 times.

Ashtead

I generally don't like cyclical businesses, but **Ashtead (AHT)** is for me one of the best out there. In the past, I have compared it to a savings account with a high rate of interest that the account holder keeps adding to. As an example of the power of compounding profits at high rates of return, I struggle to think of a better example listed on the London Stock Exchange.

The company's first-quarter results released this week were very solid.

Trading results

	Revenue		EBITDA		Profit[1]	
	2019	2018	2019	2018	2019	2018
Sunbelt US in $m	1,380.9	1,167.5	716.0	590.6	446.6	385.8
Sunbelt Canada in C$m	94.8	76.9	37.6	28.3	16.0	14.3
Sunbelt US in £m	1,090.4	877.4	565.3	443.8	352.7	289.9
A-Plant	131.4	125.6	43.6	47.5	15.4	22.2
Sunbelt Canada in £m	56.4	44.4	22.4	16.3	9.5	8.3
Group central costs	-	-	(4.7)	(3.9)	(5.0)	(4.0)
	1,278.2	1,047.4	626.6	503.7	372.6	316.4
Net financing costs					(53.6)	(30.8)
Profit before amortisation and tax					**319.0**	**285.6**
Amortisation					(14.3)	(11.2)
Profit before taxation					304.7	274.4
Taxation charge					(76.5)	(64.5)
Profit attributable to equity holders of the Company					228.2	209.9
Margins as reported						
Sunbelt US			*51.9%*	*50.6%*	*32.3%*	*33.0%*
A-Plant			*33.2%*	*37.8%*	*11.7%*	*17.6%*
Sunbelt Canada			*39.7%*	*36.8%*	*16.8%*	*18.6%*
Group			*49.0%*	*48.1%*	*29.2%*	*30.2%*

Source: Ashtead

The fortunes of this business are inextricably linked to the health of the US construction market. As long as this holds up, I see no reason why Ashtead should not continue to prosper. Its US business is not facing the same fierce competition as its UK business and offers decent organic growth and consolidation opportunities.

Sunbelt in the US continues to grow strongly, while maintaining high profit margins. The return on investment on its rental equipment has been maintained at 24 per cent.

Ashtead forecasts

	Year (£m) 2020	2021	2022
Turnover	5,226.40	5,508.60	5,746.00
Ebitda	2,505.00	2,703.80	2,797.00
Ebit	1,462.80	1,552.10	1,550.60
Pre-tax profit	1,246.10	1,366.20	1,409.30
Post-tax profit	945.2	1,071.70	1,115.40
EPS (p)	204.5	227.7	235.1
Dividend (p)	41.9	47.8	51.8
Capex	1,424.30	1,346.70	1,424.50
Free cash flow	812.3	955.4	1,068.00
Net borrowing	4,092.00	3,476.50	3,460.80

Source: SharePad

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

One day this business will see softer trading conditions, but it will protect itself by selling down the fleet, generating free cash flow and paying down debt.

The valuation of the shares reflects the cyclical risk, but I don't see them as being expensive at just under 11 times on a one-year rolling forecast PE basis, at a share price of 2,348p. The shares are up 46 per cent year to date, so can be expected to pause for breath for a while.

Morrisons

The slowdown in **Morrisons' (MRW)** sales has been well flagged, and this week's first-half results were not really surprising. Pre-tax profit increased by 5.3 per cent to £198m, which contributed to a 4.3 per cent increase in the half-year dividend and a special dividend of 2p per share on top.

Morrisons is having a tough time competing with a resurgent Tesco and the discounters, Aldi and Lidl, who are taking market share. That said, I am bullish on Morrison shares, mainly because I think it will eventually be taken over by Amazon.

Thurday's half-year results saw the announcement of a new long-term multi-year partnership between Morrisons and Amazon, compared with their current rolling agreement. Morrisons will continue to sell food to Amazon, which will help the online retail giant with its Prime Now food business.

This will see Amazon Prime customers be able to do a full Morrisons shop online. It will be handpicked in Morrisons stores and then delivered by Amazon. Same day and even one-hour deliveries will be available in parts of London, Birmingham, Manchester and Leeds. It will then be rolled out to Sheffield, Portsmouth, Glasgow, Newcastle and Liverpool.

If this works well then I think a takeover by Amazon is the next logical step. Amazon is still finding its way in food retail having bought Wholefoods in the US. Over there it is in the process of turning the stores into local distribution hubs. I think the same can be done with Morrisons stores in the UK.

At a market capitalisation of £4.6bn, even with a takeover premium, Morrisons is a mere snack for Amazon. In the meantime, Morrisons' near 5 per cent dividend yield means shareholders are getting paid to wait.

Morrisons forecasts

	Year (£m) 2020	2021	2022
Turnover	18,128.80	18,548.50	18,924.60
Ebitda	1,003.50	1,037.40	1,072.60
Ebit	500	523.1	541.8
Pre-tax profit	423.2	452.2	465.1
Post-tax profit	321.4	344.7	358.6
EPS (p)	13.4	14.4	14.9
Dividend (p)	9.5	10.4	10.7
Capex	534.1	513	514.9
Free cash flow	352.8	378.7	411.4
Net borrowing	1,426.00	1,306.90	1,194.80

Source: SharePad

Investors Chronicle adheres to a self-regulation regime under the FT Editorial Code of Practice: A link to the FT Editorial Code of Practice can be found at www.ft.com/editorialcode. Many of the charts in the magazine are based on material supplied by Thomson Datastream and S&P Capital IQ.

ISSN 0261-3115.